Global Economic Research

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Fiscal Pulse

FY2011-12 Highlights

Canadian Federal Budget

- For Canada's federal government, fiscal 2010-11 (FY11) and FY12 represent a window of opportunity for significant fiscal repair with stronger growth emerging and interest rates remaining at historically low levels. Ottawa now expects a $40½ billion shortfall for FY11, an improvement of almost $5 billion from its October 2010 estimate. Narrowing the deficit by $9-$11 billion in each of the following four years virtually eliminates the red ink by FY15, and a $4 billion surplus is forecast for FY16.

- The rise in federal net debt, from a low of 29% of GDP in FY09, is capped at just over 34% in FY12, and then is forecast to decline to just below 30% by FY16. More substantial is the forecast $10 billion rise in the debt service to $39½ billion by FY15, though relative to revenues, the interest burden is largely unchanged from FY10 at just over 13¢ of each revenue dollar.

- After Strategic Reviews from 2007 to 2010 on sequential portions of the government's operations yielding $1.4 billion of savings for FY12, *Budget 2011* proposes a comprehensive review over the next year covering $80 billion of direct program spending with a 5% or $4 billion saving objective by FY15. All else equal, even partial success suggests black ink a year earlier in FY15. Ottawa continues to maintain that it will balance its books with no tax increases, while maintaining the scheduled growth of its major transfers to individuals and other levels of government.

- In the near-term, from its fiscal improvement, the government is extending several of its stimulus measures, upping spending across a broad range of areas from targeted industry aid, to the environment, to seniors. As well, personal income tax relief largely through a range of tax credits, net of another round of tax loophole closures, will total about $300 million in FY12.

- Federal gross bond issuance is forecast to rebound from $96 billion in FY11 back to $102 billion in FY12, and a new medium-term debt strategy will increase the focus on 2-, 3-, and 5-year issuance.

- The Budget, by staying on track, is likely to have little market impact. Nevertheless, Ottawa's current ability to offer further support to the economy and Canadians while reducing its red ink will be perceived as a major advantage relative to most other developed nations.

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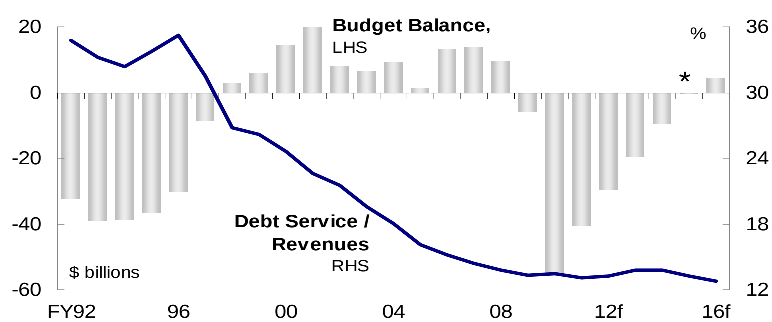
Federal Deficit Reduction Path



* FY15: $0.3 billion deficit. Source: Finance Canada.

Overview

Current Revenue Support

- Revenues in FY11 are forecast to be $3.1 billion higher than the federal government's October 2010 estimate. After the hefty 7.8% jump in FY11, revenue growth in FY12 and FY13 is forecast to average a solid 6%. In large part, the improvement reflects stronger real economic growth and the benefit of buoyant global resource prices, leading to a $24 billion increase in the nominal GDP assumed by the government for calendar 2011.

- Despite this positive development, the government is adopting some insurance by reducing the assumed nominal GDP in the *Budget* estimates by $10 billion in each year of the FY12-FY16 forecast, with a $1.5 billion initial annual revenue impact.

Positive Debt Service and Net Debt Developments

- Historically low interest rates continue to open up some additional spending room. For FY12, interest charges are projected at $33 billion, $2.3 billion less than the *2010 Budget* estimate.

- For FY11, "Other Comprehensive Income" is expected to be unusually large at $3.1 billion, largely due to the appreciation in the value of the government's General Motors equity holdings. This income does not narrow the deficit, but it is applied against the debt.

Program Spending Edges Higher

- The federal government no longer projects a program spending decline after the two years of stimulus. However, these outlays are expected to be virtually flat in both FY11 and FY12. For the five years to FY16, annual growth in program expenditures is expected to average just 1.6%.

- The government reports that its *Budget 2010* restraint measures are on target. In its contract negotiations, Ottawa negotiated the elimination of severance benefits for resignation or retirement as of FY12. Work continues in streamlining government operations, in part to reduce red tape as well as to trim spending.

Ottawa's *Economic Action Plan*

- Federal stimulus, totaling $46½ billion, will be largely spent in FY10 and FY11, but as previously announced, $0.9 billion of the funding will be extended into F12 to cover infrastructure projects under four programs begun by March 2011 but requiring a further six months for completion. The remaining amounts in the seven-year

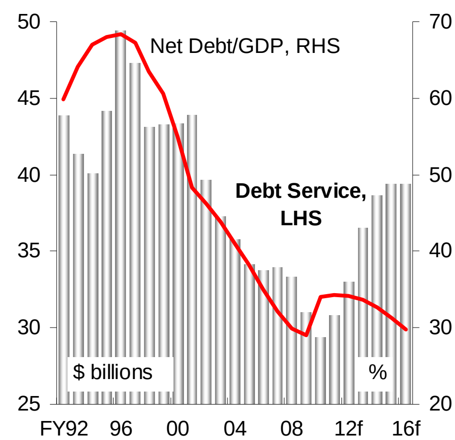
Economic Assumptions*
annual % change except where noted

	Scotia Economics		
	2010	2011f	2012f
Canada: Real GDP	3.1	3.1	2.6
Nominal GDP	6.2	5.7	4.8
CPI - All Items	1.8	2.4	2.2
Unemployment Rate,%	8.0	7.6	7.4
Oil Price WTI, US$/bbl	80	97	100
3-month T-bills,%	0.6	1.3	2.3
10-year Bonds,%	3.2	3.4	3.9
Cdn Dollar, US¢/C$	97	104	107
U.S.: Real GDP	2.8	3.0	2.7

	Finance Canada**		
	2011f	2012f	2013f-15f
Canada: Real GDP	2.9	2.8	2.6
Nominal GDP	5.8	5.0	4.6
Nom. GDP:Assumed **	5.2	5.0	4.7
CPI - All Items	2.4	2.1	2.0
Unemployment Rate,%	7.5	7.2	6.7
3-month T-bills,%	1.3	2.5	3.8
10-year Bonds,%	3.5	4.0	4.8
Cdn Dollar, US¢/C$	99.7	98.8	97.3
U.S.: Real GDP	3.1	3.1	3.2

* All data: annual averages. ** Private-sector survey except for nom. GDP assumption at $10 bn. below survey.
Source:Finance Canada, Scotia Economics (Mar.3, 2011).

The Federal Debt Burden



Source: Finance Canada. GDP forecasts: Scotia Economics.

Building Canada plan introduced in the *2007 Budget,* plus limited new spending on priorities such as bridges, will sustain significant federal infrastructure support. As well, Ottawa is making permanent the annual allocation of $2 billion to municipal infrastructure through the Gas Tax Fund.

- The next phase of the *Economic Action Plan* — providing near-term support for longer-term growth — is a basket of varied initiatives including: a two-year extension to December 31, 2013, of the accelerated straight-line 50% depreciation on processors' and manufacturers' machinery & equipment purchases; a hiring credit of up to $1,000 on small employers' 2011 EI premiums; an extension of the Work-Sharing Agreement by up to 16 weeks; an enhancement of the Wage Earner Protection Program for workers affected by an employer's bankruptcy; and, an extension of the Targeted Initiative for Older Workers. Targeted industry assistance includes $60 million for forestry to innovate and tap into overseas opportunities.

- Research and innovation also receive attention. For small business, $80 million of new funding will be allocated to the Industrial Research Assistance Program to accelerate small- and mid-size businesses' ICT adoption. Funding is directed to existing initiatives, such as the three federal research granting councils and Genome Canada, as well as new measures such as 30 new Industrial Research Chairs for colleges.

- The centre-piece of the environmental initiatives is $400 million for FY12 for the ecoENERGY Retrofit-Homes program. Other initiatives address longstanding concerns such as protecting the Great Lakes and monitoring initiatives.

- A range of measures to boost personal income and support communities are introduced such as a $300 million increase in the Guaranteed Income Supplement for Seniors; new tax credits for family caregivers, volunteer firefighters and children's Arts, and forgiveness of a portion of federal student loans for doctors and nurses willing to practice in underserved communities.

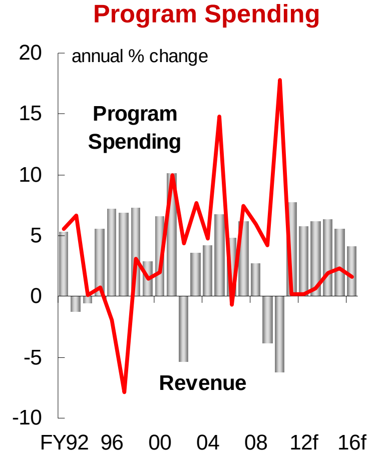
Ottawa's Budget Arithmetic

$ billions unless otherwise noted

	FY11 Rev.	FY12 Bud.	FY13 Bud.	FY16* Bud.
Personal Income Tax (PIT)	113.3	119.9	128.1	151.5
Corporate Income Tax (CIT)	28.6	32.1	32.7	38.9
Goods & Services Tax (GST)	29.1	30.1	31.8	36.8
Employ. Insurance (EI) Premiums	17.5	18.9	20.8	24.8
Other Revenue	47.0	48.1	51.0	57.2
Total Revenue	**235.6**	**249.1**	**264.4**	**309.2**
Total Transfers to Persons	68.6	70.6	72.5	79.5
EI Benefits	20.1	19.5	18.9	19.0
Other Transfers	48.5	51.1	53.6	60.5
Transfers to Other Cdn Gov'ts	53.0	56.0	57.5	65.6
Direct Program Expenditures	123.5	119.1	117.3	120.5
Total Program Spending**	**245.2**	**245.7**	**247.3**	**265.6**
Debt Service	30.8	33.0	36.5	39.4
Total Expenditure	**276.0**	**278.7**	**283.8**	**305.0**
Budget Balance	**-40.5**	**-29.6**	**-19.4**	**4.2**
Non-Budgetary Transactions	-4.0	-4.4	4.3	-0.2
Fin.Source(+)/Requirement(-)	**-44.5**	**-34.0**	**-15.1**	**4.0**
Other Comprehensive Income	**3.1**	**0**	**0**	**0**
Net Debt	**556.4**	**586.0**	**605.4**	**611.0**
Annual Change, %				
Personal Income Tax (PIT)	*9.0*	*5.8*	*6.8*	*5.7*
Corporate Income Tax (CIT)	*-5.8*	*12.2*	*1.9*	*6.0*
Goods & Services Tax (GST)	*8.0*	*3.4*	*5.6*	*5.0*
Total Tax Revenue	*5.8*	*6.3*	*5.5*	*5.4*
EI Premiums	*4.7*	*7.7*	*10.1*	*6.1*
Total Revenue	***7.8***	***5.8***	***6.1***	***5.4***
EI Benefits	*-6.9*	*-3.0*	*-3.1*	*0.2*
Other Transfers to Persons	*3.3*	*5.3*	*4.9*	*4.1*
Transfers to Other Cdn. Gov'ts	*-7.0*	*5.7*	*2.7*	*4.5*
Direct Program Expenditures	*3.6*	*-3.6*	*-1.5*	*0.9*
Total Program Spending**	***0.2***	***0.2***	***0.7***	***2.4***
Memo Items, %				
Operating Exp. Subject to Freeze	56.4	54.1	53.9	57.6
Total Revenue / GDP	14.5	14.5	14.7	15.1
Total Program Spending** / GDP	15.1	14.3	13.8	12.9
Budget Balance / GDP	-2.5	-1.7	-1.1	0.2
Net Debt / GDP	34.3	34.2	33.7	29.7
Debt Service / Revenue	13.1	13.2	13.8	12.7

* Average annual growth, FY14-16. ** Includes *Economics Action Plan.*
Source: Finance Canada; Nominal GDP forecasts: Scotia Economics.

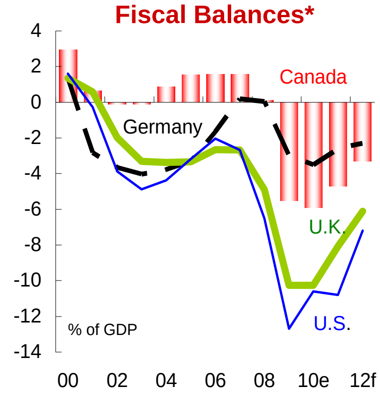
Federal Revenues and Program Spending



Source: Finance Canada.

Tax Fairness — Closing Tax Loopholes

- Measures in this *Budget* to close tax loopholes are expected to raise revenues by $240 million in FY12 and by about $1 billion in FY14. Anti-avoidance rules for Registered Retirement Savings Plans and Registered Retirement Income Funds, patterned on similar rules for Tax-Free Savings Accounts, are expected to raise federal revenues by $100 million annually, addressing self-dealing arrangements and prohibiting withdrawals without tax. Other tax loophole closures include requiring partnership income to be accrued, not deferred, in a parent company's year-end, and a package of measures to limit abuse of charitable donations incentives. For oil sands projects' intangible capital expenses, deduction rates will be lowered to the rates applicable for conventional oil & gas.



* General government basis. Source: IMF.

Financial Services

- A framework for demutualizing federally regulated property and casualty mutual insurance companies will be developed. The government will formalize existing mortgage insurance arrangements with private insurers and Canada Mortgage and Housing Corporation, including rules for government-backed insured mortgages. In addition to financial literacy initiatives, consumer protection measures will be developed for network-branded prepaid cards, and unsolicited credit card cheques will be banned.

Outlook

- This year's *Budget* marks a transition from stimulus to restraint. It is a difficult transition, as indicated by the continuation of several measures to ensure continued positive economic momentum and job creation. Yet with many advanced economies facing an unprecedented build-up in debt, the Canadian federal government remains in an advantageous position.

- Ottawa's challenge is to stay the course on eliminating its deficit. In November 2006, Ottawa introduced Advantage *Canada*, a longer-term economic strategy to meet the challenges of a rapidly changing world. With some of the expensive aspects of this strategy largely accomplished, such as corporate tax reform, some key aspects of this strategy remain, such as expanding Canada's participation in global trade and investment. However, the success of this economic strategy, given pressures such as the expanding Seniors cohort, fundamentally depends on the government consolidating its services and eventually returning to debt reduction.

Debt Management Strategy

Ottawa's financial requirements follow a path somewhat different from the declining budget deficit. After surging to a record $90 billion in FY09 given the cash needs of the *Extraordinary Financing Framework*, Ottawa's financial requirements are expected to decline to $34 billion by FY12 and $15 billion by FY13. Loans and investments related to Crown corporations will diminish and, on the purchases of insured mortgage pools under the *Insured Mortgage Purchase Program*, repayments of principal are beginning. In FY14, with these repayments peaking at $44 billion, Ottawa expects a $35 billion financial source. In FY15 and FY16, a financial source is still forecast, but at much more modest levels.

To enhance the government's liquidity, over the next three years the government will borrow $35 billion which, if the government's market access is disrupted, would cover one month of its net projected cash flow, consistent with the proposed Basel III liquidity coverage rules for banks. With the borrowing matched by a corresponding increase in interest-bearing assets, this transaction does not affect Ottawa's budget balance or its net debt.

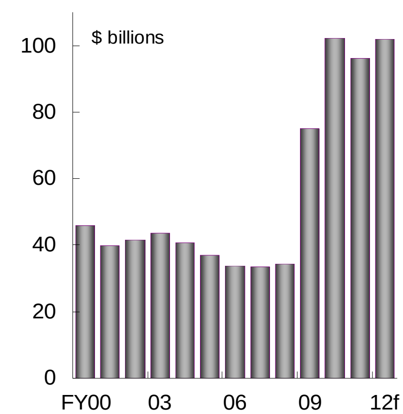
A new medium-term debt strategy, while maintaining all current funding instruments, will focus more on 2-, 3- and 5-year maturities given modeling results indicating that over a range of scenarios, a greater weighting of short- and medium-term bonds will improve the cost-risk structure of the federal debt. Over the coming decade, in this transition to a smoother maturity profile that is expected to reduce exposure to debt rollover risk, the share of bonds with original terms of 10 years or more is expected to hold steady at about 40%. The proportion of debt, net of financial assets, maturing or requiring repricing will fluctuate between 31% and 37%.

Gross bond issuance, slipping to an estimated $96 billion in FY11, will rebound to $102 billion in FY12, raising marketable bonds outstanding to $462 billion at year-end. Quarterly auctions will be kept for each maturity except 30-year bonds, with Q2 of FY12 skipped. Benchmark target sizes for 2- and 3-year bonds will increase to $8-$12 billion, and $10-$13 billion for 5-year bonds. Sizes for 10- and 30-year bonds will be unchanged at $10-$14 billion and $12-$15 billion. Real Return Bond (RRB) issuance will be maintained unchanged.

Four new maturity dates — the first of February, May, August and November — are planned, impacting the size of maturities and coupon payments on June 1 and December 1 as early as FY14. The 2-year sector will shift to the four new dates, 3-year will shift to February and August, 5-year will move back to its traditional March and September dates and the 30-year sector will shift to December, alternating years with RRB maturities. To decrease large maturities on certain dates, bond buybacks on a switch and cash basis will rise from $5 billion in FY11 to $8 billion in FY12.

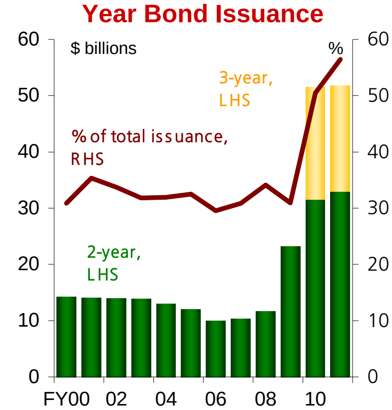
Treasury bills outstanding, after an estimated $16 billion drop in FY11, are expected to fall $15 billion in FY12 to $145 billion.

Gross Bond Issuance*



* Includes Real Return Bonds.
Source: Finance Canada.

Surging Two- and Three-Year Bond Issuance



Source: Finance Canada.

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