ECONOMIC RESEARCH AND STRATEGY

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Federal Budget 2021 – More support during and after the pandemic and a reshuffling of the debt management strategy

Finance Minister Chrystia Freeland presented today the first federal budget in over two years. In a nutshell, we used to say 2021 and 2022 were going to be a consumer-led recovery. Now, we can add to our statement that a government-led recovery is also on the front burner. First, emergency support programs are extended for individuals and businesses adversely still affected by pandemic. Second, Budget 2021 also introduces several incentives to foster an inclusive economic recovery and promote potential GDP, chief among the national childcare program. The improving economy will contribute to shrink the cyclical deficit. However, the long term deterioration in public finances will be felt for long with a debt-to-GDP ratio staying close to 50% over time. The surge in public debt leads to a major makeover of the debt management strategy that won't go unnoticed by the bond market, namely the decision to issue relatively more 10YR and 30YR bonds in order to protect public finances against the refinancing rollover risk.

More than $100B to bridge the end of the pandemic, foster the recovery and boost potential
The recovery has been uneven so far, particularly observed based on labour market data guiding the federal government's actions. For instance, the employment rate and total hours worked were only 1.3% and 1.2% below pre-pandemic levels as of March 2021. However, youth unemployment and involuntary part-time work remain elevated. This incomplete recovery partly explains the federal government's decision to inject $145B in new spending announced over the next five years, an amount combining measures of the 2021 budget and 2020 Fall Update. In FY 2021-22, the bulk of new program spending relates to short-term pandemic support ($27B). Emergency programs won't end in June. The federal government extends the Canada Emergency Wage Subsidy until September but the weekly payment will diminish over time. The Canada Recovery Benefit is prolonged by 12 weeks but claimants will get $300 per week instead of $500 starting mid-July. Employment Insurance, Canada Emergency Rent Subsidy and Lockdown Support programs are also extended. The budget document specifies that emergency programs will be extended further if the pandemic worsens.

The flagship fiscal policy of this budget relates to the introduction of a national childcare program. One objective is to cut childcare fees by half by 2022 and cap daily fees at $10/day by 2026, outside Quebec. Creating this ambitious plan will cost $30B over five years and $8.3B per year to run on a permanent basis. Our understanding is that the next big step is discussion about new federal "child care" transfers that will require equal funding from the Provinces. Several studies show the Quebec's success story over the last two decades: the higher participation rate of women generates more dollars in tax receipts relative to the cost of running the daycare program. There are too many targeted policies in this budget to name them all. We notice several business tax incentives to adopt clean technologies in order to achieve net-zero emissions by the year 2050. All in all, time will tell if the myriad of spending initiatives announced in the budget will add about 300K jobs and 2% to the level of real GDP as cited in the budget document.

Strong Economic Rebound, No Major Tax Hikes

Total expenses are projected at $498B in FY 2021-22, representing 21% of GDP. In comparison, total revenues are projected at $355B, or 15% of GDP. The Government of Canada uses the average private sector economic forecasts to come up with the revenue outlook. Real GDP growth is projected to rebound by 5.8% and 4.0% in 2021 and 2022, respectively. The story is simple: All tax revenue categories will exceed pre-pandemic levels by FY 2021-22, led by PIT and GST due to the unusual improvement of household income during this recession and confident consumers looking to spend part of their excess savings in the coming quarters.

Budget 2021 does not include major direct and indirect tax changes. The introduction of a 3% digital services taxes will become effective January 1st, 2022, and raise $3.4B over five years. Ottawa is ready to move alone even if OECD countries fail to reach a multilateral agreement on this topic. They failed to reach an agreement last Fall but new discussions are expected in the coming months. Also, a luxury tax on items such as expensive motor vehicles, boats and personal aircrafts will increase revenues by about $0.6B per year. Overall, the budget details previously announced tax measures estimated to add about $8.3B in revenues over five years.

The tax environment could change further down the road. In the budget, we learn that the federal government will consult importers, exporters and provinces on a border carbon adjustment tariff in the coming weeks. In our view, it could only be implemented in harmonised way with the United States, the European Union and other developed economies to avoid competitive disadvantage.

Overheating Housing Conditions to Stay: No Bold Measures Announced Today
The government will introduce a national annual 1% tax on the value of non-resident vacant or underused real estate, effective January 1st, 2022. This measure is expected to add $0.7B in the coffers over four years. Some investors owning empty units will be tempted to rent them out, a behaviour we observed with the 2% vacancy tax rate effective in B.C. We do not think this measure will fix the major supply shortage in place. Fortunately, housing starts have hit record high during the last six months and will contribute to restore a better demand-supply equilibrium. Clearly, there is nothing in this budget to shift the current housing market psychology: Canadians' expectations relative to home prices appreciation are at a record high according to the BoC Survey of Consumers released a week ago.

Shrinking cyclical deficit but a persistent structural shortfall
In terms of bottom line, what it comes down to? Fading emerging support programs and higher revenues will melt down the deficit by more than half, from $354B in FY 2020-21 (16.1% of GDP) to $155B in FY 2021-22 (6.4% of GDP, chart 1). In FY 2022-23, program expenses fall further and the deficit shrinks to $60B (2.3% of GDP). Program expenses are forecast to grow at roughly half the average annual pace for revenue over time (1.4% versus 3.3%).

The government falls short of showing a roadmap to eliminate the $31B deficit of FY 2025-26 representing 1.1% of GDP. Instead, the government establishes a fiscal anchor defined as a very gentle decline of the debt-to-GDP ratio over time. The level of federal debt will nearly double because of the pandemic, to $1.2T in FY 2021-22 versus $721B pre-pandemic. Thus, the debt-to-GDP figure will increase to its highest level since the mid-1990s, to 55.4% in FY 2020-21 (chart 2). The ratio will softly decline from 51.2% in FY 2021-22 to 49.2% over four years, which can be easily interpreted as a stable situation rather than a concrete improvement. This fiscal anchor shows a sustainable fiscal position but not a comfortable one. Thus, we cannot exclude the possibility of a downgrade or negative watch from credit agencies.

Get Ready for Additional Longer Term Debt Issuance
Total uses of borrowings add-up to $523B in FY 2021-22, down from $703B in FY 2020-21. Financial requirements amount to $191B, mainly composed to this year's $155B deficit and other non-budgetary transactions such as pension valuation and accounts adjustments. Financing will be met with a 44%-56% split between Treasury Bills and Bonds.

The amount of T-bills at the end of FY 2020-21 came down from $329B in the 2020 Fall Update to $219B in Budget 2021 as lower amounts were carried through toward the end of the fiscal year. For the end of FY 2021-22, the government targets a $226B record amount.

Bond issuance is projected at $286B in FY 2021-22, down from $374B in FY 2020-21. The big news for the bond market relates to the composition of issuance. Not all sectors on the curve will see fewer issuance than a year ago. The GoC will reduce 2-year, 3-year and 5-year issuance by $53B (-41%), $20B (-36%) and $34B (-41%), respectively. Meanwhile, 10-year issuance will soar by $10B to $84B, or 37% of the entire bond program. This contrasts with the 2019-20 bond program where only 9% of total issuance was tied to 10-year bonds. 30-year issuance will remain intact at a record high of $32B in FY 2021-22. Also, the government plans to reopen its ultra-long 50-year bond maturing in 2064 with $4B in issuance.

Given the elevated level of public debt in years to come, our understanding is that the debt management team of the federal government decided to mitigate the rollover risk going forward. The sensitivity measure provided in the budget shows a 100 basis points increase on the entire yield curve would deteriorate the budgetary balance by $1B the Year 1 and close to $4.5B in Year 5. Public debt charges are projected at $22B in FY 2021-22, or at 6.2% as a share of revenue (PDC). Under the base case scenario projection, PDC will remain manageable under 10% over time. The preference of issuing 10s, longs and ultra-longs will bring up the average debt maturity to 8 years over three years, the highest in over 40 years. In comparison, the average debt maturity between 1981 and 2020 was 5.9 years in Canada. Also, the average debt maturity of U.S. federal debt stood close to 5 years in late 2020. Market participants will now turn their attention to the BoC possible QE tapering announcement of Wednesday under these new conditions. The composition of tapering should not be influenced by the preference of the government to issue more long term bonds since the BoC has explained the main objective of QE is to aim for low financing rates for households and businesses. Accordingly, steeper 5s30s and 2s30s curves appear appropriate.

Our last words go to the official announcement relative to the upcoming $5B inaugural sovereign green bond for FY 2021-22, subject to favourable market conditions. A green bond framework will be published in the coming months, detailing eligible use of proceeds in green infrastructure, tech innovations and nature conservation, among others. The government will also consider the possibility of issuing a social bond, likely for FY 2022-23. Reducing homelessness and financing the national childcare program could be potential use of proceeds.

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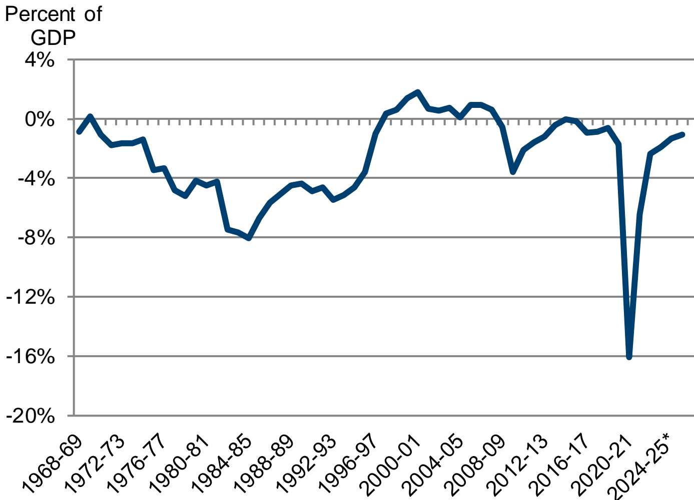
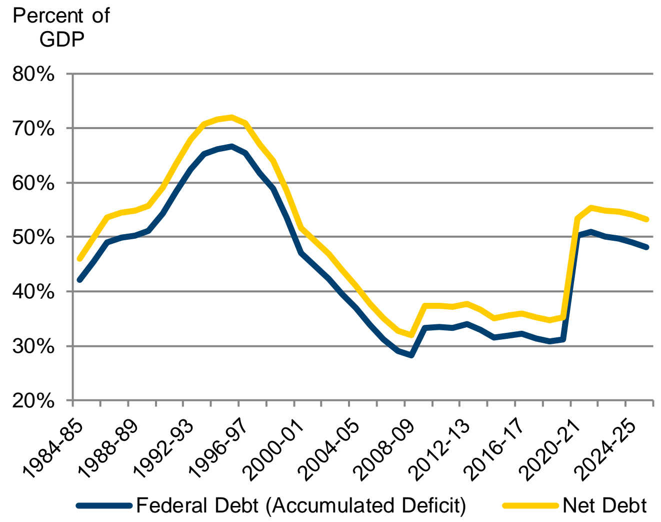
Chart 1: Federal Government Budgetary Balance



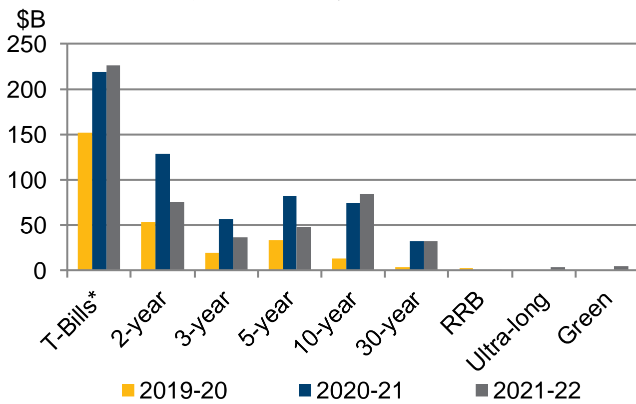
Source: Government of Canada, Statistics Canada.

Chart 2: Government of Canada Debt



Source: Government of Canada, Statistics Canada.

Chart 3: Debt Management Strategy (Actual and projected supply)



* Outstanding amount at year-end.

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