ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

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Quebec Fall Economic Update (Preview): Revenue windfall to offset additional structural spending

Quebec will present its Fall 2021 Economic Update on Thursday, November 25th. Already labelled as a "mini-budget" by Finance Minister Éric Girard, the statement will focus on labour shortages and improving critical health care and educational services. Quebec is home to one of the highest job vacancy rates in the country and has experienced a slower rebound in its labour force participation rate. A lack of personnel and resources in the healthcare sector has led to temporary emergency rooms shutdowns and lengthened surgery backlogs, among other issues. In the short-term, the revenue boost from a stronger-than-expected economic rebound in 2021 should more than offset new spending to address these issues. Overall, we anticipate significant improvement to the fiscal outlook, leaving the province with a smaller-than-anticipated deficit and borrowing program in FY 2021-22.

Strong growth and federal support boost revenue

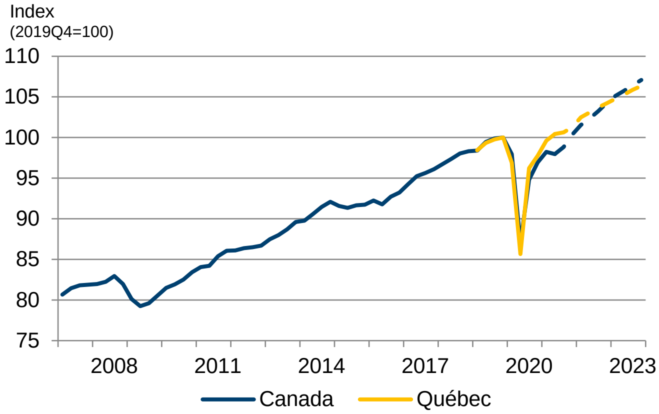
Thanks to an elevated vaccination rate and sound COVID-19 management during the third and fourth wave of infections, the province enjoys a steady reopening that started in the spring of 2021. Unlike the rest of Canada, Quebec already reached its pre-pandemic level of activity during the second quarter of 2021 (chart 1). The Bank of Canada's stringency index for Quebec shows a steady easing in restrictions since last spring, with plenty of room for further easing going forward. As a result, we forecast real GDP to grow 6.7% in 2021, following a 5.3% contraction in 2020.

Retail sales have been stronger than in the rest of the country, reflecting a healthy labour market and fuelling sales tax revenues. The unemployment rate reached 5.6% in October, compared to 4.5% in February 2020 before the pandemic started. This quick recovery, as well as federal programs, supported compensation of employees and personal income taxes. On the business side, the Canada Emergency Wage Subsidy, among other programs, inflated net operating surplus and corporate income taxes (chart 2).

Higher prices positively affect provincial coffers

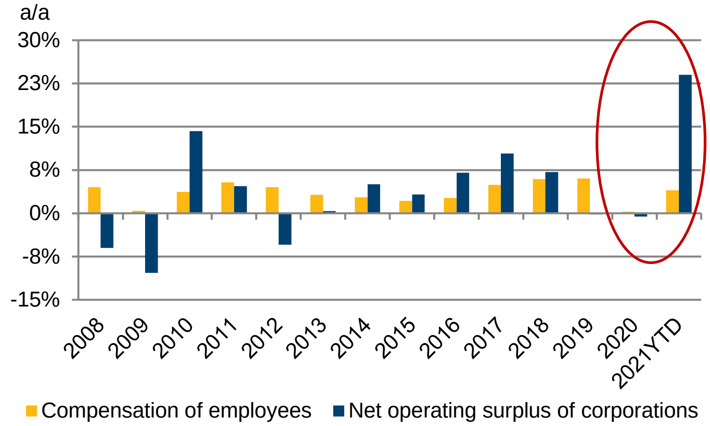
Prices in the economy also drive up provincial revenue through GDP deflator. CPI inflation hit 5.3% y/y in October, the highest reading since 1991. Residential home prices have gained 5% since March 2021 and 34% since March 2020. The terms of trade also rose faster-than-expected. Altogether, we estimate Quebec's nominal GDP growth at 11.2% in 2021 after a 4.1% contraction in 2020, the strongest increase since at least 1982, and 5 ppts above Budget 2021 estimates. Using Quebec's fiscal sensitivities, this yields $4.2B in additional own-source revenue for FY 2021-22. Assuming no changes to federal transfers, we estimate total revenue at $130B, 6% above budget projections.

Chart 1: Quebec GDP has recovered faster than Canada



Source: Statistics Canada, ISQ and LBS Econ. Res. and Strategy.

Chart 2: Unprecedented federal support boosted income for households and corporations in Quebec



Source: Quebec Ministry of Finance, LBS Econ. Res. and Strategy.

Labour shortages hamper the recovery

On the expenditure side, the government already mentioned that the Fall Update will include additional measures to address record-high labour shortages. Job vacancies reached nearly 200K in 2021Q2, with the most acute shortages located outside of Montreal. At 5.3%, the vacancy rate stood significantly higher than neighbouring Ontario, at 4.3%. A lack of skilled or unskilled labour represents the two most cited reasons preventing an increase in sales and production for SMEs according to the CFIB, denting into an otherwise stellar economic performance in 2021. In our view, labour shortages also explain why the CFIB's overall business confidence index is currently lower in Quebec than in other provinces.

Higher public sector wages and interest on debt

Because the third and fourth wave of infections have been kept under control, we believe that the $4.3B in COVID-19 support and recovery measures included in Budget 2021 will be sufficient for the entire fiscal year. However, the update is likely to factor in stronger wage growth for unionized public sector workers. Indeed, since March 2021, public sector unions and the government successfully negotiated several collective agreements, with many improvements to labour conditions. Other additional measures include a $1.0B special bonus to retain nurses in the public sector and $90M to tackle gun criminality. To absorb these spending, Treasury Board President Sonia Lebel said that spending restrictions will be imposed to other departments. Altogether, we forecast portfolio expenditures to grow 8% in FY 2021-22 versus the previous year, reaching $121B, up from 6% in Budget 2021. Investors should also watch for an increase in Quebec's interest on debt as Canadian interest rates have risen extensively over the past few months. Given our latest forecasts for interest rates and Quebec's 2020-21 fiscal sensitivities, the 10-year Canadian bond yield could average 20bps and 30bps more than the 1.4% for 2021, 1.6% for 2021 budget forecasts. This would generate around $108M more in debt servicing costs this year, growing to $240M next year.

FY 2021-22 deficit almost cut in half

All in all, stronger-than-expected revenue should offset the above-mentioned additional spending in FY 2021-22, narrowing the deficit to $5.1B (1.0% of GDP) before the $3.1B transfer to the Generations Fund. This compares to the $9.2B deficit projected in Budget 2021. Given that the third quarter of this fiscal year is coming to an end, there is also a high probability that the $1.3B provision won't be needed, thereby reducing the end-of-year deficit by the same amount. We estimate borrowing requirements at $22.4B in FY 2021-22, $6B less than Budget 2021 projections (see table). In addition to the $4B downward revision to this year's financial requirements, we anticipate a $2B improvement to the FY 2020-21 deficit (now at $10.0B), to be officialised in the public accounts expected to be released this week. The Ministry of Finance could translate lower financial needs for last year through higher pre-financing in FY 2021-22. These better-than-anticipated fiscal results put Quebec two years ahead in its 7-year path to a balanced budget. Given the offsetting effect that a stronger tax base will have on higher public sector expenditures going forward, it remains to be seen by how much the structural deficit, established at $1.3B in FY 2023-24 and $6.5B in FY 2027-28, will be reduced.

Financing Program (FY 2021-22, $M)	Budget 2021	LBS
Net Financial Requirements	20,065	15,999
*Including: deficit**	*9,170*	*5,104*
Repayments of borrowings	12,688	12,688
Use of pre-financing	-4,292	–6,265
Use of the Generations Fund to repay borrowings	0	0
Total	**28,461**	**22,422**
Variation		*-6,039*

* Before transfers to the Generations Funds.

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