Fighting debt with more debt

Todd Mattina, PhD
Senior Vice President, Chief Economist, Portfolio Manager, Team Co-Lead
Mackenzie Multi-Asset Strategies Team

Jules Boudreau, MA
Economist
Mackenzie Multi-Asset Strategies Team

Highlights

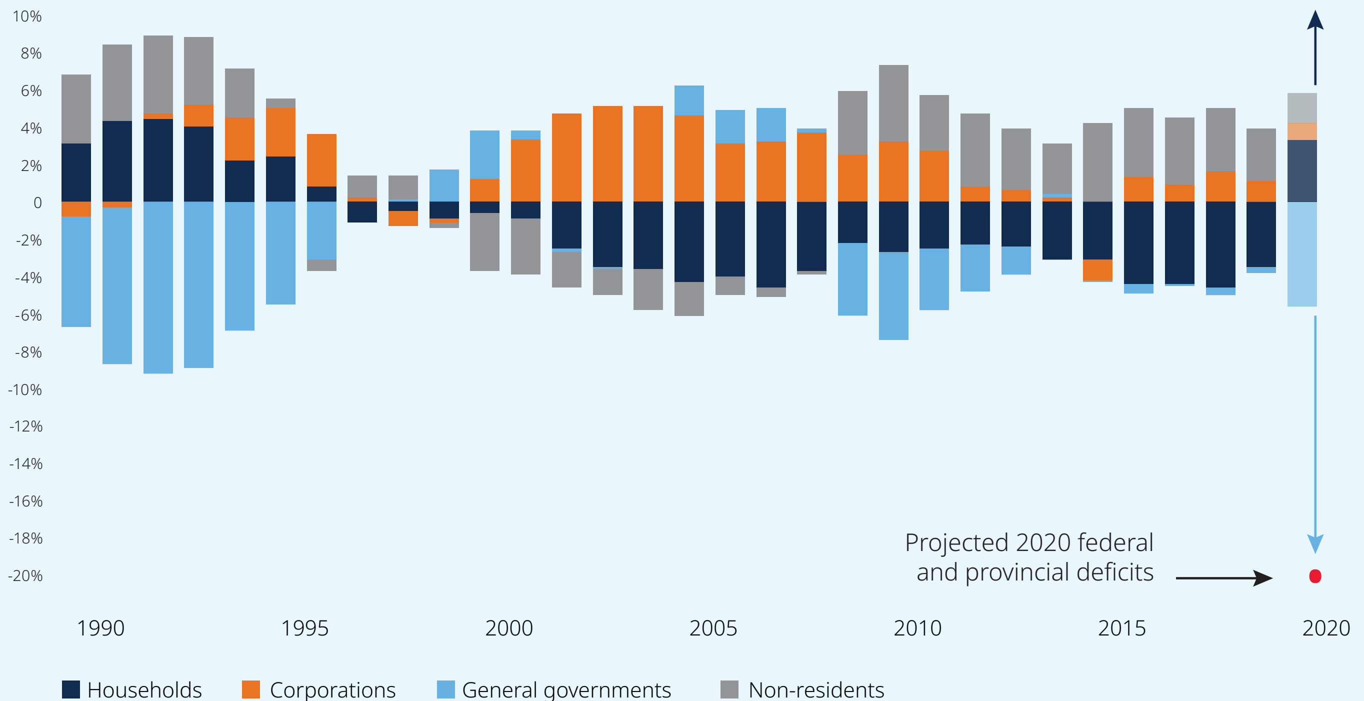
- Unprecedented government budget deficits remain essential to underpin the fragile economic recovery from the pandemic and support analyst expectations of a rebound to the pre-pandemic levels of GDP and corporate earnings by end-2021.
- We do not expect continuing high budget deficits in the near-term to put pressure on inflation or interest rates because of strong disinflationary pressures and a surge in private savings.
- Providing near-term fiscal support for the recovery should remain the top priority. However, now is the time – while financial conditions are favorable – for governments to design "growth-friendly" fiscal adjustments that reduce budget deficits after the pandemic and control public debt growth.

Global public debt ballooned this year, helping to shelter consumers and businesses from the harshest economic downturn since the Great Depression. The current recession is unique in both the depth of the initial downturn and the speed with which many economies have begun to recover. Fiscal policy has played a key role in the rebound by supporting household consumption and preventing even greater joblessness and business bankruptcies. However, the surge in deficit-financed spending has raised some investors' concerns about both long-term fiscal solvency and short-term macroeconomic stability. Despite these concerns, we believe that high budget deficits will be needed for several years to support a recovery to the pre-pandemic trend.

In addition to stabilizing economic activity in the current recession, active government spending supports long-term debt sustainability by contributing to the economic recovery. The COVID crisis has resulted in high unemployment and subdued economic activity in many sectors, creating a recessionary and disinflationary environment. Households have also sharply cut spending and boosted savings rates, adding to weak domestic demand. We expect high household saving to persist, helping to finance relatively high government budget deficits **(Figure 1)**.

Without fiscal support to lift aggregate demand and support confidence, developed economies run the risk of becoming trapped in a low-growth/low-inflation loop. Sluggish growth diminishes a government's long-term ability to service debt, while disinflationary pressures raise the real value of the public debt burden. In other words, governments need to continue fighting debt with more debt.

Figure 1. | Canada: Sources and allocation of savings, 1990 Q1 – 2020 Q2
(financial balances by economic sector as a % of GDP)



Notes: Annual Canadian flow of funds as a % of GDP by sector, including households, corporations, general government and foreign sector. An accounting identity implies that the sum of sectoral surpluses (i.e., lending) must equal the sum of deficits (i.e., borrowing). Data are from Statistics Canada. The bars for 2020 are for 2020 Q1 and 2020 Q2. The red dot indicates the projected 2020 Canadian public deficit (federal and provincial). Calculations by Mattina and Boudreau.

Deficit-financed fiscal measures have provided unprecedented emergency income to households and businesses in 2020. In Canada and the US, federal government budget deficits are expected to exceed 17% of GDP based on existing policies. The scale of federal budget deficits in 2020 compares to about 4.7% of GDP in the US and under 1% of GDP in Canada last year. Part of the increase in budget deficits reflects a large decline in tax revenues because of the severe economic downturn. Discretionary spending and income transfers, totalling around 9% and 14% of GDP in 2020 for Canada and the US, respectively, have also added to government borrowing **(Table 1)**.[1] Combined with lower GDP this year and additional spending by provinces and states, total government debt-to-GDP ratios are expected to reach record peacetime levels **(Figure 2)**.

Current economic activity in Canada and the US suggests continuing fiscal support is needed. Figure 3 illustrates the estimated gap between the current and potential level of output in Canada and the US. Despite the unprecedented fiscal support already implemented in 2020, several headwinds continue to restrain the recovery, including uncertainty about a secondary wave of the virus and the US election in November. These factors could delay business investment and hiring decisions and slow the recovery. Additional fiscal stimulus does not seem likely to cause inflationary pressures given the disinflationary pressures of the large output gap. Market-based pricing also suggests that investors expect inflation in the next decade to average around 2%.

[1]For Canada, the measures and costs are for 2020 fiscal year (March 2020-March 2021). Note that federal spending as a proportion of total government spending is lower in Canada.

MACKENZIE
Investments

Table 1. | Canada and United States: Key fiscal measures in 2020 (federal government level)

	Fiscal measure (estimated fiscal cost in % of GDP)	Description of measure
Canada	Canadian Emergency Response Benefit (3.2%)	$500/week to every adult unemployed because of COVID
	Canada Emergency Wage Subsidy (2.7%)	Subsidy for 75% of wages paid for employers with reduced revenues
	Emergency Transfer to Provinces (0.6%)	No-strings-attached transfer to provinces to cover emergency COVID spending
	Canada Emergency Student Benefit (0.3%)	$1,250 per month for eligible students from May to August 2020
	Enhanced GST Credit (0.3%)	Doubling the maximum GST credit claimable by tax filers
United States	Small Business Loans and Paycheck Protection Program (PPP) (5.4%)	Suite of conditional and unconditional small business loans from the CARES Act and the PPP.
	Increased UI Benefits (1.5%)	Increasing UI benefits by $600/week, plus other ad-hoc emergency programs.
	One-Time Tax Rebates (1.4%)	Emergency tax rebates of $1,200/adult and $500/child.

Notes: For Canada, costs are for 2020 Fiscal Year (March 2020-March 2021). For United States, costs are for 2020 Calendar Year. Calculations are based on data from Government of Canada, Parliamentary Budget Office, Statistics Canada, Congressional Budget Office and Committee for a Responsible Federal Budget.

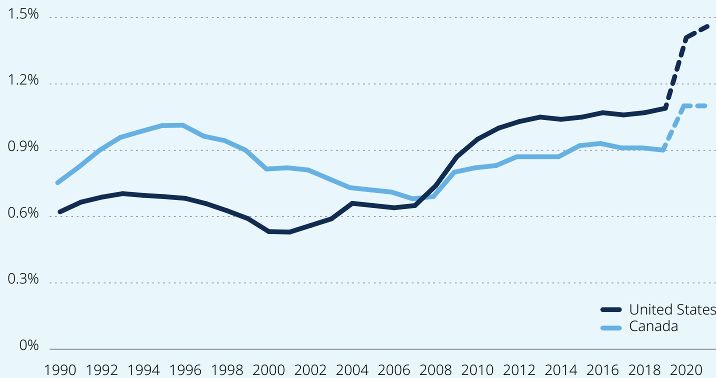
In this context, further fiscal support in this cycle could be important to underpin the fragile economic recovery. Based on forecasting surveys, analysts still expect real GDP and corporate earnings for companies listed on the S&P 500 and TSX indexes to recover to pre-pandemic levels by end-2021. A prolonged period of higher governments deficits supporting the recovery could play a key part in achieving the expected recovery. For this reason, we are monitoring developments in Canada and the US for indications on the future path of fiscal policies.

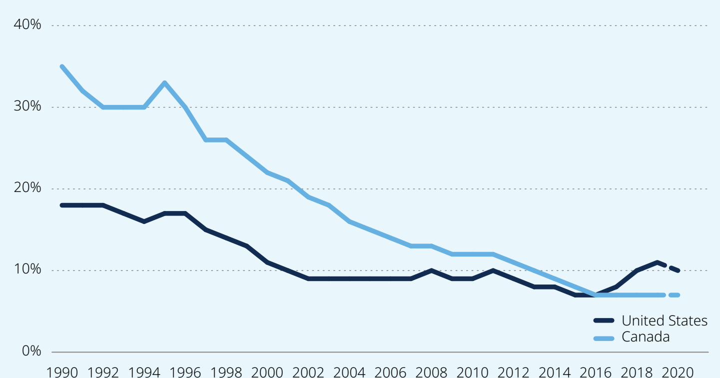
- **Canada:** The scale of the government's planned deficit-funded spending in 2020 and 2021, which is expected to be clarified in the Fall, will be important to assess both the scale of near-term economic stimulus and the credibility of adjustment plans to ensure long-term debt sustainability. In the Throne Speech on September 23, the government committed to providing the same level of fiscal support through the first half of 2021, including the income transfer provided under the current CERB.[2] However, while the government highlighted long-term fiscal sustainability, it has not yet outlined a credible long-term adjustment plan.

[2] See previous Macro Insight 'Not a time for fiscal austerity'.

MACKENZIE
Investments

Figure 2. | Public debts balloon while 'lower for longer' interest rates keep debt service costs subdued





Notes: General government debt data comes from the IMF World Economic Outlook. Debt-service data is for the federal government debt only and comes from Statistics Canada (Canada) and the Congressional Budget Office (United States).

- **United States:** Congress and the White House failed over the summer to extend the CARES Act as part of a fourth round of stimulus measures providing income support. Political gridlock ahead of the November election threatens to slow the recovery by contributing to greater uncertainty at a time when new cases of the virus have accelerated. The expiration of the Paycheck Protection Program in August could weigh on employment, disposable income and consumer spending until an extension of the CARES Act is approved by Congress. However, the extension may only be possibly after the November election.

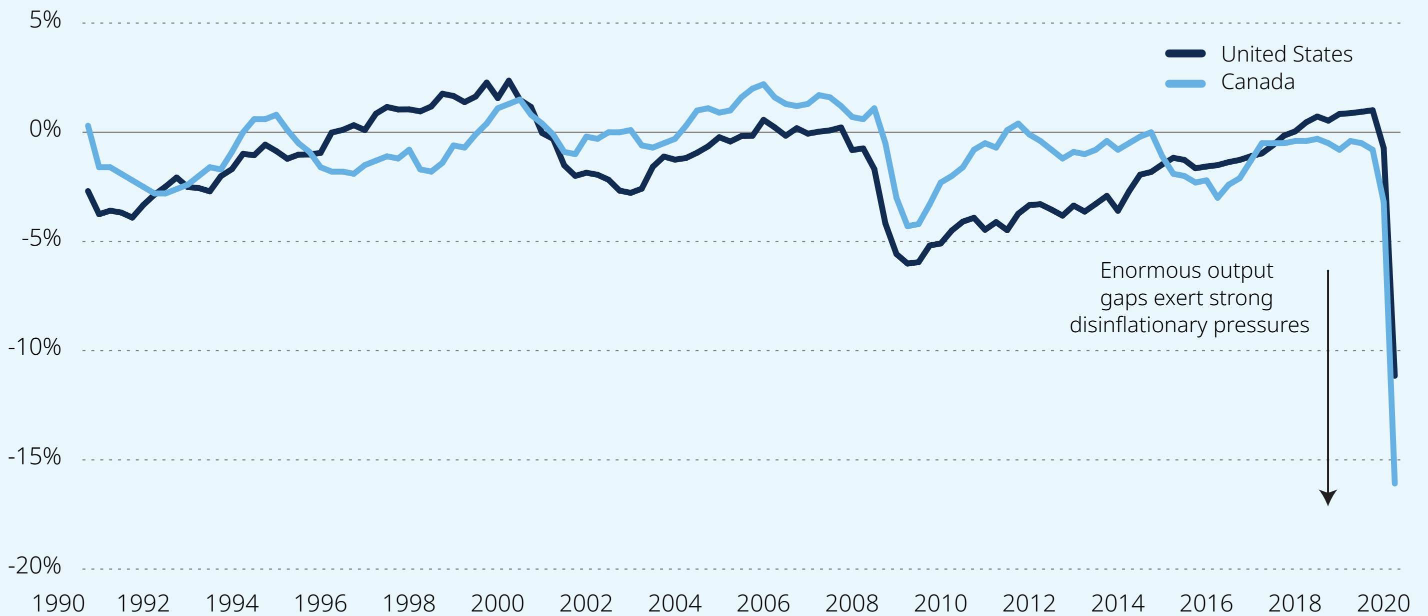
After the storm

While larger budget deficits are currently needed to support the recovery, an unsustainable path in public debt could jeopardize market confidence and macro stability in the longer term. In Canada, financial market pressures in 1995, triggered by concerns about unsustainably high debt-service charges, led to a sharp fiscal adjustment to reduce general government debt **(Figure 2)**. Important long-term reforms were also implemented, such as funding the Canada Pension Plan to ensure its long-term financial viability. These efforts were well rewarded in later years. With one of the strongest fiscal positions in the G-7 advanced economies, Canada was positioned well to weather the 2008 Global Financial Crisis and the 2020 Great Lockdown. Rebuilding Canada's fiscal space after the pandemic will be important so that public sector balance sheets can weather future downturns.

High government debt levels and unsustainable debt growth can jeopardize long-term macroeconomic and financial stability. High budget deficits and debt ratios can be associated with lower long-term economic growth, particularly if high budget deficits finance unproductive spending. Other risks include weakening investor confidence in long-term debt sustainability, and greater inflationary pressures once the economy recovers that can lead to higher interest rates and a weaker currency. Importantly, weak public sector balance sheets could prevent governments from satisfying age-related spending pressures for healthcare and other programs.

MACKENZIE
Investments

Figure 3. | Canada and the United States: Estimates of the output gap, 1990 Q1 – 2020 Q2
(gap between current and potential national output in % of potential GDP)



Notes: Output gap data from the United States comes from the Congressional Budget Office (CBO). Output gap data 1990 Q1 – 2020 Q1 from Canada comes from the Bank of Canada, extended to 2020 Q2 by calculations made by Mattina and Boudreau.

To reduce these risks, governments should start thinking now about credible plans for "growth-friendly" fiscal adjustments after the pandemic to rebuild their fiscal buffers. Long-term public debt sustainability requires a credible multi-year framework to reduce high budget deficits. We believe the ideal fiscal adjustment should be growth friendly by protecting productive infrastructure investments, avoiding poorly targeted across-the-board expenditure cuts to focus on the least productive areas of spending, such as subsidies, and closing tax loopholes. Fiscal adjustment should also be implemented in tandem with deregulation to boost private investment. The composition of fiscal adjustment after the pandemic should also differ in each country. In the US, entitlement reforms are important to control long-term spending growth. In Canada, controlling growth in healthcare spending will be important. Avoiding the temptation to cut public investment will also be important to engineer a growth-friendly fiscal adjustment.

MACKENZIE
Investments

Financial market implications

With monetary policy tools looking tapped out, the future path of government budget deficits, debt and post-pandemic fiscal adjustments could be key factors influencing financial markets. In the near term, we believe that governments need to maintain aggressive fiscal support to avoid a disinflationary and low-growth loop that would be bearish for growth-sensitive asset classes, such as stock markets, corporate credit and the Canadian dollar. We believe that governments in Canada, the US and other major economies will ultimately deliver, although it could be delayed owing to political deadlock.

After the pandemic is finally behind us, governments will need to design credible multi-year adjustment plans to reassure investors of their long-term solvency. The key question is whether governments will wait for market pressure on currencies and sovereign rates before acting, as Canada experienced in 1995, or if they will develop credible long-term fiscal anchors while financial conditions remain highly favorable today.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

This document may contain forward-looking information which reflect our or third party current expectations or forecasts of future events. Forward-looking information is inherently subject to, among other things, risks, uncertainties and assumptions that could cause actual results to differ materially from those expressed herein. These risks, uncertainties and assumptions include, without limitation, general economic, political and market factors, interest and foreign exchange rates, the volatility of equity and capital markets, business competition, technological change, changes in government regulations, changes in tax laws, unexpected judicial or regulatory proceedings and catastrophic events. Please consider these and other factors carefully and not place undue reliance on forward-looking information. The forward-looking information contained herein is current only as of September 29, 2020. There should be no expectation that such information will in all circumstances be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise.

The content of this document (including facts, views, opinions, recommendations, descriptions of or references to, products or securities) is not to be used or construed as investment advice, as an offer to sell or the solicitation of an offer to buy, or an endorsement, recommendation or sponsorship of any entity or security cited. Although we endeavour to ensure its accuracy and completeness, we assume no responsibility for any reliance upon it.

1193682 10/20