

# In the quest of a Framework for Sovereign Debt Restructuring<sup>1</sup>

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[PRELIMINARY NOTES]

## Summary

Judge Thomas Griesa's recent ruling in the case of Argentina has raised enormous questions in sovereign debt markets. Argentina is not an exceptional case. It is a symptom of the current unhealthy market-based system for resolving sovereign debt crises. The case raises fundamental issues that the global community is addressing.

This article provides background for the conference on Sovereign Debt Restructuring that will be held at Columbia University on November 17, 2014. This conference will focus on three sets of questions:

- 1) Are there quick fixes, e.g. restoring concepts such as sovereign immunity, or improvements in the private contractual approach?
- 2) What are the most important improvements in the private contractual approach? To what extent will these *solve* the problem? Are they politically achievable?
- 3) To the extent that quick fixes and private contractual approaches do not do the tricks, there is an obvious need for a more collective approach. What would an ideal solution look like? Are there halfway houses, politically achievable?

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## 1. Introduction

The debate on the necessity of a Framework for Sovereign Debt Restructuring (FSDR) has been revived by the outgoing process of Argentina's debt restructuring. These events are a manifestation of how fallible the private contractual approach can be.

Sovereign debt crises are recurrent phenomena in a world of financial globalization. Capacity of repayment is uncertain, especially for the most volatile economies. There are states of the world in which countries are unable to service their debts, and that is why most countries pay interest rates on their debt that include a compensation for risk. Sometimes these risks are miscalculated, both by the debtors and the lenders. History provides several examples of countries that engage in economic reforms with the expectation of permanent increases in the capacity of production that lead to higher levels of lending and borrowing –only to realize later on that those expected increases in productivity were not delivered, facing difficulties for debt repayment. This is, for example, the case of Argentina that in the 1990s implemented the reforms pushed by the Washington Consensus, an experiment that ended with a catastrophic economic and social crisis in 2001, including a default on its sovereign debt (Galiani, Heymann, and Tommasi, 2003).

Debt restructurings are an essential feature of the functioning of the market system. There are important economic analogies between debt restructurings of corporations and debt restructurings of sovereigns. Firstly, the possibility of bankruptcy guarantees limited liability of firms. Without limited liability, markets could not work efficiently. Sovereign defaults also impose limits to the liabilities of a country. In an extremely bad scenario, repaying sovereign debt could lead to immensely costly disruptions to the functioning of a society –in the very extreme, even to the starvation of its citizens. The possibility of default imposes a limit to the cost of downside states.

Secondly, when a corporation goes bankrupt, its assets are still valuable, and should be put to work. It would be a waste of resources for the society to have equipment that is not being utilized because the firm that owns it is bankrupt. The existence of corporate bankruptcy laws ensures that such a waste of resources does not occur. Similarly, when a sovereign cannot repay its debt, it does not mean that there are no profitable projects within the country –projects that could put the labor force back to work, whose execution may require external credit. It would also be a waste for the global economy not to make use of those opportunities. A restructuring would allow the sovereign to be able to borrow again for exploiting those economic opportunities.

Lenders would also benefit from having access to good investment opportunities. It is then in the best interest of both the borrower and the potential lenders to resume the flow of credit.

However, this basic principle of modern capitalism –that distressed debtors need a fresh start—has recently been defied by the ruling (described in section 2) of a judge of the Court for the Southern District of New York, Thomas Griesa, that makes restructurings impossible. The ruling, by encouraging holdout behavior in restructuring processes, threatens the normal functioning of international debt markets. It creates global inefficiencies and inequities, and makes the finding of a general solution a matter of urgency.

The global community is showing its preoccupation for the issue and its willingness to attack the problem. Both the private sector and the large majority of public sectors have engaged in attempts to avoid situations like the one provoked by judge Griesa in the future. The proposal of the business community consists in a modification of the terms of bond contracts that would rule out the type of behavior that characterizes the vulture funds. Although these new terms constitute an improvement over the existing terms, they leave important problems unaddressed.

The large majority of governments, on the other hand, supports the creation of an international framework for the resolution of sovereign defaults, as manifested in the recent Resolution 68/304 adopted by the General Assembly of the United Nations on September 9, in which an overwhelmingly majority of 124 to 11 voted in favor of adopting a framework of that nature.

This paper provides an overview of the outgoing debate on the necessity of a FSDR, and analyzes the advantages and disadvantages of the different approaches on the fore. Section 2 provides an overview of recent events that have shown how fallible the private contractual approach can be. Section 3 addresses the limitations of the private contractual approach, even with modifications in its terms. Section 4 proposes a set of principles that should guide the establishment of a FSDR. Section 5 concludes.

## **2. Background**

The resolution of Argentina's 2001 sovereign debt default brought back to the fore the problems of sovereign debt restructuring. Argentina defaulted on its sovereign debt in

2001 (under circumstances in which default was the only choice for the country), and restructured its debt in two rounds, in 2005 and 2010. By the end of the second round, 92.4 percent of the debt had been restructured.

After the default, a group of investors (known as vulture funds) bought a small part of the debt in default in secondary markets at a fraction of their face value, and initiated a litigation in the courts of New York (under which those bonds had been issued) demanding full payment on the principal plus interest that included a compensation for risk.<sup>3</sup>

In 2012, judge Thomas Griesa from the New York Southern District came up with a peculiar interpretation of *pari passu*, a standard contractual clause that is supposed to ensure equal treatment among equals. In plain English, his interpretation was that equal treatment meant that while the holders of exchange bonds would get paid for what they accepted in the restructuring, vultures would get paid in full –full principal and interest.<sup>4</sup> In 2014, the vultures won an injunction that prohibited Argentina from repaying the 92.4 percent of bondholders who had reached an agreement with the country unless it simultaneously paid them in full (including past interest that reflected the risk of no repayment).<sup>5</sup>

A ruling of this nature makes debt restructurings impossible. It creates a moral hazard problem. It negatively alters the incentives of holders of bonds in default for entering into a negotiation process, as it increases the payoffs of being a holdout. Under this interpretation of *pari passu*, defaults become de facto impossible. Countries, understanding this possibility, would be more reluctant to borrow in the first place. The more affected countries would be the more volatile ones, which are the ones more likely to need a restructuring. Therefore, the ruling also creates inequities in the functioning of international financial markets.

Argentina is not an exceptional case. It is a symptom of the current unhealthy market-based system for resolving sovereign debt crises. The case raises fundamental issues that the global community is addressing.

A healthy environment for international debt markets is a public good. Individual countries, when dealing with vultures, do not internalize the positive externalities that

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<sup>3</sup> The leading vulture was NML Capital, a subsidiary of the hedge fund Elliot Management.

<sup>4</sup> It had already been reasonably argued that the ratable payment theory of the *pari passu* clause is a fallacy (Buchheit and Pam, 2004).

<sup>5</sup> Vultures constituted only 1 percent of the holders of the total debt in default.

fighting them implies to the rest of the global economy. That explains in part success of the vultures' business over the last two decades. Therefore, a solution needs a global approach. The global community understands this logic. It is showing its preoccupation for the issue and its willingness to attack the problem. Both the private sector and the large majority of public sectors have engaged in attempts to avoid situations like the one experienced by Argentina in the future.

The approach supported by the private sector and a very small number of governments differs from the one supported by the large majority of governments. The private sector has recently made a serious proposal that consists in modifying the terms of the contracts (as defined in ICMA's Standard CACs and Standard Pari Passu Provision Notes of August 29, 2014).<sup>6</sup> Although the new terms are an improvement over the old ones, this approach still suffers from limitations that impede reaching a full solution to the current inefficiencies and inequities in the process of sovereign debt restructuring. The large majority of countries advocates for the establishment of an international law for resolving these issues. We will next discuss both approaches.

### **3. Limitations of the Private Contractual Approach**

The current approach for sovereign debt restructuring features a decentralized process where the country in distress negotiates with the many different creditors. These negotiations can be difficult and lengthy.

Bond contracts may or may not contain collective action clauses (CACs). If they do not contain CACs, the restructuring is not finished until all the creditors agree with a proposal. Under a unanimity rule of this nature, holdouts –and particularly vulture funds—can emerge, delaying the restructuring even when there is no disagreement on the capacity of debt repayment and the willingness of the debtor to behave according to that capacity. In the interim, the country has no access to international debt markets.

This coordination problem has been present in several sovereign debt crises. The introduction of CACs in the bond contracts has been a response to it.<sup>7</sup> CACs

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<sup>6</sup> Available at <http://www.icmagroup.org/resources/Sovereign-Debt-Information/>

<sup>7</sup> In the 1990s, bonds issued in the London market under the English law contained CACs, while bonds issued in the New York market under the law of the state of New York did not (Eichengreen and Mody, 2003). Mexico was the first country to do so under the jurisdiction of the state of New York in 2003.

implemented at the level of each bond ameliorate the coordination problem, but do not fully solve it when a country has multiple debt obligations, as it is generally the case. If a CAC establishes that the negotiation will be terminated when, say, 75 percent of the holders of a series of bonds agree with the restructuring (binding all the other bondholders of that series to accept the deal), there would still remain the possibility that one investor buys 26 percent of a unique series of bonds, and by refusing to agree to the restructuring proposal that investor would have the capacity of impeding the termination of the whole negotiation.

To solve this problem, what is needed is a formula for the aggregation of the different instruments over which CACs are applied. But this is not the only coordination problem that may arise in a restructuring process. It is simply an important one. We will show that an approach that intends to address the whole range of coordination problems needs more than simply tweaking the terms of the contracts.

### **3.1. ICMA's response to the vultures' problem**

The International Capital Market Association (ICMA) has recently proposed new terms for the bond contracts. The new terms clarify the meaning of *pari passu*. They also provide a formula for the aggregation of different classes of securities over which collective action clauses are applied.

The clarification of *pari passu* suggested by ICMA contradicts the peculiar interpretation provided by judge Thomas Griesa in the outgoing case of Argentina.<sup>8</sup> The debtor should have no obligation to pay the creditors who accepted the proposal and the holdout creditors on an equal or ratable basis.

Under the new terms, CACs could also be applied if a supermajority agrees with the restructuring proposal. The supermajority would be defined by acceptance of the aggregate principal amount of outstanding debt securities of all of the affected series, and its decisions would be binding to all the other investors.

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<sup>8</sup> ICMA's *pari passu* provision establishes that "*The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank pari passu, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, provided, however, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa.*"

These terms mainly attack the vulture funds' business and constitute an improvement over the previous terms, but leave some important issues unanswered. CACs are no panacea. If they were, there would be no need for domestic bankruptcy laws that spell out issues like precedence and fair treatment. The "fixed" private contractual approach still has important limitations. We describe them in the rest of this section.

### **3.2. The problem of sovereign immunity**

Sovereign immunity has been eroding since the 1970s, first as a result of the sanction in the US of the Sovereign Immunity Act in 1976 and the sanction in England of the State Immunity Act in 1978 that permitted that public entities could be held legally accountable for breach of commercial contracts, and later as a result of peculiar interpretations of the *pari passu* clause.<sup>9</sup>

Sovereign immunity was more recently challenged by litigation over the so-called champerty defense –an English common-law doctrine, later adopted by US state legislatures, prohibiting the purchase of debt with the intent of bringing a lawsuit. In 1999, in *Elliot Associates, LP v. Banco de la Nación and the Republic of Peru*, the Second Circuit of Appeals of New York determined that the plaintiff's intent in purchasing the Peruvian debt in default was to be paid in full or otherwise to sue.<sup>10</sup> Such an interpretation is absurd, as it is not reasonable to expect to be paid in full over a promise that was already broken. Nevertheless, the court ruled that Elliot's intent did not meet the champerty requirement because litigation was contingent.

In 2004 the New York state legislature effectively eliminated the defense of champerty concerning any debt purchase above 500,000 US dollars. That decision, besides contradicting the understanding over which hundreds of billions of dollars of debt had been issued, constituted the final attack to sovereign immunity.

The proposed tweaks in the terms of contracts do not resolve the problem of sovereign immunity.

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<sup>9</sup> Schumacher, Trebesch, and Enderlein (2014) show that there has been an enormous increase in litigation against governments since 1976.

<sup>10</sup> The issue is more extensively treated in Blackman and Mukhi (2010).

### **3.3. The coordination problem among debtors**

In the presence of imperfect information, debtors try to show that they are of a “good type” by using costly signals.

In the context of sovereign debt, debtors may choose excessively tough jurisdictions to signal they are unlikely to default. Then, even though the judiciary of a jurisdiction like the state of New York creates severe inefficiencies for debt restructuring, debtors could still resort to that jurisdiction as a proof that they are unlikely to need a restructuring. Other debtors, by acting differently, would signal that they are more likely to restructure. Hence, the payoff of deviating to a more reasonable jurisdiction would be lower. This is an inefficient global equilibrium.

This coordination problem requires a global solution –a solution that cannot be provided by the decentralized contractual approach.

### **3.4. The unresolved problem of existing contracts**

The new terms do not solve the problem for the hundreds of billions of dollars of debt that was issued under the old terms.

This problem is especially important in a weak global economy. The recent European crisis shows that not even relatively advanced economies are exempt of debt problems (and it also shows that judgments on capacity of debt repayment can be very difficult, even close to the date a country ends up facing a sovereign debt crisis<sup>11</sup>). More countries could face difficulties for debt repayment in the near future. Without the establishment of a framework that comprehends all the existing debt contracts, sovereign debt restructurings will continue being problematic.

### **3.5. Coordination among creditors**

There are complicated bargaining problems among classes of creditors. A supermajority voting does not solve those problems. A simple supermajority rule

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<sup>11</sup> Reinhart and Rogoff (2009, p. 287) provide an illustrative example of these difficulties, when they classify Greece in 2009 as a country that is a candidate for “graduation”, i.e. as a country “*that managed to emerge from centuries of serial default on sovereign debt and eventually stopped defaulting*” (p. 283).



could lead to a situation where junior creditors vote to have themselves treated equally with more senior creditors –and where they impose their position by reaching the supermajority threshold. Instead, in a court ruling over different restructuring alternatives, the judge could weigh in the different equities.

Even the debtor could manage to displace the rights of creditors by buying back the defaulted bonds. If covenants forbid the debtor from doing so, allies of the debtor could do it.

When countries issue debt under different jurisdictions, establishing priority of claims could be a daunting task, with multiple contradictions. Contracts could become inconsistent in crises times. For example, a bond issued under the jurisdiction *X* could establish that the holder of that bond has priority over all the other claims. But at the same time another bond issued under the jurisdiction *Y* could establish the same. Who would then have priority if in times of crisis it were not possible to satisfy both claims at the same time? Under a decentralized private contractual approach, solving these issues would require an intricate and lengthy negotiation, with complex legal questions.

Issues of determination of seniority are especially important in the context of sovereign debt restructurings, as the set of claimants of the country's resources include not only formal creditors, but also others like the workers and pensioners. Chapter 9 of the US Bankruptcy Code recognizes these rights. The private contractual approach, instead, does not contemplate them.

### **3.6. Credit Default Swaps and misalignment of incentives**

Sovereign debt restructuring problems may be aggravated by the non-transparent use of CDSs. CDSs separate ownership from economic consequences: the seeming owner of a bond could even be better off in the event of a default, as the payments over the CDS would be activated in such event.

The opacity of this market makes unclear what the real interests are for those who have a seat at the bargaining table. This is another reason for delaying restructurings and creating inefficiencies. The private contractual approach does not address this problem.

Efficiency in restructuring requires transparency of the interests for those who take part of the bargaining process. A court for sovereign debt restructuring could demand full disclosure of CDSs information to the investors who hold bonds in default (or to its subsidiaries).

### **3.7. Macroeconomic issues**

Empirical research shows that sovereign debt crises occur almost exclusively in bad economic times (Tomz and Wright (2007), Levy Yeyati and Panizza (2011), Panizza, Sturzenegger and Zettelmeyer (2009)). This is consistent with the predictions of economic theory (Eaton and Gersovitz (1981), Eaton, Gersovitz, and Stiglitz (1986), Aguiar and Gopinath (2006), Guzman (2014)). Those are the times when expansionary macroeconomic policies are mostly needed. The lack of capacity for running expansionary macro policies could endanger the potential recovery that a sovereign debt restructuring could trigger. Besides, such a scenario would be conducive to the underutilization of the resources of the society.

The solution implied by the private contractual approach does not internalize the positive externalities for those who do not have a seat at the bargaining table implied by the access to credit in bad times. A framework that does so requires a provision of “lending into arrears”: those creditors willing to lend to a debtor that is restructuring its debt are treated as senior creditors, facilitating access to credit when the social return is larger.

### **3.8. Final remarks on the private contractual approach**

The coordination problems we have described impose costly delays for the debtor and for the good-faith creditors. Delays affect the capacity of governments to run countercyclical macroeconomic policies when they are mostly needed. It also creates tensions between governments and the IMF, as pressures for intervention may be larger when access to credit is difficult. These costs could be reduced if debt restructurings were resolved more quickly, what requires a more rapid agreement *between* the debtor and the creditors, and a more rapid agreement *within* the creditors.

The business community is pursuing for easy fixes in the contracts to solve the current inefficiencies associated with sovereign debt restructurings. But easy fixes are not really fixes. They are insufficient amendments that leave a legacy of problems for the next debt crisis.

If the private contractual approach was viable, why has no government relied upon it? Why doesn't the private sector rely on it either, and instead rely on bankruptcy laws? Why don't contracts specify what will happen in the event of a breach of a credit contract? Specifying every possible contingency in the world we live in would lead to a problem of combinatorial explosion. That is why all contracts are incomplete. There are some elements of contingency that can be implemented in contracts that do promote a more efficient solution (like the GDP indexed bonds, where the amount that is repaid depends on the actual capacity of repayment of the country), but not every contingency can be contemplated ex-ante. And this incompleteness of contracts implies that there may be ambiguity concerning the treatment of different claims.

The market-based approach cannot solve the coordination problems that emerge in a debt restructuring. Left on their own, markets would reach an inefficient solution. The existence of CACs is a demonstration of the inability of the markets to arrive at an efficient solution ex-ante. Their existence does not ensure an efficient solution ex-post either.

What the good health of international financial markets requires is a comprehensive approach that solves the inefficiencies and inequities that arise with the decentralized private contractual approach –i.e., an international framework for sovereign debt restructurings.

#### **4. Principles for a Framework for Sovereign Debt Restructuring**

In this section we provide a brief description of the elements that a FSDR should contain (some of these issues are more extensively analyzed in Stiglitz (2002)).

The framework should contain elements from Chapters 9 and 11 of the US Bankruptcy code. The final goal is to achieve efficiency in restructuring, which means that the debt burden and constraints imposed by it should drive the economy to full employment and to the restoration of its capacity for economic growth.

In the first place, the framework should incentivize debtor countries in distress to not delay the initiation of the process. Delays are costly, as they put impediments to wealth creation –and governments tend to delay restructurings to avoid the political costs that they entail. Larger costs of restructuring imply larger incentives to delay it.<sup>12</sup>

It should acknowledge that the capacity of debt repayment is endogenous, facilitating the conditions for the restoration of economic growth. Therefore, it should establish that those creditors lending to the country after the restructuring process is initiated are treated as senior creditors.

Some time after the initiation of the process, the sovereign would propose a restructuring plan that could include the reprogramming of payments and haircuts. The proposal should delineate the economic plan that determines its economic consistency. The other parties involved in the negotiation could suggest alternative proposals. If any party proposed policies of fiscal austerity as the mean to achieve a larger sustainable capacity of repayment, it should provide economic models and empirical evidence that sustain that proposition.<sup>13</sup>

Sovereigns should be protected from disruptive legal actions while the restructuring is underway. The restructuring would finish with the ruling of the international court, which would weigh the different positions –including the position of the workers and pensioners of the country in distress, who should receive senior treatment. If creditors were not satisfied with the proposal, they could object that they are not receiving fair treatment, and the court would evaluate those claims.

The court would have the ability to resolve the coordination problems that arise among the various actors involved in the process. By doing so, it would facilitate a more rapid and sustainable economic recovery, which would ultimately affect the capacity of debt repayment.

## **5. Conclusions**

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<sup>12</sup> Orszag and Stiglitz (2002) described the analogy of this issue with calling the fire department when there is a fire.

<sup>13</sup> The existing empirical evidence shows that fiscal austerity in recessions has almost always been associated with larger economic contractions rather than expansions; see Jayadev and Konczal (2010).

Restructuring is not a zero sum game. Rules can have large effects on the overall economic performance. The current state that features a decentralized market-based process for sovereign debt restructuring makes that sum too negative –more negative than what could be achieved under a more reasonable approach.

The world needs to move to a different equilibrium. This requires the implementation of a framework for sovereign debt restructuring at the international level. The framework should be balanced. A system that is too creditor-friendly would discourage borrowing. It would also diminish the incentives of creditors to assess the creditworthiness of the debtor. On the other hand, a system that is too debtor-friendly could also discourage lending.

An approach that entails a more active role for the judiciary can resolve some of the inefficiencies and inequities noted above. The standardization of contracts and their interpretation through a unique international law solves complex coordination problems. It also solves the signaling problem that leads to an inefficient global equilibrium, where countries choose to issue debt under jurisdictions that are too tough, and where these jurisdictions enjoy a relatively inelastic demand for their services.

Efforts must be made for attaining such a legal structure. Its credibility will depend on its openness, transparency, and representativeness. The global community should be able to provide such a service to the citizens of the world.

On November 17, Columbia University will hold a conference where all these issues will be discussed –a conference supported by a variety of top academic institutions and that will include the most reputed researchers and practitioners in the field. We hope decision makers take on the insights from the consensus reached among academics, and decide what's best for the good health of global financial markets, and for the global community as a whole.

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