Balancing the Budget Would be Bad Timing by Ottawa

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Massive declines in the world oil price are unambiguously bad for the Canadian economy. Such large shocks usually merit policy responses. While the Bank of Canada acted boldly last week to cut its benchmark interest rate, the federal Finance Department hesitates, apparently unsure of both its economic and political calculations.

The 55-per-cent decline in oil prices since last summer creates both losers and winners in Canada. Oil companies reduce their production, lay off workers and scale back their investment plans. This negative impact quickly spreads to the many industries supplying Canada’s oil patch.

In contrast, consumers and businesses that use oil receive a financial windfall. Consumers find that filling their gas tanks is now cheaper, and more money is available to spend on other things. Firms that use oil-based inputs find their competitive positions improved.

Since Canada is a net exporter of oil, the economic costs from the price collapse outweigh the economic benefits. The Bank of Canada’s most recent Monetary Policy Report presents modelling results showing that the decline in the per-barrel oil price from $110 (U.S.) to $50, if it persisted throughout this year without a policy response, would reduce Canadian gross domestic product by 1.3 per cent below the level that would otherwise be observed.

So the Bank of Canada acted. In fact, it shocked financial markets when it reduced its target for the overnight interest rate to 0.75 per cent. In normal times, such a policy move would not be surprising. But after four years of stability in the overnight rate, most economists (including me) had become complacent. We expected the oil price decline to simply delay the Bank’s inevitable rate increase, not to lead to an actual rate cut.

Governor Stephen Poloz knew this complacency was out there, and also knew that the surprise would only increase the effect of his policy action. Financial markets responded swiftly, with the Canadian dollar falling by 2 cents and the S&P/TSX index rising by 3.5 per cent. The Bank’s actions will dampen the inevitable slowing of the economy; it now forecasts that Canadian GDP will grow by 2.1 per cent this year, down from the 2.4 per cent predicted last October.

Meanwhile, just down the street in Ottawa, the federal Department of Finance is unsure what to do. The first hesitation was when Finance Minister Joe Oliver delayed the budget until April, a month or more later than usual. His political opponents accused him of incompetence, but that is totally unfair.

The federal budget is a very complex document, and is based on many difficult economic and fiscal projections. Given the rapid decline in the oil price, combined with the considerable uncertainty regarding its near-term future, it is entirely sensible to delay the budget, take the time
necessary to work through the forecasting details, and improve the accuracy of the subsequent budget plan.

What is more worrying is the possibility that the federal government, faced with a slowing economy and thus a slowing tax base, may nonetheless decide to cut its spending in an attempt to honour its promise of balancing its budget by the 2015-16 fiscal year.

There is a tension here between political and economic calculations. Some hard-core fiscal conservatives clearly believe in the importance of a budget that is exactly balanced, and these people will presumably favour spending cuts in order to hit the government’s objective. Such cutting would likely be seen as sound fiscal management.

But the economics on this issue is crystal clear. In terms of the government’s debt-to-GDP ratio, which is now just over 30 per cent, it hardly matters whether there is a deficit of $3-billion or a surplus of $3-billion this fiscal year. The difference between these two numbers is less than one-third of 1 per cent of GDP. And faced with the further slowing of an already slow-growing economy, cuts to federal spending will only make things worse, and will even work against the stimulus provided by the Bank’s actions.

The Bank of Canada’s current policy position couldn’t be any clearer. As for fiscal policy, however, we’ll have to wait and see. If the government’s thinking is dominated by political calculations, we can expect spending cuts, an even slower recovery, and a balanced budget by next spring. But if the government really cares about the economy, it will avoid any spending cuts, delay its target for budget balance, and maybe even announce some modest spending increases.

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