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Asset Management

Looking Forward

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Cidel Asset Management CEO, Arthur Heinmaa Presents Our Perspective on Government Debt

The 2019 Canadian federal election campaign will soon be underway, followed by the U.S. presidential race in 2020. On both sides of the border, government deficits and debt are expected to be key talking points. Every day, articles about government deficit and debt cross my desk, and while people seem to have endless concerns about government debt, I find most discussions lack perspective.
In talking about debt, I think it is helpful to begin with a historical perspective. Recently, I came across some passages from Thomas Macaulay's The History of England where he cites very familiar angst over government debt, although this debate raged in the U.K. more than 200 years ago:

"At every stage in the growth of that debt the nation has set up the same cry of anguish and despair. At every stage in the growth of that debt it has been seriously asserted by wise men that bankruptcy and ruin were at hand... David Hume, undoubtedly one of the most profound political economists of his time, declared that our madness had exceeded the madness of the Crusaders. Richard Coeur de Lion and Saint Lewis had not gone in the face of arithmetical demonstration. It was impossible to prove by figures that the road to Paradise did not lie through the Holy Land; but it was possible to prove by figures that the road to national ruin was through the national debt...When the world was again at rest the funded debt of England amounted to eight hundred millions. If the most enlightened man had been told, in 1792, that, in 1815, the interest on eight hundred millions would be duly paid to the day at the Bank, he would have been as hard of belief as if he had been told that the government would be in possession of the lamp of Aladdin or of the purse of Fortunatus."

Conversely, if you fast-forward to the prosperous days of the late 1990s when the U.S. ran a surplus under the Clinton administration, many worried that there would not be enough government debt around for financial markets to operate properly. No one could have imagined then, with the U.S. budget surplus at more than $200 billion, that the U.S. financial landscape would shift again in a few years to the point where $1 trillion deficits are the norm, interest rates hover around 2.5% (down from 6.6% in 1999), and there is little panic in the financial markets.

A similar outcome to the 1792 to 1815 period mentioned in the excerpt above saw debt in the UK rise from £80 million to £800 million in a similar time period and rates decline from 5.5% to 4%. This historic debt level seems small by today's standards, but the worries of the population were the same. It is true that all debts eventually have to be repaid and the UK did in fact retire the debt that was issued at the end of the 18th century in 2014. You read that date correctly. The debt that was repaid can be traced back to the collapse of the South Sea bubble, the Napoleonic & Crimean wars and the Irish distress loans.

It is also important to note the debt was finally repaid because long-term interest rates had dropped so much that these perpetual bonds traded above the government's redemption option. While this debt was passed many generations, it was not as burdensome as many had feared. In fact, the media barely covered the repayment because the amount was inconsequential. With that in mind, here are some key takeaways from our perspective on government debt:

1. A nation does not have a life expectancy.

It is helpful to think about government debt much like a personal home mortgage where individuals borrow to purchase a home. While a nation's lifetime is much longer than an individual's, we still underestimate how much of an impact time plus growth and inflation have on debt. To make a very rough comparison, it is like paying an interest-only mortgage and having your income increase ten-fold. The debt has remained the same but your capacity to pay is much greater.

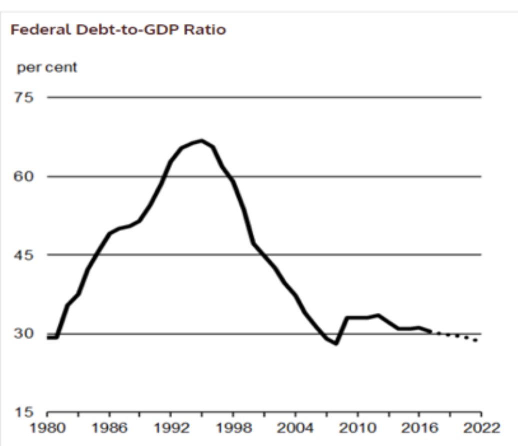
In the early 1990s, I attended a conference called "The Coming Bankruptcy in Canada." At the time, the government was running annual deficits of about $40 billion and interest rates were almost 8.0%. Contrary to the fears voiced at the time, Canada is now roughly three times larger, interest rates have declined to 1.75% and our deficit is about $18 billion. In other words, our interest paid remains constant, but as our economy continues to grow, inflation erodes the real value of the debt.

2. Debt as a number tells us nothing.

Let's start this point by quoting Macaulay again, who wrote in 1848:

"They erroneously imagined that there was an exact analogy between the case of an individual who is in debt to another individual and the case of a society which is in debt to a part of itself; and this analogy led them into endless mistakes about the effect of the system of funding. They made no allowance for the effect produced by the incessant progress of every experimental science, and by the incessant efforts of every man to get on in life. They saw that the debt grew; and they forgot that other things grew as well as the debt."

More than 150 years later, we still focus far too often on nominal amounts of debt without considering context. We forget that as our debt and deficits have grown, so have our economies. Thus, the more relevant measure is really the debt-to-GDP ratio.



Sources: Public Accounts of Canada; Statistics Canada; Department of Finance Canada calculations.

To gain perspective on debt and deficit, we should really focus on both the numerator and denominator of the ratio. When a government issues debt, it is in a fixed dollar amount which remains the same until the debt is repaid, whereas our GDP grows and inflation also increases the size of the nominal economy.

3. Increasing debt is not necessarily a bad thing.

Finally, many people view financial markets a morality play where debtors are punished and savers rewarded. Unfortunately, that is not a reliable rule for either corporations or nations. Further, the part that is hard to accept is that deficits can be beneficial.

Consider the difference between a country that a) issues debt to simply fund transfers to individuals and b) issues debt to build infrastructure or make capital investments. If you look at debt/GDP you cannot distinguish between policies. However, you can well imagine that the second scenario would encourage a much higher growth rate, despite the increasing debt.

Next, it is important to analyze how national governments account for capital expenditures – currently this is done with a unified account that groups capital expenditures, program spending and transfers into one budget. With current accounting policies, if a government, for example, spends money on a roadway with a 30-year life, the entire expenditure is accounted for in the initial year. (Compare that to a corporation, which depreciates the asset over its useful life.) Such policies lead to odd decision-making, where governments can make their budget positions appear better than they are simply because deferred maintenance is not included anywhere.

The reality is that in Canada today, many infrastructure projects could generate a real positive return over the next 30 years. Consider that our 30-year interest rates are approximately 2% and, after deducting for inflation of 2%, the government has the ability to borrow at 0%. (The situation in Europe is even more compelling with German 30-year bonds at

1.20%.) Yet, while at these levels, a deficit generated via capital expenditures is not a terrifying proposition, we still see politicians who are unwilling to spend on public investment. Essentially this is because program costs are all incurred upfront while benefits accrue long after they have left office – governments are incented against investing in our future so they can have balanced budgets.

To summarize, at Cidel, we do not believe issuing unlimited debt is prudent policy – but we do believe debt often goes hand in hand with growth and progress. That is why we do not think all debt is inherently bad. In fact, we are pretty sure that in 200 years, our current deficits will look just as quaint to future generations as our ancestors' obligations look to us today.