Financial disruption as a cost of sovereign default: a quantitative assessment

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One of the main policy questions in Europe nowadays is about the merits of fiscal austerity. One of the main objectives of fiscal tightenings is to reduce sovereign default risk, hence policy recommendations depend on the costs of a sovereign debt restructuring. Trouble is, we know very little about those costs.

A sovereign debt restructuring might affect the economy in a variety of ways and some of those are very hard to quantify. However, one important (and often mentioned) cost of default is its negative effect on the banking system. This paper tries to quantify this particular cost.

We extend an off-the-shelf macroeconomic model with financial frictions in order to allow for sovereign debt. We then consider an exogenous sovereign debt restructuring episode and study what happens to the economy. A trade-off emerges. On the one hand, sovereign debt restructuring implies a reduction in the value of banks' assets, which forces banks to deleverage, reducing credit to the economy and leading to a fall in economic activity. On the other hand, it loosens the government's budget constraint, allowing for a less contractionary fiscal policy (a debt restructuring is effectively a transfer from banks to the government). Our results show that the losses from financial disruption are offset by the benefits of a less contractionary fiscal policy, and especially so when tax rates are large.