A prominent view in economics is that malfunctioning credit markets “are not simply passive reflections of a declining real economy, but are in themselves a major factor depressing economic activity.”¹ This view has greatly influenced monetary policy. A clear example is the recent “Great Recession,” when financial markets became volatile and illiquid and the viability of some of the world’s leading financial institutions was seriously in doubt. Federal Reserve policymakers responded aggressively by lowering interest rates to near zero, implementing lending facilities, and instituting multiple rounds of quantitative easing, parts of which were aimed directly at supporting the functioning of the financial system.

Analyses linking the performance of financial markets to aggregate economic activity typically have a financial accelerator mechanism at their core. Fed Chairman Ben Bernanke eloquently summarizes the workings of this mechanism in a recent speech.² Here, I interpret movements in business credit demand and liquid asset holdings in terms of this theory.

The key links between the workings of the financial system and real economic activity are easily understood. Entrepreneurs may develop profitable projects and firms may find it profitable to expand or invest more. Both actions typically require tapping credit markets to obtain required resources. Access to credit, however, is limited by the presence of asymmetric information and principal-agent problems, which are natural in credit relations. Financial institutions appropriately monitor borrowers to help overcome these frictions.

Because of the costs incurred by lenders to monitor borrowers, external financing is generally costlier than internal financing. This external finance premium is negatively related to the borrower’s net worth and overall financial position. This relationship creates a mechanism of financial acceleration. Any shock that affects the financial position of the firm affects its borrowing capacity, which in turn affects its profitability and, ultimately, its financial position. Shocks that otherwise would be short-lived may be easily amplified through this channel.

Two natural implications of the accelerator mechanism are that (i) crises with high financial distress should be
associated with relatively larger declines in credit and (ii) a
decline in credit should be associated with a decline in
holdings of liquid assets. The chart shows the ratio of net
changes in credit market instruments (including bank loans,
commercial paper, and corporate bonds) to income before
taxes for the U.S. nonfinancial business sector. Credit
decreased substantially during the Great Recession, as
the theory predicts, given the distressed financial markets.
However, the net change in credit does not seem particu-
larly different from the two previous recessions, which were
milder and not obviously driven by financial distress. Of
note, not only did credit decline from 2008 to 2009, but firms
also started repaying their debts (the change is negative).
Furthermore, they did so while simultaneously accumulat-
ing highly liquid assets (currency, savings, and checkable
deposits). The combination of these two observations is
puzzling if one believes firms are purportedly starving for credit but
cannot obtain it.

The implementation of aggressive policies supporting
credit markets is one possible explanation why credit did
not drop more than in previous crises. It is also possible
that shocks affect small and large firms asymmetrically
and that aggregate data, as used here, mask such effects.
Finally, the recent crisis may have affected very short-term
credit instruments that are not necessarily captured in the
quarterly frequency data available from the Fed’s Flow of
Funds Accounts statistical release.

1 Bernanke, Ben S.; Gertler, Mark and Gilchrist, Simon. “The Financial
Accelerator in a Quantitative Business Cycle Framework,” in John B. Taylor and
Michael Woodford, eds., Handbook of Macroeconomics. Chap. 21. Amsterdam:
Elsevier, pp. 1341-393.

2 Bernanke, Ben S. “The Financial Accelerator and the Credit Channel.”
Presented at the Federal Reserve Bank of Atlanta Conference, Credit Channel of
Monetary Policy in the Twenty-First Century, June 15, 2007;