Abstract
This paper presents direct evidence for relational contracts in sovereign bank lending. Unlike the existing empirical literature, its instrumental variables method allows for distinguishing a direct influence of past repayment problems on current spreads (a “punishment” effect in prices) from an indirect effect through higher expected future default probabilities (“loss of reputation”). Such a punishment provides positive surplus to lenders after a default and decreases the borrower’s present discounted value of the net benefits of future borrowing, which create dynamic incentives. Using data on bank loans to developing countries between 1973-1981 and constructing continuous variables for credit history, we find evidence that most of the influence of past repayment problems is through the direct, punishment channel. (JEL: C73, D86, F34, G12, G14, G15)