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Zachary Bethune, Tai-Wei Hu, Guillaume Rocheteau

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Indeterminacy in Credit Economies*

Zachary Bethune
University of Virginia

Tai-Wei Hu
University of Bristol

Guillaume Rocheteau
University of California, Irvine

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Abstract

We characterize the equilibrium set of a two-good, pure-credit economy with limited commitment, under both pairwise and centralized meetings. We show that the set of equilibria derived under "not-too-tight" solvency constraints (Alvarez and Jermann, 2000) commonly used in the literature is of measure zero in the whole set of Perfect Bayesian Equilibria. There exist a continuum of stationary equilibria, a continuum of endogenous credit cycles of any periodicity, and a continuum of sunspot equilibria, irrespective of the assumed trading mechanism. Equilibria featuring "too-tight" solvency constraints can generate growing credit limits over time, periodic credit shutdowns, and heterogeneous debt limits across ex-ante identical borrowers. Moreover, we provide examples of credit cycles that dominate, from a social welfare point of view, all equilibria with "not-too-tight" solvency constraints.

JEL Classification: D83, E32, E51
Keywords: Credit cycles, limited commitment, money.

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