

What Would Keynes Do?

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"We're all Keynesians Now."

Richard Nixon, shortly after the U.S. abandoned the gold standard in 1971¹.

The rapid, deep and all-encompassing deterioration in the global economy has prompted governments of almost all stripes and sizes to pledge, or at least consider, sizeable fiscal stimulus. The pressure has been amplified by the seeming inability of heavy-duty rate cuts to reduce private sector borrowing costs, or to turn the tide in sentiment. Even the staid OECD recently suggested that, with the transmission mechanism for monetary policy not functioning normally, fiscal policy has a role to play.

This also applies to Canada, albeit to a lesser extent. While the recent political maelstrom undoubtedly has helped foist a more stimulative fiscal policy on Ottawa, it is, in fact, the right thing to do. The Prime Minister and Finance Minister have openly stated that January's budget will include substantial net new stimulus. However, not everyone agrees with this approach. Many economists and pundits suggest that monetary policy should continue to carry the load, and that hard-fought fiscal gains should not be risked for short-term measures that may not work. Under normal circumstances, this would be a perfectly reasonable stance. But, these are not normal circumstances, and speed is of the essence.

Here is the core of the argument for a fiscal boost in Canada:

- 1) The economy needs stimulus: This is the dispensing-with-formalities portion, now that the Bank of Canada has flatly stated that the economy has entered a recession, and has cut interest rates by a cumulative 300 basis points in the past year. There are currently a plethora of signs that Canada's economy stumbled heavily into a downturn, likely starting in November. Early data on jobs (down 70,600), housing starts (falling to 172,000 a.r.), home sales (down 70% y/y in Vancouver and 50% in Toronto), and auto sales (down 10.3% y/y), all point to a dramatic braking in activity across the board last month (*Chart 1*).

¹ Perhaps appropriately, that comment by Nixon wasn't entirely the truth, as many academic economists were in fact beginning to turn their back on Keynes' views by the 1970s. Suffice it say, his views are rapidly gaining converts.

CHART 1
CANADIAN ECONOMY HITS A WALL



CHART 2
MONETARY POLICY: NEARLY FLAT OUT

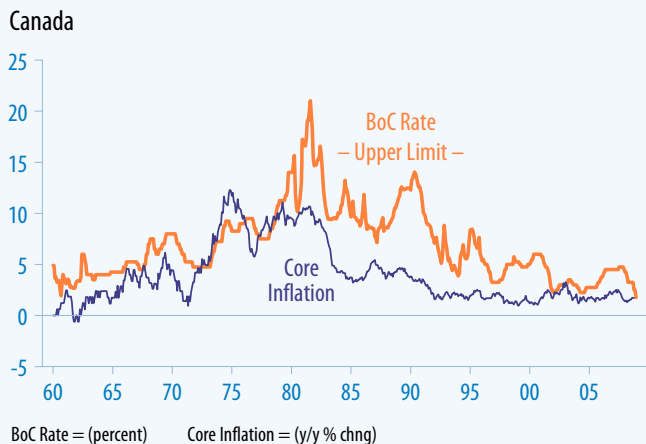


CHART 3
GOVERNMENT SPENDING: ROOM TO GROW

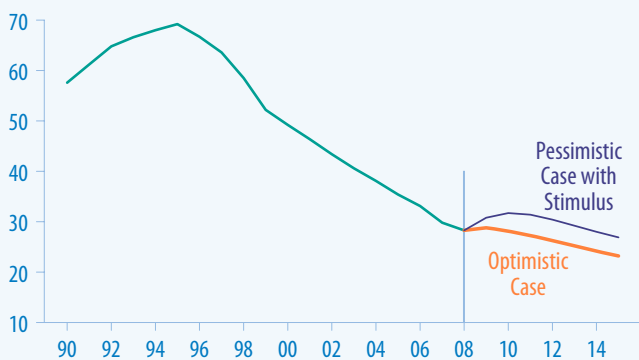
Canada (% of GDP)

Government Spending + Investment


CHART 4
GOVERNMENT DEBT BURDEN: TEMPORARY DETOUR AHEAD

Canada (% of GDP)

Federal Debt



- 2) Monetary policy could use an assist. The credit channels are still partly clogged. Interest rates are already extremely low by any standard. Even Canadian rates are now negative in real terms, something we haven't seen since the 1970s (*Chart 2*). A further dip into the red for real interest rates could be potentially distorting, and further tip the balance away from savings. The Bank of Canada has already ramped up the size of its balance sheet by almost 50% in the past three months. Moreover, while monetary policy is usually seen as the best tool to stabilize an economy, its major failing is that it takes time for changes in policy to fully affect activity (a lag time of 12-18 months). Further and more aggressive monetary policy action may not have an impact until 2010. Finally, monetary policy did not single-handedly cause the recession, so why should it be expected to single-handedly drive the recovery? In other words, why not get a second piston pumping?
- 3) The usual criticisms of fiscal policy don't fully hold. Normally, there are three steps that tend to delay the impact of fiscal policy: recognition, response, and action. But, the federal budget on January 27 will already deal with the first two. The only delay now will be how long it takes budget proposals to make an impact on the economy, and that could easily be a much shorter delay than any further monetary policy actions.
- 4) Finally, a fiscal boost is certainly affordable, especially for Canada. With the lowest public sector debt/GDP ratio among the major industrialized nations and a string of 12 years of surplus, Canada has plenty of room for a fiscal boost. After all, the string of budget surpluses in the past decade were the public sector equivalent of saving for a rainy day, and it's starting to pour.

So, **how big** should the fiscal boost be? A stimulus package of 1% of GDP (\$16 billion) would be both substantial (i.e. large enough to matter) but also affordable (it could be unwound without significantly slamming growth in the ensuing years). Measures of that size would be less than the mooted U.S. package, appropriately. Even with a fiscal boost of that size, and a relatively hefty underlying budget deficit (under a pessimistic economic outlook scenario), we estimate that the debt/GDP ratio would rise only a few percentage points, and would return to current levels within five years (*Charts 3 and 4*).

And, **what form** should a stimulus package take? This is perhaps the most vexing issue and is definitely the hard part for policymakers, as any measures will struggle to meet the oft-recommended “three Ts” (timely, temporary and targeted). Beyond the usual recommendations of accelerated infrastructure spending, assistance for the unemployed, and green subsidies for homeowners, some other possibilities include: 1) a temporary break on payroll taxes (this could be enacted quickly and would reduce the marginal cost of labour); 2) a temporary break on sales taxes (while economists and tax administrators may hate this suggestion, it could spur some activity quickly); 3) a one-time bonus payment to seniors on public pensions (this could help offset low interest earnings and damage from stock market losses); 4) spending vouchers, which carry a summer due date to ensure the funds don’t get stuffed under a mattress (this would be somewhat similar to the famous helicopter drop of money, which even the most strident monetarist would approve). 5) Finally, if Ottawa taps out of good ideas, a one-time transfer payment to the provinces could do wonders for federal/provincial relations (for a few days), and could put the money more directly into areas that need it now. For example, if Ottawa allocated half the proposed stimulus to this route, Ontario would receive roughly \$3 billion, providing the Province with much more room to manoeuvre.

Bottom Line: These are clearly unprecedented times, and the economy is certainly in need of a direct boost. Monetary policy remains the main tool for stabilizing the economy; but, in the current environment, fiscal policy can play an important supporting role. One cautionary note would be that no policy changes in Canada will completely shield the domestic economy from this global downturn. But, in line with most other major economies, Canada should do its part in supporting global growth, no matter how modest that part may be.

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