The Stimulus Myth(s)

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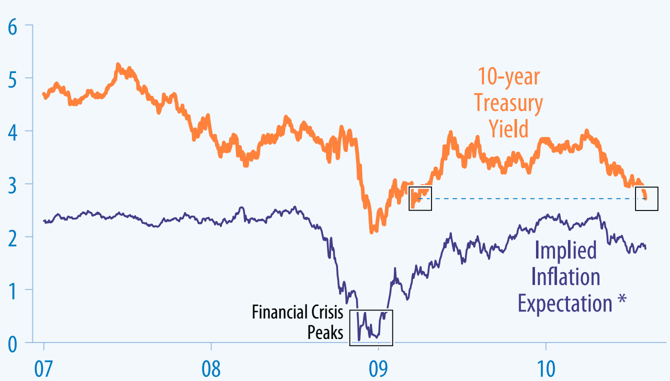
Economic debates can sometimes take on an arid academic air, dealing with subjects that may have little real-world impact. This is not one of those times. With the fledgling U.S. recovery losing altitude, the wrong diagnoses at this point could lead economic policymakers astray with potentially disastrous consequences. Probably the most pressing debate now in most of the industrialized world is whether governments should start reining in spending to corral their massive budget deficits, or to press on with more stimulus to ensure the recovery sticks. We would lean heavily in favour of the latter view. While normally not dyed-in-the-wool Keynesians, we have been consistent advocates of expansionary fiscal policies since the darkest days of the 2008 financial crisis, due to the highly unusual nature of the crisis. Normally, bailouts for automakers or Wall Street banks would not be high on our to-do list either, but extraordinary times call for extraordinary measures, and monetary policy is already doing almost all it can. To support our stance, we consider some current myths surrounding the stimulus so far.

Myth #1: Financial markets are currently stressed by large budget deficits. Let's dispense with the easy one. Some have made the case that governments should start cutting budget deficits post-haste because markets are demanding it, as shown by the deep equity correction in the wake of Europe's debt woes. Yet, aside from a few very specific countries (Greece, Portugal, Spain), most government bond markets have shown no such concern this year. Quite the contrary, as 10-year U.S. Treasury yields have recently dropped to their lowest level since April 2009, when the economy was still mired in recession and losing more than 600,000 private sector jobs per month (*Chart 1*).

Notably, the recent slide in yields is not so much a reflection of mounting deflation concerns (long-term implied inflation expectations are still close to 2%), as it is a deep dive in real yields (now below 1% for 10 years). Since real yields can be seen as a (very) rough proxy for real growth prospects, the bond market is signalling a lengthy period of exceptionally soft growth ahead. Similarly, Canadian long-term bond yields are probing levels not seen since the spring of 2009. Even European bond yields have plunged in recent weeks as the debt debacle has moved beyond the acute phase, with Germany, France and Italy all seeing yields drop below their 2008/09 crisis lows. The bond market is concerned all right, but not about too much public sector borrowing. The fact is, governments still have the borrowing field to themselves, as households and businesses are simply in no mood to borrow aggressively at this point.

CHART 1
BOND MARKET SAYS:
DON'T WORRY ABOUT THE GOVERNMENT
United States (percent)



* Nominal yield less 10-year TIPS yield

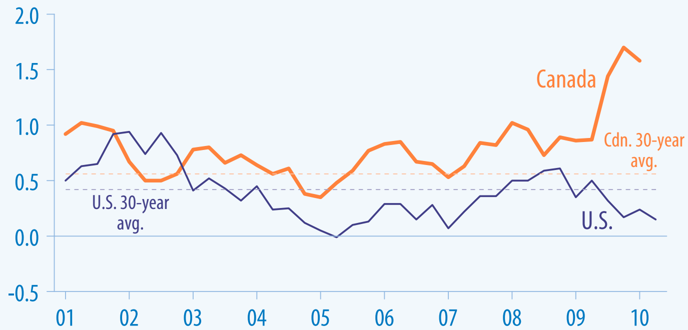
Myth #2: Massive U.S. fiscal stimulus has not worked. Part of this statement actually is true; U.S. stimulus hasn't really worked this cycle, partly because it hasn't really been tried yet. Without fully going into the Paul Krugman end of

CHART 2

STIMULUS: CANADA YES, U.S. NOT SO MUCH

(percent : 4-qtr avg.)

Net Contribution to Growth of Government Spending *



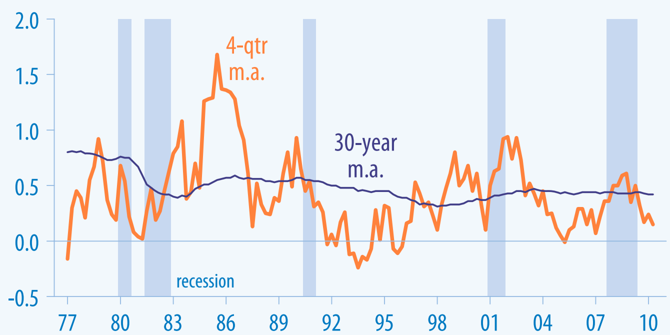
* Consumption and Investment

CHART 3

U.S. STIMULUS NOT SO STIMULATING

United States

Net Contribution to Growth of Government Spending *



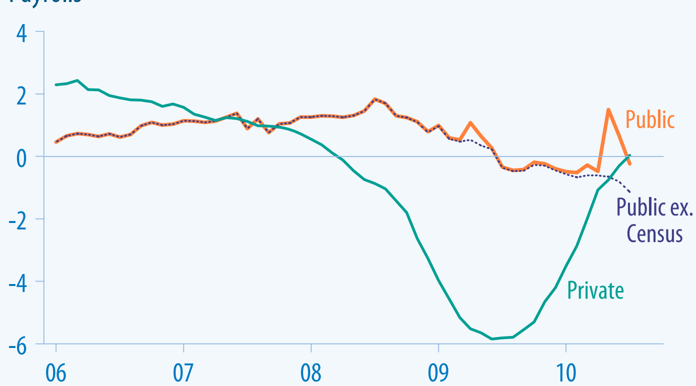
* Consumption and Investment

CHART 4

SOME KIND OF STIMULUS

United States (y/y % chng)

Payrolls



the pool, there is a strong case to be made that the much-ballyhooed $787 billion Obama stimulus package was far less than met the headlines. Measured on contribution to GDP, U.S. public sector spending and investment has barely added to growth in the past year, in stark contrast to Canada (*Chart 2*, more on Canada later) and even in contrast to past cycles (*Chart 3*). The so-called "massive" stimulus has actually added less directly to growth than during a typical year over the past three decades, and is a far cry from the true heavy-duty stimulus of the mid-1980s which backstopped that very strong recovery phase.

Whatever stimulus Washington has been pumping into the economy has been almost entirely offset by deepening cutbacks at the state and local level. This has become particularly evident in the recent jobs data, where an accelerating decline in non-census public sector employment has been one of the major reasons the labour market has begun cooling again. Just as the private sector has finally stopped shedding jobs on a year-over-year basis, the public sector has slashed 243,000 jobs in the past year outside of census workers (*Chart 4*). The bulk of these cuts have been at the local level, with teachers and other government workers axed in particular. This is why the $26 billion aid package for cash-strapped states, signed this week by the President, is so important. The cutbacks at the local level are in stark contrast to the Canadian situation, where provincial stimulus has instead amplified Ottawa's actions. That brings us to…

Myth #3: Canada's stimulus measures have been modest and largely ceremonial. Despite Ottawa's initial foot-dragging on the stimulus front in the early stages of the recession, and persistent carping about the efficacy of the measures by almost all and sundry, Canada has arguably had one of the most successful stimulus programs in the industrialized world (China is in a league of its own). Harkening back to Chart 2, the direct impact of government spending and investment has added 1.6 percentage points to GDP growth in four quarters to Q1, compared with a typical annual addition of just under 0.6 percentage points over the past 30 years. Thus, the direct effect of additional public sector stimulus to overall economic growth has been a bit more than 1 percentage point in Canada over the past year. We believe the trend

CHART 5

PUBLIC SERVICE

Canada (y/y % chng)

Payrolls

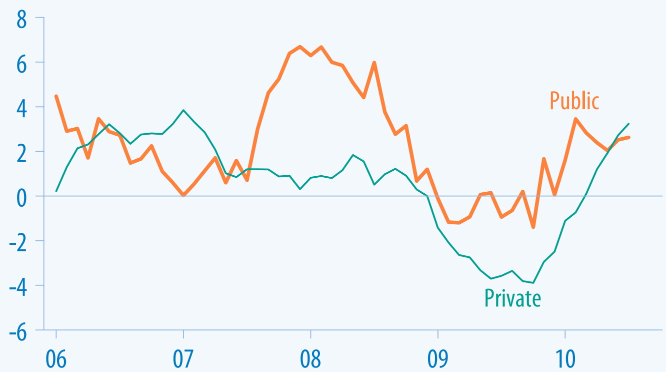
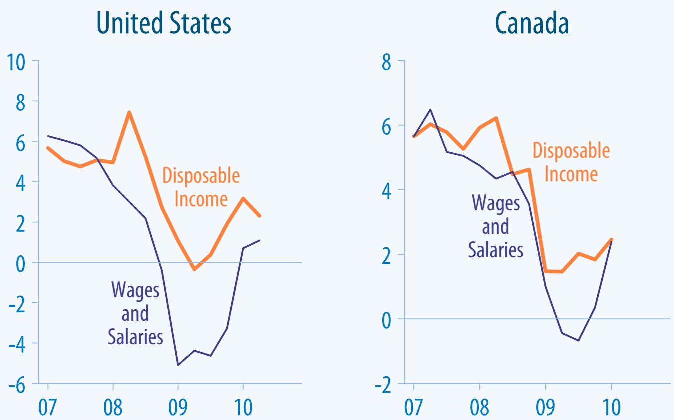


CHART 6

LESS TAXING... FOR NOW

(y/y % chng)



will look quite similar in Q2, so stimulus will have accounted for almost a third of the overall growth since the economy began recovering in mid-2009.

Again, one of the critical differences between the Canadian and U.S. stimulus efforts has been the fact that regional governments have added to growth in Canada, whereas they have subtracted from activity stateside. For better or worse, this reflects the fact that provinces have the capacity to run temporary deficits, while states are forced to aim for balanced budgets even in the darkest hours for the economy. This has also been reflected in the jobs data, with Canadian public sector payrolls expanding by 2.6% in the past year, versus a non-census drop of more than 1% in U.S. jobs. While rapidly rising public sector payrolls are normally more of a red flag than a cause for joy, recession is precisely the time when governments should be hiring, and we note that private sector payroll growth has managed to outstrip the public sector in Canada's recovery so far (*Chart 5*).

Direct government spending and employment totals are not the full picture on fiscal stimulus, as tax relief and transfers to individuals can also play a role. On that front, the U.S. has done a bit more than Canada, as shown by the gap between overall disposable income and wage & salary income (*Chart 6*). However, the difference here has not been large, and much of the U.S. stimulus has been reactive rather than proactive (belated jobless benefits, not tax cuts) and/or short-lived and of fleeting help (cash-for-clunkers, housing tax credits).

Bottom Line: Short of blowing another hole in the deficit, we believe that there is a very strong case for the U.S. to open the fiscal spigots wider yet to make sure the recovery sticks. The long-term fiscal cost from a lengthy period of sub-par growth would be much more damaging than a small down payment now—a stitch in time saves nine. The most effective way of delivering real support to the economy would be direct transfers to the beleaguered states to avert further job losses; but, at the very least, Washington should not embark on any tightening measures at this point.

For Canada, there is much less need for stimulus at this stage of our cycle. However, given 1) the still-shaky nature of the U.S. recovery, 2) that Canada's finances are improving faster than expected, and 3) that fiscal stimulus has been quite effective here, policymakers should keep their options open for the 2011 budget season, and not lock-in a hard stop on stimulus just yet.