Carefully Crafting an Economic Gift

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The Harper government has five more weeks to think carefully about its January 27th. In the fiscal update presented three weeks ago, the government promised more fiscal stimulus if the need arises. And despite the large interest-rate cut last week from the Bank of Canada, it seems clearer with each passing week of worsening economic news that some significant fiscal stimulus will indeed be necessary. Stephen Harper and Jim Flaherty must therefore get their heads around the idea of planning budget deficits for the next few years. But how large a deficit is still fiscally responsible?

Let's return to the days of Paul Martin for a little perspective. In 1994, the federal deficit was $29 billion, over 4 percent of GDP. Two decades of similar deficits had driven the government's debt to a staggering 70 percent of GDP. The IMF called Canada a fiscal basket case and Mexico's "Tequila" Crisis convinced policymakers that Canada urgently needed to get its books in order. Martin then embarked on his crusade of deficit reduction; he produced the first budget surplus by 1998 and for the next decade there was nothing but black ink. With each budget surplus, a piece of the debt gets paid off, and so the combination of budget surpluses and a fast-growing economy led to a remarkable decline in the debt-to-GDP ratio. It now stands below 30 percent, making Canada far and away the fiscal "star" among its rich-country friends.

One of the problems with a high debt ratio is that the government has no ability to use fiscal stimulus to boost a slowing economy without alarming creditors. How will the government repay this new debt? Will they inflate away its value by recklessly printing money? Where is the plan to get the debt back to sensible levels? Back in 1994, all of these questions were being asked, and we should be thankful that we didn't have an economic slowdown to worry about—if we had, the government wouldn't have been able to do anything on the fiscal side.

Thanks to Canada's subsequent fiscal responsibility, however, we are now in a very different position. With the economy heading into a recession, our low debt ratio gives the government lots of room to manoeuvre. Nobody can claim today that a federal budget deficit for the next few years would be fiscally irresponsible—as long as it is done sensibly.

What does sensible mean? Consider the size of a possible stimulus package. Suppose Jim Flaherty were to announce a fiscal stimulus of $15 billion next year, $10 billion in 2010, and $5 billion in 2011—all to be financed by new borrowing. Given the standards of current political rhetoric, many people would go ballistic and accuse the government of being profligate or insane, or maybe both. But these numbers would be easily manageable. A deficit of $15 billion is almost exactly one percent of GDP, a number at the low end of the range agreed to by the G-20 leaders a few weeks ago. Even if the Canadian economy were to shrink for a year and then take two years to get back to today's size—a typical pattern for modern-day recessions—by 2012 the debt ratio would still be below 32 percent. No problem at all, especially when you remember where we were in 1994. Canada's creditors wouldn't bat an eyelash.

Now think about the timing. The 15-10-5 plan ensures that the bulk of the stimulus is up-front, which is where it should be given that it takes time for new government spending to affect the economy. Moreover, the three-year scaling down of the stimulus means that as the economy gets back onto its feet, the budget is closer to being balanced, so the necessary adjustment to better times is that much easier. Running budget surpluses at that point is not necessary; once the economy is growing again, even balanced budgets allow the debt ratio to continue falling. And this point bears emphasis: any package of fiscal stimulus must include a clear and credible plan for getting the government back on track toward its debt-to-GDP target of 25 percent, or even lower.

So, in terms of both size and timing, the 15-10-5 stimulus package would be entirely fiscally responsible. This leaves the most difficult part of the whole exercise: the many unmentioned details. A truly sensible fiscal stimulus must see the money spent relatively quickly, on things that make sense in the long run, and in ways that encourage the private sector to increase their spending rather than their saving. It's not easy to come up with a list of spending plans that meet these criteria. That's why those policymakers in Ottawa are going to need every bit of their five remaining weeks. We should all wish them luck!

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