Taking on Debt to Support the Recovery

An Update on Canadian Government Finances

Derek Burleton, Vice President and Deputy Chief Economist | 416-982-2514
Rishi Sondhi, Economist | 416-983-8806

August 12, 2020

Highlights

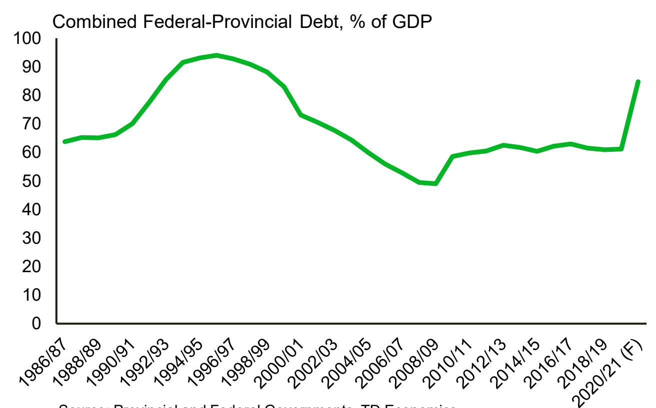
- Through measures such as the CERB and CEWS, the federal government has done yeoman's work in supporting the economy during the COVID-19 pandemic, yielding an unprecedented peacetime deficit and debt near 50% of GDP (up from 31% before the pandemic).
- The shouldering of the fiscal burden by the federal government has left provincial finances in relatively better shape. Still, the combined provincial budget deficit is set to reach levels roughly in line with the peak seen during the early 1990s fiscal crisis. These higher deficits will push provincial debt burdens higher. Fortunately, provincial credit ratings are generally sound, which will help keep government borrowing costs at bay.
- Municipal finances have taken a major hit during the pandemic, with both higher costs and much lower revenues (especially transit ridership) taking a toll on cities across the country. Fortunately, federal and provincial governments have stepped in with support for municipalities that could total about $10 billion.
- Both the federal and provincial governments will probably need to continue spending in order to backstop the recovery, including additional funds for municipalities. However, ultra-low interest rates will keep debt servicing costs manageable.

Over four months after the pandemic caused widespread lockdowns, we are only now getting a sense of the extent of fiscal deterioration in Canada this year. Led by a spike in the federal deficit, the combined federal-provincial shortfall is on track to reach roughly $420 billion, or the equivalent of about 20% of GDP, this year. Meanwhile, the combined debt level[1] is poised to surge to an unprecedented $1.9 trillion or 85% of GDP (Chart 1). This latter measure remains shy of the heights recorded during the 1990s fiscal crisis. However, that gap could close as governments likely undertake further transitionary support during the recovery phase in the months ahead.

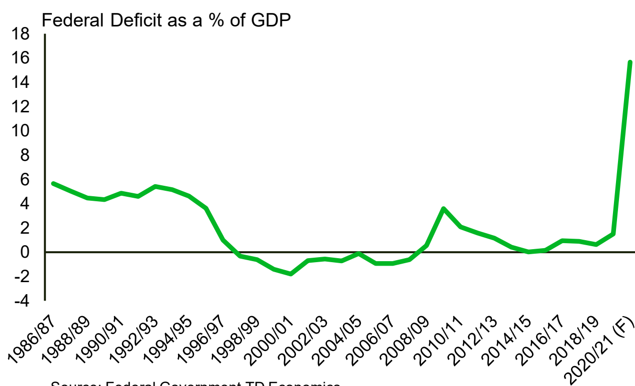
At the provincial level, governments are generally anticipating sizeable deficits ranging from about 1-7% of GDP this fiscal year, as the pandemic takes a heavy toll on revenues and as support measures for individuals, families and businesses continue to be rolled out. However, these deficits are expected to be a fraction of the federal shortfall, as the federal government has done much of the heavy lifting in terms of fiscal supports.

The pandemic has also cast the spotlight on municipal finances, which have also taken a major hit. Constrained by their inability to run deficits, municipalities across the country expect large operating shortfalls this year. This has led to growing pressure on other levels of government to step in with further bridge support until local revenue bases pick up.

Chart 1: Government Debt Approaching Levels Seen During 1990s Fiscal Crisis



Source: Provincial and Federal Governments, TD Economics.



Necessary Stimulus Measures Yield Historic Federal Deficit

On July 8th, the federal government released its "Economic and Fiscal Snapshot" (see commentary). Whisper numbers ahead of the update pegged the federal deficit at around $300 billion. In the event, the shortfall came in some $43 billion higher. At 16% of GDP, this marked the largest deficit as a share of GDP since the second world war (Chart 2).

This near $50 billion overshoot relative to expectations largely reflected increased spending on the Canada Emergency Wage Subsidy (CEWS), which the government expects to play an important role in the recovery moving forward. And for good reason, as international experience shows that wage subsidies can be effective in maintaining worker attachment and reining in unemployment (see report). To-date, about $25 billion in benefits have been accessed through the CEWS. This is a substantial figure, although it is only about 40% of what's been paid out through the CERB. In mid-July, the federal government officially extended the CEWS until December and added flexibility to the requirements for qualification (see commentary). This should boost the program's uptake. All told, the federal government expects the CEWS to cost $82 billion this fiscal year (Chart 3), which is an even larger tab than the popular Canada Emergency Response Benefit (CERB).

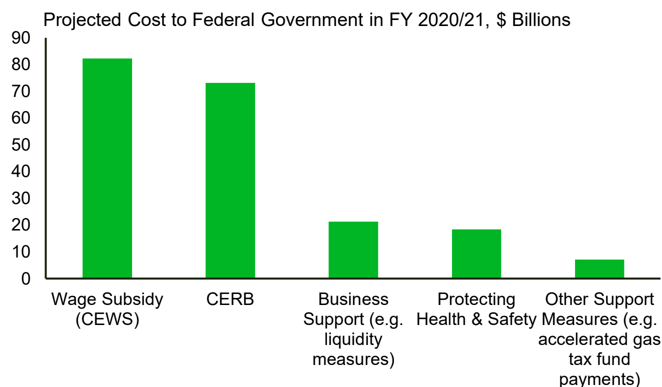
Despite the historic measures taken thus far to backstop households and businesses, further pandemic support will likely be required in light of an uneven recovery. Since the Snapshot, the federal government has pledged additional funding to provinces and municipalities and announced its intention to introduce EI changes to help unemployed workers transition away from the expiring CERB program. This could lead to an even higher deficit than currently projected. On the plus side, the government's economic forecast was quite cautious, calling for a near 7% contraction in real GDP in 2020, compared to our call for a 6% retrenchment. As such, some revenue upside is possible.

Even with the historic deficit and revised federal projection calling for the net-debt-to-GDP to climb from its pre-pandemic level of around 30% to 49% this fiscal year, markets have been taking the news in stride.

For one, the Canadian government still boasts a favourable fiscal position relative to most countries. In the U.S., for instance, the federal deficit could reach well over 20% of GDP this year. European countries are facing a similar predicament.

Perhaps more importantly, a further drop in interest rates this year has kept government debt affordable. In fact, the Canadian federal government is projecting a drop in the cost of servicing its obligations this year, despite an increase of roughly $400 billion in the stock of marketable debt (to $1.2 trillion). This is in stark contrast to the 1990s, when debt costs were rising unsustainably (Chart 4).

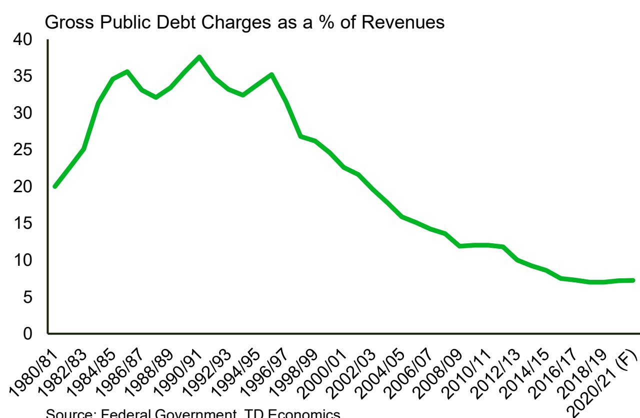
Canada continues to record one of the highest debt ratings among major countries. Ahead of the Snapshot, Fitch downgraded Canada's rating by a notch, to a still-high AA+ (with a stable outlook). More recently, however, S&P opted to leave the AAA rating intact, citing Canada's ongoing fiscal capacity and their view that the government's

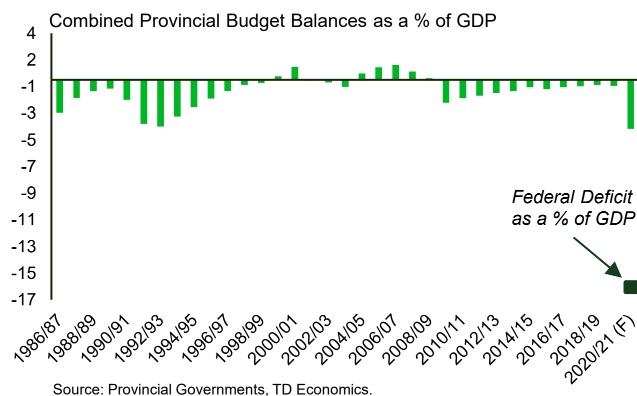


fiscal profile is experiencing only a "temporary deviation" which does not offset its credit strengths. Moody's continues to reserve its highest rating for the country.

More generally, around the world, fixed income investors have been turning a blind eye to mounting government debtloads. Notwithstanding surging supply of government debt, investor demand is keeping up in lockstep supported by large-scale asset purchases by central banks, including the Bank of Canada.

That said, this current complacency is unlikely to last forever. Indeed, among commentators, there was some disappointment that the Snapshot was quiet around how the government plans to manage the recovery and return its finances to a more sustainable track over the medium term. The federal deficit should pull back as emergency measures are phased out and the economic recovery regains a more solid footing. However, a sizeable structural deficit is likely to remain. This leaves much policy uncertainty that is not helpful to driving growth in investment. This can at least be partly addressed by mapping out a credible medium-term fiscal outlook that balances a need to nurture the recovery while gradually withdrawing its extraordinary supports. The government has been arguing that forecasting is too difficult in this environment, but the landscape may be murky for a while. Without a path to fiscal sustainability, further credit rating downgrades will likely follow. Hopefully, the government will provide more details on its medium-term plans this autumn.



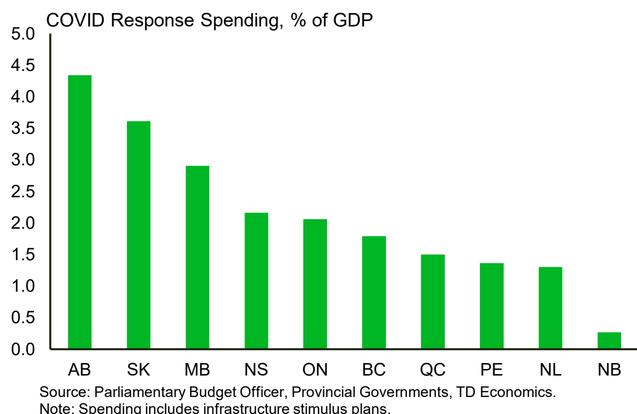


Provinces to See Sizeable, But Lesser Deficits This Year

Since May, nearly all provinces have released either fiscal updates or full budgets incorporating the anticipated impacts of the pandemic on their respective fiscal positions. Alberta and Ontario stand as notable exceptions, with fiscal updates last provided in February and March, respectively. As such, they were based on assumptions quickly rendered obsolete by the rapidly-evolving COVID-19 situation. Both are slated to provide updates shortly (Ontario this week and Alberta next alongside Saskatchewan). Alberta's Premier Kenney has gone on record stating that a deficit in the order of $20 billion is likely. In Ontario, the deficit could be some $5-$10 billion higher than the $20.5 billion figure included in the March update.

Using the latest figure cited by Alberta's Premier and the higher estimate for Ontario's deficit, we reckon that the combined provincial deficit will climb to about $80 billion this fiscal year. This would amount to about 3.5% of GDP, roughly in line with deficits observed during the peak of the early 1990s fiscal crisis (Chart 5), although several magnitudes below the federal shortfall. This suggests a less onerous path back to balance for the provinces. In fact, Quebec's government has stated its intention to return to balance within five years.

Oil producing provinces standout (in a bad way), with deficits in Alberta and Newfoundland and Labrador likely to come in about twice as high as the aggregate this fiscal year. Elsewhere, deficits in other parts of the Atlantic



Region are set to come in at around 1% of GDP, as lesser COVID-19 outbreaks have limited the economic damage in these regions. Meanwhile, in the other large provinces, as well as Saskatchewan and Manitoba, deficits are likely to fall in the 3%-4% of GDP range.

A key driver of these deficits has been support measures rolled out to combat the damage imparted by COVID-19. As a share of GDP, Alberta and Saskatchewan have spent the most (when infrastructure plans are considered). On the opposite end, the Atlantic Provinces haven't had to spend as much, while responses in Manitoba, Ontario, Quebec and B.C. have ranged from about 2 to 3% of GDP (Chart 6).

As deficits for each province climb, so too will their debt burdens. When aggregated across all provinces, net debt-to-GDP will likely rise to above 35% this fiscal year, the highest share since at least the mid-1980s. Adding in the federal burden, the combined federal-provincial ratio will climb to levels approaching where they were during the early 1990s. However, as noted earlier, a major distinction between then and now is that interest costs are low – backstopped by the Bank of Canada's provincial bond purchase program. This will keep debt servicing charges down for the provinces and help alleviate the need for painful austerity measures when the focus eventually turns to deficit reduction.

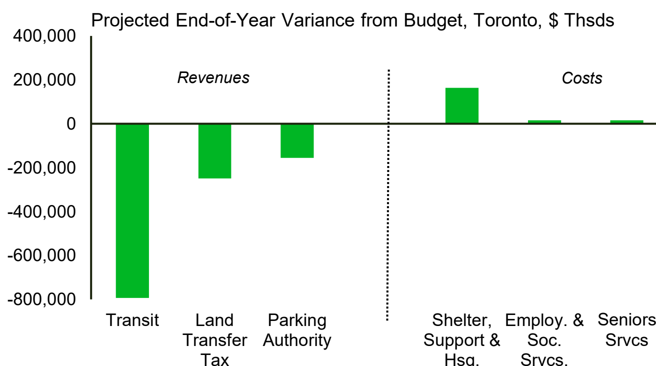
Moreover, it bears mentioning that despite these deficit projections, provincial credit ratings are generally sound (Table 1) despite a recent downgrade in Alberta and a shifting in the outlook from "stable" to "negative" in Newfoundland and Labrador by two major ratings agencies. Notably, the latter has the worst rating of any province, amid subdued growth in recent years and the largest debt-to-GDP burden. On the opposite end, B.C. retains relatively pristine ratings, although two agencies recently changed their outlooks from "stable" to "negative". Saskatchewan also recently suffered a downgrade, though sports the second highest credit rating among the provinces. Elsewhere, ratings outlooks for Manitoba and PEI were recently revised from "positive" to "stable" by separate agencies.

Moving forward, we envision growth rebounds taking place from coast to coast in 2021, but conditions could still vary. Elevated unemployment alongside a slow recovery in oil prices could further weigh on the fiscal positions of the oil-producing provinces. The larger provinces, with their denser populations, could be at increased infection risk, which would drag on provincial coffers. However, there will likely be pressure on all provincial governments to support their recoveries, meaning that increased spending may still be on the docket. Quebec, for example, has earmarked some $4 billion for additional support and recovery measures, should they be required. In addition, several provinces have announced infrastructure spending plans meant to stimulate economic growth, highlighted by $4 billion in additional spending in Alberta, (Quebec, Nova Scotia, Saskatchewan and Manitoba have plans as well).

Municipalities are Struggling

City finances have captured the spotlight in recent months, but for all the wrong reasons. Municipal fiscal positions have taken a severe hit from the pandemic. For instance, Toronto is projecting a $1.4 billion shortfall while Montreal is expecting a $500 million budget gap. For their part, Vancouver and Ottawa are both projecting $190 million holes. And, due to legal restrictions on running deficits, municipalities have resorted to cutting jobs as a way to generate cost savings.

These shortfalls are a function of pressures on both costs and revenues. On the expenses side, unexpected costs incurred include higher sanitation costs, the need to shelter the homeless, and to subsidize affordable housing. On the other side of the ledger, revenues in several major cities have been decimated by collapsing transit ridership and lower user fees (Chart 7). In April, the Federation of Canadian Municipalities (FCM) warned that the impact of



the pandemic would leave city governments facing a combined fiscal hole of at least $10-$15 billion.

Federal and provincial governments have since stepped in to provide some support to municipalities. Through the above-noted $19 billion Safe Restart Agreement, the federal government is providing about $4 billion to municipalities to help cover operating costs and transit deficits, with provincial governments required to match those contributions from their own funds. This would imply $8 billion for municipalities this year and is on top of the $2.2 billion in accelerated payments for infrastructure made available through the Gas Tax Fund. Together, these initiatives would put the federal-provincial commitment at the lower end of FCM's estimated budget gap in April.

While we don't yet have a full line of sight on how the money will be spent in every province, notable announcements have already been made. For example, $4 billion in funding will be provided to municipalities in Ontario, roughly equally split between the province and the federal government. Elsewhere, cities in Alberta will benefit from $606 million in funding. In B.C., it's currently unclear as to how much money cities will ultimately get, although the province expects to take in $2.2 billion in federal money from the Agreement, and the provincial government has earmarked up to $1 billion towards municipalities and public transit..

No doubt, this money will go a significant way to addressing municipal fiscal gaps. However, it's likely that additional support will be required in the future, given additional spending pressures and only gradual economic recoveries, particularly in the oil-producing provinces. What's more, transit ridership is likely to only slowly recover, with little current improvement even in jurisdictions that have aggressively re-opened their economies. However, cities will have to continue operating their transit systems, likely at a loss until a vaccine and/or effective treatment is widely available.

As dense jurisdictions, cities are at heighted risk of a renewed bout of infections, with the recent uptrend in cases in Calgary a glaring example of this. In addition, as case counts tend to be elevated in larger, denser municipalities, there is some risk that businesses that are open in these regions experience less traffic and thus struggle more than in other areas. This could be particularly true for industries that are expected to recover at an "L-shaped" pace (e.g. accommodation and food services; arts entertainment recreation; tourism). Policymakers need to be cognizant of this risk and be ready to deliver support to businesses in these regions.

Bottom Line

The federal government has done yeoman's work in supporting the economy during the pandemic, yielding an unprecedented peacetime deficit and net debt at near 50% of GDP. This shouldering of the burden has left provincial fiscal finances in better shape. However, even here, debt-to-GDP across provinces is likely to climb to its highest level in decades this fiscal year. While these developments could cause some to worry about a repeat of the 90s experience, a key distinction between then and now is that debt service costs are low, underpinned by ultra-low rates. This suggests that these elevated debt burdens will be manageable.

Both the federal and provincial governments will probably need to continue spending in order to backstop the recovery, which will likely unfold at an only gradual pace. This includes more funding for municipalities, whose costs have climbed, and revenues have taken a dramatic hit.

Municipal Credit Ratings			
Issuer	Moody's	S&P	DBRS
Halton	Aaa	AAA	-
London	Aaa	-	-
MFABC	Aaa	AAA	-
Montréal	Aa2	AA-	AH
Ottawa	Aaa	AA	-
Peel	Aaa	AAA	-
Toronto	Aa1	AA	AA
Translink	Aa2-	-	AA
Vancouver	Aaa	AAA	-
Waterloo	Aaa	-	-
Winnipeg	Aa2	AA	-
York	Aaa	AA+	-
Source: Moody's, Standard & Poor's, Parliamentary Budget Officer, Provincial Governments, TD Economics.			

Provincial Credit Ratings				
Issuers	Moody's	S&P	DBRS	Fitch
British Columbia	Aaa	AAA	AA high	AAA
Alberta	Aa2	A+	AA low	AA-
Saskatchewan	Aaa	AA	AA low	AA
Manitoba	Aa2	A+	A high	-
Ontario	Aa3	A+	AA low	AA-
Quebec	Aa2	AA-	AA low	AA-
New Brunswick	Aa2	A+	A high	-
Nova Scotia	Aa2	AA-	A high	-
Prince Edward Island	Aa2	A	A	-
Newfoundland and Labrador	A1	A	A low	-
Source: Moody's, Standard & Poor's, Fitch Group, Parliamentary Budget Officer, Provincial Governments, TD Economics.				

Endnotes

1. In this report, provincial net debt corresponds to the figures reported by the respective provinces, while federal net debt refers to the accumulated deficit.

Disclaimer

This report is provided by TD Economics. It is for informational and educational purposes only as of the date of writing, and may not be appropriate for other purposes. The views and opinions expressed may change at any time based on market or other conditions and may not come to pass. This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities and should not be considered specific legal, investment or tax advice. The report does not provide material information about the business and affairs of TD Bank Group and the members of TD Economics are not spokespersons for TD Bank Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. This report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise the TD Bank Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.