The instruments of debt

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Everyone is familiar, in theory, with some working definition of debt; however, we rarely contemplate its implications and influence on the day-to-day politics of finance-driven decision making. The cynical among us may argue that politics at every level is driven by economics, and that very few newspaper headlines are free of an underlying economic agenda. Most only think of debt as it relates to their daily lives – mortgages, loans and lines of credit – but the financial sector is built on the margins that arise from the balance between issuing and servicing debt, and the economy stands on a complicated foundation of government-issued paper, or debt.

Is debt bad? We've all heard the warnings: Canadians need to decrease their household debt and hunker down in preparation for an inevitable interest rate rise that will threaten the domestic economy. We are more personally in debt than we have ever been at any point in history. Or is debt good? The more money the banks put in our hands, the more money we spend. Spending drives the economy and, despite market rises of late, world economies remain in dire need of drivers. When markets are good, everyone prospers.

Personal preference and risk tolerance factor heavily into an individual's perception of what constitutes a good amount of debt. But what about the debt each one of us assumes through citizenship? The debt we hold by proxy, assumed on our behalves by our elected officials? The debt whose accrual and servicing we cannot control. How does government debt affect our everyday lives as doctors? Does it impact our health care system and the way we treat our patients? Where does all that debt come from, and to whom are we indebted as citizens of the provinces and our country?

MACROECONOMIC DEBT: HOW MUCH ARE WE IN THE HOLE?

The government of Canada is $1.2 trillion in debt. Yes, it's not as much as the Americans but it's not a trifling amount. And realistically, we don't have quite as robust an economy as our neighbours. At risk of sounding Ontario-centric, let us talk about the province of Ontario, not for any other reason than it is the worst of the Canadian debt offenders: $250 billion in debt and projected to rise to $550 billion before the end of the decade (1). It seems strange that our financiers and economists continually warn us of our impending economic collapse as a result of errant personal spending while they stimulate the Canadian economy by amassing more and more debt. In their defense, before 2008, no one really gave too much thought to debt as long gross domestic product (GDP) climbed. And who could have seen that one coming? When governments release their budgets and you don't hear the words 'balanced' or 'surplus' on the news or in the papers, it means we are spending beyond our means. A deficit is a nice word for climbing deeper and deeper into debt. A deficit means that when it was all said and done, we couldn't even afford the interest on our loans, so we sold more bills, or paper or bonds so that we could have more cash to run the country, and more money to service an even larger debt.

SO HOW MUCH MONEY ARE WE REALLY SPENDING ON DEBT?

Ever take an online mortgage calculator and play with the numbers on your own mortgage? By that I mean manipulate the amortization period, or change the terms of payment, or adjust the term and take a good look at the effect on the sum total of the interest you will pay until you're free? It can be enlightening.

That affordable monthly payment amortized over longer and longer periods of time costs you heaps of cash in interest. And yes, for the sticklers out there, agreed, only looking at the absolute value spent is misleading in that the value of the dollar is dropping as each year passes, and the value of your house is hopefully rising. But when it is all said and done, that's your money going out the door. Ever notice how it is the institutional investment advisors that encourage you to embrace a long mortgage? The longer you stretch out your terms, the less money you proportionately put toward the principle, and the more you pay in interest. Until that mortgage is paid off, you're contractually obligated to spend a portion of your income servicing debt, and with that obligation comes opportunity costs. When you must spend your money on interest, you cannot choose to spend it on vacations, renovations, your child's education or investments. Therein lies the rub and the problem with our macroeconomic debt.

We are currently servicing a mortgage on a $1.2 trillion house, with a perceived infinite amortization period, with no intention of ever paying down the principle or paying off the loan. Each year that the government runs a deficit – and there are always reasons, right? – the ratio of interest to principle skyrockets. Anything with a zero in the denominator has to be big number. In theory, an economist may argue that there is no real problem there, as long as we see a proportionate, or favourably disproportionate rise in GDP; but with no plans to ever pay off the loan, and a contractual obligation to pay out interest to lenders, at some point, say when the economy stalls and GDP falls, it all gets a little out of hand. Every year that we pour money into interest payments, without addressing the principle, while increasing debt, we are unable to spend money on essential programs such as health care. Remember, after all, it was mortgages given to borrowers in excess of earnings that was at the heart of the mortgage-backed securities scandal that collapsed our economy and decreased GDP. The take-home lesson is don't borrow more than you can afford.

$120 TRILLION: WHO GIVES OUT A LOAN LIKE THAT?

The instruments of debt are the backbone of the financial system as we know it and are really quite fascinating if you're into that sort of thing. Let's begin with a refresher on the textbook definition of debt. Simply put, debt is a contractual obligation between a lender and a borrower that stipulates the repayment terms of a loan (2). We'll come back to this because it's important.

When a government needs money, they raise funds through two channels: domestic and wholesale funding. Domestic funding raises

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money by selling savings bonds to citizens, which is to say they borrow from us. We buy bonds that are almost guaranteed, and we get a very small return on our investment. Wholesale funding, on the other hand, is the more profitable arm of government capitalization. Here the government raises money on the money market. It's sort of like selling your reputation and, in this case, ours is good. If your economy is revered, your paper is valuable. The Bank of Canada auctions off Treasury or T bills, notes, and bonds on the government's behalf to a series of primary dealers (3).

Not surprisingly, the primary dealers include all of the six major banks of Canada and a few other international players. T bills, notes and bonds are, in principle, the same, varying only by the duration of time at which they come to maturity. T bills are about as close to a sure thing as you can get in the investment world. In fact, a T bill yield is also commonly referred to in finance parlance as the risk-free rate. That yield is always cited as the opportunity cost of any other financial investment. At the time this was written, the Bank of Canada had approximately $160 billion of T bills outstanding. And, similar to corporate bonds, T bills are rated or ranked according to calibre. Most will remember the recent and relatively shocking event when the United States had their paper downgraded.

We can contrast this government form of debt issuance to a corporation who wishes to raise money for operations or investment. While they too can issue bonds, they more commonly hire an investment bank. The investment bank issues equity or stocks on behalf of the corporation and sells shares on an exchange. Equity carries no contractual obligation of payment once it is issued. The shareholder may share in the company's profit with leftover surplus, but if no surplus exists, the company, as the issuer of equity, has no contractual obligation to pay fixed interest. It's the contractual obligation that comes with a debt issuance that guarantees our government will be spending billions and billions of dollars for years to come, servicing the debt issued to run the country. Couple this to the lack of a disincentive and there is no reason for a politician not to take on more debt. You'll likely be out of office in four years, leaving it in the hands of your succesor; plus, everyone is doing it. But could this lead to problems elsewhere?

CUTS TO HEALTH CARE FUNDING AND THE NUTS AND BOLTS OF SERVICING DEBT

The incessant drone of 'there must be more money' has pervaded all aspects of Canadian health care for years of late. The American push toward broader coverage for her citizens has brought the Canadian experience under scrutiny, especially with respect to affordability on a government level.

Canada spends approximately $200 billion on health care every year (4) and spends about $60 billion a year servicing debt. That's about one-third of the money we need to run our entire single-payer health plan. Keep in mind that our debt load is getting bigger and interest rates will likely rise; $60 billion and we're not even covering the interest. Ontario is the worst offender with respect to debt. Ontarians spent about $10 billion servicing debt last year, while the controversial fee cuts to physician fee codes netted the government about $338 million in savings. This was in response to a federally mandated $8.4 billion cut-back in health care transfer payments, not a cent of which would have been necessary if we weren't spending billions of dollars servicing debt.

The government has institutionalized debt. There are no repercussions to overspending because we just borrow more. We should make health care more efficient and do away with waste. But can we really talk about financial health care reform without getting a handle on debt?

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