Justin Trudeau can’t afford to ignore Canada’s economic challenges

By William A. Macdonald
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Late in 1939, Franklin Delano Roosevelt called Harry Hopkins, his closest aide, into his office.

“Harry, up until now, I have been the New Deal president,’” he announced. “From now on, I will be the ‘war president.’”

Pearl Harbor was still two years away, but FDR could see what was coming.

Now that a new year is dawning, Justin Trudeau is in need of similar foresight. He should have the wisdom to call Gerald Butts, his closest political partner, into his office and say that, so far, he has been all about who we are and “sunny ways.” From now on, however, he will also be paying close attention to something far less esoteric: the economy.

Mr. Trudeau can still be the prime minister he campaigned to be – the champion of mutual accommodation and the notion that “better is always possible” – but only if he also goes in the right fiscal direction.

Canada’s economy is heading toward the rocks. Consumer spending and foreign borrowing to cover it are the major culprits. Mr. Trudeau must convince the country to accept a fair balance between what we want and what we can afford – between an activist government and one that rebuilds the economy.

He will not want to make the same mistake his father made. Asked, after leaving office, if he had any regrets, Pierre Trudeau said yes – he wished he had paid more attention to the economy.

If his son doesn’t learn from that, we will all pay a higher price. Not only are the Canadian and global economic fundamentals weaker now than they were then, the economic legacy left by Stephen Harper is challenging.

Doing the math

The challenge is not the deficit: Canada has the best ratio of government debt to gross domestic product in the G8. But one good number is not enough when two other key indicators are so bad that they have the economy well off course.

The first tough number is the current account deficit – that is, the gap between the value of the goods and services we import and those we export. That deficit will likely hit $67-billion this year, the result of consumer spending, not productive investment.

Another pair of dangerous numbers involves the level of household-sector debt (higher than both the comparable U.S. figures during the 2008 crisis and that of any other G8 country today) and high prices for houses, particularly in Vancouver and Toronto.

Private-sector debt on this scale can cause people (and companies) to suddenly stop spending (and investing) so that instead they can pay off what they owe, which can in turn spark what’s called a “balance-sheet recession.” Richard Koo, chief economist of Japan’s Nomura Research Institute and a global guru on such recessions, recently said that Canada is risking one.

If it happens, the Bank of Canada will be powerless to use monetary policy to offset economic weakness, as it did in 2008-09, by lowering the interest rate. Those already focused on reducing their debt won’t go out and add to it just because the carrying cost is down a bit.

The political news is perhaps as good as it could have been. The new federal government has a majority and is broadly in tune with large numbers of Canadians. And the economic news

is not in panic mode – the federal deficit forecast in the latest fiscal update from Finance Minister Bill Morneau, although higher, is not significant yet.

But it is likely to get larger because the economy, already weak, keeps declining as the price of oil drops, alongside accumulating debt challenges and not enough internationally competitive supply capacity.

Spend only where it counts

This government has big plans that involve spending, but that spending must be limited to top priorities. Deficits are not Canada's primary challenge, but if the economy is not earning its way, government spending that fails to restore its ability to do so could pose a problem.

Mr. Harper's priorities were smaller government and reduced personal taxation – valid goals if based on living within one's means. Instead, taxes were cut and the budget balanced even as Canadians were living beyond their means on a scale never seen before.

The new government's spending promises and growth aspirations will make its deficit goal (a surplus by the last year of its mandate) harder to achieve. Paul Martin's first budget as Jean Chrétien's finance minister failed to get the country back on track – he needed a second one. Mr. Morneau's first budget may meet the same fate.

Moreover, by Canada's next federal election, the current U.S. economic strength will be fading and oil prices could well be worse than expected, meaning slow growth, if not a recession, and reduced revenues in Canada. The huge household-sector debt needs to be carefully displaced by federal deficits that support investment to build the economy. There is no need for Keynesian consumer-demand stimulus – $60-billion a year in foreign borrowing is already too much.

What is needed is investment, in public infrastructure and private-sector job creation to broaden the competitive supply capacity of the economy. Growth fuelled by the private sector is the only practical way forward on jobs, rising middle-class incomes and reduced deficits.

The federal policy inherited from the Harper government, which combines rising foreign and household-sector debt used for consumption, is not sustainable.

Something is wrong

The Bank of Canada, among others, expected that consumer spending would be followed by investment and exports. Neither has happened, or seems likely to. Why has the U.S. experienced this rotation but not Canada? Why is U.S. consumer strength greater than that of Canada?

The fundamental answer is that U.S. competitive-supply capacity has been broadening, while the Canadian capacity has been narrowing.

This calls for new creative thinking. To do well, a country needs at least one of three basic economic strengths:

- A big domestic market: something Canada can never have; trade agreements to expand markets are not the same;
- Space, food, water, minerals and energy: When it comes to natural resources, only Brazil and Russia are even in the same league as Canada;
- Competitive rewards and opportunities for the best people – entrepreneurs, professionals, managers, creators and innovators: New creative Canada-centric policy is most needed here.

Canada's natural resources are a huge long-term strength, even if resource markets are cyclical. Canada's only choice is to match strength in natural resources with strength in human resources – we already excel in such

fields as financial services, medicine, hi-tech innovation and architecture.

Our two current economic challenges are, first, to reduce overall debt and rebalance it away from households toward the federal government; and, second, to strengthen the role of human resources in the economy. Canadians' standard of living is declining because of its negative terms of trade (the oil-price collapse and low commodity prices), the lower dollar (which makes imports more expensive), less income growth (the weakening economy), and less consumer room to borrow. New policy is unavoidable.

The debt anesthetic

Canada had a huge advantage over other countries at the end of the Brian Mulroney-Jean Chrétien era, as the world fell into the post-Lehman abyss in 2008. This should have been used to build our means – instead, it was used to live beyond them. Understandably, no political party has wanted to talk about this.

The problem is hardly a new one. I recall talking to a senior Canadian businessman, some 26 years before the Lehman Brothers collapse, who wanted me to agree that Ronald Reagan, although he had been president for just a year at that point, was a great man.

I argued that Reagan was getting into too much debt, but the businessman wanted something positive out of me, so he said: "You have to admit Reagan has made Americans feel good about themselves." I agreed, but said that, if I spent as much more than I earned on my wife, as the president was spending on the American people, she would feel good about herself, too.

In recent years, that is exactly what Canada has done. The challenge is to take away the debt anesthetic and help people feel better about themselves by doing real things that build a more productive Canada for the future. It is what the greatest leaders are for.

Building for a better future always requires deferring consumption. This is the biggest political persuasion and policy task the new Liberal government faces. It requires a balance between personal reward and societal reward – a balance that recognizes society's role in private opportunity, and the role of privately driven economic achievements in societal opportunity. To have success that truly lasts, each side must accommodate the role played by the other.

What's to be done

How might these challenges best be addressed?

- *High house prices – household-sector debt*: The Bank of Canada must follow the lead of the U.S. Federal Reserve and raise interest rates as federal fiscal deficits grow. We must get on the long, slow path to less household-sector debt and less foreign borrowing for the sake of consumers. We must use prospective larger federal deficits for the kind of growth that brings lasting job creation, rising incomes and better-balanced sectors.
- *Transit infrastructure*: We need a much bigger program than the one currently planned.
- *Wealth and job creation*: We need the social licence to offer incentives that reward successes that are reinvested in the economy. This approach worked for Canada in the 25 years after the Second World War, when the opportunities were in natural resources. A comparable approach is needed for the first half of the 21st century, when opportunities lie in human resources.

In the past decade, Canada's economic policy environment became too narrowly political. It lacked a longer-term strategy and discernible national vision for a constantly changing world. This must stop. A policy of tax cuts and no

deficits is too limited. Policy and politics must return to the full playing field.

Policy confusion

The Bank of Canada under Governor Stephen Poloz does not seem to have an effective strategy for the current Canadian economy and debt challenge. Not only do the bank's two rate cuts this year go in the wrong direction, Mr. Poloz has added to the confusion by suggesting a policy of negative interest rates in the event of a crisis, even though he says there is no reason to expect one will happen.

In that case, two questions:

- Why talk now about something that is not needed – is he trying to say the Bank can do a lot about where we could find ourselves? Many are not sure.
- How would negative real interest rates help us live within our means and broaden our competitive supply capacity?

Either way, the Finance Minister must keep on top of his department and the Bank of Canada, and demand clear monthly analytical updates on both house prices and household debt.

Mr. Morneau needs to know:

- What can we do, and are we doing it?
- Is that likely to work in time?
- What do we do if the job is not done in time and the bad possibility becomes real?

Mutual accommodation can help

From 1945 to 1993, Canadian politics was dominated by the Progressive Conservatives and the conservative Liberals, (the latter went off economic and fiscal balance under Pierre Trudeau). There were two great postwar dynasties, one federal (rooted in the conservative Liberals under Sir Wilfrid Laurier and William Lyon Mackenzie King), the other provincial (the Progressive Conservatives in Ontario under Leslie Frost, John Robarts and William Davis).

Each shared the idea that social and economic progress go together. This resulted in a 60-year mutual accommodation of these two powerful sets of aspirations. They came to be seen as mutually strengthening, not adversarial. They made today's Canada.

Canada now needs more balance: between natural and human resources, between indebted sectors, and between social and economic advance. Those who want a strong economy must understand the need for societal strength – and vice versa. Pierre Trudeau overreached on the economy; Stephen Harper underreached. Justin Trudeau cannot get it right if he is governed by a fiscal straitjacket.

No one, including the Prime Minister and his economic advisers, is ready yet for what is needed. A big, bold, prudent, and patient approach is the way forward.

In a recent column, The Globe's Jeffrey Simpson said that the Liberals don't really have their heart in fighting the deficit. Nor should they. But if the government doesn't meet the economic challenge it faces, the social policy that is close to its heart will be undermined.

Invoking an icon

We must echo the boldness of John A. Macdonald in building the transcontinental railway after Confederation. It will take everything Justin Trudeau has to pull it off: a capacity for mutual accommodation, the intestinal fortitude to set the right priorities and a penchant for what works.

Pierre Trudeau kept the country together; Justin Trudeau saved the Liberal Party. Can he now do the long, hard and bold things needed to build the country for the 21st century? He has shown he can be bold by doing hard politics, such as staying positive in a negative campaign and his out-of-step campaign decision to advocate running deficits.

He won big by reassuring Canadians that openness, engagement and inclusiveness are

still the best way forward. Now he must turn to the economy (as well as security, both at home and abroad). If he does not become the "economy prime minister" and get them right, he will find it almost impossible to keep his ways – and ours – very sunny.

By knowing when to change focus, Franklin Roosevelt was able to face a conflict and prevail. A quarter-century later, however, Lyndon Johnson could not keep the Vietnam War from destroying his dream of being remembered as the "Great Society president" who eliminated poverty and racial injustice.

To make it in the big leagues, even a politician needs more than one pitch.

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