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Good Policies for Bad Times

Shay Aba

The Backgrounder in Brief

On February 1, 2002, the C.D. Howe Institute invited a group of Canada's foremost economists to a seminar to present their forecasts of the economic outlook and to evaluate the response of public policy to the recent economic downturn. Forecasts ranged from moderate-to-average rates of growth for the Canadian economy over the next few years. As expected, most participants agreed that no further economic stimulus is needed from either fiscal or monetary policy. The provincial fiscal front is expected to take center stage as provincial governments need to cut spending in order to avoid consecutive budget deficits over the next few years. At the same time, tax competition among the provinces is expected to result in lower tax rates across the country. Finally, participants gave Canadian monetary policy high marks overall for its performance over the past few years. Some felt, however, that the Bank of Canada had been too slow to ease monetary conditions and that it could have done more to stop the decline of the relative value of the Canadian dollar.

About the Author

Shay Aba is a Policy Analyst at the C.D. Howe Institute and the author of several papers on Canadian monetary policy, including “The Canadian Dollar: Still a Commodity Currency,” *C.D. Howe Institute Backgrounder* 47 (with David Laidler, January 2001); “Canada's Inflation Targets: Clearer, But Not Yet Clear,” *C.D. Howe Institute Backgrounder* 50 (June 2001); “Don't Mess with Mr. In-Between: Why the Bank of Canada Should Stick to Fixed Announcement Dates,” *C.D. Howe Institute Backgrounder* 53 (October 2001); and “Productivity and the Dollar: Commodities and the Exchange Rate Connection,” *C.D. Howe Institute Commentary* 158 (with David Laidler, February 2002).

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Following several years of rapid growth, the Canadian economy began slowing sometime near the end of 2000. After average annual real growth rates of 5.1 percent in 1999 and 4.7 percent in 2000, the economy appears to have grown by a mere 1.5 percent last year. This sharp drop was accompanied by falling business and consumer confidence, and many people began preparing for a recession. Then came the events of September 11. The initial effect was an even more bleak and uncertain economic outlook, as massive layoffs in the tourism industry followed on the heels of the meltdown in the hi-technology sector. Canada's unemployment rate rose from an average of 6.8 percent in 2000 to 8 percent at the end of 2001.

More recently, however, the economy has performed better than expected. Last year's forecasts of a short recession — defined as two consecutive quarters of negative economic growth — have turned out to be wrong.

These sharp changes in the economic environment and outlook have prompted debate about what governments should do in response. On February 1, 2002, the C.D. Howe Institute convened a seminar to discuss current and future economic conditions, as well as the roles of fiscal and monetary policy. The seminar began with sessions on the outlook for the global and Canadian economies. Later, participants discussed federal and provincial fiscal policy as well as monetary policy.

This *Backgrounder* provides a summary of the discussions. To preview what follows, the presenters' economic forecasts call for moderate-to-average rates of economic growth both in Canada and in the global economy as a whole. From a policy point of view, most participants felt there was no need for further policy efforts aimed at boosting economic activity. The majority in the room also agreed that monetary policy, rather than fiscal policy, should be the main policy tool for smoothing the business cycle in the future.

The Global Economic Outlook

The Canadian economy relies heavily on international trade, and the value of the Canadian dollar is influenced by commodity prices that are set in world markets. Therefore, the future of the Canadian economy is tightly linked to the future of the global economy. It was thus only natural for participants to start the seminar with a discussion of the global economic outlook. This session was led by the University of Toronto's Peter Pauly, who presented his economic forecast for the global economy.

The Forecast

The global economic slowdown began in the United States in late 2000, then spread to Canada, Mexico, and southeast Asia. At the same time, the Japanese economy continued in recession and European economies began to weaken. Although the events of September 11 at first accentuated this downturn, stimulative monetary and fiscal policies, among other factors, seem to have helped to keep global economic activity growing.

Table 1: ***The Global Economic Outlook, 2000–03***

(growth in gross domestic product on a purchasing power parity basis)

	2000	2001	2002	2003
		(percent)		
Global	4.5	2.4	2.4	3.1
Industrialized countries	3.5	1.3	1.5	2.6
Developing countries	5.7	4.0	4.4	5.4

Note: ”Industrialized countries” are the members of the Organisation for Economic Co-operation and Development.

Source: Peter Pauly, University of Toronto.

Table 1 summarizes Pauly’s forecasts. Average global growth is now expected to be 2.4 percent in both 2001 and 2002, down from 4.5 percent in 2000.[1] Putting this in historical perspective, the significant slowdown in 2001 was similar in magnitude to the one observed during the 1998 Asian crisis. Looking further ahead to 2003, the forecast calls for global growth of about 3.1 percent. The table also shows that the growth gap between industrialized and developing countries is expected to widen, as the slowdown is more pronounced in the former.

International Trade and September 11

Most of the drop in the growth of world trade should be attributed to lower overall economic activity rather than to the events of September 11.

In 2000, world trade grew by an extraordinary 12 percent. Forecasts call for that growth to have slowed to just 2 percent in 2001, with a minor recovery to about 3.7 percent in 2002. Over the medium term, trade growth rates are expected to average between 6 and 7 percent. Most of this drop in the growth of world trade should be attributed to lower overall economic activity rather than to the events of September 11. Nevertheless, the terrorist attacks do have some implications for the future. For example, rising transaction costs, such as the increasing time it now takes to cross international borders, are forecast to reduce growth in international trade by about 0.4 percent over the next three years. Fortunately, transaction costs represent only a small proportion of the total cost of doing business.

Downside Risks to the Global Economy

Prolonged weakness in Japan and renewed financial instability both there and in emerging markets would mean lower global economic growth. Uncertainty remains about whether the downward revaluation of equity markets has come to an end, but further revaluation would probably hurt business and consumer confidence. Over the medium term, a private sector credit crunch reflecting low US saving rates is a potential risk. And as the US government increases spending, the sustainability of the US current account deficit will become of greater concern. Finally, more terrorist attacks similar to those of September 11 could cause a significant global economic slowdown and drastically change the economic outlook.

The US Dollar: Forever Strong?

So far, capital flows — both portfolio and direct investment — have been large enough to offset the US current account deficit without requiring a drop in the value of the US dollar. But the current account deficit is expected to grow, which gives rise to two important questions: Will capital inflows be large enough to

1 This forecast assumes a significant (US$60 billion) fiscal stimulus in the United States in 2001 and possible further stimulus in 2002. It also assumes that the cycle of monetary easing has come to an end in the United States and in the European Union, where the European Central Bank is trying to establish its credibility.

support the growing current account deficit without requiring a depreciation of the US dollar? If the answer is no, what are the implications of a lower US dollar?

Participants' views on the future size of the US capital account surplus varied. Some suggested that, given the forecast of a relatively stronger US economy over the next few years, foreign investors would still want to put their money in that country. Others referred to the last two episodes, in the early and late 1990s, when investors bet against the US dollar and lost. Investors, they said, have learned not to short the greenback.

At the same time, there are indications that foreign capital investment in the United States could fall. In Japan, long a major source of such capital inflows, saving rates are expected to decline as a result of Japan's policies to encourage consumer spending. And China's rapidly growing economy and the younger populations of developing countries may persuade Asian investors to look for investment opportunities there rather than in the United States.

The value of the US dollar could also be negatively affected by the introduction of actual euro notes and coins. The euro could even become the favorite currency of the underground economy simply because its largest denomination, a 500 euro note, is larger than the highest-denomination US dollar note currently in circulation.

If the US dollar falls in value, the result could be lower global economic growth. It was suggested that, aside from the psychological factors — the currency is perceived to be the strongest and safest in the world — a lower dollar would mean weaker US demand for foreign good and services.

Conclusion

Globalization and the increasingly heavy reliance on international trade imply that different countries' business cycles are more correlated than ever.

Globalization and the increasingly heavy reliance on international trade imply that different countries' business cycles are more correlated than ever. Just as the slowdown was synchronized around the globe, so too will be the recovery. Moreover, it is expected to be fairly rapid, assuming, among other things, the absence of further terrorist attacks on the scale of those of September 11.

The Economic Outlook for Canada

Participants next turned their attention to the domestic arena. Peter Dungan of the University of Toronto led the discussion.

Dungan forecast 1.5 percent economic growth for 2001, 2 percent for 2002, and as high as 4.5 percent for 2003. He cited several factors in support of such optimism. First, stimulative fiscal and monetary policy is boosting economic activity. Second, Canada's economy, unlike that of the United States, was not operating at full capacity when the downturn began and its inventory build-up was not as high as it was south of the border. Third, Canada's exports to the United States, a significant share of total Canadian output, go to sectors, such as lumber for construction, that are still performing well despite the downturn. Finally, the inventory-to-sales ratio, an important indicator of future economic activity, has passed its peak and begun to drop, which usually implies that increases in production to restock inventories are on their way.

Warren Jestin of the Bank of Nova Scotia then presented his rather less optimistic forecast for the Canadian economy, predicting 1.5 percent growth in 2001, 0.9 percent in 2002, and 3.4 percent in 2003. Canadian corporations face declining profits, which would lead to more bankruptcies, lower business confidence, and further job losses. Business investment spending would continue to be weak as long as corporate profits are weak. Other risks were posed by housing markets, which are vulnerable to rising interest rates and further job cuts, and car sales, which continue to be strong but largely as a result of gimmicks such as 0 percent financing.

A more protectionist United States would mean lower Canadian exports and, therefore, slower Canadian growth.

On the political front, the United States might become more protectionist as the unemployment rate there rises and the country's imports continue to outpace its exports. A more protectionist United States would mean lower Canadian exports and, therefore, slower Canadian growth.

Excess Capacity in Capital Stock

Participants noted that much of the recent economic downturn has been blamed on a rapid decline in business investment spending. Many analysts, in fact, regard the downturn as necessary to correct the rapid growth of business investment, which led to an overstock of information technology (IT) goods, in particular. Unlike the overbuilding of the nineteenth-century railroad boom, however, IT goods have a very short life cycle, and it will not be long before business has to purchase new software. Some more pessimistic participants felt, however, that the recovery of investment spending would depend on a rebound in profits, which will not take place for quite some time.

The Stock Market

Despite the economic slowdown, equity markets are still performing quite well. Participants suggested several reasons for this phenomenon. First, because the stock market is forward looking, it is performing in the expectation of a fairly rapid economic recovery. Second, a lot of money is tied up in guaranteed investment certificates and other assets that earn very low interest. At least some of that money will be looking for higher rates of return in equity markets, which would raise the demand for stocks and, therefore, stock prices.

At the same time, some participants cautioned that more corrections in asset prices might be on the way, since the implicit growth rate built into equity prices is too high, and price-to-earning multipliers are also somewhat higher than they should be. The unevenness of the economy's recovery will mean that some sectors will remain in the red for some time.

Conclusion

Most participants agreed that Canada's economy is recovering from its recent slump. Table 2 summarizes the forecasts presented for economic growth, unemployment, and inflation. The main point of disagreement among the seminar participants was whether the Canadian economy would return to healthy rates of growth in 2002 or 2003, which would have significant implications for unemployment forecasts.

Table 2: *Two Forecasts for the Canadian Economy, 2000–03*

	2000	2001	2002	2003
	(percent)			
	Forecast by Peter Dungan			
Real GDP	4.4	1.5	2.0	4.5
Unemployment rate	6.8	7.2	7.7	7.0
Consumer price index inflation	2.7	2.5	0.8	1.8
	Forecast by Warren Jestin			
Real GDP	4.4	1.5	0.9	3.4
Unemployment rate	6.8	7.2	8.3	8.0
Consumer price index inflation	2.7	2.5	1.0	2.0

Sources: Peter Dungan, University of Toronto; Warren Jestin, Bank of Nova Scotia.

Federal Fiscal Policy

Participants next turned their attention to what policies, if any, the federal government should adopt in view of expected economic conditions. The Bank of Montreal's Tim O'Neill led the discussion.

It was noted that the federal government's most recent budget included a stimulus package, but most participants tended to agree that no further fiscal stimulus was needed since the economy was already on the road to recovery. From a broader perspective, however, many participants questioned the usefulness of discretionary federal fiscal policy in smoothing the business cycle, given that Ottawa's share of total public spending is declining, that government spending programs are difficult to reverse, and that significant time lags can occur before a decision is made to stimulate the economy with greater spending and/or lower tax rates. Indeed, it is difficult to find specific instances when changes in federal fiscal policy have been directly and primarily targeted at smoothing the business cycle.[2]

Conclusion

Most participants tended to agree that monetary policy is a better tool than fiscal policy for smoothing out the business cycle. Fiscal policy should continue to rely on automatic stabilizers, which, when the economy slows, allow tax revenues to fall and money to be injected into the economy in the form of employment insurance and welfare payments.

Provincial Fiscal Policy

In the absence of future spending cuts, most provincial governments are expected to report budget deficits over the next few years.

Turning next to provincial fiscal policy, Don Drummond of TD Bank Financial Group led the discussion, noting that, in the absence of future spending cuts, most provincial governments are expected to report budget deficits over the next few years. At the same time, personal and corporate tax cuts are expected.

Rising Costs

An aging population and reduced funding from the federal government imply that the provinces' health bill will continue to rise. Given that health care spending already consumes between a quarter and a third of total provincial government budgets, increasing health care costs are putting considerable strain on this order

2 Recent federal tax cuts were directed at enhancing Canada's global competitiveness rather than at smoothing the business cycle.

of government. The growing demand by municipalities for increased funding will also add significant pressure to provincial budgets.

The Squeeze on Revenues

With the globalization of markets, capital and labor are becoming increasingly mobile, with the result that tax competition between Canada and the rest of the world, and among the provinces themselves, is becoming fiercer. Thus, all levels of government in Canada are under pressure to reduce tax rates. The problem is that taxes are higher in Canada than in many other countries. Thus, the provinces need to reduce significantly both their personal and corporate tax rates, as well as their reliance on capital taxes, if they want to stay competitive in their ability to attract and retain skilled workers and investors. Indeed, personal income tax rates are expected to drop in every province except Alberta over the next few years. Several provinces have already indexed their personal income tax systems. Quebec and Saskatchewan plan to adopt similar policies, thereby eliminating tax bracket creep (which occurs when inflation leads to higher incomes that push more taxpayers to higher tax brackets).

On the corporate income tax front, a few provinces have recently reduced their rates, but significant disparity still exists among them. Moreover, Alberta and Ontario have announced bold plans to slash corporate tax rates even further over the next three years, which will add to the disparity in tax rates across the country. To keep their tax rates competitive, the other provinces no doubt will have to follow with their own cuts.

Budget Balances

Table 3 shows forecasts for provincial budget balances under the assumption of no future spending cuts.

With no further tax cuts, rising costs and falling revenues in fiscal year 2002/03 would result in budget deficits in every province except Alberta, which is expected to just balance its books. Ontario and British Columbia would report further budget deficits over the next three years while other provinces return to budget surpluses. British Columbia is, in fact, in the worst shape of any province since its already large budget deficit would double next year. These numbers mean that future spending cuts are on the way if these provinces are to avoid budget deficits.

Conclusion

Given the fairly grim fiscal outlook for the provinces, rising health care costs seem particularly worrisome.

Given this fairly grim fiscal outlook for the provinces, rising health care costs seem particularly worrisome. Health care reforms, such as those recently suggested in Alberta, seem more plausible than before. Given budget pressures on provincial governments, provincial governments will need to cut spending further so as to avoid the above deficits. This means that provincial fiscal policies will probably be procyclical and offset the countercyclical federal fiscal policy. Tax competition among the provinces is expected to result in further tax cuts across the country. This should encourage business activity and force more efficient management of public funds.

Table 3: *Status Quo Fiscal Positions of the Provinces, fiscal years 2001/02 to 2005/06*

	2001/02	2002/03	2003/04	2004/05	2005/06
			($ millions)		
Newfoundland	–269	–148	–94	–42	23
Prince Edward Island	–1	–8	5	14	26
Nova Scotia	–106	–101	–70	14	124
New Brunswick	–18	–56	10	63	124
Quebec	–950	–600	–395	188	693
Ontario	140	–2,886	–2,234	–2,011	–1,620
Manitoba	–57	–134	–32	43	123
Saskatchewan	–286	–154	–133	–66	2
Alberta	12	0	481	472	580
British Columbia	–2,036	–4,798	–4,846	–4,838	–4,762
Total	–3,571	–8,884	–7,308	–6,163	–4,686

Source: Don Drummond, TD Economics.

Canadian Monetary Policy

In the final discussion, participants looked at the Bank of Canada's response to the economic slowdown. The discussion was led by Stephen Poloz of Export Development Canada.

The goal of Canadian monetary policy is to keep inflation within a 1 to 3 percent target band, with emphasis on achieving an inflation level of 2 percent, the mid-point of the band. Since an economic slowdown exerts downward pressure on prices, a countercyclical response by the Bank of Canada, which entails lower interest rates in times of economic slowdown, is consistent with achieving the inflation target. Indeed, the Bank began lowering interest rates in January 2001, and its target for the overnight rate fell by a whopping 3.75 percent over the 13-month period between December 2000 and January 2002.

Some participants felt that, with hindsight, the Bank seems to have begun to ease monetary conditions a bit too late. Overall, however, monetary policy has been successful in helping the Canadian economy recover. There was agreement among most participants that no further interest rate cuts are needed.

The Objective of Monetary Policy

Poloz argued that, under current monetary arrangements, in the face of an economic shock the exchange rate is one of the first variables to adjust to bring the economy back on track. Since other variables in the economy, such as employment and output, are slower to adjust, the exchange rate tends to overadjust to the shock and then work its way back over time. However, several negative (or positive) shocks in a row could cause the exchange rate to overshoot for long periods of time. This, in turn, could alter the fundamentals that determine the value of the dollar — as might have happened to the Canadian dollar as the Asian crisis was followed by the Russian crisis, the Latin American crisis, the bursting of the hi-tech bubble, and the events of September 11. If this is so, the Canadian dollar's decline could make it more expensive for Canadian companies to import advanced machinery, hurting Canadian productivity and validating the Canadian dollar's low level. Thus, the Bank of Canada should pay more attention to the level of the exchange rate while acting to achieve the inflation target.

Reflecting on decisions made in recent years by the Bank of Canada, most participants reacted that the Bank could not have done anything differently in its pursuit of the inflation target. In other words, these participants believe that pursuing an inflation target while aiming for some value for the exchange rate is not a viable option for Canadian monetary policy.

Response to the Weak Dollar

The value of the Canadian dollar has been declining against the US dollar for a long time and recently reached its lowest level ever. This decline cannot be explained by a financial crisis or speculative bubbles, and most participants agreed that mere verbal boosting by the finance minister or the central bank governor would be insufficient to raise the dollar's value. Instead, reversing the decline will require stronger measures, such as making Canada a more attractive place for foreign investors by reducing corporate taxes.

Summary

Perhaps to the surprise of many economists, the global economy has not fallen into a recession. The effects of the high-technology meltdown and the horrific events of September 11 have been countered by aggressive monetary stimulus in both Canada and the United States. Fiscal policy has also played a role in helping to boost the economy. The result is that both the optimistic and the pessimistic forecasts call for moderate rates of growth over the next three years.

Policymakers have done their share in responding to the economic downturn. Most participants felt that Ottawa need take no further action in the form of fiscal or monetary policy to help the economy recover, but that further tax cuts by both Ottawa and the provinces were necessary to boost Canada's competitiveness. Finally, most participants felt that monetary policy should continue to be the main policy tool for fighting any recession.

List of Participants

Shay Aba, C.D. Howe Institute
Edward A. Carmichael, J.P. Morgan Securities Canada Inc.
John Crow, Lawrence & Co. and Senior Fellow, C.D. Howe Institute
James B. Davies, University of Western Ontario and Research Fellow, C.D. Howe Institute
Donald Drummond, TD Bank Financial Group
Peter Dungan, University of Toronto
Charles Freedman, Bank of Canada
Danielle Goldfarb, C.D. Howe Institute
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Finn Poschmann, C.D. Howe Institute
Grant L. Reuber, Sussex Circle Limited.
William B.P. Robson, C.D. Howe Institute
Peter Spiro, Ontario Ministry of Finance
Gordon Thiessen.

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