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Canada's budgetary deterioration walking a fine line of materiality

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Ahead of an unannounced but imminent Fall Economic Statement (FES), the Government of Canada unveiled a fresh stimulus package designed to "give Canadians more money in their pocket" ahead of the holiday season. With investors no longer willing to give a pass to free spending governments, there was an immediate (though perhaps overdone) impact on the sovereign's borrowing costs. These latest measures are just one source of fiscal pressure that will be evident in the coming FES as the feds already appeared offside on earlier budgetary projections. Here we break down where Canada's finances stand relative to earlier estimates and what this could mean for the economy, the Bank of Canada and the bond market.

Some important fiscal context

In last year's Fall Economic Statement, the federal government established three fiscal objectives that would guide the preparation of Budget 2024. Those were:

1. "Maintaining the 2023-24 deficit at or below the Budget 2023 projection of $40.1 billion."
2. "Lowering the debt-to-GDP ratio in 2024-25, relative to the 2023 Fall Economic Statement, and keeping it on a declining track thereafter".
3. "Maintaining a declining deficit-to-GDP ratio in 2024-25 and keeping deficits below 1 per cent in 2026-27 and future years."

Budget 2024 was able to satisfy these constraints, albeit barely. It pegged the 2023-24 deficit at $40.0 billion versus the $40.1 billion 'limit' and the 2024-25 shortfall was seen dropping by a scant 0.1% of GDP from 2023-24. The ultra-slim margin for error looks like it will come back to bite them.

A larger-than-planned deficit in 2023-24…

The latest *Fiscal and Economic Outlook* published in October by the non-partisan Parliamentary Budget Officer (PBO) pegged last year's deficit at $46.8 billion. That's larger than the $40.0 billion telegraphed in Budget 2024, violating fiscal objective #1. Note that prior fiscal year deficits are usually confirmed in October, but that's been delayed this year. The feds technically have until year-end to publish the figure, but the delay could lead one to speculate it's not good news being withheld.

…gives way to a larger-than-planned deficit in 2024-25

The PBO also estimated that measures announced in the spring budget and those subsequent to it added some $8 billion to their pre-budget deficit projection. True, economic developments provide a couple billion dollars of cushion—GDP growth is tracking stronger than the budget assumed—but these aren't enough to offset net new spending. Indeed, the PBO highlighted that Canada's shortfall was tracking towards $46.5 billion versus the $39.8 billion the feds telegraphed in April. Critically, these estimates are *before* the $6+ billion of tax rebates/relief recently announced. Barring any yet-to-be announced revenue measures then, the current year's deficit could exceed $50 billion if 'rebates' are sent in March (the feds say "early spring 2025" which suggests they *could* be booked in 2025-26). That could jeopardize objective #3, maintaining a declining deficit-to-GDP ratio. The government can at least safely say it achieved one of its fiscal targets as the 2024-25 debt-to-GDP ratio will be lower than what was projected in the 2023 FES. Mind you, that's stronger nominal GDP doing the heavy lifting, *not* a smaller debt load.

Limited visibility of 2025-26 and beyond

These aren't permanent measures, the 'rebate' being a one-time payment and the tax holiday ending February 15th. Thus, absent other new measures, the FES could show a healthy drop in the deficit in the future. However, we're not putting much stock into the government's 'placeholder' estimates as there will likely be pressure to make new spending commitments in a pre-election budget next spring. Even if a heavier spending budget were to pass ahead of the 2025 election (it's not obvious it would given the government's minority position), current polling strongly points to a change in government. And as we've seen before, different governments can have very different fiscal priorities.

What's the borrowing impact?

Thus far, the GoC's bond program is progressing exactly as advertised. Based on the current quarterly bond schedule, 75% of the bond program will have been completed by the 75% mark of the fiscal year (i.e., Dec. 31). There hasn't been notable pressure on bills either. Based on recent auction sizes, outstanding T-bills are on pace to end the year right around target. That said, marginal spending needs to be financed somewhere. The government no longer has the 'excess' cash balances it enjoyed for most of the past few years so debt investors will need to be tapped. Traditionally, the bill program has been utilized to finance temporary or short-term increases in funding needs, which may be the playbook the Department of Finance opts for. But even if this was *all* steered towards bonds, we're not talking about a material increase in borrowing. The latest measures amount to roughly one extra two-year auction, or less than 3% of the total bond program. In today's environment, it's not surprising to see bond market jitters after an unfunded stimulus announcement but we don't think these measures, on their own, warrant a material or sustained impact.

Will the recent announcement influence the BoC?

In a vacuum, we wouldn't expect these new measures to have a substantial impact on monetary policy decisions. After all, this amounts to less than 0.3% of GDP. Worthy of a slight growth upgrade to be sure but unlikely to have a significant or sustained inflation impact. However, the spending announcement does not come in isolation. Stimulus efforts are also underway at the provincial level too, Ontario readying a similar taxpayer 'rebate'. Meanwhile, recent inflation data came in stronger than expected at the same as housing market activity accelerated and the unemployment rate stabilized (at least temporarily). We had argued that the size of the output gap warrants a rapid return to neutral (via a 50 bp cut in December) but for a central bank putting all its eggs in the data dependence basket, that's become a harder sell. If the Bank, like the market, viewed the 25 bp vs. 50 bp rate cut debate as a coin toss back in October, recent developments may push them to 25 bps. But even if easing is more gradual in the near term, we're not fundamentally recasting our Canadian outlook or our forecast of the terminal rate on what amounts to a modest, even if ill-timed spending announcement.

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