Economics

PROVINCIAL BUDGET BRIEFS

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Ontario budget 2021

Only five months have elapsed since Ontario's delayed 2020 budget, and today's deficit projections were little changed relative to those assumptions. Better news on the economic front, reflected in higher revenue projections, was offset by new spending on health-related issues and support for small businesses, leaving the outgoing fiscal year's deficit still at $38.5bn and the upcoming 2021/22 deficit still pegged at $33.1bn. The deficit is expected to slim further to $20.2bn by 2023/24, as time-limited spending related to Covid-19 falls out of the expenditure figures. Longer-term projections show a path back to balance by 2029/30, based on roughly 4% revenue growth and 2% expenditure growth. Partly owing to a desire to be prudent in these uncertain times, and partly reflecting the timing of when assumptions were set, the economic projections underpinning today's budget appear fairly conservative. Ontario's total funding requirement in 2021/22 is $61.9bn, which is down from $67.7bn in 2020/21 but still elevated relative to the pre-pandemic level that was in the area of $40bn. The majority of Ontario's 2021/22 funding requirement will be satisfied by long-term debt of $54.7bn, which is a reduced amount after incorporating the $5.2bn in pre-borrowing completed in this outgoing fiscal year. The net debt-to-GDP ratio is forecast to peak at 50.2% in 2023/24 from 39.6% in 2019/20. The government's debt burden reduction strategy has set specific objectives, including a target net debt-to-GDP to not exceed 50.5% over the medium-term outlook.

Table 1: Summary of fiscal position: (C$billions)

Fiscal measure	2019/20 Actual	2020/21 20 Budget	2020/21 21 Budget	2020/21 Difference	2021/22 21 Budget	2022/23 21 Budget	2023/24 21 Budget
Revenue	**156.1**	**151.1**	**151.8**	**0.7**	**154.0**	**160.0**	**167.0**
Own source	130.7	117.7	118.1	0.4	126.6	132.3	138.3
• % change	1.6	-9.9	-9.6	0.3	7.2	4.5	4.5
Federal transfers	25.4	33.4	33.7	0.3	27.4	27.7	28.7
Expenditures	**164.8**	**187.0**	**190.3**	**3.3**	**186.1**	**186.2**	**185.6**
Programs	152.3	174.6	177.9	3.3	173.0	172.5	171.0
% change	2.4	14.6	16.8	2.2	-2.8	-0.3	-0.9
Public debt charges	12.5	12.5	12.5	0.0	13.1	13.7	14.6
Less: reserve	0.0	2.5	0.0	-2.5	1.0	1.5	1.5
Budgetary balance	**-8.7**	**-38.5**	**-38.5**	**0.0**	**-33.1**	**-27.7**	**-20.2**

Economic projections improved, but still conservative

The Ontario economy, mirroring the Canadian economy more generally, fared better than anticipated during the second wave of Covid-19 cases and lockdown measures. However, with the economic projections in today's budget reflecting data up to February 3rd, that fact was only partly picked up in the assumptions underlying today's budget. Relative to last November's budget projections, the 2020 decline in GDP is no longer thought to have been as big, and the level of GDP reached by 2023 is just over 1% higher. But, given how much consensus forecasts have improved over the past month or so, the economy is probably tracking closer to the province's "Faster Growth" scenario at present. That has also brought bond yields higher than anticipated, although that shouldn't offset much of the good news in terms of GDP growth when it comes to the budget balance.

Given the uncertainty surrounding economic forecasts at this time, the province has been detailing alternative faster and slower growth scenarios in recent budgets. In today's budget, the faster growth scenario would see the economy growing by just shy of 6% this year and by the end of 2024 real GDP would be 2.6% higher than the baseline planning assumption. The slower growth scenario, on the other hand, would leave the economy 2.1% smaller by the same time.

Table 2: Key assumptions (Y/Y % chg)

Economic assumptions	2020	2021	2022	2023	2024
Real GDP	-5.7	4.0	4.3	2.5	2.0
• Private sector consensus	-	4.4	4.4	2.6	2.1
Nominal GDP	-4.8	6.2	6.4	4.5	4.0
Employment	-4.8	4.2	3.0	2.2	1.6
Unemployment rate (%)	9.6	8.2	6.9	6.5	6.3
Nominal HH consumption	-5.8	5.9	7.2	4.9	4.2
Housing starts (K)	81.3	80.2	79.3	80.2	81.2
Corporations net op. surplus	-11.5	8.0	7.4	4.4	4.2
Consumer price index	0.7	1.7	2.0	2.0	2.0

Table 3: Key financial assumptions

Financial assumptions	2020	2021	2022	2023	2024
3-month T-Bills (%)	0.4	0.2	0.2	0.5	1.1
10-year GoC Bonds (%)	0.7	1.0	1.4	1.8	2.4
Exchange rate (US¢ / C$)	74.6	78.5	78.5	79.2	80.2
WTI (US$/bbl)	39.0	47.0	52.0	56.0	57.0

Deficit projections little changed relative to November

With only five months having elapsed since last year's delayed budget, and given the fairly conservative economic forecasts, deficit projections are little changed relative to where they were in November. For the outgoing 2020/21 fiscal year, the $38.5bn projected deficit is fully in line with the November budget, as some good news on the revenue front and a wind down of the $2.5bn contingency was offset by higher expenditures. Those expenditures include some allotment of initiatives announced today, including a second round of the Small Business Support Grant and a further round of benefit payments to parents.

For the upcoming 2021/22 fiscal year, the deficit is expected to slim moderately to $33.1bn, as some of the extraordinary payments linked to dealing with the Covid-19 crisis ease. Details within today's budget show such "time-limited" spending falling from $20.1bn in fiscal 2020/21 to $6.7bn in 2021/22. Excluding those expenditure items, spending on other areas is slated to rise by almost $9bn (or around 5½%), reflecting increased funding in areas such as long-term care and broadband connectivity announced in today's budget. The deficit projection for the coming fiscal year is the same as was expected in last November's budget, with somewhat higher spending offset by better revenue projections.

Over the medium-term, total expenditures hold relatively steady in 2022/23 and 2023/24, as the time-limited spending related to Covid-19 winds down further, reaching zero by the final year. Gains in revenues as the economy continues to recover would push the deficit down to $20.2bn by 2023/24.

That deficit would still be elevated relative to where we stood before the pandemic struck, and so today's budget also included some longer-term planning assumptions that demonstrate a path back to balance. Based on revenue growth of just under 4% on average (in line with the expected trend in nominal GDP), and total spending growth of around 2%, these projections show the province returning to balance in 2029/30. Under the faster economic growth scenario, this could be achieved two years earlier, while conversely it would be two years later in the slower growth scenario.

Funding requirement lower, but still elevated

Ontario's total funding requirement in 2021/22 is $61.9bn, which is down from $67.7bn in 2020/21 but still elevated relative to the pre-pandemic level that was in the area of $40bn. That requirement covers the $33.1bn projected deficit, $11.8bn in planned capital investments, and $25.0bn in debt maturities/redemptions. Ontario's capital plan entails investments over the next 10 years of $145.4bn, including $16.9bn in 2021/22.

The majority of Ontario's 2021/22 funding requirement will be satisfied by long-term debt of $54.7bn, which is a reduced amount after incorporating the $5.2bn in pre-borrowing completed in this outgoing fiscal year. The funding plan also entails an increase in short-term borrowing of $6bn compared to $1bn in 2020/21, which allows some flexibility to alter borrowing activity should the economy recover more quickly than expected. In fact, the government also provides a lower long-term borrowing projection of $51.9bn in the Faster Growth Scenario and a higher amount of $56.5bn in the Slower Growth Scenario. We note that the borrowing program shows a build in cash and cash equivalents of $4.0bn, after these are estimated to be drawn down by $5.4bn in 2020/21.

Table 4: Borrowing requirements (C$billions)

Borrowing requirements	2020/21 Actual	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast
Budget (surplus) / deficit	38.5	33.1	27.7	20.2
Non-cash adjustments	-9.2	-9.5	-9.5	-9.5
Investment in capital assets	11.9	11.8	12.5	11.9
Net loans / investments	-0.1	1.5	-0.1	-1.0
Net financial requirement	**41.1**	**36.9**	**30.6**	**21.6**
Maturities & redemptions	26.7	25.0	30.5	33.6
Total funding requirement	67.7	61.9	61.1	55.2

Table 5: Sources of funding (C$billions)

Canada Pension Plan borrowing	2020/21 Actual	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast
Decrease / (increase) in short-term borrowing	-1.0	-6.0	-2.0	-
Increase / (decrease) in cash and equivalents	-5.4	4.0	-	-
Preborrowing in 2019/20 for 2020/21	-7.6	-	-	-
Preborrowing in 2020/21 for 2021/22	5.2	-5.2	-	-
Total long-term public borrowing	**59.0**	**54.7**	**59.1**	**55.2**
Net new issues bonds & mtns	32.4	29.7	28.6	21.6

Although the 2021/22 borrowing program does not show an amount of pre-borrowing for 2022/23, it is normal course for Ontario to stay ahead of their funding requirements with pre-borrowing for the following year. Long-term borrowing plans in later years climb to $59.1bn in 2022/23 and then drop down to $55.2bn in 2023/24, with higher debt refinancing requirements offsetting projected budgetary improvements.

Ontario's borrowing program has been well supported by the domestic and international markets, as well as by the Bank of Canada's enhanced liquidity framework, which was instituted to support the normal functioning of financial markets during the pandemic. This framework has included expanded term repos operations (now scaled back), the Provincial Bond Purchase Program (expiring May 6, 2021) and the Provincial Money Market Purchase Program (discontinued Nov. 2020). Due to the return to normal functioning of the debt markets, some of these programs were discontinued while others will not be extended when they expire in the coming weeks.

In the current 2020/21 fiscal year, 35.0% of year-to-date borrowings were in foreign currencies; that is above the 26.8% in all of 2019/20. As a result of the strong demand globally for its debt, the province has adjusted its target range to 65-80% in domestic markets (previously 70-80%). This range will be further adjusted if investor demand warrants it. The province plans to remain active in the international markets on a strategic basis. Ontario does not favor the ultra-long bond market, instead choosing to focus on the 30-year area where it has customarily executed about 25% of its annual borrowing program. It obtains good execution and is considered the most liquid provincial bond in that area of the curve, which the province views as strategically important to maintain.

The weighted borrowing average term in 2020/21 is around 11.7 years, which is down from 14.5 years in 2019/20. The debt portfolio average term is forecasted to be 10.7 years in 2020/21, down from 10.9 years in 2019/20. This shortening in term is consistent with the overall provincial market. As a result of the pandemic, provincial governments were increasingly funding a higher than usual proportion in the short-end, and joining Ontario in having a 7-year bond. These were defensive funding positions reflecting cautious investor appetites at that time, as well as a desire by issuers to bulk up on shorter dated funding ─ the need for which will eventually dissipate when the economy recovers and can therefore be retired. Although Ontario has always issued in the 7-year term, they did so with increased frequency this fiscal year.

Ontario also has an active Green Bond program and is currently the largest issuer of Canadian dollar Green Bonds with nine green issues totaling $8.0bn ($7.5bn currently outstanding). In January 2021, Ontario launched its second Green Bond of fiscal 2020–21, and ninth Green Bond overall. The issue was for $1.25bn and follows a $1.5bn Green Bond launched in October 2020. These are the two largest Canadian dollar Green Bond issues ever launched. Ontario's green bonds have been issued under the Global Canadian dollar and Domestic Medium-Term Note formats. The bonds are listed on the Luxembourg Green Exchange and Luxembourg Stock Exchange Euro MTF. They are also part of the major green bond indices.

Debt affordability remains strong in the current low interest rate environment and the government is still benefitting from the refinancing of high coupon debt. Hence, despite debt projected to climb, debt servicing requirements on an absolute dollar basis and as a percentage of revenue are not expected to ramp up significantly. Interest on debt as a percentage of revenue is projected to rise throughout the forecast period but stay below 9%. This compares to 8.0% in 2019/20. The weighted average interest rate on total debt of 3.4% in 2019/20 is projected to drop to 3.0% in 2020/21.

The province maintains a high level of unrestricted liquid reserves which averaged $45.4bn in 2020/21, a substantial increase from $32.3bn in 2019/20. The province also maintains unutilized money market borrowing capacity. These liquidity measures provide financial flexibility during periods of market dislocation.

Credit metrics under pressure, long road ahead to balance

Credit Ratings: DBRS Morningstar AA (low), Moody's Aa3, S&P A+, Fitch AA- — All Outlooks Stable

Notwithstanding that rating agencies across the board have a stable rating outlook on Ontario, there are still risks to the downside. Most of Ontario's ratings are notably at the cusp of the AA category with metrics clearly stretched under criteria for the given ratings. Thus, the province is at risk of losing its average AA (low) rating. This may be problematic for some investors based on their investment policy guidelines. That said, Ontario's bonds have outperformed during the pandemic.

Heading into the pandemic, Ontario had a high debt burden, but it was operating with modest deficits (around 1% of GDP), was exceeding budget targets, had a clear timeline to balance in 2023/24, and its debt/GDP ratio was starting to stabilizing. Like other governments around the world, the Covid-19 crisis is having a deep negative impact on the province's economy and budgetary performance that is reversing the gains of the past few years. Moreover, with the government prioritizing healthcare as well as spending to support the economy, there are significant forecasted deficits ahead and a long timeline to balance (2029/30). This budgetary outlook will add to Ontario's already elevated debt burden.

The province projects that net debt over the next three years will rise to $503.1bn at March 31, 2024 from $353.3bn at March 31, 2020 when the pandemic was just beginning. Net debt as a percentage of revenue is forecast to continue rising to 301% by 2023/24 from around 226% in pre-pandemic 2019/20. The province also estimates that net debt-to-GDP will rise to a peak of 50.2% at March 31, 2024 from 39.6% at March 31, 2020.

Of note is that in the government's debt burden reduction strategy, it has set specific objectives, including a target net debt-to-GDP to not exceed 50.5% over the medium-term outlook. As well, it has introduced two additional relevant measures of debt sustainability: 1) net debt-to-revenue and 2) interest on debt-to revenue. While there are no specific thresholds for these two new measures, the budget states that "the objective of these additional measures will be to slow their rate of increase, supported by GDP growth".

Ontario's debt metrics are trending at levels that are more consistent with criteria in the A category. Under DBRS Morningstar rating criteria, debt/GDP adjusted for unfunded pension liabilities usually falls within 15-35% for a AA rating. They project Ontario's adjusted debt ratio will stabilize in the 50-55% range, which is up substantially from the area of 42% pre-pandemic. Their stable outlook hinges on "Ontario's ability to reduce budget deficits over the medium term and to stabilize the debt-to-GDP ratio within expectations."

S&P's preferred debt measure is debt as a percentage of revenue and at well above the 240% threshold, Ontario is allocated the weakest debt anchor score. That ratio was around 246% in 2019/20 but is expected to rise beyond 275% in 2020/21. However, S&P's rating of A+ is the lowest among the rating agencies. We therefore see Ontario as having more flexibility within the S&P rating category.

Of strong importance is the institutional framework that is incorporated into rating methodologies. On this point, Moody's writes in their January 21, 2021 report: "Moody's assigns a high likelihood that the Government of Canada (Aaa stable) would act to prevent a default by the province. The high likelihood of support reflects Moody's assessment of the federal government's incentive of minimizing the risk of potential disruptions to capital markets if Ontario, or any province, were to default. It also reflects indications of a moderately positive federal government policy stance, as illustrated by the flexibility inherent in the system of federal-provincial transfers."

Moody's assigns Ontario a Baseline Credit Assessment rating of 'a2', which then receives a two-notch uplift to 'Aa3' after factoring in their assessment of federal support. Moody's January 2021 report on Ontario says "Direct and indirect budget pressures from the coronavirus pandemic are expected to persist for a number of years which will challenge the government's ability to return to balanced budgets. The lower for longer interest rate environment mitigates some of the credit challenges as it allows the province to sustain a higher debt burden than previously anticipated at the Aa3 rating level. The outlook is stable reflecting our assumption that following the impact of the coronavirus outbreak the province will succeed with a reduction in deficits that will result in a material flattening within 2-3 years of the upward trajectory of the debt burden. Concurrently, the province will continue to record an interest burden below 10% of revenue which will allow the province to support the higher debt burden without imposing increased pressure on budgetary outcomes."

With respect to Fitch, similar to the other rating agencies, it has determined that Ontario's debt sustainability assessment rating falls within the 'a' category, but other factors more than offset the weak debt burden score to raise the rating to the AA- level. In Fitch's July 10, 2020 report it writes: "Fitch's rating case projects Ontario's economic liability burden (the ratio of adjusted net debt plus a pro-rata share of central government debt to GDP), the primary metric for the debt sustainability assessment, to grow to 96.5% in fiscal 2025, well above Fitch's expectation at the last review for 69% in fiscal 2024." We also highlight that under Fitch's rating methodology it factors in Ontario's proportionate share of the federal debt, so there is a direct tie into Canada's debt burden more so than for the other rating agencies. Fitch has also taken a more cautious view of the federal government having downgraded Canada's rating to AA+ stable from AAA in June 2020; all other rating agencies have a AAA rating with stable outlook.

Ratings are qualitative and relative, as much as they are quantitative, rating agencies will be evaluating the province by comparing it against its peer group and in the context of other important factors embodied in their criteria such as the strength and resiliency of the economy, budgetary flexibility, and Canada's institutional framework of federal supports. We also expect that rating agencies will be recalibrating their ratings and methodologies as both they and government issuers reflect on what are appropriate fiscal anchors. Without question, the pandemic and the associated actions of government issuers and central banks around the world is leading to a rethinking of certain aspects of evaluating credit. Because the pandemic is an extraordinary global transitory event, rating agencies in general are looking through the pandemic toward the medium-term for a return to fiscal sustainability. In general, rating agencies have indicated that an inadequate or untimely fiscal response to achieve fiscal sustainability could trigger a rating action on a case-by-case basis.

We highlight again that if it wasn't for the pandemic, the fiscal plans of the Progressive Conservative government were advancing in a constructive manner. Ontario had even achieved fiscal sustainability according to Canada's Parliamentary Budget Officer's (PBO) 2020 Fiscal Sustainability Report that was released in February 27, 2020.

Notwithstanding Ontario's deteriorated credit fundamentals, their bonds have outperformed in this pandemic and in past economic downturns as well. Their outperformance reflects the support they have as the benchmark provincial bond in Canada, the fact that Ontario is the largest issuer in the domestic bond index, the province's importance to the Canadian economy, their bonds' strong liquidity characteristics, the benefit of their bonds being 0% risk-weighted under the Basel III Requirements (Standardized Approach), and the assumption of federal support in periods of financial stress.

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