Editorial: Surpluses, deficits – and politics

November 2, 2013 – *The Globe and Mail*

Earlier this week, the United States government and Germany got into a shouting match – and the subject was more important than U.S. spying on the Angela Merkel's phone calls. In a report from the U.S. Treasury department, the Americans sharply criticized the Germans for what are normally thought of as good things: running a large trade surplus, and having no budget deficit.

To the average person, the critique sounds bonkers. Aren't trade surpluses good, and budget deficits bad? The German government describing the criticism as "incomprehensible," and its ministers piled on, joyfully taking shots at another case of American insanity. Germany is heading into its third year in a row of budget surpluses. Isn't that supposed to earn a gold star rather than demerit points?

And yet the American position, odd as it may sound, is economically bang-on. And that gap – between the economically necessary and the politically possible – explains why the world has yet to recover from a recession that started, and should have ended, half a decade ago.

Back in the 1980s, budget deficits in most major economies were high and rising. The Mulroney Conservatives tried and failed to wrestle the deficit monster. The story played out in many countries: Tackling a chronic spending imbalance was a fiscal imperative, but it just wasn't politically popular. In Canada, it wasn't until the mid-1990s that public opinion shifted, and the serious and remarkably swift work of moving to a balanced budget became possible.

The challenge that much of the world faces right now is the same, in that economics and politics are still lined up on opposite sides. Only this time, they've switched positions. In much of the world, more deficit spending is unacceptable to public opinion, even in countries where deficit spending could be part of the economic solution.

The euro zone is the sick man of the developed world. It's suffering from persistently high unemployment, and a barely growing economy. The cause is a severe lack of demand: consumers, businesses and governments are all cutting back at the same time. In Canada, when recession hit more than five years ago, the federal government opened up the spending taps and pushed money into the economy. Ottawa moved from surplus to a deep deficit, as it counterbalanced a private sector that was pulling back. It was a surprising step for a Conservative government, but it was the right thing to do. Thanks to a temporary spike in a government spending, lower interest rates from the Bank of Canada, and a flexible exchange rate, the Canadian economy recovered.

Within a couple of years, Canada was moving to shrink deficits – and for Canada, that was the right time frame. It has been a very different story in Europe. The European recession was far deeper than in Canada. Canada had a ladder deep enough for the hole we fell into. The European ladder wasn't tall enough, and a contractionary fiscal policy means that it keeps getting shorter.

The Europeans have another problem Canada avoided: The common currency known as the euro locks inefficient economies into the same currency as highly efficient Germany. That benefits German exporters, even as it crushes those from other euro zone countries. Canada, with a floating currency, can adjust to shocks in part through currency movements. Euro zone members are stuck: Italy, Spain, Greece and others are "adjusting" through high unemployment, which will over many years drive wages down. It's an incredibly painful process. Germany could help make the transition easier by temporarily spending more, running budget and trade deficits, and also allowing a bit more inflation. It would be a win-win: Temporarily raising the living standards of Germans, and see them spending more on goods from their neighbours. The textbook idea, however, sounds crazy to the average German voter. It will not be happening anytime soon.

"The net result," as the U.S. Treasury report says, "has been a deflationary bias for the euro area, as well as for the world economy." Exactly.

The United States is stuck in a similar situation. The political debate south of the border has been largely focused on the perceived need to rapidly reduce and eliminate the U.S. federal budget deficit. But the U.S., like Europe, simply isn't in the same position as Canada. Canadian employment long ago surpassed pre-recession levels; U.S. employment is still below. U.S. spending ramped up at the start of the recession, and then pulled back sharply: the deficit has been halved since 2009. And a report last month by Macroeconomic Advisors estimated that budget cuts over the past three years have caused the unemployment rate to be 1.4 per cent higher than it would otherwise be. The U.S. budget eventually has to be brought into balance, but the speed of the move to get there has hit the economy hard. Even as the U.S. private sector has been growing and adding demand back into the economy, cutbacks in government have been subtracting demand.

Canada has benefited from some good policy, and a lot of luck. The rest of the world hasn't had enough of either. It's being left to monetary policy – central bankers – to carry the load of recovery. It's not economically conventional. But it is politically popular.