Scotiabank.

GLOBAL ECONOMICS

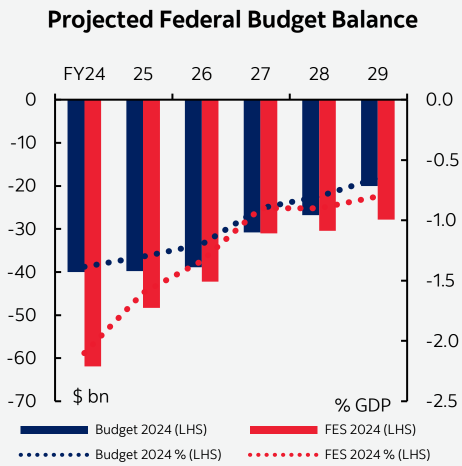
FISCAL PULSE

December 16, 2024

Contributors

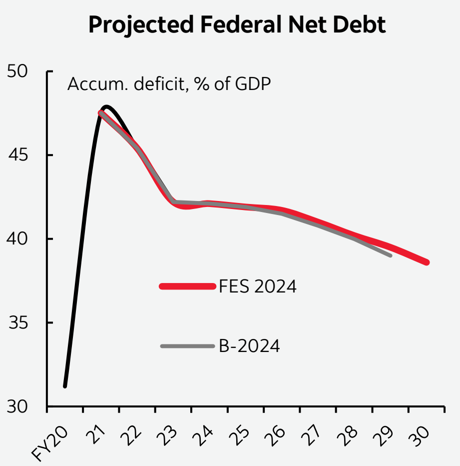
Rebekah Young
VP & Head of Inclusion and Resilience Economics
Scotiabank Economics
416.862.3876
rebekah.young@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Finance Canada.

Chart 2



Sources: Scotiabank Economics, Finance Canada.

Canada's Federal Fall Economic & Fiscal Update:

THE GOOD, THE BAD, AND THE UGLY (& THE UGLIER)

- **It was touch and go if Canadians would get a Fall economic update on December 16th as its Deputy Prime Minister and Finance Minister Chrystia Freeland resigned in the hours leading up to the update. In a scathing public letter, she essentially said this was the wrong budget for turbulent times ahead.**
- **It was nevertheless table-dropped last-minute, delivering the widely-anticipated fiscally expansive $24.2 bn package. It is not entirely clear if the plan will ever see the light of day as some aspects would most likely require legislation. That hinges on breaking the current Parliamentary stalemate under a minority government and securing enough support from other parties. This seems increasingly unlikely.**
- **For what it is worth, the biggest outlays focus positively on encouraging business investment—$18.5 bn or three-quarters of new spending. This includes the reinstatement of the Accelerated Investment Incentive ($17.4 bn); enhanced tax incentives under the Scientific Research and Experimental Development (SR&ED) program ($1.9 bn); an incentive-based approach to attracting greater pension investments in Canada (starting tangibly with AI data centres), along with an array of investments in early-to mid-stage companies.**
- **The hold-your-nose measures under the affordability banner were largely contained to the earlier-announced $1.6 bn temporary GST break. The $250 cheques did not make the cut. The GST measures are broad-based, front-loaded, and weakly-warranted (in economic terms), but were anticipated and there were no game-day surprises in this space.**
- **There were a host of government intentions announced in the update including the launch of consultations on the development of long-term mortgages; legislative amendments to enable climate-related financial disclosure requirements for large, federally incorporated privately held corporations; and new tariffs to be imposed on some Chinese goods in the new year.**
- **The new fiscal plan blows through its FY24 fiscal target by almost $22 bn with the deficit landing at $61.9 bn (2.1% of GDP) though the bulk of the overshoot stems from Indigenous contingent liabilities ($16.4 bn) and COVID adjustments ($5.9 bn).**
- **The net change to the budgetary balance amounts to -$23.4 bn (FY25–29) relative to Budget 2024 projections owing mostly to new spending outlays as minimal adjustments are made around economic impacts to the bottom line. A much stronger GDP hand-off helps fiscal ratios as a share of GDP.**
- **New projections show some deterioration in forward-looking deficit projections (after the outsized FY24 number) relative to Budget 2024 with shortfalls dipping below 1% by FY27 and declining thereafter (chart 1). While debt levels are higher, its ratio as a share of the economy over the projection horizon remains intact. It is expected to fall to 38.6% by FY30 from 42.1% in FY24 (chart 2).**
- **Even absent political uncertainty, the update would not leave us racing to change our economic outlook. Investment incentives are welcomed—and could eventually have an outsized economic impact given they mostly target sectors that punch above their productivity weight—but with pervasive uncertainties (and even more after today), it would be premature to bank on these gains just yet.**
- **The update likely gives Canadians (and critics) some stuff they'll love to hate and other stuff they'll hate to love. But it is the ugly day in Canadian politics that will likely grab most headlines.**

December 16, 2024

THE POLITICS OF ECONOMICS

Federal Fall economic updates are usually pretty sleepy events, but not this time. The federal Finance Minister announced her resignation in the hours leading up to its release on December 16th. In a scathing letter of resignation posted on social media, she withdrew her support for the fiscal direction set out by the government. She referenced "gimmicks" that Canada could "ill afford" and called for a greater preservation of fiscal firepower as the country braces for a potential trade war with the US.

The more fiscally expansive update had been widely anticipated. A series of measures had been announced in the days and weeks ahead. The now-former Finance Minister had also earlier appeared to walk back from some of her fiscal anchors ahead. In the immediate aftermath of her resignation, bond markets reacted with a sell-off, presumably spooked by an even more expansive plan that anticipated. The update mostly falls in line with past autumn updates in recent years (chart 3).

Canada will be on heightened election watch. Heading into the update, a Spring date was expected, but recent developments likely bring that much closer. It is not entirely clear that this new fiscal plan will survive. Typically, major new spending initiatives or tax changes must be approved by Parliament and the current stalemate shows no movement.

NEW MEASURES

There were some good parts to the update: an incentive-based approach to encouraging anaemic business investment is welcomed (and overdue). The big ticket item is the extension of the Accelerated Investment Incentive ($17.5 bn) first introduced back in 2017 mostly focusing on traditional business investment in tangibles. There are also pre-announced enhancements to investment tax credits through the SR&ED program ($1.8 bn). While relatively small in scale, this is a step in the right direction as these funds flow to some of the most highly productive parts of the economy (chart 4). To put these numbers in perspective, fixed non-residential investment in Canada last year was $438 bn, about a fifth ($96 bn) in IP (chart 5). Also pre-announced are planned reforms and incentives to attract pension fund investment in Canada (with a signature start around AI data centres). The latter has no direct fiscal costs associated with it, but would use the federal books to provide up to $15 bn in loan and equity financing for AI data centres with a minimum leverage ratio of 2:1.

These investment-inducing measures amount to over three-quarters of the new spend. So this is a good start—that is if it gets to the starting line and businesses respond—but it competes against a moving target as the allure of US-bound investments is set to get more attractive under some of Trump's policy proposals.

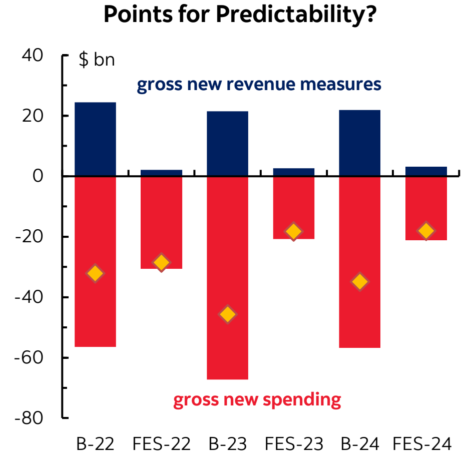
Pre-emptive (but modest) downpayments against trade risk are also unfortunate but necessary spending. The update allocates $1.3 bn to border security as expected but otherwise little else. (An almost laughable $4 mn line item for interprovincial trade was in there.)

There were also some less-appealing parts: the update records the already-legislated $1.6 bn temporary GST cut but, if anything, the surprise was that there was not much more. Namely, the $250 cheques initially announced on November 21st did not make the cut apparently owing to lack of support from other parties.

GLOVES OFF & GUARDRAILS DOWN

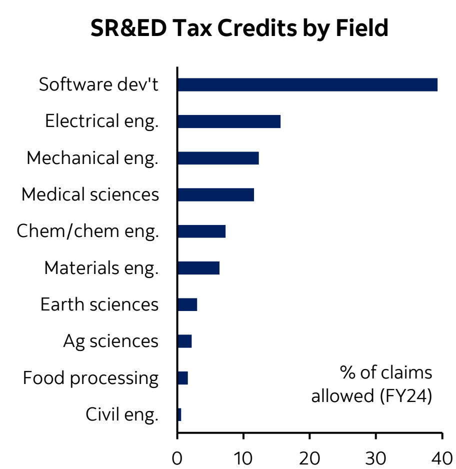
There were also some cringey parts: the new fiscal plan blows through its FY24 fiscal anchor by almost $22 bn. Recall, last year the Finance Minister codified 'fiscal responsibility' in an intricate set of targets: deficits at or below *$40.1 bn* in FY24, declining as a *ratio of GDP* thereafter, and *below 1%* beyond FY26; and a debt ratio lower than 42.7% in FY25 and declining thereafter.

Chart 3



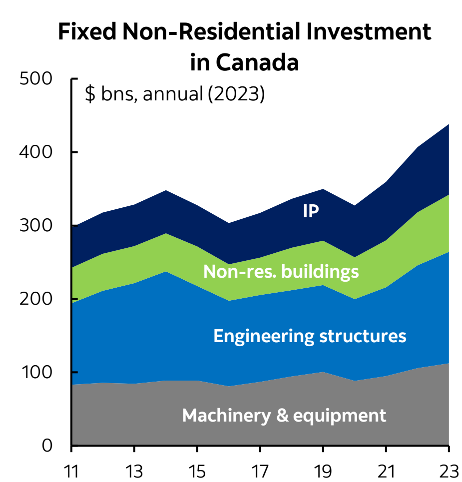
Sources: Scotiabank Economics, Finance Canada.

Chart 4



Sources: Scotiabank Economics, CRA.

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

The FY24 deficit came in at a whopping $61.9 bn—owing mostly to contingent liabilities. A big part of this pertains to $16.4 bn for Indigenous contingent liabilities, as well as $5.9 bn COVID-related adjustments owing to unrecovered loans and benefits. The update commits to developing better transparency and predictability around the accounting of future potential contingent liabilities related to reconciliation. Dated 2023 Public Accounts show these numbers have been growing exponentially in recent years (chart 6).

This likely bears minimal consequence in economic terms, but will no doubt grab headlines and provide more ammunition for critics. It may further erode credibility on the margin, but this government has already repeatedly walked away from various guardrails over the years. Declining debt as a share of GDP has mostly been the guiding fiscal anchor for this government since 2015 outside of crisis and it falls back on this one today.

Looking through FY24, deficits are still small and declining—especially relative to mostly unenviable peers—but this is not 2015. Budgetary shortfalls are still in shrug territory at around 1% of GDP except now the primary balance sits distinctly in surplus as much higher debt servicing costs erode fiscal space. Interest service will hit $53.7 bn in FY25, breaching 11% of revenues, and will hover there over the forecasting horizon (chart 7). Headline deficits also mask compositional step-changes with expenditures some 1.8 ppts higher as a share of GDP in FY25 relative to pre-pandemic levels, offset by a similar step-up in new revenue-side efforts—much of which has been extracted from more productive parts of the economy.

The debt profile does deliver on the pledge to keep it directionally downward, but economic uncertainty renders this precarious. The debt ratio stood at 42.1% of GDP in FY24 and is projected to descend more or less in line with forecasts to 38.6% of GDP by FY30 owing to a much stronger GDP hand-off and stale forecasts that predate US elections and other major and hence do not anticipate policy disruptions.

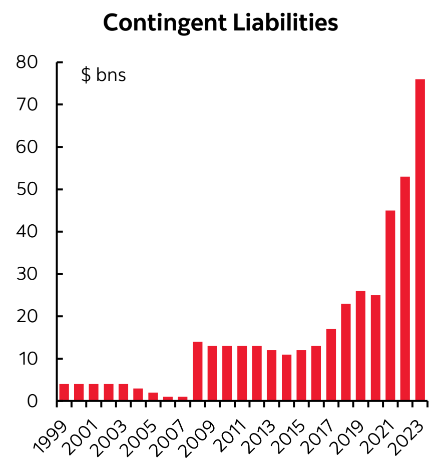
Borrowing activity gets a boost. In the near-term, the update revises up its FY25 borrowing plan by $36 bn to $536 bn with $241 bn via bond issuance (up from $13 bn). Scotiabank's Roger Quick will be providing clients with details on these changes and their potential impacts, but the net effect is ramped up bond supply into a highly uncertain environment.

THE ECONOMICS OF POLITICS

Near-term impacts are incremental but cumulative. The update folds in the expected (and already-legislated) $1.6 bn in FY25 in demand-side measures (i.e., the GST cut). If anything, there was an (economic) sigh of relief that there was not more, but there is a good chance that more will come ahead of elections (think, extension of these cuts and eventually the $250 cheques earlier costed at $4.7 bn). But federal measures come on top of $5 bn in provincial cheques (Ontario and BC), with a net effect that the *general* government primary balance will likely remain in expansive territory well into 2025 (chart 8). It also lands on the heels of 175 bp interest rate cuts since the Spring, and a relaxation in macroprudential housing rules. This should cumulatively accelerate already-rebounding consumption in Canada.

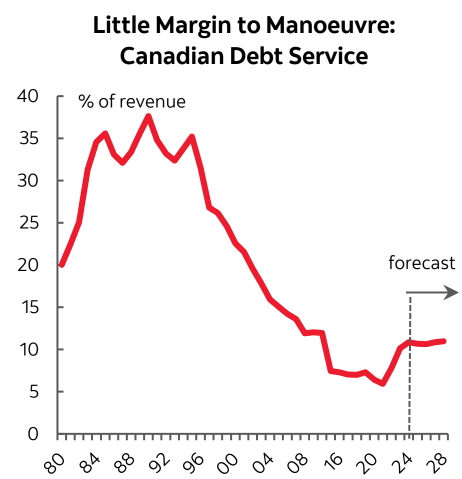
The inflation debate is a bit of a red herring. There are plenty of potentially inflationary pressures on the horizon (including in this update), but a low propensity to spend against elevated and growing savings rates (chart 9), along with some spare capacity in the economy provide some offset. The Bank of Canada had underscored in its December 11th decision that it would look through one-off shocks (coyly not commenting on extension risk to GST cuts). But importantly, there are just too many exogenous policy factors that could overwhelm growth and inflationary drivers in either direction to beat that drum too loudly.

Chart 6



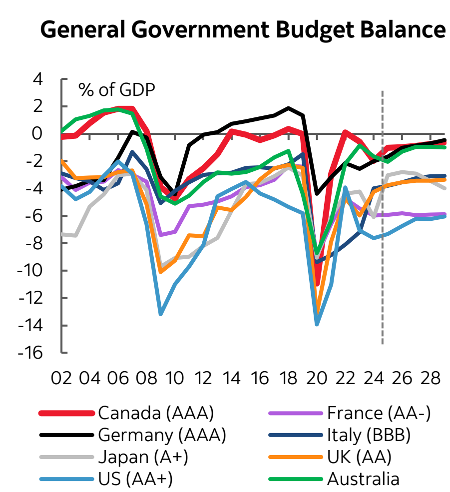
Sources: Scotiabank Economics, Public Accounts.

Chart 7



Sources: Scotiabank Economics, Finance Canada.

Chart 8



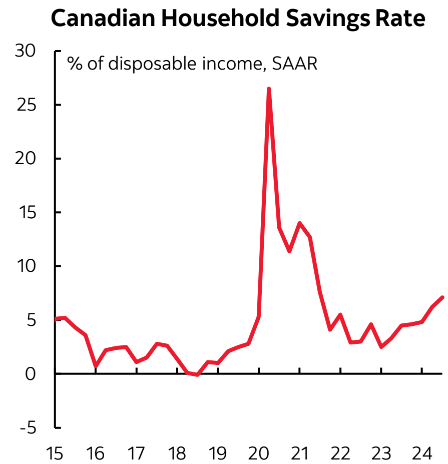
Sources: Scotiabank Economics, IMF, S&P.

The insurance argument is similarly misdirected. Stimulatory measures are hardly warranted based on an economy already poised to rebound in the baseline. The economy is not in a recession and it is not heading into one provided a full-blown trade war can be averted. If Canada finds itself on a different and darker path, it is premature to judge what fiscal tools would be most responsive given the range of potential triggers and consequent fallouts.

There is a much stronger economic argument to take out a different type of insurance, namely pre-emptive actions to ward off trade and competitiveness risks, otherwise preserving fiscal firepower is the best bet. The update starts this conversation, but more will likely be needed in the event of a full-blown trade war. More is still likely needed to boost competitiveness, to offset potential retaliatory impacts on targeted sectors and workers, and of course, the elephant in the room is that there is still weak costing of Canada's NATO 2% commitment which will be dear.

On net, there is little in the update that would lead us to revise our economic outlook just yet. Our December 12th forecasts already incorporated the pre-announced near-term spending (amounting a decimal point or two of growth) that is more or less offset by the expected population pullback. The longer term productivity-enhancing investments embolden our expectation of a rebound in investment activity. However, it comes with its own uncertainties as investment tax measures always come with implementation and uptake risk. And of course election risk hangs over all new policies on the table.

Chart 9



Source: Scotiabank Economics, Statistics Canada.

LIMITED SHELF LIFE

This new spending plan should likely be faded for a host of reasons. The most obvious reasons are the uncertainties stemming from political developments over the course of the day, putting into question how much of the document—if any—is retained. Otherwise, its foundational economic forecasts are already stale and could reasonably be blown out of the water in a couple of weeks with the change in regime south of the border. With pending elections at home (federally as well as in the most populous province of Ontario) even more spending is likely in the offing. When the election writ(s) is dropped, pledges get re-written. And a change in leadership at the top could change not just the numbers, but the composition too. Consider this update a placeholder until we know more across a whole array of fronts.

Table 1: Fiscal Outlook

		Projection					
$ billions	**FY24**	**FY25**	**FY26**	**FY27**	**FY28**	**FY29**	**FY30**
Budgetary Balance - Economic & Fiscal Developments and Policy Actions							
Budget 2024 budgetary balance	***-40.0***	***-39.8***	***-38.9***	***-30.8***	***-26.8***	***-20.0***	
% of GDP	*-1.4*	*-1.3*	*-1.2*	*-0.9*	*-0.8*	*-0.6*	
Economic & fiscal developments	*-21.8*	*-3.0*	*1.4*	*2.9*	*-2.6*	*-3.0*	
Policy actions since B-2024	0.0	-3.4	-1.1	-0.2	1.3	0.8	0.4
New measures in FES 2024	0.0	-2.1	-3.7	-2.8	-2.3	-5.5	-4.7
FES 2024 budgetary balance	**-61.9**	**-48.3**	**-42.2**	**-31.0**	**-30.4**	**-27.8**	***-23.0***
% of GDP	*-2.1*	*-1.6*	*-1.3*	*-0.9*	*-0.9*	*-0.8*	*-0.6*
Federal Net Debt (accumulated deficit)							
Budget 2024 net federal debt	**1216**	**1255**	**1294**	**1325**	**1352**	**1372**	
% of GDP	*42.1*	*41.9*	*41.5*	*40.8*	*40.0*	*39.0*	
FES 2024 net federal debt	**1236**	**1282**	**1324**	**1355**	**1385**	**1413**	**1436**
% of GDP	*42.1*	*41.9*	*41.7*	*41.0*	*40.2*	*39.5*	*38.6*

Sources: Scotiabank Economics, Finance Canada.