

Response to
“Is it Punishment? Sovereign Defaults and the Decline in Trade”
by Martinez and Sandleris

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Summary

This paper is a critique of “One Reason Countries Pay Their Debts: Renegotiation and International Trade” that I started to circulate just over two years ago. It asks the question of whether trade declines generally following a sovereign debt default/renegotiation. Particular emphasis is placed on distinguishing between trade shrinkages that occur following default between a defaulter and its official (Paris Club) creditors, as opposed to those between defaulters and *everyone*. The authors argue that trade declines vis-à-vis everyone, not just defaulters, and conclude that there’s no evidence that creditors punish defaulters through trade.

Analysis

I like the basic idea of this paper. In fact, I liked it so much that when I wrote my original paper (of which this is a critique) a couple of years ago, I searched explicitly for exactly the same phenomena.¹ So it’s not clear to me that the idea is wholly new. That’s OK; but it means that the results better be very different from mine in an important and believable way for this paper to warrant publication.

There is at least one other big issue: what does it all mean? I actually never argued that the trade shrinkage observed following default implied that creditors were punishing debtors. Indeed, the concluding paragraph of my paper reads:

“I have not identified whether the effect of default on international trade appear because of a natural shrinking of trade finance, because creditors seek to punish and deter default, or some other reason. Providing direct evidence on the mechanism that links default and trade is a natural project for future research.”

So this paper doesn’t contradict what I wrote. Indeed, it’s completely consistent with my paper, since if countries fear trade shrinkage *for whatever reason* they are more likely to repay their debts. And, it completely ignores my concluding question, namely why should trade shrink following default/renegotiation (vis-à-vis creditors or everyone)?

Big

Be fair. I included a whole sub-section on trade diversion which is highly similar (if not identical) to your basic idea. I might have done it poorly as far as you’re concerned, but then you should say what I did wrong. More generally clarify the relationship between our papers.

¹ Check out Table 5 and the “Trade Diversion” subsection of part IV of my paper, available at: <http://faculty.haas.berkeley.edu/arose/Debtshort.pdf>

Lags. I'm concerned about the persistence of your effects. I reported results with lag-lengths of up to twenty years, and have always been surprised by this persistence. Yet you cut off lags after ten years. Is this important? Are results robust if you go further back?

Importance. Paris Club members are a large part of the world's GDP. Are they a large part of the trade of a typical defaulter? In other words, are your results statistically significant but economically small? Please clarify and quantify!

Summary Statistics. At a number of points in my paper, it's clear that the initial lags of default have positive values but the later ones are bigger and negative (Table 2 is probably the easiest place to see this). I tried to make this clear, and also focus on the total effect of default on trade, after all the dynamics have worked themselves out. Why then the emphasis in your work on the first 3 or 5 lags, and the complete absence of summaries for the complete set of effects? When I look at e.g., your Tables 1 or 2, I see big negative coefficients for the creditor lags between lags 6 and 10, and big positive ones for general lags between 6 and 10. It's quite misleading to mis-represent this in your summary statistics by ignoring them and focusing on lags through three or five. Shape up!

Small

You state (correctly) on p3 that I do not formally base my argument on bilateral trade sanctions, but you certainly lead the typical reader to believe that sanctions/punishment/etc are critical to my interpretation. They're not. Please correct this mis-impression!

Add an error to the estimating equation (and perhaps an interpretation of it, and a discussion of its properties).

Clarify the role of IMF dummy variables (if you include them) in your estimating equation. They're not included in equations (1) or (2) – they're certainly not part of the standard gravity equation. But I think they're usually in. Still, why is there any uncertainty? Do lags in them matter?

Your fixed effects seem to be country-specific (p 8), but then how do you handle random effects? Why aren't both dyadic (i.e., country-pair based)? I'm open-minded, but this should all be clearer.

Why is the current account surplus/deficit "bound" to be correlated with trade as you state on p11? In what way?