Sujet: Article intéressant sur comment le Canada a affronté sa mauvaise situation financière au début des années 90 / Interesting article on Canada's experience in tracking poor financials in early'90s

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CAPITAL DAILY

Global economic and market analysis from Capital Economics

What lessons can we learn from fiscal tightening in Canada?

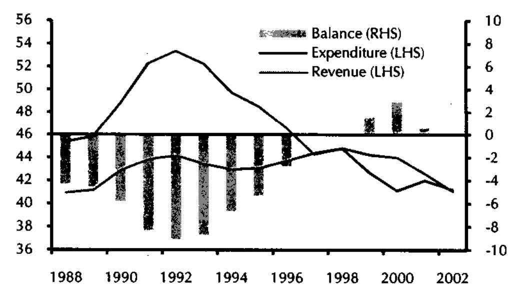
- ***Small firms still struggling in the US***
- ***Recovery in Germany likely to be steady rather than spectacular***
- ***UK's trade deficit probably narrowed in April (09.30 BST)***

Key Market Themes

It has been reported that the coming **fiscal squeeze** in the UK may be closely modelled on the approach adopted in Canada in the 1990s. A similarly large and swift reduction in the budget deficit would be a very tall order, not least because of a much less favourable backdrop for economic growth. At the very least, it would probably require the continuation of exceptionally loose monetary policy. Such a combination would presumably continue to support gilts.

In 1992, the general government budget deficit in Canada exceeded 9% of GDP. Five years later, the budget was in surplus. How did Canada do it? The short answer is by reining in public spending dramatically. Over this period, outlays fell by around nine percentage points of GDP, while receipts remained broadly unchanged as a share of output. (See Chart 1.) Stripping out the effects of the business cycle and net interest payments, the primary budget balance swung from a deficit of nearly 2% of GDP to a surplus of almost 6%.

CHART 1: CANADA GENERAL GOVERNMENT REVENUE & EXPENDITURE AS A SHARE OF GDP (%)



Sources – Thomson Datastream; OECD

Could the UK repeat the same trick? It will be difficult. In Canada, a strong economy shouldered a lot of the burden of fiscal adjustment. Real GDP growth averaged 3.4% in the five years spanning 1993-1997. By contrast, real government outlays only fell by about 0.6% per annum.

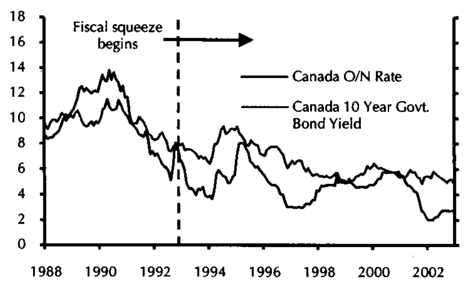
KEY DATA AND EVENTS

CAPITAL ECONOMICS

There is always the chance that the UK economy will bounce back strongly. Canada itself endured three lean years between 1990 and 1992 before it got to grips with its public finances. However, the risks are that growth will be much weaker than it was in Canada, which subsequently benefited from a strong recovery and lengthy expansion in the US. The upshot is that there will probably have to be significant outright cuts in real government spending in the UK alongside further tax hikes if the budget deficit is to be reduced as a share of GDP by as much as it was in Canada.

If that is the plan, then it will presumably necessitate a continued period of exceptionally low interest rates. Such a policy mix should continue to support gilts. Admittedly, government bond yields rose in Canada in 1994 well after the fiscal squeeze had begun. (See Chart 2.) But this was largely because monetary policy was being tightened, as it was in the US. As monetary conditions were subsequently loosened and inflation expectations fell, so bond yields declined.

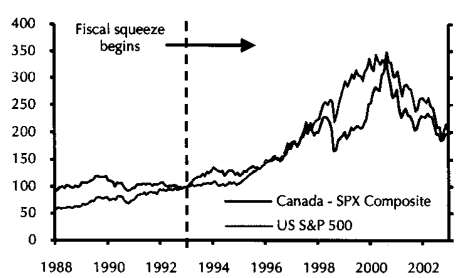
CHART 2: CANADA O/N RATE & 10 YEAR GOVERNMENT BOND YIELD (%)



Source – Thomson Datastream

The stock market performed strongly during Canada's fiscal consolidation. But we would not read too much into this. The performance of Canadian equities closely tracked that of US equities. (See Chart 3.)

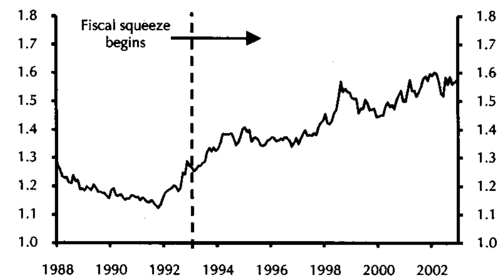
CHART 3: CANADA & US EQUITY MARKETS (REBASED AT 31ST DEC 1992 = 100)



Source – Thomson Datastream

Finally, the Canadian dollar weakened against the US dollar during the period of fiscal adjustment. (See Chart 4.) However, this depreciation may have partly reflected shifts in relative interest rate differentials. Throughout most of 1996 and 1997, overnight rates in Canada were below the Fed funds rate.

CHART 4: CANADIAN DOLLARS PER US DOLLAR



Source – Thomson Datastream

Since we do not expect key policy rates to rise in the US, UK or euro-zone in the foreseeable future, we do not expect sterling to suffer a similar drag. Indeed, to the extent that fiscal consolidation does not drive the economy into the ground, it could end up being a net positive for the UK currency by reducing the perceived risk of sovereign default. (**John Higgins**)