

# The global meltdown: Fiscal stimulus and the structural deficit

“Of course I believe in luck. How otherwise to explain the success of some people you detest?”  
*Jean Cocteau, quoted in Look*

“I am a great believer in luck, and I find the harder I work the more I have of it.”  
*Stephen Leacock, Literary Lapses*

## THE GLOBAL MELTDOWN

Canada's economy is recovering from a deep recession, which was unavoidable because of the worldwide financial meltdown and a resulting global downturn. Yet since 2008, when the global downturn began, Canada's economy has fared much better than that of other advanced industrialized countries. In particular, Canada's banks came through the financial maelstrom relatively unscathed and our housing industry experienced only a mild downturn.

As well, Canada's job losses during the recession were nowhere as deep as they were in the United States; indeed, as of January 2011, Canada had replaced all of the jobs that were lost in the recession. This is where politics and economic analysis intersect. Every politician enjoys taking credit when good things happen, but they also should take the blame when things go wrong. In June 2010, Stephen Harper and Jim Flaherty basked in the limelight of Canada's economic and fiscal performance during the G8 and G20 meetings in Toronto.

However, an objective assessment of the evidence suggests that the Conservative government had little or nothing to do with the mildness of the recent recession, the speed of the jobs recovery, or the success of Canada's banking system.

## SINCE THE RECESSION, THE CANADIAN ECONOMY RUNS AHEAD OF THE UNITED STATES

The following chart illustrates that, on an international comparative basis, Canada's output (or real GDP) contraction

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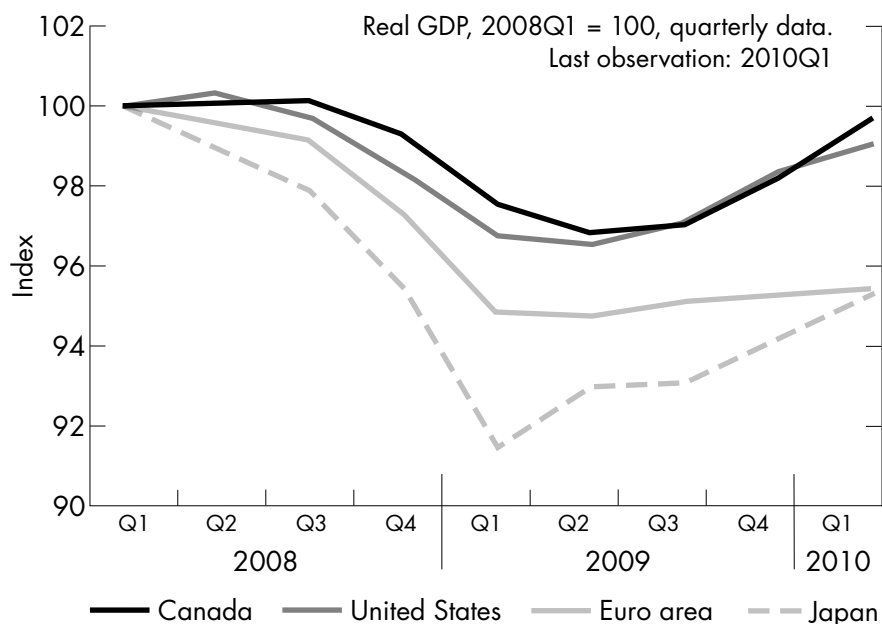
in the recent recession was relatively mild. Although Canada entered the recession slightly after the United States, Canada's overall real GDP contraction during the recession was rather similar to the American decline.

As Phillip Cross points out in Statistics Canada's May 2010 *Economic Observer*, the most remarkable feature of Canada's downturn, which started in 2008, was its speed, severity, and recovery time:

- The duration of the commodity price slump between June 2008 and February 2009 was relatively short—eight months—markedly shorter than in previous cycles. Nonetheless, the 50 percent drop in commodity prices in the current cycle was much deeper than in previous cycles.
- The recent output contraction was neither unusually long nor severe, but the rate of decline was steep.
- As for employment, Canada's latest recession was much milder than the previous two Canadian downturns.

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FIGURE 1 GDP Corrections in the Last Recession



Source: Bank of Canada, Monetary Policy Report, chart 20, July 2010 (Statistics Canada, U.S. Bureau of Economic Analysis, Eurostat, and Japan Statistics Bureau).

## A PUZZLE: WHY WAS CANADA'S DOWNTURN MILD?

What accounts for the rather mild nature of the Canadian output decline, particularly as compared with that of Japan and the Euro area? Housing and financial institution stability in this country can account for much of the difference. Indeed, the 2008–9 recession in Canada never felt quite as bad as the American counterpart. Canada suffered much less from job loss than the United States, and surprisingly, since the recession ended, the Canadian economy has restored most of the jobs that were lost.

Canada's last employment peak was in October 2008. The recovery, which in output terms began in the middle of 2009, has now replaced all of the lost jobs. Indeed, as the following two labour market charts illustrate, between July 2009 and January 2011 (the economic recovery phase), the Canadian economy has added 534,000 jobs, including 106,000 jobs in the three months ending January 2011. Because of the job market recovery, the Canadian unemployment rate was 7.8 percent in January, though it was as low as 7.6 percent in November and December.

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## THE BLEAK US STORY

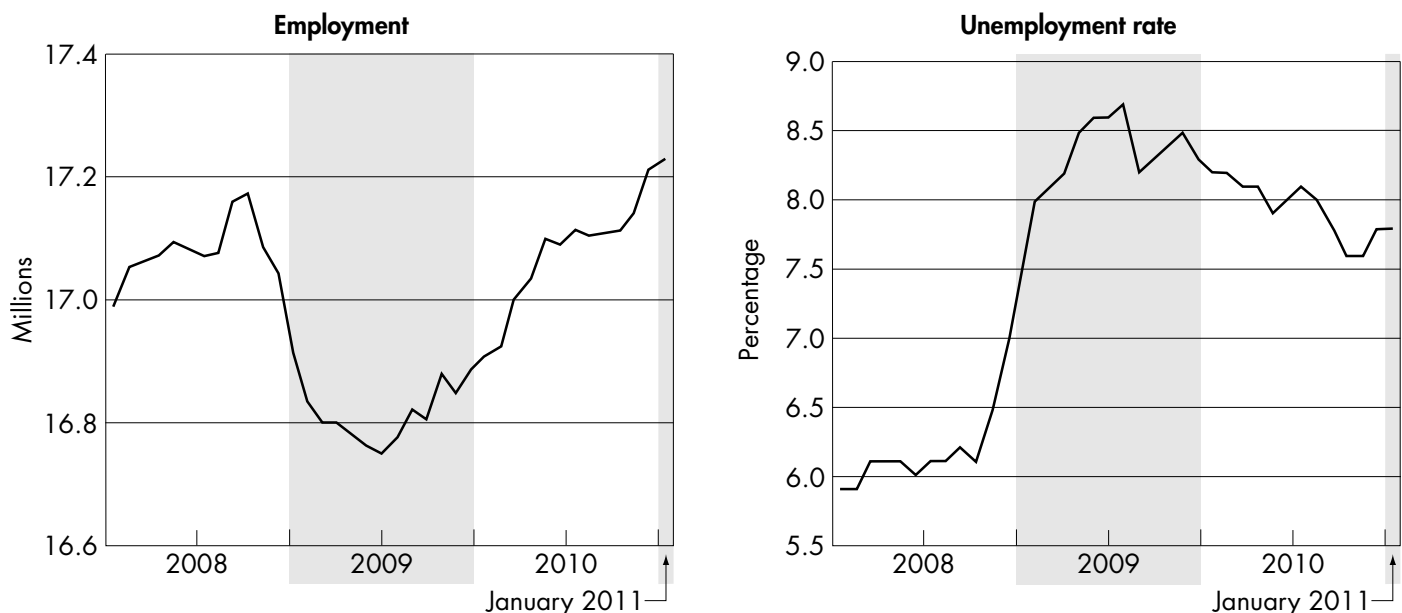
In contrast to Canada's relatively mild jobs recession and strong jobs recovery, over the past several years the US job market has deteriorated in ways not seen since the Great Depression. Indeed, since the beginning of the US recession in December 2007 and its lowest level in January 2010, the US economy had shed some 8.7 million jobs, roughly equal to the net job gains over the previous nine years. In addition, over the past year the US economy, despite the massive stimulative policies at work, regained less than a million of the lost jobs. In other words, total payroll employment in the United States was still some 7.7 million lower in January 2011 than at the previous peak in December 2007. (Interestingly, the Canadian economy created 327,000 jobs

over the past year. Had the US economy created jobs at the same pace, it would have generated 3.3 million jobs, instead of less than a million.)

Moreover, despite the fact that the job market started to grow again in the United States, the American unemployment rate has been falling (9 percent in January 2010) because of declining labour force participation, but when you look behind the numbers you can see the real problem. There are fewer people in the US workforce today than before the recession began. There simply are too few job vacancies relative to the unemployed and underemployed who are seeking new jobs.

Indeed, the US labour force shrunk by 750,000 between the peak in 2007 and January 2011. While the monthly labour

**FIGURE 2 Canadian Employment and Unemployment**



Source: Statistics Canada, Labour Force Survey, January 2011.

force change numbers are quite erratic, it turns out that in the past two months the actual shrinkage of the labour force was roughly three-quarters of a million people. Employers in the United States remain understandably skittish. They will need to see considerable evidence of positive developments on the housing and manufacturing fronts before they start hiring again in a meaningful way.

As a result, to date the United States is experiencing close to a jobless recovery—that is, an upturn in economic activity and good growth in corporate profits accompanied by an absence of job creation.

### **FROM ONE GREAT RECESSION TO THE NEXT—FROM ONE CONSERVATIVE GOVERNMENT TO THE NEXT**

It is interesting to contrast the performance of the Canadian economy under the last two Tory governments that faced hard times. Canada did not fare as well in the great recession of 1989–92 as in the recent recession. The federal fiscal deficit reached a record level of \$44 billion and the debt-to-GDP ratio was exceedingly high, as was the unemployment rate, when the previous Conservative government was voted out of office in October 1993.

The first problem for the new Liberal government headed by Jean Chrétien was to reduce unemployment and then to face the reality of the fiscal and budget problems. Over the next four years, the budget system was repaired and the fiscal deficit eliminated. For a decade, Canada's federal government ran yearly fiscal surpluses so that going into the next great recession (\$1.1 billion, 2008–9) Canada's debt-to-GDP ratio was markedly reduced and was lower than other G7 countries.

The economic expansion that occurred prior to the recent or second great recession was far more balanced in Canada than in other countries. The housing sector in particular did not experience the excesses that were evident in the United States and Europe. The reason for this is that our mortgage system differed substantially. Canada

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lacked the vast amount of incentives that the United States had for home ownership—in particular, the income tax deductibility of mortgage interest. In addition, Canada was fortunate in not having the excess of subprime mortgage lending that occurred in the United States. And Canadian banks, the major players in the mortgage market in Canada, tended to hold rather than securitize mortgages and thus were much more careful in their lending. This more balanced economy allowed Canada's unemployment rate in 2007 to fall to its lowest level in some 25 years.

### **THE FIASCO OF THE CONSERVATIVE'S NOVEMBER 2008 ECONOMIC STATEMENT**

At a time when it was obvious that a recession was under way in the United States, the Conservatives presented no plans for keeping Canada out of a major recession. The 2008 economic statement turned out to be totally unrealistic and resulted in the near defeat of the just-elected Conservative minority government. With the prorogation of Parliament for two months starting in December 2008, Canada did not respond to the widening economic and financial fiasco that was spreading into a worldwide great recession.

Finally, after the “two-month holiday,” the Conservative government got its act together and realized that a second Great Depression might be in the offing. A new expansionary budget was presented to Parliament on January 27, 2009. The budget projected a fiscal deficit of \$33.7 billion rather than the proposed surplus that the economic statement had presented just two months earlier. The deficit for 2009–10 later ballooned to about \$54 billion.

### **DUMB LUCK OR PROBLEMS FOR THE FUTURE**

We have tried to show that the Harper government has been very lucky in that Canada's economy and its job market outperformed those of other G8 countries, both in the recession and since the recovery began. However, despite this relative good luck, the federal government has made some bad policy moves that have created problems for the future.

The great recession of 2008–9 has left Canada with a legacy of large budget deficits and rising debt. In its March 2010 budget, the Harper government projected a \$49 billion budget deficit for fiscal 2010–11 after implementing year two of its economic stimulus package, down slightly from the 2009–10 budget estimate of \$54 billion. In the next three years, the fiscal deficit is projected to decline to \$28 billion, \$18 billion, and \$9 billion. The budget in 2014–15, under the Conservative's doubtful scenario, is nearly balanced, as the deficit declines to a tiny \$2 billion.

Generating this declining deficit path will be difficult if not impossible without raising taxes. The federal government has indicated that it will neither raise taxes nor cut any transfer payments relating to health care, education, and pensioners. Instead, program spending within government departments will be frozen. That means that any wage increases for civil servants, set at 1.5 percent this year, will have to be paid out of existing budgets. Through targeted spending restrictions, the budget projects that the government can save \$17.6 billion over five years and the details of these restrictions are either sketchy or unknown.

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rogue Parliament. In December 2008, however, they were divided on whether, in the circumstances that prevailed at the time, the reserve power should have been exercised. For some, those circumstances—the fear that a refusal would plunge Canada into a huge political crisis just when it was in the midst of an economic crisis, and the faith that, in the meantime, Harper would work with the official opposition on a new budgetary approach to the fiscal crisis—argued in favour of granting the prorogation.

On the other side were those who believed as a matter of principle that evasion of a vote of non-confidence called for rejection of the prime minister's advice, regardless of any adverse practical consequences. The constitutional case for rejecting prime ministerial advice in December 2009 may have been less compelling. Nevertheless, this prorogation aroused a great deal of disapproval at the level of public opinion and is credited with costing the Harper Conservatives 10 to 12 points of popular support.

## LACK OF CONSENSUS ON THE RULES

On March 17, 2010, the House of Commons passed a motion, moved by NDP leader Jack Layton, requiring that the prime minister seek the consent of the House of Commons before advising a prorogation of more than seven days. The Layton motion, because the Conservatives opposed it, lacks the political consensus needed for a binding constitutional convention. Constitutional conventions are the rules of behaviour accepted as obligatory by *all* those concerned in the working of the Constitution. Without such a consensus, the governor general is put in the position of refereeing a game in which the players do not agree on the rules.


It is high time that Canada's parliamentarians took a leaf out of New Zealand's book and codified key constitutional conventions in something like that country's Cabinet Manual. In the United Kingdom, then Prime Minister Gordon Brown asked the Cabinet Secretary to carry out such a codification, in anticipa-

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tion of an election that was expected to—and did—produce a “hung parliament.” The draft manual was submitted to a select committee of Parliament in February 2010. This process resulted in a public commitment of all parties to agree upon practices that ensure that the Queen will not be forced to take sides in a partisan controversy.

It is the height of irresponsibility on the part of our parliamentary leaders to make no concerted attempt to resolve differences over fundamental constitutional conventions of parliamentary democracy. Prorogation is by no means the only matter on which consensus is lacking. The 2008 parliamentary crisis indicated that Prime Minister Harper and

the opposition parties are at odds over whether the governor general must accede to the “advice” of a prime minister to dissolve Parliament when the government is defeated on a confidence vote shortly after an election. They are also at odds over the legitimacy of an incumbent government being replaced by a coalition not approved in advance by the electorate. These are not small questions and they are very likely to arise if the next election produces another hung Parliament.

Failure to deal with this matter, and deal with it soon, will make Canada the laughing stock of the parliamentary world and move our country back to a monarchy—the Kingdom of Stephen. 

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### A LARGER DEFICIT THAN ADMITTED

The government projects Canadian real GDP growth to average 3 percent annually for 2011 through 2013, which, on the face of it, seems a reasonable assumption. The Parliamentary Budget Officer, however, has concluded that even this kind of normal growth would leave a significant budget deficit in the fiscal books. One of the most important reasons for these continuing deficits is the reduction in the GST rate from 7 percent to 5 percent in 2007 and 2008. These tax cuts occurred at the peak of the last boom and, of course, have already resulted in significant revenue losses, roughly \$10 billion annually.

The Harper government is now wrestling with a structural budget deficit of roughly 1 percent of potential GDP in five years—still low by many global standards.

But there will be no budget balance without severe cutbacks in program spending unless taxes are increased—which the Conservatives say they will never do.

### GETTING THE PRIORITIES WRONG

After admonishing the other leaders at the G20 and G8 summits to reduce deficits and lower expenses, the Conservative government announced that Canada would spend \$9 to \$16 billion or more on unneeded new fighter jets. One really wonders what the leaders of the other G20 countries, which in many cases were reducing social expenditures, would think of Canada's ludicrous expenditure on military aircraft at a time of retrenchment in their economies.

It is an easy prediction that the Conservatives' budget numbers will be drastically revised over time. 