2011 FEDERAL FISCAL UPDATE

TD Economics

November 8, 2011

EXTRA YEAR TACKED ON TO FEDERAL DEFICIT-REDUCTION TIMETABLE

Highlights

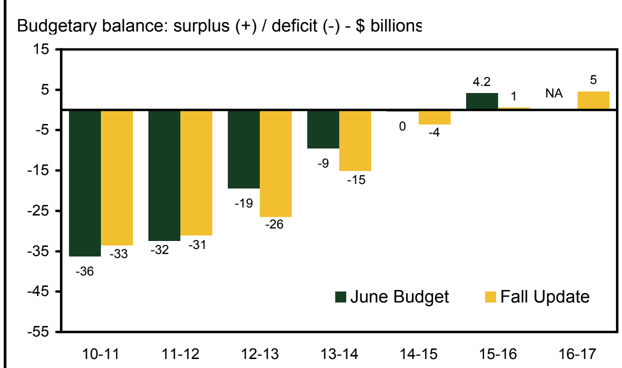
- More moderate private sector economic growth assumptions have seeped into the federal fiscal plan; the result is that the government does not expect to return to surplus until 2015-16, one year later than promised during the election campaign.
- To achieve the revised timetable, the government is embarking on a two-pronged approach. First, $15 billion in cumulative savings over five years ($4 billion more than was thought in June) need to be secured. Second, program spending growth is now set at 2.2% per year, over six years.
- Amid the global economic turbulence of late, the government announced plans to scale back Employment Insurance (EI) premium hikes in 2012 and extend work-sharing programs into next year.
- The government renewed the Bank of Canada's inflation-control mandate. The objective now rests in place until 2016 or when new legislation is tabled giving the central bank a different mandate.

The contents of today's federal fiscal update publication confirm what many, including us, had been expecting over the last few weeks – more moderate private sector consensus economic forecasts have made their way into the federal fiscal plan. As a consequence, the federal government now expects to return to surplus in 2015-16, one year later than what was last forecasted. The extra year will make some heads turn, especially given the magnitude of efficiencies ($15 billion over five years) booked into the plan. Whether surplus is achieved four years from now, or five, the medium-term return to surplus remains largely intact. Markets and investors should retain their confidence that this is the case.

It seems that calls for additional relief for Canadians amid the economic turbulence of late did not go unnoticed; two new measures were announced today. First, Employment Insurance (EI) premiums will now only increase by 5 cents per $100 of insurable earnings for employees on January 1, 2012. In the absence of today's announcement, the hike would have been 10 cents. Employer EI premiums are a 1.4 multiple of the employee rate, so businesses also stand to benefit from today's announcement. Second, the federal work-sharing program has been extended for another year.

While we argued that it might be too soon to implement new relief measures at this juncture of the economic recovery, policymakers opted to pursue only limited and targeted relief initiatives. Steps towards implementing more wide spread, large-scale stimulus measures, on top of current commitments, would put into question even the delayed schedule.

FEDERAL GOVERNMENT'S RETURN TO SURPLUS WILL NOW TAKE ONE YEAR LONGER



Source: Department of Finance Canada - 2011 June budget and 2011 November Update on Economic and Fiscal Projections.

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More moderate economic growth now prevails

When private sector economists met late last month with federal Finance Minister Flaherty, there was consensus that economic growth assumptions would be lower than what prevailed for the 2011 budget. The extent of the downgrade was confirmed when private sector numbers were released after the meeting. We summarize these forecasts and averages in the accompanying chart for the reader's reference. The government's practice of shaving off an additional $10-$30 billion from the level of consensus nominal GDP every year produces a more modest outlook for the national economy relative to the June 2011 planning assumptions. The dollar amount taken off from the consensus nominal GDP estimate has increased relative to past practices. This additional prudence reflects the volatility and uncertainty plaguing the current economic climate.

The level of nominal GDP serves as a rough proxy for budgetary revenue intake. In essence, the revised forecasts strip away $15 billion in revenues, over a six year period, versus 2011 budget projections. Second, the scale-back in EI premium rate increases, described previously, impact the revenue side of the ledger. The federal government estimates the cost of the EI premium initiative to be $600 million in 2012.

The government has now adjusted EI premium rates four years in a row; rates were frozen in 2009 and 2010 and increases were limited to five cents per $100 of insurable earnings for employees in 2011 and 2012. With these adjustments, the EI Account is not expected to return to surplus again until 2016 or 2017. The EI program serves as an automatic stabilizer in the event of a negative economic shock. The longer the EI Account remains in a deficit position, the more vulnerable the system becomes in the event of a negative, external shock.

While revenue projections are lower than what was assumed at the time of the June budget, the total expenditure profile is little changed. As a reminder, this category of outlays can be dis-aggregated into debt servicing costs and program spending. A lower for longer interest profile reduces the weight of mandatory interest payments. More specifically, debt servicing costs are lower by a cumulative $18.7 billion, over five years, relative to the June budget. Program spending growth continues to be clamped down, to an annual average 2.2% over six years.

No update was provided in today's document on the government's ongoing Strategic and Operating Review. However, the task handed to this commission is now even harder. When the group was initially set up, it was asked to find $11 billion in efficiencies over a four year period. With the revenue profile hit hard by recent developments, the revised savings target is now $15 billion over five years. These savings are already built into the fiscal plan and are separate from the annual program spending growth restraint currently in place. Being able to adhere to the expenditure profile (restraining annual program spending growth and finding annual permanent efficiencies) remains a significant downside risk to the fiscal plan.

ECONOMIC ASSUMPTIONS* FOR CANADA
Annual, percent change (unless otherwise noted)

Calendar Year	2011	2012	2013	2014	2015
Real GDP					
2011 June Budget	2.9	2.8	2.7	2.5	2.5
TD Economics*	2.2	1.9	2.6	2.4	2.3
2011 November Update	2.2	2.1	2.5	2.5	2.5
Nominal GDP					
2011 June Budget	5.8	5.0	4.9	4.5	4.5
TD Economics*	5.1	3.4	4.5	4.3	4.2
2011 November Update	5.3	4.1	4.5	4.5	4.5
Nominal GDP ($ billions)					
2011 June Budget (planning assumption)	1,709	1,794	1,883	1,969	2,058
TD Economics*	1,708	1,766	1,844	1,925	2,006
2011 November Update	1,711	1,781	1,861	1,945	2,032
2011 November Update (planning assumption)	1,691	1,751	1,841	1,935	2,022
Unemployment rate					
2011 June Budget	7.5	7.2	7.0	6.7	6.5
TD Economics*	7.5	7.4	7.1	7.0	6.7
2011 November Update	7.5	7.2	7.0	6.8	6.6
3-Month T-Bill Rate					
2011 June Budget	1.3	2.5	3.4	3.9	4.1
TD Economics*	0.9	0.9	2.0	3.6	3.8
2011 November Update	0.9	1.2	2.0	2.9	3.5
10-Year Gov't Bond Yield					
2011 June Budget	3.5	4.0	4.6	4.8	5.0
TD Economics*	2.6	2.8	3.7	4.5	4.8
2011 November Update	2.8	2.7	3.2	3.9	4.5

* As at November 2011.
Source: Department of Finance Canada - 2011 June Budget and 2011 November Update on Economic and Fiscal Projections.

Longer timeline to return to budgetary surplus

When the dust settles, and revenue and expenditure revisions made, the government is left with larger deficits compared to June 2011 budget numbers. On a cumulative basis, the deficit tally sat at $58.8 billion over four years in June; this same statistic rests at $75.9 billion this time around. The deterioration is noticeable in dollar terms, but becomes less significant relative to the size of the national economy. Still, the increased deficit load adds to the government's debt burden. Relative to the June budget, net debt, on a cumulative basis, is $72.9 billion higher. In a low interest rate environment, this additional burden should not result

FEDERAL GOVERNMENT FISCAL POSITION (C$ billions, unless otherwise indicated)											
	Actual					2011 Update of Economic and Fiscal Projections					
Fiscal Year	06-07	07-08	08-09	09-10	10-11	11-12	12-13	13-14	14-15	15-16	16-17
Budgetary revenues	**236.0**	**242.4**	**233.1**	**218.6**	**237.1**	**243.5**	**251.8**	**268.8**	**285.1**	**298.4**	**310.6**
% change	6.2	2.7	-3.8	-6.2	8.5	2.7	3.4	6.8	6.1	4.7	4.1
% of GDP	16.3	15.8	14.6	14.3	14.6	14.4	14.4	14.6	14.7	14.8	14.7
Program expenses	**188.3**	**199.5**	**207.9**	**244.8**	**239.6**	**243.0**	**247.4**	**252.5**	**257.6**	**265.3**	**272.4**
% change	7.5	6.0	4.2	17.8	-2.1	1.4	1.8	2.1	2.0	3.0	2.7
% of GDP	13.0	13.0	13.0	16.0	14.8	14.4	14.1	13.7	13.3	13.1	12.9
Public debt charges	**33.9**	**33.3**	**31.0**	**29.4**	**30.9**	**31.5**	**31.9**	**33.3**	**35.0**	**36.5**	**37.7**
% change	0.5	-1.8	-7.0	-5.1	5.1	1.9	1.3	4.4	5.1	4.3	3.3
% of Revenues	14.4	13.7	13.3	13.5	13.0	12.9	12.7	12.4	12.3	12.2	12.1
Total expenditures	**222.2**	**232.8**	**238.8**	**274.2**	**270.5**	**274.5**	**279.2**	**285.8**	**292.6**	**301.8**	**310.1**
% change	6.3	4.8	2.6	14.8	-1.3	1.5	1.7	2.4	2.4	3.1	2.8
% of GDP	15.3	15.2	14.9	18.0	16.7	16.2	15.9	15.5	15.1	14.9	14.7
Deficit reduction action plan savings target	--	--	--	--	--	**0.0**	**1.0**	**2.0**	**4.0**	**4.0**	**4.0**
Budgetary balance	**13.8**	**9.6**	**-5.8**	**-55.6**	**-33.4**	**-31.0**	**-26.4**	**-15.0**	**-3.5**	**0.6**	**4.5**
% of GDP	0.9	0.6	-0.4	-3.6	-2.1	-1.8	-1.5	-0.8	-0.2	0.0	0.2
Federal debt	**467.3**	**457.7**	**463.4**	**519.1**	**550.3**	**585.2**	**612.7**	**629.7**	**637.2**	**640.6**	**640.0**
% of GDP	32.2	29.9	29.0	34.0	33.9	34.6	35.0	34.2	32.9	31.7	30.3
						Projection - 2011 June Federal Budget					
Budgetary revenues	236.0	242.4	233.1	218.6	235.6	249.1	264.4	281.2	296.8	309.2	NA
% change	6.2	2.7	-3.8	-6.2	7.8	5.7	6.1	6.4	5.5	4.2	NA
Total expenditures	222.2	232.8	238.8	274.2	271.7	281.4	283.8	290.7	297.2	305.0	**NA**
% change	6.3	4.8	2.6	14.8	-0.9	3.6	0.9	2.4	2.2	2.6	NA
Budgetary balance	**13.8**	**9.6**	**-5.8**	**-55.6**	**-36.2**	**-32.3**	**-19.4**	**-9.4**	**-0.3**	**4.2**	NA
% of GDP	0.9	0.6	-0.4	-3.6	-2.2	-1.9	-1.1	-0.5	0.0	0.2	NA
Federal debt*	**467.3**	**457.6**	**463.7**	**519.1**	**553.1**	**585.4**	**604.8**	**614.2**	**614.5**	**610.3**	**NA**
% of GDP	32.2	29.9	29.0	34.0	34.1	34.4	33.7	32.6	31.2	29.7	NA
Source: Department of Finance Canada.											

in significantly greater debt servicing costs nor impact the government's triple-A credit rating.

With the new timetable cemented with today's release, we stand behind our earlier assessment that markets and investors should not be too irked about the development. Our reasons were as follows: (1) deficits in the out years, 2013-14 and 2014-15, are small in size relative to national GDP; (2) the multi-year, gradual return to black ink remains very much the status-quo course of action; and (3) Canadian governments, as a whole, are in comparatively better fiscal shape than many of their international counterparts.

Difficult backdrop to the task at hand

With a surplus in our grasp over the medium-term, the federal government has an opportunity to assert itself on the international stage. In the current context, governments around the world are grappling on how best to overcome fiscal consolidation challenges. We know from the federal experience in the 1990s that deficits are extremely difficult to eliminate and can lead to a painful outcome.

In the current environment, deficit reduction looks to be much harder. Modest global demand will limit the likelihood of a significant revenue windfall. In turn, expenditure restraint is being more heavily relied upon than during the 1990s. Also, volatility and uncertainty are expected to linger for some time. A multi-year deficit reduction plan is vulnerable in this type of environment.

Amid the already tough expenditure restraint backdrop and the growing downside economic risks, there has been much debate in recent weeks regarding the need to change directions. With the economic indicators to date in hand, the rationale supporting such a change is just not present. Downside risks are brewing almost entirely across the pond and south of the border. In the event of another downturn, the Canadian government would face increasing pressure to respond to the developments. If more large-scale stimulus is injected into the economy, over and above what was announced today, other compromises will need to be made or the government's return to surplus within four years would need to be revisited altogether.

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