

Optimal Joint Bond Design *

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Abstract

We study the optimal design of a joint borrowing arrangement among countries. In our model, a safe country, which has full commitment and never defaults, and a risky country, which lacks commitment and may default, participate in a joint borrowing scheme through which they allocate a predetermined amount of their bond issuance to a joint bond, which may earn a non-pecuniary premium. The joint borrowing scheme is flexible, and highlights the differences between pooled issuance, in which countries share the funds raised through the joint bond, and joint liability, in which one country guarantees the obligations of another one. We develop a simple but general condition that determines whether issuing a joint bond is welfare improving: if the total marginal increase in the amount raised by the countries – holding constant their borrowing decisions – is greater than the value of the joint liabilities that are originated, it is optimal to issue a positive amount of joint bond. We further decompose the welfare effects of varying the size of the joint bond into several distinct channels. We provide a quantitative analysis of joint borrowing agreements and find that Pareto improvements are possible.

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