ECONOMIC VIEWPOINT

Despite the increase in public investment, monetary policy can still be solicited in Canada

Last year, the shift from a rather restrictive to an expansionary fiscal policy in Canada has been acclaimed, both domestically and internationally. The federal government will soon table its budget for the fiscal year 2017–2018, and the tangible effects from the measures announced in 2016 are slow to emerge, particularly with respect to infrastructure. At the same time, there is a shift in the Bank of Canada's (BoC) rhetoric on the importance of fiscal policy. In particular, it refuted the idea that fiscal policy had taken over from monetary policy. This *Economic Viewpoint* provides a portrait of this situation. Our observation is that while it is true that the budget announcements allowed the BoC to be patient in 2016, it does not imply that it has been confined to a spectator role.

A year ago, one of the dominant themes in Canada was the government stimulus program, which was supposed to support the economy through productivity-enhancing investments, helping to compensate for the slump in the energy sector.

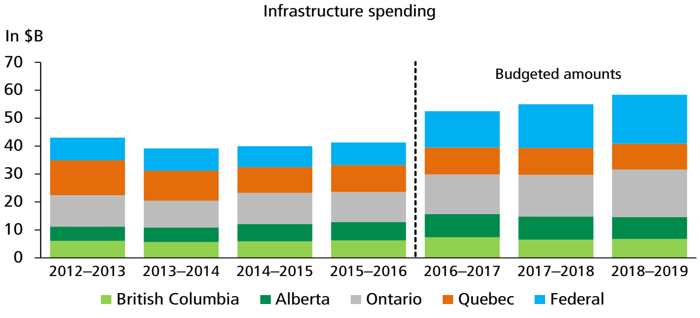
Not only did the new federal government promise to double planned infrastructure investments, but the provinces also moved forward with ambitious plans. The four largest provinces, which account for 87% of Canada's GDP, along with the federal government, had budgeted a combined 27% increase in infrastructure spending for the current fiscal year, unquestionably the most significant stimulus effort since the financial crisis (graph 1).

Not the sense of urgency of 2009

Canadian national accounts for the full year 2016 will be released at the end of the month but we estimate that real public investment grew by only 1.1% in 2016 (graph 2). In its fall update, the federal government upgraded its infrastructure plan further, but noted that most of the additional effect would only begin to be felt two years from now. This underscores the great difficulty of rapidly implementing infrastructure-based stimulus packages.

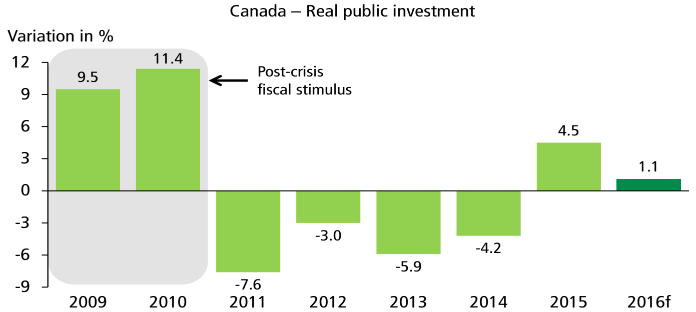
During the 2008–2009 crisis, the sense of urgency was very high. The financial market debacle had forced central banks to intervene rapidly and in a concerted manner. Fiscal authorities around the world followed suit, and priority was given to

GRAPH 1
Governments have raised the bar high for infrastructure



Sources: Government budgets and Desjardins, Economic Studies

GRAPH 2
A rather disappointing year for public investment in 2016



f: forecasts
Sources: Statistics Canada and Desjardins, Economic Studies

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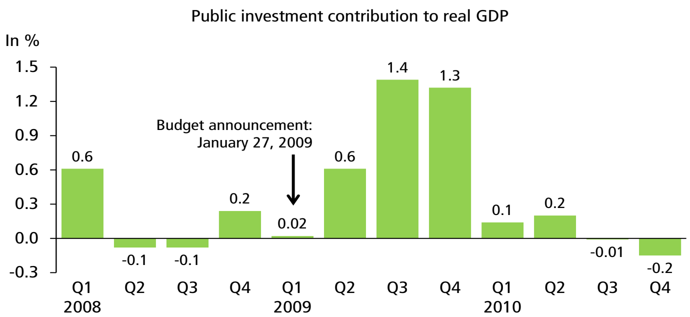
NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

infrastructure projects for which several preliminary steps had already been completed, and that could thus get rolled out quickly. In Canada, it took only two quarters for public spending to have a noticeable impact on economic growth (graph 3).

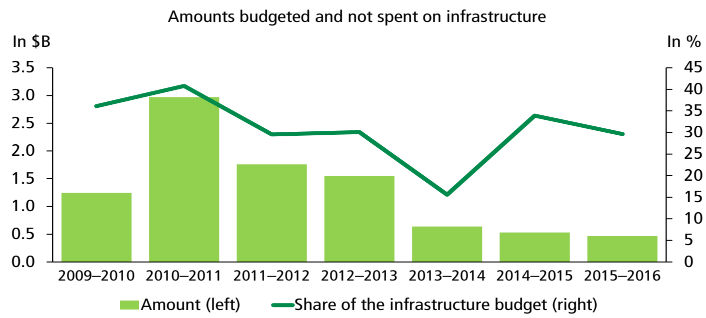
GRAPH 3
In 2009, the maximum impact was felt after two quarters



Sources: Statistics Canada and Desjardins, Economic Studies

that is not spent: it tends to increase in tandem with budgeted amounts. For instance, in fiscal year 2010-2011, still in the middle of the stimulus effort, 41% of the capital budget had not been disbursed (graph 4).

GRAPH 4
In some years, considerable shares of infrastructure budgets are not spent



Sources: Parliamentary Budget Officer and Desjardins, Economic Studies

The current situation is very different as it is not a crisis context. There is thus less of an urgency to respond. It may also be more difficult (and costly) for governments to mobilize resources for infrastructure projects during an economic expansion. In this regard, Federal Reserve (Fed) Chair Janet Yellen recently suggested that a very aggressive fiscal policy may not be very appropriate in the United States, in a context where the economy is close to full employment. When the available resources are less abundant, the impact is more likely to be felt on inflation, potentially forcing the Fed to tighten its monetary policy, a move that would counteract recovery efforts. At the very least, fiscal stimulus efforts must target measures that promote productivity gains to mitigate this risk.

The Canadian economy is obviously not in the same bright spot as the United States, but neither is it in recession. The resources available in the economy are therefore less abundant than they were in 2009, during the last major stimulus program.

No quick fix

The growth-enhancing effects of infrastructure spending should eventually emerge, but it is still difficult to determine when and at what time the maximum impact will occur. According to the Parliamentary Budget Officer, the factors that delay the deployment of infrastructure projects include, regulation, coordination issues between different levels of government, personnel inadequacies in critical departments and contracting delays with the private sector. The last two obstacles cited are symptomatic of issues pertaining to the availability of resources.

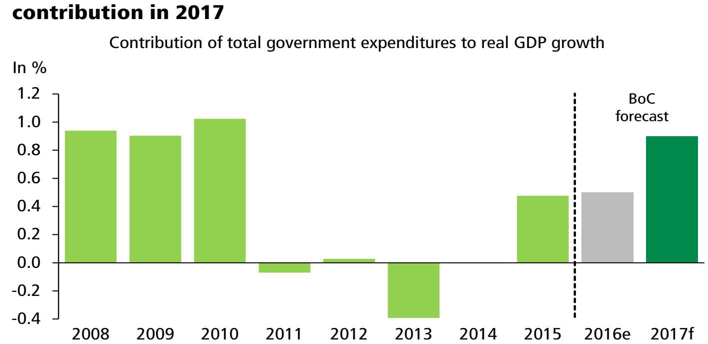
The Parliamentary Budget Officer has indeed noted that these constraints are more binding in times of rapid increases in infrastructure budgets. This is reflected in the portion of budgets

What implications for the BoC?

The experience of last year is testament to fiscal policy's influence on monetary policy. In January 2016, the BoC contradicted several investors who believed it would lower its key interest rates in response to rapidly falling oil prices. The BoC acknowledged that further easing had been considered, but it ultimately leaned towards status quo, invoking the fiscal stimulus announcements that were to be made in the spring.

Since then, and despite some indeed ambitious measures announced by governments, the BoC's speech has changed, and since October, the BoC has been making clear that further easing was possible. This despite the BoC's baseline outlook being based on the assumption of some catch-up in government spending in 2017, after last year's disappointment (graph 5).

GRAPH 5
The Bank of Canada expects more significant government contribution in 2017



e: estimates; f: forecasts; BoC: Bank of Canada
Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies

One therefore surmises that the BoC, under the risk management philosophy dear to Governor Poloz, remains aware of the potentially considerable delays that may still be involved and, by implication, the risk of another disappointment. In October, when a Member of Parliament stated that is was time for the government to take over from monetary policy to support growth, Stephen Poloz objected that the BoC still had a role to play and that it would not hesitate to use every tool at its disposal, as required. In other words, it will not rely exclusively on government actions to ensure that its inflation target is met.

Conclusion

Ramping up public investment is a useful endeavor when an economy recovers from a shock, as is the case in Canada today. Such policy has the merit of stimulating the economy more directly, and generating long-term productivity gains. However, this tool comes at the cost of speed. The hardly perceptible effects of the stimulus package so far, as well as the adjustments the BoC has performed to its rhetoric, suggest that it will not so readily hide behind fiscal stimulus if negative growth risks are to materialize. With the worrying protectionist stance of the new U.S. government, the very serious nature of these risks is hardly equivocal. However, investors seem to be reveling in the idea that the BoC will follow in the footsteps of the Fed in about a year, for a variety of reasons, including supportive fiscal policy. Awareness of the much more uncertain reality in which monetary policy is being conducted could orchestrate sudden moves, particularly in bond yields and the currency. The BoC has recently characterized the trajectories these variables have adopted since the U.S. election as “at odds” with the Canadian economic context.

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