Subject: Governmental Debt

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1. What is governmental debt?

"I, however, place economy among the first and most important republican virtues, and public debt as the greatest of the dangers to be feared."
Thomas Jefferson - 1816

Government debt, also known as public debt, is any money or credit owed by any level of government. This includes both debt to internal creditors as well as to foreign banks or other countries. Understanding government debt is a good way to understand the economy of a nation within a global context; those countries with higher levels of government debt are often at risk for serious economical issues if recession or fiscal emergencies occur.

Government debt is made up of debt by the government in local and national level. These debts can be in many forms, such as direct loans that must be paid or promises of services/ goods that have to be satisfied. A high level of government debt is often considered an economic precursor, but it depends very much on the type of debt owed to the state and the current economic trends in the country.

Government debt created by the central government is often known as external debt. This includes money, services, or goods owed to other governments, international organizations like the World Bank or other financial institutions. Most countries in the world that hold a significant amount of external debt could create global economic problems. In cases where the acquisition of external government debt is inevitable, governments and international organizations often work together to create a sustainable solution in order to prevent damage to the entire economic spectrum..

Risks and disadvantages of external debt are certainly known. This debt may turn out to be very expensive for the country, if it is raised in the wrong currency, and even more expensive on the budget, if the domestic currency must be depreciated. The exchange rate is difficult to calculate and not so easy to predict for an extended period. Foreign credits require special expertise, computer systems and communication networks, which are expensive and tend to become quickly outdated.

Internal debt is another important component of the governmental debt. This refers to any currency or debt service for individuals, businesses, or financial institutions in the country. Internal debts are often created by the municipality or municipal governments, as they generally have no power to negotiate with other countries. Internal debt may include bonds and securities, which are issued to investors with a guaranteed return at maturity, in order to increase government revenues in the short term.

Meanwhile, sovereign debt usually refers to government debt issued in foreign currency.

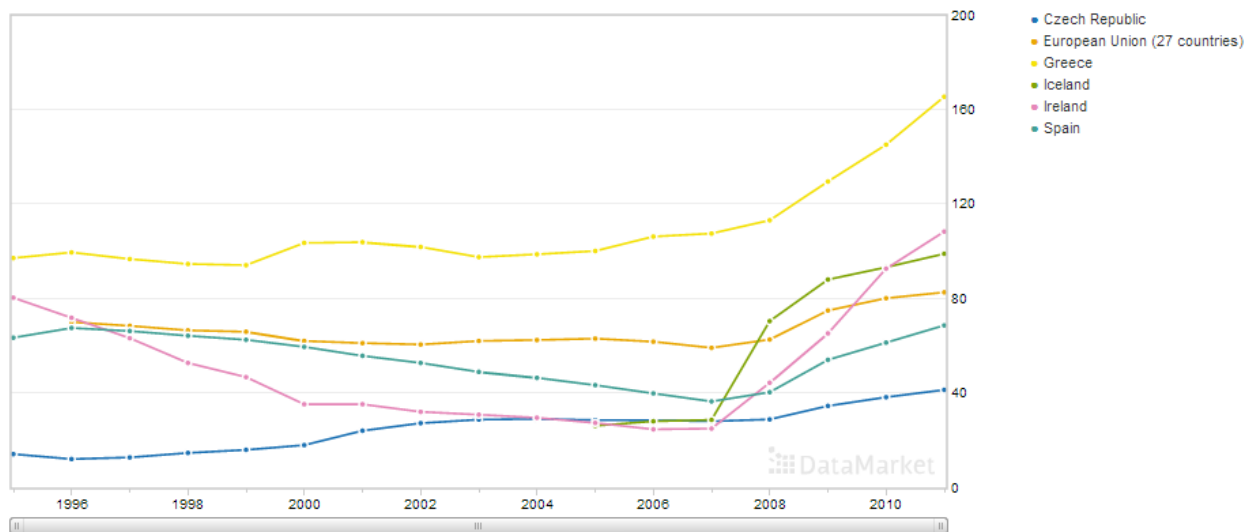
Both debts, both internally and externally can be created on the basis of short or long-term. Short-term governmental debt should be paid over a period of several months or several years, while long-term debt may be decades before it's settlement starts. Separation between short-and long-term

debt is important when it measuring a country's debt sustainability: a nation may even be able to pay its current credits, but seems to be in serious financial difficulties, when considered also all long-term debt of that country.

1.1. How to measure the percentage of governmental debt?

- General government gross debt (% of GDP)

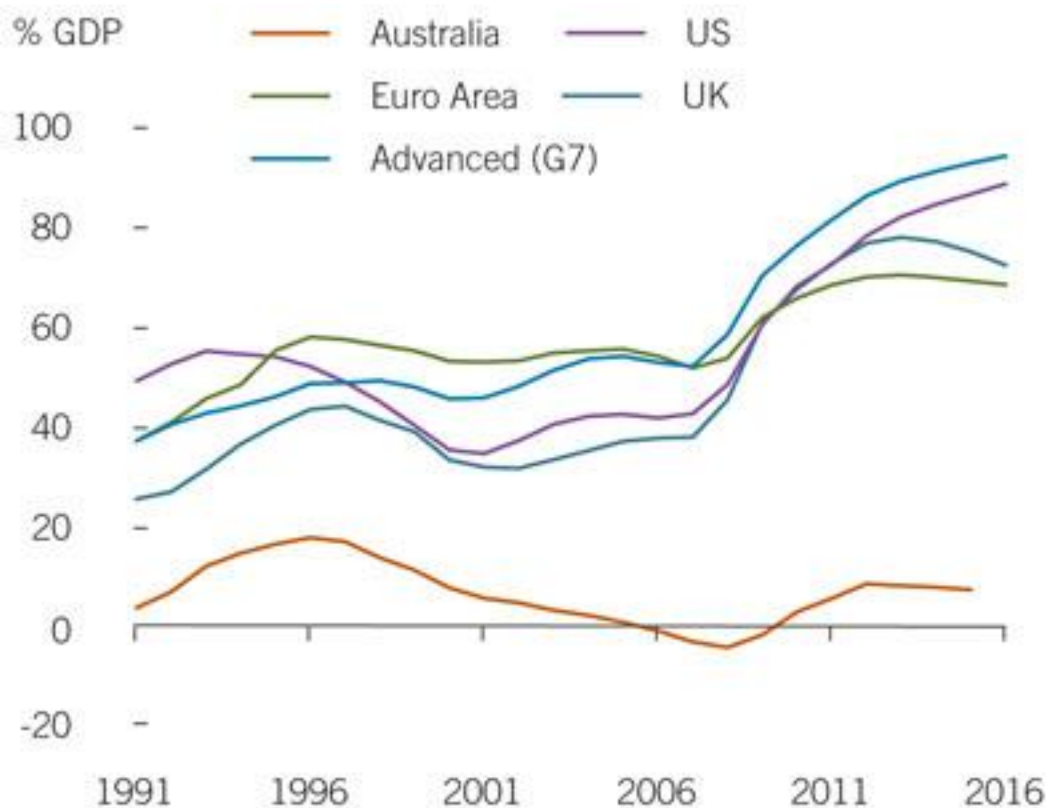
Gross debt consists of all liabilities that require payment or payments of interest and / or principal by the debtor to the creditor at a date or dates in the future. This includes debt liabilities in the form of SDR currency and deposits, debt securities, loans, insurance, pensions and standardized guaranteed schemes, and other accounts payable. Thus, all liabilities in the GFSM 2001 system are debt, except for equity, investment fund shares, financial derivatives and employee options. Debt can be evaluated in the current market, in nominal or market value. (GFSM 2001, paragraph 7.110).



- General government net debt (% of GDP)

Net debt is calculated as gross debt minus financial assets corresponding to debt instruments. These financial assets are: monetary gold and SDRs, currency and deposits, debt securities, loans, insurance, pension, and standardized guarantee schemes, and other accounts receivable.

The difference between gross debt and net debt is very large for some countries. Indeed, some analysts believe that net debt is a more appropriate measure of the debt situation of a particular country. However, since not all governments include the same type of financial assets in their calculations, the definition of net debt varies from country to country and makes country-to-country comparisons difficult. Therefore, gross debt as a percentage of GDP is the most commonly used government debt ratio and is the way that the OECD measures debt.



Many people do not realize that government debt is indirectly the responsibility of the citizens. In fact, the public pays for most debt incurred through taxes or by purchasing government-issued securities and bonds. A government bond is generally considered an excellent investment, thanks to favorable interest rates and a low rate of risk. By buying bonds, the public is funding the repayment of government debt, whether national or municipal.

There are many reasons that a government might incur debt. Some of the oldest examples of government debt date back to the plentiful wars between England and France in the Middle Ages. War is often a reason for increased government debt, but nowadays expansion and ensuring he well-being of citizens are even more common reasons.

Whether or not taking on government debt is a good idea is a matter of great debate among economists. In classical Keynesian theory, a certain amount of debt is acceptable so long as it is used to stimulate the national economy. Other theories suggest that a country should not grow faster than its resources allow, and advice against incurring government debt.

Many agree that there is considerable danger if public debt becomes overwhelming. In critical situations, governments have defaulted on debt or refused to take over payments after a governmental overthrow. The fallout of the 2008 global financial crisis has brought government debt problems into stark relief, particularly in the country of Greece. Enormous levels of public debt combined with an uncompetitive market, falling gross domestic product (GDP) and an inability to devalue their currency have put this once prosperous nation on the brink of bankruptcy.

The amount of public debt for a country is typically measured by the ratio of debt to GDP. The European Union declared in the formation of the Eurozone that a country could not become a member of the zone unless it maintained a public debt under 60% of its GDP. According to 2009 statistics, Greece maintained a debt to GDP ratio of 113.4%, the United States had 52.9%, and Mozambique had the least public debt with a ratio of 3.7%.

It is important to remember that regional and local governments are capable of incurring public debt as well. Though generally on a smaller scale, this type of public debt can still have large ripple effects on a nation's economy. If a city or state government cannot pay its debt, the national government may have to bail them out, leading to additional government spending on a national level.

If a nation defaults on public debt, billions or even trillions of dollars may be at stake. For this reason, intergovernmental agencies such as the International Monetary Fund have been established to help recognize growing potential for default and help prevent this from occurring. These agencies attempt to help countries lower public debt to help promote a healthy economy capable of paying all debts.

2. Effects of Governmental Debt

One factor in determining the economic position of a country is through a comparison of public debt to the gross domestic product (GDP) of the country. This comparison is often listed as a percentage of how much of the GDP it would take to pay off the public debt. A low public debt and GDP percentage is usually an indication of economic health, while a high public debt and GDP percentage can indicate financial trouble for a country.

Problems occur when a nation continues to borrow funds and total national debt becomes a larger portion of GDP. With more funds required for debt repayment, less money is available to pay current operating costs. A government may also begin overtaxing the private sector, which is the primary source for government tax revenues. Increased taxes typically slow down the natural growth that occurs in the private sector. Therefore, debt will stay steady or slowly increase as fewer funds come from taxes, creating a vicious cycle of borrowing and spending.

The debt-to-GDP ratio is also a crucial solvency measure in a nation. When a nation's debt is higher than its GDP, it could be said that the nation is slowly becoming insolvent. In short, it no longer has the income to pay all its bills, including debt. Proper debt management is necessary to prevent this from happening. Reduced spending and reductions in debt use are common measures to prevent this problem.

Although the ratio between government debt and GDP is important, this is not used by the nations as a means to pay their debts annually, because most of the debt is paid after a few years and also this debt may be changed or new debts could be added, for this reason, this report serves more to show the state economic prosperity of a country.

There is also a theory in determining the relationship between government debt and a country's economy that is the "Ricardian Equivalence" according to the economist who first discussed this issue, David Ricardo. Consequently, Ricardian equivalence suggests that it does not matter whether a government finances its spending with debt or tax increase, because the effect on the total level of demand in the economy is the same. Thus people may feel richer when the debt is received but poorer in the future when they have to pay higher taxes because of the governmental debt. So, the choice is tax now or tax later.

Consequently, a portion of taxes assessed and received by governments is used in paying off the public debt. This can have a damaging impact on the long-term growth of a country with high debt, as the government has to commit a significant portion of its resources to paying the interests on debt, instead of investing in schools, healthcare, infrastructure and other areas that could facilitate longer-term growth.

In general, government debt is used to facilitate deficit, but when these debts are continuously added they plague the economy of a country. As a result you have increased taxes which are followed by decreased consumption by the citizens that brings us to reduce production, thus increase in prices.

3. Governmental debt in different countries

As we have seen from this topic above the governmental debt is a issue with high impact in one's economy because it reflects changes in the way and quality of its citizens life's. The topic on governmental debt has been very discussed especially because of the Europe crisis during the last years, an effect of governmental debt that spread within the Europe countries.

The spreading of the effect of governmental debt was helped because of the introduction of Euro or to say the formation of the Eurozone. By this step poorer countries like Greece, Portugal, Spain, Italia could cover its deficits by borrowing money for other countries with the same low interest such as richer countries like Germany, even though their inflation rate was higher. But as this borrowing of money got out of hand, it led to major debt accumulation in countries like Greece, Portugal, Spain, Italy and Ireland. Therefore, these countries, named also as the "shaky five" owe money to the banks all over Europe.

Another contributing factor to the increased debt was the decrease in tax revenues. So the economies had to collect their money needed to overcome deficit through different ways of loans.

A list of what amounts owe the "Shaky five" countries to:

- Greece owes the banks of Ireland, Italy, Spain and Portugal about US $100 billion. But it owes the banks of Germany, France and Britain another US $150 billion.
- Ireland owes the banks of Shaky Club US $450 billion. But it owes the banks of Germany, France and Britain another US $400 billion.
- Italy owes the banks of Shaky Club US $600 billion. But it owes the banks of Germany, France and Britain another US $800 billion.
- Spain owes the banks of Shaky Club US $600 billion. But it owes the banks of Germany, France and Britain another US $500 billion.
- Portugal owes the banks of Shaky Club US $100 billion. But it owes the banks of Germany, France and Britain another US $200 billion.

That's about $4 trillion for the Shaky Club (alone). Even the world's financier, the International Monetary Fund (IMF), can't touch a bail out of that size. (Ed DeShields, "Shaky Five" 4 Oct-2011)

As per the EU statistics agency Eurostat the total accumulated national debt in the 17 Eurozone nations increased to 90 per cent of Gross Domestic Product (GDP) in the second quarter (2012), up from 88.2 per cent in the first three months of the year.

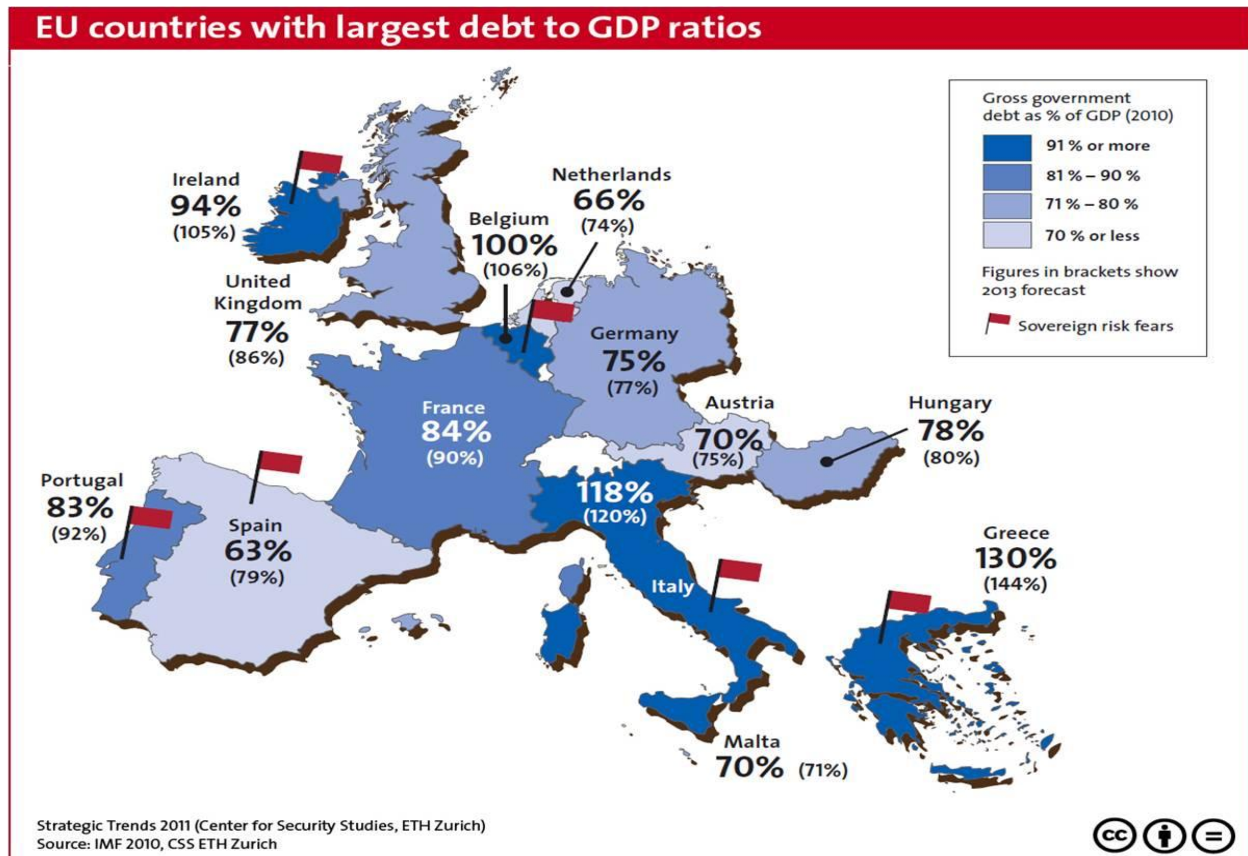
In the full 27-member EU, debt rose to 84.9 per cent from 83.5 per cent.

The EU sets a 60 per cent cap on total debt and 3.0 per cent on annual public deficits but such limits have been under pressure for years in many states and the Eurozone debt crisis has only made things worse.

The most indebted nations at the end of the second quarter were Greece, with a debt to GDP ratio of 150.3 per cent and Italy 126.1 per cent, followed by bailed-out Portugal and Ireland at 117.5 per cent and 111.5 per cent.

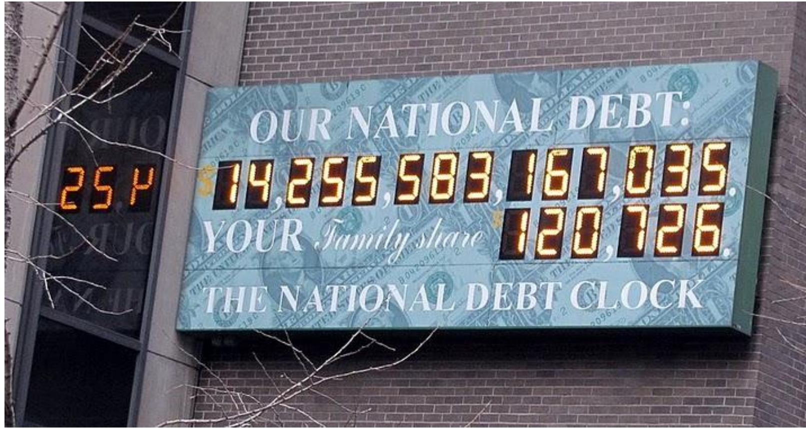
Eurostat said Estonia at 7.3 per cent, Bulgaria 16.5 per cent and Luxembourg at 20.9 per cent had the lowest debt burdens.

The rise in public debt has been seen not only in countries with a history of debt problems - such as Japan, Italy, Belgium and Greece - but also in countries where it was relatively low before the crisis - such as the US, UK, France, Portugal and Ireland.



Debt at levels approaching 100 per cent are widely seen as unsustainable for the long term but some countries such as Japan have lived with them much higher than that for years.

Japan's economy has been troubled since the 1990s. Debt as a percent of GDP broke through the 100% mark in 1997 and has risen steadily since then. It is now projected to reach over 220% in 2013**,** a high for OECD countries and more than double the average. Most of Japan's debt has been financed by Japanese investors, although this is changing, as the savings rate of Japanese households is shrinking. In contrast, in the US, for example, approximately 47% of the government debt was foreign owned as of January 2011 - a percentage that has been steadily increasing throughout the decade. Some analysts see the percent of foreign-owned debt as more critical to an economy's longer-term health than total debt.

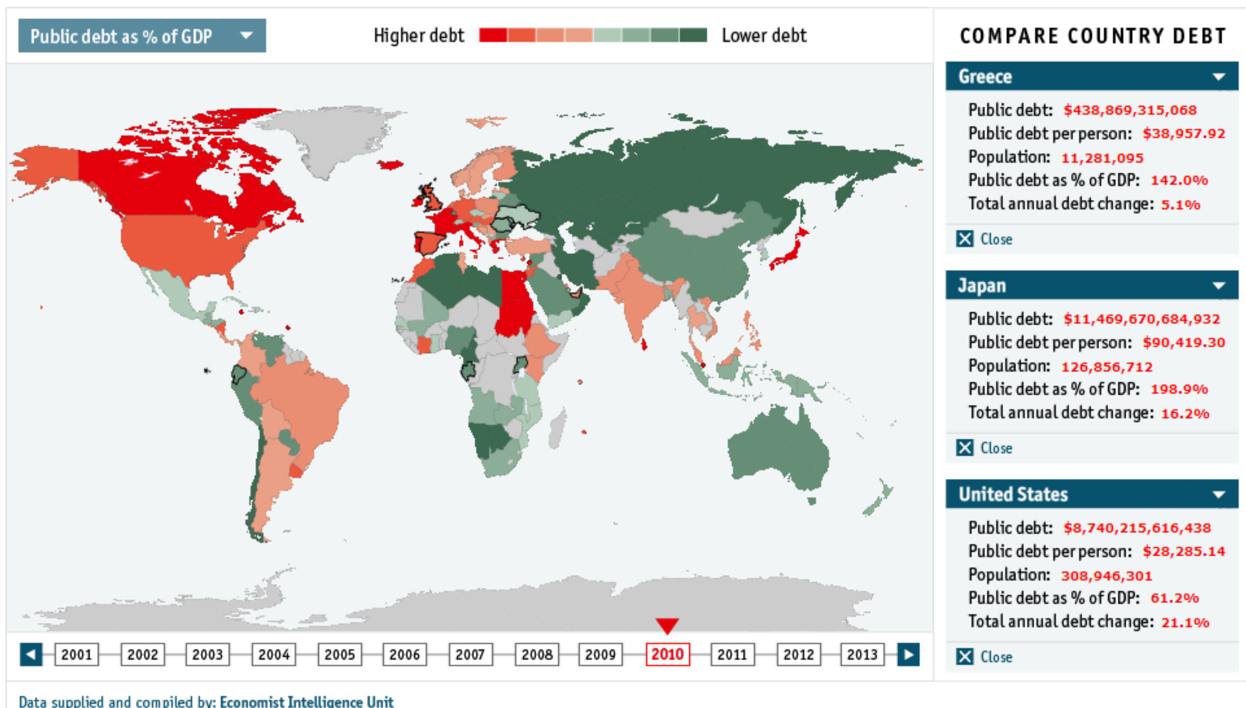


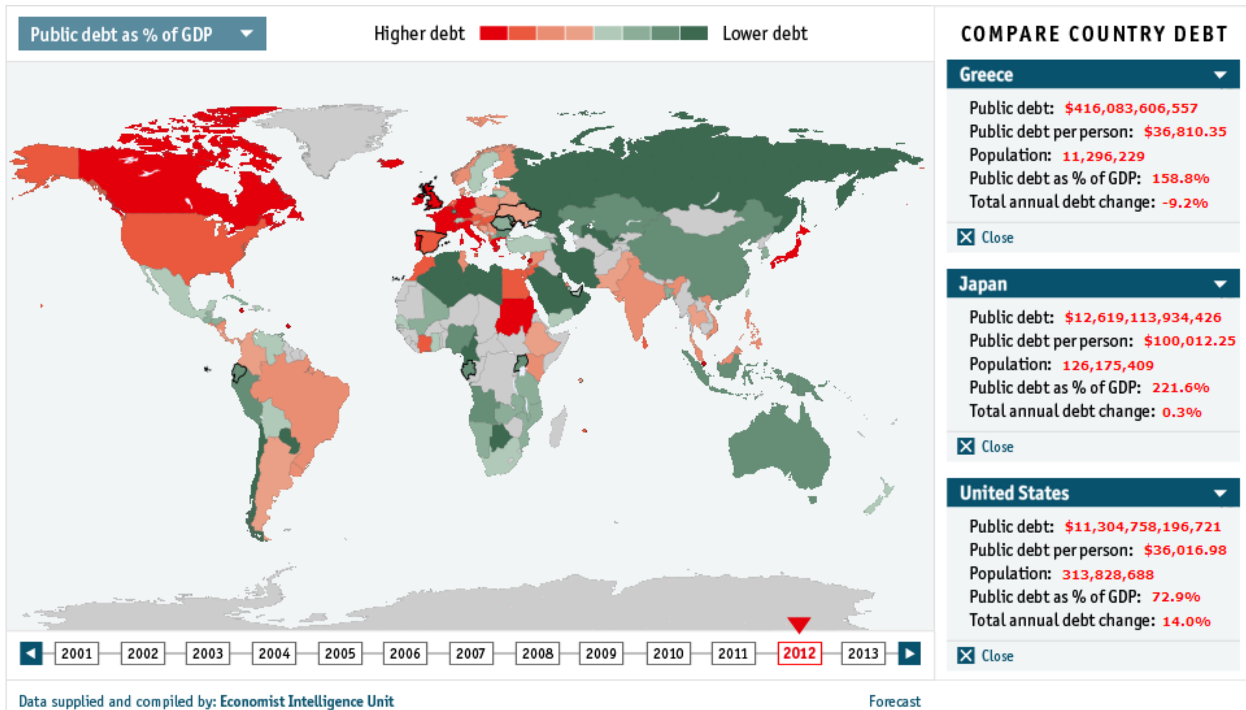
The National Debt Clock - Manhattan, New York.

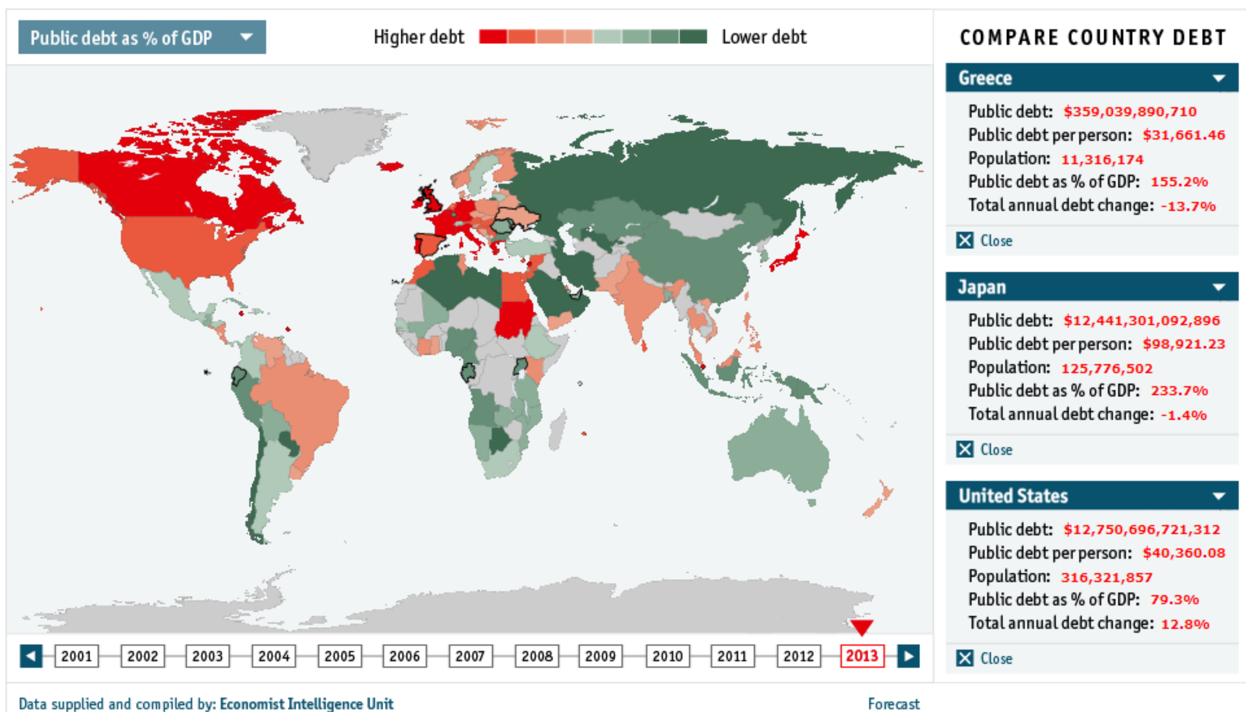
The United States have also a high percentage of governmental debt to GDP ratio, the debt is organized by selling of Treasury Securities owned by the public, and that includes *Debt held by the public and Debt held by government accounts or intergovernmental debt.*

In the United States, the percentage of debt to GDP has escalated rapidly from 36 percent in 2003, 62 percent in 2010 and 73,5 in 2012 [source: U.S. Government Accountability Office]. In other words, it means spending more than half of the national paycheck, the GDP, on debt obligations.

The United States public debt consist of approximately 53 percent owed to American public and the Federal Reserve and the rest belongs to foreign creditors, such as China, Taiwan, UK, Japan, Brazil, Russia, Hong Kong, Switzerland.







From the pictures above it can be clearly seen that the public debt in US and Japan is rising continuously, while in Greece there is a drop on it with the percentage of 9.2. In the 2013 forecast we have a slight change were it is suspected that Japan's public debt will decrease with 1.4 percent, US public debt will continue growing by 12.8 percent and Greece's debt further dropping by 13.7 percent.

4. Conclusion

Debt is a two-edged sword. Used wisely and in moderation, it clearly improves welfare. But, when it is used imprudently and in excess, the result can be disaster.
For individual households and firms, over-borrowing leads to bankruptcy and financial ruin. For a country, too much debt impairs the government's ability to deliver essential services to its citizens.

A clear implication is that the debt problems facing advanced economies are even worse than we thought. Given the benefits that governments have promised to their populations, ageing will sharply raise public debt to much higher levels in the next few decades. At the same time, ageing may reduce future growth and may also raise interest rates, further undermining debt sustainability. So, as public debt rises and populations age, growth will fall. As growth falls, debt rises even more, reinforcing the downward impact on an already low growth rate. The only possible conclusion is that advanced countries with high debt must act quickly and decisively to address their looming fiscal problems. The longer they wait, the bigger the negative impact will be on growth, and the harder it will be to adjust.

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