A PLAN TOWARDS FISCAL STABILITY AND ECONOMIC STABILITY (2024)

Issue

Inflation has been relatively sticky for the last year. As a result, the Bank of Canada has elected to raise interest rates. Interest rate increases have impacted many people and will continue to do so. Interest rates increases have resulted in unaffordable mortgages for businesses and homeowners. These high interest rates are also creating pressure on the economy resulting in the closure of businesses. The Federal Government has other policy levers to curb inflation, namely a budget surplus. Instead of increasing the cost of living and attempting to reduce it by creating more debt, the federal government should use a lever that has been proven effective, which is the balancing of their budget and running a surplus.

High government spending that is not matched by sufficient revenue can lead to fiscal deficits. To finance these deficits, the government may resort to borrowing from the central bank or financial markets. When the central bank creates money to buy government debt (monetary financing), it can potentially increase the money supply, leading to inflation.

Background

To curb inflation, Governments may pursue a contractionary monetary policy, reducing the money supply within an economy. The BoC implements contractionary monetary policy through higher interest rates. By increasing interest rates, less money will be circulating in the economy by incentivizing banks and investors to buy Treasuries, which guarantee a set rate of return, instead of the riskier equity investments that benefit from low rates.

As a result of the high levels of inflation, the BoC increased interest rates. The Consumer Price Index (CPI) has steadily decreased in some respects, but it is mostly because of geopolitical circumstances such as the war in Ukraine that was impacting oil prices. The domestic impact of interest rate increases has caused bank lending rates to increase, which has caused the cost of living to inflate dramatically.

Given that CPI includes prices of oil and groceries, which are commodities that are imported and are not affected in a significant way by domestic policy, there is a school of thought that government spending can curb inflation. Some say that during an inflation, the government should have a surplus. During a recession, a government should be spending money to stimulate the economy, and so during inflationary periods, governments should be reducing spending, ultimately reducing the money supply, to bring inflation down.

However, the information below shows the Government of Canada's spending and budget deficits during inflation:

2021 Budget	2022 Budget	2023 Budget
$90.2 billion deficit[1]	$43.0 billion deficit (updated forecast)	$40.1 billion deficit (budgeted)

In the 2023 Q1 report, it was noted that over the previous four quarters, the federal government deficit decreased by $54.8 billion compared with the same period a year earlier to stand at $27.2 billion. Both an increase in revenue (+$25.2 billion), driven by nominal GDP growth (+8.7%), and a decrease in expense (-$29.6 billion) contributed to the deficit reduction. Although total federal government expenses decreased, its interest expenses increased by $8.3 billion as interest rates rose sharply.[2]

The aggregate principal amount of money to be borrowed by the government in 2023-24 is projected to be $421 billion, about 85 per cent of which will be used to refinance maturing debt.[3]

The Inflationary Effects of Higher Debt and Excess Spending

The link between excessive public debt and inflation is well-documented in economic literature. Studies such as the research by Reinhart and Rogoff (2010) have shown that when a country's debt-to-GDP ratio exceeds a certain threshold, usually around 90%, economic growth slows down, and inflation rates tend to increase.[4] This suggests that the continuous accumulation of debt and unrestrained spending can lead to inflationary pressures, adversely affecting the overall economy and reducing the purchasing power of citizens.

Fiscal Surplus as a Measure of Economic Prudence

Contrary to the inflationary impact of high debt, fiscal surplus acts as a powerful economic stabilizer. A research report by the International Monetary Fund (IMF) in 2018 revealed that countries with prudent fiscal policies, characterized by running surpluses during periods of economic expansion, were better equipped to weather economic downturns with lower inflation rates. Building fiscal reserves during times of economic growth provides governments with the ability to stimulate the economy during downturns without resorting to excessive borrowing, which can mitigate inflationary pressures.

Striking the Right Balance

The pursuit of fiscal surplus should be balanced with responsible spending in crucial areas such as infrastructure, education, and social welfare. By strategically allocating funds to areas

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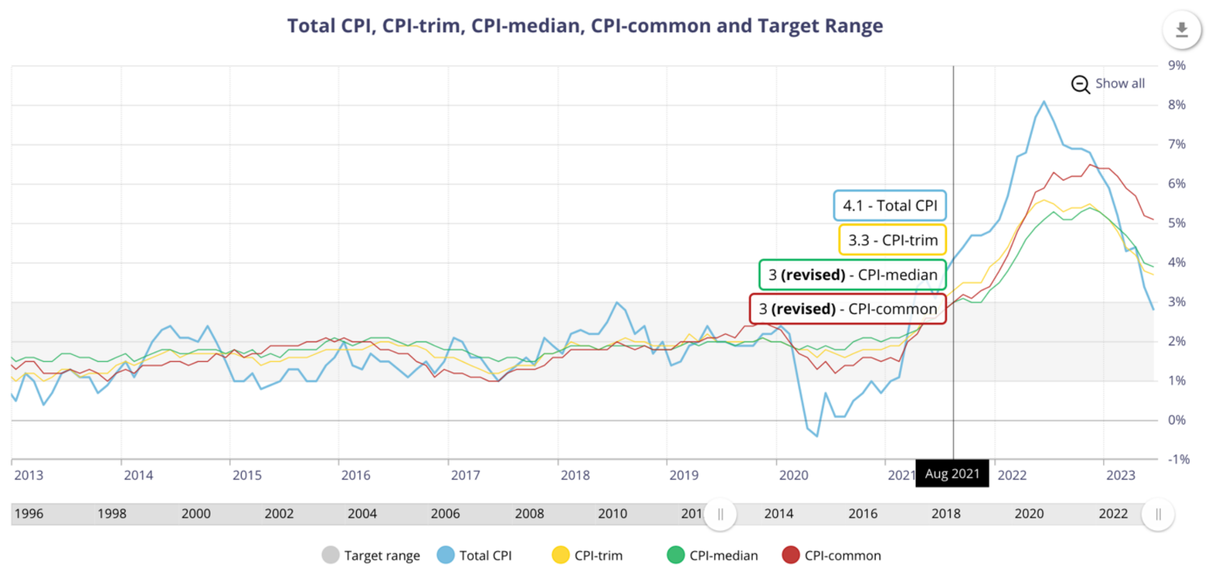
[1] https://nationalpost.com/news/canada/its-official-canada-ran-a-90-2-billion-deficit-last-year
[2] https://www150.statcan.gc.ca/n1/daily-quotidien/230626/dq230626b-eng.htm
[3] https://www.budget.canada.ca/2023/report-rapport/anx2-en.html#:~:text=The%20aggregate%20principal%20amount%20of,used%20to%20refinance%20maturing%20debt.
[4] https://mpra.ub.uni-muenchen.de/24376/1/MPRA_paper_24376.pdf

that contribute to long-term economic growth and social development, the government can bolster the economy while maintaining fiscal discipline.

<u>Building Economic Resilience</u>

In a globally interconnected and unpredictable economic landscape, a fiscal surplus provides an essential buffer against potential shocks. The ability to respond to unforeseen events, such as economic downturns or natural disasters, without resorting to inflationary measures or excessive borrowing, is crucial to safeguarding the economic well-being of the nation.

Future inflation levels should be better monitored, and action should be taken by the Central Bank expeditiously. Based on the graph below, it is evident that CPI-trim, CPI-media, and CPI-common, which are the three indicators that the Central Bank use when determining interest rate increases or decreases, were edging above the targeted levels in August of 2021. Although Canada's GDP was at a modest .4% growth (monthly change) in August of 2021[5], the trend in the graph below shows a clear trajectory of CPI towards an unsustainable level. This was the opportune time to begin increasing the interest rates to cool inflation.



Source: https://www.bankofcanada.ca/rates/indicators/key-variables/key-inflation-indicators-and-the-target-range/

<u>Monetary Policy Framework Renewal</u>

The Bank of Canada and the Government of Canada work together to set the Bank of Canada's monetary policy tools for the future five years.[6] This document sets the Bank of

[5] https://www150.statcan.gc.ca/n1/daily-quotidien/211029/dq211029a-eng.htm
[6] https://www.bankofcanada.ca/wp-content/uploads/2021/12/Monetary-Policy-Framework-Renewal-December-2021.pdf

Canada's ability to influence monetary policy. The previous monetary policy framework highlights a focus on interest rates as the primary means to correct inflation.

THE CHAMBER RECOMMENDS

That the Federal Government:

1. Should adopt a fiscal anchor and budgetary framework that ensures Federal Government spending is aligned with the goals of monetary policy to ensure low and stable inflation rates. This means reducing ineffective and inefficient spending, as well as the growth of spending and targeting budget surpluses during normal economic times.