

# 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.”

- ▶ 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

Benefits of Participation  $\geq$  Benefits of Opting Out (Default)

# Cash Transfers



# Debt Forgiveness



# 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