Discussion of Borrower and Lender Resilience

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What is it about

• Elegant Framework with heterogeneity in wealth and income and market frictions
  – Demand Externalities (unemployment)
  – Incomplete Market and Default (borrowing externality)
  – Moral hazard on the bank side (Financial Accelerator)

• Regulation
  – Regulating Bank Leverage
  – Restriction on borrowing.
Frictions as source of *Inefficiencies*

- Individuals do not internalize how their defaults could impact the lending capacity of the banks.
- Households do not recognize that by delevering they can lower overall employment.
- Do we have the tool to counter these inefficiencies?
Distribution of Risk and Regulation

• Debt positions of households differ: the risk associated with household lending now depends on individual borrower characteristics.

• A single risk weight in a capital requirement will not fully account for the distribution of risk in the economy
Time line

$t = 0$
- Endowment economy
- Incomes $y_{i0}$
- Bank makes loans, take deposits

$t = 1$
- Aggregate shock $\theta$
- Production economy
- Incomes $y_{i1}$ and $y_{i2}$ realized
- Some $i$ defaults
- Bank makes loans, takes deposits

$t = 2$
- Endowment economy
- Debt repaid
Marginal Propensity to Consume

Figure 1: Consumption function
MPC Comparative Statics

• MPC is at the heart of action in model with heterogenous agents
• As income or wealth are redistributed, consumption, borrowing and default are changing.
• Rational for intervention on borrowers
  – Reduce the credit market externality « overborrowing syndrome”
  – With effect on output via the demand externality and bank lending channel
Comparative statics

- Suppose we enter period 1 with a more compressed distribution of net positions $a$
The paper now

• A very elegant and transparent framework to think about credit and good frictions together.
  – Wasmer and Weil (AER 2004): Labor and Credit friction

• The framework can be used to answer many questions
  – Regulation on credit and borrowing (the core)
  – Mortgage Insurance
  – To much or to many default
  – Ex-post policies: loan modification for underwater loans
  – Income Inequality
  – Government Borrowing (good crowding out private borrowing)

• But now the results are still very theoretical
  – Under which condition regulation on borrowers is required (non binary outcome)
Regulation on borrowers

• Key is for regulation to be individualized
• UK Example
• US Example: Fanny Fae and Freddie Mac have targets with underserved areas (they always exceed it!)
• France: capacity to borrow and mortgage insurance
  – General rule: 33% of stable income
  – And then « reste a vivre »- what is left to live - so 20% to 40%
  – Not regulation, the bank itself enforce it (lack of competition, collusion?)
  – Mortgage Insurance (death or unemployment) is de facto mandatory
  – Very low default rate in France
  – +Loan Modification Program (Banque de France)
Mortgage Insurance

• Death and Unemployment
• A very good tool in the context of the model.
• Reduce borrowing ex-ante (cost of borrowing goes up)
• Provide insurance ex-post
• Limit default
• Limit underwater borrower
• Reduce the credit-output loop
Too much or too many default

- Martha Olney (passim) on the great depression.
- Lots of installement loans (Car Loans)
- Hypothesis: people reduced their consumption too much and not enough default $\Rightarrow$ Aggregate Demand fell too much
- Default provides some insurance ex-post but increase risk-taking ex-ante
- Cost of default and Credit and Aggregate Effect
Inequality, Credit and Crises

- Different MPCs
- Savings on Top, Borrowing on the Bottom
- Default-driven Crisis
- Less inequality, Less Crisis
- Constrained Efficient Outcome
- No Banks
- No Demand Externality
- This paper could be super useful to extend the analysis