

Intelligence MEMOS



From: Alexandre Laurin, Miles Wu and William B.P. Robson
To: Canadians Concerned about Government Debt
Date: July 6, 2020
Re: **FISCAL SNAPSHOT WILL SHOW A GRIM PICTURE OF FEDERAL DEBT**

Over the last three months, the regular spending announcements from Canadian governments in response to COVID-19 have progressed from reassuring to alarming.

In late June, one of the three largest credit rating agencies lowered Canada's rating. With more spending likely to come to stimulate the gradual economic reopening across the country, debt concerns are looming.

The upcoming federal fiscal snapshot on July 8 will provide a long overdue official outlook for federal finances and will be closely watched by investors and taxpayers worried about governments' capacity to take on new debt.

Earlier in May, we projected [several fiscal scenarios](#) for the federal government, from a more optimistic view of the future to a more pessimistic one. Now, more than three months into COVID-19, we have a somewhat clearer picture. The Parliamentary Budget Officer (PBO) recently updated its ["most likely" fiscal scenario](#) for 2020/21, yielding a possible \$256-billion deficit and a one-year jump of more than 10 percentage points in the federal debt-to-GDP ratio. Canada's largest banks' June economic forecasts, on average, anticipate declines in nominal GDP of 6.5 percent in 2020, and rebounds of 6.6 percent in 2021. With this new information, we update our earlier projections and compute a fiscal scenario for the next four years – conservatively (and rather unrealistically) assuming no new stimulus spending.

The good news is that our updated view is close to our May's most optimistic scenario, with the debt-to-GDP ratio stabilizing around 45 percent over the medium term.

The bad news is how much red ink the federal government will be spilling long after temporary income supports such as the Canada Emergency Response Benefit and the Canada Emergency Wage Subsidy have ended.

Ottawa's net debt will hit \$1 trillion by 2021/22. We project deficits of \$275.6 billion this year and an average of over \$47 billion per year from 2022/23 to 2024/25. Should the government continue to extend income supports and introduce new stimulus packages, the accumulated debt could be \$100 or even \$200 billion higher by the end of the period.

This scenario would be problematic if Ottawa was the only order of government that mattered. But provincial and local governments raise more than half of all government revenues and provide most of the direct public services to Canadians, including healthcare and education. Even before the pandemic, Canada's aging population was squeezing provincial health budgets, and COVID-19 is exacerbating their [sustainability challenges](#).

Provinces are also borrowing, and by mid-decade, they will be [looking for tax room to meet these demands](#). This is why federal finances matter. Federal and provincial governments share the same tax base, and up to recently, a largely favourable long-term outlook for the federal government had shored up taxpayer and investor confidence.

But this is changing. Expecting the coronavirus response to raise Canada's federal-provincial consolidated gross general debt to 115 percent of GDP in 2020, up from 88 percent in 2019, Fitch Ratings, one of the three leading credit rating agencies, [downgraded Canada's credit rating](#) from AAA to AA+. Fitch highlighted that Canada's gross debt ratio, and interest-to-revenue ratio, are among the highest in the AA category. Fitch highlighted several underlying weaknesses, including a deteriorating corporate income tax advantage compared to the US, slow oil and gas investments, and high interprovincial trade barriers.

Canada is not the only country downgraded during the pandemic, and it still has the third highest rating among the G7. But even in our rather optimistic scenario, rising interest rates would make it very difficult for Ottawa to keep its debt ratio from rising over the long run without increasing its revenue take, leaving provinces already pressured from rising healthcare costs in a very difficult position.

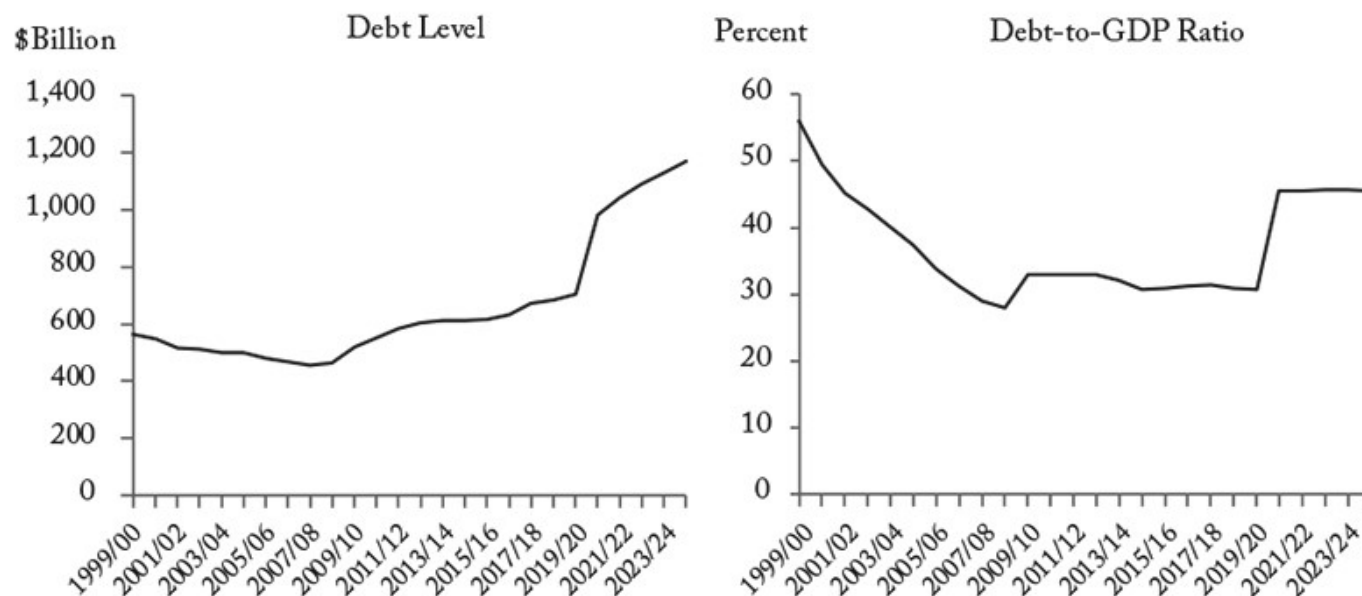
This week's federal fiscal snapshot deserves close scrutiny. A more dynamic view reveals that Ottawa needs to change course. As Canada adjusts to a post-crisis world, federal spending and borrowing have to come down. Ottawa needs to get out of the way.

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Historical and Projected Federal Debt, 2020/21 to 2024/25



Source: [Authors' May 13 Intelligence Memo](#) updated for the latest PBO analysis and the average June economic forecasts of the largest six Canadian deposit-taking institutions.

Fitch Credit Ratings for G7 Countries

G7 Countries	2019 Rating	Current Rating
Canada	AAA	AA+
France	AA	AA-
Germany	AAA	AAA
Italy	BBB	BBB-
Japan	A	A
United Kingdom	AA	AA-
United States	AAA	AAA

Source: Fitch Ratings.