Keeping the Powder Dry But the System Primed: *Fiscal Policy in a Recession*

- **The Canadian economy has demonstrated notable resilience in the face of global turbulence, but as a small, open economy, it is not immune to evolving events.**
- **While we are not presently forecasting a recession, Canada has an enviable arsenal of tools available to respond should one occur: an independent central bank with a willingness (and space) to act; a federal balance sheet with a comfortable margin to spend; and substantial safety nets to smooth the impact on households.**
- **But is a government ready to leverage all of these tools in a responsible and reinforcing manner? The Bank of Canada cannot shoulder the burden alone. Automatic stabilizers are insufficient in a serious retrenchment, while the politicization of fiscal stimulus seriously impedes its timeliness and impact.**
- **In the event of a serious recession, a policy rate approaching the lower bound would be necessary but insufficient. Fiscal support in the order of 4% of GDP would need to pick up the slack. While infrastructure should play an important role, the practical reality at this time is that it is impossible to live up to existing infrastructure commitments.**
- **Timely, targeted, and temporary fiscal stimulus can bridge the gap to a point in time when infrastructure investment can be ramped up. Targeted transfers—such as increase to the Working Income Tax credit, a boost to the Canada Child Benefit, an increase to EI benefits, or a GST rebate—can provide the needed lift in the near term.**
- **Fiscal support must be sufficiently persistent to have a meaningful impact on the recovery, though the stimulus measures must be unwound when the economy is out of the woods.**
- **Leaders should be judged not only by how they manage fiscal policy in the good times, but also how they plan to respond when the economy is weak. Last night's Leader's Debate offered little insight.**

KEEPING OPTIMISM IN CHECK

The Canadian economy has proven resilient so far to a global environment of heightened uncertainty and volatility. Robust population growth, impressive job gains, and solid wage advances have warded off any broad-based retrenchment in the economy; in fact, GDP growth rebounded in the last quarter albeit with a weakening in domestic demand (chart 1). Consumer confidence is reinforced by a solid recovery in key housing markets, while business confidence is holding up, despite waning indicators of activity (chart 2).

But Canada is not immune to evolving global events as a small, open economy. There are strong indications that the US-China trade tensions will persist through

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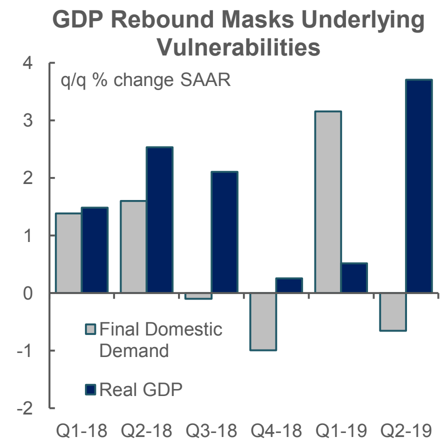
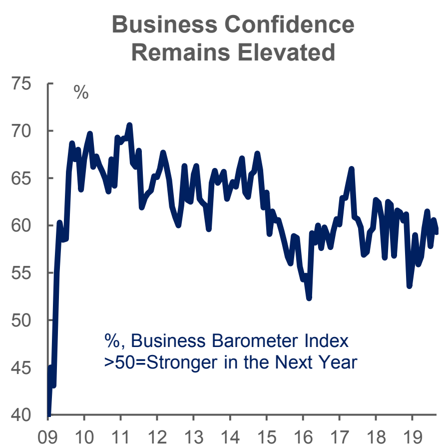
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, CFIB.

President Trump's first term, with a good chance that the conflict will escalate. Plummeting global indicators of trade and business activity are flashing warning signs. Should tensions continue to propagate, the impact to the global economy would be severe.

RECESSION-PROOFING, NOT FEAR-MONGERING

Our models are not forecasting a recession in Canada. The probability has increased in recent weeks, largely related to spillovers from the increased probability south of the border related to US-China trade tensions. It will likely continue to increase in the near term (chart 3), but still well below earlier highs. Yield curves on both sides of the border continue to gyrate as markets attempt to interpret developments.

We expect the Bank of Canada will respond to recent developments with an easing of interest rates on an insurance basis. Current Canadian fundamentals do not point to a need for additional monetary stimulus, but the risks to the outlook are clearly tilted to the downside. Given this, and the lags involved in the transmission of monetary policy, some monetary insurance now could help insulate from the current increase in uncertainty along with guarding against a potential worsening of the US-China trade conflict. We currently forecast cuts of 50 basis points in the overnight rate in the coming months. We expect this will be sufficient to offset negative headwinds from trade tensions with a minimal inflationary impact in our base case.

Monetary loosening would be an appropriate policy response in the current context on an insurance basis. It can be introduced quickly, underpinning confidence and fueling consumption and investment during an otherwise turbulent period. It can similarly be withdrawn swiftly as conditions improve. A fiscal response, on the other hand, can be slow to introduce and even slower—if ever—to retract as conditions improve.

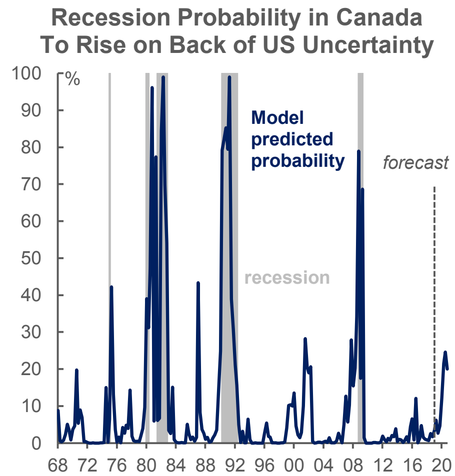
ALL HANDS ON DECK

With heightened vulnerabilities in the global economy, policy makers should make the most of Canada's present economic resilience to deliberate on an appropriate policy response to a serious downturn. After all, it is not a matter of *if*, but *when*.

It is not difficult to imagine a variety of recession scenarios at the present conjuncture. For illustrative purposes, we model a demand shock that originates from abroad—for example, an escalation in trade tensions beyond US-China to the global scale—that fuels a further spike in uncertainty levels. Canadian exports would contract sharply and hopes of a long-awaited business investment rebound would quickly evaporate. Facing lower aggregate demand, Canada would see a reversal in employment and wage growth while consumer confidence would plunge, weighing even further on domestic demand, concurrently with declining global demand. Absent any policy response, output would decline by over 2.5 % of real GDP over the course of six quarters beginning in 2019Q3 (Box 1).

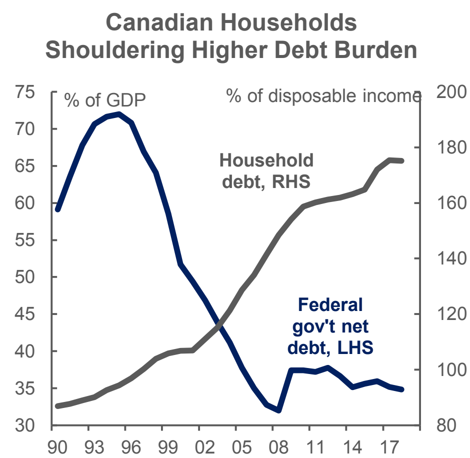
Such a serious downturn in the economy would require all policy levers working in a complementary and reinforcing manner. Monetary easing alone would neither be sufficient nor desirable. The Bank of Canada would run out of conventional space—that is, it would run up against the effective lower bound—while a real GDP shock in the order of 1% would still persist (B.1). High household debt levels would moderate

Chart 3



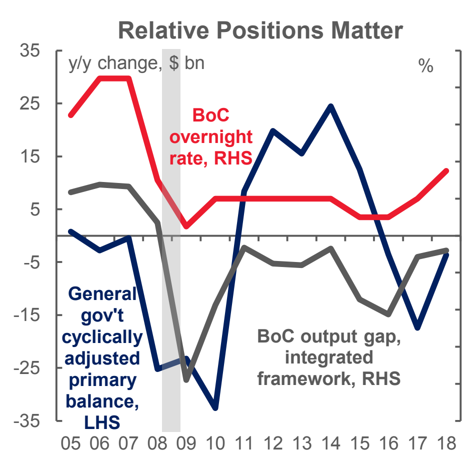
Sources: Scotiabank Economics, Haver Analytics.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Chart 5



Sources: Scotiabank Economics, IMF, Bank of Canada.

its effectiveness and raise stability risks. Automatic stabilizers would kick in, but provide only a modest dampening over the economic cycle. Meanwhile, Canada's low net federal government debt (at 30.9% of GDP) puts it in an enviable position to stimulate the economy in a recession. It is clear that the federal government has a better balance sheet to manage a downturn than households (chart 4).

NOT WITHOUT RISKS

But fiscal policy is fraught with risk. Lead-times are long as policy design can be overly complex and partisan politics can dilute its effectiveness. Fiscal stimulus more often than not misses the mark in achieving the primary objective of expedient stabilization. Lessons from Canada's response to the global financial crisis (GFC) suggest that 'shovel-ready' is a naïve concept: whereas Budget 2009 allocated about $12 bn to infrastructure over two years, almost a third had not been disbursed by the deadline. And this does not take into account the unquantified lag between disbursement and actual activity. Investments were neither shovel-ready nor strategically prioritized when these funds could otherwise have supported the immediate recovery.

The fiscal stance also impacts monetary policy. Misallocation or miscalibration of fiscal stimulus puts a greater burden on monetary policy in times of recession. The significant fiscal and monetary response during the GFC quickly reversed the sharp decline in Canada's output gap. However, the subsequent sustained withdrawal of fiscal stimulus in the immediate aftermath halted its recovery. A prolonged reliance on loose monetary conditions ensued while the output gap persisted (chart 5).

These fiscal drawbacks have led some prominent economists to call for new mechanisms that bypass limitations of current fiscal policy by placing more power in the hands of central banks (ex. 'helicopter money' or a similar proposal under Going Direct).

'Helicopter money' is a metaphorical concept to convey the simplest, fastest means to jump-start an economy. It implies printed money is literally 'dropped' from the sky. It reaches consumers immediately, avoiding overly complex policy design and prolonged political deliberations that can dilute effectiveness. In economic terms, it also increases the permanent income of households, making it more likely that it will be spent. It is categorically impracticable, but serves as a good reminder of the objectives of fiscal stimulus in times of a recession when there is a need to shift from foundation-forming to fire-fighting.

TIMELY, TARGETED, AND TEMPORARY

The opportunity cost of poorly-deployed fiscal stimulus is high. However, there is little consensus on the impact of discretionary fiscal measures. Academic literature varies widely with some citing fiscal multipliers as high as 4 (i.e., a unit increase in fiscal spending will boost output by a factor of 4). In the rare instances that Finance Canada references fiscal multipliers, it has used a more prudent factor of 1.5x or less in times of recession and even lower in stable periods (table 1).

There is broader agreement on general principles around the relative effectiveness of fiscal stimulus. Public investment multipliers can be larger than those for public consumption, but it takes much longer to reach the real economy. Multipliers for government spending are typically larger than tax multipliers, while measures

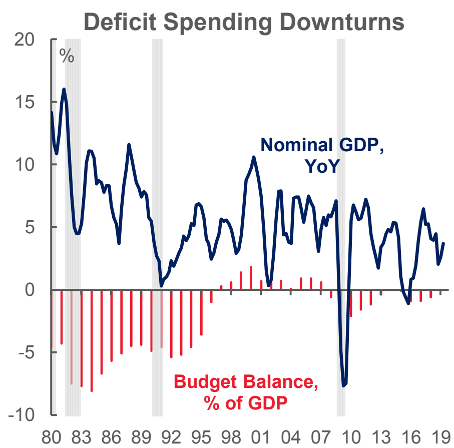
Table 1

Fiscal Multipliers: Timing, Targets and Tools Matter

% impact on real GDP	Budget 2009		Budget 2016	
	Yr 1	Yr 2	Yr 1	Yr 2
	FY10	*FY11*	*FY17*	*FY18*
Infrastructure investment	1.0	1.5	0.2	0.4
Housing investment	1.0	1.4	0.1	0.1
Measures for low-income households	0.8	1.5	0.2	0.4
Personal income tax measures	0.4	0.9	0	0
Corporate income tax measures	0.1	0.2	0	0

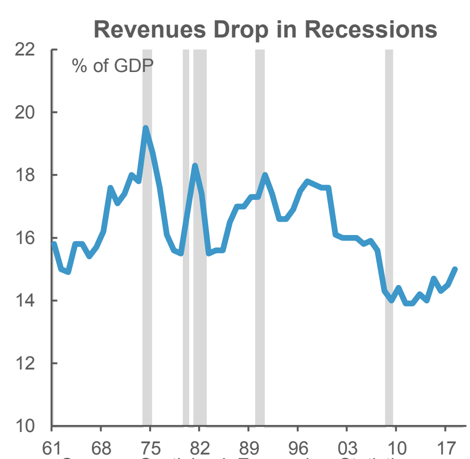
Source: Scotiabank Economics, Finance Canada.

Chart 6



Sources: Scotiabank Economics, Department of Finance.

Chart 7



Sources: Scotiabank Economics, Statistics Canada, Department of Finance.

targeting lower-income households with a higher propensity to spend have higher multipliers than broad-based ones. Spending is also more effective in times of weaker growth as it is less likely to displace private investment or push up interest rates, prompting a counteracting monetary response.

Simply put, fiscal stimulus should be timely, targeted, and temporary. It should target the channels that are most likely to respond. It should hit the real economy when it is needed and have a clear exit plan when it is not. Otherwise, prolonged fiscal stimulus can be detrimental in crowding out private activity as the recovery takes hold and raises expectations around future consolidation to pay for the tab.

A DOLLAR IS NOT A DOLLAR

Canada has a long history of relying on fiscal levers during downturns (chart 6). Substantial financing needs automatically arise as the business cycle retrenches: tax revenues decrease with employment and output, while expenditures grow with higher transfers. In past recessions, peak-to-trough revenues decreased between 1.5 to 3% of GDP depending on the severity and duration of the recession (chart 7). Consequently, deficit spending has typically increased by about 2% of GDP (peak-to-trough) *above and beyond* its starting fiscal position in past recessions (chart 8).

The impact of automatic stabilizers has varied over time with policy changes including adjustments to the tax system and the Employment Insurance program. The Parliamentary Budget Officer currently estimates that a 1% real GDP shock would impact the fiscal balance by about 0.2% of GDP ($4.1 bn) in the first year and about 0.15% of GDP ($3.2 bn) annually thereafter. Overly the medium term, Canada should consider how to strengthen automatic stabilizers which are middle-of-the pack relative to other advanced economies.

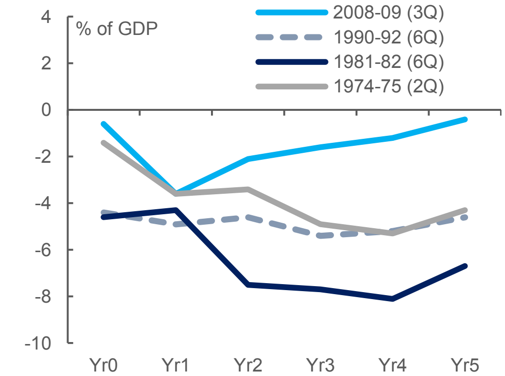
In the meantime, fiscal stimulus will play a critical role. The difference between highly effective versus poorly targeted fiscal stimulus is hefty. It is effectively the difference between running an annual deficit approaching 6% of GDP at its peak versus 2% of GDP (chart 9). A *timely, targeted and temporary fiscal impulse* in the order of $25 bn (annualized) over six quarters could substantially narrow the GDP gap if deployed in tandem with easing policy rates in our illustrative recession scenario (B.3). Essentially the money pumped into the economy is spent onward. On the other hand, *broad-based stimulus measures* would result in higher savings on part of many beneficiaries. The cost of less efficient, broad-based transfers would approach $125 bn (annualized) over the same period to stabilize the economy. This discretionary spending would be additive to the opening fiscal balance and to financing needs related to automatic stabilizers.

An important caveat is that we assume monetary policy will respond in full. The effectiveness of fiscal stimulus is much higher when monetary policy is at the zero lower bound. However it would be valid to question if and when the baton from monetary to fiscal support should be handed off. Clearly there are different benefits and risks to each policy lever.

A DECISIVE AND DISCIPLINED FISCAL RESPONSE

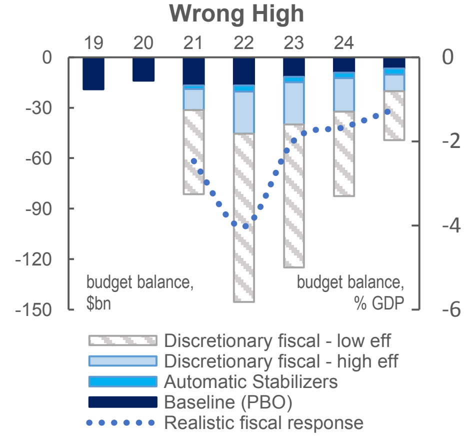
Practical considerations would limit the effectiveness of some fiscal levers in Canada in the near term. There are already tens of billions of dollars in public investment funds in backlog since the Investing in Canada Plan was announced in 2016. Until

Chart 8



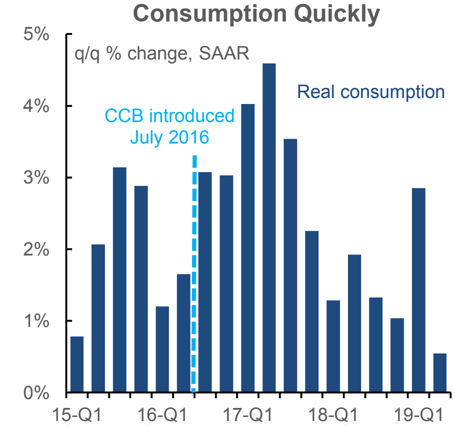
Sources: Scotiabank Economics, Statistics Canada, Department of Finance.

Chart 9



Sources: Scotiabank Economics, PBO.

Chart 10



Sources: Scotiabank Economics, Statistics Canada.

bottlenecks are worked out, pumping more stimulus through infrastructure will not spur growth in the near term. That said, a government could consider regulatory or procedural measures to speed up investment activity. PBO also reports that these funds displaced provincial spending in the order of $5bn (though additive to municipal public investment). Public housing investments are facing similar challenges. That is not to say that public investment should not be part of a medium-term response, rather that its near-term limitations should be acknowledged.

While weak business activity is clearly a concern, targeted tax cuts thus far (e.g., the accelerated depreciation measures at the federal and provincial levels) have been insufficient to spur a sustainable recovery in investment. Longer-term merits aside, corporate tax cuts would be very costly in terms of foregone revenue in the short term, without generating a return in timeframes warranted in a downturn.

A stimulus package should focus resolutely on measures with an immediate and high impact. The closest equivalent to helicopter money would be a tax cut or transfer that targets consumption. Canada has deployed this type measure frequently in the past (e.g., sales tax cuts, personal income tax cuts, increased tax credits), but often on a permanent basis and when the economy is strong. A challenge is to design and deploy measures that are credibly temporary and with transparent triggers linked to the economic environment.

A number of potential policy responses could deliver the desired outcomes. A temporary GST rebate would be one broad-based incentive to spark growth. As a flat tax, there would be some inefficiencies as higher-income households are less likely to spend the windfall in full, but it could be income-tested. The institutional architecture is already in place, though there could be a lag in deployment given links to the tax filing cycle.

A more targeted measure such as a temporary increase to the Canada Child Benefit (CCB) could potentially provide an even greater boost since it would target households with a high propensity to spend, and a transfer would be more efficient than a tax measure. The introduction of the CCB in 2016 boosted consumption in the immediate aftermath of the GFC even against the backdrop of a growing economy (chart 10). Other possible measures could target labour incentives. For example, a temporary increase to the Working Income Tax Benefit (a refundable tax credit) would encourage employment while also boosting incomes in low income households. A temporary increase to EI benefits would directly target newly unemployed individuals.

Any measures targeting corporations would need to be carefully circumscribed given the potential to save rather than spend any incentives. This is particularly true in a recession when lower aggregate demand creates headwinds for investment. The timeframe for the temporary and full depreciation of capital announced last year could be pulled forward to one year versus the current five years. This would likely receive push-back. A temporary zero rating of Employment Insurance premiums could, in theory, offset pressures to downsize, however its actual impact in practice is less evident.

It would be important to ensure any new measure is temporary by design, but sufficiently persistent to have a meaningful impact on the recovery. Predefined conditions for activation and withdrawal—such as quarterly GDP growth—would help manage expectations. While intentions to withdraw fiscal stimulus should be explicit and transparent, they should be based on economic conditions as opposed to predefined timeframes. The risk of a premature exit only puts more burden on monetary policy.

While all of these measures would fall somewhere between our two fiscal scenarios (outlined in Box 1) in terms of impact, they would better reflect the practical options available to Canada at present. They would strengthen automatic stabilizers in the system without increasing the size of government. Canada would close the GDP gap by running a deficit peaking around 4% of GDP (or about $75 bn annualized over six quarters).

WORTH A CONVERSATION

With election campaigns in full swing, there are dozens of spending proposals amounting to tens of billions in spending catering to a wide range of Canadian interests. Not only is there little discourse as to how to pay for these, there is no debate on policy directions in the event of a downturn. Will Canada's next government be ready to put the economy ahead of politics in the event of a recession?

An appropriate fiscal response should be timely, targeted and temporary. It should focus on those most likely to spend, it should reach the economy expediently, and it should be withdrawn as the economy strengthens. The costs of getting it wrong are high.

Box 1. Alternative Fiscal Stimulus Options: An Illustration

We show a prototypical recession that starts in 2019Q3 and requires a significant policy response. The shock is assumed to originate abroad, with spiralling trade disruptions and spiking policy uncertainty the main catalysts. Absent any policy response through 2020Q4 output would decline by over 2½ per cent over the course of six quarters (Chart B.1).

As the economy begins to contract, the BoC provides the first line of defense, lowering the overnight rate to the effective lower bound (ELB) of -0.5% through 2020Q4. This reduces the peak-to-trough decline in GDP by almost 1.5 ppts. This is likely the upper bound of what monetary policy can achieve as it is constrained by the lower bound, and the impact of negative rates is likely to be less effective at stimulating demand.

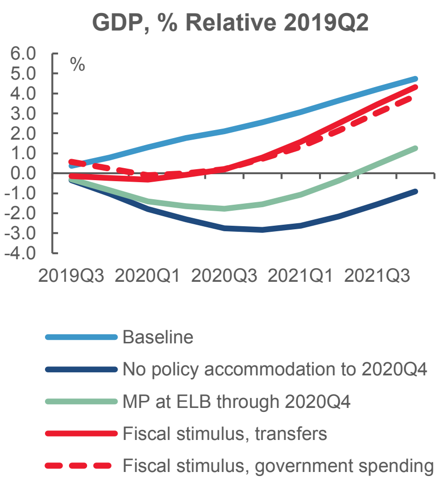
With the constraint on the policy rate binding, fiscal policy should be well-positioned to pick up the baton. First, there is no hard limit on the amount fiscal authorities can spend or borrow. Second, any additional stimulus-related borrowing by the government would be subject to low borrowing rates. Finally, while quantitative easing can also be used once the policy rate is at the ELB, fiscal spending or transfers are likely to be more effective at directly stimulating demand as they either directly affect spending on goods and services by the government, or affect households' budgets without the intermediary step of financial market operations in the case of quantitative easing.

We consider two alternative types of fiscal stimulus under the condition that the monetary policy is constrained at the ELB. First, a significant transfer to households that boosts real disposable incomes by roughly $125 bn each quarter from 2019Q3 to 2020Q4 at an annualized rate in chained 2012 dollars would offset most of the decline in GDP. Given that the transfers we are considering are not targeted, households are expected to save some of the funds and spend the remainder on a combination of imported and domestic goods and services. Import leakage and saving reduce the effectiveness of this type of stimulus.

The second alternative, and the most effective way to stimulate the economy, is to increase direct government spending. Assuming that spending can be rolled out in a timely manner, we consider a case when real government expenditures are $25 bn more each quarter from 2019Q3 to 2020Q4 at an annualized rate. This spending directly boosts GDP and has positive spillovers to domestic demand, helping to eliminate most of the decline. While this type of spending is much more effective, it faces practical constraints on the speed with which stimulus can be rolled out given the legislative process and the limited number of projects ready to be funded.

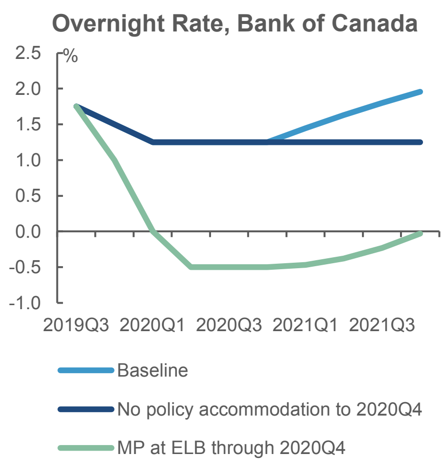
Realistically, the impact of fiscal stimulus would likely fall between the two extremes. Transfers may be more effective if primarily lower-income households are targeted, as these households are more likely to spend the money. On the other hand, any spending announcements are unlikely to lead to rapid increases in actual spending by the government, thus delaying and reducing the stimulus supplied to the economy.

Chart B.1



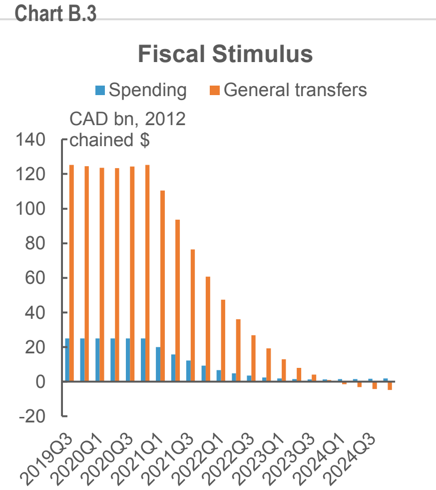
Source: Scotiabank Economics.

Chart B.2



Source: Scotiabank Economics.

Chart B.3



Source: Scotiabank Economics.