Federal Budget

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Highlights and analysis of the Canadian federal budget March 19, 2019, 4:00 pm

Pre-Election Prescription: Spending Dose

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- **Deficit will widen almost $5 bln to $19.8 bln in FY19/20; includes a $3 bln cushion**
- **Even the modest GDP assumptions in the Budget already look optimistic**
- **Double-digit deficits persist through the forecast horizon**
- **Few surprise new measures; no big tax changes; spending measures spread wide**
- **Debt-to-GDP ratio to continue drifting lower with $119 billion of bond issuance**

Overview—Don't Stop Us Now

The fourth budget of the current federal government has been overshadowed by events, but is quite important in its own right as it will serve as the pre-election economic document. The budget reinforces Ottawa's current priorities, and adds a few new ones, as stronger-than-expected revenues over the past year provided some fiscal leeway to fund yet another spending boost—and they've used most of it, leaving little to flow to the bottom line. **Ottawa is again projecting a string of double-digit budget deficits as far as the eye can see, widening to $19.8 billion in the coming fiscal year, while the key debt-to-GDP ratio continues to gradually drift lower—it's pegged at 30.7% in FY19/20**. This outlook comes as little surprise, as a fading debt ratio has become the de facto anchor for policy. A firmer-than-expected revenue backdrop has provided a big tailwind for finances, although that favourable trend has likely just about run its course with growth cooling markedly late last year and into early 2019. The major new measures in today's document did not come as a shock, and include moves to address housing affordability, skills training, support for seniors and a wide spattering of spending programs.

While the FY18/19 deficit is tracking $3.2 billion better than what was expected in the 2018 Fall Statement (effectively the now-removed risk adjustment), the upcoming two fiscal years will run slightly deeper. There remains no plan to balance the books, with a $9.8 billion deficit persisting by FY23/24. Beneath the surface, **a stronger-than-expected revenue base in FY18/19 has helped lift underlying finances by roughly $5 billion per year through the forecast horizon, but that gain has been almost precisely offset by increased spending across a wide range of initiatives**. In other words, Ottawa has chosen to let it flow rather than improving the bottom line, clearly revealing the fiscal priority. This is notable, given that the economic outlook has quickly deteriorated. For example, we now expect this year's real GDP growth to come in 0.5 ppts below the budget assumption, and nominal growth a full percentage point lower.

A contingency of $3 billion per year remains in place through the forecast horizon, but **we judge that the current downside risk from the economy carves into the entire FY19/20 reserve**. And, we'd just reiterate that we are observing some tell-tale late-cycle conditions in North America, often a period that governments should build fiscal capacity—after all, an ostensibly stable debt-to-GDP ratio will deteriorate overnight when the next downturn hits.

Table 1
Fiscal Outlook

(C$ blns, except where noted)

	Est.	— Forecast —		
	18/19	19/20	20/21	21/22
Revenues	332.2	338.8	351.4	366.7
Expenditures	347.1	355.6	368.2	378.4
Program Spending	323.5	329.4	339.7	348.3
Public Debt Charges	23.6	26.2	28.5	30.2
Adjustment for Risk	—	(3.0)	(3.0)	(3.0)
Budget Balance	(14.9)	(19.8)	(19.7)	(14.8)
Federal Debt	685.6	705.4	725.1	739.8
As a percent of GDP:				
Budget Balance	(0.7)	(0.9)	(0.8)	(0.6)
Federal Debt	30.8	30.7	30.5	30.0

Source: Federal Budget ( ) = deficit

Major Policy Measures: From Pot to Pharma

The net fiscal impact of new measures proposed in this year's budget is $4.0 billion (or 0.2% of GDP), rising to $5.7 billion in the following year—not big by any stretch, but not immaterial either. Here's a recap of some of the many new initiatives:

- ***Housing affordability:*** *This was a highly anticipated area that Ottawa has largely underwhelmed on. The headline measure is the* ***CMHC First-Time Home Buyer Incentive****, expected by September 2019. Effectively, CMHC will contribute 5% of the purchase price of an existing home (10% on a new build), with the amount to be repaid later on sale of the property. The program will only apply to those with household income below $120k, and with a maximum mortgage and incentive amount of 4-times income. As such, the impact will be contained to the lower end of the market below roughly $500,000 and, arguably, that's the level where affordability challenges only really begin. For example, the most acute affordability problems surround larger units or single-detached homes in the GTA and GVA; yet, most of these are beyond the price range covered by this program. The impact, of course, would be broader in other regions, but affordability in many of those is historically quite normal. The biggest impact will be in low-priced new builds.*
- *Ottawa will also modify the* ***Home Buyers' Plan****, which allows tax-free withdrawal from an RRSP (repaid over time). The withdrawal limit will rise from $25k to $35k.*
- ***Pharmacare:*** *Ottawa will continue to progress toward a national pharmacare program. While the advisory process is still underway, this budget takes three steps: 1) Create a Canadian Drug Agency to negotiate prescription drug prices on behalf of all drug plans, targeting $3 billion per year in long-term savings; 2) Develop a national list of prescribed drugs; and, 3) National strategy for high-cost drugs for rare diseases.*
- ***Program spending*** *will rise 1.8% in FY19/20 after a 4.9% jump in FY18/19. A big chunk of the new announcements in this budget ($4.2 billion) will be rolled out before FY18/19 ends. One of the key features is just how wide a range of areas the spending increases have been spread across.*
- ***Infrastructure spending:*** *One of the chunkier dollar amounts is an immediate $2.2 billion transfer to municipalities to top up their infrastructure funding (through the Gas Tax Fund), and $1 billion for energy efficiency.*
- ***Support for supply-managed farmers*** *totalling $3.9 billion in the wake of CETA and CPTPP ratification.*
- ***Skills training:*** *The* ***Canada Training Benefit*** *will provide a tax credit for skills training that accumulates at $250 per year, up to $5,000 over a lifetime. Income support will also be offered through the EI program.*
- ***Lower interest rate on student loans****, to prime from prime plus 2.5 ppts (variable) and to prime plus 2.0 ppts from prime plus 5.0 ppts (fixed). This is a meaningful reduction that will cost Ottawa $345 million by FY20/21.*

- ***GIS** full earnings exemption increase for seniors, from $3,500 to $5,000 and a 50% partial exemption is introduced up to $10,000.*
- ***Electric Vehicle subsidies:** Will provide $5,000 on cars with a purchase price of less than $45,000.*
- ***Stock option taxation:** Will limit the future benefit of the employee stock option deduction for high-income individuals at mature (i.e., not start-up) firms by applying a $200,000 annual cap—further details pending.*

Debt Management Strategy: Red Book

With a string of deficits still looming, government borrowing requirements will remain elevated. Gross marketable bond issuance will total $119 billion in FY19/20, up from $100 billion in FY18/19. After accounting for maturities, buybacks and other adjustments, the net increase in bonds will be $8 billion in FY19/20, versus a $2 billion decline this fiscal year. The stock of Treasury bills is projected to drift up from $131 billion to $151 billion, while the average term to maturity of domestic market debt is expected to remain stable around 5.5-to-6.5 years. **Ottawa continues to focus more of its issuance in the 2-, 3- and 5-year sectors than the longer end.**

Reflecting the above, Ottawa is projecting net new domestic **borrowing requirements of $32 billion** in the coming fiscal year, with cash balances unchanged. In turn, total federal debt-to-GDP will dip one tick, to 30.7% in FY19/20. The debt ratio is projected to eventually grind down to 28.6% by FY23/24—stability (or declines) in this measure is the fiscal anchor for now.

Economic Assumptions—Rejection of Pre-Election Projections

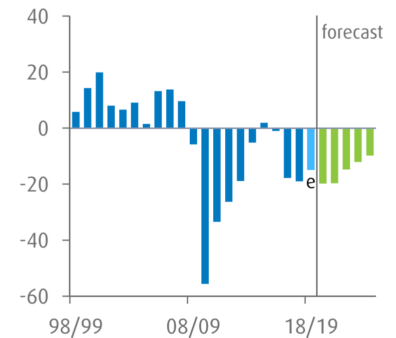
Ottawa's economic assumptions were brought together prior to the sour news on Q4 GDP and, thus, appear overly optimistic—a rare case when the consensus forecast has shifted significantly just ahead of budget day. In the budget assumptions, Canadian real GDP growth is a moderate 1.8% this year, but the latest consensus has since dropped to just 1.4% growth (and we're at 1.3%). Even last year's initial estimate has been shaved to 1.9%. The assumption for 2020 growth of 1.6% is closer to the current mark (we're actually a tad higher at 1.7%). A key message here is that **growth will be modest at best over the next couple of years**, limiting any potential upside surprises to the bottom line like we saw in the past year.

Importantly for revenues, the assumption for nominal GDP growth also looks high for 2019—the budget is based on 3.5% this year and next (our calls are 2.5% and 3.7%, respectively). This comes alongside expected further gains in oil prices—we see WTI averaging $60 in 2019/20. Some offset for finances will be provided by an even more benign interest rate environment than anticipated just a few short months ago. The budget assumed that three-month interest rates would average 1.9% this year and 2.2% next year; but, we now look for 1.7% in 2019 and just under 2% in 2020. The assumption on 10-year GoC yields of 2.4% this year and 2.7% in 2020 look wildly high, at least at this point, and we are looking for them to average less than 2% over the next two years. It's noteworthy that, aside from a brief period through 2013, much of this cycle has been characterized by lower interest rates, leading governments to revise down their debt-service cost estimates in-year. That looks very likely to be the case yet again this year. Even so, the much softer growth

Chart 1
Deficits Persist

Canada (C$ blns)

Budget Balance

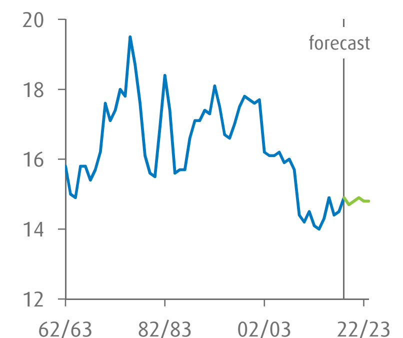


Source: Federal Budget e = estimate

Chart 2
Revenues Grow with GDP

Canada (% of GDP)

Revenue

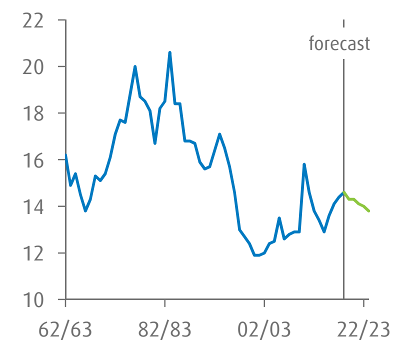


Source: Federal Budget

Chart 3
Spending Will Fade

Canada (% of GDP)

Program Expenses



Source: Federal Budget

backdrop suggests that **the risks from an economic perspective look like they will readily consume the contingency reserve in the coming year**.

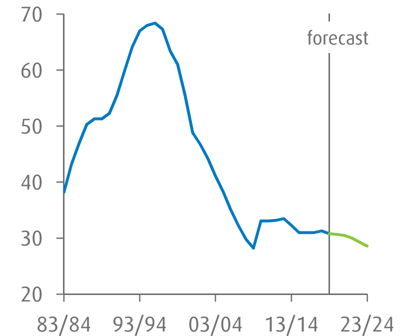
Market Impact—Small Stimulus, Even Smaller Rate Hike Odds

Canadian dollar: Today's budget is unlikely to have a major impact on the Canadian dollar, which is much more focussed on the outlook for the Fed, trade frictions and oil prices. Net new short-term measures are moderately stimulative, while a somewhat wider deficit in the coming year is buffered by much cooler economic momentum to start 2019. Looking ahead, we suspect that some further mild improvement in oil prices and a fading U.S. dollar will provide some support for the loonie. We still look for the currency to be partly on the defensive in coming months amid the ongoing trade uncertainty, but benefit overall from a broadly sluggish U.S dollar. As we note below, we suspect that the BoC will stay on the sidelines well into the second half of the year—if not even longer—even as its tone gradually shifts back to a more-hawkish bias later this year. Overall, the outlook remains for a flat currency through the middle section of 2019, but with the C$ likely to finish the year slightly firmer at around $1.32 (i.e.; just under 76 cents US), moderately above today's level.

Chart 4
Debt Ratio Tracking Lower

Canada (% of GDP)

Federal Debt



Source: Federal Budget

Bonds: The fiscal measures in the coming year of roughly 0.2% of GDP should make only a slight impression on a cautious Bank of Canada—we expect rates to stay steady until almost the end of 2019—although the tight job market will keep rate hikes in play. Accordingly, we expect long-term interest rates to nudge higher from their current extreme lows—not only are long-term rates at record negative spreads versus Treasuries, but the 10-year GoC yield is now in a rare inversion versus overnight rates in Canada. We look for long-term Canadian/U.S. spreads to begin tightening. The outlook for less negative spreads is similar at the short end, though the starting point is a tad different with Canadian two-year yields sitting more than 80 bps below their U.S. counterparts, even wider than the current spread on overnight rates.

Table 2
Economic Assumptions

(percent)	— Ottawa —			BMO Capital Markets	
	2018	2019	2020	**2019**	**2020**
GDP Growth					
Real	1.9	1.8	1.6	**1.3**	**1.7**
Nominal	3.8	3.4	3.5	**2.5**	**3.7**
Yields					
3-month T-Bill	1.4	1.9	2.2	**1.7**	**2.0**
10-year GoC	2.3	2.4	2.7	**2.0**	**2.0**

Stocks: There is precious little for stocks in this document, although insurers will keenly follow the pharmacare developments. The broader direction of long-term yields, oil prices and the U.S. economy are much bigger factors, particularly with investors now growing somewhat more concerned about the prospects for growth amid the winding down of last year's aggressive pro-growth/reflationary fiscal policy south of the border. It is notable that, even as the Canadian economy has struggled in recent months, the TSX is near the top of the international equity market pack so far in 2019.

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