Feedback from Barry Herman, USA
The New School

This is for the consultation on the debt paper (requested name and affiliation below; I started working on sovereign debt issues in the 1980s for the UN);

Here are some comments on the topics of the paper, first on some details and then on the big enchilada:

Debtor Moral Hazard:

The draft does a good job of taking apart the argument that sovereign default and debt workouts should be painful in order to dissuade debtor policymakers from defaulting. One can go further.

1. This is the same argument as that for using the death penalty to dissuade murder. It does not work. Moreover, in this case, the people who suffer during a debt crisis are not the people whose decisions caused it. I would hesitate to say the people who suffer are responsible because they elected the policymakers who caused the crisis; sometimes you can make this argument but often you cannot. At the end of the section on distributional issues, the draft does express concern about who suffers in a debt crisis. This concern is expressed as one of social consciousness, but it relates as well to whether the prospect or fact of people suffering would dissuade the government from irresponsible behavior. My point is comparable to the observation that trade sanctions against an odious regime that mainly hurt the people are usually not effective in changing the government's odious policies.

2. It is not the default and workout, per se, that is painful but the withdrawal of regular access to credit when the market or official lenders lose confidence in the debtor authorities. The default is part of the solution, not the problem, at least in cases in which the default is not voluntary (a rare example of voluntary default is Ecuador's 2008 selective default, ostensibly for odious debt reasons, but actually shrewd political opportunism; anyway, the creditors have forgiven Ecuador as evidenced by its oversubscribed bond issue this summer floated by the same regime as was in power in 2008).

Creditor moral hazard

While the existence of creditor moral hazard may be in doubt (p. 9), there is evidence that creditors have been overcompensated for risk of default (see Shari Spiegel's chapter in our book "Overcoming Developing Country Debt Crises," eds me, Ocampo and Spiegel, Oxford, 2010).

Distributional issues

I think the argument is not accurate at the top of p. 11 that short-term creditors are hurt or hurt more than long-term creditors in a restructuring. Firstly, I expect that all government securities are covered by the same "pari passu" clauses, regardless of tenor or maturity date. Secondly, there is usually an agreement (perhaps informal) to keep short-term credit lines open after default, as not doing so would just make the economic crisis far worse. So, bondholders and Paris Club creditors don't get paid first.

Proposals for sovereign debt reform
While the draft does a very good job of reviewing a number of proposal, both "ancient" (circa 2000) and recent (post-2008), it omits to discuss two important considerations.

First, neither the current system nor discussed proposals fully share the aim of bankruptcy regimes for corporations that are not being wound up, namely that the bankrupt firm emerge from insolvency with a fresh start. Something of this sort was part of the HIPC Initiative that sought to place graduates in a "sustainable" debt situation (albeit never adequately defined), or after addition of the MDRI, a situation that would not inhibit the country's efforts to attain the MDGs. The usual goal of debt workouts today is still to accord the minimum concessions from creditors to return the country to market access (or normal relations with official creditors). This is just another way to say the system has been excessively creditor friendly.

Second, the debt workout process should win the confidence of the relevant stakeholders. Indeed, one problem with putting IMF at the center of several of the proposals is that the IMF is not everywhere trusted to represent the interests of the people in developing countries (I realize that Wall Street sees the IMF as excessively friendly to debtor governments, especially those important to the foreign policy goals of the major countries; debtors and creditors could agree IMF is a political institution). Nevertheless, the proposals that take decision making about debt workouts out of the hands of the IMF Executive Board should be privileged. The Gitlin/House proposal is a step in the right direction in this regard, as it seeks to develop an independent, unbiased and expert place for addressing sovereign debt problems, although how it would actually operate and who would oversee it is left vague.

An additional proposal: A proposal from myself, José Antonio Ocampo and Shari Spiegel in our concluding chapter of the aforementioned "Overcoming Developing Country Debt Crises" seek to take account of these two factors. We would establish an international institution resembling either an international court or an independent international entity to act as an honest broker and offer a set of services to settle the details for resolving a sovereign debt crisis (this proposal is in the spirit of that in the report of an expert commission that had been appointed in 2008 by the President of the UN General Assembly ("Stiglitz Commission"). If the entity option were chosen, it would be overseen by a balanced board of directors and would sponsor independent panels of experts to help bring the parties to voluntary agreement through mediation and if that failed, the panel could reach its own conclusions on the model of the dispute settlement mechanism in the World Trade Organization. The panels would draw on the expertise of the international system (IMF, ILO, etc) and would be guided by internationally adopted principles for sovereign debt workouts, which could include, for example, provision for "debtor-in-possession" financing (loans made after default which would have first priority for repayment).

I would not insist on our proposal (which is admittedly not fully fleshed out), but would encourage consideration of the factors noted above it.