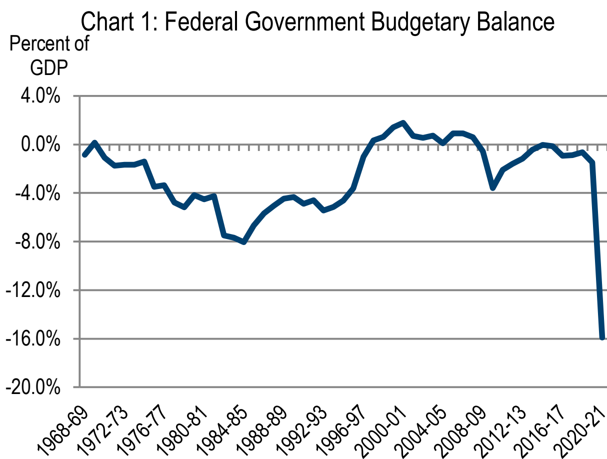
Laurentian Bank Securities
ECONOMIC RESEARCH AND STRATEGY

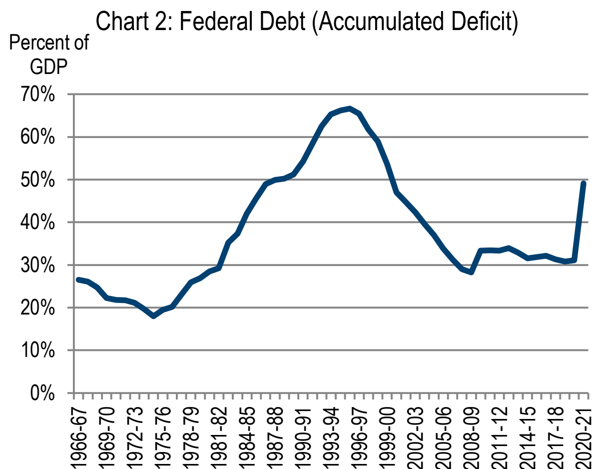
Federal Fiscal Snapshot – Ottawa Bears the Brunt of the Pandemic Cost

Public finance deteriorates at an unprecedented speed

Strong financial support from the federal government to households and businesses during the pandemic has prevented financial distress and ease liquidity pressures. The flip side of this much-needed assistance was revealed in yesterday's *Economic and Fiscal Snapshot*. The Government of Canada forecasts its largest deficit in dollar terms on record, $343B for the current FY 2020-21. Relative to the size of the economy (15.9%), the shortfall is twice as large as annual deficits recorded in the 1980s (chart 1). Program expenditures surge by $242B, or 69%, to $593B, reflecting the critical financial measures implemented since March. Two-thirds of the coronavirus spending relates to the Canada Emergency Wage Subsidy ($82B) and the Canada Emergency Response Benefit ($73B). The impact of COVID-19 on fiscal revenues is large but small when compared to the spending initiatives. The recession will result in a $72B decline in revenues, or 21% to $269B, relative to last year. This pullback is twice as large relative to the 2008-09 Financial Crisis.



Source: Government of Canada, Statistics Canada.



Source: Government of Canada, Statistics Canada.

Accordingly, the government expects the federal debt-to-GDP to jump from 31% in FY 2019-20 to 49% in FY 2020-21 (chart 2). Prior to this year, a public debt burden figure close to 50% was last observed in the early 2000s when Canada's long term debt was not yet rated AAA by rating agencies. The main difference between the early 2000s and today is the very low cost of financing public debt. Public debt charges could actually decline by $5B in FY 2020-21 despite the projected $471B increase in market debt. A low and flat yield curve environment influenced by central banks' bonds purchases programs and a persistent global search for yield and safe assets from investors explain this favourable dynamic. At 7.3%, public debt charges as a share of revenues remain close to their historical lows of 7.0% reached in FY 2018-19.

A shift in the debt management strategy: more long term debt issuance

The Government of Canada intends to use this record low interest rates environment to increase the average term of its debt stock, which stood at a 10-year high of 8.4 years in FY 2018-19. Under the economic scenario proposed, the federal government plans to borrow a record $409B in bonds, up from $124B (+230%) last year. Issuances will increase across the curve. The bulk of the additional supply remains in the 2Y, 3Y and the 5Y sectors but 10Y and 30Y issuances increase by a larger percentage. In previous years, Canada used to issue between $15B-$20B in 10Y and 30Y annually. For FY 2020-21, the government plans to issue a combined $106B in 10Y and 30Y. The increased share of total issuance allocated to 30Y (from 3% to 8%) is expected to be larger than for the 10Y (from 11% to 18%), which may put to rest the trading idea of a tighter 10s-30s spread. Overall, the share of total issuance in 10Y and 30Y will nearly double between last year and FY 2020-21. In contrast, it will decline in the 2Y (from 43% to 37%) and 5Y (from 27% to 21%) sectors and stay about the same for the 3Y sector (from 15% to 16%). The fiscal snapshot document specifies that “these changes will improve issuance capacity in the bond program”. Also, total RRBs issuances will decline by 22%, or $0.4B, to $1.4B following market consultations last fall. The number of RRBs auctions will move up from three to four.

Relative to bond issuance, the surge in T-bills issuance relative to last year is smaller, at 94%. The debt management strategy consists of reducing pressure in the T-bills sector and rebuilding contingency capacity in case a new round of emergency short term financing arises. T-bills annualized issuances are nonetheless projected to approximately double from $152B to $294B in FY 2020-21. Despite the doubling in T-bills issuance from $152B to $294B , it does not comes as a surprise to market participant as Canada has already issued a large amount of T-bills at the beginning of the pandemic, similar to what we had observed in other countries. To mitigate rollover risk, a larger share of T-bills issuance in FY 2020-21 will be allocated to the 6m and 12m maturities relative to last year.

The fiscal scenario relies on a swift recovery

The $343B deficit and $1.1T federal debt estimates are based on the key assumption that Canada and the world will not go through another significant coronavirus wave during the second half of this year. As of writing, the number of new confirmed cases is increasing rapidly in the U.S., South America and also began to resurface in Australia, a risk to Canada’s export sector and for commodity prices. The real GDP growth forecasts (-6.8% in 2020, +5.5% in 2021) used by the federal government are based on a private sector survey including our team. This forecast is less downbeat than the IMF’s latest forecast (-8.4% in 2020, +5.4% in 2021) as the latter sees a slower recovery during the second half of 2020. Even under the milder federal government scenario, we still expect other credit agencies to follow Fitch’s recent downgrade from AAA to AA+. As a comparison, in 1994, DBRS downgraded Canada in March, followed by Moody’s in May and Fitch in August. Under a more severe Covid-19 scenario including a virus outbreak in 2021 and another gargantuan deficit next year, we cannot rule out the possibility of a second credit downgrade within the next 6-to-12 months as the debt-to-GDP ratio could approach the peak reached in the 1990s. One notch lower notch would bring Canada’s credit rating to AA, similar to the mid-1990s.

Furthermore, the fiscal *snapshot* does not include additional policies or revisions to existing policies. The introduction of a guaranteed minimum income could emerge from the pandemic. Demand for a universal basic income (UBI) program grows in part because some of the existing federal support programs, including the CERB, are set to expire in October. The PBO recently estimated that six months of UBI could cost about $98B. All in all, a $100B+ deficit in FY 2021-22 is likely even if the pandemic and non-recurrent programs end this year.

Conclusion

The federal government, not provinces, bears most of the brunt of the pandemic-related costs. After including tax payment deferrals and liquidity measures, the federal government estimates it covers 86% of total Covid-19 related spending versus 14% for provincial and territorial governments. The federal support notably includes the S*afe Restart Agreement,* a $14B earmarked transfer to provinces and municipalities that has yet to be finalized. An international comparison also shows that direct support and deferrals provided in Canada as a share of GDP are the second highest across the G-7 at 13.8%, slightly below Germany (14.2%). The next reassessment of the impact of Covid-19 on Canada's economic and fiscal situation will be presented in the fall, including a longer term projection.

Sébastien Lavoie | Chief Economist
514 350-2931 | lavoies@vmbl.ca

Dominique Lapointe, CFA | Senior Economist
438 835-7626 | lapointed@vmbl.ca

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