Intelligence MEMOS

Federal budgets are an annual rite of spring in Ottawa, as is the deluge of advice to the Department of Finance. But budget-making is a yearlong process, and the work is now in progress. Accordingly, the C.D. Howe Institute is presenting a series of Intelligence Memos in the next few weeks, outlining recommendations that we hope will help inform the policy decisions that are being made now.

From: William B.P. Robson

To: Bill Morneau, Minister of Finance

Date: November 5, 2018

Re: **Stimulus is Over – Now Your Spending is Crowding Everyone Else Out**

At long last, the Canadian economy is running at full tilt. The unemployment rate has been below 6 percent for a year, inflation is above the Bank of Canada's 2 percent target, and interest rates are up across the board. An economy operating at capacity is welcome – and requires a change in fiscal policy.

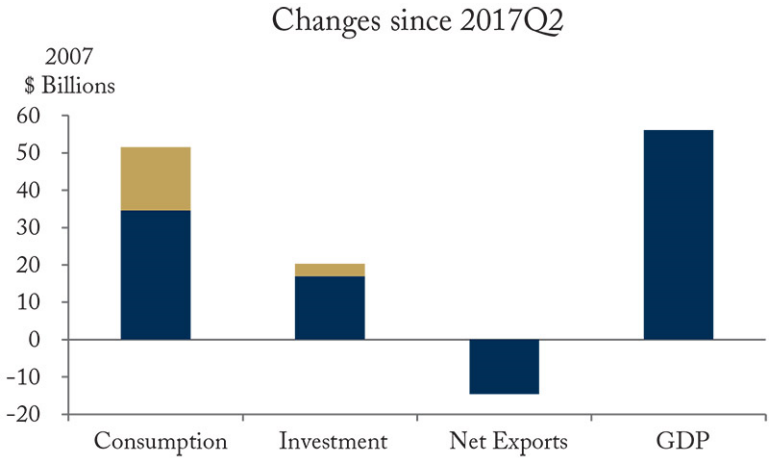
Until recently, the federal government could plausibly justify its sizeable spending increases and persistent deficits as fiscal stimulus. Whatever the merits of that argument while Canada's economy was running below its productive capacity, it does not apply now. When an economy runs out of slack, governments cannot simply spend output higher. But they can change its composition. The danger now is that further deficit-fuelled consumption will hurt the investment Canada needs to expand productive capacity and keep growing in the years ahead.

Exactly when Canadian output reached its capacity constraints will be a topic for debate by economic historians – but most will probably put it around the second quarter of 2017. The Bank of Canada publishes two measures of the output gap: one shrank to negligibility that spring; the other flipped to register excess demand. And the volume of imports has grown faster than the volume of exports as Canadians have shopped abroad for goods and services they can't produce at home.

This deterioration in our external balance is part of a larger story of government-fuelled consumption crowding out activity of which we want more. Output (GDP) in the second quarter of this year was up 1.9 percent from the second quarter of 2017 – which would be about equal to the increase in our productive capacity over that period. Measured on the same scale – relative to Canada's real GDP in the second quarter of 2017 – consumption was up 1.8 percentage points, with higher government consumption accounting for fully one-third of that (the figure breaks out government spending in gold). More happily, capital investment was up 0.9 points – though governments, for all their rhetoric about infrastructure, made only a modest contribution there. Meanwhile, however, net exports fell by 1.0 percentage points, with the increases in spending on consumption and investment outrunning our capacity to produce.

The same economics textbooks that show how governments can boost demand and output in a slack economy also show how governments that keep boosting demand in a no-slack economy will crowd out investment, hurt exports, and suck in imports. That is where Canada is in the run-up to your 2018 Fiscal Update. You can hike federal government spending further and encourage yet more household consumption with deficit-financed transfer payments. But if consumption outpaces what we can produce, our output will tip further away from the investment and net exports we need to build our future wealth.

Now that Canada's economy is running full tilt, our key task is to add productive capacity, so that our production – and the higher incomes we want for our private purposes and our public programs – can grow faster in the future. More debt-fueled consumption is not the answer. Fiscal stimulus – that was 2015. It's 2018 now. Time for something different.



Source: Statistics Canada Table 36-10-0104-01, author's calculations. Changes are in volume terms, scaled to GDP in the second quarter of 2017. Excludes changes in inventories and other minor items.

Bill Robson is the President and CEO of the C.D. Howe Institute.

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