Canada needs to re-evaluate its approach to economic stimulus

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Canada's economy has not performed well this year. Although we won't know the actual performance until September, when Statistics Canada publishes the national accounts numbers for the first half of 2015, there is little doubt that Canadian growth is hard to find.

What's the best overall policy response? The Bank of Canada did what it could by cutting short-term interest rates further, targeting 0.5 per cent as its overnight lending rate. This action is unlikely to lift growth in the very short term. Rather, the bank was no doubt guided in its decision by estimations of the economy's actual performance against its potential growth path. Using its main policy lever, the bank acted in the hope of eventually closing the so-called output gap.

The decision to lower rates has been welcomed in some quarters. While it will have longer-term impacts, our concern is that there will be unwanted consequences in the near term – with households increasing spending by taking on even more debt. Ultimately, the bank would like to see its broad-brushed monetary stimulus drive up private investment (through lower rates) and exports (because of a weaker currency), but other, less desirable, things may happen, too.

Low rates in recent years have done little to stimulate private investment, and the steep slide in the dollar since mid-last year has done little to stimulate manufactured exports. For many export sectors, Canadian producers are at peak capacity. Despite the weakness in the currency, there are few signs that businesses are set to open the floodgates on the $500-billion in extra cash reserves they've built up since the recession.

Moreover, given record-low financing costs, households have eagerly (but not irrationally) taken on debt. The situation has resulted in troublesome gains in home prices in places across the country. Concerns about overheated housing markets shouldn't be ignored.

If monetary policy has its limits, what about refining the overall economic strategy? It may be time to re-examine the balance between monetary and fiscal policy – and provide a little more fiscal, rather than monetary, stimulus.

It's not necessarily the job of the federal government to provide the fiscal stimulus boost. Given the very different regional prospects across the country – especially the negative impact of low prices on the oil industry in Alberta and Newfoundland and Labrador – a more targeted provincial approach is warranted.

Thus, we think a better policy would be to target fiscal stimulus where it's most needed: in key oil-producing provinces and sectors that are directly affected by the oil price drop. In concrete terms, this would mean as a first step accepting the reality of large fiscal deficits (for now) in Alberta and Newfoundland and Labrador due to the decline in government revenues, notably oil royalties.

Moreover, because oil price cuts have resulted in slashed investment and construction spending in the oil patch, targeted programs that boost provincial construction may be warranted. Analysis by the Conference Board of Canada indicates that spending on public infrastructure offers a solid economic multiplier for each public dollar of stimulus spending, with one dollar of spending creating more than a dollar in economic activity. Public infrastructure spending typically has high

Canadian and local content and thus makes a positive impact.

The home renovation tax credit was another very effective fiscal program during the 2009 recession. This time-limited program encouraged people to spend money today by investing in their most important asset: their home. Again, a home renovation tax credit would have high local or Canadian content, an immediate impact on job creation in the renovation business across the province and positive economic multipliers.

Putting these measures in place would involve a timely budget or economic statement and enabling legislation as required. Both types of targeted fiscal stimulus could provide some welcome relief and job creation on the ground. Specific infrastructure projects could be used to boost activity in those hardest-hit regions within provinces, while a home renovation tax credit could bolster provincewide activity for a specific industry with local supply chains. The federal government could help by providing a share of the infrastructure financing, as it normally does.

In short, we would advise taking targeted fiscal action at the provincial level through specific infrastructure projects and a home renovation tax credit, to get the stimulus to where it is most needed. Targeted provincial fiscal action could firm up growth, without adding undue stimulus in other parts of the national economy.