

Forgive or Buy Back: An Experimental Study of Debt Relief[†]

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Abstract

A large share of the debt claims owed by the world's poorest countries has been cancelled through the HIPC (highly indebted poor countries) debt relief initiative. It is believed that, with less debt burden, the HIPC will be able to devote more resources to investment and thus promote their own growth and benefit their creditors in the long run. But does debt forgiveness really provide the best incentive for those countries who suffers from debt overhang—meaning the presence of an existing, inherited debt sufficiently large that creditors do not expect with confidence to be fully repaid? In this paper, we adopt experimental methods to study the impact of two different schemes for relieving debt. The two schemes we consider here are debt forgiveness and debt buyback, with the latter being more market-based since it allows indebted countries to repurchase their own debt on the secondary market at a discount. We find that creditors tend to reduce more debt when the relief takes the form of debt forgiveness than that of buyback. To payoff their debt, debtors under the scheme of forgiveness are more willing to incur higher costs to undertake a risky investment project than that of buyback. As a result, both creditors and debtors are worse off under the scheme of debt forgiveness.

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