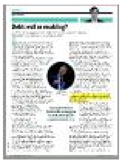

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By Johan Fourie

ECONOMY

Debt: evil or enabling?

South Africa needs urgent investment in public infrastructure to improve productivity. But should our government be borrowing money to do this?

Is debt good or bad? Economists would answer: it depends. Two things matter: the cost of the debt, which is reflected in the interest rate, and the returns on whatever you use the borrowed funds for. If your income is rising faster than the interest rate of the debt, then it makes sense to increase debt as you would be able to repay it without trouble. If not, well, then debt will be a poisoned chalice.

Of course, debt has been with us for some time. In a deeply problematic take on the history of debt, *Debt: The First 5000 Years*, David Graeber argues, this time correctly, that debt transcriptions already appear with the first civilisations in Sumeria, more than 5 000 years ago.

My own research with a former PhD student, Christie Swanepoel – who is now an economics lecturer at the University of the Western Cape – shows that debt was also central to the lives of 18th century Cape Colony settlers. Whereas historians had often regarded debt as a way for the wealthy to exploit the poor, we show that farmers in the Cape often used debt to fund new investments in land, equipment, and – depressingly – also slaves. Such investments were an important tool for upward social mobility for the poorest settlers.

What is true for individuals, now and in the past, is true for firms and for governments too. Should governments borrow to pay for new roads, power plants, schools or clinics? What about government employee salaries or pensions?

At the recent American Economic Association meetings in Atlanta, the largest and most important economics conference globally, president-elect Olivier Blanchard – emeritus professor of economics at MIT and a former chief economist at the IMF – delivered a keynote address on exactly this question.

Most readers will know him as the author of their undergraduate macroeconomics textbook.

Should governments (temporarily) borrow to pay for public spending? The conventional answer is no. If government borrowed, it would have to raise taxes to repay the higher interest. If it did not raise taxes, but instead borrowed more to repay the interest, this would result in a debt-interest spiral that would eventually make the government insolvent. This is not just a theoretical consideration; several African countries experienced debt crises in the late 1970s and early 1980s, for example.

Blanchard argued that these events are actually quite rare, and the likelihood of a debt-interest spiral is only of concern when an economy is stagnating. Here's how Simon Wren-Lewis of Oxford University explained it on his blog, *mainly macro*: "A government (like a firm or individual) should look at debt as a ratio to its ability to pay, and the easiest way to do that is to look at the debt-to-GDP ratio. GDP rises faster than debt if its nominal growth rate (real growth plus inflation) is greater than the rate of interest on that debt. In shorthand, g > r."

Olivier Blanchard
Emeritus professor of economics at MIT

Dalla Getty Images

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Most economists assume that r > g. But Blanchard pointed out that historically this rarely happens. It was only in the 1980s, when governments were fighting inflation, that the interest rate was above nominal GDP growth. So g > r may be the rule rather than the exception.

What is the implication of this? Should governments be happy to borrow more while growth exceeds interest rates? Not so fast, says Wren-Lewis: "What it means is that one of the standard objections to raising debt, which is that taxes will have to rise to pay the interest, no longer holds if g > r. If g > r the government can borrow to pay the interest, and yet the debt-to-GDP ratio will still gradually decline, because the economy is growing faster than debt. The objection to raising debt because taxes will have to rise in the future to pay for it disappears. Indeed the whole 'burden on future generations' objection to raising debt falls away, because the debt-to-GDP ratio declines by itself: there is no future burden."

Two lessons emerge for South Africa. This is all based on the assumption of a temporary increase in debt, meaning a once-off spending on infrastructure, for example, rather than funding salaries or pensions.

The second lesson is that growth is more important than most people think. Many critics of capitalism are happy to point out that growth does not always 'trickle-down' to the poorest. What they refer to is the spending multiplier, and in that narrow sense they may be correct: the spending multiplier may not always be as large as we would hope. But growth also allows a country to borrow to help pay for those goods and services not provided by the market. And without growth, such debt imposes a burden on the next generation through higher taxes. (And the poor are often the least able to escape higher taxes.) If growth is high, however, no such burden is imposed.

SA needs urgent investment in public infrastructure to improve productivity. No economy can be competitive without a reliable source of energy. What Blanchard says is that debt can be one way to finance such expenditure – again, with the proviso that the money is actually used for what it is intended for. Said Blanchard: "What do I want you to go away with? Not the notion that debt is good. But debt might not be so bad." ■

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