From: Jeremy M. Kronick and Thorsten Koeppl

To: Bill Morneau, Minister of Finance

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Re: **For a Revamped Federal Backstop**

The debate on whether and how the federal government should support the provinces given the exceptional circumstances surrounding COVID-19 has raged on over the last few weeks.

Terms such as fiscal federalism, provincial spreads, liquidity, and moral hazard have been bandied about. The truth is, no matter how you slice it, massive increases in debt will lead to increased servicing costs. The real question is can provinces support these increased costs, and should they have to.

On February 20, yield spreads for provincial 10-year bonds over equivalent federal debt were all under 100 basis points (1 percentage point). Fast forward to March 26, and all were well above 100 basis points, with Newfoundland even approaching 200 basis points.

After the Bank of Canada took the unprecedented step of announcing its large-scale asset purchase program – better known as quantitative easing (QE) – which included buying up longer-term provincial debt, spreads fell back, though still higher than they were February 20.

Perhaps more importantly, because federal government borrowing costs have been lowered across the yield curve – in part as a result of Bank of Canada purchases of federal debt – the actual borrowing costs for some provinces have fallen below where they were in February. So why would more support be necessary?

The issue comes down to sheer size. The annual increase in provincial debt is expected to be three times higher in 2020-21 than it was the year prior (from $25 billion to a little over $75 billion). As this occurs, the debt to GDP ratio will rise accordingly.

Now, the debt to GDP is a poor measure on its own as it conflates stock (debt) and flow (GDP) variables. What is needed, of course, is the interest rate, to complete the picture. Interest rates (and hence provincial borrowing costs) are lower than they were in February, but likely not by enough to compensate for the increased provincial debt loads. Some provinces with healthier balance sheets heading into the crisis will be able to take on this increase in servicing costs. Others will need further support.

Ottawa has a backstop in place in the Fiscal Stabilization Program, which is designed for exactly the current scenario, in which a large decline in a province's revenues calls for additional federal transfers. Unfortunately, the program is far too small at $60 a person, and any amount beyond that becomes an interest-free loan, which, if provinces are still in the same dire fiscal situation once the interest-free period ends, may not be much help.

A potential design option for a federal-provincial joint borrowing plan involves "consols." Consols are bonds, which in this case are issued by a province, that can be repaid at any time and that – until repaid – bear an interest payment in perpetuity. The money they raised could effectively bail out a province but would cost it something so long as interest rates were set appropriately. For example, one could use the average interest rate on a five or 10-year bond over a fixed period, say five years prior to the COVID-19 episode.

Putting real numbers to this hypothetical, the average interest rate on a five-year Government of Canada bond for the five years between January 2015 and December 2019 was 1.32 percent. Using Ontario as an example, if the federal government wanted to support half the projected $20.5 billion deficit – around $10 billion – assuming the interest rate is fixed, the cost to Ontario to service this debt (interest only) would amount to $132 million a year, or approximately $9 per person.

A province could regain full fiscal independence by redeeming the debt in the future. In effect, it would pay for its bailout but spread the cost out over a period of its own choosing.

Provinces started the current crisis from a worse fiscal position than in 2008 when, arguably, they bore the heaviest fiscal impact. Unfortunately, they did not use the subsequent recovery to put their books in order. We should not reward the poor decisions of the past but we do need to recognize that the COVID-19 economic shock is unique. Having the Bank of Canada act first was best. If some provinces need further support, a redesigned Fiscal Stabilization Program will serve. In fact, crisis or no crisis, it's time to revamp the federal backstop.

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