

Standstills and an International Bankruptcy Court

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Abstract

Recent proposals call for the establishment of an international bankruptcy court that would adjudicate debt disputes between sovereign debtors and their creditors. One component of the operation of such an institution would be the declaration, under circumstances deemed appropriate, of a standstill preventing lenders from forcing payment of debt. Such a proposal would bring the enforcement and information aggregation powers of a judicial body to international capital markets. A benefit would be the greater transparency, power, and legitimacy of such an institution and its procedures relative to the national judicial systems now charged with overseeing sovereign debt problems. But there is also a danger that such an institution could exacerbate problems between debtors and creditors. By reducing creditors' capacity to extract repayment such an institution could ultimately worsen the credit terms available to sovereigns. Another problem, also present in the current system, is that public funds might be used to bailout both private creditors and debtors. Two suggestions for mitigating such problems are: (i) escrow accounts that would be transferred from debtor to creditor in the event of a standstill and (ii) an experienced-rated tax to finance official lending.

1 Introduction

Recent proposals have revived discussion of an international bankruptcy court to adjudicate disputes between creditors and sovereign debtors. The goal is to develop an explicit framework for dealing with troubled loans to sovereign debtors, which up to this point the financial community has dealt with on a largely *ad hoc* basis.¹

Such an entity could in principle mitigate three deficiencies of the status quo in which, to the extent that creditors have any legal recourse when faced with sovereign default, they have had to work within the judicial systems of their own localities.

First, even in the most sophisticated financial centers, legal precedent and codified law provide only very limited guidance about how to deal with sovereign debt. U.S. law, for example, contains detailed provisions and provides rich precedent about how to deal with corporations, individuals, and state and local governments in default, but has little to say about how to deal with foreign governments.

Second, by virtue of the sovereignty of the debtor, these legal systems have little leverage over sovereign debtors anyway. They are also likely to lack jurisdiction over other creditors as well. Hence national legal systems have little ability to reorganize debts, seize assets, or impose new management, the standard remedies in the case of domestic bankruptcy.

Third, to the extent that these legal systems impose decisions on sovereigns in default, debtors may see them as biased in favor of creditors who, since they are often a constituent force in the creditor nation, may be expected to have more political clout.

In addressing the first deficiency, the establishment of an international bankruptcy court would require some explicit initial statement of its objectives and procedures, already reducing the murkiness surrounding the legal status of sovereign debt. The clarification of the legal

¹The proposal currently on the table is, of course, from Krueger (2001, 2002). Rogoff and Zeitelmeyer (2002) comprehensively review the history of the idea, documenting that it has been around for some time. Krueger's position as first Deputy Managing Director of the International Monetary Fund would indicate that the idea is much less speculative than previously.

environment would grow over time as the Court's decisions established precedent.

Second, while an international bankruptcy court would never have the same power over a sovereign debtor as a local court has over an entity within its jurisdiction, it would have a much better ability to enforce a unified response from the lender community as a whole, which usually spans many national borders.

Finally, the administration of the Court would presumably involve representation from both the creditor and debtor nations. Hence the court would have much greater claim to legitimacy among debtors.

For these reasons the establishment of such an entity would seem to make a lot of sense. But there is a huge gap between acknowledging that such an institution is a good idea in principle and coming up with a design for how it would actually function. The structures surrounding domestic bankruptcy provide only very limited guidance, largely because a court dealing with sovereign debt has such limited powers of enforcement compared with one dealing with local bankruptcy.

The profession has a long way to go before it can come up with a reliable blueprint for the design of an international bankruptcy court. But existing research has pointed to some specific problems that such an institution might seek to redress, and some potential pitfalls that it might fall into. In this paper I suggest a few lessons from existing work about what a Court might usefully do and how things might go wrong.

2 What Do Bankruptcy Courts Do?

How economic theory can explain the existence of a bankruptcy court in the first place, setting international considerations aside? Why in a domestic context do governments get involved in disputes among private parties? One answer is that the government, with its monopoly on the legitimate use of force, can enforce a decision more effectively than any private entity. By entering into a contract in the first place a party subjects itself to the possibility of a court-

imposed settlement down the road. The court's enforcement power thus allows agents to make more credible commitments. A second answer is that private parties may have entered into contracts that lead to behavior that may not be in society's interest, or even in the interests of any of the parties to the contract. A party may appeal to the court to correct the situation. A third answer is that parties to a contract may have different information, giving rise to disagreement. A court, as a presumably disinterested party with subpoena power, can access and examine the relevant information to make a judgment that is both well-informed and unbiased.

In the next section I discuss the enforcement powers that an international bankruptcy court might have at its disposal, which would still be much more limited than those of a court dealing with a domestic bankrupt. Section 4 turns to the sort of market failures that might arise from contract design and how an international bankruptcy court might use standstills to deal with them. Section 5 discusses the problems of asymmetric information that have been identified as particularly problematic in sovereign default, and gives an example of how such a court could make things worse. In Section 6 I turn to a couple of additional issues: official debt and private creditor market power. Section 7 concludes with a couple of very speculative thoughts about mechanisms that a Court or other international financial institutions might employ to reduce the potential for financial crisis.

3 Powers of Enforcement: Why Do Sovereign Debtors Pay?

What influence would a court have over a sovereign in default? It would not be totally powerless for the same reason that creditors themselves have enough influence over sovereign debtors to get them to repay at least some debt at least some of the time. The nature of this influence has been the subject of much discussion. During the sovereign debt crises of the 1980s academic researchers devoted a considerable amount of attention to understanding the

incentives that sovereign debtors have to repay their debt.²

In a domestic context the incentives are quite obvious: An individual debtor in default can have his assets seized. A corporation is subject to receivership or liquidation. But in an international context an external judicial authority can legitimately seize only those assets that the sovereign has abroad, which typically fall very short of the amount of debt itself. Hence there is little collateral for these debts.

What creditors can do is to disrupt the external intra and intertemporal trade of the sovereign debtor: forcing it toward autarky. To some extent the legal system in creditor countries makes this reduction in trade happen automatically in the case of default. The presence of unpaid debts in the creditor community makes the debtor an unattractive client for any potential new lender. The senior creditor could typically attach payments to any subsequent lender, rendering making new loans to a sovereign in default a bad idea. Moreover, funds of its own that a sovereign in default might attempt to invest abroad could in many circumstances be attached by creditors. Not only would these interferences in the credit market hinder a country's ability to trade intertemporally, given the pervasive use of credit in international trade they would tend to reduce intratemporal trade to barter.

The threat of a diminished ability to trade can provide a strong motivation to service debt, but only up to a point. Hence how much a sovereign debtor is willing to repay may be quite limited. This limited incentive to repay in turn reduces the sovereign's ability to borrow in the first place.

As it stands the sanctions suffered by countries in default are the *ad hoc* outcome of a complex set of legal impediments and a general loss of the country's reputation in credit markets.³

²Eaton and Fernandez (1995) provide a survey.

³Eaton and Gersovitz (1981) showed the extent to which the threat of banishment from international financial markets itself would generate an incentive to repay. Bulow and Rogoff (1988) show that for an exclusion from capital markets to have any bite banishment must hinder the sovereign's access to capital markets both as a future lender as well as a future borrower: that is, to suffer any harm from exclusion from capital markets the sovereign must be precluded from turning around and making loans that can it can itself enforce. The ability of a harmed creditor to attach any funds that the sovereign attempted to invest abroad would serve the purpose of denying the sovereign access to international investment opportunities. Kletzer and Wright (1999) show how

In some cases default might be for reasons that are beyond the control of the sovereign, in which case sanctions may not be justified. One role that an international bankruptcy court could play is in clarifying the extent of the sovereign's malfeasance in a default, and applying penalties appropriately. Where the sovereign is clearly at fault, the Court may be able to coordinate sanctions more effectively than under the current system. Tougher sanctions in response to malfeasance that leads to default is ultimately in the interest of sovereign countries, as it enhances their access to credit. At the same time the court could reduce the suffering experienced by sovereigns whose default it deems to be the consequence of circumstances beyond the sovereign's control.

An important difference between the sanctions imposed on private debtors in default domestically and those imposed on sovereigns is that, in a domestic context, sanctions often benefit creditors (as when they get to seize the debtor's assets) while having relatively little effect on third parties. In the case of sovereign debt, however, since the gains from trade are two-way, the loss of trade incumbent on default does little to benefit creditors themselves and may substantially harm third parties, including entities in creditor countries. This point has implications for the involvement of official lenders discussed in Section 6 below.

4 Contract Structure and Market Failure

An important feature of financial relationships is the potential for creditors to impose damage on debtors by withdrawing credit. A withdrawal of credit, for example, may keep the debtor from completing a profitable undertaking. This feature was the basis of the classic Diamond and Dybvig (1983) paper on bank runs. In their model, a bank run leads to the abandonment of investments whose proceeds would have backed deposits. If a bank run occurs, all deposits will not be paid off. Owing to the sequential servicing property of bank deposits, every depositor would want to withdraw her deposits as soon as possible knowing that the bank would not debt can be sustained as the renegotiation-proof equilibrium outcome in the absence of any legal sanctions incumbent upon default.

be able to honor the deposits of those at the end of the line. An equilibrium outcome is for depositors to run to the bank even though there was nothing fundamentally wrong with the loans they financed. The run causes profitable investment opportunities to be abandoned. A run in their model is bad for both borrowers and most lenders.

Sovereign debt, of course, is not formally subject to the same sequential servicing as bank deposits. But several economists in the 1980s, notably Cohen and Sachs (1982) and Krugman (1988) argued that sovereign debt nevertheless generated a very similar possibility for contract design to generate a “country run” that could make everyone worse off.

A very simplified version of the argument can be put in a three period model. In the first period, called period 0, a country borrows some amount L that, if invested through period 2, will generate an output βL^α that period. If loans are withdrawn in period 1, however, output in period 2 will be at some lower level, which for simplicity I set to 0. In the meantime, in period 1 the country has resources in amount y to repay creditors. To make the problem interesting we need to assume that y could fall below $(1+r)L$, where r is the market interest rate for one period. While y could also depend on the loan amount L it's simpler to assume that it doesn't. An efficient outcome would involve a loan of $L^* = (\alpha\beta/R^2)^{1/(1-\alpha)}$, where $R = 1+r$, with the loan in place for two periods.

A contract that would sustain this outcome would be a loan in an amount L^* at interest rate r to be repaid at the end of period 2. If potential lenders compete to provide such a loan, the country could then enter into an exclusive arrangement with this lender, ensuring the efficient outcome. The loan could either be a two-period loan or a one-period loan that the lender would commit (and want) to roll over through the second period.

However, for various reasons (one of which I will get into in the next section) no single lender typically provides all of a sovereign's funds. A debtor usually has debts outstanding to multiple lenders. With multiple lenders an equilibrium outcome has only one period loans with

the potential for lenders' demanding repayment after the first period.⁴ Say that N lenders had each extended one-period loans in period 0 in some (say identical) amount l at some rate r' . In period 1 one of the lenders decided not to renew the loan. Unless other lenders were willing to take over the loan lending would be insufficient to sustain any positive output in the second period. The country would have to default for sure. The best response for other lenders is not to renew their loans either. If $y < (1 + r')Nl$ then, with sequential repayment of debt, only the first creditors demanding payment get anything. The consequence is a country run analogous to a Diamond-Dybvig bank run: an inefficient loss of output for the country and default on at least a fraction of the country's debt. Moreover, the potential for a run has implications for the terms on which loans are available in the first place. As in Diamond and Dybvig, we can assign a "sunspot" probability to the run outcome. Because of the possibility of a run and potential default, the interest rate r' will exceed the safe rate r .

In the Diamond-Dybvig story there is a potential liquidity crisis that leads to insolvency: In period 1 the sovereign does not have enough current cash y to pay its current debts even though, if creditors are patient, by period 2 it will have enough cash to pay its debts. But an unhappy resolution of the liquidity crisis in period 1, by destroying period 2 output, generates self-fulfilling insolvency.

While the Diamond-Dybvig framework assumes that the borrower was fundamentally sound in that it could ultimately repay its loans if credit was not withdrawn, the argument would also apply if the borrower were insolvent, but continued credit would allow at least some return to be realized. Even if the country were insolvent in the best of circumstances, it could well be that there would be more for everyone if credit were extended through period 2. Nevertheless, fearing that others would not extend credit, or fearing that they would fare worse in the sharing process if they did, individual creditors might withdraw. In fact, news of potential insolvency can quite plausibly generate a run as creditors hope to get more by withdrawing early than

⁴In a recent paper Tirole (2002) shows how short-term lending may elicit better policy out of government, thereby enabling it to borrow more.

they expect to recover in any sharing of the final proceeds.

The simple story points to a role for an international bankruptcy court. In the event of a run the Court could call for a “standstill,” prohibiting even short-term lenders from liquidating their loans in period 1. It can use its police power to prevent collection (or, alternatively, prevent other judicial bodies from using their police power to enforce repayment) in period 1. The court can thus prevent a run from destroying period 2 output. The sovereign country and its creditors could all potentially end up with more.

While the story would seem to make the case for an international bankruptcy court that would impose a standstill to prevent a “country run,” in a more realistic setting the problem is not so simple. Introducing problems of asymmetric information demonstrate why the Court’s tasks are much more complex, and the actions of such a court could aggravate, rather than alleviate, market imperfections.

5 Imperfect Information and Monitoring

Combining the discussion of the previous two sections, imagine that, in the model presented above, there is a potential enforcement problem. Even if profitable investment opportunities are exploited, the sovereign may not have the incentive to repay loans large enough to exploit them at the optimal level derived above. Specifically, following Kletzer (1984), with probability π the sanctions facing the debtor if it defaults are strong enough to elicit a payment of only P , the penalty it would face if it defaults. Assume that this amount P falls short of the debt it needs to incur to invest L^* . For simplicity assume that with remaining probability the sanctions that the debtor faces are so large that it would repay the amount needed to invest L^* in period 0.

With π sufficiently large, the best outcome now would be for the sovereign to borrow only an amount P/R^2 , which it would repay under any circumstances. (Assume for now that y is so high that period 1 liquidity is never a problem). Hence competitive lenders would be willing

to lend this amount at the safe interest rate *if they knew for sure that the sovereign was not going to borrow any more*. If the sovereign does borrow more, however, its obligations will exceed what it would be willing to repay if sanctions are small, so a partial default occurs with probability π .

In fact, the sovereign will want to borrow more. If lenders cannot monitor and limit the borrower's total debt to P/R^2 then the lender has an incentive to go out and borrow more, which it can do if it offers a risk premium to compensate for the probability of default. In the absence of seniority provisions that ensure those who lend the initial P/R^2 get paid off first, the equilibrium is one in which lenders, knowing that the sovereign will borrow more than P/R^2 , will charge a risk premium. (Partly because of the information problem discussed below, seniority does not have as much meaning in sovereign lending as it does for domestic debt.)

The equilibrium loan amount \tilde{L} and gross interest rate \tilde{R} that emerge are given by the conditions for zero profit in lending:

$$(1 - \pi)\tilde{R} + \pi P/\tilde{L} = R$$

and the borrower's optimal amount of borrowing given \tilde{R} :

$$\tilde{L} = \frac{\alpha\beta}{(1 - \pi)\tilde{R}}.$$

The first generates a loan supply curve and the second a loan demand curve. Kletzer shows that, even though the borrower can borrow more than with credit rationed at P/R^2 , it is nevertheless worse off because of having to pay a higher interest rate. The borrower thus suffers from its inability not to keep borrowing once it has borrowed up to its safe limit P/R . The financial community does the country a favor by restricting credit.

A key lesson of Kletzer's paper is the importance of timely data on sovereign debt for the functioning of the markets. With default risk prices alone are not sufficient signals of market

conditions to ensure efficient participation. In this example a superior equilibrium can emerge if market participants can also observe the total amount that a sovereign has borrowed.

Despite the fact that Kletzer delivered this lesson so long ago, the data situation since then has, if anything, deteriorated. A deficiency more glaring and immediate than the absence of an international bankruptcy court: is the absence of a data authority providing timely and accurate information on sovereign debt. While the World Bank and Bank for International Settlements provide some data on country debt, it is far from comprehensive. The World Bank in its participation in the HIPC (Highly Indebted Poor Country) initiative to provide very poor countries relief from official debt conducts a comprehensive debt inventory. This methodology should be extended to all sovereign debtors and should apply to debts from both official and private sources. Recent financial scandals in the United States resulted in part because accountants were cooking the books. In the case of sovereign debt there are hardly any books to cook.

5.1 Liquidity or Insolvency: How can a Standstill go Wrong?

We can make the example above more interesting by assuming that lenders learn more about the true value of P or π in period 1 than they knew in period 0. Period 1 loan contracts will then reflect news about P or π . The news that P is lower or that π is higher than previously thought can be thought of as a “solvency crisis.” The news will shift the loan supply curve in. Less will be lent than in period 1 than was extended in period 0.

Let us also reintroduce the possibility that period 1 resources y can't cover short-term debt at the end of period 1, so that a Diamond-Dybvig type country run could occur as in the previous section. The bankruptcy court might mistake the inward shift of the loan supply curve (caused by increased fears of fundamental insolvency) for a liquidity crisis. In this case it might decide to impose a standstill forcing the lenders to stick it out to the end. A standstill, *at the time it is imposed*, is still in the sovereign's interest, since it allows it to preserve its

period 2 output. Whether or not a standstill benefits the creditors is ambiguous, however. It may well be that y , what creditors get if they liquidate their loans in period 1, may exceed what they can ultimately hope to collect by waiting until period 2.

To work through a specific example, say that in period 1 investors learn whether the value of P is some high value P^H or some low value P^L , which for simplicity we can set to zero. Assume also that the market is one in which investors can ration credit. Learning that the outcome is one in which they will not be repaid investors will want to withdraw, at least earning the scrap value y . Otherwise, in the absence of a “run,” they will be willing to relend an amount P^H at a rate r , since they will surely be repaid. Let λ denote the probability that $P = P^H$ from the perspective of the period in which the loan is initially extended. Without a potential run, then, total lending to the borrower is worth at most:

$$L^N = \frac{(1 - \pi)y}{r} + \frac{\pi P^H}{r^2}.$$

In the absence of a run that has no basis, the country could borrow up to this amount.

Say that a bankruptcy court mistakes insolvency for a groundless run, however, and forces creditors to roll over the loans. Here, then, a crisis represents conflict of interest between creditors and the sovereign rather than a simple problem of coordination among creditors. By imposing a standstill an international bankruptcy court will be siding with the sovereign. The standstill benefits the sovereign at the expense of creditors, from the perspective of the period in which the standstill is declared, *taking as given the original terms of the loan contract*.

But anticipating the court’s actions, however, borrowers perceive a loan to be worth only:

$$L^C = \frac{\pi P^H}{r^2}$$

so are willing to lend less. Whether the sovereign is better or worse off with the court is ambiguous, depending on the values of π , and y relative to P^H/r . In this example the court has the unambiguous effect of lowering loan amounts, with an uncertain effect on the borrower’s welfare. A possibility is that the borrower is still better off in that it avoids costly liquidation,

but another one is that the reduction in available credit has the dominant effect on welfare. With competition among creditors driving their expected profits to zero anyway, the effect on the borrower is the same as the effect on overall efficiency.

6 Additional Issues

The model as outlined so far ignores some additional issues that make the potential role of standstills and an international bankruptcy court even more difficult to assess. More research on these issues is called for on at least two.

6.1 Official Creditors

Little has been done to examine the role of official creditors in a standstill or their standing in an international bankruptcy court. Questions abound. For example, should a debtor continue servicing its official debt during a standstill? What level of seniority would official debts have in their treatment by a bankruptcy court?

Answers to these questions require positing the objective functions of official lenders. They have budget constraints to satisfy but also have broader social and political objectives. Bulow and Rogoff (1988) show how official creditors' concerns about the broader costs of default can lead them to pick up loans to private creditors at concessionary rates. An objective of any new financial architecture should be to avoid the use of public funds from lender countries to pay off loans to private creditors. An advantage of the standstill arrangement is that it might displace official lending as a solution to debt crises, ensuring better that private creditors not be able to dump bad loans onto the public.

Another issue is the information available to official creditors: Are they better or worse informed than their private counterparts? Gai, Hayes, and Shin (2001) provide a model in which the official sector provides information to the markets about the liquidity available to a sovereign, allowing private creditors to assess the extent to which a default is willful. Punish-

ment can thus be set accordingly. Spiegel (2002), however, argues that official institutions are inherently less well-informed than their private counterparts, citing the vastly larger research staffs in private sector institutions. He nevertheless shows how official creditors can set up lending schemes that can help avoid crises.

6.2 Creditor Market Power

A second issue that deserves further research is the role of creditor market power. Most literature, including what I have written so far, assumes that lenders are perfectly competitive. But the number of financial institutions involved in bank lending and in issuing bonds to sovereign debtors is relatively small, and there appears to be substantial geographic concentration among private creditors to individual sovereign debtors. These circumstances are suggestive of at least some market power.

Even if initial lenders are initially competitive, once loans have been extended, loan covenants may make it difficult for new creditors to enter the picture. Existing creditors may use the opportunity of a rescheduling to tighten the terms of their loans. Ozler (1989), for instance, finds that reschedulings during the 1980s were often good news for the stock market values of the banks involved. She interprets this finding as reflecting the creditors' ability to use the rescheduling to exercise monopoly power in rolling over loans, since at that point the existing creditors could keep new ones out.

What concerns does creditor market power raise for standstills and an international bankruptcy court? A primary concern is that procedures maximize competitive pressure on creditors while at the same time ensuring that loan amounts are carefully monitored. Rescheduling should not be an opportunity for creditors to increase the net present value of their debts above their original face value.

7 Two Speculative Thoughts

I conclude with two very speculative suggestions on how a remodeled system might operate. One concerns the declaration of a standstill and the second the financing of official finance.

7.1 Borrower Declared Standstills and an Escrow Account

The bundling of standstills and an international bankruptcy court in the title assigned to this paper suggests that the Court is the agency to decide when and where to stand still, weighing evidence presented by all parties. As suggested in the extended model above, a standstill might be more beneficial to the sovereign than to its creditors, at least in the short run, although there are circumstances where both could, on average, at least, benefit.

An alternative possibility to having a court decide is to give the sovereign the right to declare a standstill unilaterally. A benefit is that a standstill could be called more quickly without potentially costly negotiation. A cost is that the sovereign might use the standstill to reduce the value of the creditors' assets.

One means of mitigating this downside is to require that a portion of a loan be held in escrow at the time that it is extended. The escrow account would be turned over to the sovereign as it repaid its loan according to schedule. Upon declaration of a standstill, however, funds would be paid instead to creditors. Such an account would ensure that the sovereign participated in the cost of a standstill while creditors would receive some release. The amount of the escrow account would need to be large enough to prevent the sovereign from declaring standstills frivolously while not so large as to create an incentive for lenders to manufacture debt crises in order to get their hands on the escrow accounts.

7.2 Financing Official Finance: An Experienced-Rated Lending Tax

As discussed above, lending to sovereigns is typically characterized by the intermingling of official and private finance. An ongoing concern is that private lenders and sovereigns might

together be ripping off official creditors. Since official finance is typically financed with tax revenues from official donors, the public in the lender community is financing any (net present value) bailouts. Since the private creditors themselves are only a minuscule fraction of the tax base, they have little economic interest in minimizing the cost of any official bailout.

The design of domestic unemployment insurance in many countries suggests another means of financing official intervention that brings private incentives closer into line with the public interest. Official finance could be financed by a tax on sovereign lending by private creditors that is “experienced rated” according to the past performance of both the financial institution and sovereign. Countries or financial institutions that were more frequently involved in bailouts would find themselves paying more.

8 Conclusion

In summary, an international bankruptcy court could do a lot for the operation of international financial markets. There is a lot left to think about in terms of how it should be designed, however. But we should also acknowledge that we will not come up with a perfect design before trying it out. It might be time to move ahead set one up, acknowledging that experience will create many wrinkles to be ironed out down the road. While the current system may not be completely broke, it is not working so well that we shouldn't try to fix it.

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