Defending the Deficit Detour

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CHART 1

BUDGET BALANCE: RED DAWN...

Canada (C$ blns)

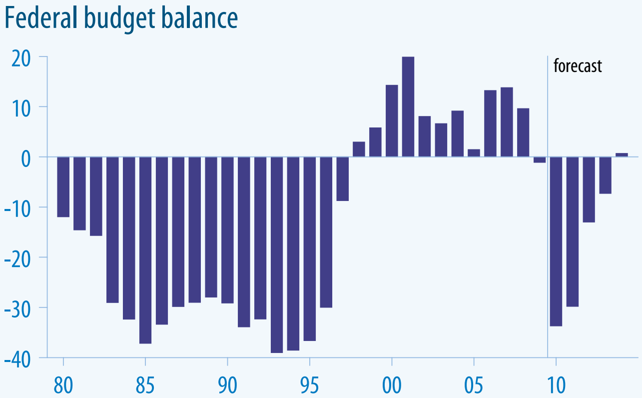


CHART 2

...BUT RATIOS STILL BELOW 80s/90s

Canada (share of GDP)

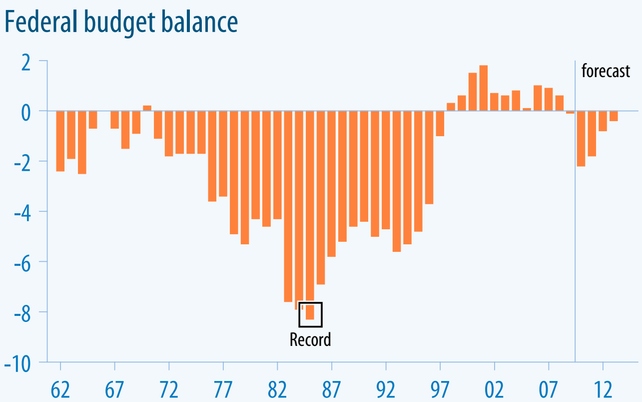
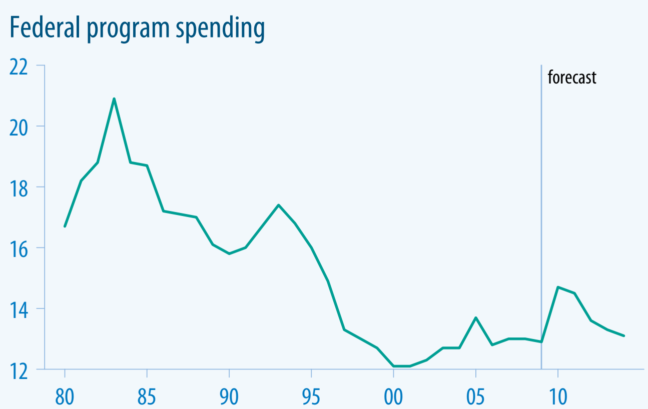


CHART 3

PROGRAM SPENDING: BUMP IN THE ROAD

Canada (share of GDP)



One overarching concern in the wake of this week's federal budget was that Ottawa's sudden dive back into the deficit pool threatened a return to the bad old days of the mid-1970s to the mid-1990s. Indeed, many decried the fact that almost the entire amount of net public debt paid down in the past decade would be quickly added back over the next four years, seemingly leaving the country at a fiscal square one. Or, some fretted about structural shortfalls. However, it is patently ridiculous to equate deficits in today's dollars with shortfalls in the early 1980s, or even the early 1990s. The Canadian economy is four times as large as it was in the early 1980s and more than twice as large as in the early 1990s.

It is true that the projected $34 billion budget deficit for the coming fiscal year will rank right up there with the largest nominal shortfalls on record from Ottawa. Technically, it would be the sixth largest ever, and not far from the record gap of $39.0 billion in FY92/93, at the tail end of the prolonged early 1990s recession (*Chart 1*). However, as a share of GDP, the expected shortfall of 2.1% doesn't even rank in the 25 all-time top deficits. In fact, it's not in the same league as the modern-day peak of 8.3% of GDP, set in FY84/85, and is less than half the typical run rate seen in the early 1990s (*Chart 2*). Putting it into further perspective, the watershed February 1995 budget—which finally broke the back of the deficit—was against the backdrop of a shortfall of 4.8% of GDP in FY94/95. Thus, it will ultimately require much less restraint to repair finances in this cycle.

Another common criticism of this week's budget was that it ramps up spending at the fastest pace in more than 25 years. Program spending is poised to leap 10.8% in the coming fiscal year, an impressive pace even by the lofty standards of recent years. However, a strong case can be made that this is precisely the time for government to step up and offset the void left by the steep drop in private sector spending. The whole point of running up surpluses during the recent times of economic plenty was not to drive government debt to zero, but rather that finances could sustain some extra spending during the hard times. Ottawa has been saving for a rainy day, and it's starting to pour. The

CHART 4
LITTLE INTEREST
Canada (share of GDP)

Federal debt interest payments

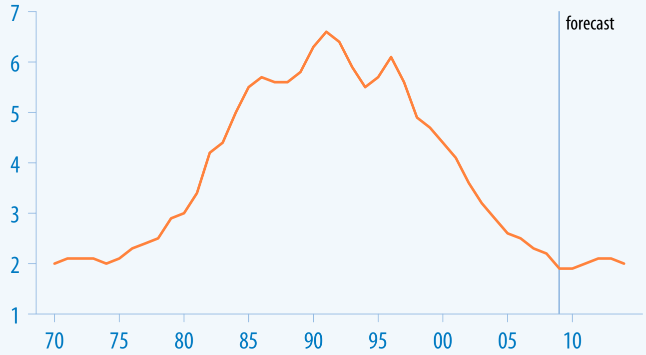


CHART 5
OTTAWA'S DEBT: PERSPECTIVE MATTERS
Federal debt – accumulated deficit

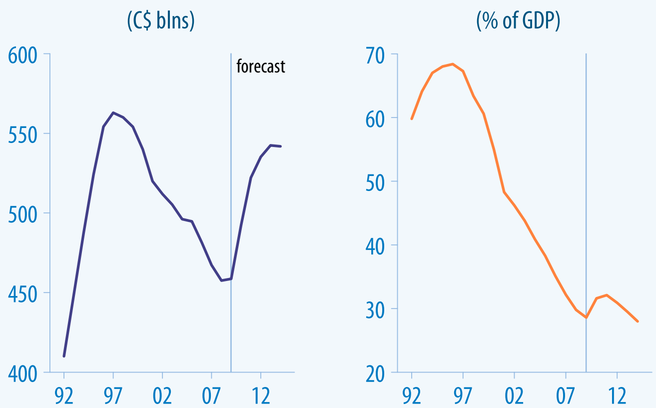
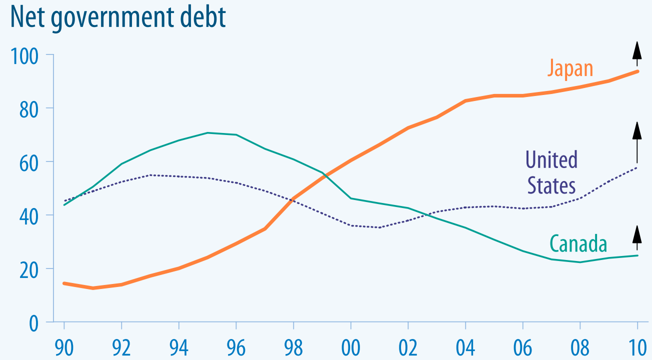


CHART 6
FROM WORST TO FIRST
(share of GDP)

Net government debt



Source: OECD, before stimulus measures

projected bump in program spending will leave it at 14.7% of GDP; true, that's well above the record lows of just over 12% hit at the start of the decade, but it's a far cry from the peaks hit in the early 1980s of more than 20% (*Chart 3*).

Meantime, debt-service charges are expected to remain quite restrained at just 2% of GDP in the next few years. That's less than a third of the peak reached in the early 1990s. Admittedly, Ottawa's debt-service tab was also 2% of GDP in the mid-1970s, just when the deficit began to spiral higher (*Chart 4*). However, a key difference in this cycle is that central banks are slashing interest rates to the bone and long-term borrowing costs are scraping the bottom, whereas rapidly rising inflation drove interest rates skyward in the late-1970s, deeply aggravating the deterioration in public sector finances.

And, even with the projected run-up in Ottawa's debt burden in the coming years, it will remain below its peak levels of the mid-1990s. The five-year string of deficits will add $85 billion to debt, taking it to $542 billion by 2013, still below the 1997 peak of $553 billion. That may sound like very small progress, but the improvement jumps off the page when stated as a share of the economy, which is the much more meaningful way to look at it. Even with the deterioration of the next few years, Ottawa's debt is expected to top out at a modest 32% of GDP this cycle, still less than half the mid-90s peak of 68.4% (*Chart 5*).

Finally, it's also critically important to keep Canada's fiscal position in context globally. The tremendous strides made in the past 15 years have transformed Canada from the company of fiscal basket cases to one of the strongest sovereign credits in the world. Every country is facing similar, or much more pressing, fiscal challenges because of the severe global downturn. For instance, the looming trillion-dollar U.S. deficits are going to add more than 8 percentage points per year to the debt/GDP ratio, in an unnerving replay of what Japan went through in the 1990s (*Chart 6*). The issue for Canada's long-term fiscal health is not the prospect of sizeable budget deficits over the next two years, but instead whether the government of the day can take the tougher political steps to remove the stimulus as the economy begins to recover.