LAURENTIAN BANK SECURITIES

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November 26, 2021

Quebec Fiscal Update: Cyclical Improvement but Unresolved Structural Deficit Situation

FY 2020-21 Recap: $7.5B Deficit instead of $15B

According to the Public Accounts released this morning before the fiscal update, Quebec registered a $7.5B deficit during the FY 2020-21 that ended March 31st 2021. The gap between expenses and revenues shrinked to only $4.2B, considering the $3.3B allocation to the Generations Fund. The Fund's book value reached $12.2B as at March 31st, 2021. Accountants will be able to say that the budget was balanced after the use of the stabilization reserve. The latter is where previous years' surpluses have been put in case of challenging times, like during a pandemic. As a reminder, the Quebec government had previously projected a $15B deficit in June and September of 2020, meaning the pandemic had led to fewer negative economic consequences than originally believed. Real and nominal GDP declined by 5.5% and 2.4%, respectively, last year.

FY 2021-22 Revisited: $6.8B Deficit instead of $12B

Plenty of developments occurred in FY 2021-22 since a $12B deficit was projected in March 2021: 1- the stronger-than-expected V-shaped recovery generated approximately $9B in additional revenues; 2- additional spending of about $5B, including $3.3B for COVID-related expenses, were introduced; 3- the removal of the $1.3B provision for risks, a move unseen so far by other provincial governments, saves $1.3B; 4- an accounting change adds $0.4B in federal transfers. All in all, the $12.3B deficit melts to $6.8B, or $5.6B after taking into account the $1.2B amount remaining in the stabilization reserve. Also, this $6.8B deficit includes another $3.3B transfer to the Generations Fund, same amount as last year and $0.2B higher than projected in the 2021 budget due to higher mining revenues. To facilitate the comparison, Quebec's $6.8B deficit expressed as a percentage of GDP stands at 0.7%, smaller than Ontario (2.2%), Alberta (2.3%), Manitoba (1.9%) and BC (1.4%, before the floods' impact), but closer to Nova Scotia (0.9%).

A clear cyclical outperformance occurs in Quebec in 2021. The real GDP rebound, pegged at 6.5% by the government, comes from multiple factors including a robust U.S. recovery, stronger housing activity, a faster rebound in consumer spending and a smaller drag from global supply chain disruptions relative to its peers. The nominal GDP surge, on track to surpass 10% in 2021, notably reflects an 8% surge in total salaries. Meanwhile, federal emergency support feeds through a 20% jump in corporate profits.

However, individuals in Quebec face a bigger deterioration in their cost of living relative to the rest of the country with CPI inflation running at its fastest pace since the early 1990s (5.1% y/y in October). The fiscal update includes a cost of living allowance for 3.3M seniors and low-income earners, a $1B measure in FY 2021-22 ($2.9B over 5 years). According to our calculations, this will offset about one-fifth of the unusually high inflation.

Also, labour shortages in Quebec are more acute than in most provinces, except BC. Quebec is home to 200K job vacancies compared to 255K unemployed, a sign of skills mismatching. A higher percentage of firms in Quebec run at full capacity according to the CFIB, limiting future sales. Accordingly, real GDP growth, pegged at 3.3% in the fiscal update, is unambiguously poised to soften materially in 2022 and beyond. Recognizing this challenge, the fiscal update provides $0.3B in FY 2021-22 ($3.4B over 5 years) to requalify workers, support training and offer higher salaries in the education and health care sectors.

With respect to debt, the pandemic momentarily boosted net debt to 42% of GDP in FY 2020-21. Net debt corresponds to liabilities les financial assets. In comparison, Ontario (43%) and NL (51%) had higher public debt burden at that time. Manitoba (38%), NB (36%), NS (35%), Alberta (21%), Saskatchewan (18%) and BC (17%) were at the lower end of the spectrum. This year's strong economic rebound will bring down the debt-to-GDP ratio to 39.9%, exactly where it stood when the pandemic began in March 2020.

For FY 2021-22, the financing program is revised down by $3.9B compared to the 2021 budget, at $24.5B. This revision is smaller than the improvement to the deficit. The difference is explained by the doubling of pre-financing for FY 2021-22, to $8.5B. In turn, this is caused by better-than-expected financial results in FY 2020-21. As of November 9th, 67% of the program had been completed. Contrasting with Ontario, Quebec has tap foreign markets more often than usual this year, with about one-third of its borrowings done externally, versus 24% on average over the last decade. Also, 97% of issuances in FY 2021-22 had a maturity of 10 years or more, for an average debt maturity of 11 years. And, with markets thinking more than before about higher interest rates, it is worth mentioning ramping debt maturity in the coming years: $12.7B in FY 2021-22, consistently going up to $19.1B in FY 2024-25.

5-Year Outlook: The Unresolved $4B Structural Shortfall

In summary, the cyclical improvement is undeniably strong. However, a significant share of this year's additional revenues is already dedicated to new initiatives to partially ease the erosion in purchasing power, palliate critical labour needs in health and education and prevent unemployment to become too sticky for some individuals.

Finally, investors may see the glass half-full and half-empty at the same time when it comes to the medium-term outlook. The structural deficit, previously estimated at $6.5B at the end of the forecast horizon, falls to $4B, bringing the province closer to a balanced budget. However, the government does not want to rely on spending cuts or tax increases to make it happen. Besides leaning in favour of measures to accelerate economic growth, Quebec continues to ask Ottawa for an increased participation in health care costs: to 35% of provincial health spending. This would add $6B annually in federal transfers.

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