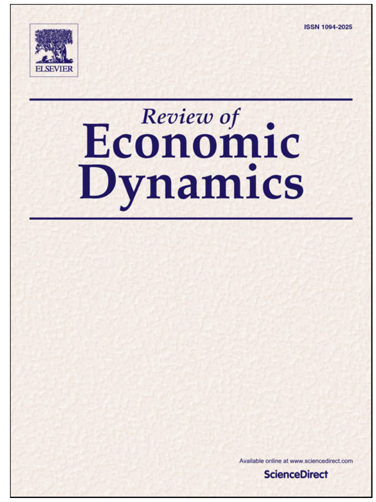
Accepted Manuscript



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PII: S1094-2025(16)30031-X
DOI: http://dx.doi.org/10.1016/j.red.2016.09.006
Reference: YREDY 781

To appear in: *Review of Economic Dynamics*

Received date: 20 November 2015
Revised date: 14 September 2016

Please cite this article in press as: Filipe Martins-da-Rocha, V., Vailakis, Y. Borrowing in excess of natural ability to repay. *Review of Economic Dynamics* (2016), http://dx.doi.org/10.1016/j.red.2016.09.006

Borrowing in Excess of Natural Ability to Repay[☆]

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Abstract

The paper aims at improving our understanding of self-enforcing debt in competitive dynamic economies with lack of commitment when default induces a permanent loss of access to international credit markets. We show, by means of examples, that a sovereign's creditworthiness is not necessarily limited by the ability to repay out of its future resources. Self-enforcing debt grows at the same rate as interest rates. If a sovereign's endowment growth rates are lower than interest rates, then debt limits eventually exceed the natural debt limits. This implies that there is asymptotic borrowing in present value terms. We show that this can be compatible with lending incentives when credible borrowers facilitate inter-temporal exchange, acting as pass-through intermediaries that alleviate the lenders' credit restrictions.

Keywords: Lack of Commitment, Self-enforcing Debt, Natural Debt Limit
JEL classification: D50, D51, F34, G13, H63

1. Introduction

An important issue that arises in dynamic, infinite horizon economies with sequential financial markets is the specification of borrowing constraints to prevent Ponzi games. Debt constraints should limit the rate at which agents accumulate debt, but they must be sufficiently loose to permit the maximum expansion of risk-sharing without introducing unjustified financial frictions.

When there is full commitment, the only requirement imposed on debt limits is that they should be non-binding at equilibrium.[1] This implies that agents' wealth–defined as the present value of future endowments–is finite and equilibrium debt, contingent to any event, is bounded from above by the "natural debt limit" (see for instance Ljungqvist and Sargent (2004), Acemoglu (2009) and Miao (2014)). Natural debt limits correspond to what an agent can pay at a contingency by never

[☆]We are grateful to the associate editor and an anonymous referee for comments and observations which improved the exposition and clarity of the paper. We have also benefited from discussions with Gaetano Bloise, Jan Eeckhout, Felix Kubler, Herakles Polemarchakis and Neil Wallace. The financial support of CNPq is gratefully acknowledged by V. Filipe Martins-da-Rocha. Yiannis Vailakis acknowledges the financial support of an ERC starting grant (FP7, DCFM 240983) and of two ANR research grants (Projects Novo Tempus and FIRE). Yiannis Vailakis acknowledges the hospitality of Kobe University (RIBE) and Université de Dauphine at early stages of the project.

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[1]See Magill and Quinzii (1994) for a detailed discussion.