

# When the Stimulus Well Runs Dry

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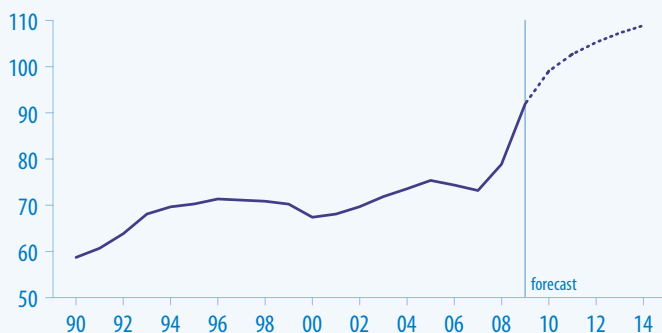
Can the fragile global economic recovery stand on its own two feet, without the helping hand of massive government spending? We may find out sooner than expected. The sudden surge in concerns about the battered state of government finances has accelerated calls for policymakers to look for the exits on fiscal stimulus measures. While President Obama has proposed using recycled TARP funds to finance another stimulus package, and the program has been extended until October 2010, Republicans are loudly calling for any excess to be funnelled into reducing the budget deficit. In Canada, Finance Minister Flaherty has made it abundantly clear that next year's budget will contain no new major measures—suggesting that the point of maximum stimulus is already upon us—and is, in fact, already seemingly more concerned about bringing down the deficit in the years ahead.

So what will happen to the recovery when the stimulus well runs dry? The immediate impact on growth is unlikely to be as challenging as widely expected. First, we would assert that the role of fiscal stimulus in turning the economy around has been typically overstated—no doubt, it has been a factor, but ultra-low interest rates and the widespread healing in financial markets have been more important in turning the tide. As well, the lion's share of the so-called stimulus has been automatic rather than discretionary in most industrialized economies. In other words, much of the extra government spending was for jobless benefits or other income support measures, while the drop in tax revenues was simply the natural by-product of shrivelling personal and corporate incomes. The good news is that this portion will not be soon reversed, so growth will not suffer untowardly in the near term. The bad news is that with so much of the fiscal spending automatic, budget deficits will remain enormous in the absence of real restraint or a surprisingly robust recovery in coming years.

Indeed, the bigger issue for financial markets and investors is not so much what happens when the stimulus measures are reversed too soon, but what happens if they're not reversed soon enough? Advanced economies are facing intense fiscal pressures even as the global economy emerges from recession (*Chart 1*). A deteriorating fiscal situation in Greece is the focus of recent concern, with a massive deficit of 13% of GDP and net debt that will likely reach 100% of GDP within the next few years. Greece would join Italy and Japan in the 100% club, with the U.S. and U.K. also in the express lane for membership. Notably, many emerging markets are moving in the opposite direction, with the IMF projecting that debt-to-GDP ratios will fall for these countries in 2012-14, following only a slight uptick in 2009-11. That theme fits with our expectation that the major emerging markets (China, India

**CHART 1**  
**GOVERNMENT DEBT: WE HAVE LIFTOFF**  
Advanced Economies (% of GDP)

Net Public Debt



Source: IMF

and Brazil in particular) will outperform advanced economies through the recovery phase. The growing divide in fiscal health is a profound change from previous crises, when emerging market debt worries were often at the epicentre, and highlighting again how economic power is shifting away from the G7 to the developing world.

As the global economy emerges from the deepest recession in 80 years, the massive fiscal stimulus will be withdrawn to avoid a potential fiscal crisis, eventually acting as a drag on growth. This headwind will allow central banks to keep interest rates somewhat lower than would otherwise be necessary, as slower growth will keep inflation pressures at bay. That will provide support to interest-sensitive domestic demand, helping to pick up more of the slack from a retreating government sector. However, the U.S., Europe and Britain will not benefit fully from this dynamic, as weak banking sectors make them less sensitive to lower interest rates, with credit conditions remaining generally very tight.

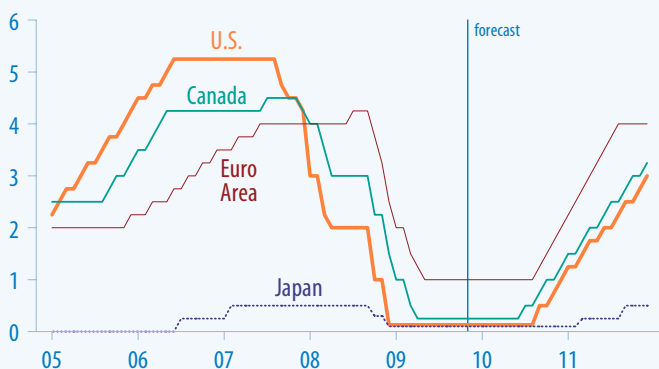
The coming removal of stimulus measures appears to be a less-pressing issue for Canada than most other industrialized nations. First, other sectors of domestic demand are already rebounding smartly, with the full recovery in housing the most spectacular example. While consumer spending is still held back by the income-sapping job losses of the past year, there does not appear to have been a fundamental change in Canadian consumer behaviour in the wake of events of the past two years. Thus, the economy likely can adjust to an orderly removal of stimulus measures.

Second, the degree of needed fiscal retrenchment over the medium term in Canada will weigh on growth, but not nearly as much as in many other developed economies. For instance, former Bank of Canada Governor David Dodge estimated in a recent speech<sup>1</sup>, that, to stabilize Canada's debt/GDP ratio, expenditure cuts and/or tax increases of 3% of GDP would be required from 2012 to 2015. Such restraint could be achieved if real government spending growth was held to zero for three years and all

"temporary" spending measures were eliminated. While certainly not an impossible task, this plan would entail very real disruptions and would act as a medium-term drag on growth. Meanwhile, Dodge estimates that required actions in the U.S. would be nearly three times as great (and on the order of what Canada went through in the 1990s). Given the less severe required restraint here and a more normal-functioning credit creation process, the Bank of Canada will likely be among the first major central banks to normalize borrowing rates in the years ahead (*Chart 2*), providing yet another underpinning for the Canadian dollar.

**CHART 2**  
**NEAR ZERO FOR A WHILE LONGER**  
(percent)

**Overnight Rate**



<sup>1</sup> "Emerging from the Crisis: Fiscal and Monetary Policy Challenges Ahead". David Dodge to the Bennett Jones Business Forum, November 27, 2009.

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