Finance Minister Bill Morneau delivers his second budget on March 22, one with "deficits as far as the eye can see". Adam Scotti photo

The Second Morneau Budget: Doubling Down on Cautious Optimism

Douglas Porter and Robert Kavcic

Very few economic analysts in Canada—or elsewhere, for that matter—possess the prescience and breadth of BMO Chief Economist Douglas Porter. Here at Policy Magazine*, as in many domains in the capital and beyond, Budget Day isn't Budget Day without Porter's summary of the key deliverables. Here is Porter's analysis of Bill Morneau's second budget, co-authored with his colleague, BMO Senior Economist Robert Kavcic.*

Compared with the fanfare surrounding last year's effort, the second budget of the current federal government arrived amid much lower expectations. And it delivered. Finance Minister Bill Morneau is still projecting a string of budget deficits as far as the eye can see, widening somewhat in the coming fiscal year, while the now-key debt-to-GDP ratio is set to hold steady.

Table 1: Fiscal Outlook

(C$ blns, except where noted)	Estimate	— Forecast —		
	16/17	17/18	18/19	19/20
Revenues	292.1	304.7	315.6	327.7
Expenditures	315.1	330.2	340.0	348.1
Program Spending	290.9	305.4	313.7	319.8
Public Debt Charges	24.3	24.7	26.3	28.3
Adjustment for Risk	—	(3.0)	(3.0)	(3.0)
Budget Balance	(23.0)	(28.5)	(27.4)	(23.4)
Federal Debt	637.1	665.5	692.9	716.3
As a percent of GDP:				
Budget Balance	(1.1)	(1.4)	(1.2)	(1.0)
Federal Debt	31.5	31.6	31.6	31.5

Source: Federal Budget ( ) = deficit

This outlook comes as little surprise, as a stable, and subsequently fading, debt ratio was well-advertised as a goal ahead of today's budget, especially in light of a somewhat firmer-than-expected economic backdrop, loaded on top of Finance's apparent aim to keep deficits below $30 billion. Two major areas of uncertainty heading into the budget were: 1) Would there be any major new spending initiatives planned for the coming fiscal year; and, 2) Would there be any significant tax changes? And all of this, of course, is set against the profound uncertainty of what the Trump administration will ultimately bring on the tax and trade fronts in the coming year.

On each of these questions, the answer is not shocking. As expected, Ottawa will stick to last year's broad stimulus plan, with minimal net new fiscal stimulus in this document. Rather, this budget's purpose is to fill in many of the spending details behind previously-budgeted dollars, with their sights set on housing, skills training, and innovation. On the tax side, Ottawa decided to forego any major moves this year, although their review of so-called tax expenditures remains ongoing, with this budget making a handful of smaller-ticket moves on this front.

"After doing away with the contingency reserve in last fall's update, Finance has added back a $3 billion per year cushion through the forecast horizon."

As a result of these measures, deficits in excess of $20 billion will persist for four more years, and a $19 billion shortfall still remains by fiscal year 2021-22—in other words, no plan to balance the books.

This scenario would see the closely-watched debt-to-GDP ratio edge up a tick this coming fiscal year, to 31.6 per cent, before grinding down through FY 2020-21. After doing away with the contingency reserve in last fall's update, Finance has added back a $3 billion per year cushion through the forecast horizon. Given that the budget is built on a relatively cautious economic forecast, it's quite likely this cushion will not be needed; indeed, if our forecast proves correct, Ottawa will have extra room in the coming year (more below). Notably, not one penny of last year's fat $6 billion contingency reserve was needed for FY 2016-17, as the deficit is on track to come in at $23 billion.

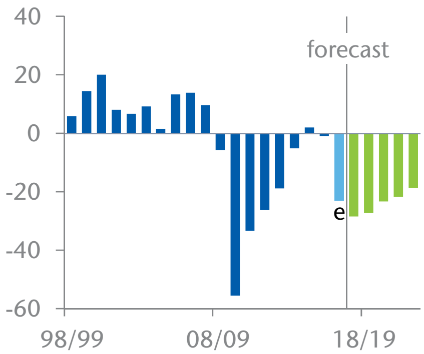
Beyond the headline $28 billion deficits over the next two years, arguably the big story in the budget plan is the ongoing lack of a serious reversal of stimulus in the ensuing years. Recall that this government was elected on a pledge to run deficits for two years (at that time, just under $10 billion), and then bring finances back to balance over the subsequent two years.

That plan has long since gone out the window, and not just because the economy has proven more challenging in the past two years. The straightforward reasoning in Ottawa is that deficits don't matter, so long as debt is stable as a share of GDP. The issue for us is that the Canadian economy now appears to be growing above trend rates again, and is late

Chart 1: Deficits Persist

Canada (C$ blns)

Budget Balance

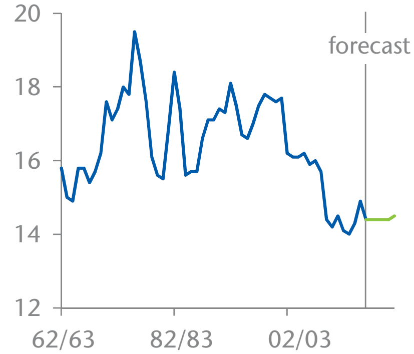


Source: Federal Budget e = estimate

Chart 2: Revenues Grow With GDP

Canada (% of GDP)

Revenue



Source: Federal Budget

Chart 3: Spending Still Rising

Canada (% of GDP)

Program Expenses

Source: Federal Budget

in the business cycle—the recovery is now almost eight years old—and that's exactly when building fiscal capacity is a wise strategy. Or, as your grandparent may have said: "*Make hay when the sun shines.*"

The net fiscal impact of new measures detailed in this year's budget is minimal. Rather, this document is largely about filling in the details behind the dollar amounts baked into the fiscal plan a year ago. Here is a quick recap of the largest of the many new initiatives:

Infrastructure spending: This budget fills in the details of the infrastructure spending program, while shuffling the timing slightly. In a nutshell, the infrastructure plan has been a bit slow to get pushed out the door, with some spending pushed into the 2018-19 period. However, new details on the proposed infrastructure bank were scant, even as Ottawa claims it will be up and running by the end of this year.

Program spending: To rise a hefty 5.0 per cent in FY 2017-18 after the 7.4 per cent surge in FY 2016-17, the strongest clip since 2010 (post-recession stimulus). As a share of GDP, program spending will rise from just under 13 per cent in FY 2015-16 to 15 per cent by FY 2017-18. That is back above the 30-year average of 14.2 per cent. Notably, program spending will begin to level off in real per-capita terms by FY 2018-19, in order to reduce the size of the deficit further out in the forecast horizon.

> *"The Canadian economy now appears to be growing above trend rates again, and is late in the business cycle—the recovery is now almost eight years old—and that's exactly when building fiscal capacity is a wise strategy."*

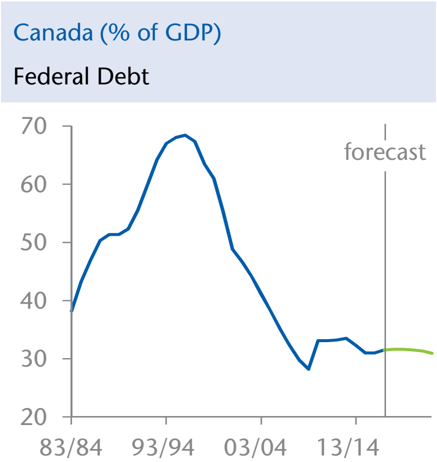
EI program modifications: There are two noteworthy modifications in this budget. Parental leave will become more flexible, allowed to be spread over a longer period of time, but at the same benefit amount. EI benefits will also be extended to caregivers. Note also that EI premium rates are set to rise in 2018.

The highly-touted **skills, innovation and middle-class jobs agenda** will deploy $1.2 billion in spending over a range of programs, or a net fiscal cost of just under $500 million after accounting for dollars already allocated. The biggest item is funding to support the growth of tech-business "superclusters"(think Silicon Valley).

Housing: StatsCan will get a budget increase (a more meaningful $40 million over five years) to collect more detailed housing data, in collaboration with provincial land registries. The inclusion of data on foreign ownership and financing characteristics is promising. Expected first release date: Fall, 2017. Ottawa is also dedicating funds, through the National Housing Fund, to increase the supply of purpose-built rental units, a small nod to supply concerns.

Various measures to improve **"tax fairness"**, aiming to raise $400 million this coming fiscal year, and just over $1 billion by FY 2019-20. This includes clamping down on tax avoidance; limiting the ability of some billing professions (e.g., doctors) to shift their tax burden; and limiting the planning ability of private corporations. **Public-transit passes:** This tax credit is a goner as of mid-2017. **Uber targeted:** Ride-sharing services will be more broadly subject to the same GST/HST rules as taxi companies. Modifying the tax treatment of **oil & gas exploratory drilling**, expenses will now be deducted gradually over time. **Canada**

Chart 4: Debt to Level Off



Source: Federal Budget

Table 2: Economic Assumptions

(percent)	— Ottawa —			BMO Capital Markets	
	2016	2017	2018	**2017**	**2018**
GDP Growth					
Real	1.3	1.9	2.0	**2.3**	**1.9**
Nominal	2.0	4.1	4.0	**4.9**	**3.9**
Yields					
3-month T-Bill	0.5	0.6	0.9	**0.5**	**0.6**
10-year GoC	1.3	1.8	2.3	**1.8**	**2.1**

Savings Bonds sales will be discontinued this year; the CSB program started 70 years ago. **What didn't change:** The **capital gains inclusion rate** (which was widely speculated); the **treatment of stock options**; and no major **asset sales**.

With a string of deficits still looming, government borrowing requirements will remain considerable. Gross marketable bond issuance will total $142 billion in FY 2017-18, up from $135 billion in FY 2016-17. After accounting for maturities, buybacks and other adjustments, the net increase in bonds will be $39 billion in FY 2017-18, versus $33 billion this year. The government will consider issuing bonds with a maturity of 50 years *"subject to favourable market conditions"*. The stock of treasury bills is projected to inch up from $130 billion to $131 billion, while the average term to maturity of domestic market debt is expected to remain stable around 5.5-to-6.5 years. If there was a surprise in the debt management strategy, it is that Ottawa continues to focus more of its issuance in the 2-, 3- and 5-year sectors, not at the longer end.

Reflecting the above, Ottawa is projecting net new domestic borrowing requirements of $39 billion in the coming fiscal year, with cash balances unchanged. In turn, total federal debt-to-GDP will rise a tick, to 31.6 per cent in FY 2017-18. The debt ratio is projected to eventually reverse course again, falling slightly to 30.9 per cent by FY 2021-22—effectively where it was in FY 2014-15. The return to that sub-31 per cent reading was delayed by a year in this budget.

> ***"Total federal debt-to-GDP will rise a tick, to 31.6 per cent in FY 2017-18. The debt ratio is projected to eventually reverse course again, falling slightly to 30.9 per cent by FY 2021-22—effectively where it was in FY 2014-15."***

Ottawa's economic assumptions are based on a somewhat outdated private-sector forecast, taken before the economy began to flash real signs of improvement. Canadian real GDP growth is expected to pick up to 1.9 per cent this year, up from the budget assumption of 1.3 per cent in 2016. To show how stale the forecast is, even that 2016 figure is now out of date (the actual result was 1.4 per cent). Since that consensus forecast was locked in late last year, we've seen a near-relentless run of positive economic data, with particular strength in employment. This has prompted us to revise up our GDP call to 2.3 per cent per cent for this year, or 4 ticks faster than the budget assumption (with some serious upside risk to boot). Next year looks in-line, with both the fiscal plan and our forecast pegged at growth closer to 2 per cent.

The consensus expects that WTI oil prices will average around $54 this year before rising further to $59 in 2018—but the recent fade in crude raises the downside risks. Importantly for revenues, we're expecting the rebound in oil prices from their 2016 lows to drive a solid 4.9 per cent jump in nominal GDP this year (this budget is based on 4.1 per cent growth, leaving some potential upside for revenues). P

Douglas Porter is Chief Economist, BMO Financial Group.
douglas.porter@bmo.com

Robert Kavcic is a senior economist with BMO Financial Group.
robert.kavcic@bmo.com