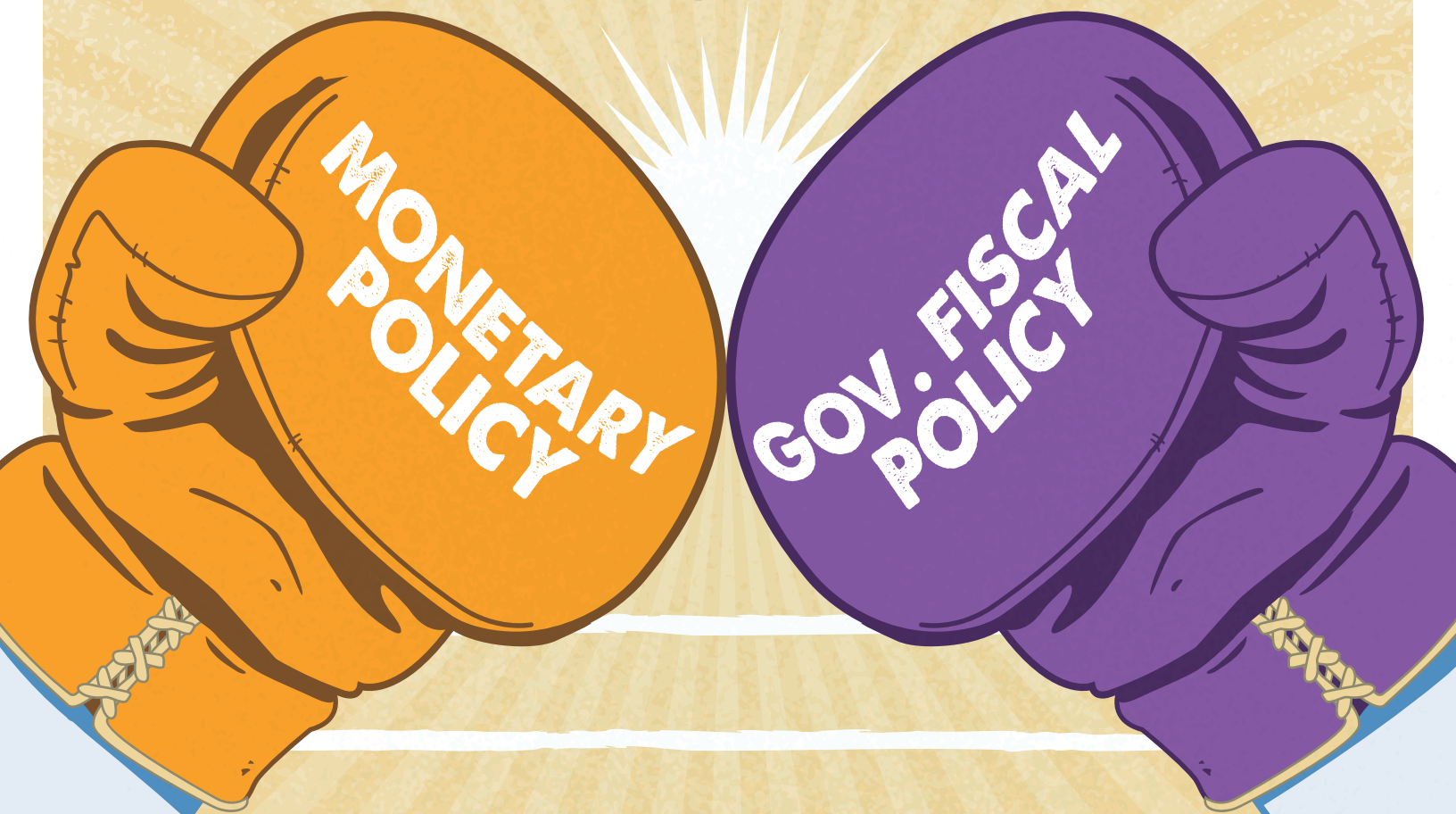

Canada's Fiscal Policy Has Undermined Efforts to Tackle Inflation

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Executive Summary

In response to the lockdown of large swathes of Canada's economy when COVID began circulating in March 2020, both monetary and fiscal policy shifted to unprecedented stimulus. The Bank of Canada lowered interest rates to near zero and expanded its balance sheet over fourfold, while governments ran deficits exceeding those incurred during wartime. This extraordinary stimulus, along with the quick adaptation of businesses and individuals to social distancing and telework, helped the overall economy recover rapidly even as industries providing client facing services continue to struggle.

However, maintaining stimulus as much of the economy expanded beyond its pre-pandemic levels helped fuel inflation by boosting demand beyond supply. After a brief period of price declines in 2020, inflation began to pick up in the spring of 2021, accelerating to a 39-year high of 8.1 percent by July 2022. In response to higher inflation, the Bank of Canada began winding down its policy of quantitative easing and then hiked its policy interest rate sharply from 0.25 percent to 4.50 percent during 2022.

In the initial stages of the pandemic, the federal government hit a record \$327.7 billion deficit in fiscal year 2020-21 and followed it up with deficits of \$90.2 billion in 2021-22 and \$43.0 billion in 2022-23. The deficits significantly exceeded those recorded before the pandemic began. According to former finance minister Bill Morneau, the federal government was "distributing billions of dollars more than was actually needed under the circumstances" during this time. Morneau revealed that the attitude of the Prime Minister's Office (PMO) to spending requests was "let's give something to keep them happy," a stance he said "shattered any pretense of fiscal restraint."

During the pandemic, government leaders consistently invoked low interest rates to rationalize their spending splurge and debt accumulation. The federal government, for instance, argued that "In today's low interest rate environment, not only can we afford these investments in Canada's future, it would be short-sighted of us not to make them." The sudden end of low interest rates in 2022, however, did not curb governments' enthusiasm for spending. Federal spending, for example, has remained at

extraordinarily high levels even as COVID relief programs wound down in 2022. In fiscal year 2019-20, before the pandemic, federal program spending totalled \$338.5 billion; in its 2023 budget, Ottawa projected program spending to be 28.9 percent above its 2019-20 level, reaching \$435.9 billion in 2022-23.

Moreover, fiscal stimulus measures introduced before 2022 are still being felt by the economy, helping to boost inflation well above the forecasts of most economists and central banks at the start of 2022. The period during which a government deficit is recorded does not always correspond to when stimulus is injected into the economy. Much of the money governments transferred to households at the onset of COVID in 2020 was saved—as “pre-loaded stimulus,” in Finance Minister Chrystia Freeland’s own words—and was then spent in 2022 as inflation squeezed household purchasing power and normal economic activities resumed.

In today’s high-inflation environment, tighter fiscal policy would dampen the increase in interest rates. Although the initial upturn of inflation has been driven largely by supply shocks in the economy (Chen and Tombe, 2022), it has also likely been fuelled in part by the large deficits posted during the pandemic. Without fiscal restraint, however, tight monetary policy alone will have difficulty returning inflation to its target rate. Monetary policy and fiscal policy must work together to reduce inflation. High government spending and deficits undermined the credibility of monetary policy in the 1960s and 1970s; acting together, tight money accompanied by fiscal restraint and regulatory reform combined to cure inflation in the early 1980s and prevented a resurgence in Canada in the early 1990s.

This paper draws on a growing literature that finds higher government spending and deficits helped fuel the recent surge of inflation and, therefore, that both monetary and fiscal policy need to be deployed to contain inflation. It is important that the federal government reverse the trend of substantially higher government spending and deficits that began in 2015 and accelerated after 2019. Although headline inflation has retreated from its peak, a return to its target rate will require fiscal policy to reinforce monetary policy restraint. Asking monetary policy alone to rein in inflation risks an outcome where inflation remains elevated while the economy stagnates. Persistent inflation would keep interest rates high and, together with slow growth, would put continued upward pressure on government deficits. The best way to avoid such an outcome is for Canada’s fiscal policy to align with monetary policy.

Introduction

In response to the lockdown of large swathes of Canada's economy when COVID began circulating in March 2020, both monetary and fiscal policy shifted to unprecedented stimulus. The Bank of Canada lowered interest rates to near zero and expanded its balance sheet over fourfold, while governments ran deficits exceeding those incurred during wartime. This extraordinary stimulus, along with the quick adaptation of businesses and individuals to social distancing and telework, helped the overall economy recover rapidly even as industries providing client facing services continue to struggle. Disposable incomes rose steadily during the pandemic, buoyed by massive government transfers, and in a little over a year both real GDP and employment recouped all the 13.0 percent drop in GDP and 15.7 percent loss of jobs recorded at the worst point of the COVID crisis in 2020.

However, maintaining stimulus as much of the economy expanded beyond its pre-pandemic levels helped fuel inflation by boosting demand beyond supply. After a brief period of price declines in 2020, inflation, as measured by the all-items Consumer Price Index (CPI) began to pick up in the spring of 2021, accelerating to a 39-year high of 8.1 percent by July 2022. In response to higher inflation, the Bank of Canada began winding down its policy of quantitative easing and then raised interest rates in 2022.

Tighter monetary policy was accompanied by governments' reluctance to withdraw fiscal stimulus from the economy. After hitting a record \$327.7 billion in fiscal year 2020-21, the federal government's deficit remained swollen at \$90.2 billion in 2021-22 and a \$43 billion in 2022-23, (Canada, Department of Finance, 2023). These deficits significantly exceed the \$14.0 billion federal deficit before the pandemic began (Canada, Department of Finance, 2022a). In fact, the deficit in 2021-22 does not fully capture the extent of fiscal stimulus that year, as households drew on their savings accumulated from overly generous government support programs in 2020 and 2021 to sustain their spending as inflation surged. Provincial governments also have struggled to balance their budgets as they introduced tax cuts and subsidies to cushion the strain of inflation on household finances. The persistence of the federal government's deficits,

however, is more notable since it alone has a joint agreement with the Bank of Canada to control inflation, which implicitly commits the federal government to conduct policy in a manner consistent with achieving the inflation target.

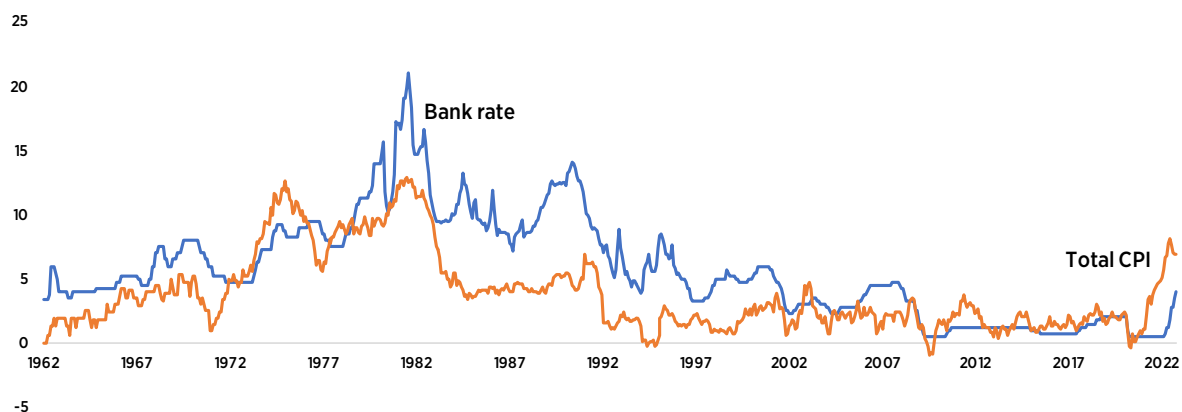
This paper draws on a growing literature that finds higher government spending and deficits helped fuel the recent surge of inflation and, therefore, that both monetary and fiscal policy need to be deployed to contain inflation. The main reason the federal deficit remains elevated even as the pandemic recedes is a nearly 30 percent increase in non-pandemic program spending from its level before the pandemic. Governments also are paying much higher interest rates on the huge amount of debt issued since 2020, as well as debt issued before 2020 that is now rolling over. The continued injection of fiscal stimulus is stoking aggregate demand and weakening public confidence that inflation will be brought under control. Rising inflation expectations fuel wage demands, risking a wage-price spiral that will keep inflation and interest rates elevated and dampen economic growth, putting renewed upward pressure on government deficits.

Monetary policy during the pandemic

Monetary policy has shifted from unprecedented stimulus in response to the pandemic to its tightest stance since at least 2007 as inflationary pressures have mounted quickly. As the pandemic began, monetary policy injected unprecedented stimulus into the economy and financial markets. Central banks slashed short-term interest rates to near zero while expanding their balance sheets more than during the two world wars (Piketty, 2022: 239). The Bank of Canada took a wide range of actions, including expanding its balance sheet from \$122.9 billion in February 2020 to \$530.5 billion a year later, intervening in specific financial markets (including provincial government and corporate bonds), providing lending guarantees, and ensuring bank liquidity (Bank of Canada, 2023a).

The Bank of Canada then delayed withdrawing some of this stimulus. While the Bank of England began hiking interest rates late in 2021, the Bank of Canada did not raise its short-term policy interest rate despite acknowledging in January 2022 that the economy had reached full employment and that “economic slack is now absorbed”—a signal that Bank policy makers should have expected an imminent upturn of inflation (Bank of Canada, 2022: 5). After this initial delay, the Bank hiked its policy interest rate sharply from 0.25 percent to 4.50 percent during 2022 as it became clear that higher prices were not the transitory supply-driven phenomenon the Bank originally assumed (see figure 1). In so doing, the Bank acknowledged that inflation was also due to an excess of demand over supply (Canadian Federation of Independent Business, 2022: 2).

A major concern of monetary policy today is making sure the surge in prices in 2022 is not reflected in higher wages, triggering a wage-price spiral. Monetary policy succeeded in heading off a wage-price spiral in the past—notably in 1990, when the implementation of the Goods and Services Tax led to a spike in the CPI, but wage increases were contained because the Bank of Canada successfully made “clear well in advance that monetary policy would not be financing any second-round inflation spillovers” (Crow, 2002: 193). The resulting drop of real household incomes during this period, however, slowed economic growth to a crawl, putting

Figure 1: Bank Rate and CPI Inflation in Canada, 1962 to 2022

Sources: Bank of Canada (2023c) and Statistics Canada (2023a).

upward pressure on government deficits that contributed to Canada's 1994 fiscal crisis.

Bank of Canada Governor Tiff Macklem clearly is concerned about a wage-price spiral, and has encouraged employers openly to restrain the wages they pay employees. Speaking to the Canadian Federation of Independent Business, Macklem said: "So as a business, don't plan on the current rate of inflation staying. Don't build that into longer term contracts. Don't build that into wage contracts. It is going to take some time, but you can be confident that inflation will come down" (quoted in Canadian Federation of Independent Business, 2022: 13). The outlook for wages in 2023 remains problematic: the Bank's own survey found that employers plan a 4.7 percent increase in labour compensation, although this is 1 percent lower than earlier expectations (Bank of Canada, 2023b). As well, the continued high level of job vacancies means slower economic growth might not translate into higher unemployment as much as in the past, and this would keep upward pressure on wages.

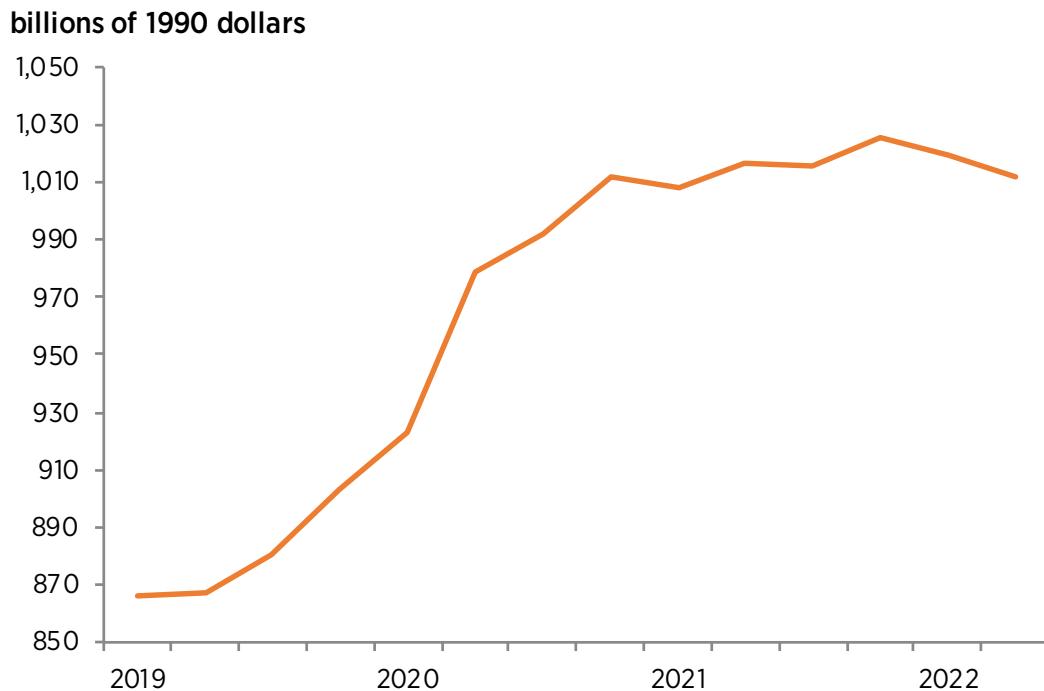
Fiscal policy during the pandemic

In response to the pandemic, governments in Canada aggressively expanded fiscal stimulus, running deficits equal to nearly 20 percent of GDP. The federal government led the way, providing emergency support to households, businesses, and other levels of government. These support programs, however, continued long after the emergency phase of the pandemic had passed, while new spending unrelated to COVID increased sharply.¹

In 2022, monetary policy shifted its focus to reducing inflation, but fiscal policy continued to inject stimulus and thus boost overall demand. Stimulus comes from ongoing deficits as well as the lagged effect of past COVID-related government transfers to individuals and businesses, leading to an extra \$200–\$300 billion of household savings accumulating during 2020, according to Bank of Canada estimates (Canadian Federation of Independent Business, 2022: 4). Figure 2 shows how some of these savings showed up in household cash and deposits during the pandemic.

¹ The same pattern of much higher government spending is evident in the United States. For example, President Biden unveiled his US\$1.9 trillion American Rescue Plan in March 2021 just weeks after Congress approved an earlier US\$900 billion package of COVID relief (Timiraos, 2022: 363), and then added a further US\$1.7 trillion over the next decade in a trio of stimulus plans unveiled over the course of 2022. Federal stimulus amounted to 15.0 percent of US GDP in fiscal year 2020-21, 12.4 percent in 2021-22, and 5.8 percent in 2022-23. Unrelenting deficit spending is why *The Economist* mockingly relabelled the Biden administration's Inflation Reduction Act of 2022 as the "Inflation Acceleration Action" (*The Economist*, 2022e).

Figure 2: Household Currency and Deposits (billions of \$), 2019 to 2022

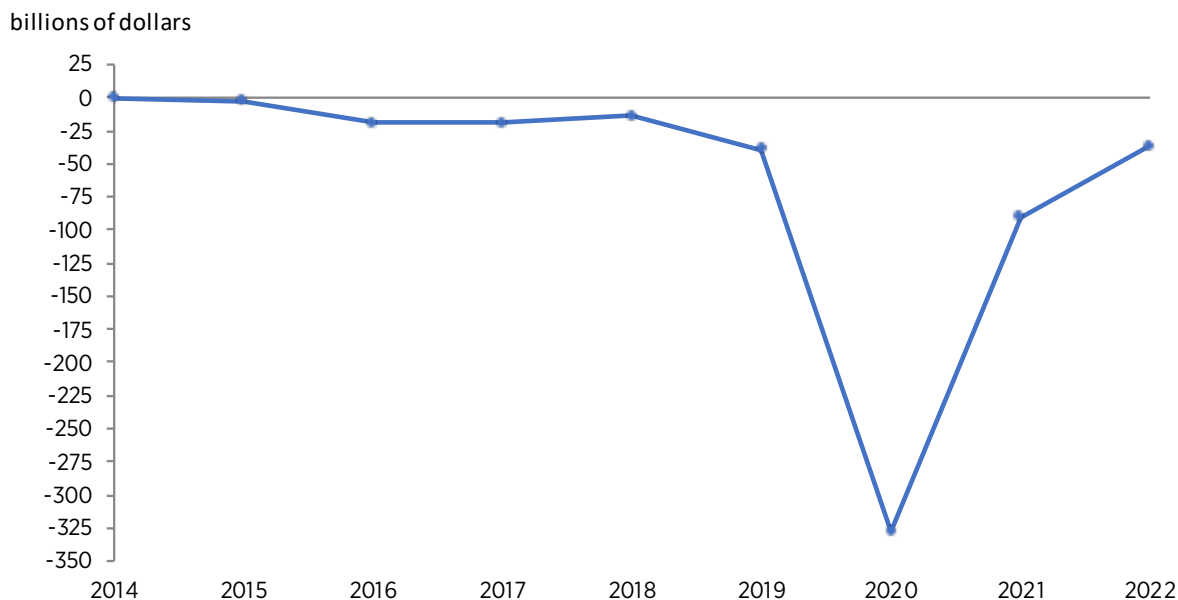


Sources: Statistics Canada (2023a; 2023b).

The soaring of federal spending since 2019

Federal spending has remained at extraordinarily high levels even as COVID relief programs wound down in 2022. The federal deficit amounted to \$327.7 billion in fiscal year 2020-21, \$90.2 billion in 2021-22, and \$43 billion in 2022-23, equivalent to 13.2 percent, 3.5 percent and 1.5 percent of GDP, respectively (Canada, Department of Finance, 2022a; 2022b; 2023). These deficits were driven by more spending, which outweighed higher revenues collected from taxation. In 2019-20, before the pandemic, federal program spending (which excludes interest payments on debt), totalled \$338.5 billion, or 14.6 percent of GDP (Canada, Department of Finance, 2022a). In its Fall 2022 fiscal update, the government projected program spending to be 28.9 percent above its 2019-20 level, reaching \$435.9 billion in 2022-23—equal to 15.7 percent of GDP (Canada, Department of Finance, 2022b). Outside of the COVID crisis, the 15.7 percent share is the highest government footprint on GDP since the year before the Chrétien government enacted fiscal austerity in 1994, and well above the low of 12.3 percent reached under the Harper government in 2013-14 (Canada, Department of Finance, 2022a). The 1.1 percentage point increase in the share of federal government program spending to GDP is one of the largest on record back to 1970. According to the Parliamentary Budget Officer, \$204.5 billion, or 35.5 percent, of the expansion of federal spending since the pandemic began was unrelated to COVID-related measures, even before additional spending programs were announced in the Fall 2022 Update or the promised new spending on Pharmacare (Canada, Parliamentary Budget Officer, 2022: 4). Figure 3 shows the federal budgetary balance from 2014-15 to 2022-23.

The 3.4 percentage point increase in federal spending as a share of GDP during the seven-plus years of the Trudeau government is the largest expansion of government over a comparable period since the mid-1970s, outside of the global financial crisis in 2008. Even after it became evident that inflation and interest rates were rising at a rapid clip in 2022, the federal government continued to boost outlays. In its Fall 2022 fiscal update, the government revealed that revenues were \$38 billion higher

Figure 3: Federal Budgetary Balance (billions of \$), 2014 to 2022

Sources: Canada, Department of Finance (2022a; 2022b).

than forecast in the spring budget and that it planned to spend \$13 billion of this windfall (Canada, Department of Finance, 2022b).

Meanwhile, total federal government outlays increased even faster than program spending because of rising interest costs on the vast amount of additional debt issued since 2020. Public debt charges dipped to \$20.4 billion in fiscal year 2020-21 as record low interest rates more than offset the huge expansion of federal debt in response to the pandemic (Cross, 2022: 28). The government now forecasts public debt charges will more than double in just two years from \$20.4 billion to \$43.3 billion in 2023-24 (Canada, Department of Finance, 2022b: 55). The Trudeau government's projection that interest payments will remain at \$50.3 billion by 2027-28 depends on the optimistic assumption that inflation will be brought under control by the end of 2024 and the interest rate hikes that occurred over the course of 2022 will be reversed.

Ottawa's actual spending likely will be higher than it projects, given the current government's track record of overshooting planned outlays. For example, when the pandemic began in 2020, the government projected its spending for fiscal year 2022-23 would be \$386 billion. It upped this figure to \$412 billion in its 2021 budget, then to \$434 billion in the 2022 budget, to \$448 billion six months later in its Fall 2022 fiscal update and finally to \$480.2 billion in the 2023 budget.

Profligate spending is hardly new for the Trudeau government. Former Finance Minister Bill Morneau complains that Trudeau's refusal to agree to a fiscal target starting in 2015 meant that Morneau had "to argue down every initiative" for more spending from his Cabinet colleagues, creating what he called a "dysfunctional process" (Morneau, 2023: 82–83). Morneau reveals that the attitude of the Prime Minister's Office (PMO) to spending requests was "let's give something to keep them happy," a stance he says "shattered any pretense of fiscal restraint" (Morneau, 2023: 123). This ad hoc approach to spending helps explain why actual spending consistently exceeds budget projections. The lax attitude to spending grew during the COVID crisis, when the PMO unilaterally raised the amount of support offered by the Canada Emergency Recovery Benefit and the Canada Emergency Wage Subsidy above the most generous proposals from the Department of Finance. The PMO's figures, according to Morneau, were "chosen with no regard for our detailed calculations and justifications, [and] meant we would be distributing billions of dollars more than was actually needed under the circumstances" (Morneau, 2023: 240). Some spending, such as increased benefits for seniors, were for "problems that didn't exist" (p. 241).

Provincial governments are also part of the story of government's expanding economic footprint. They have been slower to withdraw COVID-related fiscal stimulus than has the federal government. Altogether, provincial net borrowing totalled \$36.4 billion in 2020, \$34.1 billion in 2021, and \$32.4 billion in 2022.² Some of the increase in provincial spending was on health care due to the pandemic. Much of the 2022 deficits, however, also reflect stimulus cheques sent to households in Ontario and Quebec just before elections in those provinces, supposedly to help households contend with higher living costs stemming from escalating inflation, along with rebates for spending on travel-related services. Total provincial and federal deficits represented 19.7 percent of GDP in 2020, 5.4 percent in 2021, and 2.4 percent in 2022.³

Government leaders invoked low interest rates to rationalize their spending splurge during the pandemic. The federal government argued that, "[i]n today's low interest rate environment, not only can we afford

² The provincial government data are on a National Accounts basis, which is more comparable across provinces and timelier than data from the provinces themselves. As such, the data are not strictly comparable with the Public Accounts data cited for the federal government. The latter are used because they are the basis for the federal government's forecasts cited in this paper.

³ These data for the federal and provincial governments are more comparable to the US deficit because Canada decentralizes more of its government and almost all US states are not allowed to run budget deficits.

these investments in Canada's future, it would be short-sighted of us not to make them" (Canada, Department of Finance 2021: 24). This echoed US Treasury Secretary Janet Yellen's justification of a raft of new programs and hundreds of billions of dollars of extra spending by saying, "Right now, with interest rates at historic lows, the smartest thing we can do is act big" (Timiraos, 2022: 276).⁴

Although low interest rates were used to justify higher government spending, their sudden end in 2022 has not curbed governments' enthusiasm for spending. Federal and provincial debt continues to grow as governments introduce transfers and subsidies to insulate households from inflation and expand social programs. Moreover, fiscal stimulus introduced before 2022 is still being felt by the economy, helping to boost inflation well above the forecasts of most economists and central banks at the start of 2022. The period when a government deficit is recorded does not always correspond to when stimulus is injected into the economy. Much of the money governments transferred to households at the onset of COVID in 2020 was saved—as "pre-loaded stimulus," in Finance Minister Chrystia Freeland's own words—and was then spent in 2022 as inflation squeezed household purchasing power and normal economic activities resumed. This was reflected in a drop in the household saving rate from 26.5 percent in the second quarter of 2020 to 5.7 percent in the third quarter of 2022.

⁴ Yellen's comment contradicted her own conclusion in 2001 that containing the budget deficit in the early 1990s paid off for the United States because it "held down interest rates and made space for the private-sector investment boom." Furthermore, when asked in 2003 what could go wrong in the next decade or two, Yellen warned that "large budget deficits ... were likely to return" (Hilsenrath, 2022, 161–63).

Inflation's surprise to governments and many economists

The surge of inflation caught governments and central banks by surprise. The 2021 federal budget forecast CPI inflation of 2.2 percent in 2021 and 2.0 percent in 2022, while the actual outcome was 2.6 percent in 2021 and is on track for 6.8 percent in 2022. The 2022 budget forecast of CPI inflation was still three percentage points below its likely outcome. These forecasting errors reflect how the government underestimated the impact of stimulus on demand and the persistence of distortions to supply chains from the pandemic—Chen and Tombe (2022) conclude that supply shocks accounted for the largest part of higher inflation in Canada. Furthermore, as noted earlier, governments could not predict exactly when stimulus would be released into the economy because multiple spending programs were enacted quickly and so much of the money transferred to households was saved.

The failure of most economists to forecast higher inflation cannot be blamed solely on unexpected supply shocks. Several leading economists warned of the inflationary potential of excess stimulus. They include former US Treasury Secretary Larry Summers, who openly worried that “we’re taking very substantial risks on the inflation side... We are printing money, we are creating government bonds, we are borrowing on unprecedented scales” (Forbes et al., 2022). Former Bank of England Governor Mervyn King was blunt in saying that, during 2020, “central banks decided it was a good time to print a lot of money. That was a mistake. That led to inflation. We had too much money chasing too few goods. And the result was inflation. That was predictable. It was predicted, and it happened” (quoted in Yakabuski, 2022). One such prediction came from economists at Johns Hopkins University, who forecast US inflation of between 6 and 9 percent based on the surge in the money supply; US inflation reached 9.1 percent in mid-2022 (Hanke and Hanlon, 2022). Canadian bank executives also warned about the build-up of inflationary pressures: RBC’s chief executive officer signalled in 2021 that “there is persistent inflation building” as Canadians began spending the savings accumulated early in the pandemic (Bradshaw, 2021).

Even if the initial impulse for higher inflation in 2021 originated in supply shocks, this does not erase the economists' and policy makers' responsibility to understand supply dynamics better. Economists have only a limited understanding of how the pandemic affected potential output—notably, the labour supply. Relying too much on the unemployment rate as a proxy for unused resources failed to capture fully the disruption to supply. More broadly, John Cochrane of the Hoover Institute argues that “[t]he [US Federal Reserve] being surprised by supply shocks is as excusable as the Army losing a battle because its leaders are surprised the enemy might attack” (quoted in Varadarajan, 2022).

There is good reason to believe inflation will continue to exceed forecasts. When both economic models and financial markets have a poor record at predicting inflation, “it makes sense to put more weight on data and less on forecasts” (*The Economist*, 2022h). That is to say, more weight should be given to the recent track record of inflation rather than to the views of analysts who missed the upturn of inflation in the first place.

Fiscal stimulus helped fuel inflation in North America

In most OECD member countries, fiscal measures served their stated purpose of replacing only income lost due to the pandemic. In Canada, however, real disposable incomes rose 8.3 percent in 2020, a reflection that fiscal support not only replaced household income but enhanced it, partly because the stimulus was poorly targeted as the PMO fixated on the popularity of support programs for households and not the efficient use of public funds (Morneau, 2023: 237).

A similar pattern of excessive fiscal stimulus in the United States helped fuel price increases, which spilled over into Canada. In the United States, research by the Federal Reserve Board concludes that fiscal support measures adopted during the pandemic contributed about three percentage points to a 5 percent increase in prices (using core CPI, which excludes food and energy prices) by the end of 2021 (Jorda et al., 2022: 1). Another paper from the Fed concludes that government spending helped raise prices because it “boosted the consumption of goods without any noticeable impact on production, increasing excess demand pressures in good markets”—even before Russia’s invasion of Ukraine (de Soyres et al., 2022: 1).

As a result of rising prices, central banks tightened monetary policy in 2022. This triggered widespread losses in markets for stocks, bonds, and commodities and a slump in Canada’s overheated housing market. Nevertheless, governments continued to roll out programs that transfer money to households reeling from the impact of higher prices, thereby further stoking demand and aggravating inflation. Programs introduced in 2022 include lower fuel taxes in Ontario and Alberta, cheques of up to \$500 for drivers in Ontario, \$600 for most households in Quebec, \$600 for seniors and every child under 18 years old in Alberta, along with electricity rebates, and \$4.6 billion of support from the federal government. Quebec promised an additional “inflation shield” that included \$3.5 billion of short-term tax credits and \$1.8 billion of income tax reductions, financed by diverting funds intended for debt reduction. Such policies likely have increased the excess of demand over supply in the Canadian economy, putting additional upward pressure on inflation and interest rates.

The role of both monetary and fiscal policy in controlling inflation

Monetary policy is always inextricably linked with fiscal policy, and not just because “inflation is a tax, even if not an explicit one” (Crow, 2002: 235). Leeper and Leith (2016: 6) argue that “it is always the *joint* behavior of monetary and fiscal policies that determine inflation and stabilize debt.” Monetary policy directly affects the cost of servicing government debt (as well as private sector debt) and exerts a large influence on economic growth, which impacts government revenues and spending. In the current circumstances, the expansion of the Bank of Canada’s balance sheet to push interest rates lower via quantitative easing meant significantly shortening the maturity structure of government debt by swapping long-term bonds for shorter-term debt. This exposes public finances to rising short-term interest rates. In turn, fiscal policy affects monetary policy through its effect on economic growth as well as on investor assessments of the sustainability of the government’s fiscal position—which in turn influences interest rates (the United Kingdom discovered the importance of the latter in 2022, as outlined below).

Besides these direct connections, there are other links between monetary and fiscal policy. After a period of large budget deficits, governments might be tempted to increase inflation in order to reduce the “real” burden of their debts, which are mostly denominated in nominal terms. Milton Friedman observed that “Inflation has been irresistibly attractive to sovereigns because it is a hidden tax that at first appears painless or even pleasant, and, above, all, because it is a tax that can be imposed without specific legislation. It is truly taxation without representation” (Friedman, 1991: 25). Government tax revenues depend on both the volume of economic activity and prices, so higher prices are reflected in more government revenues. The resulting temptation to stoke inflation and thereby raise tax revenues to lower government debt is the main reason central banks were granted more independence from government directives in recent decades.

Most people today assume monetary policy has the primary or even exclusive responsibility to control inflation. This has not always been the case. Monetary policy did not take the lead in fighting inflation in the 1960s and 1970s, partly reflecting a lack of confidence—even among

central bankers—in the efficacy of monetary policy. Federal Reserve historian Allan Meltzer noted that the Employment Act of 1946 mandating the government pursue full employment ignored monetary policy because the conventional view was “that fiscal policy was powerful and monetary policy was weak or impotent.” (quoted in Berman, 33) Former US Fed Chair Arthur Burns famously declared in 1979: “It is illusory to expect central banks to put an end to the inflation that now afflicts the industrial democracies” (quoted in Hilsenrath, 2022: 90). Instead, central banks like the Fed “believed the country was experiencing something called ‘cost push’ inflation” (Leonard, 2022: 61)⁵ caused by unions pushing up the cost of labour and the OPEC cartel raising the cost of oil, which was beyond the control of monetary policy.

To fill the vacuum left by monetary policy in the 1960s and 1970s, fiscal and incomes policy moved to the forefront in fighting inflation. Canada’s then Finance Minister Edgar Benson introduced an austerity budget in 1968 to curb inflation, claiming the economy’s “central problem [is] the control of public expenditures” (Canada, Department of Finance, 1968: 5).⁶ Benson adopted more austerity in 1970 because “[o]ur fiscal policy must avoid excess demand on production and markets” (Canada, Department of Finance, 1970: 7). However, the attempt at fiscal restraint was haphazard over the next decade, with large spending binges outweighing brief periods of restraint. The last attempt at fiscal probity followed Prime Minister Pierre Trudeau’s participation in the 1978 G7 Summit, “where a consensus had emerged that growth in government spending was fuelling inflation.” Without consulting his Cabinet, Trudeau “simply declared at the time that a \$2 billion cut in government spending would be made” (Savoie, 2022: 136).

Because maintaining fiscal discipline proved difficult for governments, they increasingly turned to an incomes policy of wage and price controls in the 1970s to curb inflation. Canada’s government set the price of oil from 1974 to 1982 and introduced broad wage and price controls from 1975 to 1978. US President Richard Nixon introduced a freeze on wages and prices in 1972, which evolved into full-fledged wage and price controls and was then followed by another freeze before being ended in 1974 (Garten, 2021: 300). In both countries, the illusion that incomes policy would cap inflation encouraged expansionary monetary and fiscal policies, worsening inflation over the longer term (Garten, 2021: 301).

⁵ The Bank of England identifies four costs that can contribute to higher prices: commodities, the exchange rate, wages, and taxes (Bank of England, 2022: 148–50).

⁶ Similar thinking led the US Congress to tighten fiscal policy to slow inflation, enacting a 10 percent surtax on income in 1968 “in order to fight the inflation which was then accelerating” (Friedman, 1991: 12).

Former Fed Chair Ben Bernanke spoke for the consensus of economists when he called incomes policy “a costly failure” (Bernanke, 2022: 8). The inability of fiscal or incomes policy to control inflation in the 1970s, and the perceived success of tight monetary policy in vanquishing the inflation dragon in the 1980s, fostered a broad consensus that monetary policy was “the only game in town” for controlling inflation (Bernanke, 2022: 43).

High government spending and deficits undermined the credibility of monetary policy in the 1960s and 1970s. Acting together, tight money accompanied by fiscal restraint and regulatory reform combined to cure inflation in the early 1980s and prevented a resurgence in Canada in the early 1990s. Several economists conclude that monetary policy by itself did not control inflation in the 1980s until it was reinforced by lower government deficits and other policy reforms such as deregulation. Bianchi and Melosi (2022, 23) note that Volcker’s first attempt in 1979–80 to rein in inflation faltered because it was not backed by credible fiscal actions. It was only when President Ronald Reagan reinforced Volcker’s policy with a commitment to restrain federal spending and lower the primary deficit (which excludes interest payments) that inflation finally receded.⁷ Paul Volcker was emphatic about the need for monetary and fiscal policy to work together to control inflation. In testimony to the Senate Banking Committee in 1981, he said: “I know that the case is sometimes made that monetary policy can alone deal with the inflation side of the equation. But not in the real world—not if other policies pull in other directions, feeding inflationary expectations, propelling the cost and wage structure upwards, and placing enormous burdens on financial markets with large budgetary deficits into the indefinite future” (quoted in Shelton, 2023).

Research from the Federal Reserve Bank of Chicago, presented at the Fed’s annual Jackson Hole retreat in 2022, shows that fiscal policy must join tight monetary policy to control inflation because

[t]rend inflation is fully controlled by the monetary authority only when public debt can be successfully stabilized by credible future fiscal plans. When the fiscal authority is not perceived as fully responsible for covering the existing fiscal imbalances, the private sector expects that inflation will rise to ensure sustainability of national debt. As a result, a large fiscal imbalance combined with a weakening fiscal credibility may lead trend inflation to drift away from the long-run target chosen by the monetary authority. (Bianchi and Melosi, 2022: 1)

⁷ While Reagan lowered taxes in 1981, he signalled a lower deficit with the Tax Equity and Fiscal Responsibility Act of 1982, the Social Security Amendments of 1983, and the Deficit Reduction Act of 1984 (Bianchi and Melosi, 2022: 24).

The undermining of tight money policy by current fiscal stimulus

There is an incompatibility between lax fiscal policy and a monetary framework targeting a low and stable inflation environment. This is because raising interest rates to control inflation initiates a vicious cycle where a slowdown in the economy results in bigger deficits and a higher ratio of government debt to GDP, which stokes inflationary pressures. Without reinforcement from fiscal policy, central banks risk a kind of “fiscal stagnation” where inflation rises even as GDP growth slows because the anti-inflation reputation of central banks is undermined by lax fiscal policy. Bianchi and Melosi (2022: 3) summarize that “When inflation has a fiscal nature, monetary policy alone may not provide an effective response.” This conclusion supports Sargent’s 2013 reformulation of Friedman’s famous dictum about monetary policy⁸ in fiscal terms, where “persistent high inflation is always and everywhere a fiscal phenomenon,” at least when inflation is rooted in fiscal policy (Bianchi and Melosi, 2022: 2).⁹

Several other leading economists acknowledge the need to coordinate fiscal and monetary policy. Christine Lagarde, the president of the European Central Bank, agrees that “monetary and fiscal policy play a complementary role in fighting price pressures” and they “must work hand in hand and not contradict each other” (The Economist, 2022b: 11). The Hoover Institute’s John Cochrane, a leading proponent of the Fiscal Theory of the Price Level (which holds that in some circumstances the price level is determined by fiscal policy rather than by monetary policy), wrote that “[m]onetary policy alone can’t cure a sustained inflation. The government will also have to fix the underlying fiscal problem” (Cochrane, 2022). The interdependence of monetary and fiscal policy in controlling inflation means current Fed Chair Jerome Powell was mistaken to assert

⁸ Friedman wrote that “Inflation is always and everywhere a monetary phenomenon.”

⁹ Other economists have noted the close correlation of high inflation with large deficits. For example, Peter Bernholz, an expert in hyperinflations, has stated: “There has never occurred a hyper-inflation in history which was not caused by a huge budget deficit of the state” (quoted in Coggan, 2011: 240).

that monetary policy simply adjusts to whatever stance [is] taken by fiscal policy.¹⁰

Increase in public debt since 2019 weakens the credibility of governments' commitments to reduce current high rates of inflation. Without fiscal restraint, tight monetary policy alone will have difficulty returning inflation to its target rate. For example, even if monetary policy had turned restrictive before 2022, Bianchi and Melosi (2022: 26) estimate that large government deficits would have resulted in an easing of inflation by only one percentage point, at the cost of a 3.4 percent loss in real GDP.

Some politicians acknowledge the need to coordinate monetary and fiscal policy. French Finance Minister Bruno Le Maire recently admitted that "Central banks' restrictive policies are ineffective if public finances continue to expand" (quoted in Ip, 2022a). Many others, however, maintain that monetary policy has the sole responsibility for inflation. They include Quebec's Finance Minister Eric Girard, who dismissed the inflationary impact of his government's spending by saying inflation is the job of central banks. Similarly, as UK Chancellor of the Exchequer, Kwasi Kwarteng planned to increase spending, he "declared it [Governor of the Bank of England] Andrew Bailey's job to deal with the resulting rise in inflation" (quoted in *The Economist*, 2022c).

Shifting all the responsibility for fighting inflation to monetary policy puts central banks in an impossible position. They cannot criticize governments for not tightening fiscal policy, as it would give the appearance of unelected officials telling elected leaders what to do, but their silence feeds the erroneous conclusion that fiscal policy has no responsibility for inflation.

¹⁰ When asked at a press conference if Biden's US\$1.9 trillion stimulus in 2021 contributed to inflation, Powell replied, "It's the Fed that has responsibility for price stability. Whatever arrives in terms of fiscal activity, we take it as a given." (quoted in Ip, 2022b)

Avoiding fiscal dominance of monetary policy

Monetary and fiscal policy work best when acting in unison, but this does not mean monetary policy should be subservient to fiscal policy. The latter is called “fiscal dominance,” which is usually associated with countries dealing with war, a major disaster, or political instability (Bernanke, 2022: 363). In all these situations, the risk is that the central bank becomes a money printing operation that helps subsidize government spending.

Modern Monetary Theory (MMT) is the epitome of complete fiscal dominance. In the words of former Fed Chair Bernanke, MMT “would eliminate central-bank independence and institutionalize fiscal dominance” by keeping interest rates low at all times and charging fiscal policy with managing all economic affairs, including price stability (Bernanke, 2022: 363). Former Bank of Canada Governor Stephen Poloz is equally critical of Modern Monetary Theory, ridiculing every term in its name by noting it “is not modern. Nor is it monetary, as the envisioned stimulus to the economy comes from government spending, regardless of how it may be financed. There is also very little by way of theory in the framework: it is based on accounting, which connects the standard process of new money creation to the government balance sheet” (Poloz, 2022: 159).

Although Modern Monetary Theory has not been adopted, so-called Quantitative Easing (QE) has been widely implemented by central banks over the past decade, especially during the pandemic. QE involves central bank purchases of financial assets, usually (but not exclusively) government debt, in an attempt to raise their price and lower interest rates. Record low interest rates and the widespread adoption of QE during the pandemic encouraged governments to believe interest rates would stay low for a long period and therefore led to a view that large deficits would not be as costly as in the past.

Central bankers such as Bank of Canada Governor Tiff Macklem encouraged the belief that interest rates would stay low for a prolonged period. During a July 2020 press conference, Macklem stated: “Our message to Canadians is that interest rates are very low and they’re going to be there for a long time. If you’ve got a mortgage or if you’re considering making a major purchase, or you’re a business and you’re considering

making an investment, you can be confident rates will be low for a long time” (BNN Bloomberg, 2020). This view has been contradicted by the unexpected arrival of much higher inflation that led central banks to raise interest rates. The shortening of the maturity of government debt due to QE means that governments did not lock in debt at low interest rates, a costly error as rates normalized.¹¹ Meanwhile, the inversion of the yield curve, where short-term interest rates rose above long-term rates, combined with the shortening of the maturity of debt held by the Bank of Canada, resulted in significant financial losses for the Bank.

¹¹ Another problem is that Quantitative Easing can be quite difficult to wind down. Because central bank funding became so important to the markets for the financial assets they buy, slowing these purchases can cause price fluctuations that undermine financial stability. QE, instead of being an emergency action “that would quickly boost growth and create jobs, and which could then be repealed so everything could return to normal,” meant that central banks ended up holding their assets for much longer than they intended and pushed prices above their fundamental value, risking another financial crisis (Leonard, 2022: 139). For example, the Fed intended to end its US\$750 billion QE plan—launched after the global financial crisis of 2008–09—by June 2013; instead the value of its asset purchases ballooned to US\$1.6 trillion and did not begin to shrink until October 2017 (Leonard, 2022: 147). This delay in selling assets (mostly government bonds) on the Fed’s balance sheet encouraged government officials to believe cheap debt would persist for long periods. As shown earlier in the quotes from Yellen and Freeland, politicians were quick to seize on low interest rates as an invitation to spend freely.

Low inflation's insulation of monetary policy from fiscal dominance

Some analysts mistakenly imply a trade-off exists whereby some fiscal tightening, such as Canada implemented in 1994, can be exchanged for lower interest rates. The problem is the Bank of Canada cannot guarantee any particular interest rate outcome “because the Bank’s target was inflation, not interest rates” (Crow, 2002: 192). Although the Bank did ease monetary policy in 1994, helping to boost the economy and offset fiscal restraint, it was low inflation that allowed interest rates to fall. In today’s high-inflation environment, tighter fiscal policy would dampen the increase in interest rates because inflation likely has been fuelled in part by the large deficits posted during the pandemic. It would be difficult for Canada today to repeat what the late Harvard economist Alberto Alesina called a textbook example of “expansionary austerity” in the mid-1990s, when austerity was “accompanied by output growth above a certain threshold” (Alesina et al., 2019: 6). Expansionary austerity also requires the deficit be reduced by spending cuts, not tax increases, thereby encouraging business investment (97).

In a chapter titled “Fiscal and Monetary Policy: Together and Apart” in his book on monetary policy, Former Bank of Canada Governor John Crow articulated one aspect of how a central bank should coordinate with government fiscal policy (Crow, 2002: 183).¹² Central banks should not suppress interest rates solely to lower the cost of servicing government debt, he argues. Crow notes that the Bank clearly has a “responsibility to see to it that the government’s debt is sold at the lowest cost available,”

¹² The main conflict with fiscal policy during Crow’s tenure as Governor was “the conviction that by fighting inflation, monetary policy was keeping interest rates up, keeping the economy down, and in effect driving the budget into deficit,” while today the conflict is higher interest rates are attempting to slow inflation while fiscal policy is actively stoking demand (Crow, 2002: 187-8). Another minor irritant he notes is when the Mulroney government partly de-indexed tax brackets (only adjusting them for inflation above 3 percent), which gave the impression that the government had an inflation target of over 3 percent, above the Bank of Canada’s goal (full indexation was restored in 2000) (Crow, 2002: 186).

and by the “lowest cost available” he means as determined by financial markets, not by the Bank’s acting to keep interest rates artificially low. The Bank enables the lowest cost of credit by ensuring bond buyers have “reasonable confidence that they would not get hosed through an inflationary monetary policy” (Crow, 2002: 193).

Moreover, encouraging deficit spending through low interest rates is not stimulative over the longer term. Inevitably, more government debt issued today means more or higher taxes in the future, and higher taxes are a drag on economic growth. Economist Richard Vedder summarizes the trade-offs between increased government spending financed by debt or taxes: “Borrowing imposes a hidden burden upon taxpayers in the short run and an explicit burden in the long run, while taxes impose an explicit short-run burden and a hidden burden in the long run” (quoted in Bahnsen, 2022: 194).

Conclusion

It is important that the forthcoming federal budget reverses the trend of substantially higher government spending and deficits that began in 2015 and accelerated after 2019. Although headline inflation has retreated from its peak, a return to its target rate will require fiscal policy to reinforce monetary policy restraint. Asking monetary policy alone to rein in inflation risks an outcome where inflation remains elevated while the economy stagnates. Persistent inflation would keep interest rates high and, together with slow growth, would put continued upward pressure on government deficits. The best way to avoid such an outcome is for fiscal policy to reinforce the current restraint in monetary policy.

Appendix

Lessons from the United Kingdom's recent experience with fiscal stimulus

The importance of having fiscal policy not work contrary to monetary policy to cool an overheated economy was starkly underscored by the recent fiasco in the United Kingdom, which ultimately led to the resignation of Prime Minister Liz Truss after only 45 days in office. Truss ran her campaign for the Conservative leadership by attacking what she called “the Treasury’s obsession with the balance of taxes and spending as ‘abacus economics’” (The Economist, 2022d). Truss and her Chancellor of the Exchequer, Kwasi Kwarteng, produced a mini budget on September 23, 2022, that called for tax cuts for individuals and corporations and expanded subsidies for household facing rising energy bills without cuts to other areas of spending. This package of measures, had it been implemented, would have increased the UK government’s budget deficit by US\$78.5 billion, or 3 percent of GDP, according to an independent review by the Office for Budget Responsibility after the fact (The Economist, 2022d). Furthermore, the Bank of England was not informed of the Truss government’s intention to increase fiscal stimulus substantially at a time when the operating deficit was already very large both in absolute terms and relative to GDP.

The impression left by the Truss government’s failed initiative was that fiscal and monetary policy were at cross-purposes, with “one pressing hard on the accelerator and the other pushing down on the brake” (The Economist, 2022f). This contradiction caused turmoil in financial markets. By September 27, long-term interest rates on UK government bonds had reached 5 percent¹³ and the exchange rate had fallen over 10 percent, aggravating the upward pressure on import prices. The next day, the Bank of England announced it would temporarily buy bonds to restore order to the market, reversing its previous commitment to reduce bond holdings (Fairless, 2022). The flip-flop of the Bank’s policy to lower its holdings of

¹³ Bond yields for 30-year inflation-linked bonds soared by 68 basis points on September 26 and a record 76 points on September 27. On September 28 the Bank of England announced it would buy bonds to stabilize the market. For details on these market gyrations, see Gyftopoulou et al (2022).

government bonds and instead finance increasing government debt raised questions about the Bank's commitment to lower inflation. In response, the Bank's chief economist said the government's spending would likely force "a significant and necessary monetary-policy response" at its next policy meeting (Fairless, 2022). When Truss fired Chancellor Kwarteng and installed Jeremy Hunt as the Chancellor, he quickly cancelled US\$34 billion of planned tax cuts. Together with emergency intervention by the Bank of England, long-term government bond rates subsided to 4 percent. The upheaval in financial markets in Britain confirmed former Bank of England Governor Mervyn King's warning in 2016 that high government debt would be the most likely trigger for the next economic crisis, because "[d]ebt has now reached a level where it is a drag on the willingness to spend and likely to be the trigger for a future crisis" (King, 2016: 337).

Other countries maintained expansionary fiscal policy even as central banks struggled to lower inflation. Since September 2021, European governments have spent over half a trillion euros to keep energy prices affordable after supplies from Russia were disrupted. European Central Bank President Christine Lagarde said such a surge in spending could lead the Bank to raise interest rates (The Economist, 2022h). Germany accounted for almost half of the increase in Europe, spending 5.2 percent of its GDP on subsidies to reduce consumer's gas bills (The Economist, 2022b). In France, the Macron government unveiled plans in September 2022 to spend US\$43 billion on subsidies to cushion households from higher energy costs, after freezing gas prices and capping the rise in electricity prices to 4 percent. Following a US\$64 billion cost-of-living package passed in August, this left France's budget deficit at 5 percent of GDP in both 2022 and 2023, leading Standard & Poor's to downgrade France's credit outlook to "negative" (The Economist, 2022a). One explanation as to why markets reacted more virulently to Truss's proposals than did stimulus packages in other countries is that the UK tax cuts and resulting deficits were intended to be permanent, whereas recently announced energy subsidies for many continental Europe nations were presented as temporary. (Italy was one exception, as its bond yields shot higher in 2022; there, even temporary deficits add to one of the world's highest debt levels, which is now being financed at much higher interest rates.) US President Biden's plans to spend and run large deficits over an extended period have not provoked as negative a response in financial markets as that experienced by the United Kingdom, partly reflecting the US dollar's role as the world's dominant reserve currency.

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