Forgiveness versus financing: The determinants and impact of SME debt forbearance in Japan

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Abstract

This paper empirically examines the impact of Japan's debt forbearance policies with regard to small and medium-sized enterprises (SMEs) stipulated in the "Act concerning Temporary Measures to Facilitate Financing for SMEs." Using unique Japanese firm survey data that identify firms that received "financing" (such as through the deferral of debt repayments) and firms that received "debt forgiveness" (such as through a reduction in principal and/or interest), we examine the determinants and the effects of debt forbearance to test the theoretical predictions of Krugman's (1988) "financing vs. forgiving a debt overhang" analysis. We find, first, that banks choose debt forgiveness for firms that are more creditworthy and more profitable, which is consistent with the theory of debt overhang. Second, among firms that received debt forbearance, those that had received debt forgiveness had better access to new loans and showed superior ex-post performance than those that received financing, which is also consistent with the theory of debt overhang. Third, compared to firms that had not received any debt forbearance, firms that had received financing were more leveraged and exhibited worse performance, especially those whose forborne loans were covered by public credit guarantees, while firms that had received debt forgiveness exhibited better performance, especially those without public credit guarantees. This suggests that the effectiveness of the SME forbearance policy is adversely affected by the moral hazard generated by public credit guarantee programs.

Keywords: Debt forbearance, Debt overhang, Public credit guarantee programs
JEL classification: G21; G28; G33