2018 FALL ECONOMIC STATEMENT PREVIEW

November 13, 2018

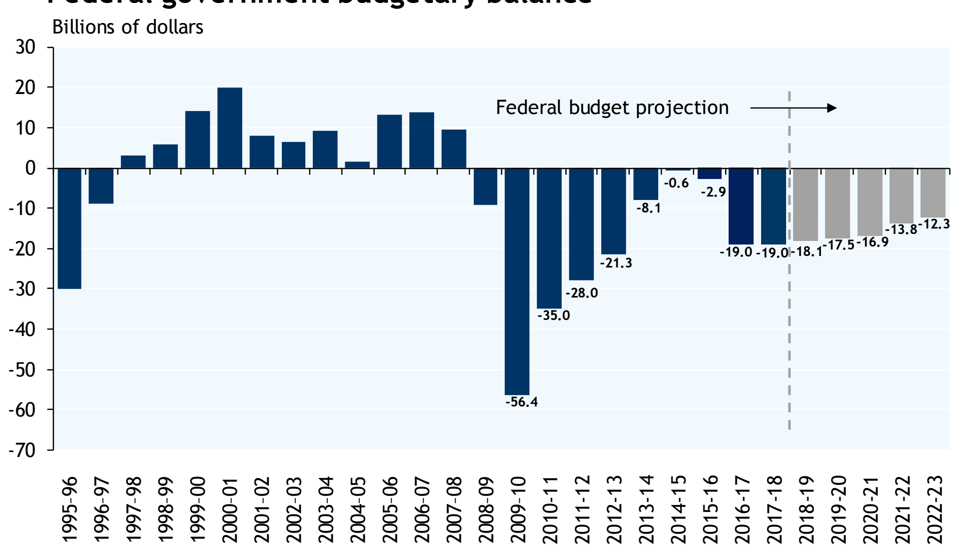
Never-ending string of deficits continues

Although the federal government's pending release of the Fall Economic Statement (FES) may hold some surprises, one near-certainty is that Ottawa will continue to run deficits as far as the eye can see. Despite a buoyant economy, any step the government takes away from the current fiscal path is likely to be in the direction of larger deficits. Ottawa long ago abandoned any pretense of balancing the budget in favour of targeting the debt-to-GDP ratio, which is a very weak fiscal anchor and encourages fiscal policy that exaggerates the economic cycle. This approach has enabled rapid growth in program spending which averaged 6 ½% annually over the last three years from an average of 1 ½% in the preceding three years. With Canada's economy currently bumping up against capacity constraints, ongoing fiscal stimulus is putting added strain on capacity as well as upward pressure on interest rates. At this point in the economic cycle, fiscal policy would be better aimed at running budget surpluses and reducing debt to better position the Canadian economy for an eventual slowing.

The fact that this type of positioning isn't likely to take place can't be blamed on the fiscal numbers to date. Revenues over the first five months of the fiscal year are running 8.0% ahead of comparable numbers for a year earlier, while program spending is tracking up 2.9%, fairly close to the 2.5% projected increase. The better-than-expected revenue growth, along with a $3 billion risk adjustment, suggests there is room for the deficit to drop into single-digit territory relative to the target of $18.1 billion for the current fiscal year and a final deficit of $19.0 billion for FY2017/18.

But we don't expect to see much outperformance relative to plan, because this year's FES is likely to be more of a mini-budget than simply a marking-to-market of the fiscal plan. The FES is likely to include some new initiatives that will eat into whatever spare fiscal room has emerged. On the spending side, Ottawa may direct some funds to support industries/sectors harmed by recent developments on the trade front. Although such spending could be reallocated from other expenditure buckets, past experience suggests it will show up as new spending.

Federal government budgetary balance



Source: Department of Finance, RBC Economics Research Forecasts

Competitiveness "Job 1"

The tax side of the books will get a little more attention than usual amid high expectations that Minister Bill Morneau will introduce some measures to improve Canadian competitiveness. Following recent tax reductions in the U.S. and some earlier policy moves in Canada, our relative competitiveness has deteriorated. This has not gone unnoticed by the Minister, who said in March that Canadian competitiveness is "Job 1" for him over the next 6 months. The bets seem to be on a move allowing businesses to write off investment more aggressively, which would have the double benefit of narrowing the gap with the U.S. and encouraging more investment in Can-

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ada. Strong investment activity would offset an expected slowing in consumer spending while providing a much-needed lift for Canada's long-term growth prospects. The fiscal hit from such a move is difficult to gauge as it depends on the scale, scope and timing of any such changes. A broad-based move would translate into a fiscal cost of a few billion dollars per year over the coming period. While no doubt a large number, program spending rose by just under $20 billion last year, suggesting some restraint on spending would limit the fiscal hit of the much-needed boost to Canadian competitiveness.

The FES may also address a couple of issues that have attracted headlines in Canada: carbon pricing and the Trans Mountain Pipeline. Over the short term, however, neither of these initiatives is expected to have a fiscal impact associated with it.

The economic assumptions underlying the fiscal plan are likely to be a little more upbeat relative to those in Budget 2018. The economic data has surprised slightly to the upside, suggesting some remaining economic momentum. A key downside risk to the outlook – the tearing up of NAFTA – has been averted. The USMCA agreement struck in late September reduces uncertainty with respect to Canada's key trading relationship. The net result has been a slight upward revision to growth forecasts relative to the Budget numbers, with GDP growth expected to hover around the 2% mark this year and next. The positive news on the growth front will be offset by upward revisions to the interest rate outlook, leaving the net economic impact on the fiscal outlook at neutral.