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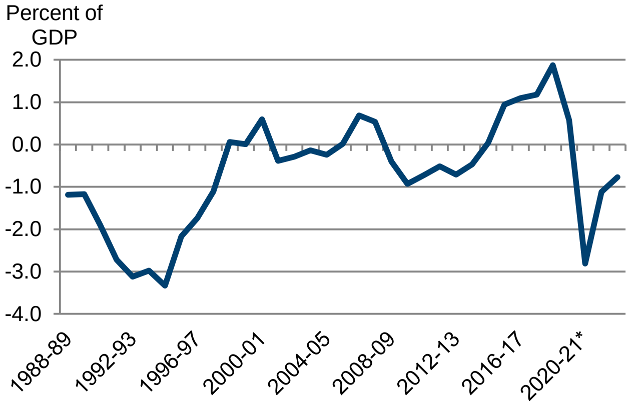
Quebec Fiscal Update 2020 – First steps into deficit reductions

Due to COVID-19 related uncertainty, the government of Quebec opted to provide a review of the financial situation for this year and limit its forecasts to the next two years, echoing the approach privileged by the Ontario government last week.

No change to the deficit this year

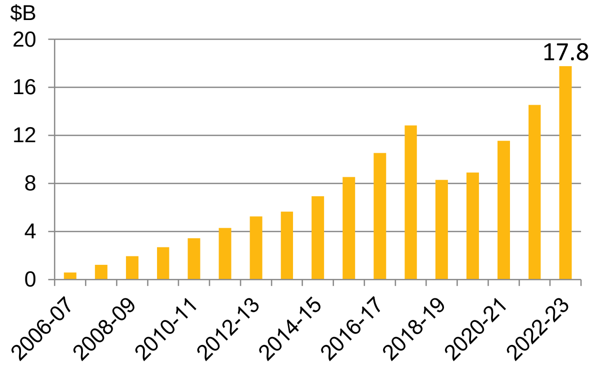
Relative to the June Update, the deficit for FY 2020-21 is unchanged at $15B (-3.4% of GDP), or $12.3B (-2.8% of GDP) before transfers to the Generations Fund (chart 1). This result from the net zero impact of upward revisions to revenues offset by additional measures introduced since June to support individuals and companies during this public health crisis. Overall, COVID-related spending measures totalling $10.5B have been implemented in FY 2020-21. Relative to the pre-COVID March budget, the story is similar to other provinces: program spending soared, debt servicing declined, own-sources revenues plunged and federal transfers surpassed expectations. Furthermore, market participants will notice that annual sums dedicated to the Generations Fund are maintained over time. After adding $2.7B, $3.0B and $3.2B in FY 2020-21, FY 2021-22 and FY 2022-23, the accounting value of the fund will reach a record $17.8B, or 4% of GDP (chart 2).

Chart 1: Quebec Budgetary Balance



Note: *Before* transfers to the Generations Fund.
Source: Quebec Government, GoC Fiscal Reference Tables, LBS Econ. Res. and Strategy.

Chart 2: Book value of the Generations Fund



Note: In FY 2018-19 and 2019-20, the government withdrew $8B and $2B from the Fund, respectively, to pay back the debt.
Source: Government of Quebec and LBS Econ. Res. and Strategy.

Deficits Cut by about half once the pandemic recedes for good

Real GDP annual growth forecasts are slightly revised up in 2020, from -6.5% in June to -6.0% in November, but revised down in 2021, from +6.0% to +5.0%. A key assumption is the availability of a vaccine by the end of 2021, allowing real GDP to return to its pre-pandemic level in the first quarter of 2022. According to this central scenario, as revenue climbs back over the next two years and Covid-related spending recedes, the budgetary shortfall shrinks to $8.3B in FY 2021-22 and $7.0B in FY 2022-23, after transfers to the Generations Funds. Also, the three-year framework is based on a total 8.2% cumulative increase in public sector employees' wages and benefits. Public sector workers currently negotiate the renewal of their collective agreements with the government. Most employees are without a bargaining contract since last March.

We estimate that the Quebec economy is near a stagnation point in 2020Q4. But the second wave of infections in the province is worsening to a point where the government considers the option of temporarily closing down schools. Accordingly, large risk provisions of $4B (3.4% of revenue), $3B (2.5% of revenue) and $1B (0.8% of revenue) for this year and the next two are included in the financial framework. Those would be used in case additional measures to fight the pandemic and promote the economy recovery are necessary. This being said, the three-year path presented today is reinforced by the elevated efficiency rate found in Phase 3 trials of the Pfizer/BioNtech vaccine released earlier this week. Even if the second pandemic wave continues to worsen and cause another contraction in Quebec's economic activity, the plausible distribution of vaccines in 2021 will lead to a sustainable recovery in 2022 and beyond. In a way, economic uncertainty appears higher in the short-term than in the medium-term.

Large borrowing requirements remain over the next two years

Relative to June, a minor $0.4B upward revision to the borrowing program for FY 2020-21 occurred in the update, now expected at $32.5B. To date, the Ministry of Finance completed 90% of the program. Assuming a constant pace of issuance until the end of the fiscal year, Quebec is therefore very likely to conduct pre-financing for FY 2021-22 in line with previous years' average ($6B-to$7B). Beyond FY 2021-22, however, despite shrinking deficits, the borrowing program forecast for the next two years remains large: $35.3B and $31.8B with a little less than half due to refinancing activities.

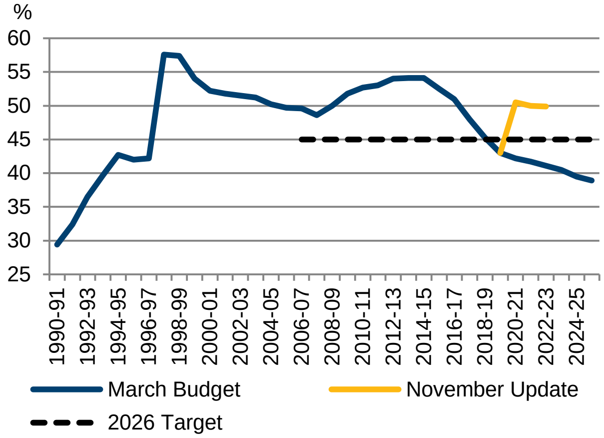
Eliminating the structural deficit: The harder part

The government of Quebec reiterated its intention to balance the books within 5 years, thus respecting the Balanced Budget Act. However, beyond the three-year period presented today, a $5.5B-to-$7.0B structural deficit will remain according to the government's estimates. Finance Minister Éric Girard plans to reveal how this structural shortfall will be eliminated in Budget 2021. Already, tax increases are not on the table. The government's strategy is to rely on stronger potential growth to generate more revenue beyond 2022. Another option lies in Ottawa's hands. Indeed, Quebec, like other provinces, request additional health care transfers from the federal government. A meeting on the topic this fall between provincial premiers and Prime Minister Trudeau has yet to be scheduled. Finally, spending growth will need to be addressed. Minister Girard repeatedly mentioned his intention to keep program expenditure growth around 3-3.5% on average, slightly below the 4% longer-term projection rate for revenue.

Revisiting the debt reduction objectives

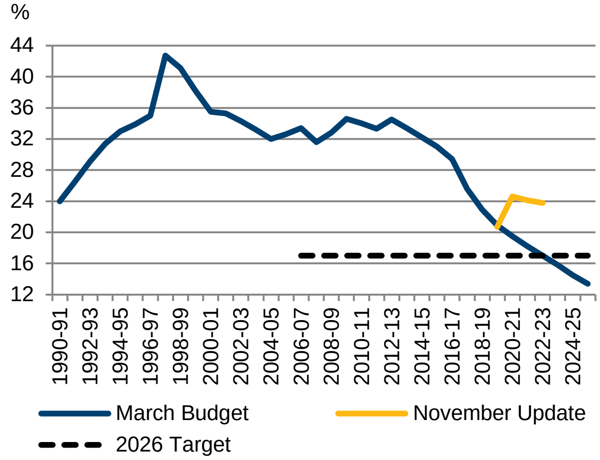
Budget 2021 will also be an occasion to revisit the legacy debt reduction objectives of reducing Quebec's gross debt-to-GDP ratio below 45% and accumulated deficits-to-GDP ratio below 17% in FY 2025-26. Pre-pandemic, Quebec was on track to reach both goals ahead of schedule. Today's update forecasts gross debt and accumulated deficits at 49.9% and 23.8% of GDP respectively, in FY 2022-23. It will be very hard to lower them back to their 2025-26 objectives within two years, a fact acknowledged in the update (chart 3 and 4). Accordingly, "the government will examine whether there is a need to review the *Act to reduce the debt and establish the Generations Fund*, particularly with regard to the achievement of the targets set for 2025-2026."

Chart 3: Gross Debt-to-GDP



Source: Government of Quebec.

Chart 4: Accumulated Deficit-to-GDP



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