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Urban J. Jermann, Vivian Z. Yue

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Interest Rate Swaps and Corporate Default*

Urban J. Jermann

Wharton School of the University of Pennsylvania and NBER

Vivian Z. Yue

Emory University, Federal Reserve Bank of Atlanta, and NBER

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Abstract

This paper studies firms' usage of interest rate swaps in a model economy driven by aggregate productivity shocks, inflation shocks, and counter-cyclical idiosyncratic productivity risk. Consistent with empirical evidence, firms in the model are fixed-rate payers. Counter-cyclical productivity risk is key for this finding; inflation risk contributes to producing the opposite outcome. Also consistent with empirical evidence, swap positions are negatively correlated with the term spread, so that firms appear to be timing the market. In the model, swaps generate only small economic gains for the typical firm.

Key words: Interest rate swaps; corporate default; derivative usage; firm borrowing and investment

Interest rate swaps are derivative contracts through which two parties exchange fixed and floating rate coupon payments. Such swaps were first used in the early 1980s. By now they are among the most popular derivative contracts. As shown in Figure 1, the notional amount of outstanding interest rate swaps denominated in dollars, for non-financial institutions, is about 10 trillion dollars. In surveys of derivative usage, a sizable fraction of the larger firms in the

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