BANK OF CANADA

Opening sta... ...
John W. Crow
Governor of the Bank of Canada
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In my opening remarks I want to comment on broad issues concerning public deficits and debt in Canada, and make some more specific observations on their relationship with monetary policy.

The increased attention paid to these fiscal questions is welcome. I have appended to this statement some charts that illustrate the kinds of changes in Canada's public finances that have taken place over the past two decades. Clearly, our public sector deficit/debt situation is a major and unavoidable challenge.

As I said in the Bank's 1992 Annual Report, released in March, "debt has weighed heavily on all levels of our government. The debt buildup resulted from a long period of sizable budgetary deficits that were not limited to times of slow growth in revenues and not offset adequately at times when revenues were more buoyant. The outcome has been a sharply reduced capacity on the part of governments to respond to unexpected developments, such as the pressures of the recent recession and subsequent slow recovery. Coping with the public debt burden is proving an arduous task. At the same time, it is welcome that a more disciplined approach to public finances has become more widespread. It needs to continue if Canada is to generate the increased savings to finance adequately its investment needs in the years ahead."

The latter part of these remarks emphasized that public sector deficits have constituted negative savings. Another way of putting the point is that these deficits tap private savings. So, unless increased public sector deficits are offset by expanded private savings, a consequence would be an increased resort to foreign savings and a larger current account deficit in the balance of payments. I would note that although private savings have been quite well maintained through the last economic cycle, they certainly have not expanded in line with public sector deficits. These developments have the effect of crowding out productive investment in the private sector to the extent that increased borrowing provokes a higher risk premium, and therefore higher interest rates for Canadian borrowers. There is no doubt that risk premia have increased.

Let me emphasize that it does not make any difference to the end result whether it is the increased government borrowing that attracts external savings directly, or whether the pressure of government borrowing forces the private sector out of the domestic market to seek foreign financing.

So it is quite wrong to suggest that the main difficulty in the present situation is the extent to which government debt is held abroad, and that there would be no economic cost to the buildup of public sector debt if "we owed it to ourselves." Alternatively put, it is wrong to cling to the notion that there is somewhere in Canada a pool of savings sitting around waiting to be used up in place of foreign borrowing if government debt or private borrowing abroad was switched back to Canada.

It is equally incorrect to single out our overall external indebtedness (public and private) as the main problem we face. Canada has traditionally tapped foreign savings, that is, run a deficit in the current account of its balance of payments. This has largely been attributable to our strong investment needs, given the capital-intensive structure of our economy, and to the investment returns available. At the same time, it must be recognized that the external debt, like all debts, must be serviced, and that it cannot increase indefinitely in proportion to our exports or our national income — measures of our underlying capacity to pay. And it is the case that the widening in our external deficit in recent years has largely reflected the increased dissaving in the public sector. Therefore, there is good reason to believe that as we improve our domestic public sector deficit situation, this improvement will show up on the external side as well. In that sense, the external debt question is only part of a broader public debt picture.

Let me now turn to the question of public debt more generally.

The broadest question that can be asked is whether the accumulation of public debt is sustainable. In other words, is our public debt on a path that can be maintained indefinitely?

What I said earlier about external debt applies also to public sector debt. It cannot grow indefinitely as a share of national income. While, as on the external side, there is no single point or absolute ceiling involved here, the pace of accumulation of debt must, eventually, at least fall to a rate that is in line with the rate of growth of the economy. And in light of the concerns to which our debt accumulation has already, manifestly, given rise, it is preferable for the growth of debt to slow to a pace below that of national income.

Let me pursue briefly what sustainability involves.

The public sector deficit and the attendant accumulation of debt can be broken down into three broad components: the pace of revenue growth, program spending (i.e., expenditures other than interest costs) and interest costs. If revenues just matched expenditures other than interest, debt would grow at a rate equal to the average rate of interest. If national income grew more slowly than that, debt would continue to grow as a ratio of income. Such a situation would be unsustainable.

To prevent debt from continuing to rise faster than national income in this situation, governments need to generate a surplus in their operations, that is, in the difference between revenues and expenditures other than interest. The size of the needed surplus increases with the level of debt. The higher the level at which the public sector eventually stabilizes the ratio of debt to national income, the greater needs to be the operating surplus as a share of government spending, and the greater will be the level of taxation that is required for any given program of government outlays.

I should add, for the sake of completeness, that printing money to fill any gap between expenditure and taxes is not a way out. An attempt to tax through inflation would ruin confidence in money and damage economic growth. In other words, this also, for other reasons, is not a policy that is sustainable.

Thus, the policy challenge facing public finances, and therefore the economy as a whole, is not how to sustain the rates of debt accumulation that we have been experiencing, but how to lower them.

In the rest of these opening remarks I will comment on the three budget components I mentioned above — revenues, program expenditures and interest costs — and on the issues they raise for lowering the rate of public debt accumulation. I will pay particular attention to where these issues relate to monetary policy.

Government expenditure has, rightly, attracted a lot of attention. This reflects the fact that outlays have been rising for many years as a share of national income. The strong upward trend in program spending, that is, spending excluding outlays on debt interest, is very evident in the attached charts illustrating public sector fiscal trends. The basic question is whether program spending should or can continue to rise in this manner. In this regard, it should be borne in mind that to lower the rate of debt accumulation at the same time as expenditure is rising as a share of income implies an even more rapid increase in taxes as a share of income. The risk is that rising tax rates will have, or already may have had, adverse implications for incentives and investment. Furthermore, increases in tax rates do not necessarily result in increased revenues.

The share of our economy to be taken up by activities accruing to, or provided by, government as opposed to those supplied in the private sector, and the level of taxation that implies, involve difficult long-run choices. At the same time, these allocative issues, while extremely important, are not really related to monetary policy.

In the short run, measures to adjust taxes and spending programs to deal with the problems of deficits and debt accumulation can have an impact on economic conditions. As well, because government revenues and some program expenditures are in turn sensitive to economic conditions, there is sometimes a concern that actions to reduce deficits may be largely self-defeating.

It is via this interaction of fiscal policy with economic conditions that there is an indirect link to monetary policy. There is an overlap between the effects of fiscal actions and monetary policy actions on economic conditions. As I indicated in the Bank's Annual Report for 1988, "both kinds of policies are, broadly speaking, demand policies. In other words, they are policies that operate mainly by affecting the pace of total spending in the economy. However, the channels through which each policy affects spending are quite different. In the case of monetary policy, the impact, though powerful, is relatively indirect... monetary policy effects are channelled through money and foreign exchange markets. The resulting changes in interest rates and the exchange rate in turn affect spending decisions. For fiscal policy, the effects on demand come largely through changes in taxes or government outlays of various kinds. They tend, therefore, to be more direct in nature.

"In the light of this, it can quite readily be seen that in a broad and very general sense, scope exists for some counterbalancing between the impacts of fiscal and monetary policy on total demand in the economy."

I will also underline here that the scope for such counterbalancing is only available within the framework of a monetary policy that continues to be directed at maintaining confidence in money by ensuring that money's purchasing value is itself maintained. To pursue an inflationary monetary policy would be self-defeating because it would damage our prospects for sustained economic growth by damaging confidence in money. It would, by the same token, put upward pressure on interest rates through the erosion of confidence in the future value of money. In that way also, it would be self-defeating.

That being said, the prospects for better sustained economic expansion in Canada, with the favourable effects on revenue performance that this implies, appear in fact to be a good deal brighter than they have been for quite a while. A number of factors are involved, but the great improvement in our inflation situation and, I believe, in expectations concerning inflation, is one element providing a basis for gains in economic activity that can be well sustained. This is the element to which monetary policy is uniquely able to contribute.

Now let me turn to debt servicing costs and the argument that there is scope for deficit reduction through lowering interest rates.

In many people's minds monetary policy and interest rates are one and the same thing. In other words, in their minds the Bank of Canada directly decides on the level of interest rates in the economy.

This is not correct. What is closer to the truth, but still not the complete story, is that monetary policy, through its management of underlying Canadian dollar liquidity in the system, can, within limits defined by evolving saver and investor confidence, have some liquidity effect on the level of short-term interest rates. What is more fundamental still is that, to the extent that monetary policy can generate increasing confidence among savers and investors in the future value of money, it can also contribute to low interest rates across the whole maturity spectrum. That is to say, liquidity is the tool, but monetary confidence is the bottom line for low interest rates, insofar as Canadian monetary policy can deliver them.

The actions taken by the Bank in helping to bring down inflation, and thereby gradually to bring down expectations regarding inflation, have certainly helped in improving the interest rate climate. This has also begun to help fiscal interest costs. In other words, for any given level of debt, interest charges will be lower in a low interest rate, price stable, environment than they would in an inflationary situation. The responsibilities of monetary policy are of course broader and deeper than any impact it might have on debt service at a point in time. But this favourable impact is nevertheless to be welcomed.

While monetary policy has an influence on interest rates in the way I have described above, there are other forces as well. Among those other influences, one that is important in its own terms, and very appropriate to highlight in this context, is the quality of the fiscal performance itself — both at the federal and the provincial level.

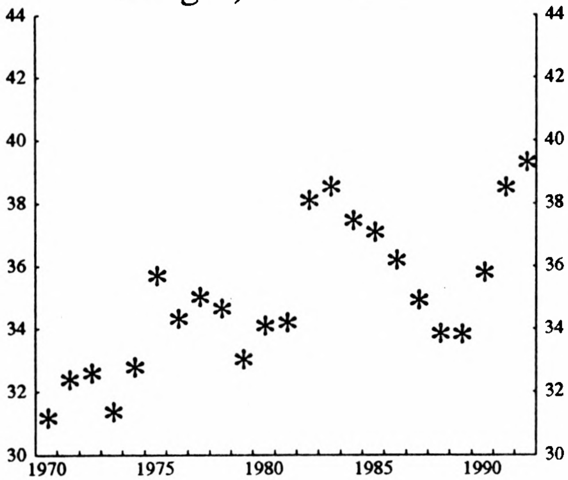
There is no doubt that interest rates, particularly medium- to long-term, are importantly affected by budgetary performance. In general, with the relatively large fiscal deficits we have had in so many countries around the world, the resulting global pressure on available savings felt in world capital markets has put upward pressure on interest rates worldwide. Canada must manage its affairs in those markets, but cannot influence greatly the broad outcome.

However, there is another influence on Canadian interest rates related to the attitudes of savers and investors to Canadian debt in particular. Public sector deficits and debt are special kinds of deficits and debt, with broad effects on confidence in financial markets. The more determination Canada displays in tackling its deficit/debt challenges, the better are the chances of improving that confidence and lowering Canadian interest rate premia — not only those paid by the public sector but also those charged to the private sector as well.

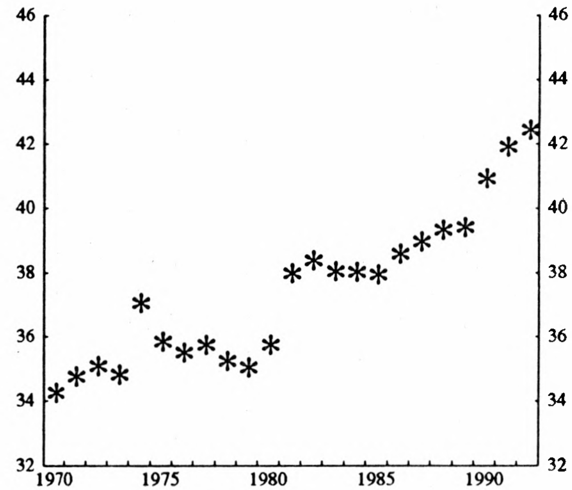
I would now be pleased to answer your questions.

GOVERNMENT FISCAL ACTIVITY IN RELATION TO THE CANADIAN ECONOMY

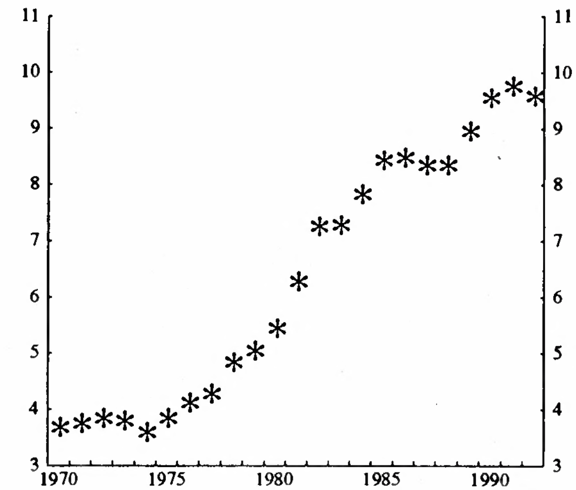
Spending (excluding debt service charges) as % of GDP



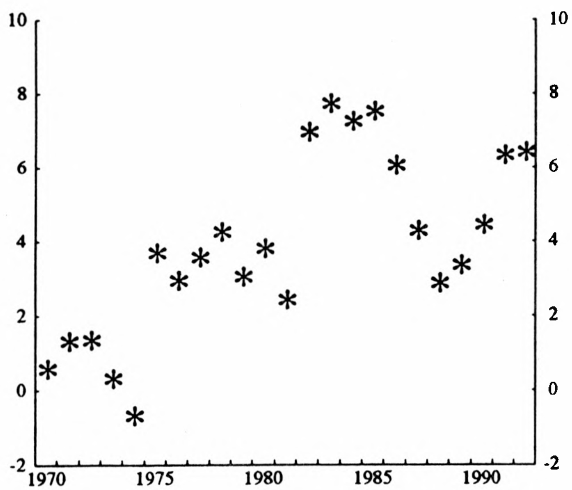
Revenues as % of GDP



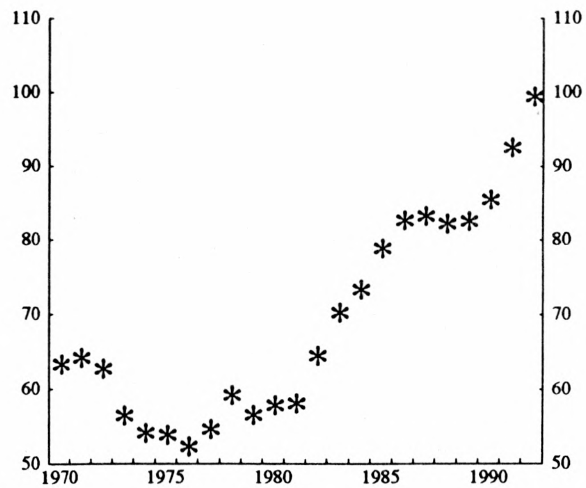
Debt Service Charges as % of GDP



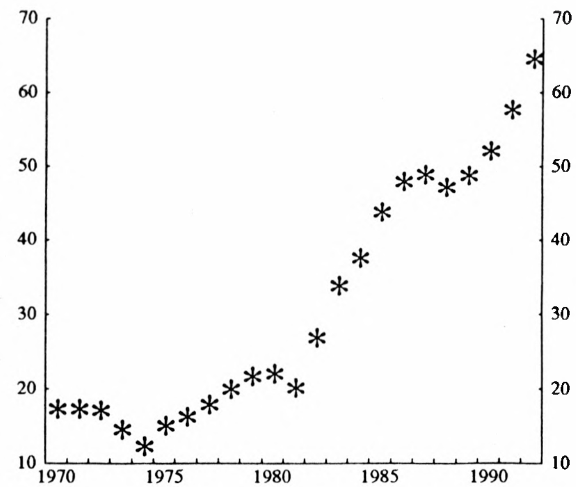
Deficit as % of GDP



Gross Debt as % of GDP



Net Debt as % of GDP



Includes federal, provincial and local governments and hospitals.
Source: National Accounts, Statistics Canada