TD Bank Financial Group

Special Report

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TD Economics
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HIGHLIGHTS

- With sovereign debt under the spotlight of late, we review Canada's fiscal position in an international context. We then peer into the fiscal exit strategies adopted by governments in their 2010 budgets, and close by looking at some of the key longer-term challenges that lie ahead.
- Different debt measures tell different stories, but appropriate metrics show Canada stacks up relatively well internationally.
- Halving Canada's overall federal-provincial deficit over the next two years appears well within reach; the harder part will be getting to zero deficits from there.
- As temporary fiscal stimulus measures lapse and the economic recovery matures, the heavy lifting will have to come from expenditure containment – especially with regards to age-related spending such as health care.

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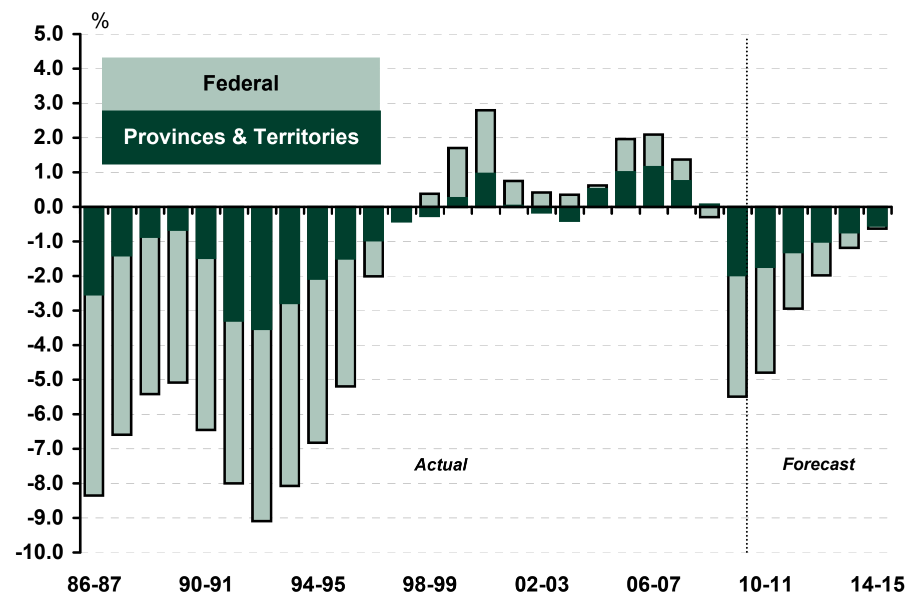
CANADA'S FISCAL EXIT STRATEGY

The G-20 consensus in June on the need to halve budget deficits by 2013 and stabilize debt-to-GDP ratios by 2016 represented a win for Canada, who had been leading the push for the inclusion of the targets in the final communiqué[1]. Not surprisingly, these goals align well with fiscal plans being implemented at home. In its 2010 budget, the federal government announced that it would cut its shortfall by two thirds over the next three years. If 2010 provincial budget plans are also factored into the equation, the combined federal-provincial shortfall is projected to fall by about 60% – to $35 billion – by fiscal year (FY) 2012-13. Canada's aggregate net debt-to-GDP ratio is also expected to peak in FY 2011-12 before beginning to head lower.

GOV'T BUDGET BALANCE, AS PERCENT OF GDP



Source: Fiscal Reference Tables; Government Budgets 2010, TD Economics.

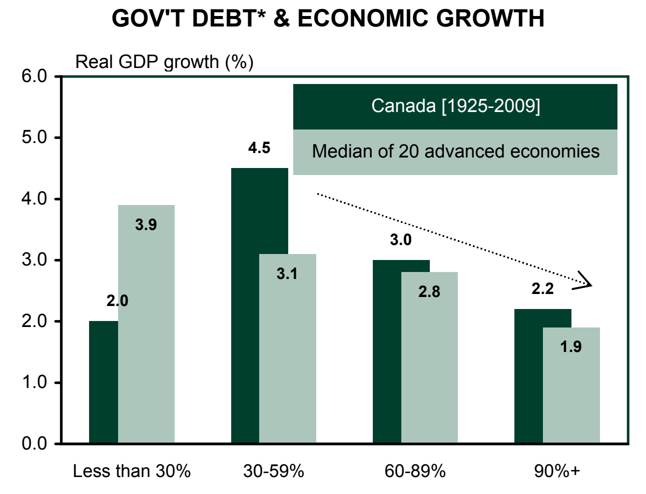
These medium-term targets appear to be well within reach, especially in light of the better-than-expected economic and job performances so far this year. But as longer-term budget plans highlight, the more difficult challenge is likely to be the second phase of fiscal consolidation – that is, moving from the intermediate targets to zero deficits. Over this longer-term time frame, a number of headwinds are expected to intensify. On balance, government budget plans – which are based on private-sector forecasts – have generally assumed relatively lacklustre long-term economic and baseline revenue growth. What's more, debt-service costs are projected to rise steadily over the next 5 years. These forces have put the onus on longer-term budget plans to hold program spending growth to about 2% on average post-FY 2011-12. Even then, the pace of deficit reduction slows dramatically. Meanwhile, it remains unclear how provinces in particular will meet these longer-term spending targets in view of underlying age-related (e.g. health care) funding pressures.

Debt matters

Despite the challenge of eliminating shortfalls in a slow growth, rising interest rate environment, the actions of governments across the country to at the very least get the ball rolling on deficit reduction underscore the high priority given to fiscal rectitude in Canada by its residents. The experience in Canada in the 1990s, when growing deficits and debt led to a gut-wrenching loss of international investor confidence, is one that Canadians do not want to repeat. This year, the situation in Europe served up another reminder of how unchecked budget problems can fester and lead to particularly harsh medicine to deal with a fiscal crisis.

Perhaps not surprisingly, there is a growing body of research that shows that countries grow faster when their debt loads are more sustainable. For example, as depicted in the chart on the right, Rogoff and Reinhart[2] show that when advanced economies' debt ratios reach 90% or more, economic growth tends to slow to a crawl.

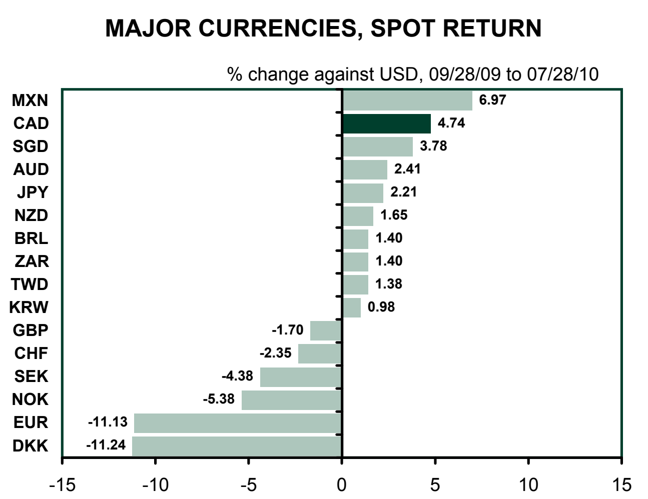
In this note, we first review Canada's fiscal position in an international context. We then look at the fiscal exit strategies adopted by governments in their 2010 budgets, and close by looking at some of the key longer-term challenges that lie ahead.



* Central gov't gross debt / GDP (x-axis). Source: Rogoff & Reinhart (2010).

Favourable fiscal perception a factor in C$ strength

Over the past year or so, forward-looking financial markets have been weighing in with approval on Canada's comparatively strong government fiscal situation. In the chart below, we see the Canadian dollar has done well vis-à-vis the U.S. dollar since the recovery in both the global economy and commodity markets began roughly ten months ago. More recently, financial-market fears over European government sovereign debt have benefitted the safe-haven U.S. dollar at the expense of virtually all other major international currencies, including the Canadian dollar. But even there – and in spite of a significant pull-back in some commodity prices – the Canadian dollar has fared comparatively well against most currencies. As of June, the trade-weighted Canadian dollar index was essentially back to pre-recession levels.



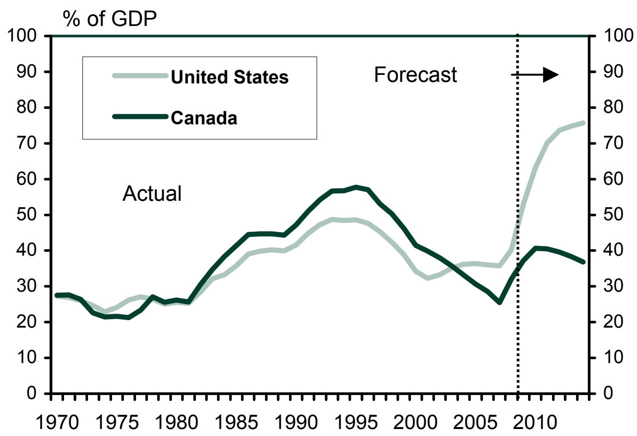
Source: Bloomberg.

Despite the recent flight-to-safety, Canada's outperforming economy and growing expectations – since then realized – that the Bank of Canada would be the first of the G-7 countries to hike interest rates have been key factors supporting the Canadian dollar. And as investor attention has shifted from the need to resuscitate ailing economies to tackling the resulting huge fiscal overhang, increasing talk of Canada's prudence in the management of government finances has provided an added a fillip to loonie strength. This solid performance has been mirrored in debt markets, where the strength in foreign purchase appetite helped to keep a lid on Canadian government long-term bond yields. Notwithstanding higher short-term rates and higher Canadian inflation, Canadian 10-year yields traded in a narrow 10-20 basis points spread over comparable U.S. Treasuries in June-July, after having traded below earlier this year.

Canada stacks up well internationally

In assessing fiscal health, many investors have been pointing to the widening gap in federal debt burdens between Canada and the United States (see chart on next page). The

FEDERAL DEBT*



* Market debt. Source: CBO (U.S.), DOF (Canada), TD Economics

story is not so much where the respective debt-to-GDP ratios have been, but where they're headed. In Canada, the federal government has issued a 5-year plan to virtually eliminate a deficit that is currently running at about 3% of GDP. As a result, the Canadian federal market debt ratio appears set to peak at around 40% before resuming its downward course.

In stark contrast, the Obama Administration is proposing a budget that would maintain a sizeable U.S. structural deficit of 4-6% of GDP through 2020. While this represents about half of the current shortfall, it would still pave the way for the U.S. federal debt ratio to reach over 75% by 2014 and 90% by decade's end, according to the U.S. Congressional Budget Office (CBO). Moreover, in March 2010, the IMF released a working paper arguing that the U.S. CBO has shown a historical tendency to issue "optimistic" forecasts. Consequently, the IMF's projected path for U.S. deficits is in the order of 5-7% of GDP and a debt ratio reaching 100% of GDP by the end of the decade. A forthcoming piece by TD Economics will provide a detailed analysis of the U.S. fiscal outlook.

The simple Canada-U.S. federal debt comparison falls short on several fronts. Most importantly, it doesn't take into account the fact that much of Canada's fiscal challenges reside at the provincial level. By our estimate, the combined net debt of the Canadian provinces amounted to a significant 26% of GDP in FY 2009-10, or about $10,000 per capita. In contrast, U.S. states – which generally aren't permitted to run operating deficits – have long-term debt outstanding of under $2,000 per capita (with the caveat that the numbers are not directly comparable). In addition, the challenge of high government indebtedness is one that cuts right across the globe. Thus, there has been a lot of interest in how Canada stacks up against a broad array of comparable economies.

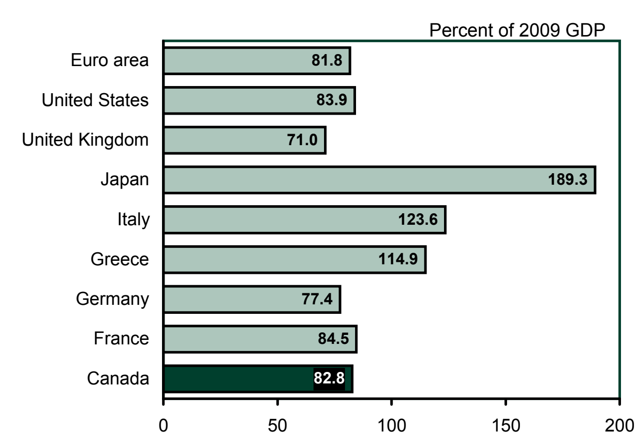
International government statistics issued by the OECD and the IMF meet this requirement. These data include all levels of government in their fiscal calculations and – while not perfect – incorporate adjustments across member country national accounts figures in an effort to bring them into line with each other. Notwithstanding this good level of comparability, there remains considerable scope for confusion due to more than one definition of government debt.

Case in point is the distinction between gross and net government debt. In April, the *Washington Post* featured a comparison of gross liabilities-to-GDP across major OECD countries, similar to that shown in the chart below. Based on that measure, Canada's debt ratio (near 83% of GDP) is roughly on par with the U.S. and the average of the Euro area. Such a middling showing appears to pour some cold water on the perception that this country has become a fiscal standout.

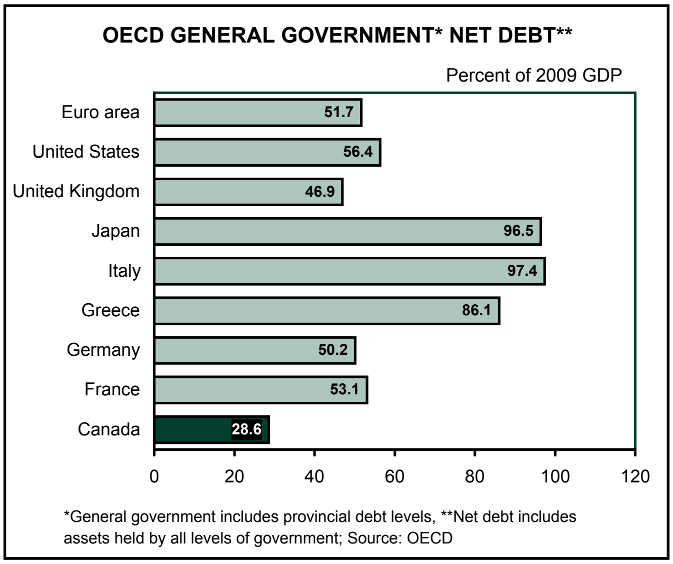
The challenge with the gross debt measure is that it provides an incomplete picture. Notably, it excludes financial assets held on government books, which in many cases, are very significant. For example, the funded liabilities of public and government employee pension funds are included in gross debt, while unfunded liabilities are not. However, the financial assets backing these obligations have not been factored in, thus penalizing countries such as Canada which are home to large but generally better funded public pension plans. Subtracting financial assets from gross debt yields a measure of net debt, as shown in the chart on the next page.

Net debt also has a few strikes against it. Knowing which assets to include and how to value them constitute a first set of challenges. The market values of financial assets

OECD GENERAL GOVERNMENT* GROSS DEBT**



*General government includes provincial debt levels, **Gross debt does not include assets held by all levels of government; Source: OECD.



can change rapidly, particularly during periods of global financial unrest. Gross debt serves as a better proxy for total borrowing requirements, which again, becomes particularly relevant when global credit markets seize up. Still, as a general gauge of government fiscal health, net debt is the more appropriate metric. And, on that count, Canada stacks up comparatively well.

Diminishing returns to deficit reduction

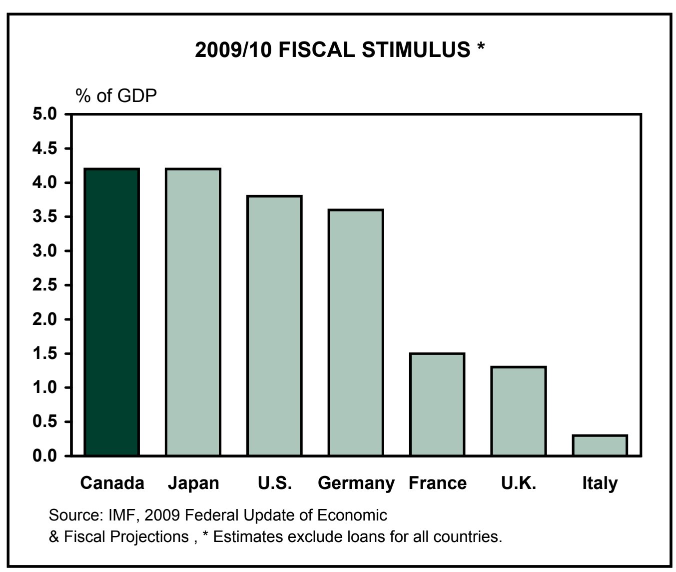
Canadian governments nonetheless saw their finances take a major turn for the worse during the recent economic and financial crisis, as revenues tumbled and the federal and provincial jurisdictions injected plenty of fiscal stimulus (see chart on the right). Accordingly, many emerged from the recession facing a large deficit. Nonetheless, at an estimated $80 billion in FY 2009-10 or 5.5% of GDP, the country's combined federal-provincial budget shortfall was still at the lower end of the international pack, well below the U.K. (-11.3%) and U.S. (-11.0%), France (-7.6%) and the total OECD (-7.9%), but near Italy (-5.2%) and larger than Germany's (-3.3%). Within Canada, about three-fifths of the aggregate deficit was at the federal level, with the remaining two-fifths at the provincial level.

In their 2010 budgets, Canadian governments took some action to ensure that theirs jurisdiction's standing doesn't erode in the future. The federal government presented a 5-year plan in its 2010 budget to lower the deficit to virtually zero by FY 2015-16. At the provincial level, eight provinces – all but Newfoundland & Labrador and Prince Edward Island, where deficits in FY 2010-11 are projected at a relatively low 1% of GDP – announced multi-year deficit-elimination targets.

The chart on page 1 used budget information to draw the projected path to fiscal balance on a combined federal-provincial basis. As can be seen, this road is unlikely to follow a straight line. Based on budget plans, the aggregate budget balance is set to drop from just under $80 billion this year to under $50 billion next year, and then take four full years to eliminate the remainder of the red ink. The significant drop in next year's overall projection reflects the unwinding of two factors that have acted to temporarily inflate deficit readings both this year and last.

The first factor relates to the short-term actions undertaken to stimulate the economy. As previously mentioned, Canada jumped on the stimulus bandwagon wholeheartedly. With many governments subscribing to the mantra "timely, targeted and temporary", the federal and provincial governments injected more than 4% of GDP in measures over two years. Indeed, several of the programs have either lapsed – or are due to lapse soon – during FY 2010-11, such as the federal home renovation tax credit, extended employment insurance benefits and amounts set aside by both levels of government for local infrastructure. The bailout money provided to GM and Chrysler is another example of a measure that had a one-time impact on spending.

The second important driver of the notable drop in the deficit in FY 2011-12 is the reversal in the impacts of automatic stabilizers – or the mechanisms that automatically "kick in" in order to reduce taxation pressures and increase government spending pressures during recessions in order to help smooth out the ups and downs in the economy. For example, tax revenues decline in tandem with personal and corporate incomes, while higher joblessness pushes up social assistance payments. As an economy begins to recover, this



negative chain begins to reverse – even if this turnaround tends to be blunted by elements built into the system such as tax loss carry forwards.

Beyond FY 2011-12, the benefits to deficit reduction from these shorter-term influences begin to diminish. Instead, progress in quickly eliminating deficits down in longer-term budget planning has been impeded by three gale-force headwinds:

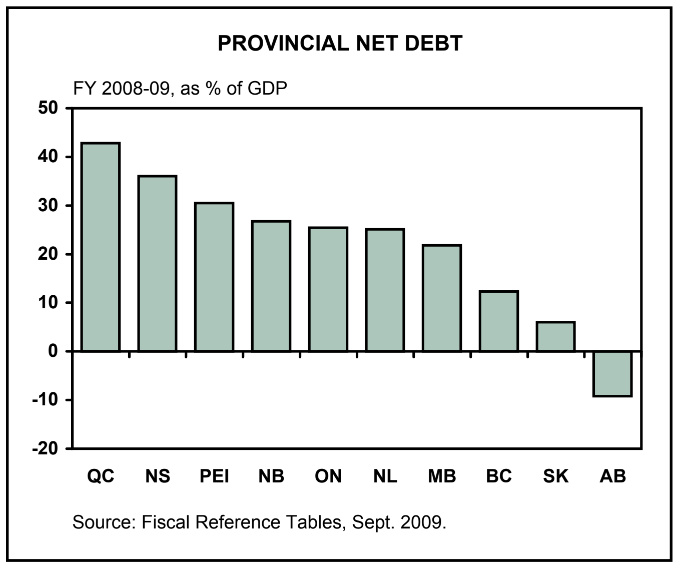
• *Modest recovery and lower trend growth* – Private-sector forecasters, whose projections are used by budget planners, generally remain wary about several clouds on the longer-term economic horizon, including the economic and fiscal challenges of Canada's major trading partners, tougher financial regulation and a high currency and ongoing restructuring in the manufacturing sector. Demographic pressures also add to the challenges of growing the economy's labour supply. Suffice to say, the balance of opinion has shifted towards a slower pace of trend growth on average in Canada of 2.0-2.5% rather than the 3% historical rate.

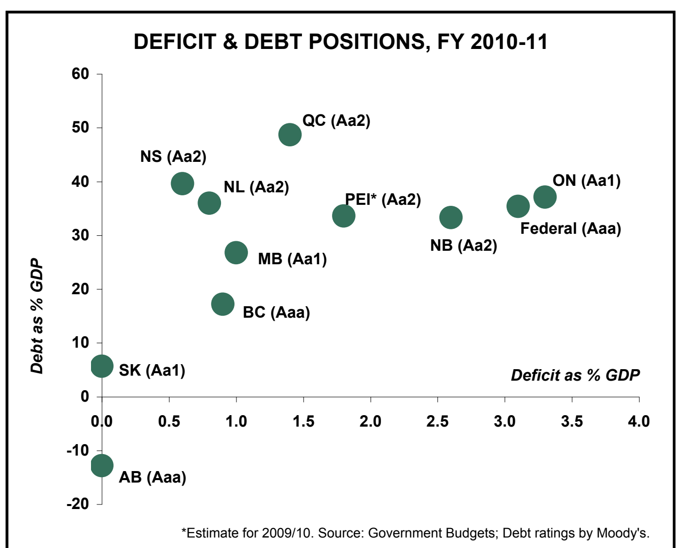
• *Faster age-related spending* – The aging of the population will continue to drive up the cost of age-related programs, such as elderly benefits and health care. For provinces, this poses a particular challenge. Health care has been growing by about 6-7% per year across the provinces, and given an aging population, little let-up in health expenditures on a status-quo basis can be expected. In most provinces, this means that health could conceivably absorb 80% of program spending within the next 15 years.

• *Rising interest costs* – These will go up as interest rates rise and debt accumulates. Under the latest budget plans, and based on private sector forecasts for interest rates, this would translate into an increase in the costs of servicing the debt from $51 billion in FY 2009-10 to $71 billion in FY 2013-14. These higher costs are almost equally spread across the federal and provincial levels of government. While the higher debt-service costs will reduce the amounts available for programs, governments across the country will continue to reap the benefits from relatively affordable debt, as measured by the average effective interest rate on outstanding debt. For example, the effective aggregate provincial rate is estimated to be just slightly over 4.5% this fiscal year.

On balance, with combined federal-provincial revenues growing at about 5-6% over the medium-term and rising debt-service costs absorbing a growing share of each revenue dollar, governments on whole will aim to contain spending growth to only about 1-2% on average in order to gradually whittle down their deficits. The combined debt-to-GDP ratio heads lower, pushed down by moderate growth in the denominator. By FY 2014-15, the federal debt-to-GDP ratio (Public Accounts) is projected to fall to 32% (from 35%), while the all-province ratio edges down to 28% (from near 30%).

Underneath these aggregate numbers lie significant variations in the extent of fiscal challenges faced across the country and in the broad budget strategies adopted to place finances in stronger medium-term positions. As the first chart below illustrates, western provinces enjoy lower debt burdens, and savings from resource royalties has helped to cap the deterioration in their budget balances over the past 1-2 years. In contrast, provinces east of Manitoba have higher deficits and debt. Ontario, hit particularly hard by the U.S. recession, has the largest deficit. On the flipside, Quebec and Nova Scotia have smaller deficits but higher debts (see charts below and detailed up-to-date fiscal tables on our website[3]).





Deficit reduction strategies

We highlight some of the different strategies adopted in the text box on the next page. For more specifics, turn to our individual budget write-ups on our website[3]. In general, the size of the deficit faced by a jurisdiction informed the length of the deficit elimination horizon chosen, with Ontario at the high end (8 years), followed by Manitoba, Saskatchewan, and the federal government opting for timetables of 5 years.

In addition, restraint was largely postponed until after FY 2010-11, with most of the planned belt-tightening earmarked for areas outside of core services and transfers like health care and education. As noted, in order to eat away at the deficit while interest payments are on the rise, governments must generally contain program spending growth to no more than 2% per year beyond FY 2011-12. This implies flat-lining or reducing non-core expenditures. Many are curtailing their civil service compensation and/or headcounts through attrition.

On the revenue side, tax increases were scattered around the country, including a built-in progressive hike in EI premiums at the federal level and a ramp-up of value-added (consumption) taxes in Nova Scotia and Quebec. A number of governments (Saskatchewan, Manitoba) are raising 'sin' taxes (alcohol & tobacco) or their gas tax (Quebec), and a few are hiking their value-added (consumption) taxes, such as Quebec and Nova Scotia. Some are deferring previously announced tax relief (Manitoba, Saskatchewan), and Nova Scotia is raising personal income taxes for higher earners.

While governments in Canada have been at the forefront of laying down deficit elimination targets, much of the hard work is just beginning. Targets are a start, but too many of the specifics about how these objectives will be met were left for later. How will governments manage to secure savings?

Compared to budget projections, short-term risks are mostly positive, due to a better-than-expected rebound in revenues. But government expenditures and investment will naturally subtract from overall economic growth over the next few years. We estimate that currently planned fiscal policy will shave an average of 0.2 to 0.4 percentage points from annualized real GDP growth. In other words, after aiding through the recession and initial stages of the recovery, fiscal policy will turn into a modest headwind.

For the longer-term, we remain concerned that economic growth might prove disappointing and/or debt-service costs rise more than expected. Another long-term risk surrounds health care. Past experience shows that savings without fundamental reform just delays cost pressures into the future.

This remains an iterative process where markets will continue to watch for clear and credible fiscal adjustment measures to eliminate deficits as soon as reasonably possible once the economic recovery is self-sustaining. The degree of fiscal austerity needed will continue to vary depending on the specific economic outlook, overall indebtedness levels, civil service buy-in, and political choices. Canada's federal and provincial governments have ample opportunity to show resolve and results to further distinguish themselves on the international stage.

Endnotes

1 Available at: http://g20.gc.ca/wp-content/uploads/2010/06/g20_declaration_en.pdf

2 Reinhart, C. and K. Rogoff, "Growth in a Time of Debt", NBER Working Paper 15639, January 2010.

3 Available at: http://www.td.com/economics/gov_finances.jsp

BACK TO BALANCE: WHEN AND HOW?

– DEFICIT REDUCTION STRATEGIES –

- Countdown to (virtually) zero deficit:
  * 3 years (FY 2012-13 for AB, SK)
  * 4 years (FY 2013-14 for BC, QC, NS)
  * 5 years (FY 2014-15 for Federal, MB, NB)
  * 8 years (FY 2017-18 for ON)
  * Unspecified (for PEI, NL)

- Program and capital spending restraint postponed until post-2010 to aid recovery (all but AB, SK)

- Program expenditure growth kept near or below 2% average post-2010 (all governments)

- Protection of core services (health and education for provinces) and transfers (CST, CHT, and equalization for federal)

- Flat-lining or outright cuts in department operational budgets and non-core program spending (all governments)

- Curtail civil service (compensation, headcount / attrition, all governments)

- Tax increases / changes:
  * Built-in automatic hikes in EI premiums (federal)
  * Value-added consumption taxes (NS, QC); fuel/tobacco/liquor taxes (QC, MB, SK)
  * User fees (water, tuition) and health premium (QC)
  * Deferral of previously announced tax relief (MB, SK)
  * Personal income taxes for higher earners (NS)

Note: This text box is meant to provide highlights and is not comprehensive. More details are available on a budget-by-budget basis in our individual government budget write-ups, available at: http://www.td.com/economics/gov_finances.jsp