Discussion of Borrower and Lender Resilience

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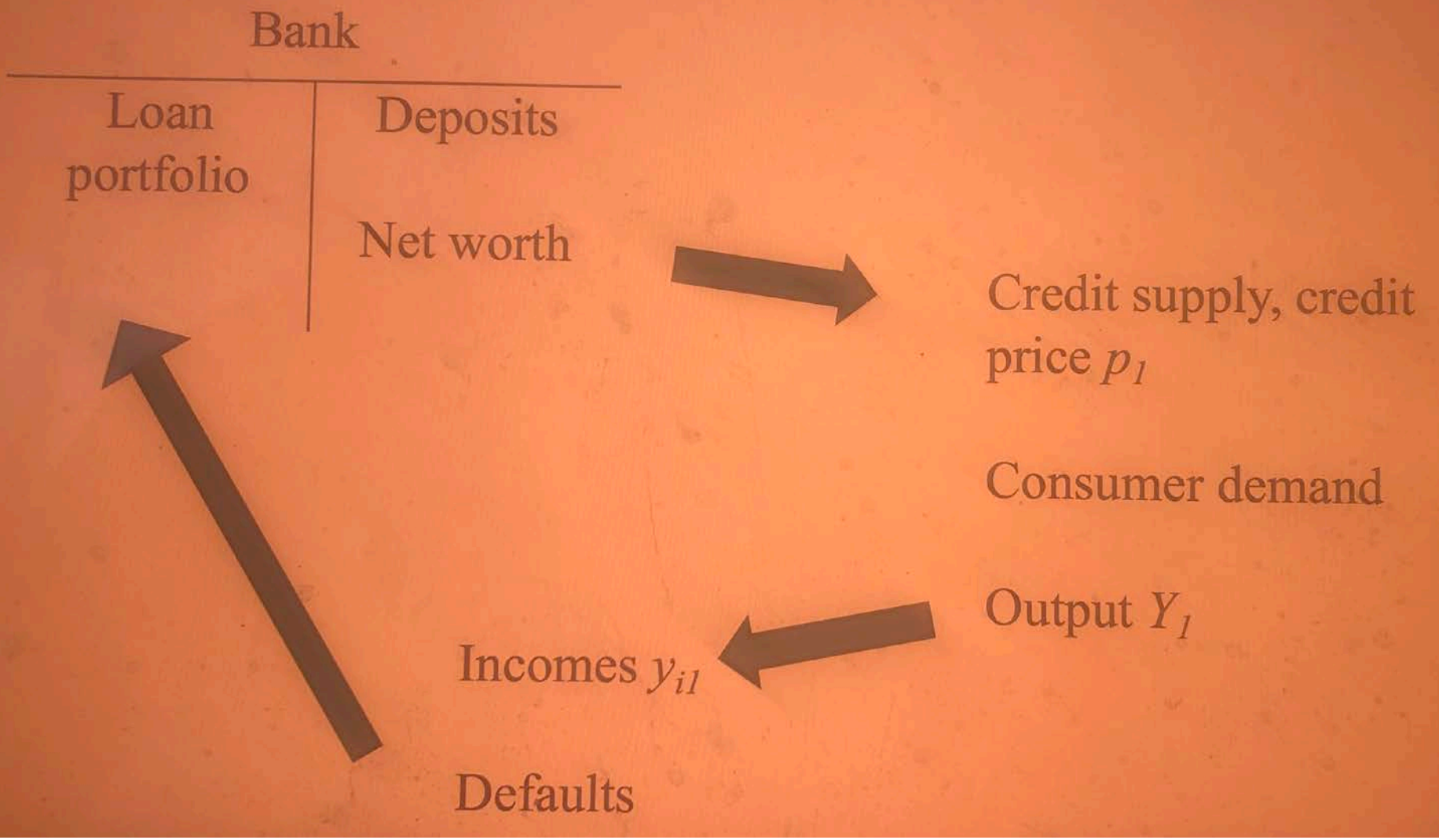
What is it about

- Elegant Framework with heterogeneity in wealth and income and market frictions
  - Demand Externalities (unemployement)
  - Incomplete Market and Default (borrowing externality)
  - Moral hazard on the bank side (Financial Accelerator)
- Regulation
  - Regulating Bank Leverage
  - Restriction on borrowing.

Feedbacks


Bank
Loan portfolio
Deposits
Net worth
Credit supply, credit price p_1
Consumer demand
Output Y_1
Incomes y_{i1}
Defaults

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 θ
- 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

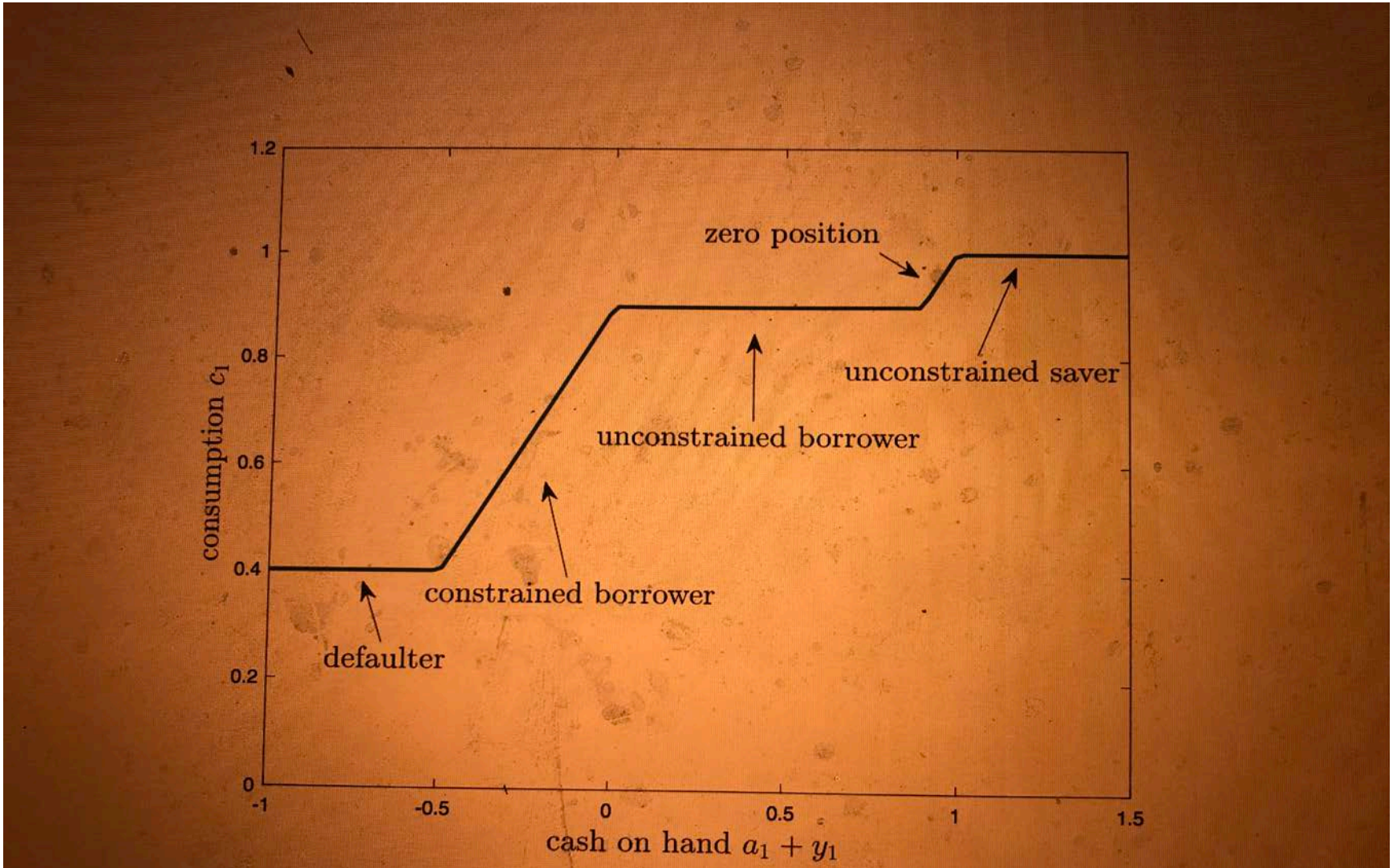


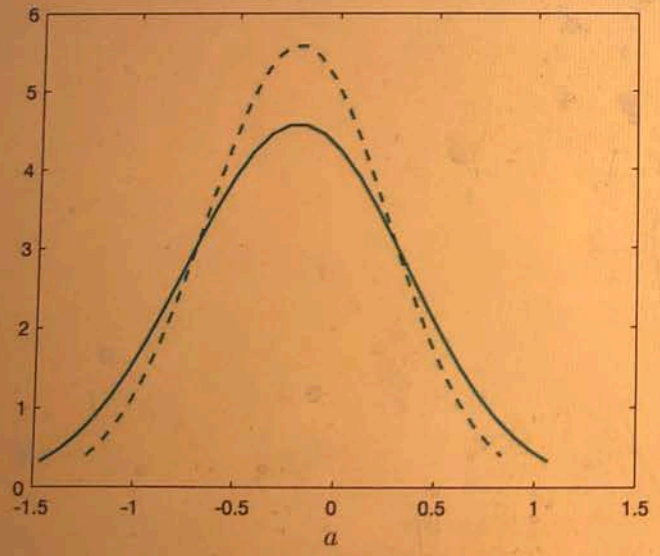
Figure 1: Consumption function

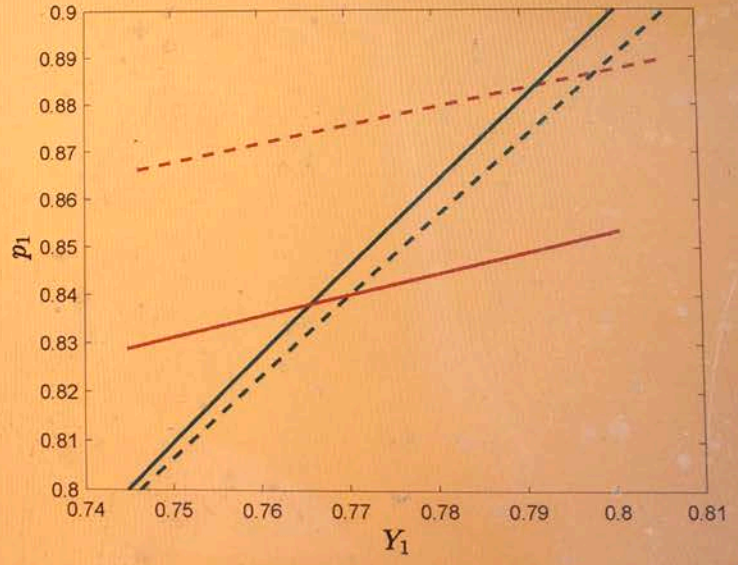
MPC Comparative Statics

- 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)
  - Mortage 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 Unemployement
- 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→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

- Kumhof-Ranciere-Winant (2015)
- Different MPCs
- Savings on Top, Borrowing on the Bottom
- Default-driven Crisis
- Less inequality, Less Crisis
- Constrained Effecient Outcome
- No Banks
- No Demand Externality
- This paper could be super useful to extend the analysis