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Gloomier economic outlook delays return to balanced budget

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Highlights

While Ontario's economy, backed by record population growth for the second year in a row, is expected to do better in 2023 than originally anticipated in the Budget, today's Fall Economic Statement (FES) shows that revenues have fallen short of earlier projections, while spending has been revised up. The result is a projected deficit for 2023-24 moving from $1.3 billion to $5.6 billion (0.5% of GDP). Faced with a gloomier economic outlook for 2024-25, the return to a balanced budget will have to wait an additional year compared to prior plans. It's now 2025-26 that the province foresees a budget balance written in black ink. While the outlook has worsened since the spring, it's not certain these budgetary projections will be realized. As always, Ontario continues to embed significant prudence into the fiscal framework in the form of reserves, contingencies, and sub-consensus growth forecasts. Ontario's FES outlines fresh action/support focused on the main axes: "Building Ontario" and "Working for you". Among other things, there's the announcement of the creation of Ontario Infrastructure Bank, the elimination of 8% provincial portion of the Ontario Harmonized Tax on purpose-built rental housing (like the Federal government announced several weeks ago), and additional investment to the Invest Ontario Fund to attract investment in Ontario. The weaker budgetary results/outlook and resulting increased borrowing needs have led to the closely watched net debt-to-GDP trajectory being revised up 0.6%-pts versus Budget 2023 to 38.4% of GDP in 2023-24. That's partially driven by nearly $20 billion being added to the long-term borrowing program through 2025-26. Expect more Ontario bonds to come in the not-too-distant future as the current fiscal year's need was revised upward by $7.2 billion (to $34.7 billion). At 43% complete, the current fiscal year's borrowing program might not look that advanced for this stage of the fiscal year, but Ontario has proven itself capable of coming out of the mid-year funding black out quickly and efficiently in the past.

- **Economic outlook** – In the first two quarters of 2023, economic growth in Ontario has been robust and stronger than the country as a whole, supported by record population growth of 463K individuals over the past year. As a result, real GDP increased at an annualized rate of 3.1% in Q1 and 0.6% in Q2 (vs. Canada Q1: 2.6%, Q2: -0.2%). However, the pace of growth is expected to slow in the second half of the year due in part to high inflation and rising interest rates. For 2023 as a whole, the Ministry estimates that the province's real GDP should grow by 1.1%, an upward revision from the 0.2% projected at the time of the budget, but still a bit conservative compared to the 1.2% expected by private-sector survey average and in line with our own forecast. However, real GDP growth was revised downward for 2024 (from 1.3% in the Budget to 0.5%) and 2025 (from 2.5% to 2.0%), but upward for 2026 (from 2.4% to 2.8%). Like real GDP, nominal GDP has surprised positively in 2023 so far, thus supporting the province's revenues. Nominal GDP growth initially projected at 2.8% in 2023 in the budget was revised upward to 3.6% but has been revised downward from 3.6% to 2.9% in 2024 as the economic outlook darkens. Nominal GDP is then expected to grow by 4.2% in 2025 and 4.8% in 2026. Employment growth has also been revised upward in 2023, from 0.5% in the budget to 2.3% in the FES but has been revised downward for 2024 to 0.8%. Employment is then expected to grow by 1.5% in 2025 and 1.9% in 2026. For its part, the unemployment rate is expected to reach 5.6% on average in 2023 before increasing to 6.4% in 2024 and falling back to 6.2% in 2025, and 5.8% in 2026. Due to the record population growth, the FES projections for housing starts were revised upward each year from 2023 to 2026. However, the activity in the home resale market is expected to be weaker than anticipated in 2023 and 2024, and to rebound strongly in 2025.

Summary of Ontario's Economic Outlook

(Per Cent)

	2022	2023p	2024p	2025p	2026p
Real GDP Growth	3.7	1.1	0.5	2.0	2.8
Nominal GDP Growth	9.2	3.6	2.9	4.2	4.8
Employment Growth	4.6	2.3	0.8	1.5	1.9
CPI Inflation	6.8	3.7	2.5	2.1	2.0

p = Ontario Ministry of Finance planning projection based on external sources as of September 29, 2023.
Sources: Statistics Canada and Ontario Ministry of Finance.

- **Budgetary outlook** – Gone are the days of substantial and positive budgetary revisions that characterized much of the past few years for Ontario. Today's update signals a 2023-24 deficit that's expected to be a bit larger than was pencilled into the 2023 Budget and Q1 update. To be exact, the province is now flagging a $5.6 billion shortfall (0.5% of GDP), which is $4.3 billon larger than earlier guidance. Contributing to the revision was both weaker revenues (-$2.6 billion vs. budget, more than fully explained by lower personal income taxes) and higher program spending (+$2.4 billion vs. budget, largely a function of the Contingency Fund top-up). Somewhat counterintuitively, interest charges look to come in a touch lower (-$0.7 billion) than expected in March.

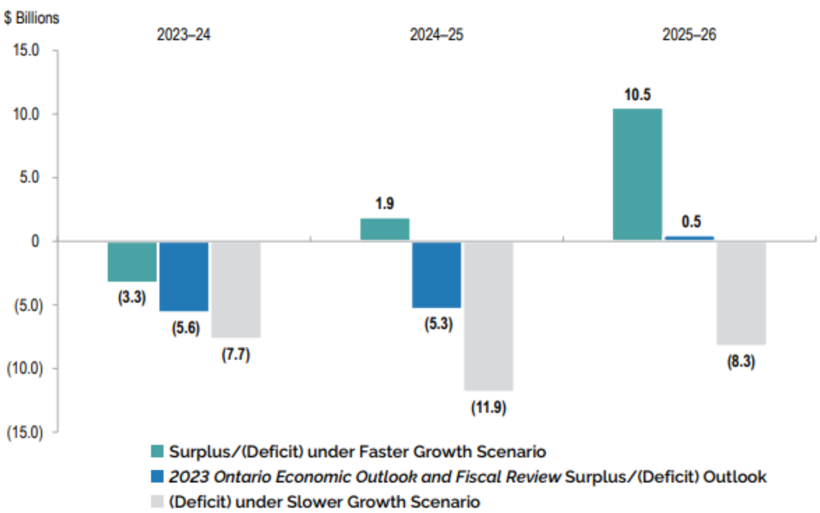
However, this is primarily due to the hand-off from lower-than-planned borrowing costs in 2022–23, as confirmed in the Public Accounts.

When it comes to the medium-term outlook, there were additional downward revisions to the budgetary trajectory. The return to balance that had previously been expected in 2024-25 has been delayed a year, the margin for error squeezed a bit too. More concretely, the province is guiding us to a $5.3 billion (0.5% of GDP) deficit in 2024-25 before registering a small $500 million surplus in 2025-26. With September's Public Accounts confirming a deficit of $5.9 billion in 2022-23 (which itself was roughly $3 billion more than expected in March), the 4-year budgetary balance (spanning 2022-23 to 2025-26) has deteriorated. In aggregate, there's been a swing of $17.5 billion relative to the fiscal markers set down in March ($20 billion if reserves are ignored).

While the outlook has worsened since the spring, it's not certain these budgetary projections will be realized. As always, the province continues to embed significant prudence into the fiscal framework in the form of reserves, contingencies, and sub-consensus growth forecasts. In terms of explicit reserves, there's still $1 billion set aside for the current fiscal year, a larger $1.5 billion buffer next year and $2.0 billion in 2025-26. Meanwhile, a net $2.2 billion top-up of Ontario's Contingency Fund has added some flexibility to the fiscal plan, allowing the province to navigate unforeseen risks more comfortably.

Regarding alternative scenarios, the FES presents both a faster and slower growth scenario and estimates the impact on the budgetary balance. Under the slower growth scenario, the 2023-24 deficit would increase to $7.7 billion and would be slightly larger the following two years. Meanwhile, the faster growth scenario would be expected to generate a $3.3 billion deficit this year and a return to balance in 2024-25.

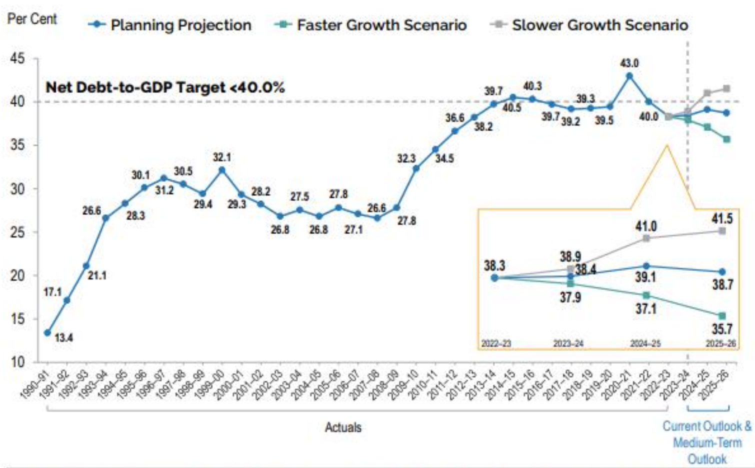
Ontario Fiscal Outlook Scenarios



Source: Ontario Ministry of Finance.

- **New initiatives** – More than a mere fiscal updating, Ontario used its midyear statement to initiate or enhance certain policies divided among two key axes: "Building Ontario" and "Working for you". The first theme proposes the creation of an Ontario Infrastructure Bank, at an initial cost of $3 billion, to attract private investment from major institutional investors for large-scale and critical infrastructure projects, such as long-term care centres, affordable housing, and infrastructure in the municipal, community, energy, and transportation sectors. This axis also includes an investment of $200 million over 3 years for the creation of a new Housing-Enabling Water Systems Fund, for the repair, rehabilitation and expansion of a variety of municipal water infrastructure projects. There's an additional investment of $100 million to the Invest Ontario Fund, for a total of $500 million, to attract investment in Ontario and support businesses already there. You'll also see the creation of the Ontario Made Manufacturing Investment Tax Credit to help Ontario's manufacturers lower their costs ($780 million over 3 years). Then there's an additional $12 million per year to expand eligibility of the Ontario Focused Flow-Through Share Tax credit to include critical mineral exploration. On the "Working for you" front, the FES proposes to extend the 5.7 cent per litre gas tax cut to June 2024, eliminate the 8% provincial portion of the Ontario Harmonized Tax on purpose-built rental housing (like the Federal announced several weeks ago), and lowering the age for regular, publicly funded breast cancer screenings from 50 to 40.
- **Debt burden & interest bite** – The weaker budgetary results/outlook and resulting increased borrowing needs have led to the closely watched net debt-to-GDP trajectory being revised up. For 2023-24, Ontario now expects net debt to be equivalent to 38.4% of GDP. That's up 0.6%-pts versus Budget 2023's estimate. Looking ahead, that's set to edge higher in 2024-25 (39.1%) before stepping lower again in 2025-26 (38.7%). By the end of the forecast horizon, Ontario's net debt-to-GDP ratio is expected to be 1.8%-pts higher than forecast in the March budget but still below their 40% debt sustainability target.

Net Debt-to-GDP



Note: See Chapter 3: A Strong Foundation for the Next Generation: Ontario's Fiscal Plan and Outlook for details on the Faster Growth and Slower Growth Scenarios.
Sources: Statistics Canada and Ontario Ministry of Finance.

Net debt-to-GDP is just one of three debt sustainability measures that Ontario focuses on. The others, net debt-to-revenue and interest on debt-to-revenue (i.e., the interest bite), have also been revised relative to the March Budget. Net debt-to-revenue has been re-estimated at 206% from 199%, above the key 200% guidepost (which is meant to show how many years it would take to pay off all debt if all revenues were dedicated to it). Ontario expects this to rise next year before moderating (but remaining above 200%) in 2025-26. The ratio hovering above 200% will be "monitored leading up to the 2024 Budget". Not surprisingly given the surge in borrowing costs, the province's interest bite is likely to edge up over the coming years. The 6.7% forecast for 2023-24 (which is actually slightly below Budget 2023 expectations) should increase to 6.9% next year and remain there the following year. Importantly, this is below the 7.5% sustainability target and even further below the proportion that had prevailed before COVID (roughly 8-9%).

The province provides projections for these three key variables under its alternative growth scenarios too. In the faster growth scenario, all three debt sustainability measures would be below their target by 2024-25. In the slower growth scenario, both debt-to-GDP and debt-to-revenue would be above target by 2024-25 (and stay there in 2025-26). In this economic outlook, the interest bite would rise too but stay below the 7.5% guidepost throughout the forecast horizon.

- **Borrowing program**– Ontario has revised its borrowing requirements higher vs. budget, the result of larger budgetary shortfalls. To some extent, you could see this coming, as the previously released public accounts confirmed a larger 2022-23 deficit as PIT revenue missed. And now the 2023-24 deficit has increased vs. plan. At $34.7 billion, the new long-term gross borrowing need is $7.2 billion larger than in March. Extending the horizon to 2025-26, nearly $20 billion has been added to the full, combined three-year funding requirement.

As always, some context is useful. The upwardly revised tally for 2023-24 ($34.7 billion) is still less than the pre-COVID run rate (where gross bond issuance averaged more like $38 billion in the three fiscal years to 2019-20). Moreover, considering the ~$31 billion of debt maturities/redemptions, the stock of outstanding Ontario bonds won't be growing by much this fiscal year. If anything, you might argue that the relatively skinny borrowing estimate from Budget 2023 ($27.5 billion) looks to have been the anomaly, since it would have essentially been the lowest figure in the post-GFC era.

Note that the official long-term borrowing program is based on a budgetary balance inclusive of fiscal padding (in the form of a reserve and sizeable contingencies). Economic uncertainty is undeniable, but it's not clear that all of Ontario's budgetary insulation will ultimately be needed. On the other hand, the official program does not formally include any pre-borrowing towards next fiscal year. Yet, Ontario generally likes to get at least a partial jump-start on its future-year issuance when/where it can, subject to favourable market conditions, of course. Notwithstanding today's non-trivial borrowing rates, we assume a degree of pre-funding will still be desirable, as it would allow Ontario to chop away a bit at what is currently a $37.4 billion long-term requirement for fiscal 2024-25 (under the base case).

As for borrowing status, Ontario has so far lifted $15 billion from debt capital markets in 2023-24 (virtually all of it domestic). That implies a current funded ratio of 43% with just under 5 months of the fiscal year to go. We would never discount Ontario's ability to make quick progress on its borrowing program. And it seems to us that the province will be looking to advance things significantly and quickly… and likely in more than one currency. Indeed, there's a stated intention to fund much of the marginal borrowing requirement (vs. budget) from core international markets (USD and/or EUR). Investor demand and arbs will presumably be monitored closely, with near-term international funding appearing likely to us (pursuant to standard due diligence/disclosure protocols). Applying the desired foreign currency funding share (10-25%) to the revised program, we might expect to see the equivalent of $3½-9 billion in foreign currency funding before the end of the fiscal year (before accounting for any potential/optional pre-funding). Caution: The targeted funding mix can/will be adjusted in response to market conditions/demand dynamics.

Green bonds remain a strategic focus, Ontario having long been a leader in the space. The province reiterated its plan to issue multiple greens each fiscal year, including during 2023-24. Subject to market conditions, that would imply (at least) two issues between now and March 2024. Note that Ontario is updating its Green Bond Framework to better align with accepted standards/principles and also to expand the breadth of its offering to 'sustainable' securities as well.

Ontario is not blind to the material shift in borrowing costs and could adjust its funding strategy if necessary. Up till now, the province has succeeded in locking in much of its debt at a relatively long-weighted average term, thereby limiting/minimizing the immediate adjustment to higher rates. Of the $15 billion so far raised in 2023-24, the average term is relatively long at 17.2 years, a figure that is boosted by the heavy domestic slant of completed issuance. One would expect the weighted average term to normalize as foreign currency markets are tapped. Nonetheless, past success issuing long gives the province latitude to move down the curve if necessary.

Beyond the demonstrated and largely unparalleled (by LRG standards) access to debt capital markets, the province's prudential liquidity buffer is material. The province ran larger-than-average reserves in the first half of the year, in order to accommodate large coupon payments and other financial obligations. Unrestricted liquid reserves are expected to end 2023-24 at $32.8 billion.

2023–24 Borrowing Program and Medium-Term Outlook

($ Billions)

	2023 Budget	In-Year Change	Current Outlook 2023–24	Medium-Term Outlook 2024–25	Medium-Term Outlook 2025–26
Deficit/(Surplus)	1.3	4.3	5.6	5.3	(0.5)
Investment in Capital Assets	13.6	0.0	13.6	18.7	19.0
Non-Cash and Cash Timing Adjustments	(9.2)	7.9	(1.3)	(11.2)	(12.0)
Loans to Infrastructure Ontario	0.1	–	0.1	0.1	0.2
Other Net Loans/Investments	0.1	(0.0)	0.1	(1.0)	(0.2)
Debt Maturities/Redemptions	31.2	(0.0)	31.2	28.0	33.1
Total Funding Requirement	**37.0**	**12.2**	**49.2**	**39.9**	**39.5**
Decrease/(Increase) in Short-Term Borrowing	–	–	–	(2.5)	(2.5)
Increase/(Decrease) in Cash and Cash Equivalents	5.0	(5.0)	–	–	–
Pre-borrowing in 2022–23 for 2023–24	(14.5)	–	(14.5)	–	–
Total Long-Term Borrowing	**27.5**	**7.2**	**34.7**	**37.4**	**37.0**

Note: Numbers may not add due to rounding.
Source: Ontario Financing Authority.

- **Current long-term credit ratings** – S&P: A+, Positive | Moody's: Aa3, Positive | DBRS: AA(Low), Positive | Fitch: AA-, Stable
  [Refer to our Provincial Ratings Snapshot for additional colour on specific credit rating drivers/considerations]

Ontario's Medium-Term Fiscal Plan — Details

($ Billions)

	Actual	Current Outlook	Medium-Term Outlook	
	2022–23	2023–24	2024–25	2025–26
Revenue				
Personal Income Tax	44.2	49.4	51.2	54.3
Sales Tax	36.1	37.7	38.7	40.7
Corporations Tax	27.8	26.0	25.8	27.4
Ontario Health Premium	4.4	4.8	5.0	5.2
Education Property Tax	6.0	5.7	5.8	5.8
All Other Taxes	18.0	17.5	19.4	21.5
Total Taxation Revenue	**136.5**	**141.2**	**145.8**	**154.8**
Government of Canada	31.3	35.1	35.4	37.0
Income from Government Business Enterprises	6.1	6.8	6.5	8.4
Other Non-Tax Revenue	19.0	18.7	19.0	19.8
Total Revenue	**192.9**	**201.8**	**206.7**	**220.0**
Base Programs[1]				
Health Sector	75.1	81.2	84.2	87.6
Education Sector[2]	33.6	34.7	36.4	37.5
Postsecondary Education Sector	11.6	12.1	12.5	13.0
Children, Community and Social Services Sector	18.1	19.4	19.9	19.9
Justice Sector	5.3	5.5	5.3	5.2
Other Programs	30.1	40.1	37.8	39.1
Total Base Programs	**173.8**	**193.0**	**196.2**	**202.3**
COVID-19 Time-Limited Funding	6.3	–	–	–
Other One-Time Expenses	6.3	–	–	–
Total Programs	**186.4**	**193.0**	**196.2**	**202.3**
Interest on Debt	12.4	13.4	14.3	15.2
Total Expense	**198.8**	**206.4**	**210.5**	**217.5**
Surplus/(Deficit) Before Reserve	**(5.9)**	**(4.6)**	**(3.8)**	**2.5**
Reserve	–	1.0	1.5	2.0
Surplus/(Deficit)	**(5.9)**	**(5.6)**	**(5.3)**	**0.5**
Net Debt as a Per Cent of GDP	38.3%	38.4%	39.1%	38.7%
Net Debt as a Per Cent of Revenue	207.6%	206.2%	210.8%	204.2%
Interest on Debt as Per Cent of Revenue	6.4%	6.7%	6.9%	6.9%

[1] For presentation purposes in the *2023 Ontario Economic Outlook and Fiscal Review*, one-time COVID-19-related spending in 2022–23 has been included within COVID-19 Time-Limited Funding. This funding will no longer be reported separately, starting in 2023–24.

[2] Excludes Teachers' Pension Plan. Teachers' Pension Plan expense is included in Other Programs.

Notes: Numbers may not add due to rounding. Current and medium-term outlook primarily reflect information available as of September 29, 2023.

Sources: Ontario Treasury Board Secretariat and Ontario Ministry of Finance.

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