Canadian Federal Economic and Fiscal Snapshot

A REFINED RESPONSE BUT NO RECOVERY PLAN YET

- **The Federal Finance Minister provided a first official glimpse of the impact of the pandemic on the Canadian economy and its finances today in his Federal Economic and Fiscal Snapshot.**
- **The Snapshot paints a sobering—but not surprising—picture with real GDP set to plunge by 6.8% in 2020 before a 5.5% rebound in 2021.**
- **The government expects to run a deficit of 15.9% ($343 bn) in 2020 with the blow to government revenues alone to contribute to almost a third of the shortfall. Meanwhile, the 2020 tally for COVID-19 spending climbed further to $230 bn.**
- **The bulk of the fiscal uptick reflects a near-doubling of the wage subsidy program to $80 bn to support an 'expanded and extended' program with details to come later this summer.**
- **Debt as a share of the economy is expected to hit 49% in 2020 with little indication of plans thereafter.**
- **Tougher policy decisions are largely punted down the road including how fiscal policy will evolve over time to support the recovery in the context of a longer-term framework to rein in debt.**
- **Overall, the Snapshot offers few surprises with the exception of increased borrowing activity that should modestly steepen Canada's yield curve. Otherwise, markets are likely to shrug off the larger deficit.**

"AN EXERCISE IN INVENTION AND IMAGINATION"

Canada's Finance Minister released his first economic update since the onset of COVID-19. A near-finished Budget 2020 was pulled last-minute in late March as it became clear the pandemic had rendered all plans and projections obsolete within a matter of weeks. Since then funding announcements have been made at a torrid pace but with little by way of the government's view on the state of the economy or the road ahead.

Real GDP is expected to contract by 6.8% in 2020 followed by a 5.5% rebound in 2021 (chart 1). As per tradition, this is informed by the average of private sector economists' forecasts, where an average annualized decline of over 40 per cent in Canada's real GDP is estimated in the second quarter of this year. These surveys are somewhat stale, now six weeks on, but they are broadly consistent with Scotiabank Economics' forecasts if not modestly more positive.

"The worst is behind us but recovery will be gradual and uneven." The government highlights industries hit hardest and where the recovery will be challenged by physical distancing constraints including the restaurant, accommodation, and travel industries. But few industries are spared in the government's projections as dampened demand will feed through almost all

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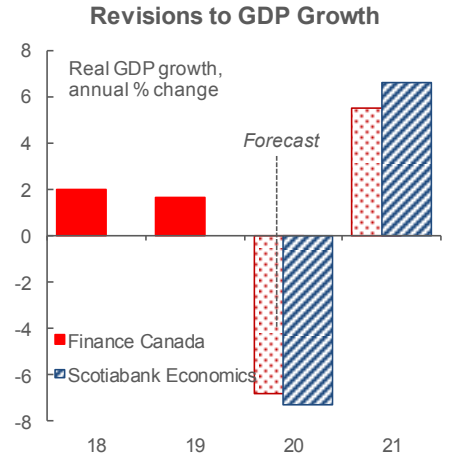
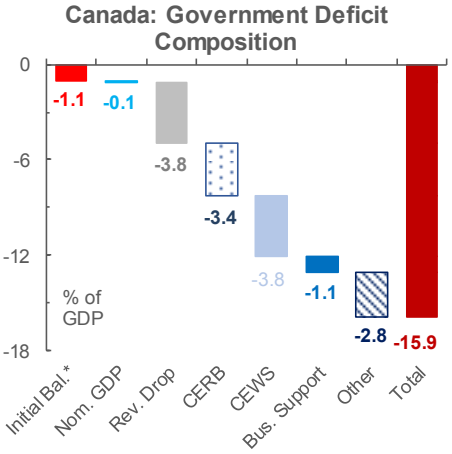
Chart 1



Sources: Scotiabank Economics, Finance Canada.

Chart 2



* Net of $3 bn contingency. Sources: Scotiabank Economics, Finance Canada.

sectors. Lower oil prices are also expected to weigh on the recovery with conservative WTI forecast at a USD32 bbl for 2020 against projections of USD57 in the December 2019 Fiscal Update.

Fundamentally, Canada's economic recovery hinges on its ability to effectively keep COVID-19 transmission down according to the Snapshot. Its outlook focuses predominantly on pandemic-related downside risks in an environment where there is no shortage of other risks including various geopolitical and trade tensions. Needless to say, uncertainty clouds the horizon.

EXPANDING NUMBERS ON THE FISCAL FRONT

A deficit of $343 bn—or 15.9% of GDP—is expected in 2020. This includes $230 bn in discretionary spending in response to the pandemic. The number is substantial but arguably comes as little surprise. The Finance Minister has been providing biweekly updates to Parliamentary Finance Committee with the end-June tally sitting at $193 bn in pandemic-related spending.

The uptick in the price tag for pandemic spending largely reflects an extension and expansion of the wage subsidy program. The Canada Emergency Wage Subsidy (CEWS) was allocated an additional $35 bn to bring the program to $80 bn. Its uptake so far has been disappointing. As of the end of June only about $16 bn had been disbursed to businesses. The government indicates it will announce new parameters for the CEWS shortly.

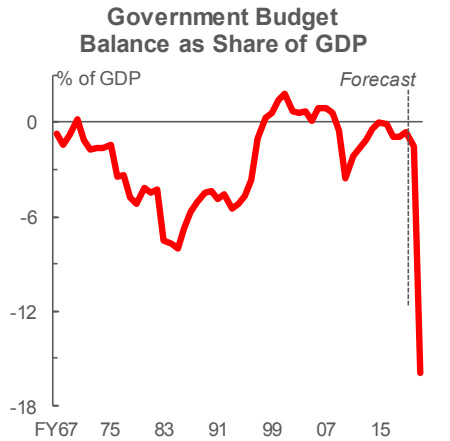
Meanwhile, the uptake for the Canada Emergency Response Benefit (CERB) has exceeded expectations. The Snapshot incorporates figures for the 8-week extension announced two weeks ago, but does not provide additional details on longer term plans for further income supports when the current term is reached at the end of the summer. This will remain a fiscal pressure.

Otherwise, a substantial hit to government revenues is expected to contribute to about a third of the budget shortfall this year. The Snapshot projects corporate tax receipts will plummet by 22% compared to 2019, while personal income tax and GST receipts could fall by 14% and 20%, respectively. These three items comprise about 80% of federal government revenues. Revenue as a share of the economy is expected to fall to an all-time low of 12.5%.

Expenditures meanwhile are expected to spike to an unprecedented of 28.4% as a share of GDP. The largest increases flow from employment-related transfers to households (with a 53% y/y increase), followed by transfers to households with children (11%), and the elderly (5%). These largely reflect the CERB, as well as one-off payments under the Old Age Security / Guaranteed Income Supplement, GST, and Canada Child Benefit programs. As they are temporary by design, these expenditures should fall back relatively quickly.

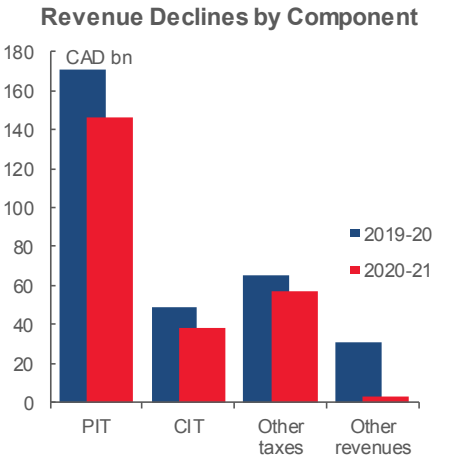
However, the government will necessarily run a high deficit in 2021 as automatic stabilizers alone will likely leave trailing budget shortfalls. While the Snapshot does not project its balance beyond the current fiscal year, Scotiabank Economics estimates a deficit in the order of -5% of GDP *before* accounting for any additional discretionary spending next year. This would largely reflect a slow climb-back in government revenues and elevated automatic expenditures over the course of the recovery.

Chart 3



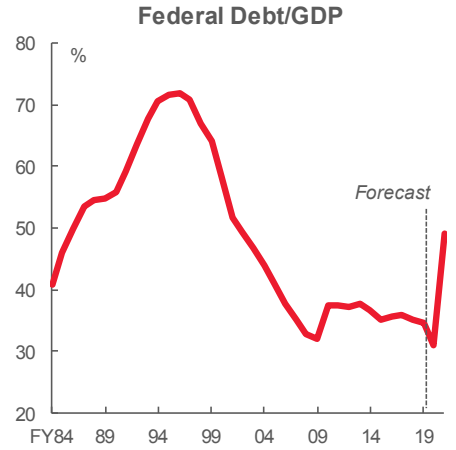
Sources: Scotiabank Economics, Finance Canada, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Finance Canada.

Chart 5



Sources: Scotiabank Economics, Finance Canada, Statistics Canada.

TIMELY, TARGETED… AND TEMPORARY

Earlier work by Scotiabank Economics gave relatively high marks for the federal government's fiscal response to the pandemic *so far*. Our modeling suggests economic output losses could have been about 3 ppts greater without the substantial support—the Snapshot concurs with this estimate. The government was able to get support out quickly to households that needed it the most. At the peak of the shutdowns in April, nearly one in four Canadians were impacted, particularly those employed in lower wage sectors. The first payments under the CERB were issued in early April and were sufficient in size to cover essential costs for the vast majority of affected households in Canada and exceeded the Finance Department's estimates of aggregate earnings shortfalls.

Transfers to businesses have faced greater challenges. The wage subsidy program was not operational until early May, while the government itself acknowledged major shortcomings of the Canada Emergency Commercial Rent Assistance (CERCA) program. The expansion of the wage subsidy today should be welcome news to Canadian businesses and suggests that over $60 mn additional support in the form of direct transfers should flow to businesses over the next quarter. While 'timely' would have been ideal, it is likely a 'better late than never' for a majority of businesses that stand to benefit from these changes.

The onus on government now is to credibly demonstrate that these exceptional bridge supports are *de facto* temporary. While big-ticket items such as the CERB and CEWS were launched explicitly on a transitional basis, both have been extended and expanded several times already. Some degree of income support will be required over the course of the recovery as unemployment remains elevated, but it will need to provide appropriate incentives to return to work as economies continue re-opening, along with supporting programs to re-skill for those in sectors facing dismal post-pandemic recovery prospects. Today's Snapshot provides little insight in this regard.

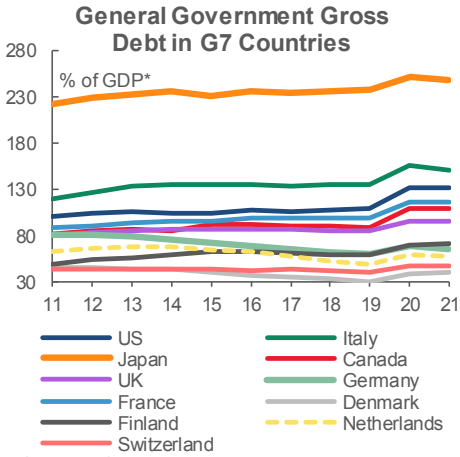
IT'S ALL RELATIVE

Canada's federal accumulated net debt is expected to soar to 49% of GDP or $1.06 tn (chart 6). Recall, in December the Finance Ministry projected net debt of 31% in 2020, with declines thereafter. But markets have not blinked at the pace of debt accumulation, not the least because all countries around the world are taking on similar liabilities—if not at a faster pace and from higher starting points. Canada's general government *net* debt (i.e., federal plus subnational debt after netting out assets) is still projected to be the lowest among G7 countries at around 41% in 2020, while its general government *gross* debt is among the lowest (charts 6 & 7).

Debt servicing costs should not impose the same degree of hardship as past periods of elevated debt burdens. The government in fact projects debt service costs to come in $4 bn less in 2020 despite burgeoning debt. With long term real interest rates expected to remain low at least over the course of the recovery (and likely beyond), debt servicing costs as a share of GDP are expected to increase only modestly in 2020, but still stabilizing below 2%. In contrast, debt servicing costs hovered around 6% of GDP in the early '90s (chart 8).

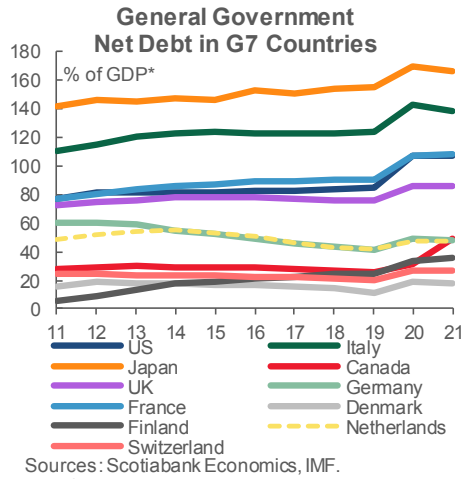
The government largely pays lip-service to debt consolidation. Minister Morneau has repeated in recent weeks that a fiscal anchor is needed to ground decisions in economic realities. He is no doubt aware of his explicit mandate to protect Canada's

Chart 6



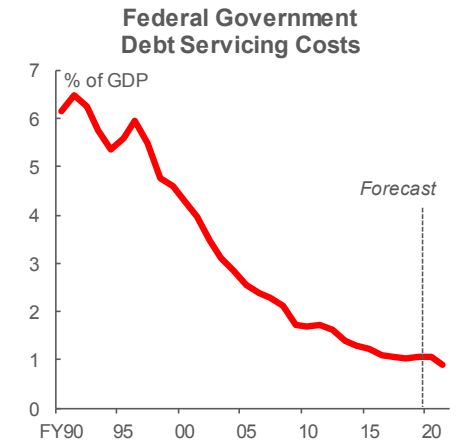
Sources: Scotiabank Economics, IMF.
*Data as of June 2020

Chart 7



Sources: Scotiabank Economics, IMF.
*As of April 2020

Chart 8



Sources: Scotiabank Economics, Finance Canada, Statistics Canada.

AAA credit status. But the Snapshot largely defers any practical considerations in this regard to a later date. For now, it appears a downward debt trajectory as a share of GDP may remain the soft anchor.

IS IT ENOUGH?

A downward debt trajectory is highly feasible provided additional discretionary spending is kept in check. Mathematically, the government can outgrow debt as a share of the economy over time in an environment of low interest rates. As the recovery takes hold, the government could be expected to re-ignite some of its 2019 platform commitments including an expenditure review and select revenue-raising measures to accelerate the consolidation path.

Minister Morneau has stressed that no new taxes are under consideration. He submits that "raising taxes is not what Canadians want us to do" though it may be premature to stake out such a position, at least economically. Prior to the pandemic, there had been growing calls, including from the International Monetary Fund, for Canada to holistically and comprehensively examine its tax architecture to ensure it best-supports growth and competitiveness in an increasingly integrated global economy. Such a review could potentially unlock stronger growth in a revenue-neutral manner, while potentially enabling greater redistribution to address equity concerns.

In the near term, the biggest challenge will be balancing views across party lines in a minority government context. The NDP have already voiced concern with a premature roll-back of government support, while the right-leaning Conservatives are calling for greater spending control. While not an incredibly binding constraint, a downward debt trajectory would likely preclude major new spending initiatives such as a universal basic income while rending pre-pandemic plans such as universal pharmacare more challenging.

MARKETS MATTER

Canada's AAA credit rating so far has largely been a political bragging right. The recent downgrade by Fitch Rating Agency may have provided political fodder, but otherwise has had no material market impact. Fitch has so far downgraded 33 sovereigns and warns of more to come in what appears to be a broad-based adjustment. Canada is still ranked as a top tier borrower with S&P Global Ratings and Moody's which last confirmed Canada's rating in November (2019) and May (2020), respectively.

Federal borrowing activity should continue to be well-subscribed though higher-than-expected issuance volumes announced today triggered a sell-off. More explicit guidance on the shift to term-out Canada's debt also contributed to curve steepening. The Snapshot set out borrowing needs of $713 bn in fiscal year 2021 once refinancing, deficit financing, and non-budgetary activities are funded. The federal government has already raised almost $340 bn in T-bills and bonds issuances ($240 bn net) in the first two months of the fiscal year alone (i.e., April and May). Nevertheless the increase in borrowing activity is larger than anticipated even after netting out the Bank of Canada's purchases (i.e., at least $5 bn per week in bonds in the secondary market as well as its standard auction allotment of ~13%). This may put pressure on the Bank of Canada towards further actions as outlined here.

Overall, market spreads on Canadian federal government debt have remained relatively tight. Canada's debt securities offer an attractive, investment-grade yield pick-up in a yield-starved environment where more than USD13 tn government debt is trading in negative territory. The government currently projects the 10-year bond rate, for example, to pick up modestly to 1% in 2021 from 0.6% this year before leveling off slightly lower but still pales relative to the US. Further movements in yields will be informed by variety of factors including credible exits, potential responses by the Bank of Canada, as well as the trajectory of the pandemic.

Differentiation should only come down the road as those sovereigns that effectively navigate their economies through an unprecedented crisis begin to demonstrate credible frameworks for debt consolidation.

THE REAL BOTTOM LINE

Arguably, structurally low growth is the biggest longer-term risk to Canada's credit rating. The composition of spending becomes equally—if not more—important than the quantum of fiscal spending once the acute phase of the crisis is past. As the government makes necessary policy trade-offs, there should be a premium on investments that will strengthen economic growth potential.

In the coming months, the Liberal government will have to pull off its biggest challenge yet. It will need to resist pressures from the right to consolidate prematurely in a manner that could throw into jeopardy Canada's fragile recovery, while pushing back against pressures to ramp up indefinitely social spending on borrowed credit. All the while, finding a middle ground that unifies Canadians (and Canada's multi-layered governance structures) around a vision for more ambitious economic growth—and an unobjectionably sustainable medium-term fiscal trajectory—for the country as a whole.

The coming months will be telling. For now, market observers can safely give the government the benefit of the doubt but expect more this Fall.