How Credit Cycles across a Financial Crisis

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We study the behavior of credit and output across a financial crisis cycle using information from credit spreads and credit growth. We show the transition into a crisis occurs with a large increase in credit spreads, indicating that crises involve a dramatic shift in expectations and are a surprise. The severity of the subsequent crisis can be forecast by the size of credit losses (change in spreads) coupled with the fragility of the financial sector (as measured by pre-crisis credit growth), and we document that this interaction is an important feature of crises. We also find that recessions in the aftermath of financial crises are severe and protracted. Finally, we find that spreads fall pre-crisis and appear too low, even as credit grows ahead of a crisis. This behavior of both prices and quantities suggests that credit supply expansions are a precursor to crises. The 2008 financial crisis cycle is in keeping with these historical patterns surrounding financial crises.

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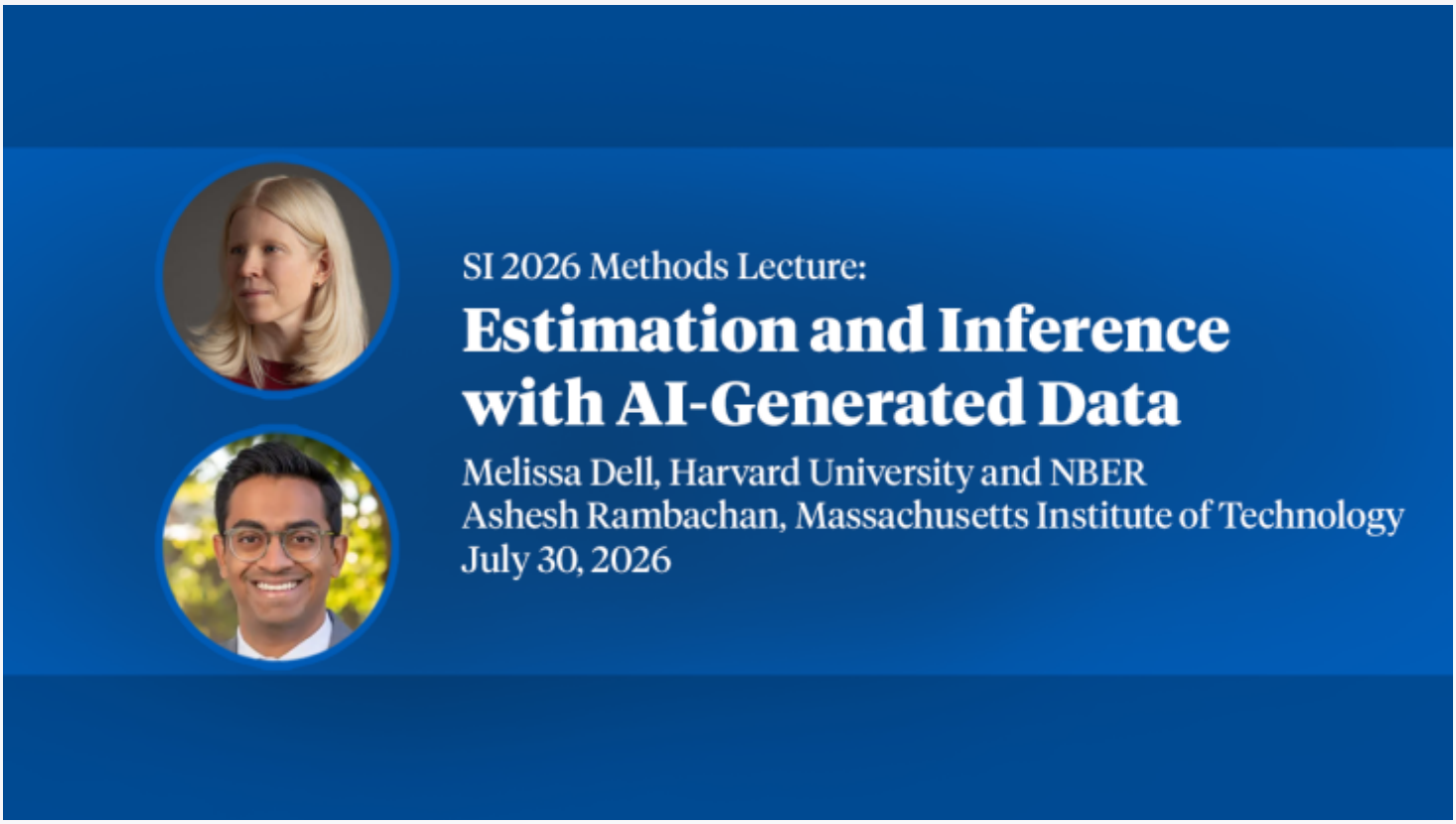

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