CAPITAL MARKETS RESEARCH

Derek Holt (416) 863-7707
derek_holt@scotiacapital.com

Karen Cordes Woods (416) 862-3080
karen_woods@scotiacapital.com

Special Update

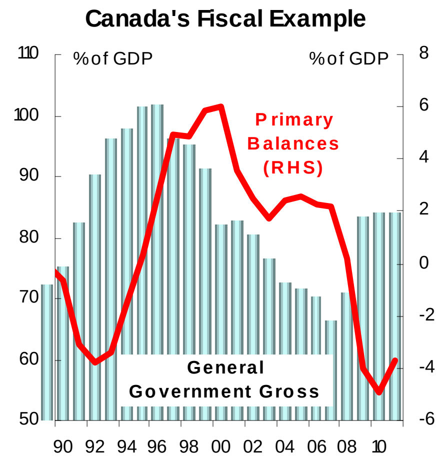
Germany's Case Is Buttressed By Canada's Experience

- **Canada achieved fiscal repair under more arduous conditions than those that are facing the US and Europe today — and did so without resorting to the printing press.**

The night of the Quebec referendum on October 30th, 1995 portrayed Canada at its worst. The palpable fear in the markets was keyed off deep intertwined concerns about the country's fiscal, economic and political circumstances. Recall this was a period when a respected US financial daily slammed Canada as a 'banana republic', yet curiously such references to its home country are absent today. I'm paraphrasing from memory, but it was also a period when the nation's political leaders dismissed capital markets critics as "armchair observers who wouldn't know how to run a country." Such a market-unfriendly back drop understandably drew the ire of rating agencies through multiple downgrades, as well as bond markets as the country faced the threat of break up and dissolution of monetary union. Simply put, Canada then was Europe today.

Within this context, the point to this note is to reject a popular argument from those who say Canada faced an easier time at restructuring its finances (chart 1) than either the US or Europe would today. Their argument is historical revisionism at best, and shameful affirmation of today's global fiscal malfeasance at worst. In what follows below, we argue that the US and core Eurozone economies face arguably easier conditions within which to pursue necessary fiscal and political reforms today than Canada faced back then — and yet Canada never resorted to the monetary printing presses back before the western world went mad in seeing this as the solution to decades of fiscal profligacy. We do so through ten then-and-now comparisons , and our broad argument is that Canada's past experience lends support to Germany's current opposition to non-sterilized bond buying by the ECB and other short-term solutions in favour of accelerated fiscal austerity and reforms. The only long-run viable policy solution for the ultimate survival of the Eurozone is through reining in the purse strings, as other policy options would only build upon imbalances and further intensify the odds that the eurozone experiment ultimately fails.

Chart 1



Source: IMF September 2011 WEO.

1. Unstable Politics

The US, France, and Germany are among the significant global economies facing elections over 2012-13. A common argument is that this makes it harder for these countries to pursue fiscal austerity today. Political instability in Canada during the 1990s, however, occurred as a backdrop to aggressively pursuing fiscal austerity. The Quebec referendum was the culmination of years of political acrimony particularly accentuated by the Meech Lake constitutional discord — all set against the back drop of rating downgrades and an enormous debt burden. Canada also faced tumultuous federal election campaigns throughout its efforts toward fiscal repair including 1993 and 1997. The Liberals who led the effort toward fiscal repair were rewarded with a third consecutive majority government in 2000.

A second proposition within a comparison of political regimes is that the very possibility of a break up of the eurozone makes this crisis different than what Canada experienced. This, however, was at least as great of a threat facing Canada in

Scotia Economics
Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia_economics@scotiacapital.com

1995. Great fear existed at the time over how the debts would be split if Quebec pulled out of Confederation, and whether Quebec would abandon Canadian monetary union with the separatists sometimes advocating joining the USD, or creating another currency. The very survival of Confederation was at stake, including through the perceived alienation of the western provinces in particular. Massive divisions existed across federal and provincial levels of government that almost ripped the country apart. The mountain of debt and the controversial push by the Federal government toward solving it in part on the backs of the provinces almost broke up Canada. Eventually federalism won in Canada simultaneous to achieving fiscal repair and it is this twin battle that Europe must fight now with the same stakes in play.

2. World Growth

It's a fallacy that it was easier for Canada to right its fiscal ship because the world economy was growing much faster during the period in which it brought its debt-to-gdp ratio lower starting from the 102% peak in 1996 through to the 80% range by the early 2000s and the 66.5% trough in 2007. For a commodity producer and trading nation like Canada, it is world GDP that matters, and the country's fiscal progress was achieved despite the Asian financial crisis, Russia's technical default and eurozone debt market turmoil that contributed toward the collapse of a major hedge fund, and the dot-com bubble's popping. Achieving fiscal repair in the context of severe strains on the world economy is something that Canada experienced long before the present day. World GDP growth was only in the 2-3 percent range from 1990 through 1995, only accelerated to about 4% growth in 1996-97, and then abruptly slowed again to the 2 ½% - 3 ½% mark over 1998-99 when the Asian financial crisis hit. The dot com bubble period lifted world growth to 4.8% in 2000 and then it crashed again to a two-handled pace in 2001-02 at about the same time that 9/11 hit, yet it was just after this point that much of Canada's fiscal repair had been achieved. This contrasts to the ease with which Europe and the US could have achieved fiscal consolidation during the 2004-07 period when global growth soared to the 5% range in each year. That would have been a far more hospitable back drop to world growth for US and European fiscal austerity than anything Canada experienced in the 1990s. After collapsing in 2009, world GDP growth was 5.1% in 2010 and we are projecting it to slow to 3.8% this year, 3.7% in 2012 and 4.0% in 2012. That is still not outside of the bounds of world growth experienced by Canada in the 1990s.

3. U.S. Growth

A further fallacy is that Canada could achieve fiscal repair only thanks to the back drop of decent US economic growth. This argument is heard more from foreign sources than from those who recall the experiences from within the Canadian market at the time. There are two key arguments against this.

First, most of Canada's fiscal improvement in the 1990s was achieved through domestic program expenditure reduction — not through revenue gains keyed in part off of US growth influences on Canada (chart 2). Federal government program spending as a share of GDP dropped from 17.4% in FY1992-93 to about 12% by FY2000-01. This five full percentage point reduction in program spending swamped any changes in revenues, as revenues were largely flat at about 18% as a share of GDP. Of this reduction in program spending, major transfers to other levels of government only accounted for a relatively small portion of the cut backs as they went from about 3.8% in FY92-93 to 2.3% by FY2000-01. Thus, the federal government largely imposed heavy austerity on itself in a drive back to balance.

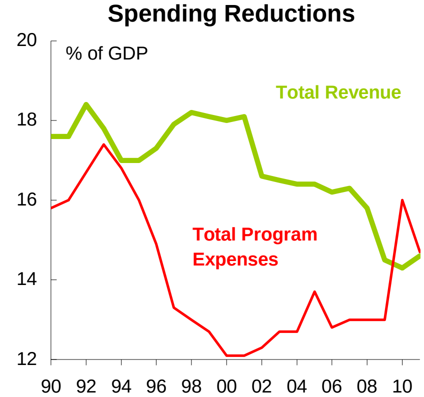
Second, we now turn to arguing that any advantage stemming from a decent US growth back drop for Canada's trade account was more than negated by other severe disadvantages facing the country versus Europe and the US today.

4. Interest Expense

It must also be noted that Canada achieved virtuous fiscal rectitude within the context of a crushing interest expense burden that neither the US nor most of Europe presently face. In the 1990s, total federal public debt charges as a share of GDP soared to about 6.6% by 1990-91 and remained over 5% until the 1997-98 fiscal year in stark contrast to how low interest rates are keeping the US interest expense burden at rock bottom levels today (chart 3). In order to achieve fiscal balance, Canada had to pursue the draconian cuts to program spending noted above as a high interest burden made achieving fiscal balance vastly more difficult. That day may come for the US and core Europe, but current bond markets afford enormous flexibility to global governments outside of peripheral European states which is not being adequately capitalized upon particularly in the United States.

Chart 2

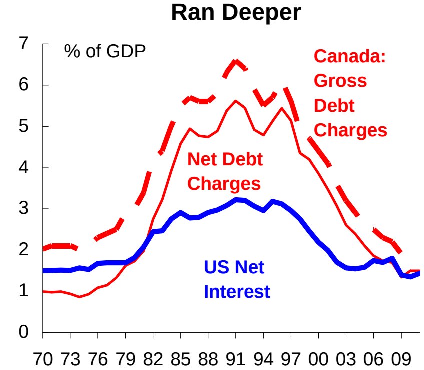
Canada Did It Through Program Spending Reductions



Source: Department of Finance, Scotia Economics.

Chart 3

Canada's Interest Burden Ran Deeper



Source: Finance Canada, OMB, Scotia Economics

5. CAD and Monetary Policy

US monetary policy is exceptionally easy right now, in stark contrast to the back drop against which Canada pursued fiscal repair in the 1990s. Indeed, Canadian financial markets were far from offering a hospitable back drop against which to pursue fiscal repair. Canada's floating currency was pummeled in the 1990s and went from 1.12 against the USD early in the decade to about the 1.40 range by 1995 before cruising around such depths until a renewed round of depreciation took it to the 1.50 mark by decade's end. This is too simplistically offered as an explanation of how Canada must have been able to achieve fiscal balance by relying upon currency depreciation through a floating exchange rate. What's missing here is what monetary policy was doing partly in response to such currency weakness which occurred despite the fact that the BoC pushed rates skyward with the overnight rate rising by about four full percentage points to about 8% by 1995 in a failed attempt to defend the currency and during the earlier days of targeting low and stable inflation including the fear that CAD depreciation would prompt a surge in import prices. This failed attempt at defending the currency — including through outright intervention - is one of the reasons why the BoC has not attempted intervention since. Thus, Canada achieved fiscal repair against the back drop of tighter monetary policy that didn't allow the mixed benefits of currency depreciation to flow through whereas the US and more of the eurozone should be pursuing fiscal austerity against the back drop of exceptionally easy monetary policy and forgiving bond markets which makes the task far easier. Indeed, the whole term structure of Canadian rates in the 1990s made the path back to fiscal balance far more difficult as Canada 10s peaked hit about 9½% in early 1995 before hitting a low of about 5% in late 1998. By contrast, US and German 10s today are yielding about 2% while short US rates are near zero. While bond yields may rise appreciably in future, that only strengthens the case for why the US and Europe should pursue more aggressive fiscal repair now versus kicking the can down the road and it merits repeating that Canada never had the glorious starting opportunity presented by an exceptionally low interest burden. The challenge of US and European fiscal austerity will be as intense as it was in Canada if they wait to face the same interest burden that Canada grappled with in the 1990s.

6. Housing Bubble

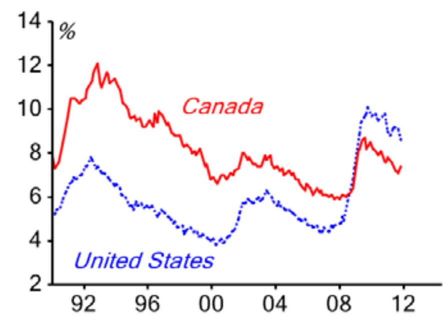
If one thinks the US and parts of Europe cannot pursue fiscal austerity today in the context of a popped housing bubble, then one doesn't recall Toronto's housing market experiences in the late 1980s through the 1990s. Like the house price collapse in the US today — and its sharply differing regional magnitudes — Canada and specifically its biggest province of Ontario was going through the popping of a housing bubble in the early 1990s. Toronto house prices had peaked by 1989 and didn't hit a trough until 1995 when they had fallen by almost 30% in value. Toronto house prices on average did not regain their 1989 peaks until 2002. While other regional housing markets performed better than Ontario's during this period, average nationwide house prices were flat in nominal terms and fell in real terms throughout the 1989-1999 period. The depressed state of the country's housing market was also reflected in housing start volumes that collapsed from the 200-280k range of the latter half of the 1980s down to the 100k-160k range from the mid-1990s throughout the rest of the decade. Against this miserable back drop for the country's largest regional economy and its national housing market, Canada nevertheless pursued fiscal austerity.

7. Labour Markets

It's an understatement to say that labour markets are stressed in the US and parts of Europe, but Canada was no better in the 1990s. As chart 4 depicts, Canada's unemployment rate was double digits even after taking account of modest measurement differences. In fact, upon including discouraged workers, Canada's truer measure of unemployment stood at about one in five back then after including discouraged workers who simply dropped out of the labour force. US pressures are comparable today, but the European experience is mixed from peripheral pressures all the way down to Germany's 7% unemployment rate.

Chart 4

Canada's Stressed 1990s Labour Market



Source: Statistics Canada, Bureau of Labor Statistics, Scotia Capital Economics

8. Corporate Balance Sheets

Europe and the US have the enormous advantage of having excellent corporate balance sheets as the back drop against which to pursue fiscal austerity today. Canada also has excellent corporate balance sheet strengths today. That wasn't at all the case for Canada back in the early 1990s, however, when the country's corporate debt-to-equity, interest coverage, and profit margin ratios were severely strained before which painful corporate deleveraging put Canada on a path toward today's corporate strengths. The fact that Canada achieve fiscal deleveraging simultaneous to both household and corporate deleveraging made its achievements far more impressive.

9. Negative Feedback Effects

A Keynesian — assuming a particular interpretation of the school of thought — might argue that now is not the time to pursue fiscal austerity because the global economy is weak. One might quip that it's apparently never a good time to do so. Regardless, had that been the prevailing wisdom for Canada in the 1990s, the country would have never achieved long run fiscal repair and planted the seeds for the benefits it began to reap in the 2000s. Had Canada not taken a big bath in the 1990s against a weak domestic growth back drop fraught with problems like poor corporate balance sheets and popping house prices, it would have never been in a position to reap the benefits of the fiscal dividend that emerged in the past decade. Instead, Canada leveraged its general government debt to GDP ratio down from a peak of 102% in 1996 steadily lower throughout the rest of the decade and to 66.5% by 2007 before accelerated pre-crisis spending and the crisis response pushed this ratio back upward to about 84% now. While this ratio has trended higher of late, it remains superior to the 100+% US ratio today and Canada's financial asset position results in a net government debt to GDP ratio of just under one-third.

10. Printing Presses

A further key distinction is that Canada achieved this track record without resorting to the monetary printing presses in contrast to the United States and some proposals for Europe. The fact that it is accepted as common wisdom in widening circles that printing money is a necessary solution to fiscal largesse is nothing short of a shocking failure of modern economics. Before priming the printing presses to fund governments became the convention across western economies, Canada achieved fiscal progress the old fashioned way: through austerity that followed an over two-decade long debt binge and by paying its bills. The country took its very hard knocks to growth and financial markets versus the unwillingness to do so across much of today's western world, and the path toward enhanced Federalism and fiscal repair was littered with doubters and critics.

It may well be that stopping the printing presses and halting increasingly accommodative monetary policy by instead allowing bond markets and rating agencies to speak more aggressively would be more in the interests of the US and European economies over the long run — as was the case for Canada. In this regard, Germany's insistence that fiscal austerity is the only long run sustainable solution for Europe's — and one might say the U.S.'s — troubles may be leveraging off of the ultimately successful Canadian experience and so might Germany's reticence to have monetary policy cross the line toward creating moral hazard issues in the financing of imprudent fiscal policy.

In fact, it's important to rectify a false impression that quantitative easing amounts to cheap insurance in a low inflation world against global sovereign debt shocks. Contrary to this view, the full consequences to Germany and the ECB to caving in to pressures to monetize debt are that fiscal profligacy never gets cured AND long-run inflation results. For one thing, the moral hazard associated with a central bank bailing out politicians could well amplify future fiscal pressures. For another, it is wistful thinking to hope that central banks will know when to turn off the taps at the right time given their historical track record, particularly the Fed's over the decades. Should such a printing scenario come to fruition, then one has seen nothing yet by way of a future crisis that would only further raise the odds of the longer run collapse of the eurozone. It is in this respect that the eurozone must pick its poison: risk a greater crisis now toward the possibility of expedited fiscal austerity and effective oversight, or cement the long run failure of the eurozone project at a later date. Against this back drop, the ECB should be much firmer in clearly stating it has no policy desire to rescue politicians in the short term.

Conclusion

As a consequence to its earlier sacrifices, Canada is today part of a dying breed of AAA rated markets. Its status as the 8th largest global bond market at face value somewhat hides the additional fact that fewer yet are AAA rated among the world's deepest bond markets. Against the myth that this was easier for Canada to achieve during different times, what's amazing about the Canadian experience is that it was achieved during at least as trying if not more troublesome times after taking account of the full global and domestic picture at the time. The country therefore offers an important lesson to nations like the United States and large parts of Europe that are delaying fiscal repair, and punting the problem down the road toward a more ruinous crisis later.

All that said, our message is not one of arrogant neglect toward the present Canadian situation. The country has done well through the crisis, but resting on its laurels and pointing to past painful achievements is no way of ensuring that the country retains its advantages. Today's large Canadian trade deficits, still sizeable fiscal deficits at Federal and some provincial governments, the increase in the general government debt to gdp ratio from a trough of 66.5% in 2007 to about 84% today following pre-crisis accelerated spending and the crisis stimulus response, high refinancing amounts on short-dated debt at combined levels of government, record high house prices by any measure, and record high household leverage are sources of concern. They are, however, mitigated by a strong financial system, little external debt relative to GDP in contrast to Europe, excellent corporate balance sheets, resource riches, and a strong government financial asset position that translates into a net debt to gdp ratio of just over one-third. This mixed assessment of the nation's finances for a trade-reliant country that is a price taker across most industries makes it prudent to continue to pursue measures that extend its relative success.