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Focus paper

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Sovereign Default and International Trade

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Countries which default on their foreign debt tend to experience a decline in their trade with the rest of the world.

In a recent research paper, Robert Zymek provides an explanation for this empirical finding: reduced access to international capital markets in the wake of sovereign debt crises can account for most of the observed impact of sovereign default on trade.

What are the economic costs of sovereign default? This question has haunted the literature on foreign borrowing from its inception. Since foreign creditors cannot rely on courts to enforce their claims on sovereign governments, the adverse economic effects of sovereign debt crises may be the main reason why countries usually choose to repay what they owe. One frequently cited claim is that governments fear being shut out from international trade if they renege on their contracts with foreigners.

Recent research by Rose (2005) and Martinez and Sandleris (2008) suggests that countries do indeed experience a decline in their trade with the rest of the world following sovereign debt renegotiations. However, these studies do not explain why this would be the case.

Is the decline in trade the result of deliberate trade sanctions imposed by creditors? Or is the causality reversed, and countries default in anticipation of lower imports and exports?

Zymek (2012) proposes and test for an alternative explanation: sovereign default causes a decline in trade because it reduces exporters' access to foreign credit. As Table 1 below shows, countries which experienced sovereign debt crises in the period 1980-2007 were less financially developed than non-defaulters, and more dependent on international capital markets. Most of these countries were running significant current account deficits prior to default, and two thirds of the subsequent default episodes were accompanied by a drop in net foreign borrowing.

	Median	
	Defaulter	Non-Defaulter
Domestic Creditc2007/GDPc2007	0.29	0.84
Avg. Financial Dependence of Expc2007	0.22	0.28
Avg. CAct/GDPct in 2 Years Prior to Default	-0.08	-

Table 1. Economic Characteristics of Defaulters, 1980-2007

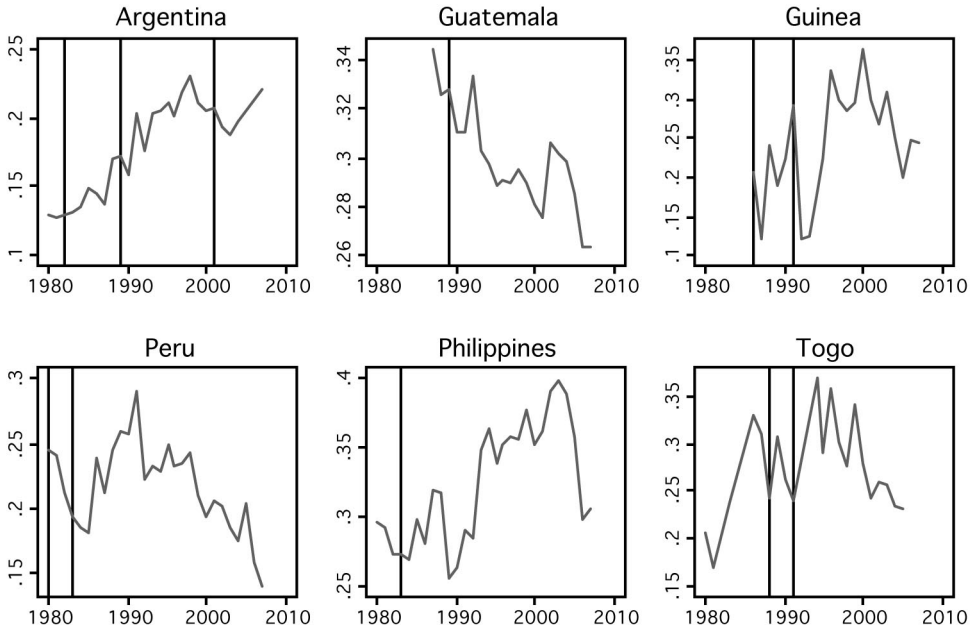

Figure 1: Avg. Financial Dependence of Exports

If default reduces exporters' access to external financing, it should cause a larger decline in the exports of sectors which are more dependent on external funds. The paper tests this hypothesis formally, employing a difference-in-difference approach in the spirit of Rajan and Zingales (1998), and finds strong support for it in the data.

Figure 1 above provides an illustrative glimpse of the main result. It plots the average financial dependence of exports for six countries which experienced at least one sovereign default in the last thirty years. Sovereign defaults (vertical lines) tend to coincide with declines in the average financial dependence of exports, indicating a shift in the composition of exports away from highly financially dependent and toward less financially vulnerable goods. The paper establishes the generality of this observation econometrically and shows that it is robust to changes in specification and sample composition.

Based on countries' export composition leading up to each of the 61 default episodes covered in the paper, on average, the financial-dependence-related effect of default should have caused a 7% decline in exports for three years. Rose (2005) and Martinez and Sandleris (2008) find an overall decline in trade flows of 6-11% for comparable periods. This suggests that the financial-dependence channel highlighted in Zymek (2012) can explain most of the impact of sovereign default on trade.

The fact that countries suffer exclusion from international capital markets in the wake of sovereign debt crises has been well documented (e.g. Gelos et al., 2003). The observed decline in trade appears to be merely a symptom of such capital-market exclusion, rather than a cost of default in its own right. Much of the recent literature on sovereign borrowing treats the threat of capital-market exclusion and the risk of "trade costs" as substitutable explanations for why countries repay their debts. Zymek (2012) suggests that this notion is mistaken: if default does not reduce the defaulting country's access to international lending, the "trade costs" of default may also fail to materialize.

References

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