Monetary Shocks, Currency Exposures, and the Cost of Sovereign Default

Non-technical Summary

Jeff K.W. Cheung (UC Davis)

This version: November 24, 2025

How costly is sovereign default? It is a simple question with enormous policy implications. When a country struggles to repay its debt, international organizations like the IMF or the ECB often step in with rescue packages worth billions of dollars. These aid programs often come with painful conditions—cutting public services and reducing social benefits—which can spark public anger at home.

However, unlike households or firms, a country cannot be forced into bankruptcy because there is no international court that can enforce repayment. This raises uncomfortable questions: if sovereign defaults have limited consequences, why should governments accept politically costly austerity measures, or even more sharply, why should they repay external debt at all? On the other hand, why should international taxpayers fund expensive bailouts if default does little economic damage?

The empirical challenge is that sovereign defaults almost always happen during deep recessions. This creates a classic chicken-or-egg problem: does the country default because its economy has already collapsed, or does default itself deepen the recession? For governments and global lenders, understanding this causal direction is crucial.

My paper uses a simple and intuitive idea to isolate the causal effect of sovereign default on output loss: think of Argentina, which borrows in—and must repay in—U.S. dollar, British pound, Japanese yen, and other foreign currencies. When the Federal Reserve raises interest rates, the peso depreciates. Since Argentina's government collects tax revenue in pesos, a stronger U.S. dollar makes its U.S. dollar debt more expensive to repay, increasing the default likelihood. Crucially, the Federal Reserve's monetary decisions are made entirely based on the U.S. economy, with no regard for Argentina's conditions.

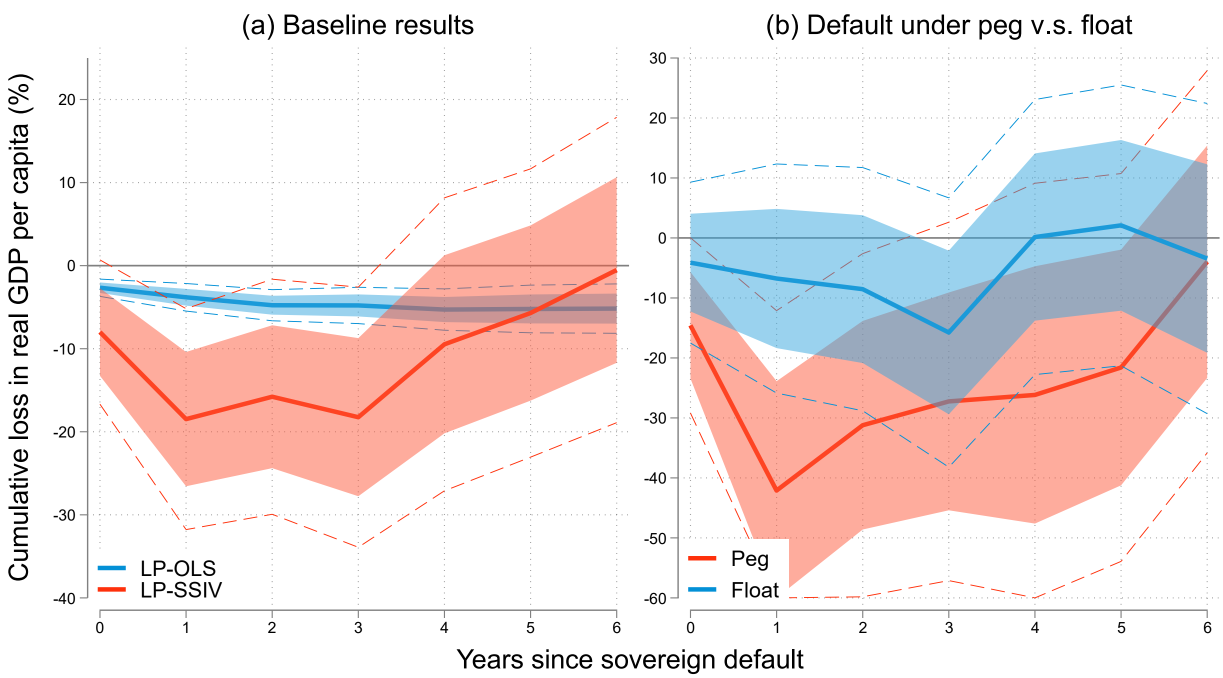
Countries differ in how much they borrow from each foreign currency. For example, many Asian countries borrow a significant amount in Japanese yen, so when the dollar strengthens, countries with more U.S. dollar debt are hit much harder than those with stronger ties to Japanese yen. This difference in exposure allows me to cleanly separate the cost of sovereign default from the recession in which it occurs.

The baseline result is that a sovereign default lowers real GDP per capita by about 8% in the first year, and the cumulative loss amounts to around 18%. However, the damage is not permanent—GDP recovers, and output losses fade to zero after about six years (Panel (a) in Figure 1). Therefore, sovereign default is painful but not catastrophic: it brings severe short-run costs, but not lasting scars.

The effects are far worse for countries defaulting under a fixed exchange rate regime, since pegs remove the monetary flexibility that governments desperately need during financial stress (Panel (b) in Figure 1). This is consistent with the prediction from the classic monetary trilemma.

The bottom line offers some grounds for optimism: sovereign default causes real economic pain in the short run, but it is not the end of the world. Countries must weigh these short-run costs against long-run feasibility of repayment, and international lenders must consider whether the expensive rescue packages truly justify their price.

Figure 1: Main LP-SSIV results on the cost of sovereign default



Notes: Robust standard errors are clustered at the country level. Solid lines show point estimates; shaded areas are one-standard-deviation (68%) confidence intervals; and dashed lines are the 90% confidence intervals. Sources: World Development Indicator; International Debt Statistics; JST Macrohistory Database; Kuvshinov and Zimmermann (2019); and Ilzetzki et al. (2019). See Figure 4 and references in the main text for details.