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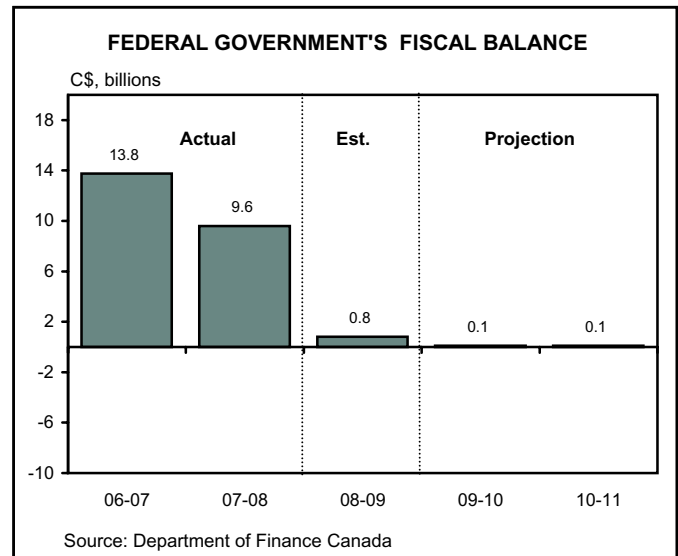
2008 Federal Economic & Fiscal Update

November 27, 2008

HIGHLIGHTS

- Slight surpluses projected for next 5 years
- Despite economic deterioration, budget balance to be shored up by planned spending cuts and asset sales
- Budget projections considerably more optimistic than TD's, suggesting deficit may be hard to avoid.

In today's Economic and Fiscal Update, the federal government has downgraded their planned budget targets modestly for this year and next compared to its 2008 budget projections while maintaining slight surpluses in each of the next five years. Despite a marked deterioration in the economic outlook compared to the budget, the government plans to fill the hole with spending reductions and asset sales, particularly next year. Without these planned actions, a budget deficit of about \$6 billion would have been earmarked for fiscal 2009-10, following a \$0.2 billion estimated surplus this year. Both of these "status-quo" numbers, which were not far off market expectations, mark a significant negative shift from the government's forecast



surpluses of \$2.3 billion and \$1.3 billion, respectively, for this year and next.

While the return to red ink has been largely blamed on the Canadian economy's souring economic prospects, this development has actually been in the making for quite some time. Since fiscal 2000-01, revenues as a share of GDP have fallen from 18.0% to 15.8% on the back of tax cuts, while the program spending-to-GDP has moved up from 12.0% to 13.0%.

With the budget cushion steadily chipped away, this year's unanticipated economic slowdown has clearly tipped the balance. The most important driver of the tax base is nominal GDP, which builds into the headline real GDP measure the impact of domestic and export/commodity prices. As shown in the table, while real GDP has been downgraded notably this year, the larger-than-expected run-up in commodity prices in the first half of the fiscal year has actually pushed up its revised nominal GDP estimate above budget plan. However, next year is a different story, when the subsequent slump in commodity prices, a weaker-than-expected U.S. economy and other growing economic headwinds will truly begin to bite both nominal GDP and revenues.

FEDERAL GOVERNMENT FISCAL POSITION				
[C\$ billions, unless otherwise indicated]				
Fiscal Year	Actual	Est.	Projection	
	07-08	08-09	09-10	10-11
Total revenues	242.4	239.0	248.5	258.9
% change	2.7	-1.4	4.0	8.3
% of GDP	15.8	14.9	15.4	15.3
Program spending	199.5	206.6	216.5	224.6
% change	6.0	3.6	4.8	8.7
% of GDP	13.0	12.9	13.4	13.3
Public debt charges	33.3	31.6	31.9	34.3
% change	-1.8	-5.2	0.9	7.5
% of rev.	13.7	13.2	12.8	13.2
% of GDP	2.2	2.0	2.0	2.0
Total expenditures	232.8	238.2	248.4	258.8
% change	4.8	2.3	4.3	4.2
% of GDP	15.2	14.9	15.4	15.3
Budgetary balance	9.6	0.8	0.1	0.1
Federal debt:				
Accumulated deficits	457.6	456.8	456.7	456.6
% of GDP	29.8	28.5	28.3	27.1

Source: Department of Finance Canada.

As noted, the government has identified a number of actions that will offset the negative fiscal hit from the economy. These actions total a net \$600 million in the current year, growing to \$6 billion in fiscal 2009-10. Most importantly, the government plans to find \$4.3 billion in savings from effective management of spending, with about half generated from yet-to-be-specified asset sales. Other areas include savings from public sector wage settlements. On the flip side, the government has proposed to temporarily reduce the minimum RRIF withdrawals by 25% at a cost of \$200 million in fiscal 2008-09. On the pension front, the government announced that they would extend the period that companies need to cover pension shortfalls from 5 to 10 years. While only a minority of workers have pensions that are regulated federally, it will put pressure on the provincial governments to follow suit.

Deficits likely to materialize

These fiscal projections today are meant to provide a snapshot of the government's anticipated budget position heading into its 2009 budget planning phase. Ultimately, the deterioration in Canada's fiscal position will in all likelihood be much sharper than shown here:

- As expected, the government offered few details on a new stimulus package, as it focused its attention on growth-enhancing measures already provided over the past few years. (Ironically, these past measures total about 2% of GDP (\$30 billion) which was the established goal made by members of the G-20 at the recent meeting. Today, Minister Flaherty said, "in the weeks ahead, we will determine the extent to which we will inject additional stimulus to our economy ...", leaving considerable uncertainty as to how much that might be. Still, any additional stimulus will further cut into the government's fiscal position.
- As importantly, the government's underlying GDP assumption for 2009 appears optimistic in our view. Given our expectation of a 33% drop in commodity prices on average next year, we believe that nominal GDP could decline by as much as 2%, which is not far off the most pessimistic of the private sector forecasters. That same forecaster (the Centre of Spatial Economics) has

ECONOMIC & FINANCIAL ASSUMPTIONS* FOR CANADA			
Annual average percent change, unless otherwise noted			
Calendar Year	2008	2009	2010
Real GDP			
2008 Budget	1.7	2.4	2.9
2008 Fiscal Update	0.6	0.3	2.6
TD Economics [^]	0.5	-1.1	2.3
Nominal GDP			
2008 Budget	3.5	4.3	4.7
2008 Fiscal Update	4.4	0.8	4.4
TD Economics [^]	3.7	-1.8	3.8
Unemployment rate (%)			
2008 Budget	6.3	6.4	6.2
2008 Fiscal Update	6.1	6.9	6.7
TD Economics [^]	6.1	7.6	7.9
U.S. real GDP			
2008 Budget	1.5	2.4	3.0
2008 Fiscal Update	1.4	-0.4	2.1
TD Economics [^]	1.3	-1.6	2.2

*Department of Finance Canada. [^]As Nov. 2008, under pessimistic scenario.

projected a "status-quo" budget deficit of about \$13 billion next year. Even this year, weaker corporate tax revenues in the coming months could push the government into a shortfall position.

The bottom line

Ultimately, it will be very challenging for the government to avoid a deficit during such difficult economic times, especially as pressure likely grows to ante up further stimulus in the upcoming budget. On the bright side, the success in the government in paying down debt in recent years has bought it some maneuvering room. Moreover, Minister Flaherty appears committed to ensuring that any deficit will remain temporary, which is important in terms of avoiding the type of slippery slope Canadian finances fell down during the 1980s and early 1990s.

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