ECONOMIC RESEARCH AND STRATEGY

LAURENTIAN BANK SECURITIES

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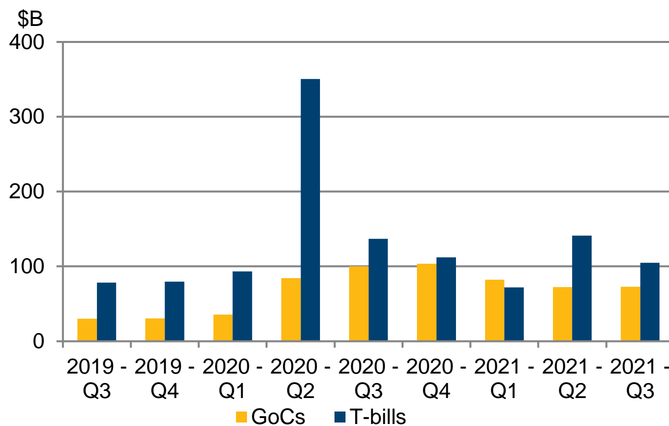
Sébastien Lavoie,
Chief Economist
LavoieS@vmbl.ca
514 350-2931

Dominique Lapointe, CFA,
Senior Economist
LapointeD@vmbl.ca
514 350-2924

Federal Economic and Fiscal Update – Fiscal improvement but the pandemic fight continues

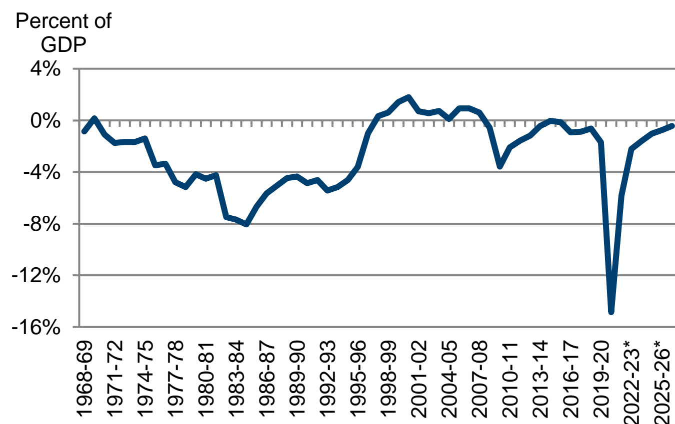
The fight against the pandemic remains front and center. Consequently, this federal Economic and Fiscal Update did not take the form of a mini budget. The government appropriately judged it is not the most appropriate time to introduce several initiatives included into the Liberal electoral platform. Thus, the update does not include measures to improve housing affordability related to the CMHC insured mortgages. Our understanding is that some of the spending and tax policies previously proposed by the government, such as the tax hike on banks and insurance companies, could be included in the 2022 budget. Altogether, this update reveals a somewhat improved fiscal situation relative to Budget 2021 released in April. Reflecting these developments, we note that both federal bonds gross issuances have declined in recent quarters (chart 1).

Chart 1: Federal Bonds and T-Bills Gross Issuances



Source: Bank of Canada, Haver Analytics.

Chart 2: Federal Government Budgetary Balance



Source: Government of Canada, Statistics Canada.

Small improvement to the FY 2021-22 deficit and bond issuance program vs budget forecasts

The final numbers for FY 2020-21 indicate a gigantic $328B deficit representing a record-high 15% of GDP (chart 2). The FY 2021-22 shortfall is now projected at $145B (5.8% of GDP), compared to $154B (6.4% of GDP) in the April 2021 budget. This small, short-term improvement in federal public finances looks pale relative to what investors have now been accustomed to in the recent round of provincial fiscal updates. Better-than-expected federal results first and foremost come from a solid rebound in nominal GDP, bumping up revenues by $16B. Expenses have also been revised down as the stronger-than-anticipated economic recovery diminishes the projected cost of emergency income programs and extraordinary transfers to provinces. However, the gap between revenues ($371B) and expenses excluding net actuarial losses ($505B) remains large in FY 2021-22 considering that nominal GDP stood 7% above pre-pandemic levels in 2021Q3.

The downward revision to FY 2021-22 borrowing requirements is somewhat subtle. T-bills levels fall by $28B, to $198B. At $255B, GoCs issuances are projected $35B lower relative to the April estimate. Most of the revisions to the bond program will occur in the 2-year (-$9B), 3-year (-$7B) and 5-year (-$8B) sectors. Smaller revisions have been made to 10-year (-$5B) and 30-year (-$2B) bonds. By maturity, the objective is to reach a 53% share of bond issuances at the 2-year,3-year and 5-year sectors versus 71% in FY 2020-21 and 85% in FY 2019-20. In other words, the debt management strategy continues to focus on the long end of the curve. The remaining 2% will go to green bonds ($5B), with the framework to be released by the end of 2022Q1.

COVID-19 near term uncertainty persists

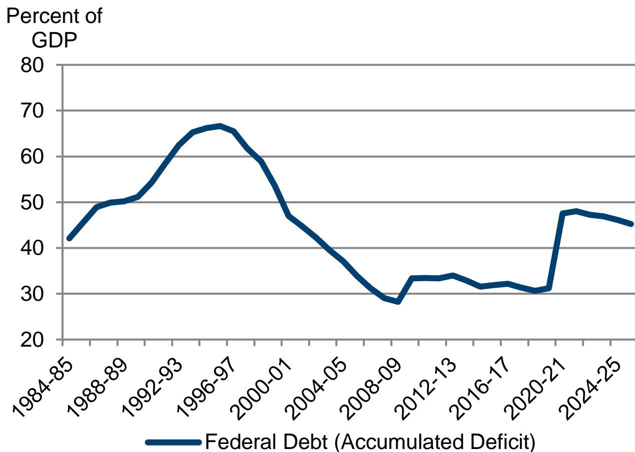
New spending has been split into three parts: 1- $29B this fiscal year for the unfinished fight against the pandemic, including a $4.5B provision for the Omicron variant and $1.5B for rapid testing; 2- $5B in provision to support British Columbia recovering from recent floods; 3- $40B in financial compensation for First Nations children and families over 5 years, including $20B already booked in FY 2020-21 and 2021-22.

Financial support programs could be extended if necessary, including the Recovery Caregiving and Recovery Sickness Benefits. A new $300/week Worker Lockdown Benefit is proposed for Canadians working fewer hours because of economic restrictions. Low income seniors and students are eligible for a one-time payment, a $0.8B measure. These would prevent financial distress if labour market conditions deteriorate again. As of November, they had already improved markedly according to the “fiscal guardrails” measured by Finance Minister Chrystia Freeland. Indeed, at 6.0%, the unemployment rate is almost back to the 5.7% print from February 2020. The 61.4% employment rate is only 0.4pp below pre-pandemic level. The total number of hours worked by Canadians is back to pre-COVID levels.

Improving medium-term path

The 5-year fiscal outlook revealed in this update, still subject to spending and tax changes in Budget 2022, shows an improved fiscal path. Deficits shrink toward a manageable amount of less than 1% of GDP in FY 2025-26 (chart 2). The federal debt-to-GDP ratio of 48% in FY 2021-22 is projected to decline steadily to 44% in FY 2026-27, compared to 31% before the pandemic hit (chart 3).

Chart 3: Federal Debt



Source: Government of Canada, Statistics Canada.

Bottom Line: Pandemic and Inflation Fight First, Electoral Promises Later

The near-term picture has improved even if the current federal government continues to spend a large share of upside surprises to revenues. There are several electoral promises still in the pipeline. The Liberal platform from the last election included about $75B in new spending over 5 years, partly offset by $25B in new revenues. This implies that most of the financing will come from borrowing. At first glance, the situation in Washington contrasts with Ottawa. For instance, the U.S. Build Back Better plan, if adopted, will be mostly financed by tax increases

over a 10-year period, as explained by the University of Pennsylvania. This being said, it is preferrable to wait until the world moves closer to the endemic phase before adopting a myriad of new revenue and spending measures. Also, the economic well-being of Canadians is challenged by the current two-decade high inflation rate. This certainly played a role into Minister Freeland's decision to renew the Bank of Canada 2% inflation target on Monday. We see the addition of inclusive labour market outcomes as conditional to where CPI inflation stands. If inflation runs within the 1-3% operating band, the BoC will have more flexibility to improve labour market outcomes, if judged necessary, by keeping an easier monetary policy stance.

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

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