Sowing the Seeds of Financial Imbalances: The Role of Macroeconomic Performance

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Are Seeds of Financial Imbalances Sown in Good Times?

Yellen (2017): “...I think that allowing the economy to run markedly and persistently “hot” would be risky and unnecessary. The combination of persistently low interest rates and strong labor market conditions could lead to undesirable increases in leverage and other financial imbalances, although such risks would likely take time to emerge.”

Financial Disturbances and the Overheated Economy

Buoyant macroeconomic conditions are a common denominator to the financial disturbances in the U.S.

Out-of-Sample Linkages

• Based on the bivariate VARs with financial vulnerability indexes and one-sided gaps.
• Models estimated recursively starting in 1973Q1.
• Evaluation sample from 1980Q1 to 2017Q4.
• Accuracy: ratio of the RMSEs produced by the VAR and the AR processes for the financial vulnerability index. If below one business cycle predicts financial cycle.
• Diebold-Mariano test for equal accuracy.

In-Sample Linkages: GIRFs

• Increase in economic slack leads to future increase in financial imbalances.

Conclusions

• We test the well-known narrative that “seeds of crises are sown in good times”.
• Economic growth is followed by a build-up of a variety of financial imbalances.
• In particular, economic growth robustly predicts nonfinancial leverage.
• Business cycle shocks are significant and sizeable drivers of nonfinancial leverage.
• Running the economy too “hot” can indeed be a harbinger of financial imbalances, consistent with Yellen (2017)'s conjecture. This finding supports the countercyclical nature of the capital buffers.

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Literature Context

Gorton and Ordonez (2017), Lopez-Salido et al. (2017), Bordalo et al. (2018), Lopez-Salido et al. (2017), and Zakrajsek (2012)...

Structural Analysis

• SVAR with narrative sign restrictions (Antolín-Díaz and Rubio-Ramírez, 2018)
• Traditional sign restrictions:

HVD for Nonfinancial Leverage

Monetary Policy Demand Cost-Push

Federal Funds Rate
Log GDP Deflator
Log Commodity Price Index
Log GDP
NFCI Nonfinancial Leverage

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