

absolute terms, and is not likely to have any noticeable effect on other countries' GDP growth.²⁴

The Exchange Rate

Clearly, Canada has relied extensively on foreign savings to make up the shortfall of domestic funds. According to Ben Friedman, "solving the budget problem with capital inflows would simply mean substituting a crowding out of the . . . economy's foreign sector, through high real exchange rates, for the crowding out of the investment sector that would otherwise come about through high real interest rates."²⁵ Friedman is claiming that an expansionary fiscal policy that is funded by an inflow of foreign capital causes an appreciation of the domestic currency. The appreciation then reduces net exports, so that the original fiscal stimulus (the deficit) generates no change in output.²⁶ If an expansionary fiscal policy reduces net exports through a currency appreciation, does it necessarily follow that a contractionary fiscal policy will increase net exports through a currency depreciation?

It should be clarified first that the exchange rate depends, among other things, on both fiscal and monetary policies. It should also be noted that, with any policy change, there are differences between the levels of variables in the short term (when they are subject to adjustment effects) and their long-term equilibrium values. Bank of Canada analysts have recently estimated both the short-term and long-term effects of changing the level of government debt as a share of GDP.²⁷ They simulated the impact of reductions in the debt/GDP ratio based on two scenarios -- one in which the economy is initially in a state of excess demand and inflation is rising, and the other in which there is initially excess supply in the economy and inflation is falling.

²⁴ At the end of 1993, outstanding international debts issued by the Canadian public and private sectors represented about 7% of the world total. See Bank for International Settlements, *64th Annual Report*, Basle Switzerland, June 1994, p. 111.

²⁵ Friedman, *op. cit.*, p. 86.

²⁶ This is the standard Mundell-Fleming model, an explanation of which is contained in O.J. Blanchard and S. Fischer, *Lectures on Macroeconomics*, MIT Press, Cambridge MA, 1989, pp. 537-40.

²⁷ See T. Macklem, D. Rose and R. Tetlow, "Government Debt and Deficits in Canada: A Macro Simulation Analysis", in *Deficit Reduction: What Pain, What Gain?*, W.B.P. Robson and W.M. Scarth (eds.), C.D. Howe Institute, Toronto Ontario, 1994, pp. 231-72.