
Comment on “How Well Do Consumers Forecast
their Future Borrowing”

By Agarwal, Chomsisengphet, Liu, and Souleles

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Main Comment

- Fascinating paper, but...
 - Agenda gets slightly ahead of the analysis.
 - Authors want to emphasize the errors that people make.
 - Establish mainly that predictions of the standard neoclassical model pretty good.
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Unique Experiment:

- Credit card holders given choice of two contracts.
 - Low annual fee and high interest rate
 - High annual fee and a low interest rate
 - Must make initial choice but can switch at any time.
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Consumer's problem

- Minimize cost of borrowing
 - $\min \{ R_{t-1}^p E_{t-1} B_t - F_{t-1}, R_{t-1}^{np} E_{t-1} B_t \}$
 - F is the fee
 - R^p and R^{np} represent the interest costs when paying the fee (p) and not paying the fee (np)
 - B is the amount of borrowing
 - The contract decision is made at date $t-1$ before borrowing is known
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Consumer's problem

- Minimize cost of borrowing
 - $\min \{ R_{t-1}^p E_{t-1} B_t - F_{t-1}, R_{t-1}^{np} E_{t-1} B_t \}$
 - Treating borrowing as exogenous simplifies the problem greatly.
 - Otherwise cannot express problem in terms of minimizing payments to the bank.
 - Understates mistakes since can always do better if adjust borrowing.
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Consumer's problem

- Minimize cost of borrowing
 - $\min \{ R_{t-1}^p E_{t-1} B_t - F_{t-1}, R_{t-1}^{np} E_{t-1} B_t \}$
 - Panel data on realizations of B_t and contract choice.
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Findings Consistent with Rational Model

- Those with higher average debt tend to pay the fee or switch to the fee.
 - Those with more frequent debt tend to pay the fee.
 - And visa versa.
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Authors then Focus on Errors

- Find almost 40% of agents choose contract that is suboptimal ex post.



Ex post errors

	Payer	Non-Payer	Total
Should be Non-payer	30.5	35.5	66
Should be Payer	24.5	9.5	34
Total	55	45	

Ex post errors among wealthy

	Payer	Non-Payer	Total
Should be Non-payer	14.5	65.5	80
Should be payer	7.5	12.5	20
Total	22	78	

Focusing on errors is a dangerous business

- The error is a measure of our ignorance
 - Tough to distinguish between true errors and bad or incomplete models.
 - Much better to test a theory directly.
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How might one theorize about errors?

- Unavoidable errors.
 - Question: Are these mistakes surprising?
 - What type of process for debt do we need to rationalize the observed contract choices?
 - Suppose that we fit a Markov chain to the debt data, would the mistakes look very different?
 - Authors discount rational mistake story
 - Say even wealthy (who should not have to borrow) borrow.
 - Yet wealthy do borrow. Why?
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Theories of errors

- Sins of omission
 - carelessness, inattention
 - Are these errors a big deal?
 - 5% make errors that cost more than \$25 per year
 - 1% make errors that cost more than \$100 per year
 - .01% make errors that cost more than \$300 per year.
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Theories of errors

- Sins of omission
 - carelessness, inattention
 - Did they know or remember that they could switch?
 - This is especially applicable those who paid the fee, since there is no reason to switch until the year is up.
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Theories of errors

- Sins of commission
 - unjustified belief that will not accumulate debt.
 - self-control
 - A story:
 - A person knows that at some future point in time they may be tempted to consume too much.
 - They know that this means that they may be borrowing on their credit card.
 - But they do not want to encourage this sort of behavior so they choose the card with the high interest rate and low annual fee.
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Concluding comments

- Very interesting data.
 - Neoclassical model does well.
 - Next steps should be to take some explicit model of the types of errors that people make and to see how it improves our understanding of the data.
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