

# On the Nature of the Financial System in The Euro Area: a Bayesian DSGE Approach

Stefania Villa<sup>1</sup>

## *Abstract for the 52nd Annual Conference of the Italian Economic Association*

The presence of financial frictions affects financial and real sectors in the economy. This paper distinguishes the source of the financial frictions between supply-side versus demand-side. From a theoretical perspective, it builds two DSGE models in a 'Smets and Wouters' economy; the first model incorporates financial frictions originating on the supply side of the credit market, à la Gertler and Karadi (2011). The second model incorporates financial frictions originating on the demand side of the credit market, à la Bernanke, Gertler and Gilchrist (1999). From an empirical perspective, this paper estimates the two models with Euro Area data using Bayesian techniques. The two models are compared on the basis of: (i) the estimated parameters and the marginal data density; (ii) business cycle moments and model-implied shocks; and (iii) the forecasting performance. The main result is that the data favour the model consistent with financial frictions originating on the supply side of the credit market.

*Keywords:* banking sector, Bayesian estimation.

*JEL Codes:* C11, E44, E5.

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<sup>1</sup> Birkbeck College, University of London and University of Foggia. Email: [s.villa@ems.bbk.ac.uk](mailto:s.villa@ems.bbk.ac.uk).