Debt, Interest, and Growth:

Newfoundland's Budget in Perspective

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Overview:

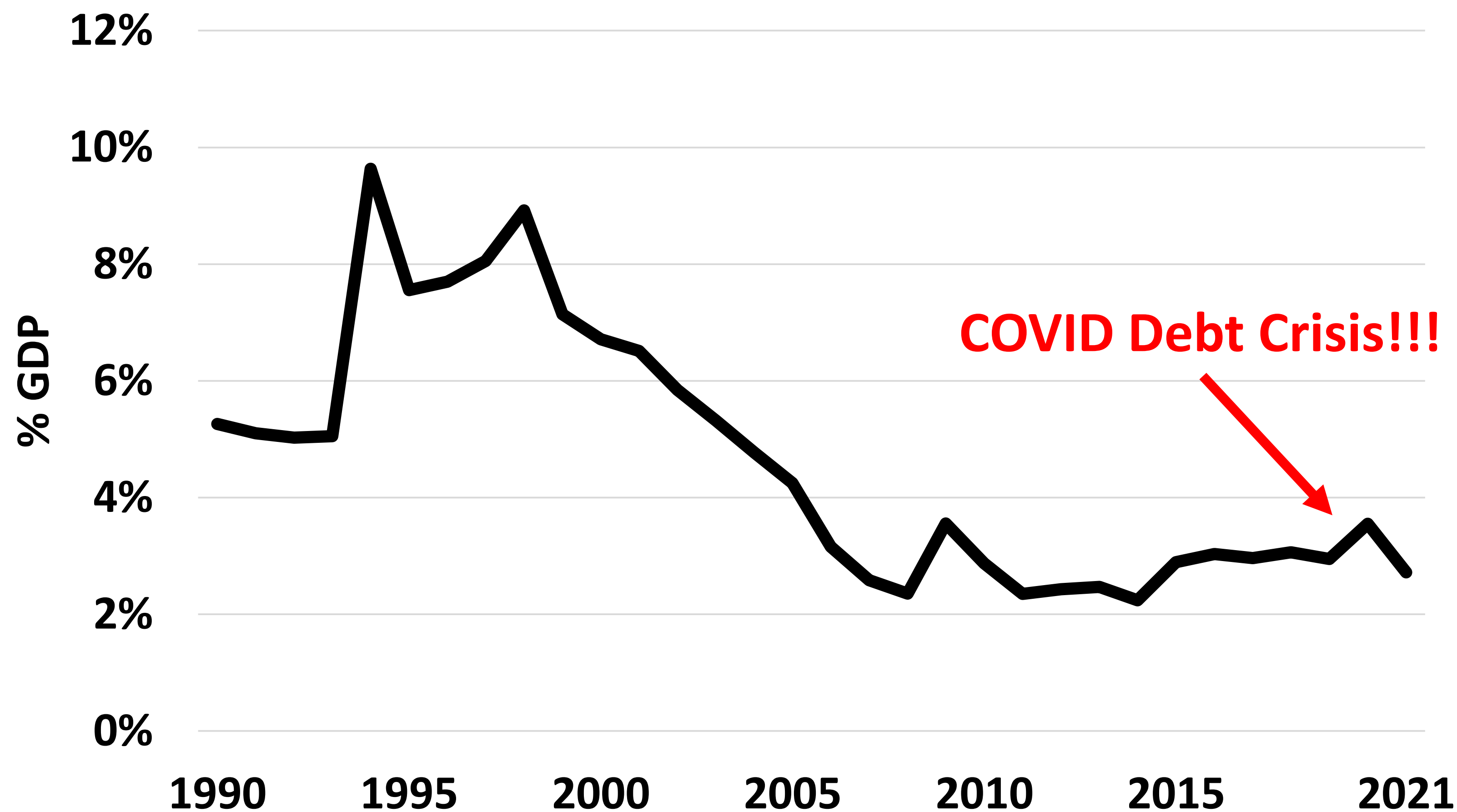
1. What is the constraint on government.
2. Understanding the dynamics of budget balances, debt, and interest.
3. Newfoundland’s fiscal evolution.
4. Addressing the real problem.
5. Learning from Europe.

Governments do NOT Have to Balance Their Budgets

(Neither do households or corporations, BTW)

- Like other actors, ongoing accumulation of debt is normal and even positive.
  - Particularly when matched to long-lived productive assets.
- For a sovereign government with its own currency, there is no binding fiscal constraint.
- For sub-national governments (or those without a currency), constraints are more binding:
  - Stability of debt burden to GDP
  - Stability of debt service costs to GDP (easier if i falls)

Newfoundland’s Debt Service



Dynamics of Budget Balance, Debt, Growth, and Interest

$$\Delta \frac{D}{GDP} = \Delta D - \Delta GDP$$

$$\Delta \frac{D}{GDP} = \frac{Def}{D} - g$$

$$\Delta \frac{D}{GDP} = \frac{iD + OD}{D} - g$$

$$\Delta \frac{D}{GDP} = i + \frac{OD}{D} - g$$

$$\Delta \frac{D}{GDP} = (i - g) + \frac{OD}{D}$$

Implications of Debt Stability

- If g > i, D/GDP tends to decline.
- D/GDP can be stable or falling with ongoing operating deficit.
- The bigger the difference between g and i, the bigger is the sustainable operating deficit.
- It gets even better, if we consider second-order effects of g on the operating deficit.

It Gets Better…

$$OD = \bar{G} - (t * GDP)$$

$$\Delta OD = \Delta\bar{G} - \Delta(t * GDP)$$

$$\Delta OD = \Delta\bar{G} - \Delta t * g$$

$$OD = OD_{t-1} + \Delta\bar{G} - \Delta t * g$$

$$\Delta \frac{D}{GDP} = \left[i - \left(1 + \frac{t}{D}\right) g\right] + \frac{OD_{t-1} + \Delta\bar{G}}{D}$$

Newfoundland's Fiscal Parameters and Debt Stability Conditions

$$\frac{D}{GDP} = 47\%$$

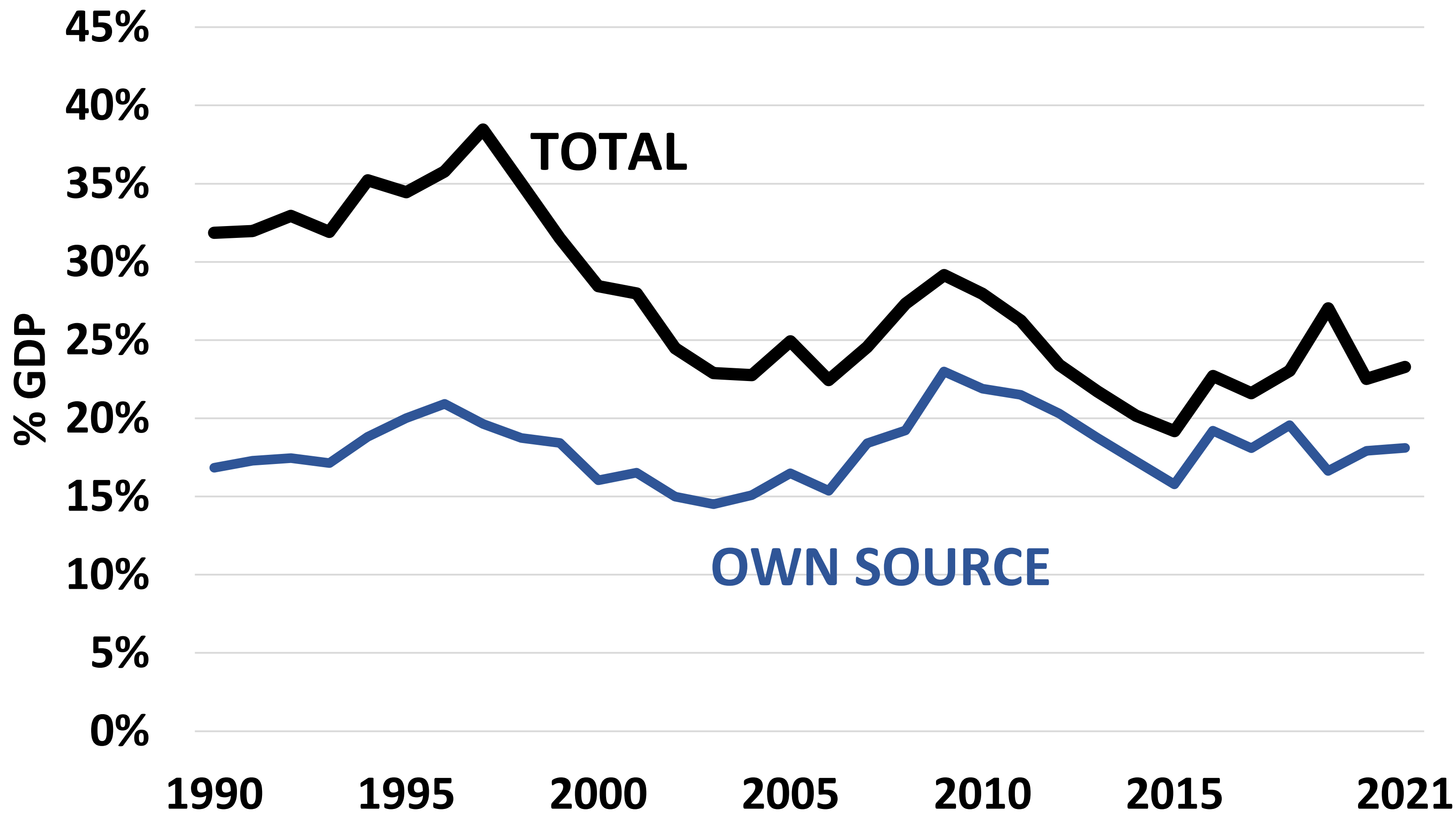
$$Avg.\, g\ (30\ yrs) = 4.5\%$$

$$i\ (avg) = 3.7\%$$

$$i\ (last\ 2\ yrs) = 1.25\%\ (7\ yrs)\ to\ 3.32\%\ (50\ yrs)$$

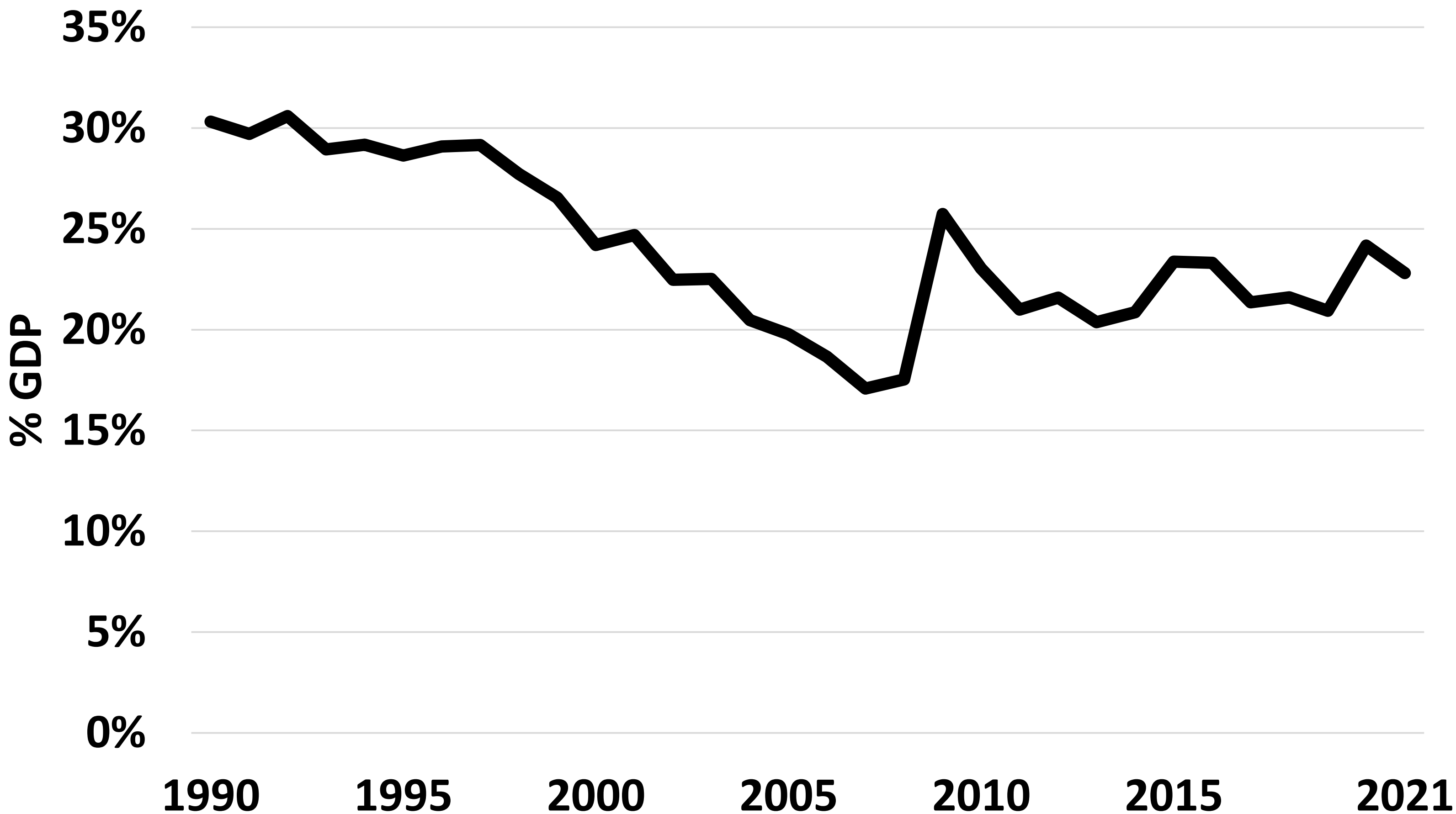
$$Sustainable\ OD \approx \$400\, million$$

Revenues

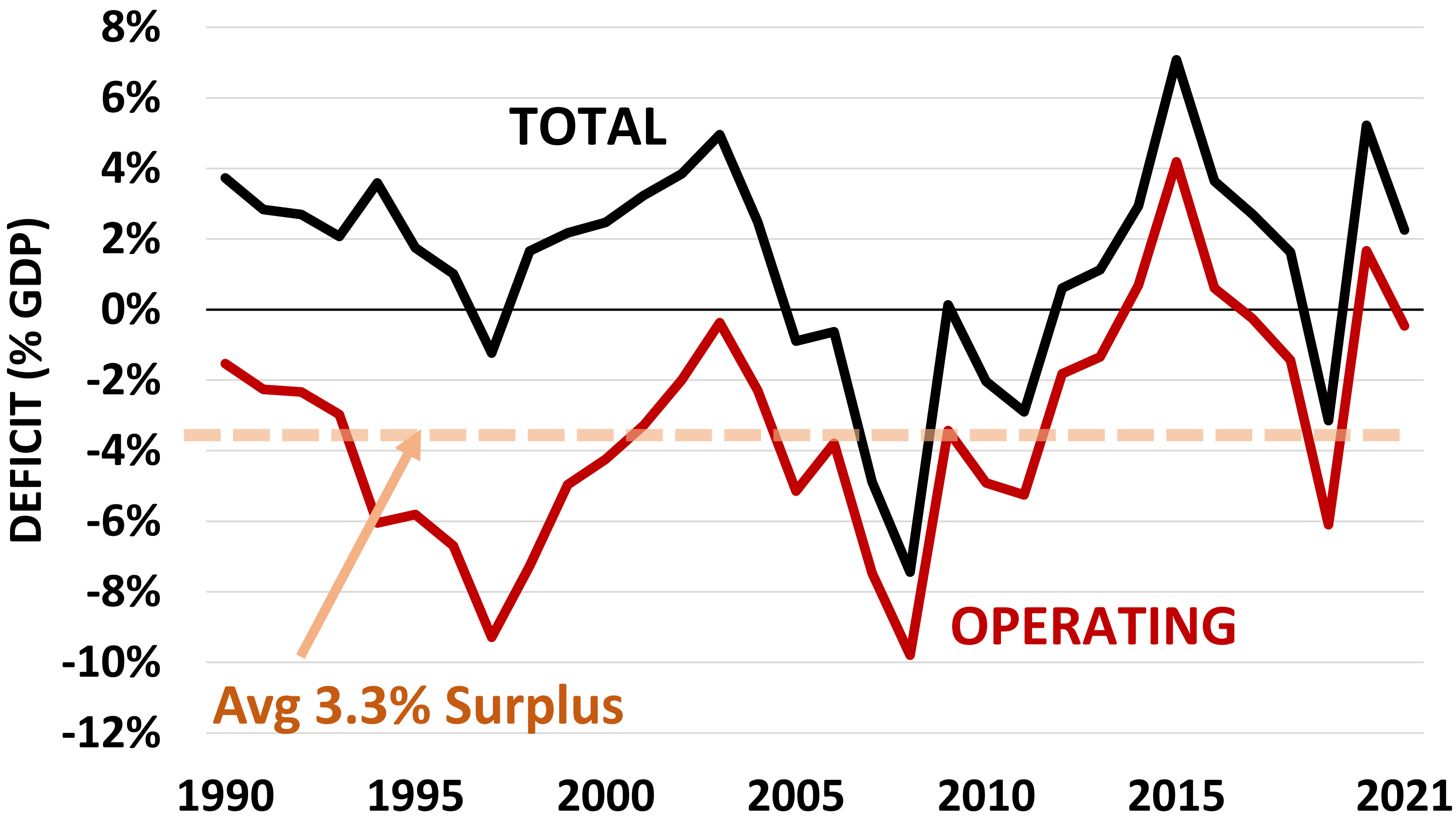


45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
% GDP
TOTAL
OWN SOURCE
1990
1995
2000
2005
2010
2015
2021

Program Spending

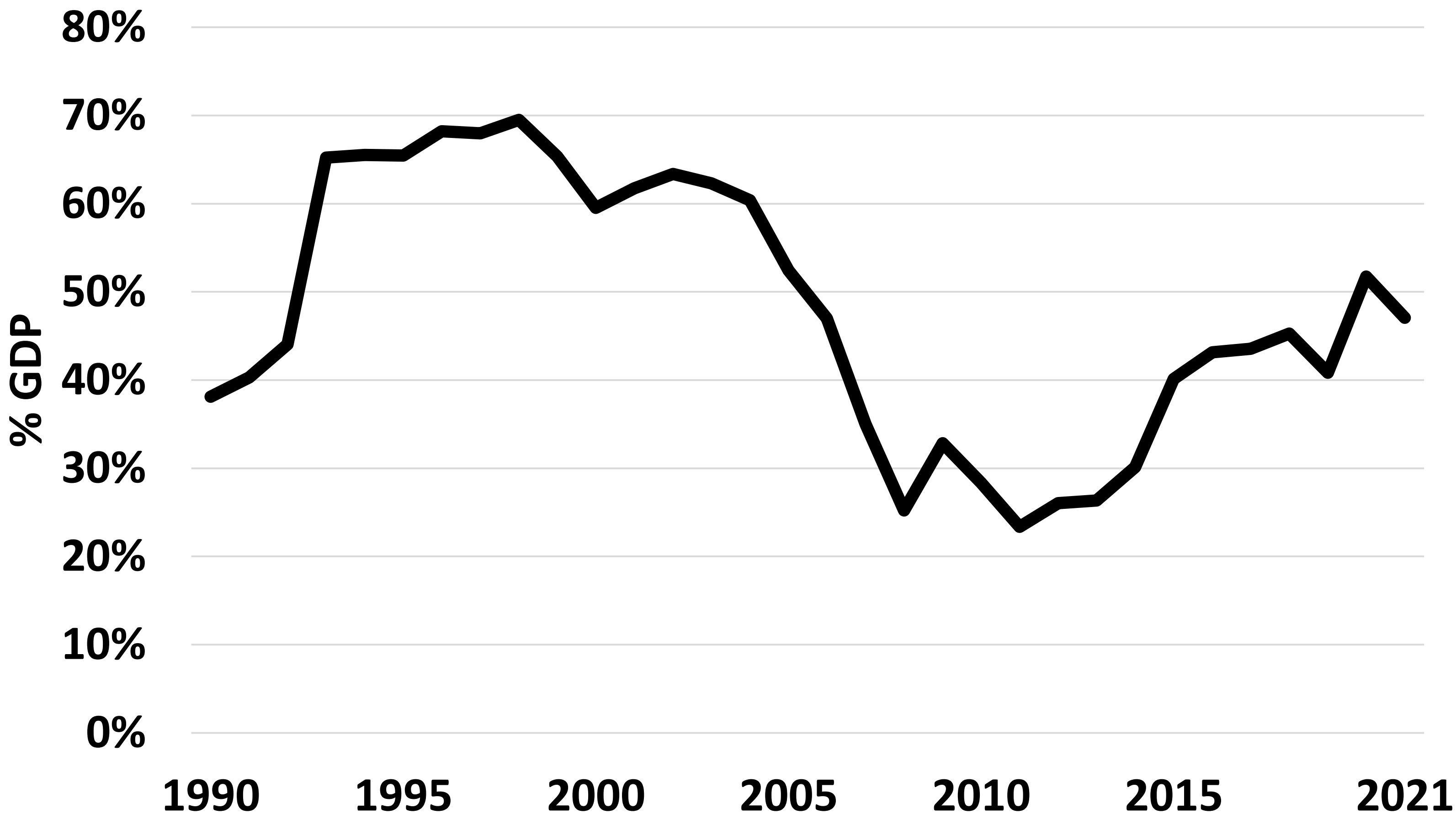


Balances

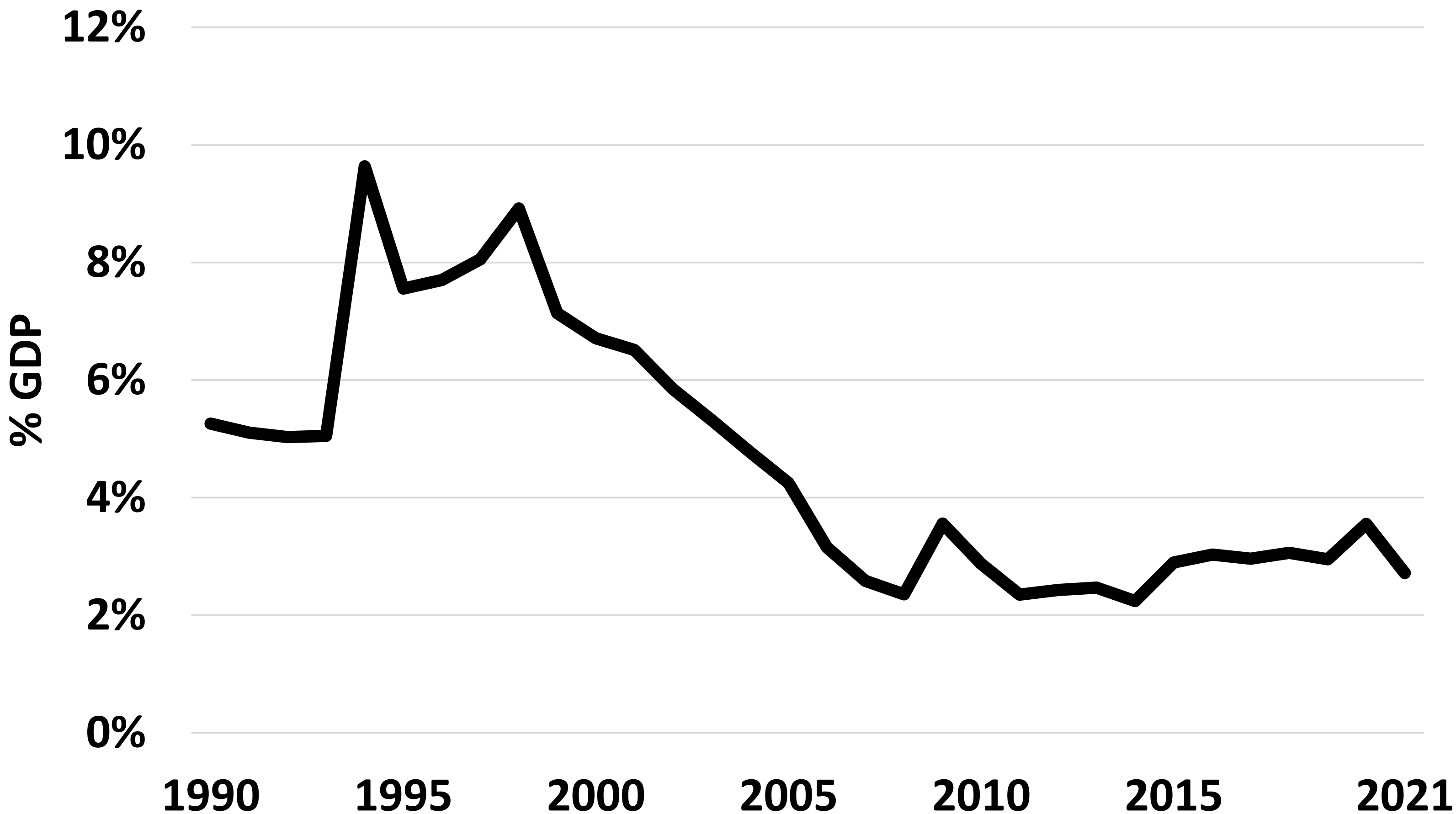


8%
6%
4%
2%
0%
-2%
-4%
-6%
-8%
-10%
-12%
DEFICIT (% GDP)
TOTAL
OPERATING
Avg 3.3% Surplus
1990
1995
2000
2005
2010
2015
2021

Net Debt



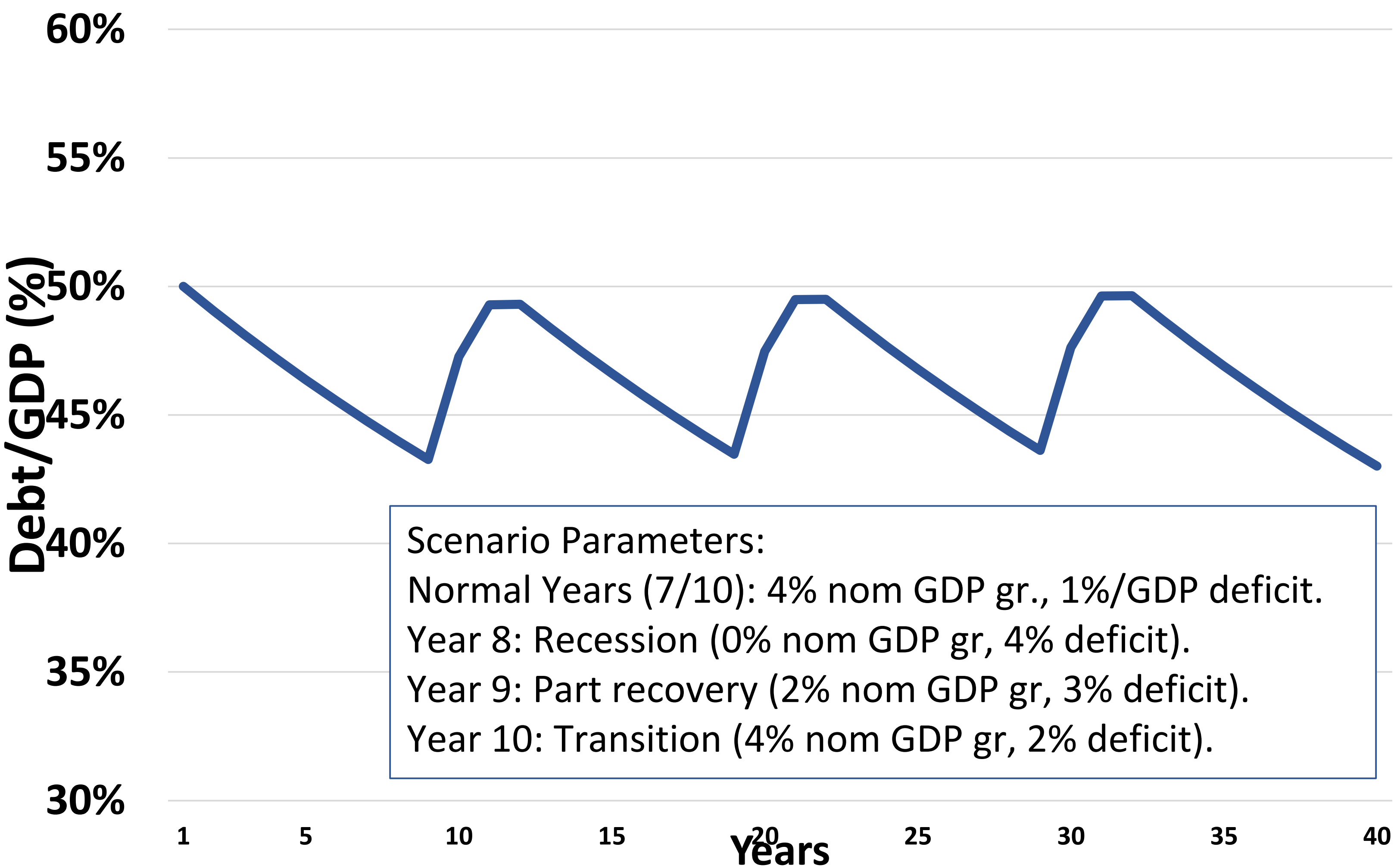
Debt Service Charges



Problem #1: Recessions Happen

- Can’t assume nominal GDP growth always positive.
- Want to leave room for counter-cyclical fiscal adjustments.
- That can be accomplished by cycling fiscal policy around a sustainable trend.
- Even then, balanced budgets are never required.

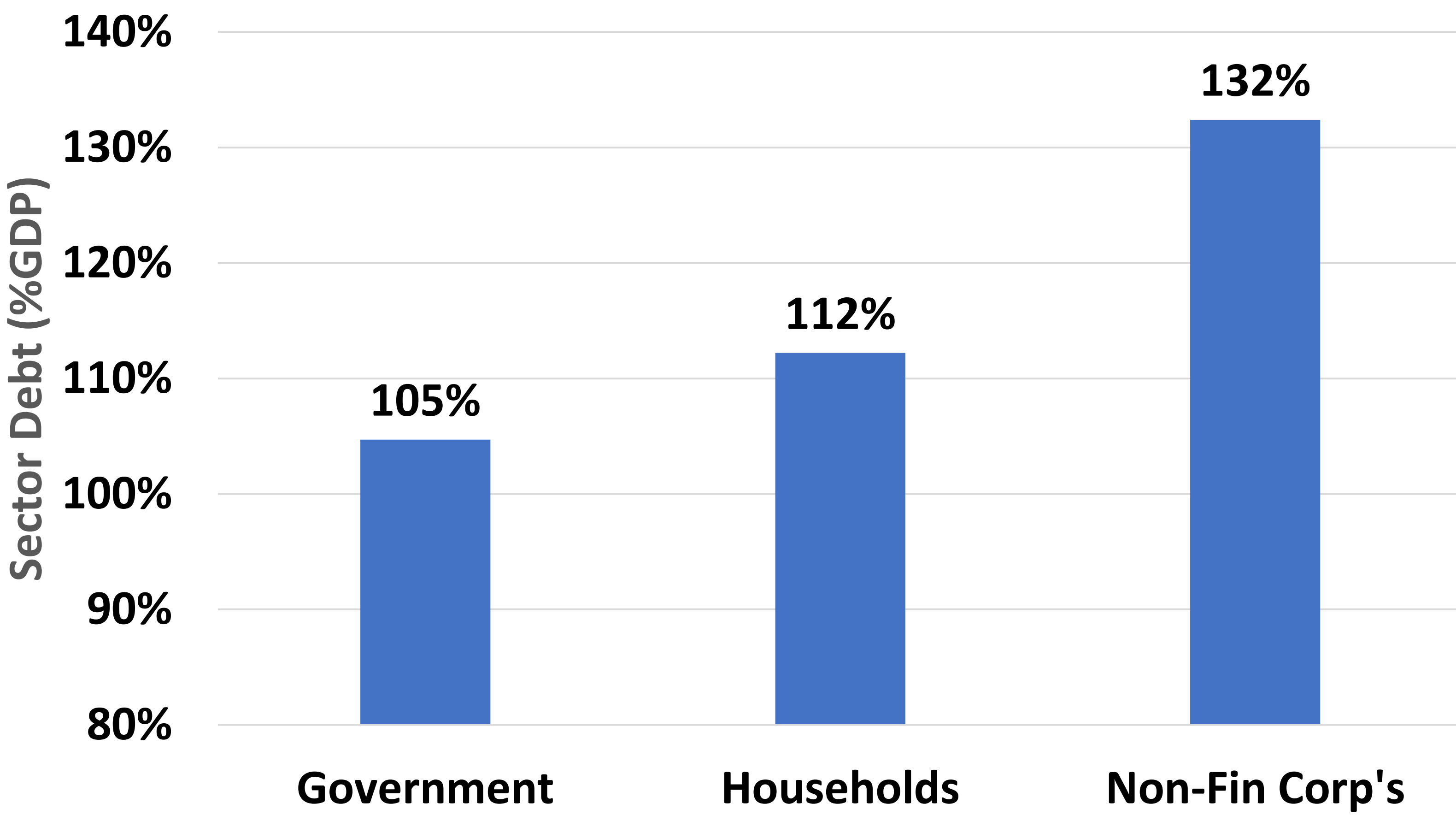
A Stable Fiscal Cycle



Problem #2: Will Interest Rates Rise?

- Interest rates are set in Ottawa, not exogenous.
- Monetary policy-makers consider the impacts of interest rate adjustments.
  - And the current monetary policy rule is not set in stone.
  - History (1930s, 2020) shows role of central bank in provincial financial stability.
- Higher interest rates will cause financial distress in private sector before governments.

Who’s in Debt?



140%
130%
120%
110%
100%
90%
80%
Sector Debt (%GDP)
105%
112%
132%
Government
Households
Non-Fin Corp's

Strategies for Sustainable Balance

- Boost g.
- Constrain i.
- Target a sustainable operating deficit:
  - Tax ratio.
  - Program spending.

Rebuilding Nominal Growth

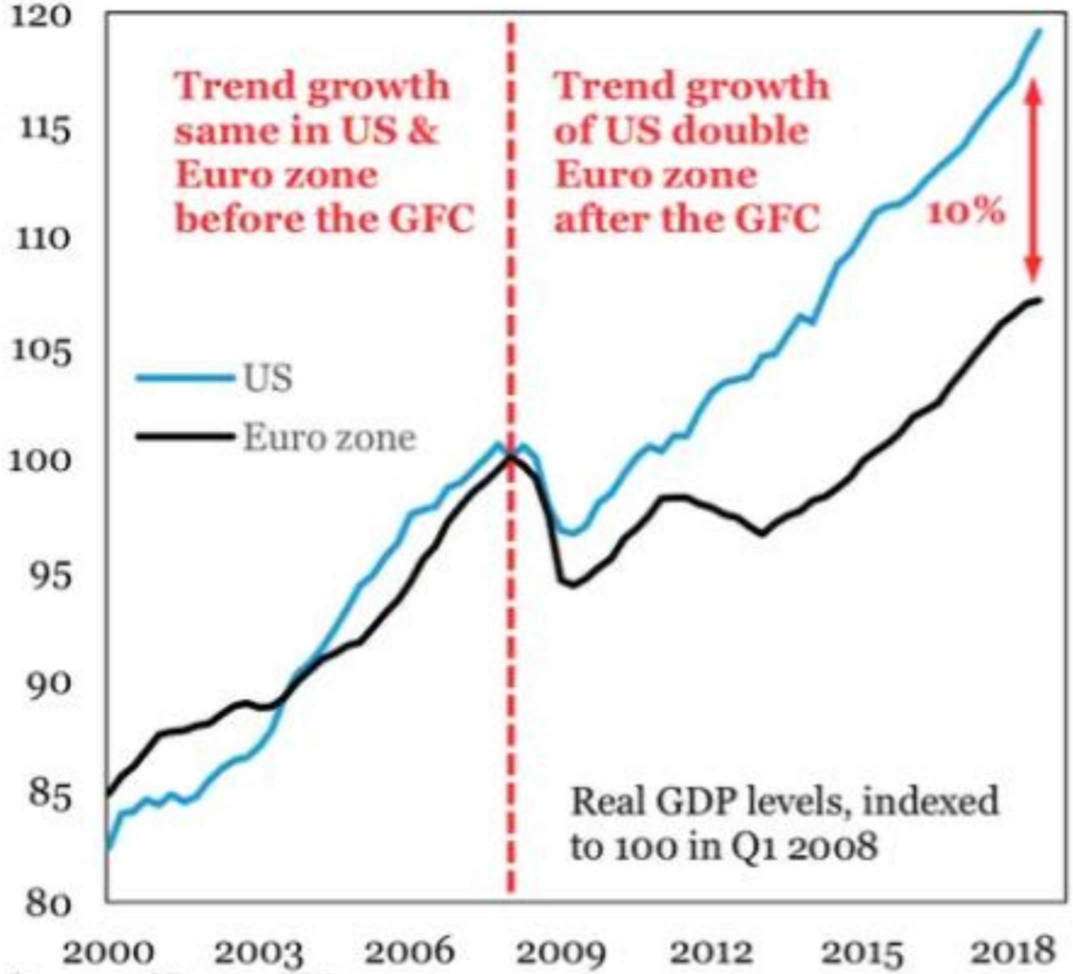
- Rebound from 2020 already visible.
- Other strategies to help in the long run:
  - Inward migration.
    - Internal (leverage WFH).
    - International.
  - Human capital / innovation.
  - Develop strong “base” industries:
    - Sustainable resources.
    - Knowledge / tech / digital services.
    - Public / human /caring services.
    - Tourism.

NB: *<u>NONE</u>* of these are helped by fiscal austerity.

Learning from Europe (and not the way you think…)

- Top-down austerity imposed on peripheral countries caused a Great Recession and enormous human cost (still suffering).
- Mainstream economists now agree this was a historic mistake.
  - OECD, IMF, leading economists.
- Those imposing the cuts were insulated from domestic political accountability.
  - Not the case in Canada.

Exhibit 1. Euro zone GDP has lagged, ...



Source: Haver, IIF

Conclusion

- Newfoundland’s fiscal situation is not dire.
- Key contraints on fiscal policy (debt/GDP and debt service/GDP) are stronger than in the past.
- Austerity will make the problem worse, and (more importantly) cause needless human suffering.
- Restraining interest rates and accelerating nominal GDP growth are the critical priorities.

Thank you!

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