Discussion of:

"One Reason Countries Pay their Debts: Renegotiation and International Trade"

by Andrew K. Rose

and

"A Gravity Model of Sovereign Lending: Trade, Default, and Credit"

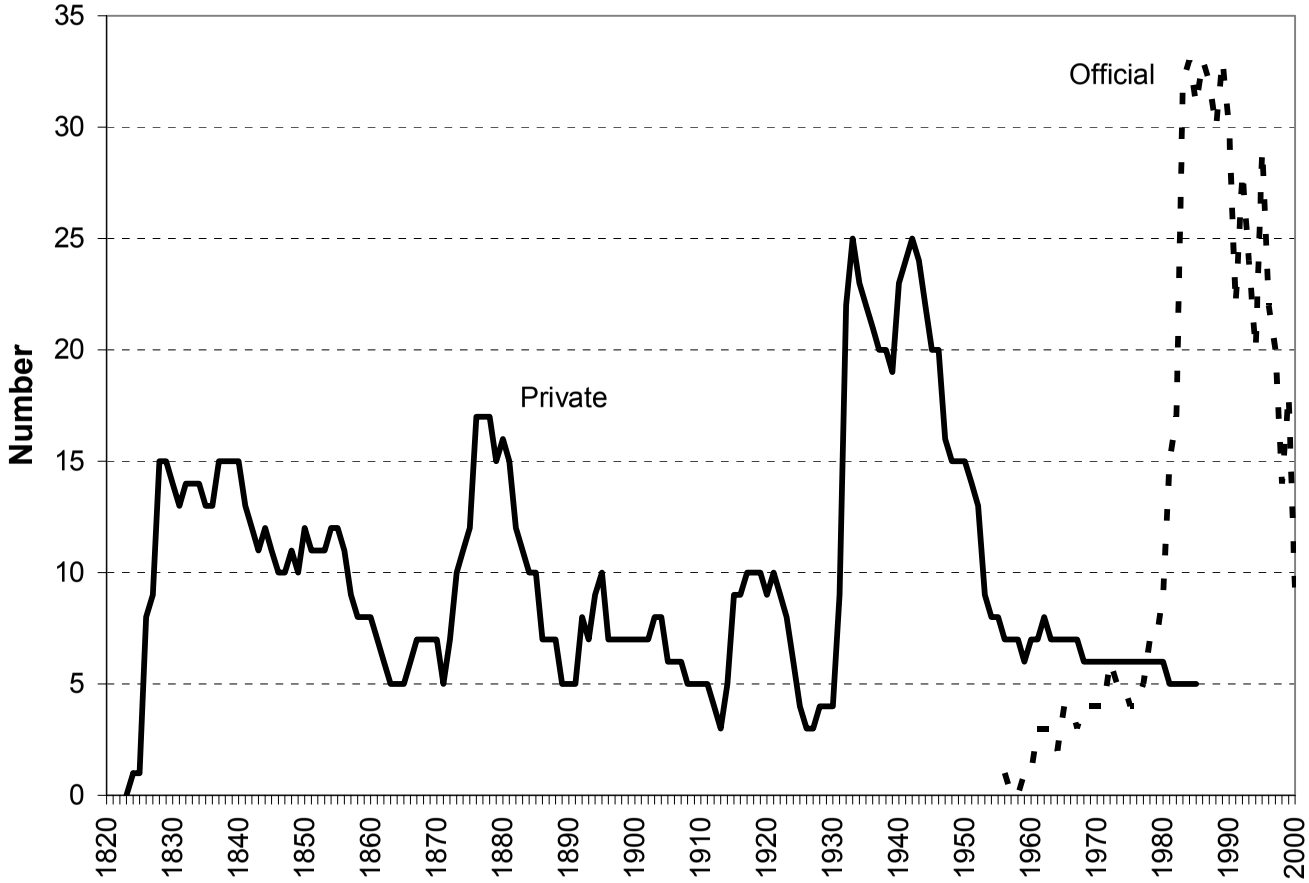
by Andrew K. Rose and Mark M. Spiegel

Mark Wright

Stanford University

SSHI Conference, February 2003

Two Centuries of Default



Sovereign Default

- Sovereign default is not uncommon
- And may be becoming more frequent
- Default appears to be very costly, to country itself and creditors
- In order to talk sensibly about "reforming the international financial architecture," we need a clear understanding of the forces governing the incentives of defaulting countries

Costs of Default

- Many theories of the costs of default
  - Legal sanctions post FSIA
  - Loss of future credit market access (Eaton and Gersovitz 1981)
    - Is this credible? (Bulow and Rogoff 1989, Kletzer and B. Wright 2000, M. Wright 2003, Amador 2003)
  - Reputation spillovers outside credit market (Cole and Kehoe 1997)
  - Trade and other direct sanctions (Bulow and Rogoff 1989)
  - Denial of trade credit (Kaletsky 1985)
- Much less evidence on costs of default

Contribution of Papers

- Uncovers two facts about sovereign default which we can use to discriminate between theories:

RESULT 1: Trade declines (a *large* amount) after a sovereign default

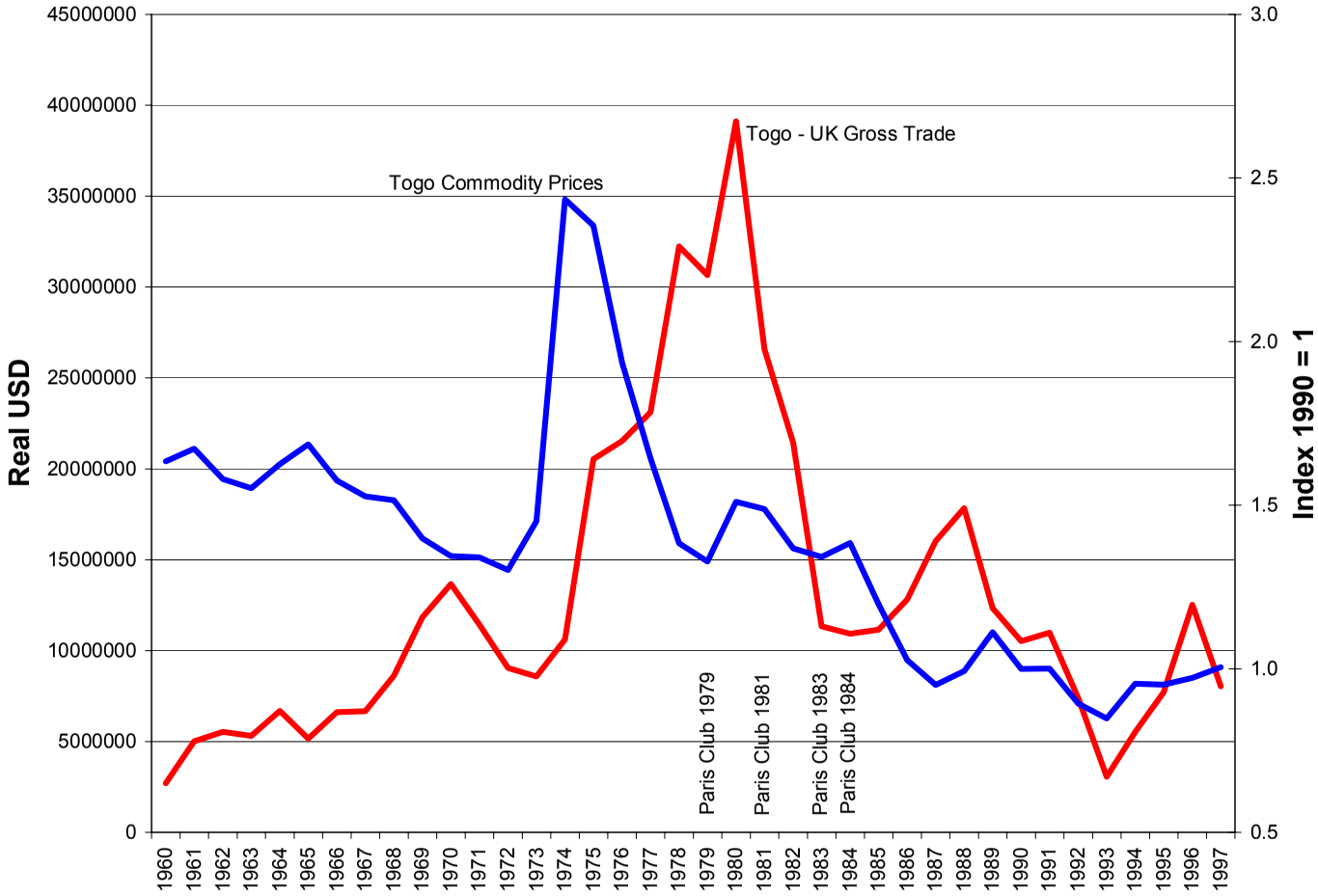
RESULT 2: Bilateral debt stocks increase with bilateral trade flows

- Argues that this is evidence in favor of trade sanctions or loss of trade credit as important cost of default

Result 1: Trade Declines with Default

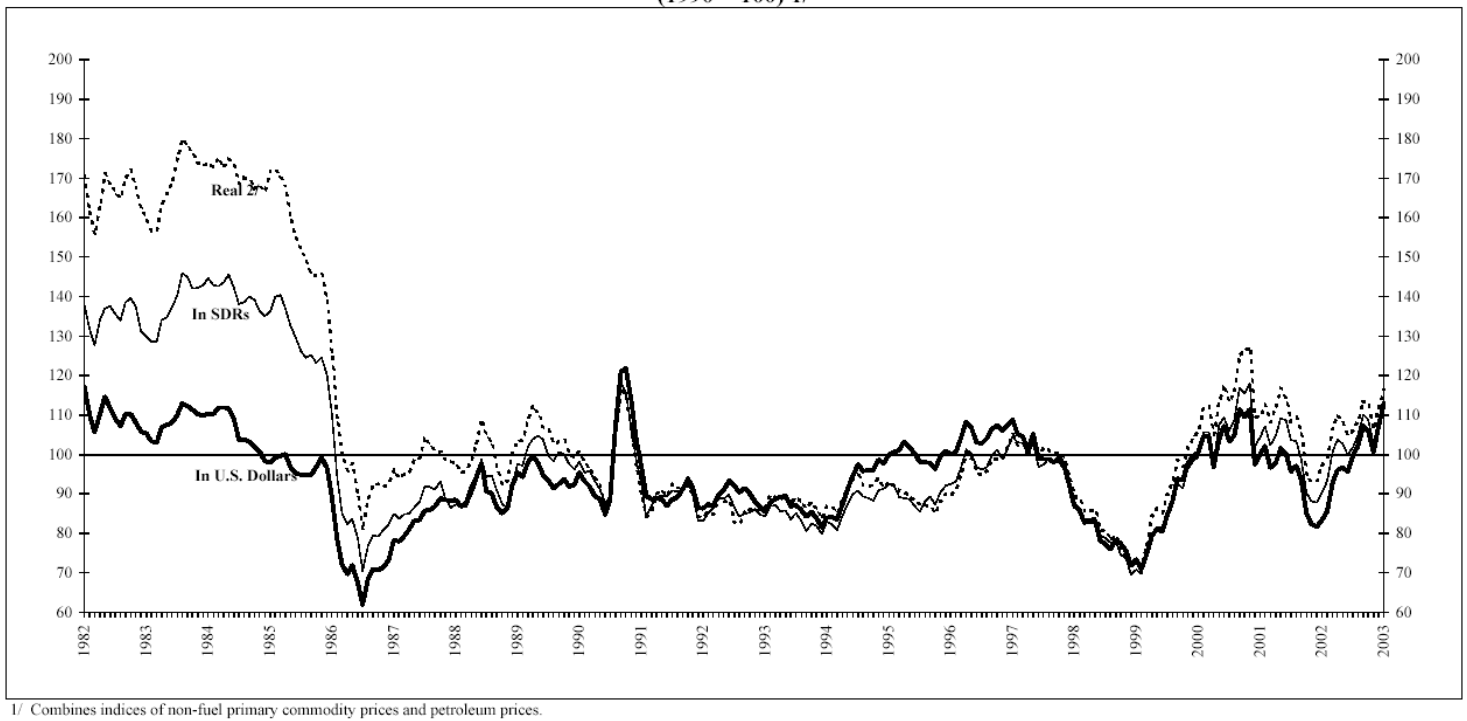
- Strategy is to add default variable to gravity equation for real trade
- Default variable is date of Paris Club agreement (timing relative to default and onset of punishment?)
- Finds that gross trade falls, over a period of 15 years, by the total of one years gross trade (a large number)
- For example: Togo
  - 1979 Paris Club agreement
  - trade with UK fell from $30.7m in 1979 to $5.5m in 1994 (real USD)

Result 1: But is it commodity prices?



Result 1: But is it commodity prices?

CHART 1
INDICES OF PRIMARY COMMODITY PRICES
(1990 = 100) 1/



1/ Combines indices of non-fuel primary commodity prices and petroleum prices.
2/ Deflated by the export unit value index for manufactures of industrial countries.

Result 2: Direction of Debts

- Add trade to a gravity equation for financial trade
  - stocks of bank debt by country on consolidated basis (not flows)
- Not surprising that debt *stocks* well described by gravity equation
  - Rey and Portes (2002): cross border equity *flows* fit gravity model
- Surprising that trade flows have additional explanatory power

Result 2: Direction of Debts

- Issues in specification:
  - bank debt *versus* bond debt
    - bank trade finance?
  - Nationality of headquarters? or branch?
- Issues in interpretation:
  - If pattern is driven by default, why is pattern stronger for industrial countries?

Evidence of trade or trade-credit sanctions?

- Why no direct evidence on trade sanctions as punishment? Declines are large!
- Little room under GATT/WTO rules for retaliatory sanctions in event of default
- Why is threat credible? Creditor countries have incentive to break a trade embargo in same way that they do a credit embargo. Bulow and Rogoff (1989) argument applies to trade credit.
- Model of Rose and Spiegel (2002) predicts selective default, but rarely observed in data.
- Studies of trade sanctions for other reasons often find trade of neighbors increases as they help break embargo (Slavov 2002)
  - alternative test: does trade of neighbors increase after default?

Are trade declines evidence against reputation?

- Loss of reputation/credit market access will predict decline in gross trade

- Can it predict *magnitude* of decline in trade?
  - Suppose that defaulters cannot borrow but can barter
  - Loss of reputation would result in decline in gross trade by amount of current account deficit (CAD) for length of embargo
  - Average CAD in emerging market sample is 12% of gross trade
  - Predicted decline in gross trade in ballpark of Rose (2002) estimates if credit embargoes last five to ten years

Is the direction of lending evidence against reputation?

- Direction of lending result more challenging to reputation story *when combined with facts on gross flows*
- Many reputation models (e.g. Kletzer & B. Wright 2000) inconsistent with large gross flows
- In multigood versions of that model, minimize gross flows by *only* borrowing from trading partners
- Other reputation models match large gross flows, but don't predict direction of lending
- It is possible for a reputation model to match both facts if add information friction that favors trading partners
  - is this plausible?

Conclusion

- Existing evidence on costs of default limited and/or problematic
  - e.g. Lindert & Morton (1989), Ozler (1993) (and others) evidence necessary but not sufficient
- Rose (2002) and Rose & Spiegel (2002) present new evidence on costs of default
  - direction of trade result, *should it prove to be robust*, is potentially very challenging for the reputation story to explain
- If trade sanctions are at work, why is there no direct evidence?
- How can we distinguish 'denial of trade credit' as a punishment *per se* from declines in trade credit for reputation reasons?

More empirical work needed!