

# Defaulting Differently: The Political Economy of Sovereign Debt Restructuring Negotiations

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Negotiations to restructure sovereign debt are protracted affairs, and their outcomes, known as “haircuts,” range from 0 to 80 percent creditor losses. Haircuts impact states’ ability to borrow, cost of borrowing, and economic recovery; they also redistribute income—between states and creditors and between domestic interest groups. I conceptualize the interaction between governments and private creditors as a bargaining game where the government’s will to repay is private information. Creditors can make inferences about repayment based on the government’s political economy, but distributional signals are muddled when there are multiple veto players. Where additional uncertainty persists, governments can issue a public declaration of default, triggering costs in international financial markets. This costly signal separates governments that are willing to repay from those that are not and extorts greater concessions as a result. Using data on haircuts and public default declarations in market-based restructurings from 1980 to 2009, I find that governments are more likely to engage in costly signaling when they face heightened domestic constraints. When governments issue public declarations, they are subsequently rewarded with higher haircuts. Defaults do not all look the same, and the economic consequences are varied.

Las negociaciones para reestructurar la deuda soberana son asuntos que tienden a prolongarse en el tiempo y sus resultados, conocidos como «recortes», pueden variar entre el cero y el ochenta por ciento de las pérdidas para los acreedores. Los recortes afectan a la capacidad que tienen los Estados para obtener préstamos, así como al coste de los préstamos y a la recuperación económica. Los recortes también redistribuyen la renta, tanto entre los Estados y los acreedores como entre los grupos de interés nacionales. Conceptualizamos la interacción entre los Gobiernos y los acreedores privados como si fuera un juego de negociación donde la voluntad de pagar por parte del Gobierno es una información privada. Los acreedores pueden hacer inferencias sobre el reembolso basándose en la economía política del Gobierno, pero las señales en lo referente a la distribución pueden resultar confusas cuando existen múltiples jugadores con derecho a veto. Cuando persiste esta incertidumbre adicional, los Gobiernos pueden emitir una declaración pública de incumplimiento, lo cual desencadena costes en los mercados financieros internacionales. Esta costosa señal separa a aquellos Gobiernos que están dispuestos a realizar reembolsos de los que no lo están y que, como resultado, exigen mayores concesiones. Concluimos, utilizando datos sobre recortes y declaraciones públicas de en reestructuraciones basadas en el mercado de 1980 a 2009, que es más probable que los Gobiernos sean más propensos a asumir estas señales costosas cuando se enfrentan a mayores restricciones internas. Cuando los Gobiernos emiten declaraciones públicas, pueden ser recompensados posteriormente con unos recortes más altos. No todos los impagos son iguales y sus consecuencias económicas son variadas.

Les négociations de restructuration d’une dette souveraine durent très longtemps. Leurs résultats, les « décotes », se traduisent par une perte de zéro à quatre-vingts pour cent pour les créanciers. Ces décotes ont une incidence sur la capacité d’emprunt d’un État, le coût du prêt et la reprise économique. Elles redistribuent aussi les revenus, tant entre les États et créanciers qu’entre les groupes d’intérêts nationaux. Je conceptualise les interactions entre les gouvernements et les créanciers privés comme un jeu de marchandage dans lequel la volonté de remboursement d’un gouvernement constitue une information confidentielle. Les créanciers peuvent déduire des informations sur le remboursement à partir de l’économie politique d’un gouvernement, mais les indications distributionnelles manquent de clarté quand il existe de multiples acteurs mettant leur veto. Lorsqu’il subsiste davantage d’incertitude, les gouvernements peuvent émettre une déclaration publique de défaut de paiement, ce qui engendre des coûts sur les marchés financiers internationaux. Cette coûteuse indication distingue les gouvernements enclins au remboursement de ceux qui ne le sont pas, et se traduit par des concessions encore plus importantes. À l’aide de données sur les décotes et les déclarations publiques de défaut de paiement dans des restructurations fondées sur le marché entre 1980 et 2009, je remarque que les gouvernements seront moins opposés aux coûteuses indications face à une exacerbation des contraintes nationales. Quand les gouvernements émettent des déclarations publiques, ils récoltent des décotes plus importantes. Tous les défauts de paiement ne se ressemblent pas et les conséquences économiques sont plurielles.

## Introduction

Global debt has ballooned in recent decades, a trend that has caused a resurgence of financial crises that require debt restructuring with private creditors. While crises have left countries as diverse as Puerto Rico, Argentina, and Gambia in default to private creditors, negotiations to restructure sovereign debt remain protracted affairs, lasting years or decades (Das, Papaioannou, and Trebesch 2012). The outcome of these negotiations, known as “haircuts,” varies significantly, ranging from 0 to 80 percent creditor losses

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in market-based restructurings. Haircuts affect the financial position of indebted states—their ability to borrow, the costs at which they can borrow (Cruces and Trebesch 2013), and their ability to reestablish positive growth (Marchesi 2015; Reinhart and Trebesch 2016; Trebesch and Zabel 2017); yet, economic variables are not always predictive of the size of haircuts imposed on creditors (DiGiuseppe and Shea 2019; Mamone 2020). If not with economic fundamentals, how else do creditors and debtors determine restructuring outcomes? The answer to these questions raises age-old questions about global distributional conflict and who ultimately adjusts in financial crises (Frieden 2015).

In this paper, I conceptualize the interaction between governments and private creditors as a bargaining game over the size of creditor haircuts. I argue that the government's political will to repay foreign debt is private information for which the government has incentives to misrepresent. Thus, time- and information-constrained creditors can only approximate, with some degree of error, borrowers' reservation points for repayment. They often rely on indirect indicators, like political institutions, to gauge leaders' support for debt policy. However, the government is rarely a unified actor; debt policy creates winners and losers. When there are competing claims from multiple politically empowered groups, creditors' uncertainty is heightened. They must estimate reservation points for more actors and make assumptions about interest aggregation. Where the information problem persists, I argue that the government can turn to behavioral tactics to signal their preferences. Governments who are unwilling to elevate creditors over pensioners can convey their "type" by publicly declaring default in front of a domestic and international audience and invoking reputational costs in financial markets. This costly signal separates governments that are politically willing to repay from those that are not and extorts greater concessions—bigger haircuts—from creditors as a result.

I test my theoretical argument in two stages. Using data on public default declarations and creditor haircuts for twenty-five countries undergoing market-based restructurings between 1980 and 2009, I establish that governments are more likely to use public declarations as a negotiation strategy when they are domestically constrained by multiple veto players. It is in these situations that creditors have the most difficult time deciphering the government's true willingness to pay without an additional signal. Controlling for this selection into public tactics, I further establish that public default declarations elicit larger creditor haircuts. Together, findings suggest that governments' negotiating tactics are an important behavioral signal of their willingness to pay, especially where other political economy cues lack clarity.

Bargaining tactics impact bargaining outcomes (Elms 2006; Schneider 2011). My findings provide insights into debt restructuring specifically, and the role of domestic politics in international negotiations more generally. First, despite the resurgence of debt crises in advanced states, we are ill-equipped to understand the political dynamics of the negotiation process itself. The majority of existing work on sovereign debt restructuring has focused on why and when default occurs, and has thus largely conceptualized default as a binary outcome. Yet, defaults do not all look the same, and the economic consequences are varied. Limited research exploiting variation in restructuring outcomes has taken a largely economic approach, focusing on underlying fundamentals rather than political institutions (Cruces and Trebesch 2013; Trebesch and Zabel 2017). Thus, this project is not only among the first to study continuous variation in debt restructuring outcomes (Connell 2019; DiGiuseppe

and Shea 2019; Mamone 2020), but it also incorporates novel variation in negotiation tactics (Enderlein, Trebesch, and von Daniels 2012). I analyze how governments act in restructuring negotiations in order to explain the size of creditor haircuts.

### Sovereign Debt Restructuring and Private Creditors

Debt restructuring negotiations are based on institutional norms, which constrain the behavior of the actors involved. As Ams et al. (2019) note, default (the event) is often conflated with actions taken during a restructuring (the process). Clarifying the difference requires a description of the procedural framework in which I situate my theoretical argument. While negotiating tactics have been explored in other intergovernmental areas, parallel understandings of sovereign debt restructuring have been more difficult, or limited to high-profile cases, due to the opacity of the negotiation process.<sup>1</sup>

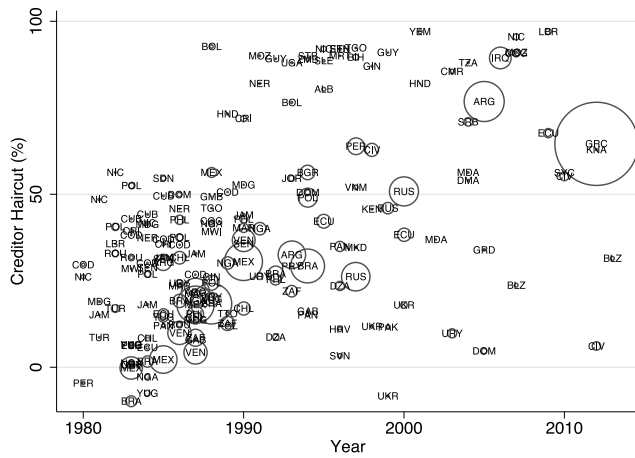
I define debt restructuring as "an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new instruments or cash through a legal process" (Das, Papaioannou, and Trebesch 2012, 7). This is different from default itself, which is defined as "the failure to meet a principal or interest payment on the due date" (Reinhart and Rogoff 2009, 11). Restructuring represents how countries default (Cruces and Trebesch 2013), and thus, the focus of this work is on how the original loan contract gets modified after a contractual breach. This can involve lengthening maturities, adjusting interest rates, reducing the face value of commitments, and debt buybacks. All of these methods of restructuring can involve a haircut, but debt restructuring and debt reduction are not synonymous.

The debt restructuring process differs significantly across creditor types. I focus on private debt claims owed to commercial banks and bondholders and incurred or explicitly guaranteed by sovereign governments. Unlike official loans, which are often used as foreign policy tools, the daily business of commercial banks and bondholders is to make a profit by pricing and managing credit risk effectively (Sturzenegger and Zettelmeyer 2006). The debt accrued by governments is similarly important because, unlike debts accrued by individuals, there is no ultimate contract enforcement for sovereign entities. Sovereign immunity and the lack of attachable assets make legal enforcement on sovereign debt contracts exceptionally weak.

Restructuring commercial bank debt occurs under the London Club. After the International Monetary Fund (IMF) has provided its seal of approval and established conditionality, the debtor contacts one or two of its largest creditors and asks them to chair a Bank Advisory Committee (BAC) with other representative creditors, who will negotiate on behalf of all banks. Once established, the BAC meets regularly with the defaulted government and exchanges offers and counter offers. Once an agreement is reached between the defaulted state and the BAC, the "terms sheet" is sent out to all other banks for approval. The final exchange offer cannot go into action without nearly unanimous approval; these decision-making procedures at the final stage provide individual creditors with an option to renege—either holding out for a better deal or suing the defaulted government in court.<sup>2</sup> This suggests that debt restructuring is a negoti-

<sup>1</sup>See Lomax (1986), Aggarwal (1996), Rieffel (2003), and Sturzenegger and Zettelmeyer (2006) for detailed case studies.

<sup>2</sup>Most restructurings require 95 percent creditor approval.



**Figure 1.** Creditor haircuts and debt restructured over time

ation in which creditors have weak tools to compel repayment.

Bond debt restructuring has been less frequent than commercial bank restructuring, but has become increasingly important with the advent of secondary credit markets.<sup>3</sup> In this case, the process unfolds in a similar, yet more ad hoc fashion. First, the defaulted state announces its debt distress and attempts to verify both its total claims and major bondholders. Second, the defaulted state prepares an exchange offer, usually with consultation from a bondholder committee.<sup>4</sup> Restructuring bond debt involves negotiations between debtor and creditors; however, the process is less routinized. Lastly, an exchange offer of new instruments for outstanding debt instruments is launched, usually as a take it or leave it offer with a minimum participation threshold.

For both bank and bond debt, once deals are concluded there exists significant variation in the negotiated settlement. Based on [figure 1](#), while the average creditor haircut in market-based restructurings is 37–40 percent, haircuts range from negative values (e.g. Brazil’s 1983 restructuring) to greater than 80 percent (e.g. Albania’s 1995 restructuring).<sup>5</sup> The estimates are even higher, almost 100 percent, for countries participating in the Highly Indebted Poor Country (HIPC) Initiative, although private creditors play a minimal role in these restructurings. Both the average haircut and haircut dispersion have increased over time.

While the opaqueness of the restructuring process has been limiting, work on the consequences of haircuts has established their economic impact. Recessions following a debt crisis are longer and deeper than more traditional recessions ([Jorda, Schularick and Taylor 2013](#)), and lead to political conflicts that can impede recovery ([Frieden 2015](#)). The size of a negotiated haircut also matters. Restructurings with higher creditor haircuts lead to larger bond spreads during default ([Cruces and Trebesch 2013](#)). However, several years after restructurings are concluded, high haircuts can soften GDP contraction ([Marchesi 2015](#)). Thus, while higher haircuts imply punishment in international financial

markets during and immediately following default, the negative effects lessen when the country exits the crisis episode ([Trebesch and Zabel 2017](#)). Similarly, the long-term economic position of indebted states improves more significantly after a restructuring when deals involve debt write-offs ([Reinhart and Trebesch 2016](#)). The economic effects of default are not fixed.

However, less is known about what determines haircuts. Leftist and party-centric democratic governments receive larger haircuts ([Connell 2019](#); [DiGiuseppe and Shea 2019](#); [Mamone 2020](#)). Studying default as a broader outcome, the idea that governments only default in “bad” times has been challenged. Evidence linking economic losses and default has been mixed ([Manasse, Roubini, and Schimmelpfenning 2003](#); [Tomz and Wright 2007](#); [Reinhart and Rogoff 2011](#)). Instead, political explanations based on institutions and distributional preferences have yielded more support ([North and Weingast 1989](#); [Stasavage 2011](#)). The potential for economic recovery depends on the outcome that can be reached during negotiations, which requires a focus on the process through which default unfolds.

### The Political Economy of Negotiations

What prevents creditors and debtors from reaching an agreement over the size of creditor haircuts? How do they overcome their conflicting preferences? I conceptualize the interaction between the borrower government and its foreign creditor group as a bargaining game over the size of creditor write-offs. I assume that the government faces an impending crisis that precludes it from fulfilling its debt obligations. To tackle the crisis, some amount of restructuring is required. The fundamental problem for office-motivated politicians is to negotiate a deal that maintains their hold on power, addressing the crisis in a way that maximizes political support for debt-related policies.

The government faces a spectrum of options. On one hand, the government can seek very small write-offs and rely primarily on domestic adjustment as a means of meeting debt obligations. Because smaller haircuts have smaller reputational costs, this option is more likely to minimize capital market exclusion and higher interest rates on future debt ([Cruces and Trebesch 2013](#)). However, it generally comes at the cost of either raising taxes or lowering government spending, which is difficult in the short term if fiscal spending is countercyclical ([Kaminsky, Reinhart, and Vegh 2005](#)). On the other hand, governments can seek large write-offs and rely less on domestic adjustment. A haircut specifies how much of the government’s original claims must be repaid, over what time horizon, and at what interest rate. Bigger haircuts can therefore provide short-term benefits to the government because the smaller the remaining obligations and the longer the length of maturities, the less the state will have to divert out of the fiscal budget in following years. The drawback of such cost-saving is punishment by international capital markets and spillover to the domestic financial sector ([Artera and Hale 2008](#); [Cruces and Trebesch 2013](#)).<sup>6</sup>

No matter which option the government pursues, the profit-motivated creditor group must agree to the deal. Intuitively, a default and subsequent restructuring always harms the creditor in the sense that they are not able to recuperate their full claim. However, initiating a credit boycott is also suboptimal; creditors are better off restructuring their

<sup>3</sup>There have been approximately twenty bond restructurings since 1950.

<sup>4</sup>For example, Belize’s 2007 bond restructuring involved a fairly concentrated creditor committee, while in Ecuador’s 2009 bond restructuring, no committee was formed. Greece’s 2012 bond restructuring was executed by a traditional creditor committee.

<sup>5</sup>[Figure 1](#) is recreated from [Cruces and Trebesch \(2013\)](#). It plots creditor haircuts over time, where the circle size represents the volume of debt (current USD) restructured in each deal.

<sup>6</sup>However, exclusion may be shorter than expected, especially where alternative creditors are willing to lend to risky, but politically strategic, recipients. See [Bunte \(2018\)](#).



original claims and reestablishing positive lending as quickly as possible (Bulow and Rogoff 1989). If prolonged crises worsen the economic position of indebted states, holdouts can lengthen the time until repayment. Debt reduction can increase incentives to undertake new efficient investments, leading to higher growth rates and cash flows to repay obligations. A Puerto Rican bondholder acknowledged this reality, stating:

“We don’t advocate for restructuring authority lightly ... Yet we believe when an issuer reaches the point where debt reduction becomes inevitable, any delay only serves to engage in value destruction through additional unsustainable borrowings, economic contraction and/or population loss due to reduced government services. Thus the restructuring—painful as it may be—provides greater value to creditors than lobbying for maintaining the status quo” (Feliciano 2016).

Thus, creditors are willing to “accept some degree of debt relief in order to enhance the collectability of the balance of exposure” (Buchheit et al. 2019, 342). However, they are still profit-motivated and seek to maximize their recovered value. For either type of government, those seeking high or low write-offs, creditors would like to be able to determine the minimum haircut that would restore economic growth—i.e., the government’s reservation point. If this information were public knowledge, the conflict would be resolved quickly, and a timely agreement over the size of a haircut would be reached.

However, concessions are not easily optimized and negotiations are prolonged because the government’s will to repay its foreign debts is private information, for which leaders have an incentive to misrepresent (Fearon 1995). Dating back to Eaton and Gersovitz (1981), there is a key distinction between a country’s ability and willingness to pay. Ability to pay refers to whether a government has the resources to meet its external obligations, while willingness to pay represents whether a government is willing to adjust those resources away from other areas of the domestic budget and into debt servicing. In other words, while all governments possess the ability to raise taxes, cut spending, or sell territory in order to compensate creditors, their willingness to do so is based on political calculations to elevate foreign debt above domestic policy concerns. Claims of poverty do not perfectly correlate with pennilessness (Tomz and Wright 2007). Leaders may claim they lack the ability to pay, when in reality they lack the political will. For example, investors in the Venezuelan negotiations in 1989 acknowledged that “the only claim for debt reduction is political” (Fuerbringer 1989). Creditors are subsequently likely to view claims of insolvency as a bluff, which creates a bargaining problem.

Therefore, while creditors would like to know the maximum value they can recover, they must make an informed judgment about the government’s willingness to pay. Creditors are politically savvy (Lienau 2014); they rely on mathematical algorithms, qualitative techniques, and third parties. Yet, they can only estimate, with some degree of error, the cost-benefit calculation of political leaders (Tomz 2007). They manage diverse portfolios and are bound by their information processing capabilities. They must economize the collection and evaluation of information (Mosley, Paniagua, and Wibbels 2020) and often rely on heuristics—cognitive shortcuts—to assess leaders’ support for debt policy (Brooks, Cunha, and Mosley 2015). There is a vast literature on the role of political cues in accessing international financial markets. For instance, democratic institutions, financial transparency, and partisanship are all cues on which creditors rely to assess willingness to pay when deciding

whether to extend credit and at what rate (Beaulieu, Cox, and Saiegh 2012; Barta and Johnston 2018; Copelovitch, Gandrud, and Hallerberg 2018). More important for this context, the literature also suggests that high-level political cues inform the concessions creditors grant in debt restructuring. For example, democracy and party-centric systems imply that leaders need larger haircuts to satisfy their broad constituencies (Connell 2019; Mamone 2020). Creditors can also foresee that negotiations with leftist governments will be more difficult and will grant higher haircuts (DiGiuseppe and Shea 2019).

While institutional cues help creditors solve some uncertainty in debt restructuring, information shortcuts can be noisy (Brooks, Cunha, and Mosley 2022). Specifically, the borrower government is rarely a unified actor. Economic consequences mean that some societal groups win and some groups lose when the government extracts creditor concessions. While the specific coalitions that form around debt policy are likely to vary between cases, some general divisions can be deduced. Stasavage (2003) argues that those who own government debt or pay taxes have preferences over repayment. Those who own public debt have a clear incentive to make the government honor the full value of its contract. Even where domestic constituents are unlikely to hold public debt, as in developing countries, spillover costs mean that economic elites derive greater utility from repayment (Roos 2019). The increased cost of private sector borrowing (Artera and Hale 2008) and the decline in trade and investment (Rose 2005; Fuentes and Saravia 2010) lead Connell (2019) to assume that financial institutions, export firms, and multinational corporations will prefer smaller haircuts. Conversely, minimizing creditor losses places a larger burden of adjustment on domestic taxpayers. The larger the share of repayment, the more the government has to rely on austerity. Those who depend on wages, government salaries, pensions, welfare, or subsidies lose when public expenditures are reallocated to pay foreign creditors (Frieden 1991; Ballard-Rosa 2016). Connell (2019) identifies labor and import-competing firms as groups that prefer high haircuts. These distributional conflicts are supported by public opinion surveys (Tomz 2004; Curtis, Jupille, and LeBlang 2014).

Debt policy is thus the subject of fierce political struggle. Where stakeholders from different coalitions have access to political power (Stasavage 2003), debt policy becomes a “complex tug-of-war within the debtor country” (Roos 2019, 42). Competing preferences from multiple politically empowered groups make the information problem more difficult for creditors to solve. While creditors can look to who controls political institutions, leaders do not always get what they want when checks and balances exist. As one commentator stated, “creditors might be better off in a situation where the party that comes to power comes decisively” (Washington Post as cited in Aggarwal [1996, 542]).

The information hurdle that creditors must overcome is therefore greater when restructuring requires the approval of multiple domestic actors who are beholden to different constituencies with different preferences. In situations with multiple veto players, uncertainty over willingness to pay can persist for two reasons. First, more domestic actors means more reservation points for creditors to estimate. This is particularly difficult if societal groups’ ability to bear distributional costs is unknown to other domestic actors (Alesina and Drazen 1991). This is also aggravated because of uncertainty over the precise costs of default. As Roos (2019) notes, political contestation endures over the perceived consequences of default, with political actors mobilizing re-

sources to sell their interpretation of an unknown parameter.

Second, creditors must make assumptions about interest aggregation. Some politicians stand to win from a higher rate of repayment, while others stand to lose. But how do politicians resolve these differences, and how do veto players exercise their authority? The question is about the policy to which the government would revert if players exercised their veto. The answer is unclear (Tomz and Wright 2013). The common conception is that more, and more ideologically dispersed, veto players increase policy stability (Tsebelis 2002). In other words, leaders who require collective assent are susceptible to gridlock (MacIntyre 2001).

Some scholars have used this idea to argue that veto players increase the likelihood of repayment. If default occurs by affirmative action, then more veto players increase the likelihood that low-haircut interests are represented. Even if low-haircut interests are in the minority, they are likely to be in an advantaged position (Roos 2019) and can form cross-issue linkages with other groups (Saiegh 2009). They can therefore block actions that would force large concessions on creditors, perhaps by calling a vote of no-confidence or leaving a political coalition (Kohlscheen 2010). Anecdotaly, Saiegh (2009) points out how in Argentina's 1999 presidential election the candidate from a multiparty coalition (Fernando de la Rúa) ran on a pro-repayment platform while the less-constrained single-party candidate (Eduardo Duhalde) favored default. Empirically, more veto players are associated with a lower probability of default and restructuring (Van Rijckeghem and Weder 2009; Kohlscheen 2010).<sup>7</sup>

Conversely, repayment requires legislation. Other scholars have used veto players' association with gridlock to argue that more veto players increase the risk of default or financial crises. If repayment requires affirmative action, when actors cannot agree on how austerity costs will be distributed, default can occur passively as a result of discord. Veto players can block the appropriation of funds for debt servicing, as was the case in Peru in 1984. The Central Bank, led by Richard Webb, refused to release the foreign exchange Peru needed to repay its foreign debts, even though Peru's President, Fernando Belaúnde Terry, adopted a more cooperative stance with creditors (Aggarwal 1996). Alesina and Drazen (1991) and Oatley (2003) argue that austerity is harder to achieve, and therefore delayed, when there are more veto players. Ha and Kang (2015) also find that more political constraints reduce fiscal and monetary tightening.

While I leave a more thorough investigation of debt policy reversion to future work, the most conservative conclusion is that the process through which preferences get aggregated to policy presents an additional information hurdle for creditors to clear. Scholarship and history is ambiguous; veto players can both increase and decrease the level of repayment, depending on the conditions in place (Tomz and Wright 2013). This heightens creditors' uncertainty about the outcome of domestic political conflict. This squares with previous findings that veto players do not have a direct impact on haircut size (Connell 2019; Mamone 2020). However, veto players lengthen the time it takes to reach a restructuring deal (Mamone 2020), which is costly to both sides (Ams et al. 2019).

Because institutional cues provide suggestive information at best, creditors are continuously looking to update their beliefs about the government's willingness to pay. This is evident in the movement of international capital markets

around political events and announcements (Bernhard and Leblang 2006; Moser and Dreher 2010; Luechinger and Moser 2014). In the following section, I theorize about how the government's behavior during restructuring negotiations can provide additional information and help resolve the bargaining problem.

#### *Public Default Declarations*

Governments' debt preferences may be inferred based on their political economy. However, these signals can be muddled. Where uncertainty persists, governments can also choose specific negotiation tactics, or observable patterns of behavior, to advance their interests. For instance, some governments take a "hard," "involuntary," or "coercive" stance vis-à-vis their creditors, while others behave more cooperatively (Cline 2004; Roubini 2004). These procedural aspects of the negotiation process have received little attention, particularly as a credible signal of the government's debt preferences.

I argue that one tactic governments can employ to resolve the information problem to their benefit is to make a public declaration of default.<sup>8</sup> While the final deal is usually subject to domestic ratification, tactical decisions can temporarily bypass domestic veto players. Thus, unlike institutional cues or policy change itself, public declarations can be used unilaterally by politicians during the negotiation stage. Rather than implying default by missing a principal or interest payment, as is most common, key officials can explicitly announce the decision to suspend payments in front of a domestic and international audience, usually via a televised speech. For example, Argentinian president Adolfo Rodríguez Saa announced in a televised national address that, "we are taking the bull by the horns ... the Argentine state is suspending payments on its foreign debts" (Krauss 2001). President Jose Sarney of Brazil was more apologetic when he announced in a television and radio speech that "the country is suspending payments on its foreign debt. I must confess it isn't easy to take a decision of this magnitude" (Hayward 1987). While the context and executive personality vary widely, when such action is taken publicly and unilaterally, it proliferates through international and domestic news sources. Unlike technical defaults, which may get lost in the pages of financial press, public declarations of default become headlines in the mainstream media. They are a clear, explicit, and costly signal.

Public declarations serve two, empirically indistinguishable, purposes in pushing the outcome of negotiations toward a high haircut outcome. First, and most importantly, public declarations are confrontational and can be seen as analogous to war (Enderlein, Trebesch, and von Daniels 2012). They imply that default is a conscious decision on behalf of a sovereign government rather than an accidental byproduct of unfavorable economic circumstances. Public declarations are thus met with a swift loss in investor confidence. Exchange rates, stock market valuations, and credit ratings fall. Bond spreads and interest rates rise. For example, after Russia's public default declaration in 1998, their sovereign credit rating was downgraded from a B- to CCC. The value of dollar-denominated debt fell 12.5 percent overnight, and the Russian stock market lost 15 percent in value (Garfield and Paterson 1998). For Peru, one banker responded to a public default by saying, "if they get

<sup>7</sup>This argument also appears in the democratic advantage literature (North and Weingast 1989; Schultz and Weingast 2003).

<sup>8</sup>Public declarations are one of many strategies available to debtors. The tradeoff and interaction between different negotiating tactics are fruitful avenues for future research.

confrontational, we'll cut of all that ... they won't be able to import food or spare parts" (Kristof 1985). Creditors were not bluffing and within a month Peru was having to ration imports because its trade credits had been revoked. As I detail in Appendix B, Greek Prime Minister Papandreou's decision to call for a national referendum on the government's 2012 restructuring deal was widely interpreted as a public declaration of default as more than 60 percent of Greek citizens were opposed to the deal (Thompson 2011). Overnight, the Athens Stock Exchange fell 7.7 percent, and Greek bond yields increased by 16 percent (Kyriakidou and Papadimas 2011). For Brazil, capital market exclusion following its 1987 public moratorium was so painful that it went out of its way in 1989 to assure creditors that delays in repayment were not a public admission of default.

Most broadly, Trebesch and Zabel (2017) find that when governments default cooperatively, real GDP per capita drops marginally and recovers quickly. However, for coercive cases, output drops drastically—7 percent in the first crisis year—and recovery is sluggish. Appendix C replicates the authors' analysis for public declarations, finding a sharp decline in per capita GDP for countries that defaulted publicly. While public declarations can incur costs through multiple mechanisms (i.e., stock markets, trade credits, etc.), the aggregate effect is negative and significant. Their costliness makes public declarations credible.

Not only are public declarations costly in international financial markets, but they also help to unify the debtors' position—sending a clearer message to creditors. Politicians have long used international negotiations to push through unpopular domestic policies (Vaubel 1986; Przeworski and Vreeland 2000). As Putnam (1988, 457) states, "international negotiations sometimes enable government leaders to do what they privately wish to do, but are powerless to do domestically." To this end, public declarations of default generate strong nationalist sentiment. Preserving the government's sovereign ability to spend its resources as it so chooses becomes a source of national pride. Conversely, repayment is cast as unpatriotic, prioritizing foreigners over citizens. As Brazilian president, Jose Sarney, stated, default is not an act of confrontation but "an attitude of courage and faith in the Brazilian people." He claimed that the "bill should not be paid with [Brazilian] misery" (Constable 1987), and those who criticized the government's debt position were guilty of treason (Dawnay 1987). In Venezuela, commentators suggested that outgoing President Lusinchi's public default was a way to limit the flexibility of his successor, who would look weak if he backed down from Lusinchi's confrontational stance (Platts Oilgram News 1989). If this framing is successful, public declarations make repayment unpatriotic. Even politicians with pro-repayment constituencies may find it difficult to counter the rhetoric of sovereignty. As Vreeland (2003) argues, voters reward the government for securing a good deal in negotiations with official creditors; this same national loyalty is likely to carry over to negotiations with private creditors. It is also likely to prevent the pro-repayment opposition from holding up the implementation of a high-haircut restructuring deal.

From this theory, two empirical implications flow. As a strategic actor, the government will weigh the benefits of achieving a restructuring outcome closer to its ideal point against the potential cost and effectiveness of a public default declaration. This implies that the distribution of veto players matters because it affects the depth of the information problem and therefore the effectiveness of a public declaration. Where the government is unified, a single position on debt policy can be communicated without incurring ad-

ditional costs. For example, Romania's Nicolae Ceausescu was an exemplar of totalitarian authority. The Romanian restructurings in 1982, 1983, and 1986 are noted as some of the most collegial negotiations—no public moratoria were issued—and some of the most painful, where the government forced citizens to live with little heat, electricity, or food in order to pay private creditors (Reinhart and Rogoff 2009). Where the government consists of numerous veto players, creditors have a harder time deciphering the government's true willingness to pay based only on institutional or distributional cues. For example, while Prime Minister George Papandreou's position was based on repayment, domestic protests, opposition parties, and people within his own party took a more anti-austerity position.<sup>9</sup> Therefore, behavioral negotiation tactics like public default declarations are more important for leaders in constrained political systems.<sup>10</sup>

**H1:** *Governments will be more likely to issue public default declarations as the number of veto players increases.*

Where public default strategies are used, they reveal information about the government's unwillingness to pay. Public strategies can not only unite nationalist sentiment, but they are also costly enough to be credible. Public declarations solve the information problem and clarify a single position on debt policy such that "from the point of view of strategic negotiations, [indebted states] are in a much stronger position" (Dow Jones Newswire 1999). The second empirical implication is that:

**H2:** *Governments who publicly declare default will receive larger haircuts.*

## Research Design

To test my hypotheses, I conduct quantitative analyses using data on public default declarations and creditor haircuts for twenty-five defaulting countries conducting market-based restructurings from 1980 to 2009. I focus solely on negotiations where private creditors play the leading role and their motivations are explicitly profit-oriented.

### Dependent Variables

There are two key outcomes of interest: (1) the decision to issue a public default declaration (H1) and (2) the negotiated outcome of restructuring, measured in terms of creditor losses (H2). For the former, I introduce a measure of default declarations from Enderlein, Trebesch, and von Daniels (2012). While many studies model default as a dichotomous decision, the authors develop the first index of government coerciveness. They code negotiation and procedural behaviors from qualitative sources, primarily the financial press. The index contains multiple indicators, but to measure the publicity of a government's position, I rely on their coding of an explicit moratorium or default declaration.<sup>11</sup> The authors note that most defaults occur silently,

<sup>9</sup>See Appendix B.

<sup>10</sup>Punishment for debt policy is also contingent on the clarity of responsibility (Powell and Whitten 1993). To blame leaders, citizens have to be able to determine who is in charge, how much control they have over the outcome, and what the alternative policy solutions are (Anderson 2000). Just as high dispersion of veto players obfuscates creditor cues, it also obfuscates domestic responsibility for debt policy. While these mechanisms are not empirically distinguishable, greater effectiveness and lower cost both point to an increased use of public declarations by divided governments.

<sup>11</sup>There is significant variation in which negotiation tactics governments turn to. See Appendix A.



whereby governments miss payments without a public announcement. In more than 80 percent of cases, governments miss a payment, thereby violating the debt contract, without announcing that information publicly. However, when a key government official (president, prime minister, minister of finance or economy, or central bank president) officially proclaims the decision to default in front of its public (usually via a televised speech), the *Declaration* indicator is coded as 1. This occurs in eleven cases of debt restructuring, and the authors code the measure on a country-year basis during periods of active negotiation.

This measure has several distinct advantages. First, the measure captures only behavior toward private creditors. Second, the indicator is coded in a general way to apply to both banks and bondholders. For example, the Dominican Republic issued several public moratoriums against its bank creditors in the 1990s as Argentina did against its bondholders in the early 2000s. This allows me to study the government's negotiation behavior continuously across different eras of lending. Third, the novelty of this dataset is such that previous studies have only attempted to study negotiation behavior as an aggregate measure of total coercive actions (Trebesch and Zabel 2017). Studying public moratoriums specifically provides a theoretical and empirical innovation by demonstrating that governments are motivated toward specific behaviors rather than coerciveness as a general concept.<sup>12</sup>

Data on default declarations are available from 1980 to 2009 and include both developing and emerging market countries. To identify debt crises, Enderlein, Trebesch, and von Daniels (2012) start with Standard & Poor's annual default lists, where a country is coded as in default if either (a) it misses an interest or principal payment or (b) it announces a debt exchange offer that is less favorable to creditors than the initial contract.<sup>13</sup> Countries with populations under one million and countries that restructured under exceptional circumstances are excluded (e.g., restructurings in Yugoslavian successor states). The data also exclude any country that restructured debt under the HIPC initiative. While this limits the sample size substantially, this exclusion is important because HIPC negotiations are led by official creditors, with private actors playing a minor role. The resulting sample covers 25 defaulting countries over 212 country crisis years or 76 market-based restructurings.

The second outcome of interest, creditor losses, requires detailed data on the outcome of restructuring agreements across a wide range of crises. Empirically, haircuts can result from changing maturities, interest payments, or face value reductions. Thus, the key dependent variable, creditor *Haircuts*, is calculated as the following in net present value terms. The discount factor used to calculate present value is denoted  $r_{it}$  and relies on exit yields imputed from market and rating data.

$$\text{Haircut}_{it} = 1 - \frac{\text{Present value of new debt } (r_{it})}{\text{Present value of old debt } (r_{it})}.$$

Data are provided by Cruces and Trebesch (2013). The data are fine-grained enough to compare the degree of burden sharing that creditors are willing to accept and represents an important advancement on previous dichotomous

<sup>12</sup>For example, veto players are predictors of public declarations but unrelated to data disputes, forced restructurings or negotiation breakdowns. Results available upon request.

<sup>13</sup>They verify this with lists of restructuring cases from the Institute of International Finance and the World Bank. For more information of the coding and sampling procedure, see Enderlein, Trebesch, and von Daniels (2012).

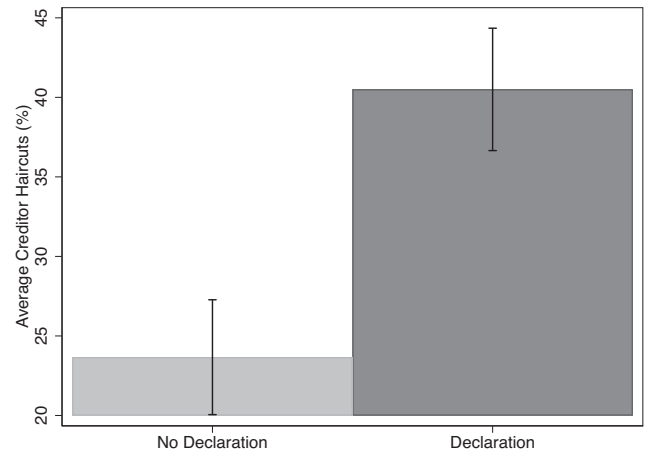


Figure 2. Average haircut (percent) by default declaration

measures. Haircuts in market-based restructurings, excluding HIPCs, range from negative values (e.g. Brazil's 1987 restructuring) to greater than 80 percent (e.g. Albania's 1995 restructuring), such that higher haircuts represent more adjustment on creditors and lower haircuts represent more adjustment on debtors. As an additional benefit, the measure is general enough to apply to both bank and bond restructurings, across different eras of lending. Finally, few studies have explored the continuous variation in haircuts, and even fewer have introduced political variables (Connell 2019; DiGiuseppe and Shea 2019; Mamone 2020).

Graphically, the relationship between public *Declarations* and creditor *Haircuts* is displayed in figure 2, where preliminary *t*-tests provide support for H2. On average, negotiation episodes that contain a public default declaration receive a 41 percent haircut. Negotiations that do not use a public declaration yield a 23 percent average haircut. The unconditional difference is significant at the 5 percent level.

#### Explanatory Variable

The causal chain implies that indebted states bear the costs of publicity only where it is necessary to solve the information problem. Therefore, indebted states will be more likely to issue a public declaration of default when veto authority is dispersed (H1). To account for this, I introduce a measure of *Veto Players* from the Database of Political Institutions, as the main explanatory variable. The measure uses electoral rules, electoral competitiveness, and party affiliations to adjust for the number of independent veto players in a given country-year (Cruz, Keefer, and Scartascini 2021). It ranges from 0 to 7 and varies with the composition of the government and its opposition, providing more temporal variation than structural variables like democracy. More veto players should increase the benefits and lower the costs of public tactics, and I thus expect a positive relationship to public default declarations.

#### Model Specification

The relationship between veto authority, public declarations, and creditor haircuts implies several stages of empirical testing. First, I test the relationship between veto authority and public declarations (H1) using Enderlein, Trebesch, and von Daniels's (2012) original country-crisis-year coding of *Declarations*. However, because the outcome that public

default declarations are trying to influence, *Haircuts*, can only be observed once in a crisis episode, I also test for results aggregated to the crisis level. In crisis-level models, *Declaration* equals 1 if a country issues a public declaration during any year of the negotiation period.

To avoid omitted variable bias, I control for additional variables that might confound the effect of political constraints on publicity. However, given sample size limitations, I balance this against concerns for overfitting the model. If there are too many variables for the number of observations, the regression coefficients can be biased. Therefore, I focus on models that are empirically precise but demonstrate in the appendix that results are robust to incorporating additional variables with sparser data coverage. I capture indebted states' economic situation by including a country's *Debt-to-GDP* ratio (log) from Abbas et al. (2010). I also include a country's annual *Inflation* (percent), *Per Capita GDP* (log), and *GDP Growth* (percent). Data are from Graham and Tucker (2019) and the World Development Indicators. Poorer, more indebted countries should be more likely to declare default publicly, given their economic inability to pay.

Global context is also important. The default literature suggests that access to foreign capital eases repayment (Manasse, Roubini, and Schimmelpfennig 2003). Domestic audiences are also likely to benchmark their reactions to economic downturns across borders (Kaysers and Peress 2012). I therefore include data on *Trade* (percent GDP) from the World Development Indicators.

Previous research notes that *Democracies* and governments with *Left Leaders* receive higher haircuts (DiGiuseppe and Shea 2019; Mamone 2020), yet the mechanism that links these characteristics to negotiation outcomes has not been determined. Similarly, I include an additional variable for *Presidential systems* (0,1). Data are from the Database of Political Institutions and the Polity IV Project.<sup>14</sup>

Because public declarations are coded dichotomously, the appropriate estimator is a probit model with clustered standard errors. To account for temporal and regional variation, I include decade- and region-fixed effects.<sup>15</sup> Temporal effects are particularly important, as the availability of global capital has waxed and waned. Coordination devices available to creditors have become less effective over time, and indebted states learn from each other and their own past interactions. I thus include an additional indicator for whether a state has completed a *Previous Restructuring* in the last 5 years. Similarly, regional effects capture the potential for spillovers as a default in one state may lead creditors to roll back credit across the entire region.

Second, testing the relationship between public declarations and creditor haircuts (H2) requires the acknowledgment that selection into public declarations is non-random. To better accord with the causal chain, I estimate a two-stage model. I output the predicted probability of issuing a public declaration from the first stage described above and use it as the main predictor of creditor haircuts in the second stage. The primary advantage of this empirical strategy is that it provides information on the likelihood of a public default declaration and controls for random or strategic uses of publicity that are not accounted for in the theory. In other words, it models the selection into public declarations by us-

ing information on when public declarations are likely to be used by the borrower government. Equally important, by modeling the process with a series of structural equations, it better approximates the theoretical model where the decision to go public is linked with the likelihood of receiving a high haircut.<sup>16</sup>

There are two main drawbacks to this approach. First, because haircuts are only agreed upon once at the end of a restructuring negotiation, this empirical strategy can only be applied to crisis-level coding of the *Declaration* models. Second, the drawback of using predicted probabilities as a regressor is that it introduces additional uncertainty into the model's estimation. Specifically, the predicted probability is not a sample statistic, and therefore has a confidence interval around its point estimation that must be taken into account. Heightened uncertainty weakens predictive power. However, as this bias works against my findings in the second stage, I can be more confident if the results are statistically significant.

I specify the second stage, *Haircuts*, using an ordinary least squares regression with clustered standard errors. Because the predicted probability of a public declaration generated in the first-stage probit is not data, I bootstrap the model estimations. Additionally, control variables from the first-stage regression on public declarations, including decade- and region-fixed effects, cannot be included in the second-stage estimation of haircuts. However, these variables are accounted for indirectly based on the way they influence the resulting probabilities.<sup>17</sup> I do, however, control for the total amount of *Debt Restructured* by the agreement (millions of constant USD, log) in the second stage.<sup>18</sup> This is consistent with the idea that creditors may have conflicting incentives when they are highly exposed. They want to avoid disorderly default at the same time as they are loath to set a precedent for high haircuts in the future. Data are from Cruces and Trebesch (2013).

This strategy addresses potential concerns about endogeneity if the factors that lead governments to issue public declarations jointly determine creditor haircuts. However, an additional threat to selection still exists. States do not default or enter into restructuring lightly. They enter restructuring negotiations, at least in part, based on the expected negotiation outcome. Therefore, it is possible that the political dynamics that explain tactical decisions may also affect the occurrence of restructuring negotiations. The literature argues that political constraints, sometimes operationalized as democratic institutions, should make states less likely to default (Schultz and Weingast 2003; Van Rijckeghem and Weder 2009). If this were the case, we would see that countries entering restructuring on average have fewer veto players than non-defaulters, potentially biasing the results. A common approach to deal with this in the literature is to estimate a double hurdle model where the first stage estimates the probability of observing a restructuring and the second stage estimates the restructuring outcome (DiGiuseppe and Shea 2019). Mamone's (2020) empirical setup speaks directly to this concern by demonstrating that veto players are

<sup>14</sup>For crisis-level models, control variables are calculated as the mean (continuous variables) or maximum (dichotomous variables) of yearly observations across the negotiation period. See Appendix A for descriptive statistics at both the crisis and crisis-year level.

<sup>15</sup>I follow Correlates of War classifications and include dummies for Africa, the Americas, and Europe.

<sup>16</sup>I do not claim to have an exclusion term, and this method accounts for selection into public declarations without relying on exogenous variation. To demonstrate the validity of this method, I use the deviance residuals rather than the predicted probability as the main regressor in the second stage as a placebo test to proxy for when governments are not likely to issue a public declaration. Results are available upon request.

<sup>17</sup>Results are robust to analyzing the second, *Haircuts*, stage separately with additional controls. See Appendix H.

<sup>18</sup>Results are robust to standardizing *Debt Restructured* by debtor GDP. Results are available upon request.



Table 1. Main results

	(1)	(2)	(3)	(4)
<i>DV: public declaration</i>	<i>Year</i>	<i>Year</i>	<i>Crisis</i>	<i>Crisis</i>
Veto players	0.411*** (0.146)	0.780*** (0.195)	0.341** (0.162)	1.114** (0.464)
Debt (% GDP, log)		0.820** (0.337)		0.435 (0.728)
Growth (%)		-0.0405* (0.0224)		-0.0642 (0.0566)
GDP per capita (log)		0.922** (0.468)		1.221 (0.744)
Inflation (%)		0.0501*** (0.0110)		0.0481*** (0.0172)
Trade (% GDP)		0.0773 (0.0806)		0.135** (0.0662)
Previous restructure		-0.354 (0.392)		2.121* (1.126)
Left leader		0.761 (0.538)		2.356*** (0.881)
Democracy		-0.0635 (0.0435)		-0.0292 (0.0669)
Presidential		-1.058** (0.464)		-1.636 (1.128)
Decade/region FE	Y	Y	Y	Y
Observations	212	199	76	72
$R^2$	0.21	0.38	0.18	0.38
<i>DV: creditor haircuts</i>				(4)
Public declaration (predicted)				23.723*** (7.542)
Debt restructured (log)				-0.235 (1.605)
Observations				72
$R^2$				0.06

Note. Standard errors in parentheses.

\* $p < 0.10$ , \*\* $p < 0.05$ , \*\*\* $p < 0.01$ .

not a significant predictor of entering into a restructuring negotiation.

However, a double hurdle model is less appropriate in this setting because the modeling strategy is already specified in two stages: *Declarations* and *Haircuts*. Because public declarations only occur after restructuring negotiations, it's also not possible to compare the predictors of public declarations in a non-default sample. Therefore, I take an alternative approach in Appendix D. Instead of making a causal claim, I further probe the determinants of entering into a restructuring negotiation as a way to point to the direction of potential biases. I emphasize the novelty of focusing on negotiation behavior and the robustness of my results to controlling for potential confounds in the default literature. In line with previous work, I find that many of the strongest predictors of default (i.e., debt-to-GDP ratio and trade) are less predictive of negotiation behavior. I reaffirm that veto players impact the government's behavior during negotiations but do not impact the government's decision to enter negotiations in the first place.

## Results

Table 1 presents the main empirical results. Beginning with the top panel, Models 1 and 2 test the relationship between veto players and public declarations (H1) using country-crisis-year observations. Models 3 and 4 test the same relationship with data aggregated to the crisis level.

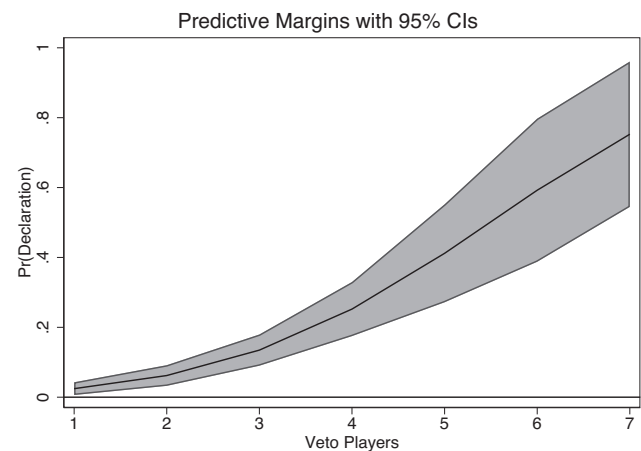


Figure 3. Predicted probability of issuing a public declaration

In all models, *Veto Players* is positive and significant, suggesting that states with more domestic constraints on decision-making are more likely to turn to public declarations as a signaling tactic. Coefficients in a probit model cannot be directly interpreted, so figure 3 estimates the predicted probability of issuing a public declaration as the num-

ber of veto players increases.<sup>19</sup> The average marginal effect of adding an additional veto player on the likelihood of public declaration is 10 percent, a sizable effect given the rarity of publicity in restructuring. For example, the probability of a more unified government (e.g., Venezuela in 1987 with two veto players) issuing a public declaration is approximately 6 percent. As governments become more divided (e.g., Venezuela in 1990 with four veto players), the probability of issuing a public declaration increases to over 25 percent.

The results also speak to the role of other economic and political variables in explaining negotiating behavior. Economic indicators are important; however, their significance varies across the crisis-year and crisis-level models. More indebted countries with higher inflation and more open economies are more likely to default publicly. Countries with higher levels of GDP growth are less likely to default publicly. On the other hand, states that completed a previous restructuring in the past five years are more likely to default publicly.

Of the political indicators, *Left* governments are more likely to rely on public declarations. This suggests one potential mechanism for DiGiuseppe and Shea's (2019) finding that leftist governments receive larger haircuts. The authors argue that because leftist governments discount the future consequences of haircuts in favor of immediate resources, they will bargain harder for creditor losses. Yet, the mechanism through which leftist governments "bargain" remains ambiguous in the original paper. These results enrich the original story to imply that one way governments with pro-default constituencies can demonstrate a credible unwillingness to pay is by issuing a public declaration. This, in turn, improves the haircut outcome.

Turning to H2, the bottom tier of table 1 also provides strong support for the second hypothesis. Controlling for selection into public tactics, public declarations increase the size of creditor haircuts. The predicted probability of issuing a public *Declaration* has a positive, significant, and substantively large effect on the resulting creditor *Haircut*. Based on Model 4, a 1 percent increase in the likelihood of public default increases the resulting haircut by approximately 0.23 percent. This suggests that behavioral tactics, like public declarations of default, are an important signal that clarifies the expectations of creditors. If governments are willing to bear the financial and domestic costs of publicity, they are rewarded with more fiscal cushion.

### Robustness

To ensure that the results are not dependent on model specification choices, I conduct additional tests, described here and reported in full in the Appendix. Where appropriate, results are reported in two stages to account for the theoretical link between selection into public declarations and creditor haircuts. First, I investigate the causal path between veto authority, public default strategies, and creditor write-offs. Specifically, I advance the argument that heightened domestic constraints impact creditor haircuts through their impact on negotiation behavior (public declarations). To bolster the validity of my argument, I introduce *Veto Play-*

*ers* into a single-stage estimation of *Haircuts* in table 2.<sup>20</sup> If checks on the government determine haircuts directly—a theoretical and empirical concern—the variable would be significant. If domestic constraints work through the mechanism that the theory suggests, then the variable should be insignificant and selection bias between the two stages should be less of a concern. As predicted, *Veto Players* are an insignificant predictor of creditor *Haircuts*, and there is no direct relationship between domestic veto players and creditor concessions. Instead, political constraints work through negotiation behavior as a signaling strategy.

Next, I turn to omitted variable bias in Appendix E, where I add additional controls to the first stage of the model's estimation. This builds on Appendix D, where the findings are robust to controlling for determinants of default. Results remain consistent when controlling for social dissatisfaction that stems from economic conditions, US military aid, and the number of creditors involved in restructuring.<sup>21</sup> Similarly, Appendix F replicates the main findings, systematically excluding notable cases that received substantial press coverage. The results consistently support the claim that domestic constraints increase the likelihood of public declarations and that publicity increases the size of creditor haircuts.

Appendix G turns to the first-stage specification (predicting public declarations). Results are robust to removing fixed effects, adding a year time trend, and using robust standard errors. Similarly, Appendix H provides alternative specifications for the second stage (predicting creditor haircuts). Specifically, it analyzes the relationship between public declarations and haircuts as a single stage under various specifications and with different control variables, including other negotiation behaviors. While a single-stage model does not account for the selection into public declarations, it does allow political and economic controls to be included directly, rather than indirectly based on their impact on predicted probability. Using observed public declarations rather than the probability of issuing a public declaration also allows for the results to be estimated with more precision. Modeling the relationship as a single stage, public declarations increase creditor haircuts.

Appendix I turns to the measurement of creditor haircuts. As originally coded, a haircut can result from many actions, including lengthened maturities, lower interest payments, and face value reductions. All of these actions can imply a haircut in net present value terms; however, a face value reduction addresses domestic resource constraints most explicitly. Governments should thus use public declarations to not only elicit a higher haircut but also to garner face value reductions. Replacing the second-stage dependent variable with *Face Value Reduction* (percent) and a *Face Value Reduction Dummy* does not change the main results. An additional concern is that several countries experienced concurrent restructurings in the same calendar year.<sup>22</sup> Because public declarations are initially recorded on a yearly basis, this could obscure which particular deal the dummy is capturing. To account for this, the main models utilize the smaller haircut observation for each of the five country crises as the most

<sup>20</sup>Because this test limits the analysis to a single stage, I include both the economic and political control variables from both stages of the main empirical analysis.

<sup>21</sup>Data are from the International Country Risk Guide, the USAID Greenbook and Ferry (2023).

<sup>22</sup>This generally occurs when countries restructure bank and bond debt separately. This occurred in five cases, and the resulting haircuts are very similar. The largest difference between two restructurings completed in the same year is 6.6 percent (Dominican Republic 2005).

<sup>19</sup>Based on Model 2 using margins and marginsplot, Stata v.16. Hanmer and Kalkan (2013) note that in nonlinear models, marginal effects at the mean (MEM) can be different than the mean marginal effects (AME) or the average partial effects. I therefore graph the average partial effects (observed values approach).

Table 2. Mechanism

	(1)	(2)	(3)	(4)
<i>DV: creditor haircuts</i>	<i>Crisis</i>	<i>Crisis</i>	<i>Crisis</i>	<i>Crisis</i>
Veto players	-0.587 (1.712)	-1.518 (1.716)	-1.838 (2.203)	-3.212 (2.372)
Declaration		15.991*** (5.614)		14.895** (5.438)
Debt restructured (log)	0.178 (1.948)	-0.899 (1.735)	0.978 (2.003)	-0.261 (1.848)
Debt (% GDP, log)			4.609 (9.505)	3.863 (10.164)
Growth (%)			1.408*** (0.473)	1.444** (0.547)
GDP per capita (log)			-10.955 (7.713)	-9.719 (7.963)
Inflation (%)			-0.093 (0.128)	-0.134 (0.124)
Trade (% GDP)			0.482 (0.855)	0.329 (0.828)
Previous restructure			-4.656 (6.442)	-4.468 (6.687)
Left leader			14.245*** (4.373)	12.078** (5.009)
Democracy			0.535 (0.653)	0.676 (0.646)
Presidential			5.179 (8.124)	6.317 (7.268)
Decade/region FE	Y	Y	Y	Y
$R^2$	0.22	0.28	0.45	0.50
Observations	76	76	72	72

Note. Standard errors in parentheses.

\*\* $p < 0.05$ , \*\*\* $p < 0.01$ .

conservative estimate. The results do not change when I use the larger haircut observation.

### Conclusion

Negotiations to restructure sovereign debt are protracted affairs that are of primary importance to the economic recovery of indebted states. The recent debt crises in advanced countries like Greece and Iceland, paired with developing country crises in the wake of COVID-19, demonstrate the perennial nature of sovereign default. International financial institutions are not unaware of the importance of debt restructuring, yet multilateral reform efforts have lacked the support of the largest creditor nations. This, paired with the prolonged recovery of Greece and the recent end to the Argentinian litigation crisis, has led Nobel laureate Joseph Stiglitz to claim that sovereign debt is at the top of the policy agenda.

This work argues that international policymakers must consider not just the economic fundamentals that predict debt crises, but also the dynamics of the debt restructuring process itself. The political incentives of the government are key to understanding how indebted states bargain and the outcomes that they reach. This paper is among the first to explain the political determinants of debt restructuring outcomes, or haircuts, and I argue that imperfect information about the government's willingness to repay leads to a protracted bargaining game. Creditors only have access to indirect indicators, which can be difficult to interpret under heightened domestic constraints. One way for governments who are unwilling to pay to resolve the information problem

in their favor is to publicly declare default—sinking reputational costs in international markets as a means of demonstrating their resolve. In two stages of quantitative analyses, I find that governments are more likely to engage in costly public signaling when they face larger domestic constraints. Where this is true, creditors reward governments who make public declarations with higher haircuts. The findings shed light on the puzzle of why governments initiate costly negotiations in the public eye, particularly when privacy is the norm in international cooperation (Stasavage 2004).

The findings also provide fodder for future research. First, they broaden our understanding of how governments choose their negotiating tactics in bargaining situations, particularly in an opaque arena. They move past the “blackbox” of conceptualizing restructuring as a dichotomous measure. However, while this paper focuses on a single strategy, public declarations of default, governments have multiple tools in their arsenal. Which tools do governments choose and in what combination? When during negotiations do governments deploy their strategies? How governments get to their preferred outcome matters, and more work is needed to understand the full landscape of debtor's behavior in debt restructuring.

Second, my findings call for additional focus on the creditors. What are the bounds of creditors' information constraints? How do creditors react to debtor signals? Do all creditors respond in the same way? While scholarship has long theorized that creditors overcome their information asymmetry by relying on information shortcuts, more recent work notes that these cues can be noisy. There can be significant heterogeneity below the surface, and therefore dif-



ferent creditors might respond to signals in different ways (Mosley, Paniagua, and Wibbels 2020; Brooks, Cunha, and Mosley 2022). Focusing on the noise of different heuristics not only explains why veto players are not systematically informative without additional information about reversion points, but it could also explain incongruencies in existing findings, for instance, the fact that democracies receive higher credit ratings but default at similar rates (Saiegh 2005; Beaulieu, Cox, and Saiegh 2012). Delineating the quality of the political cues on which creditors rely is essential to understanding their actions.

More broadly, at the heart of this paper is a question about burden sharing in debt restructuring and financial crises. The mechanism is relevant to forums as diverse as organizational contributions and environmental politics, where an agreement over burden sharing between participants is required to reach a mutually beneficial outcome. At the broadest level, this work extends a general theory of the way domestic concerns impact how governments cooperate internationally—impacting both negotiation strategy and negotiation outcomes.

### Supplementary Information

Supplementary information is available at the *International Studies Quarterly* data archive.

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