Economics

2022 CANADIAN FEDERAL BUDGET

April 7, 2022

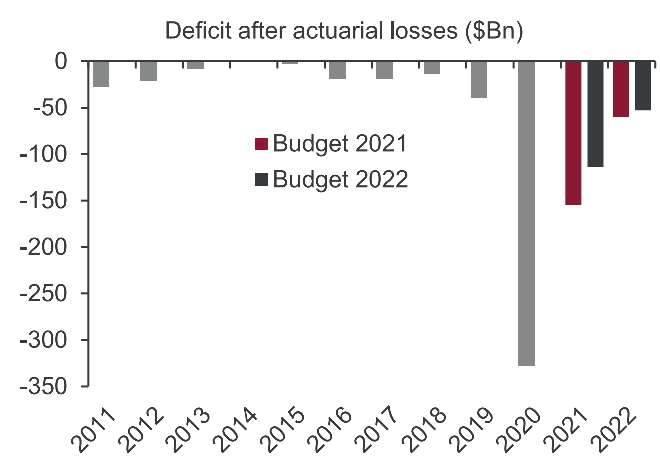
Canadian Federal Budget: Out with the old, in with the new

by Avery Shenfeld (avery.shenfeld@cibc.com) and Andrew Grantham (andrew.grantham@cibc.com)

After two years of propping up a Covid-weakened economy, Canada's Federal budget looks like a case of out with the old spending, in with the new. Strong revenue gains, and the phase out of spending tied to keeping the economy and the health care system afloat during the pandemic, have opened up elbow room for taking action on housing supply, climate change and other files. Deficits will still be melting away, but some of the battle against deficits is being fought with tax hikes rather than just spending restraint or the revenues reaped from economic growth.

A year ago, Ottawa was projecting a deficit of $154.7 bn for the fiscal year that just ended. Instead, a lift to revenues above that plan has cut the estimated deficit for that year to $113.8 bn (Table 1, Chart 1), with much of that improvement coming since the fall update. Looking ahead, the deficit is expected to fall to $52.8 bn this year, with gradual reductions thereafter.

Chart 1: Deficit path revised lower



Source: Budget 2022, CIBC

Table 1: Fiscal outlook

Billions ($)	2020/21 Actual	Budget 2021	2021/22 Budget 2022	Change	2022/23 Budget 2022	2023/24 Budget 2022	2024/25 Budget 2022	2025/26 Budget 2022	2026/27 Budget 2022
Budgetary revenues	316.4	355.1	394.4	39.3	408.4	429.5	450.8	475.1	496.0
Percent (%) change	-	*19.9*	*24.6*	*4.7*	*3.5*	*5.2*	*5.0*	*5.4*	*4.4*
Program spending ex. Actuarial losses	608.5	475.6	473.0	-2.6	425.4	430.4	439.2	453.1	463.3
Percent (%) change	-	*-22.6*	*-22.3*	*0.3*	*-10.1*	*1.2*	*2.0*	*3.2*	*2.3*
Public debt charges	20.4	22.1	24.9	2.8	26.9	32.9	37.0	39.8	42.9
Budgetary balance (before actuarial losses)	**-312.4**	**-142.5**	**-103.5**	**39.1**	**-43.9**	**-33.8**	**-25.5**	**-17.8**	**-10.2**
Net actuarial losses	*-15.3*	*-12.2*	*-10.3*	*1.9*	*-8.9*	*-6.1*	*-2.4*	*-0.8*	*1.8*
Budgetary balance	**-327.7**	**-154.7**	**-113.8**	**41.0**	**-52.8**	**-39.9**	**-27.8**	**-18.6**	**-8.4**

Table 2: Average private sector forecasts
Economic assumptions

Y/Y % chg	2021	2022	2023	2024-26
Real GDP	4.6	3.9	3.1	1.9
Nominal GDP	13.1	7.7	4.8	3.8
Jobless rate (%)	7.4	5.8	5.5	5.5
CPI	3.3	3.9	2.4	2.1
US Real GDP	5.7	3.8	2.6	1.9

Table 3: Average private sector forecasts
Financial assumptions

Y/Y % chg	2021	2022	2023	2024-26
WTI (US$/bbl)	68	80	74	68
3-month T-Bills (%)	0.1	0.8	1.7	2.1
10-year GoC Bonds (%)	1.4	2.0	2.4	2.8
Exchange rate (US¢/C$)	79.8	79.9	80.2	80.3

Economic backdrop: A necessary deceleration

This year's budget comes as the economy is benefiting from near full employment conditions. Growth will continue to be driven by a recovery in services, although held back somewhat in months where new Covid variants induce greater caution. Gains are also expected in some resource sectors that have the capacity to supplant Russia and its allies as a supplier. But the resulting inflation pressures also imply that monetary policy will be aimed at slowing growth beyond the current year, which is built into the consensus growth projections on which the budget was based (Table 2 and 3).

The consensus forecast is only slightly above CIBC's outlook, but there are still risks to the downside. Excessive rate hikes by either the Fed or the Bank of Canada in 2022 could tilt the economy into greater weakness next year. A more problematic Covid variant that combined lethality with the ability to evade current vaccines can't be ruled out. The budget offers some alternative scenarios and their implications for fiscal balances.

Note that since the survey was taken, both growth and inflation indicators have surprised to the upside. Firmer inflation is mostly a plus for fiscal finances given the link between nominal GDP and government revenues. But it also reinforces the need to push up interest rates a bit sooner than might have been expected when the consensus forecast in Table 2 was taken. However, that hasn't changed our view that, ultimately, overnight interest rates in the vicinity of 2.25% should be sufficient to moderate growth, and the budget's assumptions for rates beyond 2023 still look reasonable.

Stimulus or restraint?

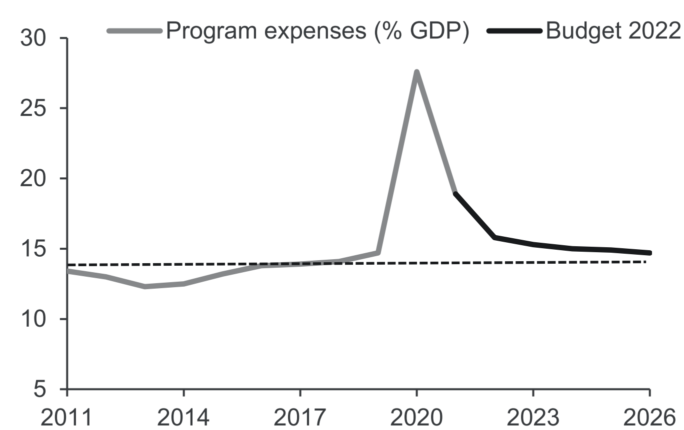
With the Bank of Canada hiking rates on a view that the risks are towards an overheating, a key macro question is whether federal fiscal policy will be adding to demand in the economy and raising the bar for central bank hikes, or will it be offering restraint that will lessen the need for monetary tightening. The answer is that post-budget, federal fiscal policy will on balance be tightening, and only marginally less so than it would have had there been no new tax and spending measures unveiled today.

On the spending side, the budget didn't shy away from the usual spate of initiatives. As expected, that fresh funding was allocated to programs related to climate change ("clean air and a strong economy" with $1.3 bn allocated this year), housing affordability ($2 bn), buttressing defense spending and foreign aid ("Canada's leadership in the world": $1.7 bn) and reconciliation with Indigenous communities ($2.5 bn), among others. In total, these and other initiatives added $9.4 bn on the spending side this year, and over $10 bn the following year.

But against that, we're facing a major retreat in Covid-related programs. The result is that program spending (excl. net actuarial losses) is set to decline by 10%, or nearly $50 bn in 2022/23, and grow by barely more than 1% the following year, which would still be a decline in real terms.

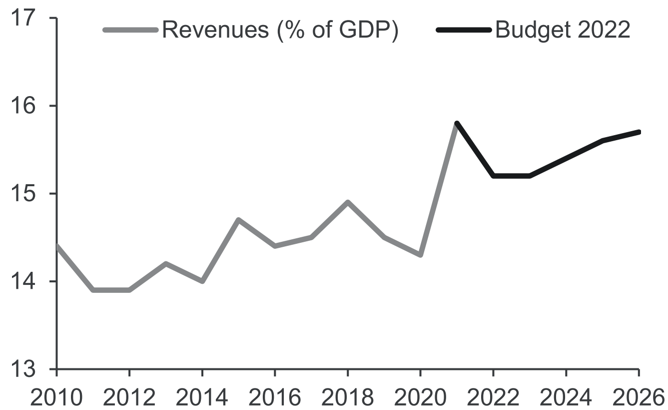
The Brookings Institution measures the degree to which US fiscal policy is stimulative or contractionary in part by looking at whether spending is outpacing nominal GDP. By that score, program spending does show some significant restraint, falling from just under 19% of GDP last year to 15.8% in the coming year, and on track to ease to 14.9% by 2025/26 and 14.7% in 2026/27 (Chart 2).

Chart 2: Spending to remain above pre-pandemic share



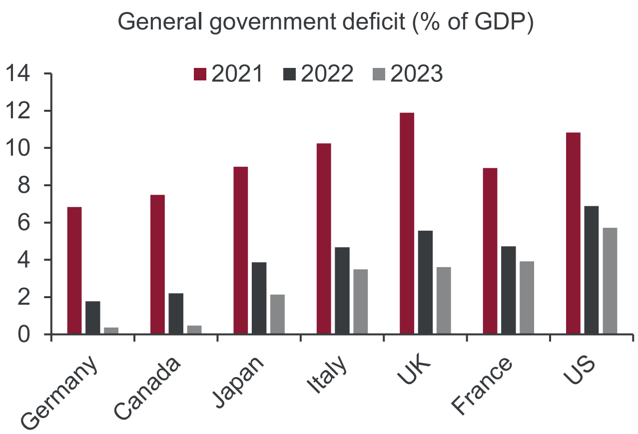
Source: Budget 2022, Haver Analytics, CIBC

Chart 3: Revenues higher as a share of GDP



Source: Budget 2022, Haver Analytics, CIBC

Chart 4: Total government deficits compare favourably to others



Source: IMF October 2021 Fiscal Monitor (estimates from prior to Budget 2022)

That end target is still a bit higher than where it stood pre-pandemic, and to achieve the targets for the fiscal balance, the government's plans have revenues also taking a larger bite out of nominal GDP than where they stood pre-pandemic (Chart 3). There is a nod to recognizing the need to contain the size of government, particularly in good economic times when stimulus isn't required. The fiscal plan pledges to find $0.8 bn in savings next year by "reducing spending in the context of a strong economy". This is a recognition that some of the prior budget's spending plans that extended into 2023/24 to support the economic recovery look to be overkill given progress made towards full employment this past year. The budget also pledges to identify a further $1 bn in savings in 2024/25, growing to $3 bn a year over the longer horizon, through a strategic policy review. That would be a welcome effort to avoid an ever-expanding tax take as new spending priorities emerges, by finding existing areas of spending that can be trimmed.

On the revenue side, new measures included a scaled down version of the earlier announced tax hikes for large banks and insurers, totaling over $1 bn this fiscal year and $6 bn over five years, a move that will leave this one sector facing a permanently higher corporate tax rate than other industries or smaller financial institutions. The other major tax hike impacted private corporations that were taking steps to reduce taxes on investment income, raising $0.7 bn this year.

Add it all up, and the budget deficit excluding actuarial losses is set to improve from $113.8 bn deficit last year to $52.8 bn in 2022/23. That's a drop of more than 2½% of GDP leaving the deficit at 2% of GDP this year, and targeted at 1.4% the following year. In in the absence of today's tax/spending measures, the 2022/23 deficit would have declined by a further $7 bn, but that's only a further 0.2% of GDP. What will be debated is whether, in light of the large upside surprise in nominal GDP, even greater progress on deficits would have been achievable, particularly since any growth impacts of that restraint could be offset by the central bank taking a more gradualist path on interest rate hikes.

Debt/GDP helped by the denominator

A much-improved track for nominal GDP has done yeoman's work to reducing Canada's debt/GDP burden from what was envisaged even a year ago, while remaining higher than pre-pandemic plans. The budget now expects a 1.4%-point drop in the debt/GDP ratio over this fiscal year, which will leave it sitting at 45.1%, versus a projection last year that only saw it retreating to 50.7%.

Still, back in 2019, Ottawa aimed to contain debt to below 30% of GDP. The need for a major rescue effort during the pandemic necessarily blew that plan off course, and the current projections only see it reaching 41.5% by 2026/27, although that again is well below the prior year's budget plan. The budget points out that after two years of historic deficits during the pandemic, Canada's debt metrics compare favourably with those of other major economies, as do its overall deficits (Chart 4), and the budget makes the case that the debt service burden, despite rising interest rates, still looks manageable.

Bond supply not as light for the private sector

As we've often pointed out, budget deficit figures don't necessarily tell the full story for bond investors, and this year is no exception to that. Non-budgetary transactions will turn from a source of funding to a requirement, and a year of heavy maturities will mean that the government's gross borrowing requirement will actually climb this year (Table 4).

Table 4: Borrowing requirements

Billions ($)	2021/22E	2022/23F
Budgetary deficit/(surplus)	113.8	52.8
Non-budgetary transactions[1]	-8.2	32.0
Net financial requirement/(source)	105.6	84.9
Domestic maturities, adj. & buybacks[2]	103.0	182.0
Gross borrowing requirement	**208.6**	**266.9**

[1] Non-budgetary transactions comprise loans/advances to Enterprise Crown Corporations, pension costs & other.
[2] Domestic bonds only; excludes refinancing requirements for Treasury bills, retail and foreign currency debt.

Table 5: Borrowing requirements
Sources of funding

Billions ($)	2021/22E	2022/23F
Cash & other (net)	-13.4	27.9
Treasury bills (net)	-32.0	26.0
Canadian dollar bonds	255.0	212.0
Retail (net)	0.0	0.0
Foreign currency debt (net)	-1.0	1.0
Total	**208.6**	**266.9**
Change in bond stock	152	30

Table 6: Gross issuance

Billions ($)	2020/21A	2021/22E	2022/23F
Treasury bills	**219**	**187**	**213**
2-year	129	67	74
3-year	56	29	24
5-year	82	40	34
10-year	74	79	54
30-year	32	30	16
RRB	1.0	1.0	1.0
Ultra-long	0.0	4.0	4.0
Green Bonds	0.0	5.0	5.0
Total bonds	**374**	**255**	**212**
Total gross issuance	**593**	**442**	**425**

Given that so much of that is to cover maturities, it looks on the surface as if the bond market is getting a bit of relief in terms of the change in bonds outstanding, which appear to drop to a much more modest $30 bn (Table 5). But that too isn't the whole picture, since a large share of the bonds maturing are now held by the Bank of Canada, and these will have to be refinanced in the public market given that the Bank is no longer reinvesting those funds in new bonds.

Our head of FICC strategy, Ian Pollick, calculates that in the prior year, the private sector only had to take up an additional $63.5 bn in GOC bonds over what had matured in their holdings. The Bank of Canada bought the rest. In this coming fiscal year, the private sector will have to add $116 bn in GOC bonds over what had matured on their books. Of course, that's exactly what the central bank intends as it shifts from quantitative easing to tightening.

Contacts:

Avery Shenfeld
416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
416 956-3219
andrew.grantham@cibc.com

Karyne Charbonneau
613 552-1341
karyne.charbonneau@cibc.com

Katherine Judge
416 956-6527
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com