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PUBLIC DEBT MANAGEMENT – A THEORETICAL ANALYSIS

Economics

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KEYWORDS:

Public debt in simple words means debt. incurred by the government in mobilisng savings of the people in the form of loans, which are to be repaid at a future date with interest. Public debt can be both internal as well as external. According to Richard Musgrave and Peggy Musgrave,1 "public borrowing involves a withdrawal made in return for the government's promise to repay at a future date and to pay interest at the interim."

The concept of public borrowing or debt as such was condemned earlier by classical economists like Adam Smith and Hume who considered that it would compel the government to tax the public and hence lead to disequilibrium in the economic system. Later the Great Depression of 1929 brought about a marked change in economic thinking of which J.M. Keynes was the pioneer. It was felt that public debt. would raise the national income, lead to effective demand in the economy, increase the employment and output. Hence it was after world war II that public debt came to occupy a prominent place in the budgets of the governments of the different countries.

When the government resorts to borrowing instead of introducing additional tax measures, to finance the budget deficit, it creates a liability on itself known as public debt. A government has various alternatives to borrow from the purpose of financing fiscal deficit. One way is to borrow directly from the central bank which is equivalent to printing of money. The other alternatives are; borrowing from domestic commercial banks, borrowing from domestic non-bank sector and borrowing from external sources. Each method has its own implications for various aspects of the economy. Government usually adopts a mix strategy and utilize a number of options at the same time.
Public debt accumulates over time if deficit in the budget persists for a long period of time. Here a number of questions arise : Does it make any difference whether the government pays for its expenditures by raising taxes or by its issuing debts ? What are the implications if debt is issued to central bank, domestic conmmercial banks, domestic non-banks or external sector ? Is debt really a burden and under what conditions it becomes unmanageable and unsustainable ? Different groups of economists have different views on these issues.

With regard to the first question an important group of professionals believes in "Barro-Ricardo Proposition of Equivalence".2 The proposition is that there is basically no difference between the two ways of financing the deficit i.e. raising taxes or issuing debt. The argument is that financing deficit by issuing bonds merely postpones taxation. In a future time period the government has to raise taxes to service the debt and there is no difference (after proper discounting) between present and future taxes. When the government finances its deficit by debt, people realize that they have to pay higher taxes in future. Thus, the people in anticipation of future payment of taxes do not consume increase in incomes due to expansionary fiscal policy. The proposition, therefore suggests that private savings will increase due to debt financing. If the proposition holds them the budget deficit does not exert any pressure on interest rates and there is no fear of crowding out. However, empirical evidences do not support this proposition. The sharp decline in US private savings rate during 1980s is obvious evidence against it. With respect to developing countries Haque & Montiel (1988)3 listed the equivalence hypothesis for a sample of sixteen countries and rejected it for fifteen countries.
Although Barro-Ricardo equivalence hypothesis is not proved empirically, yet at has some implications on social grounds. The government who issues debt to finance its expenditure actually transfers tax burden to coming one.

Public debt issued to different entities has different implications on macro economic variables. If debt is issued directly to central bank, it increases the high power money which in turn transform into monetary expansion through money multiplier. This mode of financing is considered highly inflationary and thus economists generally discourage borrowings from the central bank. A significant part of public debt is owned by commercial banks. Although this is less inflationary than debt to central bank, yet the perception is that is crowds out private investment. But in the countries like India, where banking system is less competitive and public have a lot of black money, it is inconcieviable that investment will be crowded out as a result of public debt from commercial banks.

Third source of public debt is domestic non-bank private sector. It has no effect on money supply and hence no implication for interest rates and inflation from supply side. However, according to Portfolio Balance model4 of demand for money, the debt held by people does exert an upward pressure on interest rates. When debt holdings of people increase they demand more money to offset the potential risk attached to these debts. With unchanged money supply, interest rates tend to rise due to excess demand for money. Thus issuing debt to people has a fear of crowding out due to pressures on interest rates.

This is why the theory of public debt advocates a mix strategy of debt finance which ensures a moderate increase in money supply through borrowing from banking sector while avoiding excessive bank borrowing and generating from non-bank sector.

Another important source is the foreign or external debt. Borrowing from abroad has become a major feature particularly of the developing countries.5 Foreign borrowing allows a country to invest and consume beyond the limits of current domestic production and in effect, finances capital formation not only by mobilizing domestic savings but also by tapping resources from capital surplus countries. Foreign borrowing can lead to more rapid growth. However, debt accumulation and growth has non-linear relationship. Upto certain level the impact is positive and beyond a threshold the relationship is negative. If a country borrows from abroad, it must be managed prudently because excessive foreign borrowing and its improper use generate severe debt service obligation and country accumulates more and more debt that constraints future economic policy and so, growth as is the case with Pakistan.[6]

Other important issues related to public debt are whether public debt really is a burden and why sometimes it becomes unmanageable and unsustainable. Public debt is generally considered as a matter of serious concern. Often an argument is given that each individual of a certain country bears so much of public debt burden. Is this perception correct and is the fear genuine ? In a fairly crude sense the answer is not ! The reason is that liabilities created by the government have their counterpart in the form of financial assets (treasury bills, government bonds etc.) held by people. Thus taking government and people of a country combined as a nation, the overall liabilities of the nation are equal to its assets; so net burden on the nation is zero (keeping aside the debt held by foreigners). So public debt is not a matter of serious concern as long as the nationals of the same country hold its major part.

Real burden is external debt since in this case asset holders are foreigners and the country as a whole is net debtor.

However the Economic and Social Survey of Asia and Pacific (2008)7 says that lowering high public debt ratios is essential to avoid adverse economic and social consequences. The Survey says that both domestic and external public debt carry concerns of "higher interest rates and lower private investment; higher debt servicing costs and less funding for basic services; and in the most severe cases, inflation, a debt trap, economic collapse and widespread poverty."

Public Debt Management

Debt Management is the process by which the government acquires and utilizes the debt efficiently and effectively. Debt is manageable as long as the cost of acquiring debt is reasonably low and the debt thus obtained is used efficiently in such a way that it helps growth in nation resources least in the long run. Debt is used efficiently if the ratios of debt service to total revenue and external debt service to exports fall or remain constant.

Sustainability of debt is a situation where debt-to-income ratio declines or, at least, remains constant over years. There is a formal model in literature on public debt to determine the factors contributing in its unsustainability.

There are two debt determinants which influence the debt-to income ratio; (i) primary budget deficit, and (ii) the difference between the real interest rate and real GDP growth. If there is a high primary deficit (as a percent of nominal GDP) then debt-to-income ratio tends to fall. Thus the stability in debt-to-income ratio or equivalently sustainability of public debt depends on the relative strength of the above opposite forces.

It is usually concluded that is primary defict is zero and the economy is growing reasonably then public debt is no longer unsustainable. The underlying assumption is that if the real output grows, the resource generating capacity of the economy would also grow with the same proportion. Thus, if the real interest rates are low and the rate of resource generation is high then debt would no longer accumulate unsustainably.

Over the past decade, a broad consensus has developed that good public debt management (PDM) can help countries reduce their borrowing cost, contain financial risk, and develop their domestic debt market. It can also facilitate maintaining financial stability and help develop their domestic financial system. While this holds for all countries, the needs and constraints of countries in designing good PDM systems vary depending, inter alia, on each country's degree of development. Thus, while the experience and practices of developed countries is undoubtedly helpful, emerging markets and low income countries need solutions tailored to their needs and constraints : a "cookie cutter" approach will not do. Moreover, debt management strategies need to be fitted in an overall macro-economic policy framework that preserves stability and is conducive to growth. In particular, the best debt management cannot offset a fiscal policy that results in unsustainable debt or erratic financing needs. Also, a monetary policy that keeps inflation low will facilitate the issuance of debt denominated in domestic currency.10

Good public debt management can help reduce borrowing cost in many ways. A well designed and implemented borrowing program can give confidence to investors and thus reduce the lending spread. A carefully balanced composition of securities can contain risk-which are harder to manage in countries having few alternative sources of finance.

Good public debt management can also help develop the domestic financial market. Domestic financial instituations benefit from having available public debt instruments in which to invest and which can provide benchmarks for the pricing of other instruments.

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