Scotiabank

GLOBAL ECONOMICS

FISCAL PULSE

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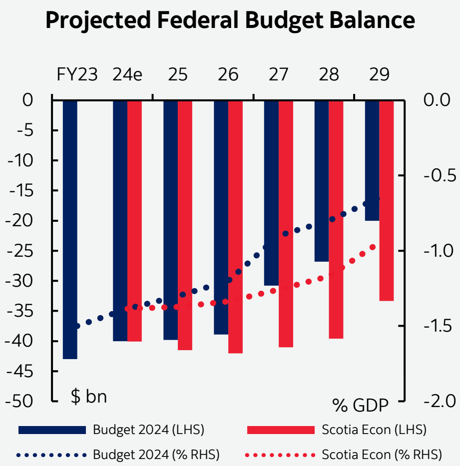
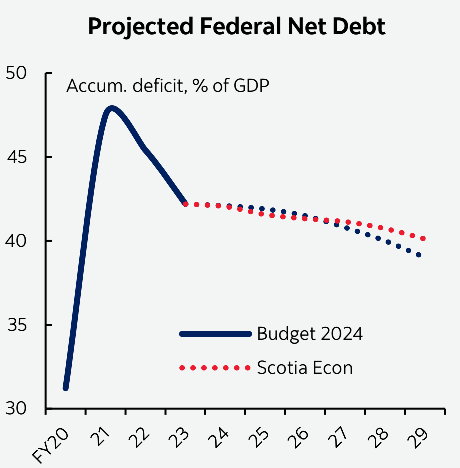
Chart 1



Sources: Scotiabank Economics, Finance Canada.

Chart 2



Sources: Scotiabank Economics, Finance Canada.

Awaiting the Inevitable (& Inevitably Uncertain)

AN UNOFFICIAL UPDATE ON CANADIAN FEDERAL FINANCES

- **Canadians are still waiting for an official update on the state of federal finances and fiscal plans ahead. It's not clear when—or even if—it will come before the holidays but the writing is mostly on the wall.**
- **More spending is clearly in the offing. NDP support paved the way for the partial passage of the November 21st stimulus measures ($1.6 bn of $6.3 bn), ending a months-long Parliamentary stand-off. The balance and then some is expected before long to keep Canadians from the polls a bit longer.**
- **The government is likely in a bind with one too many constraints—namely fiscal anchors it set just last year— crimping its room to manoeuvre against pressures to spend to stay in power.**
- **The government is not on track to meet its near-term fiscal guardrails owing to cost over-runs despite economic growth above expectation. This suggests revenue-raising measures are likely needed—and fast.**
- **Further complicating the picture, there are very likely legitimate and potentially costly measures—from military investments to corporate tax cuts to trade relief reserves—that Canadians should be deliberating on the eve of potentially tumultuous years ahead.**
- **There may or may not be an official update anytime soon. (And Canadians saw in late November that does not preclude continued spending.) It certainly wouldn't please everyone.**
- **Our best-guess is that most economists may fall in that bucket with another (eventual) spend-a-little, tax-a-little fiscal plan. We don't think they'd blow through their own near-term guardrails just yet if only for political reasons, but outer-year ones may be at play under the pretext of weaker growth. We set out here what they might do (or be doing) with or without a Fall update (charts 1 & 2).**
- **While inflation has been moderating and spare capacity opening, continued fiscal largesse across levels of government will keep central bank watchers vigilant. But incremental new spending is being digested in a crowded market (and social media) landscape.**
- **The global backdrop is fraught with uncertainty rendering wide bandwidths around Canada's economic and fiscal outlook. This cautions restraint: holding the line on incremental spending pressures, moving forward more aggressively on reducing the government's footprint, and readying the war chest for potentially tumultuous years ahead.**
- **Alas, recent announcements signal fiscal activism is set to continue with elections just around the corner, but still fighting yesterday's battle, not the one ahead.**

THE TIMES THEY ARE A-CHANGIN'

It is not clear when—or even if—Canadians will get an update on federal finances before the year is out. The annual mid-year statement typically comes out in November with a short heads-up, but there is no hint yet on a date. Rumours even swirl there won't be one, but don't discount it yet even if the Finance Minister remains mum. Pandemic uncertainty pushed the 2021 update out to December 14th, while 2019 elections delayed that one to December 16th. Backroom negotiations and rapid revisions to the spending profile are likely culprits this time around.

The government has already titled its cards towards more spending. A $6.3 bn broad-based stimulus package was announced on November 21st only to be scaled back to $1.6 bn when legislation was tabled the following week to expedite its passage. The NDP's support for this carve-out ended a filibuster that had halted all Parliamentary business for months. The NDP has made clear its vote for the balance rests on even more spending. With elections just around the corner, its wish list is much longer than an expansion of the $250 cheque-writing campaign. And this late-November legislation showed that the absence of an update does not preclude more spending.

Spending pressures signal risks to the other side of the ledger. Fiscal updates have been relatively formulaic over the past few years. Pre-announced spending is accommodated by a carefully-guarded revenue plan that keeps the fiscal trajectory trending down over the medium term (chart 3). This time around, fiscal anchors leave limited (if any) room for *net* new spending in the near-term, leaving us cautiously guarded for new revenue-raising measures in the wings (and tighter expenditure control won't yield relief soon enough).

We hazard a guess of a gross spending package in the order of $20 bn in an eventual update ($15 bn net). This would drive a bottom line marginally more expansive over the horizon, while *mostly* staying within its guardrails. Even if it would likely bear few economic repercussions (and voters likely even more ambivalent), we would find it incredulous if the government were to blow through its own near-term fiscal anchors within a year of setting them as recent economic conditions outperform against expectations. However, we wouldn't be surprised to see medium-term deficit anchors relaxed under the guise of weaker growth, while still adhering to a downward debt trajectory. (See **Box 1: Backing Out the Numbers** for details on our assumptions.)

Confidence otherwise stops there. The bandwidths of uncertainty around the economic and fiscal outlook are particularly wide. The impacts of a second Trump Presidency are largely unknowable, but biased to the downside for Canada under most scenarios. Pervasive uncertainty alone could erode Canadian GDP by some 0.7% over the term, while protracted trade tiffs could be multiples worse with potential implications for interest rates. Home-sown uncertainty around Canada's population path further clouds forecasting.

This would call for heightened caution in setting out a fiscal plan. Budget 2024 was predicated on smooth sailing ahead with real GDP averaging just above 2% and labour supply at 0.9% annually over the horizon. The government's own fiscal sensitivities suggest a 1 ppt shock to real GDP could erode the budgetary balance by some $25 bn over five years before accounting for any discretionary spending. Or a sustained 100 bp increase in interest rates could drive a deterioration closer to $30 bn over five years. Such prospects are hardly inconceivable in today's context.

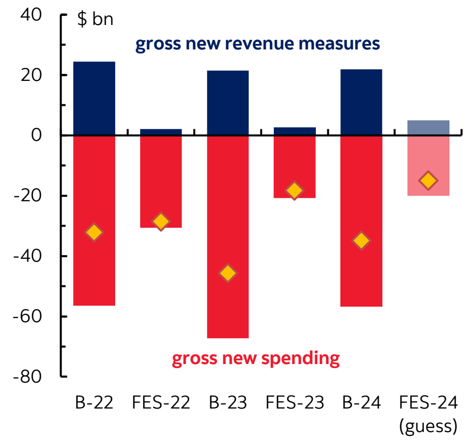
CAUTION TO THE WIND

The Canadian economy heads into the next storm on *relatively* solid footing. Higher-than-anticipated growth in 2024 (relative to budget time) provides a stronger handoff, while a continued moderation in inflation paves the way from more Bank of Canada policy rate cuts. There are tentative signs that rate-sensitive sectors are starting to respond, labour markets are proving resilient, and, coupled with pent up savings on the sidelines, the emergent recovery *should* continue to gain steam. A resurgence in the general government primary balance is also a driver behind an expected narrowing of the output gap ahead (chart 4).

A material fiscal jolt risks unfavourably tilting that delicate supply-demand equilibrium. It is once again increasingly hard to fade fiscal impacts in isolation. The recent federal stimulus would (eventually) mount to at least $6.3 bn (0.2% of GDP), bumping up to 0.3% when Ontario's $200 cheques are folded in. Both hit the economy over the span of just a few months. And—some at least—will unfold into sectors where labour supply could be gutted. If you assume the GST cuts

Chart 3

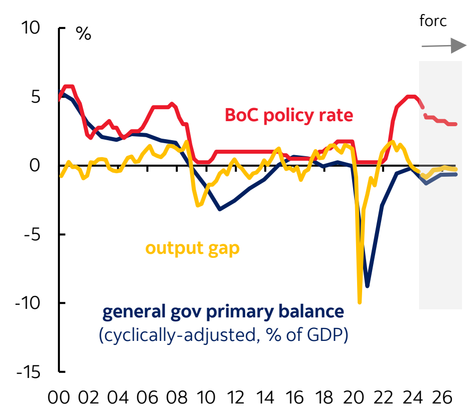
Offsets to New Spending in Update?



Sources: Scotiabank Economics, Finance Canada.

Chart 4

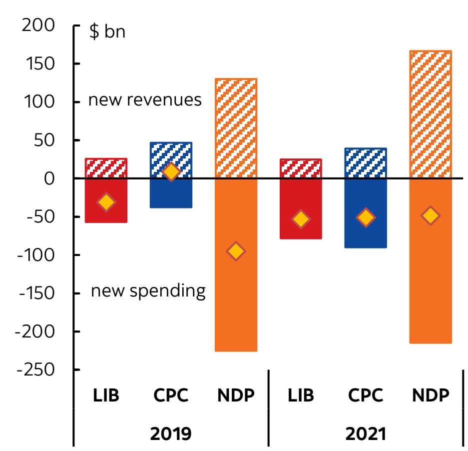
Fiscal Policy Already Primed



Sources: Scotiabank Economics, Statistics Canada, Finance Canada, IMF.

Chart 5

Elections Rewrite the Fiscal Future



Sources: Scotiabank Economics, PBO.

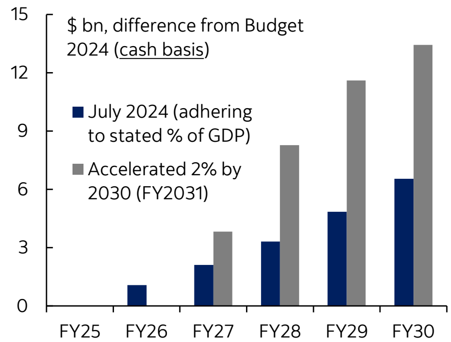
are eventually made permanent and provinces are kept whole ($1.6 bn starts to look like ~$8 bn) and that the $250 cheques are extended to an even wider base ($4.7 bn starts to look like ~$6.5 bn), the gross tally approaches 0.6 % of GDP. There is a good chance there is more to come—if not in an eventual update, then on the election trail (chart 5).

The Bank of Canada will once again be guarded against government risk. Even assuming a low multiplier of 0.2 (i.e., most gets hoarded), the fiscal impulse of recent announcements alone is still around 0.1% and mostly drops on the Bank of Canada's flight path in the first half of 2025 where consensus otherwise guides another 125 bps in cuts. A crude rule-of-thumb suggests that a sustained 25 bp hike neutralises about 0.1 ppt growth. In isolation, current excess supply may absorb some of the impact, but there are a host of other potentially inflationary pressures ahead that cumulatively bias fewer or slower cuts ahead: (even more) pre-election spending, a juiced housing market season, pending labour force curtailments, and of course, potentially inflationary trade wars.

The Bank of Canada won't likely have much more clarity on this spending spigot heading into its December 11th rate decision. Assuming an update is not tabled within the week, government spending is likely to stick in the 'risk bucket' for now (officially at least). The central bank should have more clarity by its January 29th decision with assumptions fully documented in its quarterly Monetary Policy Report.

Chart 6

Meeting Military Ambitions



Sources: Scotiabank Economics, Finance Canada, PBO, DND.

Note: July's military spending profile likely understimated GDP materially. Dark blue reflects incremental increase if the ONSAF % of GDP were met (i.e., not the stated $ level).

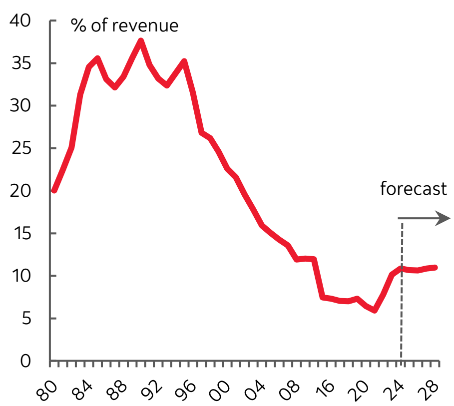
Chart 7

Government of Canada 10-Year Yield

Sources: Scotiabank Economics, Bloomberg.

Chart 8

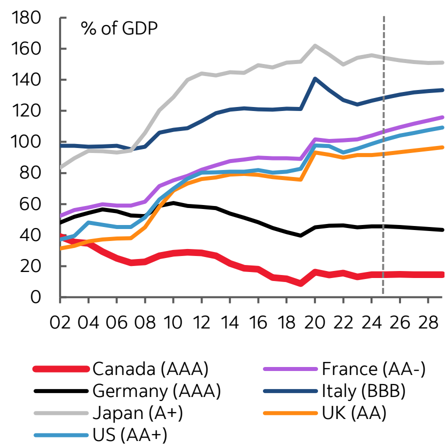
Little Margin to Manoeuvre: Canadian Debt Service



Sources: Scotiabank Economics, Finance Canada.

Chart 9

G7 General Government Net Debt



Sources: Scotiabank Economics, IMF, S&P.

BUY NOW, PAY LATER

Canada may need—or want—to use its fiscal firepower in the not-so-distant future. Early-onset trade negotiations may require significant concessions sooner rather than later. Strategically, Canada could accelerate its 2% NATO commitment from 2032 to 2030 (consistent with an even bolder vision **promoted** by the Business Council of Canada) with potential fiscal costs running in the tens of billions (chart 6, see Box 1 for details). Potentially pencil in similar orders of magnitude for corporate tax cuts to maintain (or not further erode) competitiveness with any US changes. Or the federal government could **incent** provinces to dismantle internal trade barriers (~$15 bn) with a potentially higher payoff if external routes are barriered. Canada also likely needs to start stocking a trade reserve to potentially offset the worst impacts of a full-blown trade war. The list is no doubt much longer.

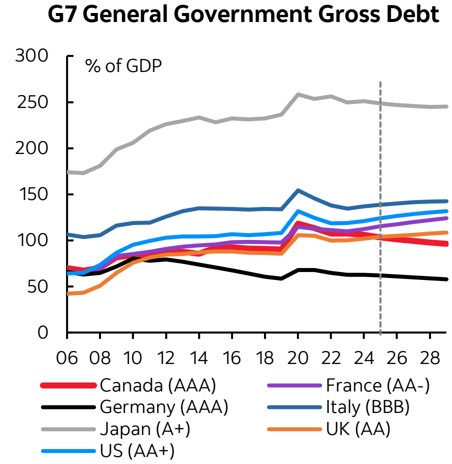
Spending now risks crowding out strategic investments down the road. Outside an outright crisis, it could be risky flirting with an upward tilting debt trajectory (unless you are the US). Under more benign economic conditions, it should not be particularly challenging to keep Canada's federal debt as a share of GDP declining over the medium term. Under our current (and tentative) expectations (i.e., a little weaker GDP, a little more spending), one can back out about $40 bn in fiscal space that would still keep the tilt *just* marginally down. But that space quickly evaporates even under more moderate levels of economic stress.

Debt service costs are beholden to largely exogenous factors. Debt charges are expected to stabilise at still-low levels by historic standards (1.2% of GDP in FY24 or 10.2% of revenues), but are predicated on the 10-year GoC bond yield staying roughly where it is today—and no more discretionary spending (chart 7 & 8). There are also likely political economy considerations with this growing line item set to overtake federal health transfers this year. It is still not clear if the Trump trade has legs, but it does cross borders in global bond markets.

Canada's comparative debt levels are decent but hardly laurel-laden. Canada can still claim it has the least-bad net fiscal positions among G7 peers (chart 9), but it lacks reserve status of bigger players. Gross levels matters more in times of stress where its relative performance is middling (chart 10). Its position dims further in contrast to triple-A peers, mostly other small, open economies (charts 11 & 12).

Few likely envy Canada right now. Apart from an economy tethered to an unequal contemporary, the country has its own structural imbalances that put growth and debt at risk in the long run. Its productivity is woeful. Federal program expenditures as a share of the economy are structurally higher and have yet to pivot down, putting even greater pressure on revenue measures—and have mostly targeted the very drivers of growth (chart 13). Fiscal imbalances persist across and within levels of government in a polarized environment in what amounts to a massive coordination failure. Despite sustained spending across levels of government in recent years, the list of economic, infrastructure and social deficits still stands long. An eventual update is unlikely to get to the heart of these issues.

Chart 10



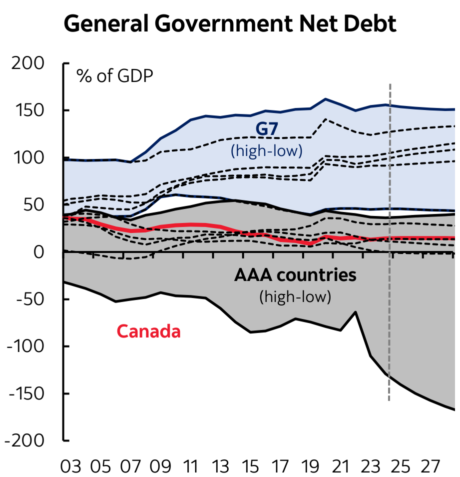
Sources: Scotiabank Economics, IMF, S&P.

LOST IN THE SHUFFLE

Any eventual update would be digested in a crowded market. Spending has been well-channeled with or without an official update. The big reveal was likely reflected in the November 21st announcement, with brief market reactions that were promptly tromped by trade threats and perceived weakness in Canadian GDP numbers. Assuming an update isn't tabled before the Bank of Canada's December 11th rate decision, the next pivotal date on January 29th will seem ages away. It may very well fall on the eve of the Federal Reserve's next rate decision on December 18th in which case most market watchers will be gazing southward.

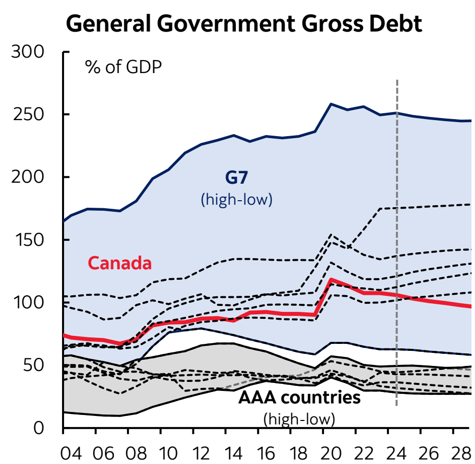
With elections around the corner in Canada, most should be faded anyway. Rules get rewritten on the campaign trail. All parties should be sharpening their pencils. Canada is a small, open economy in a rapidly evolving global landscape. It will likely have to make some concessions—and potentially costly ones—in the not so distant future to keep the ship righted. Strategically preserving fiscal firepower would (have been) the best bet, while focusing finite attention spans on readying the war chest for potentially tumultuous times ahead.

Chart 11



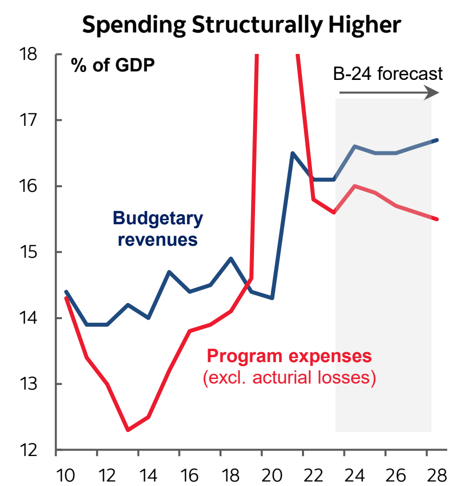
Sources: Scotiabank Economics, IMF, S&P (exc. SG).

Chart 12



Sources: Scotiabank Economics, IMF, S&P (exc. SG).

Chart 13



Sources: Scotiabank Economics, Finance Canada.

BOX 1: BACKING OUT THE NUMBERS IN A PHANTOM FISCAL UPDATE

Should an update be tabled, we would anticipate a deterioration of about $40 bn to the bottom line over the horizon (FY25-29) relative to Budget 2024 with a lot of guesswork. A material part would likely be driven by a weaker economic outlook (~$15–20 bn) despite a stronger hand-off in 2024 (and stale forecasts could underestimate potential economic headwinds). We pencil in another ~$10 bn to partially correct for presumably erroneous costing of the 2% NATO target (confirmed in July). (PBO puts that number closer to $25 bn but we save that for another day.) Gross new spending of $20 bn (including $6.3 bn already announced) wouldn't surprise. With limited fiscal room, we wager additional revenue-raising measures in the order of $5 bn. Given potential shortfalls bite in the near-term, any further expenditure restraint—while merited in their own right—are unlikely to deliver much by way of near-term revenues. *(The math: $15 bn economic weakness, less $10 bn military correction, less net $15 bn other new spending = $40 bn).*

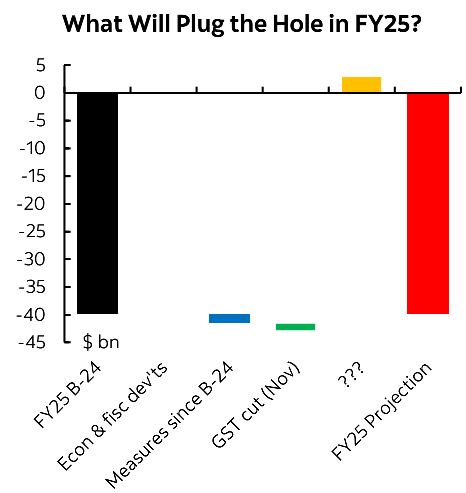
We expect an eventual update would adhere to anchors in the near-term but might relax medium-term deficit anchors under the implicit (threat-of-a-) crisis clause. Recall, last Fall's update set out a range of guardrails: deficits at or below $40.1 bn in FY24 (CY2023), declining as a ratio of GDP in FY25 and beyond, and below 1% in FY27 and beyond. It had also pledged an FY25 debt ratio lower than 42.7% and declining thereafter.

Our guess is that FY24 will clock in just under the wire. Last year's books have not yet been closed—and the Fiscal Monitor puts the preliminary balance at -$50.9 bn—but *ex poste* adjustments are fairly common. Expect stronger backward-looking revenue revisions, accounting adjustments for the timing of new bilateral transfer agreements that straddled fiscal years, and possibly unpredictable shifts in contingent liabilities, to get the match to $40.1 bn (1.4% of GDP) in FY24. Our weak conviction that the government meets the near-term metrics is mostly based on incredulity that it would abandon these anchors set only a year ago despite economic conditions mostly out-performing against expectations.

Hitting the FY25 target will take some effort (or constraint). Real economic activity in 2024 is outpacing earlier budget-time projections (0.7% versus current consensus north of 1%) and mid-year revenue receipts are slightly outperforming (7.6% ytd through September), but expenses are also elevated (11.2%). This would likely leave earlier fiscal forecasts awash before folding in any new spending. New measures including the recent $1.6 bn GST holiday could leave add up to ~$3 bn in FY25. There is still potentially a couple billion shortfall—and a line to watch—to maintain a shortfall just under 1.4% of GDP (chart 14). *It is likely be design that the $250 cheques would be punted to the next fiscal year (starting April 1st.)*

It's a mug's game after that. We pencil in modest new spending over the horizon, compounding a weakened growth outlook, that drives a slightly more expansive fiscal trajectory over the horizon with another year added to that outlook. The 1% deficit target over the medium term may be relaxed (while keeping debt directionally down) against economic headwinds. Of course, all bets are off in a much more serious economic slowdown. Or when an election writ is dropped.

Chart 14



Sources: Scotiabank Economics, Finance Canada.

Table 1: Fiscal Projections

$ billions	FY24e	FY25	FY26	FY27	FY28	FY29
		Projection				
Budgetary Balance						
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
Scotiabank Economics	**-40.1**	***-41.5***	***-42.0***	***-41.0***	***-39.6***	***-33.3***
% of GDP	***-1.4***	***-1.4***	***-1.3***	***-1.3***	***-1.2***	***-0.9***
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*
Scotiabank Economics	***1216***	***1258***	***1300***	***1341***	***1380***	***1414***
% of GDP	**42.1**	**41.6**	**41.3**	**41.1**	**40.7**	**40.1**

Sources: Scotiabank Economics, Finance Canada.