

BUDGET ANALYSIS

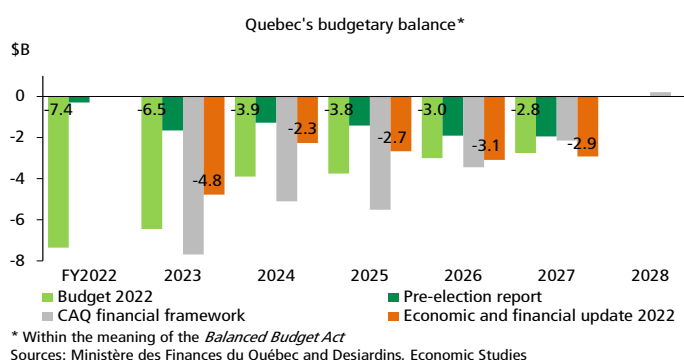
Inflation continues to influence budgetary choices

By Jimmy Jean, Vice-President, Chief Economist and Strategist, and Marc Desormeaux, Principal Economist

HIGHLIGHTS

- ▶ While Quebec's budget projections improved versus Budget 2022, they deteriorated somewhat compared with its pre-election report (Graph 1). The province expects to achieve a balanced budget (before deposits in the Generations Fund) in the year 2023-24 (FY2024).
- ▶ The province's borrowing requirements are now projected at \$25.8B for FY2023, \$27.6B for FY2024 and \$32B for FY2025. These figures represent decreases of \$1.7B, \$2.4B and \$1.8B, respectively, compared with Budget 2022.
- ▶ Bond spreads were largely unchanged after the update, but borrowing completed so far during FY2023 implies an increase in supply in the short term that could widen Quebec's spreads relative to other government of Canada benchmarks.
- ▶ A large starting point boost for revenues drove much of the fiscal improvement, with support from stronger-than-previously projected nominal GDP and inflation.
- ▶ The province did not include a recession in its baseline forecasts, but downward revisions to annual economic growth rates suggest that it expects a significant slowdown in the coming quarters. Still, Quebec's real GDP per capita is on track to approach 10% of Ontario levels within the forecast horizon.
- ▶ Some of the revenue gains are expected to be eroded by new policy designed to offer relief from inflation. This year, Quebec's measures represent the largest share of GDP of any province, but they are more targeted than previous rounds and smaller than what was announced during the recent provincial election.
- ▶ Thanks to significant help from a pandemic era revenue windfall, Quebec continues to demonstrate progress on its long-run fiscal targets.

GRAPH 1
Quebec's budgetary balance improves



Our takeaways

With a rising cost of living and an already very visible deterioration in Quebec's economic situation, the government found itself in a position where it has to make choices. One of these was to set aside a prior promise of tax cuts. In addition to the erosion of real household incomes caused by high inflation, the unemployment rate will rise in a context where labour supply and demand should rebalance somewhat. The deficit will therefore return to an upward trajectory.

The good news is that the improvement in public finances during the post-pandemic recovery was such that the budgetary balance within the meaning of the Balanced Budget Act (BBA) remains much lower than that anticipated in the last budget, despite new transfers to households, measures limiting fee indexing and enhanced financial support for seniors.

The not so good news is that, despite economic assumptions that have been trimmed significantly versus Budget 2022, downside risks abound. At 0.7%, the Ministry of Finance forecast for real GDP growth next year is equivalent to the most optimistic forecast among the private sector forecasters consulted. Our own forecast is tending toward a slight contraction for next year, which differs significantly from the government's assumption. However, the update does highlight the risks: if economic activity were to decline by 1.0% next year, more than \$5.0 billion of additional cumulative deficits would have to be absorbed over the forecast horizon. The decision to increase the provision for economic risks to \$8.0 billion is therefore justified, although the government could have demonstrated even more prudence by structuring its budget framework around a slightly more conservative short-term baseline outlook.

In any event, the leeway remains limited, with a structural deficit of about \$3B, at a time when some budgetary choices are more likely to result in higher financing costs. The days when expansionary monetary policies had a sedative effect on the reactions of financial markets are effectively over and bond investors will have to be more discerning when it comes to allocating their portfolios.

For now, we can reassure ourselves that the return to a balanced budget is still expected for FY2028. Nevertheless, we will have to see what happens if a more adverse economic situation were to have a more significant impact on public finances than what the government is predicting under its alternative scenario. In addition, the BBA should normally be reinstated next year. The government will have to present a plan to return to a balanced budget in the next spring budget, when the economy could be right in the middle of a recession. That plan could be pushed back, but policymakers should be mindful that too many adjustments to the BBA could erode the credibility of the mechanism (which has now been suspended twice since its establishment in 1996). It would be a bad time to undermine the

credibility of the BBA because it is during recessionary periods that investors are most nervous

With regard to the "Anti-Inflation Shield" measures, we welcome the fact that the latest announcements were a little more progressive than those made in the spring. For example, 71% of households eligible for the latest one-time cost of living support payment earned less than \$50,000 in 2021. Nearly a quarter of eligible Quebecers earn between \$54,000 and \$100,000 per year and will receive the minimum amount of \$400. While the debate over whether a person earning \$95,000 per year has a real need for this type of support is likely to continue, the assistance for this income bracket represents only 17.5% of the total amount. Enhanced support for seniors is structured more progressively, although the measure is not time-limited and comes with an average annual cost of \$1.6 billion.

Overall, the update shows that public finances are in good shape, at least when looking in the rear-view mirror. That is good news because we're not only seeing clouds darken on the horizon: the first raindrops are also starting to fall. Continued vigilance will be required and wise choices must be made to allow the government to engineer a robust and public investment-driven recovery in due time. Premier Legault's parliamentary session opening speech clearly showed that there is no shortage of projects, from ramping up electricity production capacity, to investments in health care infrastructure, to government digital transformation:

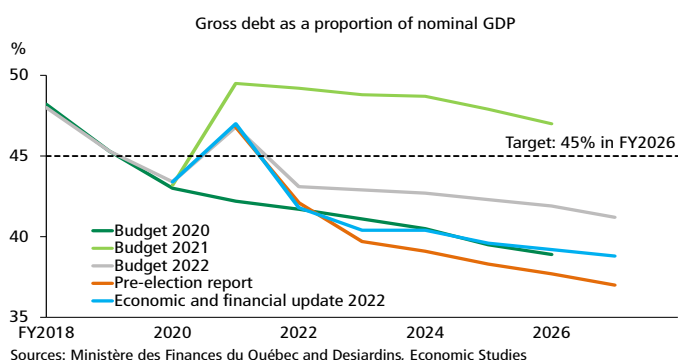
Some of these initiatives are likely to attract investment and enhance Quebec's economic potential and competitiveness, both on the Canadian and global stage. The next economic cycle will revolve around the climate transition, and we must bear in mind that Quebec (and Canada) will have to catch up to the United States, which recently enacted high-profile legislation full of substantive investments to accelerate the green transition. And all of this is happening in a context of a rapidly aging population, which has well-known effects on the structural deficit. To meet these many challenges, it will be essential to maintain a prudent approach that remains consistent with intergenerational fairness principles.

Improvement in key indicators

Quebec's budget projections were improved compared with Budget 2022 (published in March). The government is now forecasting deficits of \$4.8 billion (0.9% of nominal GDP), \$2.3 billion (0.4%) and \$2.7 billion (0.4%) for the years 2023, 2024 and 2025 (after deposits in the Generations Fund). These figures represent reductions of \$1.7B, \$1.6B, and \$1B, respectively, compared with the March 2022 financial plan. However, these deficits are \$4B, \$1B, and \$1.3B higher than the forecast in the pre-election report on the state of Quebec's finances. Before transfers to the Generations Fund, the government still expects to achieve a balanced budget in 2024, as in Budget 2022.

Consistent with the reduced deficit profile, net debt is expected to reach 33.9% of nominal GDP by FY2027, almost 3% less than forecast in Budget 2022. The province is still on track to meet its target for a gross debt-to-GDP ratio of 45% by FY2026. In fact, gross debt is expected to decrease as a proportion of the economy on a track similar to that forecast before the COVID-19 pandemic (Graph 2). As indicated in Budget 2022, Quebec will announce a new long-term debt target in its next budget, this time based on net debt.

GRAPH 2
Trend in Quebec's debt similar to before the pandemic



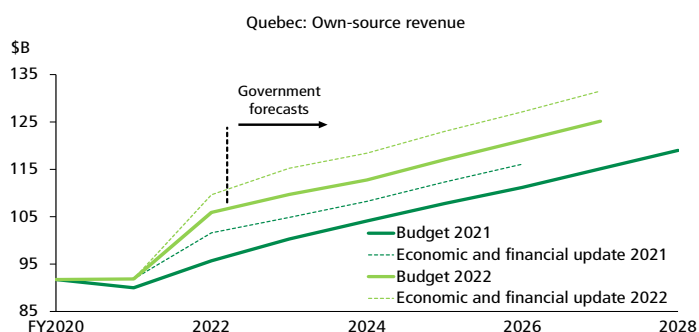
The province's borrowing requirements are now projected at \$25.8B for FY2023, \$27.6B for FY2024 and \$32.0B for FY2025. These figures represent a decrease of \$1.7B, \$2.4B and \$1.8B, respectively, compared with Budget 2022. Refinancing represents 57%, 58% and 61% of the totals for FY2023, FY2024 and FY2025, respectively. As November 17, 2022, 57% of the borrowing planned for FY2023 had been completed. At that time, the government had contracted 8% of borrowing on foreign markets, compared with an average of 27% over the last 10 years. The government stated that it "plans to continue to take advantage of opportunities to issue on foreign markets."

More optimistic near-term economic prospects bolster revenue

As expected, and as seen in several other provinces, the underlying trajectory of Quebec's revenues is much stronger than it was in budget projections (see table on page 4). That is largely due to a much stronger starting point (Graph 3), which puts the government's revenues in line with the improved trajectory described in the pre-election report. As in the other provinces, this reflects stronger-than-anticipated real growth and inflation. The forecast for nominal GDP growth in 2022 was revised from 6% in Budget 2022 to 10% in this update.

One of the questions regarding the update was whether plans would include an economic slowdown; like Ontario, Quebec did not explicitly forecast a recession in its baseline forecast. The government now expects real growth to be just 3.1% this year

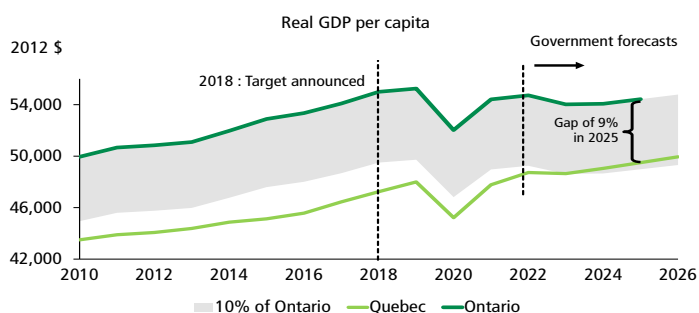
GRAPH 3
Another Windfall, Another Persistent Revenue Boost



and 0.7% in 2023. However, in an alternative scenario involving a recession beginning in the calendar year 2023, real GDP would contract by 1.0% next year, reducing the budgetary balance by \$5B over five years. This is more optimistic than the scenario presented in the pre-election report, in which the government associated a typical recession with an \$8.3B reduction in revenue over five years.

With respect to longer-term growth and productivity objectives, Quebec's forecasts indicate that its real GDP per capita is on track to achieve the target of 10% below Ontario's level before the expected date (Graph 4). The government had set this "Objective of Collective Wealth" for FY2026.

GRAPH 4
Quebec should achieve its "Objective of Collective Wealth"



New measures aimed at helping with the cost of living

In line with the Coalition Avenir Québec's 2022 financial framework, new policies aimed to help ease the rising cost of living. The flagship measure was a second series of transfers to Quebec households, due to be paid this month, with a total cost of approximately \$3.5B in FY2023. In addition to these transfers, the province will limit government fee increases to 3% for the next four years, resulting in a total tax cost of approximately

TABLE
Budgetary situation

IN \$B (EXCEPT WHERE INDICATED)	ACTUAL	PROJECTIONS				
	2021–22	2022–23	2023–24	2024–25	2025–26	2026–27
Total revenue	138.8	144.8	147.7	153.2	158.3	163.3
Own-source revenue	109.6	115.2	118.4	123.0	127.1	131.5
Federal transfers	29.2	29.6	29.3	30.2	31.2	31.8
Total expenditure	126.6	143.8	143.7	149.3	155.1	159.5
Program expenditures	118.0	133.3	134.3	139.2	144.7	148.3
Debt service	8.6	10.5	9.4	10.1	10.4	11.2
Support and recovery measures	9.4	2.0	0.4	—	—	—
Provisions for economic risks	—	1.0	2.0	2.0	1.5	1.5
Balance	2.8	-2.0	1.7	1.9	1.8	2.3
<i>% of GDP</i>	<i>0.6</i>	<i>-0.4</i>	<i>0.3</i>	<i>0.3</i>	<i>0.3</i>	<i>0.4</i>
Generations Fund	3.6	3.3	3.9	4.6	4.8	5.2
Use of the stabilization reserve	0.8	0.4	—	—	—	—
Budgetary balance within the meaning of the Act	—	-4.8	-2.3	-2.7	-3.1	-2.9
<i>% of GDP</i>	<i>0.0</i>	<i>-0.9</i>	<i>-0.4</i>	<i>-0.4</i>	<i>-0.5</i>	<i>-0.5</i>
Net debt (% of GDP)	38.1	36.0	35.7	35.0	34.4	33.9
Gross debt (% of GDP)	41.8	40.4	40.4	39.6	39.2	38.8
Debt representing accumulated deficits (% of GDP)	20.9	19.3	18.5	17.5	16.6	15.7

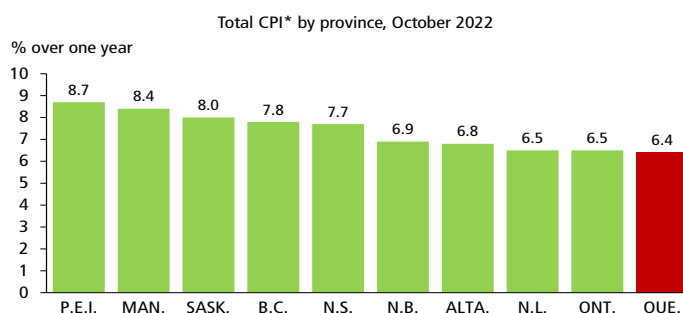
Sources: Ministère des Finances du Québec and Desjardins Economic Studies

\$1.65B from FY2023 to FY2027. As announced in the financial framework, it will also increase support for seniors, which will cost between \$1.5B and \$1.7B for each fiscal year through to FY2027.

In the past, we have noted that broad-based transfers to households have the potential to exacerbate inflationary pressures by stimulating demand. That remains the case for all provinces. As a share of GDP, Quebec's package of measures is the largest offered in Canada. However, these measures are more targeted than the first series of transfers that were made following Budget 2022 and are smaller than expected in the CAQ's financial framework. In addition, Quebec's inflation rate has been lower than that of the other provinces to date (Graph 5). The disinflationary effect of the economic slowdown could more than offset the inflationary impact of the transfers.

The government has not changed its plan for infrastructure investments. The Québec Infrastructure Plan therefore still stands at \$142.5 billion over the next 10 years. New targets will be announced in Budget 2023. As in other jurisdictions, the key question is whether the acute labour shortages and high input costs will delay major projects.

GRAPH 5
Quebec's inflation is the lowest among all provinces



* Consumer price index

Sources: Statistics Canada and Desjardins, Economic Studies

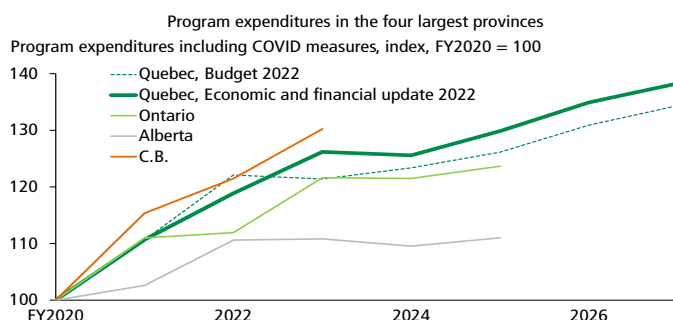
Contrary to the provincial election pledge, the government will not reduce its payments to the Generations Fund to absorb some of the costs of its initiatives. However, the financial plan includes \$8B in provisions for economic risks and other support and recovery measures to cover a recession or an unexpected increase in costs.

Higher expenditures

Besides the cost-of-living support measures, portfolio expenditure forecasts were increased by \$140M for the current fiscal year and by \$1.3B for FY2024. This mirrors increases in costs related to the delivery of public services and the cost of pension plans, among other things. Where portfolio expenditure plans were subject to a small adjustment for the current fiscal year, the situation was different for debt service costs, which were raised by \$1.7B in respect of the sharp rise in interest rates this year. All in all, the cumulative growth in Quebec's program expenditures since the pandemic should continue to exceed that of Ontario and Alberta throughout the forecast horizon (Graph 6). It is expected to be lower than that of the British Columbia plan, at least for this year.

GRAPH 6

Ambitious spending plans



Sources: Provincial Budget documents, Statistics Canada and Desjardins, Economic Studies

Bond spreads could be influenced by the issue schedule

Quebec's long-term bond spreads changed little immediately after release of the update. Investors seem to have already anticipated the revenue gains and the new measures, in line with the government's announcements and recent developments in the economy. From a fundamentals perspective, the spreads between 10- and 30-year bond yields in Quebec and those in Ontario should remain fairly narrow, assuming that public finances eventually resume their longer-term trend. Quebec's long-term bond yields have in fact been trading below Ontario's since mid-2017.

However, in the shorter run, we expect to see a boost to issuance that could widen Quebec spreads versus other Canadian government benchmarks. Quebec's 57% completion rate for its borrowing program as of November 17 contrasts with respective rates of 67%, 90% and 92% in the semi-annual updates for 2021, 2020 and 2019, all of which were published earlier in the year than this one. Being subject to a tight schedule to meet borrowing requirements for the current fiscal year, Quebec could opt for one or more transactions denominated in US dollars or euros, in a relatively short period of time.