International Finance Discussion Papers (IFDP)

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We investigate the effects of financial risk cycles on business cycles, using a panel spanning 73 countries since 1900. Agents use a Bayesian learning model to form their beliefs on risk. We construct a proxy of these beliefs and show that perceived low risk encourages risk-taking, augmenting growth at the cost of accumulating financial vulnerabilities, and therefore, a reversal in growth follows. The reversal is particularly pronounced when the low-risk environment persists and credit growth is excessive. Global-risk cycles have a stronger effect on growth than local-risk cycles via their impact on capital flows, investment, and debt-issuer quality.