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Federal Budget 2023 – Moderate Fiscal Deterioration, Big Shift in Bond Issuance Strategy

The state of federal public finances has moderately deteriorated since the mid-year update released last Fall, at a time of greater uncertainty and a North American economy sliding closer to recession territory. The 5-year outlook reveals a modest ramp-up in spending and a slightly less favorable path for revenues. This combination ends up moving Ottawa away from the so-called zone of fiscal restraint, tilting the fiscal stance instead towards expansionary and inflationary mode. In terms of numbers, let us notably highlight the $10B deterioration in annual deficits for the next two years, compared to the Fall Update. For instance, the FY 2023-24 deficit projection of $40B turns out to be almost the same figure as the $43B deficit registered in FY 2022-23 ending in two days. In other words, there is no short-term progress to be found in respect to the bottom line, looking at the differential between spending and revenues.

Deficits proposed for the next two years are not small; neither extremely huge. They are rather large, representing more than 1% of nominal GDP. Accordingly, these deficits are not small enough to bring down the net debt-to-NGDP ratio: a feature the bond market community usually prefers to see when looking for signs of fiscal sustainability. Those looking at the glass half-full will find that the net debt-to-NGDP ratio is poised to stay in the 42%-44% range in the medium-term, sufficient for Canada to maintain its excellent triple-A credit rating. Those looking at the glass half-empty will notice the surge in debt servicing tied to higher interest rates. Debt charges as a % share of nominal GDP will soar from the previous 1.0%-1.1% tight range to 1.6% in FY 2023-24, a ratio observed a long time ago in 2011 before the ultra-low rate period of the 2010s decade kicked in. In contrast to several provinces that issued their budgets lately, the federal government does not provide a roadmap toward a balanced budget. Ottawa previously had the soft intention of balancing the books in FY 2027-28 according to the 2022 Fall Update, something that has been abandoned in Budget 2023.

Short-term bond issuance favored, CMBs days could come to an end

The federal government surveyed private forecasters mid-February to build the baseline economic scenario, prior to the mid-March banking stress events. Overall, economic assumptions used are prudent, including a meagre 0.3% Canadian real GDP expansion in 2023. As we noted in other budget writeups recently, the key is to watch the magnitude and persistence of possible tightening in financial conditions to individuals and companies to assess the adverse impact on North America's economy. In the downside economic scenario proposed, the federal annual deficit deteriorates by about $7B per year relative to the baseline scenario; and the net debt-to-NGDP ratio increases at a bolder rhythm of two full percentage points in FY 2023-24: north of 44%.

Thus, Government of Canada (GoC) bond issuance pegged at $172B in FY 2023-24 under the baseline scenario may end up higher and close to the tally of bonds issued in FY 2022-23 ($185B) if the economy disappoints. On paper, Budget 2023 proposes a moderate $13B reduction in FY 2023-24 bond supply relative to FY 2022-23, without approaching the low GoC issuance level observed pre-pandemic ($124B in FY 2019-20).

The $13B proposed decline in GoC issuance is unevenly distributed across the yield curve. The normalization process after the pandemic years will bring down issuance of 10s and longs at 29% of the total. In contrast, 2YR and 5YR will represent 71% of total bond issuance in FY 2023-24, moving up and closer to the 10-year average of 77%. The 3YR issuance will be terminated after two last issuances during the first quarter of FY 2023-24, leading to a major reallocation boost in 2s and 5s. 5s and 2s will both see a $9B surge in issuance. Notably, 2YR issuance projected at $76B will represent the bulk of total GoC issuance at 44%, an unusually high concentration, by far the largest percentage share observed during the last five years anywhere across the yield curve. Besides the $14B drop in 3YR issuance versus FY 2022-23, the second largest decline ($10B) relates to 10s. At $40B, 10YR issuance will be the lowest post-pandemic and matches the 5YR issuance projection of $40B, contrasting with the previous two years, where $20B more in 10s were issued compared to 5s. While 3YR issuance days are coming to an end soon, issuance in the 30YR sector will become a rarity as the debt management plan proposes, with the smallest annual issuance post-pandemic at $10B. Furthermore, market watchers will take note of the largest T-bill issuance ever: $242B in FY 2023-24, higher than during the pandemic ($219B in FY 2020-21).

The biggest surprise for market participants came from Ottawa's newest idea of potentially bringing the Canada Mortgage Bonds program under the GoC issuance program: *"... despite carrying the same credit rating, CMBs are a more costly form of borrowing compared to regular Government of Canada bonds. In this context, consolidating CMBs into the regular Government of Canada borrowing program represents an opportunity to reduce debt charges and reinvest savings into important affordable housing programs. The government intends to undertake market consultations on the proposal to consolidate the Canada Mortgage Bonds within the government's regular borrowing program, including on an implementation plan that would ensure stable access to mortgage financing. The government will return in the fall economic and fiscal update on this matter."* If we assume a ballpark annual CMB issuance of $40B, a switch to the GoC program would boost issuance by about 30%. Also, if CMBs become rarity, it would indirectly favour the provincial credit space.

As for the Green Bond Program, "The government remains committed to regular green bond issuances" although the debt management strategy section falls short of showing any minimum target for FY 2023-24. The only green bond issued was the inaugural 7.5-year, $5B in March 2022, at the end of FY 2021-22.

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Key Fiscal Measures – Funding for Clean Economy Leads Spending to Outstrip Tax Hikes

Seeing beyond numbers, let us dig into some of the key policies announced in Budget 2023.

- Ottawa expands support for renewable energy sources in reaction to Washington's *Inflation Reduction Act*: the 15% tax credit effective FY 2024-25 will facilitate investments related to clean electricity, including wind, solar, hydro and nuclear projects.
- Additional funding to improve and fast-track the regulatory process of key investments relative to critical minerals, clean energy projects.
- A national dental care plan to cover uninsured families will start later in 2023 at a cost of $13B over five years, almost twice the size the original cost estimate.
- A 2% tax on share buybacks will become reality in January 2024 for buybacks of $1M and above.
- The alternative minimum tax for wealthy individuals will move up from 15% to 20.5%, starting in the 2024 taxation year.
- A modification to tax rules effective on dividends received after 2023 will require financial institutions to count dividends received from Canadian companies as business income.
- Future first-time homebuyers will be able to save $40K in a tax-free new account called the First Home Savings Account. This measure will become effective in a few days, April 1st.

In summary, the tax burden gets modestly heavier. However, spending initiatives including support for the cleaner economic transition and a weaker economic outlook weigh more in the balance, ultimately deteriorating the path of federal public finances over the next five years. With almost half a trillion dollars planned in annual spending during FY 2023-24 outstripping revenues and thus keeping a rather large deficit excess, Ottawa's fiscal stance remains stimulative and in conflict with the Bank of Canada trying to restore price control.

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