The sovereign default situation is very different because there is no legal framework that governs such debt and specifies creditor rights.[[1](http://dallasfed.org/research/eclett/2010/el1009.html" \l "1)] Therefore, a government will repay its debt only if it faces negative consequences for defaulting. Those costs include the possibility that a government will be unable to borrow in the future. Argentina, for example, defaulted in 2001 and still hasn’t fully regained access to international financial markets. Other costs may include disruption to international trade flows because such transactions require financing that may be cut off. Sovereign debt repayment depends more on avoiding these default costs and is less linked to solvency per se.

**Higher Interest Rate Cost**  
The incentives for governments to stay current on what they owe are hard to measure, but financial market indicators provide a way to gauge investors’ perceptions of the willingness to repay debt. International investors became reluctant to lend to the troubled European governments, especially Greece, as indicated by interest rates on government borrowing. In particular, interest rate spreads for these countries’ debt relative to safer German issuance rose dramatically. Chart 3 shows 10-year bond spreads—the difference between the interest rate on each country’s 10-year bond minus the rate on Germany’s relatively safe 10-year obligations. Movements in these spreads in recent months show that international investors required a much higher rate of return to buy each country’s debt.

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| [Chart 3: Interest Rate Spreads Spike](javascript:popUp('el1009c3.html','640','640')) [zoomClick to enlarge](javascript:popUp('el1009c3.html','640','640')) |

Suppose investors can buy a German bond at an annual interest rate of 4 percent with practically no risk, or a Greek bond that has a 3 percent chance of default. Investors will go with the German bond unless the Greek government offers an interest rate around 7 percent—a spread of about 3 percent—to cover the probability of default. Such a relationship can’t be expected to hold exactly in the data, but interest rate spreads can still be used to learn about the likelihood of default.[[2](http://dallasfed.org/research/eclett/2010/el1009.html#n2)] Chart 3 shows that in May 2010, investors’ perceived risk of default increased drastically for Greece and rose by a lesser degree for the other four countries.

**Crafting Aid Packages**  
In this context, what is an effective response to such debt crises? European policymakers have announced various aid measures—for example, loans at below-market interest rates—for Greece and other troubled governments. With high debts and deficits, these governments must continue borrowing to fund expenses and make debt payments; wide interest rate spreads make that difficult.

Policies such as subsidized loans make governments feel richer and thus more willing to pay debt service than face the costs of default. More generally, policy measures aimed at preventing sovereign default ultimately need to raise incentives to repay debt, either by making the payment of debt less costly or by raising default costs