OBSERVATION

TD Economics

April 27, 2012

ONTARIO ADDS ANOTHER DOWNGRADE NOTCH TO ITS BELT

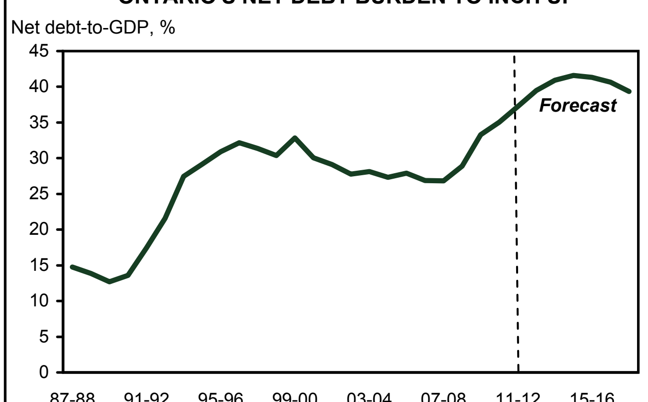
Highlights

- The Ontario government was not given much time to bask in the afterglow of the passing of its 2012 budget earlier in the week. Instead, two credit rating agencies gave the government a stark reminder of the daunting fiscal task ahead.
- On Wednesday, S&P put Ontario on a negative watch and stated that there was a 33% probability of a credit rating downgrade within two years. To add to that news, Moody's lowered Ontario's rating yesterday to Aa2. Since 2009, all three major rating agencies (DBRS, S&P and Moody's) have downgraded the Province due to concerns about its deficit profile, growing debt burden and deficit reduction efforts.
- Markets viewed the Moody's move was largely a non-event, given that the other agencies had downgraded Ontario in 2009. Since the budget was tabled on March 27th, spreads between Ontario and Canada 10-year bonds have widened only slightly by 5 basis points.
- Credit rating scores and the risk premium associated with holding provincial debt have important implications for debt servicing costs. At present, these payments already consume eight cents out of every dollar spent, leaving less money for areas like health care and education. Servicing the debt will also grow over time as interest rates increase and the debt level ratchets up.

It has been a whirlwind week for the Ontario government, with the many ups and downs characteristic of an amusement park roller coaster ride. To start, the 2012 budget passed the Legislature on Tuesday or about a month after the document was originally tabled. The minority provincial government needed to make several changes to secure the necessary political support to back the budget. For a summary of these policy moves, readers can refer to our commentary here. Ultimately, the new measures had positive fiscal impacts – the annual deficit profile was improved by anywhere from $300-600 million and a modest surplus (as opposed to budgetary balance) is now forecast for 2017-18.

The good news of the budget passing and the improved fiscal picture did not linger for very long. Instead, two major credit rating agencies gave everyone a stark reminder of the government's fiscal challenges. On Wednesday, S&P put Ontario on a negative watch and stated that there was a 33% probability of a credit rating downgrade within two years. To recall, S&P (and DBRS) downgraded the Province in October 2009, citing concerns about the government's deficit profile, growing debt burden and deficit reduction efforts in a modest economic growth climate. For these same reasons and the inherent difficult in achieving stringent program spending targets over an extended period of time, Moody's lowered Ontario's rating yesterday from Aa1 to Aa2. Although the timing of the move was unknown, the agency

WHILE DEFICIT REDUCTION PLAN IN PLACE, ONTARIO'S NET DEBT BURDEN TO INCH UP



Note: Does not capture changes for the budget to pass the Legislature.
Source: 2012 Ontario Budget, Ontario Ministry of Finance.

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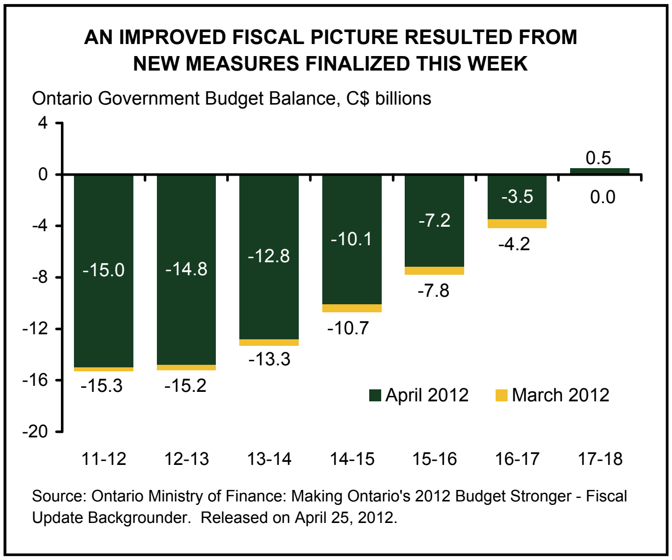

had signaled that it would follow through with a downgrade if the 2012 budget did not bring forward what the rating agency deemed to be a credible and feasible plan to restore fiscal health. While the downgrade handed down this week was equivalent to one notch, it could have been worse – in December, there was speculation that Moody's would cut the Province's score by two notches.

The concerns surrounding Ontario's fiscal challenge are not new. In fact, we have been messaging our own views for some time in various fiscal publications and budget commentaries. The provincial deficit-to-GDP share is poised to come in at just over 2% this fiscal year, the highest burden of any province or federal government in the country. Even with the medium-term plan put in place to return to a surplus position, net debt is expected to accumulate over the next few years. If we use the latest estimates available (those incorporated in the 2012 budget), net debt as share of the economy will peak at 41.6% in fiscal 2014-15. As a benchmark for comparison and to provide some perspective, five years ago the provincial debt burden stood at 26.8%.

Granted, as deficits are erased, the debt will slowly improve. However, in the interim, the government needs to service its debt through regular interest rate payments. In the current low borrowing environment, interest costs consume about eight cents out of every dollar spent. This leaves reduced spending room for other key spending priorities like health care and education – especially in a time of expenditure restraint where the total size of the spending pie is already facing downward pressure. On a status-quo basis, interest rate payments are set to inch up to eleven cents out of every dollar spent in a few years. However, if markets demand more of a premium to hold Ontario debt given credit rating agency unease, Ontarians could see less money directed towards actual programs and services.

In the overnight trading session, there was little new additional risk premium being priced into markets. In fact, we have seen spreads between Canada and Ontario 10-year bonds widen by only 5 basis points since the budget was tabled on March 27th. As markets digest the news this morning, Ontario spreads have held up quite well given the downgrade and other weekly developments. We expect this relative strength to continue for several reasons. First, Ontario bonds remain attractive compared to a lot of other national and sub-national jurisdictions in the world. The credit rating agencies also believe that the Province has the necessary fiscal flexibility to improve its balance sheet over the medium-term. Second, DBRS reaffirmed its long- and short-term ratings for Ontario yesterday. As a result, no further rating actions are expected over the next little while. Third, the Moody's move yesterday can be thought of as simply catch-up, as S&P and DBRS issued downgrades in late 2009. Fourth, even with its newly minted lower score, Ontario is in the company of six provinces at the Aa2 level. Only the federal government, British Columbia and the Prairies have a higher Moody's credit score.

After markets closed yesterday, Ontario Finance Minister Dwight Duncan recognized that a lot must be done to improve the government's fiscal position to ensure that programs and services remain of high-quality. He also stressed that the present day fiscal situation is one that must be dealt with right away. As we saw with the Drummond exercise, structural reform will be necessary to turn the fiscal ship around, but with enhanced efficiencies, there may not have to be a trade-off between services and the revenues needed to pay for them. With recent developments, interest rate increases on their way, a minority governance structure, and most of the country watching the markets, the task of restoring fiscal prosperity, in this economic climate, will remain a difficult one for the government of Ontario. Ultimately, Ontario's credit scores will depend on its ability to act on the commitments made in the budget.

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