November 15, 2018

First steps towards fiscal recovery… with long-term plan to come

10 highlights from Ontario's *2018 Economic Outlook and Fiscal Review*, the first from Vic Fedeli and a Progressive Conservative government that rose to power in June:

1. ***Current year budget balance*** — The 2018-19 deficit is now pegged at $14.5 billion or 1.7% of GDP. That's a $500 million improvement vs the $15.0 billion shortfall identified in the *Report of the Independent Financial Commission of Inquiry* (released in September) resulting from "actions undertaken by the government to find efficiencies and reduce spending". Of course, the deficit remains far removed from the $6.7 billion of red ink the prior Liberal government had projected back in the March budget. As previously explored, this more than doubling of the deficit captures a variety of elements, most notably revised accounting treatment for pension expense and electricity price relief (aka "global adjustment refinancing"), along with a reversal of year-end savings, among other things.

2. ***Medium-term fiscal outlook*** — While there's an updated, multi-year economic outlook (see #10 below), on the fiscal side of things the fall statement limits the discussion exclusively to 2018-19. Those looking for a detailed multi-year plan were left wanting… or rather waiting until at least the 2019 spring budget.

3. ***Deficit elimination timeline*** — As per above, you won't find budget balance, revenue or spending assumptions for 2019-20 and beyond. Nor has a definitive timeline for deficit elimination been set out. What we got was a repeat of an earlier refrain: the government is "working towards balancing the budget on a modest, reasonable and pragmatic timetable." Given what you might consider to be a mature phase of the national and provincial economic expansion, making significant near-term progress on the deficit would be prudent strategy to us.

4. ***Revenue outlook*** — Ontario expects to bring in $148.2 billion in revenue this fiscal year, down $2.7 billion vs the independent commission's "baseline", owing to the decision to provide new tax relief, eliminate planning tax increases and canceling the cap-and-trade carbon tax. Federal transfer account for 18% of total revenue.

5. ***Spending outlook*** — The latest program spending estimate, at $149.2 billion, is up 4.8% vs the prior year but nonetheless down over $3 billion vs the revised baseline. Restrictions on discretionary spending (e.g., travel, meals, etc) and updated forecasts for key employment/training/social programs have saved over $1.1 billion. Not proceeding with certain projects (including cap-and-trade related spending and some regional infrastructure works) cuts a further $1.8 billion from full-year spending.

6. ***Prudence*** — As per the independent commission's recommendation, the reserve has been restored to $1 billion. Given we're more than halfway through the fiscal year, that's some non-trivial padding, protecting against unforeseen pressures. As per #10, the economic outlook builds in some extra prudence in the form of a below-consensus real GDP forecast for 2018 and beyond.

7. ***Debt burden & interest bite*** — Net debt is projected to end 2018-19 at $347 billion or 40.5% of GDP. That's up from 39.2% in 2017-18 and just a snick inside of the all-time high of 40.6% established back in 2014-15. Given the significant budgetary restatements, the current year's debt burden has been set almost 3%-pts higher than the ratio flagged back in March (37.6%). Despite a successful strategy of locking in more debt for longer, interest rates have begun to rise and debt charges are stepping up (this fiscal year and presumably well into the future). For 2018-19, interest charges are set to consume 8.5% of total revenue, up from 7.9% in the prior year. As of 2017-18, Ontario's net debt per capita stood just over $23K, second only to Newfoundland and Labrador ($27.8K per person) and above Québec's corresponding level ($21.6K per person). Virtually all of Ontario's foreign exchange exposure has been hedged, with the province likewise comfortably below policy limits on net interest rate resetting exposure (just 12.7% vs a 35% limit). There's some $31 billion of unrestricted liquid reserves to ensure short-term obligations are met, regardless of market conditions.

8. ***Long-term borrowing requirement*** — Ontario's long-term public borrowing requirement has been knocked back $1.9 billion relative to the level telegraphed at the time of the independent commission report. Credit the improvement in the deficit and a paring back of capital spending for the lighter funding need. So the official long-term requirement for 2018-19 now stands at $33.2 billion. (Back in March, the long-term requirement had been pegged at $31.7 billion.) Again, there's no guidance on future years. As a reminder, the prior government's medium-term financing plan had projected

that long-term borrowing would average $39 billion/year over 2019-20 and 2020-21, in the context of what was then $6½ billion annual deficits.

9. ***Debt management strategy*** — Against the $33.2 billion long-term requirement, $25.9 billion has been completed, leaving Ontario 78% funded at the 62% mark of the fiscal year. There's a loose target of 70% domestic funding for this year. That's subject to market conditions of course, but might imply some $4 billion (CAD equivalent) of international funding is still to come. Domestically, we'd look for Ontario to take advantage of seasonal cash flows and related demand for long-dated provincial product in/around the start of December. Maintenance of exceptional domestic market liquidity remains a clear focus, to be achieved via regular issuance of 5-, 10- and 30-year bonds. The province also plans to continue issuing Green Bonds, with the next offering expected before the end of the fiscal year. Given our expectation of larger future year requirements, we would not be surprised to see Ontario get a jump start on 2019-20 via non-trivial pre-funding… assuming favourable market conditions.

10. ***Economic outlook*** — In 2018, real GDP is assumed to grow by 2%, down 0.2%-pts from the rate assumed in the 2018 budget. Future years were also revised down, due to limited capacity, higher interest rates and a slowing U.S. economy. Prudently, the assumed real GDP growth rate in all years is 0.1%-pt below the private sector consensus. Employment growth and CPI inflation are expected to come down from 2018 peaks over the next three years, but remain positive. The unemployment rate should continue to fall, supporting strong wage growth. The government foresees a continued stabilization in the housing market, while business investment and exports look to pick up. Risks to Ontario's economic outlook include continued trade uncertainty, potentially faster-than-expected interest rate normalization and eroded housing affordability.

Assorted other items — Measures to make Ontario open for business were also discussed. Amongst other initiatives, the government reiterated its intention to maintain the current minimum wage at $14 per hour until 2020, to be increased according to inflation thereafter. The government likewise indicated that it would not stand in the way of a pipeline project that would transport oil from Western Canada to Ontario or Canada's East Coast.

All told, it's a fiscal update limited in scope—dealing solely with 2018-19—with a medium-term plan and deficit reduction/debt containment strategy still to be communicated. Expect the government to continue to measure itself against the $15.0 billion shortfall deemed inherited from the prior government. To that end, there's been some initial progress on deficit reduction, while built-in padding (notably $1 billion of prudence) suggest further improvements could be in store. Long-term funding needs are up from the prior government's budget but down from the level implied by the independent commission's work, which some might view as mildly constructive. Emerging from blackout, we'd expect Ontario to take full advantage of seasonal cash and demand for duration. Note that the Finance Minister is scheduled to give a key address tomorrow, during which he would be expected to play up the government's commitment to putting the fiscal house in order. The province's spreads were mostly unchanged following the release, with the current 10-year and 30-year benchmark bonds standing around 66.5 and 80bps vs GoC, respectively.

Warren Lovely & Catherine Maltais

Ontario • Fall Economic Statement

NATIONAL BANK OF CANADA FINANCIAL MARKETS

Ontario

$ billions	Actual 2017/18	Budget 2018/19	Commission Revised Baseline 2018/19	Fall 2018/19
Revenue	**150.6**	**152.5**	**150.9**	**148.2**
Own-Source Revenue	99.7	103.6		100.9
Personal Income Tax	32.9	35.6		34.9
Sales Tax	25.9	26.8		26.7
Corporations Tax	15.6	15.1		13.8
Education Property Tax	5.9	6.1		6.1
Ontario Health Premium	3.7	3.9		3.9
Other	15.7	16.0		15.5
Federal Transfers	24.9	26.0		26.0
Income from Government Business Enterprises	6.2	5.3		5.2
Other non-tax revenue	19.9	17.6		16.1
Expenses	**154.3**	158.5	164.9	161.8
Program Spending	142.4	145.9	152.4	149.2
Interest on Debt	11.9	12.5	12.5	12.5
Reserve	**-**	**0.7**	**1.0**	**1.0**
Surplus (Deficit)	**(3.7)**	**(6.7)**	**(15.0)**	**(14.5)**
Net Debt	**323.8**	**325.0**		**347.1**
As a % of GDP	39.2	37.6	40.8	40.5
Accumulated Deficit	**209.0**	**199.2**		**223.6**
As a % of GDP	25.3	23.1	N.A.	26.1
Interest on debt as a % of revenue	**7.9%**	**8.2%**	**8.3%**	**8.5%**
Borrowing Requirement	**33.9**	**31.7**	**35.1**	**33.2**
(Surplus) Deficit	3.7	6.7	15.0	14.5
Maturities	17.4	21.5	21.5	21.8
Redemptions	0.1	0.1	0.1	0.1
Investment in Capital Assets	10.7	14.2	14.2	12.8
Pre-borrowing from 2016-17	(3.8)	-	-	-
Pre-borrowing in 2017-18 for 2018-19	11.5	(11.5)	(12.4)	(12.4)
Other	(5.7)	0.7	(3.3)	(3.6)

Source: 2018 Ontario Economic and Fiscal Review

Ontario • Fall Economic Statement

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