

Certainty in Times of Uncertainty...For Now

CANADIAN FEDERAL FISCAL FINANCES OFFER FEW SURPRISES

- Canada's federal fiscal trajectory appears broadly in line with expectations when Budget 2021 was tabled.
- In an environment where markets are reacting to daily newsfeeds, budget assumptions are holding up surprisingly well given they were locked down five-plus months ago.
- Marginal improvements in the economic outlook could see deficit spending in the order of \$145 bn in FY22, not substantially far from the \$155 bn shortfall set out in Budget 2021.
- The wild card is discretionary spending: uptake in the wage subsidy program, in particular, has decelerated recently, mostly by design, but also on the back of an improving outlook. This could offer budgetary savings in the order of \$20 bn.
- But with income supports largely exhausted by their slated expiration this Fall and elections looming, our baseline assumes no savings materialize (in fact, elections potentially put upward pressure on further spending).
- With the Bank of Canada credibly winding down its Government of Canada asset purchase program, government debt issuance will increasingly face market price discovery as net supply turns positive.
- This week's move is relatively marginal, and, importantly, overshadowed by global developments. It is unlikely to materially impact federal finances at this stage, but as the Bank (and other key central banks) retreat from highly accommodative positions over the coming quarters, this should put modestly upward pressure on yields.
- With any hope, a Finance Minister in the next government will take a page from the Governor's book, ensuring any new spending plans are calibrated to the economic recovery.
- Otherwise, this Fall could see a confluence of expansive fiscal policy (especially once provincial support is included) working against monetary tapering as the output gap rapidly closes, putting even more pressure on interest rates (chart 1).

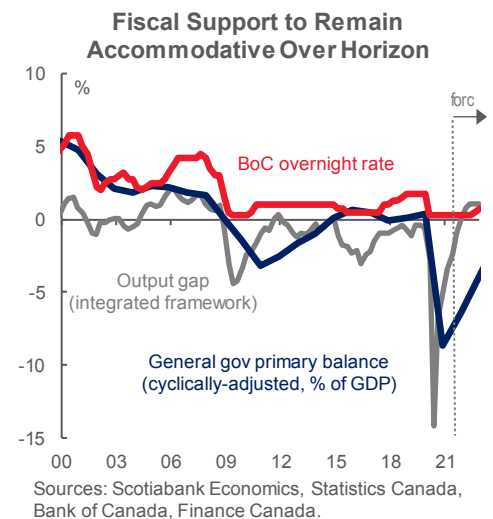
DANCING IN THE DARK

The strength of Canada's early recovery is credited to an economy firing on all cylinders (and of course its pandemic management). Early in the pandemic it was not uncommon for the Bank of Canada Governor and Finance Minister to appear jointly, as they pulled all policy levers at their disposal. It was arguably less about coordination, more an 'all hands on deck' approach.

CONTACTS

Rebekah Young
 Director, Fiscal & Provincial Economics
 416.862.3876
 Scotiabank Economics
rebekah.young@scotiabank.com

Chart 1



Coordination becomes all the more complex as the recovery advances and economic conditions suggest gradually taking the foot off the gas. This week the Bank of Canada once again pared back its purchases of Government of Canada bonds by another \$1 bn per week (to a targeted \$2 bn per week), signaling its growing confidence in the recovery. In its Monetary Policy Report, the Bank cautiously celebrated progress on the jobs front, while right-sizing its inflation outlook with a generally positive narrative that suggests downside risks to the outlook have diminished in Canada. (See a full assessment [here](#).)

This should mark a pivot—at least for markets—where the issuance of GoC bonds overtakes the rate at which the Bank has been sopping up these assets. And the pace of supply hitting markets should accelerate with widely-anticipated further curtailment in Bank purchases as the year advances. However, the net impact is also influenced by government supply. It is worth reexamining assumptions in this regard.

A TIME-TESTED BUDGET

Overall, the federal Budget 2021 still provides a reasonable line of sight on where issuance will go this year. Despite being tabled almost four months ago—and predicated on private sector forecasts another month prior—its assumptions generally hold with some tweaking. (This shelf-life is quite remarkable in pandemic times!) Real GDP, for example, was projected to land at 5.8% this year; Scotiabank Economics is currently projecting only a marginally stronger outcome at 6.1%. And much of the earlier upward momentum on interest rates had already been priced in (e.g., 10 yr GoC yield at 1.5% versus our forecast of 1.6% by the end of the year).

Inflationary pressures are more pronounced than anticipated in Budget 2021 which will have some impact on fiscal revenues. The GDP deflator is currently tracking higher (5.1% by Scotiabank Economics with revision-risk higher, against a budget assumption of 3.3%). A boost to nominal GDP growth should modestly pad government revenues, albeit partially offset by expenditures linked to inflation or nominal GDP.

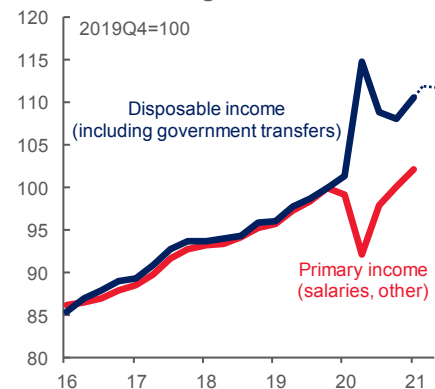
If the recovery continues to unfold as currently projected, such modest changes to assumptions could marginally improve the budgetary balance by about \$5–10 bn. Using Finance Canada's fiscal sensitivity assumptions, the bulk of this improvement would come from higher nominal growth projections. The increased cost of servicing public debt owing to the marginal uptick in interest rates is largely awash, again using Finance Canada's own sensitivities. (However, the actual fiscal impact is likely a couple of billion in positive territory once actuarial impacts—mostly around pension and benefit obligations—are included.)

KICKING THE TIRES

While an abundance of caution and caveats are warranted in forecasting in this recovery, Finance Canada's fiscal assumptions still appear largely appropriate. In the most recent Fiscal Monitor, the preliminary estimate for the FY21 fiscal balance shows a \$40 bn 'improvement' over the \$354 bn shortfall projected in Budget 2021. But end-of-year adjustments will likely close the gap by the time Public Accounts are tabled this Fall as a delayed assent of the budget bill precluded the inclusion of some measures.

Chart 2

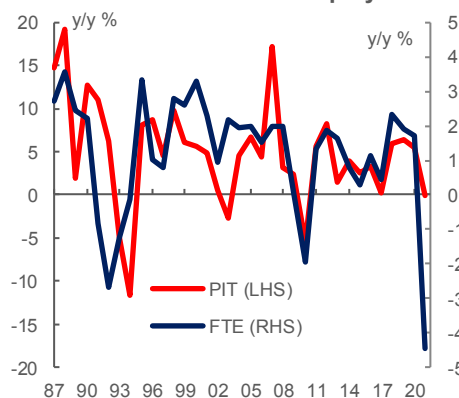
Government Transfers Offsetting Wage Losses



Sources: Scotiabank Economics, Statistics Canada (end Q1-21, Q2-21 notional only).

Chart 3

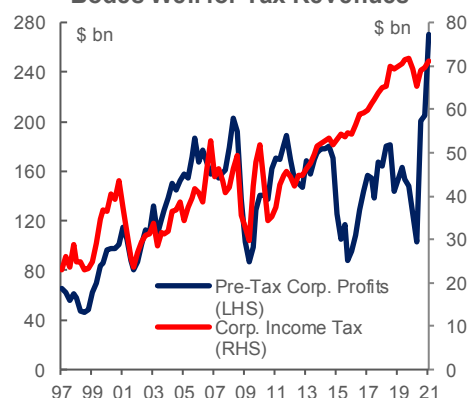
Personal Tax Revenue Historically Moves With Full-Time Employment



Sources: Scotiabank Economics, Statistics Canada, Finance Canada.

Chart 4

Surge in Corporate Profitability Bodes Well for Tax Revenues



Sources: Scotiabank Economics, Statistics Canada.

Otherwise, the hand-off to fiscal year 2022 was largely on the mark. Revenues land within 1% of projections at \$296 bn, while expenditures sit within 3% at \$613 bn. A late budget helped, of course, but in a year unlike any other, it is no doubt challenging to project fiscal impacts when policy levers have distorted—and in some cases inverted—past correlations.

Notably, extraordinary income supports to Canadian households have masked—and continue to mask—the impacts on employment. Historically, federal personal income tax revenues have closely tracked full time employment. However, each lockdown-induced dip in wage income has been coupled with a surge in disposable income. Generous government transfers have driven this M-shaped recovery for households (chart 2). Not surprisingly, PIT revenues barely dipped negative last year despite full time employment sitting well-below pre-pandemic levels (chart 3). Looking ahead, the 7% rise in these revenues penciled in for FY22 by Finance Canada appears reasonable at this stage, but with potential for material upside surprise to be reassessed as the year advances.

Corporate income tax revenues could similarly provide some upside for government coffers this year. These revenues represent a (trailing) second in contributions to federal government revenues (at 16% versus almost 50% from PIT). Prior to the pandemic, CIT revenues had been trending upward despite waning corporate profitability (chart 4). Corporate profits surged following the onset of the pandemic with preliminary estimates for CIT revenues up 2% last year despite the retrenchment in economic activity. Reassessments provide some further upside in backward revisions and a stronger hand-off to 2021, but overall, the 9% riser built into CIT revenues for FY22 by Finance Canada again seems to provide a reasonable guesstimate at this point.

THE (NOT SO) WILD CARD

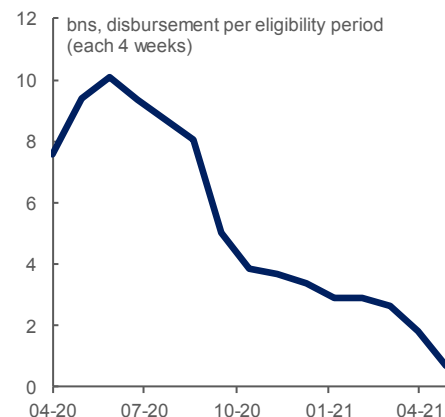
Discretionary expenditures on the other hand introduce a degree of fiscal uncertainty. Temporary pandemic-related expenditures—at about \$76 bn—account for the bulk of projected \$155 bn shortfall in FY22. Wage subsidy and income support programs alone comprise about 80% of direct support under the federal government's COVID-19 fiscal package.

The wage subsidy program could in theory punt savings to the bottom line. In a fire-first, aim-later approach, the program has undergone multiple revisions and extensions, while coming under scrutiny for disbursements to larger and more profitable firms, with unclear impacts on job protection. As of early July, the program had disbursed approximately \$86 bn against an allocation of \$110 bn. However, disbursements tail off dramatically as of June (chart 5), aided in part by re-openings, but more likely by design as revisions phase out support (and make soft payback threats to larger corporations). A best-guess is that this program, along with the far more modest Canada Recovery Hiring program, could peter out around \$90 bn by expiration in September. This would suggest savings in the order of \$20 bn.

Income support programs have had high up-take and are unlikely to offer much savings potential. The Canada Recovery Benefit (CRB), which took the baton from the Canada Emergency Response Benefit (CERB) in September 2020, has disbursed \$22 bn against its allocated \$27 bn as of early July. Claims dropped substantially in June as provincial economies re-opened (chart 6), a trend that should continue as

Chart 5

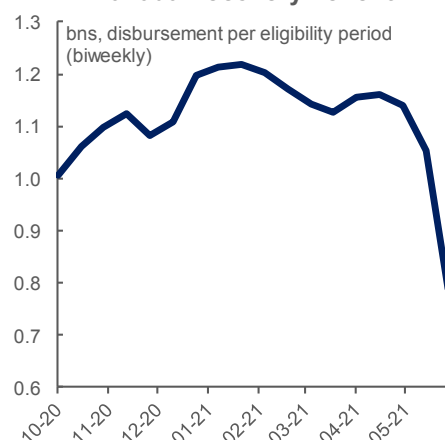
Canada Emergency Wage Subsidy



Sources: Scotiabank Economics, CRA.

Chart 6

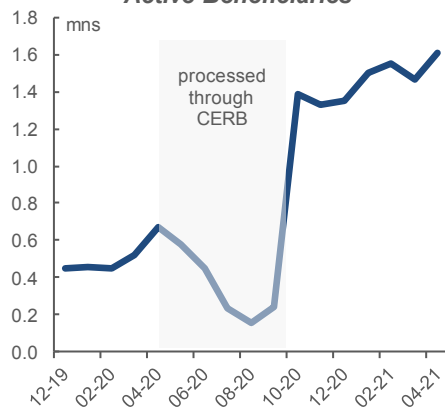
Canada Recovery Benefit



Sources: Scotiabank Economics, CRA.

Chart 7

Employment Insurance Active Beneficiaries



Sources: Scotiabank Economics, Statistics Canada.

labour conditions strengthen over the remainder of the year. Not only should the number of beneficiaries drop, the value of claims should also decline as benefits are scaled back from \$500 per week to \$300 per week in July. Nevertheless, with five more disbursement periods left, this program in theory could offer only a more modest \$2–4 bn in savings by its scheduled expiration at the end of September.

Enhanced employment insurance benefits comprise the bulk of income supports. The number of regular beneficiaries still remains high (a reported 1.8 mn individuals) as of early July and total disbursements stand at almost \$37 bn, including other smaller caregiver, parental, and sick benefits (chart 7). This is set against allocations of about \$52 bn (\$42 bn in the EI operating account and another \$10 bn enhancement). Even though improved labour conditions should support stronger employment (June's 1.6 mn unemployed Canadians should drop by another couple hundred thousand by Fall), it is not clear at this stage that the claims curve could bend substantially in this time frame. Both income support programs allow a threshold of earned income before benefits are clawed back so there could be a lagged effect (but this, overall, underpins upside potential to PIT revenues since these benefits are taxable). Resources will reasonably be depleted when enhancements are set to wind down this Fall.

On net, any upside potential from unspent wage subsidies is likely offset by pressures on income supports that will largely be exhausted when the programs are set to expire. Unemployment, while improving, should still be elevated—in the order of 7% by this Fall. And with elections imminent, the likelihood of extensions in one form or another is high. The proclivity to spend is a given, while mixed employment narratives could provide the political justification to do so. Should wage subsidy windfalls be reallocated to merely extend broad-based income supports, it would not be without risks. The jury is still largely out if temporary income supports would discourage work as businesses scramble to rehire employees as fear of the pandemic subsides.

MUCH ADO ABOUT NOTHING?

At this point, the baseline impact on the federal balance is not materially different from the Spring. A modestly improved nominal GDP growth outlook at slightly higher interest rates could put the spending path closer to \$145 bn in FY22, but it is still early in the fiscal year—not to mention an election year. Discretionary spending provides the biggest risk, with an expectation that any windfalls are likely to be spent. It is premature to weigh the impact of possible election outcomes on the fiscal trajectory at this stage other than to table it as a material risk with both up- and downsides given current polling.

However, as the fiscal trajectory remains largely unchanged, the Bank of Canada's asset purchase program continues to pivot. Prior to its July MPR decision, the Bank was on track to purchase \$196 bn in GoC bonds, whereas the federal Debt Management Strategy projected net bond issuance at \$190 bn (once refinancing is netted out) this year. Earlier in the recovery, this symmetry could be justified on the basis of managing market dysfunction and emergency funding pressures. That imperative has long ago passed. In accordance with its inflation-targeting mandate, the Bank is scaling back its purchases at a rate that should eclipse supply. Any perception that Bank purchases are paired to the issuance of Government of Canada assets should be debunked with its latest action.

Net supply of Government of Canada bonds to markets should progressively turn positive as the year advances. Whereas net bond issuance hitting markets was marginally negative in the first (fiscal) quarter of the year, this week's scale-back in Bank purchases would result in an estimated \$26 bn in GoC bonds to be absorbed by markets this year absent further reductions, according to Scotiabank's Roger Quick. However, the Bank is widely expected to continue paring back its QE operations in coming meetings. An aggressive path (for example, additional \$1 bn reductions at each of the next two MPR meetings) could push that number to around \$58 bn, according to Quick.

Signaling aside, this week's widening of supply should not have an impact on markets. *In theory*, more traditional price discovery through markets against greater supply *should* put pressure on yields. However, it is plausible, if not likely, that demand has been squeezed out by Bank purchases so markets would pick up the slack in the lower range without material impacts. A more hawkish central bank in a market where relativity matters could also exert pressure on yields, but a slightly-less-hawkish-than-anticipated message this week may have eroded some of this effect. Perhaps most critically, this gets absorbed into a market where global forces dominate broad trends (and near-term volatility). Fed-speak on surging US inflation no doubt overshadowed any policy influences north of the border this week and will likely continue to do so in the foreseeable future.

Signaling is arguably the dominant effect at this point, not the adjustment itself. Adjustments to the Bank's purchases (and the narrative underpinning it) cue markets on the order of operations for broader exists such as the timing of eventual rate hikes. A more abrupt-than-anticipated exit from balance sheet operations could pull forward rate hike expectations, putting the front end of the curve, in particular, under more pressure.

These will be important assumptions to watch as the Bank backs out of the market further in meetings ahead. Once the Bank reaches net-zero GoC bond purchases—which Scotiabank's Derek Holt suggests could reasonably happen this calendar year—it remains to be seen how the Bank manages its balance sheet thereafter. Its stated intention is to reinvest against maturities for a period of time, but it is unclear if it will roll off more securities after that. It is currently holding a record 44% of GoC bonds on its books (the Fed is closer to 30%), so if it starts rolling off materially more of this debt, this could have a more material impact on markets. Additionally, the composition of its interventions along the curve could also have impacts—something covered extensively on a high-frequency basis by Scotiabank's Fixed Income team.

All this as a caution against complacency, the Finance Minister should be less confident in overly leaning on a low-interest environment to fuel debt-financed spending. Rates will increasingly come under pressure as the Bank and others begin to more aggressively roll back accommodations as the recovery advances. This could be sooner than later if inflationary pressures prove less transitory than currently assumed. The output gap—admittedly an imprecise metric—is rapidly closing: the Bank suggests it will close sometime in the second half of 2022, whereas Scotiabank Economics' projects it could close earlier in the year. Excessively loose fiscal policy—particularly vote-buying, demand-oriented measures with inevitable lags—could pour fuel on the fire, forcing the Bank on a more aggressive path of consolidation.

Policy coordination requires a new tack in this next phase of recovery. An 'all hands on deck' approach is no longer sufficient. There is little risk of a repeat of post-GFC times that saw fiscal supports pull out prematurely, forcing the Bank's hand in keeping rates low for longer. If anything, the risk ahead is now reversed. There is already over \$100 bn in stimulatory support baked in over the next three years when the Canadian economy should be at or above potential for a good portion of that time. Calibrating supports to economic conditions is the best way to ensure that otherwise independent monetary and fiscal functions are operating in mutually reinforcing manners. *At a minimum, policymakers should be sailing in the same direction.*

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