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DECEM: FINANCIAL ALTERNATIVES FOR DEVELOPMENT AID (1)

*Public debt: a public treasure with a lot of potential*²

The world's economic and financial system is articulated around a series of multilateral institutions that oftentimes set the direction of the economic policy at the national administration level. These institutions receive the name of *Bretton Woods*³ and their origin goes back in time towards the period just before the end of World War II in 1944. At the time the British economist *John Maynard Keynes* proposed the creation of institutions of global scope, able to contribute to the economic stability and progress of the nations of the world.

The well-defined role played by both the *World Bank* and the *International Monetary Fund* has, over the years, become less specific and oftentimes their intent, *raison d'être* and goals partially overlap. Historically the World Bank has played a more notorious role against the extreme poverty of many nations, proposing economic policies that foster the growth and lending to sustainable development projects. However the International Monetary Fund proposes, *grosso modo*, austere macroeconomic policies to highly-endebted countries (external debt), so that the latter do not incur in fiscal deficits leading to the failure to service the debt owed to the first world, at the same time that it "rescues" countries in economic crisis from their bankruptcy situation, using abundant monetary

¹ About the author: Jaime Pozuelo-Monfort graduated from *Universidad Politécnica de Madrid* in 2000 with a master's and a bachelor's in telecommunications engineering, having also studied two years as an exchange student at *Telecom Paris* and *Universität Stuttgart*. Subsequently he earned master's degrees in business administration from *College des Ingénieurs* in Paris, in financial economics from *Universidad Carlos III de Madrid*, in financial engineering from the *University of California at Berkeley*, and in economic development from the *London School of Economics*. He currently pursues a master's in public administration at *Columbia University*, and will start a master's in international law and politics at *Georgetown University* at this fall. He has worked in the technology sector in Madrid, Stuttgart and Paris, and in the financial industry in New York City and London. His interests lie in the interaction between financial economics and economic development. In addition he is a columnist in written and electronic press. He speaks English, French, German and Spanish fluently, and has a beginner's level in Arabic, Italian, Portuguese and Russian.

² This is the first article of the decem series, a series of ten articles fundamentally innovative that aim at the proposal of alternative financial mechanisms to considerably raise the amount of funds available for development in the third world. Throughout the series, the author will stress the implementation aspects of the suggested ideas and will propose arguments for and against.

³ With the goal of reconstructing the international economic system, delegates from 44 allied nations met at the North-American city of *Bretton Woods*, in a conference that established the mentioned organisms.

resources with the condition of imposing ex-post (excessively) austere macroeconomic policies.

It truly is a relatively static scenario, a game in which the rules are already set in advance, and that leaves no room for alternative thinking able to generate additional monetary resources. A system which nature has been established over the years and throughout the economic crisis. A system that is not static, in spite of its appearance, although its enormous size and bureaucratic soul make it a giant incapable of reacting to the challenges and threats current world faces.

WHAT IS THE ROLE OF THE NATIONAL ECONOMIES?

In the context of suggesting policies able to considerably augment the amount of funds the first world currently devotes to development aid, the national economies in the industrialized countries can, and must play a more active role, not necessarily aligned with the austere policies imposed by the multilateral organisations referred to in the previous section.

There are alternative mechanisms that have not been taken into account yet, that could be implemented with a fundamentally positive impact for the poorest countries. Economic policies designed in and from the first world, to change a scenario of extreme poverty faced by the majority of the world's population.

In this context we propose in this first article of the series of ten⁴, the first of the mechanisms that are suggested as alternative thinking.

THE NATIONAL DEBT: A PUBLIC TREASURE WITH A LOT OF POTENTIAL

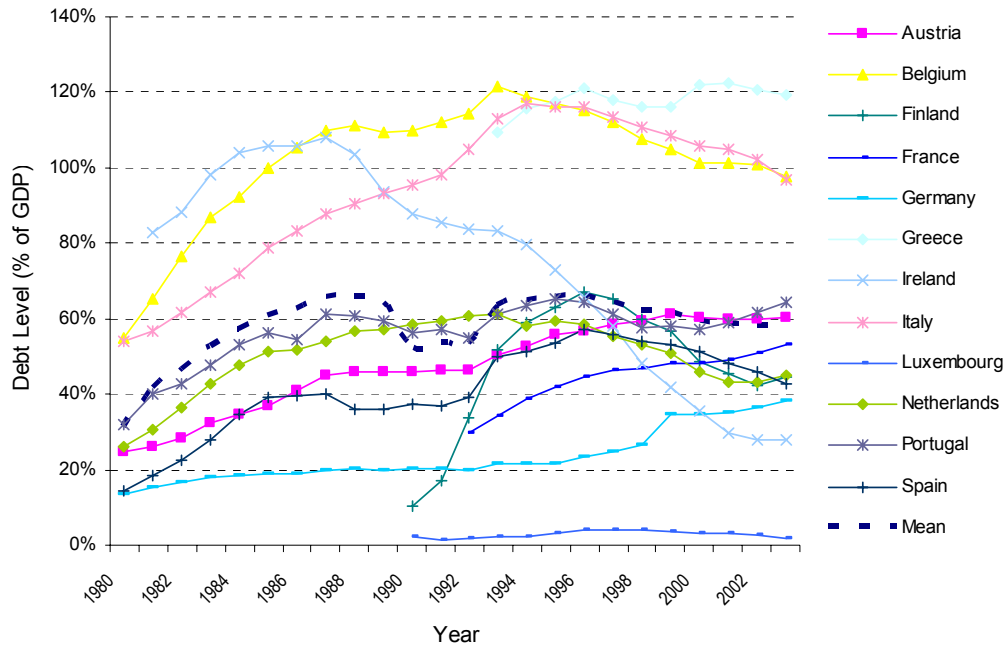
The national or public debt is a tool that enables governments to react in times of economic crisis, to finance, through public spending, infrastructure as well as public services that, on one hand permit to maintain the welfare state, and on the other, are able to sustain the unemployment level. It is about the well-known deficits and surpluses we sometimes hear about in the evening news. Fiscal deficits and surpluses that alternate in the ups and downs of the economic cycle. An austere economic policy will set a maximum ceiling to the deficit, so that a national economy does not borrow in excess.

It is in some respect the way the Republican Administration in the United States has financed the war in Irak or the rescue-packages in post-Katrina New Orleans. A concern, that of a high leverage, that will have repercussions in our children and grandchildren, some argue. For what reasons it is worth to increase a nation's debt level is a matter that some of our political leaders should respond to.

The debt of public debt relative to the gross domestic product (GDP) varies according to the country considered. There are countries that are slightly indebted such as Luxembourg, whereas others such as Italy or Greece, are highly indebted. On the other hand, the Spanish economy reached its maximum debt-to-GDP ratio in 1996 at 57%,

⁴ *Decem* es the equivalent word in Latin for the number ten.

and has subsequently diminished it to levels at around 40%. The following chart depicts the level of debt-to-GDP for a number of European economies:



Source : OCDE

Among the requirements of the *Maastricht Treaty* to join the Economic and Monetary Union, there are two related to the level of debt: (1) the fiscal deficit cannot increase beyond the equivalent of 3% of the GDP, and (2) the public debt cannot surpass the level of 60% of GDP. In numerous occasions these limits have not been respected, such as in the recent cases of France and Germany regarding (1), or Greece and Italy regarding (2).

If we observe the current level of debt in Spain and other economies of the Euro-zone, we can conclude that it would be feasible to increase the debt-level a number of percentage points, so as to devote the funds raised this way to a *great fund for development aid*.

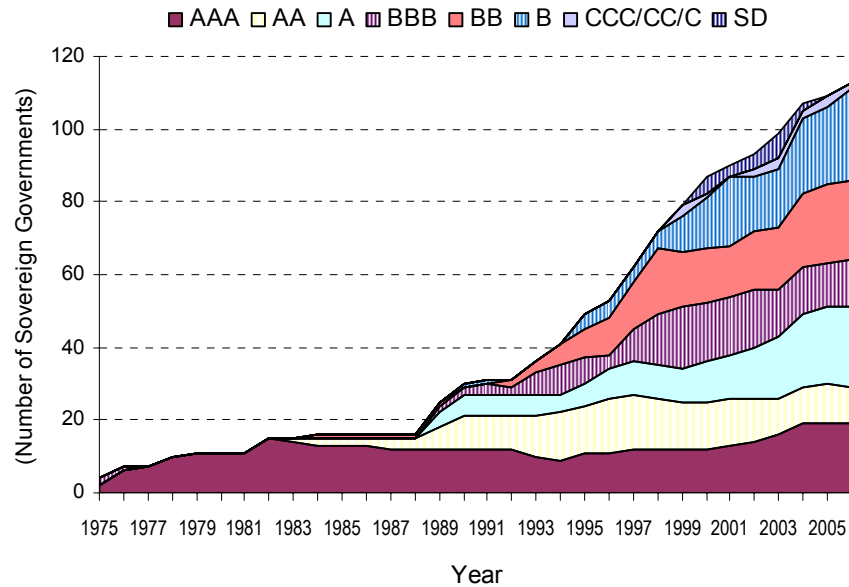
IMPACT OF A HIGH LEVEL OF DEBT

The role played by a rating agency⁶ is to determine an institution's credit risk by means of a credit rating. A credit rating is nothing else than a letter-code denoting how likely a company is to service its debt and to not go bankrupt. In the same way a rating agency can assign a credit rating to a corporation, so can it assign a rating to a national economy.

⁵ In a later article we will explain how to administer the funds obtained as a result of increasing the level of public debt by as much as 10% of a country's gross domestic product.

⁶ Moody's, Standard and Poor's and Fitch are the three main rating agencies.

These ratings are called *sovereign*. The following figure provides the number of countries having obtained a sovereign rating since 1975, with their corresponding credit rating:



Source: Standard & Poor's The Future of Credit Ratings (2006)

In 1975 only 4 national economies were rated by the agencies. By 2006 this number has increased notably, counting as many as a hundred. The credit rating is fundamental for an economy, because it is as a function of a credit rating that an economy will have a higher or lower cost of funding. Spain, for instance, currently has a maximum credit rating of triple-A, which is equivalent to stating that the probability of not servicing its current debt (or alternatively stated of going bankrupt) is negligible.

Therefore the investor in Spanish debt with a credit rating of triple-A, will demand in exchange a relatively low interest rate (the reader should not forget the relationship between risk and return). The level of indebtedness or leverage has a major impact on the probability of default of a national economy. The higher the leverage, the higher the associated probability of default will be.

The current level of a national economy's debt-to-GDP ratio determines whether or not it can undertake an additional increase of leverage of about 10%. To incur in additional leverage carries the obligation of servicing future payments to those investors that decide to purchase the debt. A sustainable level of debt guarantees the future payments, whereas a prudent increase of leverage will not lead to an immediate lowering of the sovereign credit rating. The following diagram summarizes the limitations expressed above.

