Intelligence MEMOS

From: Martin Eichenbaum

To: Canadian Deficit Watchers

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Re: **Meet r Minus g: A New Way to Worry about Deficit Spending**

Should Canadians worry about the level of government debt when interest rates are so low?

Yes. But the primary danger doesn't come so much from Canada. Instead, it comes from the fiscal behavior of the US government.

There is a serious possibility that the US is on a fiscally unsustainable path. Canadian policymakers must take this possibility into account. At a minimum, the government needs to increase the duration of its debt, as I outlined in my recent **lecture** at the C.D. Howe Institute. Unfortunately, quantitative easing has moved Canada in precisely the opposite direction.

Government debt levels have risen to historically high levels in all major industrialized countries, including Canada. The traditional canary in the coal mine for government debt is the ratio of debt-to-GDP. There is no magic number to signal fiscal doom. But high levels of debt-to-GDP ratios expose a country to trouble. If markets anticipate a crisis coming, they charge higher interest rates on government debt. Higher rates mean higher debt service payments, which leads the debt to explode even faster, ultimately culminating in a crisis.

A critical determinant of debt sustainability is the interest rate on government debt r, minus the growth rate of GDP, g. To see why, suppose, as is currently the case, that r is less than g and will remain that way indefinitely.

Suppose a government borrows large sums of money to deal with the Covid crisis or fund a social investment. It then rolls over the debt, borrowing new money to pay the principal and interest. So, government debt grows at the rate, r. If GDP grows at a rate greater than r, then debt-to-GDP slowly declines at a rate r - g. Under these happy circumstances, the government never has to repay what it borrowed, say by raising future taxes or lowering future government spending.

Should this scenario make us confident about the fiscal outlook for Canada and the US? No.

First, we cannot count on r-g remaining at its current low values. As can see from our related **Graphic Intelligence**, a wide range of outcomes have occurred in our recent past and cannot be ruled out in the future.

Second, if r-g is equal to its average value over the period 2000-2019, US deficits would have to be substantially smaller than their pre-Covid levels to prevent their debt-to-GDP ratio from exploding. In principle, the US could fix its fiscal problems. After all, the US collects only 31 percent of GDP in general revenue, well below the OECD average of 37 percent. So, the fiscal capacity is there. The question is: does the US have the political capacity to fix its fiscal problems? I see no indication whatsoever that it does. If anything, the signs point in the other direction.

At historically reasonable levels of r-g, Canada could run modest budget deficits and keep the ratio of its debt-to-GDP stable. But we cannot dismiss the possibility that markets might eventually conclude that the US is on an unsustainable fiscal path. In the wake of the ensuing crisis, the growth rate of Canadian GDP would surely fall, and the interest in debt on Canadian debt would rise. The resulting rise in r-g would have dire consequences on Canada's debt-to-GDP ratio. For better or for worse, our fiscal fate is linked to developments in the US.

What, if anything, can Canada do to minimize the damage from such a scenario? At a minimum, it can buy some insurance by lengthening the duration of government debt, locking in historically low rates on government debt.

For example, suppose you were taking out a mortgage and saw that long-term rates were incredibly very low. Would you take out a variable rate mortgage, especially if you were worried about a possible rise in rates? Of course not: you would lock in low, long-term rates.

Unfortunately, Canada and the US are doing just the opposite. Quantitative easing is a policy where a central bank buys government bonds at the long end of the yield curve and pays for those assets by issuing short-term reserves to banks. The net effect is to substantially lower the duration of outstanding government debt. While there may be advantages to quantitative easing during a crisis, it makes no sense to shorten the maturity of government debt when debt levels and the tail risk from US fiscal policy are so high. At a minimum, this consideration should be part of ongoing discussions about the speed with which the Bank of Canada winds down its quantitative easing program.

In sum, Canadians should worry about deficits even though current interest rates are so low. It would be irresponsible for Canadians to assume that US policymakers will behave responsibly in the future. At a minimum, Ottawa should revert to its virtuous pre-COVID fiscal policy and lengthen the duration of government debt.

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