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Interest rates and default in unsecured loan markets

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Abstract

This paper investigates how interest rates affect the probability of default (PD) in a general equilibrium incomplete markets economy. We show that the PD depends

positively on the interest rate.

Empirical evidence shows that the PD is also positively affected by the credit hazard

model with credit contracts from

a large European country and specific

characteristics of the credit contracts supplied by

easing credit conditions, and the credit risk of the borrowers,

increasing the credit risk of the borrowers,

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Notes

1 In the aggregate level, see Ali and Daly (2010) for an analysis of the macroeconomic determinants of credit risk using cross country data and Chu ([2001](#)) for a time series analysis of the Brazilian case.

2 Interest rate paid by Brazilian government bonds.

3 Only age was included from personal borrower's characteristics because no other variable was available in the data set.

4 Notice that endogeneity of the interest rates is not an issue here because the estimated model uses real interest rates as covariates. In addition, the economy interest rate is set according to the inflation targeting monetary policy regime, independently from the average rate of default in the economy.

5 Notice that loan contracts with different moments of default will have more than one value for τ . In this case, we use the first moment of default. However, the dynamic model is not affected by this choice. In fact, even if we use the last moment of default, the dynamic model is not affected. In fact, even if we use the last moment of default, the dynamic model is not affected. In fact, even if we use the last moment of default, the dynamic model is not affected.

6 Lagged variables were used to control for unobserved heterogeneity but they were not included in the final model.



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