The Role of Capital Requirements and Credit Composition in the Transmission of Macroeconomic and Financial Shocks

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This paper builds a general equilibrium model that incorporates banks, financial frictions, default and a capital requirements. Ex-ante heterogeneous households decide how much to save or borrow for the sake of consumption (consumer credit) or the provision of housing services(mortgages). These choices are subject to borrowing limits, which depend on the value of real estate assets (for mortgages) or labour income (for consumer loans). The model includes final goods producers who must borrow in order to finance working capital/labour requirements (business credit borrowing) and intermediate good producers subject to nominal rigidities. Saving and borrowing are intermediated by a bank facing different capital requirements for each credit category. Any shock that has an impact on bank capital (for instance, a default shock) directly affects the bank’s income, the cost of external finance and, eventually, interest rates on loans. Changes in interest rates have second-round effects on labour and consumption through the borrowing limits. Simulations of the model suggest that the business cycle properties of credit and credit quality for each credit category are consistent with what is observed in the data.

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