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FEDERAL FISCAL UPDATE **November 27, 2008**

This afternoon, Jim Flaherty, Canada's Minister of Finance, delivered the government's fiscal update. A single tax measure was announced which will affect minimum withdrawals from RRIFs and some defined contribution pension plans. With regard to the RRSP measures announced in Québec's economic update, such as increasing from 71 to 73 the age limit for converting RRSPs, they were not included, for the time being, and will therefore not go into effect.

MEASURE AFFECTING DESJARDINS

Temporary reduction of minimum RRIF withdrawals

The government plans to reduce by 25%, in 2008, the minimum required RRIF withdrawal, in order that retirees may leave a greater portion of their savings in a RRIF. This measure covers all RRIF holders, regardless of age.

RRIF holders who withdraw more than the minimum reduced amount for 2008 may redeposit the surplus into their RRIF (must not exceed the reduction amount covered by this measure), on or before March 1, 2009 or, if at a later date, 30 days following the date when this measure goes into effect. The redeposited amounts may be deducted in the 2008 taxation year.

Similar regulations will apply to those receiving variable benefits under a defined contribution pension plan.

Budget Analysis

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HIGHLIGHTS

- Economic conditions have deteriorated significantly since last February's budget. According to the Department of Finance, Canada should be going through a technical recession in late 2008 and early 2009.
- Yet risks keep pointing downwards. Ultimately, year 2009-2010 will probably show a deficit.
- The current economic conditions are affecting the federal government's budgetary balance. The minister proposes to cut spending by $4.9B during fiscal 2009-2010 to balance his budget.

Table 1
Summary statement of transactions

	Actual	*Projection*					
In $B	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013	2013-2014
Budgetary revenues	**242.4**	**239.0**	**248.5**	**258.9**	**270.9**	**283.9**	**297.3**
Program expenses	199.5	206.6	216.5	224.6	233.4	243.2	253.0
Public debt charges	33.3	31.6	31.9	34.3	36.5	36.5	36.2
Total expenses	**232.8**	**238.2**	**248.4**	**258.8**	**269.8**	**279.7**	**289.1**
Surplus	**9.6**	**0.8**	**0.1**	**0.1**	**1.1**	**4.2**	**8.1**
Federal debt[1]	457.6	456.8	456.7	456.6	455.5	452.5	449.5
% of GDP							
Budgetary revenues	15.8	14.9	15.4	15.3	15.2	15.2	15.2
Program expenses	13.0	12.9	13.4	13.3	13.1	13.0	12.9
Public debt charges	2.2	2.0	2.0	2.0	2.1	2.0	1.8
Total expenses	15.2	14.9	15.4	15.3	15.2	15.0	14.7
Federal debt	29.8	28.5	28.3	27.1	25.6	24.2	22.9

[1] Based on planned debt reduction of $3B per year in 2012-2013 and 2013-2014.
Note: Totals may not add due to rounding.
Source: Department of Finances Canada, November 2008

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ANTICIPATED DEFICIT FOR 2009-2010

Despite all the efforts mentioned in the economic and fiscal update tabled today, the Canadian government cannot avoid a deficit for fiscal 2009-2010. Economic conditions will worsen more than the government is anticipating over the coming months and revenues could be even lower. In his update, the minister mentions that the downward risks on the evolution of the economy are very high.

In effect, posting a deficit would not be dramatic for the government, especially if the economy is not doing well. Balancing public finances must be seen over the medium term. Surpluses can follow deficit and vice versa, as long as the surpluses cover the deficits over a period of three to five years, while allowing the government to pay down the debt. In this context, there is no need to fear a deficit. However, some could challenge the merits of cutting back on spending at a time when the current economic situation would call for the reverse.

ECONOMIC FORECASTS: RISKS ARE POINTING DOWNWARDS

The economic conditions have worsened significantly since the last budget was released in February 2008. In the United States, the drop in real estate prices, the increase in gas prices observed earlier in the year, the tighter credit conditions, the recent growing financial crisis and the cuts in consumer spending over recent months have visibly brought the economy into a recession, although slight at this point. This economic slowdown has global ramifications and most industrialized countries could also be in a recession.

Canada cannot avoid the worsening economic conditions. Foreign trade is hurt by the recession south of the border and domestic demand, the pillar of economic growth in Canada in recent years, is showing signs of weakness. Business investment is declining because of the worsening economic outlook and the tighter credit conditions. After years of sustained growth, residential investment is also loosing ground, although the risks of a major correction like the one seen in the United States remain limited. Lastly, the pace of consumer spending has been clearly slowing down in recent months. In the fall, the confidence of consumers has eroded significantly with the growing financial crisis.

Important revisions are being brought today to the financial and economic update in keeping with the lower economic assumptions. Accordingly, real GDP is growing 0.6% in 2008 and only 0.3% next year. The last budget anticipated increases of 1.7% and 2.4% respectively. This scenario is in fact equivalent to a technical recession for the Canadian economy (two consecutive quarters of declining output). For the last quarter of 2008, real GDP is expected to decline by 1.0%, followed by a decrease of 0.4% in the first quarter of 2009.

However, the Canadian economy benefits from several supports that lessen the effects of the crisis at home. The anticipated recession should be limited in comparison with that of the 80s and 90s. The drop in real estate prices seen in Canada has nothing in common with what is currently happening in the United States. The financial situation of households and businesses remains solid. Canadian financial institutions are well capitalized. Significant gains can still be seen in the Canadian labour market. This situation contrasts sharply with the 1.2 million job losses in the United States over recent months. The depreciation of the loonie should relieve Canadian exporters during this difficult period. Lastly, the recent drop in gas prices is increasing the purchasing power of consumers everywhere.

That said, the risks surrounding the economic forecasts used by the government are in our view clearly pointing downwards, especially for 2009. According to our forecasts, the recession could be a little more severe and slightly longer than the Department is anticipating. This will significantly impact the budgetary balance of the government and year 2009-2010 could close on a deficit. According to the Department of Finance, measures would then be taken to ensure that such a deficit remains temporary, i.e. the time that the economic conditions improve.

A CONFRONTATION IS SHAPING UP ON THE HORIZON

To offset the decrease in revenues anticipated for fiscal 2008-2009 and 2009-2010, the minister has chosen to cut spending (see box on page 3)—which is a debatable choice. We believe that at this time, it is a little early to implement economic simulation measures because it is mostly through the foreign sector that the country is suffering while the domestic economy is a more stable. There are few measures that are able to fight a weak foreign sector in the short term. However, it is not desirable to cut spending as the minister proposes.

We can only congratulate the minister for completely reviewing public spending as proposed in the update. Every one agrees that the government would benefit from improved efficiency. Yet it is not clear how the government will manage to save $4.3B for fiscal 2009-2010, but it is imperative that this money returns into the economy through increased spending in other fields so as not to slow down economic growth even more. It is obvious that cuts in department spending could even worsen the recession.

Additional measures to ensure budgetary balance

In this update, the Department of Finance is proposing several measures to offset the harmful effects of the deteriorating economic conditions on the government's budgetary balance. Without these measures, the Canadian government would have posted a deficit of 5.9B in 2009-2010 instead of a slight surplus of $100M currently anticipated. In 2010-2011, the deficit would be $3.4B, i.e. a total of $9.3B in two years. Here are the measures in a nutshell:

Effective management of government spending
Starting April 1, 2009, the government is proposing to eliminate the quarterly subsidy that political parties benefit from. In addition, the strategic review of department spending will continue to improve the effectiveness of the government machinery. It is also possible that some assets be sold. In the end, minister Flaherty hopes to recover $4.3B in 2009-2010 with these measures.

Remuneration of the public sector
The federal government proposes to curb the growth of civil servant wages. A law could suspend the right to strike of public employees until 2010-2011 for wage-related reasons.

Purchase program of insured mortgage loans
In response to the current financial crisis, the Canadian government set up a program to purchase insured mortgage loan pools evaluated at $75B. A net financial gain of approximately $1.1B is expected on these assets in 2009-2010.

Table 2
Changes in the fiscal outlook since the February 2008 budget[1]

	Actual	*Projection*				
In $B	2007-2008	2008-2009	2009-2010	2010-2011	2011-2012	2012-2013
Budgetary balance before actions	**9.6**	**0.2**	**-5.9**	**-3.4**	**-1.9**	**1.8**
Actions affecting the budgetary balance						
Effective management of government spending			4.3	1.9	1.6	1.1
Appropriate public sector compensation		0.6	0.6	0.9	1.0	1.0
Insured Mortgage Purchase Program		0.2	1.1	0.7	0.4	0.3
Temporary reduction in RRIF minimum withdrawals		-0.2				
Total		0.6	6.0	3.5	3.0	2.4
Revised budgetary balance	**9.6**	**0.8**	**0.1**	**0.1**	**1.1**	**4.2**

[1] A positive number implies a decrease in spending and an improvement in the budgetary balance. A negative number implies an increase in spending and a deterioration in the budgetary balance.
Note: Totals may not add due to rounding.
Source: Department of Finances Canada, November 2008

The same goes for the limits imposed on wage increases in the public service. This is not the time to take money out of the Canadian economy. In addition, this measure could stir up a confrontation with civil servants, all the more since the law that is suggested will suspend the right to strike for wage-related reasons. Adding the fact that the government will start on April 1, 2009, cutting the quarterly subsidy based on votes cast that political parties benefit from, the government has by the same token made more enemies. The Canadian government risks going through a period of turbulence.

THE GOVERNMENT IS WORKING AT CROSS PURPOSES

By bringing down the goods and services tax (GST) from 7% to 5% when the economy was doing well and when consumer spending was already growing strongly, the government of Canada has made our tax system even more inefficient and is doing without revenues of over $12B. At the same time, the monetary policy was in a restrictive phase and the increase in key interest rates offset in part the benefits of the GST cut. This $12B would now be very useful to face the financial crisis and the current economic slowdown. Currently, to avoid posting a deficit, the government has concocted a series of measures of effective management of government spending to cut expenses at a time when economic theory would require it to avoid doing it at all costs.

According to us, it is a bit early to present substantial economic stimulation measures. Bear in mind however that the government already acted to diminish the harmful effects of the financial crisis, like the purchase of insured mortgage pools. However, it is difficult to side with a government that is announcing spending cuts in these risky times. It is contributing to slow down the economy even more while its role should be the opposite. In addition, it is doing so by infuriating civil servants and all the other political parties. Questions come to mind as to the true intentions of the minister.