

Credit Pro-cyclicality and Bank Balance Sheet in Colombia

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The recent financial crisis has renewed the interest of economists, both at the theoretical and empirical level, in developing a better understanding of credit and its mechanisms. A rapidly growing strand of the literature views banks as facing funding restrictions that condition their borrowing to a risk-based capital constraint which, in turn, affects bank lending. This work explores the way banks in Colombia manage their balance sheet and sheds light into the dynamics of credit and leverage during the business cycle. Using a sample of monthly bank balance sheets for the period 1994-2012, we find not only that the Colombian banking sector is predominantly pro-cyclical, but also that the composition of bank liabilities provides important information to policy makers regarding the phase of the cycle of the economy. Shifts from low non-core liability ratios to higher ones during the upward phase of the leverage cycle could play the role of an early warning indicator of financial vulnerability. In addition, we find that bank heterogeneity matters and thus, an aggregate measure of bank leverage can mask successfully a fragile financial sector.

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