Household Need for Liquidity and the Credit Card Debt Puzzle

PRELIMINARY AND INCOMPLETE

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Abstract

In the 2001 U.S. Survey of Consumer Finances (SCF), around 30% of the respondents report having both positive credit card debt and positive liquid assets. These consumers tend to pay on average a 14% interest rate on their debt, while earning only 1 or 2% on their liquid deposit accounts. This phenomenon is known in the literature as the “credit card debt puzzle”. In this paper, I focus on the need for liquidity as an explanation for this puzzle: households that accumulate some credit card debt may not pay it off using their money in the bank, because they expect to use that money to pay for goods for which credit cards cannot be used. Using both aggregate and survey data (SCF and CEX), I document that liquid assets are indeed a substantial part of households’ portfolios, both as a transaction mechanism and as a savings vehicle, and that consumption via liquid assets appears to have a sizeable unpredictable component. Thus, a good candidate theory would consider both foreseeable need for liquidity and precautionary demand for liquidity. I develop a dynamic heterogeneous-agent model of household portfolio choice where credit cards and liquidity coexist as a means of consumption and saving/borrowing. The model is a generalized version of the cash good - credit good model. Receipts and payments of liquid assets are not simultaneous. Agents are subject to uninsurable idiosyncratic shocks to income and preferences. These features provide enough impetus for households to accumulate credit card debt, but not to pay it off entirely, even when their liquid means are sufficient for doing so. I will quantify the importance of the need for liquidity as an explanation to the credit card debt puzzle, by calibrating and solving a version of the model. Preliminary results suggest that the role of liquidity is significant in generating the observed behavior.

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