



# Adverse selection and the financial accelerator<sup>☆</sup>

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## Abstract

Many economists believe that credit market distortions create a financial accelerator which destabilizes the economy. This paper shows that when credit market distortions arise from adverse selection they sometimes stabilize the economy rather than destabilize it. The stabilizing forces are closely related to forces that cause overinvestment in static models. When investment projects are equity financed, or when contracts are written optimally, the distortions always stabilize the economy. Thus, stabilizing equilibria are a robust feature of the model. The empirical distinction between accelerator and stabilizer equilibria is subtle. Many empirical tests are unable to distinguish between accelerator and stabilizer equilibria.

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## 1. Introduction

The financial accelerator hypothesis says that credit market distortions magnify economic shocks. Disturbances that would be small if markets were efficient are exaggerated and prolonged due to imperfections in credit and loan markets. Put differently, credit market distortions destabilize the economy. The financial accelerator hypothesis is important because standard business cycle models require large, persistent

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disturbances to mimic the business cycles observed in the data. Because the financial accelerator amplifies and propagates shocks, it can potentially explain why business cycles are so significant even though the observed shocks are not.

This article uses an adverse selection model to re-examine the relationship between credit market imperfections and economic instability. The adverse selection problem distorts loan markets in a dynamic equilibrium model of business cycle fluctuations. The model has three central messages. First, while in some cases the distortions destabilize the economy, in others they cause the economy to be excessively stable. Stabilizing outcomes in the dynamic model are closely related to overinvestment outcomes in static models of credit market failure. Second, if investments are equity-financed or if borrowers and lenders write optimal contracts, the only equilibria that emerge are “stabilizer equilibria.” Third, in the adverse selection model, the empirical distinction between accelerators and stabilizers is surprisingly subtle. Many statistics seen as evidence in support of a financial accelerator are consistent with stabilizer equilibria.

An important contribution of the paper is that it decomposes the total amplification caused by credit market distortions into separate channels. Because each channel, or effect, has economic meaning, the decomposition clarifies the way that credit market distortions amplify shocks. In the adverse selection model, a shock that increases internal funds has three separate effects on investment. First, the increase in internal funds causes the premium on borrowed funds to fall. With a lower premium, investors have a greater incentive to invest. This is the “agency cost” channel emphasized by much of the existing literature.

Second, since borrowers internalize more of the costs and benefits of their projects when their net worth is higher, the level of investment is closer to the efficient level. This causes investment to increase in some settings; in others, however, investment may fall. This second effect is the dynamic analog of over- or underinvestment in static adverse selection models. If there is underinvestment in the static environment, investment will rise when internal funds increase. In the dynamic model, this causes shocks to be amplified. If there is overinvestment in the static environment, investment falls when internal funds increase. Consequently, the financial market imperfections mitigate shocks in the associated dynamic model. This duality between stabilization in dynamic models and overinvestment in static models has not been pointed out by the existing literature.

Finally, the allocation of investment becomes more efficient when internal funds rise. Investment increases for projects with high expected returns and falls for projects with low expected returns. Thus, even if the total volume of investment is unchanged, shocks are amplified because investment is allocated more appropriately.

The total effect on investment is the sum of these three effects. In some instances, the second effect is negative and dominates the other two effects. In such cases, the adverse selection problem inefficiently stabilizes the economy.

While the basic model can exhibit either accelerator or stabilizer equilibria, the accelerator equilibria are not robust to other forms of financing. Specifically, when firms use either equity financing or optimal contracting, the only equilibria that emerge are stabilizer equilibria. Furthermore, the stabilizer equilibria do not have overtly counterfactual implications (such as a procyclical interest rate spread). Many well-known empirical findings that have been cited as evidence for a financial accelerator are consistent with the stabilizer equilibria in this model. This suggests that stabilizing outcomes are not mere curiosities.

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