PERSPECTIVE

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NO TO STIMULUS, YES TO DEFICIT REDUCTION IN CANADA

In recent weeks, I've been asked many times about whether additional fiscal stimulus is called for in Canada and whether the focus on deficit elimination over the medium-term by federal and provincial governments is the right strategy. The inquiries reflect the extremely risk-filled and uncertain economic environment. The fiscal developments in Europe and the U.S., and the appropriate approach to fiscal policy in these countries, are also likely adding to the confusion. In Europe, the aggressive slash and burn approach of deficit fighting is contributing to a renewed downturn. In America, fiscal restraint could stall an already weak economy, and this risk has led to proposals for additional stimulus from the Oval Office.

The Canadian situation, however, is fundamentally different. The U.S. is struggling with the fallout from a balance sheet recession, where consumers are cutting back on debt despite low interest rates and where the real estate market continues to sink under the weigh of millions of foreclosures. In Europe, a financial crisis is forcing euro-zone governments toward a fiscal union, the lack of which was always the inherent structural weakness of the common currency zone. The Canadian economy does not face the deep fiscal and structural economic problems plaguing our international peers. Accordingly, the appropriate stance for fiscal policy is different than abroad. Canadian policymakers should resist the urge to provide more fiscal stimulus unless a domestic economic contraction materializes; and, even then, they should keep any stimulus modest and targeted. Moreover, in the absence of a renewed recession, governments ought to keep their focus on slaying the deficit dragon, as it is in the long-term interests of the country.

Indicators point to continued growth for Canada

Let's start with the argument for why fiscal stimulus is not called for at this point in time. There is no evidence that the Canadian economy is falling into recession. Although the economy temporarily stalled in the second quarter, the recent economic data point to moderate growth in the third quarter and there is positive momentum heading into the final quarter of the year. People also tend to forget that the economy is already receiving considerable stimulus from exceedingly low interest rates thanks to the Bank of Canada. Businesses in particular have considerable capacity to spend and invest – they just need the confidence to do so. Due to high personal indebtedness, consumers can't be the primary engine of growth, but recent employment gains should support spending growth in line with income gains. So, the most likely path is for the economy to deliver continued, albeit modest, growth.

Foreign risks plague outlook

Make no mistake, there are material downside risks to the economy, but they are risks – not reality. All of the major risks on the horizon for the Canadian economic outlook are external

in nature. The number one risk is a banking crisis in Europe arising from potential financial losses from government debt defaults. The prospects on this front are very unclear. European leaders are negotiating new policies to manage a Greece debt restructuring; they are striving to limit the risk of other governments following Greece's example; and, there are efforts to recapitalize the European banking system. Only time will tell if these actions will be successful.

Canadian leaders may wish to consider contingencies of how to respond if Europe loses control of the situation. The economic and financial environment that would arise would likely have many of the characteristics of late 2008. The result of a European banking crisis would be a renewed credit crunch, meaning that Canadian banks would be unwilling to lend to one another; and, as a result, they would be starved for the funds that they usually raise in international markets. We know from 2008 how to respond to this environment. The primary policy response would be for the Bank of Canada and Departments of Finance to restart the various programs used during the last financial storm. Such measures would ensure that Canadian financial institutions have adequate access to funding to keep credit available to Canadian consumers and businesses until the crisis abates.

The second major risk for the outlook is the fragility of the U.S. economy. So far, the economic data point to the U.S. economy growing at close to a 2.5% annual pace in third quarter and the handoff heading into the fourth quarter looks moderate. The most likely scenario is not a renewed recession. The more probable outcome is one where the U.S. will remain trapped in a modest growth, low interest rate environment for several years. This has significant implications for Canada. For example, it augurs for limited export demand growth in Canada's major trading partner. This, however, does not warrant additional fiscal stimulus in Canada. Rather, it calls for efforts and incentives to diversify Canadian international trade to faster growing markets. It also calls for efforts to improve Canada's international competitiveness.

Fiscal stimulus only if domestic economy is headed into contraction

It is important to outline when fiscal stimulus is called for. It is warranted when there is a material and sustained decline in private sector demand. The goal is to incent a change in private sector behaviour or to provide a public sector offset. There is also an important psychological dimension that is often missed. Fiscal stimulus not only acts to directly raise demand, but it can also boost confidence and help to diminish any deflation concerns that can be self-fulfilling if not addressed.

However, no private sector contraction is currently underway and inflation expectations remain well anchored at close to the Bank of Canada 2% target, so no additional stimulus is appropriate at this time. Worse still, injecting fiscal stimulus when the private sector is growing tends to crowd out private sector activity. A good example would be competition between public and private projects for construction workers. The implication is that increased fiscal outlays would come at a material cost, but may provide little lift to an economy that is already expanding.

Lastly, fiscal stimulus should be resisted because any short-term boost to the economy has to be weighed against the long-term costs. In relative terms, Canada's public finances look good. Canada is not facing a fiscal crisis like in Europe or the U.S. But, in absolute terms and relative to the size of the economy, the federal government and many of the provinces are running significant deficits. Canadian governments also ramped up their debts since 2008 and this bears a future cost in interest payments. While interest rates are likely to remain lower for longer, governments cannot ignore the future financial burden when rate hikes do eventually occur. Higher debt payments represent money lost for other key social priorities, including health care and education.

So far, Canadian governments, as a whole, have resisted calls for additional stimulus, but more importantly, all have made commitments to deficit elimination over the medium term. There are two key reasons that this is the suitable course of action. First, it is good economic policy. Governments can be excused for running deficits during economic contractions, but they need to return to balanced budgets once economic growth resumes. This should be done over a time frame that does not jeopardize the economic recovery. Second, governments need to get their finances ready for the coming demographic pressures. The first of the baby boomers turned 65 years of age last year, and the aging of the population will lead to greater demand for many government-provided services. Regrettably, this comes at a time when the outlook suggests modest-to-moderate income growth over the next several years. This, in turn, will constrain growth in government tax revenues. The simple math tells us that governments will be hard pressed to deliver on the commitments that have been made in the past.

The bottom line is that Canadians have reaped considerable dividends from putting our fiscal house in order in the mid-1990s. If the country had not acted then and pursued sound fiscal policies since, Canada would be like Europe today. The lesson is that prudent fiscal management is a core element to a healthy and competitive economy. A sound fiscal position also provides flexibility when times get truly tough – but that is not now. Governments should keep their powder dry, while considering contingencies.

Should the risks actually play out, governments will be under considerable pressure to react. Monetary policy should be the first line of defence. If fiscal policy must respond, the deficit starting point argues for a limited and targeted response, such as additional support for unemployed workers. A traditional recommendation is increased investment in infrastructure. If such projects can be brought forward, it would be a natural choice for additional stimulus. However, infrastructure can rarely be done quickly to boost the economy and one must think that the shovel ready projects were done in the first round of stimulus in 2009.

Remember, regardless of whether fiscal stimulus is applied, the Canadian economy will recover when the external shock abates. The sad truth is that one of the biggest challenges facing leaders today is the lack of awareness by the public over the importance of restoring fiscal balance before demographics weighs more heavily on government finances. While deficit-reduction measures are not topping the list of worries on national opinion polls today, policymakers cannot help but look at the numbers in front of them and know that many tough decisions lie ahead to restore fiscal health to this country.

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