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DEBT REPATRIATION : ISSUES AND OPTIONS

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DEBT REPATRIATION

There is more concern about the more than \$100 billion of Government of Canada debt now held by non-residents. (The net debt of all Canadians held by foreigners exceeds \$300 billion.) Whenever there is a run on the Canadian dollar in response to bad fiscal or political news, interest rates invariably rise as the Bank of Canada tries to moderate, but not halt completely, the decline in the dollar's external value. Currency speculators, or uninformed and jittery foreign investors, are then blamed for wreaking havoc on the Canadian economy. In addition, it is argued that non-resident holdings of debt lead to a

tax loss for the treasury, since foreign holders are less likely than domestic holders to pay Canadian taxes on their interest income.

As a result, many are calling for a repatriation of foreign-held debt through a mechanism similar to the Victory Bond programs used by the Government of Canada to finance our war efforts.

THE VICTORY BOND EXAMPLE

During World War I and World War II, federal government deficits and spending ballooned to unprecedented proportions. Until then, it had always been felt that large-scale borrowing had to be done abroad, as the savings generated by the Canadian economy would not be sufficient. The Victory Bond issues proved to be surprisingly popular and lucrative, however, raising \$2 billion during W.W.I and \$9 billion during W.W.II. Indeed, far more money in support of our war effort was raised within Canada than was raised abroad. Why not, then, use a type of Victory Bond today to repatriate the portion of debt held by non-residents?

Several things should be kept in mind. At the time of the Victory Bonds, capital markets in Canada were very crude by today's standards. It was difficult to raise funds but it was also difficult for individual Canadians to save, rather than merely hoard, money. It was, for example, far less common then for Canadians to have bank accounts. The Victory Bonds and War Savings Certificates and Stamps provided a convenient and safe way for Canadians to save on a regular basis.

The Canadian economy during the war years was very different from the economy today. During W.W.II, the country had just come out of a depression. The war effort required an incredible amount of resources. A large proportion of the population was in the armed forces and women were entering the labour force in large numbers. Foreign currency controls were in place; wage and price controls had been established; many goods were rationed. Canadians were earning record amounts of money but had little on which to spend it, as production was geared to the war effort, rather than to satisfying consumer demands. Thus, the economy generated a high degree of household sector savings, which could be used to finance public sector borrowing. When economic factors were coupled with the patriotic fervour associated with the war effort, it is not hard to see why the government found it reasonably easy to raise funds from the public.

In 1942, the net public debt of the federal government was less than \$4 billion and represented less than 40% of GDP. By 1944, annual deficits were running at \$2.5 billion, which meant that net debt had grown to about 100% of GDP; however, it fell to 40% of GDP by 1952, equalling the pre-war ratio. How was this accomplished?

From 1947 to 1952, the federal government ran budgetary surpluses. The operating surplus, i.e., the difference between tax revenues and program expenditures, never amounted to less than 4% of GDP and was sometimes as much as 8% of GDP. This fact, coupled with high rates of economic growth and low real interest rates, allowed the relative debt load to decline rapidly over a very short period of time.

The state of the economy today is very different. Canadians are much more

sophisticated savers and investors and have a wide range of savings vehicles at their disposal. We now have Canada Savings Bonds, which are in fact an offshoot of the wartime bonds. We also have savings accounts of all sorts, and instruments such as direct deposit facilities, RRSPs, GICs, and mutual funds. Because we have access to deposit insurance, safety concerns do not prompt us to lend to the federal government. We own homes and have mortgages. We live in a relatively unregulated economy and a consumer-oriented society that seeks our dollars. Governments have every opportunity to borrow our money but we have all sorts of options for saving and spending it. As for patriotism as a motivating factor, it is unlikely that the repatriation of debt is going to generate the same emotional appeal as saving the world from foreign tyrants.

CANADA'S "SAVING IDENTITY"

Today's debt repatriation challenge can be highlighted by the following statistics. In 1992, the Canadian private sector generated \$124 billion in savings. This was more than adequate to finance the private sector's investment needs of \$109 billion. Unfortunately, governments in Canada ran total deficits to the tune of \$44 billion in that year, more than offsetting the excess private savings. Consequently Canadians had to borrow \$29 billion from foreign savers, or, more correctly, to borrow \$29 billion more from that sector than we supplied to it. Unfortunately this reliance upon foreign savings in 1992 was not an exception – it was the rule prior to 1992, and has been so since; this is why the Canadian economy owes so much, on balance, to foreigners.

The above figures reflect the constraints under which the Canadian economy operates. To the investment demand of the private sector are added the borrowing requirements of governments. The supply of savings funds is made up of the savings of the private sector in Canada plus borrowings from abroad. In the absence of any reduction in the private domestic demand for savings or any increase in the domestic supply of savings, any move by the federal government to borrow less from foreign sources would compel other domestic borrowers to borrow more from such sources. And if the concern about foreign-debt holdings is based upon currency stability or the loss of tax revenues, it doesn't matter who borrows on foreign markets. New government debt instruments would merely compete with existing instruments and add nothing to the overall savings rate. They might slightly reduce borrowing costs, but their greatest impact would likely be a reduction in the amount of domestic savings available to the Canadian private sector.

Thus, if we wish to eliminate the need for foreign funds, we have three choices: reduce domestic investment; reduce government deficits; and/or increase domestic savings. (A budgetary surplus in the Canadian government sector would contribute to savings supply rather than to savings demand.)

Reducing domestic investment seems not to be a good idea. The need for investment to provide jobs and to generate wealth and income is well known. Unless we can somehow show that private sector investment is wasteful and that governments can do a better job of increasing the productive capacity of the economy, it is probably better not to discourage private investment.

We are left with two realistic choices: to reduce the government deficit and/or to increase domestic savings. The first option is very straightforward and many

governments are implementing it today. The second option is more problematic, as can be seen from past federal government attempts to encourage savings through tax incentives such as the RRSP and RHOSP and RPP. It is an empirical matter to determine whether a dollar of tax incentives generates more or less than a dollar of increased savings. If it generates less, then we are worse off; the tax incentives generate larger deficits and the resulting demand for more savings exceeds any increase in domestic savings. This is the likely outcome, as it is impossible to link the tax preference to an increase in individual savings. Instead, we are likely to see a significant amount of portfolio transfer, whereby individuals shift savings from regular instruments to tax-sheltered ones. Thus, using tax incentives to encourage Canadians to save could actually lead to increased reliance upon foreign sources of savings!

POSSIBLE OPTIONS

Consider two approaches to reducing our reliance upon foreign savings. The federal government could decide that, as of a specific date, it would honour only the debt held by Canadians. Non-residents holding about \$100 billion of debt would have to find Canadians to whom they could sell it. Where would Canadians find the funds to purchase this debt? Recall that in 1992 the Canadian economy generated only \$124 billion in savings yet required \$153 billion. Without reducing consumption, Canadians would have to sell other assets to foreigners or purchase government debt rather than investing elsewhere.

More realistically, the federal government could in future issue only non-marketable debt, restricted to Canadian investors. New issues that would have gone to foreigners would go instead to Canadians. Unless the Canadian economy was generating sufficient savings to satisfy all domestic needs, however, existing marketable Government of Canada debt might be sold to non-residents in order to provide Canadians with the funds needed to purchase new government debt. Such a strategy might increase government's overall borrowing costs without reducing its own foreign indebtedness.

In addition, the government could somehow try to restrict the private sector from borrowing abroad. For example, as of a specific date, interest payments to non-residents might no longer be eligible as deductions for income tax purposes. This would dramatically increase the after-tax cost of such debt and force Canadian corporations to search for alternatives. The private sector would seek more Canadian sources of savings, but it would have to pay more for such financing. There might be increased savings, but not enough to meet private sector demands. More ominous, however, is the possible alternative response by the private sector. If Canadian governments made it too difficult to raise financial capital to finance investments here, companies might just reduce their investment activity in Canada or shift it to other locations where financing was more readily available.

Thus, the best way to reduce the economy's reliance upon foreign savings would probably be to reduce government's demand for financial capital. While many people support a reduction in government deficits and debt, they do not realize that it is a means of repatriating foreign-held debt, which they mistakenly see as a separate issue. High levels of foreign debt do not constitute a disease; they are merely the symptoms of a disease, which is excessively large government deficits.

The beneficial effects of debt repatriation on both currency stability and tax revenues may be overstated whenever government restrictions are used. Canada has an open capital market; like other modern industrialized and democratic countries, we allow our citizens to borrow from abroad and to invest abroad. Thus, Canadians who are successful at investing in gold mines can do so profitably around the world, while those foreigners who prefer the security of government debt can help finance our deficits. Investors are better off when they can choose their investments freely from a multitude of options but borrowers are also better off because competition gives them access to funds at a lower cost. Without access to foreign funds, Canadians would lose profitable investment opportunities and the cost of capital to the private and public sectors would undoubtedly be higher.

Because of our open capital border, flight of capital can originate both within and without Canada. Canadians are no less anxious than others to seek good returns on their investments and to avoid excessive risks. Indeed, in countries that have experienced such flight, domestic funds were usually the first to leave, thereby triggering the exodus by foreigners.

The tax revenue argument is also somewhat misleading. The fact that governments and private firms have been able to borrow abroad has increased spending and investment in Canada to an extent that would not have been possible in a closed economy. Incomes, employment and tax revenues are all higher as a result. It is misleading to suggest that Canadian governments lose tax revenues on the interest paid to non-residents; such interest income would not have existed in the absence of foreign borrowing.

Moreover, the international capital market is very competitive. Canadian borrowers cannot artificially reduce borrowing costs through tax or other measures, since lenders, domestic or foreign, have such a wide range of options.

CONCLUDING REMARKS

Of course, Canadians have every right to buy Government of Canada bonds, as well as provincial government debt and corporate debt, either directly or by investing in institutions such as mutual funds that specialize in certain types of investments. Since Canadian banks today hold record amounts of government debt, we are assisting in the domestic financing of Canadian government deficits every time we deposit money in our bank accounts. We do the same thing with our pension funds.

The Government of Canada does sell non-marketable debt such as Canada Savings Bonds; like private sector borrowers, however, it has concluded that it is easiest to finance its deficits by issuing securities to someone who will have the option of reselling it if he or she tires of it or wishes to invest in something else. Any government with a large debt to finance will only increase its financing costs by restricting the size of the market to which it has access. As a result, debt sold to Canadians sometimes winds up in the hands of foreigners.

Canadians borrow from non-residents primarily because our own economy does not generate sufficient savings to meet our needs. Government initiatives to repatriate debt might change the various components of the liability side of the government's balance sheet but they could not change the balance sheet of the economy as a whole. Moreover,

to the extent that they did so, the effects would more likely be negative than positive.
