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EXTERNAL DEBT AND DEBT CRISES IN EUROPEAN ECONOMIES

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Abstract

In recent years the external government debt has been reviewed and analysed in terms of the European debt crisis and due to the high debt levels in leading economies worldwide. The EU Member States external debt is discussed in the paper as the focus is on Bulgaria and Romania and two main issues are presented in more details: 1. The EU Member States debt levels for the last decade; and 2. The private versus public debt and major challenges in their management.

Keywords: external government debt, debt crisis, private sector debt, debt-to-GDP ratio

JEL Classification: F30, F34, F60, G01

Introduction

The external government debt is one of the seriously discussed topics regarding the financial stability and economic development of each country, especially in the post European debt crisis period.

As the levels of the external debt in the developed countries have risen significantly in recent years, the issues about the impact on economic growth (C. Reinhart, K. Rogoff, 2010), the monetary policy, exchange rate fluctuations and currency risk (U. Wiriadinata, 2018) have been analysed by various authors. Another important external debt correlation is the one with the private debt due to the increasing levels in both developed and developing countries (S. Mbaye, M. Badia, K. Chae, 2018).

The external debt, both government and private, are discussed profoundly after the global financial and economic crisis in 2007 and the European debt crisis in 2010. As a matter of fact, the EU economy and the euro area have been recovering since then and there is a concern about a new debt crisis emerging. At the same time, the levels of both government and private sector debt are relatively high for most of countries in EU and worldwide.

The purpose of the paper is to analyse the challenges for the external debt management as the focus is on Bulgaria and Romania. The paper consists of two parts: 1. Debt crisis and external government debt in which are discussed the EU

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Member States debt levels for the last decade; and 2. External government and private debt where the major challenges in their management is analysed.

Debt Crisis and External Government Debt

The external debt has to be analysed as a part of the overall economy as it plays a crucial role in economic and financial policies implementation. Actually, one of the reasons for the European debt crisis in 2010 is the external government debt level in the euro area members. Thus, a brand-new form of regulations has been implemented in order to overcome the crisis and to stabilize the euro position on the financial markets. For instance, the European Financial Stabilisation Mechanism was created by the European Commission in order to provide financial assistance to the EU countries in financial difficulties, debt issues included. Another tool of the European institutions against the debt crises is the European Financial Stability Facility which later transferred into the European Stability Mechanism.

The crucial issues of the external debt levels and the debt management remain, such as the reasonable or advisable amount of debt a country should maintain in the short and the long run as well as the debt-to-GDP ratio. Although there are no current fiscal or debt crisis worldwide, the external debt levels in most of the developed countries exceed the economy output and the debt-to-GDP ratio is over 100%. As a matter of fact, this indicator is accepted as a benchmark for evaluation and comparison of economies and indebtedness. There are two key issues that are important for the external debt analysis:

- The debt-to-GDP ratio which is used for analysing the the debt management performance and the indebtedness of the economy;
- the private debt-to-GDP ratio which represents the share of the private sector indebtedness and the possibility of its transferring to the public one as was the case with the financial and economic crisis from 2007.

The external government debt-to-GDP ratio is always crucial for determining the country`s ability to pay its debt on time to investors and creditors. As shown on Figure 1, the indebtedness of the EU Members States and other major world economies ranges predominantly between 50% and 100% of GDP. In some cases, the ratio is significantly above 100%. According to C. Reinhart and K. Rogoff (2010), if a country targets both a significant economic growth and low levels of indebtedness or at least reasonable ones, then the debt-to-GDP ratio should not exceed 60%. However, if the levels of the mentioned ratio are above 90%, the opportunities of generating growth are worsened or are at risk.

There is another requirement which sets the limits on the indebtedness of the economy of the euro area candidates and Member States. The Convergence criteria include a sustainable public finances criterion which states that government debt-to-GDP should not exceed more than 60%. It is strictly followed in the transition period when a country is in a procedure of adopting the euro which is at least two years.

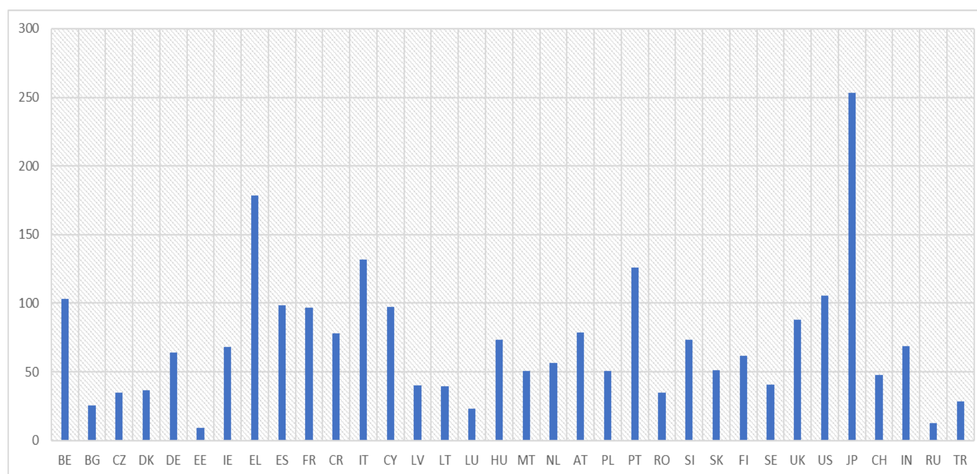
However, there is a paradox with the sustainable public finance criterion. In most cases, when a candidate adopts the euro currency, the government debt-to-GDP ratio rises dramatically. Probably the lack of financial, economic and other political measures and sanctions is the reason for such high external government debt levels. However, the increased indebtedness causes a significant vulnerability of the euro and the Economic and Monetary Union to the external environment. The European debt crisis in 2010 confirmed the high debt levels contribute to the euro disturbances on the financial market and on the euro area stability.

Most of the euro area Member States have debt levels above 60% of GDP for the period 2007 to 2017. The leading country in 2017 is Greece with government-to-GDP ratio of 178.6%, followed by Italy with 131.8% and Portugal with 125.7%. The data for the previous ten years confirms the situation in 2017.

Although Greece has the leadership of the government debt-to-GDP ratio in Europe with its over 170%, when comparing the countries worldwide, Japan has the first place of its indebtedness level with over 250% of GDP. However, Japan has not announced a debt crisis yet and there is no reason for such until the debt is payed on time and the creditors are satisfied with it. A considerable role and efforts here are made by the implemented central bank monetary policy together with the joint actions of other institutions.

Figure 1

Debt-to-GDP ratio for 2017



Source: Eurostat

On the contrary, the countries with the lowest government debt-to-GDP level in the euro area in 2017 are Estonia (9%), Hungary (23%), Lithuania (40.1%) and Luxembourg (39.7%) which perform debt-to-GDP ratio significantly below the Convergence criterion threshold. They managed to maintain sustainably the debt levels in this range for the last decade.

Although Romania and Bulgaria have not adopted the euro, they fulfil this Convergence criterion. Romania has a government-to-GDP ratio below 60% and for the last ten years it was between 15% and 40% and in 2017 it was 35%. In comparison, in the recent ten years Bulgaria has maintained the external debt-to-GDP ratio around and below 30% as for 2017 it was 25.4%.

Of course, the high levels of debt cannot be measured by the debt-to-GDP ratio only, as the amount of the debt is crucial for its impact over other countries and regions in case of an external shock or significant change in the environment. Thus, when comparing the debt levels to GDP. It is necessary to analyse the amount and structure of the external government debt.

External Government and Private Debt

According to the International Monetary Fund data (IMF, 2018), after the two crises, the financial and economic crisis and the European debt crisis, the indebtedness has increased significantly, especially in the non-financial sector. If in 2007 in the G20 countries the debt of the non-financial sector both private and public amounted to USD 80 trillion, in 2016 it was USD 135 trillion. In addition, the developing economies have accumulated more debt than the developed, especially China.

The private debt is a sensitive issue for each country as it is generated by the companies but at the same time this indebtedness is transferable to the public one. As a matter of fact, some private companies and banks restructured their debt into public in 2007 as a measure to overcome the global financial and economic crisis. This was repeated in 2010 when the European debt crisis emerged and in order to escape the insolvency difficulties companies and large banks restructured their debt.

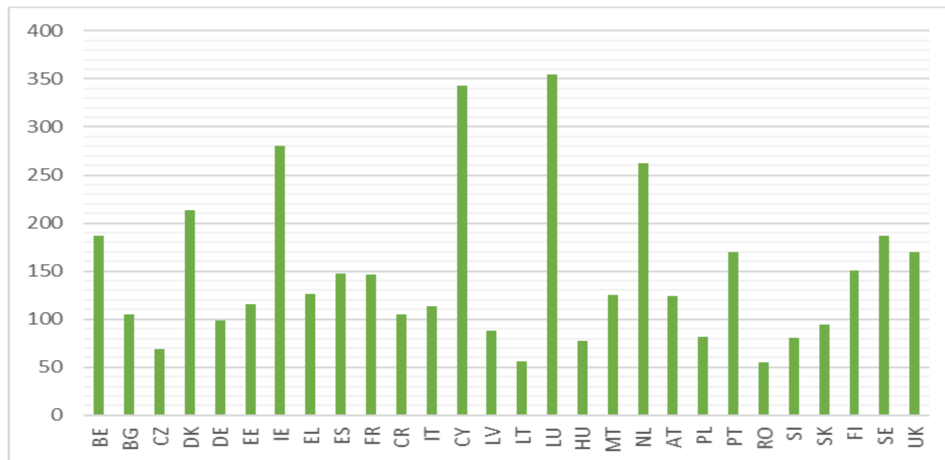
Usually, the private sector debt is higher than the external government one and, in most cases, it is around 100% and above of the GDP, as shown on Figure 2. As mentioned, the private sector debt is analysed as there exists the opportunity of transferring it into a public one in case of an instability or even a crisis. Thus, the government must intervene to ensure the stability of the whole economy.

The EU Member States with the highest private sector indebtedness in 2016 (debt-to-GDP ratio over 200%) were: Luxembourg with 354%, Cyprus with 342.8%, Ireland with 280.5%, The Netherlands 262.1% and Denmark 213.3%. There are expectations for a possible transfer of private to public debt, in case these levels of the private sector debt are not reduced. There is a transferring possibility for countries with lower level of external government debt and high levels of the private

one (Luxemburg) in case of changes in the economic environment. For other countries, where both the ratios are high, other buffers should be envisaged.

Figure 2

Private sector debt-to-GDP ratio for 2016, %



Source: Eurostat

Romania is one of the countries with low private sector debt levels in the EU. For more than a decade the private sector debt-to-GDP ratio has not exceeded 75% and in 2016 it reached 55.4%. Thus, the country has a sound private sector debt-to-GDP which expands the opportunities for economic growth and diminishes the vulnerability to the external changes in the environment.

In Bulgaria the private sector debt-to-GDP has maintained a sustainable downward trend since 2008, reaching a level of 104.9% in 2016 compared to 131.4% in 2008. Moreover, as the country is in a currency board arrangement, the international foreign reserves are maintained at least at 100% of the money supply. Thus, they are regarded as a buffer against significant economic risks and crises.

As discussed, it is possible that government in order to recover the financial or non-financial private institutions from a crisis, repurchases their debt and secures sufficient liquidity. And it was the case with the last global financial and economic and the European debt crises. However, there are other reasons for the high levels of private sector indebtedness:

- encouraging economic growth through debt;
- increase in debt as it is expected a following transfer to public one.

The high levels of the public sector indebtedness are explained by the desire of the government to increase consumption and hence economic growth trough more loans and indebtedness. However, it is difficult to manage the debt and to implement the economic and financial policies with the high levels of the private sector debt and at the same time with the extremely high external government debt, especially when risks in the environment exist. The restructuring of private to public debt is possible when there is economic growth as well (S. Mbaye, M. Badia, K. Chae, 2018).

Moreover, the psychological effect of the possibility of transferring the private debt to the public one encourages an unreasonable increase in the indebtedness of the private sector. Thus, the credit lending discipline is reduced as well as the borrowers one.

Another issue should not be missed when discussing the external debt and it is in regard with the transaction costs of the debt management. When the debt is a foreign currency, the exchange rate fluctuations further increase the risk and the transaction costs. In addition, these costs should be calculated not only in the short run but in the long run as well.

Conclusions

It is important that the high levels of debt, both private and external government, are addressed, especially in economies where there have been debt crises in the past. In case of an economic risks increase or a new global crisis, the debt levels are the crucial buffer for overcoming them and introducing economic growth.

Romania is a country with low levels of government and private sector debt which expands the opportunities for economic growth and diminishes the vulnerability to the external changes in the environment. As far as Bulgaria is concerned, the trend in recent years in both the external government and private debt shows a decrease. Due to the low levels of the public debt and the currency board arrangement and foreign exchange reserves for its maintenance, the country has enough buffers in case of an increase in the economic risks or a new crisis.

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