Scotiabank

GLOBAL ECONOMICS

FISCAL PULSE

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Contributors

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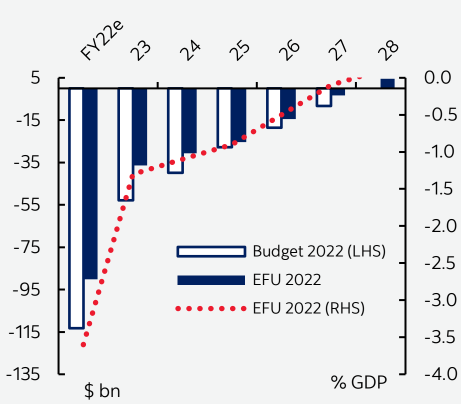
Chart 1

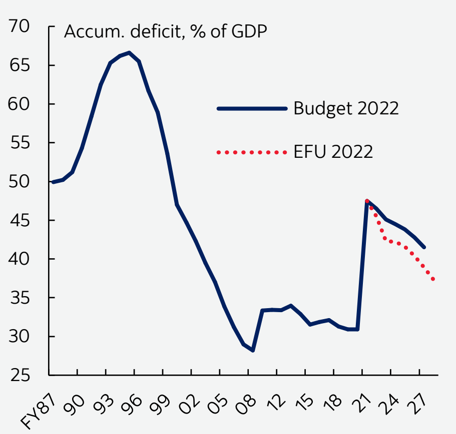
Federal Budget Balance



Sources: Scotiabank Economics, Finance Canada.

Chart 2

Federal Net Debt



Sources: Scotiabank Economics, Finance Canada.

Canada's Federal Fall Fiscal Update

POLICYMAKERS PLAY GOOD COP, BAD COP

- **Canada's Fall Economic and Fiscal Update offered few surprises today.**
- **Robust government revenue windfalls are driving sharp improvements in the fiscal balance in the near-term—$39 bn between FY22 and FY23 alone. While these drivers wane over the horizon with weaker economic activity, the strong hand-off underpins a slightly tighter bottom-line with the balance sitting modestly in surplus by FY28 (chart 1).**
- **After a material improvement in net debt (to 42.3% of GDP in FY23), a gradual descent is set to resume, landing at 37.3% of GDP by FY28 (chart 2).**
- **New spending announced in the Update is relatively contained (or contained at least from the perspective of a serial-spender government) at $27.4 bn over the horizon (FY23–28). This includes affordability measures targeting students and low-income workers amounting to $6.6 bn over the horizon (with about 1.2 bn or 0.05% of GDP flowing in FY24).**
- **Another signature measure is a $6.6 bn investment tax credit for clean technologies with strong messaging that this is a down payment towards a larger growth agenda in Budget 2023.**
- **The Finance Minister is signaling constraint in the Update, but the taps are hardly closed with more than $23+ bn set to reach pocketbooks in the coming quarters once provincial affordability measures are folded in (and provinces have yet to table their own updates).**
- **The Bank of Canada's job is hard enough with very high uncertainty on the inflation and interest rate path (at home and abroad). A modest-but-persistent expansive fiscal stance adds to this uncertainty.**
- **Domestically-driven inflationary pressures—potentially compounded by an exogenously-driven weaker growth and/or higher interest rate environment—is an undesirable outcome worth hedging against.**
- **But for now, the Finance Minister will largely play good cop and leave the heavy lifting to the central bank.**

IT'S THE ECONOMY (OR IS IT?)

Uncertainty has been a theme since the pandemic struck. That has not changed in this Update which adopts a cautious tone as it lays out an economic path that faces more potential turbulence ahead on the path to "normal". The economic outlook—an average of private sector economists' views—shows a stalling economy into 2023 as elevated inflation and rising interest rates curb activity. The economic picture looks substantially different from budget time last April across almost all indicators (table 1).

While the forecasts do not detail quarterly projections, the math suggests the economy will move sideways for several quarters that at least. This clearly complicates fiscal planning, not the lease because the biggest risk is policy misstep—at home or abroad—that could drive a deeper contraction and a slower recovery. A dovish turn by the Bank of Canada arguably increases the sensitivity to miscalculations on the fiscal side. Relatively modest new spending in this Update is unlikely to move markets—especially given it is couched between yesterday's US Fed rate decision and tomorrow's job report in Canada—but the broader signal from Elgin Street remains mixed.

DEFICITS & SPENDING

The fiscal path looks modestly tighter relative to budget-time expectations, but that path masks a host of changes underpinning the balance (table 2). In the near-term, substantial revenue windfalls—corporate and personal income tax receipts in particular—drive material improvements to the balance. Estimates for the FY22 deficit (ended March 31, 2022) show a $23 bn improvement at $90.2 bn (or 3.6% of GDP) relative to last Spring's outlook. Meanwhile, the FY23 shortfall is expected to continue contracting to $36.4 bn (or 1.3% of GDP) for a $16.4 bn improvement. Beyond that, a strong hand-off (for revenues and nominal GDP) drive continued improvements to the bottom-line over the horizon even as momentum wanes. The Update shows a modest surplus by FY28, but this can be faded for a host of reasons, including economic uncertainty, more spending to come in Budget 2023, and new mandates (and possibly new governments) over that horizon.

Modest new spending is folded into this profile. The update sets in motion an additional $30.6 bn in spending over the next six years (or $27.4 bn once netting out previously-announced Cost of Living Act which has been included above the line as parts are still moving through Parliament). This including $2.9 bn ($6.1 bn including the Act) over the remainder of the current year (FY23), of which $1.1 bn reflects relief funds for Hurricane Fiona. Incremental spending amounts to $5 bn in FY24. Meanwhile, other policy measures since the last outlook tally $21.6 bn over the six-year horizon. Otherwise, economic and fiscal developments drive the bulk of changes.

New measures announced today are relatively targeted. Key affordability measures include eliminating interest on student loans ($2.7 bn over FY24–28) and advance payments of the recently topped-up Canada Worker Benefit for low-income workers ($3.8 bn over FY24–28). In isolation, these two measures would deliver about $1.2 bn in FY24 (starting April 1, 2023) or about 0.05% of GDP to individuals with a high propensity to spend these amounts.

The Update nudges a growth agenda forward. A new Investment Tax Credit for Clean Technologies is a signature measure amounting to $6.7 bn over the horizon with details to come in Budget 2023. Intentions to proceed with the previously-announced hydrogen tax credit are reiterated without further detail. There are also modest skills and youth labour programs that don't amount to big spends. Otherwise, announcements today mostly flesh out earlier pledges—for example, around the $15 bn Canada Growth Fund that will be launched by year-end and the new Canadian Innovation & Investment Agency announced in Budget 2022.

The Update signals that these are 'down payments' towards a bigger growth agenda in Budget 2023. The Finance Minister rightly continues to emphasize serious productivity and competitiveness challenges that hinder longer-term growth prospects and signals ambitions to level the playing field with the US. This level of ambition is warranted and daunting: investments consistent with net-zero would (or should) rival annual infrastructure spending before long, while avoiding the execution pitfalls of the latter. (In this regard, the Update follows up on a Budget 2022 threat to provinces—"use-it-or-lose-it"—with a scorecard on provinces' uncommitted federal infrastructure funding.)

On the other side of the ledger, the Update perpetuates a mostly punitive approach with respect to businesses to fund a larger government. A 2% tax on share buybacks of public corporations is expected to pad coffers by another $2.1 bn over five years (coming into effect January 2024) on top of earlier special taxes and recovery dividends expected to bring in $6 bn by FY27. (Conveniently, a plan to spend another $2.2 bn on government services follows the new tax measure.) There is a re-iteration but no further details on an expenditure review that would yield an eventual $9 bn in savings. Calls should grow louder for a comprehensive tax review in Canada that strips out distortions (rather than layering them on) and supports a comprehensive growth agenda in a new world of labour scarcity, a consumption-bent economy, and an ambitious green agenda.

DEBT & BORROWING

Net federal debt dips with tighter deficits in the near-term, but improvements wane over the medium term. Narrower fiscal balances drive a sharp decline in the federal accumulated deficit to a forecasted 42.3% of GDP in FY23 (down from 45.5% in FY22 and almost 3 ppts lower than the Budget 2022 outlook). A then-gradual descent to 37.3% of GDP by FY28 is expected. This further secures Canada's status among a dwindling club of countries with low and declining debt levels—especially on a net basis. Nevertheless, Canada's lack of reserve currency status puts a lower tolerance on debt levels that limits the usefulness of such comparisons, particularly in times of potential market stress when flight-to-safety trumps fundamentals.

Higher interest rates are putting more pressure on debt servicing costs. The outlook for the 10-year Government of Canada bond yield, for example, is a 80 bps and 70 bps higher this year and next relative to the Budget 2022 outlook. This drives an additional $28 bn in debt servicing costs between FY22–27. As a share of GDP and as a share of revenue, these costs start to tick up this year, but from historically low levels. Debt service as a share of GDP is estimated at 1.0% in FY22 and is expected to peak at 1.5% of GDP in FY24 before trending down again under 'neutral' conditions. The impact on the bottom line is partially offset by downward revisions to actuarial valuations for government pension, but these have no bearing in economic (or socio-political) terms.

Borrowing activity has shifted lower relative to Budget 2022 expectations. With five months left in the fiscal year, bond issuance has been revised down by $21 bn—to $191 bn reflecting lower budgetary needs. The year-end Treasury bill stock has also been revised down by $21 bn relative to the Spring projection. There is no change to Green Bond issuance ($5 bn), while the $500 mn Ukraine Sovereignty Bond issuance is re-announced. Borrowing requirements for FY24 will only be set out in the winter budget when the fiscal picture might look different with potential new spending.

IMPLICATIONS

Near-term economic impacts are relatively contained *in isolation*. The newly-announced affordability measures at 0.05% of GDP put upward pressure on demand at the margin only. To put these amounts into perspective, Scotiabank Economics earlier estimated that the $20+ bn in affordability measures announced by the feds and provinces over the past few months could force the Bank of Canada to lean in further—potentially by an additional 25 bps—as the economy sits in excess demand. While today's incremental pressures work against the Bank's mandate, the impacts should not be exaggerated. It should not, in isolation, materially change our outlook for the Canadian economy, inflation, or the interest rate path.

At the same time, today's Update should not be evaluated in isolation. The support announced today is additive—to measures announced earlier at the federal and provincial levels—with that stimulus-by-stealth number closer to $23 bn now. By year-end, that impulse could be higher as nine provinces have yet to table Fall updates. Importantly, developments south of the border will have clear implications for Canada, whether through trade, currency, or policy rate channels. An exogenously-driven weaker growth and/or higher interest rate environment, coupled with domestically-driven inflationary pressures is an undesirable outcome worth hedging against. With the balance of risk biased in this direction, fiscal prudence would be the safe bet.

The federal government has demonstrated restraint today only in so far as it plans to spend just a "little bit more" not "a lot more" while revenue drivers continue to carry the day. For now. That may come back to bite the government in the event of a sharper downturn, when support may be needed, but not necessarily in the places it is being directed today. And a tax-and-spend approach starts to stutter.

Table 1: Economic Assumptions

%	2022	2023	2024
Real GDP			
EFU 2022	3.2	0.7	1.9
Scotia Econ. (Oct. '22)	3.2	0.6	1.4
Budget 2022	3.9	3.1	2.0
Nominal GDP			
EFU 2022	11.8	2.6	3.7
Scotia Econ. (Oct. '22)	11.5	3.1	3.1
Budget 2022	8.0	4.8	3.9
Unemployment rate			
EFU 2022	5.4	6.1	6.2
Scotia Econ. (Oct. '22)	5.4	6.0	6.3
Budget 2022	5.8	5.5	5.5
CPI			
EFU 2022	6.8	3.5	2.1
Scotia Econ. (Oct. '22)	6.9	3.9	1.7
Budget 2022	3.9	2.4	2.2
10-Yr GoC Yield			
EFU 2022	2.8	3.1	2.8
Scotia Econ. (Oct. '22)	3.1	3.4	3.3
Budget 2022	2.0	2.4	2.6
WTI crude oil price (USD/bbl)			
EFU 2022	97	88	85
Scotia Econ. (Oct. '22)	98	94	75
Budget 2022	80	74	70

Sources: Scotiabank Economics, Finance Canada.

Table 2: Fiscal Outlook

			Projection				
$ billions	**FY22**	**FY23**	**FY24**	**FY25**	**FY26**	**FY27**	**FY28**
Budgetary Balance - Economic & Fiscal Developments and Policy Actions							
Budget 2022 budgetary balance	-113.2	-52.8	-39.9	-27.8	-18.6	-8.4	
Economic & fiscal developments	23.6	29.8	18.8	11.0	10.2	11.4	
Policy actions since Budget 2022		-7.3	-4.3	-2.9	-1.8	-1.8	-3.5
New measures in EFU 2022		-6.1	-5.2	-5.8	-4.2	-4.6	-4.7
EFU 2022 budgetary balance	***-90.2***	***-36.4***	***-30.6***	***-25.4***	***-14.5***	***-3.4***	***4.5***
% of GDP	***-3.6***	***-1.3***	***-1.1***	***-0.9***	***-0.5***	***-0.1***	***0.1***
Budgetary Balance - Summary of Transactions							
Budgetary revenues	*413.3*	*445.9*	*462.5*	*479.4*	*500.8*	520.3	542.4
*change**	*18.9*	*37.5*	*33.0*	*28.6*	*25.7*	*24.3*	-
Program expenses, excl. actuarial losses	*468.8*	*437.8*	*443.8*	*457.6*	*469.1*	479	491.9
*change**	*-4.2*	*12.4*	*13.4*	*18.4*	*16.0*	*15.7*	-
Public debt charges	24.5	34.7	43.3	42.7	42.9	44.1	44.8
*change**	*-0.4*	*7.8*	*10.4*	*5.7*	*3.1*	*1.2*	-
Net actuarial losses	-10.2	-9.8	-6.0	-4.6	-3.3	-0.6	-1.2
*change**	*0.1*	*-0.9*	*0.1*	*-2.2*	*-2.5*	*-2.4*	-
EFU 2022 budgetary balance	***-90.2***	***-36.4***	***-30.6***	***-25.4***	***-14.5***	**-3.4**	**4.5**
*change**	*23.0*	*16.4*	*9.3*	*2.4*	*4.1*	*5.0*	-
Federal Net Debt (accumulated deficit)							
Budget 2022 net federal debt	1161	1214	1254	1281	1300	1308	
% of GDP	*46.5*	*45.1*	*44.5*	*43.8*	*42.8*	*41.5*	
EFU 2022 net federal debt	**1135**	**1177**	**1208**	**1233**	**1248**	**1251**	**1247**
% of GDP	***45.5***	***42.3***	***42.2***	***41.6***	***40.4***	***38.9***	***37.3***

Sources: Scotiabank Economics, Finance Canada.
*Change *since Budget 2022; positive denotes higher revenues, higher expenditures.*