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COMMENTARY
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THE ECONOMIC IMPACTS OF A MINORITY GOVERNMENT

For the first time in 24 years, Canada will have a minority government. While senior Liberals talked openly last night of governing with the support of the NDP, the NDP fell one seat short of holding the balance of power though this could change depending upon vote recounts. This note offers a number of observations on what to expect with respect to economic policy from a minority Liberal government.

The Federal budget will likely remain in small surplus position and all fiscal room above the contingency reserve will be allocated to program spending. All four parties with representation in the House of Commons pledged, during the campaign, to balance the budget. The fiscal stance proposed by the two main parties was similar, the differences being in the tax/spending mix. The Conservatives called for restrained growth in overall program spending, targeted increases for healthcare and defence and significant personal and corporate tax cuts. Conversely, the Liberals promised to hold the line on taxes and increase program spending growth with the key focus on health care.

There is some common ground on economic platforms between the Liberals, on the one hand, and the Bloc and the NDP, on the other. The NDP platform called for an even larger increase in government spending financed by tax increases on corporations and higher income individuals. The Bloc program also called for significant spending increases and no tax relief. In light of the backlash against the Liberal government in Ontario following the introduction of a health premium (effectively a tax hike) in that province, however, the federal Liberals are unlikely to agree to any tax increases. There may, however, be some risk to the commitment to debt reduction implicit in the $3B contingency reserve which has been a staple of recent Liberal budgets.

Bank of Canada policy goals will remain unchanged with the Bank remaining committed to a 2.0 % inflation target. With the overall macroeconomic impact of fiscal policy likely to be unaltered, the election result means our forecast of 75 basis points of interest rate increases this year remains unchanged. The tightening reflects a need to begin moving rates back to more neutral levels in the face of strengthening economic growth and diminishing excess capacity.

The uncertainty regarding economic policy may weigh on the Canadian dollar, but the impact should be modest. With compromise required to pass legislation, there will be greater uncertainty regarding the future direction of economic policy than under majority rule. However, polls were pointing to a minority government outcome over a month ago. To date, whatever impact from the consequent policy uncertainty there has on the Canadian dollar, it has been quite modest. Indeed, one could well argue that there has been no impact at all. Chart 1 below, shows the movements in the loonie against the US dollar, the euro, the UK pound and the Australian dollar. Over the period that minority government became a foregone conclusion, the Canadian dollar has actually risen slightly in value against both the key US currency and the Australian dollar. It has fallen against the pound and remained relatively unchanged against the euro.

The potential negative impact on the loonie of a minority government has likely been tempered by the fact that Canada's fiscal position is the strongest within the G8. The emergence of a Liberal minority government, headed

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by the man who was the Finance Minister while Canada's fiscal house was put in order, will inhibit any post-election impact.

There will be little, if any, near-term impact on the performance of the Canadian economy. With virtually no consequences for the stance of monetary or fiscal policy, and with the exchange rate largely unaffected, the election results provide no basis for altering the outlook for economic growth over the next 18 months.

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Chart 1