Economics

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Provincial Finances: Is there even more borrowing to come?

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This year's provincial budgets are highlighting increasing deficits, higher capital spending and, by extension, lofty borrowing requirements. However, with many budgets released too early in the year to incorporate US tariff uncertainty into their GDP projections, there is concern among investors that borrowing could exceed even these lofty expectations.

The good news, though, is that the provinces that released budgets earliest are also the ones who should be least impacted by US trade tensions. Moreover, with those uncertainties fading somewhat, consensus forecasts for GDP growth have started to edge up again. Having said that, if trade uncertainties take a turn for the worst again, or another shock emerges, provincial finances could deteriorate more than the downside scenarios suggested within this year's budgets.

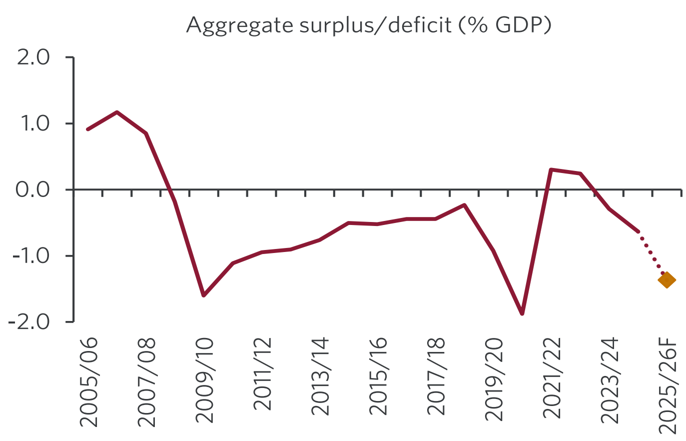
Timing isn't everything

Having posted cumulative surpluses for a couple of years prior to the pandemic, provincial governments have, on aggregate, been running deficits more recently. However, that deficit is projected to increase markedly in the current fiscal year, and at $45bn (or 1.6% of GDP) is at a scale typically only seen during periods of recession (Chart 1). Combined with large increases in capital budgets as well, this had resulted in a surge in borrowing requirements over the past few years.

However, some investors have expressed concern that borrowing requirements will end up higher than this, partly because some of the earlier-released budgets made little/no allowance for a tariff-driven slowdown within their GDP (and by extension revenue) assumptions. For example, Nova Scotia, which was the first budget released, set economic projections using information up until mid-January and stated that any tariffs within the base case would be of "limited duration". British Columbia used lower GDP forecasts to account for uncertainty surrounding tariffs, but didn't include a direct impact.

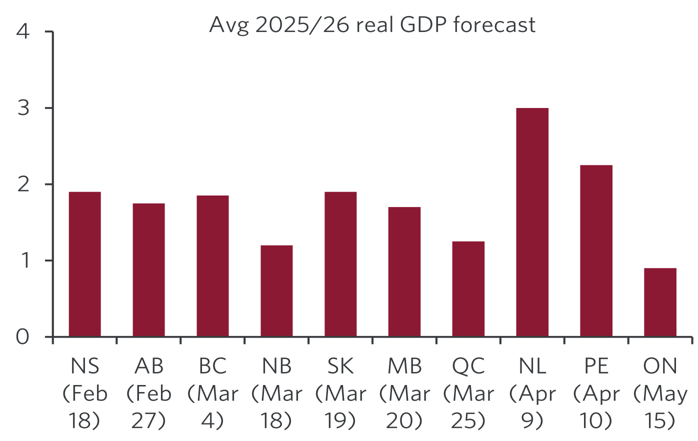
Meanwhile, later budgets often used lower GDP projections on average (Chart 2), partly because some allowance was made for a tariff impact. Quebec, for example, stated that its forecast

Chart 1: Aggregate budget deficits projected to continue rising



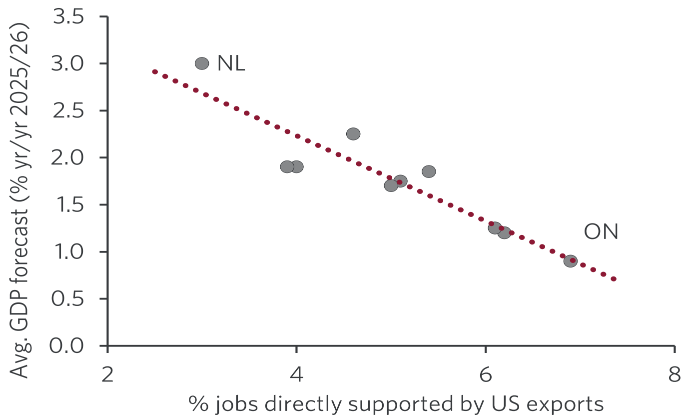
Source: Provincial budgets, CIBC

Chart 2: Provincial real GDP forecasts by date of budget release



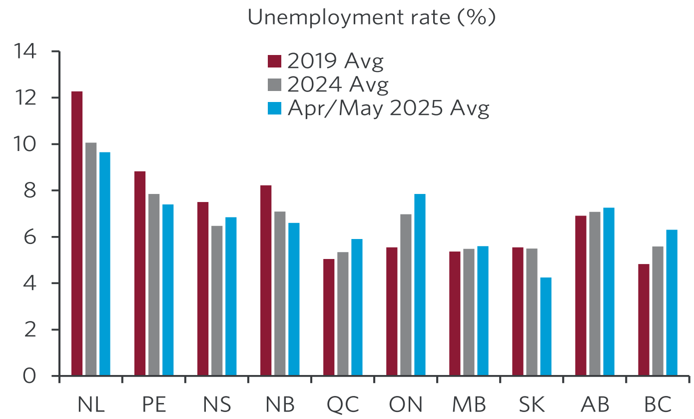
Source: Provincial budgets, CIBC

Chart 3: Assumptions for real GDP growth clearly correlated with trade sensitivity



Source: Provincial budgets, CIBC

Chart 5: Labour market points to greatest deterioration in Ontario



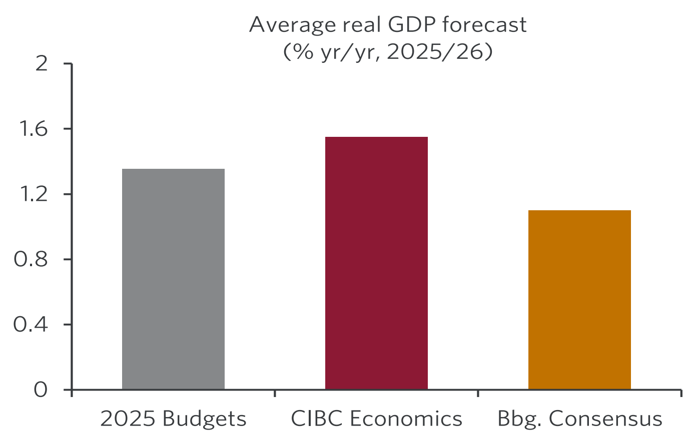
Source: Statistics Canada, CIBC

allowed for an average tariff of approximately 10% lasting for two years.

However, timing isn't everything and it shouldn't be assumed that those earlier-released budgets, or the ones with the strongest GDP assumptions, are also the provinces most likely to see lower revenues and higher deficits/borrowing requirements.

Indeed, despite the differences in timing of when forecasts were set, there is actually a clear correlation between how sensitive provinces are to US trade and how strong/weak their budget assumptions for GDP growth are (Chart 3). Newfoundland & Labrador, with the highest GDP assumptions due to expectations for a bounce-back in oil production, has the lowest share of employment that is directly supported by US trade (as measured by Statistics Canada). On the other hand, Ontario, with the greatest sensitivity to US trade, is already using the weakest GDP forecasts within their budget projections.

Chart 4: Aggregate provincial growth forecast not too much higher than current consensus



Source: Provincial budgets, Bloomberg, CIBC

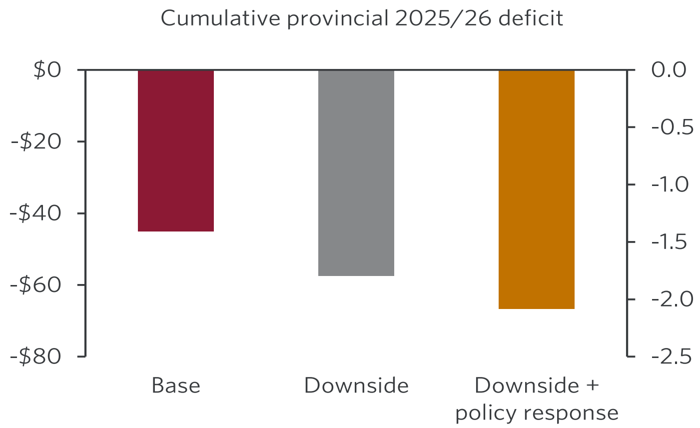
Of course, even if the forecast differences between provinces make sense, it could still be the case that all of them are too positive. But while that may have been a concern a couple of months ago, some better than expected economic data and progress towards trade deals appears to have lessened the likelihood of a worst case outcome. Indeed, with consensus forecasts for Canadian GDP growth starting to edge higher again, the provincial aggregate expectation within this year's budgets is now only slightly higher than that consensus and actually a little weaker than our own forecast (Chart 4). While we only receive provincial GDP data with a long lag, labour force figures appear to be consistent with above expectations that Ontario will be hardest hit by US trade uncertainties (Chart 5) but some other provinces may see only a minor slowdown.

Risks and rewards

However, we know that tariff news could turn quickly and investors need to be aware of just how badly such a turn could impact provincial finances. At first glance this is quite easy to do as most provinces already published downside scenarios within their budgets that are broadly consistent with a worst-case outcome for tariffs (25%, 10% energy and no CUSMA exceptions). Using these results and extrapolating for the few provinces that didn't provide such analysis would leave provinces with a $57bn aggregate deficit, or $12bn higher than in the base case.

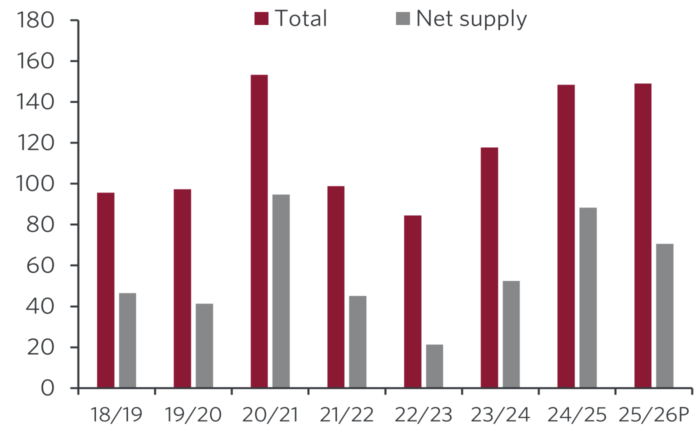
Yet that may be understating the fiscal impact of a downside economic scenario. Most of the scenario analysis undertaken in provincial budgets allowed for only the expected revenue impact from a worsening economic situation. However, as Manitoba, for one, rightly pointed out and allowed for in its own modelling, there would likely also be a bigger policy response on the spending side as well if the economy worsened. Scaling up Manitoba's allowance for this to other provinces would suggest that aggregate deficits could reach $67bn, or $22bn

Chart 6: Deficits would grow if tariffs take a turn for the worse again



Source: Provincial budgets, CIBC

Chart 8: Aggregate provincial issuance likely to increase, although net supply is lower than last year



Source: Provincial Budgets, Bloomberg, CIBC Capital Markets

more than in the base case assumptions, if these downside economic forecasts came true (Chart 6).

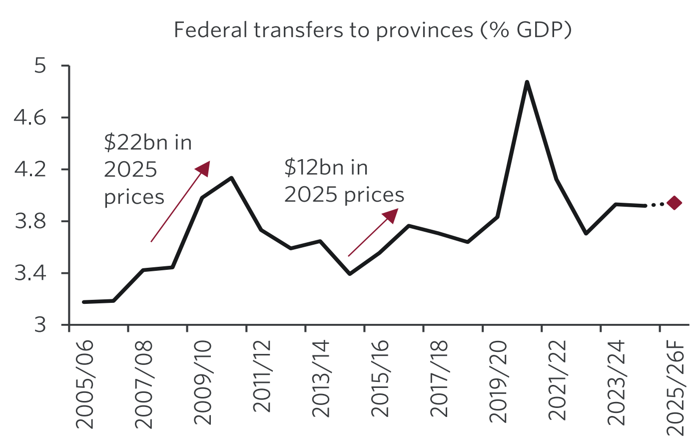
While tariff uncertainty is probably the largest downside risk to provincial finances, it isn't the only one. Wildfires that have been spreading across the prairies are also a fiscal risk, with spending to control the fires likely to once again be above what was budgeted for. Up until recently, oil prices were a slight downside risk for the finances of Alberta and Newfoundland & Labrador, but the recent spike has taken prices back above the assumptions used for budget purposes.

However, there are also upside risks, most notably the potential for higher federal transfers. During periods of slower economic growth, and especially recession, these transfers tend to rise as a proportion of GDP (Chart 7). And with the new Federal government signaling commitment to country-unifying infrastructure projects, provinces will likely be expecting greater transfers ahead. But without a Federal budget so far, the hope of higher transfers can't be inked into the province's own budgets. While a pandemic-style increase shouldn't be expected, a rise in federal transfers somewhere between that seen in the 2014 oil price shock and the 2008/09 financial crisis wouldn't be an unreasonable assumption. That would reduce province's own borrowing needs by between $12bn and $22bn over two years.

Borrowing tilted to the upside

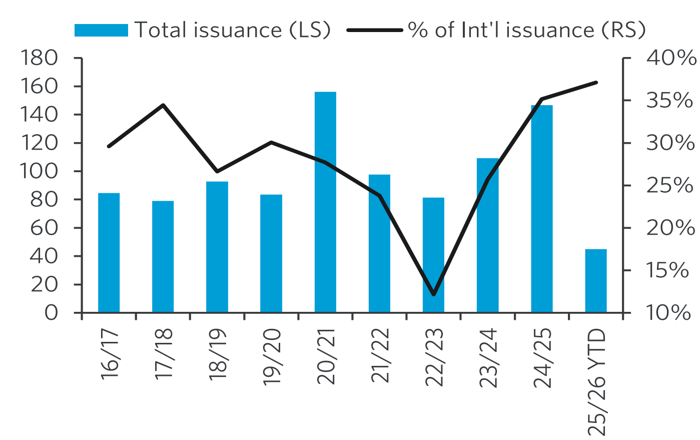
As was the case last year, impending bond maturities owing to the shorter-dated issuance that occurred early in the pandemic needs to be refinanced. Indeed, aggregate maturities are up from FY24/25 totalling around $78bn, of which 35% was originally issued as a 5yr bond. That compares to around $60bn of maturities last year, with 24% of that originally being a 5yr bond. Currently, this fiscal year's projected borrowing is approximately $150bn after incorporating some pre-funding that select provinces typically engage in, in line with last year. However, overall net supply is estimated to be lower as a result of those higher maturities (Chart 8). When including the potential shortcomings from the protectionist trade rhetoric emitting from the US, overall borrowing is tilted to the upside

Chart 7: Federal transfers forecast to remain flat as a proportion of GDP, but could rise



Source: Provincial budgets, CIBC

Chart 9: Foreign issuance increases as overall issuance increases (C$bn)



Source: CIBC Capital Markets

and could even match/surpass the total issuance observed during the pandemic year of 2020/21.

Foreign deals could help spread performance

All of this potential supply would pressure domestic spreads if it were all completed in Canadian markets, which leads us to believe that this upcoming year will experience a higher proportion of international issuance once again. Typically, when borrowing needs are higher, provinces look to expand their investor base by tapping foreign markets. Indeed, we have already seen eight non-domestic bonds issued since late-March, totaling C$16.6bn. That represents approximately 37% of all completed provincial issuance so far in this new fiscal year (Chart 9). Coupled with the lack of deal activity from other domestic issuers, namely corporates, has helped support domestic provincial spreads which are trading at the tighter-end of the range.

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