

The legal basis of sovereign debt

Q 1-01. What establishes the legal status of sovereign debt?

An appropriate legal framework is necessary to establish the authority of the state to borrow money and to commit the nation to honoring its payment obligations. In many cases, that framework will be derived or based on the state's constitution¹ or it may be a state law that draws its authority from the constitution. In either case, the legal status of sovereign debt² is derived from the legitimacy of the authority under which the debt issue occurred.

Given that the authority of the state to borrow has been established thus, other laws that constitute the framework may include those that pertain to the debt issuance entities directly. These laws may set out limits to the actions of those entities or may require particular standards of compliance of those entities. Additionally, laws and regulations may be enacted or adopted to establish the process for issuing government securities, but these are of secondary importance.

An important distinction must be made at this point. Sovereign debt needs an accommodative legal environment of laws and rules that bear on the issuance, servicing, and maintenance of government securities. Further, such an environment includes the rules that govern market participants and transactions that may involve sovereign debt. The legal status of sovereign debt, however, is derived neither from the laws that affect the securities after issue, nor from the market place. While property laws and commercial practices will certainly affect the way in which transactions in debt instruments will be conducted, these issues affect that debt, but not its legal status.

Q 1-01.01. What is the source authority for issuing sovereign debt?

Sovereign debt imposes an obligation of the greatest consequence upon the state. It would be ideal for both the power of the state to issue debt and the legal status of that debt to be established explicitly in the constitution. As the fundamental document underlying the government of the nation and because it addresses many questions outside the narrow scope of sovereign debt, however, it is unlikely to be amended to suit the needs of a sovereign debt market. That basic authority should

¹ In this text, the constitution is understood as a written document that sets out how the sovereign powers of the state are distributed. As such, it is the primary document defining the roles and responsibilities of the various organs of government.

² Sovereign debt refers to securities issued by the state in both external and domestic markets and in foreign or national currencies and for any stated purpose.

then be implemented by the enactment of a governing national law that, in many cases, is the state debt law.

Although the foundation of the legal framework should be the constitution and the debt law, in an imperfect world, the constitution and laws of many countries do not provide such authority, or do so ambiguously. As constitutions are difficult to amend, and legislatures are reluctant to enact comprehensive debt laws, the need for a “rule of law” is often only tenuously satisfied.

Q 1-01.02. What distinguishes sovereign debt from other debt?

The fact that the state debt law is derived from a Constitutional authority to borrow and that that legal basis allows the commitment of the full resources of the state to satisfaction of such indebtedness gives sovereign debt a status that other debt cannot achieve.