Intelligence MEMOS

From: Don Drummond

To: Canadian debt watchers

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Re: **The Federal Government can handle the post-pandemic debt hangover, but it will not be easy.**

The Parliamentary Budget Office estimates the federal deficit will hit $252.1 billion and the net debt-to-GDP ratio is set to shoot up about 20 percentage points to almost 50 percent of GDP. The sharp deterioration in both fiscal metrics raises questions about whether and how the federal government can manage so much debt.

Will the government have to pay back a good part or even all the debt being racked up this year?

Some **suggest** that with a little luck, Canada can avoid post-pandemic fiscal retrenchment with a repeat of the post-WWII experience when economic growth outraced federal debt relative to the size of the economy. However, there is very little prospect of repeating the strength of that postwar economic growth.

A federal net debt-to-GDP ratio exceeding 100 percent at the end of WWII had faded to about one-fifth that level by 1976. The government did not run persistent fiscal surpluses over these 31 years. Indeed, it accumulated more debt. It was growth in the economy, as measured by GDP, that shrunk the debt burden.

Nominal GDP, that is including inflation, grew at an annual average pace of 9.4 percent from a base in 1945 to 1976. This nominal growth was almost evenly split between average growth of 4.7 percent in real GDP (i.e., after inflation) and 4.5 percent in inflation. Nothing remotely close to these figures has been witnessed in Canada since the 1970s.

In a 2015 study for the Council of the Federation, the Centre for the Study of Living Standards estimated that Canada's real GDP growth rate would average just over 1.5 percent in future. Finance Canada projected 1.7 percent in its latest long-term outlook.

If we assume Canada continues to record about 2 percent inflation, as has been the Bank of Canada's agreed target, then nominal growth in the economy over the next several decades will likely average only 3.5 to 3.75 percent. That is just over one-third the heady pace of 9.4 percent post-WWII.

There are an abundance of reasons for slower growth: we have not experienced a comparable pace of productivity improvement in decades, the population is much older, the surge in female participation in the workforce occurred many years ago, and the pent-up wartime demands for housing, cars and appliances does not exist. And, by both global developments and policy design, inflation is much lower.

One debt-related advantage of the current era is low interest rates, but part of the reason interest rates are lower now than after WWII is that inflation is lower and that dampens nominal GDP growth.

That brings us to the point that the sustainability of the debt burden depends upon whether the effective interest rate on the debt is less than the growth rate of the economy.

Will that effective interest rate, for many years in future, average less than 3.5 to 3.75 percent? The interest rate is much below that now. But interest rates should rise as the economy recovers.

We have become accustomed to very low interest rates. But it is useful to remember that in 2007, just prior to the financial crisis and ensuing recession, the 90-day Treasury Bill rate was 4.17 percent and the 10-year Government of Canada yield was 4.34. If such interest rates were to reoccur, or go (even?) higher, the debt burden would be unsustainable under expected economic growth. But not by a lot.

We can and should reject the two extreme positions: the magical thinking that economic growth will cause the debt problem to evaporate, and, on the other pole, the flint-eyed insistence that we need to repay all or most of the debt being incurred this year.

We should not count on luck to produce phenomenal future economic growth rates. Nor should we count on luck to keep interest rates extremely low by historical standards. This suggests a prudent approach to future fiscal policy where the net debt-to-GDP ratio is gradually notched back from the 50 percent mark expected this year.

Reining in the federal debt burden is not an issue today. The government is doing the right thing by injecting fiscal funds into the economy to preserve as much of its structure as possible to bolster the prospects of an ultimate recovery. But there will need to be a reckoning one day, not that far off. Difficult fiscal decisions, rather than a wish for luck, will need to be made.

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