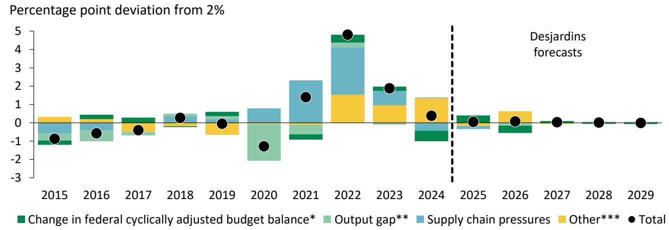
ECONOMIC VIEWPOINT

Have Government of Canada Deficits Boosted Canadian Inflation? Yes, But Not Much

By Randall Bartlett, Deputy Chief Economist

- There has been a lot of debate regarding the impact of Government of Canada deficits on Canadian inflation. Indeed, some have attributed much of the heightened inflation in 2021, 2022 and 2023 to them.
- However, while we find that federal deficits have some impact on inflation, this has tended to be quite limited when the state of the economy, supply chain disruptions and other factors are accounted for. Even during the recent period of high inflation and large deficits, the federal government's budget balance explained about 10% of above-target inflation once the state of the economy is considered (graph 1). Supply chain disruptions and higher oil prices contributed much more to the sharp increase in inflation, particularly in recent years.
- Looking forward, even though federal deficits are largely unrelated to the state of the economy, we don't expect them to make a substantial contribution to inflation. That's because it's the change in the deficit that matters more than the level itself, and the federal government is projecting deficits to shrink as a share of the economy over the medium term.

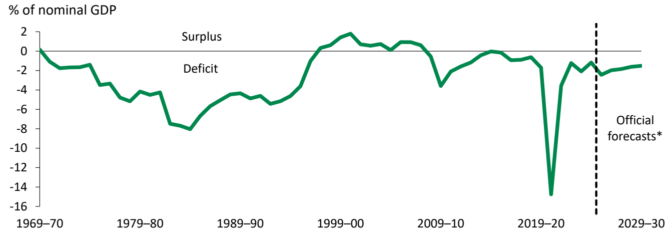
Graph 1
Federal Deficits Haven't Been, and Are Unlikely to Be, a Major Contributor to Canadian Inflation
Decomposition of the deviation in Canadian inflation from the Bank of Canada's 2% target



*Government of Canada estimate and Desjardins Economic Studies forecast
**Desjardins Economic Studies estimate and forecast
***Includes inputs such as energy price impacts uncorrelated with supply chain pressures
Federal Reserve Bank of New York, Government of Canada and Desjardins Economic Studies

There has been a lot of debate regarding the impact of Government of Canada deficits on Canadian inflation. Over the decades, the federal government has gone from regular deficits to sustained surpluses and back again (graph 2). And according to Budget 2025, the federal government plans to run ongoing deficits in the range of 1.5% to 2.5% of GDP for the remainder of the decade. With fiscal shortfalls of this magnitude expected for the foreseeable future, it's reasonable to wonder what the impact of repeated federal deficits is likely to be on inflation.

Graph 2
Federal Budget Balances Have Oscillated from Deficits to Surpluses and Back Again
Government of Canada budget balance estimates and forecasts



*Budget balance forecasts from federal Budget 2025 with nominal GDP updated for recent historical revisions
Government of Canada, Statistics Canada and Desjardins Economic Studies

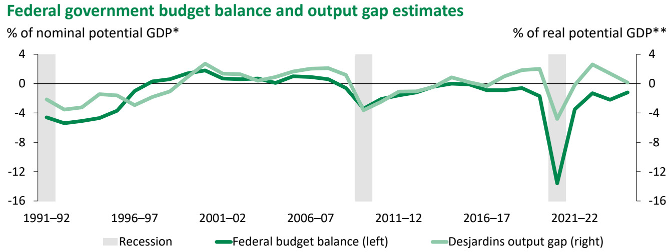
Separating the Deficit Wheat from the Economic Chaff

To isolate the specific impact of federal deficits on inflation, there are a few things we considered.

First, federal deficits aren't only caused by spending on big new programs or decisions to permanently cut taxes. Deficits are also driven by the state of the economy. When the economy is doing well, solid income growth and low unemployment typically mean revenues are healthy and few people are drawing on programs like Employment Insurance. Notionally, this should support surpluses. The opposite is true when the economy is weak or falls into a recession, with deficits becoming more difficult to avoid. Consequently, one needs to separate the impact of the business cycle from the budget balance to get a clearer picture of the impact of discretionary policies on federal finances. To do that, we use the output gap—the percent deviation of real GDP from the Canadian economy's potential or trend level of output. Graph 3 illustrates that there is a clear relationship between the output gap and federal deficits. Of course, inflation is also driven by the state of the economy, hence the Bank of Canada's focus on the output gap when making monetary policy decisions as well.

Graph 3
Federal Budget Balances Are in Part Determined by the Economy

Federal government budget balance and output gap estimates

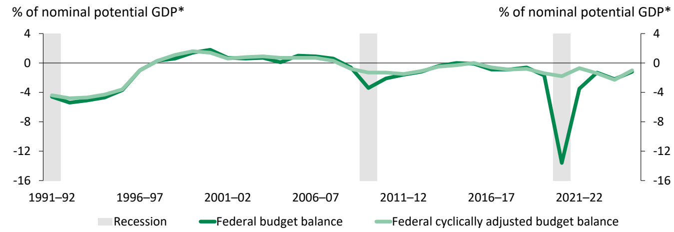


*Potential GDP estimated by Finance Canada
**Potential GDP estimated by Desjardins Economic Studies
Government of Canada, Statistics Canada, C.D. Howe Institute and Desjardins Economic Studies

Once the state of the economy is removed from the deficit estimate, what's left is generally referred to as the cyclically adjusted budget balance (CABB). The CABB should capture the changes in the federal deficit that aren't directly related the economy. The difference between the CABB and the actual budget balance is particularly striking during recessions, with the Government of Canada's CABB estimate typically staying very close to actual budget balances otherwise (graph 4).

Graph 4
Federal Deficits Tend to be Particularly Impacted During Recessions

Government of Canada budget balance and cyclically adjusted budget balance estimates

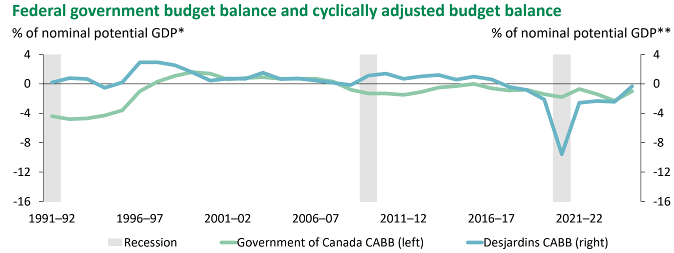


*Potential GDP estimated by Finance Canada
Government of Canada, Statistics Canada, C.D. Howe Institute and Desjardins Economic Studies

In practice, removing the cyclical impacts from government spending is challenging, and estimates of the CABB can differ considerably (graph 5). One reason is that different institutions have varied estimates of potential GDP and, hence, the output gap. Another reason is Finance Canada doesn't appear to meaningfully adjust its CABB estimate for the state of the economy outside of recessions. Finally, Finance Canada removes temporary counter-cyclical measures (e.g., temporary stimulus measures in response to the 2008–2009 global recession and the COVID-19 pandemic) and one-off fiscal operations (e.g., related to sales tax harmonization, Alberta flood costs) from its CABB estimate. Desjardins Economic Studies' estimate of the CABB, which doesn't exclude counter-cyclical measures and one-off fiscal operations, diverges notably from Finance Canada's during the 1990s and early in the pandemic.

Graph 5
Different Institutions Can Have Significantly Different CABB Estimates

Federal government budget balance and cyclically adjusted budget balance



*Potential GDP estimated by Finance Canada; ** Potential GDP estimated by Desjardins Economic Studies
CABB: Cyclically adjusted budget balance
Government of Canada, Statistics Canada, C.D. Howe Institute and Desjardins Economic Studies

The Price (Impact) of Running Federal Deficits

To get a sense of what federal deficits mean for inflation, we built a framework that allows us to estimate the impact of different price drivers. This includes both the output gap and the CABB as a share of nominal potential GDP, as well as other contributing factors. See Box 1 on page 3 for more details.

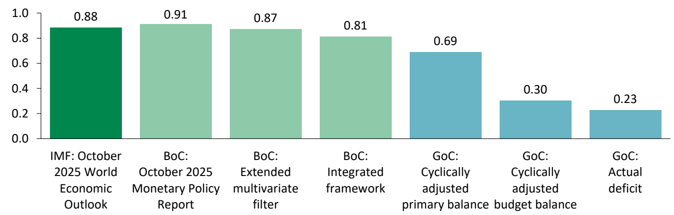
Box 1: Selecting Economic Indicators to Determine the Impact of Federal Deficits on Canadian Inflation

After trying several specifications, we landed on using the Desjardins Economic Studies output gap estimate and forecast. It's highly correlated with historical estimates published by the IMF and Bank of Canada (graph 6). In contrast, the output gap derived from Finance Canada's deficit estimates swings wildly and isn't especially correlated with measures published by other credible institutions. It's also largely uncorrelated with the deviation of inflation from the Bank of Canada's 2% inflation target, again in contrast to every other estimate of the output gap.

That said, we use the federal government's estimate of the CABB to determine the impact of discretionary fiscal policy on Canadian inflation. Finance Canada's estimate of the CABB outperforms other estimates in explaining the evolution of inflation in Canada by a wide margin. Therefore, adjustments made by the federal government for temporary counter-cyclical measures and one-off fiscal operations seem to be supported. In contrast, using Desjardins Economic Studies and Bank of Canada estimates of the output gap to determine the CABB is much less helpful in explaining inflation.

Graph 6
GoC Output Gap Estimates Are Very Different from Others

Correlation between Desjardins's output gap and those of other institutions
Correlation coefficient, 1991 to 2024

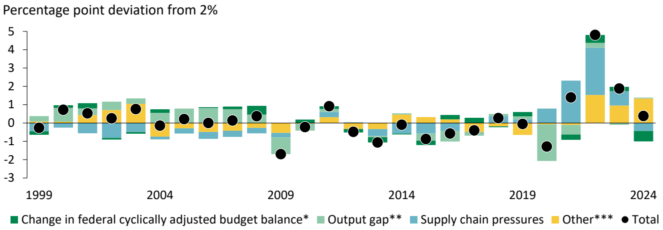


Note: Government of Canada output gap estimates are derived from the Fiscal Reference Tables.
IMF: International Monetary Fund; BoC: Bank of Canada; GoC: Government of Canada
Government of Canada, Bank of Canada, International Monetary Fund and Desjardins Economic Studies

Together, the output gap and CABB explain some of the deviation of inflation from the Bank of Canada's 2% target historically, albeit less so in recent years (graph 7). Instead, supply chain pressures, as measured by the Federal Reserve Bank of New York's Global Supply Chain Pressure Index, explain most of Canada's elevated inflation in 2021, 2022 and, to a lesser extent, 2023. This index accounts for cross-border transportation costs as well as country-level manufacturing data. Other factors like skyrocketing energy prices following Russia's invasion of Ukraine also played a role in the past few years. More recently, tariffs and countertariffs resulting from the US trade war boosted inflation as well.

Graph 7
Federal Deficits Have Not Been a Major Contributor to Canadian Inflation

Decomposition of the deviation in Canadian inflation from the Bank of Canada's 2% target
Percentage point deviation from 2%

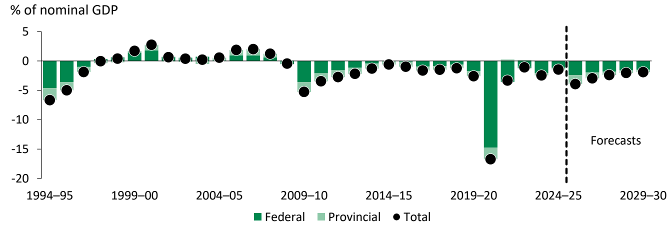


*Desjardins Economic Studies estimate
**Government of Canada estimate
***Includes inputs such as energy price impacts uncorrelated with supply chain pressures
Federal Reserve Bank of New York, Government of Canada and Desjardins Economic Studies

Another important consideration is the fiscal position of other levels of government in Canada, particularly provincial governments. Given Canada is a federation, the provinces play an outsized role in taxing and spending relative to the states and municipalities in other countries. Consequently, these budget balances are likely to have an impact on inflation. However, one-off and temporary factors would be difficult to remove for each province. Further, the combined federal-provincial CABB calculated using the Desjardins output gap falls short of explaining inflation, just as output gap-derived CABB does at the federal level exclusively. That makes sense, as combined provincial budget balances have historically moved in the same direction as those at the federal level but have been much smaller as a share of GDP (graph 8). As a result, it is difficult to isolate the provincial fiscal impact on inflation specifically.

Graph 8
Provincial Budget Balances Tend to Be Procyclical and Move with Federal Budget Balances

Federal and provincial budget balances*
% of nominal GDP



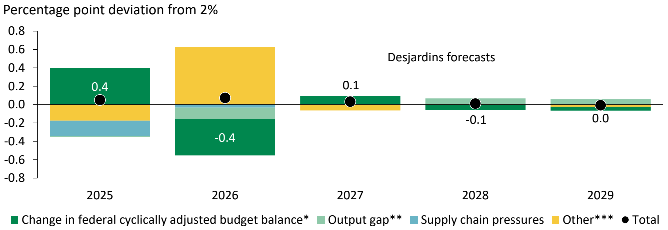
*Forecasts are a combination of official government sources and some inferred fiscal numbers in later years for select provinces
Official government sources and Desjardins Economic Studies

What Future Federal Deficits Mean for Inflation

Since Finance Canada doesn’t publish a forecast of its CABB estimate, we developed one using Desjardins Economic Studies’ output gap projection. This approach provides a forward-looking perspective grounded in our own economic outlook. While the historical correlation between the two measures is low, the Desjardins output gap offers a useful indication of the likely direction of the CABB. It’s worth noting that the largest historical deviations between Finance Canada’s and our CABB estimates have come from adjustments for temporary counter-cyclical measures and one-off fiscal operations—neither of which are anticipated in the near term. Since the output gap is forecast to be negative but relatively small, most of the projected deficits in Budget 2025 should be structural as opposed to cyclical. That means they are likely to be entirely reflected in the CABB.

However, because federal deficits are expected to shrink after the 2025–26 fiscal year, they should put little pressure on future inflation (graph 9). At least that’s what this framework tells us. But there will be crosscurrents impacting inflation that aren’t captured here. These include the positive impact on the supply side of increased infrastructure investment, which could boost Canada’s economic potential and put downward pressures on inflation over the long term. Measures to boost business investment could have a similar impact. That said, with so many public funds committed to building and purchasing infrastructure, housing and defence-related assets, it’s possible that structural federal deficits could spur inflation if supply doesn’t increase quickly or sufficiently to meet demand. This would be particularly the case for construction materials and labour, but with potential spillovers across other components.

Graph 9
While the Federal Deficit Likely Boosted Inflation in 2025, It Should Be Broadly a Wash over the Outlook
Decomposition of the deviation in Canadian inflation from the Bank of Canada’s 2% target



*Desjardins Economic Studies forecast
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***Includes inputs like energy price impacts uncorrelated with supply chain pressures, for example
Federal Reserve Bank of New York, Government of Canada and Desjardins Economic Studies

Conclusion

While the outlook is for structural federal deficits as far as the eye can see, if all goes as planned in Budget 2025, shrinking deficits should mean little pressure on inflation. That’s good news. But risks to expansionary fiscal policy remain, particularly if the demand it’s intended to spur is not met with increased economic supply. Then Canadians could have an inflation problem on their hands.