



Don't Remove the Fiscal Punchbowl Just Yet

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We saw confirmation this week that businesses continued to invest in machinery and equipment in both Canada and the U.S., a necessary condition for continued economic recovery. U.S. production of business equipment jumped 0.9% in June, the fourth consecutive monthly rise and 11.4% above last year. In Canada, the May trade figures reflected a meaningful increase in business imports of capital equipment, a continuation of the much-needed rise in business investment in productivity-enhancing technology. With the Canadian dollar strong, businesses must increase productivity to become more competitive. The strong loonie and the government's elimination of import duties on these products make this investment more affordable.

The rebound in equipment and software investment in the U.S. began even earlier than in Canada, rising throughout the second half of last year. Business investment has been one of the driving forces behind the recovery, accounting for nearly 20% of the growth in the U.S. It wasn't really until the first quarter of this year that Canadian business finally followed suit. Over the same period, however, Canadian employment surged and is now almost at the level posted before the recession began. In direct contrast, U.S. employment has increased only modestly, leaving the jobless rate painfully high. This implies that U.S. productivity growth will remain well above that in Canada, but at the price of continued low levels of consumer confidence and considerable strains on the household sector. It also makes it very dangerous for the U.S. to consider short-term deficit reduction. In fact, additional stimulus is needed.

Not only is job growth anaemic in the U.S., but deflation pressures are mounting. While corporate earnings are rising sharply, businesses are hoarding cash rather than hiring workers, buying back stock or increasing dividends. This suggests a lack of business confidence as well. It will take rising sales and full order books to boost animal spirits.

Small business development is a crucial factor. Chairman Bernanke emphasized the importance of this in a speech early this week when he pointed out that small businesses employ roughly one-half of all American workers and account for about 60% of gross job creation. *"Newer small businesses, those less than two years old, are especially important: Over the past 20 years, these start-up enterprises accounted for roughly one-quarter of gross job creation even though they employed less than 10 percent of the workforce."*

It takes confidence to start a new business and it takes credit. The formation and growth of small business have been hampered in this recovery by difficult credit conditions. A large proportion of the respondents to the latest National Federation of Independent Business (NFIB) survey reported that credit conditions have tightened in the prior three months. Bank loans to small businesses remain well below the levels posted before the recession. Whether or not this is due to weak demand because of fewer new business formations and weaker growth prospects as opposed to restricted credit supply, it results in very disappointing civilian job growth and a continued lack of confidence in the household sector.

The Bottom Line: The challenge for the Obama administration is to convince Congress to provide the kind of additional stimulus that would save hundreds of thousands of jobs in cash-strapped states. The economy needs stimulus now, followed by budget discipline when the economy is on firmer ground. Confidence will not be built by fiscal restraint today. To be sure, without further federal assistance, state and local government layoffs will increase sharply. Those who suggest that fiscal stimulus does not create jobs do not consider how dire the situation would be without the stimulus. Preventing a further deterioration buys time for the kick-start in private-sector hiring to emerge.

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