Relational Contracting under the Threat of Expropriation - Experimental Evidence

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Abstract
We examine how relational contracting in credit and investment relationships is affected by the potential expropriation of funds. We implement credit relationships in which repayment is not third-party enforceable, i.e. borrowers can default on their loans. In our main treatment the borrower can expropriate the lender’s funds: a defaulting borrower can reinvest the loaned funds in future periods. In a control treatment borrowers cannot expropriate borrowed funds, i.e. if they default they cannot reinvest these funds in future periods. We find that potential expropriation decreases the overall volume of credit as lenders offer smaller loans in initial periods. Borrowers are more likely to default in earlier periods of the relationship when expropriation is possible, especially when they receive large loans. Together these results suggest that relational contracts may be particularly difficult to establish in markets where the expropriation of funds is feasible. This finding is relevant to credit markets in which lenders’ rights are weak, but also to sovereign lending, as well as to foreign direct investment in countries with weak investor protection.