Public Declarations:
The Political Economy of Sovereign Debt Restructuring Negotiations

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Abstract

Negotiations to restructure sovereign debt are protracted affairs and their outcomes, known as "haircuts," range from zero to eighty percent creditor losses. Haircuts impact states' ability to borrow, cost of borrowing and economic recovery, yet economic fundamentals imperfectly explain burden sharing. I analyze the interactions between governments and private creditors as a bargaining game under incomplete information. Not only do governments have incentives to plead poverty to lenders, they also have reason to hide their economic distress from domestic audiences. Governments that are unwilling to repay their full claims, can convey their "type" by issuing a public default and invoking political punishment. 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 from 1980-2009, I find that public declaration increases creditor concessions, but only where the action is politically costly.

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Introduction

Global debt has ballooned to greater than 200 percent of world GDP, a trend that has caused a resurgence of financial crises that require debt restructuring with private creditors (International Monetary Fund, 2016). While crises have left countries as diverse as Puerto Rico, Argentina and Belarus in default to private creditors, negotiations to restructure sovereign debt remain protracted affairs, lasting years or decades. The outcome of these negotiations, known as "haircuts", vary significantly, ranging from zero to eighty percent creditor losses (Das, Papaioannou and Trebesch, 2012). 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; Trebesch and Zabel, 2017; Reinhart and Trebesch, 2016); yet, economic circumstances imperfectly predict the size of the haircut imposed on creditors. Why? 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 analyze 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 unobservable, private information for which the political leadership normally has incentives to misrepresent. Governments possess finite economic resources, but their willingness to redirect scarce funds away from domestic objectives and towards debt servicing is a political calculation that is hard for creditors to observe. Not only do governments have incentives to plead poverty to lenders, but they also have reason to hide their economic distress from domestic audiences. Governments that are unwilling to elevate creditors over pensioners, however, can convey their "type" by publicly announcing their debt distress and invoking political punishment. 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 steps. Using data on public default declarations and creditor haircuts for 25 defaulting countries from 1980-2009, I first establish that public signals of debt distress elicit larger creditor haircuts. Yet, if public declarations increase creditor concessions, what prevents all indebted governments from using a public strategy? The mechanism implies

that public declarations are rare and should only be effective at eliciting concessions when they are costly to the politicians that send them. To further probe the theoretical mechanism, I suggest that public declarations are most costly where competing domestic factions can fight over the shrinking size of the domestic "pie," holding up the normal political decision making process. Based on expectations of infighting under various domestic political configurations, I analyze the political determinants of issuing a public default declaration on a country-crisis-year basis. The findings suggest that governments rely on public declarations when they are sufficiently costly to convey credibility.

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. Limited research exploiting variation in restructuring outcomes has focused on the economic consequences, rather than the political causes (Rose, 2005; Cruces and Trebesch, 2013). This project is not only among the first to study continuous variation in debt restructuring outcomes (DiGiuseppe and Shea, 2019), 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.

Second, previous work has elaborated on how domestic politics impacts the conduct of leaders at the international bargaining table, as a means of signaling responsiveness to domestic audiences (Putnam, 1988; Fearon, 1994; Dreher, 2003; Dai, 2005; Caraway, Rickard and Anner, 2012; Chaudoin, 2014; Schneider and Slantchev, 2017; Schneider, 2019) or extorting concessions out of foreign actors (Rickard and Caraway, 2014). My findings build on the latter, positing that conflicting claims on redistribution in financial crises are at the heart of a government's constraints in international negotiations. By highlighting negotiating strategies that increase the risk of gridlock and impede normal political decision making processes (Binder, 2004; Tsebelis, 2002), I demonstrate that strategically induced political costs born in equilibrium can be used by leaders at the international level to win concessions from their negotiating partners. This suggests that the same hand-tying

mechanisms that prevent governments from defaulting, can be used as leverage against creditors in a top-down signaling framework (Stasavage, 2004). While institutional checks and balances make governments appear more creditworthy (North and Weingast, 1989; Schultz and Weingast, 2003; Saiegh, 2009; Biglaiser and Staats, 2012; Beaulieu, Cox and Saiegh, 2012), they also make governments more coercive post-default. My analysis builds on these insights from comparative and international politics to demonstrate how domestic politics matters in international negotiations as a signaling mechanism to credibly reveal private information and elicit preferential policy outcomes.

Sovereign Debt Restructuring

This section provides background on the sovereign debt restructuring process, based on 187 private debt restructurings since 1970. Like in other international forums, debt restructuring negotiations are based on institutional norms, which constrain the behavior of the actors involved. These norms provide a framework to situate my theoretical contribution. They also highlight that while negotiating tactics have been explored in other intergovernmental areas (Dür and Mateo, 2009; Bailer, 2012), parallel understandings of sovereign debt restructuring have been more difficult due to the opaqueness of the negotiation process. Previous studies of restructuring dynamics have been largely limited to case studies of the most high profile cases.[1]

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). This is different than default itself, which is defined as "the failure to meet a principal or interest payment on the due date" (Reinhart and Rogoff, 2009). Restructuring can occur without default as it does in approximately one third of all contemporary cases, usually when default risk is high ex-ante (Asonuma and Trebesch, 2016). Regardless of whether restructuring occurs preemptively or post-default, the focus of this work is on the explicit renegotiation and

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[1]See Das, Papaioannou and Trebesch (2012) and Tomz and Wright (2013) for a review of the literature. See Lomax (1986), Aggarwal (1996), Rieffel (2003) and Sturzenegger and Zettelmeyer (2006) for detailed case studies.

modification of the original loan contract. 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 (bilateral, multilateral, commercial, and bondholder). I focus on private debt claims owned 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). This makes both creditor incentives and negotiations different from other types of debt restructurings. 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 makes legal enforcement on sovereign debt contracts exceptionally weak. Below, I briefly provide information about the restructuring process for sovereign debts owed to private creditors.

Restructuring commercial bank debt occurs under the London Club, where an indebted state in default, or close to default, first approaches the IMF. After the 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 steering committee.[2] If these actors agree to chair a steering committee, they are then responsible for forming a larger Bank Advisory Committee (BAC) and inviting other representative banks that will negotiate on behalf of all banks. The committee generally encompasses those banks with the highest exposure and is designed to include representation from multiple countries; however, there is no official formula.[3] Once established, the BAC meets regularly with the defaulted government to verify statistics and exchange 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. It is often accompanied by "road shows" where lead banks and govern-

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[2]The London Club will usually refuse to meet without an IMF agreement. However, there are exceptions like Venezuela's 1986 restructuring.

[3]For example, Japanese banks held 60% of Algerian debt in 1996. However, due to inexperience, the chairmanship passed to French bank Societe Generale.

ment officials attempt to sell the outcome to the prerequisite number of foreign banks. The final exchange offer cannot go into action without nearly unanimous approval.

However, the requirement of near unanimity at the final stage provides each individual creditor with an option to renege from the settlement reached. Instead of signing onto the terms sheet, creditors have the option of holding out for a better deal or taking their chances by suing the defaulted government in court. This holdout option is unique to private debt negotiations and can lead to significant delays (Trebesch, 2010). While sovereign immunity theoretically limits a creditor's ability to act as such, creditor litigation against defaulting countries has become increasingly common (Schumacher, Trebesch and Enderlein, 2015).[4]

Bond debt restructuring has been far less frequent than commercial bank restructuring, but has become increasingly important with the advent of secondary credit markets.[5] 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, sometimes with consultation from a bondholder committee.[6] Thus, while restructuring bond debt can involve negotiations between debtor and creditors, the process is less routinized than the London Club. 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. Even if enough bondholders agree to the deal, bondholders have still been known to hold out and litigate against indebted sovereigns.

For both bank and bond debt, once deals are concluded there exists significant variation in the negotiated settlement. While the average creditor haircut in market based restructurings is 37-40%, haircuts range from negative values (ex. Brazil 1983) to greater than 80% (ex. Albania 1995). The estimates are even higher, almost 100%, for countries participating in the World Bank's Highly

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[4]Litigation has risen from 5% in 1980 to 50% of contemporary cases.

[5]There have been approximately 20 bond restructurings since 1950.

[6]For example, Belize's 2007 bond restructuring involved a fairly concentrated creditor committee while in Ecuador's 2009 bond restructuring, no committee was formed.
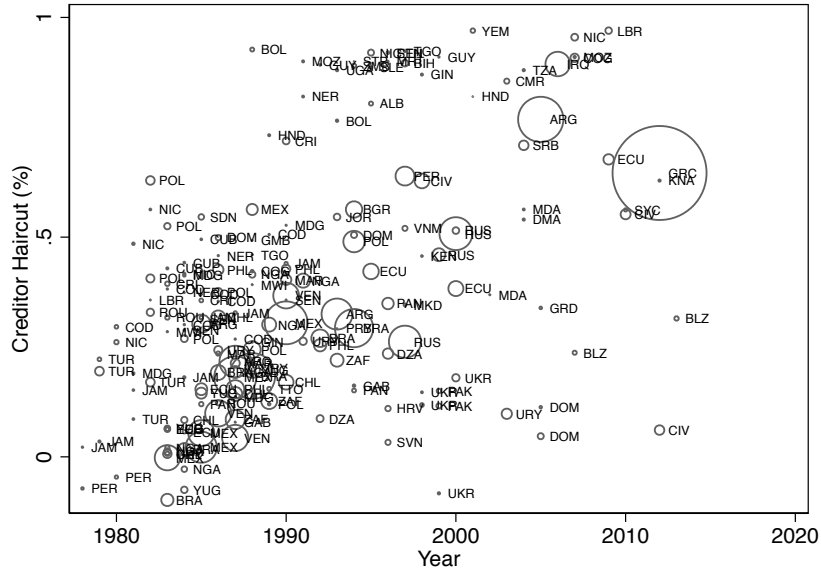
Figure 1: Creditor Haircuts and Debt Restructured over Time

Note: The figure is recreated from Cruces and Trebesch (2013) with updated data. It plots creditor haircuts over time where the circle size represents the volume of debt restructured in each deal.

Indebted Poor Country (HIPC) Initiative.[7] Both the average haircut and haircut dispersion have increased over time, with more recent crises being more likely to receive a face value reduction (Cruces and Trebesch, 2013).

While the opaqueness of the restructuring process has been limiting, work on the consequences of haircuts has established their economic impact. Recessions following a financial crisis are longer and deeper than more traditional recessions (Jorda, Schularick and Taylor, 2013), but the size of a negotiated haircut has an additional effect. Restructurings with higher creditor haircuts lead to larger bond spreads during default (Cruces and Trebesch, 2013). However, after restructurings are concluded high haircuts soften GDP contraction (Marchesi, 2015). Thus, while higher haircuts can cause much steeper declines in GDP during default, the negative effects end when the country exits the crisis episode (Trebesch and Zabel, 2017). Similarly, Reinhart and Trebesch (2016) find that the economic position of indebted states improves more significantly after a restructuring when deals involve debt write-offs. These findings highlight that the economic effects of default

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[7]Official creditors take the lead in these negotiations. Commercial debt obligations are small and the restructuring procedure is different.

aren't fixed – there is a tradeoff between austerity and capital market exclusion.

However, little is known about what determines haircuts. Richer governments and preemptive restructurings receive smaller haircuts, while more indebted and leftist governments receive larger haircuts (DiGiuseppe and Shea, 2019; Asonuma and Trebesch, 2016). Studying default as a broader outcome, the idea that governments only default in "bad" times has been challenged. Evidence linking economic losses and default have been mixed (Manasse, Roubini and Schimmelpfenning, 2003; Tomz and Wright, 2007; Reinhart and Rogoff, 2011). Instead, political explanations based on institutions (North and Weingast, 1989) and distributional preferences (Stasavage, 2011) have yielded more support. The potential for economic recovery depends on the outcome that can be reached during negotiations, which requires an understanding of the norms that govern the debt restructuring process.

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 model the interaction between the government and its foreign creditors as a bargaining game over the size of creditor haircuts. I assume that the government faces an impending crisis that precludes it from fulfilling its debt obligations. To tackle the crisis, restructuring with foreign creditors is required. The government must coordinate this restructuring while at the same time maintaining control at home. The fundamental problem for office-motivated politicians is to negotiate a deal that maintains their political power, by minimizing adverse economic effects, austerity, and domestic turmoil – which is no easy feat.

One way for the government to stem domestic pressures is to win large concessions from creditors at the international bargaining table. Bigger haircuts are beneficial to the government in the longer term, after an agreement has been implemented. A haircut specifies how much of the government's original claims must be repaid, over what time horizon, and at what interest rate. The smaller this remaining obligation and the longer the length of maturities, the less the state will have to divert out of the fiscal budget in the following years. In other words, a high

haircut unlocks funds previously committed to debt servicing, which can be used to secure the government's position in office. Whether the government uses these funds to minimize fiscal austerity broadly or to protect particular interest groups, fiscal stimulus can buy government support. This is reminiscent of the political business cycle where excess funds allow the government to manipulate the economy at strategic intervals (Nordhaus, 1975) or time elections with economic expansions (Kayser, 2005). Yet, this is not to say that the benefits of a high haircut don't come with significant reputational costs (Tomz, 2007). Governments that demand bigger haircuts trade debt relief for longer capital market exclusion and higher interest rates on future debt (Cruces and Trebesch, 2013). Bigger haircuts also increase the likelihood of triggering litigation (Schumacher, Trebesch and Enderlein, 2015).[8]

However, profit-motivated creditors may prevent the government from achieving the concessions they require to appease their domestic critics.[9] Intuitively, a default and subsequent restructuring always harms the creditor in the sense that they are not able to recuperate the entire value of their claims. However, initiating a credit boycott is always suboptimal for the lender; creditors are better off restructuring their original claims and reestablishing positive lending as quickly as possible (Bulow and Rogoff, 1989). If prolonged crises worsen the economic position of indebted states, holdout can lengthen the time until creditors see renewed repayment. Debt reduction can increase incentives to undertake new efficient investments, leading to higher future growth rates and cash flows to repay obligations.[10] The Puerto Rican bondholder and mutual fund Nuveen Asset Management 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

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[8]However exclusion may be shorter, especially where alternative creditors are willing to lend to risky, but politically strategic, recipients (Bunte, 2018).

[9]I assume for theoretical simplicity that restructuring negotiations are carried out with a homogenous creditor group.

[10]Commercial banks have been shown to benefit from providing debt reductions, as in the Brady Plan that raised the stock prices of major US commercial banks with large developing country portfolios. See Kho, Lee and Stulz (2000).

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, while creditors are willing to restructure, they are still profit-motivated and seek to maximize their returns up until the point that would incur a full, costly, default. The fundamental conflict in bargaining negotiations is that while both creditors and debtors are willing to negotiate, they prefer to inflict the maximum adjustment costs onto the other party.

Ideally, creditors would be able to determine the minimum haircut that would avoid default and optimize its offer at the debtor's reservation point. If this information were public knowledge, in the form of economic indicators like debt to GDP and debt to external reserves, the conflict would be resolved quickly and a timely agreement on the size of a haircut would be reached. However, I argue that concessions are not easily optimized and negotiations prolonged because the government's political will to repay its foreign debts is unobservable, private information. Only the government has full information on the political implications of debt repayment, which makes its ability to pay and its political willingness to pay distinct concepts. A country's ability to pay refers to whether it has the financial resources to meet its commitments, even if this means redirecting expenses away from other areas of the government budget and into debt servicing. A country's political willingness to pay focuses on whether the government is willing to make these adjustments, usually at the expense of other domestic objectives. Thus, I argue that willingness to pay is the only concept that matters as governments can raise taxes, cut spending, or sell territory to compensate for repayment.[11] Government resources are fungible but finite and therefore, a government's willingness to pay is based on their preferences to elevate foreign debt above domestic policy concerns - to pay creditors rather than pensioners. Claims of poverty do not perfectly correlate with pennilessness, making an evaluation of an indebted states' debt dynamics "a matter of judgement" (The New York Times, 1989).[12]

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[11]They can also commandeer foreign exchange from private entities.

[12]Not all governments plead poverty. Venezuela made a large debt payment in 2015 by draining its foreign reserves in the midst of a recession. In comparison, Ecuador restructured its debts in 2007 following

The role of imperfect information in the bargaining game implies that indebted governments have strong incentives to misrepresent their distress (Fearon, 1995). Creditors lack the information required to confirm a haircut's necessity, which gives the government an opportunity to exaggerate their distress in hopes of hoodwinking creditors into a larger haircut. Indebted governments may be in significant financial distress, but the ambiguity of political will makes credibility hard to establish.

Given the nature of the debt restructuring game, how do creditors with imperfect information and debtors with incentives to misrepresent overcome their conflicting preferences? One way the government can solve the bargaining problem in its favor is to publicly reveal information as a costly signal about their "type." Specifically, governments that lack the political will to pay can convey their type by publicly announcing default and invoking political punishment. The domestically costly signal separates governments that are politically willing to pay from those that are not and extorts greater concessions from creditors as a result.

To be credible as a signal of debt distress, two things about public declarations must be true. First, the signal must be costly and second, the signal must be sufficiently costly to separate debtor types - to separate debtors that are politically willing to pay from those that are not (Fearon, 1995). To the former, governments are loathe to reveal any economic downturn to domestic audiences, who will crucify leaders for economic mismanagement (Fiorina, 1981; Lewis-Beck, 1988); yet, the link between financial crises and tenure is mixed (Crespo-Tenorio, Jensen and Rosas, 2014; DiGiuseppe and Shea, 2016; Arias and Stasavage, 2019). Regardless of accountability, as long as incumbents remain in power, they must continue to govern. International debt restructuring negotiations do not exempt the government from its legislative and administrative duties; instead they make these duties more difficult by exaggerating the domestic tug-of-war to redistribute increasingly scare resources (Frieden, 2015). Debt crises are more severe than traditional downturns (Reinhart and Rogoff, 2009; Jorda, Schularick and Taylor, 2013), and leaders in financial crises face increased polarization, legislative fractionalization, riots and protests (Funke, Schularick and Trebesch, 2016; Hernandez and Kriesi, 2016; Mian, Sufi and Trebbi, 2014). By publicly announcing debt distress, the government highlights the full impact of the impending crisis to competing do-

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high growth in the 2000s commodity boom.

mestic factions. Even if domestic groups can already observe a general economic decline, a public admission of default is likely to reify that the crisis is going to get worse and last longer. Public declarations of default increase scarcity's salience and incentivize domestic groups to do battle over resources today in fear that they won't be there tomorrow.[13] The political knives come out as the pie shrinks and conflicting claims on redistribution can quickly lead to political stalemates, reminiscent of the US Congressional deadlock in 2011 (Mian, Sufi and Trebbi, 2014). The log jam of distributional claims in the wake of a public default announcement disrupts the normal policy making process, adding substantial costs for politicians who must continue to govern (Funke, Schularick and Trebesch, 2016).[14]

To the latter, the signal must be sufficiently costly to separate government "types," where I conceptualize type as a range of expected government payoffs at full debt repayment. Because repayment siphons away money from other, more popular, domestic purposes, repayment is more costly for some governments than others. At one extreme, are governments whose expected payoff is low without additional resources to satisfy supporters. Incumbents require fiscal space due to resource constraints and/or because tax hikes and spending cuts are not viable options. The heightened cost of repayment makes governments unwilling to honor their contracts, and makes public declarations the less costly alternative. Only those governments that need debt relief to survive, because current payments are infeasible, will choose to pay governance costs in equilibrium. At the opposite extreme, are governments that have a high expected payoff at current repayment rates, because they have more baseline resources or because reallocating resources is less problematic. They have a heightened sense of security and therefore, repayment is less costly. For

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[13]I do not make assumptions about which groups will do the fighting. For a review of the political economy literature on domestic adjustment see Pepinsky (2014) and for a theoretical framework of group preferences see Frieden (2015).

[14]The costs of a public negotiation strategy articulated here are not synonymous with the use of audience costs. Audience costs stem from the punishment a government would incur if they back down from a public threat (Fearon, 1994). In this paper, the costs stem from the revelation of information that is harmful to the leader, not because of electoral mechanisms, but because of information's role in disrupting the normal political decision making process. The costs occur as soon as information is revealed and are not conditional on the leader's actions following the revelation.

these governments, public declarations are the more expensive option and they will be reluctant to bare any additional governance costs if they don't have to. Because public declarations generate domestic costs, only where publicity is less costly than repayment will governments turn to the costly signaling mechanism.

When the signal is costly, it communicates credible information to a government's creditors. Only governments that are politically unwilling to repay their foreign commitments will endure governance costs and creditors should adjust their bargaining position accordingly. Public declarations solve the information problem, demonstrate significant distress , and should be rewarded with higher concessions. The main empirical implication is that *governments who publicly declare their distress will receive higher haircuts*. In the sections that follow I demonstrate the mechanism in the 2012 Greek bond restructuring, conduct a quantitative analysis of creditor haircuts, and offer a more detailed description and test of publicity's costs.

Greek Bond Restructuring

To further elucidate the theory's mechanism, I turn to the Greek bond restructuring of 2012, which demonstrates the existence of private information, incentives to misrepresent, and an attempted public declaration. By most accounts, the story of the Greek financial crisis began in 2009 when years of imprudent lending and financial mismanagement culminated in Prime Minister Papandreou's announcement that the Greek economy was in "intensive care" (The Guardian, 2009). Greece's budget deficit for 2009 was revised from 3.7% to 12.5% and later to 15.6% of GDP and its statistical irregularities were confirmed by the EU in January 2010. Yet, new evidence reveals that secret EU conversations between EU, IMF and Greek officials actually began as early as 2008 to discuss what financial instruments could be used in a Greek crisis, given the constraints of a monetary union (Schneider, 2019; Blustein, 2016). This new evidence makes clear that the Greek government and other officials held private information in 2008 that an impending crisis was on the horizon; Yet, Greek citizens and international capital markets remained in the dark.

Greece accepted a preliminary bailout from the IMF and European Union in May 2010. Following the bailout, the government remained firm in Greece's ability to repay its bond debts without

a formal restructuring of its bond obligations. On May 2nd, and reiterated again on May 21st, 2011, Papandreou publicly stated that Greece would rule out restructuring with the aid of EU/IMF bailouts and domestic reforms. When public conversations turned to the inevitability of restructuring in June 2011, they came not from the Greek government but from the German Finance Minister Schaeuble. However, Blustein (2016) suggests that while Greece publicly maintained its ability to repay, specific plans for a Greek bond restructuring began in private in 2010. He recounts that in the spring of 2010 a clandestine meeting took place at a Washington hotel where IMF and EU government officials met to discuss strategies that would inflict losses on bondholders. As the author describes, "Secrecy was of the essence...the official position in capitals was to dismiss talk of debt restructuring as absurd. The purpose of secret talks was to see if support might be forthcoming..." (Blustein, 2016). While the specific details are unknown, history has made clear that private conversations about bond restructuring were occurring simultaneously with government rhetoric touting repayment. Again in 2010, the Greek government knew restructuring was the most likely outcome, but they chose to hide that information.

The government's ability to continue legislating, passing austerity measures in particular, demonstrates the benefits of keeping restructuring conversations private. Even though Papandreou campaigned on a tax-and-spend socialist platform, he was able to push five austerity programs through Parliament between 2009 and 2011. Not only did these programs raise taxes and cut spending, they did so on the optimism that Greece could recover without a formal default or restructuring – and without inciting a full on domestic tug of war. Initially, more than 60% of Greeks though that austerity measures were justified (Reuters, 2010). While left wing political parties (primarily the communist KKE) organized protests and demonstrations, 76% of Greek citizens were also against strike action (Dow Jones Newswires, 2010). Even Papandreou's main opponent, New Democracy's Samaras initially pledged support to help Papandreou push through key austerity measures. Rhetorically claiming repayment over repudiation, Papandreou's socialist party (PASOK), minimized log jams and potential stalemate, even winning 7 out of 13 regional elections in November 2010. Unfortunately, as the theoretical tradeoff suggests, the downside of maintaining private information is that when the Institute of International Finance (IIF) presented their first offer for "voluntary participation" in a bond restructuring in July 2011, it was only for a

20% haircut (Zettelmeyer, Trebesch and Gulati, 2013). Economists suggest that the market value of the haircut was actually significantly lower and even Germany's finance minister believed it "may have been too low" (Zettelmeyer, Trebesch and Gulati, 2013).

This earlier period of the Greek financial crisis can be juxtaposed against Papandreou's actions in October 2011 when the premier agreed to a second IMF/EU bailout that included a bond restructuring. On October 31st, 2011, Papandreou made a "bombshell decision" to call for a national referendum on the restructuring deal, just days after he had supposedly agreed to the deal in Brussels.[15] The call for a national referendum was widely interpreted by domestic voters and foreign leaders as a public admission that Greece was prepared to default and exit from the Euro. A public referendum would serve as a reminder to the world that if Greek citizens voted no, disorderly default was a distinct possibility.

Papandreou's aids proclaimed to the media that a public referendum was a calculated and logical gamble (The Guardian, 2011a). The potential benefit for the government was that the threat of a no-vote and a subsequent default would serve as an international wakeup call. According to one official, "...they [European officials] may be pissed off today but tomorrow when they wake up they will need to think through the implications of pushing Greece too far" (The Guardian, 2011a). One political commentator analyzed the announcement to the conclusion that "Papandreou is in a stronger position than people think" (The Guardian, 2011b). Not only was it possible that Papandreou might win a "no" consensus from the referendum,[16] but the depth of the "when you owe the bank €1000 you have a problem but when you owe €100 billion the bank has a problem" paradox implied that the IMF and EU would probably be willing to soften the terms to safeguard against a disorderly default (The Guardian, 2011b). The government expected to gain significant leverage with their creditors by making clear that default was a possible reality.

However, the government's plea of distress wasn't cheap talk, it was a public declaration with significant domestic costs. Widespread domestic reactions began immediately, largely centered

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[15]Finance Minister Venizelos, made clear that Papandreou was the "sole instigator" and BNP Paribas also stated that "nobody saw it coming" (Reuters, 2011).

[16]Polls showed that 60% of the population were against the terms of the bailout, but 70% were against leaving the monetary union, which would be the natural result of a disorderly default.

around the future stability of Greece and the Eurozone. Greeks were acutely aware that the €800 billion tranche of EU/IMF bailouts to be received in November would run out in January, leaving the government unable to pay salaries and maintain public services (EKathimerini, 2011). Within a week, only 1 in 8 Greek citizens expressed trust in the Premier's handling of the economy, down from 17% at the end of September (Public Issue, 2011). Renewed protests and riots sprung up on the streets of Athens and other major cities. Most importantly, PASOK's governing coalition crumbled amidst intra and inter-party squabbling. Within PASOK, one minister, Milena Aposto-laki, immediately resigned while six others wrote an open letter to the coalition calling for new elections. PASOK still attempted to fast-track the referendum process, but on November 3rd, plans were waylaid by additional resistance from within the cabinet, primarily led by Finance Minister Venizelos. PASOK was forced to revoke its call for a referendum given what opposition leader Samaras, called the "indirect national schism" caused by the announcement (Enet.gr, 2011). All legislation surrounding the IMF/EU bailout would encounter a stalemate until a new government could be formed.[17]

While the absence of a counterfactual prevents a true comparison, financial markets indicate that Papandreou's announcement was considered credible. The Athens Stock Exchange fell 7.7%, Eurozone bank stocks fell more than 10%, and Greek bond yields increased by 4% overnight – all indicators that the markets took disorderly default seriously. The restructuring deal that was signed in March 2012 was the largest sovereign credit event in modern history. Private creditors agreed to accept a 53.5% nominal reduction, which equates to a 65% reduction in net present value terms (Zettelmeyer, Trebesch and Gulati, 2013).

Do Public Signals Lead to Higher Haircuts?

To test the broader implications of my theoretical argument, I conduct a quantitative analysis using data on public default declarations and creditor haircuts for 25 defaulting countries from 1980-2009. Because it is only possible to observe the final haircut in a debt restructuring negotiation, the unit of analysis is the restructuring episode.

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[17]Papandreou resigned on November 6th, 2011 due to dissent in his own party.

Dependent variable

My central question is whether public declarations of debt distress serve as a costly signal to creditors, in order to increase creditor haircuts. A test of this hypothesis requires detailed data on the outcome of restructuring agreements across a wide range of crises. Empirically, haircuts can result for 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 is provided by Cruces and Trebesch (2013) based on the methodology of Sturzenegger and Zettelmeyer (2008). The data is fine grained enough to compare *the degree* of burden sharing that creditors are willing to accept and represents an important advancement on previous dichotomous measures. Haircuts in market based restructurings range from negative values (Brazil 1987) to greater than 80% (Albania 1995) 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, with the exception of DiGiuseppe and Shea (2019).

Main Explanatory Variable

To capture public signals of debt distress, I introduce a measure of default declarations. While many studies model default as a dichotomous decision, Enderlein, Trebesch and von Daniels (2012) develop the first index of government coerciveness. They code negotiation and procedural behaviors from qualitative sources, primarily the financial press. The index has nine indicators that capture observable actions towards private creditors, but to measure the publicity of a government's position I rely on their coding of an "explicit moratorium or default declaration." The authors note that most defaults occur "silently" whereby governments miss payments without a

public announcement. In 80% 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 dummy indicator is coded as 1.[18] Because the dependent variable, creditor haircuts, is only observed once in a crisis episode, I aggregate the indicator to the crisis level. *Declaration* denotes whether a country issued a public declaration during any year of the negotiation period.

This measure has several distinct advantages. First, the measure captures only behavior towards private creditors. It does not include actions towards official creditors, where the negotiation process is less profit motivated. 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 (Enderlein, Trebesch and von Daniels, 2012). Studying public moratoriums specifically provides a theoretical and empirical innovation, by demonstrating that governments are motivated towards specific behaviors rather than coerciveness as a general concept.

Data on default declarations is available from 1980-2009 and includes both developing and emerging market countries. Debt crises are identified based on the annual default list published by Standard and Poors, with the Highly Indebted Poor Countries, countries with populations under one million, and countries that restructured their debt under exceptional circumstances excluded. The resulting sample covers 25 defaulting countries over 218 country-crisis-years or 76 separate restructuring periods.[19]

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[18]Other actions governments take towards their creditors may be observable to segments of the general public, especially if they get reported by the financial press. I simply argue that a statement from a government official in front of a public audience is the most visible to the largest segment of the population. See Appendix C to compare the nine indicators.

[19]For more detailed information on the coding and sampling process see Enderlein, Trebesch and von Daniels (2012). For a list of crises covered, see Appendix A. For a list of cases that issued a public declaration
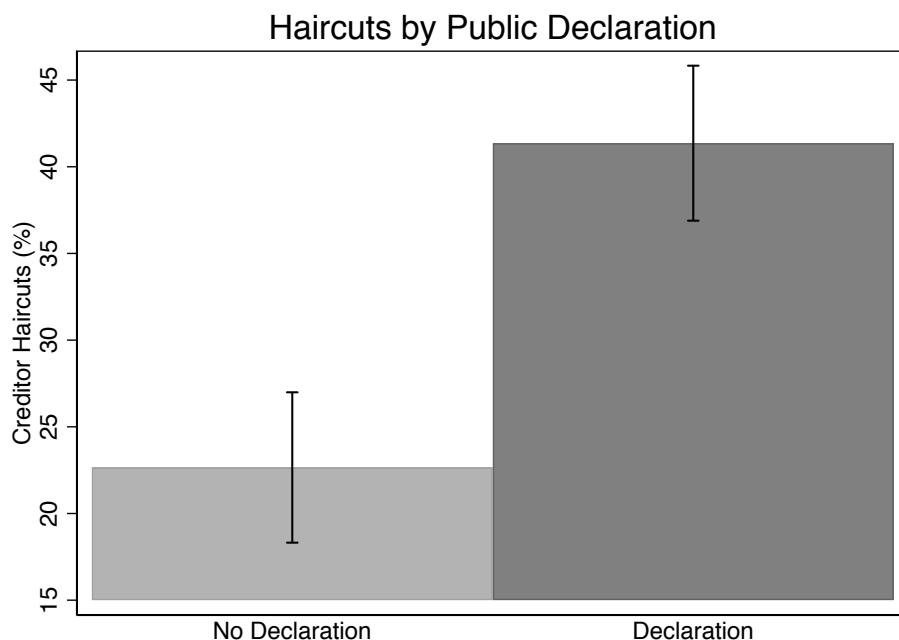
Figure 2: Average creditor haircut by default declaration

Graphically, the relationship between public declarations and creditor haircuts is displayed in Figure 2, where preliminary t-tests provide support for my main hypothesis. On average, negotiation episodes that contain a public default declaration receive a 41% haircut. Negotiations that don't use a public declaration yield a 23% average haircut. The difference is significant at the 1% level (p=0.002). Public declarations appear to be effective at extracting creditor concessions.

Model specification

Given sample size limitations, the declaration models are empirically precise. While it is important to limit the potential for omitted variable bias, I rely on control variables that are available historically for a large cross section of developing countries. To represent the negotiation episode and accord with the measurement of the dependent variable, I aggregate all yearly measures to the crisis level.[20] I also demonstrate in the robustness section that the results hold when incorporating

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see Appendix B.

[20]I use the average of yearly indicators across the negotiation period.

additional controls with less extensive coverage.[21] To capture indebted states' economic need, I include a country's *Debt to GDP* ratio, from Abbas et al. (2010).[22] I represent a country's baseline level of development and current economic position by including *Per Capita GDP* (log) and annual *GDP Growth (%)*. Data is from Graham and Tucker (2017).[23] Including these variables allows for the results to separate the effects of economic fundamentals from political dynamics. Additionally, I account for characteristics of the negotiations themselves by including *Debt Restructured* by the agreement (constant 2012 USD, log), which is consistent with the idea that creditors 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 is from Cruces and Trebesch (2013). I also include a measure of *Serial Restructuring* as an indicator coded as 1 if a country reached a previous restructuring agreement in the last 3 years. Finally, I include Bauer, Cruz and Graham (2012)'s indicator of whether an indebted country is under an *IMF Program* in the year the negotiation is finalized.

I rely on ordinary least squares regression with country level clustered standard errors to estimate my main results.[24] To account for temporal variation in bank versus bond lending and the role of key cases in establishing precedent, I include decade-level dummy variables, and demonstrate that the results hold using a year time trend. As the cross-country effects are theoretically relevant, I exclude country level fixed effects and choose to use regional dummies to proxy for differences in lending practices and potential contagion across regions.[25]

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[21]Results are robust to measures of short term debt obligations, strategic interests of creditor countries, and financial openness.

[22]By combining multiple sources, this dataset represents the most extensive coverage.

[23]Data from the World Development Indicators is supplemented with the Penn World Tables.

[24]A second approach would be to estimate models that take into account how selection into public declarations may depend on variables that also determine the size of haircuts. I address this alternative in the following selection by estimating a two stage model. I also show that the main predictors of issuing public declarations do not align with results from the literature on the occurrence of default.

[25]I include dummies for Latin America, Europe and Africa.

Main Results

Table 1 presents the main empirical results, starting with a base model (Model 1) and adding economic and negotiation specific controls (Model 2). Model 3 relies on only economic fundamentals to provide a comparison between the explanatory power of economic indicators and political dynamics. Model 4 replicates results with standardized beta coefficients.

In accordance with my hypothesis, the effect of the main explanatory variable indicates that when indebted sovereigns issue public declarations, creditor haircuts increase. The *Declaration* indicator is consistently positive, significant, and substantively large. Based on Model 2, I find that a public declaration is associated with a 14% increase in creditor haircuts, holding all else constant. In comparison, a country's *Debt to GDP* ratio would have to increase by more than 80% for the economic effect to equal the impact of a public declaration.

The results also speak to expectations from the economics literature. Regarding the control variables, only the *Debt to GDP* ratio and *GDP Growth* are significant predictors of haircut size. More indebted countries receive higher haircuts; yet, countries with higher growth also receive larger haircuts, which is contrary to expectations. While it is beyond the scope of this paper, debt and GDP growth are only weakly correlated and the results may imply that creditors prefer to write off their commitments in cases where debtors have better prospects for recovery. None of the other economic conditions or negotiation characteristics are robust.

Finally, comparing Models 2 and 3 indicates that controlling for political dynamics over and above economic fundamentals increases the overall explanatory power of the model. Together, this suggests that predictions of creditor haircuts that ignore the political dynamics of debt negotiations are underspecified. It highlights the contributions of this work in explaining more fine-grained variation in restructuring outcomes based on both political and economic considerations.

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. First, in Appendix E I rely on an alternative coding 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

Table 1: Creditor Haircuts

DV: Creditor Haircuts	(1) Base	(2) Main	(3) Economic	(4) Standardized
Public Declaration	14.015**	14.066**		0.250**
	(6.113)	(4.706)		(0.084)
Debt/GDP		0.136**	0.130**	0.252**
		(0.062)	(0.067)	(0.084)
GDP Growth (%)		1.155**	1.148**	0.220**
		(0.488)	(0.442)	(0.093)
GDP Per Capita (log)		-1.766	-3.583	-0.061
		(4.020)	(4.163)	(0.139)
Debt Restructured (log)		-0.437	1.000	-0.031
		(1.871)	(2.047)	(0.133)
Serial Restructuring		-4.383	-5.961	-0.110
		(4.373)	(4.385)	(0.110)
IMF Program		-3.416	-1.707	-0.061
		(7.326)	(8.128)	(0.131)
Decade/Region FE	✓	✓	✓	✓
N	76	72	72	72
R^2	0.28	0.39	0.34	0.39

Standard errors in parentheses. *$p < 0.10$, **$p < 0.05$

resource constraints most explicitly, providing a greater and more immediate benefit. Indebted states should use public declarations to not only elicit higher haircuts but also to garner face value reductions more specifically. Replacing the dependent variable with a *Face Value Reduction Dummy* and a *Face Value Reduction Percentage*, the results remain robust. While the specific terms of restructuring agreements are outside the scope of this paper, not all means of receiving a haircut are created equal.

Appendix F addresses concerns of omitted variable bias by adding additional controls into the model's estimation. Controlling for debtor and global-level financial variables, domestic political institutions, and geopolitics, the positive effect of public declarations on haircuts is robust. Appendix G analyzes the robustness of my results in terms of specification, removing fixed effects, adding a year time trend, and using robust standard errors. Finally, Appendix H accounts for the fact that several countries in the sample experienced concurrent restructurings within the same calendar year. This generally occurs when countries restructure their commercial bank and bond

obligations separately, yielding two different deals with similar haircuts a few months apart.[26] Because the key independent variable, public default declarations, is initially recorded on a yearly basis, this could obscure which particular deal the dummy is capturing.[27] To account for this, I opt for the smaller haircut observation for each of the five country-crises in question as the most conservation choice in the main models. I show in Appendix H that the results are robust to using the larger haircut observation and dropping the five cases in question. My main results do not change - governments that issue public default declarations are rewarded with significantly higher creditor haircuts.

Are Public Declarations Costly?

The empirical results strongly support my primary hypothesis that public declarations increase creditor concessions. Yet, if this were unequivocally the case, what prevents all indebted governments from using a public strategy? Further unpacking the theory's mechanism implies that public declarations should only be effective at eliciting concessions when they are costly to politicians. A public declaration only provides credible information if it separates debtor states based on their political willingness to pay.

For my argument, the key mechanism is that politicians face competing claims for redistribution and therefore have difficulty governing after revealing negative economic information. Thus, I rely on theories of political gridlock under collective decision making to determine when public declarations are most costly to incumbents. When are they costly? Public declarations of debt distress should be particularly costly when governments are already significantly constrained in the policy making process.

I acknowledge that governments can be constrained by a multitude of actors (citizens, interest groups, firms, etc.) and institutions (elections, judiciaries, etc.) but I focus on how, especially

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[26]This occurred in the Dominican Republic (2005), Mexico (1985), Nigeria (1985), Pakistan (1999) and Russia (2000).

[27]While important, the resulting haircuts in these special cases are very similar. The largest difference between two restructurings completed in the same country-crisis-year is 6.6% (Dominican Republic 2005).

during financial crises, quick interventions are often required by the state, and the government must be able to legislate to restore economic growth. To pass legislation, the government needs support from other key actors - which may be difficult to obtain if different factions are engaged in an all-or-nothing tug-of-war. The more actors or interests whose support legislation requires, the more likely the government is to find itself in a political stalemate, unable to govern as it should.

Alexander Hamilton highlighted the relevance of gridlock as the "inefficacy of...government" (Hamilton, 2001). Since then, the causes and consequences of deadlock have been studied from American and Comparative perspectives. In American politics, divided government, inter- and intra-branch rivalry all contribute to inefficacy (Binder, 2004). In comparative politics, the more veto players in a system, and the more ideologically disperse they are, the more difficult it is to make or change policy (Tsebelis, 2002). Translated into debt restructuring, this implies that the amount of impact – the costs – a public default declaration has on the normal political decision-making process, depends on the possibility of essential supporters withholding their support. Leaders who govern unilaterally are unlikely to encounter logjams, whereas leaders who require collective assent are more susceptible. Competing groups with a take-no-hostages approach will fight to secure their own section of government resources before providing support. Empirically, financial crises demonstrate gridlock through increased polarization, fractionalization and popular discontent (Funke, Schularick and Trebesch, 2016; Hernandez and Kriesi, 2016; Mian, Sufi and Trebbi, 2014).

This implies an additional hypothesis about the theory's mechanism. The credibility of public declarations depends on their cost, and governments will face higher costs when they are highly constrained in their decision making.Therefore, I hypothesize that *more constrained leaders will be more likely to issue public declarations of default* as their actions are costly enough to be credible.

Variable Descriptions

Governments publicly declare default less than 20% of the time and most defaults occur without the government highlighting their insolvency. To test whether politicians use public default announcements when they are politically costly, I rely on the dichotomous measure of default *Declarations*, introduced above, as the dependent variable in my mechanism test. The indicator is

designed to capture instances where a key government official proclaims the decision to default in front of a public audience. Because the explanatory variables in my mechanism test, introduced below, are reported on a country-year basis, I opt for the variable's original country-crisis-year coding in order to increase my variation and sample size. This allows for 218 country-crisis-year observations rather than 76 negotiation episodes. I show that the results are robust to crisis-level aggregation in alignment with the first set of empirical results.[28]

I expect that public declarations will be most costly where the political decision making process is already highly constrained. To account for this, I introduce a measure of *Checks* on the government from the Database of Political Institutions (DPI), 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, 2018). 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 constraints on the government and I expect a positive relationship to public default declarations.

Model Specification

I control for a number of additional variables that may confound the effect of political constraints on public declarations. My choice of control variables is based on factors that are historically available for a cross-section of developing countries, however the results hold when incorporating additional measures.[29] As I argue that public declarations create governance costs in the form of a distributional tug-of-war, it is important to control for the underlying size of the domestic pie. To capture underlying economic conditions I include a country's *Debt to GDP* ratio, from Abbas et al. (2010). I also represent a country's baseline level of development by including *Per Capita GDP* (log) and *GDP Growth (%)* from Graham and Tucker (2017). Additional work on the determinants of debtor coerciveness have also found that *Inflation* (log), which is a more visible indicator of crisis, is a driver of coercive behavior (Enderlein, Trebesch and von Daniels, 2012). Poorer, more

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[28]See Appendix J.

[29]Results are robust to measures of financial pressure, democratic institutions, and election timing.

indebted countries with high inflation should be more likely to declare default publicly given their economic inability to pay. Finally, existing work suggests that domestic audiences benchmark their reactions to economic downturns across borders (Hellwig and Samuels, 2007; Kayser and Peress, 2012). Public declarations may be less likely to trigger domestic infighting in the midst of systemic crises and I include two measures of a country's susceptibility to global trends. I include *Trade Openness* as the sum of imports plus exports divided by GDP, and *Investment* as a percentage of GDP. These variables are also commonly used in the default literature and data are from the World Development Indicators.

The dependent variable, public declarations, is dichotomous and the appropriate estimator is a probit model with country-level clustered standard errors. To account for temporal and regional variation, I include dummy and region fixed effects based on the Correlates of War classifications. The results are robust to using a year time trend.

Mechanism results

Table 2 presents the estimation results for two specifications: (1) a base model, (2) and a main model with the expanded set of controls. *Checks* is positive and significant suggesting that more constrained governments are more likely to publicly announce their debt distress. Coefficients in a probit model can't be directly interpreted, so I estimate the marginal effect of constraints on public declarations from Model 2. The average marginal effect of an additional veto player on the likelihood of a public declaration is 7%, a sizable effect given the rarity of publicity in debt restructuring. The probability of a less constrained government (ex. Panama in the 1980s with 3 veto players) issuing a public declaration is 6%. As governments become more constrained (ex. Argentina in the early 1990s with 5 veto players), the probability of issuing a public declaration increases to over 20%.[30]

Interestingly, *GDP Growth (%)* is the only significant control. None of the other control variables have a systematic effect on publicity. While counterintuitive, this is in line with earlier findings that economic variables are more powerful predictors of debt distress than debt crisis

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[30]Holding all other variables at their mean. See Appendix I for the predicted probabilities plot. The effects are insignificant below 2 veto players.

Table 2: Public Declarations		
	(1)	(2)
DV: Public Declarations	Base	Main
Checks	0.414**	0.425**
	(0.147)	(0.167)
Debt/GDP		0.007
		(0.005)
GDP Growth (%)		-0.044**
		(0.016)
GDP Per Capita (log)		-0.471
		(0.334)
Inflation (log)		-0.036
		(0.111)
Investment (% GDP)		-0.818
		(3.057)
Trade Openness		-0.007
		(0.006)
Decade/Region FE	✓	✓
N	212	196
R^2	0.21	0.26

Standard errors in parentheses. *$p < 0.10$, **$p < 0.05$

resolution (Enderlein, Trebesch and von Daniels, 2012). Default is more of an economic-based decision, whereas tactical choices during negotiations are more political-based decisions.

While the results offer support for the mechanism, that public default declarations are successful because they are domestically costly, they also speak to how the decision making process over negotiation strategies differs from that of default. A major finding on the determinants of default is that checks and balances on political power diminish the probability of default (North and Weingast, 1989), especially when they represent different interests (Stasavage, 2011). More veto players, in the form of coalition governments and independent judiciaries, increases creditworthiness (Saiegh, 2009; Biglaiser and Staats, 2012); Democracy – constrained by the potential for electoral punishment – may also have a hand tying effect (Schultz and Weingast, 2003; Beaulieu, Cox and Saiegh, 2012).[31] These results add to larger discussions about the link between domestic political institutions and debt, suggesting that checks and balances can have different effects at different points in the borrowing relationship. Political constraints tie hands when honoring

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[31]However, Saiegh (2005) finds that democracies pay higher interest rates.

commitments, but once restructuring begins, they can be leveraged *against* creditors to achieve favorable outcomes. In addition to the theoretical implications, this also ameliorates concerns about selection. Political constraints do not appear to effect the decision to default and negotiation behavior in the same way.

To ensure the robustness of my mechanism level results, I provide alternative specifications in the appendix. The primary concern is that a test of the costly signaling mechanism implies that selection into public declarations is non-random and could influence the main finding, that public declarations are rewarded with higher creditor haircuts. To ensure that this is not the case, I estimate a selection model using the predicted probability of going public as the main regressor in the prediction of creditor haircuts in Appendix J.[32] The primary advantage of this two stage strategy is that it provides more information on the likelihood of a public moratorium and controls for random or strategic uses for publicity that are not accounted for in the theory. In other words, it models the selection into public declarations by using information on when public declarations are expected to be costly.[33] Using crisis-level data, Appendix J confirms that politicians are more likely to issue public declarations when they are costly enough to ensure credibility and creditors react to public declarations with higher haircuts.

Appendix L demonstrates that the findings are robust to using alternative conceptions of political constraints, including Henisz (2000)'s Political Constraints Index III and Cheibub, Gandhi and Vreeland (2010)'s Democracy indicator in particular. Appendix M analyzes the robustness of my results with respect to omitted variable bias. The positive relationship between political constraints and public declarations is robust to the inclusion of variables for financial pressure, political institutions, elections, and transparency. Appendix N turns to specification and presents results removing fixed effects and adding a yearly time trend and robust standard errors. It also

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[32]I do not claim to have an exclusion term, and the structural model here is different from a two stage least squares regression. This method accounts for selection into public declarations without relying on exogenous variation. It offers a more conservative test to increase confidence in the strength of the correlation.

[33]Appendix K presents placebo tests introducing measures of government constraint into the original estimating equation for creditor haircuts. As expected, government constraints are not significant predictors of creditor haircuts, implying that the effect works through the mechanism of public declarations.

recalculates the main model lagging all independent variables one year and recodes the dependent variable as the onset of a public declaration. Finally, to account for potential outliers, in Appendix O I exclude notable cases that received substantial press coverage. Overall, the robustness checks shed further light on the theoretical mechanism, supporting the claim that governments are more likely to issue public declarations where they are politically costly.

Conclusion

Negotiations to restructure sovereign debt are protracted affairs that are of primary importance to the economic recovery of indebted states. As sovereign debt rises, the number of restructuring negotiations in our sample is likely to increase. The recent debt crises in Greece, Spain, Iceland, and Ireland also demonstrate that debt crises are not limited to the developing world. 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, have led Nobel laureate Joseph Stiglitz to claim that sovereign debt is at the top of the policy agenda.

This work argues that international policy makers must consider not just the economic fundamentals that predict debt crises, but the political 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 political will to repay foreign debt leads to a protracted bargaining game. Privileged information about the government's political, rather than economic, incentives provides the government with incentives to misrepresent by exaggerating distress towards lenders at the risk of causing bargaining failure. One way for the government to resolve the information problem is to publicly declare default – inciting a domestic tug-of-war over the redistribution of increasingly scare resources – and disrupting the normal political decision making process. Strategically activating governance costs serves as a costly signal to separate governments that are politically unwilling to repay from those that are and to extort greater creditor concessions as a result. In

two stages of quantitative analyses I find that governments are more likely to engage in costly public signaling when when they are already constrained in their policymaking. Where this is true, creditors reward governments who make public declarations with higher haircuts.

By highlighting how bureaucratic infighting over revealed scarcity makes public statements credible, I show that opportunistic governments can manipulate predictable domestic constraints to win favorable international outcomes. Moreover, unlike audience costs, governments are willing to actually bear domestic costs in equilibrium if they believe the costs will be outweighed by the benefits of international concessions (Fearon, 1994). 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). They broaden our understanding of how governments choose their negotiating tactics in bargaining situations (Dür and Mateo, 2009; Bailer, 2012), particularly in an area that has remained opaque.

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 as a general theory of the way domestic concerns impact *how* governments cooperate internationally - impacting both negotiation strategy and negotiation outcomes.

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