Linkages across Sovereign Debt Markets*

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June 18, 2014

Abstract

We develop a multicountry model in which default in one country triggers default in other countries. Countries are linked to one another by borrowing from and renegotiating with common lenders. Countries default together because by doing so they can renegotiate the debt simultaneously and pay lower recoveries. Defaulting is also attractive in response to foreign defaults because the cost of rolling over the debt is higher when other countries default. Such forces are quantitatively important for generating a positive correlation of spreads and joint incidence of default. The model can rationalize some of the recent economic events in Europe as well as the historical patterns of defaults, renegotiations, and recoveries across countries.

Keywords: Contagion; Sovereign default; Renegotiation; Self-fulfilling crisis; European debt crisis

JEL classification: F3, G01

*We thank Laura Sunder-Plassmann for superb research assistance. The views expressed herein are those of the authors and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System. E-mails: arellano.cristina@gmail.com; yanbai06@gmail.com

1 Introduction

Sovereign debt crises tend to occur in tandem. During the 1980s, almost all Latin American countries defaulted and subsequently renegotiated their sovereign debt. Greece, Ireland, Italy, Portugal, and Spain struggled with their sovereign debt throughout the recent European debt crises, and Greece defaulted in 2012.[1] Yet, despite sovereign debt crises occurring in tandem, theoretical work on sovereign default has mainly studied countries in isolation.

This paper develops a multicountry model in which default in one country triggers default in other countries. Countries are linked to one another by borrowing from common lenders. Countries default together because by doing so they can renegotiate the debt simultaneously and pay lower recoveries. Defaulting is also attractive in response to foreign defaults because the cost of rolling over the debt is higher when other countries default. Such forces are quantitatively important for generating a positive correlation of spreads and joint incidence of default. We show that the main empirical implications of the model are borne in historical cross-country data: recoveries are lower when many countries renegotiate, renegotiation probabilities are higher when many countries are renegotiating, and default probabilities are higher when many countries are defaulting.[2]

The model economy consists of two symmetric countries that borrow, default, and renegotiate their debt with competitive lenders that have concave payoffs. The price of debt reflects the risk-adjusted compensation for the loss that lenders face in case of default. Default entails costs in terms of access to financial markets and direct output costs. After default, countries can renegotiate with a committee of lenders through Nash bargaining and pay the debt recovery. When multiple countries renegotiate, they do it simultaneously with lenders.

Countries are connected because the recovery and the price of debt are determined jointly and depend on countries' choices to default, borrow, and renegotiate, as well as on their states of debt, credit standing, and income. Importantly, borrowing countries are strategically large players and understand that their choices impact all recoveries and bond prices. They engage in Cournot competition when optimizing. We consider a dynamic recursive Markov equilibrium.

A foreign default increases incentives to default at home because it makes default less costly and new borrowing more expensive. Foreign defaults make home default less costly by lowering future recoveries because countries can extract more surplus if they renegotiate

[1]The clustering of default crises is studied at length in Reinhart and Rogoff (2011).

[2]The Brady Plan of the early 1990s is an example in which many Latin American countries renegotiated together and received an unusually good deal. These countries were able to exchange their defaulted debt for new Brady bonds with principal collateralized by the U.S. government.

simultaneously. Foreign defaults also make it more difficult for the home country to service the debt because these defaults lower lenders' payoffs, which in turn tighten bond prices at home. This dependency arises during fundamental foreign defaults, where the foreign country defaults because of high debt and low income, and also during self-fulfilling defaults, where both countries default only because the other is defaulting.

Recoveries crucially depend on whether one or the two countries renegotiate, because all parties renegotiating in a given period do it simultaneously with Nash bargaining. If two countries renegotiate with lenders, their recoveries are lower than when only one renegotiates because the outside option for lenders is lower. During simultaneous renegotiations, the threat value for lenders in case of renegotiation failure is autarky, whereas during single renegotiations, this threat value is the one from continuing to trade with the other country. Hence, a foreign renegotiation increases the incentives to renegotiate at home. This desire to renegotiate together in turn gives incentives for both countries to default together and take advantage of the lower recovery during renegotiation.

The bond price schedule incorporates the lenders' cost of funds and the risk-adjusted default probability and recovery rate. When the foreign country defaults, the bond price schedule worsens at home because lenders' marginal valuation rises, which increases the cost of funds, and because of higher future default probabilities and lower future recovery rates at home. Such tightening of the price schedule increases incentives to default at home.

We parameterize the model to Europe. To focus on our mechanisms, in the benchmark parametrization we study the case of uncorrelated income shocks across countries. The important parameters that determine the extent of debt market linkages are those controlling the bargaining process and the curvature of lenders' payoff function and the parameters. We calibrate these parameters to the observed average recovery rate of 0.60, the lower recovery observed during multiple-country renegotiations of 0.44, and volatility of the risk-free rate of 1.4. Other parameters of the model are calibrated to match observed spreads in Greece.

The model predicts that country interest rate spreads and borrowing comove. The cross-country correlation of spreads across countries in the model is 0.43, which implies that about half of the correlation of spreads between Italy and Greece of 0.97 can be attributed to linkages in their debt markets. Our model also predicts that the correlation of countries' borrowing is positive, as shown in the data of Greece and Italy, and equal to 0.30 and 0.56 in the model and data, respectively.

Through comparative static exercises, we find that the majority of the linkages across countries' debt markets arises because strategic countries renegotiate together to take advantage of lower recoveries. This effect alone would deliver a correlation across spreads of

0.28 and an even higher correlation in default, as shown in an exercise in which lenders have linear payoffs. Concavity in the lenders' payoff function does increase the correlation across spreads to the benchmark of 0.43 because the bond price functions at home respond not only to foreign defaults but also to the level of foreign borrowing.

We also consider the case of correlated income shocks. We use the joint process for output for Italy, Greece, and Spain to calibrate the model's stochastic structure. We find that in our model with correlated shocks, the correlation of spreads increases from 0.42 in the benchmark to 0.67, explaining about 70% of that in the data. Moreover, the dependencies across countries through the lender are exacerbated in the model with correlated shocks.

Finally, we use a broader dataset on defaults, renegotiations, and recoveries for 77 countries since 1970 and show that the main empirical implications of the model are consistent with historical experiences of countries. We find that the probability of default (renegotiation) in any one country increases (decreases) when the fraction of countries in default rises and decreases (increases) when the fraction of renegotiators rises. Moreover, recoveries are higher when the fraction of defaulting countries increases and are lower when the fraction of renegotiators increases. These effects are statistically and economically significant and robust to adding country fixed effects, world business cycles, and controlling for selection issues.

The model in this paper builds on the benchmark model of equilibrium default with incomplete markets analyzed in Aguiar and Gopinath (2006) and Arellano (2008), and in a seminal paper on sovereign debt by Eaton and Gersovitz (1981). These papers analyze the case of risk-neutral lenders, abstract from recovery, and focus on the default experiences of single countries. Borri and Verdelhan (2009) and Lizarazo (2013) study the case of risk-averse lenders, and Pouzo and Presno (2011) study the case of lenders with uncertainty aversion. They show that deviations from risk neutrality allow the model to generate spreads larger than default probabilities, which is a feature of the data. Borri and Verdelhan also show empirically that a common factor drives a substantial portion of the variation observed. Lizarazo (2009) and Park (2013) study contagion in a model similar to ours in which multiple borrowers trade with risk-averse lenders. Their model can generate comovement in spreads across borrowing countries; however, they abstract from any debt recovery and strategic interactions because they both consider competitive borrowers. Yue (2010), D'Erasmo (2011), and Benjamin and Wright (2009) study debt renegotiation in a model with risk-neutral lenders. They find that debt renegotiation allows the model to better match the default frequencies and the debt-to-output ratios.

Our model also presents new types of self-fulfilling equilibria that lead to sovereign defaults. Coordination failures have been popular explanations for sovereign debt crises. The main channel analyzed in the literature, however, emphasizes coordination failures among lenders, whereas we focus on coordination issues among borrowers.[3] Cole and Kehoe (2000), for example, develop a model with multiple equilibria in which defaults are self-fulfilling: lenders refuse to completely roll over the country's debt because they think that countries will default on the debt, which in turn leads to default. Relatedly, Lorenzoni and Werning (2013) develop a dynamic model with self-fulfilling defaults arising from high interest rates. Lenders charge higher interest rates because they predict high default rates. These high rates lead to faster debt accumulation and self-fulfilling high default rates. In contrast, the self-fulfilling equilibria of our model arise because of strategic interactions among large borrowers, which we view as also relevant for the case in which sovereign countries borrow from international lenders.

2 Model

Consider an economy in which two symmetric countries, Home and Foreign, borrow from a continuum of foreign lenders. Countries are strategically large players who borrow, default, and renegotiate their debt. Lenders are competitive and have a concave payoff function. Countries that default receive a bad credit standing, are excluded from borrowing, and suffer a direct output cost. Countries in bad credit standing can renegotiate their debt with a committee of lenders and bargain over the debt recovery. After renegotiation is complete, countries regain their good credit standing.

The current period payoff to each borrowing country i is $u(c_{it})$, and the current payoff to lenders is $g(c_{Lt})$, where c_{it} is the consumption of the representative household in each country and c_{Lt} is the dividend to lenders. The functions $u(\bullet)$ and $g(\bullet)$ are increasing and concave. The lifetime payoff to each borrowing country i is $E\sum_{t=0}^{\infty}\beta^t u(c_{it})$, and the payoff to lenders is $E\sum_{t=0}^{\infty}\delta^t g(c_{Lt})$. Borrowing countries are more impatient than lenders: $0<\beta<\delta<1$.

Each borrowing country receives a stochastic endowment each period. Let $y=\{y_i\}_{\forall i}$ be the vector of endowments for each country in a period. These shocks follow a Markov process with transition matrix $\pi(y',y)$. We assume that lenders face no additional shocks. The endogenous aggregate states consist of the vector of countries' debt holdings $b=\{b_i\}_{\forall i}$ and their credit standing $h=\{h_i\}_{\forall i}$. The economy-wide state s incorporates the endogenous and exogenous states: $s=\{b,h,y\}$.

[3] In the context of private borrowing, Arellano and Kocherlakota (2012) present a model in which borrowers default when other borrowers are also defaulting in environments in which private debtors cannot be punished when many are in default.

2.1 Borrowing Countries

The government of each country is benevolent, and its objective is to maximize household utility. The government trades one-period discount bonds with foreign lenders, decides whether to repay or default on its debt, and after a default, decides whether or not to renegotiate the debt. The government rebates back to households all the proceedings from its credit operations in a lump-sum fashion. We label country i as Home and country $-i$ as Foreign. Below we describe in detail the problem for the home country. The problem for the foreign country is symmetric.

We consider a Markov equilibrium where the governments take as given future decisions. The *current strategy* for the government at Home incorporates its repayment or renegotiation decision d_i and its borrowing decision b'_i. When the country is in good credit standing $h_i = 0$, it decides to repay the debt by setting $d_i = 0$. Only after deciding to repay can the country choose its new borrowing b'_i. If the government decides to default by setting $d_i = 1$, the government cannot borrow and its credit standing changes to bad the following period. When the home government is in bad credit standing $h_i = 1$, it decides to renegotiate by setting $d_i = 0$. Renegotiation changes the government's credit standing to good the next period. After renegotiation the government starts with zero debt, $b'_i = 0$. The current strategy for both countries is summarized by $\{b', d\} = \{b'_i, d_i\}_{\forall i}$.

The home prices for loans $q_i(s, b', d)$ and recovery $\phi_i(s, b', d)$ are functions that depend on the current strategies for both countries as well as the aggregate state. In making decisions, the governments take as given the price and recovery functions. The bond price function compensates the lender for the risk-adjusted loss in case of default and depends on the strategies of both countries and the aggregate states because the lenders' kernel, as well as future defaults, renegotiations, and recoveries, depend on all of these variables. The recovery function is the result of a bargaining process, the outcome of which depends on the countries' strategies and the aggregate state. Below we specify how the bond price and recovery functions are determined.

The current home consumption depends on the aggregate state and the current strategies of both countries $c_i(s, b', d)$. Consider a case where the home country is in good credit standing, $h_i = 0$, and has an arbitrary strategy to repay $d_i = 0$ and to borrow b'_i. Consumption in this case is

$$c_i = y_i - b_i + q_i(s, b', d)b'_i. \tag{1}$$

Note that consumption for country i also depends on the state and strategy of the other country by their effect on the price q_i. Now consider consumption with a strategy to default, such that $d_i = 1$. Default results in exclusion from trading international bonds and output costs $y_i - y_i^d$, with $y_i^d \leq y_i$. Consumption equals output during these periods:

$$c_i = y_i^d. \tag{2}$$

Following Arellano (2008) we assume that borrowers lose a fraction λ of output if output is above a threshold:

$$y_t^d = \begin{cases} y_t & \text{if } y_t \leq (1-\lambda)\bar{y} \\ (1-\lambda)\bar{y} & \text{if } y_t > (1-\lambda)\bar{y} \end{cases}$$

where $\bar{y}$ is the mean level of output.

Finally, consider the case when country i is in bad credit standing such that $h_i = 1$. When renegotiation is chosen, $d_i = 0$, the country pays the recovery $\phi_i(s, b', d)$, starts tomorrow with zero debt, $b_i' = 0$, and consumption is

$$c_i = y_i - \phi_i(s, b', d). \tag{3}$$

Here, the state and strategy of the other country also affect home consumption by their effect on the recovery. If the home country does not renegotiate, then consumption satisfies (2).

We represent the home borrowing country's payoffs as a dynamic programming problem. The government today takes as given all the decisions of future governments, which are summarized by the continuation value function from tomorrow on $v_{i,t+1}(s')$ when the state tomorrow is s'. The lifetime payoff of the home country today when the state today is s for arbitrary current strategies (b', d) is

$$w_{i,t}(s, b', d; v_{t+1}) = \{u(c_i(s, b', d)) + \beta \sum_{y'} \pi(y', y) v_{i,t+1}(s')\}. \tag{4}$$

Tomorrow's state $s' = \{b', h', y'\}$ depends on the current strategy of both countries. Specifically, the future credit standing and debt tomorrow depend on the default and renegotiation of each country, as follows:

$$h_i' = \begin{cases} 1 & \text{if } d_i = 1 \\ 0 & \text{otherwise} \end{cases} \qquad \text{for all } i \tag{5}$$

$$b_i' = \begin{cases} b_i' & \text{if } h_i = 0 \text{ and } d_i = 0 \\ b_i & \text{if } d_i = 1 \\ 0 & \text{otherwise} \end{cases} \qquad \text{for all } i \tag{6}$$

In our model, each borrowing country internalizes the effects its strategies have on bond prices and recoveries. The intraperiod game between the two countries has two stages. In the first stage, countries make their default and renegotiation decisions. In the second stage, if countries chose to repay in the first stage, they make their borrowing decisions and engage in Cournot competition with one another.[4]

To develop the intraperiod game, we start with the second borrowing stage after default and renegotiation decisions d have been made. The nature of this subgame depends on the credit standing of countries and their repayment decisions. When all countries are in good credit standing and repay, $\{d_i = 0\}_{\forall i}$, equilibrium borrowing strategies $B(s,d) = \{B_i(s,d)\}_{\forall i}$ are Nash in that $\{B_i = x_i^b(B_{-i}, s, d)\}_{\forall i}$, where $x_i^b(b'_{-i}, s, d)$ is the borrowing best response of each country i for arbitrary borrowing strategies b'_{-i}, given states s and repayment choices d,

$$x_i^b(b'_{-i}, s, d) = \{b'_i : \max_{b'_i} w_i(s, b', d; v_i(s'))\} \text{ for all } i. \tag{7}$$

When each country starts with a bad credit standing or it defaults, it cannot borrow and hence does not enter the second borrowing stage of the game. Here, the remaining country i chooses its borrowing to satisfy (7), where b'_{-i} equals b_{-i} or 0 according to the default and renegotiation choices given by (6).

In the first stage of the game, each country i chooses its repayment strategy d_i taking as given the equilibrium borrowing strategies of the second stage. The equilibrium repayment strategies $D(s) = \{D_i(s)\}_{\forall i}$ are Nash in that $\{D_i = x_i^d(D_{-i}, s, B(s,D)\}_{\forall i}$, where $x_i^d(d_{-i}, s, B(s,d)\}$ is the repayment best response of each country i for arbitrary repayment strategies d_{-i}, given states s and taking into account the outcome of the second borrowing stage $B(s,d)$:

$$x_i^d(d_{-i}, s, B(s,d)) = \{d_i : \max_{d_i} w_i(s, B(s,d), d; v_i(s'))\} \qquad \text{for all } i. \tag{8}$$

The resulting outcome of the intraperiod game is summarized by the repayment and borrowing functions $\{D(s)\}$ and $\{B(s) = B(s, D(s))\}$, as well as the consumptions $c(s) = \{c_i(s)\}_{\forall i}$ and values $v(s) = \{v_i(s)\}_{\forall i}$.

Definition 1. *A Markov partial equilibrium takes as given price functions $\{q_i(s,b',d)\}_{\forall i}$ and recovery functions $\{\phi_i(s,b',d)\}_{\forall i}$ and consists of equilibrium strategies $\{B(s), D(s)\}$ and payoffs $c(s)$ and $v(s)$ such that*
(1) Given future value functions $v(s')$, period equilibrium strategies $\{B(s), D(s)\}$ are the

[4] We subdivide the intraperiod game between the two countries into a repayment and borrowing stage because it substantially simplifies our computational algorithm.

solution of the intraperiod game such that they satisfy (7), (8), and (6).
(2) Equilibrium payoffs $v(s)$ implied by equilibrium strategies $\{B(s), D(s)\}$ are a fixed point

$$v_i(s) = w_i(s, B(s), D(s); v_i(s')) \qquad \textit{for all } i.$$

2.2 Lenders

Competitive lenders trade bonds with the two borrowing countries. Every period lenders receive a constant payoff from the net operations of other loans $r_L L$ and deposits $r_d D$, which we summarize by $y_L = r_L L - r_d D$. We assume that lenders honor all financial contracts.

Lenders take as given the evolution of the aggregate state,

$$s' = H(s) \tag{9}$$

and the corresponding decision rules for debt, default and renegotiation, $\{B(s), D(s)\}$. Lenders choose optimal dividends c_L and loans to the borrowing countries $\ell' = \{\ell_i'\}_{\forall i}$, taking as given the prices of bonds $Q = \{Q_i\}_{\forall i}$ and recoveries $\Phi = \{\Phi_i\}_{\forall i}$. The value function for the lender is given by

$$v^L(\ell, s) = \max_{\{c_L, \ell_i' \text{ if } h_i = h_i' = 0\}_{\forall i}} \{g(c_L) + \delta \sum_{y'} \pi(y', y) v^L(\ell', s')\}. \tag{10}$$

Lenders maximize their value subject to their budget constraint that depends on the credit standing of each borrowing country and whether they repay,

$$c_L = y_L + \sum_i (1 - D_i(s)) \left((1 - h_i)(\ell_i - Q_i \ell_i') + h_i \frac{\Phi_i \ell_i}{b_i} \right), \tag{11}$$

the evolution of the endogenous states when they do not trade with each country,

$$\ell_i' = \begin{cases} \ell_i \text{ if } h_i' = 1 \\ 0 \text{ if } (h_i = 1 \text{ and } h_i' = 0) \end{cases} \qquad \text{for all } i, \tag{12}$$

and the evolution of the aggregate state (9).

Using the first order conditions and envelope conditions for the lenders' problem, one can show that bond prices satisfy

$$Q_i = \sum_{s'} [m(s', s)(1 - D_i(s')(1 - \zeta_i(s'))] \qquad \text{for all } i, \tag{13}$$

where $\zeta_i(s')$ is the present value of recoveries and is defined recursively by

$$\zeta_i(s) = \sum_{s'} m(s', s) \left[(1 - D_i(s')) \frac{\Phi_i(s')}{b'_i} + D_i(s')\zeta_i(s') \right] \qquad \text{for all } i. \tag{14}$$

and $m(s', s)$ is the lenders' stochastic discount factor or pricing kernel,

$$m(s', s) = \frac{\delta \pi(y', y) g'(c_L(s'))}{g'(c_L(s))},$$

where $c_L(s)$ are the equilibrium dividends in state s.

The bond prices in (13) and the values of recoveries in (14) are easily interpretable. The bond price contains two elements: the payoff in nondefault states $D_i(s') = 0$ and the payoff in default states $D_i(s') = 1$. The lender discounts cash flows by the pricing kernel $m(s', s)$, and hence states are weighted by $m(s', s)$. For every unit of loan ℓ'_i, the lender gets one unit in the nondefault states and the value of recovery $\zeta_i(s')$ in default states. The recovery value is the expected payoff from defaulted debt the following period. It also contains two parts. If the country renegotiates next period, $D_i(s') = 0$, and the value of recovery for every unit of loan is $\frac{\Phi_i(s')}{b'_i}$. If the country does not renegotiate, $D_i(s') = 1$, and the present value of recovery is the discounted value of future recovery given by $\zeta_i(s')$. These future recovery values are weighted by the pricing kernel $m(s', s)$, which implies that recovery values are weighted more heavily for states s' that feature a higher pricing kernel.

The bond price compensates the lender for any covariation between its kernel and the bond payoffs. If default happens in states when $m(s', s)$ is low, the price contains a positive risk premia for low payoff in the default event. Moreover, if the value of recovery is low when $m(s', s)$ is low, the price also contains positive risk premia for the covariation of recovery.

2.3 Renegotiation Protocol

During renegotiation, countries renegotiate their debt with a committee of lenders. The renegotiation protocol we consider is one in which the committee of lenders bargains simultaneously with all the countries renegotiating using Nash bargaining.[5]

First consider the case in which only country i renegotiates its debt. Consider a candidate recovery value $\hat{\phi}_i$. The payoff for lenders from renegotiating and receiving recovery $\hat{\phi}_i$ equals the value of the representative lender evaluated at the aggregate debt values, $V^L(s; \hat{\phi}_i) \equiv v^L(b, s; \hat{\phi}_i)$. The payoff for the borrower from renegotiation is $v_i(s; \hat{\phi}_i)$ for this candidate

[5] Such bargaining protocol has often been used in industrial organization models of multifirms. See Dobson (1994) and Horn and Wolinsky (1988) for details.

value of recovery $\hat{\phi}_i$. If the two parties do not reach an agreement, the defaulter country is in permanent financial autarky with $y_i = y_i^d$ and gets a threat value equal to

$$v_{i,aut}(y) = \{u(y_i^d) + \beta \sum_{y_i'} \pi(y', y) v_{i,aut}(y')\}.$$

All lenders recover zero debt and are permanently precluded from trading with the defaulter country. Lenders, however, will still have access to financial trading with the other nondefaulting country. Let $V_{fail}^L(s_{-i})$ be the value to all lenders from trading only with the nondefaulting country. This value arises from the single-country Markov equilibrium described in detail in Appendix I.

The recovery ϕ_i maximizes the weighted surplus for borrowing country i and the lenders. The bargaining power for the borrower is θ and that for lenders is $(1-\theta)$. Recovery ϕ_i solves

$$\max_{\phi_i \epsilon [0,1]} \left[v_i(s;\phi_i) - v_{i,aut}(y)\right]^{\theta} \left[V^L(s;\phi_i) - V_{fail}^L(s_{-i})\right]^{1-\theta} \tag{15}$$

subject to both parties receiving a nonnegative surplus from the renegotiation: $v_i(s;\phi_i) - v_{i,aut}(y_i) \geq 0$, and $V^L(s;\phi_i) - V_{fail}^L(s_{-i}) \geq 0$, and law of motion (9).

Now consider states when both countries renegotiate simultaneously with the committee of all lenders. If the parties do not reach an agreement, all parties remain in financial autarky thereafter. The recoveries $\{\phi_i\}$ for all i solve

$$\max_{\phi_i \epsilon [0,1]} \left[v_i(s;\phi_i) - v_{i,aut}(y)\right]^{\theta} \left[V^L(s;\phi_i,\phi_{-i}) - V_{aut}^L\right]^{1-\theta} \text{ for all } i \tag{16}$$

subject to all parties receiving a nonnegative surplus from the renegotiation and law of motion (9). The outside option for the lenders in this case is autarky $V_{aut}^L = \frac{g(y_L)}{1-\delta}$. The interpretation for lenders having autarky as their outside option is that countries have an agreement ex-ante on a cooperative bargaining strategy to send offers to the committee of lenders, and the committee has to accept or reject both offers simultaneously.[6]

An important aspect of the renegotiation protocol we consider is the simultaneity in bargaining between the committee of lenders and all countries renegotiating. Under such protocol, countries send offers to lenders, and they have to accept or reject all offers simultaneously.[7] Such simultaneity implies that the threat value for lenders depends on whether

[6]Such an assumption is reminiscent of proposals to create debtors' cartels during episodes where many countries experienced crises such as the Latin America debt crises of the 1980s and the recent European debt crises.

[7]Dobson (1994) describes such protocol as *strict simultaneous bargaining*, where countries have an agreement beforehand to eliminate any other alternative bargaining strategy for lenders.

only one country renegotiates or two countries renegotiate. The differences between these two threat values have implications for the simultaneity of defaults and renegotiations across countries.

2.4 Functions for Bond Prices and Recoveries

The lenders' problem and the renegotiation protocol determine the functions for bond prices and recoveries. First consider the case when both countries are in good credit standing, $\{h_i = 0\}_{\forall i}$. Here, bond price functions $q(s, b', d) = \{q_i(s, b', d)\}_{\forall i}$ solve the demand system determined by lenders' first order conditions:

$$q_i = \sum_{s'} [m(s', s; q, b', d)(1 - D_i(s')(1 - \zeta_i(s'))] \text{ for all } i, \tag{17}$$

where the state tomorrow $s' = \{b', h', y'\}$ depends on countries' current strategies (b', d) and the lenders' kernel $m(s', s; q, b', d)$ is itself a function of prices, countries' strategies, and current and future states.

Now consider the case when country i is in good credit standing and country $-i$ is in bad credit standing, $h_i = 0$ and $h_{-i} = 1$. The bond price function for country i and the recovery function derived from (15) for country $-i$, $\{q_i(s, b', d), \phi_{-i}(s, b', d)\}$ solve

$$q_i = \sum_{s'} [m(s', s; q, b', d)(1 - D_i(s')(1 - \zeta_i(s'))] \tag{18}$$

$$\frac{\theta u'(y_{-i} - \phi_{-i})}{\left[v_{-i}(s; \phi_{-i}) - v_{-i,aut}(y_{-i})\right]} = \frac{(1 - \theta)g'(c_L(s, q_i, \phi_{-i}, b', d))}{\left[V^L(s, q_i, \phi_{-i}, b', d) - V^L_{fail}(s_i)\right]},$$

where the lender's dividends and values are evaluated for every strategy and corresponding price and recovery.

Finally, when both countries are in bad credit standing, $\{h_i = 1\}_{\forall i}$ recovery functions $\phi(s, b', d) = \{\phi_i(s, b', d)\}_{\forall i}$ are derived from (16) and solve

$$\frac{\theta u'(y_i - \phi_i)}{[v_i(s; \phi_i) - v_{i,aut}(y)]} = \frac{(1 - \theta)g'(s, q_i, \phi_{-i}, b', d)}{[V^L(s, \phi, d) - V^L_{aut}]} \text{ for all } i. \tag{19}$$

2.5 Equilibrium

We focus on recursive Markov equilibria in which all decision rules are functions only of the state variable s.

Definition 2. *A recursive Markov equilibrium for this economy consists of (i) countries' policy functions for repayment, borrowing, and consumption,* $\{B(s), D(s), C(s)\}$*, and values* $v(s)$*; (ii) lenders' policy functions for lending choices and dividends* $\{\ell'(\ell, s), c_L(\ell, s)\}$ *and value function* $v^L(\ell, s)$*; (iii) the functions for bond prices and recoveries* $\{q(s, b', d), \phi(s, b', d)\}$*; (iv) the equilibrium prices of debt* $Q(s)$ *and recovery rates* $\Phi(s)$*; (v) the evolution of the aggregate state* $H(s)$*; and (vi) the lenders' value in the case of renegotiation failure* $\{v^L_{i,fail}(\ell_i, s_i)\}_{\forall i}$ *such that given* $b_0 = \ell_0$*:*

1. *Taking as given the bond price and recovery functions, the policy and value functions for countries satisfy the Markov partial equilibrium in definition (1).*

2. *Taking as given the bond prices* $Q(s)$*, recoveries* $\Phi(s)$*, and the evolution of the aggregate states* $H(s)$*, the policy functions and value functions for the lenders* $\{\ell'(\ell, s)$, $c_L(\ell, s)$, $v^L(\ell, s)\}$ *satisfy their optimization problem.*

3. *Taking as given countries' policy and value functions, bond price and recovery functions* $\{q(s, b', d), \phi(s, b', d)\}$ *satisfy (17), (18), and (19).*

4. *The prices of debt* $Q(s)$ *clear the bond market for every country,*

$$\ell'_i(s) = B_i(s) \text{ for all } i.$$

5. *The recoveries* $\Phi(s)$ *exhaust all the recovered funds,*

$$\phi_i(s, B(s), D(s)) = \Phi_i(s) \text{ for all } i.$$

6. *The goods market clears,*

$$c_1 + c_2 + c_L = y_1 + y_2 + y_L.$$

7. *The law of motion for the evolution aggregate states (9) is consistent with countries' decision rules and shocks.*

8. *The lenders' value in the case of renegotiation failure* $\{v^L_{i,fail}(\ell_i, s_i)\}_{\forall i}$ *arises from the single-country Markov equilibrium.*

3 Joint Defaults

In this section, we develop a simple two-period example to illustrate why countries have incentives to default together.

Consider a two-period version of our model with no uncertainty, where countries have identical endowment paths y and y'. The lenders' payoff function is $g(c_L) = \frac{c_L^{1-\alpha}-1}{1-\alpha}$. In period 1 the two countries with debt b_i and b_{-i} are in good credit standing and are deciding whether to repay their current debt or default on it. If countries repay their debt, they choose to borrow. In period 2, countries either repay their debts if they borrowed in period 1 or pay the recovery ϕ' if they defaulted in period 1. In this example without uncertainty, in period 2 countries with good credit always repay and countries with bad credit always renegotiate, $\{d'_i = 0\}_{\forall i}$. Default does not happen in equilibrium in period 2 because default would be perfectly foreseen and the price of such a loan would be zero. Default incentives in period 2, however, limit the borrowing possibilities for period 1. In particular, in period 1 countries effectively face a borrowing limit $\bar{b}$, which is the maximum repayment that countries would be willing to make and equals the default penalty in period 2, $\bar{b} = y' - y^d$, where $y^d < y'$ is the income in case of default.

In this example, we assume that β is sufficiently less than δ such that it is optimal for countries to borrow to the limit in period 1. Hence, we abstract from the interdependence across countries in the borrowing decisions and focus on the interdependence in their repayment/default decisions. In this simplified environment, the relevant states for bond prices are the debt states b and the default decisions of both countries d, $\{q_i(b,d)\}_{\forall i}$. The relevant states for recovery tomorrow are the credit standing of both countries h', which is determined by d, $\{\phi'_i(h')\}_{\forall i}$. This example has these reduced states because we are assuming that endowments are constant for the countries. Here again, we label i as Home and $-i$ as Foreign.

In period 1, each country repays and sets $d_i = 0$ if the value of repayment is greater than the value of default:

$$u(y - b_i + q_i(b,d)\bar{b}) + \beta u(y' - \bar{b}) \geq u(y^d) + \beta u(y' - \phi'_i(h')) \text{ for all } i. \tag{20}$$

It is apparent that default is more likely for country i when debt b_i is high, the price q_i is low, and the recovery tomorrow ϕ'_i is low. The default decisions of the two countries are linked because bond prices today and recoveries tomorrow depend on the decisions of both countries through the lenders' problem.

It is useful to derive the home country's default best response conditional on the foreign country's default decision, $x_i^d(d_{-i}, b)$. The foreign default decision affects the home country's future recovery ϕ_i' and current debt price q_i. A foreign default today decreases the home recovery ϕ_i' tomorrow because the surplus from renegotiating is higher when both countries renegotiate together, $\phi_i'(h_{-i}' = 1) < \phi_i'(h_{-i}' = 0)$. A foreign repayment increases the recovery because here the country borrows $\bar{b}$ in period 1 and repays it in period 2. The $\bar{b}$ payment gives the lender a high outside option during renegotiation with the home country, which in turn increases the equilibrium $\phi_i'(h_{-i} = 0)$. This force implies that a foreign default $d_{-i} = 1$ increases the right-hand side of equation (20) and thus increases the incentive to default for the home country.

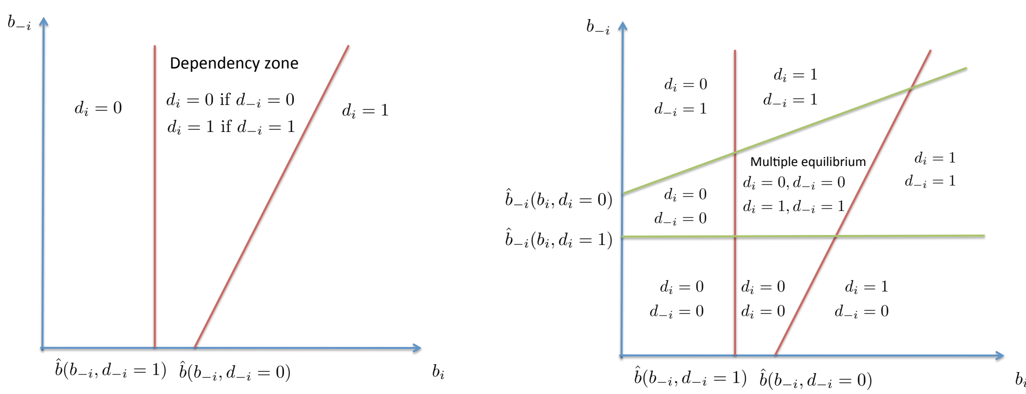
Proposition 1. *When two countries renegotiate simultaneously, recovery is smaller than when one country renegotiates alone:* $\phi_i'(h_{-i}' = 1) < \phi_i'(h_{-i}' = 0)$

Proof. See Appendix II.

The second effect to consider is how a foreign default affects price q_i. This effect depends on the net capital flows that lenders forgo with the foreign default, $b_{-i} - q_{-i}\bar{b}$. The larger the foreign forgone capital flows, the more unfavorable the home bond price becomes with a foreign default. The following proposition shows that capital flows are increasing with b_{-i}, and the effect of a foreign default is increasingly detrimental for q_i the higher b_{-i}.

Proposition 2. *Home bond prices increase with the foreign country's debt when the foreign country repays:* $q_i(b, d)$ *is increasing in* b_{-i} *when* $d_{-i} = 0$.

Proof. See Appendix II.



(a) Home Best Response (b) Equilibrium

Figure 1: Debt Linkages

As in single-country default models, the home country will default when its current debt b_i is sufficiently high. It is useful to consider two home debt cutoffs $\hat{b}(b_{-i}, d_{-i} = 0)$ and

$\hat{b}(b_{-i}, d_{-i} = 1)$, which depend on the foreign state and default decision. Home defaults when its debt level is above these two cutoffs.

The effects of a foreign default on the price q_i and the future recovery ϕ_i' imply that $\hat{b}(b_{-i}, d_{-i} = 0)$ is increasing in b_{-i} and that $\hat{b}(b_{-i}, d_{-i} = 1)$ is independent of b_{-i}. The ranking of $\hat{b}(b_{-i}, d_{-i} = 0)$ and $\hat{b}(b_{-i}, d_{-i} = 1)$ at $b_{-i} = 0$ depends on the details of the utility of lenders. We assume that the effect of default on recovery is strong enough such that $\hat{b}(b_{-i} = 0, d_{-i} = 0) > \hat{b}(b_{-i} = 0, d_{-i} = 1)$.

To summarize this analysis, Figure 1(a) plots the home best responses for default as a function of its own debt level b_i and the foreign country's debt level b_{-i} conditional on the foreign default decision d_{-i}. For sufficiently low (or high) levels b_i, the home country always repays (or defaults) independently of the foreign decision. For intermediate levels of b_i, however, the home country repays only if the foreign country repays. We label this region the *dependency zone.* By symmetry, the best response of the foreign country is identical to that of the home country, such that for intermediate levels of debt, the foreign country repays only if the home country repays.

Figure 1(b) illustrates the equilibrium in this example by considering both best response functions. The figure shows that in the dependency zones, both countries have joint repayments and joint defaults. Consider the dependency zone for country 1. When the foreign debt is low enough, the foreign repayment guarantees a home repayment. For high foreign debt, a foreign default guarantees a home default. When the foreign debt is in the intermediate region, our model features multiple equilibria: either both countries default or both countries repay. Nevertheless, even in this region the equilibrium features either joint defaults or joint repayments.

This example has highlighted the forces that in our model lead to joint defaults due to a common lender. The main idea is that foreign defaults lead to home defaults because foreign defaults lead to lower future recoveries and tighter current bond prices for the home country. Joint defaults and joint repayments occur for fundamental and self-fulfilling reasons. In this example, however, we have abstracted from debt dynamics and have considered an arbitrary level of initial debt. In practice, the level of debt is endogenous to countries' decisions and their choices interact with defaults and renegotiations. In the following section, we analyze the general dynamic model with endogenous borrowing and default.

4 Quantitative Analysis

We solve the model numerically and analyze the linkages across the two borrowing countries in terms of spreads, defaults, recoveries, and renegotiations. Debt market linkages are quantitatively important and can generate strong positive comovements among spreads and debt exposures.

4.1 Calibration

The utility function for the borrowing countries is $u(c) = \dfrac{c^{1-\sigma}}{1-\sigma}$. We set the intertemporal elasticity of substitution (IES) $1/\sigma$ to $1/2$, which is a common value used in real business cycle studies. The utility for lenders is $g(c_L) = \frac{c_L^{1-\alpha}}{1-\alpha}$. The IES for lenders $1/\alpha$ is calibrated below.

The length of a period is one year. We assume the stochastic process for output for the borrowing countries is independent of one another and follows a lognormal AR(1) process: $\log(y_{t+1}) = \rho \log(y_t) + \varepsilon_{t+1}$ with $E[\varepsilon^2] = \eta^2$. We discretize the shocks into a nine-state Markov chain using a quadrature-based procedure (Tauchen and Hussey, 1991). To calibrate the volatility and persistence of output, we use an annual series of linearly detrended GDP for Greece for the period 1960–2011, taken from the World Development Indicators.

We calibrate six parameters: the lenders' and borrowers' discount rates δ and β, the lenders' IES $1/\alpha$, the lenders' endowment y_L, the default cost λ, and the borrower's bargaining parameter θ, to match seven moments: the average yield and volatility of German one-year bonds of 4% and 1.4%, the average spread and volatility of Greek euro bonds of 1.5% and 2.6%, the volatility of German exposure to Greek debt of 15%, the average recovery of 60% and the difference between recoveries when many countries renegotiate their debt, and recoveries in single-country renegotiations of 16%.

The German exposure to Greek debt is measured as the total level of Greek debt held by the German financial sector. The series is taken from the Bank of International Settlements dataset on cross-border claims. The volatility is computed from a log and linearly detrended series.

The average recovery of 60% is the one reported in Cruces and Trebesch (2013) across 182 sovereign restructures for the period 1970-2010. With this dataset we compute the difference in average recoveries in years with single relative joint renegotiations. We define joint renegotiation years as those with four or more final renegotiations. We find that average recoveries are 16 percentage points lower in joint renegotiation years[8].

[8] We found similar results using an alternative dataset of renegotiations provided by Benjamin and Wright

Table 1 summarizes the parameter values.

Table 1: Parameter Values

	Value	Target
Borrowers' IES	$1/\sigma = 1/2$	Standard value
Stochastic structure for shocks	$\rho = 0.88$, $\eta = 0.03$	Greek output
Calibrated parameters		
Output cost after default	$\lambda = 0.016$	German yield: mean and volatility
Borrowers' discount factor	$\beta = 0.82$	Greek spread: mean and volatility
Lenders' discount factor	$\delta = 0.96$	Recovery rate: mean and conditional
Lenders' endowment	$y_L = 1.4$	Volatility of exposure
Lenders' IES	$1/\alpha = 1/0.65$	
Bargaining power	$\theta = 0.38$	

We solve the model as the limit of a finite horizon model in which each period both countries engage in Cournot competition with one another, taking as given the future decisions that are encoded in the future values. As in the simple example, for a certain region of the parameter space, our model features multiple equilibria. We select the equilibrium that maximizes the joint values for the two borrowing countries, $v_1 + v_2$. The numerical algorithm is explained in detail in Appendix III.

4.2 Main Results

We simulate the model and report statistics summarizing debt markets for the home country. Because of symmetry, statistics for the foreign country are equal.

Table 2 reports the calibration results as well as the correlation of spreads and exposures across countries predicted in the model and their empirical counterparts. The risk-free rate is defined as the inverse of the lender's kernel $r^f = 1/Em - 1$. Spreads are defined as the difference between the country interest rate and the risk-free rate $spr = 1/q - r_f - 1$. Recovery rates are defined as the recovery relative to the debt in default $100 \times \phi/b$. Exposure equals the market value of debt every period, qb'.

The calibration generates a fairly tight fit between the model predictions and the targets. In the model, the mean and volatility of the risk-free rate are 4.2% and 1.6%, which are close to the data statistics of 4.0% and 1.4%. In the model, the mean and volatility of the spread are 1.6% and 1.8%. The mean spread is close to its empirical counterpart of 1.4%, whereas

(2009). In this dataset, recovery rates are 13% lower in years with joint renegotiations.

volatility in the model is lower than the 2.6% found in the data. The volatility of detrended exposure in the model is 16%, close to 15% in the data. In the model, the average recovery and the difference in recoveries between single and multiple renegotiations are 66% and -13%, which are in line with the empirical estimates of 60% and -16%.

Although the calibrated moments are jointly controlled by all parameters, certain parameters affect certain moments more. The mean risk-free rate is mostly determined by the lenders' discount factor. The mean spread is mainly controlled by the borrowers' discount factor and the output cost of default. The volatility of the risk-free rate is controlled by the lenders' average output and their IES. The volatility of exposure is controlled by the lenders' IES, the borrowers' discount factor, and the output cost of default. The mean recovery and the recovery difference are controlled by the bargaining power and by the output cost of default.

Table 2: Main Statistics

	Data	Model
Calibrated moments:		
Mean risk-free rate	4.0	4.2
Mean spread	1.4	1.6
Volatility risk-free rate	1.4	1.6
Volatility spread	2.6	1.8
Volatility of exposure	15	16
Mean recovery	60	66
Change in recovery with multiple renegotiations	-16	-13
Other moments:		
Correlation of spreads	0.97	0.43
Correlation of exposure	0.56	0.30

Table 2 also shows that the model generates a substantial cross-country correlation of spreads and exposure of 0.43 and 0.30. The correlations of Greek spreads and those for Italy, Portugal, and Spain are 0.96, 0.97, and 0.97, respectively. The correlations of German exposure to Greek debt and German exposure of debt from Italy, Portugal, and Spain are 0.78, 0.31, and 0.58, respectively. Recall that the process for output is assumed to be uncorrelated and that the model generates positive correlations only because of the debt market linkages across countries. Hence, through the lens of our model, about half of the correlations in spreads and exposures across countries are attributed to the linkages in lending, default, and renegotiation.

To further understand country linkages in our model, Table 3 reports probabilities of default, renegotiation, recovery rates, and spreads for the home country across the limiting distribution of states conditional on whether the foreign country is repaying, defaulting, renegotiating or not. The probability of default and the spread is only observed in states when the home country is in good credit standing. The renegotiation probability and the recovery is only observed in states when the home country is in bad credit standing.

Table 3: Debt Linkages

	Overall	Foreign Good Credit		Foreign Bad Credit	
Home	Mean	Repay	Default	Renegotiation	Nonrenegotiation
Default prob.	4.5	2.9	37.3	0.03	100
Renegotiation prob.	98	100	1	100	–
Recovery	66	71	90	58	–
Spread	1.6	1.6	1.9	1.1	–

Table 3 shows that the default probability in the model is 4.5% and the renegotiation probability is close to 100%. The frequency of these events, however, is strongly affected by what the foreign country does. When the foreign country is in good credit standing and is repaying, the default probability at home is 2.9%, but it jumps to about 37% when the foreign country is defaulting. When the foreign country is in bad credit standing and is renegotiating the debt, the home default probability is close to 0, but it jumps to 100% when the foreign country is not renegotiating the defaulted debt. The two forces that lead to these patterns are how recoveries and spreads vary with foreign decisions. When the foreign country defaults, recoveries and spreads are the highest, equal to 90% and 1.9%, respectively, leading to a low renegotiation probability and a high default probability at home. When the foreign country is renegotiating, recoveries and spreads are the lowest, equal to 58% and 1.1%, respectively, leading to a high renegotiation probability and a low default probability at home.[9] The home country also defaults together with the foreign country to take advantage of the low recoveries when both renegotiate jointly.

[9]The limiting distribution does not have any mass in states in which both countries are in bad credit standing and only one renegotiates. When countries are in bad credit standing, they renegotiate jointly.

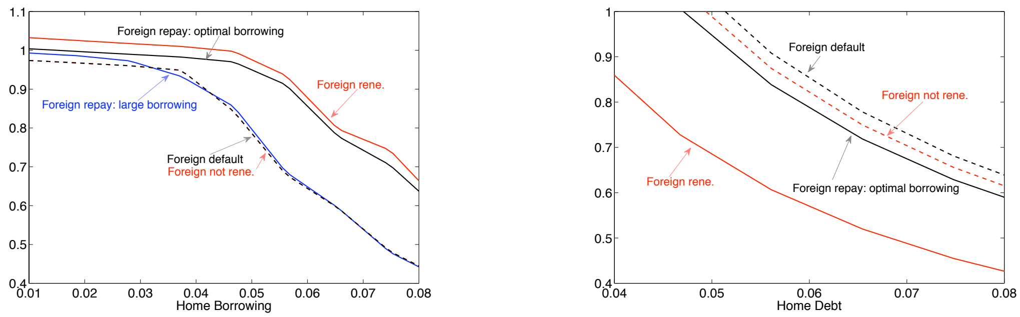
These statistics arise in our model due to the shapes of the functions for bond prices and recoveries. We now illustrate these functions and demonstrate the two main forces in the model that links countries. First, a foreign default makes the home debt price schedule tighter, which makes it harder to roll over the debt and hence can induce a default. Second, countries want to renegotiate together because recoveries are lower with joint renegotiations. A foreign default lowers the future recoveries for the home country, which can also induce a default.

Figure 2(a) plots the bond price schedules for the home country $q_i(s, b', d)$ as a function of their borrowing level, b'_i. The schedules are for a level of income that is two standard deviations lower than the mean and debt at the mean $b_i = b_{-i} = 0.06$ for both countries. We plot the schedules as a function of the two foreign credit states $h_{-i} = \{0, 1\}$ and for various foreign choices for loans b'_{-i} and repay/renegotiate d_{-i}. Bond prices are always decreasing in borrowing levels because both default probabilities and risk-free rates increase with larger loans. Risk-free rates increase with loans because the lenders' marginal utility increases with larger transfers to the home country.

Consider first the case in which the foreign country is in good credit standing. We plot the schedule for three foreign choices: the optimal borrowing choice $b'_{-i} = B(s, d)$, a large borrowing choice 30% larger than optimal, and default $d_{-i} = 1$. When the foreign country repays and borrows an optimal amount, which is modest here, the schedule for the home country is the most favorable. When foreign borrowing is large or when the foreign country defaults, the schedule is tighter because of the increase in the risk-free rate (as illustrated by the vertical distance across schedules at zero borrowing) and because of higher default probabilities in the future (as illustrated by the steeper slope of the bond price function). Foreign default increases default at home because debt renegotiation after default is more beneficial when renegotiating simultaneously. Large foreign borrowing increases its future default probabilities, which in turn translates into high home default probability too.

The figure also plots the price function when the foreign country has bad credit $h_{-i} = 1$. It considers two foreign choices, renegotiate $d_{-i} = 1$ and do not renegotiate $d_{-i} = 0$. The bond price schedule at home is most lenient when the foreign country renegotiates because of the low foreign default risk and low risk-free rates. The bond price schedule for not renegotiating is tight and coincides with that for default.

We now turn to recoveries. Figure 2(b) plots the recovery rate for the home country $\phi_i(s, b', d)/b_i$ as a function of the home country's debt state b_i. The levels of income and foreign debt are as in the bond price figure. We plot the schedules as a function of the two foreign credit states $h_{-i} = \{0, 1\}$ and for foreign choices for optimal loans $b'_{-i} = B(s, d)$ and



(a) Bond Price (b) Recovery

Figure 2: Equilibrium Functions

repay/renegotiate d_{-i}.

Recovery rates are decreasing in the level of defaulted debt because the recovery level $\phi_i(s, b', d)$ is independent of b_i. The home country faces the most lenient recovery function when the foreign country is also renegotiating because with joint renegotiations, the outside option of lenders, which is autarky, is lower. With single renegotiations, the outside value for lenders is the value of trading with the foreign country, which is higher given that lenders have the foreign country's assets. Nevertheless, the extent of this effect is controlled by the bargaining parameters. For example, if lenders have all the bargaining power, then their outside options are irrelevant for the equilibrium.

The recovery functions are the tightest if the foreign country would default or not renegotiate. In these cases, the lenders' outside option relative to the value of renegotiation is the highest because default or not renegotiating lowers the lenders' value of renegotiation, whereas the outside option is fixed across these potential choices for a given state.

Our model also provides a laboratory in which to analyze whether the observed defaults and renegotiations for the home country are induced by the defaults and renegotiations of the foreign country. We find that many defaults in one country could be avoided if other countries were to not default, and most renegotiations can be facilitated if other countries renegotiate. To conduct this experiment, we consider the home best responses for default or renegotiation observed in equilibrium, $x_i^d(d_{-i}, s, B(s, d))$, as a function of the foreign country strategy for default or renegotiation d_{-i}. We define home events as independent if the event continues to occur even if the foreign country changes its strategy from default to repay, from renegotiate to do not renegotiate, or vice versa. If the home event changes when the foreign country changes its default/renegotiation strategy, we label such events as dependent.[10] Self-fulfilling events are those dependent events that have two equilibria. Table 4 reports the fraction of the defaults, repayments, renegotiations, and nonrenegotiations for the home country that are independent and dependent. As the table shows, a substantial portion of the home events are induced by the foreign country decisions; 25% of the defaults, 27% of the repayments, 93% of the renegotiations, and 100% of the nonrenegotiations are dependent. Self-fulfilling equilibria are a substantial portion of the equilibria during renegotiations and nonrenegotiations but are also sizable for defaults. Nevertheless, the majority of the default and repayment events are independent with a portion equal to 75% and 73%, respectively.

Table 4: Types of Defaults and Renegotiations (%)

	Default	Repay	Renegotiation	Nonrenegotiation
Independent	75	73	7	0
Dependent	25	27	93	100
Self-fulfilling	14	0	36	87

The dependent defaults at home happen mostly because the foreign country is defaulting, although 2% of the defaults happen because the foreign country is not renegotiating. All of the dependent repayments happen because the foreign country is repaying. Of the dependent renegotiations at home, 55% happen because the foreign country is renegotiating and 39% because the foreign country is repaying. Of the nonrenegotiations, 100% happen because the foreign country is defaulting.

4.3 Comparative Statics

Standard quantitative default models as in Arellano (2008) abstract from debt linkages across countries because each country is considered in isolation. Our model generates strong linkages in debt markets across countries by deviating from a standard default model along three dimensions. First, the standard model considers one large borrowing country, whereas we consider two large borrowing countries, which leads to the analysis of the strategic interactions

[10] More precisely, default and renegotiation events are independent for country i if $D_i(s) = x_i^d(1 - D_{-i}(s), s, B(s,d))$, where $D_i(s)$, and $D_{-i}(s)$ are the equilibrium policy functions, x_i^d is the home best response function, and $B(s,d)$ is the outcome of the second stage intraperiod game when default/renegotiation strategies are $d_{-i} = 1 - D_{-i}(s)$ and $d_i = x_i^d(1 - D_{-i}(s), s, B(s,d))$. If $D_i(s) \neq x_i^d(1 - D_{-i}(s), s, B(s,d))$, the event is dependent.

among them. Second, the standard model considers risk-neutral lending, whereas we consider lenders that have concave payoffs. Third, the standard model does not consider renegotiation, whereas we add renegotiation in an environment with two borrowing countries interacting with lenders.[11]

In this section we show that these three forces are important for our results and that they interact with each other. To that end, we compute three versions of our model. We compute a *linear* model, where we set $\alpha = 0$. This version highlights the roles of two large borrowing countries interacting with one another through renegotiation. We also compute a *low IES* model by lowering the IES to $1/\alpha = 1/5$. This version explores the role of the elasticity of substitution.[12] We also compute a *small country* model, where we add a competitive small country that is otherwise identical to the home country to the benchmark model.[13] This version highlights the role of strategic interactions.

Finally, we explore the case of correlated income shocks across countries in the benchmark model. This parametrization highlights a complementary mechanism for debt linkages across countries that relies on common shocks.

Table 5 reports the sensitivity results for the three versions of our model as well as for the benchmark model. First consider the results for the linear model. In terms of means (default probabilities, spread, recovery, and debt), the linear model behaves very similarly to the benchmark. Having linear lenders in our model, of course, implies a zero risk-free rate volatility, which is far from that observed in the data. The volatilities of spreads and exposures are comparable to the benchmark. The correlations of spreads are greatly reduced in the linear model from 0.44 to 0.28 even though the correlation of defaults increases from 0.34 to 0.45. The reason for the increase in the default correlation is the higher incidence of more dependent states. The fraction of defaults that are dependent increases from 25% to 35%, and such events are mainly due to foreign defaults.

In the linear model, the main force that operates for linkages is that countries want to renegotiate together because their recoveries will be lower. The results from the linear model show that this effect is powerful and important for the results in our benchmark model. Nevertheless, the correlation of spreads is lower in the linear model because foreign borrowing

[11] As noted in the introduction, several papers have analyzed some of these extensions in isolation: Yue (2010) and D'Erasmo (2011) study renegotiation in the case of one borrowing country, and Lizarazo 2009, 2013 studies the impact of risk-averse lenders.

[12] With power utility, risk aversion and elasticity of substitution are controlled by the same parameter. We focus on describing the effects of the elasticity of substitution because when we extended our analysis to an Epstein-Zin utility function, we found that the key parameter controlling this result is the IES and not risk aversion. We found that risk aversion played only a minor role.

[13] In Appendix I, we lay out the small country problem in detail .

Table 5: Sensitivity

	Benchmark	Decomposing Mechanism			Correlated
		Linear	Low IES	Small Country	Shocks
Mean (%)					
Default probability	4.5	4.2	1.3	5.7	4.2
Spread	1.6	1.7	0.6	2.8	1.9
Recovery	66	66	62	77	64
Recovery $multiple - single$	-13	-10	-18	-2.5	-17
Debt service / GDP	6.3	6.3	5.9	7.4	6.4
Volatility (%)					
Risk-free rate	1.6	0.0	4.0	1.6	1.6
Spread	1.8	1.7	1.2	5.4	2.0
Exposure	15	15	17	8.5	30
Correlations across countries					
Spreads	0.42	0.28	0.52	0.17	0.67
Exposure	0.30	0.34	0.51	0.07	0.74
Default	0.34	0.45	0.32	0.11	0.59
Fraction dependent events (%)					
Default	25	35	31	–	41
Repay	27	27	22	–	22
Renegotiation	93	94	95	–	94
Nonrenegotiation	100	100	100	–	66

does not affect the risk-free rates. Recall that in the benchmark model, a home default is induced not only by a foreign default but also by large foreign loans, which increase the risk-free rate. In the linear model, this effect is absent, thereby lowering the correlation of spreads.

Consider the results from the low IES model. When lenders have low IES, the bond price functions are much tighter, which limits borrowing and leads to a lower default probability and spread in equilibrium. The volatility of the risk-free rate is the highest in this model because risk-free prices are more sensitive to lenders' consumption paths when they have a low IES. This model generates a higher correlation of spreads than the benchmark, 0.52 relative to 0.42, despite generating a comparable correlation of defaults. More curvature in lenders' utility amplifies the effects from large foreign borrowing on home bond prices.

Now consider the results from the small country model. In this model, the small country takes as given the evolution of the aggregate states and decisions of the two large borrowing countries arising from the benchmark model. This assumption matters for the small country because it determines the evolution of the risk-free rate. Moreover, the income shock of the small country is identical to that of the home country. Table 5 reports the statistics for the small country across its own limiting distribution of debt. The small country borrows more, defaults more, and faces higher spreads because the small country does not internalize that large borrowing increases the risk-free rate. The correlations across the spreads and defaults of the small country and the foreign country are small and equal 0.17 and 0.11. The positive correlations reflect the fact that countries face common risk-free rates. Nevertheless, correlations are small and less than half of that observed across the home country and the foreign country because the small country does not engage in any strategic interactions with the foreign country. This experiment shows that the large cross-country correlations in the benchmark are mainly driven by the strategic interactions across countries and that the modest variation in the lenders' condition plays only a minor role when countries are not strategic.

Finally, consider the results where countries have correlated income shocks in the benchmark model. The main takeaway from this exercise is that the benchmark results are robust to countries having correlated shocks.

We use data from Greece, Spain, and Italy to estimate an AR(1) process using two countries at a time with spillovers and correlated shocks, $\log(y_{t+1}) = A\log(y_t) + \varepsilon_{t+1}$ with $E[\varepsilon_{it}\varepsilon_{jt}] = \Omega$. To make results comparable, we maintain the symmetry assumption and use the average parameters of the six pairs of countries. The resulting parameters are: $A_{11} = A_{22} = 0.89$, $A_{12} = A_{21} = 0.06$, $\Omega_{11} = \Omega_{22} = 0.0011$, and $\Omega_{12} = \Omega_{21} = 0.00065$.

The means and volatilities of the correlated model are very similar to the benchmark, whereas the correlations increase. The correlations of spreads increase from 0.42 in the benchmark to 0.67. Thus, our model with correlated shocks can explain about 70% of the 0.97 correlation in the data. The correlations of exposure and default also increase substantially. The model with correlated shocks also increases the fraction of dependent defaults in the model from 25% to 41% and decreases the fraction of dependent nonrenegotiations from 100% to 66%.

5 Broader Empirical Results

The parametrization of the model focused on the recent European experience. In this section, we use a broader dataset on defaults, renegotiations, and recoveries to offer empirical support for the main implications of the model. As Table 3 shows, the main empirical implications of the model are as follows:

1. Default probabilities are higher when other countries are defaulting and lower when other countries are renegotiating.

2. Renegotiation probabilities are lower when other countries are defaulting and are higher when other countries are renegotiating.

3. Recovery rates are lower when other countries are renegotiating and higher when other countries are defaulting.

We show that these empirical implications are consistent with the historical experiences of countries. We assemble a panel dataset of 77 developing countries from 1970 to 2011, which include all the countries that have experienced a default event as defined by Standard and Poor's (S&P) or are in the Cruces and Trebesch (2013) dataset in addition to all emerging market countries.

We measure whether the fraction of countries that are in default and the fraction of those that are renegotiating correlate with the probability that any one country i defaults or renegotiates at time t. Specifically, we run the following two linear probability regressions:

$$\text{default}_{it}[\text{renegotiation}_{it}] = \alpha_i + \beta_D \text{ Frac Default}_{it} + \beta_R \text{ Frac Renegotiate}_{it} + \beta_{dy} \text{ Debt/GDP}_{it} + \varepsilon_{it}.$$

The variable default_{it} is a binary and equals 1 if the country is in default according to S&P and zero otherwise. The variable $\text{renegotiation}_{it}$ equals 1 if a country that is in default renegotiates the debt and is no longer in default according to S&P and equals zero if it is in default without renegotiating the debt. The variables Frac Default_{it} and $\text{Frac Renegotiate}_{it}$ are the fraction of countries, not including i, that are in default or are renegotiating in the dataset. To smooth discrete changes of these variables, we use five-year moving averages. Finally, the variable Debt/GDP_{it} is equal to the external debt to GDP ratio and is taken from the World Development Indicators database.

The first implication of our theory predicts that in the default regression, $\beta_D > 0$ and $\beta_R < 0$. Moreover, as in standard default models, we expect $\beta_{dy} > 0$. The second implication of the theory predicts that in the renegotiation regression, $\beta_D < 0$ and $\beta_R > 0$. We include country fixed effects that absorb the average default frequency for each country.

A main channel in our model for the default/renegotiation comovement is the variation in recoveries. As already shown in the calibration of the model, recoveries are lower on average in years with multiple renegotiations. Here we extend this analysis and examine how recovery varies continuously with the two variables, Frac Default_{it} and $\text{Frac Renegotiate}_{it}$ as well as with Debt/GDP_{it}. We run a similar regression as follows

$$\text{recovery}_{it} = \alpha + \gamma_D \text{ Frac Default}_{it} + \gamma_R \text{ Frac Renegotiate}_{it} + \gamma_{dy} \text{ Debt/GDP}_{it} + \varepsilon_{it}$$

Recovery$_{it}$ equals the recovery rate estimates from the Cruces and Trebesch (2013) dataset.[14] Our theory predicts that $\gamma_D > 0$ and $\gamma_R < 0$. Moreover, as in other models of renegotiation, our model predicts that $\gamma_{dy} < 0$.

Table 6: Cross-Country Regressions

	Default	Renegotiation	Recovery
Fraction in Default$_{it}$	1.36***	-0.88***	0.92***
Fraction Renegotiating$_{it}$	-2.13*	4.60**	-7.39***
Debt/GDP$_{it}$	0.11**	-0.03*	-0.21***
Country fixed effects	Yes	Yes	No
Adjusted R^2	0.28	0.06	0.34
Observations	2682	552	139

Table 6 reports the regression results. All standard errors are clustered at the country level. The coefficients on all the independent variables of interest have the sign predicted by the theory and are significant. The results in the default regression indicate that a 1% increase in the fraction of other countries in default increases the default probability of any one country by 1.4%, whereas an increase of 1% in the fraction of other countries renegotiating decreases the default probability by 2.2%. More indebted countries also are more likely to be in default. An increase in 10% in Debt/GDP$_{it}$ increases the default probability by 1%. In the renegotiation equation, an increase of 1% in the fraction of countries in default decreases the renegotiation probability by 0.9%, whereas a 1% increase in the fraction of countries renegotiating increases the renegotiation probability by 4.6%. Debt to GDP has no effect on the renegotiation probability. The results in the recovery equation say that a 1% increase in the fraction of countries in default increases recovery by a bit less than 1%, whereas an increase in the fraction of renegotiators increases recovery by 7.4% from an average of 60%. Appendix IV contains additional robustness results as well as descriptive statistics for all the variables. It shows that the main results are maintained when controlling for world GDP as well as for selection issues.

The historical patterns across countries documented in this section are consistent with our theory. Countries default together and renegotiate together because recoveries are more favorable during multiple renegotiations.

[14]For some defaults Cruces and Trebesch (2013) report various recovery rates that correspond to partial renegotiations. We only use the recovery during final renegotiations. The results are similar if we use a weighted average recovery.

6 Conclusion

We developed a multicountry model of sovereign default and renegotiation in which default in one country triggers default in other countries. Debt market conditions for borrowing countries are linked to one another because they borrow from a common lender with concave payoffs. In our model, country interest rates are correlated because countries tend to default together. Joint defaults occur because a default abroad makes the price of debt more stringent and recoveries lower at home. Our model provides a framework in which to study some of the recent economic events in Europe and is consistent with a broader historical dataset of defaults, renegotiations, and recoveries.

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Appendix I. Auxiliary Models

One Large Country Model

Let $v^L_{i,fail}(\ell_i, s_i)$ be the value to the lender when trading only with country i:

$$v^L_{i,fail}(\ell, s_i) = \max_{\{d_L, \ell'_i \text{ if } h_i = h'_i = 0\}} \{g(c_L) + \delta \sum_{y'_i} \pi(y'_i, y_i) v^L_{i,fail}(\ell', s'_i)\}, \tag{21}$$

subject to its budget constraint,

$$c_L = y_L + [1 - D_i(s)] \left((1 - h_i)(\ell - Q_i \ell') + h_i \frac{\Phi_i \ell}{b_i} \right),$$

the evolution of the endogenous states akin to equation (12), and a law of motion of aggregate states for the case that country i is dealing alone with lenders $s'_i = H_{fail}(s_i)$. The optimal solution of the lender is given by $c_{L,fail}(\ell, s_i)$ and $\ell'_{fail}(\ell, s_i)$.

The problem for country i in the case when it trades alone with the lenders is similar to one described in Section 2.1 with three main differences. First, its aggregate states are only $s_i = \{b_i, h_i, y_i\}$. Second, the price function $q_{i,fail}(s_i, b'_i, d_i)$ and recovery $\phi_{i,fail}(s_i, b'_i, d_i)$ depend only on its own states and its own strategies. Third, the intraperiod Nash game between countries is absent. The decision rules for this problem are labeled $B_{i,fail}(s_i)$ for borrowing and $D_{i,fail}(s_i)$ for repayment. These decisions in turn determine the evolution of the aggregate state $s'_i = H_{fail}(s_i)$.

When $h_i = 0$, the price function $q_{i,fail}(s_i, b'_i, d_i)$ solves

$$q_{i,fail} = \sum_{s'} m_{fail}(s'_i, s_i; q_{i,fail}, b'_i, d_i) \left[1 - D_{i,fail}(s'_i)(1 - \zeta_{i,fail}(s'_i))\right]. \tag{22}$$

Here, the decision rules of the country and the lender's kernel are those corresponding to the problem when country i trades alone with the lender.

When the country is in bad credit standing and chooses to renegotiate, the recovery function $\phi_{i,fail}(s_i, d_i)$ solves

$$\frac{\theta u'(y_i - \phi_{i,fail})}{[v_i(s_i; \phi_{i,fail}) - v_{i,aut}(y_i)]} = \frac{(1 - \theta) g'(s_i, \phi_{i,fail}, d_i)}{[V^L(s_i, \phi_{i,fail}, d_i) - V^L_{aut}]}. \tag{23}$$

- A single-country recursive Markov equilibrium consists of (i) the country i's policy functions for repayment, borrowing, and consumption, $\{B_{i,fail}(s_i), D_{i,fail}(s_i), C_{i,fail}(s_i)\}$, and values $v_{i,fail}(s_i)$; (ii) lenders' policy functions for lending choices and dividends

$\{\ell'_{fail}(\ell, s_i),\ c_{L,fail}(\ell, s_i)\}$ and value function $v^L_{i,fail}(\ell, s_i)$; (iii) the functions for bond prices and recoveries $\{q_{i,fail}(s_i, b'_i, d_i), \phi_{i,fail}(s_i, d_i)\}$; (iv) the equilibrium prices of debt $Q_{i,fail}(s_i)$ and recovery rates $\Phi_{fail}(s_i)$; (v) the evolution of the aggregate state $H_{fail}(s_i)$ such that given $b_0 = \ell_0$:

- *Taking as given the bond price and recovery functions, the country i's policy functions for repayment, borrowing, and consumption,* $\{B_{i,fail}(s_i), D_{i,fail}(s_i), C_{i,fail}(s_i)\}$, *and values* $v_{i,fail}(s_i)$ *solves country i's problem when it trades alone with the lenders.*
- *Taking as given the bond prices* $Q_{fail}(s_i)$, *recoveries* $\Phi_{fail}(s_i)$, *and the evolution of the aggregate states* $H_{fail}(s_i)$, *the policy functions and value functions for the lenders* $\{\ell'_{fail}(\ell, s_i),\ c_{L,fail}(\ell, s_i)\}$, $v^L_{i,fail}(\ell, s_i)\}$ *satisfy lenders' optimization problem in (21).*
- *Taking as given countries' policy and value functions, bond price and recovery functions* $\{q_{i,fail}(s_i, b'_i, d_i), \phi_{i,fail}(s_i, d_i)\}$ *satisfy (22) and (23).*
- *The prices of debt* $Q_{fail}(s_i)$ *clear the bond market,* $\ell'_{i,fail}(b_i, s_i) = B_{i,fail}(s_i)$.
- *The recoveries* $\Phi_{i,fail}(s_i)$ *exhaust all the recovered funds:* $\phi_{i,fail}(s_i, D_{i,fail}(s_i)) = \Phi_{fail}(s_i)$.
- *The law of motion for the evolution aggregate states* $H_{fail}(s_i)$ *is consistent with country i's decision rules and shocks.*

Small Country Model

The model for the small country is a one-country competitive version of the benchmark model. This model is studied in Yue (2010), but here the risk-free rate is time varying and depends on the evolution of the aggregate states. The recursive problem for the small country takes as given the law of motion of aggregate states (9). Given the individual state (b_s, y_s, h_s) and aggregate state s, the small country's problem is given by

$$v_s(b_s, y_s, h_s = 0, s) = \max_{d_s=\{0,1\}} \{(1 - d_s)v^0_s(b_s, y_s, h_s = 0, s) + d_s v^1_s(b_s, y_s, h_s = 0, , s)\}.$$

If it repays, the small country chooses optimal consumption and savings:

$$v^0_s(b_s, y_s, h_s = 0, s) = \max_{c_s, b'_s} \{u(y_s - b_s + q_s(b'_s, y_s, s)b'_s) + \beta E v_s(b'_s, y'_s, h'_s = 0, s')\}.$$

If it defaults, the small country's value is given by

$$v_s^1(b_s, y_s, h_s = 0, s) = \{u(y_s^d) + \beta E v_s(b_s, y_s', h_s' = 1, s')\}. \tag{24}$$

If the country is in bad credit standing, it chooses whether to renegotiate according to

$$v_s(b_s, y_s, h_s = 1, s) = \max_{d_s=\{0,1\}} \{(1 - d_s) v_s^0(b_s, y_s, h_s = 1, s) + d_s v_s^1(b_s, y_s, h_s = 1, s)\}.$$

Its renegotiation value depends on the recovery $\phi_s(b_s, y, s)$ and is given by

$$v_s^0(b_s, y_s, h_s = 1, s) = u(y_s - \phi_s(b_s, y, s)) + \beta E v_s(0, y_s', h_s' = 0, s').$$

Without renegotiation, its value is the same as the default value given by equation (24).

In equilibrium, bond price and recovery functions for the small country satisfy the following equations:

$$q_s = E\left[1 - d_s'(b_s', y_s', h_s', s')(1 - \zeta_s(b_s', y_s', h_s', s'))\right] E m(s', s),$$

$$\zeta_s(b_s, y_s, h_s, s) = E[(1 - d_s'(b_s, y_s', h_s', s')) \frac{\phi_s(b_s, y_s', h_s', s')}{b_s} + d_s'(b_s, y_s', h_s', s') \zeta_s(b_s, y_s', h_s', s')] E\left[m(s', s)\right],$$

$$1 - \theta = \frac{\theta u'(y_s - \phi_s)}{[v_s^0(b_s, y_s, h_s = 1, s; \phi_s) - v_{aut}(y_s)]},$$

where $m(s', s)$ is the equilibrium pricing kernel from the two-big-country problem.

Appendix II. Proofs

Proof for Proposition 1. Let us call ϕ_2^i and ϕ_2^{-i} the recovery values for country i and $-i$ respectively when the two countries renegotiate jointly with lenders, and ϕ_1^i be the recovery value when country i renegotiates alone with lenders. Nash bargaining implies that ϕ_2^i satisfies

$$\frac{\theta u_c(y_2'^i - \phi_2^i)}{u(y_2'^i - \phi_2^i) - u(y^d)} = \frac{(1-\theta) g'(y_L + \phi_2^i + \phi_2^{-i})}{g(y_L + \phi_2^i + \phi_2^{-i}) - g(y_L)} \leq \frac{(1-\theta) g'(y_L + \phi_2^i + \phi_2^{-i})}{g(y_L + \phi_2^i + \phi_2^{-i}) - g(y_L + \phi_2^{-i})}.$$

The inequality holds because g is an increasing function and $\phi_2^{-i} \geq 0$. Suppose the following condition holds:

$$\frac{(1-\theta) g'(y_L + \phi_2^i + \phi_2^{-i})}{g(y_L + \phi_2^i + \phi_2^{-i}) - g(y_L + \phi_2^{-i})} \leq \frac{(1-\theta) g'(y_L + \phi_2^i + \bar{b})}{g(y_L + \phi_2^i + \bar{b}) - g(y_L + \bar{b})}. \tag{25}$$

Then, the recovery under two borrowing countries ϕ_2^i satisfies

$$\frac{\theta u_c(y_2'^i - \phi_2^i)}{u(y_2'^i - \phi_2^i) - u(y^d)} \leq \frac{(1-\theta)g'(y_L + \phi_2^i + \bar{b})}{g(y_L + \phi_2^i + \bar{b}) - g(y_L + \bar{b})},$$

where recovery alone ϕ_1^i satisfies

$$\frac{\theta u_c(y_2'^i - \phi_1^i)}{u(y_2'^i - \phi_1^i) - u(y^d)} = \frac{(1-\theta)g'(y_L + \phi_1^i + \bar{b})}{g(y_L + \phi_1^i + \bar{b}) - g(y_L + \bar{b})}.$$

It is easy to show by contradiction that $\phi_2^i \leq \phi_1^i$ because u and g are increasing and concave. Note that concavity is not necessary to guarantee $\phi_2^i \leq \phi_1^i$.

We still need to show that inequality (25) holds. Given $\bar{b} \geq \phi_2^{-i}$, we need to show that the function $f(x) = \frac{g'(y_H+x)}{g(y_H+x)-g(y_L+x)}$ with $y_H = y_L + \phi_2^i \geq y_L$ weakly increases with x. Under the assumption that $g(c) = c^{1-\alpha}/(1-\alpha)$, we can write $f(x)$ as

$$f(x) = \frac{-\alpha(1-\alpha)}{\Delta^2}\left\{1 - \left(\frac{y_H + x}{y_L + x}\right)^{\alpha-1} + \frac{1-\alpha}{\alpha}\left(1 - \left(\frac{y_H + x}{y_L + x}\right)^{\alpha}\right)\right\}$$

where $\Delta = (y_H + x)^\alpha \left[(y_H + x)^{1-\alpha} - (y_L + x)^{1-\alpha}\right]$. It is easy to show that $f'(x) \geq 0$. Q.E.D.

Proof for Proposition 2. Conditional on repaying, country i's net capital flow to lenders increases with its initial debt holding b_i. To see this, let $\omega_L(b_{-i}, d_{-i})$ and $\omega_L'(d_{-i})$ be the lenders' wealth from trading with the other country $-i$ in period 1 and period 2, respectively. In particular,

$$\omega_L(b_{-i}, d_{-i}) \equiv y_L + (1 - d_{-i})TB(b_{-i}).$$

We can define the net capital flow from country i as $TB_i = b_i - q_i\bar{b}$, where q_i solves

$$q_i = \frac{\delta g'[\omega_L'(d_{-i}) + \bar{b}]}{g'[\omega_L(b_{-i}, d_{-i}) + b_i - q_i\bar{b}_i]}.$$

It is easy to show that

$$\partial TB_i / \partial b_i = \frac{g'[\omega_L(d_{-i}) + b_i - q_i\bar{b}]}{g'(\omega_L(b_{-i}, d_{-i}) + b_i - q_i\bar{b}) - q_i g''(\omega_L(b_{-i}, d_{-i}) + b_i - q_i\bar{b})\bar{b}} \geq 0.$$

Higher b_{-i} therefore leads to higher net capital flow TB_{-i} and so higher lenders' wealth from country $-i$ since $\omega_L(b_{-i}, d_{-i})$. The bond price of country i thus increases with b_{-i} conditional on country $-i$ repaying.

Appendix III. Computational Algorithm

We first discretize the endowment space $y = (y_1, y_2)$ into 81 pairs using Tauchen-Hussey (1991) method and the debt space $b = (b_1, b_2)$ into 225 pairs. We then compute the model as the limit of a finite horizon model with T periods. We start with a large enough T and solve the problem backwardly until the value functions and decision rules converge. In each period, we compute two models: a single-country model and a two-country model. We need to compute the first model, since its equilibrium values are used in solving for the Nash bargaining allocations of the second model.

We now describe the algorithm for a generic period $t \leq T$.

1. Single-country model.

   In this computation, we take as given the following functions from period $t+1$: country i's value function and default decision $\{v^1_{i,t+1}(s), D^1_{i,t+1}(s)\}$, discounted value of future recovery $\zeta^1_{i,t+1}(s)$, and lenders' consumption and value function when dealing with country i alone $\{c^L_{i,t+1}(s), V^L_{i,t+1}(s)\}$ for $i = 1, 2$ and $s = \{(b_i, h_i, y_i)\}_{i=1,2}$[15]. We then update these function for period t using the optimal decisions from this period.

   Let's first construct expected future value function W and expected repayment function ψ on the grids of (b', s). They both depend on the current state s and are a function of debt choice b':

$$
\begin{aligned}
W^1_{i,t+1}(b', s) &= \sum_{y'} \pi(y'|y) v^1_{i,t+1}(s') \\
\psi^1_{i,t+1}(b', s) &= \sum_{y'} \pi(y'|y) g'[c^L_{i,t+1}(s')] \left\{ (1 - D^1_{i,t+1}(s')) + D^1_{i,t+1}(s') \zeta^1_{i,t+1}(s') \right\}.
\end{aligned}
$$

   With these two functions, we can solve the single-country model at period t. In particular, we solve it in two cases: when the country has good credit standing and when the country has bad credit standing.

   For the country in good credit standing, we solve its problem in two steps. In the first step, we find the optimal borrowing decision conditional on repaying. In the second step, we find the optimal default decision taking as given the optimal borrowing decision and repaying value from the first step.

[15] For convenience of notation, we write the state space of the single-country model the same as that of the two-country model. Of course, in the single-country model, country $-i$'s state (b_{-i}, h_{-i}, y_{-i}) does not affect country i's problem.

1.1 Borrowing decision. Taking as given expected future value function W and expected repayment function ψ, we solve the following optimization problem

$$\begin{aligned} v_{i,t}^{1,r}(s) = \max_{b'} \quad & u(y_i - b_i + qb') + \beta W_{i,t+1}^{1}(b', s) \\ s.t. \quad & qg'[y_L + b_i - qb'] = \delta \psi_{i,t+1}^{1}(b', s). \end{aligned} \tag{26}$$

Note that we do not use grid-search method to solve for the optimal b'. Instead, we solve b' continuously by interpolating the functions of $W_{i,t+1}^{1}(b', s)$ and $\psi_{i,t+1}^{1}(b', s)$. Let $B_{i,t}^{1,r}(s)$ and $Q_{i,t}^{1}(s)$ be the optimal borrowing decision and the corresponding equilibrium bond price satisfying equation (26) when $b' = B_{i,t}^{1,r}(s)$, respectively.

1.2 Default decision. It's a zero-one choice depending on which value is larger, repaying or defaulting:

$$v_{i,t}^{1}(s) = \max_{d} \ (1-d) v_{i,t}^{1,r}(s) + d \, v_{i,t}^{1,d}(s),$$

with the default value is given by $v_{i,t}^{1,d}(s) = u(y_i^d) + \beta W_{i,t+1}^{1}(s)$. Let $D_{i,t}^{1}(s)$ be the optimal default decision.

For the country in bad-credit standing, we solve it in two steps as well. In the first step, we solve the optimal recovery for each grid s . We then figure out the optimal renegotiation decision taking as given the optimal recoveries.

1.3 Recovery function. For each grid s with $h_i = 1$, the optimal recovery ϕ satisfies the following equation:

$$\frac{(1-\theta) g'(y_L + \phi)}{g(y_L + \phi) + \delta E V_{i,t+1}^{L}(s') - V_{L,t}^{aut}} = \frac{\theta u_c(y_i - \phi)}{u(y_i - \phi) + \beta W_{i,t+1}^{1}(0, s) - v_{i,t}^{aut}(y)}$$

where the autarky value for lenders is given by $V_{L,t}^{aut} = g(y_L) + \delta V_{L,t+1}^{aut}$ and the autarky value for the country is given by $v_{i,t}^{aut}(y) = u(y_i^d) + \beta \sum_{y'} \pi(y'|y) v_{i,t+1}^{aut}(y')$. The optimal recovery is denoted as $\phi_{i,t}^{1}(s)$.

1.4 Renegotiation decision. Taking as given the recovery schedule $\phi_{i,t}^{1}(s)$, the country makes zero-one choice over renegotiation:

$$v_{i,t}^{1}(s) = \max_{d} \quad (1-d)[u(y_i - \phi_{i,t}^{1}(s)) + \beta W_{i,t+1}^{1}(0, s)] + d[u(y_i^d) + \beta W_{i,t+1}^{1}(b, s)].$$

Let $D_{i,t}^{1}(s)$ be the optimal non-renegotiating decision.

We can now evaluate lenders' consumption at period t according to

$$c_{i,t}^L(s) = y_L + (1 - D_{i,t}^1(s)) \left[(1-h_i)\left(b_i - Q_{i,t}^1(s)B_{i,t}^{1,r}(s)\right) + h_i\phi_{i,t}^1(s)\right].$$

The value of the lender is given by

$$V_{i,t}^L(s) = g(c_{i,t}^L(s)) + \delta\sum_{y'}\pi(y'|y)V_{i,t+1}^L(s'),$$

where the future debt in s' for country i is $B_{i,t}^1(s)$. In particular, $B_{i,t}^1(s) = B_{i,t}^{1,r}(s)$ if $h_i = 0$ and $D_{i,t}^1(s) = 0$, $B_{i,t}^1(s) = 0$ if $h_i = 1$ and $D_{i,t}^1(s) = 0$, and $B_{i,t}^1(s) = b_i$ if $D_{i,t}^1(s) = 1$.

The discounted value of future recovery at period t is given by

$$\zeta_{i,t}^1(s) = \delta\sum_{y'}\pi(y'|y)g'(c_{i,t}^L(s'))\left[(1-D_{i,t}^1(s'))\phi_{i,t}^1(s') + D_{i,t}^1(s')\zeta_{i,t+1}^1(s')\right].$$

2. Two-country model.

   We take as given the following functions from period $t+1$: country i's value function and default decision $\{v_{i,t+1}(s), D_{i,t+1}(s)\}$, discounted future value of recovery $\zeta_{i,t+1}(s)$, and lenders' consumption and value function when dealing with country i alone $\{c_{L,t+1}(s), V_{L,t+1}(s)\}$ for $i = 1,2$ and $s = \{(b_i, h_i, y_i)\}_{i=1,2}$. We then update these function for period t using the optimal decisions from this period.

   we first need to construct the expected value function W and the expected repayment function ψ for any pair of $b' = (b_1', b_2')$ on the grid:

$$\begin{aligned} W_{i,t+1}(b', s) &= \sum_{y'}\pi(y'|y)v_{i,t+1}(s') \\ \psi_{i,t+1}(b', s) &= \sum_{y'}\pi(y'|y)g'[c_{L,t+1}(s')]\left\{(1-D_{i,t+1}(s')) + D_{i,t+1}(s')\zeta_{i,t+1}(s')\right\}. \end{aligned}$$

   We solve this model in two steps. In the first step, taking as given default/renegotiation choices of the two countries, we solve the optimal borrowing decisions and update the value functions for repaying, defaulting, renegotiating and non-renegotiating. In the second step, we find the optimal default/renegotiation decision taking as given the optimal borrowing decisions in the first step.

   2.1 Borrowing decisions and value functions. We solve three cases in this step.

- Case 1. Both countries are in good credit standing. We solve three sub cases.
  - Case 1.1. Both choose not to default.
    In this case, taking as given $\{W_{i,t+1}, \psi_{i,t+1}\}_{i=1,2}$, we look for the fixed point $\{B_{i,t}(s,d), B_{-i,t}(s,d)\}$ that satisfies for each $i = 1, 2$

$$B_{i,t}(s,d) = argmax_{\{b'_i, q_i, q_{-i}\}} \ w_{i,t}(s, (b'_i, B_{-i,t}(s,d)), d),$$

    subject to the following conditions:

$$\begin{aligned} w_{i,t}(s, b', d) &= u(y_i - b_i + q_i b'_i) + \beta W_{i,t+1}(b', s), \\ q_i g'[y_L + (b_i - q_i b'_i) + (1 - d_{-i})(b_{-i} - q_{-i} b'_{-i})] &= \delta \psi_{i,t+1}(b', s), \\ q_{-i} g'[y_L + (b_i - q_i b'_i) + (1 - d_{-i})(b_{-i} - q_{-i} b'_{-i})] &= \delta \psi_{-i,t+1}(b', s). \end{aligned}$$

    Let the equilibrium bond prices be $Q_{i,t}(s,d)$ for $i = 1, 2$.
  - Case 1.2. Country i repays but country $-i$ defaults.
    We only need to solve country i's optimal debt

$$\begin{aligned} & B_{i,t}(s,d) = argmax_{\{b'_i, q_i\}} \ w_{i,t}(s, b'_i, d) \\ & s.t. \quad w_{i,t}(s, b', d) = u(y_i - b_i + q_i b'_i) + \beta W_{i,t+1}(b', s), \\ & \qquad q_i g'[y_L + (b_i - q_i b'_i)] = \delta \psi_{i,t+1}(b', s). \end{aligned}$$

    The value of country $-i$ is given by

$$w_{-i,t}(s, B_{i,t}(s,d), d) = u(y^d_{-i}) + \beta W_{-i,t+1}((B_{i,t}(s,d), b_{-i}), s).$$

    Let the equilibrium bond prices be $Q_{i,t}(s,d)$ for $i = 1, 2$.
  - Case 1.3. Both choose to default.
    The value functions of default are given by, for each i

$$w_{i,t}(s, b, d) = u(y^d_i) + \beta W_{i,t+1}(b, s). \tag{27}$$

- Case 2. Country i is in good credit standing and country $-i$ is in bad credit standing. We solve four sub cases here.
  - Case 2.1. Both choose to repay.
    In this case, $d_{i,t} = d_{-i,t} = 0$. We only need to solve country i's optimal

debt with $b'_{-i} = 0$:

$$
\begin{aligned}
&B_{i,t}(s,d) = argmax_{\{b'_i, q_i, \phi_{-i}\}}\ w_{i,t}(s, b'_i, d) \\
&s.t. \quad w_{i,t}(s,b',d) = u(y_i - b_i + q_i b'_i) + \beta W_{i,t+1}((b'_i, 0), s), \\
&\qquad q_i g'[y_L + (b_i - q_i b'_i) + \phi_{-i}] = \delta \psi_{i,t+1}((b'_i, 0), s) \\
&\qquad \frac{\theta u'(y_{-i} - \phi_{-i})}{v_{-i}(s;\phi_{-i}) - v_{-i,aut}(y_{-i})} = \frac{(1-\theta) g'(s, q_i, \phi_{-i}, b', d)}{V_t^L(s, q_i, \phi_{-i}, b', d) - V^L_{fail}(s_i)}.
\end{aligned}
$$

Country $-i$'s value is given by

$$
w_{-i,t}(s, (B_{i,t}(s,d), 0), d) = u(y_{-i} - \phi_{-i}) + \beta W_{-i,t+1}((B_{i,t}(s,d), 0), s).
$$

Let the optimal recovery be $\phi_{-i,t}(s,d)$ and the equilibrium bond price be $Q_{i,t}(s,d)$.

- Case 2.2. Country i repays but country $-i$ chooses not to renegotiate. Country i's optimal debt and value solve the following problem: We only need to solve country i's optimal debt with $b'_{-i} = b_{-i}$:

$$
\begin{aligned}
&B_{i,t}(s,d) = argmax_{\{b'_i, q_i\}}\ w_{i,t}(s, b'_i, d) \\
&s.t. \quad w_{i,t}(s,b',d) = u(y_i - b_i + q_i b'_i) + \beta W_{i,t+1}((b'_i, b_{-i}), s), \\
&\qquad q_i g'[y_L + (b_i - q_i b'_i)] = \delta \psi_{i,t+1}((b'_i, b_{-i}), s)
\end{aligned}
$$

Country $-i$'s value is given by

$$
w_{-i,t}(s, (B_{i,t}(s,d), b_{-i}), d) = u(y_i^d) + \beta W_{i,t+1}((B_{i,t}(s,d), b_{-i}), s).
$$

Let the equilibrium bond prices be $Q_{i,t}(s,d)$.

- Case 2.3. Country i defaults but country $-i$ renegotiates.
The recovery function ϕ_{-i} solves the following equation:

$$
\frac{\theta u'(y_{-i} - \phi_{-i})}{v_{-i}(s;\phi_{-i}) - v_{-i,aut}(y_{-i})} = \frac{(1-\theta) g'(s, \phi_{-i}, b', d)}{V_t^L(s, \phi_{-i}, b', d) - V^L_{fail}(s_i)}.
$$

Let the optimal recovery be $\phi_{-i,t}(s,d)$. With $b' = (b'_i, b'_{-i})$, $b'_i = b_i$ and

$b'_{-i} = 0$, the value functions of the two countries are given by:

$$w_{i,t}(s, b', d) = u(y_i^d) + \beta W_{i,t+1}(b', s)$$
$$w_{-i,t}(s, b', d) = u(y_{-i} - \phi_{-i,t}(s, d)) + \beta W_{-i,t+1}(b', s)$$

– Case 2.4. Both choose not to repay.
The values of the two countries are updated according to equation (27) .

- Case 3. Both countries are in bad credit standing.
The two recovery functions solve the Nash bargaining problem jointly. Otherwise, the two recovery functions are independent of each other.

2.2 Default/renegotiation decisions.

Taking as given the optimal borrowing decisions and value functions from Step 2.1, we find the equilibrium default/renegotiation decisions $\{D_{i,t}(s), D_{-i,t}(s)\}$ that solve jointly

$$D_{i,t}(s) \in argmax_{\{d_{i,t}\}} w_{i,t}(s; d_{i,t}, D_{-i,t}(s), B(d_{i,t}, D_{-i,t}(s)))$$

$$D_{-i,t}(s) \in argmax_{\{d_{-i,t}\}} w_{-i,t}(s; D_{i,t}(s), d_{-i,t}, B(D_{i,t}(s), d_{-i,t})).$$

If there are multiple pairs of $(D_{i,t}, D_{-i,t})$ as equilibrium for a state s, we take the pair that maximizes $w_{i,t}(s, D_{i,t}(s), B_{i,t}(s, D_{i,t}(s))) + w_{-i,t}(s, D_{-i,t}(s), B_{-i,t}(s, D_{-i,t}(s)))$. We use these equilibrium default/renegotiation decisions to update the functions for period t.

2.3 We finally update the period t value for each country i:

$$v_{i,t}(s) = w_{i,t}(s, D_{i,t}(s), B_{i,t}(s, D_{i,t}(s))),$$

lenders' consumption

$$\begin{aligned} c_{L,t}(s) = y_L &+ \sum_{i=1}^{2} [(1 - h_{i,t})(1 - D_{i,t}(s)) \left[b_i - Q_{i,t}(s, D_{i,t}(s)) B_{i,t}(s, D_{i,t}(s))\right] \\ &+ \sum_{i=1}^{2} [h_{i,t}(1 - D_{i,t}(s)) \phi_{i,t}(s, D_{i,t}(s))], \end{aligned}$$

and the expected discounted recovery ζ

$$\zeta_{i,t}(s) = \delta \sum_{y'} \pi(y'|y) g'(c_{L,t}(s')) \left[(1 - D_{i,t}(s'))\phi_{i,t}(s') + D_{i,t}(s')\zeta_{i,t+1}(s') \right].$$

The value of the lender is given by

$$V_{L,t}(s) = g(c_{L,t}(s)) + \delta \sum_{y'} \pi(y'|y) V_{L,t+1}(s'),$$

where the future debt in s' for country i is $B^*_{i,t}(s)$. In particular, $B^*_{i,t}(s) = B_{i,t}(s, D_{i,t}(s))$ if $h_i = 0$ and $D_{i,t}(s) = 0$, $B^*_{i,t}(s) = 0$ if $h_i = 1$ and $D_{i,t}(s) = 0$, and $B^*_{i,t}(s) = b_i$ if $D_{i,t}(s) = 1$.

Appendix IV. Empirical Robustness

This appendix provides descriptive statistics and robustness of the empirical results in Section 5. Figure 3 plots the five-year moving average of the fraction of countries in default and

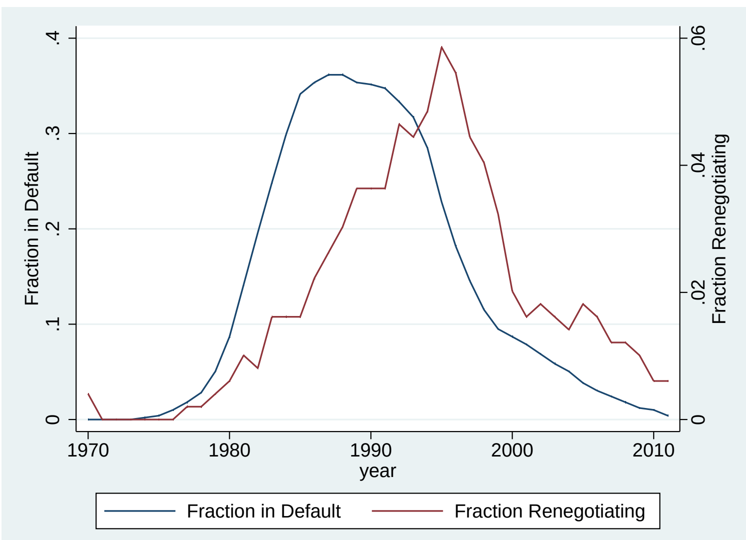

Figure 3: Historical Defaults and Renegotiations

the fraction of countries renegotiating over time. The figure illustrates that default rose in the early 1980s and remained elevated until the mid-1990s. Such an inverted hump shape mainly reflects the debt crises of the 1980s across Latin America. The fraction of countries renegotiating the debt rose to almost 0.06 in the mid-1990s.[16]

We provide two sets of robustness analysis for the regression results. We first address the concern that a common world shock might be driving the fraction of countries in default and the fraction of countries renegotiating. In Table 7 we add linearly detrended world GDP to all the regressions. World GDP is significant in the renegotiation and recovery regressions. World booms are associated with fewer renegotiations and higher recovery rates. The variables Frac Default_{it} and Frac Renegotiate_{it} continue to be significant and with the expected sign in all specifications. All standard errors continue to be clustered at the country level.

Table 7: Cross-Country Regressions with World GDP

	Default	Renegotiation	Recovery
Fraction in Default_{it}	1.36^{***}	-0.44^{**}	0.44^{**}
Fraction $\text{Renegotiating}_{it}$	-2.18^{*}	3.14^{**}	-5.28^{***}
Debt/GDP_{it}	0.11^{**}	-0.04^{*}	-0.21^{***}
World GDP_t	0.03	-2.42^{***}	2.52^{***}
Country fixed effects	Yes	Yes	No
Adjusted R^2	0.28	0.06	0.38
Observations	2682	552	139

We also estimate the renegotiation and recovery regressions, taking into account the inherent selection of these observations. Being in a state where renegotiation and recovery are nonmissing observations requires the country to be in a default state. Default state equals 1 in years where each country is in default or renegotiates. Table 8 presents the maximum likelihood estimation results from this specification with clustered errors. We estimate the selection equation with a probit and use lags of the independent variables as regressors. The coefficients on Frac Default_{it}, Frac Renegotiate_{it}, and Debt/GDP_{it} in the renegotiation and recovery equations continue to be significant and with the expected sign. Economically, the coefficients are somewhat smaller than in the benchmark specification.

[16] Recall that in the regressions, the main independent variables Frac Default_{it} and Frac Renegotiate_{it} are of the fraction of countries, not including i, that are in default or are renegotiating. In this figure, however, we simply illustrate overall fractions.

Table 8: Cross-Country Regressions with Heckman Selection Estimates

	Renegotiation	Recovery
Fraction in Default$_{it}$	-0.55**	1.44***
Fraction Renegotiating$_{it}$	2.45**	-6.83***
Debt/GDP$_{it}$	-0.03**	-0.19***
Selection Eq.	State default	State default
Fraction in Default$_{it-1}$	5.13***	5.12***
Fraction Renegotiating$_{it-1}$	-6.43	-6.23
Debt/GDP$_{it-1}$	0.39*	0.40*
Observations	2682	2279