# Article information:

Leverage Dynamics without Commitment - DEMARZO - 2021 - The Journal of Finance - Wiley Online Library  
<https://onlinelibrary-wiley-com.virtual.anu.edu.au/doi/10.1111/jofi.13001>

# Article summary:

1. The paper studies equilibrium leverage dynamics in a trade-off model where the firm can continuously adjust leverage and cannot commit to a policy ex ante.

2. Shareholders issue debt gradually over time due to the leverage ratchet effect, but asset growth and debt maturity cause leverage to mean-revert slowly toward a target.

3. Credit spreads rise to the point that the firm is unable to capture tax shields, and default costs and investment distortions fully offset the benefits of leverage, making firms indifferent to their future debt maturity structure.

# Article rating:

Appears moderately imbalanced: The article provides some useful information, but is missing several important points or pieces of evidence that would be required to present the discussed topics in a balanced and reliable way. You are encouraged to seek a more balanced perspective on the presented issues by exploring the provided research topics and looking at different information sources.

# Article analysis:

The article "Leverage Dynamics without Commitment" by DeMarzo (2021) presents a model for understanding the dynamics of leverage in firms that cannot commit to a specific policy. The paper provides insights into how leverage adjusts over time and how it affects credit spreads, investment, and growth. While the paper offers valuable contributions to the literature on corporate finance, there are some potential biases and limitations that need to be considered.

One potential bias is that the model assumes no other frictions or transaction costs apart from corporate taxes and default costs. This assumption may not reflect the real-world complexities of financial markets, where there are often additional frictions such as asymmetric information, agency problems, and market imperfections. These factors can affect the behavior of investors and firms in ways that are not captured by the model.

Another limitation is that the model assumes that debt can be freely adjusted over time. In reality, firms face various constraints on their ability to issue or repurchase debt, such as regulatory requirements, covenant restrictions, and market conditions. These constraints can limit the flexibility of firms to adjust their leverage levels in response to changing circumstances.

The paper also makes some unsupported claims about investor behavior. For example, it suggests that investors fully anticipate future debt issuance and raise credit spreads accordingly. However, this assumption may not hold if investors have imperfect information about future borrowing plans or if they face other constraints on their ability to adjust credit spreads.

Moreover, the paper does not explore counterarguments or alternative explanations for its findings. For instance, it does not consider whether changes in interest rates or macroeconomic conditions could affect leverage dynamics differently than changes in firm profitability. It also does not examine whether different types of shocks (e.g., idiosyncratic vs. systemic) could have different effects on leverage adjustment.

Finally, while the paper notes some potential risks associated with excessive leverage (e.g., bankruptcy costs), it does not provide a comprehensive analysis of these risks or discuss possible policy implications for regulating leverage levels in firms.

In conclusion, while "Leverage Dynamics without Commitment" offers valuable insights into how leverage adjusts over time in firms without commitment policies, it has some limitations and potential biases that need to be considered when interpreting its findings. Further research is needed to explore these issues more comprehensively and provide a more nuanced understanding of corporate finance dynamics.

# Topics for further research:

* Constraints on debt issuance and repurchase in firms
* Frictions and transaction costs in financial markets
* Imperfect information and investor behavior
* Alternative explanations for leverage dynamics
* Risks associated with excessive leverage in firms
* Policy implications for regulating leverage levels in firms

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