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Growth and external debt under risk of debt repudiation $\hat{\alpha} \dagger$

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Abstract

We analyze the pattern of growth of a nation which borrows abroad and which has the option of repudiating its foreign debt. We show that the equilibrium strategy of competitive lenders is to make the growth of the foreign debt contingent on the growth of the borrowing country. We give a closed-form solution to a linear version of our model. The economy, in that case, follows a two-stage pattern of growth. During the first stage, the debt grows more rapidly than the economy. During the second stage, both the debt and the economy grow at the same rate, and more slowly than in the first stage. During this second stage, the total interest falling due on the debt is never entirely repaid; only an amount proportional to the difference of the rate of interest and the rate of growth of the economy is repaid each period.



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