

## [Default Cycles](#)

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Recessions are often accompanied by spikes of corporate default and prolonged declines of business credit. This paper argues that credit and default cycles are the outcomes of variations in self-fulfilling beliefs about credit market conditions. We develop a tractable macroeconomic model in which leverage ratios and interest spreads are determined in optimal credit contracts that reflect the expected default risk of borrowing firms. We calibrate the model to evaluate the impact of sunspots and fundamental shocks on the credit market and on output dynamics. Self-fulfilling changes in credit market expectations trigger sizable reactions in default rates and generate endogenously persistent credit and output cycles. All credit market shocks together account for about 50% of the variation of U.S. output growth during 1982-2015.