Charge-offs, Defaults and the Financial Accelerator

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Abstract

U.S. banks countercyclically vary the ratio of charge-offs to defaulted loans (COD) and the standard deviation of COD is roughly 15 times that of GDP. We show that canonical financial accelerator models cannot explain these facts, but introducing stochastic default costs and stochastic risk can potentially resolve the discrepancy. Estimating the augmented model and including both surprise and news shocks reveals that default cost news shocks account for most of the variance of COD. Also, in the many model specifications we work with, default cost news shocks always account for at least 20 percent of the variance of investment, while risk news shocks account for a significant portion of the variation in the credit spread, and around ten percent of the variation in investment growth. Both news shocks also account for a material amount of the variance of hours and output growth.

KEYWORDS: Charge-offs and defaults, default cost shocks, news shocks, risk shocks, financial accelerator models, business cycles.
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