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Credit market heterogeneity, balance sheet (in)depence, and financial shocks

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Although the development of macroeconomic models with a role for credit has come a long way since Kiyotaki and Moore (1997), the majority of models assume a single representative credit market. As such, the literature is silent on the evolution of credit composition over the business cycle. Furthermore, the absence of credit market heterogeneity implies an incomplete understanding of the benefits associated with operational diversification in the financial sector. We aim to fill this gap in the literature by investigating how financial sector balance sheet linkages within the financial sector impacts on the stability benefits offered by operational diversification.

We find that credit market heterogeneity plays an important role in attenuating the impact of financial shocks by allowing borrowers to substitute away from the affected credit market. The shock attenuation property of credit market heterogeneity works through asset-pricing channel and substitution toward alternative credit types. The degree of attenuation offered by credit heterogeneity can be limited by balance sheet linkages within the financial sector. Finally, we find that the origination of financial shocks can influence both the size and persistence of their impact. Specifically, when savers are directly hit by financial shocks, the size of their impact on the real economy is limited by reducing their influence on the functioning of the financial system. At the same time, their impact can be persistent through limiting savings behaviour. In comparison, shocks borne entirely by the financial sector are amplified as a result of their influence on the ability of the financial sector to efficiently intermediate fund flows between savers and borrowers.

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