Comment on "Commercial Banks, Default Insurance and IMF Reforms"
By Rockerbie and Easton

Rockerbie and Easton propose an innovative solution to the problem of sovereign debt default. They point out that the IMF indirectly bails out the holders of such debt when it lends to nations in economic distress that threaten to default on their obligations. They suggest that commercial banks be allowed to join the IMF and purchase insurance from the Fund. The sovereign borrower would then be obligated to pay back the IMF. The proposal is thought-provoking, but has several severe disadvantages.

While commercial banks continue to be important providers of capital flows in some areas, corporate bonds became the chief form of external debt in most emerging markets after the bank debt crisis of the 1980s. This proposal would do little to resolve problems in this market. The IMF sought to devise a solution when it proposed the institution of a sovereign debt resolution mechanism, which included a prominent role for itself, in 2003. However, private lenders objected to the proposal and it was eventually withdrawn. Instead, collective action clauses, which allow a supermajority of bondholders to negotiate with a government that can not meet its obligations, have become more common. There is little systematic evidence to date on the effectiveness of these procedures, but there have been no signs that they need to be superseded or supplemented by an external agent.

Debt issued by foreign banks was held in many Eastern European and CIS economies and probably contributed to the severe downturn in those areas during the current crisis. To date, the IMF has lent to Hungary, Belarus, Serbia, Romania, the Ukraine and Latvia. However, replacing the foreign banks with the IMF as the debt holder would cause new problems. Duane and Rockerbie claim sovereign lenders would need to work out a repayment schedule with the IMF (p. 8), but there are moral hazard issues. A sovereign borrower may find the threat of being held in arrears at the IMF insufficient to compel repayment, and might hold out for more concessional terms than private lenders would have accepted. Conversely, lenders have less incentive to negotiate a rescheduling if they know that they will be paid by the IMF.

The proposal also has implications for the governance of the IMF at a time when the governance procedures have become an issue of contention. The emerging markets that seek to increase their influence at the IMF would not want to face banks that are largely headquartered in the United States and Western Europe. The banks themselves may distrust involvement in an institution where they could be outvoted by governments with substantially larger voting power.

Duane and Rockerbie deserve credit for addressing a market imperfection that affects lending to developing countries. While IMF membership may not be a feasible solution to sovereign debt default, an insurance mechanism could be useful for low-income countries with little access to private capital flows. An international agency that did provide such coverage might address the concerns that potential lenders have about countries with relatively little exposure in the international capital markets. It would better, however, to make such insurance available through an arm of the World Bank or the multilateral development banks.