One Reason Countries Pay Their Debts: Renegotiation and International Trade

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Summary

Why do countries pay their international debts? Three reasons are typically proposed. First, countries that renege on their debts may have their overseas assets seized by foreign creditors. Second, countries with poor repayment reputations may be cut off from capital flows in the future. Third, delinquent countries may suffer reduced benefits of international trade. While all three penalties are of interest, this paper is concerned with the last explanation. The first sanction is of limited potency for net debtors with little foreign collateral. A number of economists (most visibly Bulow and Rogoff) have disputed the importance of future exclusion from capital markets. The third explanation is widely accepted, but has never been quantified. The objective of this paper is to estimate empirically the effect of sovereign debt renegotiations on international trade.

There are at least two reasons why international default may reduce trade in principle. First, trade credit may naturally shrink after default. Alternatively, creditors may wish to punish default with reduced trade benefits, in order to discourage future default, or default by third parties. Thus there are valid theoretical reasons why default should be associated with reduced international trade. In practice, default seems to be strongly associated with reduced trade. I use a large panel data set covering over 200 trading partners over fifty years of data to estimate a "gravity" model of trade. I show that debt renegotiation is associated with a decline in bilateral trade that is both economically and statistically significant, adding up to a year's worth of trade, although the effect is spread over fifteen years. This result is robust to a number of econometric perturbations concerning lag length, treatment of simultaneity, censoring and sample size. There is weak evidence of trade diversion, and the exports of defaulters are hit somewhat harder than imports.