

Introduction to the special issue on sovereign debt restructuring

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1. The current context

After the ‘wasted decade’ of the Latin American debt crisis of the 1980s, and the long-running saga following Argentine default in 2001, sovereign debt crises were widely regarded as a feature of ‘emerging market’ economies, but not for ‘advanced economies’, which had been enjoying a period of macroeconomic stability since the mid-1980s. That illusion was shattered when the period known as the Great Moderation ended abruptly in the financial crisis of 2008/9 and problems of sovereign debt management spread across Europe. Adverse speculation in the Eurozone pushed interest rates on the sovereign debt of Italy and Spain to unsustainable levels in 2012,¹ for example; with contagion leading to substantial Greek default soon thereafter.

In fact, sovereign borrowing and sovereign debt crises seem to go hand-in-hand. Why should this be so? Consider the nature of the contracts involved. Domestically, sovereign debt obligations play the role of a public good – serving as the benchmark for pricing other securities, as a base asset in banking systems, and as collateral in multi-trillion-dollar money markets. For states issuing these obligations, moreover, borrowing allows the act of spending to be separated from that of raising revenue – useful for ‘tax-smoothing’ and invaluable in times of war.

With such debt contracts, however, the state formally assumes all the risk involved in debt service – in particular, the risk that its debt will not be ‘rolled over’. As Lee Buchheit (2014, p.467) puts it with characteristic lucidity:

No purchaser of a sovereign debt instrument today does so in the hope and expectation that, when the debt matures, the borrower will have the money to repay it. The purchaser does so in the hope and expectation that, when the debt matures, the borrower will be able to borrow the money from someone else in order to repay it. ... Therein lies the problem. Market access can be interrupted by many factors, only some of which relate to the sovereign borrower. A general

1 Until Mario Draghi, President of the European Central Bank, famously promised to do ‘whatever it takes’ to calm the panic.

downturn in world markets, an unsettling political event, a rise in interest rates, ... [With] any of these a sovereign's ability to refinance maturing debt can evaporate. The result is a sovereign debt crisis.

Consequently, when times are bad and the sovereign is unable to refinance, there is chaos in domestic capital markets and the domestic financial system is threatened with collapse.

For private debt, there is collateral for disgruntled creditors to pursue; and there are bankruptcy courts to which litigants can turn for equitable resolution after default.² But, for sovereigns, there is little that creditors can seize; neither is there an international bankruptcy court to oversee proceedings after default. In practice, however, *sovereign debt restructuring* does introduce an element of risk-sharing. How does this work? As Philip Wood, QC explains:

The mechanisms for the resolution of sovereign debt problems are much simpler than those in the case of corporate groups. In the ordinary case, the sovereign offers to exchange existing bonds held by bondholders for new bonds that are worth less and have longer maturity. ... It is then up to the bondholders, whether they will accept. The sovereign debtor usually makes it clear that the sovereign debtor will not pay out to bondholders who do not accept – the holdout creditors. (Wood, 2014, pp.387–8)

However, the recent success of holdouts who sued Argentina for full payment of bonds they bought at a great discount has posed an awkward question: can sovereign debt crises help to resolve the issue of enforceability? By proving costly to the debtor state – in terms of disruption to its trade and financial affairs, internationally and domestically – do they not give an effective incentive for debt repayment?

The authors of the CIEPR report on *Revisiting Sovereign Bankruptcy* tackle this issue, beginning with a first-best outcome:

Suppose that it were possible to write contracts (implicitly or explicitly) or create institutions so as to make sovereign defaults costly if and only if they cannot be 'excused' by shocks to fundamentals outside the control of debtor countries. That is, repudiations would be severely punished (and as a result, would never occur), while shocks to debt service capacity would lead to a corresponding adjustment in the debt burden without any punishment. In such a world, costly debt crises would never arise, in spite of the presence of an enforcement problem. (CIEPR, 2013, p.6)

They go on to acknowledge, however, that in reality:

debt crises cannot be neatly separated into excusable defaults driven by fundamentals and inexcusable repudiations. Yet there may be institutional or contractual improvements – for example, debt contracts that index repayments to variables such as international commodity prices – that reduce the frequency or costs of debt crises. ... It may be possible to reduce the costs of crises through institutions or contracts that legitimize debt restructurings in certain circumstances (which would obviously exclude strategic defaults). (CIEPR, 2013, p.6)

This special issue consists of a selection of papers originally presented at the Workshop on Sovereign Debt Restructuring, 29–30 August 2016, organized by Sayantan Ghosal (University of Glasgow), Domenico Lombardi (Centre for International Governance

2 Under Chapter 11 of the US bankruptcy code, for example, the judge may arrange a debt-equity swap to avoid the closure of a firm facing a temporary crisis of liquidity.

Innovation), and Marcus Miller (University of Warwick). Taken as a whole, these investigate – both theoretically and empirically – mechanisms that help ensure the orderly functioning of sovereign debt markets, as well as conditions under which these same mechanisms lead to default, crisis, and costly debt restructuring.

2. Historical background

Anthropological evidence shows that interest-bearing debt was being used to finance private sector trading enterprise in the fertile river valley of Mesopotamia in 2,400 BC (Graeber, 2011, p.64). Debt contracts issued by sovereigns did not gain widespread acceptance until very much later, as Eichengreen *et al.* (2018) note in their fascinating overview of the history of public debt. They argue that prerequisites for successful issuance of sovereign debt include the existence of durable states with limited government that respects contract law and faces demands for expenditure varying relative to the tax base (so as to defend state boundaries and fight foreign wars, for example). Hence:

Although the written record points to instances of public borrowing satisfying these criteria as long as two thousand-plus years ago, recent scholarship points to 1000-1400 A.D. as when borrowing agreements with states were concluded with regularity and debt contracts entered into by sovereigns were increasingly standardized. (Eichengreen *et al.*, 2018, p.2)

There were contrasting national styles of debt issuance as between different states, apparently. In Italy, the issuance of perpetual debt was pioneered as a means of financing Papal expenditures without violating the law on usury, while it was Holland that first encouraged the sale of public debt to non-residents.

The emergence of the Westphalian state in Europe in the seventeenth century played an important role, as the centralized governments that emerged, being more fiscally responsible than their absolutist predecessors, were able to secure lower sovereign yields. After the Glorious Revolution of 1688, for example, the English government was able to borrow on the security of taxes raised by Parliamentary decree, with the Bank of England – privately chartered in 1694 – acting as its banker and borrowing at 3%.

After the French revolution, indeed, the British government went heavily into debt to finance the war against Napoleon by sea and on land, acquiring a formidable navy in the process (Ferguson, 2013). This was followed by a protracted, but ultimately successful, fiscal consolidation in the nineteenth century, with the debt to output ratio falling from 160% in 1830 (shortly before Queen Victoria came to throne) to 25% in 1913, Crafts (2016, p.206). Spurred by the Industrial Revolution, the economy was growing by about 2% yearly during this period – as this was less than the average the real interest rate of about 4%, however, sustained fiscal surpluses were needed to achieve this consolidation.³

In the twentieth century, wars were again to prove a major factor causing national debt to expand, in the UK and elsewhere – with Keynes famously warning in *The Economic Consequences of the Peace* (Keynes, 1919) that imposing war debt *ex post* on defeated Germany would prove disastrously counterproductive. Later, in 1940, he argued that compulsory national saving in public debt was *How to Pay for the War* for Britain (Keynes, 1940).

3 With an assist from Goschen's debt conversion in 1888.

Post war UK national debt stood at almost twice annual GDP in 1950.⁴ The pattern of post World War II fiscal consolidation in Britain was, however, very different from that under Queen Victoria. For, as [Crafts \(2016, p.220\)](#) observes:

After the Napoleonic Wars, the debt to GDP ratio was steadily reduced over a long period by running primary budget surpluses which were underpinned by a strong commitment to the balanced budget rule. After World War II, the debt to GDP ratio was reduced very rapidly as primary budget surpluses were strongly augmented by policies of financial repression which held the real interest rate below the real growth rate.

In concluding their survey of public debt through the ages, Eichengreen and his co-authors indicate how the driving factors have changed over time:

Public debt has a long history, not all of it happy. For hundreds if not thousands of years, sovereigns have borrowed to secure borders to fight foreign military campaigns. The 19th century was a transitional period when governments, while still borrowing to prosecute wars, increasingly issued debt to build roads, railways, and ports and to invest in education. The 20th century again saw sharp increases in debt burdens as a result of major wars but also as a result of recessions, banking panics and financial crises, and of the public-policy responses to these events. The end of the last century also saw, for the first time, a secular increase in public-debt-to-GDP ratios in a variety of countries in conjunction not with wars or crises but in response to a growing range of popular demands on governments for pensions, health care, and other often unfunded social services. ([Eichengreen et al., 2018, p.43](#))

This last factor is also emphasized by [Nick Crafts \(2016, pp.219, 220\)](#):

The huge rise of social transfers as a percentage of GDP during the 20th century was driven by the spread of democracy, the desire for safety nets in the face of major economic crises, and population ageing. ... After the interwar depression in an age of mass democracy, the ideas of Beveridge and Keynes ruled the roost in post-war Britain [for example]; for both Conservative and Labour governments financing a much expanded welfare state had priority over balancing the budget and paying off the national debt.

The risk that default rates on public debt could be inefficiently high when democratically elected politicians are unable to make credible commitments to pay back debt is explored in this issue. In their article *Sovereign debt: election concerns and the democratic disadvantage*, Amrita Dhillon, Andrew Pickering, and Tomas Sjöström argue that domestic institutions shielded from short-term political pressures are required to mitigate what they term the ‘democratic disadvantage’ ([Dhillon et al., 2019](#)). They construct a measure of institutional far-sightedness from the Global Insight Business Risk and Conditions database, and show how the observed relationship between credit ratings and democratic status is, indeed, conditional on the presence of domestic institutions that are far-sighted.

Not all sovereigns borrow through the open market, however. For, as [Anna Gelpern \(2016, p.49\)](#) points out, after World War II:

Chronically poor countries cut off from private markets borrowed instead from governments and multilateral institutions such as the IMF, the World Bank, and regional development banks. [But] many of the economic reform and development programs financed with foreign official

4 After World War II, while Germany was to benefit from a generous debt write-off, countries such as Britain were left with public debt largely intact.

credits failed to deliver thanks to some combination of bad design, bad implementation, and bad luck. By the late 1990s, some countries' debts had grown and their economies had deteriorated so much that stretching out repayments (rescheduling) and even substantial debt reduction by Paris Club creditors could not put them on a sustainable path: their debts would keep growing in perpetuity.

In 2002, Jeffrey Sachs famously criticized the Paris Club for failing to ensure sufficiently deep restructuring for official debtors to achieve a 'fresh start' – so many were destined to return to Paris for further treatment (Sachs, 2002).⁵ Official policy was, in fact, shifting:

In response to a global civil society campaign, the G-7 unveiled new dedicated debt relief programs, the Heavily Indebted Poor Countries (HIPC) initiative in 1996 and the Multilateral Debt Relief Initiative (MDRI) in 2005. Throughout the 1990s and into the 2000s, a mix of outside pressure, creditor country politics, new research and policy experience prompted a succession of program changes to deliver more relief in exchange for more reform. Multilateral debt of the world's poorest countries eventually would be cut for the first time alongside bilateral debt, with relief tied to policy and governance conditionality. (Gelpern, 2016, pp.49, 50)

An earlier paper, 'From debt collection to relief provision: 60 years of official debt restructurings through the Paris Club' (Cheng *et al.*, 2016), confirmed the policy shift. In their complementary study in this volume, covering all Paris Club settlements over these years (between 1956 and 2015), Gong Cheng, Javier Diaz-Cassou, and Aitor Erce focus on 'The macroeconomic effects of official debt restructuring' – on economic growth, in particular (Cheng *et al.*, 2019). Their results confirm that Paris Club settlements can have a significant effect on economic growth, stronger when the settlement included Nominal Debt Relief – seemingly because of a bigger effect on investment.

3. Recent developments

History has demonstrated that, notwithstanding their lack of 'state contingency', plain vanilla debt contracts have played an important role in economic development; it also shows the private sector acting as 'first mover' in terms of financial innovation. It is hardly surprising, therefore, that attempts to improve the operation of sovereign debt markets should draw on prior developments in the private sector – in respect of judicial debt discharge, for example, or of restructuring by creditors themselves.

3.1 Debt discharge under English law

Mechanisms to ensure repayment in the case of private debt, which work well from a micro-prudential perspective, can lead to gross inefficiency in the face of aggregate shocks.⁶ To reduce such inefficiency, English courts of law were, at the beginning of the eighteenth century, given powers to restructure private debts. As Kuttner (2013) notes:

The British devised the concept of legal discharge from debt not out of a sudden attack of compassion but because the economic crisis of the 1690s had put much of the merchant class in jail. The cause was not improvident or immoral behavior on the part of debtors, but general

5 As a criterion for judging what write-down may be appropriate for these public sector write-downs, he advocated looking at their impact on achieving the Millenium Development Goals.

6 A point stressed by Kiyotaki and Moore (1997), for example, where the inefficiency is attributed to the presence of 'pecuniary externalities'.

economic dislocation beyond their control, caused by the confluence of bubonic plague, recent wars with France, and a storm that devastated the merchant fleet in 1703.

when the law was finally enacted, [in 1706] allowing a magistrate to settle debts with partial repayment, only substantial merchants could qualify for relief. Yet an important conceptual breakthrough had occurred. Canceling some debts was deemed economically efficient.⁷

The same issue was analysed in connection with sovereign debt by Grossman and Van Huyck (1988) in their distinction between inexcusable repudiations and ‘excusable’ defaults driven by adverse shocks to fundamentals outside the control of the debtor countries.

The combination of the very sharp rise in US interest rates and the fall in commodity prices in the 1980s, which rendered the dollar debts of many Latin American countries essentially unsustainable, provides a case in point (Guimaraes, 2007). At first, under the Baker plan, there was no write-down: dollar loans were ‘ever-greened’ instead. But later:

the Brady Plan was launched in 1989, allowing for the restructuring and securitizing of commercial bank debts and giving the bond market a liquid base on which to build. Seven-plus years of crisis had to be endured prior to this resolution, however, during which the high-income countries denied the need for principal reduction, hoping against hope that their banks could rebuild their capital cushions prior to commencing the write-down process. But with the Brady Plan finally in place, capital flows to emerging economies accelerated. (Eichengreen *et al.*, 2018, pp.25–6)

The long delay involved in the ‘lost decade’ in Latin America – and the Mexican crisis of 1994/5 – stimulated the search for more efficient procedures for managing crises in heavily indebted countries. One of these, the Sovereign Debt Restructuring Mechanism (SDRM) proposed by Anne Krueger (2001, 2002) attempted to create a bankruptcy court for sovereigns, based on the IMF. As the IMF is typically a creditor for indebted countries seeking restructuring of their debts, this involved a conflict of interest, however. This was one reason why the plan was blocked by the USA and large emerging markets, including Mexico and Brazil, in favour of a less ambitious mechanism where creditors themselves can decide on what should be done.

3.2 Collective action clauses

The insertion of ‘collective action clauses’ (CACs) into bond contracts allows a supermajority of creditors to approve restructuring terms and to bind the dissenters. Since the late nineteenth century, CACs had been included in corporate debt contracts issued in London, and so it was for sovereign bonds issued there. Not so in New York, where, since the 1930s, corporate bonds required unanimous consent to amend financial terms. This practice was carried over to New York sovereign bonds until CACs were promoted⁸ as a market-friendly alternative to SDRM, with Mexico leading the way by issuing a dollar bond with CACs in 2003.

7 Legal historians, such as Bruce Mann, have observed that, for capitalism to proceed, it was necessary to shift the economic thinking and legal policy governing debt from moral questions to instrumental ones.

8 As, for example, in the influential report of Eichengreen and Portes (1995).

3.3 The problem of holdouts

There was, however, a loophole in the provisions. For, as [Gelpern \(2016, p.68\)](#) points out:

The practical operation of CACs seemed secondary next to the goal of defeating SDRM. Lost in the successful drive for contract change was the fact that CACs were simultaneously good at boosting creditor participation in an exchange offer, *and* bad at blocking committed free-riders. . . .

CACs had traditionally operated within individual bond issues, [so] creditors who bought a blocking minority in a single small issue could reject the restructuring offer, see the rest of the debt stock swept into the restructuring, and then sue for preferential settlement.

Much legal ingenuity has been shown in efforts to ‘aggregate’ across bond issues to pre-empt such behaviour by specialist creditors, on the grounds that this will undermine the willingness of other creditors to accept any restructuring. ‘ICMA [International Capital Markets Association] proposed new contract reforms in August 2014, including stock-wide aggregated majority voting adapted from the 2012 Greek Bondholder Law. [These] “super-aggregated” CACs were a product of International CMA’s collaboration with other industry bodies, large emerging market debtors, the IMF and official bilateral creditors.’ ([Gelpern, 2016, p.86](#))

In their contribution to this volume, ‘Pre-emptive sovereign debt restructuring and holdout litigation’, Kartik Anand and Prasanna Gai take a contrary position, however ([Anand and Gai, 2019](#)). In a framework where sovereign debt contracts are designed in anticipation of holdout litigation *ex post*, they argue for the rights of holdout creditors to be prioritized (so that they are paid in full) to improve *ex ante* efficiency.

But what if the extraordinary legal support that has recently been provided for holdouts is attributable to ‘bad faith’ on the part of sovereign debtors – in denying them any compensation whatever, for example, as Argentina did? In that case, [Obi and Thomas \(2018\)](#) argue, the adoption of ‘good faith’ principles by the debtor may be sufficient to secure an equilibrium in which holdouts do accept a haircut.

4. Current issues

As the debate on holdouts indicates, the way *ex post* amelioration of debtor costs may affect *ex ante* behaviour is a major issue when it comes to debt restructuring. Of the three ‘pathological cases’ discussed in [CIEPR \(2013\)](#) where improvement should be possible, two are the subject of papers in this volume.

4.1 Restructuring that comes too late

If sovereign debt crises prove costly to the debtor state – in terms of disruption to its trade and financial affairs, internationally and domestically – this will surely provide an effective incentive for debt repayment. But if the sanction for any default, even if ‘excusable’, is severe, then debtors who cannot repay in full may delay taking action until too late, when a full blown debt crisis is inevitable. As [Panizza \(2013\)](#) put it: ‘The biggest problem with the status quo relates to the fact that policymakers . . . often postpone necessary defaults at great costs for society and creditors.’

[Cruces and Trebesch \(2013\)](#) and [Mariscal et al. \(2015\)](#) present evidence that sovereign bond restructurings involve costly delay (see also [Roubini and Setser, 2004](#), and [Sturzenegger and Zettlemeyer, 2007](#)). This provides a *prima facie* case for debt

restructuring mechanisms that combine a reasonable degree of risk-sharing with safeguards to limit debtor moral hazard (as, for example, registration in third party courts and/or IMF ‘conditionality’ seek to do).

Not all delay in restructuring has negative consequences, however. It may be that postponing a final settlement will allow for increase in the resources available to be divided between the negotiating parties. This is the case for beneficial delay made by Merlo and Wilson (1998) who suggested that the delay in settling the Latin American debt crisis may have had this feature, in that it allowed the banks to provision for the debt write-down that came later.

The paper contributed by David Benjamin and Mark Wright, ‘Deconstructing delays in sovereign debt restructuring’, demonstrates that delay can improve welfare, as long as it has a permanent positive effect on economic activity in the defaulting country (Benjamin and Wright, 2019). They also argue that prohibiting debt issuance by the defaulting country as part of a settlement makes delay less likely.

4.2 Too little restructuring

While noting that the average duration of more recent default episodes was much shorter than in the 1980s, the authors of the CIEPR report warn that this may not give the debtors a ‘fresh start’:

Quick debt restructurings with attractive offers, can lead to insufficient debt reduction and may not restore debt sustainability. The current system may thus generate two, equally bad, equilibria (Powell, 2011). In the first equilibrium, countries implement quick and creditor-friendly restructurings but do not solve their debt-sustainability problem. The second equilibrium can deliver larger debt relief at the cost of long negotiations and protracted litigation. Evidence showing a positive relationship between haircuts (i.e., the losses faced by bondholders during debt restructuring episodes) and the duration of restructuring episodes and the bimodal distribution of haircuts is consistent with such a view. (CIEPR, 2013, p.11)

This issue is the focus of the paper by Sayantan Ghosal, Marcus Miller, and Kannika Thampanishvong, ‘Waiting for a haircut’, where the debtor is faced with a choice between *reprofiling* (where the NPV of debt is reduced by extension of maturity and lowering the interest rate) and *debt restructuring* proper, involving a significant haircut upfront (Ghosal *et al.*, 2019). Assuming there are two types of debtor, Optimistic and Cautious, where the latter stands in need of *restructuring* proper, they argue that Cautious may choose extra delay as a costly signal of its type, consistent with the positive correlation between delay and write-down reported by Powell (2011).

Could the IMF not advise on the type of debtor so as to avoid delay? The authors conclude that such action would be subject to the same conflict of interest that undermined the case for an SDRM based on the IMF.

In his contribution to this volume, ‘Resolving sovereign debt crises: the role of political risk’, Christoph Trebesch finds a positive correlation between delay and domestic political risk in the debtor country, for both of which a rich set of data is compiled (Trebesch, 2019). Whether this finding – that ‘politics matters’ – can be reconciled with the delay-in-bargaining perspectives just discussed is an interesting issue. Could the political risk be part of the cost that makes delay a credible signal in bargaining? Or is it a sign of disarray that contradicts any such account of orderly negotiation?

The author accepts that his finding on political risk and delay is one of correlation rather than causation: it could be that delay causes political turmoil, or vice versa. On the issue of whether domestic political factors matter because governments *do not want to* conclude debt negotiations, or because they render them *unable* to do so, the author concludes his data indicate the latter to be the dominant channel.

4.3 Over-borrowing

Happily, there is a case where there is no conflict between the reducing *ex post* costs of resolution and *ex ante* incentives – that is when unsustainability arises from over-borrowing. In what is described as a ‘stereotypical’ case:

economic reforms and financial liberalization are followed by rapid and unsustainable capital inflows channeled to the private sector by domestic banks and fueled by excessive optimism among residents, foreign investors and policymakers. A global shock, or the realization that the inflows are not sustainable, is often followed by a sudden stop (Calvo, 2005), economic collapse and financial crisis. At this point, private sector liabilities are transferred to the sovereign, exacerbating the impact of public overborrowing during the preceding upswing. (CIEPR, 2013, p.9)

In cases such as this – and the example of Iceland in 2008 springs to mind – tighter borrowing constraints *ex ante*, including controls on excessive capital inflows, would improve welfare.

4.4 Empirical questions

How, as an empirical matter, can one determine when a country’s sovereign debt is unsustainable? That is the issue considered by Antonio Bassanetti, Carlo Cottarelli, and Andrea Presbitero in their contribution to this supplement, ‘Lost and found: market access and public debt dynamics’ (Bassanetti *et al.*, 2019). The use of conventional debt sustainability analysis (DSA) may give the impression that it is essentially the *level* of debt relative to income that matters. With the use of empirical methods on data for emerging market countries from 1970 to 2014, however, they show that *rates of change* of the ratio also matter for the risk of default – and for the probability of regaining market access.

Don’t exchange platforms where sovereigns choose to list bonds perform a monitoring and certification role (the so called ‘bonding hypothesis’) which should prevent over-borrowing? In their paper, ‘The sovereign debt listing puzzle’, Elisabeth de Fontenay, Josefin Meyer, and Mitu Gulati show that which exchange a sovereign chooses to list its bonds makes little difference to its yield, and argue that there is little or no empirical support for the ‘bonding’ hypothesis (De Fontenay *et al.*, 2019). Instead, they interpret their empirical results as evidence supporting an alternative explanation – namely, ‘regulatory arbitrage’. Globally, certain institutional investors may hold foreign securities – of whatever governing law – only if they are listed on an exchange. Sovereigns are thus incentivized to list their bonds, but they seek out the least restrictive exchange that qualifies – leading to a race to the bottom among exchanges. Thus, sovereign bond listings do not appear to add value for investors (nor mitigate over-borrowing).

5. Conclusion

Sovereign debt restructurings in the late 20th and early 21st centuries have had a remarkable track record of operational success and substantive failure. Deals got done, but few debtors got

timely and durable relief. The informal, modular regime with the IMF at the center, which has dominated sovereign debt restructuring since the 1980s, is now under stress as a result of changing patterns of international capital flows, the rise of new creditors, and old stakeholder disinvestment. (Gelpern, 2016, p.94)

The papers in this volume aim to throw light on some of the issues involved and on possibilities for improvement.

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