<u>Ottawa's Fiscal Policy Needs to Promote Growth, Not Just Avoid Deficits</u>

Christopher Ragan
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The global economy has been stuck in a slow-growth recovery for six years, and now it's gearing down even further. The same is true for Canada. This situation naturally raises the question of whether our macro policymakers are doing all they should to enhance growth. It's hard to avoid the conclusion that our "mix" of monetary and fiscal policies is off kilter, and that electoral politics is partly to blame.

When the federal government released its budget in April, after oil prices had fallen sharply and then stabilized, the budget's assumption for 2015 growth in Gross Domestic Product (GDP) was 2 percent. This growth rate now appears all but impossible. The Canadian economy has been shrinking for the past few months, so growth of 2 percent for the year could only occur if the next five months displays an enormous rebound, which nobody now expects. The IMF has recently downgraded its 2015 forecast for Canadian GDP growth to 1.5 percent.

Joe Oliver, the federal Finance Minister, continues to stress that his forecast of a $1.4 billion surplus for 2015-16 is still on track, despite the slowdown. Yet his economic advisors must be explaining to him that slower GDP growth leads to a slowdown in revenues and thus to a smaller budget surplus and very likely a deficit. So how can he be so confident that he will end the fiscal year with his target surplus?

The answer, which was made quite clear by Stephen Harper last week, is that the feds will respond to the economic slowdown by maintaining strict fiscal discipline. In other words, as revenues decline along with the economy, the government will cut spending as necessary to ensure the target budget surplus is achieved.

If all you care about is the target for the budget surplus, this approach to fiscal policy is admirable. But if you care about economic growth, and especially the livelihoods of the thousands of Canadians still unable to find jobs in this slow-growth economy, then this approach to fiscal policy leaves much to be desired.

The government's single-minded pursuit of a budget surplus will only worsen an already bad economic situation. What's worse is that it is the impending federal election, and the government's desire to claim the high ground on "fiscal responsibility", that is driving this behaviour.

I'm not recommending a massive fiscal stimulus of the kind we had in 2009 and 2010. Those were dramatic policy responses made necessary by the severity of the global financial crisis. Appropriate today would simply be a more relaxed return to fiscal balance. Rather than making the spending cuts needed to achieve the target surplus, the government could instead increase spending modestly on worthwhile programs or projects. New spending of $6 billion, for example, would slightly enhance growth but would have almost no effect on the government's debt-to-GDP ratio of 31 percent, which is a far better indication of our fiscal responsibility than the annual budget surplus and is currently much lower than in most other countries.

Fiscal policy also affects the actions taken by the Bank of Canada. Governor Stephen Poloz, confronted with a weakening economy and every indication that federal policy is set to make things worse, may have no choice but to use his single, blunt instrument the only way he can. His second reduction in the Bank's target for the overnight interest rate, this time to 0.5 percent, is looking pretty likely.

The problem is that the Canadian economy badly needs a renaissance in business investment and exports. But domestic firms are not holding back their investment plans because interest rates are too low; they're holding back because of deficient demand and shattered confidence. And Canadian exports aren't so low because the Canadian dollar is too strong, but because global growth is weak and the demand for Canadian products has evaporated. Further reductions in Canadian interest rates aren't likely to make a dent in these two problems, but they would continue to fuel domestic concerns we have been talking about for a while – rising household debt and rising home prices.

Canada's current macro policy mix needs to be turned around. A more expansionary fiscal policy would provide a valuable boost to growth, and this would then allow a gradual tightening of monetary policy. But as long as we're still planning to have a federal election this October, we'll be unlikely to see this much-needed adjustment.

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