Canada's Fiscal Deficits and Debt

Challenge and Response

A Graphical Exposition

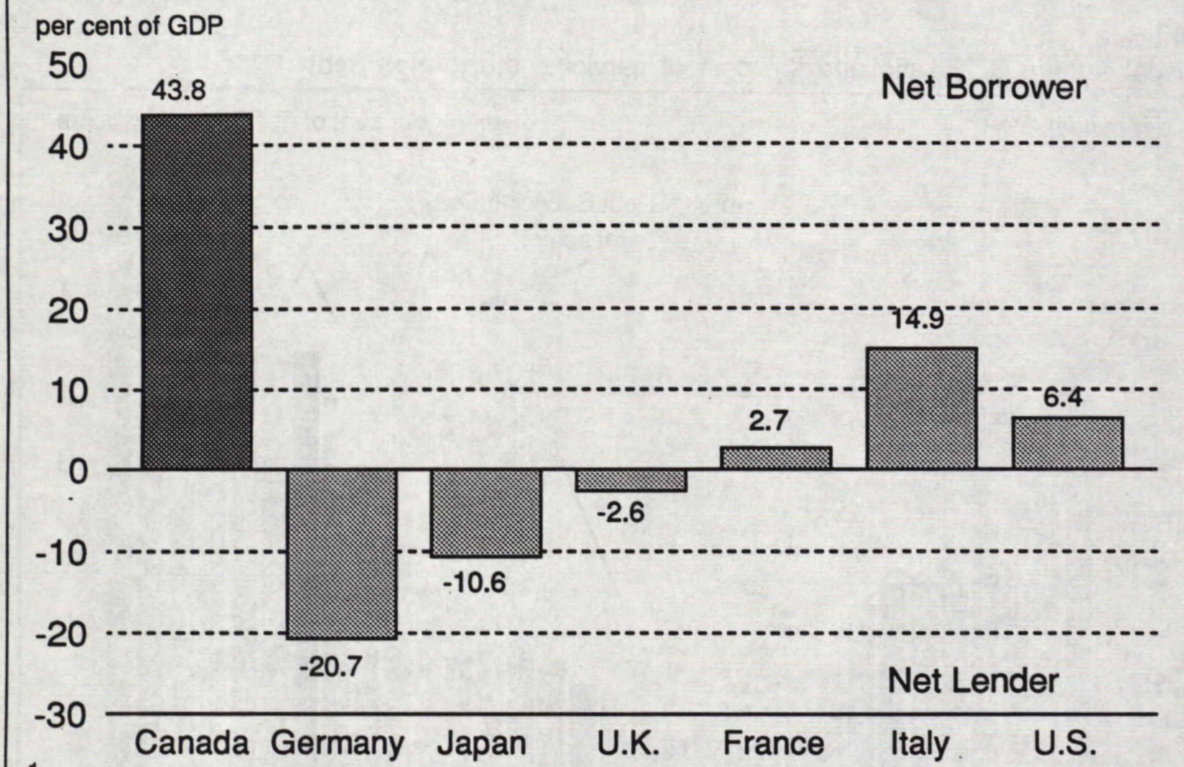
May 1993

Department of Finance
Government of Canada

Canada's Foreign Debt is Worst in the G-7

- Canada has the highest level of foreign debt (both public and private) relative to GDP of all the G-7 countries.

Chart 1
G-7 Countries' net international investment position[1]

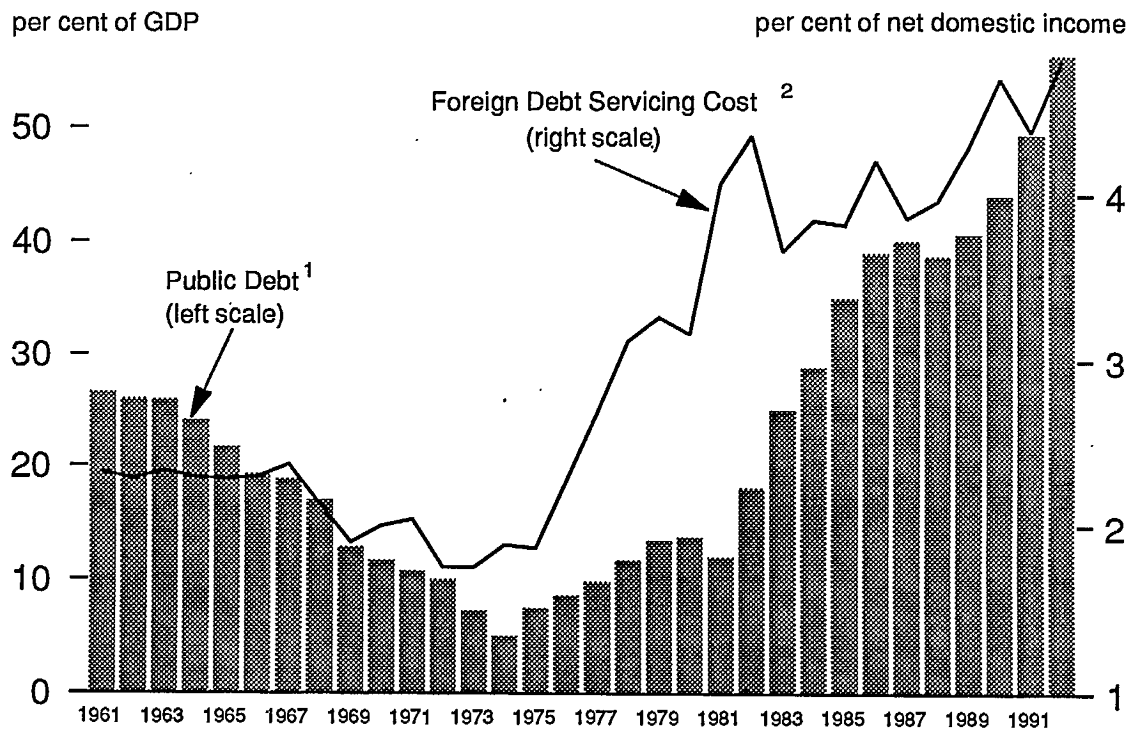


1 1992 for Canada, 1991 the United States, Germany, Italy, United Kingdom and Japan, 1990 for France.

Foreign Debt Service Reduces our National Income

- As a result of rising fiscal and national indebtedness, more and more of Canadian income must go to foreigners to service Canada's foreign debt.
- Were it not for Canada's success at controlling and lowering inflation and, hence, interest rates, the costs of servicing our foreign debt would be even higher.

Chart 2
Fiscal debt-to-GDP ratio and the cost of servicing the foreign debt

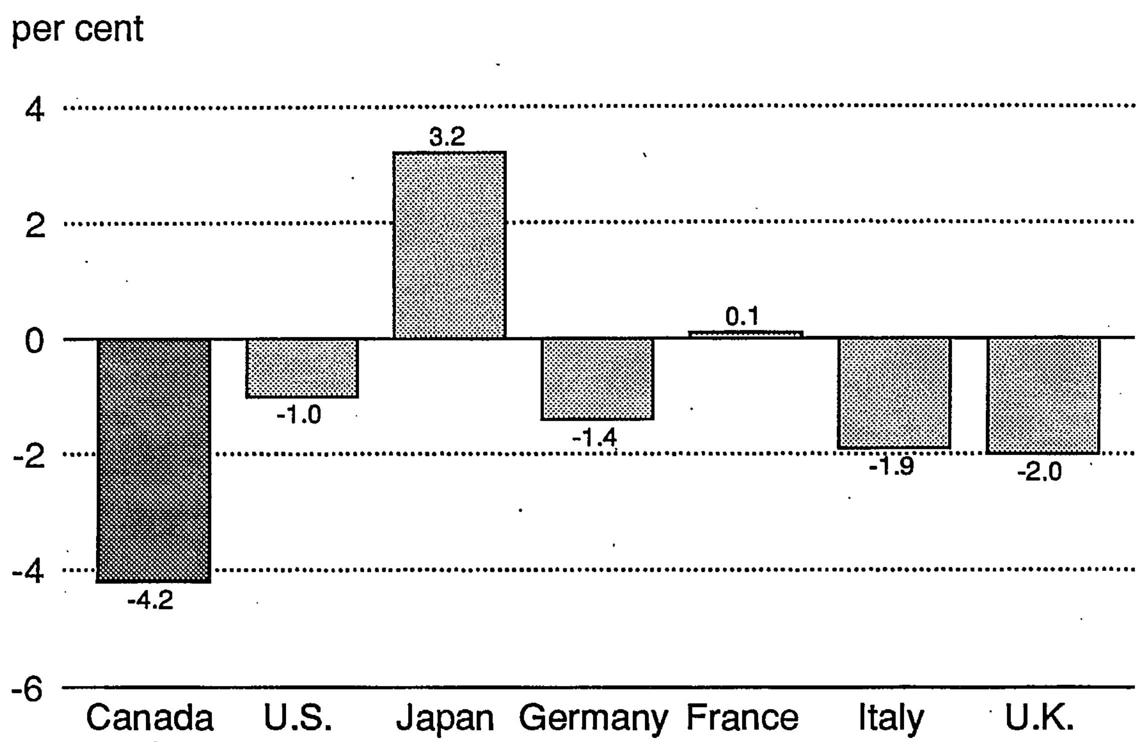


[1] Total government debt on a national accounts basis as a share of GDP
[2] Difference between net domestic and national income as a share of NDI

Canada's Current Account Deficit is Worst in the G-7

- High investment demand coupled with large government deficits has resulted in Canada relying heavily on foreign savings.
- The current account deficit is a measure of how much we rely on foreign savings.
- Canada has the worst current account deficit, relative to GDP, in the G-7.

Chart 3
Current Account Deficits of G-7 Countries - 1992
(Per cent of GDP)

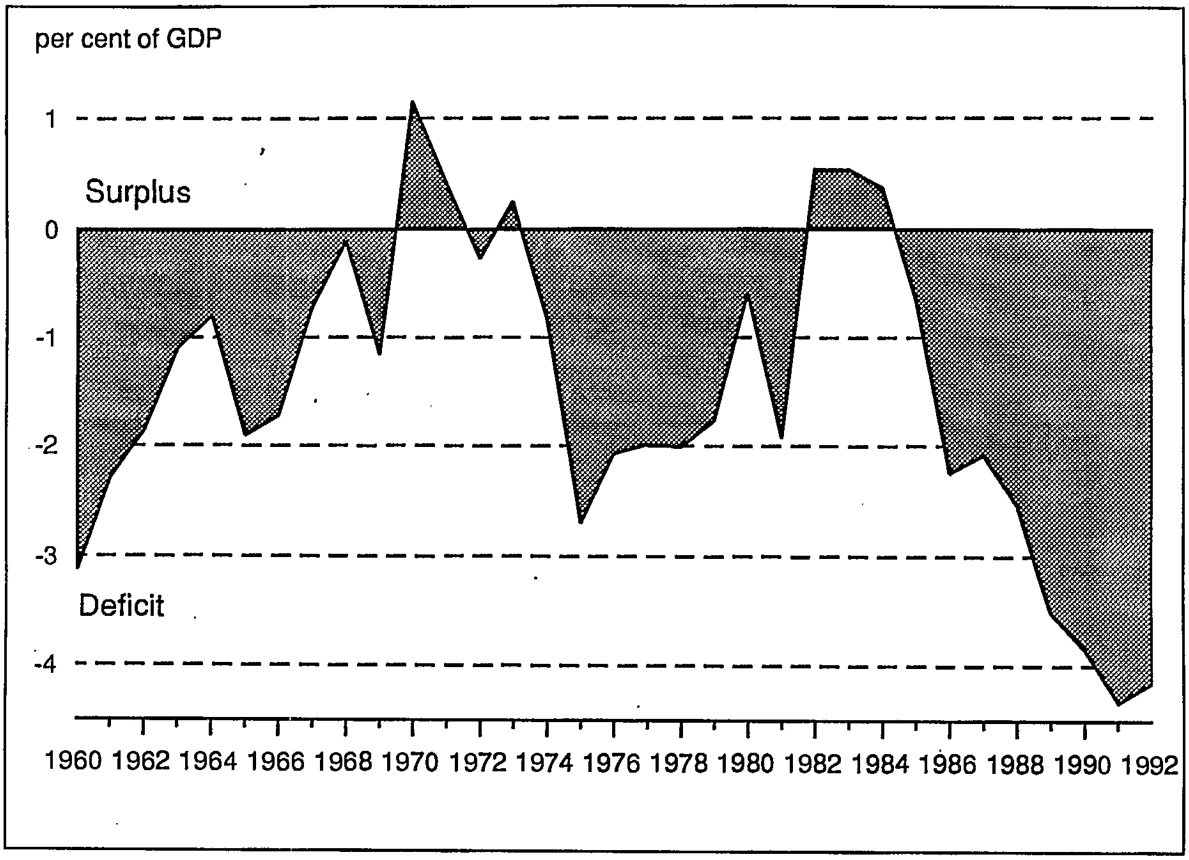


Figures for France and Italy are from OECD Economic Outlook, December 1992.

Canada's Current Account Deficit Has Soared in Recent Years

- Canada typically runs a current account deficit.
- In the early 1980s, however, Canada's current account deficit was much smaller.
- In recent years Canada's current account deficit has soared. This shows we are becoming increasingly dependent on foreign savings.

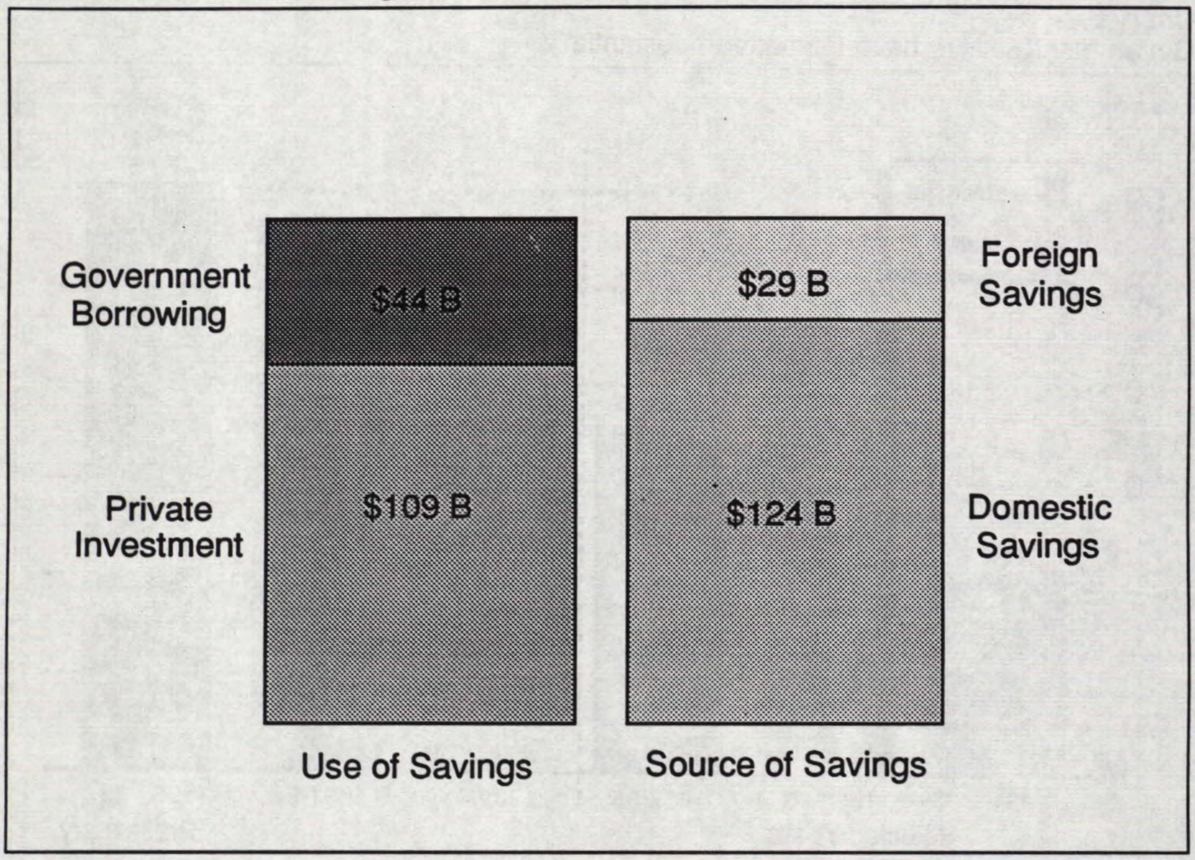
Chart 4
The evolution of Canada's current account deficit



Fiscal Deficits Absorb Domestic Savings

- Domestic savings could completely satisfy Canada's private investment needs if there were no government deficits. Instead, governments soak up over a third of Canada's savings.
- To finance needed investment, we are pushed to a heavy reliance on foreign savings.
- This competition for savings also puts upward pressure on real interest rates.

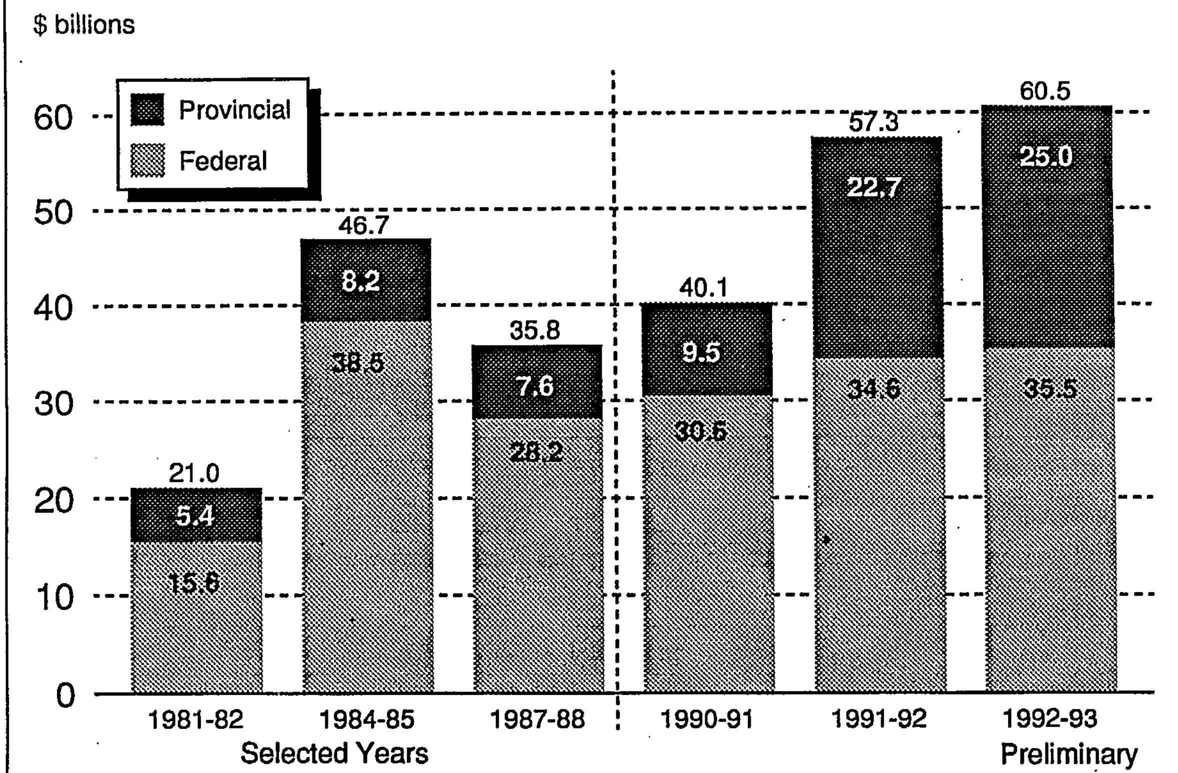
Chart 5
Sources and Uses of Savings in Canada in 1992



Deficits are a National Problem

- Deficits are no longer just a federal problem. Provincial governments now make a large and growing contribution to the total government deficit.
- In 1992-93 provincial deficits totalled $25 billion.
- This combined provincial deficit was well over two thirds of the $35.5 billion federal deficit.
- The combined federal and provincial deficits totalled over $60 billion -- 8.8 per cent of Canada's GDP.

Chart 6
Government deficits have increased substantially

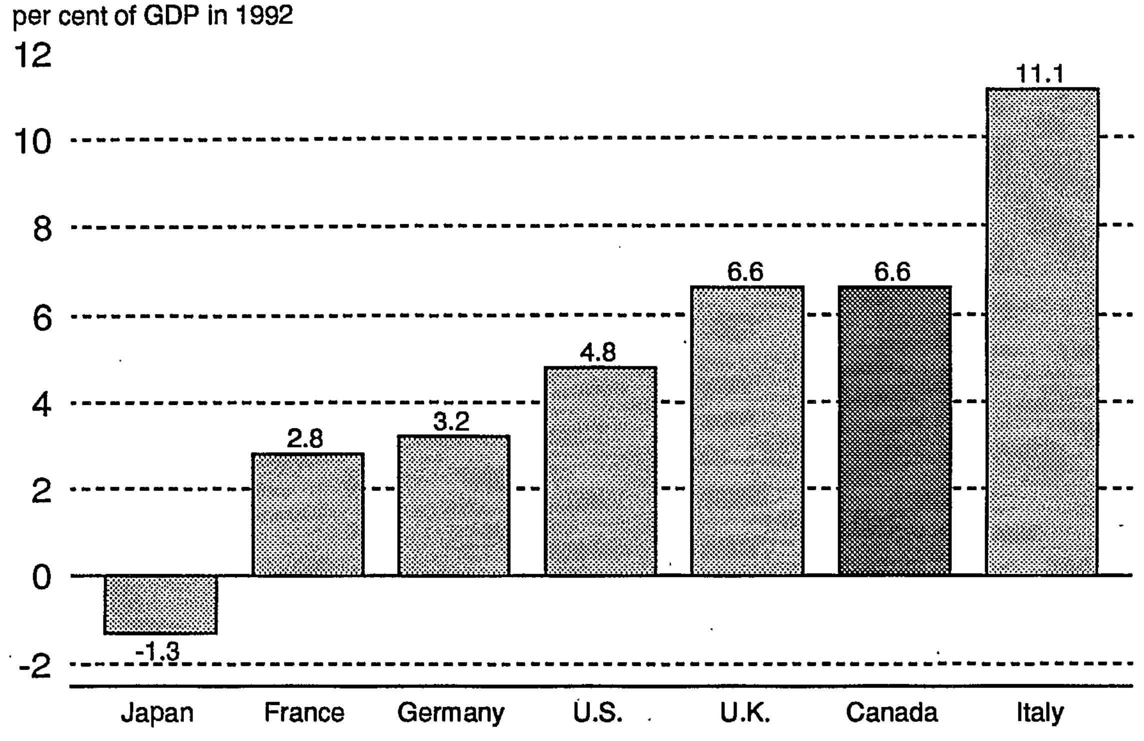


Source: Department of Finance estimates based on provincial data (Public Accounts basis)

Canada's Deficit is Second-worst in the G-7

- In 1992 Canada's total government deficit was 6.6 per cent of GDP on a national accounts basis.
- Only Italy was higher among the G-7 countries.

Chart 7
Canada's total-government budget deficit is the second worst in the G-7

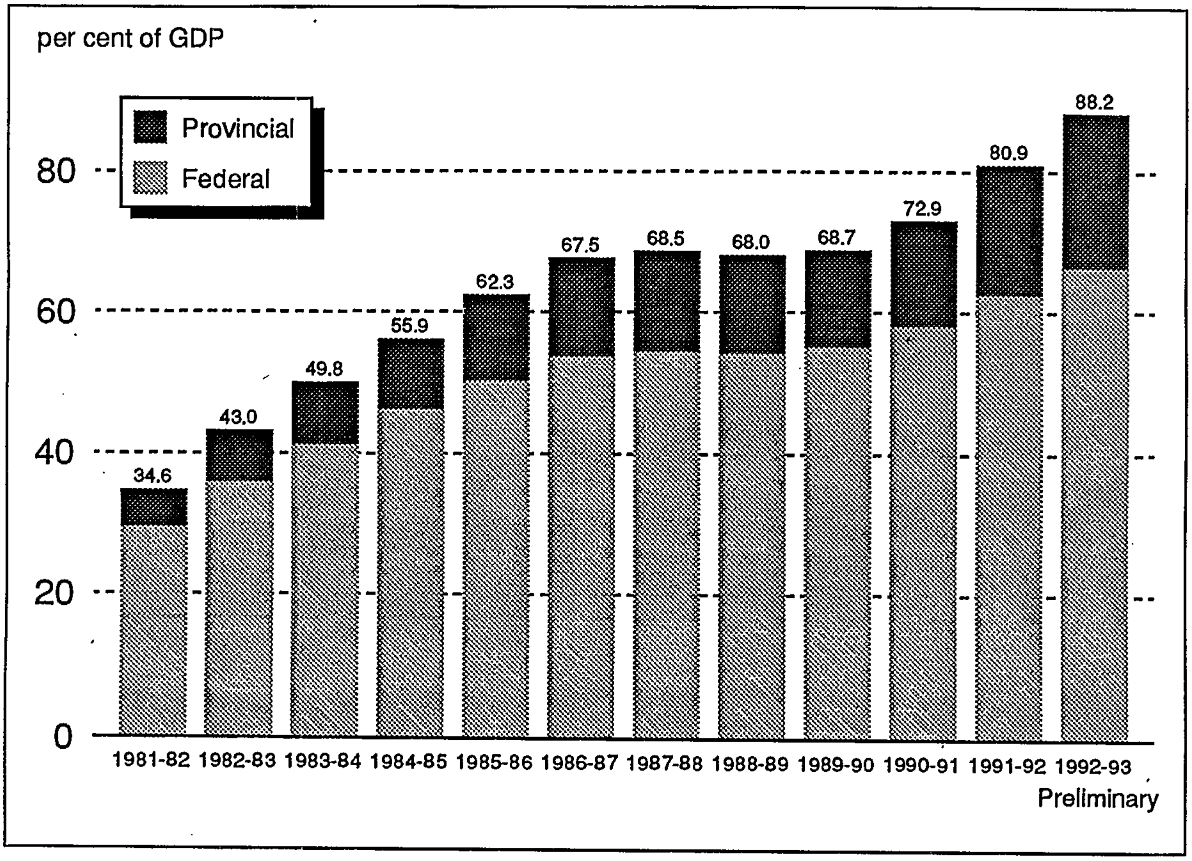


Source: OECD and Department of Finance

Canada's Fiscal Debt is Growing Rapidly

- In relation to GDP, combined federal and provincial debt (on a public accounts basis) has increased two and a half times since 1981-82.
- The combined net debt in 1992-93 of over $600 billion is over $22 thousand for every man, woman and child in Canada.

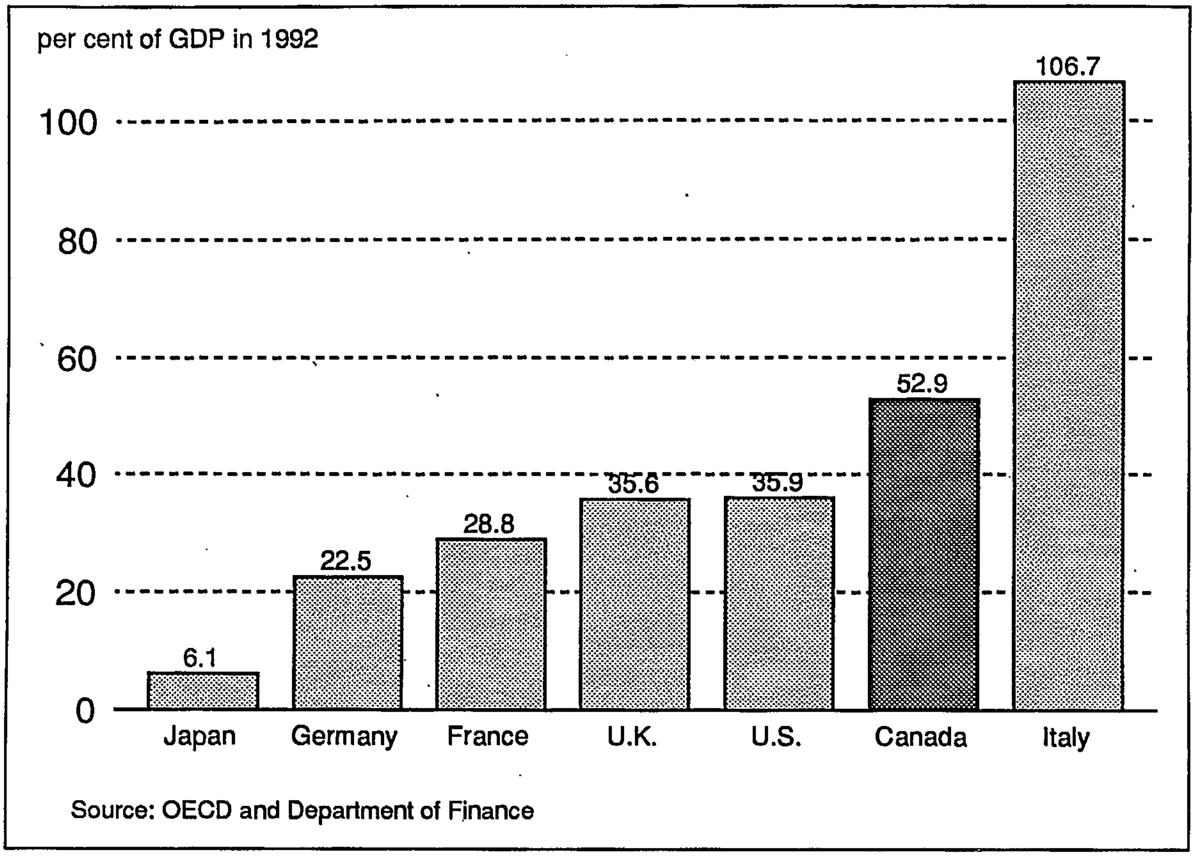
Chart 8
Government debt has been growing faster than the economy



Canada's Fiscal Debt is Also Second-worst in the G-7

- Canada's total public debt of 52.9 per cent of GDP, on a national accounts basis, is also the second largest among the G-7 countries.
- This high debt level makes Canada very vulnerable to interest-rate developments.

Chart 9
Canada's total-government net fiscal debt is also the second worst in the G-7



Governments Stopped Paying Their Way

- Canada's fiscal problems began when governments stopped paying their way: they started spending more than they took in in revenue -- running very large operating deficits. As a result, the deficit soared.
- Large deficits mean heavy borrowing and burgeoning debt. Canadian debt soared relative to the economy. This was not sustainable.

Chart 10
Total government revenue and program spending

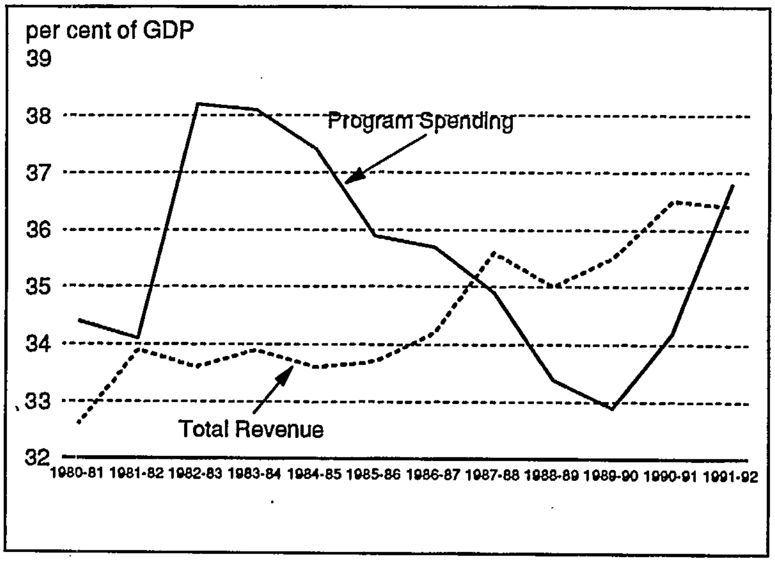
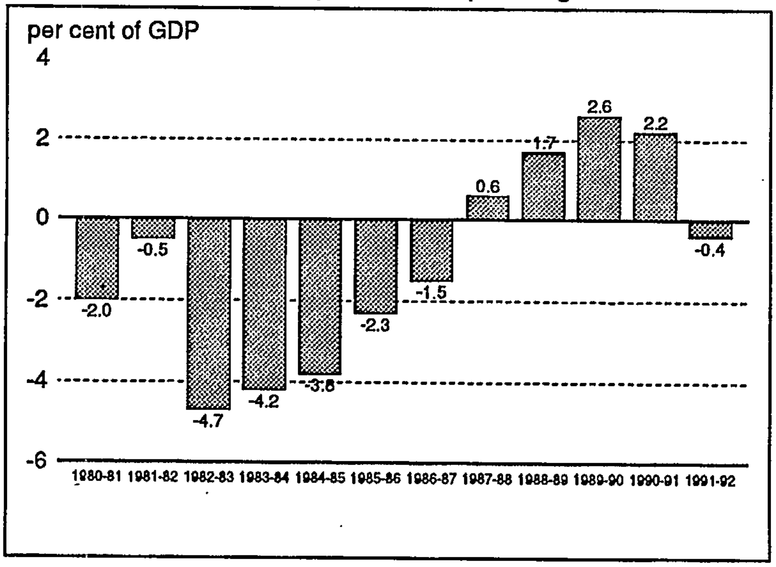


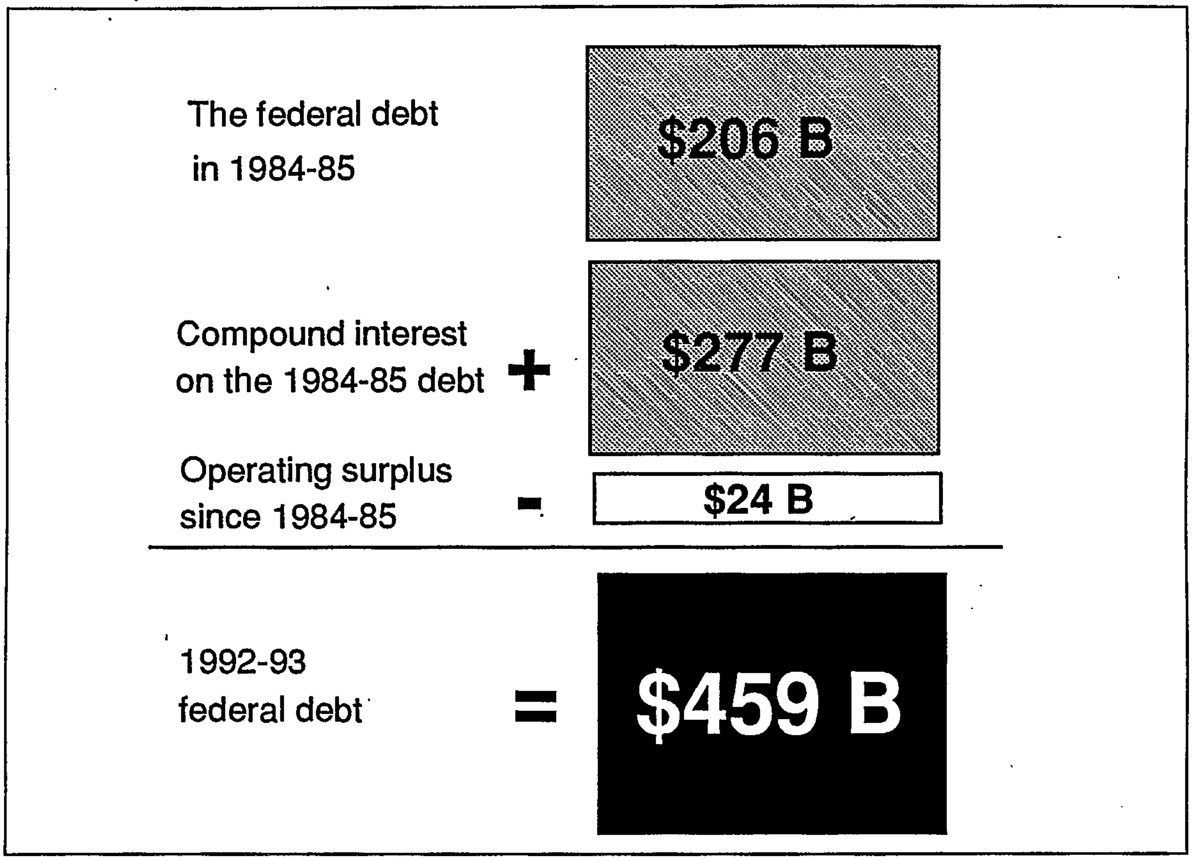
Chart 11
Combined federal and provincial operating balance



Compound Interest Makes the Problem More Urgent

- In the second half of the 1980s, the federal government tried to live within its means. Large operating deficits were turned into large operating surpluses. But, the compound interest on the existing debt caused deficits to stay high and the debt doubled. Waiting to deal with the deficit only lets interest compound even more.
- The provinces are in a similar situation.

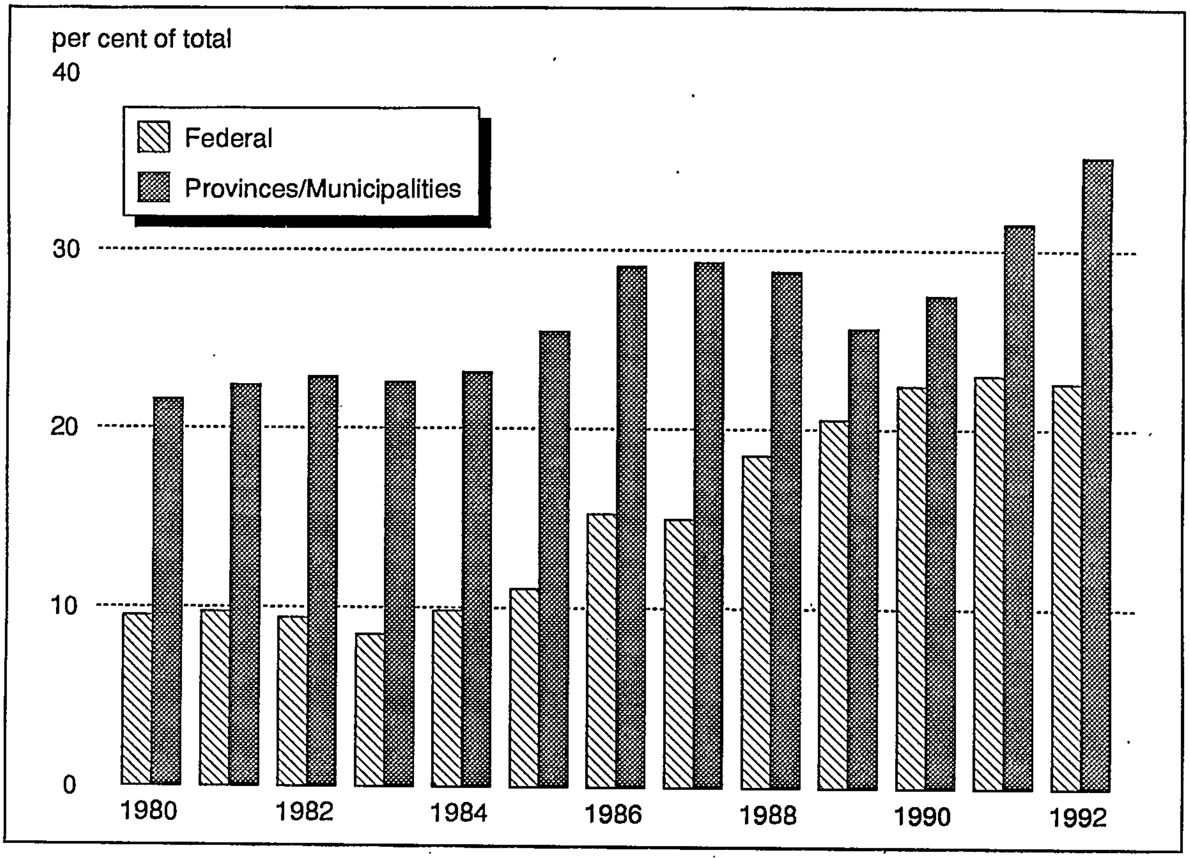
Chart 12
How compound interest pushed up the federal debt



We Don't Owe the Debt Only to Ourselves

- Some people argue that the debt is not a problem because we owe it to ourselves.
- This is simply not so. The provinces and municipalities have always relied heavily on foreign borrowing. More recently, foreigners have also been buying a large share of federal bonds.

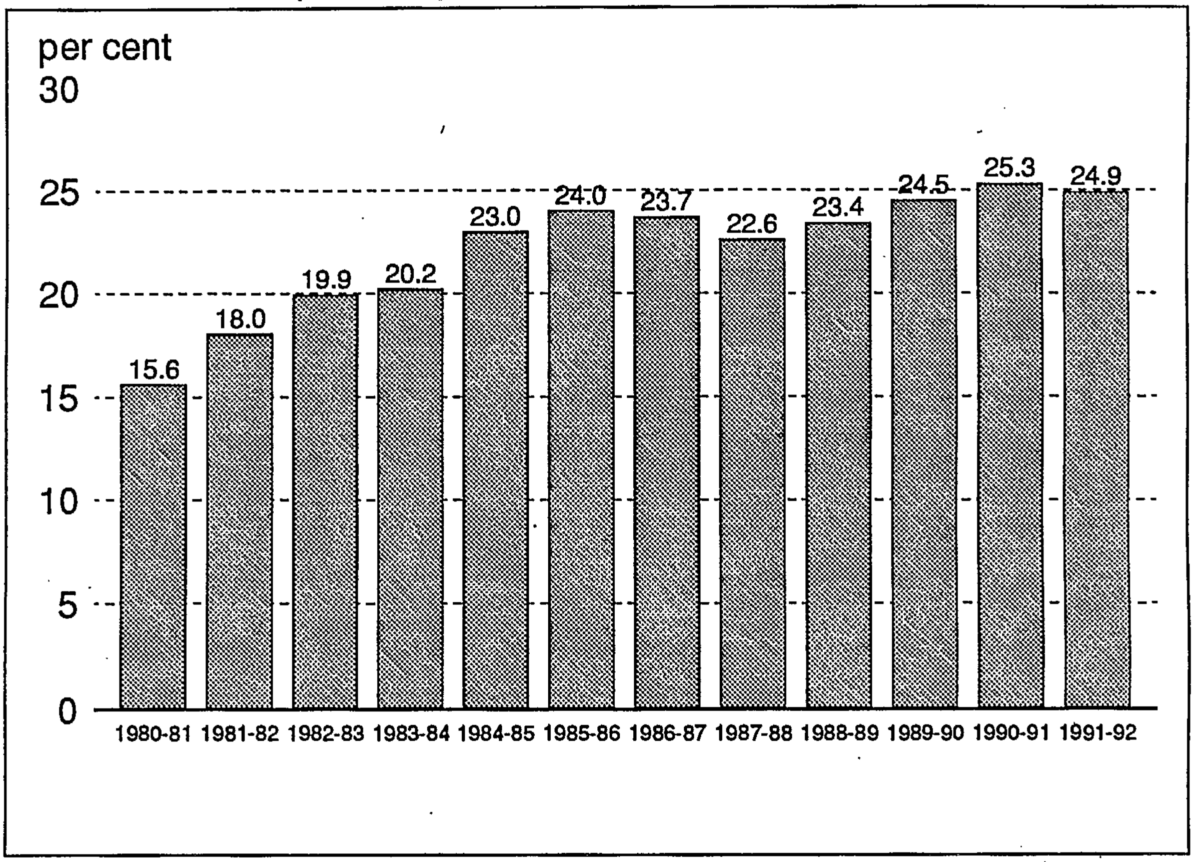
Chart 13
Debt Securities Held by Non-Residents



Rising Interest Costs Reduce Fiscal Flexibility

- The high and rising levels of debt have also robbed the federal and provincial governments of fiscal flexibility.
- In 1991-92, almost 25 cents of every dollar of federal and provincial revenue went to pay interest on the existing debt rather than for needed programs.
- The share of revenues paid for interest is up 9 percentage points since 1980-1981.

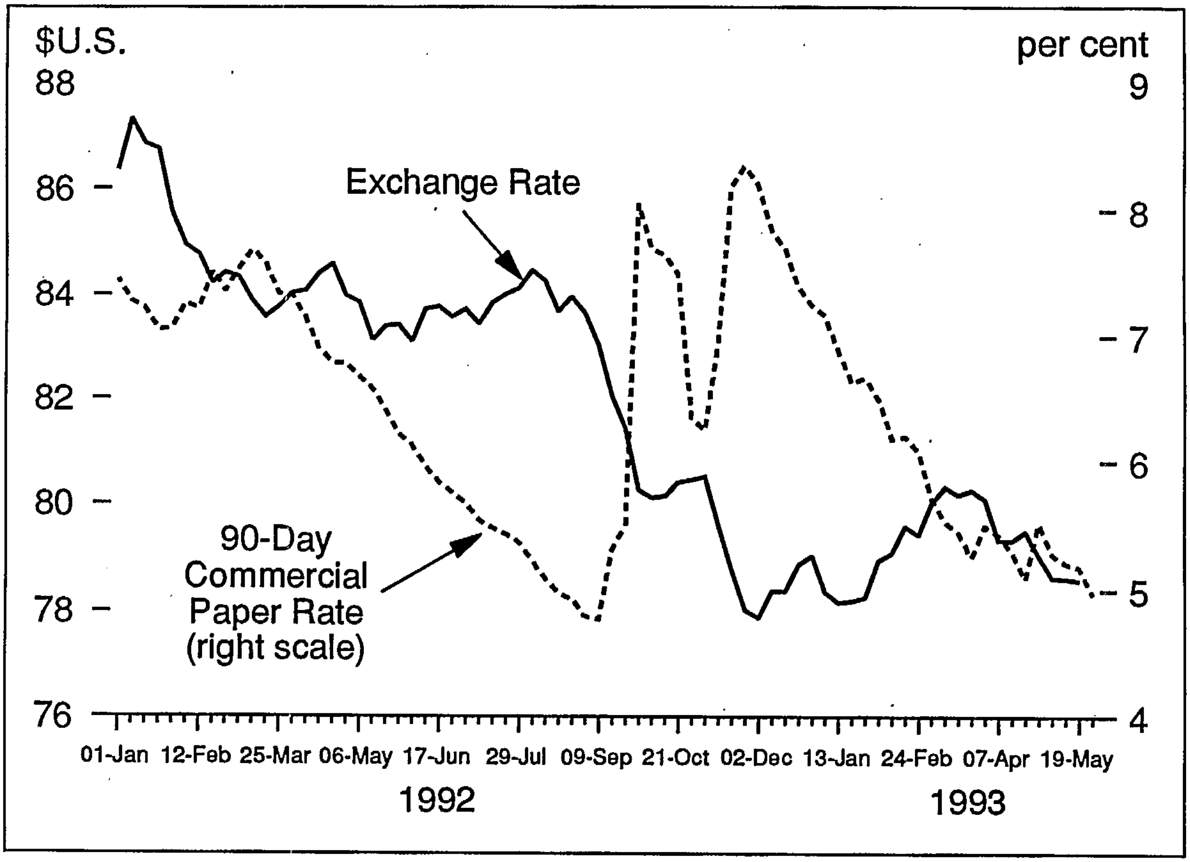
Chart 14
Share of federal and provincial government interest payments in total revenue



Large Deficits Have Made Financial Markets Nervous

- When government debt gets this large financial markets become very nervous.
- Bond rating agencies, which advise lenders on the risks of loaning to different governments, as well as to different businesses, think that lending to Canadian governments is becoming more risky.
  - Several provinces have experienced reductions in their bond ratings, as has some federal debt.
  - Lower bond ratings shrink the market for our debt and mean we must pay higher interest rates to compensate lenders for the increased risk they see in lending to us.
- Nervous financial markets make for a volatile dollar and volatile short-term interest rates. In recent months the nervousness about Canadian fiscal problems has led to frequent ups and downs in the dollar and interest rates.

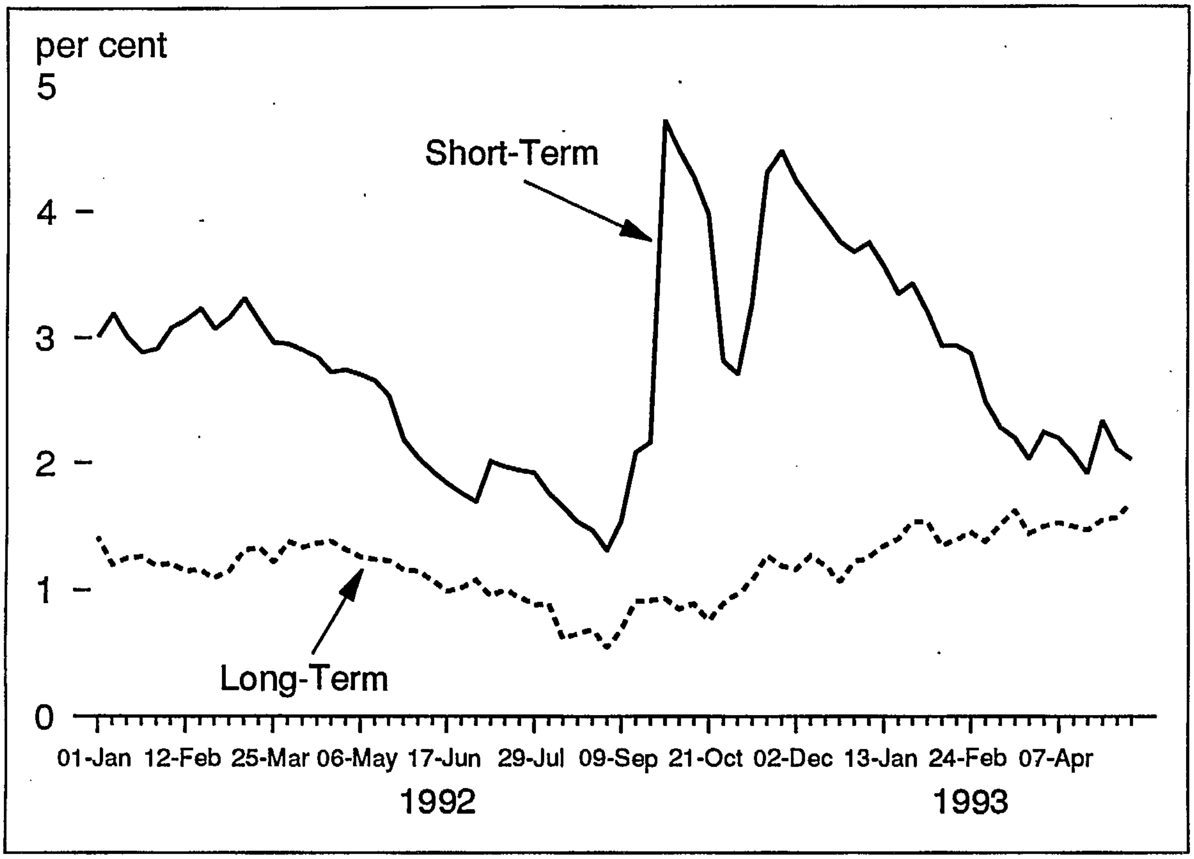
Chart 15
Short-term interest rate and exchange rate



These Worries are Especially Evident in Long-term Interest Rates

- Worries about the Canadian fiscal situation are especially evident in long-term bond markets.
- With Canada's inflation below that in the U.S., Canadian short-term interest rates have fallen faster than those in the U.S. and the differential has shrunk.
- In contrast, the differential between Canadian and U.S. long-term interest rates has risen in recent months because of nervousness about Canada's fiscal problems.

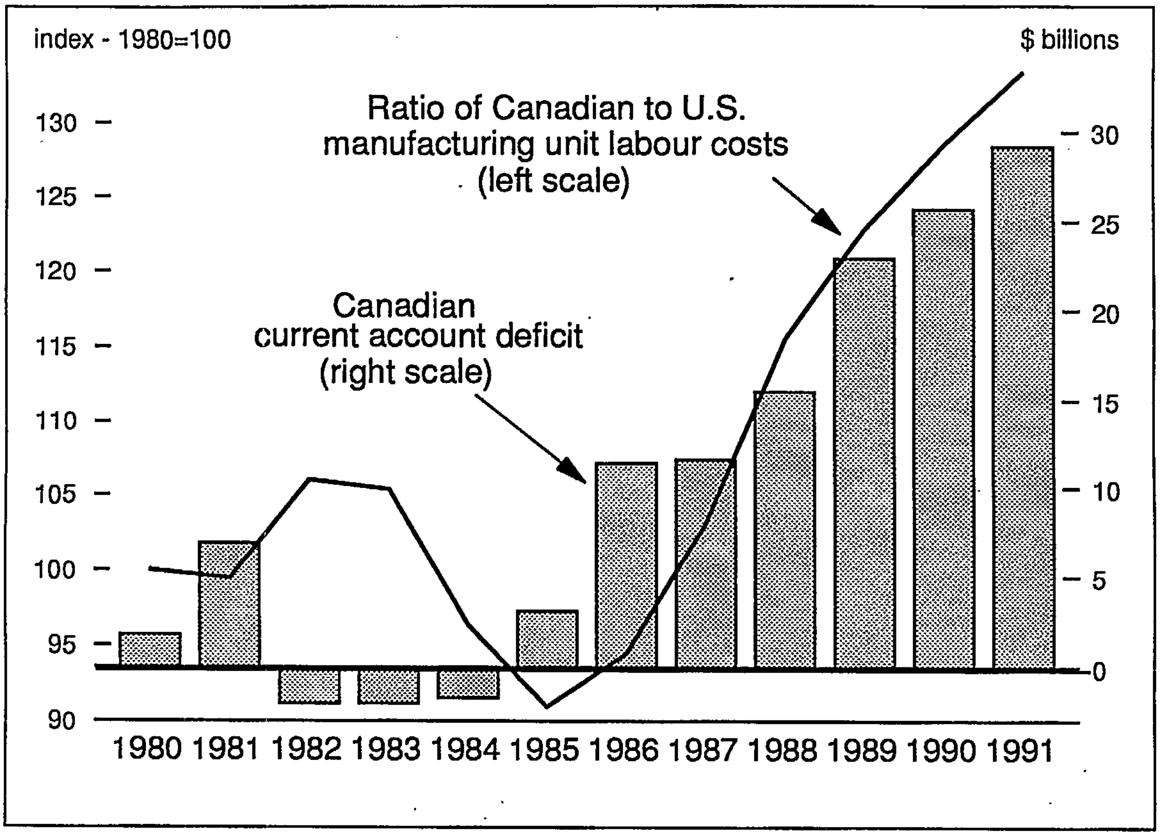
Chart 16
Canada-U.S. Interest Differentials -- Short-term and Long-term



Canada Also Let Its Costs Get Out of Line

- Another contributing factor to Canada's high current account deficit was letting Canadian cost increases get out of control.
  - Over the 1980s, unit labour costs in Canadian manufacturing rose twice as fast as those in the U.S., reducing Canada's ability to compete.
  - The resulting loss in competitiveness contributed to the sharp rise in Canada's current account deficit.
  - The exchange rate was not a factor on balance over the 1980s.

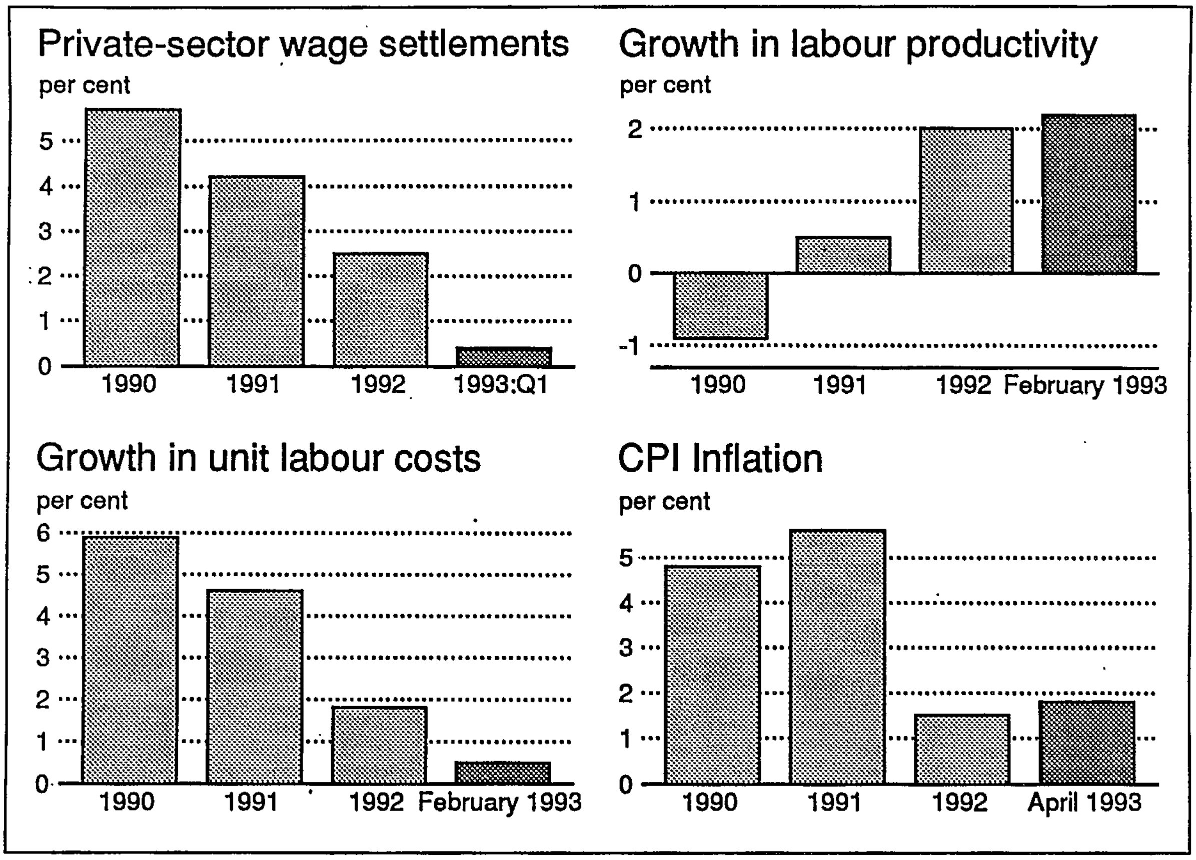
Chart 17
Ratio of Canadian to U.S. manufacturing unit labour costs in $U.S.



Canadian Inflation Pressures Are Down Sharply

- Canadian inflation pressures have fallen sharply.
- In 1992, CPI inflation fell to 1.5 per cent -- the lowest in 30 years and the lowest in the G-7. Since then inflation has risen temporarily due to the one-time effects of the fall in the Canadian dollar.
- As a result of improving productivity growth and falling wage increases, unit labour costs in February were up only 0.5 per cent from a year ago.

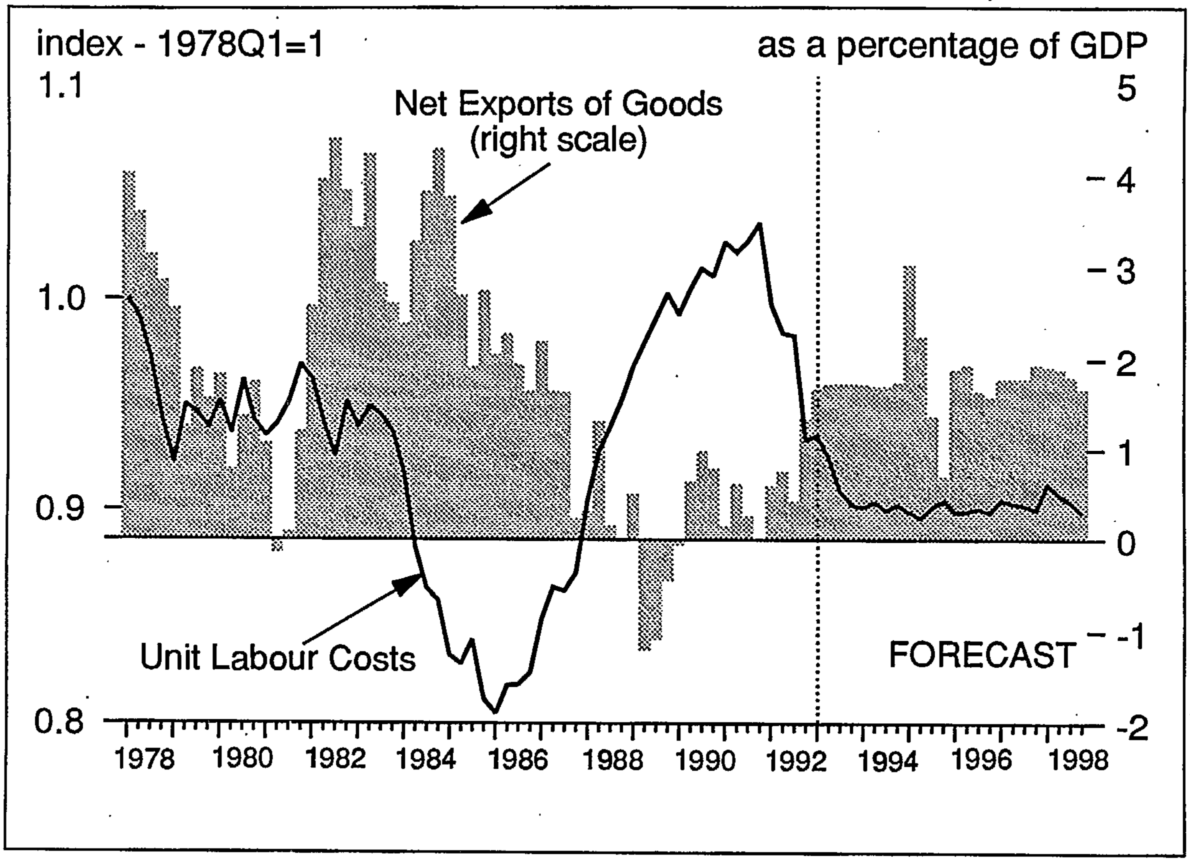
Chart 18
Improvements in competitiveness



Improved Competitiveness Means a Strong Trade Balance

- The record shows that when Canada keeps its costs relative to its major trading partners under control, our net exports are strong.
- Canada's low inflation rate will significantly improve our competitive position -- on an ongoing basis.
- That improved competitive position, in combination with the improved access to markets gained under the Canada-U.S. Free Trade Agreement, will contribute to very strong growth in Canada's exports and a strong trade balance for the rest of the 1990s.

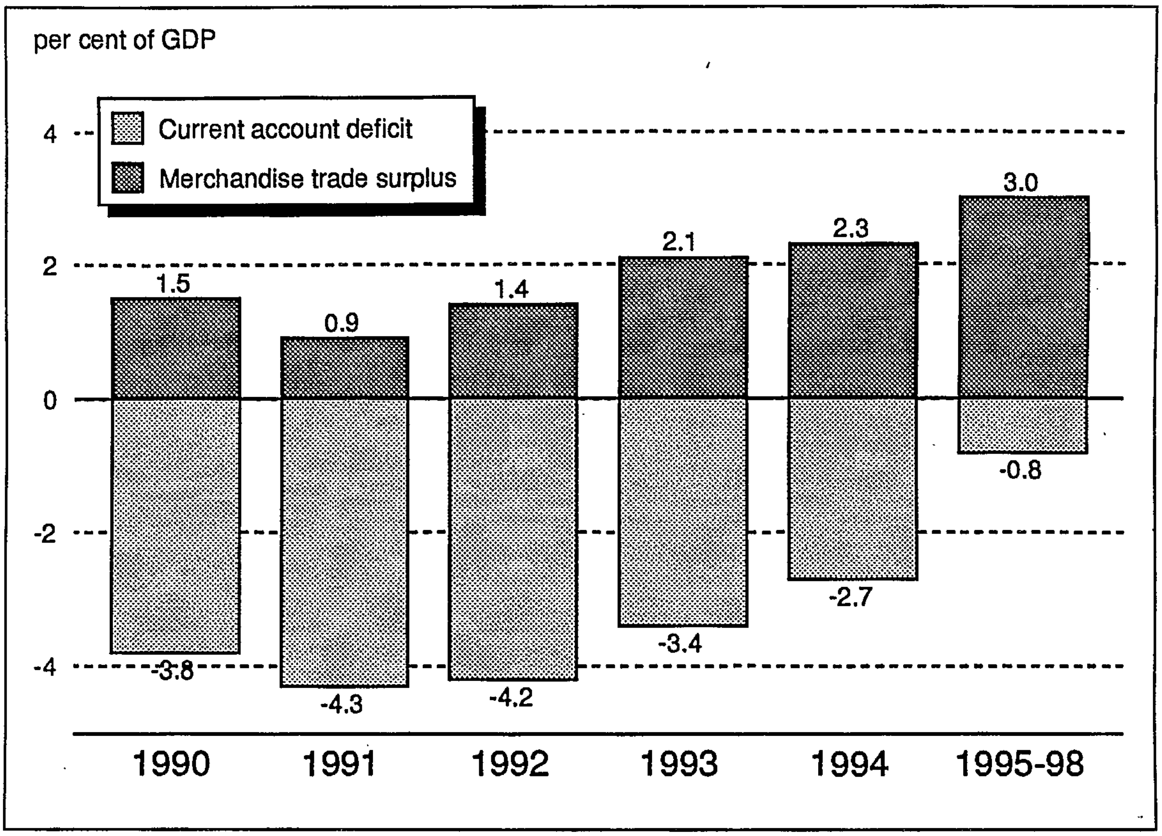
Chart 19
Ratio of Canada and U.S. Unit Labour Costs and Canadian Real Net Exports of Goods



A Stronger Trade Balance Will Improve the Current Account Deficit

- That strong trade balance will help shrink our large current account deficit.

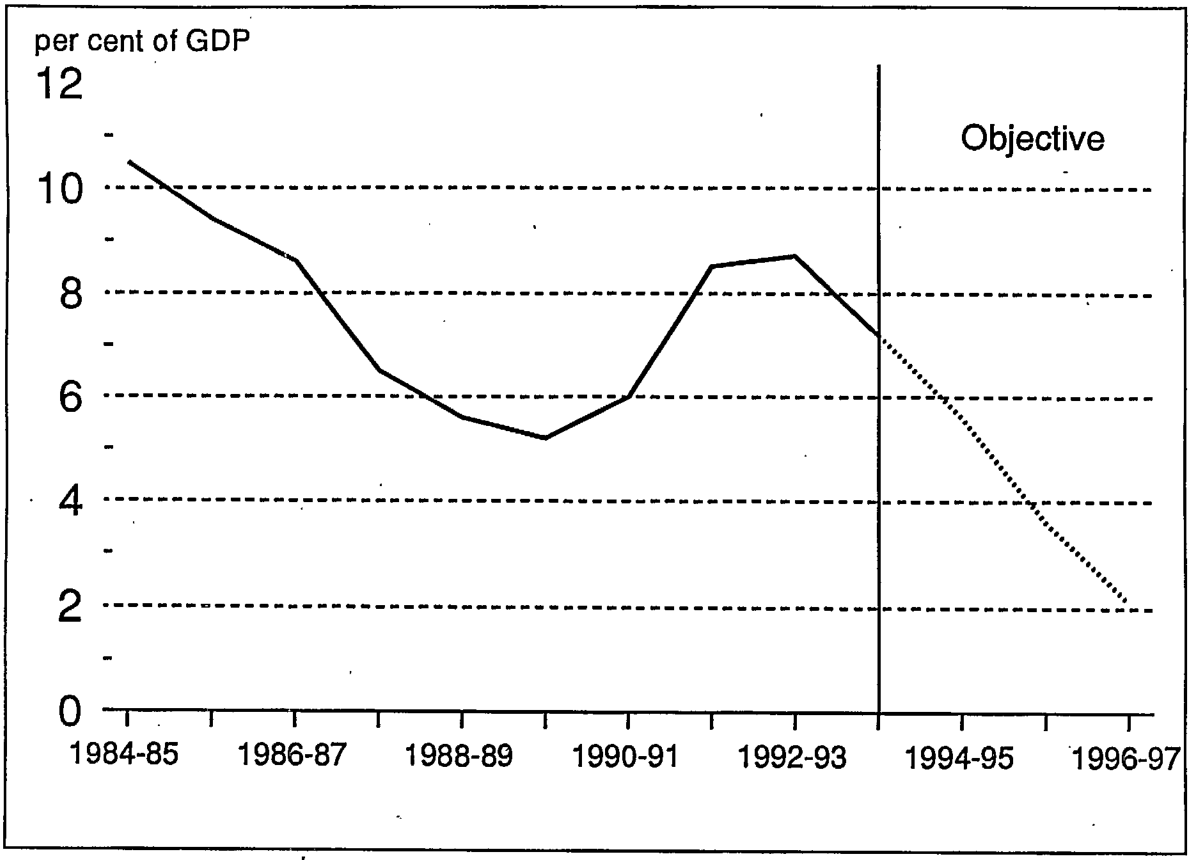
Chart 20
The current account deficit and merchandise trade surplus



Actions Are being Taken to Get Deficits Down

- The actions taken in the recent federal and provincial budgets will put Canada's fiscal deficits on a downward track, starting in fiscal year 1993-94.
- Indeed, the federal government is expected to run a surplus on financial requirements by 1997-98.
- However, an ongoing committment to realize the fiscal plan will be needed to ensure that deficits come down.

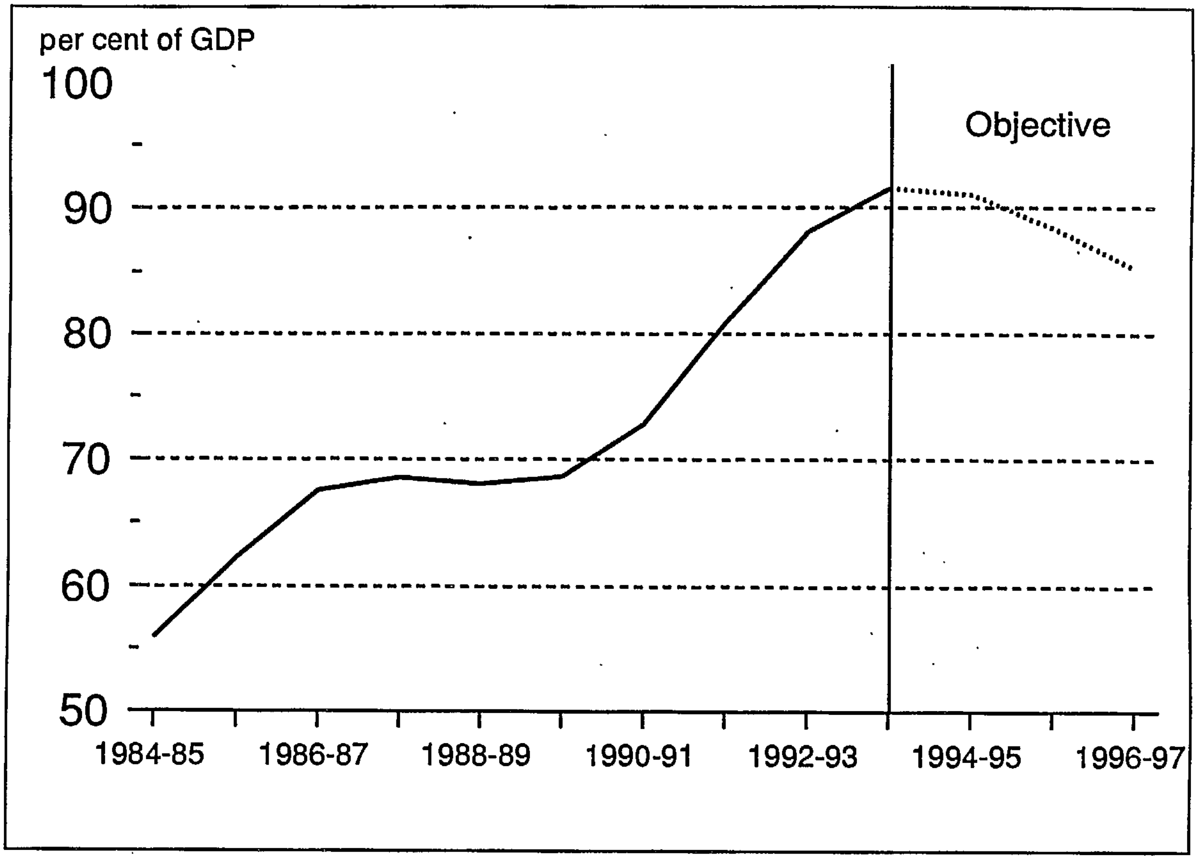
Chart 21
Combined Federal and Provincial Budgetary Deficit (Public Accounts Basis)



These Actions Will Control Debt Growth

- Getting deficits down sharply will reverse the growth in Canada's fiscal debt.
- By 1994-95, the combined net debt of the federal and provincial governments is expected to begin falling relative to GDP, a sure sign that government finances are being moved to a sustainable basis.

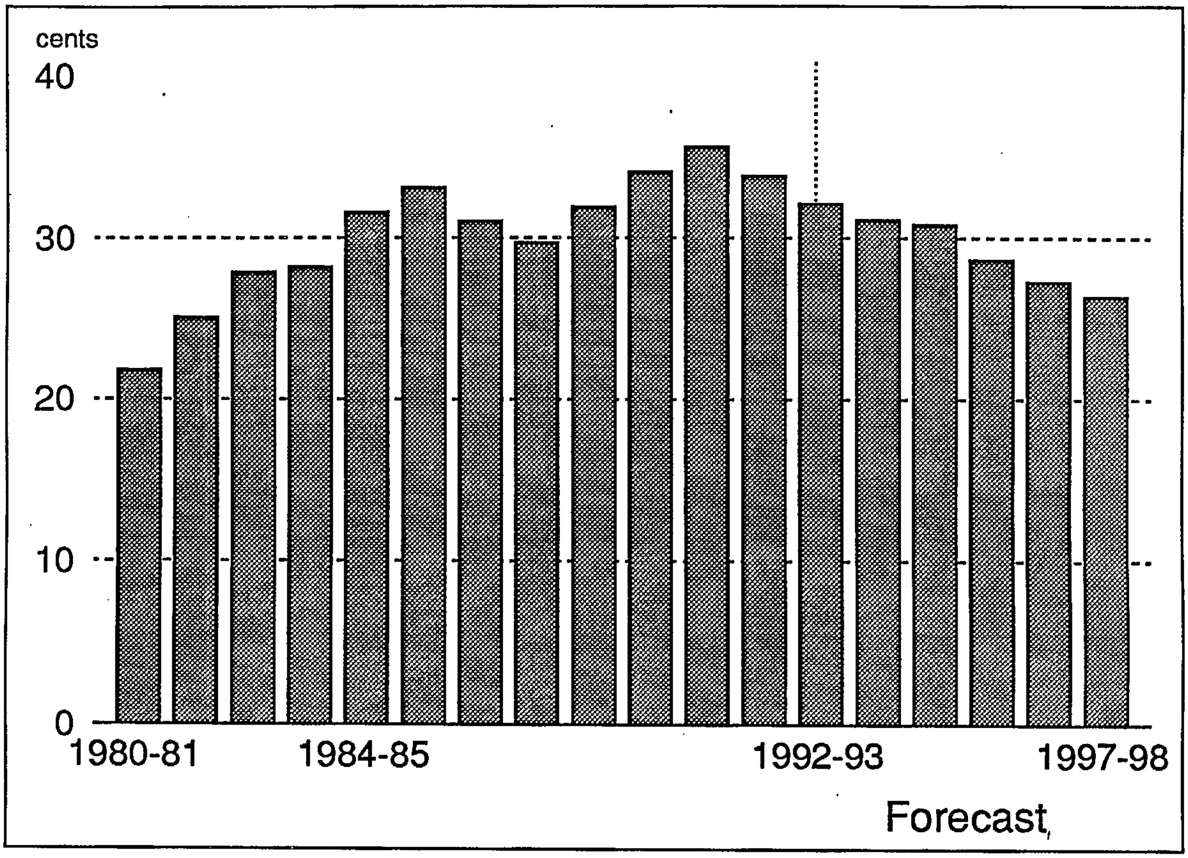
Chart 22
Combined Federal and Provincial Net Debt (Public Accounts Basis)



Fiscal Control Will Pay Off

- Putting deficits on a sustainable basis will pay dividends:
  - Financial markets will become less nervous. This will permit long-term interest rates to fall to be more in line with Canada's inflation prospects.
  - Governments will achieve some fiscal flexibility as slower growth in debt and low interest rates will reduce the burden of interest payments.

Chart 23
Federal public debt charges per dollar of revenues



Fiscal Deficit Control Will Control the Current Account Deficit

- But the key to getting the current account deficit down to a manageable size is still getting rid of fiscal deficits.
- As long as a significant portion of Canada's domestic savings are absorbed by government deficits, Canada will have to rely on foreign savings to meet our investment needs and continue to run a current account deficit.
- The April Budget projection shows how getting fiscal deficits under control will also get our current account deficit under control.

Chart 24
Sources and uses of savings