# Ontario 2020 Economic & Fiscal Update

Economics and Strategy

NATIONAL BANK OF CANADA FINANCIAL MARKETS

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# Joining the fight against COVID-19

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In the midst of the COVID-19 pandemic, with policy makers around the globe rushing out measures and non-essential services shut down across the province, Ontario convened a special legislative session to present an Economic and Fiscal Update. Today's update, labeled *Ontario's Action Plan: Responding to COVID-19*, limits its focus to the 2020-21 fiscal year. In this way, it deviates from a full-blown budget, which is required to provide multi-year guidance. Despite the shorter-term horizon, the document and supporting material offer a preliminary take on how much economic growth and revenue might be lost due to the coronavirus. Despite the federal government undertaking a large-scale response, Ontario took meaningful action of its own, equivalent to ~2% of GDP. There's a clear focus on ensuring the health care system can cope, alongside relief for hard-hit businesses, disaffected workers and the most vulnerable. A suite of additional measures aim to bolster liquidity and/or provide cash flow relief. These efforts have been dubbed "phase one" or a "first step" in terms of the government's response. As it stands, Ontario is projecting a $20.5 billion deficit for 2020-21, putting the corresponding long-term borrowing requirement at $43.6 billion. So a notably larger deficit and a sizable (albeit not unprecedented) borrowing program lies ahead. It goes without saying that there's a tremendous amount of uncertainty attached to the economic and fiscal figures presented here. As such, Ontario has embedded exceptional contingencies and reserves into its 2020-21 plan. Regular updates will be forthcoming, with a comprehensive and longer-term budget to follow later this year (once there's improved visibility on the economic and fiscal road ahead).

## Highlights

- **Economic outlook** – While not without certain challenges, Ontario's economy had been enjoying a relatively solid run before the onset of COVID-19. The labour market, in particular, had been a picture of health, having attained what most economists would consider "full employment". But virus-induced dislocation is now the name of the game, with GDP growth crashing lower across the globe. Ontario specifically, and Canada more generally, has not been spared. In terms of planning assumptions, today's update pencils in zero growth in real provincial GDP for 2020. There's really no reliable or consistent private sector consensus against which to measure this assumption, with economists moving the economic yardsticks minute by minute. Employment growth is likewise slated to downshift markedly this year, although again, the slowdown in hiring (and resulting increase in the jobless rate from 5.6% to 6.6% on a full-year basis) comes after an exceptionally impressive run. As virus-related disruptions ease, Ontario sees the economy getting back on track, leading to 2% real GDP growth in 2021. The GDP deflator is pegged at 2% both this year and next. Again, we'd emphasize the highly uncertain nature of the economic outlook, which the province willingly acknowledges and has attempted to compensate for. See the discussion of prudence below.
- **Results for the fiscal year just ending (2019-20)** – While a rear-view mirror, the 2019-20 budget deficit is now estimated at $9.2 billion, inclusive of a $200 million residual reserve. That budget balance is $1.1 billion better that what was originally planned for a year ago in Budget 2019 and not that far removed from the $9 billion shortfall ($8 billion before the reserve) flagged in a more recent Q3 financial update (presented in January 2020).
- **Near-term fiscal outlook (2020-21)** – Fiscal 2019 feels like a world away, and sure enough, training the focus on 2020-21 reveals a significant shift in Ontario's fiscal fortunes due to COVID-19. Officially, this update puts the coming fiscal year's deficit at $20.5 billion or roughly 2.3% of GDP. On the surface, that would surpass the prior record for the provincial deficit (in dollar terms) set during the prior global financial crisis and would be in a different area code vs. the $6.7 billion deficit Ontario had hoped to be running in 2020-21 (based on November's medium-term estimates). Again, as this is "update" and not a "budget", there's no guidance beyond 2020-21.
- **Prudence** – In light the highly uncertain and rapidly evolving backdrop, Ontario has opted for an unprecedented amount of prudence. Prudence takes a few forms. Most directly observable is a $2.5 billion "reserve"—the largest on record. Then there are sizable spending contingencies, both general and virus-related, set at $1.3 billion and $1 billion respectively. The province has likewise emphasized what it considers to be a prudent outlook for revenue and debt servicing costs. The former entails subjecting revenue to a larger hit than underlying economic assumptions would traditionally imply, while the latter relates to an assumed borrowing rate well above prevailing levels. Collectively, all this adds up to some material insulation, which could well be needed. The reserve alone notionally protects against a 3½%-pt disappointment in nominal GDP growth. (Fiscal sensitivities suggest a 1%-pt hit to nominal output robs the province of $700 million in revenue.) It's believed that this prudence gives the government "fiscal flexibility to respond as conditions evolve".
- **Revenue outlook** – Total revenue is currently forecast to fall ~$0.5 billion (-0.3%) vs. 2019-20, owing to the economic damage being wrought by COVID-19. The revenue picture would look worse in the absence of a positive prior-year base effect. Further to the comment on revenue forecast prudence, the update emphasizes that the revenue profile has been taken down 4%-pts relative to prior thinking, compared to a 1.5%-pt downgrade in assumed nominal GDP growth. Note that the revenue outlook is also somewhat impacted by new tax relief measures, discussed below. Ontario expects to receive $26.3 billion in revenue from the federal government (mostly health and social transfers but no Equalization), comprising ~17% of full-year revenue.

- **Expenditure outlook** — Spending will step up notably in 2020-21, where projected program outlays of $161 billion are 5.2% higher than the prior year. Again, that's inclusive of exceptional contingencies, and captures a host of action plan measures. Read on.
- **Measures to combat COVID-19** — Notwithstanding federal action/leadership, Ontario's update outlines broad and significant measures along three main fronts:
  i. First, there's $3.3 billion in new health care funding. The majority, $2.1 billion, represents direct action to fight/contain/mitigate/respond to COVID-19, including increased assessment/treatment capacity at hospitals and long-term care facilities and in the community, incremental telehealth resources, new protective equipment and is also inclusive of the aforementioned $1 billion health care contingency fund. The balance of the new health care money, $1.2 billion, is designed to shore up the provincial health care system more generally.
  ii. An additional $3.7 billion package was outlined to support vulnerable people and to protect jobs. There are a number of specific initiatives here, including (but not limited to) extra help for low-income seniors and relief for families impacted by school/daycare closures (via a one-time payment per child). There will be a six-month grace period related to provincial student loan payments and new funding for community/emergency services (including food banks, shelters, etc). As previously announced, Ontarians will also get meaningful relief on their electricity bills. Meanwhile, a temporary doubling in the exemption threshold for the Employer Health Tax (a payroll tax) will lessen the burden on businesses to the tune of $355 million, while a new corporate income tax credit aims to drive investment into regions with underperforming labour markets. A planned property tax reassessment for 2021 has been postponed. Rules pertaining to delivery trucks are being eased in order to better ensure timely delivery of critical goods (including food). Together with the health care funding (i), this adds up to $7 billion in direct and timely support for the provincial economy, its most vulnerable citizens, workers and businesses.
  iii. A further $10 billion is being made available via liquidity/cash flow measures. Here, the highlights include a five-month delay/deferral in provincial tax payments for businesses. There's a 90-day deferral in municipal payments of provincial education property taxes, which it's hoped will allow local governments to, in turn, provide property tax relief to residents/businesses. Additionally, Ontario is deferring Workplace Safety and Insurance Board (WSIB) payments by businesses for six months. All told, Ontario' $17 billion COVID-19 action plan constitutes serious action, equivalent to nearly 2%-pts of provincial GDP. And we'd stress that these provincial initiatives are in addition to the comprehensive and still growing suite of federal fiscal and liquidity measures being unveiled by the Trudeau government in Ottawa.
- **Debt outlook** — In light of the larger deficit and planned investments in tangible capitals, Ontario's net debt level is slated to rise some $24 billion in 2020-21 to $379 billion. That would push the debt-to-GDP ratio, which looks to be ending 2019-20 just a snick under 40%, up to 41.7% come March 2021, temporarily establishing a new high-water mark for this key leverage ratio. We won't trivialize the $13.2 billion in interest costs telegraphed for 2020-21, amounting as does to the fourth largest spending line in the budget (after health care, education and social assistance). But on a relative basis, the interest bite will remain quite manageable. Public debt charges are forecast to consume 8.4 cents of Ontario's revenue dollar (vs. 8.0% of total revenue in 2019-20). Moreover, as highlighted earlier, the assumed weighted average borrowing rate for the coming year, at 2.71%, can be considered relatively prudent when held up to the prevailing yields on outstanding Ontario debt. Sensitivities suggest a 1%-pt parallel shift lower in interest rates (compared to the forecast) saves roughly $400 million in interest in the first year.
- **Long-term borrowing requirement** — Ontario is closing the books on a 2019-20 fiscal year in which it issued the equivalent of $36 billion in long-term debt. That surpassed, by more than $4 billion, the underlying financing need, as the province took advantage of earlier, more favourable market conditions to pre-finance. That decision looks prescient in light of more recent turbulence. As expected, the majority of financing undertaken in 2019-20 ($25.4 billion or 70%) was steered to the domestic (C$) market—mainly in the form of syndicated benchmark trades, but also inclusive of an annual bond auction and two green bond deals ($1.25 billion combined). Meanwhile, some $10½ billion (CAD equivalent) was sourced from international markets (mostly US dollars). For some time, Ontario has been focused on taking advantage of low interest rates to extend term, sporting a 14.3-year weighted average term on the outgoing year's new borrowings—a fresh cyclical high. Turning to 2020-21, $43.6 billion of long-term borrowing has been flagged, after netting off the $4.1 billion that was pre-financed and a planned $2 billion increase in short-term outstandings. This is obviously a larger bond requirement than Ontario has seen in recent years, reflecting the extra budgetary red ink. Still, it's not exactly without precedent; just under $44 billion of term borrowing was successfully sourced in 2009-10 (at a time when global debt capital markets and economies were smaller than they are today). And in three separate years since then, Ontario's long-term borrowing was right around $40 billion (2010-11, 2014-15 and, most recently, 2018-19). Approximately 70-80% of the coming year's financing will look to be sourced domestically, and in general, the well-established preference to extend term remains. Green bonds likewise remain a strategic focus, so look for Ontario to remain an "active issuer" in 2020-21… in C$s and maybe even another currency as well. Given financial market volatility, Ontario (like a growing number of issuers) has opted for a more pragmatic approach to debt issuance, *temporarily* adjusting some its guidelines/practices. Minimum sizes needed for the "large order syndication procedure" (so-called 'carve-outs') are being reduced by $200 million in each of the three key benchmark tenors. The new minimums are as follows: 5-year $400 million; 10-year $300 million; 30-year $200 million. Likewise, there's a more relaxed requirement for the free-float (or additional bonds) that must accompany a large order (30% additional from 60% previously). The province will consider, again on a temporary basis, re-opening old benchmarks (so-called 'back-dates'), subject to a minimum size of $250 million and distributed by a single dealer (or small group of dealers) to a handful of investors on behalf of the syndicate. Ontario will also entertain extra-long trades of $50 million or more "without requiring evidence of inversion to the current benchmark long bond". The above-noted

changes are meant to be temporary in nature, but as always, the province retains the right to further modify its guidelines/approach should conditions warrant ever greater flexibility. In light of current market volatility, it's worth noting that Ontario is currently sitting on $36 billion in liquid reserves, which could keep the lights on and the bills paid if, in a truly extreme scenario, access to capital markets was fully closed off. Finally, we'd note that Ontario successfully accessed the Bank of Canada's fresh Provincial Money Market Purchase (PMMP) program today, which constitutes but one part of the Government of Canada's rather extensive suite of financial market liquidity measures rolled out in response to the COVID-19 pandemic.

- Current long-term credit ratings – S&P: A+, Stable | Moody's: Aa3, Stable | DBRS: AA (Low), Stable | Fitch: AA-, Stable

## Conclusion

Whether you want to call this a budget or not, today's document gives a sense of where Ontario's economy and finances are headed near term, even if many key assumptions are subject to extreme uncertainty. As befits a global pandemic, the picture isn't exactly pretty, with economic growth grinding to a halt, the deficit pushing decisively higher, tentative progress on the debt burden undone and significantly more borrowing to do (at least temporarily). It should be noted that while the incremental red ink is partly a function of a weaker GDP profile, it also captures Ontario's meaningful action plan to combat COVID-19. Rather than leaving things to chance and relying solely on federal government to drive the response to this health crisis, Ontario has joined the fight in a very real way. When it comes to action, robust, timely and coordinated are the key watchwords. A word of caution: with the recently ordered economic shutdown of non-essential services and uncertainty about the date of reopening, fiscal contingencies/reserves may well be needed. For our part, we now expect a contraction of 5% in real GDP at the national level in 2020. More positively, to the extent the combined federal-provincial response proves successful, the economy could be put back on track later this year, allowing the temporarily inflated deficit to contract and restoring a more sustainable debt trajectory (which is where Ontario was headed before this global health crisis flared up). In the meantime, Ontario has some work to do in debt capital markets, but it's been here before and has done its level best to cultivate investor demand at home and abroad for its relatively liquid securities. We likely won't need to wait long to gauge investor reaction to Ontario's new economic and fiscal reality, with the province looking to kick start its 2020-21 borrowing program immediately (as early as Thursday in the domestic market, and as early as next week for any prospective international financings).

***Ontario***

| $ billions | Actual 2018-19 | Budget 2019-20 | Interim 2019-20 | Plan 2020-21 | Update 2020-21 |
|---|---|---|---|---|---|
| **Revenue** | **153.7** | **154.2** | **156.7** | **159.8** | **156.3** |
| Own-Source Revenue | 105.5 | 106.1 | 108.7 | 109.8 | 108.2 |
| *Personal Income Tax* | 35.4 | 36.6 | 37.6 | 38.2 | 37.3 |
| *Sales Tax* | 27.8 | 28.1 | 29.1 | 28.9 | 29.1 |
| *Corporations Tax* | 16.6 | 15.2 | 15.4 | 15.7 | 15.2 |
| *Education Property Tax* | 6.2 | 6.1 | 6.2 | 6.2 | 6.3 |
| *Ontario Health Premium* | 3.8 | 4.0 | 4.1 | 4.2 | 4.1 |
| *Other* | 15.7 | 16.2 | 16.2 | 16.7 | 16.3 |
| Federal Transfers | 25.1 | 25.5 | 25.4 | 26.6 | 26.3 |
| Income from Government Business Enterprises | 5.5 | 5.8 | 5.7 | 6.2 | 4.1 |
| Other non-tax revenue | 17.6 | 16.8 | 16.9 | 17.2 | 17.6 |
| **Expenses** | **161.1** | **163.4** | **165.7** | **165.6** | **174.3** |
| Program Spending | 148.8 | 150.1 | 153.1 | 151.9 | 161.1 |
| Interest on Debt | 12.4 | 13.3 | 12.6 | 13.7 | 13.2 |
| **Reserve** | **-** | **1.0** | **0.2** | **1.0** | **2.5** |
| **Surplus (Deficit)** | **(7.4)** | **(10.3)** | **(9.2)** | **(6.8)** | **(20.5)** |
| **As a % of GDP** | **-0.9%** | **-1.2%** | **-1.0%** | **-0.7%** | **-2.3%** |
| **Net Debt** | **338.5** | **359.9** | **355.2** | **372.3** | **379.2** |
| As a % of GDP | 39.5 | 40.7 | 39.9 | 40.7 | 41.7 |
| **Accumulated Deficit** | **216.6** | **230.0** | **225.6** | **235.8** | **243.6** |
| As a % of GDP | 25.3 | 26.0 | 25.3 | 25.8 | 26.8 |
| **Interest on debt as a % of revenue** | **8.1%** | **8.6%** | **8.0%** | **8.6%** | **8.4%** |
| **Borrowing Requirement** | | **36.0** | **36.0** | **32.8** | **43.6** |
| (Surplus) Deficit | 7.4 | 10.3 | 9.2 | 6.8 | 20.5 |
| Maturities/Redemptions | | 27.5 | 27.4 | 26.4 | 26.6 |
| Investment in Capital Assets | | 11.6 | 11.6 | 11.1 | 10.4 |
| Pre-borrowing in 2019-2020 | | - | 4.1 | - | (4.1) |
| Other | | (13.4) | (16.3) | (11.6) | (9.9) |

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