

Not a time for fiscal austerity

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In the Throne Speech on September 23, the federal government outlined its plans to fight the pandemic-related downturn in the near term and restructure the economy in the longer term. We believe the government's focus on creating jobs, fighting the pandemic and setting the stage for a sustainable and inclusive recovery are the right priorities at this early stage of the recovery. The Throne Speech was striking by the breadth of policy commitments, covering a large swath of the Canadian economy. However, the government also appeared to recognize investor concerns about adding to an already **unprecedented budget deficit of over \$340 billion (17% of GDP)** with ambitious new programs. Following the Throne Speech, the reactions of bond yields, the Canadian dollar and the stock market were subdued. Looking ahead, the economic and market impacts will depend on specific details about the new programs, the scale of deficit-financed spending and the trajectory of public debt. The minority Liberal government also needs broader support in Parliament to avoid an election this Fall.

Pandemic Response

The government pledged to create one million jobs through investments in the social sector, infrastructure and job retraining programs. Promising to use "whatever fiscal firepower" is required, the government is aiming to support businesses and workers manage through a second wave of the virus and underpin a stronger recovery. While cost estimates were lacking, specific areas of policy focus included:

- **Canadian Wage Subsidy (CWS).** Extending the CWS for businesses until next summer. By some estimates, the fiscal cost could range between \$20 billion and \$40 billion.
- **Canadian Emergency Response Benefit (CERB).** Replacing CERB with an expanded EI program as the main approach to provide income support to affected workers.
- **Infrastructure.** Investing in clean energy, broadband, energy-efficient retrofits and affordable housing.
- **Other Business Support.** Expanding the Canada Emergency Business account for small business loans, enhancing business credit availability, and supporting industries hardest hit by the pandemic, such as the hospitality and travel sectors.

Finance Minister Chrystia Freeland is expected to provide a fiscal and economic update in the Fall, which will be important for investors to assess the fiscal cost of the announced measures, the government's future borrowing needs and the future debt trajectory.

Long-Term Fiscal Policy Priorities

The government also committed to far-reaching policy changes over the long term, including:

- **National Childcare Program.** The Throne Speech announced a widely anticipated investment in an Early Learning and Childcare program. Universal childcare would substantially increase government spending and put upward pressure on government budget deficits and debt.
- **Fighting Climate Change.** The Throne Speech unveiled numerous climate change-fighting policies, including cutting carbon emissions by 30% by 2030 and legislating a target of zero emissions by 2050.

- **Expanding EI.** The Throne Speech indicated the need to broaden EI to workers in the gig economy and others. The government also hinted that an expanded EI program could stay in place after the pandemic.
- **Pharmacare.** The government reiterated a commitment to work towards a universal pharmacare program.

The impact of these measures on the government's 'structural' budget deficit could be sizable. The government emphasized its commitment to a sustainable approach to public debt management. However, the childcare and pharmacare programs alone could lead to large increases in the budget deficit unless there are offsetting savings or new revenue measures.

The main tax measures announced in the Throne Speech included measures to address extreme wealth inequality, such as limits on stock options deductions. The government also indicated it will focus on tax avoidance by "digital giants". However, these measures appear inadequate to offset the fiscal cost of higher spending commitments.

Policy Assessment and Economic Implications

Fortunately, the federal government strengthened its fiscal buffers before the pandemic to help weather the storm of the current pandemic-related downturn. Canada has benefitted from one of the lowest levels of net debt as a share of GDP in the G-7 advanced economies. Canada's initially robust debt position has helped to maintain the country's strong sovereign credit worthiness.

Looking ahead, the government's fiscal framework appears to be about spending whatever it takes to support the current economic recovery while keeping an eye on the long-term debt trajectory. We believe this is a sensible approach overall, but the devil is in the details as the announced measures are not clearly accompanied by offsetting revenue measures on the other side of the ledger.

Over the medium term, the sustainability of a potentially large increase in deficit-financed spending hinges on 'lower for longer' interest rates. The near-term plan of using Canada's fiscal firepower to support the economic recovery will likely be the easy part. The challenge will be stabilizing government budget deficits and debt levels after the pandemic, which may require a mix of unpopular spending cuts and higher taxes. As Milton Friedman famously quipped, "Nothing is so permanent as a temporary government program". Relying on permanently lower long-term borrowing costs relative to long-term economic growth rates would not be a prudent strategy to ensure the health of Canada's public finances.

Market Reaction

Canadian financial markets were remarkably subdued following the Throne Speech. Both the Canadian dollar and Canadian Government 10-year bond yield were largely unchanged following the Throne Speech. The limited reactions reflected several factors, possibly including relief that more ambitious and costly initiatives were not a focus, such as a guaranteed minimum income program. Investors may have also appreciated the fiscal commitment to support the fragile economic recovery while conventional monetary policy tools are tapped out.

Investors' attention in the near term may now shift to the reaction of other party leaders in Parliament. If the Liberal government can avoid a Fall election, the focus may turn to Minister Freeland's Economic and Fiscal Update in the Fall, outlining more clearly the government's expected path for Canada's public finances.

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