

Intelligence MEMOS



From: John Crow
To: The Minister of Finance and his budget builders
Date: June 2, 2016
Re: INTEREST RATES AND TARGETS IN THE BUDGET

You followed the longstanding budget convention of broad economic and financial assumptions explicitly based on private sector forecasts. This helps to focus attention on tax and expenditure actions rather than on the validity of those broad assumptions – also, though, implicitly assumed to be quite middle-of-the-road.

But this can also generate curious consequences, as it surely has this latest time.

Take another look at the assumed path of interest rates – tucked away on p. 232 of the budget document. Both short and long term interest rates rise by some 2 percentage points over the five-year forecast horizon. That's more than fivefold for the Treasury bill, and over double at longer term.

We don't know particularly what private sector suppositions were behind those forecasts, but they probably reflect two, fairly standard, elements: one is a well-telegraphed rise in US rates toward more normal levels; and the other a similar path for Canada, also presumably justified (at least at the short end) to feed the 2 per cent inflation target.

But what happens to budgetary numbers is not so standard. Debt service outlays start rising again, going up from 8.8 per cent to 10.3 per cent of revenue. On the other hand, the rapid rise in program spending is sharply curtailed for the final two forecast years. Your information on this cutback is sparse, but one notable result is that the debt/GDP ratio, at just over 30 per cent, finishes back where it started. Your budget statement declared this outcome to be important, with the earlier balanced budget commitment now characterized as a "responsible return to balanced budgets" – date undeclared.

If this interest rate outlook causes complications for the federal government, with its relatively benign debt starting point, it will generate really tough times for the provinces and a heavily mortgaged private sector. So watch this large space.

Did the Department of Finance believe this forecast? If it did, the rise in rates would have had to play a role in its treatment of fiscal multipliers (p.256). But the discussion there calls for no role. And if it *really* believed this forecast, the budget surely would have signalled some effort to lengthen debt maturities. But it didn't.

Could it have used Bank of Canada forecasts? Well, the Bank publishes economic forecasts, but only out two years. In any event, though unlike some other central banks, it does not publish interest rate forecasts.

All in all a bit of a budgetary puzzle, quite likely generated by a mechanical approach to out-year results. Looked at another way, just as the Bank of Canada targets *forecast* inflation, your government is targeting an unchanged debt ratio for the final out year, 'come hell or high water' so to speak. And it's apparently not targeting, for now, much else. The deeper question the above raises is whether out years are really worth forecasting.

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