Intelligence MEMOS

From: William B.P. Robson

To: Canadians Worried about a Hard Landing

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Re: **THE FEDERAL GAS PEDAL MEETS BANK OF CANADA BRAKES**

With inflation pushing 6 percent, and federal debt up about half-a-trillion dollars in two years, Canadian macroeconomic policy is a mess.

It will get worse. The Bank of Canada is moving to get inflation down – applying the brakes. Tomorrow's federal budget will show tens of billions more borrowing and spending – foot firmly on the gas. Monetary tightening and fiscal excess prefigure a wild economic ride ahead.

Perhaps a recession.

The R word might seem alarmist with the economy on a tear. Employment is well above, and unemployment well below, pre-pandemic levels. Economy-wide spending rose an eye-popping 12 percent over the past year.

The problem, though, is that this surge comes disproportionately from the Bank of Canada and the federal government jointly placing their feet on the fiscal accelerator.

Three-quarters of that 12-percent spending surge reflected higher prices, not real growth, even as labour shortages are at historic highs. Our economy is over the speed limit.

The monetary policy problem is obvious, partly because the results of monetary excess appear faster. Inflation well above the Bank of Canada's 2-percent target is in our faces every time we fuel up, visit the grocery store, and pay our bills. And partly because the Bank got it wrong, as it now admits. Bank officials are warning that interest rates may rise further and faster than people were expecting.

The problem with fiscal policy is less obvious. We don't see bigger government crowding private activity directly. Compounding interest payments have not yet squeezed the rest of the federal budget. Also, and unlike the Bank of Canada, the federal government still maintains all is well.

Deficits were a signature policy for this government well before COVID-19 set the stage for unprecedented borrowing with equally unprecedented lack of accountability – no budget even presented in 2020. Concerns about out-of-control finances led the Finance Minister, in her Fall Economic Statement that year, to describe indicators – "fiscal guardrails" – that would trigger a return to prudence. By the time of the 2021 update, the economy was clearly at or past those guardrails. But that update said nothing about guardrails or prudence. Since then, we have had commitments to major new programs, mostly financed by more debt.

Meanwhile, a government running pedal-to-the-metal is compressing the rest of the economy. Public-sector employment is up 8 percent since before the pandemic – no wonder businesses have trouble hiring. With no slack left in the economy, consumption is crowding out private investment. The stock of business plant, equipment and intellectual property products per worker is falling.

That brings us back to monetary policy. The Bank of Canada itself is highlighting now that low business investment means weak growth in productive capacity. And weak growth in productive capacity means that less of each additional dollar of debt-fuelled spending induces real output, and more of it induces higher prices.

In response to the resulting surge in inflation, the bank has only tapped the brake so far. Even after a quarter-point rise in February, the bank's policy interest rate is more than 4 percentage points less than the rate of inflation. It may need to rise that far to cool things off. With the US Federal Reserve also signalling it is ready to jam on the brakes, concerns about a slowdown or worse are growing.

As for fiscal policy, higher interest rates will raise the cost of servicing the federal government's rapidly rising debt, even as flagging growth damps its revenues. Its foot will come off the accelerator, and if interest rates and concerns about mounting debt become severe enough, it may shift to the brake itself. Another reason why a breakdown – a recession sometime in the next couple of years – is a serious prospect.

To improve our chances of navigating the economic road safely in the years ahead, the federal government should acknowledge that its spending and borrowing have exceeded what the Canadian economy needed, and are making us vulnerable. It needs to ease off the gas – which, in turn, will let the Bank of Canada ease off the brake. The feds' foot on the accelerator and the bank's foot on the brake is driving us toward a breakdown.

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