

OBSERVATION

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ONTARIO'S DEBT RATING PUT ON NEGATIVE WATCH BY MOODY'S

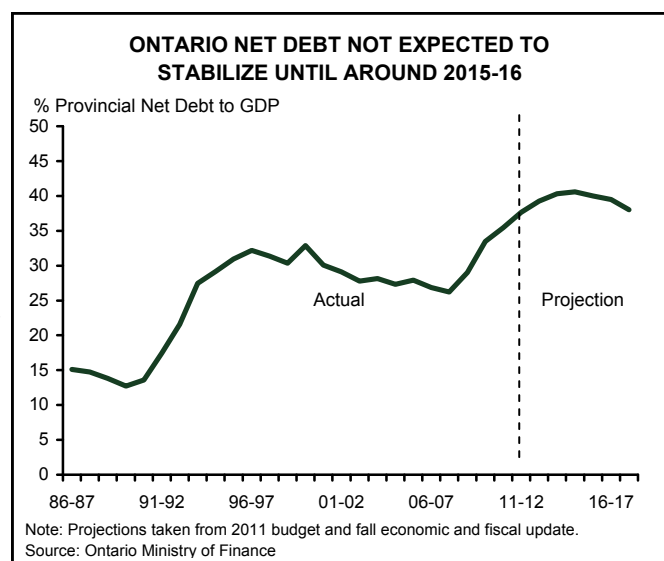
Concerned about the Ontario government's ability to meet its medium-term budget targets and its rising debt level, Moody's Investors Service announced that it has revised the outlook on the Province's credit rating to negative from stable. At Aa1, Ontario's rating remains one notch below Aaa and has been unchanged since it was upgraded from Aa2 in July 2002. Moody's indicated that it would follow through with a downgrade if the 2012 spring budget does not bring forward a credible plan to address the fiscal challenges at hand.

Recall that Ontario's 2011 budget reiterated the government's goal to eliminate the budget deficit – at an estimated \$16 billion this year – by fiscal 2017-18. Even with the steady decline projected in the deficit, the province's net debt is poised to rise further over the next few years – to 40.6% – before stabilizing in FY 2015-16. Only five years ago, this ratio was about half that level. It is still the case that the Province's debt remains affordable, as evidenced by the fact that the share of each revenue dollar required to service debt has stayed low. Still, this picture is expected to erode significantly over the medium term as debt continues to accumulate and interest rates rise back to normal.

Moody's highlighted that the extended path of consolidation opens up the possibility that an unexpected economic shock could knock the fiscal targets off track. As importantly, the agency is concerned with the government's ability to meet the difficult spending targets embedded in its plan, especially given the absence of broad public support. Indeed, making good on the government's commitment to hold average spending growth to a minimal 1-1.5% per year over the next six years would represent the longest period of austerity that Ontario has seen in the Post-War period.

A clearer sense of whether Ontario's debt rating will ultimately get downgraded by Moody's will come over the next 3-4 months. The Drummond Commission – announced by the government in the 2011 budget, and tasked with recommending ways to restructure public services and find efficiencies – will issue its preliminary report sometime in January. According to the Commission, everything is on the table. The government's response to the findings of that report will be a key input in Moody's next move.

This outlook revision has had little impact in financial markets, with spreads between Ontario and federal debt holding quite steady in its wake. The Moody's announcement follows that of Fitch, which put the province on negative outlook in May. In October 2009, both S&P and DBRS downgraded Ontario's debt rating a notch. An actual cut by Moody's should have a more material impact since it would likely raise expectations of further downgrades to come. And the increases in borrowing rates that would materialize would make the task of restoring fiscal balance all that more difficult.





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