

ECONOMIC VIEWPOINT

Federal Fiscal Update Preview: Federal Deficits are Smaller Than Expected but Don't Get Used to It

By Randall Bartlett, Senior Director of Canadian Economics

The primary takeaways from this analysis are:

- ▶ The federal deficit was much smaller last year than expected in Budget 2022.
- ▶ High inflation, a tight labour market and a better starting point are expected to boost revenues and reduce the deficit significantly again this year.
- ▶ However, we are forecasting a return to larger deficits starting next year, primarily because of our outlook for a recession in Canada in 2023.
- ▶ Government of Canada borrowing costs are also set to rise sharply but to remain low by historical standards.
- ▶ Despite still elevated deficits, the federal debt-to-GDP ratio is likely to fall much more quickly than expected in Budget 2022.
- ▶ But the risks to the federal fiscal outlook are tilted toward larger, not smaller, deficits.

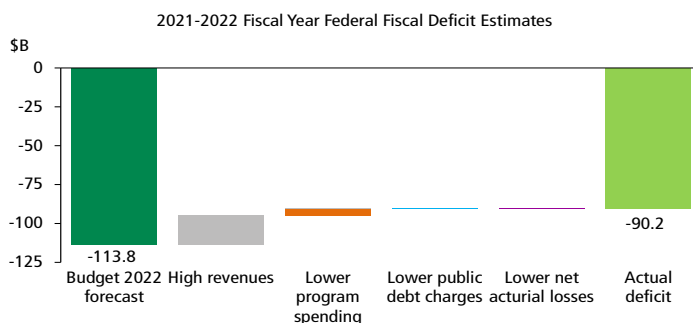
The federal deficit was much smaller last year than expected in [Budget 2022](#) (graph 1). Indeed, the estimate for the 2021-2022 fiscal year budget deficit improved from \$113.8 billion back in the spring to \$90.2 billion in the official [Public Accounts of Canada](#). This bested even our relatively optimistic deficit estimate of closer to \$97 billion, as well as that of the [Parliamentary Budget Officer \(PBO\)](#). The \$23.6 billion improvement can largely be chalked up to stronger revenues (\$18.9 billion) and, to a lesser extent, lower program spending (\$4.2 billion). The upside surprise to revenues was broad based, albeit concentrated in personal (PIT) and corporate income tax (CIT) revenues, as a tight labour market and strong profit growth helped to boost the federal government's tax take.

High inflation, a tight labour market and a better starting point are expected to boost revenues and reduce the deficit significantly again this year (graph 2 on page 2).

Revenues were coming in much hotter in the 2022-2023 fiscal year than expected in Budget 2022. Meanwhile, program expenses (total expenses excluding public debt charges) are

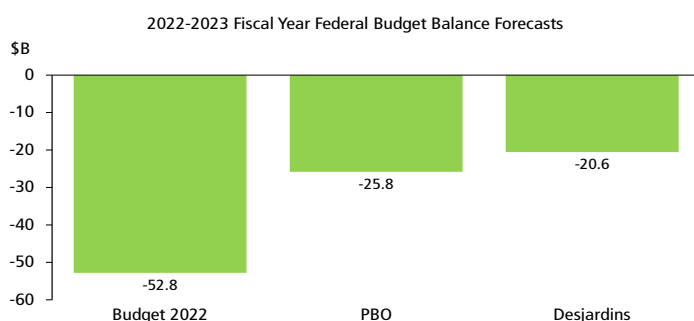
GRAPH 1

The federal deficit came in much smaller than expected last year



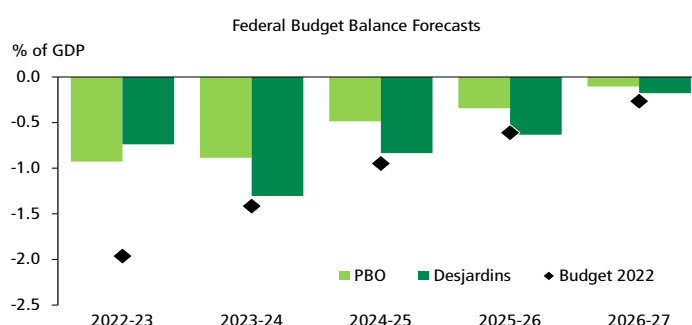
Sources: Department of Finance Canada and Desjardins, Economic Studies

falling more quickly thanks to the end of COVID-related spending. The improvement in the federal fiscal outlook comes even as public debt charges move materially higher. This has led us to forecast a much smaller deficit in the 2022-2023 fiscal year than the federal government anticipated back in Budget 2022.

GRAPH 2
Federal deficits are expected to shrink significantly this year


Sources: Parliamentary Budget Office (PBO), Department of Finance Canada and Desjardins, Economic Studies

However, we are forecasting a return to larger deficits starting next year, primarily because of our outlook for a recession in Canada in 2023 (graph 3). Our forecast is for a recession in the first half of 2023 as a result of aggressive monetary policy tightening weighing heavily on interest-rate sensitive sectors of the economy (see our most recent Economic and Financial Outlook for more information). This leads to an annual projection for real GDP growth in 2023 which is much weaker than either that of the Government of Canada or the PBO (table 1). It also leads to a forecast for a higher unemployment rate. This will act to slow revenue growth and push up program spending due to automatic stabilizers like Employment Insurance (EI). And while inflation is providing a tailwind to revenues now, what inflation giveth it ultimately taketh away. That's because inflation is insidious, feeding into higher program spending down the road even as the fillip to revenues is long in the rear view. This is true for indexed transfers

GRAPH 3
An improvement in the federal deficit forecast is unlikely to last


Sources: Parliamentary Budget Office (PBO), Department of Finance Canada and Desjardins, Economic Studies

to low-income seniors and households with children as well as transfers to provinces for health care. It should ultimately be reflected in higher compensation for public servants as well, as unions negotiate gains in real compensation for their members. Together, this is anticipated to push the federal deficit outlook back toward the path published in Budget 2022 starting in the 2023-2024 fiscal year.

Government of Canada borrowing costs are also set to rise sharply but to remain low by historical standards (graph 4 on page 4).

The Bank of Canada and other central banks are raising interest rates aggressively to combat inflation, and in so doing are driving rates higher across the yield curve. This is raising borrowing costs for governments along with everyone else, and the Government of Canada is no exception. However, what makes the federal government stand out is the short-term nature of its debt obligations relative to other

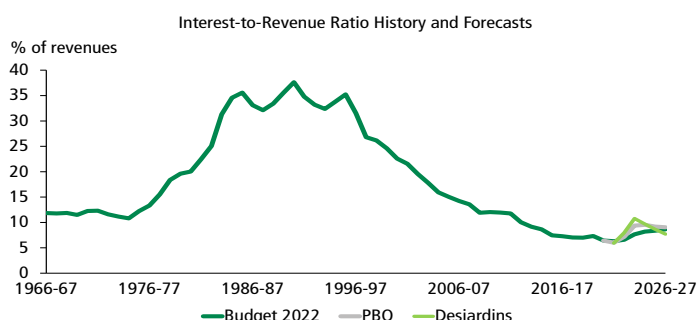
TABLE 1
Economic and financial forecasts

AVERAGE ANNUAL GROWTH IN % (EXCEPT IF INDICATED)	2021	2022f			2023f		
	Actual	2022 Budget	PBO (Oct 22)	Desj. Group	2022 Budget	PBO (Oct 22)	Desj. Group
Real GDP	4.5	3.9	3.1	3.2	3.1	1.2	0.0
GDP deflator	8.1	3.7	8.2	8.0	1.7	2.2	0.2
Nominal GDP	13.0	7.7	11.6	11.4	4.8	3.4	0.2
Treasury bills—3-month	0.1	0.8	2.4	2.6	1.7	3.9	3.9
Federal bonds—10-year	1.4	2.0	2.8	3.1	2.4	3.4	3.1
Unemployment rate	7.4	5.8	5.4	5.4	5.5	5.7	6.5
Exchange rate (US\$/C\$)	79.8	79.9	77.7	75.5	80.2	78.9	72.5
Real GDP—United States	5.9	3.8	1.6	1.7	2.6	1.0	0.0

f: forecasts

NOTE: Data may not add to totals due to rounding.

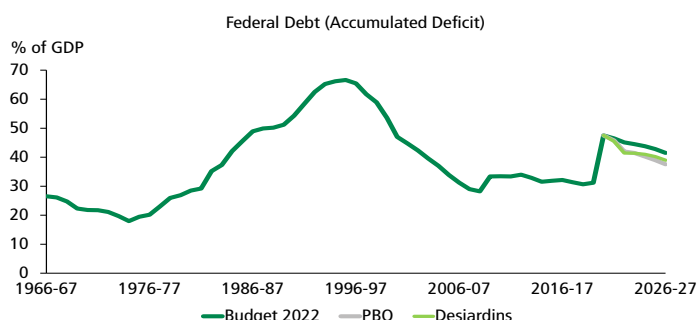
Sources: Department of Finance Canada, Parliamentary Budget Officer (PBO), Statistics Canada and Desjardins, Economic Studies

GRAPH 4
Federal interest costs are rising but they remain modest


Sources: Parliamentary Budget Office (PBO), Department of Finance Canada and Desjardins, Economic Studies

advanced economies (OECD 2021). And that didn't change much during the pandemic, despite stated intentions. As such, we expect debt issuance in the current high-interest environment to be similarly shorter term. As a result, the Government of Canada will feel the impact of higher interest rates more quickly than other jurisdictions that took advantage of ultra-low-for-long borrowing rates. Consequently, we are of the view that the federal government will see public debt charges increase more quickly than anticipated by the PBO as the effective interest rate on the federal debt ratchets up. This said, public debt charges are expected to remain low, by historical standards, as a share of revenues.

Despite still-elevated deficits, the federal debt-to-GDP ratio is likely to fall much more quickly than expected in Budget 2022 (Graph 5). This is a story of lower deficits early in the forecast leading to a slower pace of federal debt accumulation. For the debt-to-GDP ratio, it also reflects a higher denominator in the form of nominal GDP. But no matter how you slice it, the federal debt-to-GDP ratio is on a downward trajectory and is likely to fall more quickly than anticipated in Budget 2022.

GRAPH 5
The federal debt should fall faster than expected in Budget 2022


Sources: Parliamentary Budget Office (PBO), Department of Finance Canada and Desjardins, Economic Studies

But the risks to the federal fiscal outlook are tilted toward larger, not smaller, deficits. First, our forecast assumes no new spending beyond what was in Budget 2022, besides the modest inflation-relief measures announced recently. This will be a challenge to maintain given the temptation to support low-income households in the current inflationary environment. Second, we believe the risks to Desjardins' economic outlook are tilted to the downside. An overtightening by the Bank of Canada could lead to a more severe recession than we currently expect, pulling down revenues while boosting spending in the process. But as it stands, the federal fiscal outlook is broadly headed in the right direction (table 2 on page 4).

TABLE 2
Summary of transactions

IN \$B (EXCEPT IF INDICATED)	ACTUAL	DESJARDINS PROJECTIONS				
	2021–2022	2022–2023	2023–2024	2024–2025	2025–2026	2026–2027
Budgetary revenues	413.3	444.6	461.9	477.5	491.8	507.8
<i>Growth (%)</i>	30.6	7.6	3.9	3.4	3.0	3.2
Program spending	-468.8	-420.9	-443.6	-453.7	-467.9	-476.1
<i>Growth (%)</i>	-23.0	-10.2	5.4	2.3	3.1	1.7
Debt charges	-24.5	-35.4	-49.8	-46.3	-42.5	-39.2
<i>Growth (%)</i>	20.3	44.4	40.8	-7.0	-8.1	-7.9
Net actuarial losses	-10.2	-8.9	-6.1	-2.4	-0.8	1.8
Budgetary balance	-90.2	-20.6	-37.6	-24.8	-19.4	-5.7
Federal debt ¹	1,134.5	1,155.1	1,192.7	1,217.5	1,237.0	1,242.6
<i>Growth (%)</i>	8.2	1.8	3.3	2.1	1.6	0.5
Budgetary revenues (% of GDP)	16.6	16.0	16.0	16.1	16.0	15.9
Program spending (% of GDP)	18.8	15.1	15.4	15.3	15.2	14.9
Public debt charges (% of GDP)	1.0	1.3	1.7	1.6	1.4	1.2
Budgetary balance (% of GDP)	-3.6	-0.7	-1.3	-0.8	-0.6	-0.2
Federal debt (% of GDP)	45.5	41.4	41.4	41.0	40.2	39.0

¹ Debt representing the accumulated deficits including other comprehensive income.

Sources: Department of Finance Canada and Desjardins, Economic Studies