Economics

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Rethinking Canadian fiscal policy

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In the battle against inflation, there's more than one weapon in policymakers' hands. Anything that slows demand will do the trick, but in Canada, as in many other countries, the job has largely been left to interest rate hikes to do the dirty work. A deeper fiscal belt tightening could accomplish the same thing, and, as we argue here, would have had side benefits for the country that we won't see by letting monetary policy fly solo.

We still see inflation decelerating in Canada, and reaching the 2% target next year, alongside similar developments in the US, but both countries are in need of a stall in growth to make that happen (Tables 1 and 2). If the job of engineering that slowdown is left only the to Bank of Canada, monetary policy will have to squeeze on growth for a longer period than we previously thought, given that the labour market hasn't opened up much slack thus far. The Bank of Canada raised rates again in June, likely has a 25 basis point follow-up in store in the coming months, and we've pushed back the timing of the first interest rate cut to June of next year (Table 3). Even by the end of next year, overnight rates will likely still be well above the 2½% level seen as neutral.

But it's not too late to consider a fiscal policy shift. Fall updates at the federal and provincial levels, for example, don't always have to be about adding spending. It's not that fiscal policy is significantly fueling the inflation we're now seeing, it's that it would be even better if, at least in the near term, it was actually putting some downward pressure on inflation by helping to cool off the fire. At a minimum, this isn't the year for finance ministers who find a bit more money in their coffers at mid-year to look for new ways to spend it or dole it out to households.

Not much restraint post-2022

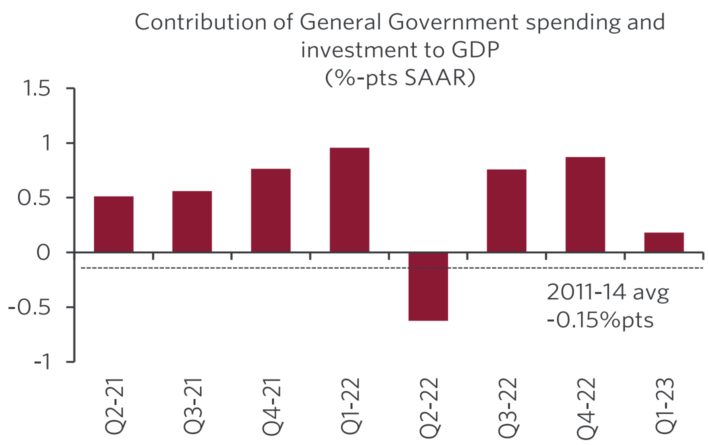
All three levels of government combine to set the fiscal direction for the country, but federal and provincial budgets do much of the steering. Local governments are often compelled to balance budgets, and more senior levels of government are key sources of funding for urban capital projects.

Ottawa and the provinces retreated from pandemic-related expenditures in the past year, and that wind down was key to preventing the need for an even steeper initial escalation in interest rates. Deficits dropped dramatically at both levels in 2022, with some provinces attaining surpluses. But remember that some of that was tied to revenue gains from strong nominal GDP growth, rather than active fiscal restraint.

With the phase-out of pandemic support programs now behind us, progress on deficits is set to slow, and fiscal restraint is less pronounced. Looking at government spending on goods, services and capital, they were still collectively adding a couple of ticks to annualized growth in the first quarter of 2023, and contributed more significantly in the last half of 2022 while the Bank of Canada was ramping up interest rates in an attempt to lean the other way (Chart 1).

That's a contrast to the recovery after the 2008 recession. After 2010, real spending by governments subtracted an average of 0.15%-points from economic growth in the next four years, and was also a drag in the US. That allowed both central banks to

Chart 1: Government spending still adding to GDP, unlike post-financial crisis



Source: Statistics Canada, CIBC

keep interest rates very low, with the US sticking with near zero rates, and the Bank of Canada holding at 1% after a modest initial tightening.

Governments are also playing a role in Canada's overheated labour market. Relative to 2019 pre-pandemic staffing levels, public sector employment has significantly outpaced the private sector (Chart 2). If public sector employment had merely kept up with that of the private sector, its headcount would be lower by 250K. In a worst-case scenario where none of those people found jobs elsewhere and stayed in the labour force, or squeezed others out of private sector jobs, the unemployment rate would be more than 1% higher than at present, obviating the need for the Bank of Canada to further cool the labour market.

The tightness of the labour market, and its impact on wage inflation, is a key concern for the Bank of Canada. Public sector wage rates have not led the way higher, having generally trailed what we've seen in the private sector (Chart 3). But recent wage settlements with federal workers, while not exceeding the private sector trend, do appear to have caught up with it, and could set a precedent for union negotiations with other federal and provincial workers.

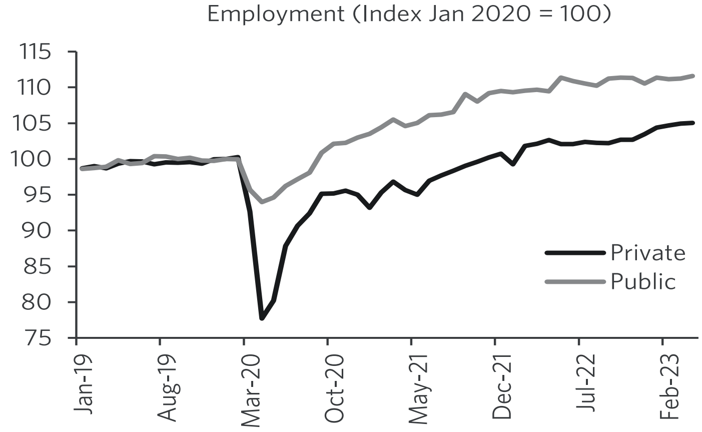
Some of the largest swings in the government's role during the pandemic didn't show up in national account expenditures, which only track government purchases of goods and services (including those provided by public sector workers). Instead, billions went out in the form of transfer payments to persons and businesses impacted by the pandemic, a key factor behind the quick rebound after the second quarter of 2020.

While those extraordinary payments ended, recent quarters have seen cheques going out to households for other reasons. The federal government and some provinces justified these as helping families cope with inflation. Some provincial finance ministers opted to share the revenue bounty coming from a strong recovery in nominal GDP in 2022, or to be frank, were hoping for a spinoff benefit at the polls in impending elections.

Stripping out savings on cyclical programs like employment insurance, but also leaving out the increase in social security transfer payments tied to an aging population, governments are still not being quite as restrained in terms of benefits as they were in the prior cycle, measured as a share of incomes (Chart 4). While such payments were softer in Q1, the second quarter will see a boost coming from the "grocery rebate" sent by the federal government, which if all spent in the quarter would lift GDP by an annualized 0.4%-points.

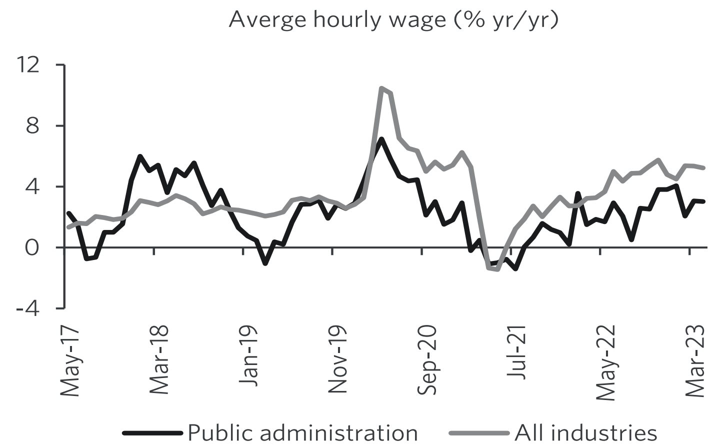
Tax payments from the household sector are rising of late, taking a bit of steam off spending power, but that appears to be driven by the strength in jobs and incomes that pushes more of Canadians' earnings into higher brackets. Neither the federal government nor the provinces attempted to speed up their fiscal recovery by announcing significant tax hikes on the household sector in the past set of budgets.

Chart 2: Public sector employment has surged ahead of private sector



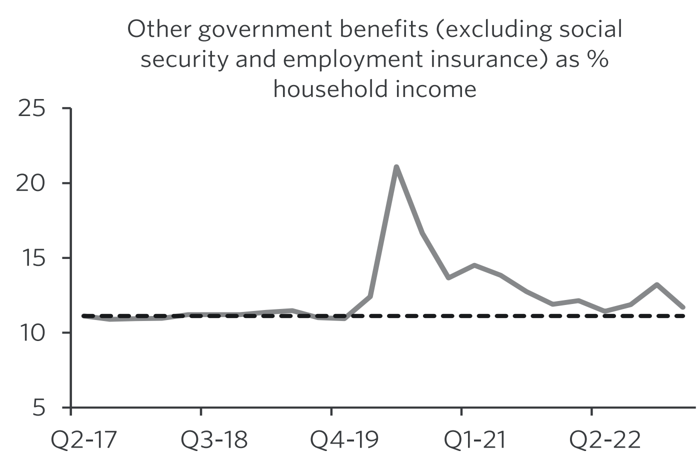
Source: Statistics Canada, CIBC

Chart 3: Public sector wage inflation has lagged, but likely accelerate



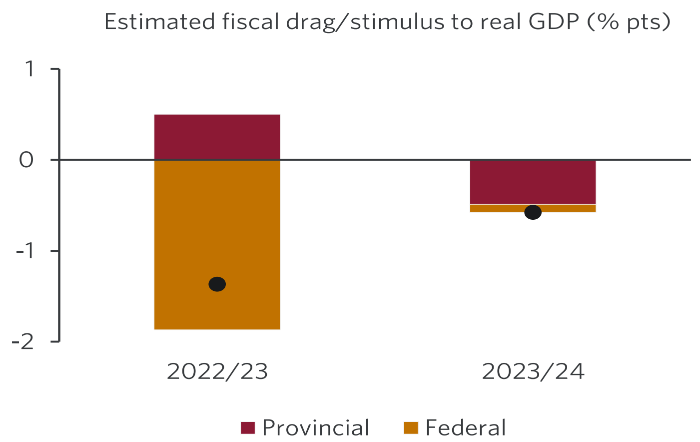
Source: Statistics Canada, CIBC

Chart 4: Benefit payments still making up a larger share of household incomes than pre-pandemic, could bounce up in Q2



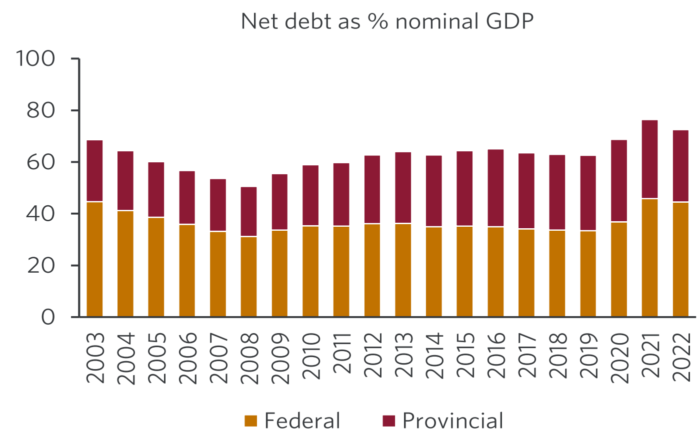
Source: Statistics Canada, CIBC

Chart 5: Less of a fiscal drag in 2023/24



Source: Government budgets, CIBC

Chart 6: Debt-to-GDP still higher than pre-pandemic



Source: Haver Analytics, CIBC

Adding it all up

Putting both current and capital spending, as well as taxes and transfers together, the broadest measure of Canada's fiscal stance shows that having reverted to a drag on growth in fiscal 2022-23, federal and provincial governments will be getting closer to a neutral stance (Chart 5) in fiscal 2023. However, the drag on growth last year would have been larger without a surge in provincial spending. While much of the spending was labelled as a way of helping households with the cost of living, the bump up in transfers went above and beyond inflation and represented a stimulus in real terms. The winding down of federal spending was a drag on growth, although the actual impact was likely somewhat smaller, as households drew down on transfers they received in the prior year but didn't spend.

Fiscal policy will represent a much more modest drag on growth this year, and will therefore not be materially assisting the Bank of Canada in cooling the economy's inflationary fires. While much of the extra provincial spending in 2022/23 was maintained in fiscal 2023/24, it wasn't significantly added to and as such would represent a slight drag in inflation-adjusted terms. That is, of course, unless governments decide to announce further spending measures in upcoming quarterly or mid-year statements, something we've often seen in the past.

A missed opportunity

Addressing deficits, or reducing debt ratios by running surpluses, is never pain free for the economy, a reason why voters aren't typically crying out for such measures, and politicians shy away from them when elections loom. Those advocating less spending often do so as a means of financing lower taxes, rather than lowering government deficits. But in this case, we're missing an opportunity to do more to reverse the debt/GDP build up from the pandemic without paying any economic price.

One way or another we will need to go through at least a stall in growth to get inflation back to the 2% target. So the drag from fiscal restraint would be offset by the ability to chart a softer course on interest rates, by cancelling further hikes we might still face and bringing forward the timing for some interest rate reductions

That alternative mix offers some other benefits. Canada's overall public debt burden is still manageable, but it has deteriorated from where we were in 2019 (Chart 6). That was a necessary evil to combat the economic drag from the pandemic, but it does mean that future federal and provincial budgets will collectively face a higher debt servicing bill, leaving somewhat less room for programs.

One negative of an exclusive reliance on higher interest rates is that it puts housing construction at the centre of the resulting economic slowdown. That's hardly ideal in an environment in which a shortage of housing is pressuring apartment rents and the overall cost of home ownership.

As well, high existing debt levels in the Canadian household sector create risks that the lagged impacts of monetary policy will end up overshooting in terms of the economic slowdown we need to get inflation to 2%. Mortgage renewals for Canadians in 2024 and 2025 could be a significant risk to household financial stability if the Bank of Canada hasn't sufficiently eased policy by then. A somewhat tighter fiscal path would give the central bank more elbow room to start that process.

Finally, improving productivity is a friendlier route to lowering inflation, by reducing business costs, and allowing corporate Canada to ease up on its demand for currently scarce labour by substituting more mechanization. But relying exclusively on interest rate hikes, rather than a mix of monetary and fiscal tightening, puts more downward pressure on business capital spending, which tends to be adversely impacted by higher borrowing costs. Governments are stepping up with fiscal largesse, in the form of heavy subsidies, to spur capital spending in some green industries, but a policy mix that was tougher on fiscal policy, and easier on interest rates, would provide a broader improvement in the capital spending backdrop.

Table 1: Canada forecast detail (real % change, SAAR, unless otherwise noted)

Variable	23Q1A	23Q2F	23Q3F	23Q4F	24Q1F	24Q2F	24Q3F	24Q4F	2022A	2023F	2024F
Real GDP Growth (AR)	3.1	1.2	0.3	-0.4	1.0	1.0	1.6	2.1	3.4	1.5	0.8
Real Final Domestic Demand (AR)	2.6	0.1	0.2	-0.1	1.1	1.4	1.8	2.5	2.7	0.7	0.9
Household Consumption (AR)	5.7	-0.7	-0.4	-0.7	0.7	0.8	1.0	2.7	4.8	2.0	0.4
All Items CPI Inflation (Y/Y)	5.1	3.5	3.2	2.9	2.9	2.0	1.8	1.7	6.8	3.7	2.1
Unemployment Rate (%)	5.0	5.1	5.4	5.7	5.9	5.9	5.8	5.7	5.3	5.3	5.8

Table 2: US forecast detail (real % change, SAAR, unless otherwise noted)

Variable	23Q1A	23Q2F	23Q3F	23Q4F	24Q1F	24Q2F	24Q3F	24Q4F	2022A	2023F	2024F
Real GDP Growth (AR)	1.3	1.9	-0.8	0.3	0.5	0.8	0.9	1.7	2.1	1.4	0.6
Real Final Sales (AR)	3.4	1.7	-0.7	0.3	0.4	0.7	1.0	1.8	1.3	1.9	0.5
All Items CPI Inflation (Y/Y)	5.8	4.0	3.1	2.5	2.3	2.0	2.1	2.2	8.0	3.8	2.2
Core CPI Inflation (Y/Y)	5.6	5.2	4.1	3.0	2.4	1.9	1.8	1.9	6.2	4.5	2.0
Unemployment Rate (%)	3.5	3.6	4.0	4.1	4.3	4.3	4.3	4.2	3.6	3.8	4.3

Table 3: Canadian interest rates (end of period)

Variable	2023 9-Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
Overnight target rate	4.75	5.00	5.00	5.00	4.50	3.75	3.50
98-Day Treasury Bills	4.86	5.20	5.10	4.80	4.35	3.60	3.35
2-Year Government Bond	4.51	4.80	4.60	4.25	3.65	3.20	2.80
10-Year Government Bond	3.41	3.50	3.45	3.20	3.00	2.90	2.75
30-Year Government Bond	3.30	3.40	3.30	3.25	3.00	2.90	2.85
Canada - US T-Bill Spread	-0.37	-0.60	-0.65	-0.80	-0.50	-0.75	-0.75
Canada - US 10-Year Bond Spread	-0.35	-0.40	-0.35	-0.30	-0.25	0.00	0.00
Canada Yield Curve (10-year — 2-year)	-1.10	-1.30	-1.15	-1.05	-0.65	-0.30	-0.05

Table 4: US Interest rates (end of period)

Variable	2023 9-Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
Federal funds rate	5.125	5.625	5.625	5.625	5.125	4.375	4.125
91-Day Treasury Bills	5.23	5.80	5.75	5.60	4.85	4.35	4.10
2-Year Government Note	4.59	4.90	4.70	4.30	3.60	3.00	2.80
10-Year Government Note	3.77	3.90	3.80	3.50	3.25	2.90	2.75
30-Year Government Bond	3.91	4.00	3.80	3.75	3.45	3.30	3.20
US Yield curve (10-year — 2-year)	-0.83	-1.00	-0.90	-0.80	-0.35	-0.10	-0.05

Table 5: Foreign exchange rates

Exchange rate	2023 9-Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
CAD-USD	0.75	0.76	0.76	0.76	0.77	0.78	0.78
USD-CAD	1.33	1.32	1.31	1.31	1.30	1.29	1.28
USD-JPY	139	130	127	124	122	120	118
EUR-USD	1.08	1.06	1.08	1.11	1.14	1.15	1.15
GBP-USD	1.26	1.24	1.27	1.29	1.32	1.32	1.32
AUD-USD	0.67	0.67	0.68	0.69	0.69	0.70	0.70
USD-CNY	7.13	6.85	6.79	6.75	6.73	6.71	6.69
USD-BRL	4.90	5.20	5.40	5.20	5.20	5.40	5.00
USD-MXN	17.3	19.0	19.5	19.5	20.0	20.0	19.5

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