Market View
Economics and Strategy

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

November 23, 2023 – (Vol. VII, No. 91B FES)

The one 'junk fee' Ottawa can't regulate away

By Warren Lovely

If you've missed it, the federal Liberal government, in its ever-lasting defense of put-upon consumers, is going after 'junk fees'. These are the nuisance (or unfair) fees that Canadians get variously saddled with. Targeted fees in this week's Fall Economic Statement (FES) included: airfares for children under 14 accompanied by an adult, international mobile roaming charges and NSF fees levied by banks. This follows earlier action on 'junk fees' and there's a promise to crack down further.

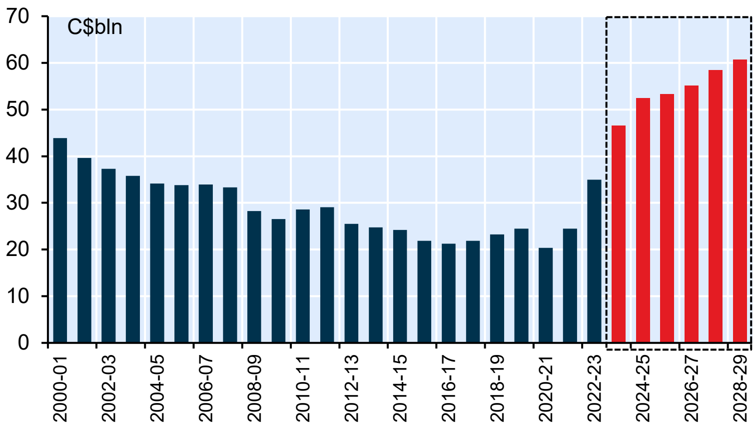
Leaving aside editorial comment on the need for consumer protections, there's a bigger and rapidly expanding 'junk fee' Ottawa can't simply regulate away. It's a growing nuisance that the government must take partial responsibility for and one that complicates its life. Yes, we're talking about **public debt charges**.

You've perhaps heard interest on debt labeled a 'dead-weight loss'. Unlike program spending, debt servicing payments really get you no 'good stuff' in return… no new doctors or nurses, not better schools or shiny new infrastructure, no new tax relief or marginal supports for the needy. Just the appeasement of investors asked to backstop your liabilities. Perhaps the best you can say is that servicing your debt avoids an act of default, enabling future capital markets access.

What's happening to Ottawa's interest bill is nothing short of extraordinary. Two fiscal years ago (i.e., back in 2021-22), the feds paid about $25 billion/year to service the public debt. Yes, we understand, interest rates were *much* lower back then. Following the onset of the pandemic, the Bank of Canada drove its policy interest rate to the effective lower bound and kept it there till March 2022. Ten-year Canada bonds averaged barely 1.5% during the 2021-22 fiscal year. This was clearly an artificial period of uber-cheap borrowing and a time when the central bank was willing to hold a considerable share of the sovereign's debt on its balance sheet.

Chart 1: Federal interest charges… up, up and away

Federal public debt charges

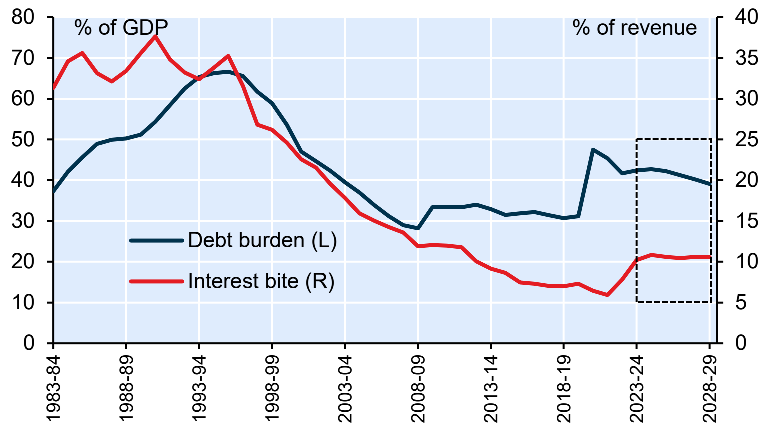


Source: NBF, GoC | Note: Actuals to 2022-23; FES projections from 2023-24 on

Fast forward to the current fiscal year (i.e., 2023-24)… As per Tuesday's FES, Ottawa's annual interest bill has swelled to $46.5 billion. That's a two-year cumulative increase of 90%, vastly outstripping the corresponding advance in federal revenue (10%). The resulting interest bite (i.e., public debt charges vs. revenue) has got to hurt, even if the share of Ottawa's revenue dollar consumed by these 'empty' interest charges remains far removed from the ultra-dark days the sovereign stumbled through in the early 1990s. History buffs may know that public debt charges ate up an extremely alarming 37% of federal revenue in 1990-91. Ouch!

Chart 2: Granted, this is nothing like 1990s (thank goodness!)

Federal debt-to-GDP ratio & public debt charges-to-revenue ratio

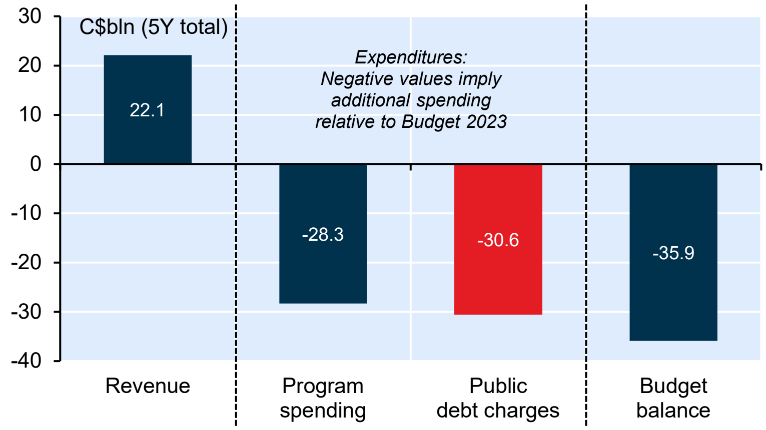


Source: NBF, GoC | Note: Actuals to 2022-23; FES projections from 2023-24 on

Returning to the current situation… The extra interest the feds must dole out to debt holders is contributing to ongoing fiscal leakage. Looking at the 5-year period ending 2027-28, some $35 billion in additional budgetary red ink is now due to be spilled vs. Budget 2023. You'll find an additional $30 billion in public debt charges over that same timeframe relative to the latest budget plan. Put another way, bonus revenue is no longer sufficient to cover *both* extra program spending commitments and an enlarged interest bill. The pace of federal deficit reduction thus slows. That's not great.

Chart 3: Extra debt charges contributing to larger deficits

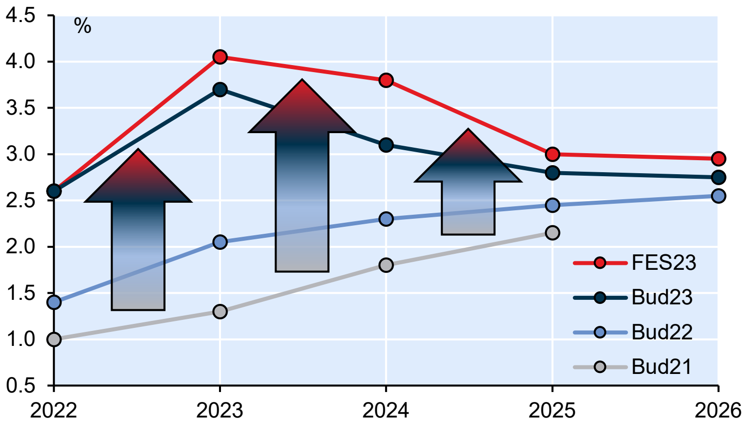
Change in federal finances, FES vs. Budget 2023: 5Y sum to 2027-28



Source: NBF, GoC | Note: Represents cumulative chg from 2023-24 to 2027-28 inclusive

It should be no secret what's going on here. First, the amount of federal debt continues to grow. That's what happens when you run a sustained deficit, even whilst attaining full employment. Meantime, an expectation of stickier inflation and higher-for-longer policy rates—which to some extent are a byproduct of Ottawa's fiscal and immigration policies—boosts the average borrowing rate. Finally, the feds carry considerable interest rate-reset risk and have for some time. No one doubts the sovereign's ability to access the market, but the short(ish) average term of the federal debt stock (vs. provinces or other sovereigns) leaves Ottawa more immediately vulnerable to a rapid/violent jump in interest rates. The corollary, it should be noted, also holds, in that a shorter-duration debt portfolio can capture interest savings more quickly when borrowing rates head lower. But that's a story for another day.

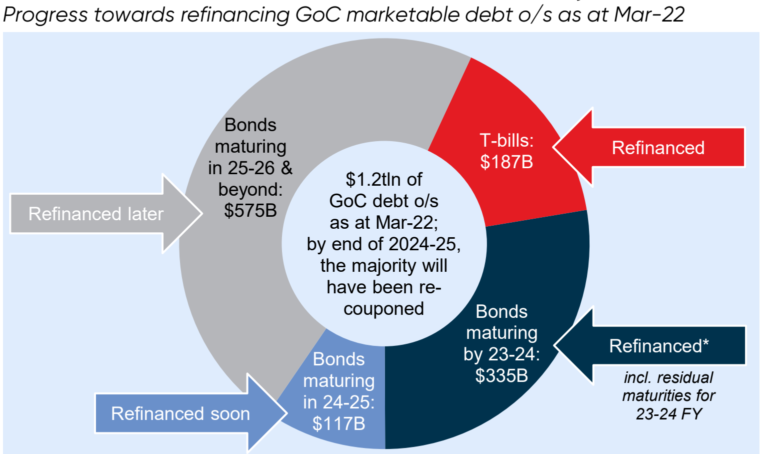
Chart 4: Higher-for-longer interest rates big part of story
Federal interest rate planning assumptions: Avg of 3M & 10Y GoC yield



Source: NBF, GoC | Note: Simple avg of calendar year forecast, based on consensus

If there's good news (and we're reaching here), it's that the re-couponing of the federal debt stock is well in train. It's definitely been painful, but it's progressing quickly. At this point, a meaningful share of the federal debt that existed back in March 2022—when the BoC delivered its first hike—has already been rolled over at higher rates. That obviously includes full turnover of the T-bill stock (never longer than 12 months) plus the refinancing of a good number of GoC bonds.

Chart 5: Federal debt stock has rolled relatively fast
Progress towards refinancing GoC marketable debt o/s as at Mar-22

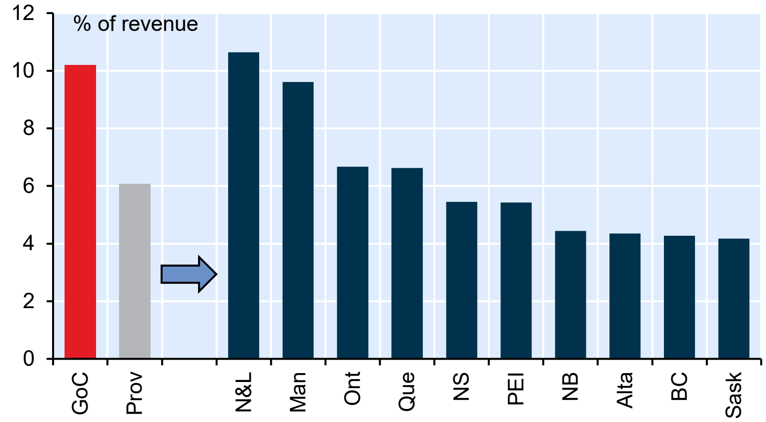


Source: NBF, BoC | Note: Refers only to re-couponed debt; debt level has also grown

Another slug of Canada bonds will be re-couponed in the coming fiscal year. These near-term maturities bear a weighted average coupon of <1.7%, which is far below the current cost of funds (ranging from ~5% in short bills to ~3.5% at the back end of the bond curve).

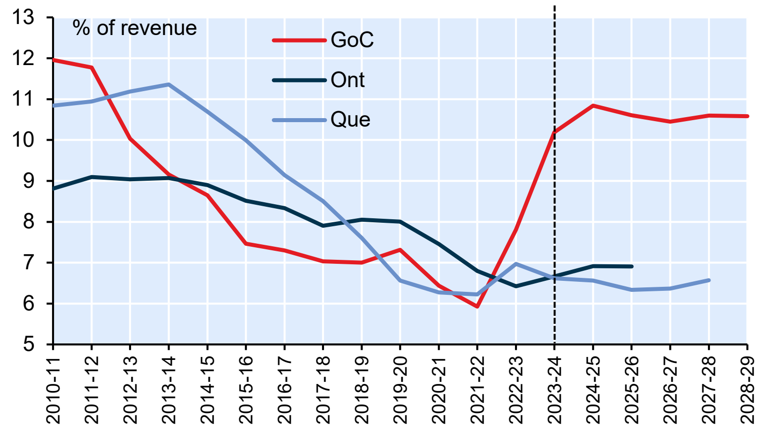
So public debt charges are set for another double-digit increase next fiscal year, pushing the interest bite to a cyclical peak of 10.8% of revenue. Fun fact (or sober reality): The feds now use as much of their revenue dollar to service debt as in Newfoundland & Labrador, and much more than the provincial average. As many surely appreciate, the long-standing practice of locking-in liabilities for longer at the provincial level blunts/slows the debt servicing shock. There's also simply less net debt at the provincial level these days. Beyond 2024-25, things should settle down a bit in terms of the federal interest bill (or at least stop jumping), assuming of course that expected interest rate relief materializes. We believe it will.

Chart 6: Federal interest bite far exceeds provincial average
Federal-provincial public debt charges-to-revenue ratio: 2023-24



Source: NBF, GoC, prov gov'ts | Note: Based on latest official government projections

Chart 7: Provinces have better protected themselves
Public debt charges-to-revenue ratio: Federal, Ontario & Quebec



Source: NBF, GoC, Ont, Que | Note: Includes estimates/projections from latest FES

The feds may like to hold up Canada's G7-leading general government net debt burden, but ongoing spending commitments, the resulting red ink, the relatively shorter-dated debt stock and higher borrowing rates have thrown debt charges into overdrive.

Ask the average Canadian what they think about public debt charges outgrowing program spending by a ratio of 3½:1 over the next handful of years (as is now assumed in the FES) and we can guess at the answer. It's not necessarily a recipe for voter contentment. And unlike roaming charges, NSF fees or even grocery prices, there's no arm for the government to really twist here. Interest on the federal debt can't simply be regulated away. Nor is debt monetization on. QT means the central bank is in the process of turning GoC bonds back to end investors. This is the reality the government must contend with.

The lessons, if not already obvious, are: debt is not free; prudent fiscal management has merit; when an opportunity for fiscal consolidation presents itself, it's wise to seize it; despite notionally favourable comparisons to bygone eras (the 1990s) or more profligate nations (like our neighbour to the south), the feds have a growing debt load to service; and outsized interest rate-reset risk can and does cut both ways. On this final point… to the extent there's any sensitivity to the size of the deficit in Ottawa (there may be some debate), the extra debt charges that must be swallowed may rob the feds of near-term fiscal room should the economy stumble more than expected. In a sense, the government's own policy choices may have tied their hands behind their own back here. That's a nuisance to be sure.

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