North-South Lending with Moral Hazard and Repudiation Risk

Trinity Economic Paper Series
Technical Paper No. 98/9
JEL Classification: E44, F21, F34

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Abstract

We show that the joint presence of moral hazard and repudiation risk generates an important interaction effect. In order to provide the proper incentives to borrowers, the optimal financial contract under moral hazard calls for all available resources to be paid to the lender in the event of a poor realization for output. Repudiation risk limits the size of this transfer, as the debtor has the option to default. This upper bound on the resource transfer exacerbates the moral hazard problem, reducing lending and the equilibrium level of investment and output.

Acknowledgements

This paper is forthcoming in the Review of International Economics. I am grateful to an anonymous referee for comments. Views expressed belong solely to the author and do not necessarily reflect the opinion of the Department of Economics of Trinity College Dublin.