The ABC of Economic Literacy: 'D' is for debt

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In Shakespeare's Hamlet, Polonius's sage advice to his son about friendship was "Neither a borrower nor a lender be For loan oft loses both itself and friend." In contrast, borrowing and lending between complete strangers makes the world a better place.

People deposit savings with institutions that on-lend those funds to people who need to borrow to buy a house or expand their business. Globally, banks and other such intermediaries shift savings from countries that have a surplus of savings over investment opportunities, such as China in recent decades, to deficit countries. People with surpluses are better off than if their opportunities to invest were narrower and people with deficits are better off than if their opportunities to borrow were fewer.

These transfers of savings may take the form of debt or equity. This article is about debt.

Unlike equity, debt involves no ownership control of the borrower's enterprise. Instead, the borrower typically agrees to pay the lender interest and principal according to a pre-determined schedule, as for term deposits or payments on government bonds. The lender is risking that the borrower will default, and needs to take care as a result. Higher interest rates can compensate for greater risk, but not if the borrower defaults. Conversely, borrowers who borrow too much can inflict severe future distress on themselves and their associates.

Borrowers have less incentive to be prudent when they are merely the agent of the person who is really liable. For example, when large companies or governments are borrowing, they are putting their shareholders and taxpayers at risk respectively, rather than the managers, politicians or officials who are signing the borrowing contracts. Unless such agents are well-controlled, they may borrow imprudently.

Similarly, lenders have less incentive to be prudent when they are merely someone's agent, or when they can assume that someone else, such as the government, is assuming the risk. Government-backed lenders, Fannie Mae and Freddie Mac, were major underwriters of the last US housing bubble.

Misplaced confidence in financial soundness is a dangerous thing, particularly for taxpayers. Unsurprisingly, research has found evidence that government guarantees for bank deposits increase the risk of bank failure.

Peace-time debt crises of national significance commonly reflect government mismanagement of fiscal, exchange rate, monetary, industry and/or prudential policies. But they can also have climatic and international causes. The costs in unemployment and lost output can be very serious.

The New Zealand Initiative is a Wellington-based think tank formed by the merger of The New Zealand Business Roundtable and The New Zealand Institute. www.nzinitiative.org.nz. CEO Dr Hartwich is a regular speaker at PortfolioConstruction Forum programs.
