Looming Sovereign Debt Crisis – What's Wrong with State-Regulated Economics

Mirza Khidasheli
Doctor of Business Administration, Professor, Kutaisi University
Mirza.khidasheli@unik.edu.ge

Abstract

On January 19, 2023, the United States hit its debt ceiling, leading to a debt-ceiling crisis. US sovereign debt, for decades, was considered a risk-free investment, but the 2023 US debt ceiling crisis shocked the financial world. The COVID-19 pandemic has hung a heavy burden on public finances. Quarantined economic activity heavily affected state budget revenues all over the world. Before the Covid-19 crisis, there was the 2008 financial crisis with its famous outcomes, when economic stimulus was provided including state budget programs financed by sovereign debts. It was still pandemic circumstances when on 24 February 2022, Russia invaded Ukraine in an escalation of the Russo-Ukrainian War. In less than 20 years period the world has had three global-scale crises, but the deterioration social-economic picture is far less dramatic than it will be without state interventions. Nothing is free, it is an obvious and well-known economic axiom, so if the costs of these crises are not on the surface, it means that the problem is hidden somewhere and postponed in time**.**

In a simplified picture we see that states' actions in the field of public finance aren't rational. When revenues are decreasing, from a household point of view it is normal to turn on some austerity mode and live with less luxury, but different approaches are taken by the states when GDP growth and tax revenues are decreasing. The bright examples of these we saw during the 2008 financial crisis and the COVID-19 crisis. From an economic point of view, loans couldn't be a source of prosperity. Moreover, sovereign credit puts on long-run burden on the real economy.

Money is considered a sign of wealth and prosperity, but actually, in the fractional reserve banking system, it is not the same. For the creation of debt money in the modern credit system, we don't need savings, we can create it simply from "thin air". So, an increased volume of money and debt in the economy doesn't mean prosperity, it means more burden on future generations and the economy at all. The real economy has to pay these debts in the long run future and there it will negatively affect welfare and prosperity.

More Fiat money doesn't create prosperity, prosperity is a result of economic growth and savings. Printing money without proportional economic growth or creating debt money without adequate savings, only exacerbates allocation of resources and wealth. So, money multiplier is not about wealth creation it's about wealth allocations.

Empirical pieces of evidence from the current century showed us that, a crisis is a signal, it is a communication instrument that should be considered correctly and with some scrutiny examinations about its origins and foundations. Tactical solutions can't give strategic outcomes. When empirical evidence shows that instruments used by the state to extinguish crises create much more scaled ones, it's time for rethinking and structural reforms.

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Introduction

In an era characterized by the relentless pursuit of economic growth and stability, the global economy has become an intricate web of interconnected financial systems and geopolitical interests. Over the past few decades, the world has witnessed unprecedented economic expansion and technological advancement, coupled with a corresponding increase in the role of state regulation in the global economic landscape. However, as we enter the third decade of the 21st century, there looms a dark cloud of uncertainty and concern, stemming from a two-fold crisis that has begun to grip nations across the world: a global economic slowdown and a mounting sovereign debt crisis.

The intertwining challenges of a slowing global economy and sovereign debt crises have raised fundamental questions about the effectiveness and sustainability of state-regulated economic systems. Governments, irrespective of their political ideologies, have been playing an ever-expanding role in economic affairs – from fiscal stimulus measures to comprehensive regulatory frameworks. Yet, despite these interventions, economies worldwide seem to be grappling with instability and stagnation.

This thesis embarks on a critical exploration of the factors contributing to the ongoing global economic slowdown and the surge in sovereign debt crises, with a particular emphasis on the role of state regulation in these phenomena. It seeks to unravel the complexities surrounding state-regulated economies and investigate the mechanisms by which they may inadvertently contribute to these crises. By dissecting the interactions between government policies, fiscal decision-making, and the broader global economic landscape, this research aims to shed light on what might be wrong with the prevailing state-regulated economic paradigm.

The hidden costs of blurred picture

On January 19, 2023, the United States hit its debt ceiling, leading to a debt-ceiling crisis. US sovereign debt, for decades, was considered as a risk-free investment, but the 2023 US debt ceiling crisis shocked the financial world. The COVID-19 pandemic has hung a heavy burden on public finances. Quarantined economic activity heavily affected state budget revenues all over the world. Before the Covid-19 crisis, there was the 2008 financial crisis with its famous outcomes, when economic stimulus was provided including state budget programs financed by sovereign debts. It was still pandemic circumstances when on 24 February 2022, Russia invaded Ukraine in an escalation of the Russo-Ukrainian War. In less than 20 years, the world has had three global-scale crises, but the deteriorating social-economic picture is far less dramatic than it will be without state interventions. Nothing is free, it is an obvious and well-known economic axiom, so if the costs of these crises are not on the surface, it means that the problem is hidden somewhere and postponed in time.

Among the challenges facing developing countries, none is arguably more crucial than the significantly deteriorated fiscal situation that threatens to erase several years of progress on development agendas. According to some estimates, almost 60 percent of the poorest countries are either in or at high risk of debt distress, nearly doubling since 2015 (World Bank 2022a). In most developing countries, the cost of servicing external debt now exceeds expenditures on health, education, and social protection combined (UNICEF, 2021)

As empirical pieces of evidence show, sovereign debt is not a universal solution, especially when we are talking about public spending that does not directly or indirectly influence long-run economic growth. Taking sovereign debt without a coherent cost-benefit analysis violates future sustainability. Such kinds of approaches are like “pain relievers” when there are serious diseases.

The new wave of sovereign debt defaults and restructurings is underway. Lebanon, Russia, Sri Lanka, Suriname, and Zambia are officially in default; Argentina, Ghana, Pakistan, and El Salvador are likely on the brink of debt crises. A decade of easy money has come to a crashing end, the result of the COVID-19 pandemic, the war in Ukraine, surging import prices, and rising interest rates globally as central banks respond to inflationary concerns. Many emerging markets are at risk of default, austerity, and economic and political upheaval (Mosley L, Rosendorf P, 2023)

In most cases, governments are judging from a populist point of view, including in cases of democratic states they have 4-year terms and they are trying not to fail in their term. So short-run results are more important than long-run consequences.

In 2020, we observed the largest one-year debt surge since World War II, with global debt rising to $226 trillion as the world was hit by a global health crisis and a deep recession. Debt was already elevated going into the crisis, but now governments must navigate a world of record-high public and private debt levels, new virus mutations, and rising inflation. Global debt rose by 28 percentage points to 256 percent of GDP, in 2020, according to the latest update of the IMF’s Global Debt Database. Borrowing by governments accounted for slightly more than half of the increase, as the global public debt ratio jumped to a record 99 percent of GDP (See Figure 1.). Private debt from non-financial corporations and households also reached new highs. (IMF, 2021)

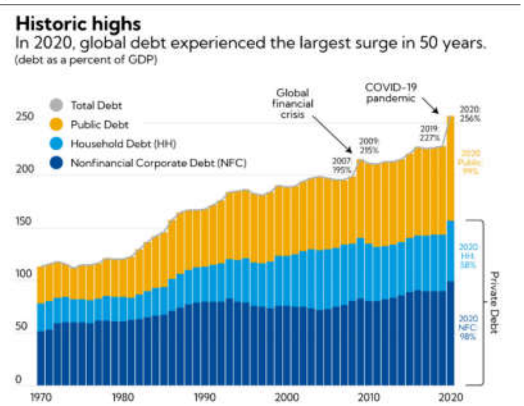

Figure 1. Global Debt by Decades. Source: IMF Global Debt Database and IMF calculation

Debt has long been a double-edged sword in the world of economics. When used judiciously, it can be a powerful tool for driving economic growth, facilitating investments, and improving living standards. However, an overreliance on debt can quickly transform an economy from a bastion of prosperity into a fragile and unstable system

Public debt around the world has been on the rise over the last decades. Cascading crises in recent years triggered a sharp acceleration of this trend. As a result, global public debt has increased more than fivefold since the year 2000, clearly outpacing global GDP, which tripled over the same time.

In 2022, global public debt – comprising general government domestic and external debt – reached a record USD 92 trillion. (See Fig 2) Developing countries owe almost 30% of the total, of which roughly 70% is attributable to China, India and Brazil (UNCDAT, 2022)

Global debt has hit a record $300 trillion, or 349% leverage on gross domestic product. This translates to $37,500 of average debt for each person in the world versus GDP per capita of just $12,000. Government debt-to-GDP leverage grew aggressively, by 76%, to a total of 102%, from 2007 to 2022. (S&P Global, 2023)

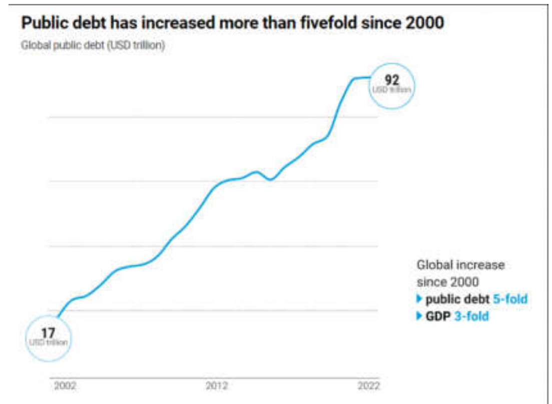

Figure 2. Global Public Debt 2002 -2022
Source: UN Global Crisis Response Group Calculation Based on IMF World Economic Outlook (April 2023)

One of the primary reasons why debt-driven economies are inherently fragile is the risk of falling into a debt trap. As borrowing becomes easier and interest rates remain low, individuals, businesses, and governments often accumulate excessive debt relative to their income or revenue. Initially, this can lead to increased consumption, investment, and economic growth. However, when debt levels become unsustainable, they can quickly trigger a financial crisis.

The global economy's "speed limit"—the maximum long-term rate at which it can grow without sparking inflation—is set to slump to a three-decade low by 2030. An ambitious policy push is needed to boost productivity and the labor supply, ramp up investment and trade, and harness the potential of the services sector, a new World Bank report shows. Nearly all the economic forces that powered progress and prosperity over the last three decades are fading. As a result, between 2022 and 2030 average global potential GDP growth is expected to decline by roughly a third from the rate that prevailed in the first decade of this century—to 2.2% a year. (World bank, 2023)

Debt-driven economies are highly sensitive to changes in interest rates. When interest rates rise, the cost of servicing debt increases, potentially leading to defaults and financial stress. Central banks often use interest rate adjustments as a tool to control inflation or manage economic cycles. When an economy is heavily leveraged, even modest interest rate hikes can have a significant impact on debt servicing costs, which, in turn, can strain borrowers and disrupt economic stability.

Therefore, while credit deepening may contribute to economic development, this is unlikely to happen through rapid debt booms. Such booms are instead often episodes when credit expands for reasons unrelated to economic fundamentals, and where the expansion generates distortions and vulnerabilities that often end in crisis. In short, credit booms are not the way toward financial development-led growth, and we should view debt booms and credit deepening as fundamentally different phenomena that operate through different channels. (Verner E, 2019)

How long can the economic growth caused by non-natural factors due to the credit expansion go on? The duration of the economic growth achieved due to artificially cheapened credit resources is in direct connection with the duration of the artificial interest rates. If the lowering of the interest rate of interest is made on a one-time basis, the artificial economic growth would be very short-term, but in fact, the reduction in the interest rate lowers the market level and is not of a one-time and short-term nature. However, despite the continuous nature of monetary interventions, proceeding from its artificial nature, its permanent existence is impossible. After a certain time, the visible inflation, low liquidity, and other similar factors prevent the continuation of the process in a permanent state. Therefore, sooner or later, this process of credit expansion is interrupted, and the market starts to recover. Macroeconomic indicators tend to market equilibrium. (Khidasheli M, Chikhladze N, 2019)

Easy access to credit can inflate asset prices, such as real estate and stocks, creating bubbles that eventually burst. When these bubbles burst, it can lead to a sharp drop in asset values, causing financial instability and wealth destruction. The 2008 financial crisis is a stark example of how an overreliance on debt and the bursting of the housing bubble led to a global economic downturn.

Conclusions:

In a simplified picture we see that states' actions in the field of public finance aren't rational. When revenues are decreasing, from a household point of view it is normal to turn on some austerity mode and live with less luxury, but different approaches are taken by the states when GDP growth and tax revenues are decreasing. The bright examples of these we saw during the 2008 financial crisis and the COVID-19 crisis. From an economic point of view, loans couldn't be a source of prosperity. Moreover, sovereign credit puts on long-run burden on the real economy.

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