Asset Price Booms and Macroeconomic Debt Overhang

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Abstract

We propose a tractable two-period model of financial crises that replicates empirical regularities: credit-fueled asset-price booms often collapse, followed by deep and persistent recessions with productivity declines. Risk-shifting firms amplify the booms and busts of asset prices by purchasing the assets by borrowed money. Resultant debt overhang lowers productivity and output by discouraging borrowers from expending additional efforts because all additional gains would be taken away by the existing lenders. The inefficiency is aggravated by the aggregate output externality, a spillover in the monopolistic competition. Collapse of a larger asset-price boom leads to a deeper and more persistent recession. Our debt overhang story is in line with the observation that the persistent stagnation is accompanied by contraction of credit demand, rather than credit supply. Zombie borrowers may not be intrinsically unproductive. Ex-post government subsidy to lenders for facilitating debt restructuring can restore the borrowers' productivity and improve the lenders' payoff and social welfare, without inducing time inconsistency.

Key words: Financial crisis, love-for-variety, risk shifting, zombie lending.

JEL Classification: E02, G01, G33.