Global Insights

By, Samuel Baker and Nyirakanani Regine

Living on borrowed time: A view on debt

At a recent Global Shapers event I attended, there was no shortage of questions during the Q&A session. "*You say that you plan to create more jobs, but young Rwandan entrepreneurs are struggling with debt; how can we succeed while relying on costly debt*?" one gentleman asked the Economic Empowerment Director at the youth ministry. The tone of the gentleman's question revealed a deep frustration, "*debt is very damaging*" he lamented.

Judging from this encounter, debt has a negative connotation among people, however, it is important to remember that debt can be looked at in different ways.

Like all dietary fat, all debt is not created equal. While common nutritional guidelines tell us that fat is bad and should not be a large part of any diet, we also know that there are healthy fats and unhealthy fats. Healthy fats (from nuts, avocados and olive oil) support cellular function, fuel the metabolism and are vital for the body. Unhealthy fats (from fried food, meat and butter) on the other hand, tax the body, can clog arteries in your heart and can lead to a range of health problems down the road.

Debt can also be characterised similarly as productive and unproductive. It is instructive to consider debt through the following lens:

- For what purpose is the person, business or government using the borrowed money?
- Is the money going to enhance productivity or simply serve to increase spending?

Productive debt is like the healthy type of fat, because it can be used to fuel growth and support real economic activity. When a company borrows money to expand its factories, for example, it leads to an increase in employment and output. A consumer taking out an auto loan for a much-needed vehicle to drive to and from work may gain efficient travel and save time and money on commuting.

Contrary, unproductive debt is similar to unhealthy fat. It is undeniably enjoyable in the moment and may seem harmless, but bears a range of potential repercussions down the line. For example, excessive debt that pushes a consumer's spending beyond sustainable levels or a company borrowing, in part, just to repay existing debt obligations. (The exception would be if companies are taking advantage of low rate environments to strategically refinance their debt obligations, something experienced recently in some advanced countries since rates fell so dramatically). At the extreme, useless forms of debt can be used to prop up zombie companies or to roll over non-performing loans.

Debt is useful but can also be painful

Economists worry about debt because of its ability to cause acute crises when solvency concerns arise and its ability to operate as a slow but steady drag on growth. Take two possible outcomes of overindulging in unhealthy fat. At the extreme, blocked arteries can lead to an acute crisis like a heart attack, while a slow and steady drag on your body's functions would look more like failing to run a 10km marathon, or doing it slowly.

In the first outcome, debt can cause acute stress in the financial markets and the broader economy if concerns about the borrower's solvency arise. Consider the subprime mortgage crisis and the European sovereign debt crisis. Both events were characterised by what seemed like sudden anxiety about debt repayment and a stark realisation that borrowers had taken on more debt than they could ever pay back. During the European debt crisis, Greece was a striking example. Once investors realised the true state of the Greek balance sheet, lenders revolted, demanding significantly higher compensation for their credit risk, quickly driving yields on 10-year Greek government bonds from single digits to over 30%. This, in turn, made Greece's financial situation even more untenable than it already was, fuelling a vicious cycle.

In the second outcome, unsustainable high debt levels, often described as a "debt overhang," can manifest as a steady drag on economic growth through various channels. In the corporate sector, organisations with unsustainable high debt levels may have to turn down new investment projects with potentially positive returns as debt service becomes more onerous. In the public sector, debt overhang might divert resources away from productive spending in critical areas like education and research and development. Furthermore, elevated sovereign debt levels may force a government to increase taxes and limit its ability to enact expansionary fiscal policy when the economy needs it most.

In Rwanda, the current elevated level of non-performing loans is of concern and as BNR works to find solutions to this problem and question why it happened in the first place, it is crucial that we engage participants (both financial institutions and individuals) in conversations on debt and its two-faced characteristic.

When one is diagnosed with fat related health issues, they may think that all fat is equally dangerous and risk not consuming the healthy and useful fat. Similarly, when individuals, institutions or governments experience bad debts, they may be pushed away from taking on debt that may even be useful. For the guy at the event, any debt is damaging and any entrepreneur is doomed to think of using debt financing. However, you and I know, this is simply not true!

Government borrowing, personal borrowing as well as corporate borrowing are not always as bad as the term debt is often portrayed; but the two questions will always determine the outcome – for what purpose are you taking on the debt, and will it be productive?