The Impact of Credit Market Sentiment Shocks

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Abstract:

This paper investigates the role of credit market sentiments and investor beliefs on credit cycle dynamics and their propagation to business cycle fluctuations. Using US data from 1968 to 2014, we show that credit market sentiments are indeed able to detect asymmetries in a small-scale macroeconomic model. By exploiting recent developments in behavioral finance on expectation formation in financial markets, we are able to identify an unexpected credit market news shock exhibiting different impacts in an optimistic and pessimistic credit market environment. While an unexpected movement in the optimistic regime leads to a rather low to muted impact on output and credit, we find a significant and persistent negative impact on those variables in the pessimistic regime. Therefore, this article departs from the current literature on the role of financial frictions for explaining business cycle behavior in macroeconomics and argues in line with recent theoretical contributions on the relevance of expectation formation mechanisms as source of macroeconomic instability.