SPECIAL REPORT

TD Economics

October 27, 2011

ANALYZING THE FEDERAL FISCAL PLAN AMID GROWING CALLS TO CHANGE COURSE

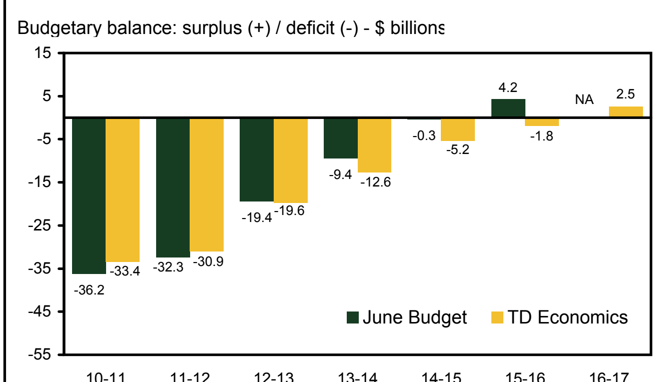
Highlights

- Unless new fiscal restraint measures are announced and in the absence of any new fiscal restraint measures, there is a risk that the federal government will return to budgetary balance in 2016-17, two years later than previously estimated.
- However, with small deficits forecast in the last two years of the revised timetable (0.1-0.3% of GDP), additional fiscal restraint, above what has already been announced, need not be pursued. Investors and markets should remain confident that a medium-term plan is firmly in place to return to surplus.
- Returning to a surplus position is an extremely difficult task due to the sizeable reliance on restraining annual program spending growth. Given the current economic climate, some would prefer to ease up on the spending brakes, while others are even calling for another dose of fiscal stimulus.
- In our view, the bar should be set fairly high when making the decision to veer away from the current plan towards a new course of action.

As leaves begin to change colour, fiscal analysts like us start getting ready for government budget update season; the federal such publication is expected in the coming weeks. A critical step in this document-writing process is now complete: private sector economists met on Monday to provide input on economic planning assumptions. The private sector consensus is for a more modest economic growth profile for Canada relative to where things stood in March. Armed with our own revised economic numbers in hand, we analyze the implications for the federal fiscal plan. Based on TD Economics' projections, the federal deficit will be eliminated in 2016-17 – two years later than the government's current commitment of 2014-15. However, the delay to the timetable should not: (1) make alarm bells go off; and (2) spur the implementation of more aggressive fiscal restraint measures than what are already in place. Neither knee-jerk reaction seems warranted as deficits for 2014-15 and 2015-16 are just 0.3% and 0.1% of GDP, respectively. What's more, the additional debt burden under the revised timetable is not large relative to the size of the Canadian economy.

Due to heightened fears about a double-dip global recession, there has been talk over the past few weeks to slow down federal public spending restraint. Some have even taken the discussion a step further, calling for another injection of fiscal stimulus to help propel the economic recovery forward. With enduring costs associated with stimulus and only temporary benefits, the bar dictating the need for additional support should be set fairly high.

LOWER ECONOMIC GROWTH SEEPS INTO THE MEDIUM-TERM FEDERAL FISCAL PLAN



Source: Department of Finance Canada - 2011 June budget.
Note: 2010-11 deficit figure taken from Annual Report. Projections by TD Economics, thereafter, as at October 2011.

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Lower economic growth projections increase the fiscal challenge

In the forthcoming federal fall update, the government will adjust its fiscal plan to factor in updated private sector consensus projections. Relative to where these numbers stood at the time of the March/June budgets, economic growth assumptions are much more modest over the near-term. This outcome is clearly visible in the table on the right, which shows budget numbers, our current forecast, and the September 2011 private sector consensus survey.

Using revised economic numbers, we present an updated snapshot of the status-quo, federal fiscal forecast. By 'status-quo', we mean that existing policies, platform promises, and budget announcements remain in place.

In generating these projections, we have used TD Economics' forecasts, instead of the consensus survey. We have done this for two reasons. First, in recent years, the federal government has shaved roughly $10 billion from the consensus nominal GDP forecast to build more prudence into the fiscal plan. We have no reason to think there will be a change in practice. When such a calculation is done, budgetary planning assumptions should be in line with our forecasts. Second, we stand behind our economic growth call and furthermore, believe that the numbers appropriately balance both downside and upside risk to the forecast.

Better starting point for fiscal plan

In the government's Annual Report released earlier this month, we learned that 2010-11 deficit number inked in the record books came in at $33.4 billion. This final tally beats the June budget forecast by a hefty $2.8 billion. Improvement was noted on the revenue side of the ledger with coffers bringing in $1.5 billion more than forecast. Lower-than-expected expenditures worth $1.2 billion also helped the bottom line; these savings arose from reduced transfers to persons and fewer direct program expenses than was originally booked into the plan.

The improvement noted in 2010-11 carries forward to the current fiscal year, such that we expect $1.4 billion to be taken off the deficit tally. To explain this projected outcome, let us begin with the revenue profile. Our GDP growth assumptions for 2011, in both real and nominal terms, are slightly lower than those presented in the June budget. However, the level of nominal GDP, a proxy for the general tax base, does not differ across the two sets of forecasts. As a result, revenues are assumed to be generally in line with June 2011 budget estimates.

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
Private Sector Consensus**	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
Private Sector Consensus**	5.3	4.1	4.5	4.5	4.5
Nominal GDP ($ billions)					
2011 June Budget	1,719	1,804	1,893	1,979	2,068
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
Private Sector Consensus**	1,711	1,781	1,861	1,945	2,032
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
Private Sector Consensus**	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
Private Sector Consensus**	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
Private Sector Consensus**	2.8	2.7	3.2	3.9	4.5

* Department of Finance Canada - 2011 June Budget. * As at October 2011. ** Finance Canada September 2011 Survey of Private Sector Economists

The 2010-11 Annual Report reveals that $1.2 billion in lower spending was secured relative to the numbers in the June budget. Insufficient details were provided to determine whether these efficiencies were permanent in nature. To build some prudence into our projections, we have assumed that only 50% of these efficiencies ($620 million) carry forward on an annual basis. Lower debt servicing costs versus those included in the June budget shave off $500 million from the deficit tally in the current fiscal year.

Medium-term plan takes the brunt of the economic downgrade

While better news looks to be in store for the 2011-12, the same cannot be said for the medium-term fiscal plan. To understand why this is the case, we begin with our economic growth assumptions. Heightened risks to our forecast stemming primarily from abroad have led us to noticeably downgrade our 2012 and 2013 GDP growth forecasts. For 2012, we are calling for nominal GDP growth to come in 1.6 percentage points (ppts) lower than the budget forecast. If realized, this outcome will carve off about $3 billion from government coffers. Our lower nominal GDP growth assumptions vis-à-vis the budget persists in 2013-15, but the gap closes to roughly 0.2 to 0.4 ppts. Because each revenue hit is cumulative in nature, an $8 billion revenue wedge is ultimately created by 2015-16.

Moving over to program spending, we have little information, other than what is publicly available, to ascertain if stringent targets will be met. We do know that a Strategic and Operating Review is currently underway to identify areas where administrative efficiencies are possible. According to the Conservatives' platform document, $11 billion in savings over four years have been earmarked in the fiscal plan, but details are outstanding. Finding efficiencies of this magnitude will undoubtedly be hard to achieve. Recognizing the tough task ahead, but with no other information to the contrary, we have assumed an identical program expenditure profile to that included in the budget. However, as previously explained, we have pared back the annual figures by $600 million to reflect an estimate of the permanent savings secured in 2010-11.

For debt servicing costs, we have incorporated $2.3 billion in cumulative savings over five years into our fiscal outlook. These foregone expenditures should be obtained due to 'lower for longer' interest rates now expected to take hold.

Putting the bottom line in perspective

When we combine the revenue and expenditure sides of the ledger within our projections, we focus on the budgetary balance and federal debt implications. In doing so, we conclude that the federal government no longer looks set to return to surplus in 2014-15. Instead, this outcome will be accomplished two years later in 2016-17. The extended deficit profile brings with it greater public debt burdens ($5.6 billion more debt over five years) than originally forecast.

While the original deficit reduction timetable will likely be missed, unless additional measures are taken, markets should not be too fussed about the development for the following reasons.

- Comfort will be had that a commitment to return to surplus is in place and that the task will be achieved within five years. This gradual, multi-year timetable remains very similar to the plan already in place.
- Deficit levels in the last two years of the reduction plan are insignificant relative to the size of the economy (0.1-0.3% of GDP). Put in context, these shares seem very

FEDERAL GOVERNMENT FISCAL POSITION
(C$ billions, unless otherwise indicated)

	Actual					Projection - TD Economics					
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**	**249.3**	**261.3**	**274.8**	**289.3**	**301.5**	**314.2**
% change	6.2	2.7	-3.8	-6.2	8.5	5.2	4.8	5.2	5.3	4.2	4.2
% of GDP	16.3	15.8	14.6	14.3	14.6	14.6	14.8	14.9	15.0	15.0	15.0
Program expenses	**188.3**	**199.5**	**207.9**	**244.8**	**239.6**	**247.8**	**246.7**	**251.4**	**257.1**	**265.0**	**273.2**
% change	7.5	6.0	4.2	17.8	-2.1	3.4	-0.4	1.9	2.3	3.1	3.1
% of GDP	13.0	13.0	13.0	16.0	14.8	14.5	14.0	13.6	13.4	13.2	13.1
Public debt charges	**33.9**	**33.3**	**31.0**	**29.4**	**30.9**	**32.5**	**34.3**	**36.1**	**37.4**	**38.4**	**38.5**
% change	0.5	-1.8	-7.0	-5.1	5.1	5.1	5.6	5.1	3.8	2.5	0.3
% of Debt (t-1)	7.0	7.1	6.8	6.3	6.0	5.9	5.9	6.0	6.1	6.2	6.2
% of Revenues	14.4	13.7	13.3	13.5	13.0	13.2	13.4	13.5	13.5	13.6	13.7
Total expenditures	**222.2**	**232.8**	**238.8**	**274.2**	**270.5**	**280.2**	**281.0**	**287.4**	**294.5**	**303.3**	**311.7**
% change	6.3	4.8	2.6	14.8	-1.3	3.6	0.3	2.3	2.5	3.0	2.7
% of GDP	15.3	15.2	14.9	18.0	16.7	16.4	15.9	15.6	15.3	15.1	14.9
Budgetary balance	**13.8**	**9.6**	**-5.8**	**-55.6**	**-33.4**	**-30.9**	**-19.6**	**-12.6**	**-5.2**	**-1.8**	**2.5**
% of GDP	0.9	0.6	-0.4	-3.6	-2.1	-1.8	-1.1	-0.7	-0.3	-0.1	0.1
Federal debt*	**467.3**	**457.7**	**463.4**	**519.1**	**550.3**	**581.2**	**600.9**	**613.5**	**618.7**	**620.5**	**618.0**
% of GDP	32.2	29.9	29.0	34.0	33.9	34.0	34.0	33.3	32.1	30.9	29.6
						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

* Accumulated deficits. Source: Department of Finance Canada. Projections by TD Economics as of October 2011.

small compared to the numbers recorded at the height of the recession (3.6% in 2009-10).

- Federal debt levels, expressed as a share of GDP, are set to decrease over the medium-term. The extra $5.6 billion in debt burden built into the plan will certainly add to the challenge at hand, but the load is not large relative to the $1.5 trillion Canadian economy.
- TD Economics' growth projections are on the lower range of consensus expectations. To recall, it is nominal GDP that the government uses to forecast revenues. If nominal GDP came in $10 billion higher than our forecast, the government would meet its 2014-15 target.

Risks discussed to this point have been concentrated to the downside. Upside risks also loom. Notably, the persistence of low interest rates could spark stronger consumer spending growth over the next few years than is currently built into our base case scenario. If this upside risk were to materialize, government coffers would likely benefit in the form of higher GST and corporate income tax revenues.

High bar for veering in a new direction

Amid the already tough expenditure restraint backdrop and the growing downside risks, there has been much debate in recent weeks about the course of the fiscal plan. In response to the cries heard, Finance Minister Flaherty has said that the government needs to be flexible, but that fiscal commitments should not be changed. This messaging helps reassure Canadians that a prudent, fiscally responsible plan is in place, but that international events are also being recorded.

If economic conditions were to take a sharp turn for the worse relative to the current path, heightened pressures could lead the government to consider veering off course – either by implementing new temporary stimulus or slowing down the pace of restraint. In this scenario, the shorter-term benefits of the actions would need to be weighed against the longer-term costs. Some of the key risks/costs include:

- A larger debt burden requires greater interest payments. Such costs impede the government's ability to deal with intensifying age-related spending pressures like health care, and public pension and senior benefits.
- If the fiscal plan were to deviate markedly from the current course, the government's AAA credit rating could be put in jeopardy. A greater debt servicing burden, on top of higher debt loads, might be one of the fallouts from any such downgrade.
- Experiences abroad, as well as in Canada in the 1990s, show how deficits can quickly get out of control. From these examples, we have seen that a fiscal crisis could lead to an economic crisis, if investors lose confidence in the government's ability to manage its purse.
- Changing course can also weaken household and investor confidence. Indeed, one of the reasons why U.S. businesses are holding back investment is the result of significant tax and spending policy uncertainty.

Bottom line

Private sector economic forecasters agree that modest growth looks to be in store for Canada over the next few years. Still, if the global economic recovery were to become in serious trouble, the federal government could face increasing pressure to stimulate the economy. The bar should be set high for such a policy response in light of the sizeable costs and the inherent risks associated with a change in direction mid-path.

In a perspective released earlier today, our Chief Economist, Craig Alexander, argues that now is not the time for fiscal stimulus in Canada. Still, if policymakers were not to heed this advice, any new measures should at the very least, be targeted and limited.

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