An Early Warning Model for Predicting Credit Booms Using Macroeconomic Aggregates

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In this paper, we propose an alternative methodology to determine the existence of credit booms, which is a complex and crucial issue for policymakers. In particular, we exploit the Mendoza and Terrones (2008)’s idea that macroeconomic aggregates other than the credit growth rate contain valuable information to predict credit boom episodes. Our econometric method is used to estimate and predict the probability of being in a credit boom. We run empirical exercises on quarterly data for six Latin American countries between 1996 and 2011. In order to capture simultaneously model and parameter uncertainty, we implement the Bayesian model averaging method. As we employ panel data, the estimates may be used to predict booms of countries which are not considered in the estimation. Overall, our findings show that macroeconomic variables contain valuable information to predict credit booms. In fact, with our method the probability of detecting a credit boom is 80%, while the probability of not having false alarms is greater than 92%.

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