The Bank of Canada Cannot Afford to Unduly Delay Normalization

When the Canadian economy was suffering the effects of the oil shock in 2015 and after the Bank of Canada (BoC) further had to cut interest rates that were already very low, it became clear that the economic policy mix was unbalanced; the time had come for a more expansionary fiscal policy. During the 2015 federal election campaign, the Liberal Party made such commitment, and was successful. In its spring 2016 budget, the government announced $120B in total infrastructure projects over a 10-year period. An additional $81B was announced in the fall update.

The government is now approaching the middle of its mandate, and while some fiscal interventions have paid off (notably the family tax credits), the economic impact of the public infrastructure component is widely regarded as a disappointment to date. This is a crucial component of fiscal policy. Infrastructure spending has higher multiplier effects than tax relief for households. It also helps boost productivity growth, thus ensuring long-term gains.

There are, however, some signs that may indicate the beginning of a more substantial effect. True, the national accounts revealed an anemic annualized growth rate of 0.5% in government fixed capital formation for Q2, hardly contributing to GDP growth. However, part of the weakness is due to an annualized decline of 4.1% in public investment in non-residential buildings, as well as a 1.0% contraction in investment in intellectual property. These declines masked a robust 14.7% expansion in engineering works, the component most directly related to public transit infrastructure projects. And this might only be the beginning. According to Infrastructure Canada, 60% of the first public transit investment fund remains to be allocated, mainly in Quebec and Ontario.

**IMPLICATIONS**

Even while the Canadian economy hovers near its full capacity, the full effect of announced infrastructure investments has yet to be felt. It speaks to the main shortcoming of fiscal policy: its slowness. There are implications that can be drawn for monetary policy. The risk is that the Canadian economy is over-stimulated, which would in principle lead to upward pressure on inflation and force the BoC to tighten its monetary policy more rapidly. With the high debt load of Canadian households, an abrupt tightening would not be the ideal scenario. This is why, despite the uncertainty that prevails on several issues, the BoC cannot afford too much delay in its normalization. Rather, the BoC would be better off signaling that, apart from a major negative shock, it will continue to reduce the degree of monetary accommodation in gradual fashion.

Jimmy Jean, CFA, Senior Economist

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**GRAPH**

Is the infrastructure boost finally becoming palpable?

Real public investment in engineering works

Quarterly annualized variation in %

-30 -20 -10 0 10 20 30


Sources: Statistics Canada and Desjardins, Economic Studies

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### References

François Dupuis, Vice-President and Chief Economist • Mathieu D’Anjou, Senior Economist
Benoit P. Durocher, Senior Economist • Francis Généreux, Senior Economist • Jimmy Jean, Senior Economist • Hendrix Vachon, Senior Economist
Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

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