THE ROLE AND EFFECTS OF PUBLIC AND PRIVATE DEBT IN THE ECONOMY

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Abstract*:*
The purpose of this article is to carry out a qualitative and quantitative analysis, highlighting the role and effects of government and private loans in the economic development of a country, as well as determining the advantages and disadvantages of these loans. The first part of the paper aims to create an overview on the concepts and particularities of state loans, public debt and budget deficit, emphasizing the role and effects of public debt in the economy, while in the second part will be analyzed the role and effects of private loans in the economy, focusing on how credit activity influences the evolution of an economy. A special role will have the analysis of the impact of the present pandemic on these credits and the challenges it will bring to the economy. This paper aspires to update the state of knowledge of the subject in the academic literature and to capture the attribution of state and private loans as an inevitable process of indisputable importance, which promotes the economic development of a country.

Keywords: *Credit Activity, Government Loans, Private Loans, Public Debt.*

JEL Classification: *G2, H6.*

1. Introduction

Public loans are a means of indebtedness of the state to internal and external creditors. States contemplate borrowing either out of treasury needs or out of budgetary needs. In order to reach the minimum standard of living, reduce unemployment, make public investments that surround us everywhere and stimulate economic growth, governments must bear expenses that exceed limited incomes. They are therefore indebted, a normal process of economic activity, which allows all market players to meet their targets in terms of consumption or investment level, enabling economic growth and productivity. The economic crisis of 2007 forced many states to borrow because, on the one hand, their tax revenues were reduced as a result of the recession, on the other hand public spending was increased by implementing wrong social policies, assumed by the governments of these countries.

The financial crisis that many countries have faced has drawn the attention of many economists to public debt issues, leaving aside another type of debt as important to a country's economy as private lending. Given that alternative sources of financing for business projects outside banking channels are limited, private lending has a major impact on the country's economic growth. Thus, the private sector plays an important role in the economic development of each country. On the other hand, credit for the economy is an important element of the country's economic development, serving as a financial lever and stimulating the growth of economic activity. In addition, it is also one of the most important channels of the monetary policy transmission mechanism in the real economy.

The purpose of this article is to carry out a qualitative and quantitative analysis, highlighting the role and effects of government and private loans in the economic development of a country, as well as determining the advantages and disadvantages of these loans. Also, the motivation behind this paper was the need to understand the concepts of public debt, budget deficit, state or private loans, internal or external creditors and how they can affect economic development.

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2. The Role of Public Debt in the Economy

State loan represent an inevitable process of undeniable importance, which promotes the country's economic development, generates equality between generations and contributes to increasing the well-being of everyone by allocating capital to finance productive and necessary public projects from priority sectors such as : security, justice, infrastructure, health, education, etc. Public debt is one of the key macroeconomic indicators, which shapes the image of a country in international markets and a key factor in stimulating the flow of foreign direct investment. It is a lever that, if used well and efficiently, provides a positive impetus for economic growth. If misused, a country can reach the limits of the financial crisis. Budget deficit is usually defined as the difference between government spendings (including interest on debt) and government revenues.

At a time when public debt levels are steadily rising globally, various researchers have undertaken a series of analytical and empirical studies on the effects of these increased levels, mainly on economic growth and all key macroeconomic variables such as inflation, interest rates or unemployment. Mainly, over time, economists' views on the effects of budget deficits on a state's economic performance have referred to two main approaches. On the one hand, deficits resulting from reduced marginal tax rates were considered to have a stimulating effect on labor productivity. On the other hand, budget deficits were considered a cause of economic stagnation and instability.

Public debt is the main instrument that guarantees the efficient use of economic resources and ensures the optimal distribution of government policies allowing the provision of public goods and services at any time, whether or not the necessary funds are available. Thus, if governments manage to run public debt carefully, they can have a powerful tool for economic development (Keynes, 1936; Checchetti et.al, 2011). On the other hand, despite the benefits that public debt brings to the economy and the reasons why it is used, theoretical and empirical analyzes prove statistically that its high levels beyond a certain limit lead to misleading pro-cyclical fiscal policies, affecting the reduction the pace of economic growth or the worsening of other indicators such as inflation, interest rates and the likelihood of an economic crisis (Modigliani (1961), Calderon and Fuentes (2013)). This is the reason why numerous studies have been undertaken to find the optimal level of public debt that guarantees and stimulates only economic development, but the desired critical point is impossible to find. Wysplotz (2005) emphasizes that the sustainability of public debt is an essential feature of solid macroeconomic policies, but the precise and unified definition of the concept along with its testing remains a real challenge for all.

The public finance literature accepts different perspectives on the effects of high government debt and budget deficit in the economy. Thus, in addition to the positive effects, these indicators can have an impact in stopping the development of the economy due to the impossibility of their service. Modigliani (1961), Rogoff and Reinhart (2010) and many others, through their studies, argued the negative effects of public debt and budget deficit levels on GDP that first influence low levels of economic growth, to continue the rise in

interest rates and inflation associated precisely with changing consumer behavior towards investment and savings.

On the other hand, other economists such as Keynes (1936), etc. supported the use of public borrowing by the government, especially in times of economic recession, due to the stimulating effects that public debt and the budget deficit have on economic development as a whole. According to Keynesian views, budget deficits and public debt have a positive impact on each country's economic activity, especially through the public spending mechanism, arguing that the increase in public spending is the result of deficits and debt caused by expansionary fiscal policy. However, even these authors believe that their level in the economy should be measured to ensure only positive effects and that the sustainability of public debt is achieved not only in the short term but also in the long term.

According to Nuno H. et.al. (2012), the specific factors and determinants of each country affect the efficiency of public borrowing and its effect on GDP. According to them, no link can be found between the debt crisis, the level of public debt and its impact on GDP. They analyzed the benefits and disadvantages of public borrowing and the causes of the debt crisis in European Union countries. Schclarek (2005), analyzing 59 developing countries and 24 developed economies, stated that in the case of developing countries, there is always a negative and significant relationship between the total debt of each country and economic growth. However, for developed countries, it has not found a significant link between public debt and economic growth.

Pre-crisis, post-crisis and post-crisis public debt management for three members of the European Union: the Netherlands, Ireland and Hungary is addressed in the study of Badurina A. and Svaljek S. (2011). These three countries were chosen by the authors because they all had a relatively well-developed pre-crisis public debt management system, as well as the fact that those responsible for public debt management pursued during the crisis a sustainability policy in the current circumstances of the market. The global economic crisis has had various effects on the budget deficit and the development of public debt in these countries. In conclusion, the authors provide an overview of public debt management in Croatia during the crisis and compare it with public debt management in the three countries studied. But debt is a double-edged sword. When used wisely and in moderation, it clearly improves well-being, but when misused it can be a disaster for individuals, families and businesses as it leads to bankruptcy and financial ruin. For a country, high debt undermines the government's ability to provide the services it needs to its citizens.

According to Cecchetti S. et.al, (2011), developed countries have problems with an increasing public debt more than developing countries, because the aging population of these countries will significantly increase the level of public debt in the coming decades. At the same time, an aging population can reduce future economic growth and raise interest rates, further undermining debt sustainability. Therefore, in their opinion, the only possible conclusion is that developed countries with a high level of debt must act quickly and decisively to solve their fiscal problems. The longer they wait, the greater the negative impact on economic growth and the more difficult it is to regulate these impacts.

Kadiu D. (2015), studied the role of public debt on economic growth in Albania for the period 1992-2012, as well as the main determinants of these two indicators. The results showed that public debt has a statistically significant negative effect on Albania's economic growth, but government spending has a positive impact on economic growth, contrary to theory. This conclusion is reached because Albania is a transition country where the public sector is very important in the progress of economic reforms and private sector development.

The stabilization of public debt at its sustainable level depends on: the capacity of a national economy to generate primary surpluses, the interest to which the markets lend to the state, depending on the risk premium attached, as well as its own economic growth rate. This

means that the idea of debt sustainability must be thought of in individual terms, as long as it depends on one's own economic conditions. Regarding Romania, the risks related to the above estimates both scenarios can be considered of medium intensity. The risks are rather related to the need to generate primary surplus in order to stabilize the debt at its sustainable level (Socol 2013).

The coronavirus hit the global economy hard and with unprecedented speed. In addition to its public health consequences, the coronavirus pandemic has led to an increase in public debt worldwide. The global economy is expected to shrink, a recession that is likely to cause tax revenues to drop, although governments in the United States, Europe and elsewhere spend billions of dollars on emergency aid measures to try to reduce those effects. For some governments, debts contracted for the COVID-19 exemption will be added to those already on their records before the pandemic arrives.

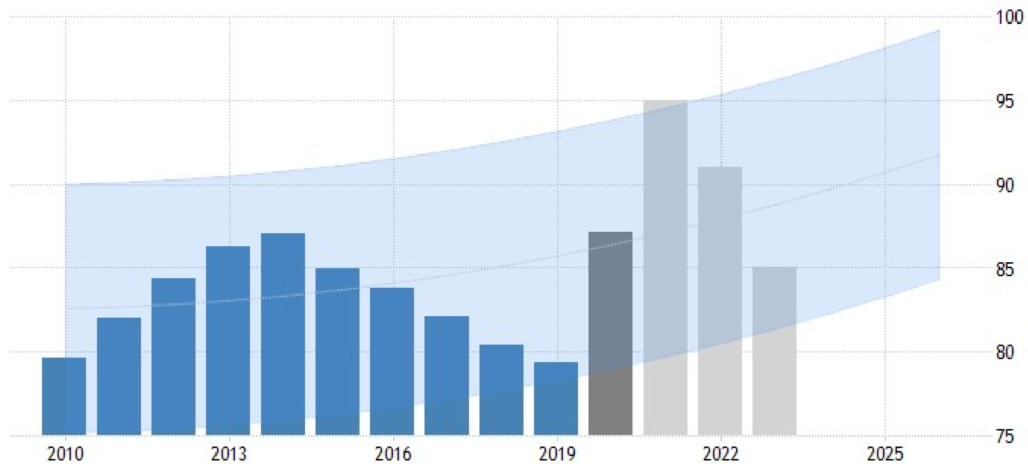

Fig. nr. 1. EU Government Debt to GDP, Source: https://tradingeconomics.com

European Union recorded a public debt equivalent to 79.3% of the country's GDP in 2019, prior to COVID-19 outbreak. The Covid-19 crisis has witnessed extraordinary actions by governments around the world, such as expanding support for the economy with increased spending and borrowing, while collecting less tax revenue due to higher unemployment and the slowing business sector. All these actions have led to substantial increases in public debt. Government Debt to GDP in EU is expected to reach 95% by the end of 2020, according to Trading Economics global macro models and analysts expectations (fig.nr.1). In the long-term, the EU Government Debt to GDP is projected to trend around 91% in 2021 and 85% in 2022 (fig.nr.1).

The private sector encompasses government debt, while investors give up other debt securities, fearing that the economic collapse makes them too risky and instead seek safe havens in public debt. As a result, the interest rates that governments pay to borrow have decreased even as the amount they borrow has increased. This is not how interest rates work normally, but economic crises and pandemics are not normal times. On the other hand, most new Keynesian economists believe that the high level of public debt will not in itself be a problem for advanced economies. They even suggest that further debt increases would be desirable, as this would help reverse the trend of secular stagnation in several countries. They believe that higher public debt is the right buffer for the private sector facing temporary and unpredictable economic crises.

3. The Role of Private Debt in the Economy

In recent years, private sector involvement in development policies has been the subject of discussions in several international forums. The Fourth Development Forum, held in Busan (2011), emphasizes the role of the private sector as a driver in accelerating innovation and mobilizing local resources, creating new jobs, ensuring a better standard of living and a superior level of health care in less developed countries.

The analysis of private debt is of particular importance, because private debt is associated with financing business projects and increasing consumer demand, which leads to economic growth and improve the country's macroeconomic parameters. This is more important, especially for recessionary economies (Martti Randveer et.al. (2011)). A high level of private debt before the recession is associated with lower economic growth and vice versa, the increase in private debt after the recession is associated with economic growth, due to the fact that after the recession people consume less to accumulate what they lost during the recession. A similar analysis in the corporate context shows that a high debt burden prevents revenue and investment growth and the recruitment of new workers. In times of recession, companies with higher debt levels respond to economic decline faster than companies with lower ones.

The private sector is recognized as a partner in the economic development of a country, as a provider of income, jobs, goods and services, to improve people's lives. The private sector and private sector employees are the largest contributors to tax and fee revenues and support government operations. This leads to a natural link between the private sector and the public sector. While the private sector is essential for development, it cannot act alone without the support of the public sector, which plays a key role in providing public services, environmental management and economic growth.

The relationship between the business environment and banks is the basis for the success of economic activity. This relationship increasingly depends on the evolution of the surrounding economic environment. At present, not all sectors of the economy are equally affected by the credit crunch and not all companies face the same problems. However, businesses are currently experiencing a decline in activity and revenue. Business relationships with banks are considered necessary and important, while the lending process is considered a difficult process. Bank loans, according to business estimates, remain expensive. The business-bank relationship in the lending process is all the more difficult in terms of the guarantees that companies are required to provide to banks for their loans. Most of the collateral is occupied by real estate, such as land, business buildings, residential apartments, etc. However, although most non-performing loans are covered by collateral, banks incur additional costs due to the ones associated with the collateral execution process.

A literature review on the relationship between private debt and economic growth is very imporant, as it deals with studies by various authors on the relationship between private debt and economic growth, discussions on the role of private capital and its positive or negative effects on a country's economic development. Many studies have clarified the impact of private capital on economic growth, such as: a nation improves productivity and capital capacity through technological advances or increases its labor productivity through human capital investments, promoting successful entrepreneurship or high-debt companies hindering growth, and investments and recruit new employees, as they are forced to respond more quickly to the economic downturn. However, there are studies that show that economic growth also contributes to private activity and increases private capital.

The question of whether there is a link between financial development and economic growth has long been debated. The question is whether there is causality and, if so, in which direction: is financial development the one that induces economic growth, or perhaps financial development only seeks economic growth. Most empirical studies (Fink, Haiss and Vukšić

2005, etc.) usually conclude that the development of the financial sector accelerates economic growth. Through their actions, financial intermediaries increase efficiency in several ways, for example, by reducing savings, allowing the development of longer-term projects with higher returns or allowing risk-sharing. All these effects have been shown to have a positive impact on macroeconomic growth.

According to Gross (2002), one of the factors influencing the positive impact of deepening the financial sector on growth and employment is the ability of firms to raise capital. At the macroeconomic level, the level of credit has a direct influence on economic growth (Levine, Loayza, & Beck, (2000)). The work of Dima Bogdan and Opriș Petru Eugen (2014) analyzes the relationship between financial intermediation and economic growth of developing economic systems. The result suggests that financial intermediation as part of financial development is positively associated with economic growth.

Credit expansion has been associated with faster economic growth and the emergence of financial crises, a pair of results that seem to contradict each other. Angeles (2015) gave an explanation for these results, by separating credit to the private sector into corporate credit and household credit. Empirical analysis showed that credit to firms is responsible for the positive effect of growth, while the higher occurrence of crises is mainly due to household credit. The events of the last decade, in which the rapid expansion of credit has led to crises and very little growth, can be understood as a change in the composition of credit to the component of its household.

On the other hand, for the Eurozone, Leitao (2012) concluded that inflation and bank credit have a negative impact on economic growth. This highlights the importance of monitoring the evolution of credit in the monetary policy toolkit and underpins the reasoning that gives monetary and credit analysis a prominent role in the ECB's monetary policy strategy.

Given that the EU has often been described as having bank-dominated (or hybrid) financial systems, an understanding of the peculiarities of credit flows and their interference with changes in the business cycle (either in the boom or in the bust phases) is essential, not only for decision makers, but also for market participants.

It's not easy to talk about possibilities during a pandemic that is causing such a significant human tragedy globally. But private debt has a critical role to play in financing the recovery from the global slowdown caused by Covid-19. For creditors, this is an opportunity to show to stakeholders, including investors, regulators, asset owners and governments, that sustainable and supportive economic growth can be supported. The speed and magnitude of the crisis surprised investors unexpectedly, as asset classes, and especially private debt, were affected by an unprecedented combination of global demand and supply shock and extreme pressure on cash positions.

As the world recovers from the coronavirus pandemic, the private credit industry has the opportunity to position itself as a strong partner for long-term post-crisis growth. But sustainability must be the focus of private creditors. Given the current global developments with the coronavirus outbreak, private debt in the second quarter of 2020, has recorded a substantial rise, with the tendency to maintain this trend in the near future. As seen in (fig.nr.2), European Union's Private accounted for 93.14% of its Nominal GDP in June 2020, compared with a ratio of 88.72% in the previous quarter.

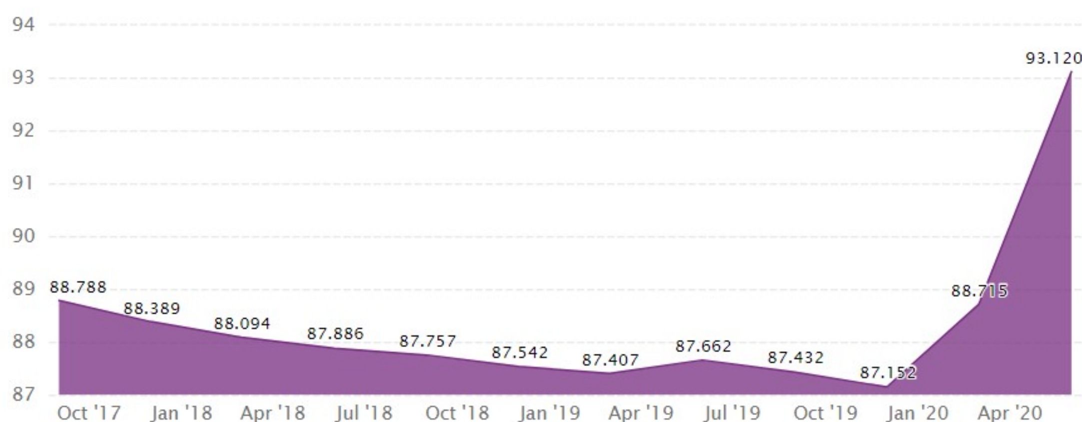

Fig. nr. 2. EU Private Debt to Nominal GDP, Source: https://www.ceicdata.com/

3. Conclusions

An important conclusion is the need for more careful decision-making by the government to ensure that the financial resources gained from public debt are channeled in the right direction and used as efficiently as possible by all segments of society, while determining an "optimal" level of accumulated public debt that affects the flexibility and adaptability of other macroeconomic variables to the conditions in which a country is.

Since Covid-19 halted global growth earlier this year, major advanced economies have made some of the biggest policy changes ever seen in such a short time. Fiscal and monetary policymakers have introduced massive stimulus packages almost instantly, as opposed to the much slower response to previous recessions, including the 2008 financial crisis. As a result of the recent developments, there are deficits of spending and employment, but surpluses of income and debt. Emphasis must be placed on stimulating the recovery and reshaping the economy towards one that supports employment, sustainable industries and reduces economic and social inequalities.

Credit is vital for the economic activity of any business or individual. Families borrow money to facilitate the consumption and purchase of housing. Firms often need loans to finance long-term investments. Private sector lending is linked to economic policy. They affect the monetary transmission mechanism and are the key determinant of financial stability. Non-performing loans are today the main threat to the stability and development of the banking system. The increase in non-performing loans is closely linked to the public debt ratio and, at the same time, one of the main causes of the decline in banks' lending activity.

As COVID-19 spreads around the world, a contraction in global growth is causing a short-term adverse reaction to the economy and financial markets. Transactions with strong protection against disadvantages should remain more resilient during the crisis, while the degree of contagion from public markets to private debt remains unclear. Given the current environment and challenges, the private credit industry has the opportunity to position itself as a strong partner for long-term post-crisis growth. Growth will require vision, purpose, innovation and "out of the box" thinking.

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