"Expectation effects of switching financial frictions "

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Abstract

This paper investigates the effects of time-varying financial market conditions on macroeconomic variables by extending a standard dynamic stochastic general equilibrium model (DSGE) model to incorporate switching degrees of financial friction derived from switching uncertainty process in a costly-state-verification problem. We emphasize the expectation effect of switching financial condition. Transition probabilities influence agents' choice through expectation effect: upon an adverse shock, a bleak outlook of financial market causes slow recovery of investment. The novelty of this paper is that we introduce feedback from past fundamental shocks to switching dynamics through time-varying transition probability given explicitly as a function of these shocks. Empirically, we uncover evidence of time-varying transition in the U.S. data and quantify the contribution of each fundamental shock.