LAURENTIAN BANK SECURITIES

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Quebec Budget 2022: Positive Short-term Dynamics, Cheques to Offset Inflation and Long-Term Challenges

The big picture has not materially changed since last December's mid-year update. In summary, the cyclical pulse remains positive but long-term challenges persist.

Corporate profits, wages and consumer spending all performed above expectations in 2021, growing close to 10% in nominal terms. Thus, the level of revenues in FY 2021-22, and for the 5-year financial framework proposed in the budget, has been revised up.

Sending cheques to preserve purchasing power

At the same time, new funding initiatives moderately increase the spending profile. A large $3.2B will be distributed in FY 2022-23 to more than 90% of the population to mitigate the impact of inflation, by far the largest new spending measure included the budget. Without these individual $500 cheques, households' disposable income would have significantly dropped in real terms this year, more than during previous downturns. This form of support will partly ease the inflation pain, at least until central banks cool off price pressures with monetary policy tightening. We estimate that this non-recurrent measure will offset about half of the higher-than-usual 4.7% projected CPI inflation rate in 2022.

More efforts in healthcare and the environment

Also, additional expenditure representing more than $1B annually will be dedicated to the health care system. Quebec currently has below-average hospital bed capacity per capita. The government also plans to add an additional $1.0B to its $7.6B 5-year plan to fight climate change, with the lion share allocated to reduce GHG emissions (not included in the current fiscal framework). Overall, the budget proposes a slightly faster pace of spending growth (+3.2%) than revenue (+2.9%) over the next five years, with the bulk of the increases occurring in FY 2022-23.

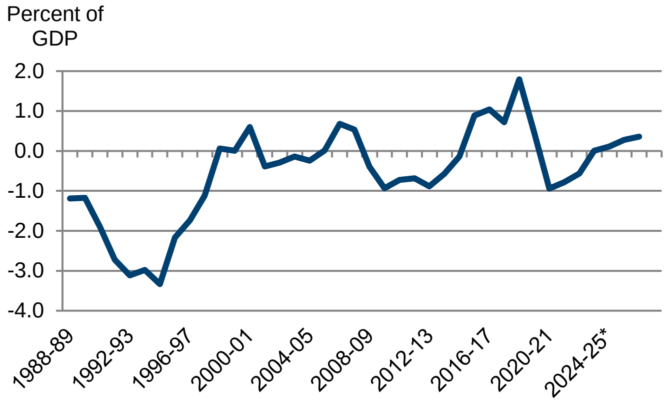
Provisions for risk useful in these uncertain times

The budget includes contingencies and recovery measures of nearly $5B: $2.4B for COVID-19 support in case of future pandemic waves, and $2.5B for economic risks. The biggest risk to the economic and financial outlook is the unclear implications of the Russian invasion of Ukraine and other geopolitical developments. Part of the $2.5B economic provision could turn out to be useful since the budget assumes an upbeat 3.6% increase in U.S. real GDP this year. As a comparison, the Federal Reserve marked down its 2022 forecast to 2.8% last week. This large 0.8pp gap likely reflects the fact that economic assumptions were made weeks ago by the Ministry of Finance as part of the budget planning process, not incorporating the latest surge in commodity prices, additional supply chain disruptions and the consequences of the war in Ukraine.

A balanced budget next year, before transfers to the Generations Fund

The budget projects $138B in revenues and almost the same in spending ($137B), indicating that Quebec's public finances are close to be balanced in FY 2022-23 (-0.6% of GDP, chart 1). But, after adding the $5B provisions and the $3.4B transfers to the Generations Fund, the deficit increases to $6.4B, a $1B improvement from the deficit registered in FY 2021-22. Smaller projected shortfalls after transfers to the Generations Fund shrink from $3.9B in FY 2023-24 to $2.8B in FY 2026-27. The latter represents the structural deficit, or the unresolved long-term fiscal challenge. On that front, Quebec faces slower labour force growth relative to Ontario, Alberta and BC, notably. Also, the *Institut du Québec* noted in a recent report how low productivity gains, ageing demographics, costly climate change events and additional health care spending will keep expenses above the revenue line. One solution is additional health care funding from Ottawa. Based on a Council of the Federation report released last year calling for the federal government to participate 35% in provincial health care funding, Quebec would receive $6B in additional CHT annually.

Chart 1: Quebec Budgetary Balance



Note: *Before* transfers to the Generations Fund.
Source: Government of Quebec, GoC Fiscal Reference Tables, LBS Econ. Res. and Strategy.

New debt reduction targets next year

Recognizing these long-term challenges, the Quebec government indicates its intention to propose a new debt reduction objective in Budget 2023. The new target would likely start after the current 2026 debt objectives deadlines, as specified in the *Act to reduce the debt and establish the Generations Fund*. Thus, at the moment, there is no fundamental shift: both the gross-debt-to-GDP and accumulated deficits-to-GDP ratios return to their pre-pandemic downward trend, after a brief surge caused by the pandemic. After 2026, it remains to be seen if the same weight will be placed on debt reduction, as it has been the case since the Generations Fund was established in 2006. As such: "*the [new debt reduction] target will need to consider the challenges facing Québec now and those it will face in the coming years… pending the setting of a new debt target, the government intends to pursue a gradual reduction of the debt burden beyond 2025-26"*.

Our last words go to borrowing requirements. We estimate the FY 2021-22 final borrowings at $23.4B including last week's $0.5B issuance and pre-funding of $5.9B for FY 2022-23. The average borrowing cost was 2.43% and the average maturity reached 18 years. A sizeable 37% has been borrowed in foreign markets in FY 2021-22, above the 10-year average of 24%.

Bond issuances will stay elevated in upcoming years, including $27.6B in FY 2022-23, $30B in FY 2023-24 and $33.9B in FY 2024-25. Elevated borrowing requirements result from high capital spending and increasing maturities, more than offsetting lower deficits. In a world highly constrained by the supply side, boosting annual public infrastructure investments above $15B per year came somewhat as a surprise. Record-high labour force shortages and raw materials prices could end up causing more inflation in public infrastructure projects than generating real capital spending, including repair. In comparison, the Ontario government projects public capital spending at $13B in FY 2021-22. Finally, the budget says that Quebec intends to continue to be a regular issue of Green Bonds. Six issues totalling $3.3B have been made since the Green Bond program was launched in 2017.

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