

How Canada Escaped the Global Recession

by David Lee on August 29, 2011

Four months ago, Canadians emphatically renewed the ruling party's conservative mandate, handing Stephen Harper and the Tories the country's first majority government in over a decade. This victory was underscored by the humiliating decline of the Liberals — the country's "natural governing party" — who were displaced by a radical fringe party in their office of Official Opposition in the Canadian House of Commons. Adding insult to injury, the leader of the Liberals, former Harvard professor Michael Ignatieff, failed to win his own seat and was sent unceremoniously into political retirement.

The May 2 triumph of the Conservative Party in Canada's federal election marks a dramatic climax to what has been an unlikely course of political events in a country whose very identity had been inextricably tied to its reputation for being a Liberal stronghold. This shift in political climate becomes all the more striking when viewed against the political developments that had been taking place concurrently in the rest of the developed world.

As Republicans and Democrats pushed America further and further to the left and Europe approached ever closer to its socialist ideals, Canada's political discussion turned from which party could offer the greatest subsidies to the greatest number, to which party's program of tax cuts would be of more benefit to the economy. For a country where an openly avowed socialist party regularly polls in the top three in provincial and federal elections, this is no small feat. For perhaps the first time in its history, Canada finds itself at the most pro-market limit of the political spectrum among the world's industrialized nations.

It is not only in this regard that Canada has become an island unto its own. Equally unique to the country is its economic performance subsequent to the financial crisis of 2007 and throughout the ensuing alternations between recession and stagnation that has characterized the experience of the greater part of the developed world since. As the world teeters from crisis to crisis, Canada has proven remarkably resilient in spite of its heavy economic dependence on international trade. Whether there is any significance to the coincidence of these two anomalies will be examined in what is to follow.

By no means is this piece to be taken as an unqualified endorsement of the policies undertaken by the incumbent administration. Despite the overall tenor of the article, this piece could have just as easily been scathing indictment as commendation. The appraisal to be made varies directly with the choice of benchmark. Measured against examples that more closely approximate the free-market ideal such as 1980s-era Hong Kong and Jacksonian America, Canada falls hopelessly short.

But take the broad index of industrialized countries as a point of reference, and few will debate the strength of Canada's record. It is only in this latter context that anything in the present article is to be taken as a voucher for Canadian economic performance and it is only against the policies of the countries thus referenced that Canadian policy is being demonstrated to be superior.

Performance

That Canada has fared considerably better than the balance of countries hit by the financial crisis is commonly accepted. As noted in *The Economist*, by 2010 Canada had already been well into recovery from one of its mildest recessions on record while the rest of the developed world was struggling to keep from plunging headlong into economic chaos.^{[1],[2]} Statistics Canada reported that Canada's recession was the shortest and mildest among the countries that make up the G7, lasting only three quarters as compared to between four and six quarters in the rest of the group, and output, as measured by GDP, falling by 3.3 percent from third quarter 2008 to third quarter 2009 as compared to 3.7 percent in the United States — a number that understates the contraction given the recent downward revision from a cumulative 4.1 percent decline to 5.1 percent for the 2007–2009 period — and even larger declines in Europe and Japan.^[3]

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Canada's GDP has since been on an uninterrupted run of consecutive quarterly increases, capped recently by an annualized rate of 3.9 percent^[4] reported for the first quarter of the current year after posting an overall rate of 3.3 percent for 2010.^[5] Meanwhile, new figures for the United States show the economy skirting contraction in the fourth quarter of 2010 and overall anemic growth rates persisting to the present.^[6] The situation in Europe need hardly be recounted.

Subsequent to the financial crisis and onset of recession, the initial job loss was also markedly lower in Canada than in other countries. Now, Statistics Canada reports that the economy added net 7,100 jobs over the past month, following increases of 28,400 in June; 22,300 in May; and 58,300 in April, and has effectively recouped all the job losses sustained since the beginning of the financial crisis.^[7] Canada's overall unemployment rate currently stands at 7.2 percent^[8] as compared with 9.2 percent^[9] in the United States.

In a recent Bank of Canada survey, businesses reported the highest hiring expectations on record amid broad optimism about future demand. A quarter of the Canadian businesses that responded are facing labor shortages. Respondents also indicated plans to increase investment spending — a factor critical to economic productivity that is far too often overlooked in the misguided obsession over consumer spending.^[10] All of this has contributed to a surging Canadian dollar, which has risen from a low of 0.77 USD/CAD to well above parity and is presently making record highs on a regular basis.^[11] By any conventional metric, Canada's economic performance can thus be demonstrated to have surpassed those of its peers during and subsequent to the recession.

Policy

To the extent that economic outcomes are determined by the actions of market participants, and are not exclusively the result of factors beyond their control, it is reasonable to assume that a large proportion of any differences in outcome between two given economies can be explained by the different courses of action pursued by the largest market player in each respective economy, which in virtually all cases is the government. Having established Canada's economic strength, it is thus well to review the record of government policy in Canada and the ways in which it differed from policy in other developed countries in order to discover the source of Canada's outperformance.

Beginning with the more immediate causes of the divergence in trajectory between the Canadian economy and the others, a logical starting point would be to contrast Canada's response to the financial crisis of 2007 with those of its peers. Sharing the same prospect of economic havoc with the rest of the developed world in the face of the largest financial collapse in recent history, what is unique to Canadian policy during that period lies in the design and execution of its stimulus plan.

While the United States rose to the occasion with their monolithic trillion-dollar stimulus package and the rest of the world followed suit, Canada, as noted by many opponents of the ruling party at the time,^[12] all but sat idly by, and what little it did in the way of spending did nothing to contribute to its aversion of disaster, as demonstrated by the Fraser Institute.^[13]

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According to then-Liberal finance critic John McCallum, "whereas other countries like England, France and Japan [were] pouring tens of billions of dollars into stimulus, and China and the United States hundreds of billions, what [did] this government do? Nothing. All it [did was] cut."^[14]

When opposition parties finally prodded the Tories into putting forward a stimulus package, the result was quite the anticlimax. As Canada's leading left-leaning policy think tank, the Canadian Centre for Policy Alternatives quite cogently pointed out, the government's stimulus package was "only one quarter the size of the U.S. package and half the amount advocated by the International Monetary

Fund. ^[15] Clearly, Canada's "stimulus package" was about as ambitious as a homeless man. In effect it was little more than a clever display of political gamesmanship whereby the appearance of action was maximized, while the action itself was minimized in order to control the damage the stimulus would cause while absolving itself of any culpability in the event of any externally induced shocks.

That the ideal policy would have been to do completely nothing, rather than merely almost nothing, is a conclusion that would have been laughed to scorn by policymakers and the public at large at the time but is nevertheless a fact that has been made painfully apparent now that the results of massive government deficit spending have become manifest. And so, with reference strictly to the differences in policy following the financial crisis, the question as to how Canada managed to escape the fate of the United States and Europe is answered not by what Canada did but rather by what Canada failed to do. It is precisely in this abstinence that we find Canada's source of relative success.

As far as the immediate policy response following the crisis is capable of explaining the economic results that obtained thereafter, the foregoing provides the answer to the disparity between the Canadian economy and those of its counterparts. However, it should be understood that a debacle like Greece is not simply a product of the policies undertaken over the prior year. Likewise for the current predicament in the United States — it takes more than one political term to drive what was once the world's largest creditor nation into near-default.

The relative strength of Canada's balance sheet is thus not to be ascribed in whole to the Conservative Party and the seven years it has now been in power but rather to the oversight it received at the hands of its ruling authorities throughout the broader period encompassing both the Conservative administration, which took power just before the financial crisis and the administration preceding it. And here we find an unlikely protagonist in the Chretien-era Liberal Party.

Under the joint leadership of Prime Minister Jean Chretien and Finance Minister Paul Martin, Canada underwent one of the most fiscally responsible periods in its history. Debt reduction was a goal that figured prominently throughout the ten years of the Chretien administration and in the subsequent two years of the finance minister's administration. Taking power as Canada's debt levels were hitting record levels, Martin made it clear from the start that the priorities of the government would be fixed squarely on eliminating the deficit and the record of the following decade leaves little doubt that this was a commitment that was delivered upon powerfully.

Martin went to great lengths to bring the public on board, televising the lobbying efforts of interest groups and publishing dire reports on Canada's fiscal situation, and then embarked on what was in all probability the greatest reduction in government spending ever undertaken in Canada from its inception. Following a peak deficit of \$42 billion in fiscal 1993–1994, the administration managed to reverse the deficit and produce a surplus by 1997–1998, and sustain the surplus over the following two years before posting a historical record of \$17.1 billion in budgetary surplus in fiscal 2000–2001.

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From that point, the government was able to produce a surplus every year up to 2007–2008, at times finding itself alone among G7 administrations in doing so. This was a period during which several significant tax cuts were implemented including a \$58 billion tax-cut package in 2001 ^[16] alongside the reintroduction of inflation indexing for personal income taxes. This paralleled the experience in the provinces, which themselves were able to achieve budget balance in the aggregate by 2000 while concomitantly applying substantial cuts in personal income and corporate tax rates. ^[17]

And thus effectively the whole of the fiscal turnaround in Canada, to the extent it was effected through endogenous factors, can be quite unambiguously attributed to cuts in government spending. Altogether, Chretien and Martin presided over more than \$80 billion in surpluses ^[18] and there is no doubt that this is the single most enduring feature of their legacy.

Equally instructive is the counterexample of the preceding administration. Prior to the Chretien regime, the Mulroney-led Conservative Party had led Canada into a protracted period of economic decline due to its inability to shake off the prevailing Keynesian orthodoxy of deficit spending as a means of reducing unemployment.^[19] Incidentally, the dramatic spending cuts implemented by Martin were accompanied and followed by a steep decline in the unemployment rate — from a high of 11.4 percent in 1993 to 6 percent in 2007.^[20] Having raised Canada's level of debt-to-GDP to an unprecedented high of 67 percent,^[21] the Mulroney administration is a typical example of the futility of free-market rhetoric in shaping the course of the economy so long as practice remains bound by the spell of Keynesian doctrine. Together, the two episodes form an addition to the endless wealth of historical instances of economic outcomes occurring in precisely the opposite manner from that predicted by Keynesian theory.

The lesson of the succeeding Harper government is largely the same. Following the example of Paul Martin and the Chretien administration, Finance Minister Jim Flaherty and the Conservative Party posted surpluses in their first two years in power, helping to bring down the debt-to-GDP ratio — a measure that had been as high as 68.4 percent in fiscal 1995–1996 — to 28.8 percent in 2009,^[22] giving Canada the lowest ratio in the G7^[23] and making Canada the only G7 country to post ten consecutive surpluses since 1960.^[24] Although this quickly deteriorated into unseemly deficits in fiscal 2008–2009 and 2009–2010 due to the political jockeying of a vulnerable minority government, by that time it was too late to overcome the favorable impact of the policies of the preceding decade.

Lessons

By now it should be clear that Canada was an economic anomaly in a world falling apart through the duration of the global recession that began in 2007. As the crisis in Europe continues to spread and the US economy reels after narrowly averting national default, while Canada contemplates interest-rate hikes amid a broadly strengthening economy, it appears this is a story that has little changed. Insofar as this aberration is not to be entirely attributed to the conspiracy of fortuitous circumstances, the most logical explanation is to be found in the differences in policy between Canada and the rest of the developed world and, further, that this difference consists most convincingly in its relative restraint of government spending both immediately following the financial crisis and throughout the preceding decades.

Thanks to Canada's own debt problems at the expiration of Mulroney's term, deficit spending by the government had acquired a bad taste in the mouths of Canadians and this negative association has persisted up until the present as announcing budget deficits has become almost anathema to the voting public. This goes far in explaining why the political developments in Canada leading up to 2007 were so markedly different from other developed countries and why the country is the fiscal envy of the world today.

The big story of the 2007 financial crisis and indeed of the continuing global meltdown is the sovereign-debt crisis unfolding throughout the West. The approach to government largesse that differentiated Canadian policy from that in the rest of the world is now paying dividends as the financial media swoons over Canada's current fiscal situation.^[25] If there is a lesson to be gleaned from this experience, it is that, whatever the supposed short-term benefits may be, the long-run economic implosion necessitated by rampant government spending can only be delayed, never averted.

No nation is exempt from the laws of economics and, as the United States and Europe are now learning, the ultimate bankruptcy of an unbounded government is just as inexorable in the developed world as it is in third-world countries.

But surely this is all just common sense, the reader may object — and rightly so. It is the specialty of economists to cause rational human beings to forsake the self-evident in favor of absurdities — sometimes to the benefit of society, but more often not. One of the greatest naiveties upheld throughout this episode consisted in the thinking that reckless spending and budget deficits, when they occurred in third-world countries, were a sign of irresponsible government, but that somehow when adopted by developed countries it became "fiscal stimulus."

We are now witnessing the failure of Keynesianism on a grander scale than has ever been experienced — never before has the impotence of Keynesian policy been demonstrated so comprehensively. Regardless of how many Nobel laureates continue to insist that the problem was and continues to be insufficient spending, it is clear that the undoing of Keynesian economic theory is now complete and unequivocal, and one of the greatest frauds ever perpetrated on the public under the guise of economic science has finally been put to rest.

Prospects

Of course no evaluation of a country's economic policies would be complete without making note of the missteps that invariably occur. Aside from questions of magnitude, where improvement can always be found by simply increasing the scope of the beneficial changes effected, the fact that Canada incurred a \$55.6 billion deficit in 2009^[26] in order to finance its misguided stimulus package stands out as a particularly large step backwards.

Aside from the tax cuts, everything earmarked in the package including the bailout of the auto sector can safely be counted as pure waste. Monetary policy is another abortive scheme to manage the market being carried out in Canada that is destined to fail. Although the Bank of Canada has not indulged in the profligate excesses of the printing maestro at the Federal Reserve, its ostensibly conservative mandate of inflation targeting is nonetheless a poor substitute for the market processes that are necessary to prevent long-term disequilibrium in the economy.

The artificially low interest rates induced by its policies have been producing housing bubbles across the country that may potentially cripple the economy when they burst. Their role in the underpricing of risk and the related rise in household debt entails consequences that are equally inauspicious. Even apart from these weaknesses, no country is entirely immune to the vagaries of global markets. Though Canada may have escaped the brunt of the fallout of the global recession, by no means can it expect to emerge unscathed when the global depression begins in earnest.

However, if Canada's ruling authorities remain true to their stated intentions and revive their pre-recession legacy of cutting both spending and taxes, there is no doubt its recovery will come to Canada sooner and with much greater vigor than it will in the rest of the countries affected, proof of which can be found in its experience over the last five years.

It is not unremarkable that a historically unpopular party has managed not only to maintain but also substantially increase their popular support in two consecutive elections in the midst of global economic turmoil. A country whose economy depends on international trade for the bulk of its economic output and whose largest trading partner happens to be one of the primary victims of the worldwide economic crisis would quite naturally be among the countries least expected to reelect its governing party into power in such conditions.

The fact that this nevertheless occurred stands as testament to the strength of Canada's economic record. If the United States and Europe hope to have any role in the world of the future, it is clear they have much to learn from the Canadian example and the lesson of Canada can be summarized as follows: the size of a country's problems is directly proportional to the size of its government.