# What Is Sovereign Debt?

## It plays a pivotal role in the world economy but comes with risks

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**WHEN EDWARD III** of England ran out of money to finance the Hundred Years' War with France, he turned to the banking families of Florence. The loans they gave him were extremely expensive, and when Edward failed to become king of France, he was unable to repay the debt in full. Over the centuries, the sovereign's debt became sovereign debt: the multitrillion, multinational, multicurrency network of debt obligations that we know today.

### Why do sovereigns borrow?

Governments borrow to spend beyond what they can or want to raise through general taxation. There are several economic motives for this. When tax revenues are down, such as during a recession, governments will borrow to pay for existing spending commitments. This is better for the continuity of public services such as schools and hospitals and means that the government is not forced to cut spending when the economy is already weak—something that could make the situation worse. This is known as "tax smoothing." Governments may go a step further and actually increase spending, or reduce taxes, during a recession to try to boost growth. This "fiscal stimulus" is financed by issuing sovereign debt.

But these reasons cannot typically explain the high level of debt seen in many countries. Another motive to borrow is to invest in the future. Governments might borrow large sums to help build a major new highway, power plant, or subway system. The up-front costs can be extremely high, and so repayment is spread over many years. But hopefully these investments boost longer-term growth, justifying the borrowing. As well as physical capital, governments can also invest in human capital, such as education and health. Again, the long-term benefits should outweigh the cost of borrowing.

### Who do they borrow from?

Governments can be very creative in finding potential lenders, as they seek out those who might charge them the lowest interest rate. There are often trade-offs associated with this choice of lender, however. For example, sovereigns can borrow from within their own country or from abroad. Domestic borrowing—from local banks and asset managers or directly from households—can be a steady and reliable source of financing. But often there is a limited amount of money available and repayment maturities tend to be short. And so governments also borrow from international capital markets, in larger amounts and usually at longer maturities. These markets can be fickle, however, especially for lower-income countries. It can be dangerous to assume that these lenders will always provide a readily available source of finance.

A diverse range of private sector entities lend to sovereigns, too. Asset managers, such as pension funds, typically hold a large amount of government debt. They need relatively safe long-term assets to match their long-term liabilities. Banks also hold large amounts of sovereign debt, especially of governments in the countries where they are

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based. But this "bank-sovereign nexus" has caused problems in the past. During the 2010–12 euro area sovereign debt crisis, for instance, troubled banks reduced their funding to governments, raising sovereign borrowing costs. This led to a vicious cycle of further tightening of financial conditions that aggravated the economic recession and problems in the banking system. Today there is greater understanding of these risks on both sides.

Finally, governments can borrow from other governments or international organizations. Often this form of lending is not motivated primarily by commercial objectives (although the lender may not say this in practice). One government might lend to another to strengthen bilateral ties. The World Bank or African Development Bank might lend money to a country to help build a sanitation system, fund vaccinations, or reform the power sector. And the IMF can provide financing if a country finds itself facing balance of payments difficulties.

## How do they borrow?

There are also various contractual ways for a government to borrow. Loans are a familiar form of financing. They are normally arranged bilaterally, or through a syndicate of lenders, and repayment is often spread out over several years. By contrast, bonds are issued to hundreds or thousands of creditors, and the entire amount normally needs to be repaid at once. In addition, there are many exotic instruments through which a sovereign can borrow, but these tend to be much smaller in scale.

Governments seek to minimize the cost of their borrowing—the interest rate—while preventing the structure of their debt from becoming too risky. For example, many governments find it cheaper to borrow in US dollars or euros than in their own currency. But this can cause problems if their currency depreciates, as this increases the real burden of the debt. Similarly, some governments prefer to pay a fixed rate of interest on debt, as this ensures debt-service costs are stable. But it can be cheaper (at least initially) to issue debt that is linked to a variable interest rate or consumer price inflation. Yet this too can be risky if these variables move in an unexpected and unfavorable direction.

A prudent public debt structure can help keep sovereign borrowing costs low over the long run. But many other factors also influence a sovereign's creditworthiness and its borrowing costs, such as its level of economic development, the size of its financial markets, its record of honoring its obligations, and its vulnerability to external shocks, as well as global financial conditions. Many of these factors are beyond the control of governments. Sovereign rating agencies and international institutions, including the IMF, maintain elaborate models that continuously assess sovereign creditworthiness.

## What happens when they can't pay?

Like people and companies, sovereigns can struggle to repay their debt. This could be because they borrowed too much or in a way that was too risky—or because they were hit by an unexpected shock, such as a deep recession or a natural disaster.

In these circumstances, the sovereign needs to restructure its debt. But unlike people and companies, there is no bankruptcy court for sovereigns that can compel the debtor and its creditors to resolve the issue. Instead, it becomes a negotiation: creditors want to recover as much of their money as possible, while the sovereign wants to regain "normal" status in financial markets, without paying out too much.

These restructurings are often costly for both the debtor and for creditors. This makes them relatively rare events. Well-known examples include Russia (1998), Argentina (2005), Greece (2012), and Ukraine (2015). Costs are normally much smaller when an agreement can be reached before a sovereign defaults, by missing a payment on its debt. These preemptive restructurings are usually resolved quickly and have smaller spillovers to the rest of the economy and financial system. But once a sovereign defaults on its debt, the subsequent restructuring process can be long and expensive.

Sovereign borrowing has come a long way since Edward III's military forays into France. It has become larger, more sophisticated, and more international, and it plays a pivotal role in the world economy by allowing governments to keep their economies afloat during recessions and other unexpected shocks and to finance investments that lift productivity and growth. But the risks—overborrowing and potential default—remain with us to this day. FD

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