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CAPITAL INFLOWS, MONETARY POLICY, AND FINANCIAL IMBALANCES*

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Abstract: Ahead of the global financial crisis, financial imbalances built up across advanced economies as credit grew and was increasingly funded in wholesale financial markets. This paper investigates empirically three potential drivers of the build-up of these financial imbalances: rising global imbalances (capital flows); loose monetary policy; and inadequate supervision and regulation. We perform panel data regressions for OECD countries from 1999 to 2007 to explore the relative importance of these factors. We find that differences in the build-up of wholesale-funded credit were driven by the strength of capital inflows. Moreover, we document an interaction effect, whereby the effect of inflows on the build-up was amplified where the supervisory and regulatory environment was relatively weak. In contrast, differences in monetary policy did not significantly affect differences across countries in the build-up of these financial imbalances ahead of the crisis.

JEL: E5, F3, G28
Keywords: Global imbalances, monetary policy, supervision and regulation

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