

Discussion of: On overborrowing

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- Pricing of emerging mkts borrowing based on macroeconomic indicators - as opposed to individual solvency indicators

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- Does this practice induce **overborrowing**?

The Answer

- No!
- Interest rates (based on macro indicators) are an effective way of prevent over-borrowing
- Interest rates can be chosen to enforce individual credit limit

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$$U_c [q^* - \xi] = \beta \int U'_c \quad (\text{Micro})$$

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Set $q = q^* - \xi$ and there is no overborrowing

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- Key reason is that default risk ties down the interest rate

A minimal set-up

- 2 Periods, Risk Neutral Lender, Risk Averse Borrower
- Borrower has 0 in period 1 and $A \sim F(A)$ in period 2
- At date 1 borrows qb .
- At date 2 either repay, gets $A - b$ or default, gets $(1 - \delta)A$
- Default if $\delta A < b$ so eq. price $q = 1 - F(\frac{b}{\delta})$

Micro v/s Macro pricing

- 1 Micro pricing (Eaton - Gersovitz, Arellano)

$$U_c \left[q - \frac{1}{\delta} f \left(\frac{b}{\delta} \right) \right] = \beta \int U'_c$$

- 2 Macro pricing (Dubey, Genakoplos and Shubik)

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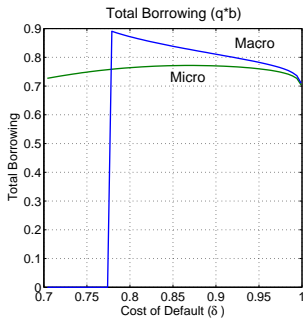
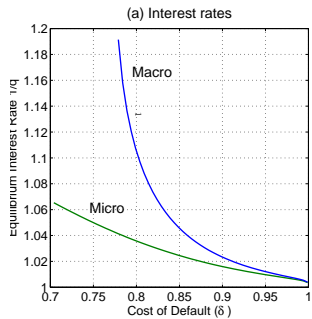
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If $\frac{1}{\delta} f \left(\frac{b}{\delta} \right)$ is big equilibria can be very different!

A numerical example

Equilibria with micro and macro pricing and different default costs



Summary

- If individuals do not internalize the effect of their actions on default risk, overborrowing, sudden stops and large welfare losses can arise
- Individual credit screening might be important for emerging countries who face high default risk