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In Praise of Debt: Why Greece's Mistakes Shouldn't Hurt Emerging Borrowers

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September 2011

www.cgdev.org/content/publications/detail/1425439

ABSTRACT

The Greece debt imbroglio could have wider and more damaging reverberations across Europe and—even worse—throughout the developing world. The current engines of the global economy—the emerging and frontier markets—also require access to risk capital to keep the growth machine going. Politicians and economists alike hold up Greece as a cautionary tale to other countries, including the United States, about the dangers of debt. But it could really hurt billions of people in developing countries if the Greek mess gives people the wrong idea—yet again—about borrowing for development.

This paper originally appeared on Bloomberg Businessweek on August 31, 2011.
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In Praise of Debt: Why Greece's Mistakes Shouldn't Hurt Emerging Borrowers

Imagine, for a second, that your son has just graduated college. You've generously agreed to pay off his student loans. His immediate reply is: "Thanks, Dad! You're the best. Now I'm going to borrow $100,000 more!" Is this good news or not? It depends, of course. If it's to pay for business school—presumably raising his future income and allowing him to pay off the loan himself—then this is wonderful news. That B-school loan could be the spark to build a career and a happy, independent life. But if that $100k merely enables your son to sleep late, watch TV, and buy a sports car, then it's a disaster. The loan isn't a springboard but rather the beginning of dependency and financial trouble. You are probably going to have to bail him out again.

The same goes for countries. Whether government borrowing is a good investment or a way to avoid hard choices depends on how the capital is deployed. Using new long-term debt to build highways and power plants that will contribute to rapid growth and exports might be a terrific idea. The future income should more than cover the payments and the country is better off for having borrowed. Yet if the loan capital is merely used to avoid laying off excess government workers or to subsidize failing state-owned companies, new borrowing just delays tough decisions and sows the seeds of debt stress.

The unresolved debt crisis in Greece, which threatens to smother the global economic recovery, destroy the euro, and hasten the demise of the European welfare state, is a fresh illustration of the downsides of debt. To extend the analogy above, Greece is a version of your deadbeat son. The country piled up nearly half a trillion dollars in debt it cannot repay. It deferred hard choices for years, until its economy teetered on the edge of collapse. Even after its neighbors coughed up more than 100 billion euros in aid last year, Greece still couldn't get its house in order and had to go back for more. European governments have again agreed to contribute additional billions to help Greece, but that deal is stuck because some of its neighbors insist on some kind of collateral. So much for Greece's credibility to make real changes. How long the Greeks can put off the day of reckoning is anyone's guess.

It's Not Debt—It's Greece

The Greece imbroglio could have wider and more damaging reverberations across Europe and—even worse—throughout the developing world. The current engines of the global economy—the emerging and frontier markets—also require access to risk capital to keep the growth machine going. Politicians and economists alike hold up Greece as a cautionary tale to other countries, including the United States, about the dangers of

debt. But it could really hurt billions of people in developing countries if the Greek mess gives people the wrong idea—yet again—about borrowing for development.

Tapping foreign credit has long been an essential way for nations to finance growth. The Japanese government borrowed millions from the World Bank in 1961 to build the Tokaido Shinkansen, the bullet train between Tokyo and Osaka, which became a key backbone of the Japanese growth boom and easily allowed the government to repay the debt. In the United States in the 19th century, “canal bonds” were issued to raise capital to build the Erie Canal, enabling an explosion in trade by connecting the Midwestern economies to the eastern seaboard and overseas markets.

The big picture, in fact, suggests that developing countries—which don’t have the long-term pension obligations and other demographic problems that are a source of debt distress in the United States and Europe—absolutely should borrow plenty more. Given the low yields on U.S. Treasuries and slow growth in rich countries, capital should be seeking higher returns in the fast-growing emerging economies. These countries also tend to be short on the capital-intensive infrastructure that drives and sustains economic growth. This should be a no-brainer.

Global Backlash against Debt

Yet respectable opinion has turned against Third World debt, which is now widely considered only a millstone around the necks of the world’s poor. The Jubilee movement—with activists from Bono to the Dalai Lama—spent much of the past two decades campaigning to successfully erase the debts of the world’s poorest countries. More recently, the U.S. decided to write off a billion dollars in Egyptian debt in the name of bolstering Egypt’s precarious transition to democracy. Here in the United States, the political mood has made debt itself the enemy, even at a time of high unemployment. Among politicians and policymakers, the received wisdom is that large bills doom prospects for the future.

Is that always really true? The bond markets sure don’t seem to think lending to risky emerging markets is a problem right now. Private lenders looking for yield may not consider Greece or Ireland a good bet, but they are putting plenty of money into countries that—just a few years ago—the average fund manager thought of as places for exotic vacations, not investments. Soon after cleaning its books, Ghana, a promising West African country of some 24 million people, went back to the Eurobond market and easily raised $750 million in 2007. Other African emerging markets such as Gabon, Senegal, and Nigeria followed suit, while Kenya, Uganda, Zambia, and Angola are all preparing to return to commercial debt markets, too.

There is still good reason to be vigilant about debt. Many developing-country governments have been awful intermediators of capital in the past. They've often borrowed money and then wasted it by pouring it into dud projects, paying the salaries of ghost workers, or just allowing funds to "leak" into offshore bank accounts. Ivory Coast borrowed millions in the 1980s to build the massive Basilica of Our Lady of Peace of Yamoussoukro, a replica of the Vatican's Saint Peter's Cathedral, in the president's home town. Kenya has borrowed from the World Bank more than a dozen times to fix its railways, with little to show for it. Just as with your son, Kenya's creditors have struggled (somewhat predictably) to figure out how Kenya really uses such loans. In too many countries, borrowing has left countries—and their creditors—worse off.

So the big question, for both borrowers and lenders today, is: Can debt ever be a force for good again, as it was for Japan in the 1960s and the U.S. in the 1800s? And should the world continue to extend credit to governments whose track record on paying off their creditors is anything but stellar?

Ghana's Frustrating Track Record

Let's again look at Ghana, which on the surface seems an ideal borrower. Growth has recently been 6 percent or better, the country recently found oil, and the economy is restrained by massive unmet demand for power and roads. Investors should be lending Ghana additional billions to fuel even faster growth and generate meaty returns. But past borrowing repeatedly got the country into trouble. It needed a near total debt write-off in 2004. And no one can adequately explain where the $750 million raised four years ago has really gone.

But 2011 is turning out to be very different from the 1980s for countries such as Ghana. Economic management is almost universally better and once-marginal countries are now easily plugged into global financial and communications networks. The key for creditors is that countries must maintain a healthy growth rate and pay on the coupon. The real number to watch is not how much a country borrows, but the ratio of its debt to other economic indicators. In other words, it doesn't really matter if Ghana borrows $1 billion or $10 billion today; what counts is the size of its economy and exports in the future. On that score, there is reason for optimism. If Ghana continues to grow at 6 percent to 7 percent annually, the economy will be twice its current size—cutting its debt-to-GDP ratio in half—by 2020. Things look good now, although no one can know what real growth will be. (By comparison, Ghana's debt-to-GDP ratio is about 40 percent, vs. 150 percent in Greece.)

China is also, not surprisingly, central to the story. While Capitol Hill frets about the size of Chinese holdings of U.S. debt, China is lending across the globe. The China Export-Import Bank and other quasi-official entities are flush with cash and are using debt

diplomacy to help build markets for Chinese goods and construction projects around the world, including in lots of developing countries. It helps that the Chinese are pretty good at building power plants and roads, precisely what emerging markets really want. (Just this week, Ghana's parliament gave a green light to a new $3 billion loan from a Chinese state bank for investment in infrastructure and the petroleum sector.) This will turn out fine if these loans generate returns greater than the borrowing costs in the form of higher future growth and exports. It will end badly if cheap credit merely builds railways that will never be maintained—or just buys time for dictators.

Anxieties about future growth, the use of new loans, and what the Chinese are up to should make people a little nervous. But worries over debt—to Greece, your slacker son, or anyone else—shouldn't thwart lending to those that show they can put capital to good use. Debt can fund the building blocks of wealth or become the white elephants of catastrophe. But it would be wrong if stagnation and intractability in the oldest parts of Europe were to suffocate the promise of the next generation of economic powers.

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