

Economic Policy

62nd Panel Meeting
Hosted by the Banque Centrale du Luxembourg
Luxembourg, 16-17 October 2015

Policies for Macrofinancial Stability: How to Deal with Credit Booms?

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The organisers would like to thank the Banque Centrale du Luxembourg for their support.
The views expressed in this paper are those of the author(s) and not those of the supporting organization.

Policies for Macrofinancial Stability: How to Deal with Credit Booms?

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September 2015

Abstract: This paper explores several questions about credit booms and busts: What triggers credit booms? When do credit booms end up in busts, and when do they not? What is the role of different policies in curbing credit growth and/or mitigating the associated risks? We find that credit booms are often associated with financial reform and economic growth. They also tend to be more frequent in fixed exchange rate regimes. Booms that are followed by a crisis or below-trend growth tend to be larger and last longer. Macroprudential tools have at times proven effective in containing booms, and more often in limiting the consequences of busts, due to the buffers they helped to build.

JEL codes: E58, G01, G28

Keywords: credit booms; financial stability; macroprudential regulation

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I. INTRODUCTION

“Credit booms” – episodes of rapid credit growth – pose a policy dilemma. More credit means increased access to finance and greater support for investment and economic growth (Levine, 2005). But when expansion is too fast, such booms may lead to vulnerabilities through looser lending standards, excessive leverage, and asset price bubbles. Indeed, credit booms are often associated with financial crises (Reinhart and Rogoff, 2009). Historically, only a minority (albeit a significant one) of booms has ended in crashes, but some of these crashes have been spectacular, contributing to the notion that credit booms are at best dangerous and at worst a recipe for disaster (Gourinchas, Valdes, and Landerretche, 2001; Borio and Lowe, 2002; Enoch and Ötoker-Robe, 2007).

These dangers notwithstanding, until the recent global financial crisis the policy debate paid limited attention to credit booms, especially in advanced economies.² This might have reflected two issues. First, with the diffusion of inflation targeting, monetary policy had increasingly focused on interest rates and had come largely to disregard monetary aggregates.³ And regulatory policy, with its focus on individual institutions, was ill-equipped to deal with aggregate credit dynamics.⁴ Second, as for asset price bubbles, there was the long-standing view that it was better to deal with the bust than to try to prevent the boom: Unhealthy booms were

² In a few emerging markets, however, credit booms were an important part of the policy discussions, and warnings on possible risks were put out prior to the crisis. See, for instance, Backé, Égert, and Zumer (2005), Boissay, Calvo-Gonzales, and Kozluk (2006), Cottarelli, Dell’Ariccia, and Vladkova-Hollar (2003), Duenwald, Gueorguiev, and Schaechter (2005), Hilbers and others (2005), and Terrones (2004).

³ Of course, there were exceptions, such as the “two-pillar” policy of the ECB and the more credit-responsive approach of central banks in India and Poland.

⁴ Again, there were exceptions, like the Bank of Spain’s dynamic provisioning, the loan eligibility requirements of the Hong Kong Monetary Authority, and the multipronged approach of the Croatian National Bank.

difficult to separate from healthy ones, and in any event, policy was well equipped to contain the effects of a bust.

The crisis, preceded by booms in many of the hardest-hit countries, has challenged that view. In its aftermath, calls for more effective tools to monitor and control credit dynamics have come from several quarters (see, for instance, FSA, 2009). And the regulatory framework has already started to respond. For instance, Basel III introduced a capital buffer that is adjusted upward “when there are signs that credit has grown to excessive levels” (Basel Committee on Banking Supervision, 2010).

Yet, while a consensus is emerging that credit booms are too dangerous to be left alone and are crucial for macrofinancial stability,⁵ there is little agreement on what the policy response should be. First, there is the issue of whether and when to intervene. After all, not all booms end up in crises, and the macro costs of curtailing credit can be substantial. Second, should intervention be deemed necessary, there are questions about what form such intervention should take. Is this a natural job for monetary policy, or are there concerns that favor other options?

This paper addresses both of these issues by exploring several questions about past credit booms and busts: What triggers credit booms? When do credit booms end up in busts, and when do they not? Can we tell in advance those that will end up badly? What is the role of different policies in curbing credit growth and/or mitigating the associated risks?

The findings reported here show that credit booms are often associated with financial reform and economic growth. Fixed exchange rate regimes, weak banking supervision, and loose macroeconomic policies are more conducive to booms. The larger and the longer is a boom, the

⁵ “Macrofinancial stability” refers to the strong macro-financial linkages in modern economies and the resulting interdependence between macroeconomic and financial stability.

more likely that it ends up badly. Monetary and fiscal policies do not appear to be effective in limiting booms. Macroprudential tools, by contrast, have at times proven effective in containing booms, and more often in limiting the consequences of busts, due to the buffers they helped to build.

The analysis here contributes to the literature by providing an all-round analysis of credit booms. Several studies have analyzed specific aspects (e.g., association with financial distress, capital flows, etc.) of this phenomenon but, to the best of our knowledge, this is the first comprehensive look at determinants of (bad) credit booms and the role of policies in mitigating booms. On the latter, while recent research on macroprudential policies have explored their effectiveness in the context of systemic risks associated with credit booms, we go beyond and discuss all macro policies (the finding on the relative ineffectiveness of monetary and fiscal policies, to the best of our knowledge, is new in the literature). We do so using a large cross-country dataset covering 170 countries over the period 1970-2010 (176 credit boom episodes). The paper thus serves as a useful reference point for researchers and policymakers interested in the topic.

We proceed as follows. Section II proposes a methodology for measuring credit booms, and presents some stylized facts on the characteristics of credit booms. Section III discusses the triggers of credit booms. Section IV analyzes the characteristics of booms that end up in busts or crises. Section V discusses the policy options and their effectiveness in dealing with credit booms. Section VI concludes.

II. CREDIT BOOMS: DEFINITION AND CHARACTERISTICS

Two caveats before we start. First, in this paper, we limit our attention to bank credit. Obviously, there are other sources of credit in the economy (bond markets, nonbank financial

intermediaries, trade credit, informal finance, and so on). And future booms in these markets may prove as dangerous as those in bank credit. However, data availability makes a cross-country analysis of these alternative sources of funding difficult and with a few exceptions (notably the United States), bank credit accounts for an overwhelming share of total credit.⁶ Hence, we are confident that we are capturing the vast majority of macro-relevant episodes. Second, we confine our attention to countries with credit-to-GDP ratios above 10 percent. Unfortunately, this automatically excludes the vast majority of low-income countries. However, given these countries' different institutional and structural characteristics, an analysis of their credit dynamics is better conducted in a separate paper.⁷

We are interested in episodes that can be characterized as “extraordinary” positive deviations in the relationship between developments in credit and economic activity. Admittedly, what constitutes an extraordinary deviation and how the “normal” level of credit growth should be computed are both open to discussion (Gourinchas, Valdes, and Landerretche, 2001; Mendoza and Terrones, 2008; Barajas, Dell’Ariccia, and Levchenko, 2008; Jordà, Schularick, and Taylor, 2011; Claessens, Kose, and Terrones, 2012; Mitra and others, 2011). Most methodologies in the literature compare a country’s credit-to-GDP ratio to its nonlinear trend (some focus on absolute growth thresholds). But the methodologies differ in several respects, such as whether the trend and the thresholds identifying the booms should be country-specific, whether information unavailable at the time of the boom should be used for its identification, and whether the credit

⁶ Based on the World Bank’s domestic credit to private sector series, banks provide, on average, 94 percent of the credit. The ratio is 45 percent for the United States but exceeds 60 percent for all other countries.

⁷ Dropping the cases in which the credit-to-GDP ratio is less than 10 percent is common practice in the literature. The reason for the practice is twofold. First, the data series tend to be less smooth, making it difficult to distinguish between trend-growth and abnormal growth episodes. Second, financial deepening is more likely to be the main driver of rapid credit expansion episodes in such financially underdeveloped economies.

and GDP series should be filtered separately or directly as a ratio. Fortunately, the set of booms identified using different methods is rather robust (see Appendix 1 for a comparison to other methodologies).

Our aim in this paper is to provide a definition that can be applied using the standard information that is available and therefore can be used as a guide in policymaking. For that reason, we opt for feasibility first and accept the cost of ignoring information that exists today but was not available to policymakers in real time. This contrasts with methodologies that use the entire time series to detect deviations from trend (for example, Mendoza and Terrones, 2008). We also apply a mix of country-specific, path-dependent thresholds and absolute numerical thresholds. This is because thresholds for the credit-to-GDP gap are often hard to determine or interpret (and have been shown to miss many of the episodes associated with financial crises; Mitra and others, 2011). In contrast, absolute thresholds for credit growth are easier to interpret, but abstract from country- and time-specific characteristics. Overall, our methodology allows us to account for differences across countries as well as changes over time within the same country, and it avoids the risk of missing episodes due to an over-fitting trend. (More details on our approach, its pros and cons, and comparison to other methodologies are in Appendix 1.)

Specifically, we identify boom episodes by comparing the credit-to-GDP ratio in each year t and country i to a backward-looking, rolling, country-specific, cubic trend estimated over the period between years $t-10$ and t . We classify an episode as a boom if either of the following two conditions is satisfied: (i) the deviation from trend is greater than 1.5 times its standard deviation and the annual growth rate of the credit-to-GDP ratio exceeds 10 percent; or (ii) the annual growth rate of the credit-to-GDP ratio exceeds 20 percent. We introduce the second condition to capture episodes in which aggregate credit accelerates very gradually, but credit

growth reaches levels that are well above those previously observed in the country. Similar thresholds identify the beginning and end of each episode. Since only information on GDP and bank credit to the private sector available at time t is used, this definition can, in principle, be made operational.

We apply this definition to a sample of 170 countries with data starting as far back as the 1960s and extending to 2010. We identify 176 credit boom episodes for our sample period 1970-2010.⁸ This translates into a 14 percent probability of a country experiencing a credit boom in a given year.⁹ Based on this sample, the stylized facts that characterize credit booms are as follows:

- The median boom lasts three years, with the credit-to-GDP ratio growing at about 13 percent per year, or about five times its median growth in non-boom years (Figure 1).
- Credit booms are not a recent phenomenon. But the fraction of countries experiencing a credit boom in any given year has seen an upward trend since the financial liberalization and deregulation of the 1980s. It reached an all-time high (30 percent in 2006; see Figure 2) in the run-up to the global financial crisis when a combination of factors – such as the financial reform associated with EU accession in Europe and the expansion of securitization in the United States – provided further support for credit growth. Since the global financial crisis erupted, the frequency of credit booms came down as global banks deleveraged.

⁸ The number of countries reported, 170, is before the 10-percent threshold applied so that we do not exclude the cases where the credit-to-GDP ratio started from a very low level and rapidly exceeded the threshold later in the sample period. See Appendix 1 for a full list of countries in the sample and the booms identified.

⁹ This probability is calculated by dividing the number of country-year observations that correspond to a credit boom episode by the number of (non-missing) observations in the dataset.

- Most booms happen in middle-income countries (both in absolute and relative terms). This is consistent with the view that, at least in part, credit booms are associated with catching-up effects. Yet high-income countries are not immune to booms, suggesting that other factors are also at play.
- More booms happen in relatively undeveloped financial systems. The median credit-to-GDP ratio at the start of a boom is 19 percent, compared to a median credit-to-GDP ratio of about 30 percent for the entire dataset. This supports the notion that booms can play a role in financial deepening.
- Geographically, booms are more likely to be observed in Sub-Saharan Africa and Latin America. This partially reflects these regions' country composition and historically volatile macroeconomic dynamics. Eastern Europe stands out in the later period, reflecting the expansion of the EU and the associated integration and catching up that fueled booms in many of the new or prospective member states. Of course, this summarizes past experience, and inferences on the probability of future booms should be drawn with caution.

A. Macroeconomic Performance around Credit Booms

Real economic activity and aggregate credit fluctuations are closely linked through wealth effects and the financial accelerator mechanism (see, among others, Bernanke and Gertler, 1989; Kiyotaki and Moore, 1997; Gilchrist and Zakrajsek, 2008). In an upturn, better growth prospects improve borrower creditworthiness and collateral values. Lenders respond with an increased supply of credit and, sometimes, looser lending standards. More abundant credit allows for greater investment and consumption and further increases collateral values. In a downturn, the process is reversed.

Not surprisingly, economic activity is significantly higher during booms compared to non-boom years (Table 1). Real GDP growth during booms exceeds the rate observed in non-boom years by roughly 1.4 percentage points, on average.¹⁰ Private consumption expands faster during booms. But it is private investment that picks up markedly, with the average growth rate almost doubling compared to non-boom years. This is in line with the important role played by banks in financing real-estate and corporate investment in many countries, but it also reflects, at least in part, the role played by capital inflows in the form of foreign direct investment.¹¹

The increase in consumption and investment associated with credit booms is often more pronounced in the nontradables sector. Consistently, booms are typically associated with real exchange rate appreciations (Terrones, 2004). Interestingly, inflation remains subdued (more on this later). Taken together, these findings suggest that domestic imbalances that may be building up through the external sector. Indeed, during a boom the current account deteriorates, on average, by slightly more than 1 percentage point of GDP per year. Most of the associated increase in net foreign liabilities comes from the “other flows” category, which includes banks’ funding by foreign sources.

Since asset price cycles tend to co-move with business and credit cycles (Claessens, Kose, and Terrones, 2012; and Igan and others, 2011), the comparison between non-boom years and booms carries over to these indicators. Both stock and real estate prices surge during credit

¹⁰ Note that non-boom years include (asset price and/or credit) busts and recessions. The comparative statistics, however, remain broadly the same when the bust and recession years are excluded.

¹¹ See Mendoza and Terrones (2008), Igan and Pinheiro (2011), and Mitra and others (2011) for more on the behavior of macroeconomic variables and some micro-level analysis around credit booms. At the macro level, there is evidence of a systematic relationship between credit booms and economic expansion, rising asset prices, leverage, foreign liabilities of the private sector, real exchange rate appreciation, widening external deficits, and managed exchange rates. At the micro level, there is a strong association between credit booms and firm-level measures of leverage, market value, and external financing, and bank-level indicators of banking fragility.

booms and lose traction at the end of a boom. The difference from non-boom years is more striking than in the case of GDP components: equity prices rise at almost quadruple the rate in real terms. House prices, on average, grow at an annual rate of around 2 percent in non-boom years but accelerate sharply during booms to a growth rate of 10 percent. This synchronization with asset price booms may create balance sheet vulnerabilities for the financial and nonfinancial sectors, with repercussions for the broader economy.

B. Long-Run Consequences of Credit Booms

Credit booms can also be linked to macroeconomic performance over the long run. After all, financial development—typically measured by the credit-to-GDP ratio, the same variable used to detect credit booms—has a positive effect on growth (King and Levine, 1993; Rajan and Zingales, 1998; Levine, Loayza, and Beck, 1999; Favara, 2003).¹² Moreover, the economic magnitude of this effect is substantial: increasing financial depth (measured by M2-to-GDP ratio) from 20 percent to 60 percent would increase output growth by 1 percent a year (Terrones, 2004).

Obviously, whether episodes that sharply increase the credit-to-GDP ratio have long-term beneficial effects depends on two factors. The first is the extent to which credit booms contribute to permanent financial deepening. The second is the extent to which financial deepening resulting from a sharp increase in credit is equivalent to a deepening achieved through gradual growth.

As for the first question, booms are sometimes followed by financial crises (see next section) that are typically associated with sharp drops in the credit-to-GDP ratio. However, in

¹² This causal interpretation is supported by its differential impact across sectors: financial development affects economic growth more for sectors with external financing needs for investment (Rajan and Zingales, 1998).

about 40 percent of the episodes, the credit-to-GDP ratio seems to shift permanently to a new, higher “equilibrium” level. In fact, there is a positive correlation between long-term financial deepening (measured as the change in the credit-to-GDP ratio over the period 1970-2010) and the cumulated credit growth that occurred during boom episodes (Figure 3).

The second question can be answered only indirectly, by looking at the relationship between credit booms and long-term growth. This task is complicated, because growth benefits gained from increased financial deepening due to a boom are likely to take time to be fully realized, making it hard to measure them at a given point in time. That said, some evidence does point to such benefits. There is a positive correlation between the number of years a country has undergone a credit boom and the cumulative real GDP per capita growth achieved since 1970 (Table 2). However, this relationship seems to flatten when credit booms become too frequent, and since countries with more credit booms also experienced more crises (on average), there seems to be a trade-off between macroeconomic performance and stability (Rancière, Tornell, and Westermann, 2008).

C. Credit Booms and Financial Crises

Balancing the benefits described earlier is the notion that credit booms are dangerous because they lead to financial crises. This is not just an underserved bad reputation due to a small fraction of episodes that were particularly bad. Credit growth can be a powerful predictor of financial crises (Borio and Lowe, 2002; Mendoza and Terrones, 2008; Schularick and Taylor, 2009; Mitra and others, 2011; Gourinchas and Obstfeld, 2012). In our sample, about one in three

booms is followed by a banking crisis (as defined in Laeven and Valencia, 2010; and Caprio and others, 2005) within three years of its end (Table 3).¹³

The recent global financial crisis has reinforced this notion. After all, the crisis had its roots in a rapid increase of mortgage loans in the United States. And it was exactly the US regions that had experienced greater booms during the expansion that suffered greater increases in credit delinquency during the crisis (Figure 4; also see Dell’Ariccia, Igan, and Laeven, 2012). In addition, across countries, many of the hardest-hit economies, such as Iceland, Ireland, Latvia, Spain, and Ukraine, had their own home-grown credit booms (Claessens and others, 2010).

Credit booms had also preceded many of the largest banking crises of the past 30 years: Chile (1982), Denmark, Finland, Norway, and Sweden (1990/91), Mexico (1994), and Korea, Malaysia, Philippines, and Thailand (1997/98) (Figure 5). And going further back, the Great Depression has also been cast as a credit boom gone wrong (Eichengreen and Mitchener, 2003).¹⁴

The fact that several credit booms that did not end in full-blown crises were followed by extended periods of subpar economic performance adds further concern. In our sample, three out of five booms were characterized by below-trend growth during the six-year period following their end. During these below-trend periods, annual economic growth was on average 2.2 percentage points lower than in “normal” times (excluding crises). Notably, the two types of

¹³ This is not very sensitive to the choice of methodology and thresholds used in identifying boom episodes. There is a slight tendency for methodologies based on a trend calculated over the whole sample to overestimate the probability of a credit boom ending badly, since the trend is then affected by the years that follow the boom. See Appendix 1 for a comparison of the good and bad booms identified here and those identified elsewhere in the literature. Actually, the baseline used here is the smallest when the percentage of booms followed by a banking crisis is compared across different methodologies used to identify booms.

¹⁴ Credit booms are generally associated with banking crises rather than other types of crises. For comparison, 15 percent of the booms in our sample were followed by a currency crisis and 8 percent by a sovereign debt crisis. Although some of these same countries also had systemic banking crises, the positive association remains when these cases are excluded. And although some of these credit booms coincided with housing booms, the association is robust to excluding those cases (Crowe and others, 2011; Leigh and others, 2012).

events—financial crisis and suppressed economic activity—often coincide but do not perfectly overlap. Overall, in the aftermath of credit booms something “goes wrong” about two times out of three (121 out of 176 cases). In line with this, in the recent global financial crisis, countries that had previously experienced bigger changes in their credit-to-GDP ratio were also the ones that had deeper recessions (Figure 6).¹⁵ This is consistent with the view that credit booms leave large sectors of the economy overleveraged, leading to impaired financial intermediation in their aftermath, even when a full-blown crisis is avoided.

Indeed, credit booms are a good predictor of “creditless recoveries,” that is, economic recoveries that happen in the absence of credit growth (typically in the aftermath of a crisis). Such recoveries are inferior, with average growth about a third lower than during normal recoveries (Abiad, Dell’Ariccia, and Li, 2011). Industries that are dependent on external finance and financing-sensitive activities (for example, investment) appear to suffer more during creditless recoveries, potentially indicating that resources may be allocated inefficiently across industries and activities.

III. WHAT TRIGGERS CREDIT BOOMS?

So far, we have summarized how credit booms are linked to short- and long-term economic performance and how often they coincide with financial crises. But macroeconomic and financial factors, including policies, may themselves contribute to the occurrence of credit booms. Hence, we next look at the other side of the coin, based on the literature and the empirical regularities in our dataset: the triggers of credit booms. Identifying these triggers could help gauge a country’s susceptibility to credit booms and devise policies to reduce it.

¹⁵ The extraordinary experience of the Baltic countries and Ireland may seem to be driving this finding. But this correlation, albeit weaker, holds for the rest of the episodes as well.

Three often concurrently observed factors are frequently associated with the onset of credit booms (see, for instance, Mendoza and Terrones, 2008; Decressin and Terrones, 2011; and Magud, Reinhart, and Vesperoni, 2012):

- The first factor is financial reforms. These usually aim to foster financial deepening and are linked to sharp increases in credit aggregates. Roughly a third of booms follow or coincide with financial liberalizations. In contrast, only 2 percent follow or coincide with a reversal of such policies. Given that our sample contains more liberalization episodes than reversals, these percentages are less divergent when expressed in relative terms, but still point in the same direction: 18 percent of liberalizations are linked to credit booms, compared with 7 percent of reversals.

- The second factor is surges in capital inflows, often in the aftermath of capital account liberalizations. These generally lead to a significant increase in the funds available to banks, potentially relaxing credit constraints. In our sample, net capital inflows intensify during the three-year period prior to the start of a credit boom, increasing from 2.3 percent of GDP to 3.1 percent of GDP, on average.

- Third, credit booms generally start during or after buoyant economic growth.¹⁶ More formally, lagged GDP growth is positively associated with the probability of a credit boom: in the three-year period preceding a boom, the average real GDP growth rate reaches 5.1 percent, compared to 3.4 percent in an average tranquil three-year period.

¹⁶ From a longer-term perspective, technological groundbreakers and their diffusion are also likely to act as triggers. For instance, the ratio of bank loans to GDP on a “global” scale increased relatively fast during the last third of the 19th century and then again starting in the early 1980s with the introduction of new financial products, thanks to the information technology revolution (Schularick and Taylor, 2009).

These triggers may occur across countries simultaneously. Financial liberalization happens in waves, affecting multiple countries more or less at the same time. In emerging markets, surges in capital flows often relate to changes in global liquidity conditions (as proxied by the U.S. federal funds rate¹⁷; see Figure 2) and, thus, are correlated across countries. Trade and the transmission of technological advances across borders tend to synchronize economic activity.

Of course, domestic factors may also matter. The differential incidence of booms across countries suggests that local structural and institutional characteristics and policies are important. In particular, credit booms seem to occur more often in countries with fixed exchange rate regimes, expansionary macroeconomic policies, and low quality of banking supervision (Table 4). In economies with fixed exchange rate regimes, monetary policy is directed toward maintaining a fixed exchange rate and is therefore unable to respond effectively to the buildup of a credit boom. In such regimes, a lower global interest rate may translate into a lower domestic interest rate, spurring domestic credit growth. By stimulating aggregate demand, expansionary macroeconomic policies risk building up asset price booms. Prolonged loose monetary policy, in particular, reduces the cost of borrowing and boosts asset price valuations, which in turn can trigger credit booms. Finally, the quality of banking supervision has a bearing on the enforcement of bank regulation and the effectiveness with which supervisory discretion is applied to deal with early signs of credit booms. For example, supervisors can use their discretion to take measures (such as higher capital requirements) to lower the pace of credit growth.

¹⁷ See Borio, McCauley, and McGuire (2011) on the role of global conditions in the context of credit booms.

The discussion and the empirical regularities presented so far are in a univariate framework, which has several shortcomings. In particular, not controlling for all relevant variables may generate spurious correlations. In Table 5, we examine in a multivariate regression framework the association between the various macroeconomic and structural indicators and the likelihood of credit boom episodes. Specifically, we estimate the following regression equation:

$$(Boom = 1)_{it} = \alpha + \beta X_{it}' + \varepsilon_{it}$$

where X is a vector of macroeconomic indicators and structural variables. We focus on the boom episodes we have identified and compute the values of these variables as the average of their values one year before the start of the boom and during the first year of the boom. If the number of boom episodes in a country is more than one, we treat all boom episodes as a single observation and take the average across those episodes. For the non-boom observations, explanatory variables are calculated as the average for the sample period of no booms. Hence, we have dataset comprised of observations that characterize the circumstances in a country in “normal times” and at the verge of a boom episode.

We find that GDP growth and financial reform are associated with an increased likelihood of credit booms, while flexible exchange rate regimes are less likely to be associated with credit booms.¹⁸

That said, it is difficult to predict credit booms. Regression analysis suggests that the triggers and macroeconomic conditions described above may have some bearing on assessing the

¹⁸ Langfield and Pagano (2015) show that bank-based financial systems suffer deeper banking crises. To address this, we also include a dummy indicator for bank-based financial market in the regression. That is, we first construct the ratio of bank private credit to the sum of bank private credit and stock market capitalization for each country-year. Based on this ratio, we further create a dummy which is one if the ratio is greater than the global median. We do not find significant results for bank-based systems being associated with a greater likelihood of credit booms.

susceptibility of a country to a credit boom. But they are far from giving definitive signals: the residual variability is substantial and identifying causality is problematic (see Section V).

IV. CAN WE TELL BAD FROM GOOD CREDIT BOOMS?

The analysis in the previous sections implies that policymaking may face a trade-off between standing in the way of financial deepening (and thus in the way of present and perhaps future macroeconomic performance) and allowing dangerous imbalances to jeopardize financial stability. The question then arises, whether we can improve on this trade-off by distinguishing, ahead of time, bad booms from good ones.

Here we address this question by exploring whether a boom's characteristics, such as duration, size, and macroeconomic conditions, can help predict whether it will turn into a crisis and/or a prolonged period of subpar economic performance. Formally, we classify a boom as "bad" if it is (i) followed by a banking crisis within three years of its end date, or (ii) associated with a recession or an inferior (below-trend) medium-term growth performance.¹⁹

First, we compare the summary statistics on the characteristics of bad booms to those for good booms. Second, we conduct a regression analysis. As in other similar exercises, there are limitations associated with cross-country regressions (see, for example, Levine and Renelt, 1992). In particular, there is a trade-off between sample size and the homogeneity of the

¹⁹ Subpar macroeconomic performance is defined in reference to the trend of log real GDP. Specifically, growth is deemed to be subpar if the current level of log real GDP is below its trend calculated using a moving-average filter over the past five years. Note that this may be overstating how bad macroeconomic performance is, since the trend calculations include the strong growth years during the boom, yet the findings are robust to using alternative definitions, e.g., comparisons of real GDP growth rate to its medium-term trend. Note that, in many cases, the criteria (i) and (ii) overlap: in 16 out of 57, or 28 percent, of the cases in which there is a crisis, growth stalls (see Table 3).

countries covered. We mitigate this problem by controlling for regional fixed effects and various country characteristics.

Given that a boom is in place, the probability of its turning bad is modeled as:

$$(\text{Bad boom} = 1)_{it} = \alpha + \beta X_{it}' + \gamma P_{it}' + \varepsilon_{it}$$

where X is a vector of macroeconomic indicators and structural variables and P is a vector of measures of the policy stance *during* the boom. In summary, we find that:

- “Bad” credit booms tend to be larger and last longer (Figure 7), and
- Booms that start at a higher level of financial depth (measured as the level of credit-to-GDP ratio) are more likely to end badly.

These findings are more or less in line with those reported elsewhere. For instance, the magnitude of a boom (manifested as a larger rise in the credit-to-GDP ratio from start to end or duration) has been identified as a predictor of whether the boom ends up in a banking crisis (Gourinchas, Valdes, and Landerretche, 2001; Barajas, Dell’Ariccia, and Levchenko, 2008). Other macro variables, like larger current account deficits, higher inflation, lower-quality bank supervision, and faster growing asset prices, are sometimes associated with bad booms. But their coefficients are rarely significant and they are unstable across subsamples and model specifications.²⁰ In addition, while there is a general tendency to think that credit booms in emerging markets are more likely than booms elsewhere to end up in a crisis, we do not observe such regularity in our sample.²¹

²⁰ This is based on a regression analysis using the specifications in Table 5 (see Section V) with bad boom dummy as the dependent variable. The results are not included for the sake of brevity but are available from the authors upon request.

²¹ In absolute terms, many of the booms ending in a banking crisis occurred in emerging markets (27 out of 57). Yet in relative terms, 38 percent of the booms happening in emerging markets are followed by a crisis within three years after the boom ends, while the ratio is 57 percent for advanced economies.

In general, the lack of statistically significant differences in key macroeconomic variables in bad versus good booms has been noted elsewhere (see, for instance, Gourinchas, Valdes, and Landerretche, 2001). Notably, indicators that have been identified as predictors of financial crises, such as sharp asset price increases, a sustained worsening of the trade balance, and a marked increase in bank leverage (Mitra and others, 2011) lose significance once we condition for the presence of a credit boom (as measured in this note). Indeed, in our sample, while asset prices grow much faster during booms than in tranquil times (for example, for equity prices about 11 percent versus 4 percent a year), they grow at about the same pace during both bad and good booms (again, for equity prices, about 11 percent a year for both).

While statistical evidence to pin down ahead of time whether a boom is a good or bad one is underwhelming, the results suggest that policy intervention to curb credit growth become increasingly justified as booms become larger and more persistent. In particular, we find that close to half or more of the booms that either lasted longer than six years (4 out of 9), exceeded 25 percent of average annual growth (8 out of 18), or started at an initial credit-to-GDP ratio higher than 60 percent (15 out of 26) ended up in crises. These regularities (see also Mitra and others, 2011; and Borio, McCauley, and McGuire, 2011) can guide policymakers in weighing the benefits and costs of an ongoing boom and in setting thresholds that would trigger policy action.

V. POLICY OPTIONS

The evidence presented so far shows that credit booms can stimulate economic activity and even promote long-term growth, but also that they are associated with disruptive financial crises. Indeed, about one boom in three ends with a bust. More often, booms end without a full-blown crisis, but their associated leverage build-ups have a long-lasting impact on corporate and household behavior, leading to below-trend economic growth.

Theory has identified several channels through which financial frictions can lead to excessive risk taking during episodes of rapid credit growth. Contributing to looser lending standards and greater credit cyclicality may be managerial reputational concerns (Rajan, 1994), improved borrowers' income prospects (Ruckes, 2004), loss of institutional memory of previous crises (Berger and Udell, 2004), expectations of government bailouts (Rancière, Tornell, and Westermann, 2008), and a decline in adverse selection costs due to improved information symmetry across banks (Dell'Ariccia and Marquez, 2006). In addition, externalities driven by strategic complementarities (such as cycles in collateral values) may lead banks to take excessive or correlated risks during the upswing of a financial cycle (De Nicolò, Favara, and Ratnovski, 2012). Such financial frictions can explain why, as the old banking maxim goes, "the worst loans are made at the best of times" and justify intervention to prevent excessive risk taking during the boom.

Some of these frictions and their associated risks were well known before the global financial crisis, yet policies paid limited attention to the problem (with notable exceptions in emerging markets). This limited attention reflected several factors.

First, with the adoption of inflation targeting regimes, monetary policy in most advanced economies and several emerging markets had increasingly focused on the policy rate and paid little attention to monetary aggregates. There were a few exceptions. Australia and Sweden adjusted their monetary policy in response to asset price and credit developments and communicated the reason explicitly in central bank statements. Other policies, such as the

European Central Bank's (ECB's) "two-pillar" policy, were regarded by several observers as vestiges from the past and played a debatable role in actual policy setting.²²

Second, bank regulation focused on individual institutions. It largely ignored the macroeconomic cycle and was ill-equipped to respond to aggregate credit dynamics. As for asset price bubbles, by and large a notion of benign neglect prevailed, namely that it was better to deal with the bust than try to prevent the boom. Again, there were exceptions. Spain introduced "dynamic provisioning." Bolivia, Colombia, Peru, and Uruguay adopted similar measures (Terrier and others, 2011). Other emerging markets experimented with applying prudential rules to counteract credit and asset-price cycles (Appendix 2).

Third, financial liberalization and increased cross-border banking activities limited the effectiveness of policy action. In countries with *de jure* or *de facto* fixed-exchange-rate regimes, capital flows hindered the impact of monetary policy on credit aggregates. And prudential measures were subject to regulatory arbitrage, especially in countries with developed financial markets and a widespread presence of foreign banks.

In what follows, we discuss the major policy options (monetary, fiscal, and macroprudential tools) to deal with credit booms, with particular attention to their pros and cons, summarized in Appendix 2, in the light of the experiences of various countries and econometric analysis. We examine what policies, if any, have been successful in stopping or curbing episodes of fast credit growth. But we also investigate whether certain policies have been effective in reducing the dangers associated with booms, even if they did not succeed in stopping them. In

²² The ECB has rejected the notion that it followed a strict money-growth targeting from the start (ECB, 1999). In December 2002, the policy strategy was revised to reduce the prominence of "the monetary analysis" by placing it as the second rather than the first pillar and using it mainly as a "cross-check" for the results from the first pillar ("the economic analysis"). Even then, the two-pillar strategy was criticized by many (Svensson, 2003; Woodford, 2008). And, in the eye of several observers, the role played by monetary aggregates in the ECB's policy has been debatable (Berger, de Haan, and Sturm, 2006).

that regard, we look at the coefficients of the policy variables obtained in the econometric analysis specification described in the previous section.

One concern is that policies may respond endogenously to the incidence of credit booms. This is particularly relevant for macroprudential regulations that are intended to manage the dangers associated with credit booms. In our empirical analysis of the incidence of credit booms, we therefore use either lagged or initial values of all explanatory variables. More specifically, for the boom observations, we compute all explanatory variables (including the policy variables) as the average of their values one year before the start of the boom and during the first year of the boom (if the number of boom episodes in a country is more than one, we treat all boom episodes as a single observation and take the average across those episodes). For the non-boom observations, explanatory variables are calculated as the average for the sample period of no booms. In the analysis on the determinants of “bad” booms, i.e., booms that end up in crises, we also lag the explanatory variables. Specifically, macroprudential policy is set equal to the value of the macroprudential variable in the year before the start of the boom, while all other policy variables (fiscal and monetary policy) are computed as averages over the boom years. This mitigates concerns about policy endogeneity.

A. Monetary Policy

When it comes to containing credit growth, monetary policy seems the natural place to start. After all, M2, a common measure of the money supply, is highly correlated with aggregate credit. In principle, a tighter monetary policy stance increases the cost of borrowing throughout the economy, and lowers credit demand. Higher interest rates also reduce the ability to borrow through their impact on asset prices, and thus on collateral values, via the credit channel (Bernanke and Gertler, 1995). Finally, higher interest rates tend to reduce the growth of market-

based financial intermediaries' balance sheets (Adrian and Shin, 2009) as well as leverage and bank risk taking (Borio and Zhu, 2008; De Nicolò and others, 2010).

However, several factors may limit the effectiveness of monetary policy in preventing or stopping credit booms, or in ensuring good booms do not turn into bad ones. First, there may be a conflict of objectives. True, credit booms can be associated with general macro overheating. In that case, higher policy rates are the obvious answer. But they can also occur under seemingly tranquil macroeconomic conditions, as was the case in several countries in the run-up to the financial crisis (Figure 8). Under those conditions, the monetary stance necessary to contain the boom may differ substantially from that consistent with the inflation target (such conflicts are likely to be even stronger when the boom is concentrated in a single or a few sectors, for example, real estate loans). In addition, since tightening will buy lower (unobservable) risk at the cost of a higher (observable) unemployment rate, it will likely run into strong social and political opposition, making the decision to raise policy rates harder.

A second tension may arise if crucial elements of the private sector (banks, corporates, and households) have weakened balance sheets. An increase in interest rates to tame credit growth with the objective of safeguarding future financial stability would have the side effect of increasing the present debt burden and lowering asset prices. If the debt-service obligations are already at or near capacity, this would threaten balance sheet stability (similar to the threat discussed in the debate on whether central banks should be in charge of bank supervision).

Third, complications can arise when capital accounts are open and “the impossible trinity” comes into play. Countries with a fixed exchange rate regime simply do not have the option to use monetary policy. Those that float might be concerned about large exchange rate swings potentially associated with carry trade when monetary policy is tightened. In addition,

unless intervention can be fully sterilized, capital inflows attracted as a result of higher interest rates can undo the effects of a tighter stance. Moreover, credit funded by capital inflows brings additional dangers, including an increased vulnerability to a sudden stop.

Fourth, monetary tightening may fail to stop a boom and instead contribute to the risks associated with credit expansion. For instance, higher cost for loans denominated in domestic currency may encourage borrowers and lenders to substitute them with foreign-currency loans. Alternatively, to make loans more affordable, shorter-term rates, teaser contracts, and interest-only loans may come to dominate new loan originations. This is especially relevant when there are explicit or implicit government guarantees that protect the banking system, or when there are widespread expectations of public bailouts should the currency depreciate sharply (Rancière, Tornell, and Westermann, 2008).

In line with these concerns, we find little evidence in support of the view that tighter monetary conditions (measured as deviations from a simple Taylor-rule-like equation) lower the frequency of credit booms (Table 6). The regression coefficient has the expected negative sign, but is never significant. Furthermore, tighter monetary policy does not seem to reduce the probability that a boom already in place would end up badly either (Table 7).²³ Partly in contrast, a growing literature suggests that easy monetary policy conditions are conducive to lower lending standards, which in turn could lead to credit booms (see Maddaloni and Peydró, 2011; Dell’Ariccia and others, 2014; Jiménez and others, 2014; Ioannidou and others, 2015).

These regressions may underestimate the effectiveness of monetary policy due to an endogeneity problem (although, lagging the explanatory variables assuages this concern): Should

²³ The lack of statistical evidence in support of monetary policy is in line with the findings in Merrouche and Nier (2010) for a sample of advanced countries ahead of the global financial crisis. By contrast, they find the strength of prudential policies was important in containing these booms.

central banks tighten the policy rate in reaction to credit booms, on average higher rates would coincide with faster credit growth. Put differently, positive deviations from conditions consistent with a Taylor rule would stem from the credit booms themselves. This would tend to reduce the size and significance of the regression coefficients, that is, it would bias the results against monetary policy effectiveness.

That said, our results are consistent with country-case studies, which, in general, lend very limited support to the notion that monetary policy can effectively deal with a credit boom. During the last decade, many central and eastern European countries tightened monetary policy to contain inflation pressures, but these had little tangible effect on credit growth. In some cases, this reflected high euroization and ineffective monetary transmission channels. In others, increased capital inflows reversed the intended effects. Where the tightening seemed to have some short-lived impact on containing the boom (for example, Hungary and Poland), shifts to foreign-currency-denominated lending were observed (Brzoza-Brzezina, Chmielewski, and Niedźwiedzińska, 2010).²⁴

Countries that allowed their exchange rates to appreciate more freely (for example, Poland, Czech Republic, and Slovakia) did experience smaller credit booms. And in many advanced countries, the mortgage credit and house price booms recorded prior to the global financial crisis can be linked to lax monetary conditions (for example, Crowe and others, 2011, and references therein).²⁵ However, there is an emerging consensus that the degree of tightening

²⁴ This is also consistent with the evidence presented in Ongena and others (2015), who find using loan-level Hungarian data that loose domestic monetary policy leads to more credit initiation in the domestic currency but not in the foreign currency. Put differently, the bank lending channel of domestic monetary policy loses its potency when it comes to the supply of credit in the foreign currency.

²⁵ Long time series data on mortgage (or household) credit and house prices for a large number of the countries in our sample are not available. Hence, we do not include them in the regression analysis here. For a smaller set of

(continued)

that would have been necessary to have a meaningful impact on credit growth would have been substantial and would have entailed significant costs for GDP growth.

Summarizing, monetary policy is in principle the natural tool for intervention to contain a credit boom. In practice, however, there are constraints that limit its effect. From the evidence above, we expect monetary policy to be more effective in larger and more closed economies, where capital inflows and currency substitution are less of a concern. The benefits of monetary tightening will be more evident and its costs lower when credit booms occur in the context of general macro overheating. In contrast, the increase in interest rates necessary to stem booms associated with sectoral bubbles (such as those in real estate) may entail substantial costs—especially since, during these episodes, expected returns vastly overwhelm the effect of marginal changes in the policy rate.

B. Fiscal Policy

Both cyclical and structural elements of the fiscal policy framework may play a role in curbing credit market developments. Most importantly, a prudent and countercyclical fiscal stance may help reduce overheating pressures associated with a credit boom. On the structural side, removing provisions in the tax code that create incentives for borrowing may reduce long-term leverage.

More critically, fiscal consolidation during the boom years can help create room for intervention to support the financial sector or stimulate the economy if and when the bust arrives. Based on the average gross fiscal cost of banking crises, estimates suggest that a buffer of 5

countries, several studies have shown that the type of credit matters for booms, crises, and economic growth (see, for instance, Büyükkarabacak and Valev, 2010; Beck and others, 2012; Bertay and others, 2015).

percent of GDP over the life of the boom would be actuarially fair (the number would drop to about 3 percent of GDP if based on net costs).²⁶

From a practical point of view, however, traditional fiscal tools are unlikely to be effective in taming booms. As in the case of macroeconomic cycle management, their significant time lags prevent a timely response. Political economy factors may also play an important role, with election cycles introducing additional oscillations. And in the long run, the removal of incentives for borrowing in the tax code is unlikely to have a cyclical effect on credit growth.

Our empirical results support these considerations. A tighter fiscal (computed as the error term by which the general government surplus in percent of GDP deviates from its predicted level based on a simple regression of the surplus on real GDP growth) is associated with higher (rather than lower) incidence of credit booms (Table 6). This perhaps reflects unexpectedly high tax revenues associated with buoyant economic growth during the boom years or reversed causality: the possibility that fiscal policy is tightened in response to the credit boom. Further, a tighter fiscal stance is not statistically significantly associated with a lower probability of a boom ending badly (Table 7).

New fiscal tools have been proposed in the aftermath of the global financial crisis. These could take the form of levies imposed on financial activities—measured by the sum of profits and remuneration (Claessens, Keen, and Pazarbasioglu, 2010)—or a countercyclical tax on debt aiming to reduce leverage and mitigate the credit cycle (Jeanne and Korinek, 2010). These would go directly to the heart of the problem: the externalities associated with leverage and risk taking.

²⁶ The average gross fiscal cost of systemic banking crises is estimated to be about 15 percent of GDP (Laeven and Valencia, 2010). Multiplying this with the probability of a banking crisis following a credit boom (33 percent) gives 5 percent. This buffer comes on top of the margins one would normally associate with prudent fiscal policy over the cycle and may not be enough to leave room for fiscal stimulus in the case of a recession.

Such “financial activities taxes” or “taxes linked to credit growth” could put downward pressure on the expansion of individual financial institutions, preventing them from becoming “too systemically important to fail.” The associated revenues could be used to build a *public* buffer rather than private buffers for individual institutions (as capital requirements do). Moreover, unlike prudential regulation that applies only to banks, the proposed tools could contain credit expansion by nonbank financial institutions as well.

However, there are practical difficulties with the newly proposed fiscal tools as well. Incentives to evade the new levies may lead to an increase in the resources devoted to “tax planning.” These incentives may actually strengthen when systemic risk is elevated because, as the possibility of having to use the buffers increases, financial institutions may attempt to avoid “transfers” to others through the public buffer. A further complication may arise if there are provisions to protect access to finance by certain borrowers or access to certain types of loans: circumvention through piggy-back loans or by splitting liabilities among related entities may generate a worse situation for resolution if the bust comes. In addition, in order for these new measures to be effective, they would have to take into account how banks will react to their imposition. This would likely mean a diversified treatment for different categories of banks (which opens up the risk of regulatory arbitrage) and progressive rates based on information similar to what is used for risk-weighted capital requirements (see Keen and de Mooij, 2012).

In summary, while fiscal policy is important to tame macro overheating and create room to provide stimulus and financial support if and when the bust comes, its effectiveness in *directly* dealing with credit booms may be limited. The newer proposals advocating “financial taxation” make sense on paper, but remain to be tested.

C. Macroprudential Regulation

So far, the empirical analysis and the case studies suggest that the effectiveness of macroeconomic policies in curbing credit booms is questionable. A more targeted approach can, in principle, be more effective and reduce the costs associated with policy intervention (although this obviously is not true if one espouses the view that monetary aggregates, and therefore credit, are the major determinant of inflation pressures). Macroprudential policies offer such a targeted approach. Moreover, the externalities that exist between financial institutions and that contribute to the accumulation of vulnerabilities during the boom or amplify the negative shocks during the bust provide a rationale for macroprudential regulation.

Macroprudential policies are policies aimed at limiting systemwide financial risks. In a strict sense, they include prudential tools and regulation to address externalities in the financial system (BIS, 2011; and IMF, 2011a). In a broader sense, however, the objective of macroprudential policies is to smooth financial and credit cycles in order to prevent systemic crises and provide cushion against their adverse effects. For our purposes, the broader interpretation is relevant. From this perspective, the most commonly used macroprudential tools can be grouped into the following three categories²⁷:

- *Capital and liquidity requirements*: These measures affect the cost and/or composition of the liabilities of financial institutions by increasing their capital and liquidity buffers. For instance, countercyclical capital requirements aim at making lending more expensive and build buffers, in good times. Dynamic loan-loss provisioning rules, which build up capital buffers in the form of reserves in good times to absorb losses during bad times, also fall into this category. Capital and liquidity requirements can be countercyclical to smooth the

²⁷ Note that tools from different categories can be combined to address specific sources of systemic risk.

credit cycle and/or include surcharges for systemically important financial institutions to limit the build-up of systemic risk.

- *Asset concentration and credit growth limits:* These measures alter the composition of the assets of financial institutions by imposing limits on the pace of credit growth or on asset concentration. Examples include speed limits on credit expansion, limits on foreign currency exposure or foreign-currency-denominated lending, and limits on sectoral concentration of loan portfolios. The aim of these measures is to reduce the exposure of bank portfolios to sectoral shocks and, to the extent that slower credit growth improves average loan quality, to aggregate shocks.

- *Loan eligibility criteria:* These measures limit the pool of borrowers that have access to finance to improve their average quality. Examples include loan-to-value (LTV) and debt-to-income (DTI) limits. LTVs also safeguard lenders by increasing loan collateral. Eligibility criteria can be tailored to fit a loan portfolio's risk profile. For example, LTV limits can be linked to local house price dynamics or be differentiated based on whether loans are made in foreign currency to unhedged households or not.

Several obstacles make the econometric analysis of the impact of macroprudential policy on credit booms difficult. First, there are serious data availability and measurement issues. Macroprudential policy frameworks have not been around for a long time, and a mere handful of countries have used them regularly. Second, macroprudential policy is often implemented in combination with changes in the macroeconomic stance and involves multiple instruments in the same package. Therefore, attributing specific outcomes to specific instruments is a difficult task. Third, in most cases, policies are implemented in reaction to credit market developments. Hence, endogeneity is a major problem, and we must underline that our analysis does not attempt to

establish causality. That said, endogeneity would result in positive coefficients: more credit growth leads to macroprudential tightening. Thus, a significant negative correlation between the use of macroprudential tools and credit booms would suggest that these policies are effective in alleviating the boom.

We construct an aggregate measure of macroprudential policy that includes the sum of the following six measures: differential treatment of deposit accounts, reserve requirements, liquidity requirements, interest rate controls, credit controls, and open foreign exchange position limits.²⁸ We compile information on these measures from various issues of the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* and complement this with information from IMF Article IV reports and responses of country authorities to an IMF questionnaire (see IMF, 2011b).²⁹ The identified measures have been used more intensely over time since the mid-90s (Figure 9). Reserve and liquidity requirements, followed by limits on open foreign exchange positions, have been used most frequently.

This exercise brings some promising results, suggesting that macroprudential tools can reduce the incidence of credit booms and decrease the probability that booms end up badly (Tables 6 and 7).³⁰ Consistent with the focus of macroprudential tools on financial sector vulnerabilities, the reduction in the probability of a bad boom is found primarily for booms that end up in a financial crisis (Table 7). This suggests that macroprudential policy can reduce the

²⁸ Ideally, we would like to use a variable that indicates the macroprudential policy stance throughout the duration of the boom. While we are able to do that with the monetary and fiscal policy variables, there is not enough variation for measuring macroprudential policy in the same way.

²⁹ Note that, especially in the early years of the sample period, the use of such measures may not reflect macroprudential concerns as they came to be defined in the aftermath of the global financial crisis (for such a definition of macroprudential policy, see BIS, 2011, and IMF, 2011a).

³⁰ When estimating regressions using the subcomponents of the macroprudential index, we find that credit and interest controls and open foreign exchange position limits enter significantly in most regressions, although their significance is sensitive to the specific combination of variables included.

risk of a bust while simultaneously reducing the vulnerability of the rest of the economy to troubles in the financial system.³¹ These findings are in line with those in Lim and others (2011), who suggest that macroprudential tools, such as LTV and DTI caps, ceilings on credit growth, reserve requirements, and dynamic provisioning rules, can mitigate the “procyclicality” of credit. Similarly, Cerutti and others (2015) report that usage of macroprudential tools is generally associated with lower growth in credit.

This empirical evidence fits with the experience of countries that have used macroprudential policy tools. In general, these tools have been found to perform better in avoiding bad outcomes following credit booms rather than in preventing them altogether. Country experience with the most common macroprudential tools can be summarized as follows:

- *Capital and liquidity requirements:* These measures have been broadly successful in building up buffers to deal with busts. But they have been less successful in curtailing the incidence and duration of credit booms. Tight capital and reserve requirements in Croatia are viewed as having been effective in increasing the banks’ liquidity and capital buffers. This helped banks weather the global financial crisis, but was less effective in slowing credit growth and capital inflows (Kraft and Galac, 2011; Ostry and others, 2011). Likewise, Peru’s reserve requirements on deposits in 2008 helped contain the risks posed by rapid credit growth while shielding the inflation targeting framework (Terrier and others, 2011). Dynamic loan-loss provisioning rules introduced in Spain in 2000 allowed Spanish banks to better absorb negative shocks and maintain exposures during the crisis. In this way, they worked in their intended countercyclical fashion (Jiménez and others, 2011). Yet they did not stop the boom, and reliance

³¹ We interact the macroprudential policy measure with the macroeconomic policy variables to control for any complementarities or conflicts between these policies. We obtain no significant results.

on historical series to determine their magnitude may have made the buffers too small for what turned out to be an exceptional boom-bust cycle. In an interesting case targeting a specific class of assets, Brazil raised the risk weight on high-LTV car loans in December 2010, to restrain the rapid growth in this segment. Preliminary data suggest that this move has had its intended effect of raising interest rates on car loans and slowing down the supply of such credit.

- *Asset concentration and credit growth limits:* These measures have had some success in slowing down the pace of credit, although often at the expense of building up concentrations of risk elsewhere in the system. For example, while credit growth in Romania remained strong despite a wave of measures, strict foreign exchange exposure limits introduced between September 2005 and January 2007 managed to curb foreign-currency-denominated loan growth. In Croatia, speed limits on credit growth by banks were introduced in 2003 (limiting the annual growth of banks' domestic credits to 16 percent), combined with a penalty in the form of minimum holdings of central bank's bills, if credit growth exceeded this limit. These had some success in reducing the growth rate of bank credit (which fell from 28.7 percent in 2002 to 11.8 percent in 2003), since the penalty for breaching the rule was high. However, the growth of total domestic credit (including credit from nonbanks) barely declined, as banks circumvented the rule by booking loans directly on their foreign parent banks and by lending to the private sector through their nonbank (for example, leasing company) subsidiaries (Kraft and Galac, 2011). This contributed to the build-up of systemic risk in the nonbank financial sector.

- *Loan eligibility criteria:* Experience using these measures is limited, but when implemented they seem to have been effective in curbing the deterioration in lending standards typically associated with credit booms (Dell'Ariccia, Igan, and Laeven, 2012). For example, the resilience of the banking system in Hong Kong during the Asian financial crisis in 1998 has been

attributed to the introduction of actively managed LTV and DTI restrictions (Wong and others, 2011). Similarly, in Korea, LTV and DTI limits seem to have discouraged speculation in housing markets (Igan and Kang, 2011). In Poland, loan eligibility requirements on foreign-currency-denominated mortgage loans were credited for keeping default rates low during the global financial crisis—this in spite of the zloty’s significant depreciation against the currencies (euro and Swiss franc) in which these loans were denominated.

As a whole, macroprudential tools show some promise in dealing with credit booms and busts. However, more time and analysis are needed for a full assessment of their effectiveness. Their targeted nature entails a more favorable cost-benefit balance. Yet a potential problem with their targeted nature is that it makes these instruments more susceptible to circumvention and political resistance.³² Circumvention may end up masking or increasing systemic risks by shifting credit activity into less-regulated intermediaries or to riskier loan types. And these distortions may prove economically important, similar to those documented for credit controls (Kane, 1977; Borio, 2003 and 2009). Another potential issue is whether one can separate the procyclical dimension of credit from its cross-sectional dimension (Horváth and Wagner, 2014). Providing insurance against aggregate fluctuations may increase incentives to take on more risks on the latter dimension, with potentially adverse consequences because of increased common exposures and probability of joint distress.

³² Indeed, Cerutti and others (2015) find that effects of macroprudential tools are less in financially more developed and open economies, suggesting some circumvention. Turning to political resistance, the evidence presented in this paper suggests that the benefits and costs of credit booms materialize over different time horizons. This opens the question of institutional aspects of macroprudential policy—it may be necessary to give the control of these tools to an agency that is shielded from short-term pressures or use rules rather than discretion in their implementation (see, for example, Nier and others, 2011, for more). A related question is how macroprudential and monetary policies interact. Bruno and others (2015), for instance, find that macroprudential policies are more successful when they complement monetary policy by reinforcing monetary tightening. This suggests an important role for the central bank—an agency often independent and immune from political pressures—in the conduct of macroprudential policies.

VI. CONCLUSIONS

Prolonged credit booms are a harbinger of financial crises and have real costs. Our analysis shows that, while only a (significant) minority of booms end up in crises, those that do can have long-lasting and devastating real effects if left unaddressed. Yet, it appears to be difficult to identify bad booms as they emerge, and the cost of intervening too early and running the risk of stopping a good boom therefore has to be weighed against the desire to prevent financial crises.

While the analysis offers some insights into the origins and dynamics of credit booms, from a policy perspective a number of questions remain unaddressed. In part this reflects the limited experience to date with macroprudential policies and the simultaneous use of multiple policy tools, making it hard to disentangle specific policy measures' effectiveness.

First, while monetary policy tightening seems the natural response to rapid credit growth, we find only weak empirical evidence that it contains booms and their fallout on the economy. This may be partly the result of a statistical bias. But there are several "legitimate" factors that limit the use and effectiveness of monetary policy in dealing with credit booms, especially in small open economies. In contrast, there is more consistent evidence that macroprudential policy is up to this task, although it is more exposed to circumvention.

All of the above raises important questions about the optimal policy response to credit booms. Our view is that when credit booms coincide with periods of general overheating in the economy, monetary policy should act first and foremost. If the boom lasts and is likely to end up badly or if it occurs in the absence of overheating, then macroprudential policy should come into play. Preferably, this should be in combination and coordination with macroeconomic policy,

especially when macroeconomic policy is already being used to address overheating of the economy.

Second, questions remain about the optimal mix and modality of macroprudential policies, also in light of political economy considerations and the type of supervisory arrangements in the country. Political economy considerations call for a more rules-based approach to setting macroprudential policy to avoid pressure from interest groups to relax regulation during a crisis. But such considerations have to be weighed against the practical problems and unintended effects of a rules-based approach, such as the calibration of rules with rather demanding data requirements and the risk of circumvention. The design of a macroprudential framework should also consider the capacity and ability of supervisors to enforce such rules so that unintended and potentially dangerous side effects can be avoided.

Third, the optimal macroprudential policy response to credit booms, as well as the optimal policy mix, will likely have to depend on the type of credit boom. Because of data limitations, our analysis has focused on aggregate credit. While it seems natural that policy response should adapt to and be targeted to the type of credit, additional analysis is needed to assess the effectiveness of policies to curtail booms that differ in the type of credit.

Fourth, policy coordination, across different authorities and across borders, may increase the effectiveness of monetary tightening and macroprudential policies. Cooperation and a continuous flow of information among national supervisors, especially regarding the activities of institutions that are active across borders, are crucial. Equally important is the coordination of regulations and actions among supervisors of different types of financial institutions. Whether and how national policymakers take into account the effects of their actions on the financial and macroeconomic stability of other countries is a vital issue, calling for further regional and global

cooperation in the setup of macroprudential policy frameworks and the conduct of macroeconomic policies.

APPENDIX 1. TECHNICAL DEFINITION OF A CREDIT BOOM

We focus our attention on “extraordinary” deviations in the relationship between credit and economic activity. In this context, we define a “credit boom” as an episode in which the ratio of credit to GDP grows faster than what is implied by its trend, which follows the normal pace of credit growth in that particular country. An episode of rapid credit growth is marked as a boom when the deviation from trend exceeds a country- and path-dependent or *ad hoc* threshold. To put it more specifically, credit-to-GDP ratio in each year t is compared to a country-specific, backward-looking, rolling cubic trend estimated over the period between years $t-10$ and t . The cubic trend lets us introduce two inflection points so that both financial deepening and its reversal are allowed. An episode becomes a boom if either of the following two conditions is satisfied: (i) the deviation from trend is greater than 1.5 times its standard deviation and the annual growth rate of the credit-to-GDP ratio exceeds 10 percent; or (ii) the annual growth rate of the credit-to-GDP ratio exceeds 20 percent.

To capture the borderline cases, we also use a more *ad hoc* rule, which defines any period during which the annual growth rate of the credit-to-GDP ratio exceeds 10 percent as a boom. The start of the boom is the earliest year in which either (i) the credit-to-GDP ratio exceeds its trend by more than three-fourths of its historical standard deviation while its annual growth rate exceeds 5 percent; or (ii) its annual growth rate exceeds 10 percent.

A boom ends as soon as either (i) the growth of the credit-to-GDP ratio turns negative; or (ii) the credit-to-GDP ratio falls within three-fourths of one standard deviation from its trend and its annual growth rate is lower than 20 percent. Note that, since credit is a stock variable measured at year-end while GDP is a flow variable, the credit-to-GDP ratio is constructed with the geometric average of GDP in years t and $t+1$. We check the robustness of our definition by employing different thresholds and comparing the list of booms we obtain against the lists reported in previous studies. While the main insights remain the same, only the empirical findings using the baseline definition are discussed due to space constraints.

There are several advantages and drawbacks in using this methodology. On the positive side, the financial sector is not considered in isolation: by looking at the credit-to-GDP ratio rather than credit itself, the methodology relates credit developments to the size of the economy and accounts for the procyclicality of credit. In addition, only standard information about relevant past credit growth readily available in real time is used to set the benchmark, which is a particularly desirable feature for policymaking. On the negative side, the methodology may erroneously tag an observation as a credit boom when the credit-to-GDP ratio jumps up not because of an increase in credit but because of a decrease in GDP. We manually check such cases and drop them from the list of booms. Another potential drawback is that the aggregate measure used captures only *bank* credit to the private sector (line 22d from the IMF’s *International Financial Statistics*). While nonbank financial institutions constitute a small portion of the financial system assets and provide a negligible amount of credit to the private sector in many countries, credit booms driven by nonbank provision of loans may be missed. The discrepancy between bank credit and total credit is larger in countries with market-based, rather than bank-based, financial systems. Two countries that particularly stand out in this regard are the United Kingdom and the United States. All in all, the methodology provides an operationally convenient way to detect credit booms in real time.

A natural question is how much the methodology used to define and identify the credit boom episodes alter the major empirical regularities underlined during the analysis. As mentioned at the beginning of Section II, there are various methodologies used in the literature. We compare our methodology to that in Gourinchas Valdes, and Landerretche (2001) and that in Mendoza and Terrones (2008). In addition, we check the identification of booms with these trend-based methodologies to an *ad hoc* rule which deems any growth in credit-to-GDP ratio above 20 percent as a boom. The correlation between the boom dummies created by these four methodologies is high (Appendix Table A1).³³ Hence, the list of episodes we identify is not very sensitive to the methodology used. In particular, the major booms (for example, those preceding the Scandinavian and Asian crises) are captured under all methodologies. The differences appear in small and medium-sized booms, since thresholds start binding.

Perhaps a more important concern is that, depending on which booms each methodology leaves out, the incidence of bad booms may be different. Indeed, in their original analysis, these methodologies arrive at different probabilities of booms that are linked to banking crises. Specifically, Gourinchas, Valdes, and Landerretche (2001) looks at 80 booms based on absolute and relative (to the credit-to-GDP ratio) deviation from trend – rather than setting the thresholds first, they limit the number of episodes. Using the criterion of calling a boom bad if it is followed by a crisis within three years from its end, 50 percent of absolute booms and 38 percent of relative booms they identify are bad. Mendoza and Terrones (2008) look at credit per capita instead of credit-to-GDP ratio and identify 58 episodes, with 47 percent ending badly. Since the differences may also be due to the sample periods and the data, we apply the methodologies used in these two papers to our dataset. The bad boom incidences reported in our baseline are actually on the lower end of the distribution (Appendix Table A2).

Table A1. Correlation of Booms across Definitions

Boom dummy constructed using:	(1)	(2)	(3)	(4)
Ad hoc threshold 1/	1			
Backward-looking, rolling, cubic trend 2/	0.99*	1		
Hodrick-Prescott over entire series 3/	0.50*	0.52*	1	
Hodrick-Prescott from t_0 to t_4 /				
Absolute	0.55*	0.58*	0.63*	1
Relative	0.75*	0.80*	0.47*	0.84*

* indicates statistical significance at the 1 percent level.

1/ Boom if credit-to-GDP ratio increases by more than 20 percent.

2/ Barajas, Dell'Ariccia, and Levchenko (2008) definition. Baseline used in this paper.

3/ Mendoza and Terrones (2008) definition.

4/ Gourinchas, Valdes, and Landerretche (2001) definition.

Table A2. Incidence of Bad Booms across Definitions

Boomepisodes identified using:	Number of booms	Followed by banking crises within three years from end
Ad hoc threshold 1/	112	38%
Backward-looking, rolling, cubic trend 2/	175	33%
Hodrick-Prescott over entire series 3/	112	37%
Hodrick-Prescott from t_0 to t_4 /		
Absolute	138	43%
Relative	60	42%

1/ Boom if credit-to-GDP ratio increases by more than 20 percent.

2/ Barajas, Dell'Ariccia, and Levchenko (2008) definition. Baseline used in this paper.

3/ Mendoza and Terrones (2008) definition.

4/ Gourinchas, Valdes, and Landerretche (2001) definition.

³³ Given that we are comparing binary variables constructed as “binned” realizations of an underlying continuous variable, we use a tetrachoric correlation.

The full list of the countries in our sample and the boom episodes identified are in Appendix Tables A3 and A4.

Table A3. Availability of Banking Credit to Private Sector (scaled by GDP)			
Country	Period	Country	Period
Afghanistan, I.R. of	1970-1981	Denmark	1970-2008
	2006-2008	Dominica	1978-2008
Albania	1994-2008	Dominican Republic	1971-2008
Algeria	1970-2008	Ecuador	1970-2008
Angola	1995-2009	Egypt	1970-2008
Antigua and Barbuda	1978-2008	El Salvador	1970-2008
Argentina	1970-2009	Equatorial Guinea	1986-2009
Armenia	1995-2008	Eritrea	1995-2008
Australia	1970-2009	Estonia	1993-2009
Austria	1970-2009	Ethiopia	1982-2008
Azerbaijan, Rep. of	1995-2008	Fiji	1970-2009
Bahrain, Kingdom of	1981-2009	Finland	1970-2009
Bangladesh	1974-2008	France	1970-2009
Belarus	1995-2008	Gabon	1970-2009
Belgium	1970-2009	Gambia, The	1970-2009
Benin	1970-2009	Georgia	1996-2008
Bhutan	1983-2008	Germany	1971-2009
Bolivia	1970-2008	Ghana	1970-2006
Bosnia and Herzegovina	1997-2009	Greece	1970-2009
Botswana	1972-2008	Guatemala	1970-2008
Brazil	1970-2008	Guinea	1989-2005
Brunei Darussalam	1999-2007	Guinea-Bissau	1990-2009
Bulgaria	1998-2008	Guyana	1970-2008
BurkinaFaso	1970-2009	Haiti	1992-2008
Burundi	1970-2008	Honduras	1970-2008
Cambodia	1994-2008	Hungary	1982-2008
Cameroon	1970-2009	Iceland	1970-2006
Canada	1970-2008	India	1970-2009
Cape Verde	1987-2008	Indonesia	1980-2008
Central African Republic	1970-2009	Iran, I.R. of	1970-1977
Chad	1970-2009		1979-2009
Chile	1970-2008	Iraq	1970-1976
Hong Kong	1990-2009	Iraq	2004-2008
China	1985-2009	Ireland	1970-2009
Colombia	1974-2008	Israel	1970-1976
Comoros	1982-2008	Israel	1986-2009
	1994-1995	Italy	1970-2009
Congo, Dem. Rep. of	2000-2009	Jamaica	1970-2008
Congo, Republic of	1970-2009	Japan	1970-2008
Costa Rica	1970-2008	Jordan	1970-2009
Croatia	1994-2008	Kazakhstan	1996-2008
Cyprus	1970-2009	Kenya	1970-2008
Czech Republic	1993-2008	Korea, Republic of	1970-2009
Côte d'Ivoire	1970-2009		

Table A3. Availability of Banking Credit to Private Sector (scaled by GDP)			
Country	Period	Country	Period
Kuwait	1970-1989	Romania	1996-2008
	1991-2008	Russian Federation	1996-2008
Kyrgyz Republic	1997-2007	Rwanda	1970-2005
Lao People's Dem. Rep	1989-2008	Saudi Arabia	1970-2009
Latvia	1993-2008	Senegal	1970-2009
Lesotho	1973-2008	Serbia, Republic of	1998-2008
Libya	1991-2009	Sierra Leone	1970-2009
Lithuania	1993-2008	Singapore	1970-2009
Macedonia, FYR	1995-2008	Slovak Republic	1993-2008
Madagascar	1970-2009	Slovenia	1993-2009
Malawi	1970-2009	Solomon Islands	1978-2008
Malaysia	1970-2008	South Africa	1970-1990
Mali	1970-2009		1992-2008
Malta	1971-2009	Spain	1972-2009
Mauritania	1970-2009	Sri Lanka	1970-2009
Mauritius	1977-2008	Sudan	1970-2008
Mexico	1970-2008	Suriname	1970-2008
Micronesia, Fed. Sts.	1995-2009	Swaziland	1970-2008
Moldova	1994-2008	Sweden	1970-2008
Mongolia	1991-2008	Switzerland	1970-2009
Montenegro	2002-2009	Syrian Arab Republic	1970-2008
Morocco	1970-1985	SãoTomé and Príncipe	2002-2008
Morocco	1990-2009	Tajikistan	1998-2007
Mozambique	1988-2008	Tanzania	1989-2008
Myanmar	1970-2004	Thailand	1970-2008
Namibia	1990-2008	Timor-Leste	2002-2008
Nepal	1970-2008	Togo	1970-2009
Netherlands	1970-2009	Tonga	1976-2008
New Zealand	1970-2009	Trinidad and Tobago	1970-2009
Nicaragua	1970-2008	Tunisia	1970-2009
Niger	1970-2009	Turkey	1970-2008
Nigeria	1970-2008	Uganda	1970-2008
Norway	1970-2006	Ukraine	1995-2008
Oman	1972-2008	United Arab Emirates	1974-2009
Pakistan	1970-2007	United Kingdom	1970-2009
Panama	1970-2008	United States	1970-2008
Papua New Guinea	1973-2008	Uruguay	1970-2008
Paraguay	1970-2008	Venezuela, Rep. Bol.	1970-2009
Peru	1970-2009	Vietnam	1992-1993
Philippines	1970-2007	Vietnam	1995-2009
Poland	1986-2008	Zambia	1970-1991
Portugal	1970-2009	Zambia	1993-2008
Qatar	1971-2008	Zimbabwe	1985-2005

Table A4. Boom Episodes by Country			
Country	Period	Country	Period
Albania	2003-2008	Croatia	2001-2006
Algeria	1998-2002	Cyprus	1991-1991
Argentina	1977-1979	Cyprus	1996-1999
Argentina	1987-1987	Cyprus	2006-2008
Argentina	1992-1994	Czech Republic	2005-2007
Argentina	2005-2007	Denmark	1986-1988
Armenia	2004-2008	Dominican Republic	1999-2000
Australia	1984-1986	Ecuador	1993-1994
Azerbaijan, Rep. of	2003-2007	Egypt	1974-1977
Bahrain, Kingdom of	1991-1992	Egypt	1994-1999
Bangladesh	1983-1985	El Salvador	1983-1985
Bangladesh	1994-1996	El Salvador	1992-1995
Belarus	2003-2008	Estonia	2002-2007
Belgium	1988-1989	Ethiopia	1992-1997
Belgium	2006-2007	Fiji	1989-1991
Benin	1985-1986	Fiji	2000-2001
Benin	1998-2000	Fiji	2005-2006
Benin	2003-2008	Finland	1985-1989
Bhutan	2001-2007	Gabon	1997-1999
Bolivia	1975-1978	Gambia, The	1976-1978
Bolivia	1987-1993	Gambia, The	2006-2008
Bosnia & Herzegovina	2002-2008	Georgia	2004-2008
Botswana	1990-1992	Ghana	1996-2000
Botswana	1998-2000	Greece	1999-2001
Brazil	1986-1988	Greece	2005-2007
Brazil	1992-1994	Guatemala	1994-1995
Brazil	2006-2008	Guatemala	2003-2003
Bulgaria	2002-2008	Guyana	1981-1984
Burkina Faso	1973-1978	Guyana	1986-1988
Burundi	1988-1991	Guyana	1994-1998
Burundi	1998-2002	Honduras	1996-1999
Cambodia	2003-2004	Honduras	2006-2007
Cambodia	2006-2008	Hungary	2000-2000
Cameroon	1977-1978	Hungary	2003-2007
Cameroon	1980-1981	Iceland	1982-1983
Central African Rep.	1974-1974	Iceland	1997-1997
Chile	1971-1974	Iceland	1999-2000
Chile	1977-1981	Iceland	2003-2006
China, P.R.: Mainland	2009-2010	India	1975-1977
Colombia	1980-1981	India	1999-2002
Colombia	1989-1990	India	2004-2006
Colombia	2006-2007	Indonesia	1989-1990
Costa Rica	1992-1993	Ireland	2004-2006
Costa Rica	1996-2001	Israel	1972-1974

Table A4. Boom Episodes by Country (continued)			
Country	Period	Country	Period
Jamaica	1981-1983	Nepal	1984-1986
Jamaica	1987-1989	Nepal	1994-1995
Jamaica	2002-2004	Nepal	2006-2008
Jamaica	2006-2007	Netherlands	1998-2000
Japan	1987-1988	New Zealand	1984-1987
Jordan	1973-1976	Nicaragua	1988-1988
Jordan	1978-1979	Nicaragua	1997-1999
Jordan	2004-2006	Niger	1978-1980
Kazakhstan	2000-2006	Niger	2004-2008
Kenya	2008-2008	Nigeria	1980-1982
Korea, Republic of	1978-1980	Nigeria	1999-2001
Korea, Republic of	1996-2002	Norway	1984-1987
Kuwait	1994-1996	Oman	1983-1984
Kyrgyz Republic	2003-2007	Oman	1997-1997
Latvia	2002-2006	Pakistan	2003-2004
Lesotho	1984-1985	Panama	1991-1993
Lesotho	1993-1994	Panama	1998-2001
Lesotho	1997-1997	Papua New Guinea	1980-1982
Lesotho	2005-2005	Papua New Guinea	1997-1998
Liberia	1977-1978	Papua New Guinea	2005-2008
Lithuania	2003-2007	Paraguay	1991-1994
Luxembourg	2005-2007	Paraguay	2007-2008
Macedonia, FYR	2006-2008	Peru	1980-1982
Madagascar	1977-1980	Peru	1991-1997
Madagascar	2003-2004	Peru	2006-2007
Malawi	1978-1979	Philippines	1978-1979
Malawi	1989-1992	Philippines	1992-1997
Malaysia	1978-1986	Poland	2006-2008
Malaysia	1995-1997	Portugal	1995-2001
Mali	1995-1999	Qatar	1982-1983
Malta	1989-1991	Qatar	1985-1987
Mauritania	1999-2004	Qatar	1991-1992
Mauritius	1997-1998	Qatar	2005-2007
Mexico	1989-1994	Romania	2003-2007
Mexico	2006-2007	Russian Federation	2003-2007
Micronesia, Fed.Sts.	2004-2006	Saudi Arabia	1978-1979
Moldova	2001-2007	Saudi Arabia	2004-2005
Mongolia	2001-2007	Senegal	1972-1974
Morocco	1973-1974	Senegal	1977-1979
Morocco	1991-1993	Senegal	2000-2000
Mozambique	2005-2006	Senegal	2005-2005
Myanmar	1995-1997	Serbia, Republic of	2004-2005
Myanmar	2000-2001	Serbia, Republic of	2007-2008
Nepal	1977-1981	Sierra Leone	1986-1989

Table A4. Boom Episodes by Country (concluded)			
Country	Period	Country	Period
Sierra Leone	2001-2004	Zambia	1994-1996
Sierra Leone	2007-2009	Zambia	2006-2008
Singapore	1978-1981	Zimbabwe	1991-1993
Slovak Republic	1996-1997		
Slovak Republic	2005-2007		
Slovenia	1998-1999		
Slovenia	2004-2007		
Spain	2003-2007		
Sri Lanka	1977-1979		
Sri Lanka	1993-1994		
Sudan	2000-2006		
Suriname	1996-1998		
Suriname	2007-2008		
Swaziland	2002-2006		
Sweden	1988-1989		
Syrian Arab Republic	2003-2005		
Tanzania	2001-2007		
Thailand	1976-1978		
Thailand	1987-1995		
Togo	1976-1977		
Tonga	1985-1988		
Trinidad and Tobago	1976-1978		
Trinidad and Tobago	1997-1998		
Tunisia	1981-1982		
Tunisia	1989-1989		
Tunisia	2000-2000		
Turkey	1981-1982		
Turkey	1995-1997		
Turkey	2004-2008		
Uganda	1980-1981		
Uganda	1992-1993		
Ukraine	2002-2007		
United Arab Emirates	1986-1987		
United Arab Emirates	2005-2008		
United Kingdom	1972-1973		
United Kingdom	1981-1984		
United Kingdom	1988-1989		
United Kingdom	2006-2008		
Uruguay	1977-1979		
Uruguay	2001-2002		
Venezuela, Rep. Bol.	1975-1976		
Venezuela, Rep. Bol.	2004-2007		
Vietnam	1999-2007		
Zambia	1981-1982		

APPENDIX 2. POLICY RESPONSES TO CREDIT BOOMS

Table A5. Policy Responses to Credit Booms

Measure	Countries	Impact assessment
Macroeconomic policy		
Monetary tightening	Australia, Brazil, Chile, China, Colombia, Croatia, Hungary, Iceland, Latvia, Romania, Sweden	Higher interest rates did not prove to be effective in controlling domestic demand for loans. In some cases, increased capital inflows and/or shift to FX-denominated loans posed further challenges.
Fiscal tightening	Bulgaria, Hungary	Fiscal consolidation, in most cases, was not enough to offset the surge in domestic demand.
Removal of incentives for borrowing in the tax code	Estonia, Lithuania*, Netherlands, Poland, United Kingdom	Gradual facing out of mortgage interest deductibility was somewhat successful in the U.K. but did not have much effect on household debt accumulation in the other cases.
Regulatory policy		
Reserve requirements	Albania, Bosnia, Brazil, Bulgaria, China, Colombia, Croatia, Estonia, Finland, India, Indonesia, Korea, Latvia, Malaysia, Mongolia*, Peru^*, Romania^, Russia^, Serbia, Ukraine, Uruguay^	Evidence remains mixed with success in taming the rate of growth reported in some cases (e.g., Bosnia) but not in others (e.g., Serbia).
Differentiated/Time-varying capital requirements	Brazil, Bulgaria, Croatia, Greece, India, Nigeria, Poland^, Portugal^, Switzerland*	Sizeable slowdown in credit growth rates was noted in several cases but reversal to higher pace was not uncommon. Some have argued that these tools, even when they failed to prevent or curb a credit boom, were effective in ensuring that the banking sector was better prepared for the bust as capital buffers were higher.
Higher risk weights	Albania, Bulgaria, Brazil*, Croatia, Estonia^, Iceland, India, Ireland, Italy, Malaysia, Norway^, Poland^, Serbia, Spain, Turkey, Uruguay^	
Liquidity requirements	Argentina^, Brazil^, Colombia, Croatia, France*, Iceland, New Zealand*, Turkey^, Uruguay^	More than the impact on credit growth, the improvement in liquidity positions were to praise.
Dynamic/Increased provisioning	Bolivia, Bulgaria, Colombia, Croatia, Greece, India, Mongolia*, Peru, Portugal, Russia, Spain, Uruguay	In many cases, there was some but not large effect on the rate of credit growth. However, the buffer built during the boom appeared to have helped during the bust.
Limits on credit growth/new loans	Argentina^, Austria^, Bulgaria, Brazil^, China, Colombia, Croatia, Greece, Hong Kong SAR, Hungary^*, Korea^*, Malaysia, Romania^, Serbia, Singapore, Turkey^	There has been some effect, especially when the measures were applied only to narrowly-defined categories of loans. Yet, overall effectiveness on aggregate credit was muted as lending shifted to foreign banks or less-regulated financial intermediaries.
Limits on loan-to-value ratio	Brazil^*, Canada*, Chile, China, Colombia, Croatia, Hong Kong SAR, Hungary^*, India, Korea, Latvia, Malaysia, Norway*, Romania, Singapore, Slovak Republic, Sweden*, Thailand, Turkey*	Studies focusing on Asian countries report success for such loan eligibility criteria both in curtailing real estate price appreciation and in reducing defaults if and when a downturn starts. There tends to be, however, less support for these tools' ability to control household and bank leverage. Also, issues concerning the calibration of the policy response remain (see, e.g., Igan and Kang, 2011).
Limits on debt-to-income ratio	China, Colombia, Croatia, France*, Greece, Hong Kong SAR, Hungary^*, Korea, Malaysia, Norway*, Poland*, Romania, Thailand	Evidence for other countries is even more limited since the rules have only recently been enforced.
Exposure/Credit concentration limits	Colombia, France, Hong Kong SAR, Malaysia, Mexico, Mongolia*, New Zealand*, Nigeria, Peru*, Poland, Portugal, Romania, Serbia, South Africa, Thailand, Ukraine, Uruguay	
Net open position limits	Argentina, Colombia, Hungary, Indonesia, Israel^*, Korea^*, Malaysia, Mexico, Nigeria, Peru*, Romania, Russia, Serbia, South Africa, Thailand, Turkey, Uruguay	Direct impact on aggregate credit growth rate is difficult to detect, but positive effect on the resilience of financial institutions seems to exist. Having said that, circumvention problems have been reported, especially in the case of exposure or credit concentration limits.
Maturity mismatch regulations	Italy, Mexico, Mongolia*, New Zealand*, Singapore, South Africa, Uruguay	

Sources: IMF country reports; Enoch and Ötger-Robe (2007); Borio and Shim (2007); Crowe and others (2011); Lim and others (2011); Terrier and others (2011); Detragiache, Vandenbussche, and Vogel (2012).

Note: This is not intended to be an exhaustive list of all measures taken in all credit boom episodes identified in the sample but rather a simplified illustration of various tools used in various cases. Some measures can be classified under multiple categories, e.g., application of higher risk weights or additional capital requirements based on whether the loan meets a loan-to-value limit criterion, and in most cases several policy tools are used in one package. Tools listed under regulatory policy have been used in a prudential rather than in a "macroprudential" sense in most cases, especially before the global financial crisis, and such usage may not necessarily fit within the definition of macroprudential policy used since the crisis (see BIS, 2011, and IMF, 2011a, for such definitions). ^ denotes the cases in which the measure was applicable to a certain type of lending, most commonly, foreign-currency-denominated loans. * indicates that the measure was taken very recently (in 2010 or later), in several cases as a response to the global financial crisis rather than to an ongoing or looming credit boom.

Table A6. Policy Options to Deal with Credit Booms

	Potential impact	Side effects	Practical issues
<u>Macroeconomic Policy</u>			
<i>Monetary measures</i>			
Tightening of monetary policy (e.g., through a rise in key policy rates)	drain excess liquidity in the system, increase the cost of borrowing, and potentially reduce the deterioration in inflation and current account	inflict damage to economic activity and welfare; attract capital inflows; hurt fiscal position by raising the cost of borrowing	identifying 'doomed' booms and reacting in time; weakness in monetary transmission mechanism; constraints imposed by monetary regime
<i>Fiscal measures</i>			
Tightening of fiscal policy	reduce potential overheating related to credit expansion and create room for stimulus in case of a bust	potential output costs that may come with significant tightening	considerable lag in fully mobilizing the measures and little room if the fiscal stance is already tight
Removal of incentives for borrowing (e.g., mortgage interest tax deductibility, subsidies/guarantees for mortgages, corporate tax shield provided by debt)	reduce distortions in the demand for bank loans and other types of debt	conflicts with socially-motivated housing goals	only a one-off effect with little room for cyclical implementation
Financial sector taxation	reduce probability of crisis by dampening systemic excessive risk taking during the boom and cost of crisis by acting as a buffer in the bust phase	risk of imposing excessive costs on the financial sector and, thus, impairing financial intermediation	loopholes for tax arbitrage and tax havens in the absence of international coordination; design details still in infancy
<u>Regulatory Policy</u>			
<i>Macroprudential measures</i>			
Reserve requirements Differentiated capital requirements Higher risk weights Liquidity requirements	increase cost of borrowing while building buffer to cope with the bust	costs associated with potential credit rationing	may get too complicated to enforce, especially in a cyclical context; effectiveness also limited when capital ratios are already high
Dynamic provisioning			
Limits on credit growth	(could) limit rapid expansion and leverage	loss of benefits from financial deepening	move lending outside the regulatory periphery
Limits on loan-to-value ratio	(could) limit rapid expansion and leverage while decreasing probability of default	costs associated with potential credit rationing	calibration is difficult, circumvention is easy
Limits on debt-to-income ratio			
Credit concentration limits Net open position limits Maturity mismatch regulations	limit exposure to certain types or sources of risks	not directly aimed at the aggregate credit growth; may shift risks to other types or sources of risk	window-dressing and circumvention may be an issue
<i>Monitoring measures</i>			
Intensified surveillance on vulnerable Stress testing Stronger disclosure requirements	improve resilience of the financial sector in the aftermath	reliance on hard information and less incentive to gather soft information; (potentially) increase rent-seeking	difficult to take action at good times, may still miss tail risks

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Table 1. Economic Performance

	All years	
	Non-boom years	Booms
Average change in:		
Credit-to-GDP	1.4	16.6
GDP	4.0	5.4
Consumption	4.4	5.4
Investment	5.4	10.5
Equity prices	4.3	11.1
House prices	1.2	9.5

Notes: Average across all credit boom episodes. Average annual changes expressed in percent. The differences between non-boom years and booms are statistically significant at conventional levels.

Table 2. Long-Term Growth and Credit Booms

Years spent in a boom:	Change in Real Per Capita Income	
	Mean	Median
None	40%	38%
Between 1 and 5	54%	60%
More than 5	61%	59%

Table 3. Credit Booms Gone Wrong

Followed by financial crisis?	Followed by economic underperformance?					
	No		Yes		Total	
	Number	Percent of total cases	Number	Percent of total cases	Number	Percent of total cases
No	52	30%	67	38%	119	68%
Yes	14	8%	43	24%	57	32%
Total	66	38%	110	63%	176	

Notes: Number and proportion of credit boom episodes are shown. A boom is followed by a financial crisis if a banking crisis happened within the three-year period after the end of the boom and is followed by economic underperformance if real GDP growth was below its trend, calculated by applying a moving-average filter, within the six-year period after the end of the boom.

Table 4. Economic and Financial Policy Frameworks, 1970-2013
(frequency distribution, in percent)

	Exchange Rate Regime		Monetary Policy		Fiscal Policy		Banking Supervision	
	Fixed	Floating	Loose	Tight	Loose	Tight	Low	High
1970-79	10.8	5.4	7.0	8.5	14.4	5.4	14.6	1.1
1980-89	16.9	3.0	16.2	2.1	19.8	7.2	21.9	0.6
1990-99	22.2	4.8	25.3	0	27.0	8.1	24.2	2.8
2000-13	25.9	10.8	35.9	4.9	12.6	5.4	18.5	16.3
All years	75.9	24.1	84.5	15.5	73.9	26.1	79.2	20.8

Notes: Exchange rate regime categories are based on Reinhart and Rogoff (2004). Monetary policy is tight when the policy rate exceeds the predicted level based on a simple regression of policy rates on inflation and real GDP growth by more than 28.71 percent (the top quartile). Fiscal policy is tight when the change in the surplus exceeds its predicted level based on a simple regression of the surplus on real GDP growth by more than 2.55 percent of GDP (the top quartile). Banking supervision quality measure is from Abiad, Detragiache, and Tressel (2008).

Table 5. Regression Analysis: Incidence of Credit Booms, 1970-2010

	DV: Dummy=1 if Credit Boom		DV: Dummy=1 if House Price boom and Credit Boom	DV: Dummy=1 if Household Credit Boom	DV: Dummy=1 if Firm Credit Boom
	(1) OLS	(2) Probit	(3) OLS	(4) OLS	(5) OLS
GDP per capita	-0.0410 (0.0458)	-0.128 (0.138)	-0.0450 (0.0348)	-0.0317 (0.0353)	0.0430 (0.0477)
GDP growth	0.0398* (0.0205)	0.120** (0.0601)	0.0465*** (0.0125)		
Capital inflow surge	-0.0342 (0.0247)	-0.106 (0.0741)	-0.0355* (0.0206)	-0.0730*** (0.0202)	-0.0503** (0.0192)
Financial reform	0.813** (0.313)	2.465*** (0.944)	1.178*** (0.257)	1.103*** (0.301)	0.833** (0.323)
Inflation	0.00704 (0.00939)	0.0209 (0.0250)	-0.0146*** (0.00525)	-0.00377 (0.00713)	-0.00299 (0.00831)
Current account balance	0.0104 (0.00981)	0.0343 (0.0267)	0.0130 (0.0101)	0.0361*** (0.00979)	0.0303*** (0.0100)
Trade openness	-0.00152 (0.00135)	-0.00482 (0.00371)	-0.00301*** (0.000998)	-0.00189 (0.00130)	-0.00205** (0.00100)
Exchange rate regime	-0.0260* (0.0136)	-0.0753* (0.0413)	-0.0168 (0.0124)	-0.0136 (0.0156)	-0.0181 (0.0136)
Bank orientation	-0.161 (0.115)	-0.486 (0.346)	-0.216** (0.106)	-0.189* (0.110)	-0.223** (0.100)
Consumption growth				0.0143 (0.0111)	
Investment growth					0.0364*** (0.00923)
Observations	125	123	104	117	114
R-squared	0.210		0.618	0.477	0.519
Region FE	YES	YES	YES	YES	YES
Pseudo R-squared		0.166			

Notes: All regressions –except for column (2) which uses Probit– are estimated using OLS. GDP per capita, in real terms, is in log. GDP growth is the annual growth rate of real GDP. Capital inflow surge is the sum of direct, other and portfolio investment flows as percent of GDP. Financial reform is a normalized index, as calculated by Abiad, Detragiache, and Tresselt (2008), with higher values indicating a more liberal and standardized regulatory framework. Inflation is the annual percentage growth in CPI. Current account balance is expressed in percent of GDP. Trade openness is the sum of exports and imports divided by GDP. Exchange rate regime denotes the Reinhart-Rogoff fine classification, with higher values corresponding to more flexibility in exchange rate determination. Bank orientation is a dummy variable that takes the value of 1 if the ratio of bank credit-to-GDP over the sum of bank credit-to-GDP plus stock market capitalization of listed companies as a percentage of GDP is greater than the median of the ratio across first year boom observations. Consumption growth is the annual growth rate of real consumption. Investment growth is the annual rate of growth of real investment. All variables except the categorical ones are winsorized at the 5 percent level. For the boom observations (where dummy=1), all explanatory variables are calculated as the average of their values one year before the start of the boom and during the first year of the boom (if the number of boom episodes in a country is more than one, we treat all boom episodes as a single observation and take the average across those episodes). For the non-boom observations (where dummy=0), explanatory variables are calculated as the average for the sample period of no booms. Columns (1) and (2) use Credit Boom as the dependent variable, column (3) uses a dummy=1 if there was a Credit Boom and a House Price boom, column (4) uses a dummy=1 if there was a Household Credit Boom, and column(5) uses a dummy=1 if there was a Firm Credit Boom. The sample period is 1970 to 2010. Robust standard errors are in brackets. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

Table 6. Regression Analysis: Incidence of Credit Booms, 1970-2010
 Dependent variable: Dummy=1 if there is a credit boom

	(1) Boom OLS	(2) Boom OLS	(3) Boom OLS	(4) Boom OLS
GDP per capita	-0.0365 (0.0478)	-0.0603 (0.0425)	-0.155*** (0.0502)	-0.162*** (0.0497)
GDP growth	0.0371* (0.0208)	0.0234 (0.0205)	0.0593*** (0.0172)	0.0500** (0.0196)
Capital inflow surge	-0.0297 (0.0255)	-0.0262 (0.0257)	-0.0234 (0.0215)	-0.0150 (0.0250)
Financial reform	0.715** (0.358)	0.774** (0.332)	0.972*** (0.271)	0.758** (0.323)
Inflation	0.00668 (0.00973)	0.00204 (0.00970)	0.00479 (0.00866)	-9.70e-05 (0.00937)
Current account balance	0.00917 (0.0104)	0.00326 (0.0111)	0.0151* (0.00807)	0.00781 (0.0104)
Trade openness	-0.00134 (0.00134)	-0.00158 (0.00137)	-0.00228** (0.00110)	-0.00164 (0.00140)
Exchange rate regime	-0.0239* (0.0133)	-0.0268 (0.0163)	-0.0145 (0.0132)	-0.00455 (0.0167)
Bank orientation	-0.160 (0.116)	-0.234** (0.117)	-0.261** (0.106)	-0.333*** (0.109)
Monetary policy stance	-0.00105 (0.000980)			-0.000814 (0.000933)
Fiscal policy stance		0.0903* (0.0527)		0.107** (0.0465)
Macro prudential controls			-0.135*** (0.0205)	-0.136*** (0.0240)
Observations	125	117	125	117
R-squared	0.218	0.259	0.342	0.375
Region FE	YES	YES	YES	YES

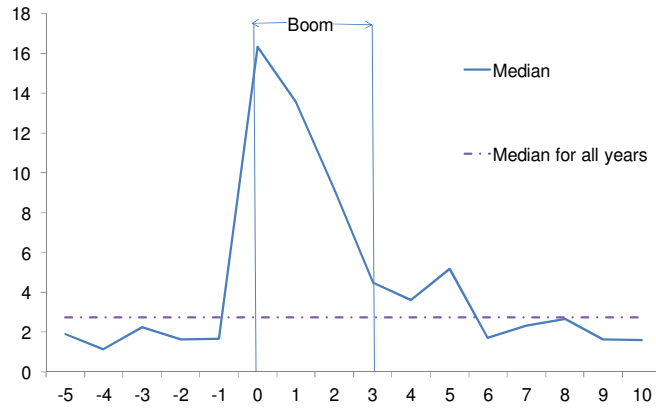
Notes: All regressions are estimated using OLS. GDP per capita, in real terms, is in log. GDP growth is the annual growth rate of real GDP. Capital inflow surge is the sum of direct, other and portfolio investment flows as percent of GDP. Financial reform is a normalized index, as calculated by Abiad, Detragiache, and Tressel (2008), with higher values indicating a more liberal and standardized regulatory framework. Inflation is the annual percentage growth in CPI. Current account balance is expressed in percent of GDP. Trade openness is the sum of exports and imports divided by GDP. Exchange rate regime denotes the Reinhart-Rogoff fine classification, with higher values corresponding to more flexibility in exchange rate determination. Bank orientation is a dummy variable that takes the value of 1 if the ratio of bank credit-to-GDP over the sum of bank credit-to-GDP plus stock market capitalization of listed companies as a percentage of GDP is greater than the median of the ratio across first year boom observations. Monetary policy stance is calculated as the percentage deviation by which the policy rate exceeds its predicted level based on a simple regression of policy rates on inflation and real GDP growth. Fiscal policy stance is computed as the error term by which the general government surplus in percent of GDP deviates from its predicted level based on a simple regression of the surplus on real GDP growth. Macroprudential controls is the count of macroprudential tools such as reserve and liquidity requirements, foreign exchange open position limits, or interest rate controls. All variables except the categorical ones are winsorized at the 5 percent level. For the boom observations (where dummy=1), all explanatory variables are calculated as the average of their values one year before the start of the boom and during the first year of the boom (if the number of boom episodes in a country is more than one, we treat all boom episodes as a single observation and take the average across those episodes). For the non-boom observations (where dummy=0), explanatory variables are calculated as the average for the sample period of no booms. The sample period is 1970 to 2010. Robust standard errors are in brackets. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

Table 7. Regression Analysis: Policy Effectiveness in Preventing Credit Booms from Going Wrong, 1970-2010

	DV: Dummy=1 if bad				DV: Dummy=1 if banking crisis				DV: Dummy=1 if economic performance			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Duration	0.0512*	0.0363	0.0879*	0.0850	0.0122	0.00881	0.0379*	0.0458	0.0507*	0.0282	0.0878*	0.0850
	(0.0306)	(0.0346)	(0.0458)	(0.0665)	(0.0244)	(0.0302)	(0.0203)	(0.0362)	(0.0302)	(0.0335)	(0.0448)	(0.0665)
Initial Credit-to-GDP	-0.000183	-0.00149	-8.23e-05	-0.00170	0.00320**	0.00312	0.00415***	0.00294	-0.000196	-0.00172	4.38e-05	-0.00170
	(0.00144)	(0.00213)	(0.00153)	(0.00466)	(0.00154)	(0.00209)	(0.00146)	(0.00431)	(0.00148)	(0.00247)	(0.00152)	(0.00466)
Years of Low Rate	-0.00263	0.109	-0.0361	0.00646	0.0332	-0.00526	0.0351	-0.0563	-0.0151	0.109	0.0453	0.00646
	(0.0919)	(0.130)	(0.0969)	(0.283)	(0.0974)	(0.123)	(0.0941)	(0.239)	(0.0954)	(0.140)	(0.122)	(0.283)
L.Monetary policy stance	0.000399			0.00188	0.00007			0.00192*	0.000159			0.00188
	(0.000654)			(0.00128)	(0.000645)			(0.00100)	(0.000684)			(0.00128)
L.Fiscal policy stance		0.00628		0.00202		0.0193		-0.0109		-0.00215		0.00202
		(0.0172)		(0.0309)		(0.0159)		(0.0260)		(0.0182)		(0.0309)
L.Macroprudential controls			-0.0270	0.0378			-0.0357*	-0.00138			-0.0213	0.0378
			(0.0281)	(0.0546)			(0.0213)	(0.0464)			(0.0284)	(0.0546)
Observations	129	89	73	39	129	89	73	39	129	89	73	39
R-squared	0.103	0.072	0.194	0.266	0.119	0.161	0.294	0.262	0.100	0.065	0.174	0.266
Region FE	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES	YES

Notes: All regressions are estimated using OLS. Duration, measured in years, shows how long the boom has lasted and is also a proxy for its size. Initial Credit-to-GDP is the value of the Bank Credit-to-GDP at the start year of the boom episode. Years of Low Rate is the number of years (in logs) in which the policy rate is below the predicted policy rate. Monetary/Fiscal policy in a given year is measured by a dummy that is 1 if there was tightening. Monetary policy is deemed to have tightened when the policy rate exceeds the predicted level based on a simple regression of policy rates on inflation and real GDP growth by more than 28.71 percent (the top quartile). Fiscal policy is deemed to have tightened when the change in the surplus exceeds its predicted level based on a simple regression of the surplus on real GDP growth by more than 2.55 percent of GDP (the top quartile). Macroprudential policy is an indicator variable that takes on the value 1 if at least one macroprudential tool was in place one year before the start of the boom and 0 otherwise. For all policy variables, the average over the boom years is taken, except for macroprudential policy which is the value in the year before the start of the boom. The sample consists of boom episodes only and each boom episode is treated as a separate observation. Standard errors are in brackets. ***, **, and * denote significance at the 1, 5, and 10 percent levels, respectively.

Figure 1. A Typical Credit Boom
(Growth rate of credit-to-GDP ratio around boom episodes)



Sources: IMF *International Financial Statistics*; staff calculations.

Figure 2. Concurrence of Credit Booms, 1978-2009

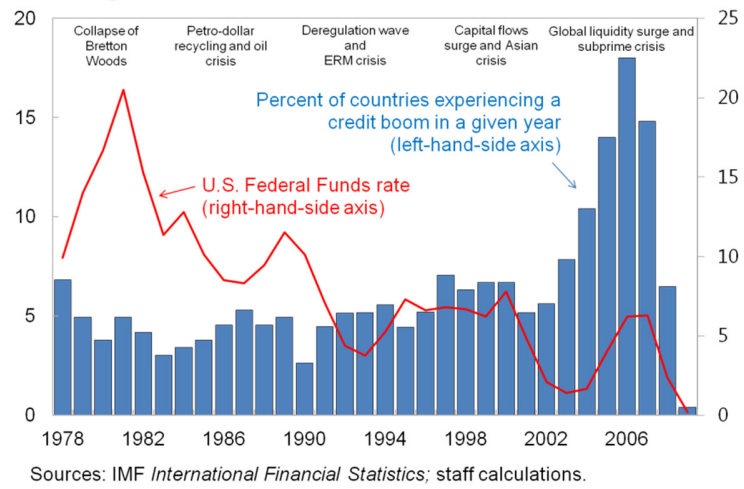
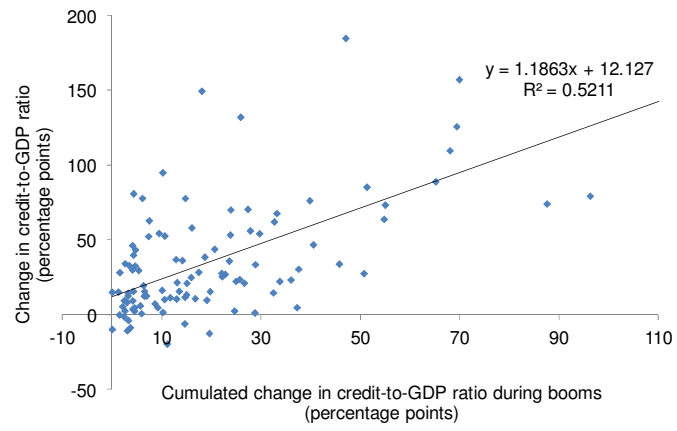
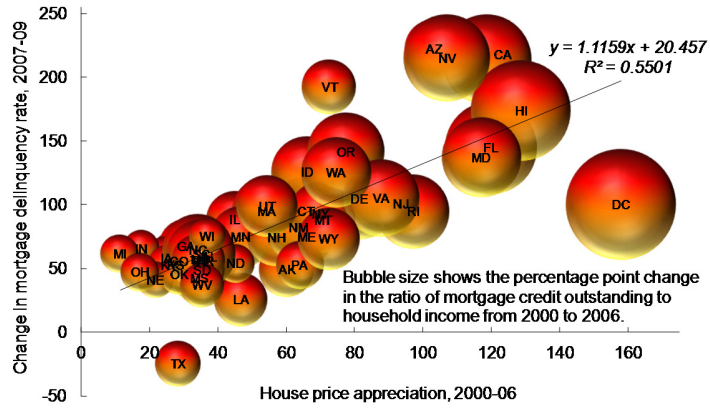


Figure 3. Credit Booms and Financial Deepening, 1970-2010



Sources: IMF *International Financial Statistics*; staff calculations.

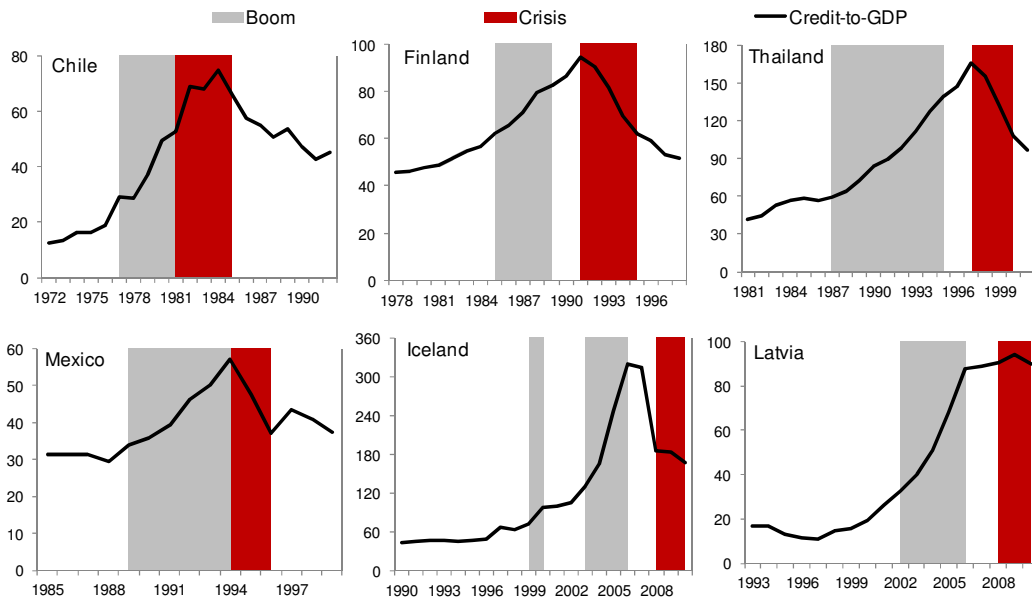
Figure 4. Leverage: Linking Booms to Defaults



Sources: Federal Housing Finance Agency, Mortgage Bankers Association, Bureau of Economic Analysis, U.S. Census Bureau.

Note: Each data point corresponds to a U.S. state, indicated by the two-letter abbreviations.

Figure 5. Credit Booms and Financial Crises: Examples of Bad Booms



Sources: Laeven and Valencia (2010), IMF *International Financial Statistics*; staff calculations.

Figure 6. Credit Growth and Depth of Recession

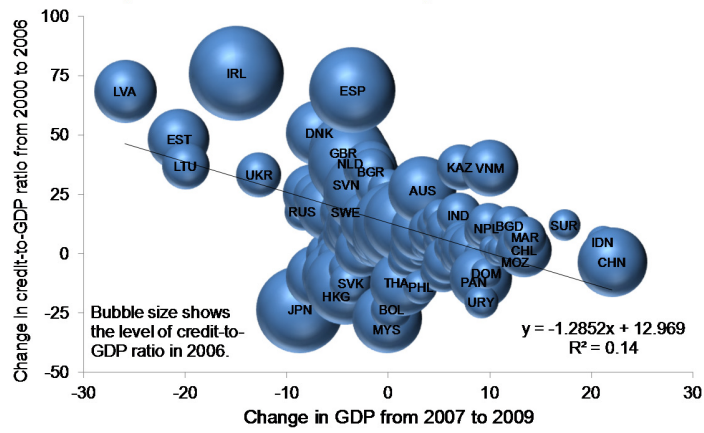
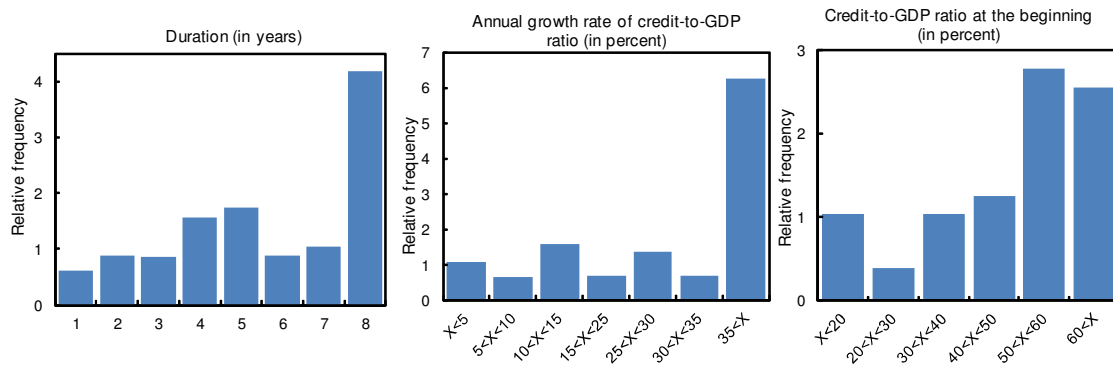


Figure 7. Bad versus Good Booms

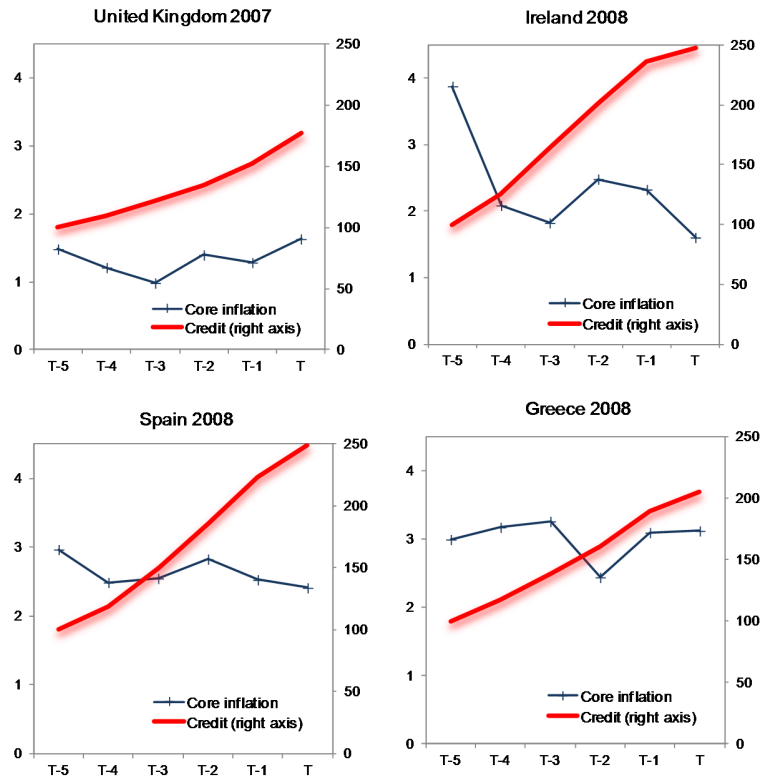
Booms that last longer and that develop faster are more likely to end up badly. Booms that start at a high level of credit-to-GDP also tend to be bad.



Sources: IMF *International Financial Statistics*; staff calculations.

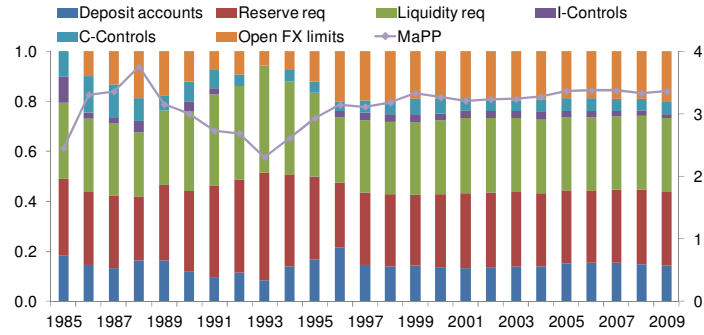
Notes: Relative frequency is the frequency of a given attribute in bad booms divided by the frequency in good booms. Credit booms are identified as episodes during which the growth rate of credit-to-GDP ratio exceeds the growth rate implied by this ratio's backward-looking, country-specific trend by a certain threshold. Bad booms are those that are followed by a banking crisis within three years of their end.

Figure 8. Credit Growth and Monetary Policy
 (Selected countries that had a boom in the run-up and a crisis in 2007-08)



Sources: IMF *International Financial Statistics*, *World Economic Outlook*; staff calculations.
 Notes: Credit is indexed with a base value of 100 five years prior to the crisis.

Figure 9. Macroprudential Index and its Components



Sources: IMF Annual Report on Exchange Arrangements and Exchange Restrictions, Article IV reports, surveys with country teams and country authorities (IMF, 2011b).

Notes: Deposit accounts, I-Controls, C-Controls, and MaPP stand for differential treatment of deposit accounts, interest rate controls, credit controls, and macroprudential policy (the composite measure), respectively. Each component, shown on the left-hand-side axis, is indicated by the proportion of countries adopting it in a given year. MaPP, shown on the right-hand-side axis, is constructed as the within-year average of the within-country sum of component dummies.