Financing vs. Forgiving a Debt Overhang

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WORKING PAPER 2486

DOI 10.3386/w2486

ISSUE DATE January 1988

This paper examines the tradeoffs facing creditors of a country whose debt is large enough that the country cannot attract voluntary new lending. If the country is unable to meet its debt service requirements out of current income, the creditors have two choices. They can finance the country, lending at an expected loss in the hope that the country will eventually be able to repay its debt after all; or they can forgive, reducing the debt level to one that the country can repay. The post-1983 debt strategy of the IMF and the US has relied on financing, but many current calls for debt reform call for forgiveness instead. The paper shows that the choice between financing and forgiveness represents a tradeoff. Financing gives the creditors an option value: if the country turns out to do relatively well, creditors will not have written down their claims unnecessarily. However, the burden of debt distorts the country's incentives, since the benefits of good performance go largely to creditors rather than itself. The paper also shows that the tradeoff itself can be improved if both financing and forgiveness are made contingent on states of nature that the country cannot affect, such as oil prices, world interest rates, etc.

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Acknowledgements and Disclosures

Citation and Citation Data

Published Versions

Journal of Development Economics, Vol. 29, pp. 253-268, (1988). citation courtesy of RePEc

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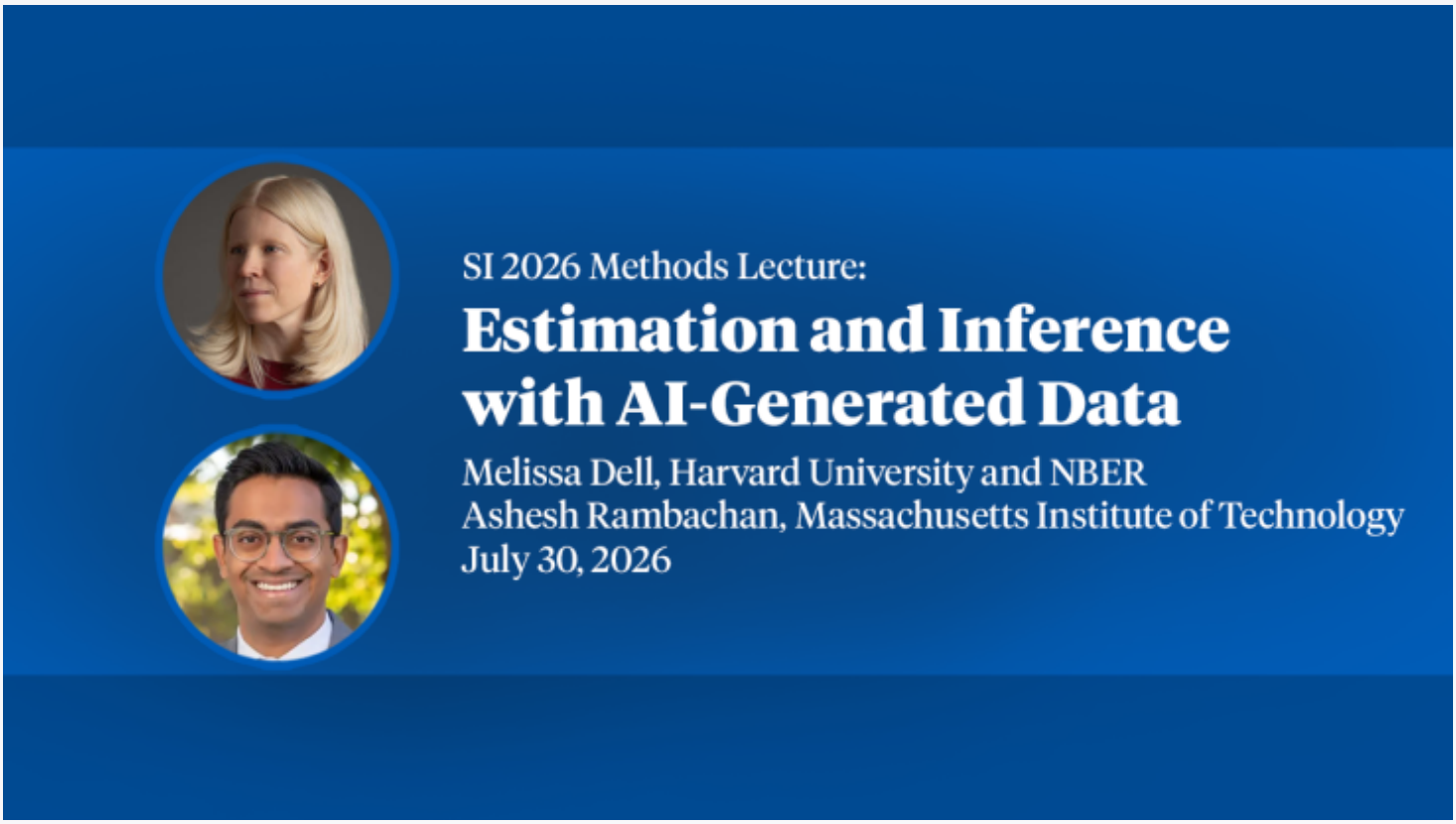


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