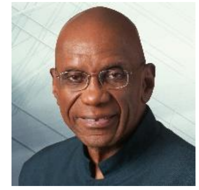

OCTOBER ECONOMIC LETTER

Distinguishing Between Good and Bad External Debt

This month I draw your attention to an important article by Professor Charles Wyplosz of the Graduate Institute of International and Development Studies, Geneva, on the above topic. It may be found at *Project-syndicate.org*. Professor Wyplosz makes the point that borrowing for investment is good, but borrowing to consume more than earnings becomes problematic.

Barbados is one of very many countries worldwide that imports more than it earns in foreign exchange, year after year. The difference is financed by borrowing abroad, by the private sector and by Government. Whether this borrowing can continue indefinitely depends crucially on what the borrowed funds are used for.

Professor Wyplosz points out that “If a country borrows heavily to finance productive investment, ensuring that the rate of return on the investment exceeds borrowing costs, more borrowing would translate into more wealth. In this situation, a country should not have any difficulty servicing its debt, as has been the case with Australia for decades.”

However, he goes on to warn that any country that borrows to finance "excessive public spending" will probably run into difficulty, because lenders may become worried about the risk that government may default on its obligations. “An awareness of these risks may cause foreign lenders, rightly or wrongly, to panic and stop lending to a country with large external debts, making it impossible for that country to finance its ongoing deficit.”

Professor Wyplosz gives examples of good and bad debt. “Consider the US, which ran large and persistent deficits throughout the nineteenth century – deficits that were used to finance the massive investment needs of the country’s fast-growing population and vast geography. For the most part, the investments made were highly productive, and the foreign lenders who provided the funding largely became rich.”

He contrasts that experience with recent crises in Europe: “In Greece and Portugal, current-account deficits were closely tied to large and persistent public deficits. In Cyprus, Ireland, and Spain, it was the private sector that had borrowed huge amounts. In all of these cases, external borrowing had been used for non-productive spending.”

The parallels with Barbados' recent experience are clear.