February 22, 2022

Deficit down but not out, as new investments offered in cautious plan

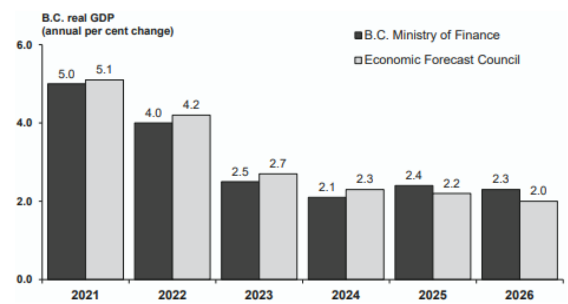
By Warren Lovely, Alpa Atha and Daren King

Highlights

Relative to last year's self-proclaimed 'deficit budget', British Columbia is closing out the second year of a pandemic with its public finances in considerably better shape than originally planned. A near-$10 billion deficit ultimately failed to materialize in 2021-22, as multiple revenue streams swelled. Strip out residual prudence and a budget surplus is likely when the public accounts are formally presented. With some one-off revenue gains unlikely to be repeated and some major investments offered up, a deficit of $5.5 billion is planned for 2022-23 (equivalent to 1.5% of GDP). In all, the budget projects $12.8 billion in combined red ink over the fresh three-year fiscal plan. The suspension of the legislative requirement for balanced budgets is being extended and there's no definitive timeline for erasing the deficit. Instead, a collection of loose fiscal guardrails remain in place. There's uncertainty and risk to contend with, but in keeping with past practice, the budget incorporates significant prudence. This could protect BC's finances from an adverse turn of events or, as was the case in 2021-22, leave the budget closer to balanced if fiscal padding is not needed. For the outgoing fiscal year, a dramatically improved budget balance seriously limited debt accumulation, with BC remaining a relatively low-debt provincial jurisdiction. Operational shortfalls plus capital spending commitments would nonetheless see new debt built up from here, the taxpayer-supported debt-to-GDP ratio edging higher in each year of the fiscal plan (rising from 17.8% in 2021-22 to 22.8% by 2024-25). Still, no province has a lighter interest bite, taxpayer-supported debt charges currently consuming just 2.8% of revenue and likely a still-skinny 3.7% in three years' time. In the end, the gross borrowing requirement for 2021-22 was more than halved relative to budget (collapsing from $19.2 billion to just $8 billion excluding a residual forecast allowance). Officially, the budget outlines $19 billion in gross borrowing for 2022-23 and more than $49 billion over the full three-year financing plan. These are non-trivial requirements, although we reiterate that official figures embed substantial prudence, suggesting actual cash needs could be materially lighter. Moreover, BC has consistently demonstrated access to debt capital markets at home and abroad. All in all, the budget allows for some fiscal give-back after an enormously positive 2021-22, in part to finance some major new investments. But it's a plan with near- and medium-term fiscal upside just the same. And so begins an important budget season for Canada's provinces, with bond investors keen to gauge just how much of last year's extraordinary fiscal upgrade can be sustained while simultaneously positioning for monetary policy tightening and contending with elevated geopolitical uncertainty.

- **Economic outlook** – British Columbia's economy continued its recovery in 2021, as real GDP is estimated to have grown by 5.0%. This was stronger growth than that seen in Canada, and was secured in spite of the pandemic, drought, forest fires and floods. These natural disasters once again illustrate how sensitive the province's economy is to climate risks. Despite this, the recovery in the labour market was also the strongest of all Canadian provinces. Some 470K net new jobs were created between May 2020 and January 2022, the resulting level of employment 2.4% above its pre-pandemic peak. For 2022, the budget is based on conservative real GDP growth of 4.0%, that growth rate set below the average private sector forecast of 4.2% and our latest projection of 4.4%. The economy is expected to be fueled by the recovery of consumption in the service sector, the return of tourism and reconstruction efforts following the floods that took place in late 2021. At 2.5%, 2023 real GDP growth is expected to fall temporarily below the national average, returning to an above-average clip thereafter (i.e., growth of 2.1% in 2024, 2.4% in 2025 and 2.3% in 2026). Nominal GDP growth should generally support the province's finances, especially given the high level of commodity prices. After an impressive increase of 12.4% in 2021, nominal GDP is expected to advance 5.8% in 2022, 4.1% in 2023, 4.0% in 2024 and 4.3% in 2025 and 2026. It's believed that a 1%-pt increase in nominal GDP growth produces a $200-300 million annual fiscal benefit. Labor shortages are expected to constrain growth in the short and medium term due to increasing retirements and an aging population. As a result, the unemployment rate is expected to average 5.5% in 2022, 5.4% in 2023, 5.3% in 2024 and 5.2% in 2025 and 2026. Note that the economic forecast does not incorporate new fiscal measures outlined below.

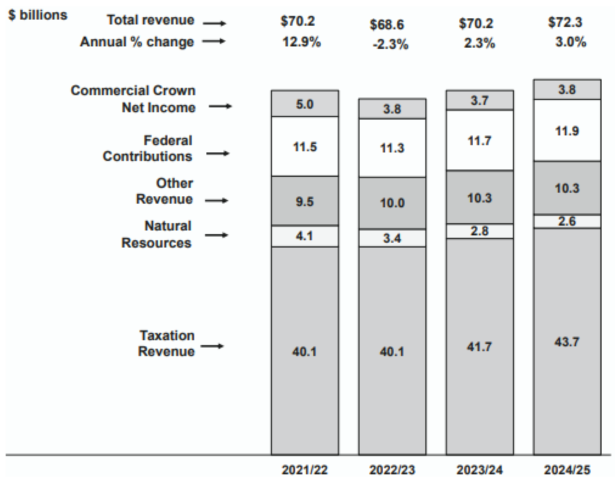
Prudent Economic Forecast



- **Latest (but not yet final) estimate of 2021-22 budget balance** – Consistent with a by-now-well-appreciated fiscal narrative, British Columbia's budgetary position improved markedly in 2021-22. The province now projects a deficit of $483 million, inclusive of a $1 billion forecast allowance. Assuming that forecast allowance goes unused, the province could well report a budget surplus when public accounts are formally presented. No question, this is a massive in-year fiscal improvement relative to the $9.7 billion shortfall originally planned for. It likewise represents a fiscal upgrade vs. the $1.7 billion deficit more recently flagged in BC's Q2 update. A much rosier revenue picture has keyed the fiscal recovery, top-line revenue tracking $2 billion above the mid-year projection and more than $11 billion (or almost 20%) above the original budget plan. Credit a surprisingly robust recovery. The latest revenue upgrade (vs. Q2) captures a variety of gains, including but not limited to corporate tax, sales tax, property transfer tax (owing to a red-hot housing market), natural resources (mainly forests), in addition to buoyant results for commercial Crown corps (the result of higher investment earnings). Total expenses expanded relative to Q2, including $466 million under the Emergency Program Act for recovery purposes related to extreme flooding brought about by climate change. Still, of the total revenue surprise in 2021-22, more than 80% was used to improve the fiscal bottom line.

- **Medium-term fiscal outlook (2022-23 & beyond)** – Budget 2022 projects a $5.5 billion deficit for 2022-23, equivalent to 1.5% of GDP. This represents a year-over-year erosion in the budget balance when compared to latest budgetary figure for 2021-22. That's partly a function of some extraordinary/temporary revenue gains failing to repeat, as total revenue is projected to decline 2.3% from the increasingly elevated 2021-22 base. In particular, federal health transfers and certain own-source revenue streams (e.g., property transfer tax, natural resources, net income at Crown corps) are slated to step down. For context, federal transfers are meant to account for for ~17% of provincial revenue in the coming fiscal year, with BC standing with its provincial peers in requesting a major and permanent enhancement in federal health care funding. Natural resources look to directly comprise less than 5% of revenue, highlighting the relatively lighter resource leverage here vs. the neighbouring province to the east. The larger 2022-23 deficit also captures the leading edge of some major new investments (highlighted below). While there is no definitive timeline for erasing the deficit, the budgetary shortfall is meant to decrease in successive fiscal years. The budget flags a deficit of $4.2 billion for 2023-24, en route to $3.1 billion in red ink come 2024-25. These latter two years assume an average annual revenue growth of 2.7%, against a 2.4% average gain in regular spending, alongside a step down in pandemic contingencies. Understandably, the budget flags a variety of risks/uncertainties. So in keeping with past practice, BC has incorporated significant prudence along the following lines:
  - **Conservative growth assumptions** – As discussed in the economic overview, budget planning assumptions for real GDP growth have been set 0.2%-pts below the private sector consensus for each of 2022, 2023 and 2024;
  - **Forecast allowance** – Equivalent to $1 billion each year of the fiscal year. There remains $1 billion set aside in the outgoing fiscal year, despite March 31st being not far off. That hints at additional scope for budgetary improvement when the dust settles on 2021-22;
  - **General Contingencies** – Sizeable contingencies of $2.8 billion in 2022-23, rising to $3.4 billion in 2023-24 and $4 billion in 2024-25. That's equivalent to 4-5½% of total spending over the fiscal plan. These funds help deal with disaster recovery costs;
  - **Pandemic and Recovery Contingencies** – Additional, pandemic-specific contingencies have once again been set aside for future years, amounting to $2 billion in 2022-23 and $1 billion in 2023-24.

Chart 1.2 Revenue Forecast



- **Select new investments** – Dubbed 'Stronger Together', Budget 2022 outlines a series of major investments, amounting to $6.6 billion in new program spending over the three-year fiscal plan. Substantial new funding was outlined for health care, which in light of the ongoing pandemic, remains a clear priority area here as in other provinces. Homelessness likewise remains a focus, while additional funding was outlined for child care. (BC has formalized an agreement with the federal government pursuant to Ottawa's national daycare commitment, which is worth $3.2 billion over five years.) A series of investments fall under the banner of 'building a stronger economy', including skills development/training, support for scientific research, connectivity, affordable housing, economic diversification and reconciliation. On the environment, the budget clearly highlighted the impact climate-related disasters have had on the province. More than $1 billion of new funding was earmarked to help fight climate change, including supports for clean transportation, energy efficient buildings and industry decarbonization. That's on top of new funding to help people and communities better prepare for and recover from disasters, including recent flooding. As it relates to flooding, note that the federal government's December 2021 fiscal update allocated $5 billion to cover disaster costs in BC. While total flood costs are not yet known, BC's budget allocates some $1.5 billion over three years related to flood response/recovery, on top of the above-noted federal funding. Beyond new program spending, BC's three-year taxpayer-supported capital plan of $27.4 billion is the largest ever. An additional $12 billion over three years will go towards capital spending at self-supported Crown corps. Elsewhere, 'marketplace facilitators' will be required to collect and remit tax on BC sales, clarifying tax collection/remittance obligations for these sellers/service providers.

- **Path to balance & fiscal guardrails** – Despite earlier promising to outline a 'path to balance', there's no definitive timeline for erasing the deficit here. Instead, the legislative requirement for balanced budgets has been extended through 2024-25, with the government noting the need to take a 'broader perspective' on fiscal repair. A variety of 'fiscal guardrails' were put in place in last year's budget and continue to guide budgetary policy. For Budget 2022, these include year-over-year declining deficits (starting from 2022-23 not 2021-22), targeted spending, time-limited COVID contingencies, overall prudent budgeting and transparent/timely reporting. As for 'debt affordability indicators', BC emphasizes a debt-to-GDP ratio that is to remain below 25% and a debt-to-revenue ratio that compares favourably to provincial peers. The province's access to 'affordable financing' will likewise be monitored. A variety of additional indicators could influence BC's fiscal posture, covering everything from health to economic/business conditions, local/community recoveries and of course ESG considerations (where the province's detailed 'values' have been spelled out). All that to say, BC has opted to keep its longer-term fiscal options open, in order to respond to major pressures and/or advance the investments deemed necessary today and into the future.

Chart 1.4 Debt to GDP

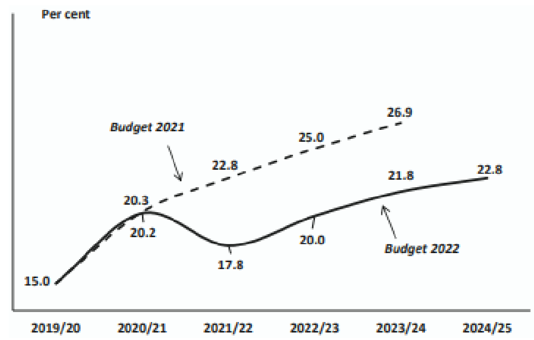
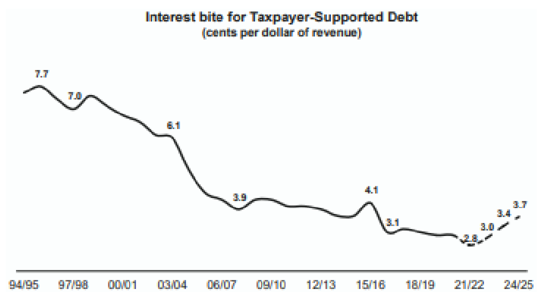


Chart 1.5 Debt Affordability



- **Debt outlook & interest bite** – With a sizeable projected deficit all but erased over the course of 2021-22, the preferred debt measure—taxpayer-supported debt—is poised to end the fiscal year far below plan. Specifically, the freshly estimated debt level, at $61.7 billion, is tracking almost $10 billion lower than in Budget 2021. Taxpayer-supported debt works out to 17.8% of GDP or 92.9% of revenue, both of which are serious improvements vs. plan. Leverage calculations benefit from what has been exceptional growth in nominal output and by extension provincial revenue. In light of planned deficits and meaningful capital spending, BC expects to accumulate debt in absolute and relative terms. Some $29 billion of incremental taxpayer-supported debt has been flagged through 2024-25, the corresponding debt-to-GDP ratio rising in each of the three coming fiscal years (to 20.0% in 2022-23 and to 22.8% by 2024-25). This would still leave the debt ratio on an improved footing vs. the prior trajectory, owing to the serious improvement registered in the outgoing fiscal year. The revised metrics would likewise keep BC at the lower end of the spectrum relative to its provincial peers. As we've routinely highlighted, BC's more modest debt burden also gets reflected in a smaller 'interest bite' and relatively less interest rate reset risk. No question, interest bills are being examined more closely these days, as North American central banks prep for what could be a series of policy rate hikes. But taxpayer-supported interest charges consumed just 2.8% of revenue in 2021-22, and the interest bite should be no higher than 3.7% by the end of the three-year fiscal plan. For reference, interest rate planning assumptions allow for a series of BoC and Fed rate hikes. The yield on 10-year Canada bonds is seen averaging 1.82% in 2022 and 2.14% in 2023. Fiscal sensitivity analysis suggests that a 1%-pt increase in interest rates would add $185 million to the annual interest bill in year one. Alternatively, adding $1 billion in new provincial debt would come at an annual fiscal cost of $22-26 million. Flipping this on its head, the vast budgetary improvement booked in 2021-22 (and cumulative multi-year fiscal improvement vs. Budget 2021) will save British Columbian taxpayers from a larger interest bill. We'd note that other Canadian provinces have likewise taken advantage of bonus revenue to bolster the bottom line, limiting at the margin the amount of debt needing to be issued/serviced.

- **Long-term borrowing requirement** – When BC set down its 2021 budget in April of last year, a gross borrowing requirement of more than $19 billion was flagged for 2021-22. Well, scratch that. After a major-league fiscal improvement, the outgoing fiscal year's gross borrowing need has been formally slashed to $9 billion… or more likely $8 billion if you assume a residual $1 billion forecast allowance goes unused. In meeting the new, lower requirement, BC secured roughly $8.8 billion from term markets. That included $5.2 billion in public syndicated CAD bond deals, alongside some $3½ billion (CAD equivalent) in international funding—BC having long enjoyed a strong following abroad. For the upcoming, 2022-23 fiscal year, the projected deficit plus sizeable capital requirements produce an official gross borrowing need of $19.0 billion. Further out, the budget hints at gross requirements of $16.4 billion for 2023-24 and just under $14 billion for 2024-25. For the fresh three-year financing plan, combined requirements total $49.4 billion. As always, we would emphasize that conservative budgeting and layers of prudence could mean much lighter cash requirements when all is said and done. As Canada's top-rated province, with demonstrated access to debt capital markets at home and abroad, we consider BC's borrowing requirements (gross and net) to be manageable. Saying that, all borrowers may need to be mindful of looming central bank balance sheet reductions (aka Quantitative Tightening) and a gradual tightening of financial conditions. By design, QT entails placing more net debt with end investors and is a process that looks to get under way—at the U.S. Federal Reserve and for the first time ever at the Bank of Canada—in the coming months. Given the evolving monetary policy backdrop (i.e., expected rate hikes and balance sheet reductions), prospective fiscal improvements, whether in BC or elsewhere, could serve to limit net bond supply. That, in turn, could prove technically helpful as central banks aspire to normalization in today's high inflation environment.

- **Long-term credit ratings (latest rating report/review date in parentheses):**

  S&P: AA+, Stable (29-Nov-21) | Moody's: Aaa, Stable (2-Jun-21) | DBRS: AA(high), Stable (15-Jun-21) | Fitch: AA+, Stable (25-Jul-21)

  Note: BC was downgraded a single notch by both S&P and Fitch in 2021, the outlook in both instances then returned to 'stable'. Notwithstanding these downgrades, BC remains the highest rated provincial government based on the long-term ratings currently assigned by each of the four major credit rating agencies listed above. Refer to our *Provincial Ratings Snapshot* for additional colour on specific credit rating drivers/considerations.

NATIONAL BANK OF CANADA FINANCIAL MARKETS

British Columbia

$000,000	Budget 2021/22	Forecast 2021/22	Budget 2022/23	Plan 2023/24	Plan 2024/25
Taxation revenue	33,782	40,052	40,070	41,679	43,646
Resource revenue	2,532	4,123	3,387	2,798	2,606
Other revenue	9,220	9,550	9,991	10,210	10,314
Other federal transfers	10,530	11,482	11,340	11,742	11,932
Commercial Crown corporation net income	2,865	5,013	3,764	3,748	3,827
as of Insurance Corporation of British Columbia (ICBC)	*154*	*1,904*	*327*	*240*	*280*
Total revenue	**58,929**	**70,220**	**68,552**	**70,177**	**72,325**
Program spending	60,570	62,757	65,239	65,692	66,953
Debt servicing costs	2,807	2,696	2,926	3,255	3,566
Contingencies	1,000	1,000	2,848	3,412	3,987
Total spending	**64,377**	**66,453**	**71,013**	**72,359**	**74,506**
Pandemic and Recovery Contingencies	(3,250)	(3,250)	(2,000)	(1,000)	-
Forecast allowance	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)
Surplus/Deficit	**(9,698)**	**(483)**	**(5,461)**	**(4,182)**	**(3,181)**
Provincial Debt Changes					
Deficit (surplus) before forecast allowance	8,698	(517)	4,461	3,182	2,181
Taxpayer-supported capital spending	8,479	7,157	9,279	9,333	8,815
Self-supported capital investments	4,976	3,828	4,374	4,437	3,144
Commercial Crown corp. retained earnings	(187)	2,906	1,074	1,137	1,245
Amortization and other capital asset changes	2,633	2,619	2,813	3,001	3,068
Other items	(9,205)	(11,548)	(8,115)	(9,400)	(9,983)
Increase in total provincial debt	**15,394**	**4,445**	**13,886**	**11,875**	**8,470**
Total provincial debt	**102,880**	**91,545**	**105,431**	**117,306**	**125,776**
Taxpayer-supported	**71,642**	**61,731**	**73,475**	**83,302**	**90,846**
Self-supported	**30,238**	**28,814**	**30,956**	**33,004**	**33,930**
Forecast Allowance	**1,000**	**1,000**	**1,000**	**1,000**	**1,000**
Total provincial debt / GDP	32.7%	26.3%	28.7%	30.6%	31.6%
Taxpayer-supported	22.8%	17.8%	20.0%	21.8%	22.8%
Capital Spending	**13,455**	**10,985**	**13,653**	**13,770**	**11,959**
Taxpayer-supported capital spending	8,479	7,157	9,279	9,333	8,815
Self-supported	4,976	3,828	4,374	4,437	3,144
Provincial borrowing requirements	**19,248**	**9,025**	**19,013**	**16,402**	**13,994**
Operating deficit (surplus)	9,698	483	5,461	4,182	3,181
Capital spending	13,455	10,985	13,653	13,770	11,959
Refinancing requirements	3,869	3,952	4,189	3,532	3,888
Other financing sources	(7,774)	(6,395)	(4,290)	(5,082)	(5,034)

Source: Budget documents, British Columbia Ministry of Finance

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King
Economist
daren.king@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich
Rates Strategist
taylor.Schleich@nbc.ca

Alpa Atha
Fixed Income Economist
alpa.atha@nbc.ca

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 70 St. Mary Axe, London, EC3A 8BE.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only.

This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA")which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.