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PUBLIC DEBT CRISIS: ROOTS, EVOLUTION & CONSEQUENCES

JEL classification: G01

Abstract
Public debt was considered a reason of concern for many states. The problem became acute in the early ‘80s, when external debts ceased to be paid. Between 2001 and 2011, several developed countries were directly involved in external loans, because these investments could cover the bill for oil imports. The sovereign debt crisis is present not only in the European States, but in most countries experiencing high levels of indebtedness. Based on statistical data, the present paper highlights the roots, evolution and consequences of the public debt crisis in the EU, USA and Japan.

Keywords: public debt, GDP, budget deficit

1. HISTORY AND EVOLUTION OF PUBLIC DEBT

Public debt was considered a reason of concern for many states. This problem became acute in the early ‘80s, when the debt crisis spread in several countries, especially in Central and South America, which stopped paying external debts.

After a thorough examination of the events that took place worldwide since the 1960s and especially after the first oil shock, developed countries had good reasons in lending large sums to countries requesting loans, notably those from Latin America. In other words, developed countries were directly interested in giving external loans because, through this measure, they could cover the bill for oil imports. Hence, extensive work has been initiated with regards to the recycling of Eurodollars and petrodollars.

As Perkins (2006) boldly states, one notable example comes from the US: its “economic hit men” had the mission of convincing countries (important to the US from a strategic point of view) to accept enormous loans, usable for developing infrastructure and ensuring profitability for the US corporations. Ending up with staggering debts, such countries were controlled by the US and the World Bank.

Public debt managers in countries with high debt levels should be aware of all the aspects with which deeply indebted countries had to struggle, in order not to repeat the same mistakes. Errors arising from adopting inappropriate debt policies – still faced by some countries – should be taken as harsh lessons by countries that have begun acquiring loans at a very brisk pace.

Several times, a crisis which apparently did not seem to affect the global economy impacted not only the underdeveloped countries or developing economies, but also the global market. The stock market crash experience of 1929 is still vivid in the minds of many, and the large-scale effects it had generated are not that remote. Moreover, the global crisis of 1929-1933 stands behind the creation of the International Monetary Fund. Structural adjustment policies began to be implemented after the debt crisis, as a response of governments within industrialized countries and international financial institutions losing control over poor countries.

In the interval 1940-1960, with the development of Asian and African states after gaining independence, the expansion of the East European block, the triumph of the Chinese revolution, the Cuban and Algerian movements, emerging organizations generated international chaos, due to the dominance threat issued by major capitalist powers.

The sovereign debt crisis was fueled both by the decrease in prices of products exported from least developed countries (LDCs) and the increase of the interest rate. As Toussaint (2000) pointed out, indebted countries announced their difficulties in repaying private debt, banks refused to guarantee new loans and demanded the old debt to be paid. The IMF and industrialized countries granted new loans, with the aim of allowing private banks to recover money and limit bankruptcy. Moreover, the IMF and the World Bank supported structural adjustment plans imposed on indebted countries.

Great world debtors world during the Asian crisis were countries from Latin America and Africa, but also Central and Eastern Europe. The poorest and most indebted received the best treatment with respect to the repayment of foreign debt. This was known as the “Toronto improved conditions” and offered possibilities of reducing debt. Low-income countries applied “Houston conditions” and other debtor countries appealed to the “Paris Club Standard Conditions”. The latter countries have signed agreements with creditor banks, which allowed them to reduce external debt, reschedule the remaining debt, and in some cases, obtaining new loans. Countries signing such agreements were Costa Rica, Venezuela, Uruguay, Nigeria, Argentina, Jordan, Brazil, Dominican Republic, Ecuador, Panama and Peru.

The financial crisis deepened the problems of several European countries due to the monetary and financial structure of the Euro zone and the final outcome was an extreme liquidity shortage for European banks. During 2007-2008, banks from the core Euro zone countries (Germany, France, The Netherlands, Belgium) continued to lend money to peripheral countries (Greece, Ireland, Italy, Portugal, Spain, or PIIGS), totaling 1.5 trillion Euros in 2008, which exceeded three times the capital of core banks. Then, governments started defaulting on their debts. After the recovery from the global financial crisis and recession, a second wave of crises threatened: the sovereign debt crisis.

As long as there are still countries barely over public debt (especially foreign debt), the public debt problem cannot be seen as solved. With respect to this, considerable efforts were supported by lending institutions, international financial institutions and borrowers to end this global problem. Erasing public debt is extremely important for poor countries, but also for countries in which governments rejected austerity budgets, thus respecting their citizens’ will. In their view, it is necessary to give priority to human needs by abandoning structural adjustment policies, by reconstructing multiple control mechanisms and by redistributing capital.

Regarding the evolution of public debt in the period 2002-2011, it can be noticed that Germany increased its indebtedness from 504 billion Euros (2007) to nearly 862 billion Euros. France and the UK recorded similar levels. Italy increased its indebtedness by more than 600 billion Euros, half of the sum during the crisis. Greece counts debts of 200 billion, Poland and Portugal are below 100 billion. There are cases of countries where public debt grew almost exclusively since the financial crisis, namely Belgium, Finland, Ireland and the Netherlands.

One of the rules to enter the Euro zone is ensuring that the total public debt should not exceed 60% of the GDP. The sovereign debt crisis SPREAD not only to the European States, but to most countries experiencing high levels of indebtedness. The crisis is more serious within the EU because there isn't a unitary procedure to delay and mitigate such policy effects.

In counterpart, the US budget deficit was more than 10% of GDP in 2010, but it dropped almost to 6% of GDP in 2012. In Japan, the deficit rate amounted 9% of GDP in 2010 and slightly increased in the following year. The reason why US and Japan, though facing a sovereign debt crisis, do not have the same problems as EU members is that these two countries have monetary independence, i.e., when fiscal policy cannot be used, they turn to the monetary policy, printing money in order to refinance debt.

2. PUBLIC DEBT CRISIS IN ROMANIA

Developing countries, including Romania, have accumulated public debt (especially foreign debt) during the postwar period, especially in the '70s-'80s, and it has increased over time, especially since the 2007 global financial crisis started.

In the early '80s, Romania's access to foreign loans was considerably reduced. Consequently, the Minister of Finance (Gigea-Gorun, 2003, p.6) stated back then that, due to not paying loans at maturity, the country would be facing the situation of paying loans only partially. After his declaration, several deposits of the Romanian government from abroad bank accounts were fore closured by creditors, who could dispose of them as they wanted. Amid the onset of strong external debt crises worldwide, Romania ended up borrowing from foreign markets. By 1981, the volume of Romania's foreign debt reached $13.9 million, without taking into account the $6 million in interest paid. In these circumstances, the only solution for Romania was to start negotiating with the IMF, Paris and London Clubs about rescheduling its external debt.

If we refer to the volume of public debt registered by Romania in 2011, one can see it has constantly increased since the 1980s. During the whole period 2002-2011, the only year when Romania reached the minimum debt level of 3.5% of GDP was 2006. Romania's public debt has risen quite strongly since 2007. According to the Eurostat data, the debt had a level of €14763 million in 2007 and €44675 million in 2012. Like other countries across the globe, Romania has not escaped the current debt crisis.

3. PUBLIC DEBTS CRISIS IN EUROPE

Started in 2007, the financial crisis has spread within the European Union, strongly affecting economies of member states. After a timid recovery in 2010, the crisis deepened in 2011 and still continues nowadays. There are several reasons for the current situation: 1) states increased public debt, many of them in conditions of excessive liquidity and low interest rates; 2) increasing budget deficits trough various programs meant to stimulate the economy; 3) the recession forced governments to keep borrowing. According to Gust, Parpandel & Grigorescu (2012), the indebtedness level increased because markets were no longer willing to finance states. For the first time, due to indebtedness, many European governments were not able to intervene on the market by increasing budget deficits in order to combat the recession, as the public expected. Taking no action was out of the question, because it would have led to an uncontrolled decrease in the debt, generating huge job losses on the market. Blanchard and Giavazzi (2002) argued that budgetary deficits might not be a problem for the Euro zone, but they might be a problem for poorer countries which were registering an increasing consumption rate on the newly unified market.

Recently, after 10 years of experience, Obstfeld (2012) goes against the two abovementioned authors. In his opinion, countries with increasing budget deficits might also face liquidity problems, both external and internal (resulting from massive capital withdrawals by residents). Regarding the external factors generating a liquidity crisis, one of them might be the large variance in traded shares and financial derivatives. Because banks cannot recapitalize in due time, they are forced to borrow from outside the country, thus public debt.

In his article, Blundell-Wignall (2012) argues that one of the important features of the sovereign debt crisis is the extensive phenomenon of financial contagion. This phenomenon represents a serious problem for Europe, found in a poor fiscal condition due to the lack of fiscal consolidation. Thus, contagion could have a much higher expansion rate and generate the increase public debt rates.

The present study analyzes the public debt evolution of EU member states (EU27). With the EU, the uncontrolled growth of public debt is considered to be the main reason for which investors sanction European countries and maintain a climate defined by lack of confidence in the financial markets. During the financial crisis, government spending increased considerably due to the effort of stabilizing the financial system and stimulating the economy. One consequence was a sharp decrease in fiscal revenues. Higher expenses generated budget deficits or deepened existing deficits.

Table 1

Budget deficits within the EU

GEO/TIME	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
European Union	-2.6	-3.2	-2.9	-2.5	-1.5	-0.9	-2.4	-6.9	-6.5	-4.4
Belgium	-0.1	-0.1	-0.1	-2.5	0.4	-0.1	-1.0	-5.5	-3.8	-3.7
Bulgaria	-1.2	-0.4	1.9	1.0	1.9	1.2	1.7	-4.3	-3.1	-2.0
Czech Republic	-6.5	-6.7	-2.8	-3.2	-2.4	-0.7	-2.2	-5.8	-4.8	-3.3
Denmark	0.4	0.1	2.1	5.2	5.2	4.8	3.2	-2.7	-2.5	-1.8

Germany	-3.8	-4.2	-3.8	-3.3	-1.6	0.2	-0.1	-3.1	-4.1	-0.8
Estonia	0.3	1.7	1.6	1.6	2.5	2.4	-2.9	-2.0	0.2	1.1
Ireland	-0.4	0.4	1.4	1.7	2.9	0.1	-7.4	-13.9	-30.9	-13.4
Greece	-4.8	-5.6	-7.5	-5.2	-5.7	-6.5	-9.8	-15.6	-10.7	-9.4
Spain	-0.2	-0.3	-0.1	1.3	2.4	1.9	-4.5	-11.2	-9.7	-9.4
France	-3.1	-4.1	-3.6	-2.9	-2.3	-2.7	-3.3	-7.5	-7.1	-5.2
Italy	-3.1	-3.6	-3.5	-4.4	-3.4	-1.6	-2.7	-5.4	-4.5	-3.9
Cyprus	-4.4	-6.6	-4.1	-2.4	-1.2	3.5	0.9	-6.1	-5.3	-6.3
Latvia	-2.3	-1.6	-1.0	-0.4	-0.5	-0.4	-4.2	-9.8	-8.1	-3.4
Lithuania	-1.9	-1.3	-1.5	-0.5	-0.4	-1.0	-3.3	-9.4	-7.2	-5.5
Luxembourg	2.1	0.5	-1.1	0.0	1.4	3.7	3.2	-0.8	-0.8	-0.3
Hungary	-9.0	-7.3	-6.5	-7.9	-9.4	-5.1	-3.7	-4.6	-4.4	4.3
Malta	-5.8	-9.2	-4.7	-2.9	-2.8	-2.3	-4.6	-3.9	-3.6	-2.7
Netherlands	-2.1	-3.1	-1.7	-0.3	0.5	0.2	0.5	-5.6	-5.1	-4.5
Austria	-0.7	-1.5	-4.4	-1.7	-1.5	-0.9	-0.9	-4.1	-4.5	-2.5
Poland	-5.0	-6.2	-5.4	-4.1	-3.6	-1.9	-3.7	-7.4	-7.9	-5.0
Portugal	-3.4	-3.7	-4.0	-6.5	-4.6	-3.1	-3.6	-10.2	-9.8	-4.4
Romania	-2.0	-1.5	-1.2	-1.2	-2.2	-2.9	-5.7	-9.0	-6.8	-5.5
Slovenia	-2.4	-2.7	-2.3	-1.5	-1.4	0.0	-1.9	-6.0	-5.7	-6.4
Slovakia	-8.2	-2.8	-2.4	-2.8	-3.2	-1.8	-2.1	-8.0	-7.7	-4.9
Finland	4.2	2.6	2.5	2.9	4.2	5.3	4.4	-2.5	-2.5	-0.6
Sweden	-1.3	-1.0	0.6	2.2	2.3	3.6	2.2	-0.7	0.3	0.4
United Kingdom	-2.1	-3.4	-3.5	-3.4	-2.7	-2.8	-5.1	-11.5	-10.2	-7.8
Iceland	:	:	:	4.9	6.3	5.4	-13.5	-10.0	-10.1	-4.4
Norway	9.3	7.3	11.1	15.1	18.5	17.5	18.8	10.6	11.2	13.6
Croatia	-4.1	-4.5	-4.3	-4.0	-3.0	-2.5	-1.4	-4.1	:	:

Source: Eurostat

From the data presented in table 1, it can be observed that all EU members have violated the Maastricht treaty regarding budget deficit requirements in 2009-2011, namely every country registered a deficit exceeding the benchmark of 3% of GDP.

Greece, for example, registered the whole period a deficit above the 3% limit. Even after joining the EU, its budget deficit still remained 7.9% of GDP. In Ireland, during 2009-2011, the budget deficit surpassed nearly three times the limit imposed by the treaty, it reached the level of 13.9% in 2009 and sky rocketed to 30% of GDP in 2010. Regarding Spain, the deficit widened since 2008, thus reaching its most significant level of 11% of GDP in 2009. Italy has registered problems since 2009 and reached the highest level of 7% this year.

To mitigate budget deficits, EU states have reduced costs, on one hand, and increased some taxes, on the other hand. If in the period 2002-2007 the EU27 public debt registered small fluctuations around the level of 50%, since 2007 it has sharply increase by approximately 20% (figure 1).

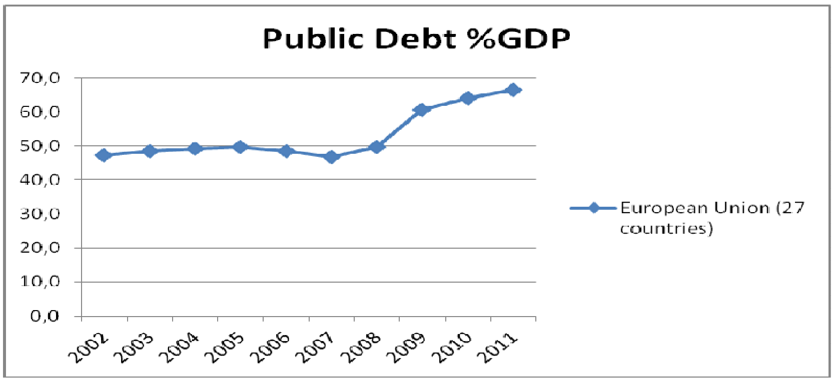

Figure 1. The evolution of EU27 public debt

Source: Based on Eurostat data

The Eurostat data unravels that the most risky countries proved to be Greece, Italy, Ireland, Spain, and Portugal. These countries have the highest investment risk, their public debt has grown rapidly in recent years and they continue to accumulate additional debt due to large budget deficits. The highest degree of leverage in the EU is towards Greece, i.e., 119.2% of GDP, followed by Italy with 101.6% of GDP.

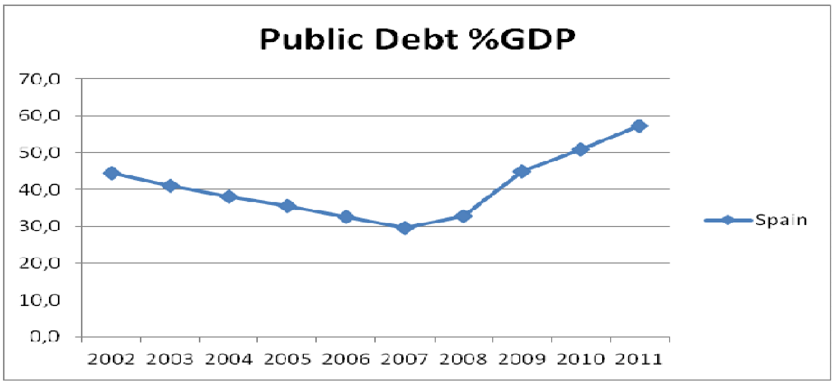

Figure 2. The evolution of Spain's public debt

Source: based on Eurostat data

As figure 2 shows, Spain registered a sharp rise in public debt from almost 29% of GDP in 2007 to around 60% of GDP in 2011.

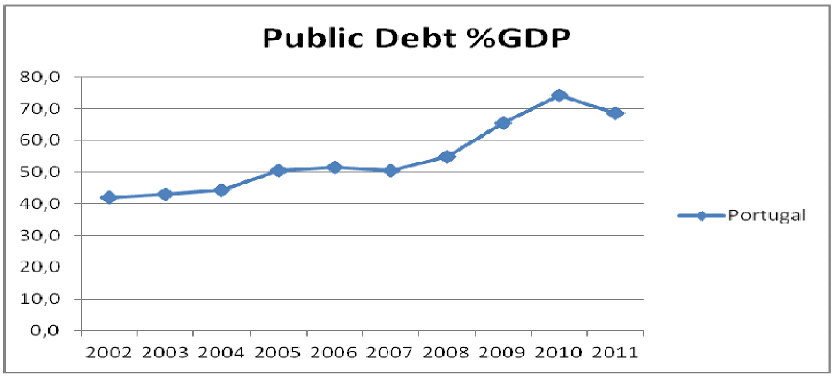

Figure 3. The evolution of Portugal’s public debt

Source: based on Eurostat data

From figure 3, one can see that, in Portugal, the maximum level of debt was registered in 2010, with about 80% of GDP, while in 2011 it slightly decreased to 70% of GDP.

More and more countries have a debt above 60% of GDP, thus increasing tension within financial markets and also investment risk. In recent years, even countries with stronger economies like Germany, France, or UK surpassed the safety limit, as shown by the following graphs.

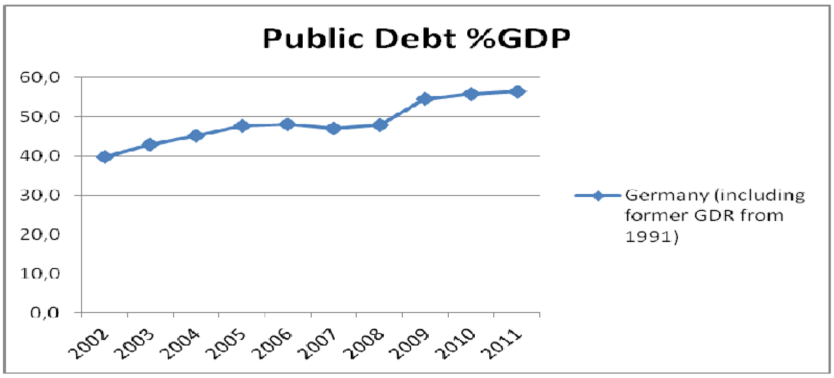

Figure 4. The evolution of Germany’s public debt

Source: based on Eurostat data

Germany is close to the maximum level of public debt under the Treaty of Maastricht, which is 60% of GDP (figure 4).

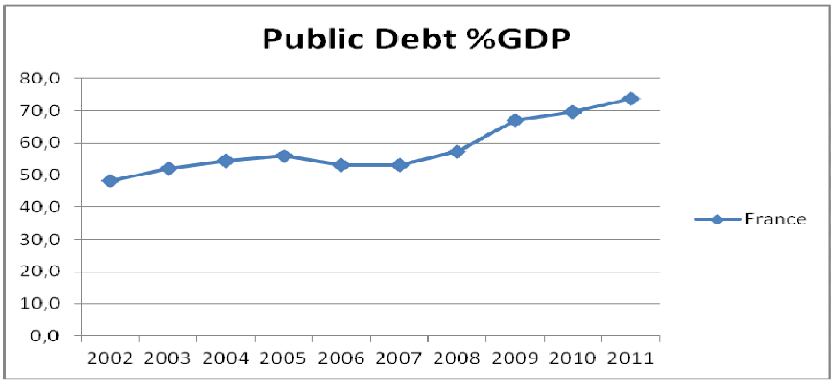

Figure 5. The evolution of France's public debt

Source: based on Eurostat data

Based on figure 5, France has exceeded the maximum level of public debt by almost 15 %.

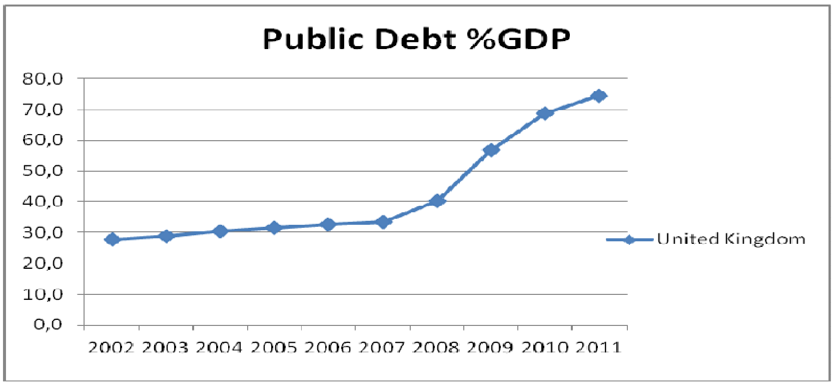

Figure 6. The evolution of UK's public debt

Source: based on Eurostat data

UK also has faced an increase in public debt, especially after the nationalization of Northern Rock bank in 2007.

Another group of countries are those with an average indebtedness level, ranging from 40% to 60% of GDP. These countries have managed to keep public debt under control: Czech Republic, Denmark, Poland, Sweden.

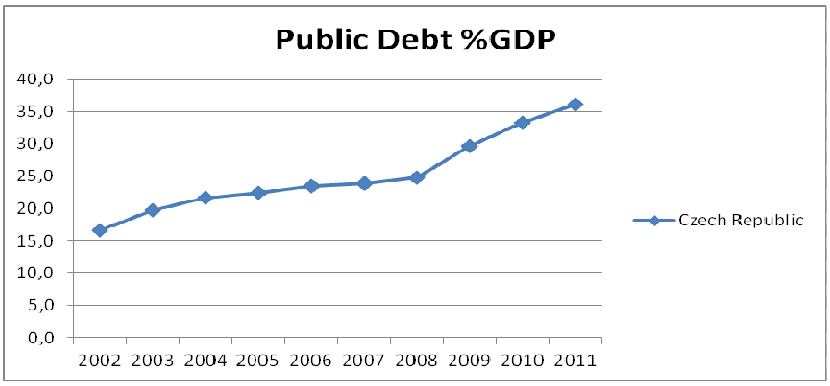

Figure 7. The evolution of Czech Republic's public debt

Source: based on Eurostat data

In Czech Republic, the level went from a minimum of 15% of GDP in 2002 to 35% of GDP in 2011. In our opinion, since 2003, the country could not be considered as having a low level of indebtedness.

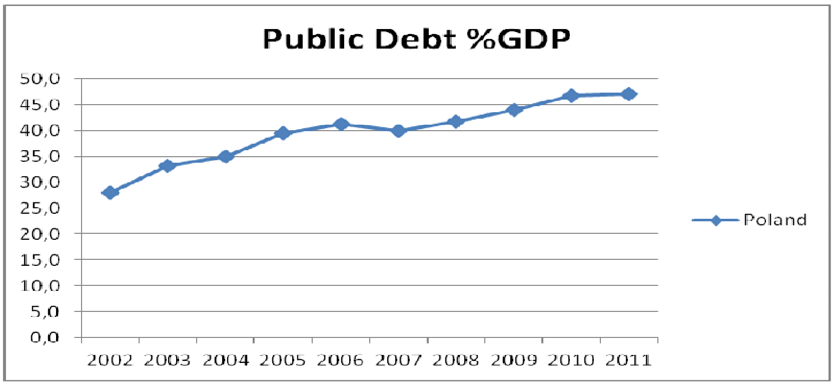

Figure 8. The evolution of Poland's public debt

Source: based on Eurostat data

As for Poland, the level of public debt remained unchanged for the last two years of study, i.e., 45% of GDP.

The least indebted countries are those with a ratio below 20% of GDP. Among them are Estonia and Luxembourg. Romania also qualifies for this category, with an average public debt.

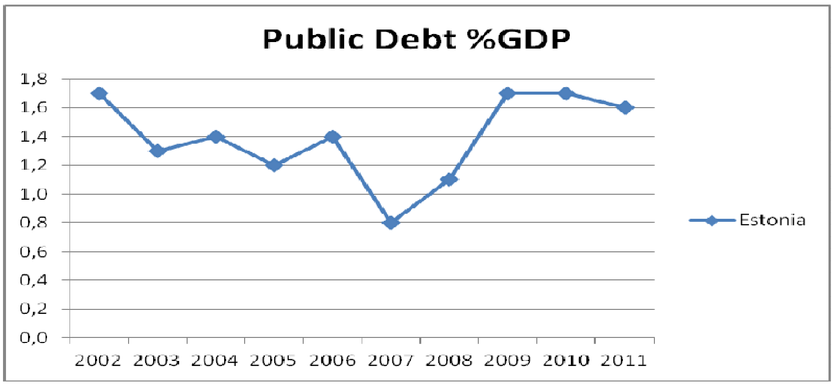

Figure 9. The evolution of Estonia's public debt

Source: based on Eurostat data

Figure 9 shows that debt rate in Estonia, though varying over the reporting period, does not exceed 18% of GDP, turning Estonia into a low gearing country.

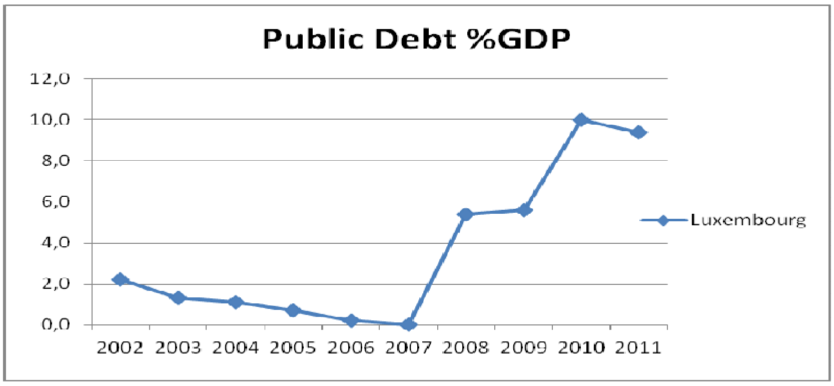

Figure 10. The evolution of Luxembourg's public debt

Source: based on Eurostat data

From figure 10, one can observe that, until 2007, Luxembourg had a very small public debt, closely to zero. The maximum level of debt was registered in 2010, with 10% of GDP.

4. CONCLUSIONS

Both debtor and creditor countries have been actively involved in searching for alternative solutions in order to solve the increasing public debt problem, especially the foreign debt issue.

Theory along with practice account that, for all governments, state loans were the only method of minimizing the effects of a financial crisis and covering extraordinary investment and consumption outlays. This method was also implemented by Romanian governments over time.

The blame for the sovereign debt crisis can be attributed to: 1) irresponsible fiscal policies implemented by some EU members, which sharply increased public debts; 2) imprudent bank lending strategies, which fueled asset bubbles and housing bubbles; 3) large-scale actions taken to save the banking sector, all funded by taxpayers; 4) fragility of the global financial system.

One of the important features of the sovereign debt crisis is the widespread phenomenon of financial contagion. This phenomenon could be defined as a situation in which financial instability of a market, an institution or a country is passed on to one or more markets, institutions and countries. A country with a poor fiscal situation can trigger contagion across countries with which it has economic ties. In the EU and moreover in the Euro zone, interconnection is stronger, therefore contagion might have a higher speed and a greater magnitude.

Throughout history, many countries poorly supervised their public debt ratio, fact which fuelled or spread crises. The uninspired structure could be attributed to: wrong maturities; interest rates; the currency in which the loan is contracted; the existence of governmental collateral.

As shown by the data presented, all EU member states have disregarded the Maastricht Treaty by exceeding, in 2009-2011, the benchmark budget deficit of 3% of GDP. To reduce budget deficits, EU member states have benefited from guidance and the aim would be achieved during the interval 2011-2014. Another treaty requirement has also been disregarded by all members, which have exceeded the maximum 60% of GDP level regarding public debt.

Any political or institutional solution given to the sovereign debt crisis should address the issue of debt reduction, without jeopardizing the objectives of the European Economic Recovery Program. One possible way of achieving this might be by combining the process of debt reduction with an increase in the investment in order to counterbalance the deflationary effects of debt reduction.

The sovereign debt crisis requires both a political and a financial solution, because it has raised concerns regarding the fairness and transparency of financial arrangements aimed at ensuring the stability of the single currency, the Euro.

If, during the banking crisis, it was often said that some banks were "too big to be allowed to fail", nowadays we refer to member states faced with rising public debt as "too important to be allowed to enter into default".

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