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In economic theory the borrower is modeled as an individual who chooses a lifetime pattern of consumption, taking on debt to adjust the flow of goods over time. In practice, modern borrowers increasingly engage in problem debt behavior, diminishing their potential life-time consumption opportunities. This paper argues that the individualistic orientation of the economic model fails to account for macro influences on debt behavior caused by economic growth fueled by high status consumption.

PROBLEM DEBT

Economists and psychologists agree that excessive debt is a problem for individuals. Economists believe that problem debt arises only when unforeseen circumstances interrupt the consumption patterns that individuals choose over the course of their lives. Alternatively, psychologists believe that problem debt arises from personality traits or is caused by compensation for past experiences. Although problem debt is commonly associated with an inability to repay loans, this situation may not be perceived to be a problem by the debtor. Problem debt is characterized by either lack of self-control, overindulgence or difficult circumstances. Ignorance of the implications of credit borrowing is the primary cause of debt problems; other causes include unwarranted risk taking, a failure to come to terms with unfortunate consequences, or a deliberate flaunting of the limits of one's purchasing power.

Standard economic explanations view problem debt through the overly narrow lens of individual preferences. The mainstream approach looks to dual preference models that analyze problem debt as a competition between desires for immediate gratification and desires for long-term good. When applied to the use of credit cards, this approach shows that credit-financed consumption by weak-willed consumers appears to generate increased purchasing power but actually diminishes it over the long run when repayment is not prompt.

Arguments for the dual preference model are unable to explain why long run preferences do not prevail over short run preference sets. Problem debt behavior is supposed to reflect a temporary disequilibrium that is necessarily untenable given the unsustainability of problem debt behavior. But the dual preference model cannot assume that a rational consumer will dig him or herself out of this disequilibrium by measuring costs and acting consistently. The assumption of rationality begs the question when it comes to explaining why profligate behavior must come to an end.

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In dynamic settings, psychological models conceptualize debt behavior as arising from loss of self control due to overstimulation of either income or lure of goods. Maintenance of long run equilibrium can be upset by sudden changes of income (as with lottery winners), changes in attitude or inappropriately regulated impulses. Since impulses are influenced by social factors, behavioral or cognitive models should incorporate the importance of social context.

POSSIBLE MACRO-MICRO LINKAGES

Debt behavior can be examined in an environment without economic growth (static) or with growth (dynamic). The general equilibrium model provides a useful framework for analyzing the relationship between debt behavior and economic sectors in both environments. In a static context,

> Household consumption is financed out of income, earned in the other sectors, plus credit from the retail and financial sectors. If the retail sector provides credit it will be acting as an agent for a financial institution as stores do not make the loans themselves. For the financial sector, credit/debt is a product from which it seeks to extract profit. The essential problem of macroeconomics is the co-ordination of individual plans into a mutually consistent whole. In a general equilibrium model this is achieved through price signals. For credit/debt the interest rate serves this function. (211)

If there are too many overspenders and not enough lenders, the usual corrective is an increase in interest rates, raising the costs of incurring debt. Creditors then attempt to minimize their risks, attempting to distinguish borrowers who pose good and bad risks. This effort leaves a fringe of rejected borrowers-to-be, creating a market for creditors interested in providing high interest loans to high risk borrowers. Higher interest rates, in turn, increase the probability of default for higher risk borrowers.

In a dynamic setting, aspiration levels are determined by social comparison. Following Duesenberry's view that interdependent preferences generate demand for social status goods, consumption of certain kinds of goods become essential to the maintenance of self-esteem. In part this may be based on an unrealistic picture of one’s reference group: people systematically overestimate others’ consumption of high-status goods, an error which rises with the amount of television watched. Since individuals cannot determine whether their comparison group's growing consumption pattern is based on current income or on borrowing (or even whether it exists beyond the TV screen, in some cases), aspirations may drive a credit explosion. Individuals who pursue externally driven aspirations while overlooking borrowing costs inevitably wind up caught in a cycle of dissatisfaction, resisting the disincentives of higher interest rates as they increase borrowing to fund the consumption dictated by higher and higher aspiration levels.

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