Sovereign Debt: Vice or Virtue? [1]

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Let me start by thanking the Gaidar Forum for organizing this event and for giving me the opportunity to address one of the defining economic questions of our age: is sovereign debt a vice or a virtue?

We have seen in Europe and in Russia in recent history that excessive accumulation of debt by governments and subsequent loss of confidence in their ability to repay can have grave consequences. It causes deep economic recessions, triggers bank failures, and wipes-out household wealth and economic opportunities.

[1] I would like to thank Richard Hughes and Tom Josephs for their contributions.

But it is also the case that government bonds can assume the status of safe assets. They are not only a crucial indicator of public finance management capacity, but also a cornerstone of the financial system. In the U.S. in the late 18th century, the development of Treasuries as safe assets was a key element in the establishment of an effective federal government. It was central for the development of finance. In turn, this was a cornerstone for private investment and economic growth.[2]

So, in my eyes, whether government debt constitutes a vice or virtue depends upon the answer to two questions:

- First, does government debt constitute a safe asset in both the near-term and long-term?
- Second, do governments, markets, and citizens have all the information they need to assess whether public debt is safe?

Let me start with my first question: "Does government debt constitute a safe asset in both the near term and long term?"

[2] For further discussion of the role of sovereign debt in the economic and financial development of the United States and Europe, see Vitor Gaspar (2015), "The Making of a Continental Financial System: Lessons for Europe from Early American History", Journal of European Integration, Volume 37, Issue 7 (also issued as IMF Working Paper /14/183.

Unfortunately, the question of what constitutes a “safe” or “sustainable” level of government debt is quite a conundrum. Some governments have lost investor confidence and faced spiraling borrowing costs with debt to GDP at 45 percent.[3] Other governments, like Japan’s, have continued to borrow at low interest rates even after debt exceeded 200 percent of GDP.

So to answer the question “what constitutes safe debt?”, we must look beyond the level of *debt* itself. We must take the most comprehensive view we can of the overall *net worth* of the sovereign. This constitutes the ultimate measure of its ability to honor its financial obligations. This means looking beyond debt, into all public assets and liabilities, and overall gross financing needs. It means looking beyond just central government ministries and agencies, and into the myriad of enterprises, banks, and investment vehicles owned or controlled by the state.

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[3] Nazim Belhocine and Salvatore Dell’Erba (2014) “The Impact of Debt Sustainability and the Level of Debt on Emerging Markets Spreads,” IMF Working Paper WP/13/93.

Finally, it means looking not only at the value of the public sector balance sheet today, but at the risks that may affect it in the future.

Perhaps no country better illustrates the importance of taking this comprehensive perspective than Russia. Russia has one of the most extensive public sector balance sheets of any leading economy. Let me illustrate this with figures drawn from the Fiscal Transparency Evaluation, which the IMF conducted at the request of the Russian government in 2014:[4]

- Looking only at the debt of Russia's central and local governments, one sees outstanding gross debt of around 20 percent of GDP. This is a modest amount compared with other European economies today.

[4] Richard Hughes, Tom Josephs, Viera Karolova, Vladimir Krivenkov, and Gösta Ljungman (2014), "Russia: Fiscal Transparency Evaluation" IMF Country Report No. 14/ 134.

- But this narrow perspective ignores a further 285 percent of GDP in other liabilities in the form of public sector pension obligations and public-private partnership arrangements. On the asset side, it also ignores subsoil oil and gas reserves, estimated at 200 percent of GDP in 2014.

- Finally, it also ignores the approximate 100 percent of GDP in liabilities and 125 percent of GDP in assets of Russia’s over 40,000 state-controlled enterprises.

A more comprehensive view provides a fuller picture of the current financial position of the Russian state. It also serves to highlight the risks to that position over the long-term. In so doing, it poses more fundamental questions about the sustainability of government policies and, ultimately, the safety of government debt.

Let me illustrate what I mean, again using Russia as an example. If we were to look at only Russia's 20 percent of GDP in general government debt, we might conclude that only minor adjustments to fiscal policy settings are required to maintain fiscal sustainability.

However, if one looks at the full balance sheet one sees a more complex picture.

- In early 2014, when oil was selling at around $100 a barrel, Russia's total public sector public sector net worth was minus 20 percent of GDP. This implies that Russia's total public sector assets, including oil and gas reserves, were 20 percent of GDP less than total public sector liabilities, including future pension costs. This appears to be a relatively healthy fiscal position.
- However, at oil prices of around $40 a barrel, a rough calculation suggests the value of Russia's subsoil assets falls to around 100 per cent of GDP, half our 2014 estimate. If this 60 percent drop in oil prices is permanent, this would imply a fall in Russia's overall public sector net worth from around minus 20 percent of GDP to minus 120 percent of GDP. This is a very significant deterioration.[5]

[5] Other items in the balance sheet would be affected by the fall in oil prices and other macroeconomic factors, such as the depreciation of the ruble, but we have not attempted to model these. It is likely that the most significant impact of oil prices would be on the value of sub-soil assets.

If current oil prices persists, Russia faces fundamental choices – whether to revisit its pension promises, to reconsider other spending items, or to significantly broaden its government revenue base beyond hydrocarbons.

The value of taking a "whole balance sheet" approach to evaluating a government's financial position is important for all natural resource exporters. We stressed this point in the IMF's October 2015 Fiscal Monitor.[6] When a government uses revenues from exhaustible resources to fund current expenditure, it reduces public assets and net wealth. When a government instead accumulates financial savings or non-financial assets, for example through public investment in economic and social areas, it can maintain overall net wealth for future generations. Liquid financial savings can also provide a buffer to help governments manage the volatility of resource revenues. Russia provides an example of this mechanism in action.

[6] IMF (2015), "The Commodities Roller Coaster: A Fiscal Framework for Uncertain Times", IMF Fiscal Monitor: October 2015.

Accumulated savings in the Reserve Fund has been used this year to finance the deficit, helping to smoothen fiscal adjustment following the drop in oil prices.

I hope I persuaded you of the case for taking a comprehensive balance sheet approach to evaluate the sustainability of government finances and the safety of government liabilities.

Let me now turn, more briefly, to my second question: "Do governments, markets, and citizens have all the information they need to assess whether public debt is safe?" The answer to this question is much simpler: "Not in most countries." The disclosure of information about governments' financial prospects is sorely wanting. Let me give you some examples drawn from a recent FAD paper on Trends in Fiscal Transparency:[7]

[7] Rachel F. Wang, Timothy C. Irwin, and Lewis K. Murara (2015), "Trends in Fiscal Transparency: Evidence from a New Database of the Coverage of Fiscal Reporting" IMF Working Paper WP/15/188.

- Fewer than 45 percent of governments produce fiscal data covering the general government, let alone the wider public sector including public enterprises.
- Less than 30 percent of governments produce balance sheets of their financial assets and liabilities. Only 15 percent of governments publish full balance sheets which also include their non-financial assets, such as land and oil, and liabilities, such as pensions.
- Only a handful of countries publish fiscal risk statements setting out the scale and likelihood of risks to their reported financial position.

If governments are to weigh the kind of complex and forward-looking decisions I have just described, they need more sophisticated information about the state of their finances. And citizens need this information to both understand the need for those decisions and hold governments to account for making them. The challenge is particularly pressing for natural resource rich countries.

The IMF has been leading the global effort to improve fiscal transparency. Our Fiscal Transparency Code and Evaluations help governments, markets, and citizens understand the information they need to make effective judgements about the public finances. They also show how much of that picture is missing in their own countries.[8] We are very grateful that the Russian authorities were one of the first countries to volunteer for a Fiscal Transparency Evaluation. In it, we found that Russia's fiscal transparency practices have improved significantly in recent years. However, important gaps remain. In particular, the evaluation stressed the need to improve disclosure about the financial activities of state-owned enterprises. It also stressed the need to provide estimates of the value of Russia's sub-soil oil and gas assets and future pension liabilities.

[8] For more information see www.imf.org/fiscaltransparency

For the reasons I have mentioned, these issues have become all the more critical for fiscal policymakers around the world today. For example, recently we have seen reporting of renewed concern around the increase in debt issued by state-owned companies in emerging markets.[9] This debt often does not appear on the government's balance sheet or in fiscal reports, despite having implicit backing from the state and constituting a source of significant risk to the fiscal position. This is why our Fiscal Transparency Code emphasizes the importance of reporting on the full public sector balance sheet and on fiscal risks.

So, does sovereign debt constitute a vice or virtue? It depends on whether current levels of government debt are safe, and on whether governments and citizens are equipped with the information they need to make this judgement. If the answer to either of those questions is "No" or even "Who knows?", then governments should approach additional borrowing with caution and take urgent and effective steps to allow better

[9] "Fears mount over rise of sovereign-backed corporate debt", Financial Times, 5th January 2016.

answers to be forthcoming. Thank you!