The Macroeconomics of Debt Overhang

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Debt Overhang

- Outstanding stock of debt depresses investment
  - Dilutes returns
  - Weakens credibility
- May occur even when contracts are efficient
Policy Questions

- One important policy issue: How to provide aid to countries or individuals with debt overhang
- Reduce debt (debt forgiveness or debt “buy backs”)
- Give direct transfers
Buy Back Boondoggle

- Bulow and Rogoff demonstrated that even in the presence of debt overhang, direct transfers dominate buy backs.
- The buy backs leak back to creditors
- More generally, the best way to raise welfare is to expand the budget set rather than make decisions on behalf of the recipient
  - Mimic missing insurance markets
  - Avoid pitfalls of paternalism
Buy Backs Reconsidered

- That transfers dominate debt buybacks not robust to reasonable modeling alternatives
  - Political Economy of Sovereign Debt (Amador; Aguiar and Amador)
  - Externality (this paper): bailouts of households can backfire

- Key insight: “Participation” brings some additional benefits and policy needs to raise the incentive to “opt in.”
BC vs. IC

- Budget Sets versus Incentive Constraints
  
  - If incentive constraint binds, return to relaxing incentive constraint is positive and should influence how aid is given.
  - Expanding budget set is no longer sole objective.
  - Often can combine the two (debt restructuring).
Incentive Constraints

\[ \text{Benefits of Participation} \preceq \text{Benefits of Opting Out (Default)} \]
Cash Transfers

Benefits of Participation
↑
Cash Transfer

Benefits of Opting Out (Default)
↑
Cash Transfer
Debt Forgiveness

Benefits of Participation

↑

Debt Forgiveness

⇑

Benefits of Opting Out (Default)
Moving beyond Aid to External Effects

- Nature of the novel externality:
  - Private Gain: Pay Debt $\Rightarrow$ Participate in investment projects and receive payment on assets
  - Externality: Pay Debt $\Rightarrow$ Raise return to financial assets $\Rightarrow$ Raise incentive for others to participate

- Paying debt is not just a transfer (and with linear utility pure transfers are uninteresting).

- Paying debt relaxes IC constraint of everyone else (gets closer to efficient level of investment)
Global Bailouts

- In global setting, individual countries view bailouts like Bulow-Rogoff – transfer abroad
- Do not internalize effect on IC constraints of others
- Role for coordination
Conclusion

- Very nice framework to study external effects of debt overhang
- Helps move focus of policy making from budget sets (missing insurance markets) to IC constraints