Abstract

This paper studies the optimal lending contract between an international lender and a sovereign country. A benevolent government finances uncertain expenditures - which are privately observed by the country - using external debt and optimally choosing domestic debt and taxes as in a standard Ramsey environment. Without imposing any restriction on the structure of the loan, we determine the optimal lending contract offered by the lender when the domestic fiscal policy is observed and when the fiscal policy is not observed by the lender. In the first case, we show under which conditions the optimal loan contract is contingent not only on the realization of government expenditures, but also on the sovereign fiscal policy. Whenever the loan is not policy-contingent, the optimal contract prescribes default in equilibrium as a way to improve the insurance against expenditure shocks. Finally we show how the optimal loan contract influences equilibrium taxes and prices in a welfare increasing manner. In particular, the external loan can be used as instrument to reduce the distortions induced by the Ramsey government on the domestic economy.

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