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WHEN CREDIT BITES BACK:
LEVERAGE, BUSINESS CYCLES, AND CRISES

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ABSTRACT

This paper studies the role of leverage in the business cycle. Based on a study of nearly 200 recession episodes in 14 advanced countries between 1870 and 2008, we document a new stylized fact of the modern business cycle: more credit-intensive booms tend to be followed by deeper recessions and slower recoveries. We find a close relationship between the rate of credit growth relative to GDP in the expansion phase and the severity of the subsequent recession. We use local projection methods to study how leverage impacts the behavior of key macroeconomic variables such as investment, lending, interest rates, and inflation. The effects of leverage are particularly pronounced in recessions that coincide with financial crises, but are also distinctly present in normal cycles. The stylized facts we uncover lend support to the idea that financial factors play an important role in the modern business cycle.

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