

Economic Growth and what governments do to manage it

Corporate Economics occasionally publishes briefing notes to help interested readers understand the economy. Most of our briefing notes are highly technical and are geared toward an audience that is aware of the current economic state of Calgary, Alberta, Canada and the world.

With the global economy in a state of volatile flux we believe it is appropriate to put aside the daily news about which price is suddenly spiking, take a step back and look at how economic systems work. To this end we present this introductory paper on national level economic theory and practice in Canada. A series of similar introductory papers describing economic theory applied to other markets will follow over the course of the next year, covering such topics as; the economic performance of Calgary, the oil and gas markets and the Calgary real estate market.

Economic Growth

Economic growth is an increase in the overall level of economic activity in a country. Economic activity can include many things such as retail sales, construction, inventory build-ups, manufacturing and international trade. Even government spending on goods and services is included. This paper explains what governments can do to help economic growth happen.

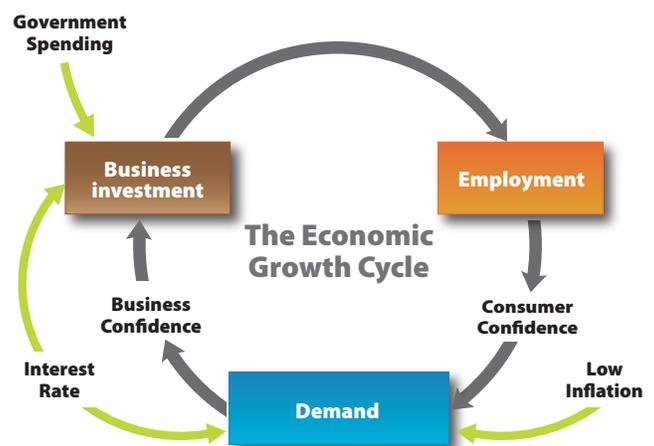
The Growth Cycle

Population growth is a major driving factor to economic growth so immigration and the natural birth rate are important considerations, however, income is the key driver of economic growth. The more income a business or person has, the more they tend to spend and this drives the economic growth cycle.

Usually businesses start the cycle. When they think they will have more income if they expand their operations, they borrow money and buy machines, land and buildings and hire

people. The first sign of economic growth is an increase in business purchases, followed by an increase in job creation.

The availability of financing, low interest rates and confidence that there will be a market for products are underlying forces that help start economic growth. After employees are hired; consumer confidence, low unemployment, high wages, low inflation and low interest rates encourage consumer spending which, in turn, leads to greater business confidence and more investment and the economic growth cycle becomes self-perpetuating.



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Briefing Note

Economic growth can happen too slowly, too quickly, and possibly in the wrong direction. To manage economic growth governments use two tools: government spending (fiscal policy) and interest rates (monetary policy).

Fiscal Policy

Fiscal policy is government spending money to buy goods and services from local suppliers. That spending gives businesses a reason to buy land, buildings and machines, and to hire people. Once the people are hired, they spend money, which creates more new growth in the economy. If governments are careful what goods and services they buy the growth cycle can become self-perpetuating. If they are not careful then the spending can create inflation and no economic growth at all.

One approach governments can employ to help the growth cycle is to invest in innovation. This can get businesses to invest in new products while lowering the cost of those products so that people can afford to buy them. When people buy those products these new industries can become profitable, with spin-off employment and growth for the entire economy.

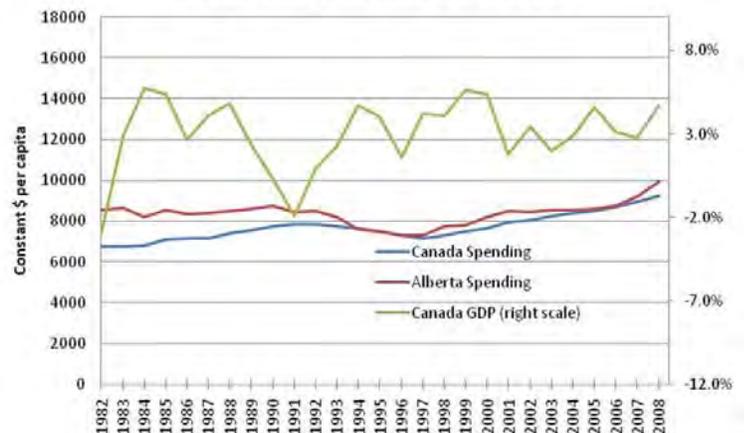
Another approach governments can use is to buy goods and services that could be used by a multitude of businesses and allow access at prices that are much lower than if they had to get those products or services at market prices. Roads and infrastructure are prime examples. The growth process is started when the government commissions a road. Businesses are encouraged to buy the materials and machinery to build the road and create some employment. Spending by the employees creates demand for other businesses. The road that is built facilitates trade that helps both the local and national

economies grow. However, charging a toll for the road is counter-productive limiting the economic benefits to people and business from trade. In fact, if a toll is high enough and in place longer than necessary to pay for construction, it is possible that the local economy would be better off if the road were not built in the first place.

Recent Events in Canadian Fiscal Policy

The chart below shows the spending by the Canadian and Alberta governments on goods, services and construction between 1982 and 2008 as well as the growth in the Canadian Gross Domestic Product during that time. Congruent with the recession of 1991-1992 the federal government increased its spending in an attempt to restore growth in the Canadian economy. When the economy was again showing signs of growth the federal government pulled back on its spending programs. The Alberta government followed a similar pattern and both levels of government did not resume growth in their spending until 1997.

Fiscal Policy and GDP 1982-2008



Briefing Note

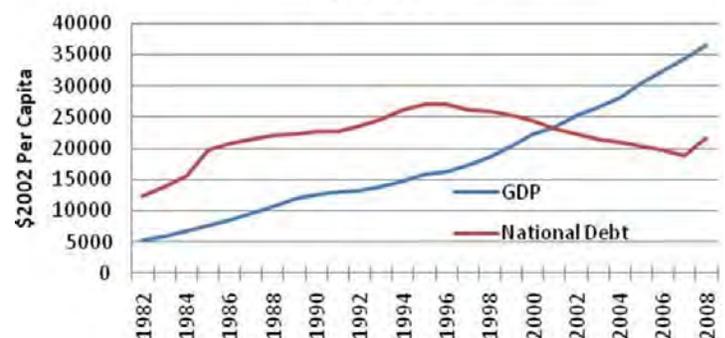
The Downside of Fiscal Policy: Debt

In 1996 the federal deficit was a significant burden on Canadians. At about 65% of GDP the overall amount owing was relatively low by today's international standards. However, interest rates were much higher, resulting in significant debt servicing costs. About 29% of the federal government's operating budget was being consumed to service the national debt¹. As a result, international bond rating agencies downgraded Canada's credit rating which resulted in Canada having to pay even higher interest rates to obtain financing from international markets². In response, the federal government of the day decided to re-define what fiscal policy means in Canada³.

Instead of focusing entirely on the economy, the federal government redefined its fiscal policy to first look to the long range fiscal sustainability of the federal government. Timing was on the side of the federal government as the Canadian economy emerged from the recession of the early 1990s, allowing the federal government to cut some spending while revenues from taxes were increasing. Fiscal restraint imposed by the policy of looking to long range sustainability of government spending meant that surpluses were utilized to pay down some

of the accumulated debt. While other nations found it difficult to constrain spending during this period and enjoyed rapid economic growth, Canada had moderate sustainable growth.

**Canada GDP and Federal Debt
1982-2008**



The recession of 2008 necessitated international fiscal policy responses, when interest rates were lowered to historic minimums with minimal effect. The Canadian federal government began a short term spending initiative targeting specific interests. The auto industry received significant support which aided not only auto manufacturers but a multitude of domestic parts manufacturers and materials suppliers. Education and retraining initiatives also received funding while public works projects that were “shovel ready” and which would increase productivity of Canadian workers when completed received priority grants. The federal government used fiscal policy to support the Canadian economy through the recession while positioning Canada to emerge from the recession poised for growth. The Canadian fiscal policy of the 1990s, that enforced restraint of government spending to what is sustainable in the long term, gave the federal government the ability to invest in Canada in the 2010s.

- 1 <http://www.cbc.ca/money/taxseason/story/2010/02/25/f-federal-budget-interest-rates-debt.html>
- 2 Moody's downgraded Canada on June 2, 1994 from Aaa to Aa1. Moody's restored Canada's credit rating to Aaa on May 3, 2002. Canada's credit is currently rated as stable and not on watch. (source: Moody's)
- 3 For a short detailed history of federal fiscal policy during this period see: Bank of Canada Working Paper 2004-28, Virginie Traclet, Monetary and Fiscal Policies in Canada: Some Interesting Principles for EMU? , available at: <http://www.bankofcanada.ca/fr/res/wp/2004/wp04-28.pdf> pp. 17-20.



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Monetary Policy



Interest Rates

Another method governments can use to help the growth cycle is to employ monetary policy. By making rules and by setting the interest rate, governments can make borrowing money cheaper and easier. This has dual effects: first it lowers the cost of doing business so that businesses can afford to expand their operations. Second, it allows employees the freedom to spend more money. The combined effect is to encourage the growth cycle from both sides at the same time.

The Bank of Canada, unlike the US Federal Reserve, has few mandates. In the US the Federal Reserve is responsible for:

- ▶ Government market transactions,
- ▶ Maintaining the stability of the financial system,
- ▶ Regulating banks,
- ▶ Protecting credit rights of consumers, and
- ▶ Monetary policy which is conducted by influencing

markets to achieve maximum employment, stable prices and moderate interest rates⁴.

These multiple objectives sometimes come in conflict with each other. In contrast, the Bank of Canada concentrates on:

- ▶ Government market transactions,
- ▶ Supplying paper money, and
- ▶ Monetary policy that keeps inflation under control.

In contrast to the US Federal Reserve's multiple monetary policy goals and multitude of other distracting obligations, the Bank of Canada has only one monetary policy goal with only one objective: "to contribute to solid economic performance and rising living standards for Canadians by keeping inflation low, stable, and predictable"⁵.



Bank of Canada original granite building circa 1938, flanked by 1979 expansion. www.bankofcanada.ca/en

To manage inflation, the Bank of Canada adopted a policy of "inflation targeting" in 1991. The Bank selects

4 Board of Governors of the Federal Reserve System, <http://www.federalreserve.gov/aboutthefed/mission.htm>

5 <http://www.bankofcanada.ca/en/about/do.html>

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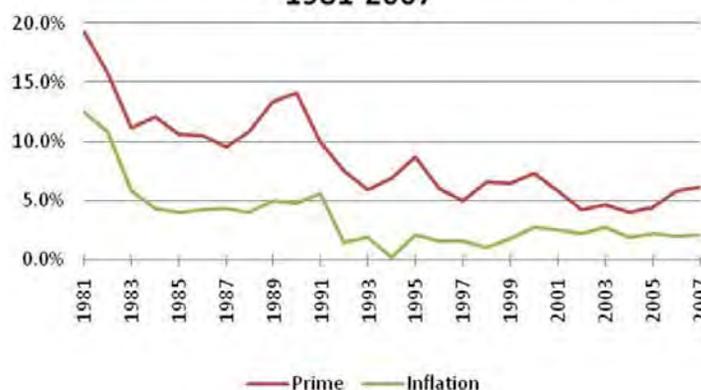
a target for inflation and uses its ability to set the Prime Lending Rate to achieve that target inflation. In 1991 the initial objective was to reduce inflation from 4-5% to 2% by 1995.⁶ Since 1995 the policy has evolved to include a “target range” of 1-3%, but the inflation target has remained at 2% since 1991.

The Bank’s policy of inflation targeting seems to have been a success.

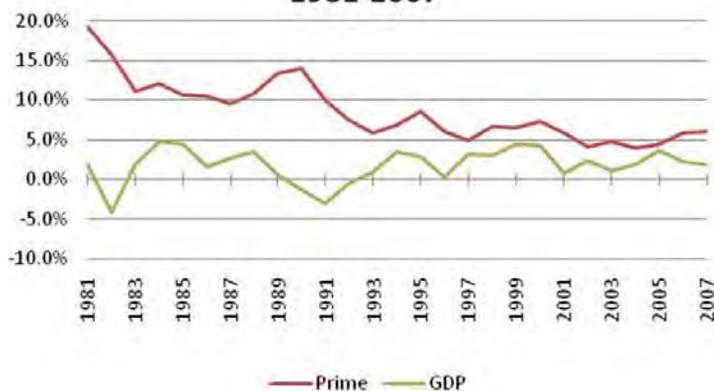
Between 1981 and 1991 real GDP per capita in Canada⁷ grew at an average 1.2% while after 1991 real GDP per capita grew at an average 2.2%. As well, the Canadian economy did not record negative growth between 1992 and 2008, though it did dip into negative growth temporarily during 2009 due to the global economic recession.

Between 1981 and 1991 Canadian inflation averaged 5.9% but after the Bank started inflation targeting inflation has averaged only 1.8% and has not gone above 2.8% in any year.

**Canada Prime Lending Rate and Inflation
1981-2007**



**Canada Prime Lending Rate and GDP
1981-2007**



The Bank’s inflation targeting policy and lower inflation after 1991 is not just coincidence. Between 1981 and 1991 Canadian inflation averaged 1.5% above US inflation but since 1991 Canadian inflation has averaged 0.8% below US inflation. This is even more impressive when one considers that currency exchange rates have fluctuated wildly over this period.

6 Bank of Canada, Renewal of the Inflation-Control Target - Background Information, November 2006, p.3

7 GDP stands for Gross Domestic Product. It measures the economic activity in an economy over a year. Dividing GDP by the population gives a rough indicator of the economic well being of a nations population. In order to make meaningful comparisons across years, inflation must be netted out of the calculation. “Real GDP per capita” is used to measure the change in a populations economic conditions over time.



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Putting it together: Fiscal and Monetary Policy



Fiscal and monetary policy can be used to manage economic growth. However, they interact, limiting the effectiveness of each other.



If a government uses fiscal policy for an extended period then deficits rise. If deficits rise too much then bond markets will demand a higher premium before lending any more money to a government and the cost to carry the debt rises. These increased costs put strain on the government's budget so that it is forced to stop deficit spending. However, governments are not the only ones

affected. When interest rates are forced up businesses face higher costs to make investments while customers face higher financing costs. The end result is that economic growth in every sector of the economy is curtailed.

Pushing fiscal policy too far can result in a multi-year cycle that erases all the economic gains from using fiscal policy in the first place. In a worst case scenario, too much spending can cause the economy to suffer more damage than if fiscal policy had not been used in the first place.



If a government uses monetary policy and keeps interest rates low for an extended period of time then people can become used to cheap access to financing. Economic growth can accelerate, putting upward pressure on prices. In turn this can put upward pressure on wages and soon inflation can accelerate. In this case fiscal policy can become useless. Even if the government stops spending the growth cycle can continue accelerating and spiral out of control. Even worse, monetary policy itself can become ineffective if rising interest rates are seen as merely another source of inflation to be passed on through even higher prices and wages.

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Should a government keep interest rates high for an extended period then people can become used to austerity as a lifestyle and growth can be stymied by a reluctance to spend or invest. In this case fiscal policy can have limited impact as whatever funds are injected into the economy stop circulating shortly after the injection. Even lowering interest rates might have little impact if people or businesses worry that interest rates will rise on money they originally borrowed at low rates. High interest rates for too long can make it very difficult for governments to use their tools to get an economy moving.

Summary

Governments have two economic tools to manage growth with: fiscal policy and monetary policy. They both work in appropriate circumstances for achieving certain goals.

- ▶ Fiscal policy can be used to provide targeted stimulation to an ailing industry. It can also be used to calm overall growth, but only if it is employed before excess demand builds up.
- ▶ Monetary policy can be used to broadly stimulate or restrict economic growth. It works best when used for short periods of a few years and if government deficits are under control.

Who We Are

Over the past ten years Corporate Economics has researched dozens of economic topics and developed reliable methods of forecasting and analysis. Monitoring economic trends allows us to develop unique insights on how external events are impacting the local economy and the Municipal Corporation. We provide services in four areas: forecasting, information provision, consulting and policy analysis.

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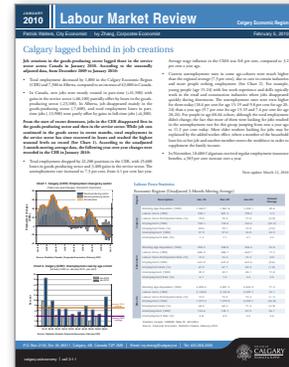
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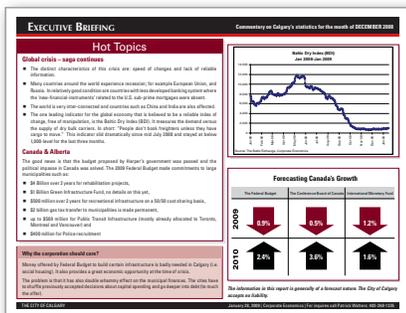
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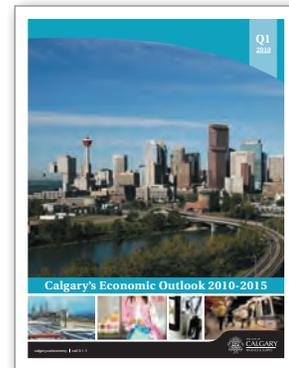
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