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Balance Sheet Strength and Bank Lending: Evidence from the Global Financial Crisis*

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Abstract

We use the 2007-2008 financial crisis as a lens to study the link between banks' financial health and the strength of transmission of financial sector shocks to the real economy. We find that banks with ex-ante stronger balance sheets, in particular higher levels of common equity, were better able to maintain credit supply when faced with liquidity shocks during the crisis. Bank recapitalizations mitigated the lending gap between high and low capital banks, but only in countries with strong sovereigns. These findings support the view that strong financial intermediary balance sheets are key for the recovery of credit and economic performance after large financial sector shocks.

JEL Codes: G21, G18, G01**Keywords:** international shock transmission, bank lending channel, wholesale funding, high-quality capital, Basel III

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