

Public Debt and Development: The New Structural Economics Perspective<sup>1</sup>  
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I'd like to use this opportunity to make three points. The first one is why public debt is desirable for development. The second point is the determinants of debt's sustainability. Under what situation, debt will be sustainable, and under what situation, debt will not be sustainable. The third point is the desirability of providing more debts to a highly indebted country. I'd like to provide my analysis based on the New Structural Economics which I have been advocating in the past decades.

Why is public debt desirable for development? Because economic development is a process of structural transformation, in which a country transforms from an agrarian economy to an industrialized economy and climbs up the industrial ladders continuously, through technological innovation and reallocation of resources from lower value-added industry to higher value-added industry. The technological innovation and industrial upgrading make the improvement of productivity feasible. But technological innovation and industrial upgrading only provide the production possibility frontier. To be on the productivity frontier, promised by the technology and the industry, it is necessary to have suitable infrastructure, including electricity, road, port facility and telecommunication. Infrastructure investment is lumpy, and there a minimal scale to make it work. Infrastructure also has a large externality. Private sectors will not be able to provide the needed infrastructure sufficiently for the structural transformation. Therefore, the state has an essential role to play in the provision of infrastructure. Because it is lumpy and needs to have a minimal scale, very often the government in a developing country won't have sufficient domestic resources to provide needed infrastructure for the structural transformation. So there is a need to get more financial support outside the country, either from the development aids or from the international borrowing to support infrastructural investment. That is my first point.

If the government borrows debts to support infrastructure investment or for any other kinds of usage, there is a concern about whether the government will be able to pay back those debts. If they cannot, the country may encounter a crisis and this might even trigger a crisis in the world. From the New Structural Economics' point of view, debts will be sustainable, if the debts are used to facilitate the transformation of industries from latent comparative advantages to actual comparative advantages in the country. The improvement of the infrastructure turns the latent comparative advantage of an industry to actual comparative advantage by reducing transaction cost. We know the comparative advantage is determined by a country's factor endowments. If an industry and technology used by the industry are consistent with the nature of the economy's factor endowments, we say that the industry have the comparative advantage. But to be precise, this is only the latent comparative advantage. Because if the industry and technology are consistent with the factor endowments, it only implies a low production

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cost. In the domestic market and the international market, competitiveness is determined by total cost. Total cost includes two components. One is production cost, basically determined by their factor costs of production. The other one is transaction cost. Transaction cost is largely determined by the condition and the availability of infrastructure. So for a country, during its industrial structural transformation, in order to turn their latent comparative advantages into the actual comparative advantages, the government needs to help reduce the transaction cost by improving the infrastructure. If there is adequate infrastructure, the latent comparative advantages can be transformed into the actual comparative advantages quickly. By that, the industry can compete in the domestic market and the international market. It can create jobs, promote growth, increase exports and enlarge the country's foreign exchange earnings. And with that the country will be able to pay back the debt. That means the country will not have the sustainability issue.

In a developing country, infrastructure is almost poor everywhere. So under this situation, the government needs to provide adequate infrastructure to support industries transforming from latent comparative advantages into actual comparative advantages. However, the government does not have sufficient funding for providing infrastructure to the whole nation. It would be desirable to be pragmatic, adopting an enclave approach by improving infrastructure in a special economic zone, an export processing zone or an industrial park. Within the parks or zones, the government can make infrastructure sufficiently good to help the country's latent comparative advantages to become actual comparative advantages. This pragmatic approach, targeting latent comparative advantages instead of targeting high-tech "advanced" industries can help the country to have a virtuous cycle. By that the country can grow very fast. The government will generate more resources, which can further support the industrial upgrading and improvement of infrastructure in other parts of the country. If a country follows this kind of pragmatic approach, advised by the New Structural Economics, the public debt will be sustainable.

Debt will not be sustainable if the government is too ambitious, trying to develop industries which look very advanced and very modern but not consistent with their comparative advantages. Under that situation, even the government makes the investment and provides infrastructure, the industry's production cost will be too high. The industry will not be competitive at all. That was the case in China before 1978. China had a comprehensive set of heavy industries even though China was a poor agrarian country. But the cost of production was too high, and those industries were not competitive at all. So if a country develops sectors which are too advanced and are not consistent with the country's comparative advantages, the country will not be able to pay back the debt. If the government supports sectors which are consistent with the country's latent comparative advantages, but the country encounters a global shock, which shrinks global market. Even the sectors are consistent with comparative advantages, the country may not be able to export and will not be able to earn enough foreign exchanges to pay back the debt. That is the second situation--external shocks.

And the third situation is that sometimes the government borrows the debts not to facilitate the structural transformation directly. They borrow debts for non-production purposes, for example, education, health, unemployment relief, and environment protection and so on. All of those have good purpose. But they would not contribute to the export growth and enhance the ability to earn more foreign exchanges. With this, they may not be able to pay back the debt either. Then the sustainability will be an issue. So that is my second point. The country needs to be pragmatic, targeting the right sectors at right locations.

Many countries in the past, especially the developing countries, did not follow the advice of New Structural Economics because at that time there was no New Structural Economics. So they did many wrong things even they had good intentions. For example, they invested a lot in the heavy industries which they did not have comparative advantages. Or they build industrial parks in everywhere in the country, but none of them had adequate infrastructure. Or they borrow money for humanitarian purpose, education, health, and environment and so on. As a result, they cannot generate sufficient foreign exchanges to pay back the debt and even become highly indebted. Should the global development community continue to support them? It certainly depends. Unless they get forgiveness, they need to pay back the debt. Even the debt is restructured, they also need to pay back the debt. If a country wants to pay back the debt, the country should enhance its capacity for export. As I just elaborate, the country needs to have adequate infrastructure to make that happen. So unless the international community comes up with plans to forgive the highly indebted country's debt, otherwise the international community needs to support them with more debts for infrastructure investment. But this time the country should follow the pragmatic principle, supporting sectors with latent comparative advantages to turn into actual comparative advantages by providing adequate infrastructure. In this way, the country can be competitive in the domestic and international markets. And with that the country can generate foreign exchange earnings. The country will not only be able to pay back the new debt, but also have the ability to gradually pay back the old debt. This principle should also be applied to development assistance and development aids. If this pragmatic principle is applied, the international support, and any kind of support will be helpful to a developing country for a dynamic structural transformation and sustainable growth.