



ECONOMICS

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Fiscal Stimulus: How Will We Pay For It All?

by Royce Mendes

If the continuing announcements of billions of dollars in government spending have your head spinning, you're not alone. The numbers are unprecedented. Inevitably, the question being asked by many Canadians is 'how will we pay for it all?'. Periods of fiscal largesse have in the past been followed by tough austerity measures in the forms of spending cuts and tax hikes to bring about sustainability in government finances. But before jumping to any conclusions, it's worth taking a look at how the current situation adds up, and whether that needs to be the case again.

Adding Up The Bill

In response to COVID-19, the federal government has so far announced direct support measures which add up to \$146bn (not including the CECRA), with an additional \$85bn in tax and customs

duty payment deferrals and \$86bn in loan guarantees. Then there's also the more than \$2bn in aid for the oil patch and an important \$3bn earmarked for protecting the health and safety of Canadians.

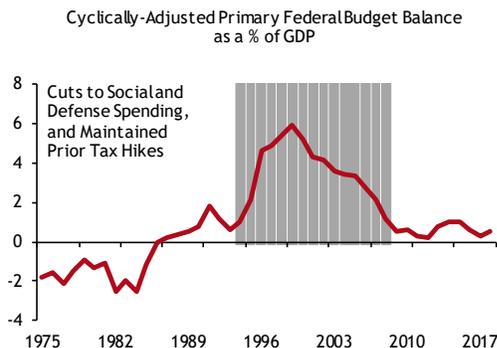
That's not all added to the deficit since some of it is in loans and deferrals. But it still has the federal budget shortfall tracking more than \$200bn for the current fiscal year and, if new programs are required, it could actually end up being closer to \$300bn.

That amount of red ink would equal between 11 and 14% of GDP. So, even at the low end, it's going to be the largest deficit as a share of the economy since World War II. But, there are key differences between these and even the more recent hefty budget deficits in the 1980s and '90s, which of course ended up requiring sweeping measures by the Chretien-led Liberal government to rein in (Chart 1).

Not Much Interest

The prevailing interest rate environment is miles below the levels of 30 years ago and clearly sets this situation apart from deficits in the past. Had the current government been operating in a situation where its benchmark 10-year bond yield was averaging more than 10%, as it was in the 1980s (Chart 2), there would be a huge cost in taking even a one-time hit to the budget deficit. Without tax increases or spending cuts, the debt, compounding at 10% annually, would be growing much faster than the economy and, therefore, lead to a spiraling debt-to-GDP ratio.

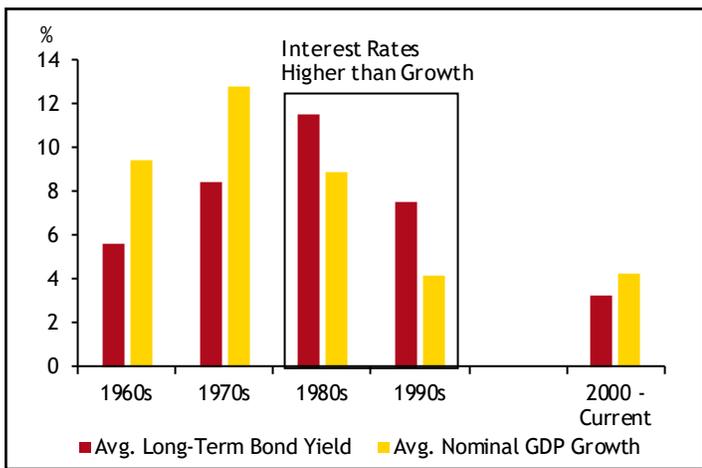
Chart 1
Austerity in the 1990s Was Needed to Bring About Debt Sustainability



Source: Department of Finance Canada, Haver Analytics, CIBC

<http://economics.cibc.com>

Chart 2
Interest Rates Have Again Averaged Lower than GDP Growth Over the Two Decades

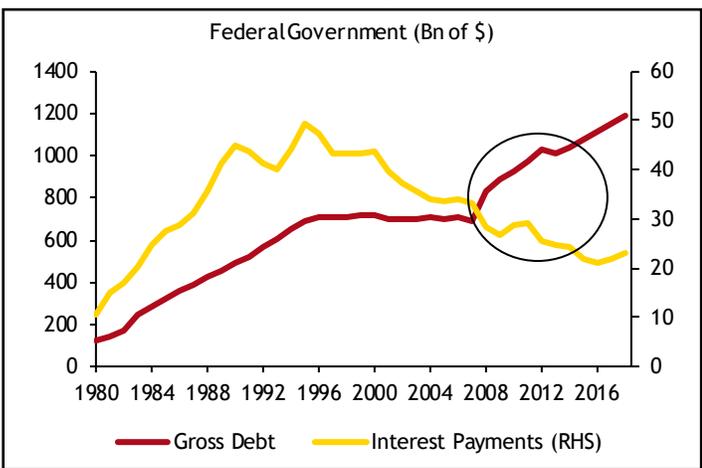


Source: Bank of Canada, Statistics Canada, CIBC

Fortunately, that’s nowhere near the case today, with the federal government able to fund the crisis response by borrowing for 10 years at a rate of just 0.6%. In fact, the federal government’s bill for interest payments in dollar terms might not change all that much, with the refinancing of debt at these rock bottom rates largely offsetting additional interest payments on new debt. Indeed, that’s exactly what happened after the initial surge in federal debt following the financial crisis (Chart 3).

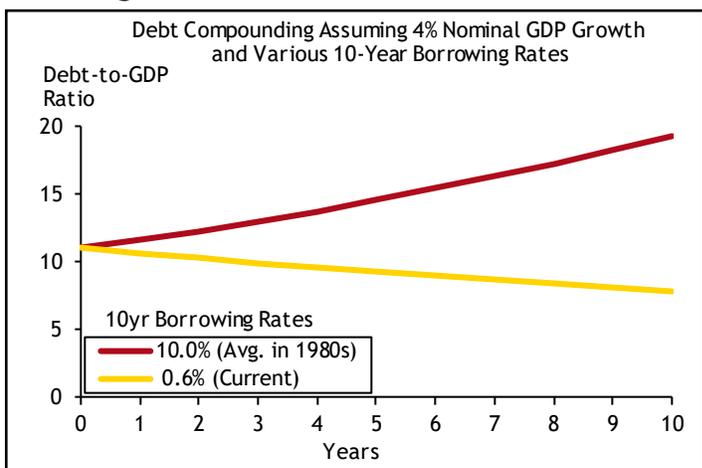
Moreover, supposing the federal government, instead of raising taxes or cutting spending, chose to simply issue new debt each year to pay the interest on the bonds sold

Chart 3
Dollar Value of Interest Payments Can Fall Even When Stock of Debt Is Rising



Source: Department of Finance Canada, CIBC

Chart 4
New Borrowing to Pay for COVID-19 Expected to Compound at a Slower Pace Than GDP, Automatically Reducing Its Ratio to GDP Over Time



Source: CIBC

to finance the COVID-19 rescue package, the debt would compound at a much slower rate than the likely run-rate of nominal GDP growth. Then, so long as it was indeed a short-lived hit to the deficit, and GDP growth continued to outpace bond yields, the debt-to-GDP ratio would be on a declining path without the need for additional taxes or spending cuts (Chart 4).

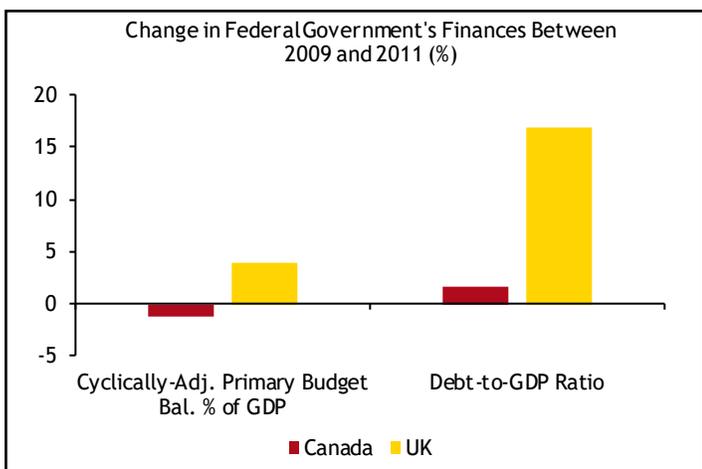
One And Done?

That brings us to the second key difference. A majority of the current deficit is being driven by actions needed to keep households and businesses afloat until the economy can reopen. As a result, many of the largest programs have a clear end game — bridge the gap until consumers and businesses can get back to work. So, there’s no need to cut program spending or raise taxes to rein it in. Conversely, the swollen deficits recorded in the late twentieth century were more persistent, averaging more than 5% of GDP from 1977 to 1993, and almost 7% of GDP from 1982 to 1987.

It’s true that assuming a one-and-done increase in the deficit probably paints too rosy a picture, since the economy will be underperforming for some time even after the emergency measures are no longer needed. But the aftermath of the financial crisis provides some very relevant guidance on how best to manage deficits and the debt-to-GDP ratio during the nascent stages of a recovery.

Chart 5

The UK Made A Sharp Turn To Austerity in 2010, But Saw Its Debt Ratios Rise More



Source: IMF, CIBC

Setting An Example

After the worst of the fires related to the financial crisis of 2008-09 were put out, there was a sharp turn towards austerity in the name of debt sustainability in many jurisdictions. But, for some of those countries like the UK, which both cut spending and raised taxes in 2010, the government still saw its debt-to-GDP ratio spike.

On the other hand, the Canadian federal government, which actually provided slightly more stimulus in 2011 as the recovery took hold than in 2009 (as evidenced by the wider cyclically-adjusted primary deficit), ended up with little change in its debt-to-GDP ratio (Chart 5).

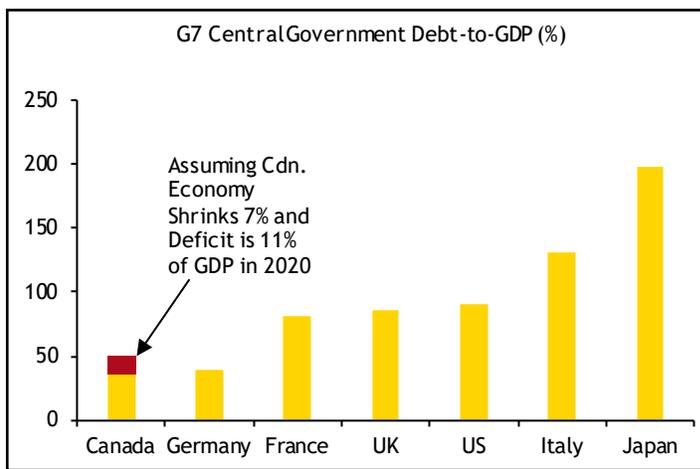
Research by then-IMF Chief Economist Olivier Blanchard in 2011 began demonstrating how austerity could actually be self-defeating when attempting to lower debt-to-GDP ratios, since the multipliers for government stimulus appeared to be very large when the economy was in a depressed state. In essence, every dollar cut by the government was slashing GDP by as much as \$1.50. And, the opposite also seemed true too, with every dollar of stimulus provided by the government, seemingly generating as much as \$1.50 in GDP. As a result, it might cost more in terms of both GDP and the debt-to-GDP ratio to raise taxes or cut program spending too early.

Canada Has A Head Start

The last difference between the current fiscal situation and that of the 1990s is probably the most talked about. The federal government entered the COVID-19 crisis

Chart 6

Favourable Starting Point For Debt Ratio Gives Canada A Head Start



Source: IMF, CIBC

with a head start on its global peers in terms of its fiscal position. Canada had the lowest central government debt-to-GDP ratio of the Group of Seven economies. In contrast, prior to the fiscal consolidation of the mid-1990s, Canada ranked sixth, with only Italy behind it on that metric.

It is true that, with the federal deficit now easily topping \$200bn this fiscal year, the debt-to-GDP ratio is going to rise. But, even assuming a shrinking economy in 2020, that size of deficit would still leave Canada's federal debt load as a share of GDP below where most of its counterparts stood before the crisis (Chart 6). At roughly 50% of GDP, the debt load would also be comfortably below the debt-to-GDP ratios of more than 65% in the early 1990s, while every other G7 economy is operating with a higher ratio than it was three decades ago.

But what about the provinces with their large stocks of sub-national debt? Canada's general government debt-to-GDP ratio, which includes all levels of government, entered the crisis roughly in line with the average of other G7 economies. Moreover, after netting out financial assets held against liabilities, it actually stood lower than any other G7 nation.

That doesn't suggest that the provinces can or should shoulder too heavy a load in supporting the economy. It just means that if, as some ratings agencies assume, the federal government is implicitly underwriting the debt of provinces, the numbers aren't all that staggering whether or not the sub-national debt is included.

A Little Help From Some Friends

Still, the provinces face challenges. Outside of Quebec and Nova Scotia, each entered the current COVID-19 crisis with a higher debt-to-GDP ratio than the financial crisis of 2008. That's seemingly kept the response restrained at the provincial level, with the packages rolled out adding up to less than a quarter of what Ottawa has unveiled, a stark difference than in the aftermath of the financial crisis.

The shakier debt situation in some provinces could end up meaning that the federal government aids provinces more aggressively, with some already asking for such support. But more likely, most provincial governments will simply need to pull back on spending sooner than the federal government or even potentially raise taxes earlier. But,

in the latter case, the federal government would be well served stepping up its efforts to offset the economic drag created by provinces pulling back, or else we'd likely be stuck with an even longer run of zero interest rates. As a result, it seems clear that the majority of the tab for the coronavirus pandemic is going to be left for the federal government to pick up.

To be clear, we are in no way advocating a permanent diet of high deficits. We're answering the question of how we can afford all this borrowing by the federal government by showing how the costs of inaction or worse, a move too quickly towards austerity measures, clearly outweigh any perceived benefits. At some point, the federal government might raise taxes or cut program spending to create more room for the next downturn, but it doesn't need to do so in the near-term.

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