Federal Budget Update: Targets Still Moving

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Ottawa's budget update reveals the fiscal cost of the ongoing pandemic, with this year's budget deficit now expected to clock in at a towering $381.6 billion (up from the July estimate of $343.2 billion), or 17.5% of GDP. While some deterioration was expected in view of the series of spending announcements in the past three months, the widening is a bit larger than generally anticipated, partly reflecting some of the measures announced today. The other new news here is that Ottawa has set out a forecast for where finances go in the next few fiscal years, a first since the pandemic began—and the picture is mildly reassuring. Finance looks for the underlying deficit to narrow substantially in the coming fiscal year (starts April 1, 2021) to $121.2 billion, or 5.2% of GDP, pending further stimulus.

Looking further afield, the shortfall is expected to moderate to $50.7 billion in the next year (just over 2% of GDP, versus a pre-virus trend of around 1% of GDP). However, this relatively quick drop in **the deficit does not factor in some more negative potential scenarios for the economy** (under various levels of lockdown), **nor does it account for a planned $70 billion to $100 billion of additional stimulus spending** over the next three fiscal years as the economy recovers.

Fiscal Outlook
(C$ blns, except where noted)

	19/20e	20/21f	21/22f	22/23f	23/24f	24/25f	25/26f
Revenues	334.1	275.4	335.9	357.8	377.3	398.5	417.3
Expenditures	362.9	641.6	441.5	396.4	410.1	423.4	438.4
Program Spending	338.5	621.4	421.2	373.9	384.4	392.9	404.0
Public Debt Charges	24.4	20.2	20.3	22.4	25.7	30.5	34.3
Net actuarial losses	(10.6)	(15.4)	(15.6)	(12.1)	(10.5)	(6.0)	(3.9)
Budget Balance*	(39.4)	(381.6)	(121.2)	(50.7)	(43.3)	(30.9)	(24.9)
Federal Debt	721.4	1,107.4	1,228.5	1,279.3	1,332.6	1,353.4	1,378.3
As a percent of GDP:							
Budget Balance	(1.7)	(17.5)	(5.2)	(2.1)	(1.7)	(1.2)	(0.9)
Federal Debt	31.2	50.7	52.6	52.1	51.6	50.6	49.6

**Excludes $70-to-$100 bln of spending planned FY21/22 through FY23/24*
Source: Fall Economic Statement *( ) = deficit; e = estimate; f = forecast*

While the fiscal forecast makes for suitably grim reading, we would point to a few factors that may contain the underlying deficit, or possibly even lead to slightly less-bad outcomes. First, the economic scenario is generally reasonable, but seems a tad on the cautious side for 2021, even with the likelihood of a short-term hit to growth from second-wave restrictions. Fiscal projections are based on an assumed 5.8% drop in GDP this year and then a 4.8% rebound next year; our latest call is for -5.7% and +5.5%. Second, it appears that a high degree of caution is built into the spending and revenue figures. Finally, there is the uncertainty on the degree of take-up for some of the new spending measures; Ottawa has often over-estimated the costs of new programs (e.g., CEWS). These multi-tiered layers of prudence are perfectly understandable given the murky near-term economic outlook, but also seem to leave plenty of room for a better-than-projected fiscal outcome. On the other side, additional planned spending could more than offset these potentially positive factors.

The three key issues that today's fiscal update help to address are what it implies for 1) the economic outlook; 2) the borrowing outlook; and 3) the medium-term fiscal outlook. Before digging into each of those items, let's first look at what specific new measures were introduced today:

Summary of Major New Measures

There were $25.1 billion worth of new measures announced in this update. Here are some of the key items:

Wage subsidy expansion: Increasing the maximum subsidy rate to 75 per cent for the period beginning December 20, 2020, and extending this rate until March 13, 2021.

Commercial rent subsidy extension: Extended for an additional three periods, to March 13, 2021.

Direct industry support for air transportation, live events and arts amounting to $528 million.

Support for families with children: $1,200 per child in 2021 under age 6, if household income is below $120k (reduced by half for CCB-eligible families with income above that threshold).

Supply management: Net $1.2 billion funding increase for farmers in FY20/21.

Home energy retrofits: Grants of up to $5,000 for energy-efficient home improvements.

Provincial fiscal stabilization: Program cap will rise to $170 per capita from $60 for FY19/20, and will grow in line with GDP per capita.

Digital tax: Foreign providers of digital products/services will be required to collect GST/HST on taxable sales to Canadian consumers. GST/HST also required for short-term accommodation providers.

Home office expense deduction: Standard (up to) $400 expense claim for those working from home, without a signed tax form from their employer.

National tax on foreign owners of Canadian real estate: Measure to be announced in the coming year.

Economic Outlook

The budget update is based on a relatively—and understandably—cautious economic outlook. While the consensus is likely shifting even now on recent new restriction measures, the assumption of a 5.8% drop in GDP this year and then a moderate 4.8% bounce next year is likely close to current consensus and below what we are currently assuming. We would note that since the spring, the economy both in Canada and much of the rest of the world has managed to perform a bit better than widely expected. And part of that better-than-expected outcome has been driven by the extreme level of fiscal support on hand, notably in Canada.

Economic Assumptions

(percent)		Ottawa			BMO Capital Markets	
		2019	2020	2021	2020	2021
GDP Growth	Real	1.7	-5.8	4.8	**-5.7**	**5.5**
	Nominal	3.6	-5.5	6.9	**-5.0**	**7.8**
Yields	3-month T-Bill	1.7	0.4	0.2	**0.5**	**0.1**
	10-year GoC	1.6	0.7	0.9	**0.8**	**1.0**

Net new spending measures for the current fiscal year announced today will add incrementally to the near-term growth outlook. But the bigger underlying message is that fiscal policy in Canada will remain extraordinarily generous—both by historical standards, but also compared with other economies. By a number of metrics, Canada's fiscal policy has been as generous as any other major economy in the world in 2020, and that looks to be sustained in the coming year. This is one key factor behind our above-consensus call of a sturdy (and well above consensus) 5.5% rebound in growth in 2021.

Clearly, the massive wildcard for the near-term outlook is what path the virus and any additional restriction measures take in coming weeks and months. Finance has set out a variety of scenarios with different degrees of economic shutdowns—the extended and escalated shutdown scenarios. These lead to softer growth in 2021 of 4.1% and 2.9%, respectively. Yet, perhaps the key message here is that even under the "escalated shutdown" scenario, and even with heavy new stimulus spending, Finance is still expecting a budget deficit of $166.7 billion next year. We wouldn't quite consider that a "worst case" outlook, but it's close, and yet the deficit would still be less than half of this year's expected outcome.

Medium-Term Fiscal Outlook

The medium-term fiscal outlook is still layered with uncertainty from the economic outlook and, more specifically, another wave of stimulus spending that has yet to be unleashed. These yet-to-be allocated funds will focus on post-COVID priorities. Still, even assuming the high-end of that estimate gets spread relatively evenly over those three years, it points to a path of deficit reduction that is roughly in line with what we had been assuming. By FY23/24, the deficit would likely be below 3% of GDP, which is getting back into more sustainable territory. Meantime, federal debt is expected to rise to $1.3 trillion by FY23/24, up from $1.1 trillion this fiscal year. As a share of GDP, federal debt is expected to peak next year at 52.6% of GDP, and then gradually fade back toward the 50% mark.

This document **does not include an explicit fiscal anchor.** Ottawa notes that stimulus will be appropriate until it determines that the economy has recovered from the pandemic, using data on the employment rate, total hours worked and the unemployment rate as a guide. When this is achieved, Ottawa will shift to a fiscal anchor with longer-term sustainability in mind. It remains to be seen what that anchor might look like.

Debt Management Strategy Update

Despite a larger deficit for FY20/21, the borrowing needs are little-changed overall at $703 billion. What has changed is the make-up of the borrowing, with a larger share in T-bills and a modest decline in bonds with a maturity of 5 years and under. Demand for T-bills has been consistently solid with yields trading through the Bank of Canada 0.25% overnight target rate driving the increase from $294 billion to $329 billion. Bond issuance is falling to $374 billion from $409 billion, with cuts in the 2-year, 3-year and 5-year sectors. The 10-year and 30-year issuance plans were unchanged. Indeed, the focus on extending the average maturity of the debt stock remains. The government will again look at potentially re-opening the 50-year bond, last issued in 2017.

Looking ahead to FY21/22, there weren't any issuance projections, but we can make some assumptions based on coming maturities and the deficit scenarios provided. For starters, we'll assume that the T-bill stock will remain steady. The deficit scenarios for next year (ranging from $136.7 billion to $166.7 billion), along with approximately $96 billion in maturities, puts gross bond issuance in the $233-to-$263 billion range. That's down at least $100 billion from this year and about in line with our assumption heading into today's update. The federal government is also planning on entering the Green Bond market to fund "*green infrastructure and other green initiatives*", with initial issuance planned in FY21/22.

Markets took the modest changes in borrowing for the rest of this year in stride, with little reaction after the update was unveiled. Assuming the above estimates for FY21/22 issuance are close, there will be an impact on the Bank of Canada. Currently, the BoC buys 13% of every auction and $4 billion per week in QE. Over 52 weeks, that adds up to $238 billion (using the bottom of the issuance range above). The BoC won't want to be absorbing all the issuance, so **another QE taper is possible in the early part of next year**. For FY20/21 QE is on track to total around $246 billion, which is about two-thirds of gross issuance. Using the $238 billion estimate, a similar QE share would mean about $157 billion in buying from the BoC, or around $3 billion per week (below the current $4 billion pace). Note that the BoC also buys 13% of bond auctions, so they're on track to buy just under 80% of gross issuance this year.

The Bottom Line: Ottawa's long-awaited fiscal plan marks the first glimpses of a potential transition away from the highly aggressive short-term measures to support the economy through the pandemic to a medium-term plan to stabilize finances. The update highlights the fiscal damage from the pandemic, but also suggests that the repair to the government's balance sheet won't be fast. Beyond some of the moderate sector-specific measures announced today, and a down-payment on some new focus areas (such as child care), the big news was the upgrade to the budget deficit estimates for this year and a much more moderate path for shortfalls in coming years. A key question will be whether the government will manage to stick with this medium-term plan, especially given the lofty ambitions on a variety of files and still-heavy needs from a number of hard-hit sectors.

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