



Default risks, interest rate spreads, and business cycles: Explaining the interest rate spread as a leading indicator[☆]

Noh-Sun Kwark^{a,b,*}

^aDepartment of Economics, Texas A&M University, College Station, TX 77843, USA

^bDepartment of Economics, Dongguk University, Pil-dong, Chung-gu, Seoul, 100-715, South Korea

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Abstract

The interest rate spread between risky loan rates and risk-free rates has been shown to have high predictive power for subsequent fluctuations in real output. This paper examines the relationship between the interest rate spread and default risk and how this relationship may generate the leading behavior of the interest rate spread over the business cycle within a general equilibrium model that includes a financial intermediary. This study shows that the interest rate spread may contain information on future fluctuations in output when investment decisions are inflexible to adjust to a new shock. © 2002 Elsevier Science B.V. All rights reserved.

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* Correspondence address: Department of Economics, Dongguk University, Pil-dong, Chung-gu, Seoul, 100-715, South Korea. Tel.: + 82-2-2260-3267; fax: + 82-2-2260-3684.

E-mail address: kwark@dgu.ac.kr (N.-S. Kwark).

1. Introduction

It is generally accepted that financial variables such as stock prices and interest rates adjust to new information much faster than real variables. As a result, some variables in the financial market have been used as leading indicators to predict future conditions of the real economy. One such variable is the interest rate spread, measured as the difference between the interest rates on commercial paper and Treasury bills or the difference between risky bond yields and risk-free Treasury bill rates. This interest rate spread has been emphasized to have high predictive power for future business conditions (Stock and Watson, 1989; Friedman and Kuttner, 1992; Bernanke, 1983). A decrease in the interest rate spread is associated with a subsequent increase in output.

The interest rate spread is often thought to reflect a risk premium for risky loans. Even if financial intermediaries are risk neutral, as long as some loans are expected to be in default at the maturity date, the risky loan rate should be higher than the risk-free deposit rate in order to compensate for loan default. Thus, the spread reflects expectations of the performance of risky loans. Friedman and Kuttner (1993) and Gertler et al. (1991) suggest default risk as a reason for the leading behavior of the interest rate spread. Certainly, the average size of the interest rate spread may not be explained solely by default risk. Tax differentials and financial intermediation costs may also determine the size of the spread. However, fluctuations of the interest rate spread are generally considered to be related to movements in default risk over the business cycle.¹ This study focuses on the interest rate spread resulting from default risk and attempts to explain how and why the risk spread leads business cycles.

Explanations for the leading behavior of the interest rate spread suggested by previous studies are based on investors' perceptions of the future economy (Friedman and Kuttner, 1993). If investors expect future economic conditions to be favorable and the bankruptcy risk on risky investments to decrease accordingly, then they might require a relatively small risk premium over the risk-free interest rate, which then reduces the interest rate spread. If there is no new investment demand in response to a better economic condition in the future, this statement is obviously true. However, what if new investment projects are undertaken due to expectations of better economic conditions? It is possible that

¹ For the fluctuations of the spread between the commercial paper rate and the Treasury bill rate, some other explanations have been suggested, such as monetary policy channels, or changes in companies' demand for funds. See Bernanke (1990), Friedman and Kuttner (1993), and Kashyap et al. (1993). Friedman and Kuttner (1998) show the failure of the spread for the 1990–1991 recession and propose several potential explanations. However, it seems that the failure of prediction comes from an anomaly of the recession not particularly from a change in the commercial paper and T-bill markets since the recession was also hard to predict by other indicators (see Estrella and Mishkin, 1998).

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