Intelligence MEMOS

From: Don Drummond

To: Canadian debt watchers

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Re: **It's 2035. Do You Know Where Your Deficit Is?**

As the Liberal government in Ottawa starts ramping up for the big October 19 celebration of Prime Minister Justin Trudeau's 20 years in power, fiscal storm clouds loom.

A gradual but modest rise in interest rates, the continuation of 15 years of slow economic growth and several supply and demand shocks have laid bare the unsustainability of Canada's public finances. Now, as autumn 2035 approaches, we face what is clearly turning into a fiscal crisis.

What got us here? The easy answer is the economic and fiscal impact of the COVID-19 pandemic that wreaked havoc on the economy and public finances in 2020 and 2021. The federal and many provincial governments saw the ratio of their net debt to their GDP jump 20 percentage points in a year.

That was a very bad fiscal break but not the whole explanation for our current predicament. Many Canadian governments, particularly provinces, had been on an unsustainable fiscal course well before the pandemic hit and there had long been warnings of future fiscal pressures, especially around health-care costs. As the economy recovered from the pandemic, so too could public finances have recovered – if only different policy choices had been made.

From the vantage point of three decades on, it is now clear the Canadian economy shifted into an era of lower productivity growth around 2000. A gradual rise in the population's average age limited labour force growth and as a result the economy's trend rate of growth shifted down. As with a similar decline in productivity growth in the 1970s, it took a long time for this new economic fact of life to be recognized and factored into budget planning. That slow reaction in the last third of the 20th century led to the fiscal crisis of the mid-1990s. As we move into the second third of the 21st century, precisely the same failure has led to the fiscal challenges – and maybe now the fiscal crisis – of the mid-2030s.

Coming out of COVID-19, many Canadians assumed the rate of economic growth would remain above the effective interest rate on public debt (i.e., interest expense divided by total debt).

This led to projections that government debt burdens would eventually decline from their pandemic-related peaks: if GDP is growing fast enough, government borrowing to cover interest payments will decline as a share of GDP. To everyone's peril, however, analysts in the early 2020s ignored the fact that the level of the debt burden also matters. They all knew the debt burden would remain high and that should have sounded alarm bells.

Now, in 2035, it is painfully clear that the predictions of the 2020s were too optimistic. In retrospect, that's not surprising. Eventually, the massive borrowing that low interest rates encouraged have caused interest rates to rise – with potentially devastating effects to anyone or any institution, including government, that is heavily indebted.

It remains puzzling that clear warnings were dismissed. As early as February 2021 a report from the Canadian Institute for Climate Choices made it clear that the transition to net-zero emissions would be challenging for Canada. For decades the Canadian economy has been subject to economic, financial or fiscal shocks every 10 years or so. The early 2020s added health shocks to the mix. By then it was also clear that natural disasters related to climate change would happen more often and be more costly. Extremely high debt burdens should not have been piled on top.

The fiscal implications were clear. A July 2021 report from the C.D. Howe Institute warned that slower growth combined with only modest increases in interest rates would produce a federal net debt-to-GDP ratio of about 60 percent in 2055, double what Ottawa had projected in its 2021 budget, as well as a federal-provincial debt approaching 140 percent of GDP. Now, in 2035, it is clear we are far down the road to fiscal disaster.

The early 2020s featured a philosophical tug-of-war between "history repeats itself" and "this time will be different." We see now that while history never quite repeats itself, "mean reversion" is a powerful phenomenon. Sluggish economic growth, together with rising interest rates, spending pressures from aging and the environment, and the baggage from previous fiscal excesses, now require corrective fiscal action that will level another wrenching blow to the economy. Hindsight also highlights the message that while it is fine to try to grasp the economy's potential upsides, attention must be paid to protecting against the downsides. Governments back in the 2020s clearly forgot that lesson.

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