



Fiscal Policy

During and After the Crisis

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Outline of Talk

- **Role of fiscal policy in stabilizing the economy**
- **Impact of stimulus in Canada**
- **Aftermath – need for consolidation**
- **Canadian experience of mid-1990s**
- **Canada's exit strategy**





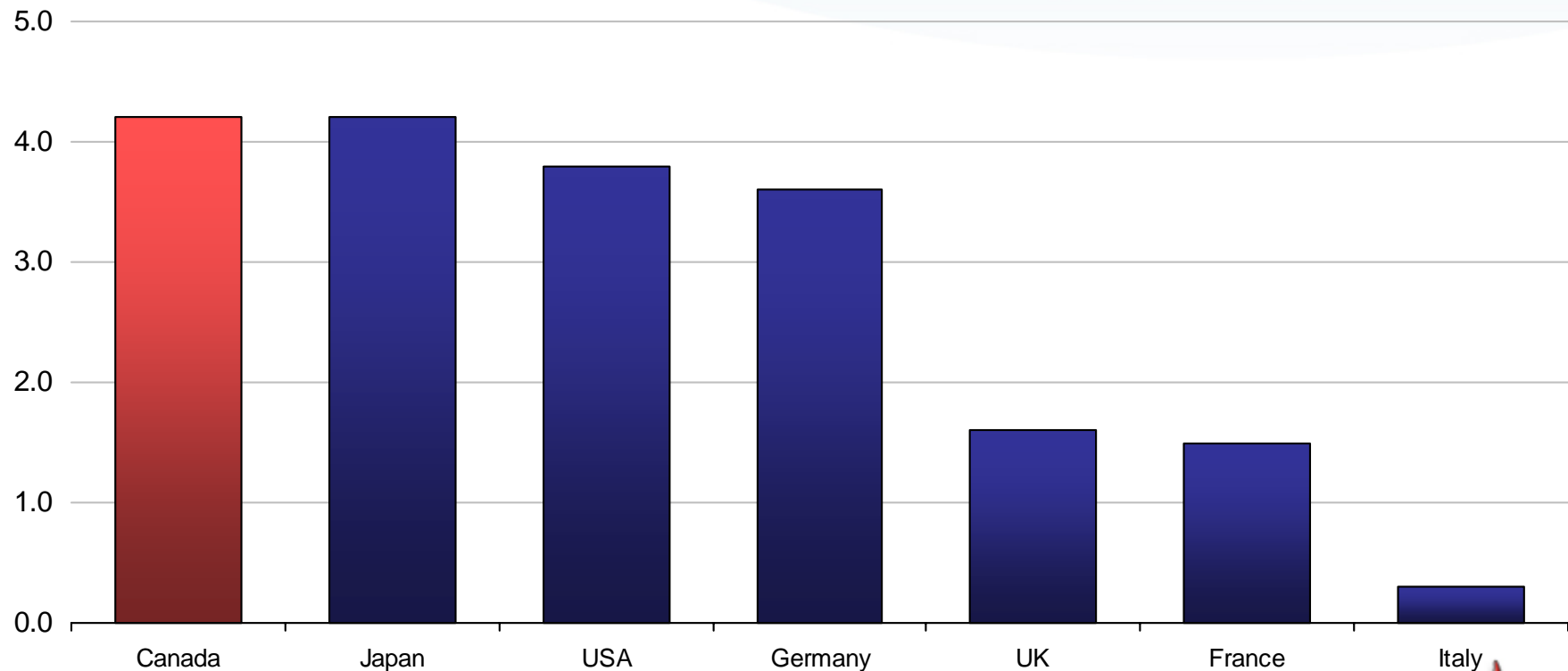
Role of Fiscal Policy in Stabilizing the Economy



In addition to automatic stabilizers, large discretionary stimulus measures were implemented in response to the largest global recession since the 1930s

Discretionary Measures in 2009 and 2010, G7 countries

Per cent of GDP



Sources: IMF, *The State of Public Finances Cross-country Fiscal Monitor*, November 2009.

IMF estimates exclude loans, including those to the auto sector, for all countries. Figure for Canada includes provincial-territorial stimulus in addition to that assumed in the Economic Action Plan as estimated by the Department of Finance Canada.



The effectiveness of fiscal policy in stabilizing the economy depends on several factors

Response of monetary authority

- Accommodation
- Zero-bound constraint

Degree of leakage (imports and savings)

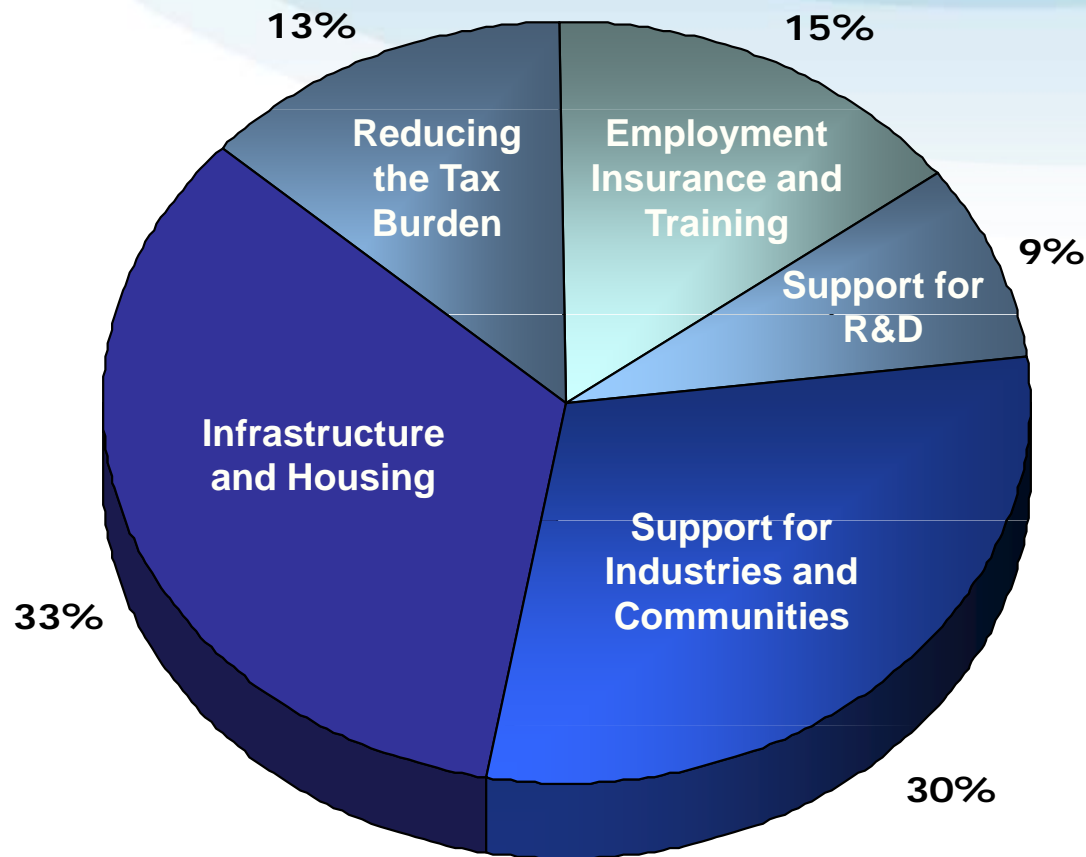
Degree to which consumers are forward looking

Perceived fiscal position (sustainability)

Speed of implementation



Canada's stimulus plan is "well-diversified and structured for maximum effectiveness" IMF, May 2009



An additional \$200 billion to improve access to financing

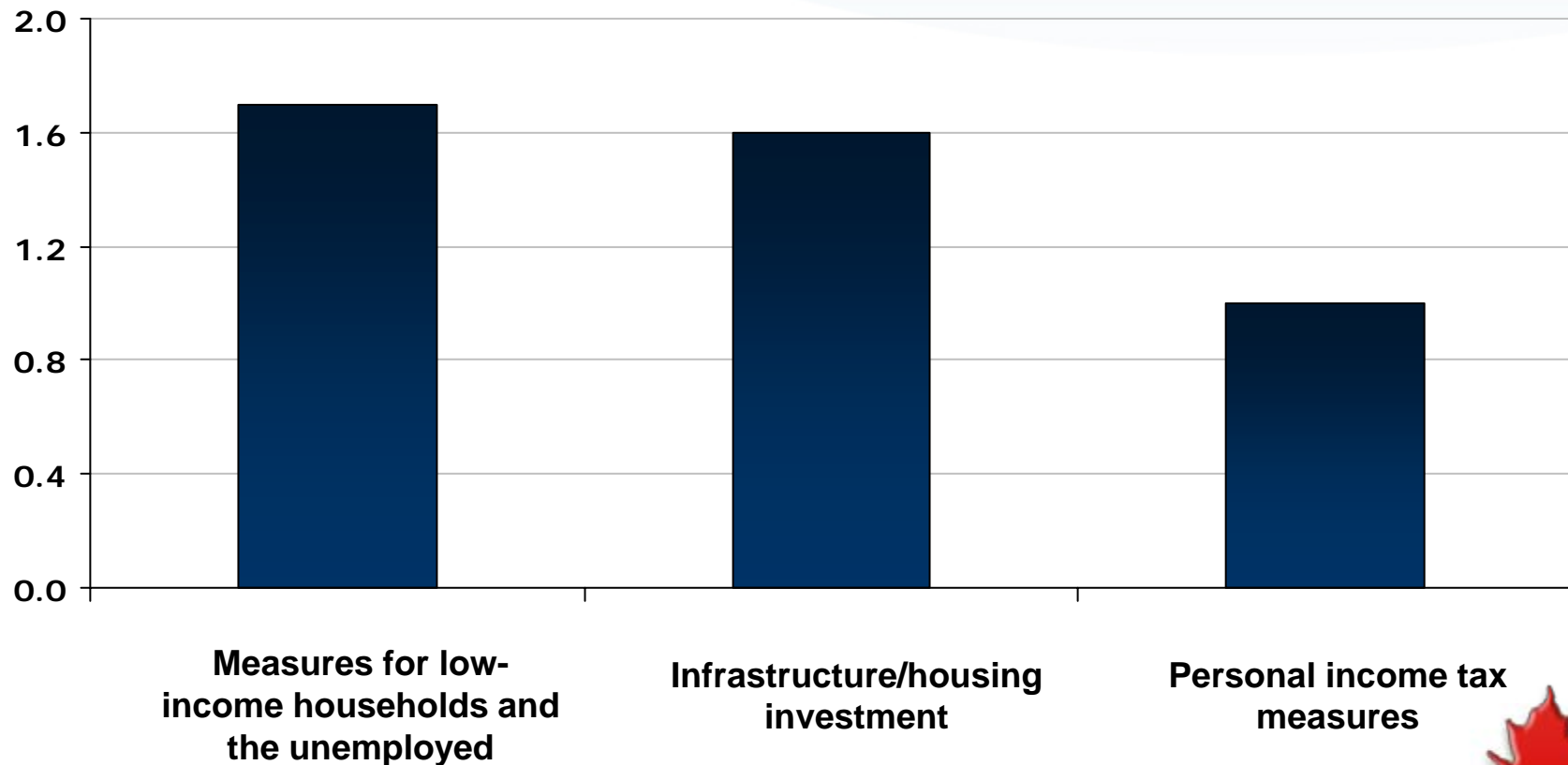
Note: Figures do not include provincial, territorial or municipal leverage. Measures to support research and development include infrastructure improvements to colleges and universities. Measures to support industries and communities include targeted reductions to corporate income tax announced as part of the Economic Action Plan in Budget 2009.

Source: Budget 2010 – Canada's Economic Action Plan, Year 2



Prudent fiscal multipliers were used in assessing the impact of the stimulus

Dollar impact (after 8 quarters) on the level of real GDP of a one-dollar increase in fiscal measures



Design and situation suggest high effectiveness

- **The sustainable fiscal situation, the composition of the stimulus and its rapid implementation contributed to its effectiveness**
- **Widespread global actions limited import leakages**
- **Fiscal policy should have led to crowding-in effects with the policy interest rate essentially at zero and with forward-looking agents**
 - See NBER Working Paper “When is the Government Spending Multiplier Large?” by Christiano, Eichenbaum and Rebelo, October, 2009





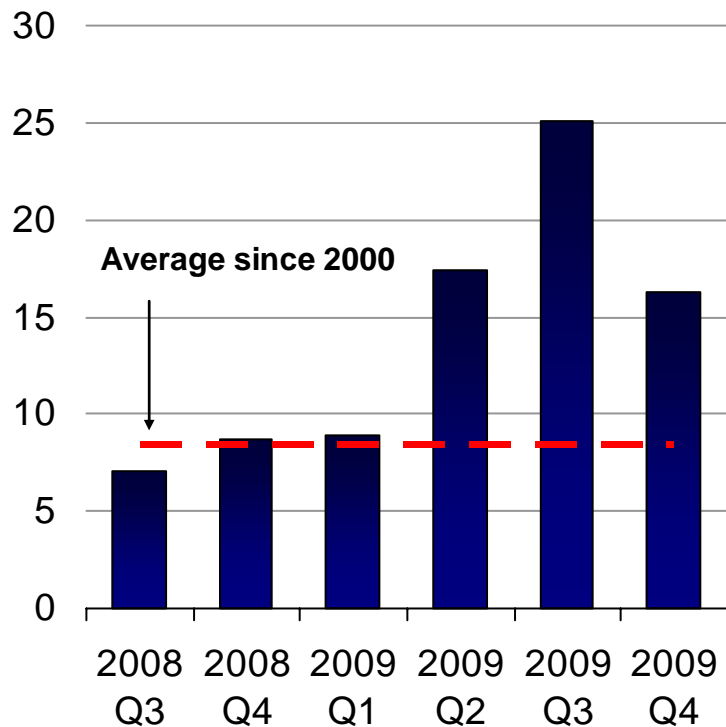
Impacts of Fiscal Stimulus in Canada



Areas targeted by the Economic Action Plan rebounded strongly following its implementation

Real Government Fixed Capital Formation Growth

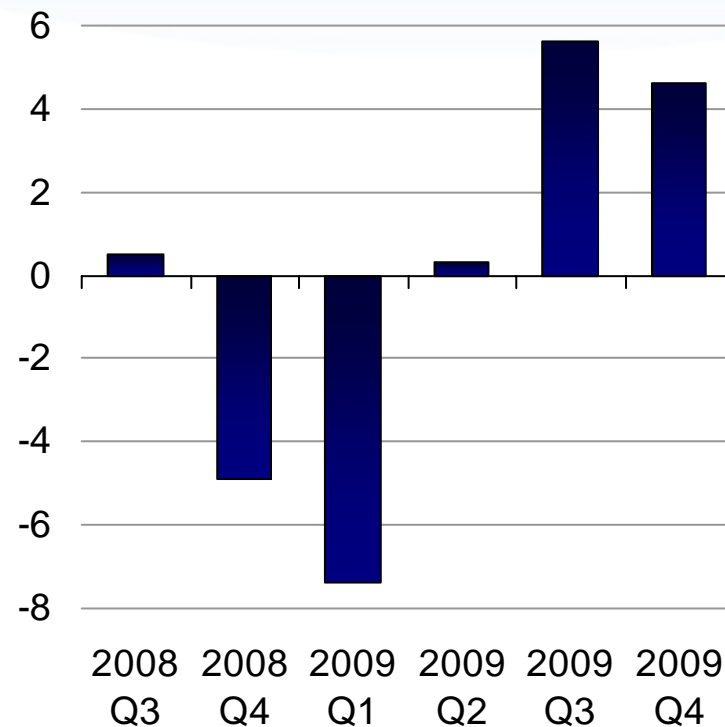
per cent, period to period at annual rates



Source: Statistics Canada.

Real Final Domestic Demand Growth

per cent, period to period at annual rates



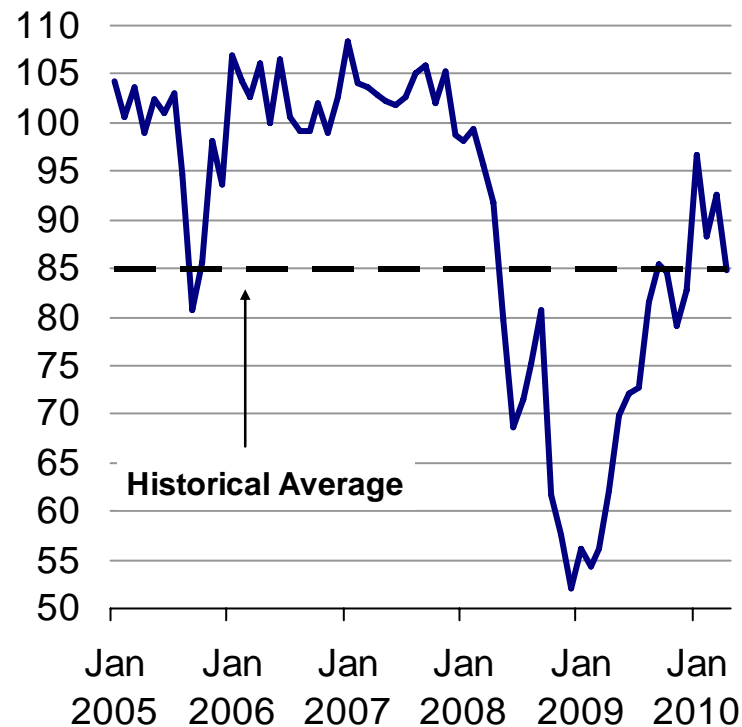
Source: Statistics Canada.



Consumer and business confidence improved markedly

Consumer Confidence

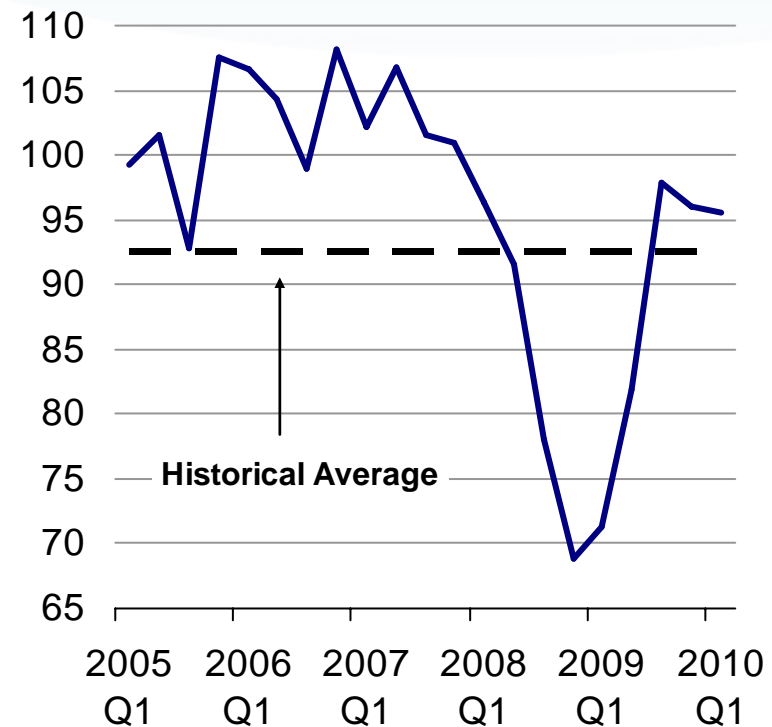
index, 2002 = 100



Source: The Conference Board of Canada.

Business Confidence

index, 2002 = 100



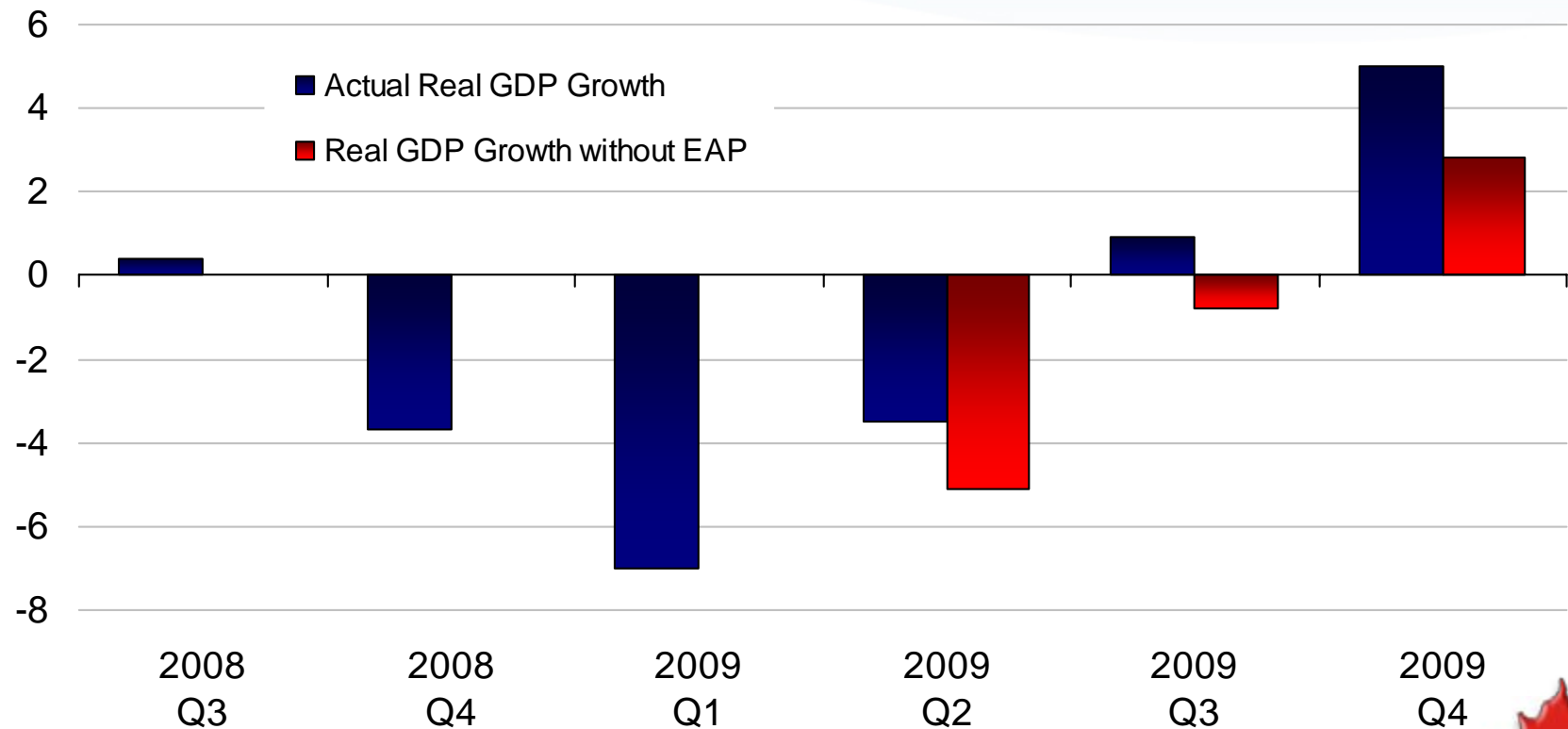
Source: The Conference Board of Canada.



Model-based estimates suggest that the Action Plan has had a significant impact on growth ...

Real GDP Growth and the Economic Action Plan

per cent, period to period at annual rates



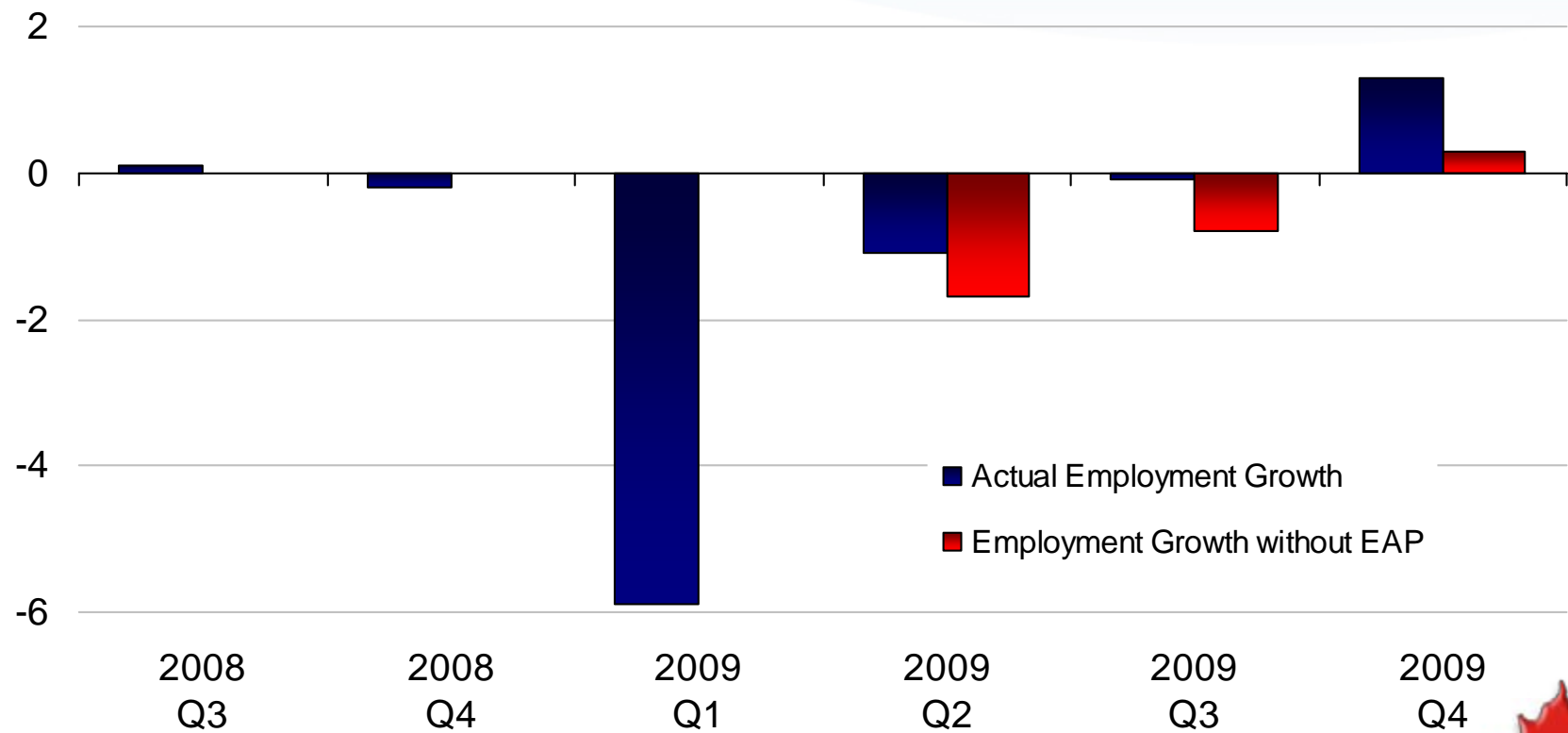
Source: Budget 2010.



... and employment

Employment Growth and the Economic Action Plan

per cent, period to period at annual rates



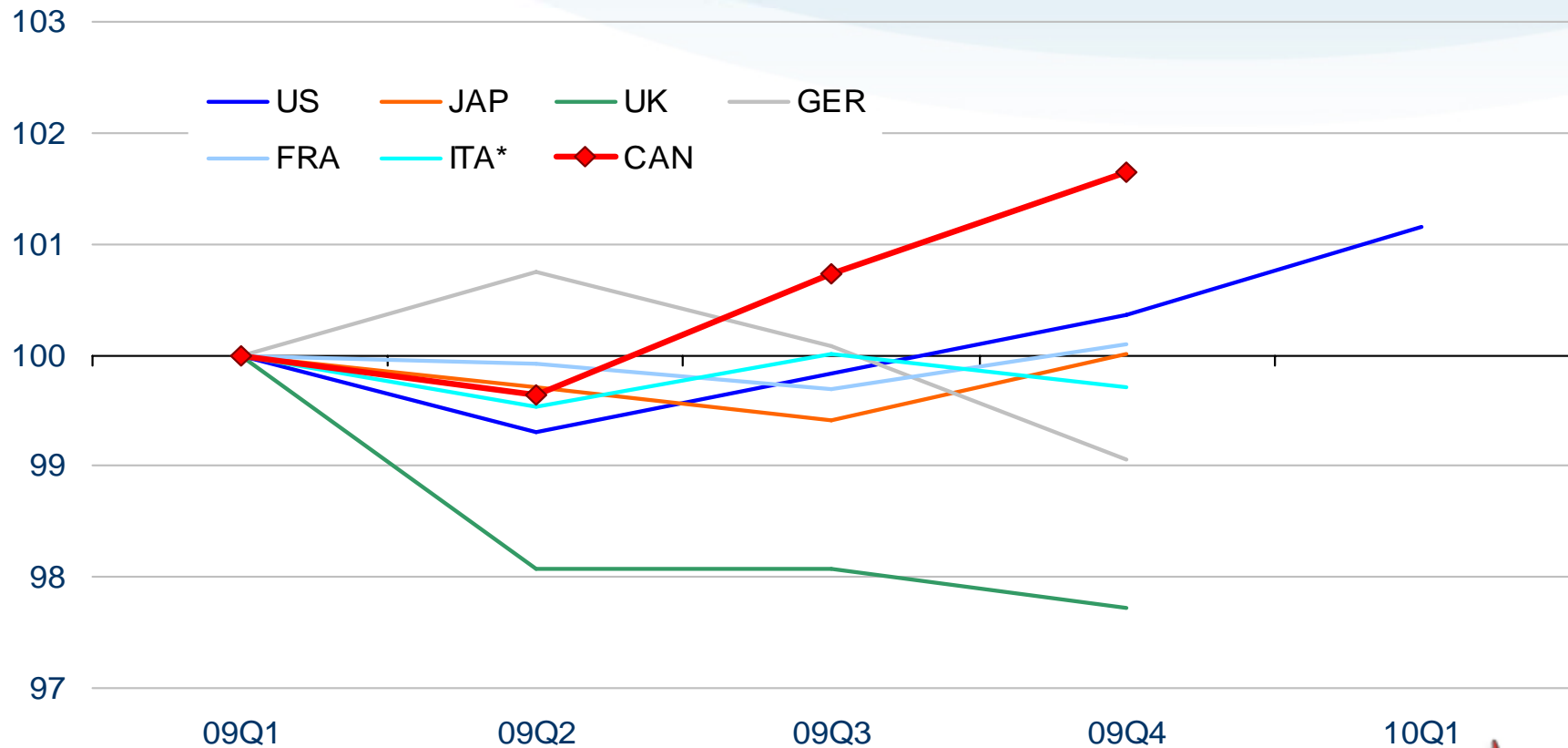
Source: Budget 2010.



Private demand has rebounded in Canada but remains fragile in most other G7 countries

Evolution of Real Private Final Domestic Demand¹

Index, 2009Q1 = 100



¹ Private consumption expenditures and private fixed investment.

* Italy does not publish separate estimates for private and public fixed investment. As a result, Italy's private final domestic demand includes government fixed investment.

Sources: Statistics Canada; U.S. Bureau of Economic Analysis; Cabinet Office; Office for National Statistics; Deutsche Bundesbank; Institut National de la Statistique et des Études Économiques; Istituto Nazionale di Statistica; Department of Finance calculations.



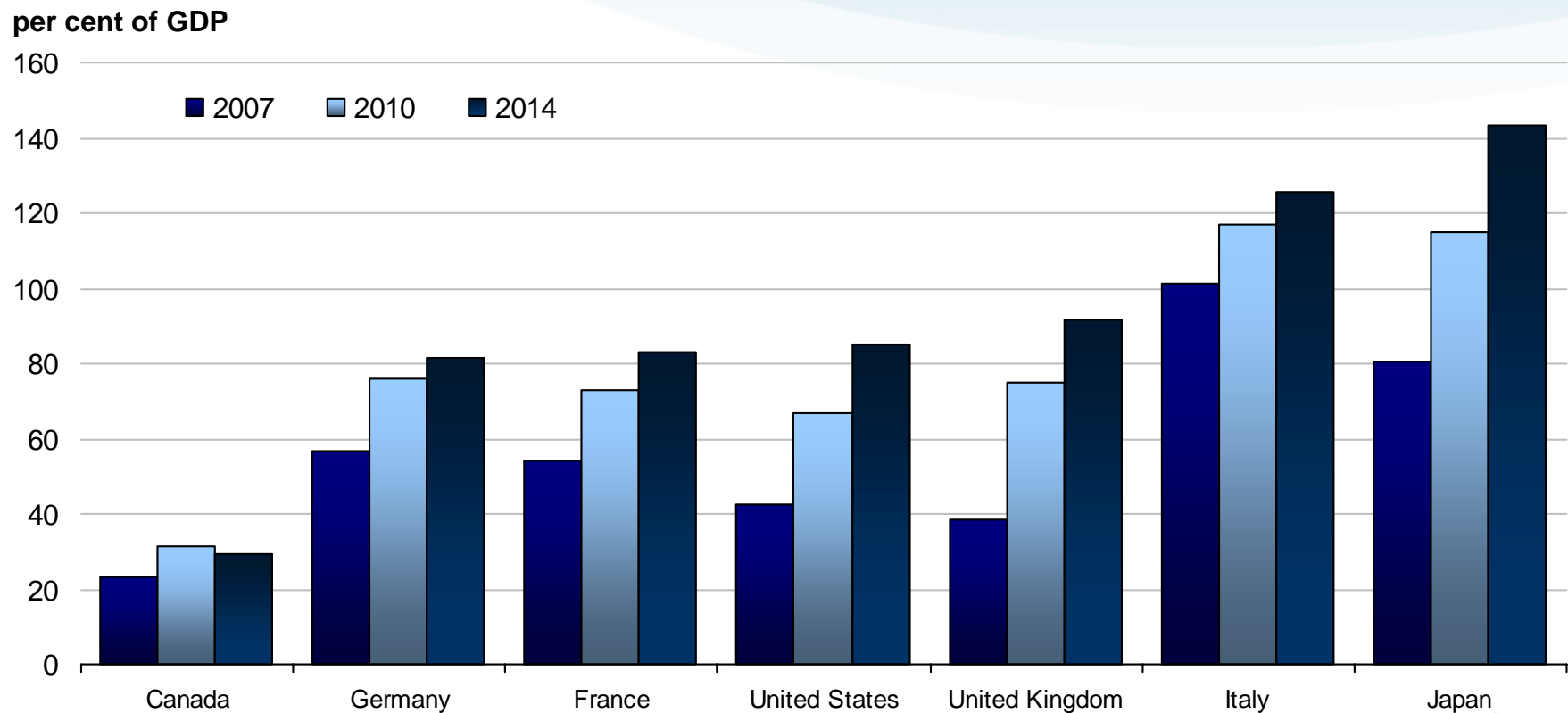


Aftermath: The Need for Fiscal Consolidation



Stimulus was appropriate and necessary, but there has been a rapid deterioration in the fiscal situation

Total Government Net Debt, G7 Countries



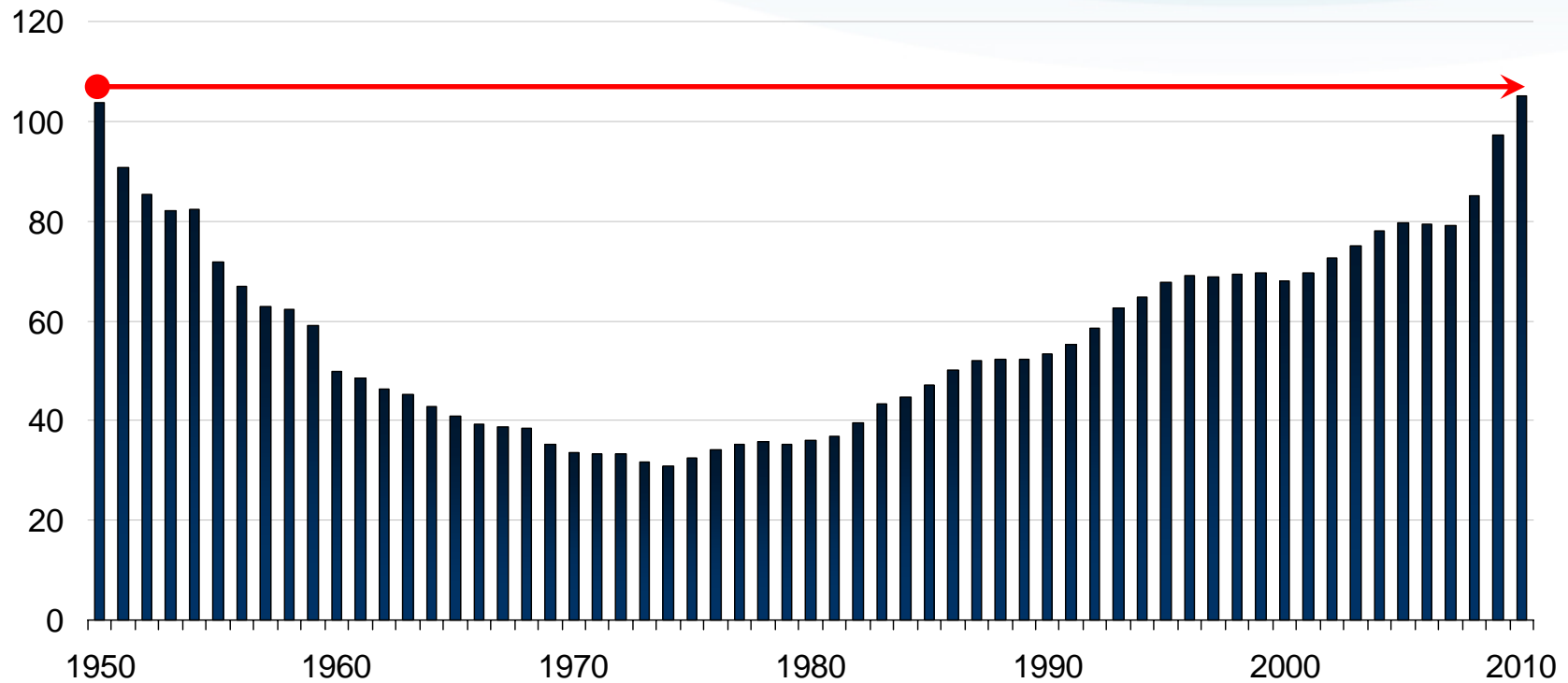
Source: IMF, *World Economic Outlook* (October 2009).



Gross debt in the G-7 now as high as in the early 1950s

G-7 Gross Government Debt, PPP weighted

per cent of GDP

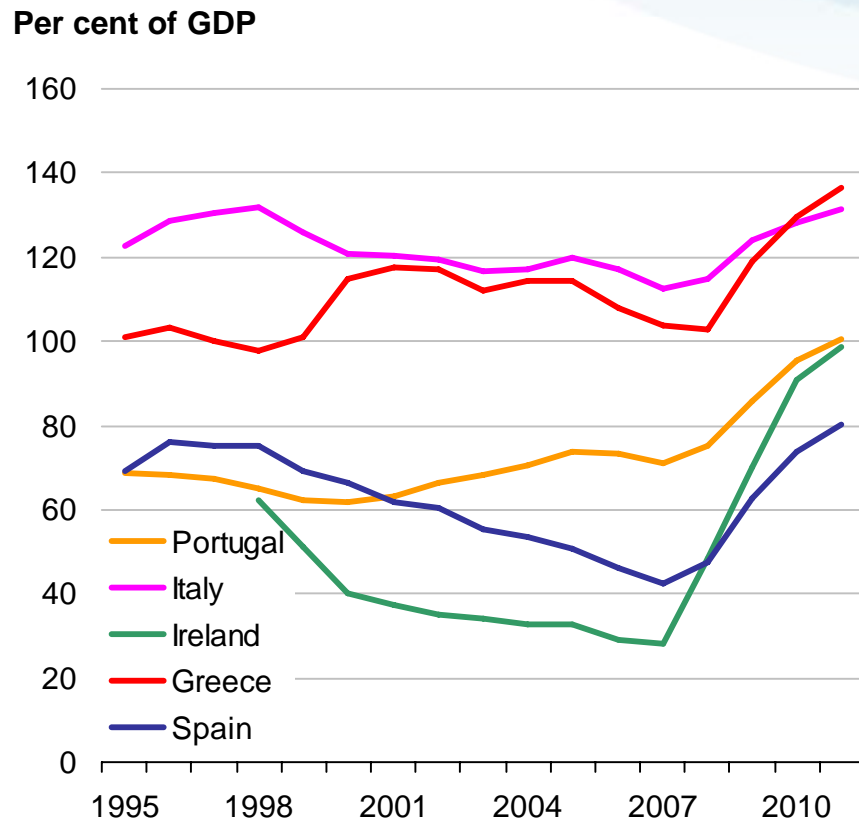


Source: IMF Calculations

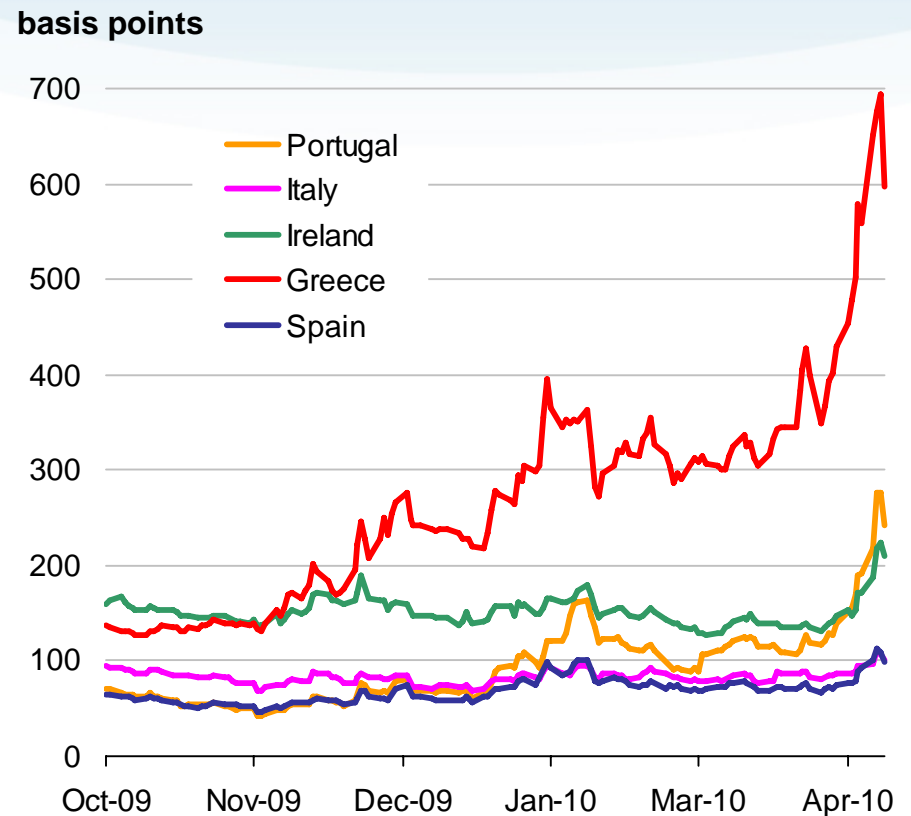


Sharp rise in public debt is exposing governments with weakest fiscal positions to rapidly rising risk premia

General Government Gross Financial Liabilities



10-Year Spreads to Germany



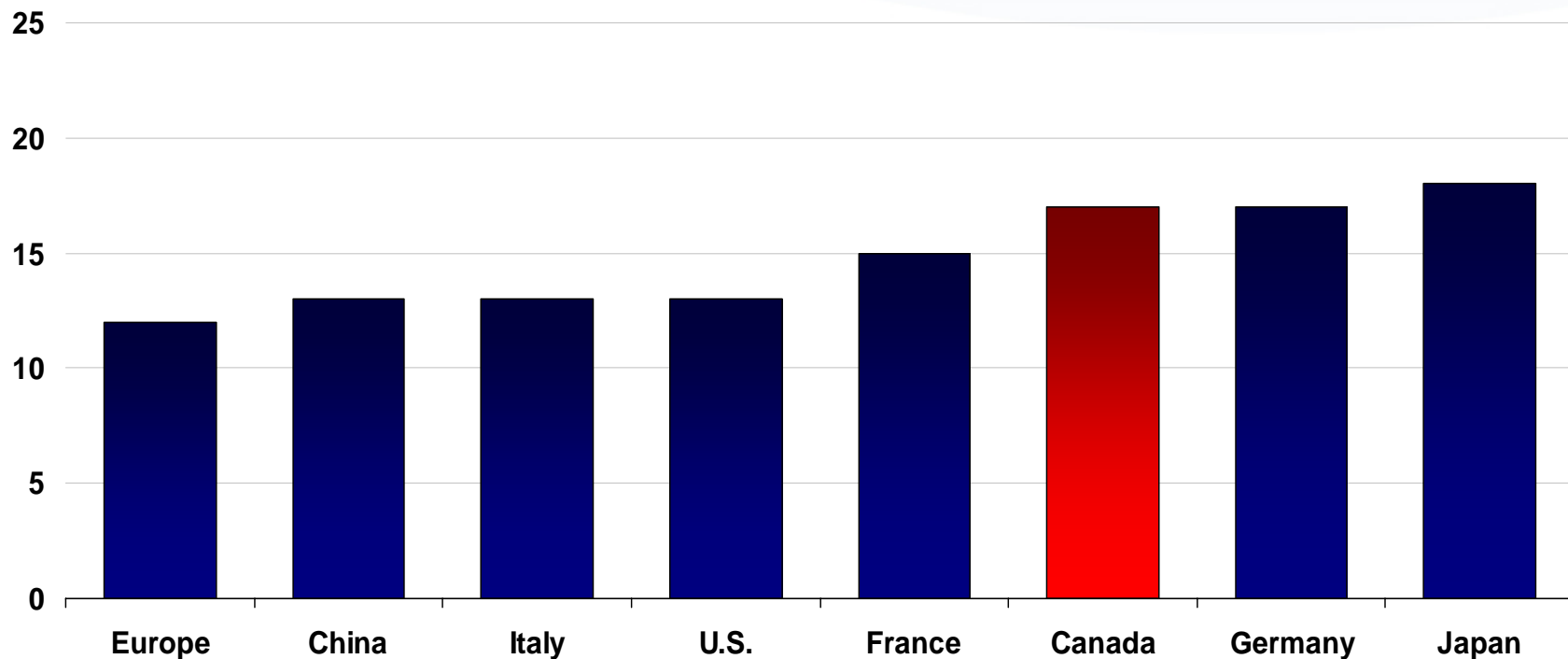
Source: OECD



Most countries facing additional pressure from population aging

Elderly (age 65+) as a Proportion of the 15-64 Population: Expected Changes from 2010 to 2030

percentage points



Source: United Nations World Population Prospects 2008





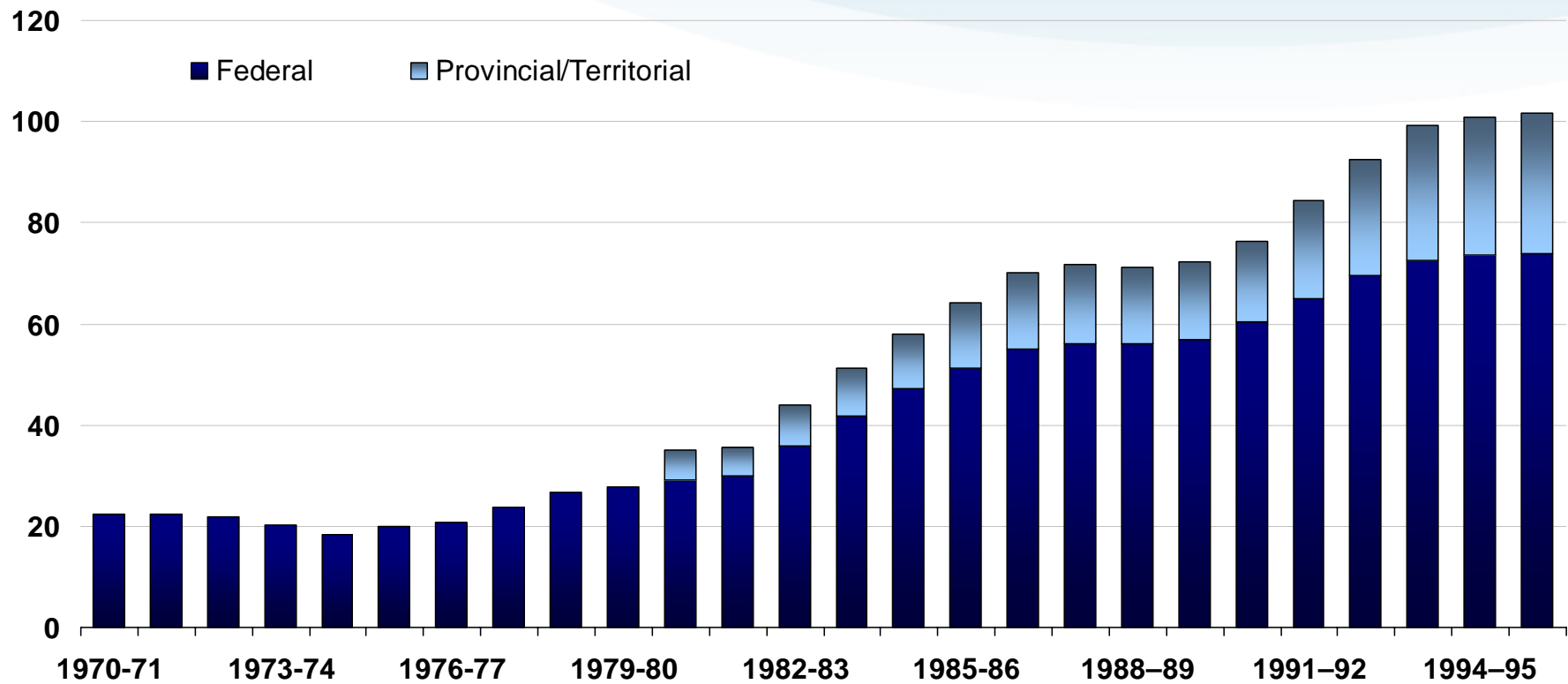
Canadian Consolidation Experience of the mid-1990s



Debt burden rose steadily for more than two decades

Net Debt

per cent of GDP



Source: Canada and Provincial Public Accounts



Growing sense of crisis by mid-1990s provided the impetus for significant action

1994 Mexican peso crisis

- **Rapid depreciation of the Canadian dollar**
- **Demonstrated the vulnerability of high-debt nations to international financial markets**

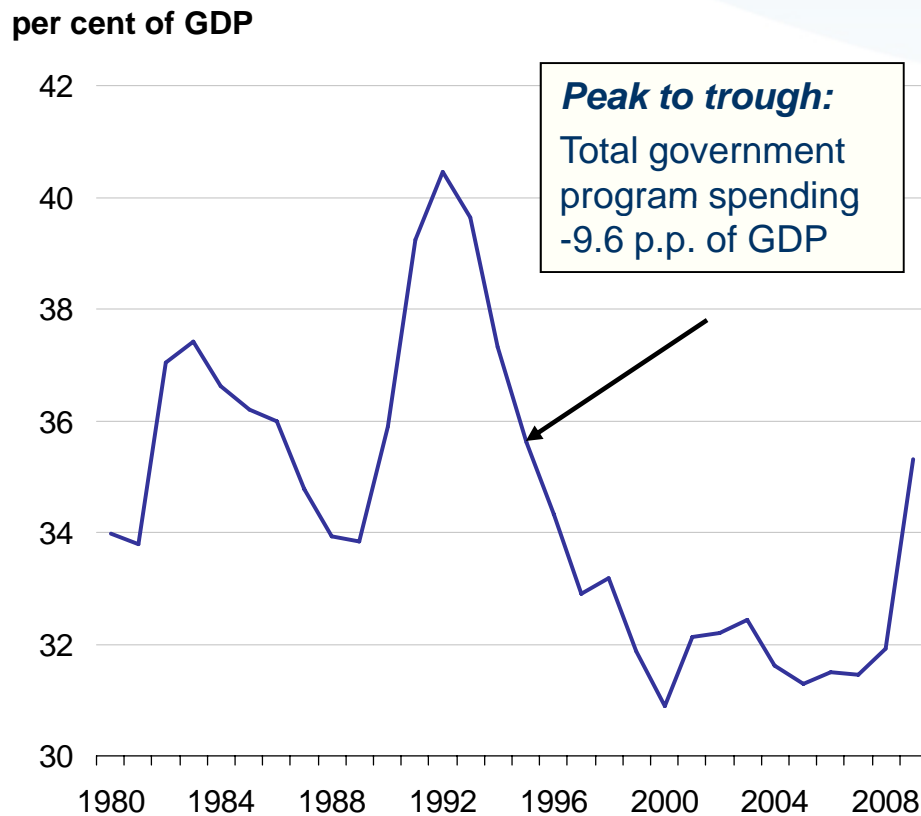
WSJ Editorial: “Bankrupt Canada?” (January, 1995)

- ***“Honorary member of the third world”***
- ***“Canada could hit the debt wall and have to call the IMF”***

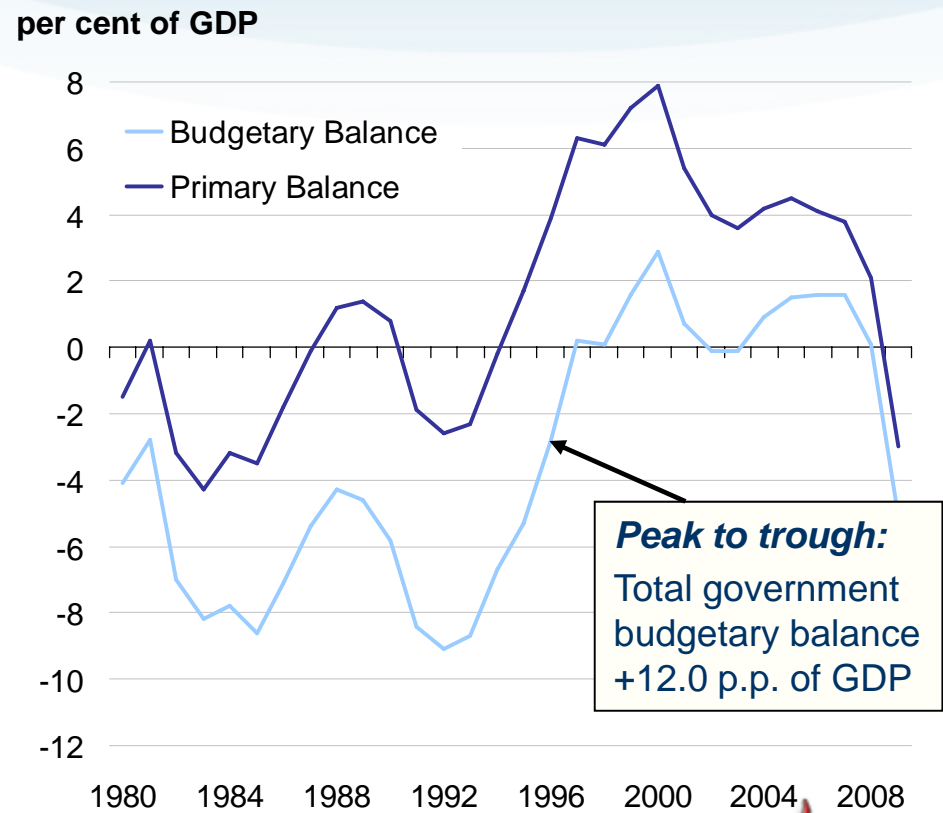


The policy actions were very difficult and painful, but led to the elimination of a large deficit in just four years

Total Government Program Spending



Total Government Fiscal Balance

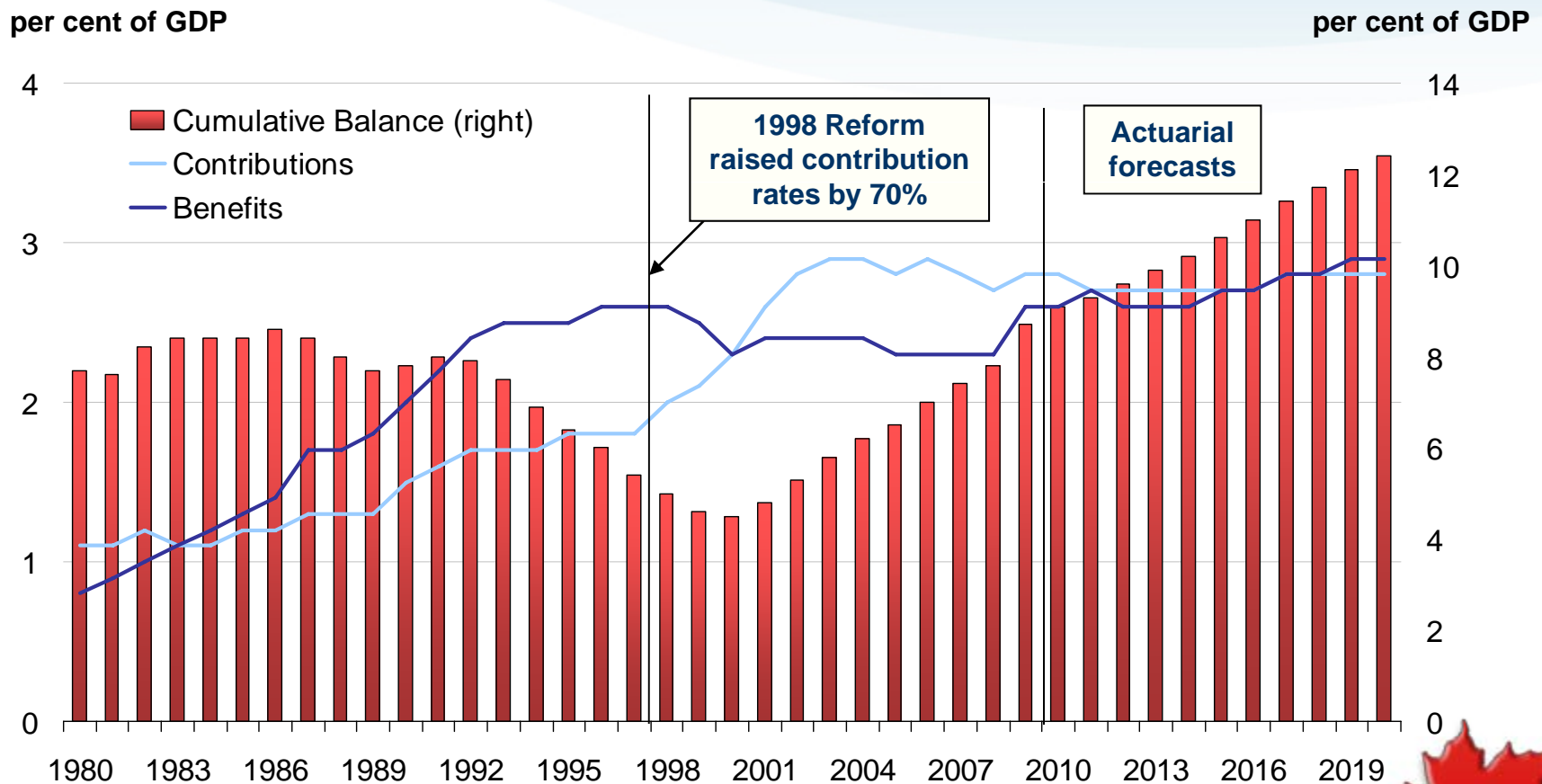


Source: Statistics Canada.

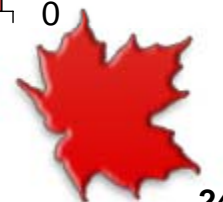


Major 1998 reform to CPP/QPP also put the systems on a sustainable path over the long run

CPP and QPP Contributions and Benefits

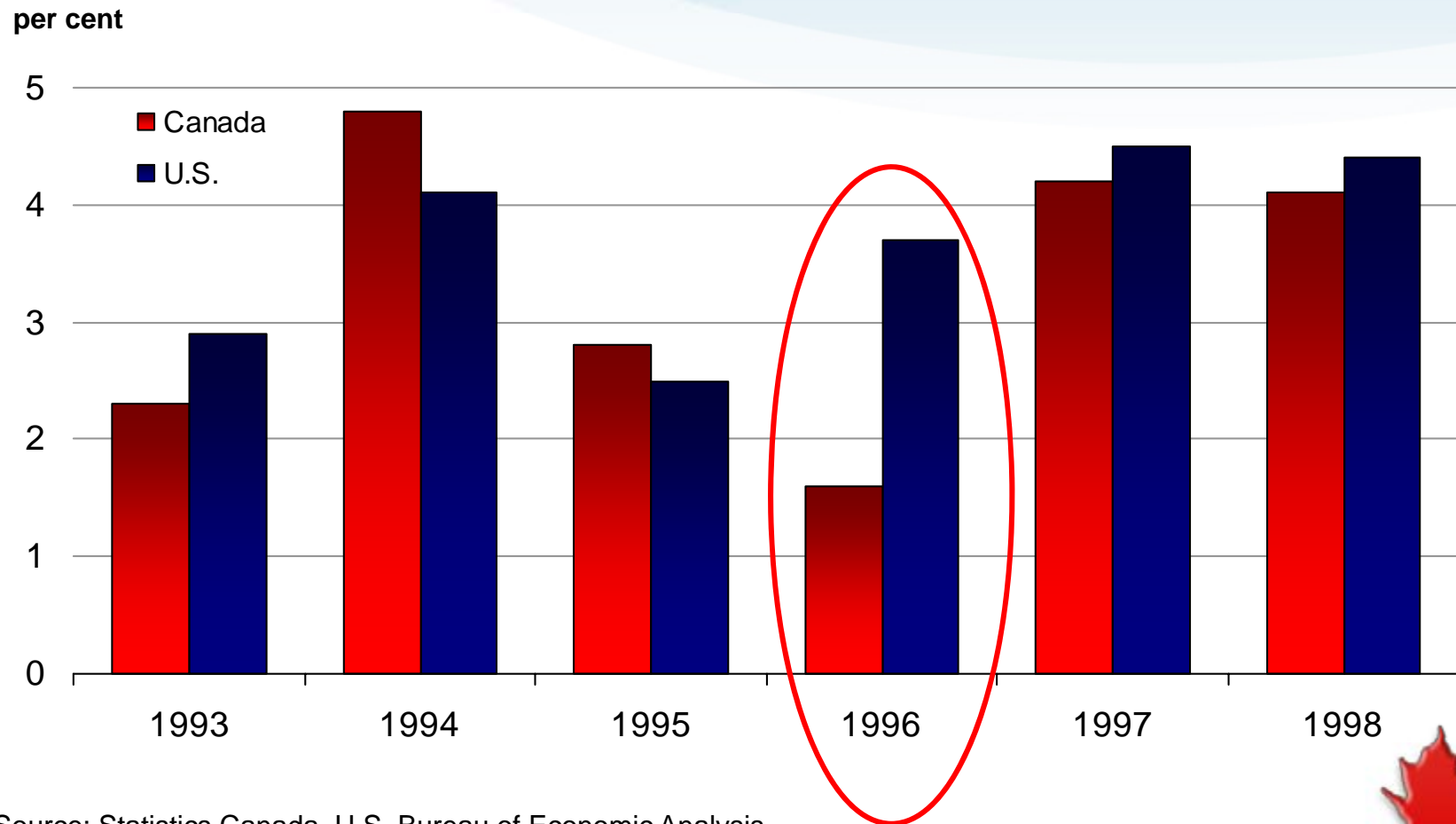


Sources: Statistics Canada, OSFI Actuarial Report on Canada Pension Plan (2009); L'analyse actuarielle du Régime de rentes du Québec (2007).



Large fiscal consolidation lowered growth temporarily in 1996, but growth bounced back as credibility and confidence built up

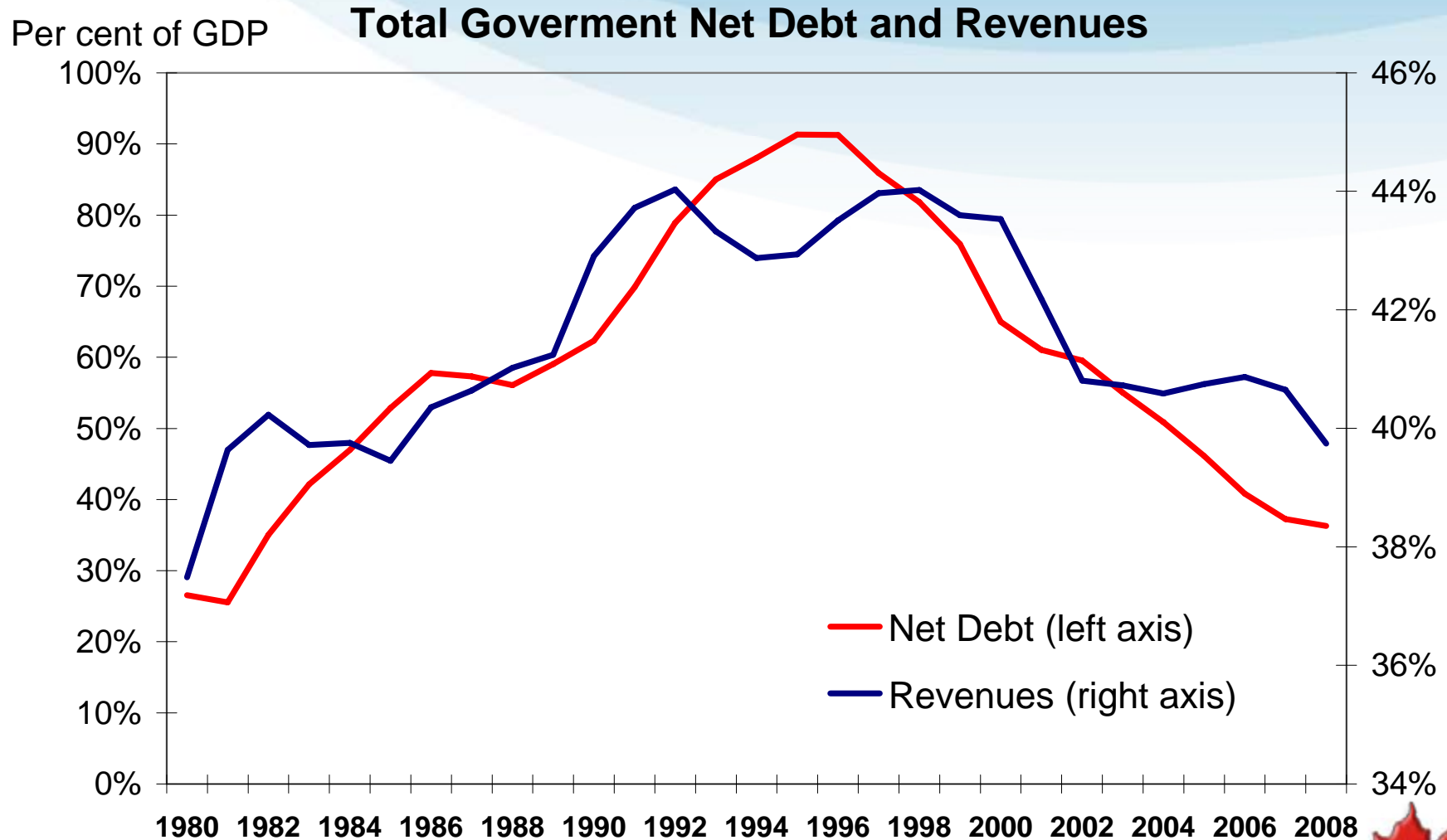
Real GDP Growth in Canada and the United States



Source: Statistics Canada, U.S. Bureau of Economic Analysis.



Lower debt service costs led to significant debt and tax reductions



Source: National Balance Sheet – Book Value



Lessons Learned from Canada's Fiscal Consolidation of the mid-1990s

- 1. Credible plans must be developed and communicated early**
 - Measures well identified
 - Prudent economic assumptions
 - Under-promise/over-achieve
- 2. Initiate consolidation as soon as possible - don't be too gradual and allow monetary policy to play its macrostabilization role**
- 3. Focus on spending reductions and measures that will increase potential growth**

 **What does this mean for the current situation?**





Canada's Exit Strategy



Budget 2009 implemented temporary stimulus and early actions to secure sound long-run fiscal position

Temporary Action Plan stimulus, concentrated in 2009 and 2010

Permanent actions to maintain sound structural finances:

- Reforms to Equalization to ensure sustainability
- Better managed federal compensation regime
- Reviews of departmental spending and corporate assets



Budget 2010 builds on Budget 2009 early actions by setting out a 3-point plan to return to budget balance

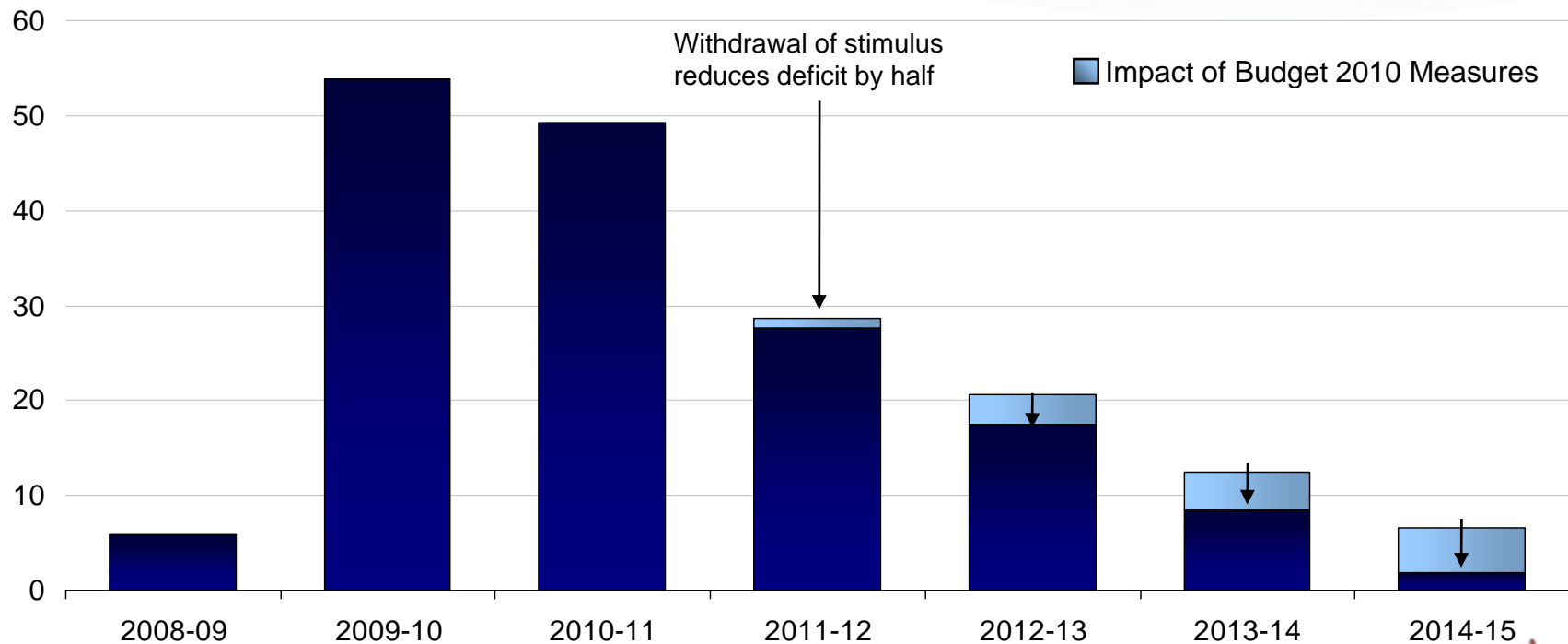
- **Follow through on the “exit” strategy in the Economic Action Plan by ensuring that temporary stimulus is wound down by the end of this fiscal year**
- **Targeted measures to restrain direct program spending growth that build over the medium term**
- **Comprehensive review of government administrative functions and overhead costs**



Budget 2010 track to return to balance

Projected Federal Budgetary Deficit

billions of dollars



Source: Budget 2010.



Conclusion

- **Fiscal policy has very different impacts in normal and exceptional economic circumstances**
- **Discretionary stimulus actions taken were necessary, appropriate and worked**
- **Consolidating in aftermath of crisis as important as stimulus actions**
- **Markets already demanding commitment to reduced public debt and improve fiscal sustainability**
- **Lessons from Canadian experience**





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