



TD Economics

The 2009 Federal Budget

January 27, 2009

HIGHLIGHTS

- **\$30-34 billion deficit in FY 09-10 and FY 10-11**
- **Balance to be restored by FY 13-14**
- **Debt-to-GDP to reach 32%, less than half its 1990s peak**
- **Stimulus 3:1 in favour of spending over tax relief**
- **Market borrowing to rise sharply next year ...**
- **... but ongoing strong demand should keep yields low**

Today, Canada's Finance Minister Jim Flaherty unveiled a stimulus package totaling about \$40 billion in measures over the next two years. About three-quarters of this total pie was earmarked towards new spending, with infrastructure and enhanced training and employment insurance benefits stealing a good part of the show. Tax relief measures

featured hikes in the basic personal amount as well as the top threshold of the first and the second personal income tax brackets. Furthermore, employment insurance premiums were frozen for two years (See summary of the budget measures at the back.)

From significant deficit to balanced budget in 5 years

Unlike past years, there was little suspense surrounding the budget forecast. Today, earlier reports of the projected deficits – \$30-\$34 billion over the next two years then falling to zero by fiscal 2013-14 – were confirmed. What wasn't known in advance was the estimate for the current fiscal year, where the budget balance shown in December's Fall Update was revised downward to a small deficit.

The big push into red ink reflects more than the cost of the measures announced today. Even before factoring in the new measures, the government had projected "status quo" (i.e., pre-stimulus) deficits of \$16 billion and \$14 bil-

FEDERAL GOVERNMENT FISCAL POSITION													
(C\$ billions, unless otherwise indicated)													
Fiscal Year	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Est.	Projection				
	01-02	02-03	03-04	04-05	05-06	06-07	07-08	08-09	09-10	10-11	11-12	12-13	13-14
Budgetary revenues	183.9	190.6	198.6	211.9	222.2	236.0	242.4	236.4	224.9	239.9	259.4	276.4	294.3
% change	-5.4	3.6	4.2	6.7	4.8	6.2	2.7	-2.5	-4.9	6.7	8.1	6.6	6.5
% of GDP	16.6	16.5	16.4	16.4	16.2	16.3	15.8	14.7	14.4	14.7	15.0	15.0	15.2
Program expenses	136.2	146.7	153.7	176.4	175.2	188.3	199.5	206.8	229.1	236.5	235.1	244.5	254.1
% change	4.3	7.7	4.8	14.8	-0.7	7.5	6.0	3.7	10.8	3.2	-0.6	4.0	3.9
% of GDP	12.3	12.7	12.7	13.7	12.8	13.0	13.0	12.9	14.7	14.5	13.6	13.3	13.1
Public debt charges	39.7	37.3	35.8	34.1	33.8	33.9	33.3	30.7	29.5	33.3	37.2	39.2	39.6
% change	-9.7	-6.0	-4.0	-4.6	-1.0	0.5	-1.8	-7.9	-3.9	12.9	11.7	5.4	1.0
% of GDP	3.6	3.2	2.9	2.6	2.5	2.3	2.2	1.9	1.9	2.0	2.1	2.1	2.0
% of revenues	21.6	19.6	18.0	16.1	15.2	14.4	13.7	13.0	13.1	13.9	14.3	14.2	13.5
Total expenditures	175.9	183.9	189.4	210.5	209.0	222.2	232.8	237.4	258.6	269.7	272.3	283.7	293.7
% change	0.8	4.6	3.0	11.1	-0.7	6.3	4.8	2.0	8.9	4.3	1.0	4.2	3.5
% of GDP	15.9	16.0	15.6	16.3	15.2	15.3	15.2	14.8	16.6	16.6	15.7	15.4	15.2
Budgetary balance	8.0	6.6	9.1	1.5	13.2	13.8	9.6	-1.1	-33.7	-29.8	-13.0	-7.3	0.7
% of GDP	0.7	0.6	0.8	0.1	1.0	0.9	0.6	-0.1	-2.2	-1.8	-0.8	-0.4	0.0
Federal debt*	511.9	505.3	496.2	494.7	481.5	467.3	457.6	458.7	492.4	522.2	535.2	542.4	541.8
% of GDP	46.2	43.8	40.9	38.3	35.1	32.2	29.8	28.6	31.6	32.1	30.9	29.5	28.0

* Accumulated deficits. Source: Department of Finance Canada.

ECONOMIC & FINANCIAL ASSUMPTIONS* FOR CANADA			
Annual average percent change, unless otherwise noted			
Calendar Year	2008	2009	2010
Real GDP	Est.	Forecast	Forecast
2009 Budget	0.7	-0.8	2.4
November Fiscal Update	0.6	0.3	2.6
TD Economics [^]	0.7	-1.4	2.4
Nominal GDP	Est.	Forecast	Forecast
2009 Budget	4.4	-2.7	4.3
November Fiscal Update	4.4	0.8	4.4
TD Economics [^]	4.3	-3.2	5.1
Unemployment rate (%)	Actual	Forecast	Forecast
2009 Budget	6.1	7.5	7.7
November Fiscal Update	6.1	6.9	6.7
TD Economics [^]	6.1	7.7	8.3
3-Month T-Bill Rate (%)	Actual	Forecast	Forecast
2009 Budget	2.3	0.8	1.7
November Fiscal Update	2.3	1.9	2.7
TD Economics [^]	2.3	0.8	1.5
10-Year Gov't Bond Yield (%)	Actual	Forecast	Forecast
2009 Budget	3.6	2.8	3.4
November Fiscal Update	3.6	3.7	4.2
TD Economics [^]	3.6	2.5	2.9
U.S. real GDP	Est.	Forecast	Forecast
2009 Budget	1.2	-1.8	2.1
November Fiscal Update	1.4	-0.4	2.1
TD Economics [^]	1.1	-2.0	2.7

* Department of Finance Canada. ^ As at Dec.08-Jan.09.

lion, respectively, over the next two years – along with smaller deficits in the years thereafter – as a result of downward adjustments to economic projections since the Update. The \$40 billion in stimulus, equivalent to 2.5% of GDP, represents the difference between the status-quo and the headline deficit projections over the next two years, which is when most of today's measures are focused.

The government has taken some action to help ensure the budget deficit targets over the next two years are met. Recognizing that the private-sector average projection of nominal GDP (-1.2%) was overly optimistic, the government has marked down that number for the purposes of budget planning to -2.7%. It still remains higher than that of TD Economics (-3.2%), but at least it appears much more in touch with reality in our view.

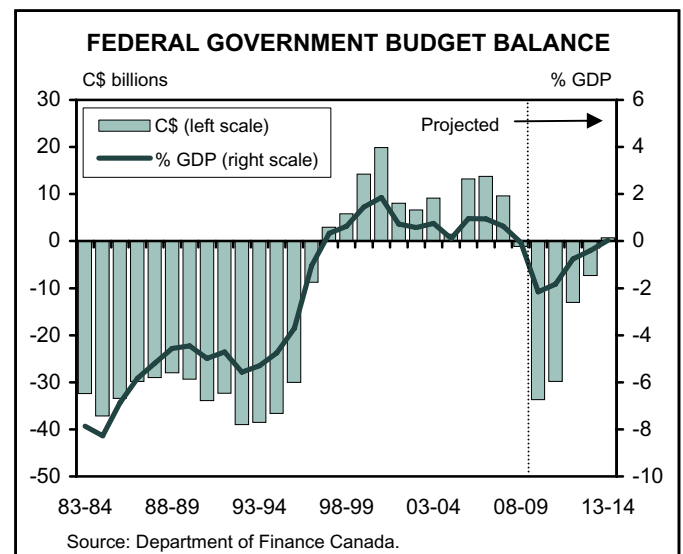
As importantly, the stimulus announced today will provide an economic boost that was not factored into the fiscal projections. The government has estimated its stimulus plan – combined with the effect of matching infrastructure investment from other levels of government – will boost real GDP by 1.6% in 2009 and a total of 1.9% by 2010. Comparable employment benefits were assessed at 0.5% and 1.1%.

Such calculations are rife with uncertainty, since it involves making assumptions on the timing of when the measures induce spending increases by households and busi-

nesses, how of that resulting activity leaks out of the economy through imports and whether the income is spent or saved. In our view, the government's assessment of the economic impact of the stimulus is on the high side – we would place the real GDP lift closer to about 1% over the next two years and more back-end loaded to 2010 when much of the infrastructure spending will flow. Regardless, these positive economic impacts could mean a smaller deficit.

Looking further out, the task of eliminating a \$30 billion budget deficit in three years will still be challenging. The -0.6% drop in program spending forecast for fiscal 2011-12 reflects the fact that much of the infrastructure spending is booked in the two years prior, and hence falls out of the numbers. Our concerns lie more on the revenue side, where the government is relying on above average revenue growth of 7% per year based on a robust nominal GDP growth (6% per year) in 2011-13. That could be a tall order.

Regardless, the federal government's fiscal position will remain rock solid. Planned deficits in the order of \$30-\$34 billion over the next two years represent 2% of GDP, which would pale in comparison to the deficits of 4-8% of GDP racked up during the recessions of the 1980s and 1990s. The federal government has not surprisingly abandoned its longer-term goal of lowering the debt-to-GDP ratio to 25% by fiscal 2012-13. Nonetheless, the ratio is projected to edge up to a peak of 32% by next year, which is less than half of the heights of close to 70% reached in the mid-1980s. The fiscal comparison looks equally as favourable when Canada is stacked up against its international counterparts. In particular, in the United States, the deficit-to-GDP ratio could rise above 10% in the current year once a new stimulus plan is adopted by the U.S. Congress. The federal government also trumpeted the fact that Canada's



debt ratio remains the lowest in the G-7.

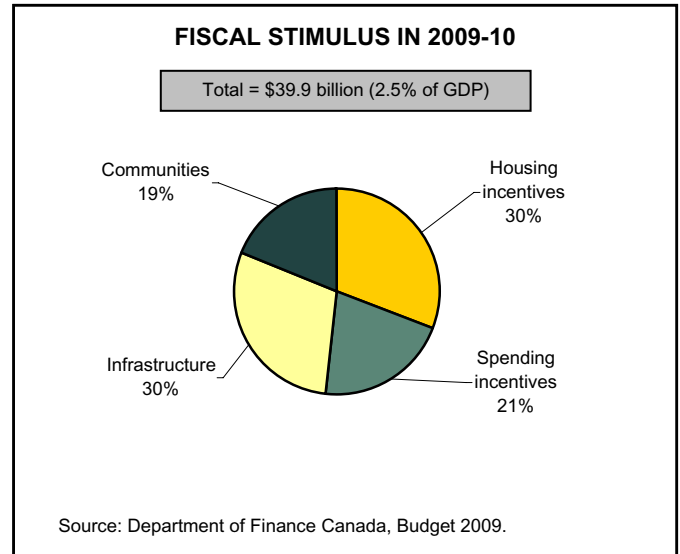
Budget to be passed

The focus will now turn to the official opposition, who could bring down the government as early as Thursday if they vote against the budget. In recent days, the official opposition had identified some broad criteria for supporting the budget, including help for the vulnerable, the protection of jobs, building for the future and a clear plan to eliminate the deficit over the medium term. While the opposition will likely disagree with specific measures, the broad elements of the plan would appear to meet their general criteria.

Market reaction

From an investor perspective, today's budget is unlikely to trigger a major reaction from financial markets. Many of the spending measures – such as aid for troubled sectors such as autos and forestry – were known ahead of the budget. On the tax side, there were no unexpected changes to the capital gains tax, dividend taxation or marginal personal income tax rates, which would have generated a stir. The stimulus package has improved the outlook for economic growth and profits above what otherwise would have been the case without the package, but likely not enough to trigger a meaningful response in equity markets, particularly in view of the significant downside risks that remain. Lastly, the projected deficits were known in advance of the budget, and even then, they had caused barely a ripple in markets when first announced late last week.

More of a concern in debt markets could be the government's sizeable financing requirement, which measures the difference between cash coming in to the government and cash going out. In addition to the deficit, it would include non-budgetary transactions such as pensions and other accounts and borrowing on behalf of crown corporations. Based on this measure, the government will need to tap money and bond markets to the tune of \$101 billion in fiscal 2009-10. About half of that amount reflects the government's move – announced today – to increase funding under the Insured Mortgage Protection Program (IMPP) from \$75 billion to \$125 billion. In sum, the government will need to raise \$312 billion through debt markets in fiscal 2009-10, with two-thirds coming through T-bills and one-third through bonds. Keep in mind that this figure doesn't include provincial borrowing needs, which are also expected to be lofty over the near term, especially with the all-province deficit-to-GDP ratio poised to rise above 2%



of GDP in fiscal 2009-10.

Notwithstanding the possibility of a short-term negative impact in debt markets, we believe that substantial issuance can be absorbed without a major increase in bond yields over the next year. For one, low risk government bonds are expected to remain an attractive investment alternative in the year ahead. Second, the increase in government borrowing is likely to continue to be offset by lower private sector borrowing in the bond market. And lastly, investors will take some comfort in the fact that the government's net financing requirement is forecast to fall dramatically after next year, to about \$30 billion. These factors, combined with another reduction in the Bank of Canada rate at its next fixed announcement date in March, should leave government bond yields at historically low levels in the coming months.

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SUMMARY OF BUDGET MEASURES

(Over FY 2009-10 and FY 2010-11, unless otherwise noted)

Spending measures

Infrastructure investments (\$10.7B)

- \$4B Infrastructure Stimulus Fund
- \$0.4B for Green Infrastructure Fund
- \$1B accelerated payments under provincial-territorial funding initiative to expedite 'ready-to-go' projects
- \$1B in community and recreational facilities
- \$0.5B in First Nations infrastructure
- \$3.1B in knowledge infrastructure (post-secondary education facilities, laboratories, electronic health records, broadband, and other facilities)
- \$0.7B in Federal infrastructure projects

Skills and Transition Strategy

- \$1.9B to fund stronger EI benefits (extra 5 weeks of benefits, more extensive long-tenure and work-sharing programs).
- \$1.9B to enhance availability of training (EI and non-EI).

Communities

- \$1B Community Adjustment Fund for mono-sectoral (forestry, livestock, automotive, ...) regions in distress
- \$0.4B for Southern Ontario development agency
- \$2B for social housing, some on cost-shared basis with provinces

Tax measures

Individuals / Households

- Basic personal exemption amount increased by \$720 to \$10,320.
- Two lowest personal income tax (PIT) brackets increased by 7.5% from 2008 levels. The top of the first bracket (income taxed at 15%) goes from \$37,885 to \$40,726. The top of the second bracket (income taxed at 22%) moves from \$75,769 to \$81,452.
- Employment Insurance (EI) premium rates frozen for 2009-10.
- Higher level at which the National Child Benefit supplement for low-income families and the Canada Child Tax Benefit are phased out.
- Effectively doubling the tax relief provided to low-income earners by the Working Income Tax Benefit (WITB).
- Age Credit increased by \$1,000 to help low and middle-income seniors.
- Temporary (two year) extension of all regular EI benefit entitlements by five weeks and increasing the maximum benefit duration by five weeks.
- Home Buyer's Plan withdrawal (from RRSP) limit increased from \$20,000 to \$25,000.
- Home Renovation Tax Credit (HRTC) of up to \$1,350 (15% credit for expenses exceeding \$1,000, up to \$10,000).
- First-Time Home Buyer credit worth \$750 of closing costs.

Corporations

- Extension of the 50% straight-line capital cost allowance (CCA) rate to investment in manufacturing or processing machinery and equipment undertaken in 2010-11.
- Introduction of a temporary 100% CCA rate for eligible computer & software acquired over next two years (after Jan. 27, 2009 and before Feb. 1, 2011).
- Repeal of the interest deductibility constraints in section 18.2 of the Income Tax Act.
- Small business income cap increased by \$100,000 to \$500,000 as of Jan. 1, 2009.

Credit Markets

The government has provided up to \$200 billion in existing and new liquidity and financing under 'Extraordinary Financing Framework (EFF). The following are new:

- Additional \$50B for the Insured Mortgage Purchase Program (IMPP), now totaling \$125B, to be purchased in first half of 2009-10.
- Additional \$13B in financing flexibility for Export Development Canada (EDC), Business Development Bank of Canada (BDC), Canada Mortgage and Housing Corporation (CMHC), and other Crown corporations. At least \$5B of this incremental financing will be delivered through enhanced cooperation between these Crown corporations and private sector financial institutions under a new Business Credit Availability Program (BCAP).
- New \$12B Canadian Secured Credit Facility to support vehicle leasing through purchases of term asset-backed securities.
- Extending the deadline for issuing guaranteed instruments under the Canadian Lenders Assistance Facility (CLAF) to Dec. 31, 2009 (from April 30, 2009).
- Establishing a Canadian Life Insurers Assurance Facility (CLIAF), modeled on the CLAF, to guarantee wholesale term borrowings for life insurers.
- Higher eligible loan amounts under the Canada Small Business Financing Program, an enhancement of \$300 million per year.

Financial Regulation

The government intends to:

- Obtain the standby authority to inject capital into federally regulated financial institutions.
- Enhance disclosure and improve business practices in respect of credit cards issued by federally regulated financial institutions.
- Assist the Office of the Superintendent of Financial Institutions (OSFI) in providing flexibility to supplement the temporary solvency funding relief for federally regulated private pension plans proposed in the November 2008 *Economic and Fiscal Statement*.
- Enhance the Canada Deposit Insurance Corporation's (CDIC) ability to safeguard financial stability in Canada through various measures.

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