Ontario 2020 March Update

Ontario is stepping up with new measures to help support healthcare, businesses and individuals through the extraordinary circumstances emanating from the COVID-19 outbreak. Those measures are worth around $17bn, or 2% of provincial GDP, with $10bn coming in the form of temporary tax relief. Combined with the hit to revenues from a weakening economic outlook, that extra spending will see the deficit rise to $20.5bn in fiscal 2020/21, from $9.2bn in outgoing 2019/20. While the economic growth projections included in today’s update (2% nominal GDP growth in 2020) are on the high side given events of the past couple of weeks, the fiscal projections included additional prudence in a number of forms including a record high $2.5bn reserve. Although the deficit is projected to rise by more than $11bn, the borrowing plan is expected to increase somewhat more modestly to $43.6bn, from $36.0bn, thanks to just over $4bn of pre-borrowing. The province estimates that net debt-to-GDP will be 39.9% at March 31, 2020, lower than the 40.7% forecast in the 2019 Budget, but will rise to 41.7% by the end of 2020/21.

A Changing and Challenging Economic Environment

Given the escalating impact of COVID-19 on the global, national and provincial economies, economic forecasts were rapidly changing in the run-up to today’s update and were a key reason why a full budget wasn’t tabled at this stage. Also as a result, the economic projections provided in today’s release, for 0.0% real GDP growth and 2% nominal growth this year, appear optimistic.

However, due to the rapidly changing economic backdrop, the fiscal projections for this year included a number of contingencies and other adjustments which should protect the bottom line in the face of weaker economic numbers. Most obviously, the deficit projection for upcoming fiscal 2020/21 included a $2.5bn reserve. That’s well above the $1bn reserve that was used for the first couple of years’ worth of projections in Budget 2019, and based on fiscal sensitivities (with a 1% change in nominal GDP worth about $700mn in revenue), would protect against an approximate 3½% undershoot in nominal GDP. There was also a $1.3bn contingency included.
Meanwhile, the revenue projections for upcoming 2020/21 weren’t simply based on the usual relationship between nominal GDP and tax takes. In fact, total tax revenue is assumed to fall by 0.4% in 2020/21, in contrast to the 2% growth projection for nominal GDP, with that projection based on past experience from periods of sudden economic downturns. The total estimated revenue impact of COVID-19, including the nominal GDP forecast downgrade versus Budget 2019 but also the added prudence, is expected to be $5.8bn.

Additional prudence was also included in the deficit projections through an extra healthcare contingency for fighting COVID-19 worth $1bn (included within the $2.1bn of new measures to support healthcare) and the use of interest rate forecasts that are now much higher than current market rates. As such, the projected increase in interest payments (to $13.2bn from $12.6bn) may be more modest.

**Deficits on the Rise Again**

The deficit for the outgoing 2019/20 fiscal year is now expected to be $9.2bn (around 1% of GDP), with a small $0.2bn reserve still included. While that’s slimmer than the $10.3bn projected at the time of Budget 2019, that prior projection included a $1.0bn reserve and as such the current projection for fiscal 2019/20 is very much in line with what was anticipated a year ago. At the same time, however, it will be achieved in spite of $3.0bn in additional spending for critical programs and services in response to the COVID-19 outbreak.

However, the same can’t be said for the 2020/21 projection, given the impact that COVID-19 is having on the economic and revenue projections, and the new measures that were announced today to help households and businesses through what will hopefully be a short, but sharp, economic shock. This package of measures amounts to $17bn, or around 2% of provincial GDP.

The majority of that ($10bn) comes in the form of temporary tax relief, particularly for businesses with $6bn being made available to provide five months of interest and penalty free relief for businesses to file and make payments for the majority of provincially administered taxes.

In terms of direct support, health care will receive an additional $3.3bn, of which $2.1bn is directed toward dealing with the coronavirus outbreak. That amount includes the aforementioned dedicated COVID-19 contingency of $1.0bn. It also includes an additional $1.2bn for the long-term care sector.

There’s also an additional $3.7bn in supports for households and employees. These supports include a one-off $200 per child (under 12) payment to families and a doubling of the Guaranteed Annual Income System (GAINS) maximum payment to help low-income seniors.

These additional measures, alongside the impact that the weaker economic backdrop will have on revenues, are expected to see the deficit more than double to $20.5bn in fiscal 2020/21. Because of the extraordinary circumstances, projections were not given for future years and as a result today’s release didn’t classify as a full budget under the provincial regulations. A full budget will need to be tabled in the Fall (before November 15th).
COVID-19 Raises Borrowing Requirements

The province plans to borrow $45.6bn in 2020/21 of which $43.6bn will be in long-term debt. However, gross borrowing requirements are $49.7bn. The reduction reflects $4.1bn in pre-borrowings in 2019/20 which brought total gross borrowings in the current year to $39.0bn, including $36bn in long-term public borrowings.

The gross borrowing requirements in 2020/21 include $20.5bn for the projected deficit, $10.4bn for the capital program and $26.6bn in debt maturities. The year-over-year change in net debt in 2020/21 is projected at $24.0bn, bringing total net debt to $379.2bn or 242% of revenue. The province estimates that net debt-to-GDP will be 39.9% at March 31, 2020, lower than the 40.7% forecast in the 2019 Budget, but will rise to 41.7% by the end of 2020/21.

In 2019/20, 29.4% of the borrowings were in foreign currencies — at the upper end of the government’s policy band. That policy is to borrow 70-80% in domestic markets. The province plans to opportunistically remain active in the international markets in the coming year and also fund with treasury bills. Ontario also has an active Green Bond program.

Debt affordability remains very high in the low interest rate environment and the government is still refinancing some high coupon debt. Hence, debt servicing requirements are coming in better than plan. The weighted average effective interest rate on total debt was 3.5% in 2019/20. The average annual borrowing rate in 2019/20 was 2.17%. This was better than the 2019 Budget forecast of 3.44%. In 2020/21, the projected average annual borrowing rate is 2.71%.

The province maintains a high level of restricted liquid reserves which averaged around $32.1bln in 2019/20. The province also maintains unutilized money market borrowing capacity. These liquidity measures provide financial flexibility during periods of market dislocation.

Credit Ratings Will Be Pressured

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

As we expected, the COVID-19 crisis will have a deep negative impact on the province’s projected deficit and the timeline to balance is now uncertain. Understandably, this is a change in course from the Fall Economic Outlook and Fiscal Review that was building upon the steady progress of the Progressive Conservative Government to reduce the deficit, restrain the debt burden (i.e. net-debt-to-GDP) and return to balance in 2023/24. This is also a divergence after Ontario achieved fiscal sustainability according to Canada’s Parliamentary Budget Officer’s (PBO) 2020 Fiscal Sustainability Report — an accomplishment only a handful of provinces can claim.

As we are seeing in many jurisdictions given the current economic shock, this budget will pressure Ontario’s credit metrics at a time when it is contending with a very high debt burden. Several of its ratings are at the cusp of the AA category with its metrics stretched under rating 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.
At the same time, however, while ratings are both quantitative and qualitative, they are also relative. Thus, it remains to be seen if the rating agencies will be accommodative recognizing that the pandemic is an extraordinary event that is impacting the global economy. All governments around the world are being challenged financially.

The temporary nature of some elements of the COVID-19 shock, such as the temporary self-isolation/social distancing directives that are restraining demand as well as the temporary deferral of taxation revenues, may also help to cushion the impact on the ratings.