ABSTRACT

THE ROLE OF CREDIT IN THE THEORY OF THE HOUSEHOLD

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The purpose of this paper was to analyse the role of credit in the theory of the household. First a simple Fisher model was used to demonstrate the basic proposition that it may be rational to borrow against future income in order to obtain a preferred consumption path over time. Second, using a Fisher model, it was demonstrated that if the household was allowed investment as well as consumption choice it could increase the present value of its income stream by investing part of current income. Again the household could borrow (or lend) to achieve its preferred consumption path.

Next models of the type developed by Kelvin Lancaster and Gary Becker were developed. Thses type models view the household as a little enterprise engaged in the production of consumption services. In the model developed, the household can forego consumption services this year in order to invest in a more productive method of producing consumption services. Again, borrowing (or lending) allows the household to achieve its optimum consumption expenditure path.

Last, an attempt was made to apply the theory of corporate finance to the problem of financing the household. In this model the household achieved the maximum present value of its future flow of consumption expenditures by choosing its optimum debt equity ratio and optimum saving ratio. Rising debt cost limit the debt-equity ratio; rising growth costs limit the saving ratio. We also considered an alternative model where the household was assumed to maximize the rate of growth of its flow of consumption expenditures.

The implications of the paper for credit policy were that lenders should view the household as a little enterprise engaged in the generation of an income stream and the production of a flow of consumption services. The household may wish to accumulate earning assets in order to increase its income stream; it may wish to accumulate consumer durables in order to increase its flow of consumption services. Both purposes may require the use of credit. In lending money to consumers lenders should look at the income stream and the ability to repay. Increased use of package loans and consumer financial consulting services may allow lending institutions to increase the average size of loans, to reduce risk and to reduce the costs of consumer credit.