ECONOMIC RESEARCH AND STRATEGY

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Sébastien Lavoie,
Chief Economist
LavoieS@vmbl.ca
514 350-2931

Luc Lapointe,
Senior Economist
LapointeL@vmbl.ca
514 350-2924

Quebec Economic and Financial Update — Sizeable Financial Support to Individuals and Weaker Outlook Restrain Financial Progress

With a deficit reduced to $0.7B, the August pre-election report showed a better fiscal position compared to last March's budget when the shortfall was set at $6.5B. The main question was whether there had been any consolidation or deterioration in light of multibillion-dollar election promises and the outlook moving closer to an economic slowdown in 2023.

The mid-year economic and financial update confirms that anti-inflation shield measures have undermined Quebec's fiscal situation relative to last summer's figures. The deficit for fiscal year 2022-23 is now estimated at $4.8B, or 0.9% of nominal GDP. This deficit, below the budgeted figure, is within the meaning of the Balanced Budget Act, that is after integrating expenditures related to the COVID-19 support and recovery measures ($2B), payment to the Generations Fund ($3.3B), provision for economic risks ($1B) and the use of the stabilization reserve ($0.5B). In the reference scenario, the annual deficit projection for the next four years has deteriorated slightly by an average of $1 billion per year, from $2.3B for 2023-24 to $2.9B for 2026-27. This is mostly related to new redistribution in response to high inflation. Also, the weaker economic outlook shaves, relative to the pre-election report, annual own-source revenues by $0.3B on average during the next 4 years. The return to a balanced budget is maintained for 2027-28.

At $145B, projected total revenues for 2022-23 remain essentially unchanged relative to this summer's figure. The absence of a change for total revenues comes from positive and negative revisions within various categories. Consumption taxes are notably revised down, corporate taxes up. Also, revenues from Hydro-Québec are revised up due to high exports. Anticipated expenses are up $5.5B to $144B, of which $5B is attributed to the anti-inflation shield introduced during the current fiscal year, namely the one-time assistance for the cost of living ($3.5B) taking the form of cheques to 6.5M individuals and the enhancement of the amount for support to seniors ($1.5B). In total, over five years, $13.2B will be spent in the anti-inflation shield, including a 3% limit on indexing government fees.

Debt service charges for FY 2022-23 remain anchored near last summer's $10.5B forecast. However, debt servicing represents a 22% increase relative to the initial budget due to the rapid increase in interest rates. Debt service as a proportion of revenues is on an uptrend, within the 6.5%-6.9% range over the medium-term, above most provinces but lower relative to Quebec's own history of a 10%+ DSR-to-revenue ratio back 10-15 years ago. The reference scenario also forecasts an average rate of 4% for the BoC policy rate in 2023. In light of the early December 50bps increase to 4.25%, the overnight rate target could reach 4.50% next January and stay at this elevated level for quite some time. According to the province's sensitivity analysis, such a difference could lead to an increase of nearly $300M, or 3%, in debt service charges, and the deficit would be larger than in the base case but lower than this year most likely.

Within debt servicing, the government reiterated the main driver that was announced in the August pre-election report: lower investment income of the Sinking Fund for Government borrowing. The expected return stands at -3% instead of a 6.4% positive gain. In comparison, the downward revision of $168M to investment income of the Generations Fund expected to reach $19B in March 2023 is very small.

The Quebec Finance Ministry has lowered its forecast for real GDP growth to 3.1% for 2022 and 0.7% for 2023 (3.4% and 1.7% last summer). The update was prepared earlier this Fall, just before private sector economists downgraded the economic outlook. Thus, for 2023, this forecast is a bit optimistic with respect to private sector expectations of 0.3%. The update includes an alternative scenario where a recession would occur in 2023. Real GDP growth would then contract by 1%. In this scenario, nominal GDP growth would fall from 2.8% to 1.0%. This negative shock would be followed by a rebound in 2025 and 2026 so that economic activity would reach a level equivalent to the reference scenario at the end of 2026.

The net debt ($200B) to nominal GDP ratio is projected at 36% in March 2023, a modest 2% decrease from the March 2022 ratio considering nominal GDP expanded near 10% annually for a second consecutive time this year. However, this is a huge improvement from the 40-50% levels seen in the second half of the 2010s. Under the recession scenario, the 2023-24 net debt to GDP figure would increase to 36.7% instead of going down to 35.7%. Fortunately, the mid-year update includes a provision for economic risks of $1B in 2022-23, $2B in 2023-24 and 2024-25, and $1.5B thereafter until 2026-27. This total reserve of $8B is significant because the alternative downside recession scenario would add $5B increase in deficits over this 5-year period. For 2022-23, borrowing requirements are reduced to $25.9B (of which $16.2B is already completed), a small $1.7B reduction versus the March 2022 budget. In 2023-24, they are projected to increase at $27.6B, and average $30.6B annually for the next three years, reflecting higher than usual maturity. The update indicates that the Province has achieved 8% of its borrowing in foreign markets for 2022-23, compared to an average of 27% over the past 10 years. The average maturity of Quebec's public debt stands at 11 years, same as Ontario. Also, the government continues to be a regular Green Bonds issuer, tapping the market twice so far this year in that respect. The Quebec Green Bond framework received the highest possible rating from the Center of International climate Research.

All in all, the mid-year fiscal and economic update reflects the deterioration of the economic situation and increasing financial support in response to high inflation. The provisions are sufficient to counter possible unpleasant economic surprises. Finally, investors will have to pay attention to crucial fiscal developments that will occur in 2023. First, the government is poised to deliver on its promise to establish a new debt reduction plan, which could be tied to average net debt-to-GDP ratio observed in other provinces. This could alter the path of the Generations Fund beyond the expected fulfilment of the electoral promise relative to personal income tax cuts financed with future transfers to the Fund. Accordingly, future dedications to the Generations Fund, kept intact in the fiscal update, are subject to downward revisions (39% of contributions will be necessary to finance tax cuts according to Premier Legault's comment last summer summer). Second, the spending outlook could be altered on the upside, depending on the outcome of the upcoming wage negotiations between public sector employees and the Quebec government. Existing contracts end in March 2023. Unions ask for a 2%-3%-4% annual increase for 2023-24-25 on top of an inflation-protective adjustment.

Luc Lapointe | Senior Economist
514 350-2924| Lapointel@vmbl.ca

Sébastien Lavoie | Chief Economist
514 213-4571| LavoieS@vmbl.ca