Listen to Poloz: Debt is not a dirty word

By Edward Trapunski
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The world is drowning in debt, the Doomsday economists tell us. Public debt, personal debt and corporate debt is bound to sink us and to plunge our children into a future they will never be able to swim out of.

For right-of-centre politicians, debt, and accompanying taxes, is the filthiest dirty word, representing the most vile of social evils infecting the civilized world.

Canada’s central banker, the Bank of Canada’s new Governor Stephen Poloz, is most influential in determining how much debt is good and how much is bad. The Governor made his first policy statement on Wednesday, keeping interest rates low, signalling that he still encourages borrowing.

In his only previous public statement, Governor Poloz said that Canada’s relatively good economic fortune was largely thanks to households that took on personal debt. In the same speech he nudged businesses to get off their assets and use them to build and create, and do their part to stimulate the economy.

And with this, his first policy statement, it seems that Governor Poloz is indicating that not all debt is bad. This is also a reality that investors should bear witness to if they want to see their assets grow.

In the current political climate, there is little doubt that the heat was on Governor Poloz to proclaim that debt is bad. Here are a few arguments Governor Poloz can make in the future that show how debt is good, and good for investors:

**Public debt**

Public debt is the way countries get money to invest in economic growth. The government raises money by issuing bonds and treasury bills. It is investors who buy the bonds, either through their pension plans or directly. Public debt is especially attractive to risk-averse investors, since it is backed by the government itself which, especially in a developed country like Canada, is a good credit risk. Notwithstanding what has happened in southern Europe recently, governments pay back their debts.

When used correctly, public debt generally improves the standard of living in a country. Government puts the money it raises back into the economy, building roads and bridges, improving education, and providing other beneficial services. Government money spurs private spending further boosting economic growth – all good for the investor.

The worst slumps typically occur after a financial collapse – like the one in 2008 – because the whole economy goes into a self-reinforcing tailspin. Employers are too risk-averse to hire workers, consumers are too traumatized to buy everything the economy is capable of producing, and banks, awash in money, won’t lend to any but the most blue-chip borrowers. The whole economy remains stuck in second gear. That’s when government borrowing can come in to improve a depressed economy’s performance. In his testimony to the U.S. congress on Wednesday, U.S. Federal Reserve Chairman, Ben Bernanke indicated that U.S. economic growth has been restrained by its government’s spending cuts.

Usually the government borrows to fund things the economy needs anyway to make it more productive. As the economy improves, unemployment rates go down and growth goes back, more consumers and business pay more taxes and the ratio of the public debt to overall economic output starts coming down.
In those circumstances what smart investors wouldn’t lend the government money even while they are complaining about the debt load?

**Personal Debt**

Governor Poloz acknowledged that consumer, or personal, debt is what kept the Canadian economy humming. But he urged homeowners and other individuals to do the arithmetic to manage their debt. In other words, he was differentiating between good debt and bad debt.

Good debt is an investment that grows in value or generates long-term income. Taking out a mortgage to buy a home is usually good debt. The interest rate for mortgages is lower than most other debt. Most people consider buying house to be a good investment because you expect your house to increase in value over time, at least enough to negate the interest you have paid. The relatively low monthly payments on a mortgage also frees up the money for other investments.

Most financial advisors consider car loans and the use of your credit card to buy fancy clothes to be bad debt. But if you need a car to get to and from work, or to to do business, it is money well allocated. If borrowing money to buy the $945 shoes with red soles gives you the confidence to land that plum job, then it is a good investment.

**Corporate Debt**

We are always told that it is wise to invest in companies that have a lot of cash and no debt because they can weather the downturn. We are also told to invest in companies with a lot of leverage because that is the way they are going to grow.

What a mixed messages, and who is right?

The classic study of the ideal balance between corporate debt and corporate equity is the Modigliani-Miller theorem on capital structure. Nobel Prize winners, Franco Modigliani and Morton Miller, argued that big companies don’t carry enough debt and that their value would increase if they substituted debt for equity. Other economists maintain that mature, profitable companies with the least need to borrow probably benefit most from doing so. Capital-intensive industries, like utilities or telcom companies need debt to purchase equipment and property. It is what Ted Rogers used to develop Rogers Communications into a colossus. Investors are eager to lend money to companies with collateral and steady income.

It is cheaper for a company to finance with debt than with equity. Equity is riskier for investors than debt. Companies aren’t obligated to pay dividends to shareholders, so shareholders want a certain rate of return whereas bondholders are more sure that they will get their money and are prepared to accept a lower rate of return. This is known as the risk premium.

Debt-holders and financial institutions are generally more diligent in assessing a company’s value and usually have more access to information. So when the lenders are prepared to loan a company money, the equity investor should feel more confident about the credibility of that company’s prospects.

With his first policy statement, Governor Stephen Poloz has indicated that debt isn’t always “evil or “crippling” or “unforgiving.” Debt can be a good sign of strength for the economy, and investors, as long as it is managed responsibly.