INDEBTED WORLD AND KNOWLEDGE FOR THE FUTURE

RICHARD POSPISIL
Associate Professor, Ph.D.
Moravian University College Olomouc
Kosmonautu 1, Olomouc
CZECH REPUBLIC
richard.pospisil@mvso.cz

Abstract: - For more than a decade, the amount of public debt is one of the biggest problem in advanced economies. Level of public debt is not only the very one indicator of the risk of national bankruptcy, even though it is the most important indicator. Solution of debt service in indebted economies basically consists of two possible options. The first option is the way of saving of all kinds of expenses, with the exception of investments, the other option is to support economic growth with a positive impact on the relative level of public debt. At the same time it shows that bankruptcies of national economies happen in clusters and linked adjacent to each other due to financial market integration. The aim of this article is to show possible ways of solution of consequences of financial crisis and he high debt levels of advanced economies.

Keywords: debt, deficit, GDP.

JEL Code: H 63, H 68.

1. Introduction

For nearly one decade the whole world is suffering from the overhang of debt and deficit. Discussions are currently taking place in Europe about restructuring Greece's massive state debt, which has risen sharply since 2008. Greece is only one example of a growing number of countries whose debt levels are considered by many to be unsustainable. The most significant cause for the high level of indebtedness for a number of countries was the bursting of the financial bubbles that emerged in the early 2000s, leaving the taxpayer responsible for bailing out the financial institutions which had made multi-billion losses. In other cases, debt has been a long-standing issue, rooted in a colonial past or the exorbitant interest rates on debt repayments. Still other countries have had persistent problems with declining economic growth over many years (Smith, 2015).

Since 2008, when the crises began, public debt in OECD countries (federal, national and local) has risen up by 35 percentage points of total economic output (McKinsey, 2015). In many advanced economies it has risen by much more: 47 points in Italy, 50 points in United Kingdom, 83 points in Portugal. Debt had been gradually building in Italy over several years, but the real problem hit with the economic crisis of 2008. Italy's economy has never recovered since, with it being the only country in the G7 not to have returned to output levels prior to the crisis. Currently, its output is 9 percent below 2008 levels and its total debt is approximately 130 percent of economic output. Portugal was the second country to receive a bailout from the EU and IMF after its financial sector, much like Greece's, faced immanent collapse. By 2013, its debt rose to 129 percent of economic output. The country's mounting difficulties contributed to the risks facing the euro, which was in danger of collapsing in 2012 and has still not been stabilized today.

Greece is only one example of a growing number of countries whose debt levels are considered by many to be unsustainable. The most significant cause for the high level of indebtedness for a number of countries was the bursting of the financial bubbles that emerged in the early 2000s, leaving the taxpayer responsible for bailing out the financial institutions which had made multi-billion losses. In other cases, debt has been a long-standing issue, rooted in a colonial past or the exorbitant interest rates on debt repayments. Still other countries have had persistent problems with declining economic growth over many years.

The after effects of the 2008 economic crisis were responsible for Ireland's massive expansion of state debt, which prior to that, had been comparatively low. The crisis resulted in the virtual collapse of the country's financial system, an outcome that was prevented only by a multi-billion bank bailout organised by the

government. This meant that by 2012, debt to GDP stood at 118 percent. Since then, the figure is widely estimated to have risen above 120 percent, with the economy continuing to contract until last year and then only slowly returning to growth.

The debt-to-GDP ratio is a measure of a country's debt compared to its economic output. When a country's economy slows, government will frequently borrow to meet its obligations or to stimulate its economy. If the former is the reason, it can be said that the government had very little cushion in its cash flow and the slow economy has reduced tax revenue making it necessary for the government to borrow. If the government is borrowing to stimulate its economy, for example, to create work programs for the unemployed, then it hopes that this will shorten the duration and severity of the economic downturn. In any event, excess government borrowing for whatever reason, has to be repaid and that's where this ratio is useful (Patton, 2014).

A country can dispose such frightening debt several ways. First way is savings and austerity and second economic growth with low interest rates. Often used are more radical steps of restructuring debt by reducing interest, prolonging the maturity or slashing the amount owed. Around the world are many countries with very toxic combinations of high debt and low growth (Lund, 2014). And high federal debt puts the United States at risk for a number of harmful economic consequences, including slower economic growth, a weakened ability to respond to unexpected challenges, and possibly a debt-driven financial crisis.

2. Cluster defaults

Country defaults tend to come in clusters (Reinhart and Rogoff, 2009). In the 1930s, the Great Depression hurled defaults throughout Europe and Latin America. In 1980s, commodity prices hurled a wave of defaults by emerging economies that had borrowed heavily from Western banks. Single defaults this time around the world are rare. They include Greece, Cyprus and Argentina (Argentina linked to its prior-decade restructuring). Argentina's economy is in its second recession in as many years. The last one occurred in 2012 and was slightly worse than the current downturn. Although the country has an abundance of natural resources and a well educated population, it relies heavily on exports. Hence, with the global economy struggling, Argentina has found it difficult to sustain economic growth. As the third largest South American country by population, Argentina's economy is saddled with an inflation rate some believe to be as high as 25%, though the official rate is 10.9%. Its labor market is also weakening with a current unemployment rate of 7.1%, up from 6.4% one month ago. However, as evidenced by the chart below, even at 7.1%, it's well near the low end of the range since 2002 when it exceeded 20% (Patton, 2014).

For another example, Ukraine is now seeking to restructure its debt to private investors, as is Puerto Rico. Opposition politicians in Ireland, Portugal and Italy have in the past pressed to restructure some of those countries´ debts, which stood last year at 115 %, 129 % and 133 % of GDP, respectively (Mc Kinsey, 2015). The trend of development of Debt to GDP from 2004-2014 shows sheet 1 (Patton, 2014).

Debt-to-GDP Ratio 10 Year Trend		
Country	2004	2014
Japan	165.5	227.2
Greece	98.6	175.1
Italy	103.9	132.6
Portugal	57.6	129.0
Singapore	98.0	105.5
United States	62.7	101.5
Belgium	94.2	101.5

We can see, that actually, Japan, Greece, Italy and Portugal are in much worse shape than the U.S. despite our $17.6 trillion debt. Lower interest rates have been the trend since 2008. Considering all of the countries listed on the chart, the U.S. has the highest short-term government interest rate at 0.25%. Singapore's

rate is 0.17%, the four European nations are at 0.05%, and Japan is at 0.00%. That's correct, Japanese short-term government debt is paying zero.

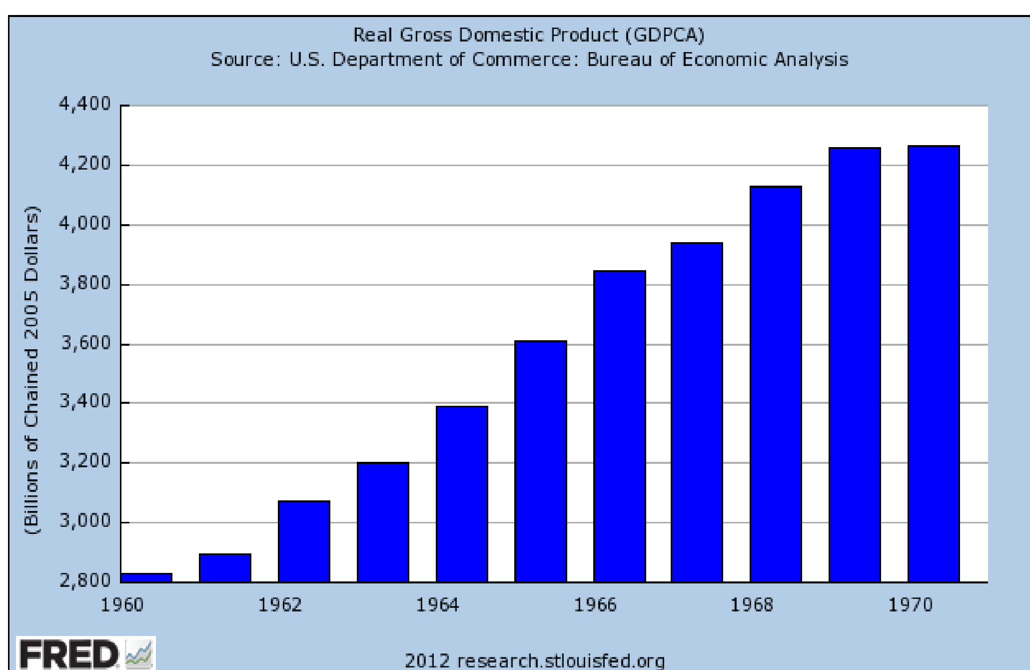
Countries that have borrowed in their own currency, such as USA, Japan and United Kingdom, need never default, since they can, if needed, print their own money-currency. Nonetheless, these countries must still find some other way to slash down their debts. Japan leads the way in terms of its debt to GDP ratio, which was 226 percent in 2013. Since the early 1990s, the world's third largest economy has experienced almost continuous stagnation. More recently, policies pursued by the government to resolve the crisis have tended to push debt levels even higher. These include moves by the country's central bank to print more money in a quantitative easing program similar to that adopted in the United States. In part as a result of this policy, the currency dropped by 18 percent in 2013. The debt rate is still showing no sign of declining.

3. GDP growth or economy drive

The less painful way is – by far – through economic growth. An expanding economy automatically reduces the ratio of debt to the whole of economy and generates tax revenue to shrink deficits. Economic growth has been key to the deleveraging in the past – from the USA after World War II (when entire debt had reached 121 % of GDP) to Sweden and Canada in the 1990s and 2000s. Canada is avoiding many of economic headaches that have plagued other nations. Fiscally conservative leadership combined with robust regulations have kept Canadian banks from melting down during the crisis that crippled many American and European firms. Those factors, combined with low public debt levels, allowed a nimble response to the crisis from the Canadian government. So Canadian economy is relatively stable: with unemployment rate of 7,3 % and projected federal budget deficit of just 1,5 % of GDP.

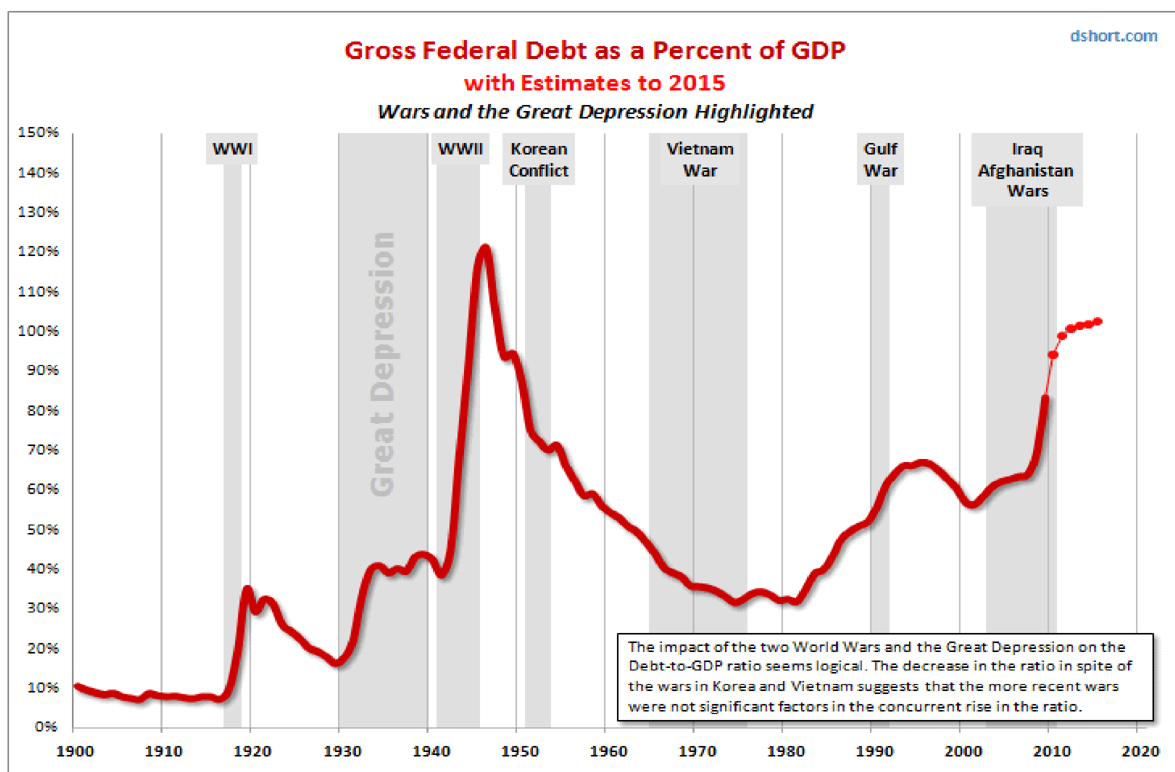
Sweden and Canada were able to compensate the pain of budget cuts by letting their currencies drop and rising export to other countries. They will not work if every country is trying to offset the pain of deleveraging by exporting more at the same time, of course.

After World War II – in 1960s – the USA underlying potential growth was supported by brisk expansion in the labor force and productivity. By contrast, potential growth around the world is now slipping. This has been an underappreciated contributor to the global debt problem. For example, one reason the International Monetary Fund is so pessimistic about Greece´s ability to pay its debts is that, given historically weak productivity and a shrinking working age population, its potential growth is likely negative. A similarly toxic combination of shrinking GDP and budget deficits has pushed Puerto Rico to the breaking point. Italy´s economy is the same size as it was in 2000. The real GDP growth in USA in 1960s shows figure 1 (Stewart, 2012).



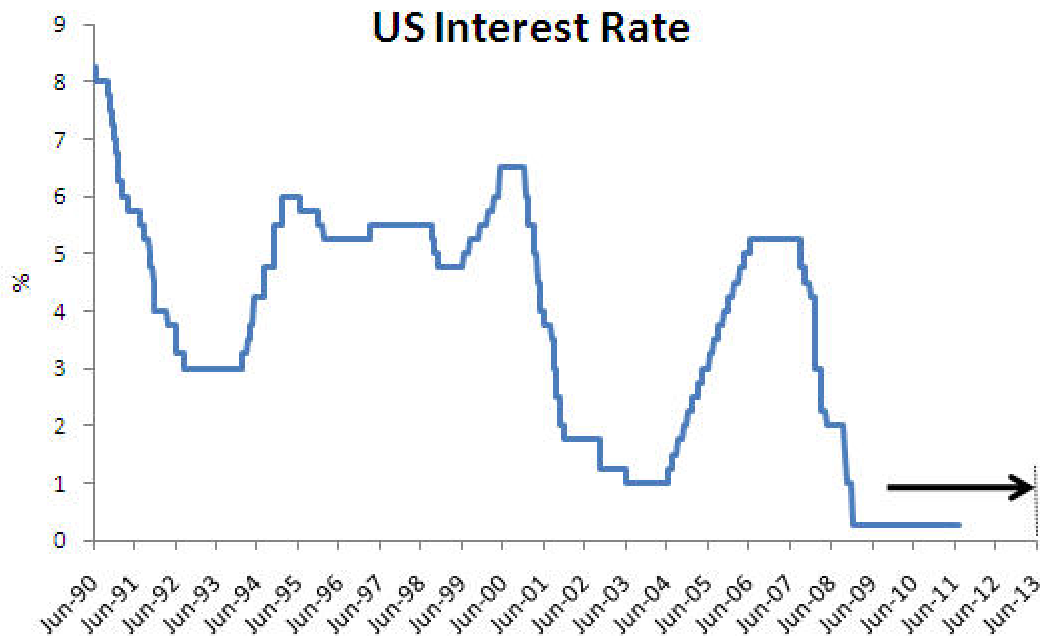
In August 2015 USA administration reduced projected GDP growth for this year, and now sees the federal debt, which it once though would fall steadily, fixed above 74 % of GDP for the coming decade. The USA economy is growing again after its first-quarter slump. Many analysts estimate it is expanding at an annual pace between 2,5 % to 3 % of GDP in the end of 2015. And meantime, the job market continues to improve, driving the unemployment rate down to 5,3 %. Declining long-term growth means more debt reduction will have to come from reduced spending or higher taxes. History has proven that lower tax rates have a stimulating effect on the economy and higher taxes have the opposite result. Although there are many detractors from this position, but again, the data has proven this over and over.

But too much austerity too soon can make matters worse by reducing GDP, and fuel a political backlash that kills the effort. By this time the federal debt may be 17.000 billion USD. This equates to about 54.000 USD per person or 149.000 USD per taxpayer. Even though the annual deficit is falling, it is still 787 billion USD, down from its 1.000 billion USD level just one year ago. The tax law changes that went into effect in USA in 2015 were mainly targeted at the highest income earners (Shirley, 2015). Of course, the expiration of the payroll tax holiday caused tax rates to rise on everyone who earns a paycheck, but the majority of the tax hikes hit the higher income earners. The more income government requires, the more taxes will have to be raised. The problem is that there are not enough “high income earners” to satisfy today’s debt and deficits. This means that middle income will soon be in the scope of the lawmakers. As mentioned before, a government can over-tax the rich until they are no longer rich. However, the rich will take measures to avoid this, and they can certainly afford to do so. Because the poor have nothing to tax, the middle class will be forced to ante up. The development of debt federal USA debt to GDP during last 100 years shows figure 2 (Short, 2010).



The GDP growth leaves one other tool to reduce debt ratios. If central banks can keep real interest rates low, or even negative, then even debts over 200 % of GDP can be sustained indefinitely. While this might raise inflation, that would be welcome, as inflation is currently too low and higher inflation would – by raising the nominal value of GDP – cut the debt ratio. Despite two years of solid growth and falling unemployment, inflation has fallen. Financial market forecasts for the timing of the first increase in interest rates have been consistently pushed back, while predictions of the eventual peak in rates have been lowered. This works with one or two exceptions, it has only been during and immediately after wars that inflation has risen to high levels in developed western economies. For the rest of the time, competition tends to keep prices under control. And

labor markets have been operating under intensely competitive conditions. Workers in countries such as the UK have been threatened with their jobs being off-shored, have seen the pool of labor increased by the arrival of skilled immigrant labor, and have seen trade union power reduced. A US interest rate rise has been a long time coming. The last time the Fed pushed up the cost of borrowing was in 2006, so it can hardly be accused of being trigger happy. Having waited this long, however, it is going to conclude that there is no harm done in waiting a little longer (Elliott, 2014). The interest rates in USA given by Fed are shown in figure 3 (Smith, 2013).



Savers, of course, must be sure to accept such paltry results. After World War II, capital controls and other forms of financial repression gave savers little alternatives. Nowadays this is more likely to come in the guise of prudential regulations that require banks and pension funds to hold more government debt (Reinhart and Reinhart, 2015).

The good news then is that there is a way out of today´s crushing debts other than default. It will take some combination of growth, austerity, and for savers punitively low interest rates. And it can take 40 years (Lund, 2015).

4. Conclusion

What does all this mean? Whatever this data pretends, it's clear that governments are continuing to acquire debt. If these governments have been attempting to stimulate economic growth with government spending, then perhaps we'll see the fruits of this in the near future. However, if they have been incurring debt to meet obligations and if economic growth doesn't return soon, we could see a global shock as countries fail to meet debt obligations. In essence, this could be a ticking time bomb or a slow path to recovery. Only time will tell.

Demographic and economic factors will combine to drive spending in social and medical care. The major entitlements and interest on the debt will devour all tax revenues in less than one generation. Lawmakers should reform entitlement programs - to eliminate waste, duplication, and inappropriate spending, to privatize functions better left to the private sector and to leave areas best managed on the local level to states and localities. Cutting unnecessary government spending will set free the people to create jobs, wealth, and prosperity for families and future generations.

There is a strong need to growth-oriented tax reform. There is a growing consensus that a simpler, flatter tax code - one with fewer, lower marginal rates and only essential deductions - is one of the best ways to promote growth. Heritage favors an even bolder approach with a single rate on spent income. In any case, as long as government must tax, it should do so with the least possible burden on and interference with free-

market choices. Higher taxes on small businesses and on investment capital always weaken the economy. Revenue will grow when the economy grows, but higher spending and taxes will reduce growth. The most effective way to spur economic recovery is to increase the incentives that drive growth.

Another possible step to solve these problems is to transfer the entitlements to local governments. Most highways, education and economic development programs should be devolved to state and local governments, which have the flexibility to tailor local programs to local needs. Government ownership of business also crowds out private companies and encourages protected entities to take unnecessary risks. After hopeful profits, government-owned businesses frequently lose billions of dollars, leaving taxpayers to foot the bill.

Another possible or necessary part of solutions is financial advising and higher level of financial literacy. Free Internet and on-line for the poorer will help build population's education level for jobs and so on. Libraries can be built in smaller towns to give people something to do. It will reduce crime, and other problems.

References:

[1] Elliott, L. (2014). U.S. interest rates are going nowhere. Available on-line at: http://www.theguardian.com/business/2015/aug/26/us-interest-rates-are-going-nowhere-fast-despite-upbeat-news-at-home

[2] Lund, S. (2015). Debt and (not much) deleveraging. Insight and Publications, Mc Kinsey.

[3] Mc Kinsey. (2015). Big data: The next frontier for innovation, competition and productivity. Available on-line at: http://www.mckinsey.com/insights/business_technology/big_data_the_next_frontier_for_innovation

[4] Patton, M. (2014). The Seven Most Indebted Nations. Available on-line at: http://www.forbes.com/sites/mikepatton/2014/09/29/the-seven-most-indebted-nations/

[5] Reinhart, C., Reinhart, V. (2015). Financial Crises, Development and Growth: A long-term perspective. World Bank Economic Review, Vol. 29 (1), 1-24.

[6] Reinhart, C., Rogoff, K. (2009). The time is different: eight centurie of financial folly. Harvard University Press.

[7] Shirley, J. (2015). EU/USA National Debt Solutions and Other Economic. Available on-line at: https://www.linkedin.com/pulse/euusa-national-debt-solutions-other-economic-jack-shirley-mba

[8] Short, D. (2010). Reminder: The Connection Between Tax Rates and The Deficit is Non-Existent. Available on-line at: http://www.businessinsider.com/tax-rates-deficit-doug-short-2010-8

[9] Smith, J. (2015). The Most Debet Countries in the World. Available on-line at:

[10] Smith, M. (2013). Economic Crisis and Commodities via Winston Churchill, Available on-line at: http://fuelfix.com/blog/2011/08/11/economic-crisis-and-commodities-via-winston-churchill/

[11] Stewart, H. (2012). How Keynesian Econ Works. Available on-line at: http://bonddad.blogspot.cz/2012/04/how-keynesian-econ-works.html