NATIONAL BANK OF CANADA FINANCIAL MARKETS

Public Sector Strategy

Fixed Income Trading Desk Strategy

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Quick Hit — The juxtaposition of the federal—sub-sovereign debt outlook

With the recent release of Canada's national balance sheet accounts for 2018:Q1, we were offered some comforting news that Canadians appear to be easing up on their borrowing binge. While household finances remain a predominant focus, one shouldn't overlook developments in Canada's government sector. The latest installment of national balance sheet data, complete with its detailed breakdown of the financial position by level of government, jives with our long-held view that the federal and provincial levels of government remain on fundamentally divergent fiscal paths.

Ottawa may still be running a budgetary deficit, but there's been noted consolidation in the federal debt burden (as a share of GDP) from an already healthy starting point. Canada's sub-sovereign governments, particularly provinces, have chosen a different path however, racking up $330 billion more debt than the feds over the past eight years.

Chart 1 illustrates the gross debt burden over time for the federal government and for all other levels of government. Consider that in 2010, in the early stages of recovery following the financial crisis, Ottawa held a slight gross debt edge of roughly 5%-pts of GDP. Fast forward to the first quarter of this year and that difference has widened to nearly 20%-pts, the largest gap on record, even though the sub-sovereign gross debt ratio is a couple ticks removed from its recent peak.

Of course, gross debt isn't the only way to look at government leverage. Factor in the value of financial assets and you're left with a narrower definition of indebtedness… that is, net debt. Here again, the latest balance sheet data paint an interesting picture.

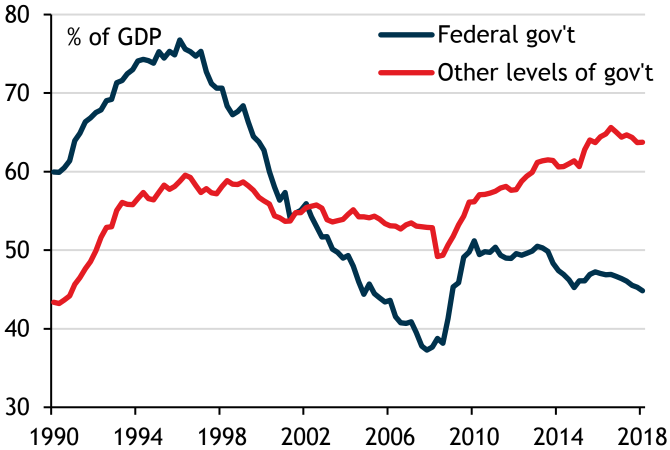
Net debt at the federal level has been coming down since 2011. It's now within striking distance of pre-crisis lows (29% of GDP today vs 28% in 2008). The net debt burden for Canada's other levels of government has, however, been on a steady incline since 2009 (Chart 2). At this rate, we're likely but one or two quarters removed from an unprecedented situation, whereby Canada's sub-sovereign governments will be managing a heavier net debt burden than the federal government. Fiscal sustainability analysis—our own or that conducted by the non-partisan Parliamentary Budget Officer in Ottawa—suggests that, barring corrective action, the aggregate provincial net burden is likely to continue to climb while the federal net debt load plumbs newer and newer lows.

Provincially, net debt accumulation reflects budgetary shortfalls and ongoing capital expenditures. To be fair, the growing value of non-financial assets means the net worth of the sub-sovereign government sector looks healthier. Still, control for where we are in the economic cycle and factor in a rising interest rate environment, and it's understandable that rating agencies are somewhat nervous about debt burdens in more than a few provinces. Keep in mind, however, that not all provinces have seen their debt burdens rise. Detailed fiscal analysis reveals that some provinces, notably Quebec and Nova Scotia, have been working *down* their net debt burdens, earning praise from rating agencies and investors alike.

Finally, turning our focus solely to the sovereign, we'd be remiss if we didn't mention another stark juxtaposition. As we've written about in the past, the new debt trajectory of the US federal government (following the implementation of Trump's vaunted tax cuts) is now diametrically opposed to that of Canada. The US Congressional Budget Office projects that the federal debt burden in Washington will balloon from 78% of GDP in 2018 to over 86% by 2028, while in Canada, the federal government forecasts continually declining debt-to-GDP over their own forecast horizon. The impact of these diverging debt trajectories are already evident in the rates space, where looser fiscal policy and much heavier net supply south of the border have contributed to wider interest rate differentials vis-à-vis Canada's more fiscally sustainable sovereign.

Chart 1: Diverging gross debt trajectories …

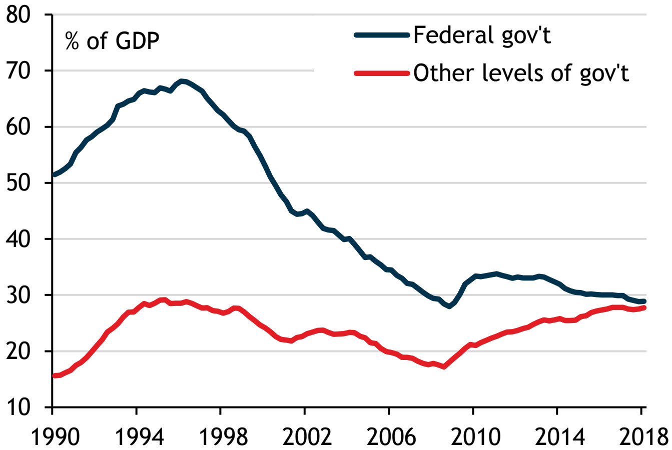
Gross debt as a % of GDP since 1990



Source: Statistics Canada, NBF

Chart 2: … But not so severe on a net debt basis

Net debt as a % of GDP since 1990



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