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Well positioned for post-COVID recovery

By Warren Lovely / Stéfane Marion

A fresh budget update from Québec understandably focuses on the damage COVID-19 has done to the provincial economy and public finances. Québec has been the epicentre of the virus in Canada, and the update lays bare the related and unprecedented hit to jobs and growth, while nonetheless flagging confidence that the province will return to growth rapidly. Confidence in the recovery also reflects the numerous forceful actions policymakers have taken: both monetary and fiscal measures, including a high degree of engagement at both the provincial and federal levels. As we're seeing everywhere, the budgetary outlook has been substantially revised. The update provides a transparent and comprehensive picture that dovetails with the Finance Minister's earlier pronouncements: that of a $14.9 billion deficit that will likely take five years to erase. Consistent with the sharp (albeit temporary) budgetary erosion, Québec's long-term borrowing requirement for 2020-21 has stepped up $18.2 billion to $32.1 billion. Notwithstanding the enlarged requirement, Québec's funding program is relatively well advanced as the first quarter of the fiscal year draws to a close.

- Revised 2020-21 fiscal picture: Just over three months ago (on March 10th), Québec presented its 2020 budget. Since then, the global economy has been turned upside down by COVID-19, triggering the sharpest contraction in economic activity since the Great Depression and requiring policymakers to step into the breach. Rapid-onset economic weakness combined with the deployment of large-scale counter-cyclical stimulus has pushed Québec from an underlying budget surplus position to a deficit of $14.9 billion for the 2020-21 fiscal year, equivalent to 3.4% of GDP. That's *after* a $2.6 billion deposit to the Generations Fund, and *before* accounting the stabilization reserve. That's a record shortfall in dollar terms and as per the update: "This exceptional situation requires use of the stabilization reserve to comply with the *Balanced Budget Act*." Note that the surplus for the prior fiscal year, 2019-20, is now pegged at $3 billion—an upward adjustment of $1.1 billion relative to prior guidance. The improved balance for 2019-20 nicely illustrates the favourable situation Québec was in prior to the onset of the coronavirus.

- Revenue profile: A 4% contraction in nominal GDP translates into a notably weaker-than-expected revenue profile. Own-source revenue is tracking $8.5 billion or 9% below plan. Weakness is most heavily concentrated in income and sales taxes, as hundreds of thousands of Québecers have been off work, while shaken consumers have been forced to stay home. Federal transfers of $29.8 billion account for just over one-quarter of Québec's overall revenue dollar this fiscal year.

- Expenditure profile: Total expenditures are set at $123.8 billion in 2020-2021, up 11.2% from last year. Program expenditures are estimated at $115 billion while debt services charges are expected to rise to $8.3 billion. Health (up 12.6% this year) is to account for 44.4% of total program expenditures in 2020-21. We note that within the space of a few weeks, the government introduced unprecedented financial support, equivalent to that put in place within 24 months during the 2008-2009 financial crisis. The budgetary impact of this support to fight COVID-19 totals more than $6.6 billion (~ 1.5% of GDP):

  a) $3.7 billion to strengthen our health care system to address the public health crisis;

  b) $1.0 billion to support workers and individuals;

  c) $2.0 billion to mitigate the economic impact of the pandemic.

  According to the government, these measures have made over $28 billion (~6.4% of GDP) in liquidity available to various economic actors in Québec.

- Substantial contingency reserve & path back to balance: The current year's deficit is inclusive of an unprecedented $4 billion contingency reserve, which works out to 3.5% of revenue and nearly 1% of GDP. That provides some significant padding should a second wave of the virus materialize or in the event of other unforeseen pressures. All else equal, it creates a potential opportunity for the deficit in come in below today's $14.9 billion headline. Finance Minister Girard repeated his earlier message that it will likely take five years to return to balance. Notably, the deficit reduction strategy will not entail tax increases, but will maintain the province's demonstrated focus on building a green economy.

- Debt burden: The combination of an outsized budget deficit and sharply lower nominal GDP means that, in Québec and the other provinces, debt burdens are stepping up notably… albeit temporarily. In Québec's case, gross debt is set to rise $22.9 billion in 2020-21, reflecting the record deficit, net capital investments and investments/loans, among other factors. That leaves the corresponding debt-to-GDP ratio at 50.4% vs. the prior fiscal year's ratio of 43.4%. Attribution analysis would assign nearly one half of the 7%-pt year-over-year increase in the debt burden to the lower level of nominal GDP. Recall that back in March's budget, the 2020-21 debt ratio had been projected to be 42.2%. Despite the large upward revision, the gross debt ratio is still lower than the level which prevailed in 2016-17 (51%). To Québec, a temporary COVID-induced increase in relative indebtedness "in no way affects our will to make debt reduction a government priority." Saying that, the government may need to review debt reduction legislation, particularly as it relates to targets set out for 2025-26. To be clear, the debt burden remains affordable, as debt service payments are set to consume a very manageable 7.2% of revenue this fiscal year. (Ten years ago, the interest bite was north of 10% and it was more like 14½% when the new millennium dawned.)

- **Borrowing requirement:** To no surprise, a larger financing requirement goes hand-in-hand with the weaker budgetary picture. The 2020-21 borrowing requirement has been boosted to $32.1 billion, which is up $18.2 billion vs. budget. For comparison, Québec borrowed just over $20 billion in fiscal 2019-20, which was inclusive of almost $8 billion in pre-financing. The government has definitely been "proactive" in accessing debt capital markets, having already secured $12.3 billion of term funding since the start of the fiscal year. That includes a series of domestic benchmark offerings (i.e., conventional bonds), but also features two notable international offerings—one in US dollars the other in euros. To date, 63% of contracted funding has been C$-based. To us, Québec's debt offerings have met with relatively strong demand at home and abroad, with confidence in the provincial sector having been bolstered by Bank of Canada provincial debt purchase programs (money market and bonds).

The government's financing program
(millions of dollars)

	2019-2020	2020-2021
Net financial requirements	1 946	28 197
Repayments of borrowings	16 562	10 346
Use of the Generations Fund to repay borrowings	–2 000	—
Withdrawal from the Accumulated Sick Leave Fund	–100	—
Use of pre-financing	–5 949	–7 988
Change in cash position	1 771	—
Deposits in the Retirement Plans Sinking Fund (RPSF)(1)	1 500	—
Transactions under the credit policy(2)	–1 675	1 560
Pre-financing	7 988	—
TOTAL	**20 043**	**32 115**

Note: A negative entry indicates a source of financing and a positive entry, a financial requirement.
(1) Deposits in the RPSF are optional. They are recorded in the financing program only once they are made.
(2) Under the credit policy, which is designed to limit financial risk with respect to counterparties, the government disburses or receives amounts following, in particular, movements in exchange rates. These amounts have no effect on the debt.

- **Economic outlook:** After growing 2.7% in 2019, Québec's real GDP is assumed to fall 6.5% in 2020 due to COVID-19 and the economic shutdown in March. In April, there were no housing start recorded in urban areas. In mid-May, certain sectors were allowed to reopen, notably construction and manufacturing. Gradual reopening of the economy is still underway. Next year, real GDP is expected to rebound 6.0%. Nominal GDP is expected to contract 4.0% in 2020 and to rebound 7.1% in 2021. As in other jurisdictions, temporary job losses are driving the unemployment rate sharply higher. Employment was off 13.4% from February to May, with the unemployment rate surging from 4.5% to 13.7%. In April, retail sales were off 39% from February. For 2020 as a whole, jobs are expected to fall 5.3% compared to the average level in 2019, with a 3.9% rebound in 2021, with the unemployment rate surging from 5.1% in 2019 to 9.5% in 2020 before declining to 7.5% in 2021. However, the various measures taken by the governments to boost household disposable income will mitigate the labour market downturn. However, a very high degree of uncertainty is weighing on economic forecasts, the impact of the health crisis on economic activity and the pace of recovery are hard to assess. Furthermore, there could be a second wave of infections by the end of the year.

Conclusion

COVID-19 and strict measures meant to contain it brought the global economy to its knees in 2020, and Québec has not been immune. Indeed, as the epicentre of the disease in Canada, the local economy looks to be somewhat harder hit here than in certain other provincial jurisdictions. Nonetheless, there's cautious optimism that growth will recover as physical distancing measures continue to ease and more and more activity gradually resumes. One can expect that a full recovery will take time, but Québec households may be better positioned financially compared to other Canadians. The provincial economy is well diversified and seeds of renewal are sprouting, encouraged by unprecedented stimulus. Meanwhile, lower average housing prices imply relatively less vulnerability to a correction. The virus has had a pronounced effect on the current fiscal year's budget. But in much the same way the economic hit is meant to pass, the fiscal picture should begin to improve in 2021-22. Earlier serious work on debt consolidation looks prescient, leaving the province relatively well positioned to weather the financial fallout from the virus. After all, Québec was one of the few provinces that entered the COVID-19 crisis with a structural surplus. We'd highlight that the sizeable $4 billion contingency offers significant padding should a second wave of the virus emerge. To us, this is a prudent element and suggests that, all else equal, the $14.9 billion deficit (after the Generations Fund deposit) may be an upper bound. As for today's larger borrowing requirement, its looks imminently manageable. The province successfully sourced a lot of liquidity early in the fiscal year and its debt offerings continue to attract solid demand from both domestic and international investors… to say nothing of the Bank of Canada's provincial bond purchase program (implemented in May) that offsets a non-trivial portion of the sector's outsize increase in issuance.

Overview of the budgetary situation – June 2020
(millions of dollars)

	2019-2020	2020-2021
Revenue		
Own-source revenue excluding revenue from government enterprises	87 831	82 338
% change	*2.0*	*–6.3*
Revenue from government enterprises	4 555	3 316
% change	*–17.9*	*–27.2*
Federal transfers	25 158	29 781
% change	*8.8*	*18.4*
Total revenue	**117 544**	**115 435**
% change	***2.4***	***–1.8***
Expenditure		
Portfolio expenditures	–103 724	–115 504
% change	*6.1*	*11.4*
Debt service	–7 648	–8 304
% change	*–12.3*	*8.6*
Total expenditure	**–111 372**	**–123 808**
% change	***4.6***	***11.2***
Estimated losses on the CSeries investment	–603	—
Provision for economic risks and other support and recovery measures	—	–4 000
SURPLUS (DEFICIT)(1)	**5 569**	**–12 373**
BALANCED BUDGET ACT		
Deposits of dedicated revenues in the Generations Fund	–2 606	–2 567
Use of the stabilization reserve	—	14 940
BUDGETARY BALANCE(2)	**2 963**	**—**

(1) Balance within the meaning of the Public Accounts.
(2) Budgetary balance within the meaning of the *Balanced Budget Act*, after use of the stabilization reserve.

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