In Focus

March 12, 2019

ECONOMICS

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The Kids are Alright: Will Canadian Deficits Burden Our Children?

by Avery Shenfeld and Royce Mendes

With budget season underway in Canada and its provinces, talk has turned to the age old question of what's appropriate for debts and deficits. Is a balanced budget the holy grail?

In the US, a fringe chorus under the banner of Modern Monetary Theory argues deficits aren't the evil they are made out to be. Some make the puzzling claim that deficits are the only tool to get to full employment even when there's room to cut rates, or that debt can be financed ad infinitum with printed money. Just check out the inflation record for Zimbabwe, Venezuela or Weimar Germany to find out how that works out. Where its proponents are less extreme, they're not really saying much beyond standard Neo-Keynesian economics.

But when the former chief economist of the IMF, an agency that historically preached fiscal austerity, says that for other reasons government debt isn't as scary as earlier thought, it's worth our attention. Olivier Blanchard has contributed to and summarized research that downplays the future fiscal and economic costs associated with government borrowing even when it's not financed by the central bank's printing press.

What does all of this suggest about the need for Canada to exercise fiscal restraint? Will we bury our children in interest costs? That depends on what level of government, the reasons behind the deficits or debt issuance, and where we are in the business cycle. It adds up to less to worry about for some types of deficits, but not others.

Made-in-Canada Math

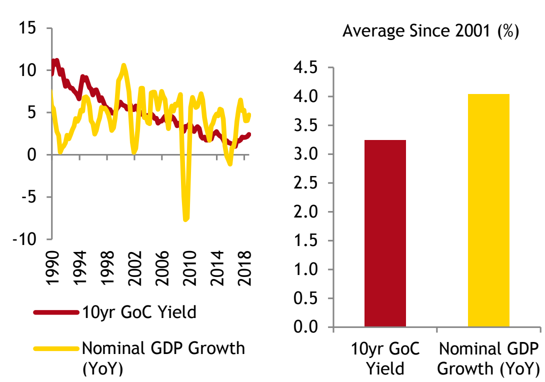
Blanchard's argument comes down to two central propositions. The first shoots down the cliché that when the government borrows today, we are automatically putting an additional tax burden on our children. If the interest rate on safe government debt (r) is lower than the nominal economic growth rate (g), a one-time operating deficit does not have a future fiscal cost.

That is, it does not require higher future taxes rates (as a share of GDP) to pay for it. In such cases, GDP will grow faster than the accumulated interest, so the government can simply roll over that debt and interest in future debt, and it will still be shrinking relative to the tax base (GDP).

That condition, $r < g$, has been true for many sovereign governments, not only recently, but in many historical periods as well. For Canada, that's been generally true at the federal level (Chart 1).

Chart 1

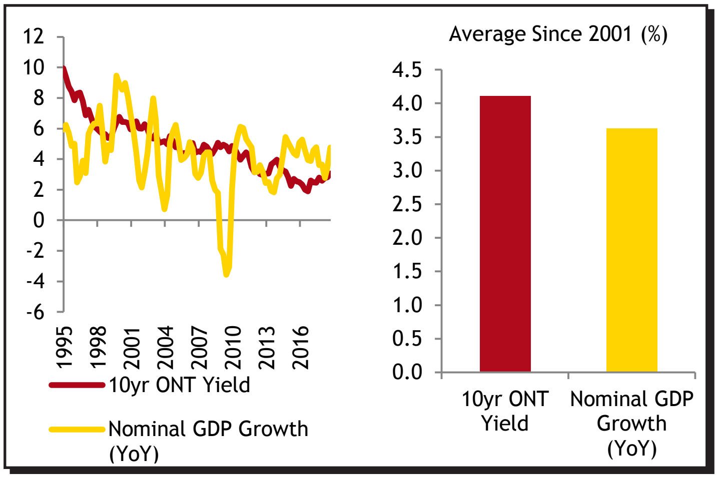
Cdn Gov't Yields Are Below Nominal Growth



Source: Bloomberg, CIBC

Chart 2

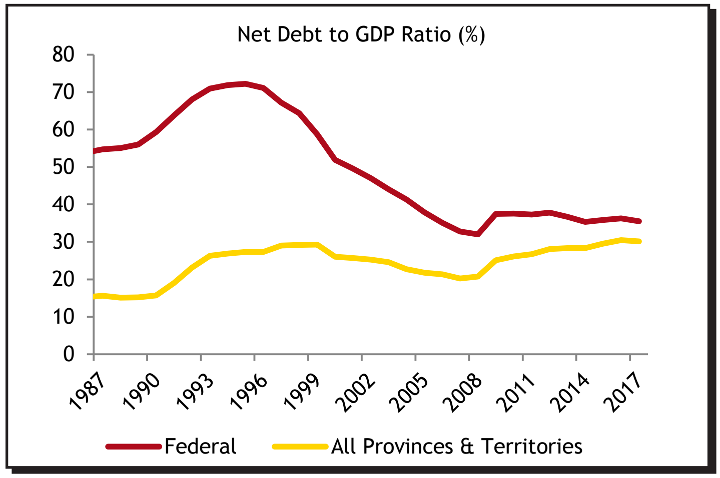
Provincial Yields Exceed Nominal Growth



Source: Bloomberg, Ontario Ministry of Finance, CIBC

Chart 3

Federal Net Debt Stable, Provincial Debt Has Climbed As Share of GDP



Source: Department of Finance Canada, CIBC

But taking Ontario as the benchmark, it hasn't been as consistently true at the provincial level (Chart 2), where borrowing costs are higher. **The bottom line is that, for now, deficits at the national level might not add to future tax burdens, but the same can't be said for the provinces**.

Moreover, many have misinterpreted this finding by taking it too far. Being able to borrow at a rate below nominal growth might not last forever under a profligate fiscal plan. A one-time debt financing, followed by zero primary deficits (i.e. borrowing that only repays maturing principal and interest) would see declining debt/GDP. Repeatedly running primary deficits would elevate debt/GDP ratios, and in the real world, constantly trying to roll these over into new debts would eventually incur higher debt service costs relative to GDP. That can mushroom into a negative feedback loop in which higher borrowing rates add to deficits which in turn raise borrowing rates.

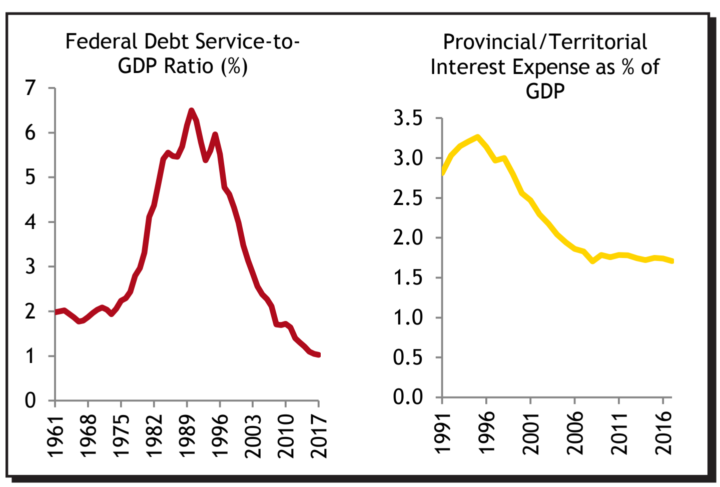
For Canada, we haven't come close to crossing that Rubicon. Total public sector debt has stayed well below its 1990s peak, a factor behind the low rates the federal government now faces on its AAA-rated debt. Together with the r < g relationship for Canadian federal debt, that makes a solid case that running a deficit of 1% of GDP, or even a bit higher, will not entail a tax rate cost to future generations.

In contrast, provincial debt has been climbing relative to GDP (Chart 3). Rates could move out as global investors demand a higher return on spread product due to both the slowing pace of global growth, and the fact that sovereign bonds are no longer paying such abysmally low yields.

So far, despite some provincial ratings downgrades that we saw in the post-recession period, **interest rates and debt levels have not, in combination, been placing an increased debt service burden relative to either nominal GDP or government revenues at the federal and provincial levels** (Chart 4).

Chart 4

Debt Service Costs Not Growing As Share of GDP



Source: Statistics Canada, CIBC

Crowding Out and Welfare Effects

Blanchard's second key proposition deals with the distortion that government borrowing does to the pattern of consumption and investment over time. The borrowing associated with running an operating deficit absorbs private savings that might have otherwise been borrowed by the business sector for investments in new plant and equipment, which in turn would have raised future output.

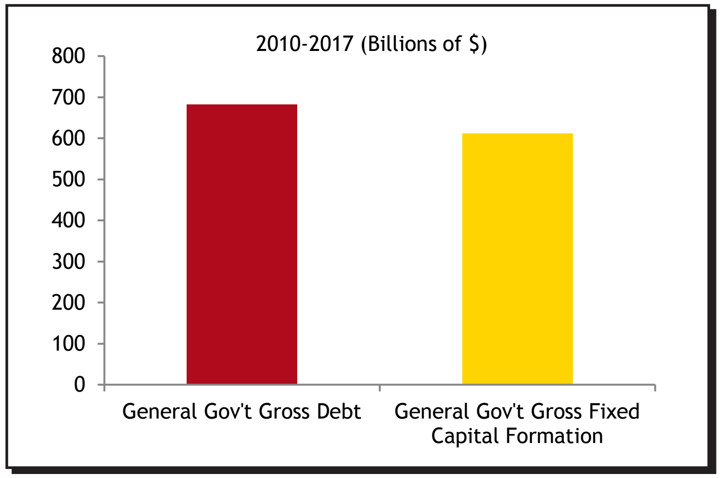
That's less of an issue in recessionary times, particularly when the room to cut interest rates to get back to full employment is limited. In such cases, fiscal deficits might not actually crowd out any private investment, and might instead be needed to boost growth to the point where such private sector projects look viable.

But that's not where Canada is today, sitting near full employment and with room to cut interest rates if things deteriorate. While the math gets tricky for this publication, Blanchard's conclusion is that when government borrowing crowds out capital accumulation, the economic welfare costs of that distortion depends not only on the safe rate, but the higher, risky rate for the marginal product of capital which would typically exceed the nominal GDP growth rate. Still, he concludes these costs are likely modest in the US case.

We won't explore the task of measuring that rate of return for Canada, because there is another factor at play: governments can run deficits not just to boost current spending, but also for investment in public sector capital (i.e. infrastructure) that generates its own future returns in enhancing GDP growth. In fact, 90% of the recent additions to government debt can be attributed to additions to infrastructure (Chart 5).

Chart 5

Capital Spending Has Accounted For 90% of the Increase in Government Debt Over 2010-17



Source: IMF, Statistics Canada, CIBC

That suggests that we put less focus on "how much" debt is being issued, again particularly at the lower-cost federal level, than on "where" those infrastructure dollars are being allocated in terms of the future economic returns. Are the transit projects, hospitals, schools, roads getting those dollars the ones most needed to lift future output and well-being the most? Banging the table that budgets must be balanced is a lot easier than getting down to those details. Perhaps that's why it's still such a popular sport in Canada.