

What Is Debt Sustainability?

Many factors go into assessing how much debt an economy can safely carry

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COUNTRIES INCUR DEBT by borrowing. Borrowing can enable countries to finance important development programs and projects—but, taken too far, the burden of debt repayment can overwhelm a country's finances, at worst leading to default.

Elevated debt in low-income countries and emerging market economies in recent years has raised concerns about countries' capacity to sustain these levels of debt. COVID-19 is adding to spending needs as countries seek to mitigate the health and economic effects of the crisis. The resulting rise in public debt will likely heighten the tension between meeting important development goals and containing debt vulnerabilities.

When debt is sustainable

A debt instrument is a financial claim that requires payment of interest, principal, or both by the debtor to the creditor at a future date. Countries incur debt to a wide range of creditors, including private bond holders, banks, other countries and their official lending institutions, and multilateral lenders such as the World Bank.

A country's public debt is considered sustainable if the government is able to meet all its current and

future payment obligations without exceptional financial assistance or going into default. Analysts look at whether policies needed to stabilize debt are feasible and consistent with maintaining growth potential or development progress. When countries borrow from financial markets, risks associated with refinancing are important too.

The definition of public debt varies depending on its purpose. A commonly used narrow definition of public debt covers the budgetary central government. A broader definition is the general government (budgetary central government, state and local government, extrabudgetary units, and social security funds).

The broadest definition of public sector debt combines general government with public nonfinancial corporations and public financial corporations, including the central bank. It also covers publicly guaranteed debt (debt the public sector does not hold but has an obligation to cover) and external public debt (debt held by nonresidents of the country).

To properly assess a country's debt sustainability, it is important to cover all types of debt that pose a risk to a country's public finances.

Focusing only on a narrowly defined concept of *public* debt can lead to unexpected increases. For example, if a loss-making state-owned enterprise is not able to service its debt, the burden ultimately falls on the central government because such debt is *publicly guaranteed*, leading to unexpected weakening in a country's debt sustainability.

In advanced economies and emerging markets, debt sustainability analysis frequently—though by no means exclusively—focuses on the general government. However, in low-income countries nearly complete coverage of both *public* and *publicly guaranteed* debt is standard.

The holders of public debt also matter. Assessments of debt sustainability carried out by the IMF and World Bank cover both domestic and external public sector debt. However, sovereign credit rating agencies that focus on the risk of debt distress typically concentrate on market-based external public sector debt.

Why some debt is good

As noted above, public debt is one way to raise money for development. There are other ways to mobilize financing, such as by raising domestic revenue, improving the efficiency of spending, reducing corruption, and improving the business environment. But these may take time to materialize and may not be enough.

Countries should be prepared to keep debt sustainable and ensure it does not jeopardize growth and stability. Unsustainable debt can lead to debt distress—where a country is unable to fulfill its financial obligations and debt restructuring is required. Defaults can cause borrowing countries to lose market access and suffer higher borrowing costs, in addition to harming growth and investment.

Three key considerations stand out for countries deciding whether to take on new debt:

- New borrowing should be consistent with fiscal spending and deficit plans. The new borrowing should be carefully set to keep public debt on a sustainable path.
- Countries should take a comprehensive approach and compare the return from contracting debt with the cost of accumulating debt. Debt that finances productive social and infrastructure spending can lead to higher income that may ultimately offset the cost of debt service and help balance the risks to debt sustainability.
- Countries should make efforts to improve debt reporting and debt statistics in the context of comprehensive medium-term debt management strategies. Debt statistics should include coverage of public and publicly guaranteed debt that is as broad as possible, including debt of state-owned enterprises. Sharing this data with lenders can encourage responsible lending.

How much is too much?

Several factors determine how much debt a country can carry before the burden becomes too much. A country's debt-carrying capacity depends on several factors—among them the quality of institutions and debt management capacity, policies, and macroeconomic fundamentals. A country's capacity to carry debt can change over time, as it is also influenced by the global economic environment.

The frameworks the IMF uses to assess debt sustainability in low-income countries and countries with access to capital markets take into consideration

individual countries' debt-carrying capacity. The assessments are calibrated in reference to previous episodes of debt distress for groups of countries with similar economic characteristics. The calibrations lead to debt sustainability analysis thresholds for key public debt indicators that signal higher risk if that indicator exceeds (or is expected to exceed) its threshold and can be either based on historical experience or convey information about the likelihood of future debt distress.

These frameworks consider the degree of uncertainty in the projections of the debt and debt service indicators. This is done through fan charts and stress tests. Because these assessments are based on projections of debt, interest, and key macroeconomic variables, both frameworks also rely on tools to help to gauge the realism of these forecasts. The IMF's approach to debt sustainability also leaves room for informed judgment.

Amid the pandemic, one question is whether debt-carrying capacities have improved sufficiently to handle elevated debt levels. After all, since the global financial crisis, low interest rates have arguably increased countries' capacity to borrow.

However, this does not necessarily translate into an ability to handle higher debt service. Even if interest rates are low and the availability of financing is ample, experience has shown that there are limits to countries' debt-carrying capacity—and that rising debt-service burdens need to be carefully managed.

Another factor that will play a key role is growth. All else equal, higher growth improves debt dynamics. Indeed, most historical cases of significant debt reductions without restructuring have involved a surge in growth. In many of these cases, however, growth was driven by factors outside the countries' control, such as a global boom, the coming onstream of natural resources exports, or improved terms of trade (a country receiving relatively higher prices for its exports and paying relatively lower import prices).

Without such external impulses, stimulating growth domestically for a sustained period can be difficult, and can require new debt—for instance, to fund public investment. With the current uncertain outlook for growth, debt service needs to be carefully managed, and strengthening debt management and debt data should be top priorities. **FD**

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