The dollar, bank leverage and real economic activity: an evolving relationship

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The dollar, bank leverage and real economic activity: an evolving relationship

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Abstract

The interest in how financial conditions affect real economic activity has grown since the Great Financial Crisis (GFC), not least because some of the mechanisms at play in the financial sector may have changed. We shed light on this issue by examining the empirical relationship between global Purchasing Managers’ Indices, world trade and indicators of global financial conditions, with a special focus on the broad dollar index. We show that the influence of the dollar on real economic activity and global trade seems to have increased since the GFC, while that of the VIX has decreased.


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Introduction

The COVID-19 pandemic has heightened awareness of the how tightening financial conditions spill over to real economic activity. How do financial conditions affect real economic activity, and how have the transmission channels changed since the Great Financial Crisis (GFC) of 2008-9?

An important backdrop to our discussion is the set of changes in the pattern of financial intermediation that have taken place over the past decade or so. These changes have had a bearing on the transmission of financial conditions to economic activity, with the emphasis shifting from the banking sector to market-based intermediation.

We shed further light on the impact of financial conditions on real economic activity by examining the empirical relationship between global manufacturing Purchasing Managers’ Indices (PMIs) and indicators of global financial conditions.

A notable finding in our study is the growing role of the broad dollar index. As well as its classical role as the relative price of goods in international trade, the broad dollar index affects real economic activity through its impact on financial conditions, and has attributes of a barometer of risk capacity affecting financial intermediaries.

Section II looks more closely at the evolving relationship between the dollar and indicators of global economic activity. In Section III, we identify drivers of change in these linkages. Section IV concludes with reflections on the nature of risks in the new environment.

1 Changes in Financial Intermediation

The focus of our study is on how the transmission channels of financial conditions on real activity may have changed since the GFC. Three recent changes in financial intermediation bear on this question.

First, the formal banking sector has been noticeably subdued in the post-crisis period, especially in advanced economies that bore the brunt of the financial crisis. Figure 1 plots the total assets and book equity for a group of 43 large US and euro area banks.1 Assets and equity expanded strongly before the crisis, but they have subsequently grown more slowly. Euro area banks have been particularly subdued, seeing steady contraction of total assets since the GFC.

Second, the relationship between bank leverage and measures of risk appetite has changed. Before the crisis, bank leverage (total assets divided by equity) was closely correlated with the VIX index of implied volatility in equity markets (Adrian and Shin 2010, 2014). When the VIX was low, bank leverage was high, and vice versa. Figure 2 illustrates the relationship between VIX and leverage through the US broker-dealer sector, which offers a window on market-based

1See appendix for definitions of variables and data sources (including the list of banks) for all figures.
intermediation. The negative relationship between leverage and the VIX index has broken down since 2009: even though the VIX eased close to pre-crisis lows up to 2019, bank leverage continued to fall. Forbes and Warnock (2020) and Miranda-Agrippino and Rey (2020) similarly note the diminished role of the VIX as an explanatory variable for credit growth and capital flows.

The right-hand panel of Figure 2 shows the structural break: the grey dots indicate a negative relationship between leverage and the VIX before the GFC; the black dots indicate that, post-crisis, leverage no longer responds to shifts in the VIX.

Third, the pricing of bank balance sheet capacity has changed after the crisis. One notable symptom has been the breakdown of covered interest parity (CIP). CIP is the proposition that the interest rate on a currency in the money market is equal to the implied interest rate on that same currency in the FX swap market.
Figure 3, taken from Avdjiev et al. (2019), shows the difference between the money market interest rate and the implied interest rate for the dollar implicit in the FX swap market (averaged across ten advanced economy currencies vis-à-vis the dollar). The figure reveals that, whereas CIP held pretty well before the crisis, it broke down after the crisis. Avdjiev et al. (2019) shows that a dollar appreciation is associated with a widening of the CIP deviation. This empirical association holds even in first differences and at daily frequency. For this reason, they argue that the broad dollar index serves as a good concurrent indicator of bank balance sheet costs.

In sum, changes since the GFC suggest a diminished role for the formal banking sector in financial intermediation, and a greater role for market-based intermediation and the dollar as a key indicator of risk appetite. Just as the VIX index was a good summary measure of the price of the balance sheet before the crisis, so the dollar has become a good measure of the price of the balance sheet after the crisis.

2 The Evolving Relationship between the Dollar, PMIs and Trade Growth

In view of these changes, we may expect that the channels of transmission of financial conditions may also have changed since the GFC.

Commentary accompanying monthly PMI releases suggests that purchasing managers closely follow financial data in order to assess the financing conditions their firms face and, more broadly, the current and expected economic activity. Furthermore, given the structural break in banking sector balance sheet costs around the time of the GFC, we may expect to detect changes in the way that financial conditions feed into real activity.
In the post-crisis period, a strong dollar has emerged as a concurrent indicator associated with weak PMI and real activity. We investigate the empirical relationships through a small-scale VAR. The VAR features, in order, changes in world equity prices, the nominal effective exchange rate of the US dollar (the “dollar index”), global manufacturing PMIs (excluding the United States), and global trade growth.\(^2\) The number of lags is fixed at six. We compute the monthly changes over a 30-day period around central PMI survey dates so as to align market information available to purchasing managers at the time of the poll.\(^3\) This ordering defines a Choleski identification that is underpinned by the timing of financial variables: changes in equity prices and the dollar index are computed over a 30-day window that predates the survey of at least one half of purchasing managers. This timing sequence supports the assumption that changes in equity prices and dollar indices are ordered first, that is, they do not react contemporaneously to PMI- and trade-specific shocks.

Based on this ordering, the first shock, associated with equity price changes, can be interpreted as the continuous flow of news related to macroeconomic and financing conditions. Financial market participants process this information and incorporate it in equity prices at high frequency before the PMI and world trade data are released. The second shock, associated with the dollar index, can be thought of as the additional information conveyed by changes in the dollar exchange rate.\(^4\) The third shock (associated with PMIs) is then the change in PMIs that was not already priced into financial variables, and can thus be related to private information available to purchasing managers during the polling period.

Estimating this VAR on pre- and post-GFC samples highlights a striking change in the transmission of US dollar shocks.\(^5\) Before the GFC, global PMIs (excluding the United States) expanded moderately after an unexpected dollar appreciation (Figure 4, grey line). This response is in line with a view that US import demand increases after a dollar appreciation. After the GFC, however, global PMIs contract in response to an unexpected dollar appreciation (black line). The results are even more striking when the response of trade is considered (Figure 5). Before the GFC, unexpected dollar appreciation boosted world trade growth (grey line). After the GFC, unexpected dollar appreciation depresses world trade growth, despite making dollar-denominated exports cheaper (black line).

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\(^2\)See appendix for details. Changes in world equity prices are computed as the weighted average of equity price changes across 32 major economies. For the US dollar index, we use the FRB’s Trade Weighted U.S. Dollar Index: Other Important Trading Partners, Goods.”

\(^3\)The additional assumption is that the survey respondents fill their questionnaires on average around the central date of the polling window.

\(^4\)This ordering stacks the odds against a role of the dollar: the dollar shock is by construction orthogonal to and a residual of the global equity shock, which absorbs the bulk of information on the global outlook and financing conditions.

\(^5\)We excluded the GFC from the sample on purpose, so that the effect of the crisis does not dominate the system’s dynamics.
Figure 4: Impulse responses of global PMIs (excluding the US) to dollar appreciation

Figure 5: Impulse responses of global trade growth to dollar appreciation
Table 1: Nowcasting PMIs with the first principal component of financial variables

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<th>Full sample</th>
<th>Pre-GFC</th>
<th>Post-GFC</th>
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<tbody>
<tr>
<td>$PMI_{t-1}$</td>
<td>0.944</td>
<td>0.944</td>
<td>0.943</td>
</tr>
<tr>
<td>$\Delta pc_t$</td>
<td>0.215</td>
<td>0.200</td>
<td>0.077</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.936</td>
<td>0.910</td>
<td>0.912</td>
</tr>
<tr>
<td>RMSE</td>
<td>0.843</td>
<td>0.906</td>
<td>0.950</td>
</tr>
</tbody>
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Note: All coefficients and RMSE are significant at 1%. RMSE is computed as the ratio over a plain AR(1) benchmark; significance is determined by Clark and McCracken (2012) test. Full sample: 2/1998 – 10/2019 (261 observations); pre-GFC: 2/1998 – 12/2007 (119 observations); post-GFC: 1/2010 – 10/2019 (118 observations).

Sources: FRB St Louis, FRED; Bloomberg; Datastream; ICE BofAML indices; IHS Markit; MSCI.

3 Financial Variables and PMIs: What Has Changed?

We now turn to the relationship between PMIs and financial conditions. Erik et al. (2019) shows that equity prices, corporate bond spreads, and the broad dollar index are good predictors of current-month PMIs. Building on this earlier work, we estimate monthly regressions of the form

$$PMI_t = \alpha + \beta \Delta pc_t + \phi PMI_{t-1} + \epsilon_t$$  \hspace{1cm} (1)$$

where $PMI_t$ is the global manufacturing PMI release in month $t$, and $pc_t$ is the first principal component of monthly changes in a set of financial indicators that include equity prices, corporate bond spreads, the VIX, and the broad dollar index. As before, we compute the monthly changes over a 30-day period around central PMI survey dates so as to mimic market information available on average to purchasing managers at the time of the poll.

Table 1 compares the PMI nowcasting performance of the principal component model with the model based on the global composite equity price index, the best performing one in Erik et al. (2019). A test for superior in-sample predictive ability (Clark and McCracken 2012) highlights significant gains over a benchmark model that only includes lagged PMIs. One notable finding is that the nowcasting gains diminish when the GFC period is excluded from the sample. Another is that estimated coefficients are smaller in the post-GFC sample. However, the nowcasting gain, as measured by RMSE, remains significant (Erik et al. 2020).

To shed further light on the results, we examine how the principal component factor loadings have evolved over time. Figure 6 compares the loadings in the pre- and post-GFC periods (1998-2007 and 2010-2019). It highlights the changes

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Figure 6: Factor loadings of the first principal component of financial variables in the loadings of the dollar and the VIX: the dollar loading has increased, and the VIX loading has decreased. This evidence is consistent with the results in Forbes and Warnock (2020) and Miranda-Agrippino and Rey (2020), which also note the diminished post-crisis role for the VIX. Notably, the sign of the dollar loading is negative, that is, dollar appreciation acts as a drag on global PMIs, consistent with Bruno and Shin (2015, 2019).

4 Role of the Dollar Post-GFC

What could explain the greater role of the dollar as a determinant of global economic activity? One possible channel is through determinants of risk capacity, and in particular the role of the dollar exchange rate as an indicator of this risk capacity (Bruno and Shin (2015)). Indeed, the dollar is closely correlated with the growth of dollar-denominated credit outside the United States. Figure 7 shows the four-quarter growth rates of lending in dollars to emerging market economies (EMEs) and the four-quarter change in the EME-weighted dollar index. The two series are negatively correlated: when the dollar strengthens, lending in dollars to EMEs slows.

The negative relationship between dollar strength and growth of dollar credit may be explained by the financial channel of exchange rates, which works through the greater liquidity of assets (Diamond, Hu, and Rajan 2020), or through fluctuating lending capacity of banks that intermediate US dollar credit (Bruno and Shin 2015). If a global bank has a diversified portfolio of loans to borrowers around the world, a broad-based depreciation of the dollar results in lower tail risk in the bank’s credit portfolio and a relaxation of the bank’s Value-at-Risk (VaR) constraint. The result is an expansion in the supply of dollar credit through increased leverage. In this way, a broad depreciation of

Sources: FRB St Louis, FRED; Bloomberg; Datastream; ICE BofAML indices; IHS Markit; MSCI.
the dollar is associated with greater risk-taking by banks.

Interestingly, Niepmann and Schmidt-Eisenlohr (2019) shows that domestic credit in the United States also has a negative relationship with the dollar, even to firms in the nontradeables sector. The mechanism is through the demand from institutional investors in the secondary market for loans originated by US banks.

The resulting shifts in dollar credit conditions may affect financing requirements for manufacturing firms, especially those participating in global supply chains. These firms generally have large working capital financing requirements because they need to carry on their balance sheet inventories of intermediate goods, and often of accounts receivable when selling to other firms along the supply chain (Bruno, Kim, and Shin 2018). With manufacturing and, increasingly, services being globally integrated, dollar credit conditions would therefore have some impact on economic activity along global supply chains. Shousha (2019) shows that real activity in emerging market economies is negatively affected by a stronger dollar.

Another explanation of the impact of a stronger dollar on global trade is the invoicing channel of trade. Gopinath and Stein (2018a, 2018b) show that when the US dollar is used as an invoicing currency for trade, the volume of trade between two countries (neither of which is the United States) may experience a decline because of the competitive implications of dollar invoicing. Both in the invoicing and our channel, a stronger dollar is associated with weaker trade activity. The invoicing channel works through the bilateral dollar exchange rate against the export destination country. Bruno and Shin (2019) uses matched firm- and bank credit-level data from Mexico and finds evidence of both the invoicing and financing channels.

Overall, the findings in our paper suggest that structural changes have oc-
curred in the banking sector after the GFC.

Most notably, the mantle of the barometer of risk capacity and leverage has slipped from the VIX and passed to the dollar. Risk capacity appears to be better measured through the broad dollar index than the VIX. The formal banking sector has remained subdued, giving way to market-based financing and non-bank intermediation. We have explored some implications for real economic activity of this shift. Future research will undoubtedly uncover more details.

References


Appendix

Figure 1: Total assets and book equity of 17 US and 26 euro area banks

United States  
- Bank of America Corporation;  
- Bank of New York Mellon Corporation;  
- Capital One Financial Corporation;  
- Citigroup Inc.;  
- Citizens Financial Group Inc.;  
- Fifth Third Bancorp;  
- JPMorgan Chase & Co.;  
- Morgan Stanley;  
- Goldman Sachs Group Inc.;  
- Northern Trust Corporation;  
- PNC Financial Services Group Inc.;  
- Regions Financial Corporation;  
- State Street Corporation;  
- SunTrust Banks Inc.;  
- Truist Financial Corporation;  
- U.S. Bancorp and Wells Fargo & Company.

Euro area  
- AIB Group Plc;  
- Banca Monte dei Paschi di Siena SpA;  
- Banco Bilbao Vizcaya Argentaria SA;  
- Banco Bpm SpA;  
- Banco de Sabadell SA;  
- Banco Popular Español SA;  
- Banco Santander SA;  
- Bank of Ireland Group;  
- Bankia SA;  
- BNP Paribas SA;  
- CaixaBank SA;  
- Commerzbank AG;  
- Crédit Agricole SA;  
- Crédit Industriel et Commercial SA;  
- Deutsche Bank AG;  
- Dexia SA;  
- Erste Group Bank AG;  
- ING Groep NV and Nordea Bank Abp.;  
- Intesa Sanpaolo SpA;  
- KBC Group NV;  
- Natixis SA;  
- Raiffeisen Bank International AG;  
- Société Générale SA;  
- UniCredit SpA;  
- Unione di Banche Italiane SpA.

Sources: Datastream Worldscope; authors’ calculations.

Figure 2: Leverage and VIX index

Leverage  
Total assets divided by equity for the broker-dealer sector in the US.

VIX  
CBOE Volatility Index.

Sources: Federal Reserve, Flow of Funds; Bloomberg; authors’ calculations.
Figure 3: Deviation from covered interest parity

US dollar index       Federal Reserve Board trade-weighted US dollar index, broad, goods.
Mean cross-currency basis spread Mean of five-year cross-currency basis spread across AUD, CAD, CHF, DKK, EUR, GBP, JPY, NOK, NZD and SEK.

Sources: Federal Reserve Bank of St Louis (FRED); Bloomberg; authors’ calculations.

Figure 4-5: Impulse responses of global PMIs (excluding the US) and global trade growth to dollar appreciation

World equity price       Weighted average of equity prices in major local stock exchanges across 32 economies based on GDP and PPP exchange rates.
US dollar index          Federal Reserve Board trade-weighted US dollar index, other important trading partners, goods.
Global PMI                Simple average of manufacturing PMIs across 31 economies (excluding the United States) (less countries for earlier periods due to data constraints).
Global trade growth       World trade volume index, seasonally adjusted.

Sources: Federal Reserve Bank of St Louis (FRED); CPB Netherlands Bureau of Economic Policy Analysis; Bloomberg; Datastream; IHS Markit; authors’ calculations.
Figure 6: Factor loadings of the first principal component of financial variables

Equity (1) MSCI All Country World Index, local currency (2,844 constituents; large and mid-cap firms in 23 advanced economies and 26 EMEs; US (56%), Japan (7%), UK (5%), China (4%), France (3%), others (25%).
Equity (2) MSCI All Country World Industrials Index, local currency (432 constituents).
Equity (3) MSCI Emerging Markets Index, local currency (1,194 constituents).
Equity (4) Weighted average of equity prices in major local stock exchanges across 32 economies based on GDP and PPP exchange rates.
Spread (1) ICE BofAML Global Corporate Index, investment grade, option adjusted spread (14,404 constituents).
Spread (2) ICE BofAML Global High Yield Index, below investment grade, option adjusted spread (3,131 constituents).
Spread (3) ICE BofAML Global Non-financial Corporate Index, investment grade, option adjusted spread (10,346 constituents).
Spread (4) ICE BofAML Global Industrial Index, investment grade, option adjusted spread (8,430 constituents).
VIX CBOE Volatility Index.
USD Federal Reserve Board trade-weighted US dollar index, broad, goods.

Sources: Federal Reserve Bank of St Louis (FRED); Bloomberg; Datastream; ICE BofAML indices; MSCI; authors’ calculations.

Figure 7: Dollar denominated credit to emerging market economies

Total credit Total credit denominated in USD to non-banks in EMEs.
Loans Loans denominated in USD to non-banks in EMEs.
US dollar index Federal Reserve Board trade-weighted US dollar index, other important trading partners, goods.

Sources: Federal Reserve Bank of St Louis (FRED); Dealogic; Euroclear; Thomson Reuters; Xtrakter Ltd; national data; BIS local banking statistics; authors’ calculations.
Table 1: Nowcasting PMIs with the first principal component of financial variables

\[ PMI_{t-1} \] Global manufacturing PMI.
\[ \Delta pc_t \] First principal component of the following variables: equity (1-4), spread (1-4), VIX and USD (see note for Figure 6 for variable descriptions).

Sources: Federal Reserve Bank of St Louis (FRED); Bloomberg; Datastream; ICE BofAML indices; IHS Markit; MSCI; authors’ calculations.
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