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Quebec 2023 Budget – Proactive Generations Fund Withdrawal in Reaction to Higher Interest Rates

FY 2022-23 ended on a positive note. The deficit estimate improved very modestly to $4.6B in the 2023 budget from $4.8B in the December update on better-than-expected revenues. This slight, near-term improvement contrasts with BC, Alberta and Manitoba. These three provinces recently reported a deterioration in their respective FY 2022-23 budgetary balances.

For financial markets, the most important news relates to the proactive assets-liabilities management from Finance Minister Éric Girard and his staff. In response to higher interest rates, the Quebec government will withdraw $2.5B from the Generations Fund in both FY 2023-24 and FY 2024-25 to restrain the increase in borrowing requirements and debt servicing. The all-in average cost of new borrowing of the QC government on the yield curve has moved upward and toward 4% (a 1pp rise in interest rates increases debt servicing by about $0.5B during the first year and $0.9B the second year).

For the second time only since the Generations Fund was created in 2006, Quebec registered a negative carry in 2022: the Fund recorded a market investment loss of $0.8B and the cost of new 10-year bond borrowings jumped to 3.5% from less than 2% in recent years. Also, expected investment income of $0.9B in FY 2023-24 on the $19B Generations Fund looks uncertain given recent global market turmoil. This being said, the Fund has been extremely positive from a longer-term perspective. On top of lowering public debt, the Fund generated an average return on investment of 5.3% versus the average cost of new borrowings at 3.1%, for a positive carry of 2.2%.

After reaching $24B in both FY 2021-22 and FY 2022-23, the QC government projects larger borrowing requirements of $29.5B in FY 2023-24 and $28.6B in FY 2024-25. This increase in bond issuance principally reflects three factors: a 5% increase in capital program spending, modest operational deficits and maturing bonds. Borrowing requirements would have been north of $30B per year without withdrawals from the Generations Fund.

The Generations Fund will temporarily stall at $19B this year and next as deposits to the Fund (close to $2.4B annually) coming from Hydro-Québec and other sources of revenues will virtually match the temporary withdrawals (of $2.5B). After a 2-year pause, the Generations Fund will grow again but at a slower pace than before, at an average annual pace of $2.6B instead of $4B+ as projected in the previous budget. Smaller future contributions to the Generations Fund relative to the 2022 budget is tied to the personal income tax cut, the flagship measure of this budget for individuals. The 1% personal income tax rate reduction for the first two tax brackets will be effective July 2023. 4.6M individuals will benefit from this measure. A family earning $50K will save close to $300 per year. A person living alone with a $50K annual income will save more: closer to $400.

The 5-year fiscal outlook proposes a modest deficit reduction over time, until a balanced budget is reached in FY 2027-28. The revenue outlook is based on a soft-landing scenario including a modest Quebec real GDP expansion of 0.6% in 2023 and 1.4% in 2024. Our projections released last month were a notch lower. However, instability in global financial markets tied to the U.S. and European banking is poised to weigh down on economic momentum. The adverse impact in terms of magnitude is difficult to assess at this stage. Bank liquidity hoarding and tighter banking credit conditions may cut U.S. real GDP growth by 0.5pp in both 2023 and 2024 according to preliminary estimates. The fiscal outlook includes a contingency reserve of $1.5B in FY 2023-24 and $1B in FY 2024-25 representing close to 1% of own-source revenues. This buffer appears sufficient under a mild recession but insufficient under a severe one (a 1pp change in Quebec nominal GDP translates into a $1B annual change in own-source revenue). Under the alternative — modest — recession scenario proposed in the budget (0.8% real GDP contraction in 2023), the FY 2023-24 deficit would stand at a moderate $6.2B instead of $4B under the baseline scenario.

Another key facet of this budget for bond investors relates to the new long-term debt objective: a 30% net debt-to-NGDP ratio figure in 15 years, versus 37% today. The 30% goal is a lower figure than the average net debt-to-GDP ratio observed today from all provinces. Put simply, the budget proposes a gentler downward debt burden path than in the past. For instance, Quebec's net debt-to-NGDP ratio plunged from 50% in 2016 to about 37% today, outperforming other provinces.

Budget 2023 also includes a section on environmental policies. The Quebec government continues to press forward with its 2030 Green Economy Plan to boost electrification and initiate climate change policies. New funding will be dedicated to implement commitments announced at the United Nations COP15 conference including water and biodiversity protection. In a report released last year, the Canadian Climate Institute ranked Quebec very high in terms of climate transition-opportunity companies, capital raising and competitiveness. Quebec issued twice under the Green Bond program in FY 2022-23, in May and November of last year. The government pledges to be a regular issuer of Green Bonds.

In summary, Finance Minister Éric Girard unveils a fiscally responsible roadmap to begin the second 4-year term of the CAQ government. He and his team opted for the reasonable trade-off of committing to a soft debt reduction path and implementing modest tax income relief for individuals. The Quebec government also shelters its balance sheet, and ultimately taxpayers, from the interest rate risk by taking out $5B of the Generations Fund over two years, a prudent move that should be positively received by the financial market community. Lastly, the magnitude of the ongoing economic slowdown will determine if Quebec needs to borrow more than the elevated bond issuance already proposed under the baseline scenario.

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