



The output costs of hard and soft sovereign default[☆]



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ABSTRACT

How costly are sovereign debt crises? In this paper we study output losses during sovereign default and debt renegotiation episodes since 1980. In contrast to previous work, we account for the severity of default and not only for its occurrence. Specifically, we distinguish between “hard” and “soft” defaults, using new data on debtor payment and negotiation behavior and on the size of haircuts towards private external creditors. We show that hard defaults are associated with a much steeper drop in GDP, of up to ten percent, compared to soft defaults. The results are consistent with theoretical models assuming proportional output costs of default.

1. Introduction

How costly is a sovereign default? Answering this question is important for our theoretical understanding of sovereign debt¹ and for policymakers in crisis situations. Past empirical work on the cost of default commonly relied on a binary debt crisis measure of default versus non-default. In this paper, we propose the use of more continuous default measures to study output losses during debt crises. Specifically, we distinguish between cases of “hard” and “soft” default based on a new procedural index that tracks a government’s payment and negotiation behavior vis-à-vis foreign creditors during a default spell. We also use a continuous outcome measure of debt crises, namely the size of creditor losses or “haircuts” captured at the end of a debt crisis. Our results show that the output loss during a debt crisis is much deeper for episodes of “hard” defaults. This new stylized fact suggests that not only the incidence of default matters, as implied by much of the previous literature, but also the scope and severity of default.

Our research design is motivated by the striking differences between debt crisis events, as documented in case studies by [Roubini and Setser \(2004\)](#) or [Sturzenegger and Zettelmeyer \(2007\)](#). On the one hand, there are cases such as Russia during the 1990s, Ecuador 2008/2009 or Argentina 2002–2005, in which governments opted for a unilateral payment moratorium, engaged in anti-creditor rhetoric, and at times even refused to negotiate with their foreign banks and bondholders. These confrontational defaults also involved high creditor losses (haircuts) of up to 70%. On the other hand, there are debt crises that got resolved in a consensual manner, with close creditor consultations, little (or no) missed payments, and low haircuts of around 10–20%. Examples include Ukraine in 1999/2000 (and in 2015) or Uruguay in 2003.

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¹ Since [Eaton and Gersovitz, \(1981\)](#), assumptions on the cost of default have crucially influenced the setup and results of sovereign debt models (see the surveys by [Eaton and Fernandez, 1995](#); [Panizza et al., 2009](#); [Aguar and Amador, 2014](#)).

The differences in crisis resolution strategies are influenced by a central trade-off for distressed governments: on the one hand, governments can decide to adopt a confrontational policy towards external creditors, by halting all debt payments, by demanding high haircuts (debt relief), and by delaying negotiations and thereby postponing the day until debt servicing is resumed. This strategy frees up resources that can be distributed to the domestic population during the default and may buy political support at home. However, one can expect deep haircuts and confrontational debtor behavior to also cause negative spillovers on the domestic economy and the financial sector (see Panizza et al., 2009). One potential channel behind this is reputation: “hard” defaults as in Argentina 2001 are likely to send a negative signal about fundamentals and worsen country reputation more than “soft” defaults as in Uruguay 2003 (e.g. Cole and Kehoe, 1997). The expected outcome is a decline in access to external credit, less trade, less investment and, thus, a drop in GDP (see Mendoza and Yue, 2012). The alternative choice for governments in distress is to adopt a creditor-friendly stance, by continuing debt payments to foreign banks and bondholders and by demanding low haircuts (little debt relief). This strategy may mitigate the negative reputational effects of a default, but will shift the burden to the domestic population, which can expect higher taxes and less transfers during and after the default spell (D’Erasmus and Mendoza, 2016).

The main contribution of this paper is to take the heterogeneity in sovereign debt crises seriously and to show in a stylized form that the output losses in a default increase in the severity of default. This result casts doubt on one of the most widely used assumptions in quantitative sovereign debt models, namely that defaults trigger output costs that are fixed and lump-sum, irrespective of the type of default or the size of haircuts. The notion that the output costs of default are proportional (rather than lump-sum) shapes modeling in a fundamental way and also has “far-reaching implications for policy analysis”, as emphasized by Corsetti and Dedola (2012).

We proceed in two steps. First, we analyze output *during* debt crises, since defaults can take many years to resolve (sometimes more than a decade). In a second step, we focus on post-crisis growth, i.e. output performance after countries exit default with a debt restructuring. Our main explanatory variable *during* default is a measure on “government coerciveness” towards creditors. This “coerciveness index” is based on a new database on debt crisis resolution processes by Enderlein et al. (2012), which categorizes a government’s debtor policies on a scale from 1 (very creditor-friendly) to 10 (very confrontational). The dataset tracks government actions towards private external creditors for each year throughout a debt crisis along nine dimensions of payment and negotiation behavior. Debtor coerciveness shows a strong variation not only across debt crises and defaulting countries, but also within crisis spells. This is advantageous compared to a simple default dummy, since it allows us to exploit both the cross-sectional and the time-series variation in debtor behavior. Our main explanatory variable *after* debt crises is the size of haircuts, i.e. the scope of creditor losses implied by a debt restructuring at the end of a default spell as measured by Cruces and Trebesch (2013). In sum, we thus trace the output performance in “hard” and “soft” defaults over the entire crisis episode, starting from the first missed payments to the conclusion of the debt restructuring and the subsequent post-default period.

We find that coercive government behavior during default is associated with a significantly worse output performance. In “hard” defaults, real GDP sees a strong and long-lasting decline, while this is not the case in “soft” defaults in which the government opted for a consensual stance towards creditors. This descriptive finding is confirmed when we use annual per capita real growth as dependent variable and regress it on our proxies for hard and soft defaults as well as economic fundamentals and fixed effects. However, with cross-country panel data, it is difficult to identify the causal effect of coercive debtor policies and high vs. low haircuts.²

In particular, we face two main identification challenges: (i) omitted variable bias, as common shocks and/or socio-political changes could affect both output and coerciveness/haircuts, and (ii) reverse causality, since changes in output could explain the type of default and not vice versa. To address the problem of omitted variable bias, we include country and time fixed effects and a host of economic and political control variables, including the set of macro controls commonly used in the growth literature, but also crisis duration, banking and currency crises, IMF programs, and political risk. We also include a lagged dependent variable as a control and account for country-specific time trends. Regarding reverse causality, we test whether past output performance (growth) helps to predict debtor coerciveness later on, but do not find that past economic growth drives current coercive behavior. Moreover, we attempt to disentangle the role of expected and unexpected government coerciveness and tease out the surprise component in debtor behavior by using forward-looking, start-of-year country credit ratings. Taken together, the result of these checks are encouraging and help to alleviate endogeneity concerns. Despite this, we cannot rule out that some unobserved, time-varying confounder drives our results, so that the coefficients should be interpreted with caution. We show strong conditional correlations and do not claim to show causal effects.

With this caveat in mind, we show that the estimated coefficients for debtor coerciveness *during* default are both large and robust. In our most demanding specification, moving from a soft default as in Uruguay 2003, to a coercive default as in Argentina 2001–2005, is associated with a three percentage point lower growth rate in each default year. Because debt crisis spells span more than 5 years, on average, this correlation coefficient would translate to a more than 10 percentage point lower GDP level in hard defaults as opposed to soft defaults (in the short- and medium-term).

While the differences are large during ongoing crisis spells (in each year of default), we find no evidence for long-term effects post-crisis, i.e. once the country finally receives debt relief and exits default. The coefficient of coercive debt policies is no longer significant after the default exit and we also find no robust relationship between the size of haircuts and post-crisis growth performance.³ This result may be due to the positive impact of debt relief on post-crisis investment and growth, as suggested by

² See Hebert and Schreger (2016) for a smart strategy to identify the output cost of default in one crisis case, namely Argentina 2014.

³ See Kuvshinov and Zimmermann (2016) for an analysis on the short vs. long-term impact of sovereign defaults on growth.

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