In both scenarios, the fiscal contraction reduces aggregate demand in the short term, although less so in the excess supply case. Inflation falls, allowing monetary authorities to ease policy, and short-term interest rates and the risk premium on government debt decline. As interest rates decline, the domestic currency depreciates in real terms causing an increase in net exports.[28]

Over the long term (approaching 20 years), aggregate demand responds positively to the reduction in interest rates and inflation. The reduction in net international indebtedness increases the share of domestic output that is available for domestic consumption. That permanent gain in domestic consumption is the basis for the Bank analysts' conclusion that, despite the short-term costs of reducing the debt/GDP ratio (including a temporary reduction in domestic consumption), the long-term gains are substantial and worthy of pursuit.

In terms of the real exchange rate in the long term, in both scenarios it is virtually unaffected by the fiscal initiative. There is a slight real appreciation in both cases. The lesson (in terms only of the real exchange rate effects) is that net exports can be positively stimulated by a reduction in the level of government debt relative to GDP in the short and medium term, but not in the long term.

Conclusion

The size of the public sector debt in Canada suggests that it will cast a shadow over the domestic economy for some time. Realistically, large public debts that accumulate over several years cannot be eliminated at once, at least not without significant economic displacements. The federal government now has a credible plan for reducing its deficit and easing the debt burden, both of which are critical to enhancing the domestic macroeconomic environment and raising the level of investors' confidence in the Canadian economy.

[28] A similar relationship between fiscal restraint, the exchange rate and net exports was also revealed in a modelling exercise undertaken to evaluate the impact of deficit reduction in the U.S.. See R.C. Bryant, *Consequences of Reducing the U.S. Budget Deficit*, Brookings Discussion Papers in International Economics, No. 104, The Brookings Institution, Washington DC, February 1994, pp. 10-1. Such an impact on the exchange rate is not, however, accepted by all analysts. Some believe that deficit reduction will increase the confidence of foreign investors in the Canadian economy and boost the value of the dollar. See, for example, W.B.P. Robson and W.M. Scarth, "Debating Deficit Reduction: Economic Perspectives and Policy Choices", in *Deficit Reduction: What Pain, What Gain?*, W.B.P. Robson and W.M. Scarth (eds.), C.D. Howe Institute, Toronto Ontario, 1994, p. 25.