A Convenient (But Uncomfortable) Truth

CANADA'S FEDERAL FISCAL RESPONSE PREVENTING A FAR WORSE ECONOMIC OUTCOME

- **Prime Minister Trudeau has announced unprecedented fiscal support since the onset of the COVID-19 pandemic. Direct spending currently amounts to over $160 bn (8% of GDP), which would bring the deficit to around 12% of GDP.**
- **Canada's federal net debt as a share of the economy is expected to surge above 45% from its relatively low pre-COVID-19 forecast of around 34%*.**
- **The sheer scale and pace of escalation of debt no doubt raises unease, with questions on how Canadians will pay for this down the road. The recent rating downgrade by Fitch stirs these embers.**
- **Scotiabank Economics has expanded its modeling capacity to ground this debate in economic realities. We estimate that Canada's real GDP would have declined by 10.3% in 2020 (versus our current forecast of -7.3%) absent the substantial discretionary fiscal response.**
- **Furthermore, a more prolonged recovery would only see the output gap closing by early 2023, a full year beyond our current baseline.**
- **Net debt as a share of the economy would have surged well above 40% in any case as automatic stabilizers would kick in against a larger GDP shock. It would stabilize only a few percentage points below current baseline projections.**
- **In other words, today's fiscal spending is contributing to *substantially better* economic outcomes while raising net debt levels only *marginally*.**
- **Meanwhile, the toll on Canadian households and businesses would have been far worse. Unemployment would peak at 15% and the potential for non-linear responses by businesses would be elevated.**
- **Fiscal policy calibrated to a highly uncertain recovery path should matter most to markets (and Canadians) at present as a premature withdrawal of support could do more harm than good.**

THE BIG SPEND

Federal deficit spending is on track to set an all-time record in 2020. The budget balance is currently estimated at 12% of GDP (or -$260 bn) (chart 1). Only wartime spending rivals this quantum, which otherwise dwarfs past recessionary spending by multiples. Recall, deficit spending peaked just shy of 4% of GDP during the Global Financial Crisis.

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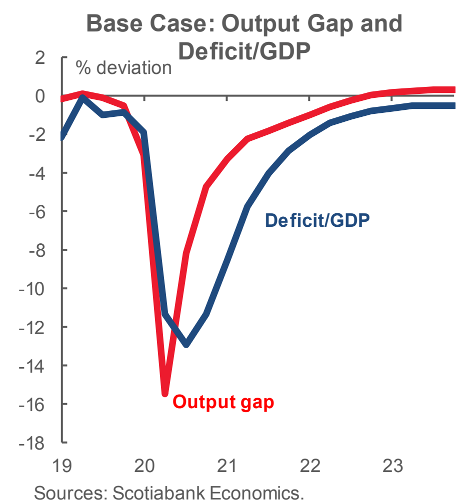
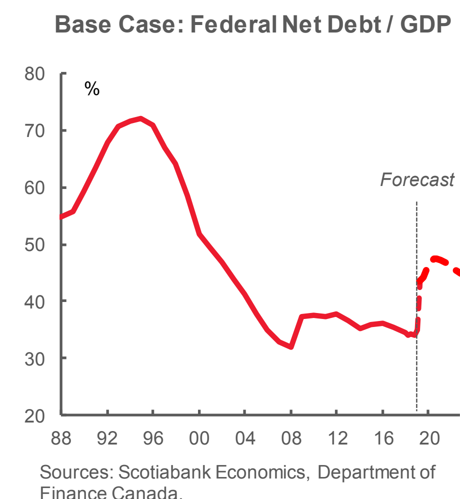
Chart 1



Sources: Scotiabank Economics.

Chart 2



Sources: Scotiabank Economics, Department of Finance Canada.

* *Net debt is slightly higher than the oft-cited "accumulated deficit", which nets out non-financial government assets in addition to financial assets.*

The pandemic price tag will likely continue to mount as the year advances. The uptake of big ticket measures such as the Canada Emergency Response Benefit (CERB) has already doubled original estimates, surpassing $50 bn to-date. While new applicants appear to have leveled off, there will no doubt be pressure to continue to extend its provisions in some form beyond the summer months. Transfers to provinces may yet come out higher than $14 bn—the opening offer from the Feds—as provinces grapple with cumulative budget shortfalls in the order of $50 bn this year.

Temporary spending increases will push up expenditures, but automatic stabilizers will also contribute to budgetary shortfalls. Revenues are expected to decline substantially through cyclical effects before recovering pre-crisis levels (as a share of GDP) by 2022 (chart 3). Expenditures—both temporary pandemic-related spending as well as automatic stabilizers—will unwind with the recovery.

Debt levels will surge. We estimate federal net debt as a share of GDP will peak in the first half of 2021 at around 47% (annualized) before beginning a gradual descent (chart 2). These levels by no means rival the highs of the early '90s when debt levels were in the high 60s and debt servicing costs hovered around 6% of GDP.

Debt servicing costs would increase modestly, but still stabilize at relatively low levels. Pre-crisis debt servicing costs sat around one percent of GDP. Looking ahead, effective interest rates on government debt (driven largely by long term interest rates) are expected to pick up modestly next year before leveling off. This suggests interest payments on federal debt as a share of GDP would increase in the near term—both as a function of higher debt as well as weaker growth—but should level off under 2% of GDP over this horizon (chart 4).

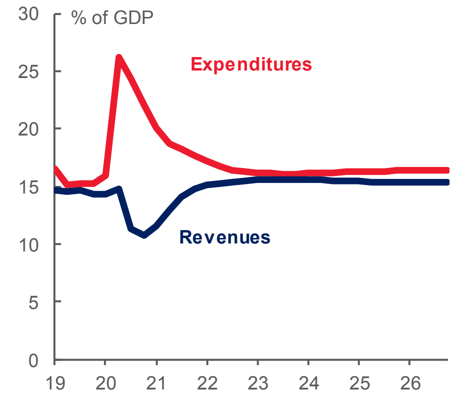
SMOKE BUT NO FIRE

Fitch Ratings sounded the alarm with a downgrade to Canada's credit rating. It took down Canada down a notch to AA+, Stable Outlook, citing both structural factors (i.e., mediocre growth potential, energy reliance, and high provincial debt), as well as the federal government's massive fiscal response to the pandemic that will drive the surge in government gross debt levels.

Markets rightly shrugged off the rating action. Canada's fiscal response falls in the middle of the pack relative to peers. While its general government *gross* debt will rise—again on terms comparable to peers (chart 5)—its general government *net* debt should still sit well-below peers and, in some cases, by orders of magnitude (chart 6). Recall, general government *gross* debt tallies the liabilities of all levels of government, while general government *net* debt subtracts financial assets held against these liabilities. Canada holds sizable assets (over 60% of GDP) across a broad range of assets including currency and deposits, debt securities, loans, equity and investment fund shares, and accounts receivable.

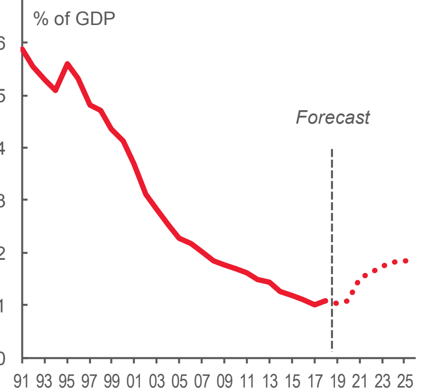
International sovereign debt comparisons fail to capture public sector pension funding dynamics. Canada is one of only two G7 countries (along with the US) and one of six advanced economies that reports its unfunded public sector pension obligations. Furthermore, these obligations are relatively well-funded in Canada. For others, public sector pension funding gaps can be substantial, for example, in the range of 30–50% of GDP for Germany. However, given data constraints, the OECD and the IMF do not include public sector pensions in their debt metrics. Consequently,

Chart 3



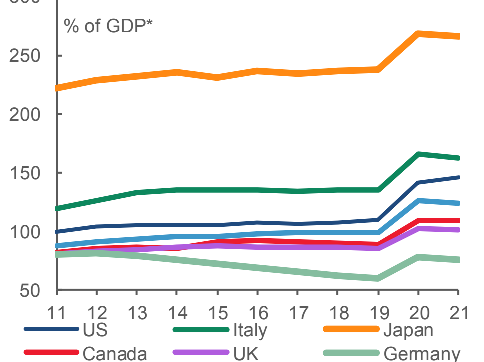
Sources: Scotiabank Economics.

Chart 4



Sources: Scotiabank Economics, Department of Finance Canada, Statistics Canada.

Chart 5



Sources: Scotiabank Economics, IMF.
*Data as of June 2020

this inflates Canada's comparable gross debt (because Canada issues debt against these obligations), while it underestimates the gross debt of countries with poorly funded pension plans.

Nevertheless, the appetite for *Buy Canada* should remain strong. The Bank of Canada is committed to purchasing a substantial portion of government debt over the course of the recovery, while Canada is one of the few countries with a stable outlook offering yield pick-up in a yield-hungry environment.

CANADA'S FISCAL RESPONSE A PLUS

Canada's decisive fiscal response to COVID-19 underpins its growth outlook. We have updated our forecasting model to better capture the effects of fiscal policy (see Appendix for details). We estimate that real GDP growth would fall by 10.3% in 2020 absent the current discretionary fiscal response. Furthermore, the recovery would be elongated by an additional year with the output gap closing only by 2023 (chart 7).

Canada's debt as a share of the economy would surge well-above 40% regardless. The more serious retrenchment in economic activity would further shrink the denominator, while automatic fiscal stabilizers (i.e., government revenue losses and increased expenditures) would have kicked in, pushing up deficit spending (i.e., inflating debt as the numerator).

The debt trajectory would stabilize only a few percentage points below its current projected path (chart 8). Meanwhile, the impact on households and businesses would be far more deleterious absent government support to bridge the shutdown. Unemployment, for example, would peak closer to 15% versus just above 13% in the baseline case (chart 9). There would also be far more uncertainty around the longer term impacts on growth with a higher potential for hysteresis via an elevated risk of chronic unemployment and capital stock erosion.

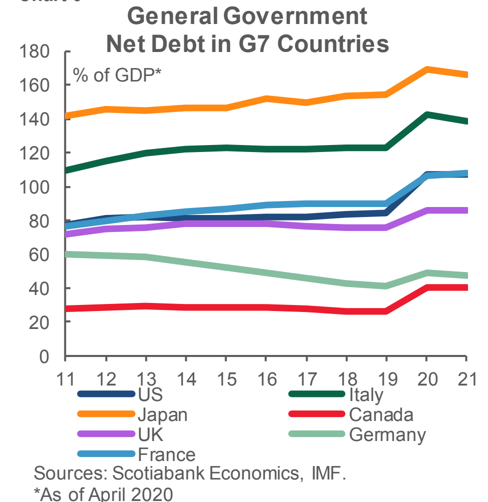
CALIBRATING THE RESPONSE TO THE CONDITIONS

Fiscal support will continue to be an important component of Canada's recovery. A deficit in the order of 5.3% of GDP next year is not only likely, but also warranted, from an economic perspective given the multi-year economic recovery ahead. A second wave of outbreaks in the Fall (or the W-shaped scenario)—though not our baseline—would warrant an even steeper spend in the order of over another 4% of GDP bringing debt levels above 50%, along with a second peak in unemployment (charts 10–13).

Fiscal spending would be all the more effective in securing a stronger recovery with monetary policy at its effective lower bound. We estimate a fiscal multiplier of 0.67 this year, further strengthening to 0.80 in 2021. In effect, with the Bank of Canada trying to raise inflation to its target, it is not likely to offset the inflationary response of increased spending. As a result, the real policy rate is lower than it otherwise would be, amplifying the stimulative effect of fiscal spending.

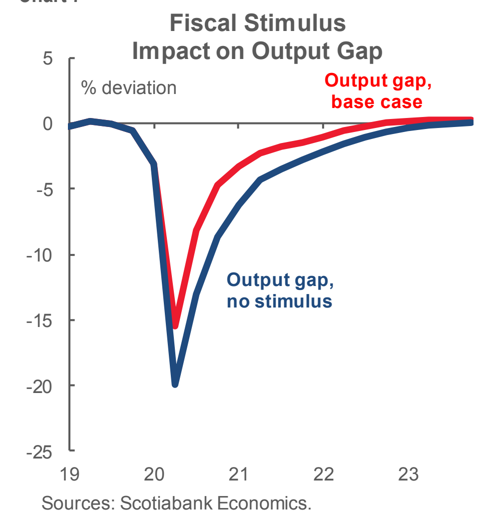
A shift in the composition of fiscal spending could further strengthen this outlook. As the recovery takes hold, a shift from direct transfers intended to stimulate demand (or at least keep households whole), towards productivity-enhancing investments could strengthen Canada's growth potential. This would further accelerate the decline in Canada's debt trajectory.

Chart 6



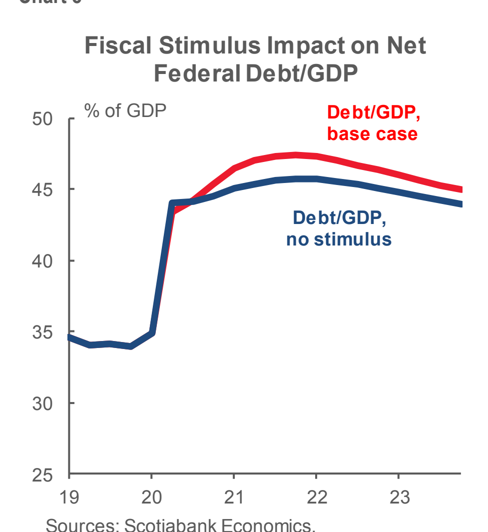
Sources: Scotiabank Economics, IMF.
*As of April 2020

Chart 7



Sources: Scotiabank Economics.

Chart 8



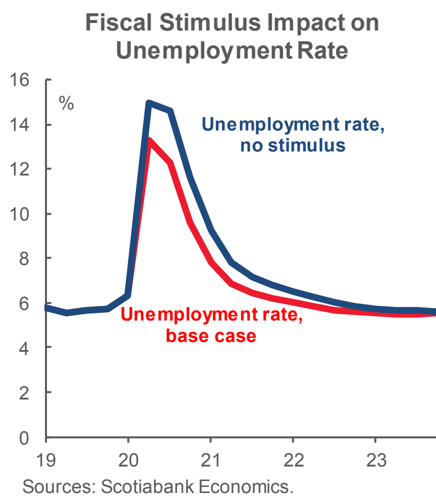
Sources: Scotiabank Economics.

On the other hand, substantially larger discretionary spending could lead to a deterioration in the outlook. Our analysis assumes that government spending and revenues return roughly to historical levels in the future. If the federal government chooses to expand programs, such as higher transfers to provinces, or provide more generous income support programs on a permanent basis post-COVID, fiscal dynamics in the medium-term would clearly be very different than assumed in this note.

ANTICIPATING AN UPDATE

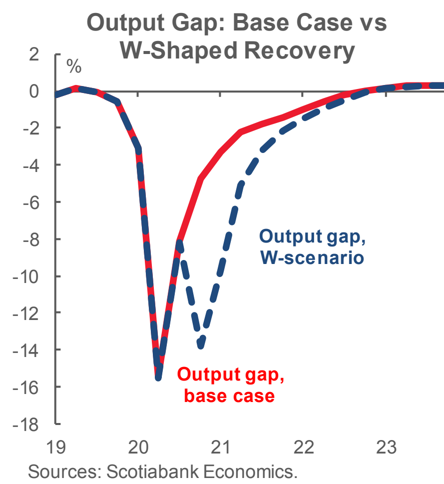
As Canadians await a fiscal update on July 8th from the federal government, markets should look for fiscal policy that is anchored in economic conditions with flexibility amidst a highly uncertain path ahead. A premature withdrawal of fiscal support to pacify debt watchers could do more harm than good to Canada's economic outlook.

Chart 9



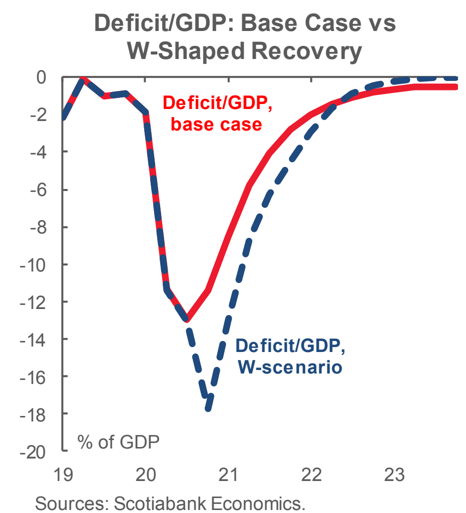
Sources: Scotiabank Economics.

Chart 10



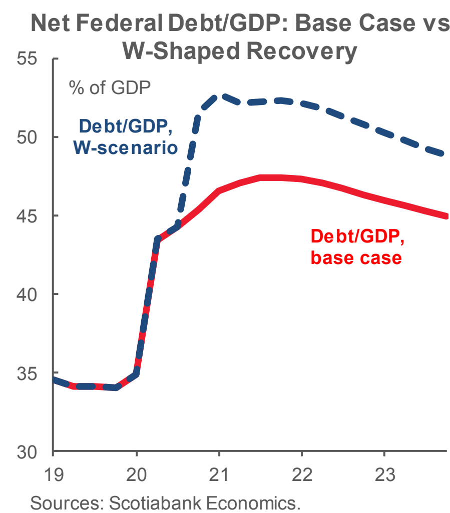
Sources: Scotiabank Economics.

Chart 11



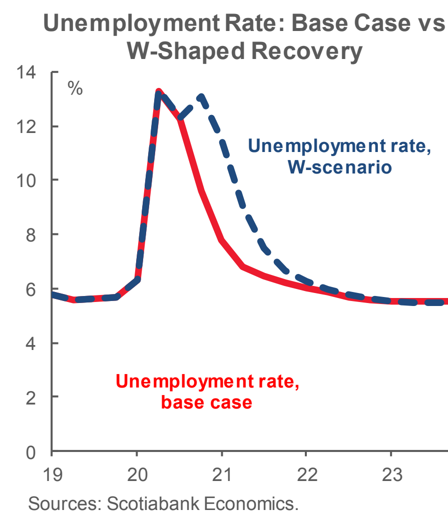
Sources: Scotiabank Economics.

Chart 12



Sources: Scotiabank Economics.

Chart 13



Sources: Scotiabank Economics.

APPENDIX 1: ADDING A CANADIAN FEDERAL GOVERNMENT FISCAL BLOCK TO THE SCOTIABANK GLOBAL MACROECONOMIC MODEL (SGMM)

To better identify Canadian Federal Government fiscal prospects in this period of intense uncertainty, we updated our Canada/US macroeconomic forecasting model by estimating equations for federal transfers to individuals, transfers to provinces, interest payments on the debt and total revenues. The model contains a stock flow dynamic meaning that expenditures and revenues gradually adjust in such a way that the deficit to GDP ratio slowly converge to a level that is consistent with a sustainable long run debt to GDP ratio target of 40%. We have calibrated the model to this long run ratio as a reasonable and gradual approach to putting debt on a firmly downward trajectory but other long run targets within reason (e.g., 35% to 45%) produces approximately similar results in the near term.

In the long run we also assume that the annual interest rate on the Federal Debt is 60 basis points above the annualized growth rate of GDP. We use the same modelling approach as for the rest of the SGMM. The model is a fully estimated general equilibrium model similar to semi-structural models used at the Bank of Canada, such as MUSE (Gosselin and Lalonde 2005), IMPACT (Blagrave et all, 2020) and LENS (Gervais and Gosselin, 2014). The fiscal block features forward-looking behaviour, with the federal Government attempting to optimally set the level of its decision variables, such as transfers to individuals and provinces, in the face of adjustment costs conditional on the expected evolution of many economic drivers.

The drivers of the transfers to individuals and provinces are (sign of the effect and explanation in parenthesis):

- Nominal Potential GDP (+) (implicit long run target relative to GDP)
- Output gap (-) (automatic stabilizer)
- Unemployment rate (+) (automatic stabilizer)
- Labour market participation rate (-) (structural factors and aging of population)
- The gap between the Debt to GDP ratio and its long run target (-) (long run convergence to the debt to GDP ratio target)
- Judgement

The drivers of discretionary spending are:

- Nominal potential GDP (+) (implicit long run target relative to GDP)
- The gap between the Debt to GDP ratio and its long run target (-) (long run convergence to the debt to GDP ratio target)
- Judgement

The drivers of total revenues are:

- Nominal GDP (+)
- Unemployment rate (-)
- The gap between the Debt to GDP ratio and its long run target (+) (long run convergence to the debt to GDP ratio target)
- Judgement

The drivers of interest payments on the debt are:

- Debt in the previous period (+)
- 10 years government bond rate (+)
- Short term interest rates capture by the policy rate (+)
- Estimated long run premium of annual interest rate on the debt relative to the long run growth rate of GDP (+)

Consequently, the model includes variables that capture:

- The automatic stabilizers (output gap and unemployment rate)
- Structural factors (potential GDP and labour participation rate)
- The effect of economic activity on the revenues
- The convergence of the fiscal decisions' variables to long run targets (stock flow dynamic)
- And the effect of the interest rates on the interest payments on the debt

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