Quantifying the costs of sovereign defaults using a natural experiment

Fabian Horn (Otto-von-Guericke-Universität Magdeburg, Germany)

Sovereign defaults enable the defaulting countries to get rid of its debt which raises questions on the reason why sovereign debt can exists since lenders have to fear losing their money. Thus, a cost burden must exist for a country to achieve the government paying its debt. What are the costs that prevent the government from neglecting its debt, as mentioned by Eaton and Gersovitz in 1981? Historically, sovereign defaults mostly occur in times of low GDP growth rates, making it impossible to isolate the defaults' impact on macroeconomic fundamentals since the vice-versa causality cannot be ruled out when a traditional regression analysis is applied. This makes it impossible to quantify the defaults' idiosyncratic costs. An instrument variable for a sovereign default does not exist and it is likely that such an instrument does not exist at all. This paper applies a natural experiment approach to circumvent the above mentioned causality problem. Odious debt cases, as well as scenarios where the government leaders have argued that the government debt is illegitimate, are applied to quantify the sovereign default on macroeconomic fundamentals. Since only few of these cases are available, a panel analysis is conducted, using the Abadie and Gardeazabal (2003) and Abadie et al. (2010) synthetic control method for comparative case studies, in order to generate synthetic counterfactual countries that have the same macroeconomic fundamentals in the pre-default period. In addition to that, the creditors' behavior towards the defaulting country is analyzed, giving hints that FDI's, bank-lending as well as development aid decline after the non-necessary default is announced. Consequently, unilateral defaults are expensive.

JEL-Codes: C82, E01, F21, F34, F35, F51, N20, N26, N27, O54, O55