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Federal Fiscal Update – Modest Improvement at Best in Public Finances, Recession Warning Sent

Economic developments in the early stages of FY 2022-23 have been generally better-than-expected compared to the 2022 budget was released last April. Income taxes are revised up massively due to elevated inflation, but high interest rates will add almost $8B in terms of debt servicing to the $1.2T federal debt. Overall, the net fiscal impact derived from better economic conditions is large, standing at $30B. At the same time, policy measures taken since the March 2022 budget, in addition to new ones announced in this fiscal update, will cost $13B. Altogether, the FY 2022-23 budget deficit of $53B was revised down by $17B to a manageable $36B (1.3% of NGDP).

Since the federal government surveyed private forecasters in September to build the baseline economic scenario, the outlook unfortunately deteriorated. Accordingly, the nimble Ministry of Finance staff came up with an alternative downside scenario: a mild recession in 2023 (-0.9% Canadian real GDP growth instead of +0.7%). Under this plausible scenario, the deficit will be closer to $50B in both FY 2022-23 and FY 2023-24, superior to the $36B and $31B shortfalls proposed in the baseline scenario. In a way, the baseline scenario looks like an optimistic scenario to us. It is difficult to pinpoint, but deficits may end up somewhere in-between the baseline and downside scenarios, or worse if the recession turns out to be long and severe.

Under the baseline scenario, the net debt-to-NGDP ratio gently softens from 42% this year to slightly below 40% over the course of the next 5 years. Under the downside scenario, the debt-to-NGDP ratio temporarily increase to 45% in FY 2023-24 without surpassing the pandemic peak of 46%. The absence of a major, sustained increase in the debt burden is reassuring for bond investors anxious since the UK fiscal policy mistake led to a 200bps+ surge of interest rates across the Gilt yield curve. In fact, relative to previous fiscal updates, the ratio of almost 1-to-3 in terms of new policy measures versus the upside in revenues shows a modest step toward fiscal discipline. It contrasts with the December 2021 fiscal update when higher-than-expected revenues of $16B were entirely used to finance the same amount in new initiatives.

Bond investors will take notice of the $21B, or 10%, downward revision to T-bills and GoCs bond issuance under the baseline scenario. T-bills issuance of $192B in FY 2022-23 is very close to its historical average level. As for bonds, the $191B planned issuance remains high relative to the past ($125B, for instance, in FY 2019-20). Across the curve, almost half of the $21B decline in GoCs issuance will come from 2YR and 3YR sectors. Benchmark targets sizes for 2s, 3s and 5s will all be reduced by a large $2B. The main surprise for markets relates to the immediate ending of Real Return Bonds issuance. The federal government also plans another green bond issuance before the end of FY 2022-23. An allocation report for the inaugural $5B green bond will be available before the end of FY 2022-23, followed by the first impact report.

Companies and equity investors will take notice of the 2% tax on share buybacks proposed by the federal government. The tax will become effective in 2024, potentially impacting companies with stronger cash positions, notably among the TSX energy sector. The economic literature on this subject appears extremely thin: in the U.S., we found an old 2004 NBER study estimating a 1% tax on share buybacks could lead to a 1.5% increase in dividend payouts. Details about the tax will be announced in Budget 2023. With this 2% tax, the federal government's objective is to promote investment and wages. To boost capex spending and facilitate the low-carbon energy transition, the fiscal update also proposes a new tax credit ranging from 30% to 40% to support clean hydrogen projects, depending on emissions levels. Also, the update includes a new clean tech tax credit equal to 20% or 30% of the capital cost of investments in electricity generation and storage systems, zero-emissions machinery & equipment, etc. This new investment tax credit will become effective when Budget 2023 will be released, possibly next winter or next spring.

In summary, the federal government prioritizes the financial protection of the most vulnerable groups and proposes targeted decarbonization policies. The 5-year revisited fiscal outlook suggests at best modest upgrades relative to the 2022 budget. Also, the valuable fiscal sensitivity presented in the baseline and downside scenarios should lead investors to anticipate moderate deficits this year and next. At least, deficits should be smaller than the gargantuan shortfalls of FY 2020-21 ($312B) and FY 2021-22 ($90B). This being said, in contrast to several provinces that strengthened fiscal discipline when the economy was running hot during the 12-18 months, the federal government has no fiscal buffer to protect its financial framework in case of a long and severe recession.

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