

**Impact of Budget 2009 Stimulus Lost in the Wash
of Updated Economic Growth Forecasts**

March 2009

Statistics Canada has just reported that the Canadian economy shrunk by 3.4% in the fourth quarter of 2008. We can expect economic forecasters to revise their forecasts for economic growth for 2009 downward, yet again. This will leave the small positive impact of the fiscal stimulus of Budget 2009 on our economic growth for 2009 lost in the wash of the impacts of the other strong negative forces on the economy.

Budget 2009 provided about \$34 billion in fiscal stimulus which, according to Budget 2009, would increase the size of the economy by about 1.9% by the end of 2010. In December, according to the opposition, it was so important to provide this stimulus that, had the government not agreed to do so, they deserved to be replaced. And – it was so important to the government (the need for the stimulus - or the threat of being replaced?) that they agreed to move up the date of Budget 2009 to introduce a stimulus Budget in January.

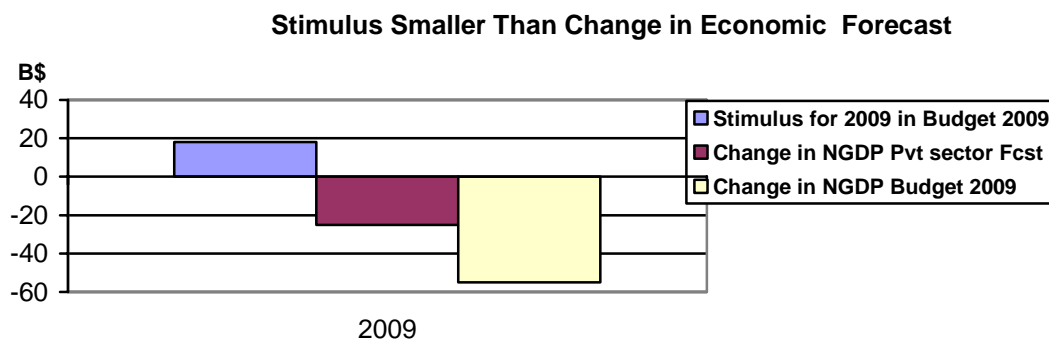
The January 27 stimulus budget is now behind us. However, the controversy over the fiscal stimulus is, if anything, growing in importance. There is contentious political and economic debate regarding the timing and effectiveness of the fiscal stimulus actions in the Budget. The opposition has made monitoring of the fiscal stimulus initiatives a key condition for their support for Budget 2009. As well, satisfactory results from the monitoring of the implementation of the stimulus initiatives could determine the political life of this government and the timing of the next election. The economy has continued in freefall since the Jan. 27 Budget and there has already been discussion of the need for further fiscal stimulus. The March 2 release of the very weak performance of the economy in the last quarter of 2008 only exacerbates the political and economic debate over the need for more stimulus.

Most economists, including myself, agreed that by the end of 2008 we had done most of what could be done with monetary policy, and that, given our bleak economic prospects, some "timely, temporary and targeted" fiscal stimulus was in order. After reviewing Budget 2009, I concluded that the government had done a reasonable job of balancing the many economic, fiscal and political challenges presented to them in the Budget and that the best course of action was to pass the Budget and get on with the fiscal stimulus actions as soon as possible.

The Fiscal Stimulus of Budget 2009 was Small Relative to the Size of the Economy

The impact the stimulus measures would have on Canada's economy was one of the more prevalent and more important issues I was faced with in post Budget questions and interviews. I emphasized that the Budget 2009 measures, while helpful to our economic growth, must be kept in perspective. Understandably, \$34 billion dollars strikes most Canadians as a lot of money. It is over \$1,000 per person. This \$34 billion is spread over two years and at \$18 billion for 2009/10, it is just over 1% of the Nominal GDP (NGDP) of 2009.

While the stimulus package of Budget 2009 is equivalent to about 1% of Nominal GDP per year, total program spending by the federal government will be less than 15% of NGDP. The infusion of an extra \$18 billion of fiscal stimulus into the economy in 2009 must be put in the context that, between the Economic and Fiscal Update of November 27, 2008 and Budget 2009 of January 27, 2009 private sector forecasters have revised NGDP (the general tax base) for 2009 down by \$25 billion. On net, most of the downward revisions to NGDP in recent months have been due to downward revisions to exports, as opposed to the other components of NGDP.



We conclude that the fiscal stimulus of \$18 billion for 2009/10 followed by another \$15.5 billion in 2010/11, for a total of about \$34 billion over the two year period, is relatively small compared to the size of our economy, or even the changes in the forecast of the size of the economy for 2009.

Correctly anticipating future downgrades to the forecast, Budget 2009 was based on a forecast more pessimistic than the private sector consensus of NGDP. Budget 2009 used an estimate for 2009 NGDP of \$1,560 billion, as opposed to the private sector forecast of \$1,590 billion. Rather than a downgrade of \$25 billion from the November 2008 Economic Update, this is a downgrade of \$55 billion. The extra \$30 billion downgrade to the forecast for NGDP (the general tax base) would lead to a forecast for 2009/10 federal revenues about 4 or 5 billion dollars lower than otherwise. This “prudent” move by Mr. Flaherty in Budget 2009, to a lower forecast for the general tax base was very perceptive. The very weak fourth quarter data just released will probably bring the March private sector forecast of NGDP for 2009/10 into the range used in Budget 2009.

The Impact of the Fiscal Stimulus on the Economy Has Already Been Lost in Forecast Changes

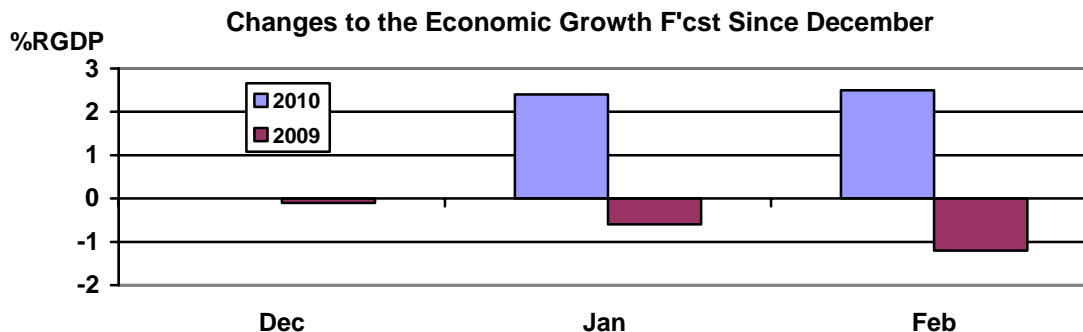
In post Budget 2009 commentary I emphasized that the timing and pace of economic recovery for Canada will depend primarily upon the pace and timing of recovery in the U.S., on oil prices, interest rates and exchange rates, as opposed to the stimulus measures of Budget 2009. I commented that, in a matter of months, the positive impact of these fiscal stimulus measures on the economic forecast will be lost in the wash of changes to the forecast caused by the weak performance of the economic indicators driving economic growth. In late my comment was met with some skepticism and disappointment.

Budget 2009 did note (page 242) that, including the anticipated participation by other levels of government, "the positive impact on real GDP growth is expected to be 1.6% in 2009 and 0.2% in 2010." Very few forecasters have made explicit what positive impacts on economic growth for 2009 and 2010 they have included in their February forecast. To my surprise, with the February updates to the economic forecast, less than one month after Budget 2009 of January 27, 2009, the positive impact of the fiscal stimulus measures on the forecast for economic growth for 2009 has already been overwhelmed by the negative impacts of the economic indicators.

A dozen private sector forecasters have updated their economic forecasts monthly in recent months. The December 2008 forecasts did not include any impacts of fiscal stimulus anticipated in Budget 2009. Some forecasters included some anticipated stimulus from Budget 2009 in their January forecasts. All forecasters included their estimate of the impact of Budget 2009 into their February forecasts.

What we can conclude from the chart below is that these private sector forecasters, post Budget 2009 forecasts made in February expect the economy to grow by less in 2009 (- 1.2%) than their pre Budget 2009 forecasts of December 2008 (0 growth). This is a net downward revision of 1.2% points between the December and the February forecasts.

A reasonable conclusion upon observing these downgrades to the forecast for 2009 in recent months is that most of the forecasters do not accept the Budget 2009 estimate that "the positive impact on real GDP growth is expected to be 1.6% per cent in 2009." It is difficult to accept that the negative impact of other factors has so completely washed out a positive 1.6% impact from fiscal stimulus for 2009, accounting for the downward revision from 0 growth in December to -1.2% in February. It is much more reasonable to conclude that the positive impact from fiscal stimulus for 2009 incorporated by most forecasters was well short of 1.6%, to yield the net downgrade of 1.2% points.



Many forecasters did not provide a forecast for 2010 in December 2008. Between January 2009 and February there was only a tiny upgrade in the forecast for 2010, from 2.4% to 2.5%. It seems unlikely these forecasters incorporated the full positive 1.8% impact estimated by Finance over the two year period, and if they did it was overwhelmed by the negative impact of developments affecting economic indicators.

The weaker than anticipated results from fourth quarter 2008 released March 2 can be expected to lead to yet another downgrade in the forecast for economic growth for both 2009 and 2010. The consensus forecast in February for 2009 was about -1.2%. I expect most of the March forecasts for 2009 growth to drift down sharply into the -1.5% to negative - 2.5% range. The February consensus for 2010 was 2.5%. I expect slight downgrades here, with most of the forecasts in the 2.0% to 2.5% range. This implies a decent, but somewhat plodding recovery, picking up over the course of the year.

The Bank of Canada, who in mid January forecast 2010 growth to be a very robust 3.8%, indicated on March 3, that they expect to be revising that forecast downward. We conclude then, that by the time the March forecasts are out, real GDP growth for 2009 will have been revised down at least 2% points from the pre-stimulus December forecasts and 2010 growth will also have been revised down slightly. This implies that, in the upcoming March forecasts, the level of GDP by the end of 2010 will be forecast slightly more than 2% points lower than forecast in December 2008.

Therefore the Budget 2009 forecast that the stimulus actions of the budget would make the level of GDP almost 2% higher than otherwise by the end of 2010 have been completely overwhelmed by the impact of economic indicators. And it is most likely that most economists do not accept that these stimulus actions will boost economic growth as much as the budget claimed they would.

The Impact of the Fiscal Stimulus of Economic Growth

Budget 2009 did note (page 242) that, including the anticipated participation by other levels of government, " ...the positive impact on real GDP growth is expected to be 1.6% in 2009 and 0.2% in 2010." Budget 2009 added, "By the end of 2010 the level of real GDP is almost 2% higher than would otherwise be the case without the Economic Action Plan." These estimates were based on "multipliers" which trace the impact of the various

types of expenditures and tax changes, from the fiscal stimulus provided through the relevant channels to economic activity. These multipliers account for the direct, indirect, and induced impacts on economic activity as well as the relevant "leakages" to savings and imports.

I accept these "multipliers" for what they are – very simple standard algorithms for tracing the impact of an expenditure commitment, which is immediately followed with a stream of economic activity assumed to be incremental to the economy. These multipliers were not calculated to specifically apply to the fiscal stimulus initiatives of Budget 2009 and the economic climate of 2009. These multipliers would be generally applicable to the more effective tax and spending actions historically.

If I were willing to accept that every dollar of fiscal cost reported in the stimulus package would immediately and effectively be spent to cause economic activity incremental to the economy, I too would have estimated the economic impacts of the stimulus package to be close to what is estimated in Budget 2009. However, when I examined the specific spending and tax initiatives of the fiscal stimulus package of Budget 2009, in the context of the economic climate of 2009, I concluded that there are simply too many ways in which the spending commitments may not be drawn upon, may be drawn upon later, and/or may result in economic activity which is not fully incremental to the economy.

Some of the more likely slips between the plans of Budget 2009 and reality with respect to the spending actually beginning as soon as planned are the federal/ provincial agreements for infrastructure spending and the training program. The take up may not be as large as forecast for the federal/ provincial infrastructure spending, the home renovation tax credit and/or the training program. Examples where the take-up may be as great as planned, but the spending may not be completely incremental to what would have occurred without the Budget 2009 initiative, would be the home renovation tax credit and the jointly funded infrastructure spending.

It must be emphasized that estimating the impact on economic growth of fiscal initiatives is a complex calculation, where considerable judgment is involved and there is considerable room for reasonable people to differ. While few private sector forecasters have explicitly provided their estimates of the economic impacts of the fiscal stimulus initiatives, the Parliamentary Budget Officer (PBO) has estimated that the economic impact to the end of 2010 will be only about 60% as large as forecast in Budget 2009. I believe the estimate of the PBO is in the right range. I also believe that most of the impact on economic growth will be realized in 2010 rather than 2009, reverse of the estimate in Budget 2009.

Conclusions

- The \$34 billion fiscal stimulus introduced in Budget 2009 was a reasonable response to the political and economic challenges facing the government at the time. The best strategy at this point is to proceed as expeditiously and effectively as possible to implement these stimulus actions.

- The fiscal stimulus actions of Budget 2009 can be expected to provide some modest positive impact on economic growth this year and a slightly stronger impact next year. This is an impact slightly smaller and particularly later than estimated in Budget 2009.
- In early December, none of the economic forecasts anticipated any fiscal stimulus actions in their forecast for economic growth for 2009 and 2010. Since December, the positive impacts of Budget 2009 on growth have been fully incorporated into the forecasts. However, the private sector consensus forecast for growth in 2009 has fallen from 0% in December to -1.2% in February and will move into the negative - 1.5% to -2.5% territory with the upcoming March updates. The forecast for 2010 will probably also be lower than in December. The March updates will show the level of real GDP at the end of 2010 to be slightly more than 2% lower than what was anticipated in December. The impact of the fiscal stimulus initiatives of Budget 2009 is incorporated as an offsetting small positive in this net downgrade to the growth forecast.
- Given the overwhelming negative impact of economic indicators on the forecast for growth, relative to the small offsetting positive impact of the fiscal stimulus initiatives, it will be very difficult to estimate the impact of the fiscal stimulus actions of Budget 2009 on economic growth. The speed and effectiveness of implementation of these measures can be measured from an accounting perspective. This is, however, a measure of input. Even if the measures have been implemented effectively, it will be very difficult to estimate what impact they have had in their objective of stimulating economic growth.
- Given the continuing significant reductions in forecast growth for this year, it is understandable that the opposition, along with many interest groups, will argue for even more fiscal stimulus in the coming months. These arguments for more fiscal stimulus must be given an extra dose of “sober second thought” however. We have already used up the most effective fiscal stimulus initiative, i.e. accelerating as many “shovel ready” infrastructure projects into 2009 and 2010 as can be effectively implemented.
- Attempts to identify additional significant stimulus expenditures which can be effectively implemented before the end of 2010 is a risky strategy. It is risky from the perspective of effective use of taxpayer’s funds, the risk of drifting into 2011 and 2012 and crowding out private investment and of passing on an even greater debt burden to our children, with little offsetting benefit to them.