

## Canadian Federal 2019 Economic & Fiscal Update

### THE NEW FISCAL TRILEMMA

- The Federal Finance Minister provided an update on the state of the Canadian economy and government finances today in the 2019 Economic and Fiscal Update.
- While the economic outlook has not changed substantively, deficit spending will increase on average by an additional \$7 bn annually, peaking at 1.2% of GDP over the next two years before declining.
- There are no major new announcements in the update apart from a modest expenditure review that will only partially offset last week's tax cut. The major change to deficit spending largely stems from substantial actuarial adjustments to pension obligations.
- Just days after receiving his mandate, the Minister already falls short of a key fiscal anchor of declining debt as a function of the economy. The debt-to-GDP ratio will in fact increase marginally this year to 31.0% of GDP where it will stay until FY22 before it begins to decline marginally.
- With substantial platform commitments still outstanding, the Minister will face tough choices if he is to credibly re-set debt on a downward trajectory as per his mandate.

### NEW MANDATE, SAME MESSAGE

Canada's Finance Minister released his first economic update under the new government with today's release of the Fall Economic Statement (FES).

Minister Morneau once again takes the reins of the Canadian economy, this time facing a slowing economy and stretched household balance sheets following a prolonged period of global uncertainty. In a minority government context, he faces a political minefield at all levels of government as he steers the fiscal path forward.

Today's update highlights the challenges the Minister will face in delivering on his agenda. After winning the election on net new spending pledges totalling \$25 bn over the next four years, the government has committed to pursuing "a responsible fiscal plan to keep the economy strong and growing". Last week, the Finance Minister was mandated to invest to improve quality of life for Canadians, while reducing debt, preserving Canada's AAA credit rating, and preparing for the next downturn. Some constraints will prove to be more binding than others particularly as last week's announced tax cuts largely constrict his room to manoeuvre without tax hikes or expenditure cuts down the road.

### AN EVOLVING ECONOMIC LANDSCAPE

The update takes a cautiously optimistic tone on its outlook for the Canadian economy. After repeated markdowns in growth expectations over the past year, this update forecasts a modest boost of 0.2 ppt to nominal GDP growth in 2019 and 2020 over Budget 2019 forecasts (to 3.6% and 3.7% respectively) before leveling off around 3.8%. Real GDP forecasts have not

### CONTACTS

**Rebekah Young**  
 Director, Fiscal & Provincial Economics  
 416.862.3876  
 Scotiabank Economics  
[rebekah.young@scotiabank.com](mailto:rebekah.young@scotiabank.com)

Chart 1

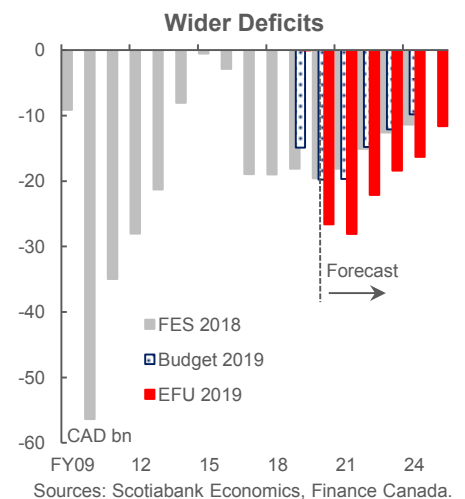
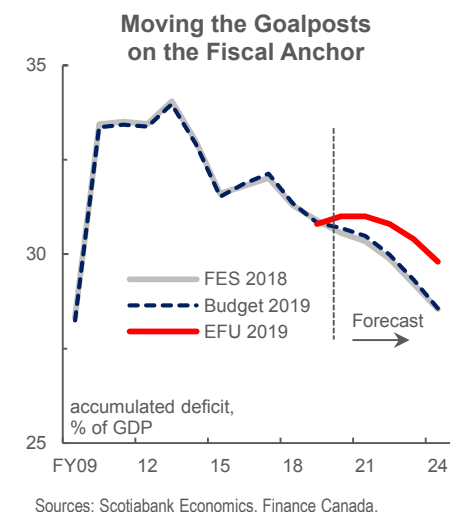


Chart 2



changed at 1.7% and 1.6% for 2019 and 2020 respectively. The update largely attributes economic resilience to strong labour markets and rising household incomes.

**The composition of risks has shifted since the last update.** Notably, trade uncertainty has abated somewhat with the recent signing of USMCA, along with signs of an abatement—if not improvement—in the US-China trade war. On the other hand, recent core Canadian economic indicators are sending mixed signals: recovering oil prices, strengthening housing markets, and a recent pickup in business investment stand in contrast to the recent loss of momentum in job growth. With Canada's resilience so far underpinned by solid household consumption that has stretched balance sheets, all eyes will be on a sustainable return of business activity. This presents both up- and down-side risks to the outlook.

### FEW SUPRISES ON THE FISCAL FRONT

**Canada's federal government balance sheet has largely been resilient against the backdrop of uncertainty over the past year.** The fundamental trajectory of fiscal trends is largely intact, however, headline numbers announced today are misleading as they incorporate annual charges in the order of \$5 bn related to actuarial losses on pension obligations in light of the low interest rate horizon. Once tax cuts are added in and expected savings from a modest expenditure review are subtracted (\$1.5 bn annually), net new deficit spending increases on average by \$7bn annually over the horizon above deficits anticipated in Budget 2019.

**Needless to say, deficit spending will continue.** The government now expects a deficit of \$26.6 bn in FY20, increasing to \$28.1 bn next year, before declining steadily to \$16.3 bn by FY24 (chart 1). The deficit will still be relatively modest, sitting at around 1.2% of GDP this year and next, before declining marginally to about 0.4% of GDP in FY25 (chart 2).

**Stronger-than-anticipated revenue growth has provided a partial offset to new policy measures announced since Budget 2019.** Revenue gains will provide an anticipated windfall of \$1.7 bn this year, and will continue to modestly increase thereafter. Personal income tax receipts largely drives the gains with growth of 4.7%, whereas the outlook for corporate income tax revenues is more pessimistic with an expected decline of 7.1%, though this should bode well for the growth outlook—should it transpire—as it assumes substantial take-up of the accelerated depreciation write-offs introduced last year. There is likely a degree of [prudence](#) built into the forecasts, particularly as mid-year fiscal updates from Canada's largest provincial economies reveal continued resilience. This should provide some upside to the federal balance sheet as the fiscal year advances.

**There is little headroom left for additional platform commitments absent additional revenue-generating measures.** Recall, net new spending under the Liberal platform amounted to about \$4 bn next year (FY21) ramping up to \$9 bn by FY24. Net metrics obscured a much bigger spend with one part savings measures to offset two parts of new spending pledges. This update wisely holds off on additional spending commitments in light of the current debt ratio path.

\$ bn	FY20	FY21	FY22	FY23	FY24
Budget 2019 (w/o risk factor)	-16.8	-16.7	-11.8	-9.1	-6.8
Less econ & fisc dev'ts	-4.2	-5.9	-4.1	-2.2	-1.5
Of which pension-related	-4.9	-7.6	-6.3	-4.8	-4.2
Less policy actions*	-3.4	0.5	0.9	1.1	1.0
Less 2019 tax cut	-0.7	-3.0	-4.1	-5.1	-6.0
Revised fiscal projections	-25.1	-25.1	-19.1	-15.3	-13.3
Plus risk factor	-1.5	-3.0	-3.0	-3.0	-3.0
New budget balance, \$bn	-26.6	-28.1	-22.1	-18.3	-16.3
New budget balance, % GDP	-1.2	-1.2	-0.9	-0.7	-0.6
Federal debt (% of GDP)	30.9	30.9	30.5	30.0	29.3
Remaining platform commitments (net)	0.0	-2.6	-4.3	-4.1	-3.8

\*Includes \$1.9 bn Hibernia Dividend in FY20.  
Source: Scotiabank Economics, Finance Canada, Liberal Platform, PBO.

Chart 3

### G7 General Government Net Debt

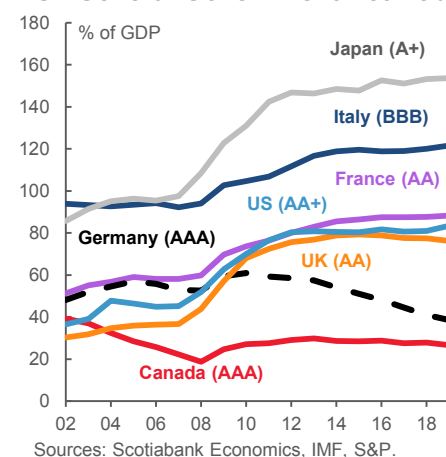
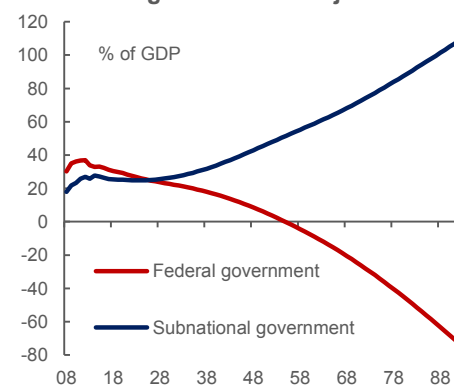


Chart 4

### Diverging Paths for Long-Term Debt Projections



## THE IMPOSSIBLE TRINITY (PLUS ONE)

**The Finance Minister has his work cut out for him as he sets out on his new mandate.** He has been asked to invest to improve Canadians' welfare, while keeping debt-to-GDP on a downward trajectory, protecting Canada's AAA credit rating, and saving for a rainy day. This will force some tough trade-offs as the minority government faces constant pressure to seek support from other federal parties, while rebuilding relations with key provincial governments.

**Canada's debt as a function of the economy will already breach one of these constraints.** Net debt-to-GDP will increase this year (FY20) and will only begin its descent in FY22. Even assuming the government gets one free-pass, little fiscal space remains thereafter. Under today's growth forecasts, there is essentially no fiscal room in the next two years. It is also subject to risk: a shock of just 0.2% of GDP could be enough to bend the ratio upward. Meanwhile, net new platform commitments stand at \$15 bn over the next four years even before substantial, but largely undefined, pressures related to implementing universal pharmacare and a transition to zero net-emissions by 2050 are factored in.

**Canada presently enjoys an enviable net debt position.** Its current relative fiscal stance remains among the best in the world with total debt across all levels of government (after netting out financial assets) amounting to about 27% by the end of last year. That positions Canada the best (or least worst) among peers and in some cases by a long shot (chart 3). Canada continues to offer a significant yield pick-up relative to many other global debt markets and that will likely dominate considerations in a reach-for-yield market environment. Today's modest federal deficit forecasts in the order of 1.2% of GDP are unlikely to impact market positions.

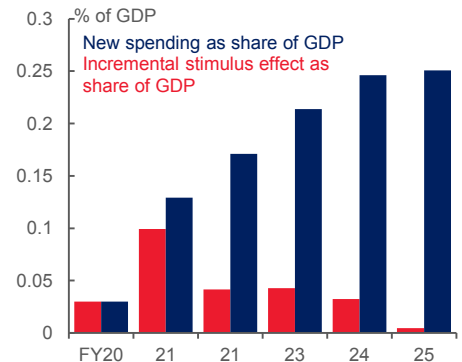
**But Canada's AAA status is a function of the economy as a whole and all of its governing institutions.** While the federal debt burden is set to decline in the long run, provincial debt levels will face pressure with aging demographics and waning productivity. While the PBO's annual projections (chart 4) should be updated shortly, the trend is unlikely to be substantially different despite current consolidation across provinces as there has been limited progress in addressing structural drivers of growth. Fitch fired a shot over the bow after last year's federal budget, flagging a longer-term concern in this regard albeit referencing *gross* not *net* general government debt. In a funding crisis, the latter arguably becomes more important. Nevertheless, linking his mandate to Canada's sovereign rating adds a constraint on the federal Finance Minister where he has few policy levers beyond more spending.

**Meanwhile, the Finance Minister must invest for "a better quality of life" for Canadians.** For the most part, promised spending will provide a small and transitory boost to growth, largely through transfers to households. The largest measure—the recently announced [tax cut](#)—will barely register as a rounding error relative to GDP (chart 5). Additional transfers promised during the election will go to households with a higher propensity to spend (e.g., seniors, students, parents of infants, disabled and sick). These should similarly provide a small and temporary lift to growth, but will do little to enhance the productive capacity of the economy which is ultimately needed to secure longer-term quality of life gains.

**The Minister is also instructed to preserve fiscal firepower for a downturn.** While no serious forecasters are calling an imminent recession (and even the most pessimistic scenarios in the update do not predict a recession), this is appropriate preparation as downturns are always costly. In past Canadian recessions, deficit spending has typically increased between 3 to 6% of GDP (peak-to-trough) above and beyond its starting fiscal position (chart 6). We have [estimated](#) Canada would need to run a deficit peaking at around 4% of GDP (or about \$75 bn annualized over six quarters) to respond to a recession today. Beyond preserving fiscal firepower, the Minister would be wise to also evaluate his policy tools to tackle a recession before they are needed including strengthening automatic stabilizers.

Chart 5

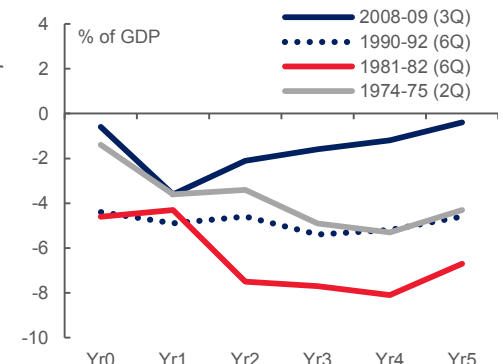
### Small Impact in the Bigger Picture



Sources: Scotiabank Economics, Finance Canada..

Chart 6

### Deficit Spending Following Past Recessions in Canada



Sources: Scotiabank Economics, Statistics Canada, Department of Finance, CD Howe

**FIRST AMONG EQUALS**

**A downward debt-to-GDP trajectory will continue to be the dominant fiscal anchor.** Today's update sets out a fiscal path aligned with campaign promises. The government will continue to run modest, but declining deficits that markets will shrug off. Investments will largely target household affordability by "putting money in the pockets of those who need it the most" in the government's own words. The soft anchor will provide a pushback to substantial new spending pressures, but any fiscal windfalls from upside risks will likely be spent.

**While deficits are modest, today's spending does little to enhance the productive capacity of the Canadian economy.** With a narrow output gap and employment tight in most markets, incremental spending is best directed towards investments that would strengthen Canada's growth potential such as reducing internal trade barriers, addressing infrastructure bottlenecks, or increasing female labour force participation. Direct transfers to households may modestly alleviate short-term pressures, but will do little to secure sustainable gains in quality of life that can only be achieved through stronger growth.

**All anchors get discarded in the event of a serious downturn.** The government would no doubt provide substantial stimulus should the Canadian economy take a major turn for the worse. Even running deficits in the order of 1% of GDP, government balance sheets would still be in a position to respond accordingly. Unfortunately, this reduces any binding nature of this constraint.

**Hopefully today's update provides greater clarity for the central bank.** Namely, a stay-the-course fiscal path for the federal government with some constraints on any major new spending pressures, against near-universal consolidation by provinces, suggests the Bank of Canada should not be anticipating any substantial fiscal support to Canada's economy in the near-term, as it noted in its recent statement that fiscal policy developments will figure into its updated outlook in January. A continued wait-and-see approach may miss the window for insurance cuts against an uncertain external environment and a weary consumer.

### Economic Forecast Assumptions

Annual % change except where noted

	19f	20f	21f	Average 21-23f
<b>CANADA - Real GDP</b>				
Finance: 2019 Budget*	1.7	1.6	1.7	1.8
2018 Fall Statement	2.0	1.6		1.8
Scotiabank Dec. 5, 2019	1.7	1.7	1.9	n.a
<b>GDP Deflator</b>				
Finance: 2019 Budget*	1.6	1.9	2.0	2.0
2018 Fall Statement	2.1	1.7		2.0
Scotiabank Dec. 5, 2019	1.5	1.7	2.2	n.a.
<b>Nominal GDP</b>				
Finance: 2019 Budget*	3.4	3.5	3.7	3.9
2018 Fall Statement	4.1	3.3		3.9
Scotiabank Dec. 5, 2019	3.3	3.4	4.1	n.a
<b>Unemployment Rate, %</b>				
Finance: 2019 Budget*	5.7	5.9	6.0	6.0
2018 Fall Statement	5.8	6.0		6.0
Scotiabank Dec. 5, 2019	5.6	5.8	5.8	n.a
<b>T-Bills**, 3-month, %</b>				
Finance: 2019 Budget*	1.9	2.2	2.3	2.4
2018 Fall Statement	2.1	2.4		2.5
Scotiabank Dec. 5, 2019 (%) eop)	1.7	1.3	1.3	n.a
<b>Bonds**, 10-year, %</b>				
Finance: 2019 Budget*	2.4	2.7	2.8	3.1
2018 Fall Statement	2.8	3.0		3.2
Scotiabank Dec. 5, 2019	1.5	1.5	1.8	n.a
<b>Canadian Dollar**, US\$/C\$</b>				
Finance: 2019 Budget*	76.3	77.2	77.7	78.6
2018 Fall Statement	78.4	78.7		80.3
Scotiabank Dec. 5, 2019 (eop)	76.9	80.0	80.0	n.a
<b>U.S. - Real GDP</b>				
Finance: 2019 Budget*	2.4	1.7	1.7	1.8
2018 Fall Statement	2.5	1.8		1.9
Scotiabank Dec. 5, 2019	2.3	1.6	1.9	n.a
<b>WTI Oil, US\$/barrel</b>				
Finance: 2019 Budget*	59	60	61	63
2018 Fall Statement	68	65		68
Scotiabank Dec. 5, 2019	57	55	62	n.a

\*Updated for historical revisions, retroactive change in Government's discount rate methodology for unfunded pension benefit obligations

\*\*Annual averages.

Sources: PBO election assumptions, Finance Budget 2019, Scotiabank Economics.

### Fiscal Summary

\$ billion except where noted

	FY19	FY20		FY21
	Final	Bud.	EFU	EFU
Personal Income Tax (PIT)	163.9	170.4	171.6	177.5
Corporate Income Tax (CIT)	50.4	46.3	46.8	49.1
Other Tax Revenue	66.4	69.0	67.6	69.6
<b>Total Tax Revenue</b>	<b>280.7</b>	<b>285.7</b>	<b>285.9</b>	<b>296.2</b>
Employ. Insurance (EI) Premiums	22.3	22.0	22.6	22.5
Other Revenue	29.1	28.7	31.6	33.6
<b>Total Revenue</b>	<b>332.2</b>	<b>338.8</b>	<b>340.1</b>	<b>352.3</b>
Elderly Benefits	53.4	56.2	56.1	59.5
Employ. Insurance (EI) Benefits	18.9	19.9	19.3	21.0
Children's Benefits	23.9	24.3	24.1	24.7
<b>Major Transfers to Persons</b>	<b>96.1</b>	<b>100.4</b>	<b>99.5</b>	<b>105.2</b>
Transfers to Other Levels of Gov't	75.9	76.9	76.3	79.5
Direct Program Spending	150.9	152.1	165.0	168.8
<b>Total Program Spending</b>	<b>322.9</b>	<b>329.4</b>	<b>340.8</b>	<b>353.6</b>
Debt Service	23.3	26.2	24.4	23.7
<b>Total Expenditure</b>	<b>346.2</b>	<b>355.6</b>	<b>365.2</b>	<b>377.4</b>
Adjustment for Risk	0.0	3.0	1.5	3.0
<b>Budget Balance</b>	<b>-14.0</b>	<b>-19.8</b>	<b>-26.6</b>	<b>-28.1</b>
<b>Accumulated Deficit</b>	<b>685.5</b>	<b>705.4</b>	<b>713.2</b>	<b>741.4</b>
<b>Annual Change, %</b>				
Personal Income Tax (PIT)	6.7	4.0	0.7	3.5
Corporate Income Tax (CIT)	5.4	-8.1	1.0	5.0
Total Tax Revenue	6.7	1.8	0.1	3.6
EI Premiums	5.5	-1.3	2.7	-0.4
<b>Total Revenue</b>	<b>5.9</b>	<b>2.0</b>	<b>0.4</b>	<b>3.6</b>
Elderly Benefits	5.4	5.2	-0.2	6.1
Employ. Insurance (EI) Benefits	5.4	5.3	-3.0	9.0
Children's Benefits	2.0	1.7	-0.8	2.5
<b>Major Transfers to Persons</b>	<b>2.5</b>	<b>4.5</b>	<b>-0.9</b>	<b>5.8</b>
Transfers to Other Levels of Gov't	7.6	1.3	-0.8	4.2
Direct Program Spending	3.1	0.8	8.5	2.3
<b>Total Program Spending</b>	<b>3.9</b>	<b>2.0</b>	<b>3.5</b>	<b>3.8</b>
<b>Total Expenditure</b>	<b>4.1</b>	<b>2.7</b>	<b>2.7</b>	<b>3.3</b>
<b>Memo Items, %</b>				
Tax Revenue / GDP	12.6	12.4	12.4	12.4
Total Revenue / GDP	14.9	14.7	14.8	14.8
Total Program Spending / GDP	14.5	14.3	14.8	14.8
Budget Balance / GDP	-0.6	-0.9	-1.2	-1.2
Accumulated Deficit / GDP	30.8	30.6	31.0	31.0
Debt Service / Revenue	7.0	7.7	7.2	6.7

Sources: Scotiabank Economics, Finance Canada, Statistics Canada.

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