Which Financial Frictions? Parsing the Evidence from the Financial Crisis of 2007-9*

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Abstract

The financial crisis of 2007-9 has sparked keen interest in models of financial frictions and their impact on macro activity. Most models share the feature that borrowers suffer a contraction in the quantity of credit. However, the evidence suggests that although bank lending to firms declines during the crisis, bond financing actually increases to make up much of the gap. This paper reviews both aggregate and micro level data and highlights the shift in the *composition* of credit between loans and bonds. Motivated by the evidence, we formulate a model of direct and intermediated credit that captures the key stylized facts. In our model, the impact on real activity comes from the spike in risk premiums, rather than contraction in the total quantity of credit.

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