Research Digest

Sovereign debt—funds borrowed by national governments, often by selling bonds—is the focus of much attention these days, from policymakers and economists alike. Their concern is that governments in difficult economic straits will default on their sovereign debt, not only harming the lender holding that debt, but potentially leading to systemic financial stress as international bond markets tighten in response.

Several recent papers by Minneapolis Fed economists examine different aspects of sovereign debt. This *Digest* discusses two of those studies.

The first paper, by Cristina Arellano, a senior research economist at the Minneapolis Fed, and Yan Bai of the University of Rochester, suggests a possible mechanism behind "debt contagion"—a historically recurrent phenomenon in which several nations default on their sovereign bonds at about the same time. Arellano and Bai's explanation hinges on the idea that nations interact strategically in international debt markets because they borrow from the same set of lenders. Default spreads from one country to another, the economists argue, because the first country's default tightens current bond prices faced by other nations and also lowers the debt repayment rates that lenders will then accept.

How should national governments best manage their sovereign debt when faced with financial stress (so that default might be avoided)? In the second paper discussed here, Minneapolis Fed economist Manuel Amador and Princeton University's Mark Aguiar propose that nations should "go short"—shift the composition of their bond portfolios toward short-term debt by actively engaging in short-term debt markets (despite the potential risk of facing higher interest rates for new short-term debt as they pay off the old), but managing long-term bonds passively: Pay them off only as they come due, not before.

The key idea is that long-term bond prices depend on future fiscal trajectories that governments cannot credibly commit to when issuing them. Therefore, pricing in debt markets will consistently move against long-term bonds, they contend, and governments would always have to sell them at low prices and buy high. Not optimal. Shortening the "maturity composition" of the sovereign debt portfolio is therefore the best strategy.