Debt Write–Downs and Debt–Equity Swaps in a Two Sector Model

ABSTRACT

Investment disincentives due to a "debt overhang" have led to investigations of Pareto–improving "market–based debt–reduction schemes," under an assumption of creditor seizure in bad states. These models usually reach the conclusion that while pure debt forgiveness is in the interest of debtor nations, debt repurchase programs are not.

This paper introduces a "safe sector" into the debtor nation which is unexposed to seizure during default states. The magnitude of the debt overhang is shown to affect both the composition of investment and the returns to factors in the debtor nation. Two important results which emerge are that debt forgiveness is not necessarily in the interest of all debtors, and the potential for Pareto–improving debt–equity swaps is magnified.

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