NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Federal
Fiscal Update
Economics and Strategy

October 24, 2017

Fiscal outlook improves following recent economic strength

Highlights

- From the annual report, we already knew that the deficit for FY 2016-17 was $17.8 billion, a $5.2 billion improvement over last March Budget. Mostly due to stronger than expected revenue, the deficits for the current FY has been revised down by $8.6 billion ($1.5 billion due to a lower adjustment for risk) to $19.9 billion, and by $8.8 billion to $18.6 billion for 2018-19. For the following three FYs, deficits are cut on average by $5.3 billion per year to average $16 billion per year over that period. Cumulative deficits over the current FY and the next four amount to $86.5 billion, a $33.5 reduction from the March Budget.
- The last year of the forecast horizon is 2022-23 with a projected deficit of $12.5 billion. There is no target date set to return to a balanced budget.
- Economic growth of 3.1% is forecasted for 2017, compared to 2.0% as of March Budget. Projections are little changed for the following years. In 2018, economic growth is expected at 2.1%, to fall below 2.0% over the next three years. Nominal GDP growth is expected at 5.5% this year, compared to 4.2% as per March Budget. Over the remaining years of the forecast horizon, the annual nominal growth projections are slightly weaker than initially assumed, with nominal GDP growth projected at 4.0% in 2018 and at an average of 3.6% over the next three years.
- In the Fall Update, two new spending measures have been introduced, amounting to $7.7 billion over the next five FYs, bringing total new spending since the March budget to $19.1 billion. The Canada Child Benefit is going to be indexed to inflation beginning in July 2018, two years earlier than scheduled, for a cost of $5.6 billion over five years. The Working Income Tax Benefit will be enhanced beginning on January 1rst 2019, for a cost of $2.1 billion over five years.
- The Government confirms its commitment to move forward on two fiscal measures. The first is restricting income sprinkling by private corporations, effective for the 2018 and subsequent taxation years, with revised draft legislative proposals to be released later this fall. The second is limiting the benefit of investing passively in private corporations, with proposed rules to be released in Budget 2018.
- Improved deficits and a stronger economy mean a lower debt-to-GDP ratio than at Budget time. From 31.2% as of last March, the ratio is expected to decline to 30.5% as of the end of March 2018, and to decline on average 0.4 percentage points in each of the following five years to reach 28.5% by the end of 2022-23.

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Much improved revenue

For fiscal 2016-17, the $5.2 billion improvement in the deficit from $23 billion to $17.8 billion was mostly the result of lower spending, which came $3.7 billion under the estimate of last March Budget. But for 2017-18, if it were not for measures taken since last March Budget, the $25.5 billion deficit forecast in last March (before the adjustment for risk) would have been revised down $8.9 million due to economic and fiscal developments, of which a $6 billion improvement in revenue. After accounting for the measures taken since the Budget, which cost $1.8 billion this year, and for the $1.5 billion reduction in the adjustment for risk, we arrive at the $8.6 billion improvement reported in the 2017-18 deficit after the adjustment for risk, from $28.5 billion to $19.9 billion.

Of course, the larger than expected economic growth forecasted for 2017, with little change in the economic growth projections for subsequent years, mean the revenue improvement is "once and for all", and will also be reflected in subsequent years. Thus, the $33.5 billion improvement in the cumulative deficits for the current FY and the next four, from $120 billion to $86.5 billion, mostly come from a hotter economy in 2017 than was originally forecasted last March.

Let's remark that from 2017-18 to 2021-22, cumulative program expenses projected in the Update are $2.4 billion below the projections done for last March Budget. This means that the improved economy (for instance a lower unemployment rate) also has a beneficial impact on program expenses.

Yes, there is an improved fiscal outlook, but still no forecast return to budgetary balance. If it were not for the new measures introduced since last March, the deficit, from its starting point of $17.8 billion in 2016-17, would have slightly declined each year (even after the inclusion of the $3.0 billion adjustment for risk) so as to be projected at $5.2 billion in 2022-23 (instead of the $12.5 billion projected following the measures taken since March budget). So the new measures are not to be blamed for no return to a balanced budget over the forecast horizon.

New measures

Two new measures are introduced in the Update. The Canada Child Benefit is going to be indexed to inflation beginning in July 2018, two years earlier than scheduled, for a cost of $5.6 billion over five years. The Working Income Tax Benefit will be enhanced beginning on January 1rst 2019, for a cost of $2.1 billion over five years. The new measures amount to $7.7billion over five years, and add up to the measures taken since the March budget but prior to the Update, and amounting to $12.2 billion over this year and the next five years.

Needless to say, $7.7 billion over five years is not the kind of stimulus susceptible to alter the Bank of Canada's view about its monetary policy stance.

An improved economy

Year-to-date the Canadian economy has been stronger than expected and although it should grow at a slower pace in the second half, private sector economists are now looking for the economy to grow by 3.1% in 2017, compared to 2.0% in the March Budget.

In 2018, the economy is expected to grow by 2.1%, one tick stronger than projected initially. With stronger growth, the unemployment rate has been revised down four ticks in both 2017 and 2018 to 6.5% and 6.3% respectively. The outlook for GDP inflation has been revised up for 2017, from 2.1% to 2.4%. Consequently, nominal GDP should grow by 5.5% in 2017. Over the remaining years of the forecast horizon, the annual nominal growth projections are slightly weaker than initially assumed. Nonetheless, the fall Update shows the level of nominal GDP being higher by $30 billion on average per year.

Based on private sector forecasts, crude oil (WTI) is projected to average US$ 54 between 2017 and 2021, this is US$ 4 less than in the Budget. The exchange rate (US cents/C$) has been revised up to 77.8 in 2017 and 81.3 in 2018, compared to 74.5 and 76.1 initially. The interest rate assumptions have also been revised up by 20 and 60 basis points for the average 3-month Treasury bill rate to 0.8% in 2017 and 1.5% in 2018.The average yield to maturity on 10-year government bonds has been left unchanged for 2017 (1.8%), but revised up 20 basis points to 2.5% for 2018. U.S. GDP is forecasted growing 2.2% in 2017 and 2.3% in 2018.

Federal debt growth slows

The March Budget was projecting the Federal debt to grow by 18.8% between 2016-17 and 2021-2022. It is now forecasted to grow by 13.9% over that period, from $631.9 billion in 2016-17 to $719.5 billion in 2021-22.

Improved deficits and a stronger economy mean a lower debt-to-GDP ratio than at Budget time. From 31.2% as of last March, the ratio is expected to decline to 30.5% as of the end of March 2018, and to decline a further 0.4 percentage points on average over each of the following five years to reach 28.5% by the end of 2022-23.

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Summary Statement of Transactions

billions of dollars

		Projection					
	2016–2017	2017–2018	2018–2019	2019–2020	2020–2021	2021–2022	2022–2023
Budgetary revenues	**293.5**	**310.7**	**323.1**	**333.3**	**345.3**	**359.6**	**371.3**
Program expenses	287.2	304.9	312.2	319.0	328.9	338.6	347.9
Public debt charges	24.1	24.2	26.6	28.7	30.2	31.9	32.8
Total expenses	**311.3**	**329.1**	**338.8**	**347.7**	**359.1**	**370.5**	**380.7**
Adjustment for risk		-1.5	-3.0	-3.0	-3.0	-3.0	-3.0
Final budgetary balance	**-17.8**	**-19.9**	**-18.6**	**-17.3**	**-16.8**	**-13.9**	**-12.5**
Federal debt[1]	631.9	652.8	671.5	688.8	705.6	719.5	732.0
Per cent of GDP							
Budgetary revenues	14.5	14.5	14.5	14.5	14.5	14.5	14.5
Program expenses	14.2	14.3	14.0	13.9	13.8	13.7	13.5
Public debt charges	1.2	1.1	1.2	1.2	1.3	1.3	1.3
Budgetary balance	-0.9	-0.9	-0.8	-0.8	-0.7	-0.6	-0.5
Federal debt	31.2	30.5	30.2	29.9	29.5	29.1	28.5

Note: Totals may not add due to rounding.

[1] The projected level of federal debt for 2017–18 includes an estimate of other comprehensive income.

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Economics and Strategy

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