NATIONAL BANK
FINANCIAL MARKETS
A division of National Bank of Canada

FEDERAL
Fiscal update
Economics and Strategy

November 1, 2016

Dealing with slower growth; playing the infrastructure card

Bill Morneau has been finance minister for all of a year, but he's learned pretty quickly to deal with economic disappointment. Over the course of a single budget and two fiscal updates, Canada's Liberal government has witnessed firsthand the fiscal fallout that attends subpar growth and lukewarm inflation. Although hardly unique to Canada's sovereign, a lower and flatter trajectory for nominal GDP has robbed the government of hoped-for revenue. Importantly, the sizeable amount of prudence set aside in Budget 2016 (fully $6 billion per year) has been called on to blunt the impact on the budget balance. That's why today's revised deficit profile (which *no longer* incorporates an annual buffer) isn't terribly far removed from March's post-prudence figures. Factoring in efforts to revitalize a moribund national economy, the budget shortfall is now pegged at $25.1 billion for 2016-17, peaking at $27.8 billion one year later. With no adjustment for risk set aside, let's hope that downgrades to the economic outlook are now a thing of the past. There may not be a precise timeline for getting back to balance, but the government's preferred "fiscal anchor" and an admittedly better gauge of fiscal sustainability—the debt-to-GDP ratio—still looks quite favourable by advanced economy standards (peaking at <32% in 2018-19). More than simply recalibrating the fiscal base case to the new, weaker economic outlook, today's update included additional colour on infrastructure investments ($81 billion over 11 years, much already contained within the existing fiscal framework). A portion of those of those extra infrastructure funds will be used to seed a new Canada Infrastructure Bank, which is meant to stretch/leverage the government's infrastructure dollar. There was funding for a new Invest in Canada Hub tasked with attracting foreign investment, a skills strategy focused on speeding up approvals of work visas/permits, enhanced independence for both the Parliamentary Budget Officer and Chief Statistician, alongside other measures meant to bolster transparency and openness. In all, this was more than a run-of-the-mill fall update, with new colour on priority areas and some targeted investments made. While there are some longer-term commitments, Ottawa held off providing additional short-term support for the economy in hopes that existing stimulus efforts hit their mark and manage to propel growth forward starting in 2017.

The economic reality: slower growth, again

Subpar real growth and lukewarm GDP inflation: it's a tough combo for any budget maker and a challenge hardly unique to Canada. Still, national fortunes have faded, as many of the downside risks identified in the federal budget materialized (e.g., slower US growth, limited export traction, disappointing business investment, ongoing oil price fallout, external hiccups).

Updated consensus economic projections tell the tale. Despite hailing the resiliency of the economy, real GDP growth has been marked lower each and every year from 2016 through 2020. GDP inflation has likewise been revised lower across much of the forecast horizon. The end result; there's a growing gap between a revised trajectory for nominal GDP and what was envisioned back in Budget 2016. The good news, if you can call it that, is that Ottawa built a sizeable "adjustment for risk" into its 2016 budget. This ends up being a vital offset to the more downbeat consensus growth forecast.

Updated fiscal projections

So what does the overall fiscal picture look like? Ottawa is now projecting a $25.1 billion deficit for the current fiscal year, equivalent to 1.2% of GDP. The deficit is set to get a little larger in 2017-18, hitting $27.8 billion or 1.3% of GDP, before gradually declining to $14.6 billion (0.6% of GDP) way out in 2021-22.

Revised budget figures do not include an adjustment for risk. Nor is there a precise timeline for federal deficit elimination. Still, debt is highly affordable, as interest charges currently consume less than nine cents of the federal revenue dollar. Moreover, the debt-to-GDP ratio, Ottawa's preferred "fiscal anchor", is seen peaking at just under 32% of GDP in 2018-19. That ratio ended 2015-16 at 31.1%, so that isn't much of a run-up in what is already a pretty low federal debt burden. The government aims to take this ratio down over time, and should fiscal and economic projections hit the mark, the federal debt burden would be barely above 30% by 2021-22.

So those are the official figures. But we caution that one needs to be a bit careful when comparing to the original budget plan. To better understand Ottawa's fiscal transition, you need to isolate for prior year base effects, control for economic adjustments and add in costs tied to new measures. Critically, you also need to control for the aforementioned prudence that had been previously set aside. The gory details follow, so keep reading…

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Fiscal arithmetic and the use of prudence

Notwithstanding an improved starting point (i.e., a smaller deficit and lower debt level for 2015-16), economic adjustments vs budget are less than favourable starting in 2016-17. How much pressure is there? For the current year, the economic fallout is manageable enough at $1.3 billion—well within the $6 billion buffer that had been allocated at budget time. But the economic hole starts to exceed the $6 billion prudence buffer in 2018-19. All told, there's a ~$25 billion fiscal hit from the economy over the entire five-year period ending 2020-21, even after allowing for a lighter interest bill due to a more benign interest rate environment.

What of targeted policy actions undertaken in recent months? Those include a CPP enhancement, immigration commitments, defense/security operations, support for First Nations children, to name but a few. Together, commitments made since the budget but prior to today's update total ~$5 billion over the same five year period.

Then there's the fresh announcements contained in today's update. Seemingly most notable was the $81 billion committed to infrastructure over 11 years, which builds on the $11.9 billion initial infrastructure investment outlined in Budget 2016. Consider this "Phase 2" of the government infrastructure roll-out. Technically, the extra infrastructure funds start in 2017-18, but the dollars are really more notable in the out years of the plan: $4 billion in 2018-19, rising to $6.7 billion by 2021-22 and topping out at $11.3 billion/year in 2025-26 and beyond.

When it comes to the infrastructure funds allocated in today's update, note that much comes via "funds existing in the fiscal framework/sourced from departmental resources". The net fiscal impact of this enlarged infrastructure plan is therefore limited when you focus on the medium-term horizon. To wit: the $20.9 billion of additional infrastructure money now formally allocated through 2021-22 is slated to add just $2 billion to the cumulative deficit after existing funds are tapped (most of that net impact coming in 2018-19).

So here's the basic fiscal math, covering the five year period from 2016-17 to 2020-21 and relative to the published deficit figures in Budget 2016:

- Add $25 billion to the five-year deficit due to the weaker economic outlook;
- Add $5 billion to the combined deficit for commitments made after the budget but before the fall statement;
- Add another $2 billion to the aggregate shortfall for today's announcements (net of prior allocations);
- Subtract $30 billion of prudence, which has been fully released (i.e., no longer set aside);
- The net result: a seemingly modest $2 billion deterioration in the aggregate deficit from 2016-17 to 2020-21. More precisely, the five-year balance goes from a $113 billion deficit to a $115 billion shortfall.

Depending on your perspective then, one could say that the aggregate deficit profile appears little changed compared to the headline deficits outlined in the budget; in fact, this year's deficit is tracking $4 billion below the $29 billion figure outlined in the spring. Alternatively, it would be fair to say that the dual effect of a weaker economy and some targeted new investments has added $32 billion of extra red ink to Ottawa's *underlying* fiscal picture compared to pre-prudence budget projections.

There's some nuance here, to be sure. Clearly though, the sizeable buffer set aside at budget time was a good call, and has gone a long, long way towards blunting the fiscal fallout from the new, weaker economic forecast. We'd caution that having done away with an adjustment for risk, today's revised budget figures are vulnerable to any further economic downdrafts. Official sensitivities imply that a 1%-pt miss in real GDP growth adds $4.6 billion to the annual deficit in year 1. Let's just hope that what have become rather persistent downgrades to Canada's growth/inflation outlook are now a thing of the past. For our part, we remain somewhat less optimistic than a number of other Canadian forecasters.

A new Canada Infrastructure Bank

As noted, infrastructure allocations were a big feature of today's update. The additional $81 billion over 11 years will be dedicated to public transit, green projects, social infrastructure, transportation/trade, rural/northern communities and so-called 'smart cites'. Further details on precise allocations within each of these envelops will come in Budget 2017. What is known, is that $15 billion of this federal infrastructure money will be used to seed a Canada Infrastructure Bank (CIB), the creation of which was strongly endorsed by the finance minister's Advisory Council on Economic Growth. A further $20 billion in capital will be available to allow the CIB to invest in assets (equity or debt), resulting in no impact on the federal net debt position. So there's at least $35 billion of federal cash being committed to the CIB, which will focus on complex/large projects and aim to leverage private sector capital by as much as 4:1. While accountable to government, the infrastructure bank will operate at arm's length. Refer to the box on page 3 for additional details on the Canada Infrastructure Bank.

The additional infrastructure funding outlined today brings the total federal infrastructure envelop (new and existing) to a whopping $187 billion over a dozen years. That's an average of more than $15 billion per year through 2027-28. There may not be extra near-term stimulus, but with today's update, it's clearer than ever that infrastructure lies at the very heart of the government's plan to drive long-term jobs and growth in Canada. We don't want to trivialize action on other priorities, but if you were to characterize this government as intensely focused on infrastructure, you'd get no argument from us.

Other measures

Like the infrastructure bank, some other measures piggy backed on advisory council recommendations. There was $218 million allocated over five years for a new Invest in Canada Hub, which will employ a dedicated sales force tasked with spurring foreign investment in Canada. On a

Canada Infrastructure Bank

Mandate

The Canada Infrastructure Bank will make investments in revenue-generating infrastructure projects and plans that contribute to the long-term sustainability of infrastructure across the country. It will be mandated to work with project sponsors to:

- Structure, negotiate and deliver federal support for infrastructure projects with revenue-generating potential;
- Use innovative financial tools to invest in national and regional infrastructure projects and attract private sector capital to public infrastructure projects;
- Serve as a single point of contact for unsolicited proposals from the private sector; and
- Improve evidence-based decision making and advise governments on the design and negotiation of revenue-generating infrastructure projects.

Governance

The Canada Infrastructure Bank will hire the talent and expertise necessary to develop and execute project deals with private sector investors to deliver the best value for public resources.

The Canada Infrastructure Bank's governance model will reflect its broad and ambitious mandate. The government will be responsible for setting the overall policy direction and high-level investment priorities for the Canada Infrastructure Bank, consistent with the commitments outlined in ministerial mandate letters.

The Canada Infrastructure Bank will play a complementary role in developing innovative infrastructure financing deals, resulting in more total infrastructure investment than would otherwise be the case.

Though arm's length, the Canada Infrastructure Bank will be responsive and accountable to the government for the allocation of federal resources.

Financial Tools

The Canada Infrastructure Bank will be a key component of Investing in Canada, concluding and executing complex infrastructure deals using a wide breadth of financial instruments at its disposal, including:

- Direct investments;
- Repayable contributions;
- Debt (e.g., loans, loan guarantees), both unsubordinated and subordinated;
- Equity investments, both unsubordinated and subordinated; and
- A hybrid of the above.

The Canada Infrastructure Bank will be responsible for delivering at least $35 billion on a cash basis to large infrastructure projects that contribute to economic growth. The objective of the Canada Infrastructure Bank's participation will be to structure its financial support in order to attract private sector capital and conclude project deals. The timing and design of federal support will seek to minimize the amount of government support required to make the project financially viable.

Source: Fall Economic Statement 2016 (pg 28)

related note, the threshold to trigger a review of foreign investment under the Investment Canada Act is being increased to $1 billion as of 2017—two years ahead of plan. Guidelines stipulating which investments will be subject to national security provisions will also be forthcoming.

On skills, the government announced new, speedier standards for the approval of work permits and visas, alongside a new work permit exemption for "short-duration" work terms (classified as <30 days a year).

Under the banner of open and transparent government, the government unveiled steps to bolster the independence of both the Parliamentary Budget Officer and the Chief Statistician of Canada. This is getting a little more detailed, but there was a promise to open up previously secretive Board of Internal Economy, as well as revamp of the Estimates process to provide greater clarity and perspective to Parliamentarians when it comes time to vote on federal spending. We applaud these transparency/independence measures.

As usual, the fall update did not update Ottawa's financing requirements. But with the current year's deficit not far removed from the original plan ($25.1 billion today vs March's after-prudence $29.4 billion target), it's hard to see a significant shift in underlying funding patterns through fiscal year end. The government has consulted widely on its 2017-18 Debt Management Strategy, which will outlined in detail in Budget 2017.

Warren Lovely

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Economic and Fiscal Developments Since Budget 2016
billions of dollars

	2015–2016	Projection 2016–2017	2017–2018	2018–2019	2019–2020	2020–2021	2021–2022
Budget 2016 budgetary balance[1, 2]	**-5.4**	**-29.4**	**-29.0**	**-22.8**	**-17.7**	**-14.3**	n/a
Forecast adjustment from Budget 2016		6.0	6.0	6.0	6.0	6.0	
Budget 2016 budgetary balance (without forecast adjustment)	-5.4	-23.4	-23.0	-16.8	-11.7	-8.3	
Developments since Budget 2016 (including policy actions and fiscal investments)	4.5	-1.7	-4.8	-9.2	-7.6	-8.5	
Final budgetary balance	**-1.0**	**-25.1**	**-27.8**	**-25.9**	**-19.3**	**-16.8**	**-14.6**
Economic and fiscal developments by component:							
Budgetary revenues							
Income taxes	5.0	-0.8	-2.7	-4.5	-4.8	-6.2	
Excise taxes/duties	0.0	-0.5	-0.6	-1.1	-1.4	-1.6	
Employment Insurance premiums	0.1	-0.1	0.2	0.3	0.2	0.2	
Other revenues	-0.9	-1.2	-1.6	-2.8	-3.2	-3.2	
Total	4.2	-2.6	-4.7	-8.1	-9.2	-10.9	
Program expenses							
Major transfers to persons	0.2	0.2	-0.4	-0.8	-1.2	-1.6	
Major transfers to other levels of government	0.0	0.2	0.1	0.3	0.5	0.6	
Direct program expenses	-0.1	-0.2	-1.6	-4.1	-2.3	-1.8	
Total	0.1	0.1	-1.9	-4.6	-3.0	-2.8	
Public debt charges	0.1	0.8	1.9	3.5	4.6	5.2	
Total economic and fiscal developments	**4.5**	**-1.7**	**-4.8**	**-9.2**	**-7.6**	**-8.5**	

Note: Totals may not add due to rounding.
[1] Budgetary balance includes forecast adjustment.
[2] A negative number implies a deterioration in the budgetary balance (lower revenues or higher spending). A positive number implies an improvement in the budgetary balance (higher revenues or lower spending).

Summary Statement of Transactions
billions of dollars

	2015–2016	2016–2017	2017–2018	Projection 2018–2019	2019–2020	2020–2021	2021-2022
Budgetary revenues	**295.5**	**291.1**	**303.3**	**313.2**	**326.2**	**339.5**	**355.0**
Program expenses	270.8	291.3	306.5	313.2	317.2	326.0	336.5
Public debt charges	25.6	24.9	24.6	25.9	28.2	30.3	33.1
Total expenses	**296.4**	**316.1**	**331.0**	**339.1**	**345.4**	**356.3**	**369.6**
Final budgetary balance	**-1.0**	**-25.1**	**-27.8**	**-25.9**	**-19.3**	**-16.8**	**-14.6**
Federal debt[1]	616.0	642.0	669.8	695.7	715.0	731.8	746.4
Per cent of GDP							
Budgetary revenues	14.9	14.4	14.4	14.3	14.4	14.4	14.5
Program expenses	13.7	14.4	14.6	14.3	14.0	13.8	13.7
Public debt charges	1.3	1.2	1.2	1.2	1.2	1.3	1.3
Budgetary balance	0.0	-1.2	-1.3	-1.2	-0.8	-0.7	-0.6
Federal debt	31.1	31.8	31.8	31.9	31.5	31.0	30.4

Note: Totals may not add due to rounding.
[1] The projected level of federal debt for 2016–17 includes an estimate of other comprehensive income.

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