Provincial Budget Briefs

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QUÉBEC BUDGET 2018

A strong economy, combined with the benefits of an improved fiscal starting point, mean that Québec can table another balanced budget in 2018/19, while also loosening the purse strings. This is the fourth consecutive balanced budget. New fiscal measures, totaling $16bn over six years with $2bn for the upcoming fiscal year, result in slimmer budget surpluses before flows into/out of the Generations Fund and Stabilization Reserve respectively. These flows bring the balance to zero. Projections show surpluses starting to re-accelerate in 2019/20. Record capital spending will push gross debt up; however, debt as a proportion of GDP will continue to move down – a trend that will be aided by the Province earmarking $2bn a year over five years from the Generations Fund to reduce debt and interest expense. Québec is on track to achieving its gross debt target of 45% of GDP by 2025/26. Note that this is the final budget before the October 1st general election. The financing program for 2018/19 will amount to $13.4bn. That's understated by pre-funding of $9.3bn in the outgoing year, which is above the typical pre-funding undertaken (10-year average of $6.6bn). This reflects prudent measures ahead of this year's election.

Table 1

$Billions	2016/17 Actual	17-Bud	2017/18 18-Bud	Change	2018/19 18 Budget	2019/20 18 Budget	2020/21 18 Budget	2021/22 18 Budget	2022/23 18 Budget
Consolidated Revenue	**102.9**	**106.3**	**107.2**	**0.9**	**109.6**	**113.4**	**116.8**	**120.2**	**123.7**
Own-Source	*82.7*	84.3	84.5	0.2	85.9	88.6	91.5	94.6	97.7
% change		*1.9*	*2.2*	*0.3*	*1.7*	*3.1*	*3.3*	*3.4*	*3.3*
Federal Transfers	20.2	22.0	22.7	0.6	23.7	24.8	25.3	25.6	26.0
Consolidated Expenditure	**98.5**	**103.7**	**104.1**	**0.3**	**108.7**	**111.5**	**114.2**	**116.9**	**120.1**
Expenditure	89.0	93.9	94.8	1.0	99.3	102.1	104.7	107.3	110.5
% change		*5.5*	*6.5*	*1.1*	*4.7*	*2.8*	*2.6*	*2.5*	*3.0*
Public Debt Interest	9.5	9.9	9.2	-0.6	9.4	9.4	9.5	9.6	9.7
Contingency Reserve	-	0.1	0.0	-0.1	0.0	0.1	0.1	0.1	0.1
Budget Balance (Public Accounts Basis)	**4.362**	**2.488**	**3.142**	**0.654**	**0.904**	**1.771**	**2.512**	**3.265**	**3.502**
Generations Fund Deposit	-2.001	-2.488	-2.292	0.196	-2.491	-2.707	-2.991	-3.265	-3.502
Use of the Stabilization Reserve					1.587	0.936	0.479		
Budget Balance per *Balanced Budget Act*	**2.361**	**0.000**	**0.850**	**0.850**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**

Quebec's Economy Setting Records

Québec's economy is now on track to have grown by 3.0% in 2017, the strongest annual pace since 2000, backed by consumer spending and growth in business investment. Robust job creation has seen the unemployment rate reach record lows that has supported household income growth. While the Province doesn't expect such strong growth to continue, the real GDP forecasts for 2018 (2.1%) and 2019 (1.7%) have been slightly upgraded from Budget 2017. Those forecasts are in line with ours, as well as the consensus average.

The assumption for nominal GDP, which is more important from a revenue perspective, is slightly lower than the private sector average at 3.5% for 2018. It is then forecast to average just over 3% for the remainder of the horizon. Having fallen so much over the past couple of years, the jobless rate is expected to remain pretty steady, around current levels of just under 5½% in 2018 and 2019.

Table 2	Key Assumptions			
Y/Y % Chg	2017	2018	2019	2020-22
Economic Assumptions				
Real GDP	3.0	2.1	1.7	1.4
Private Sector Average	*2.9*	*2.2*	*1.7*	*1.4*
Nominal GDP	4.4	3.5	3.3	3.1
Private Sector Average	*4.5*	*3.9*	*3.5*	*3.2*
Employment (K)	90.2	60.6	30.1	
Jobless Rate (%)	6.1	5.4	5.3	
Household Consumption	4.5	4.3	3.3	
Housing Starts (K)	46.5	40.3	33.8	
Household Income	3.8	3.7	3.3	
Corporate Net Operating Surplus	11.9	4.9	4.8	
CPI	1.0	1.8	1.8	
Financial Assumptions				
3-month T-Bills (%)	0.7	1.4	2.1	
10-year GoC Bonds (%)	1.8	2.5	2.9	
Exchange Rate (US¢/C$)	77.1	81.4	80.4	

Note: 2020-22 is three-year average

Raising Spending, But Keeping Balances Rolling

Spending restraint had been a key factor in earlier budget balances, but increased revenue from strong economic growth and the benefits of earlier fiscal prudence means the province can now table balanced budgets with slightly higher spending projections.

The outgoing 2017/18 fiscal year is now slated for a $850mn surplus, which would have been larger were it not for initiatives announced today and earlier in the fiscal year. Initiatives announced at the November 2017 update came at a cost of $578mn for 2017/18, while a $733mn government contribution was made towards the REM transit project.

New initiatives announced in Budget 2018 also had a $848mn impact on the outgoing fiscal year. In sum, these new measures amount to $16bn over six years, around $2bn of which comes in fiscal 2018/19. They include increased spending for education and health, as well as some tax relief for small businesses.

In upcoming 2018/19, spending is expected to rise by 4.7%. While that would be a deceleration over the prior year's updated projection, it would be higher than the 2014/15-2017/18 average of 3.0%. After 2018/19, spending growth is forecast to settle back down into a 2.5-3.0% range.

In contrast, own-source revenue is forecast to rise by only 1.7% in 2018/19, and 2.3% excluding government enterprises. That seemingly sluggish pace relative to nominal GDP growth reflects tax changes starting to kick in, most notably a reduction in the bottom income tax rate announced in the Fall. The Province estimated that were it not for such measures, revenue growth would be more like 3.7% in 2018/19. Total revenue is being helped by increased federal transfers, which are slated to rise by a further $1bn in 2018/19, after having already jumped in 2017/18.

Before deposits into/out of the Generations Fund and Stabilization Reserve respectively, a budget surplus of around $900mn is expected for 2018/19. That's down from $3.1bn in 2017/18, but surpluses are expected to rise again thereafter as spending growth slows once again.

The Province will continue to save money in the Generations Fund, with an almost $2.5bn deposit expected to be made in 2018/19. However, to make such deposits on a slimmer budget surplus, the Stabilization Reserve will be reduced in the coming years. This is separate from the Generations Fund (which cannot be used for deficit funding) and is financed from the hefty budget surpluses of recent years. Because of those surpluses in 2015/16 through 2017/18, that reserve currently totals $5.4bn. Of that, $3.0bn is expected to be used over the coming three fiscal years, 2018/19-2020/21, leaving the reserve at $2.4bn.

Gross Debt is Climbing; but its Share of the Economy is Shrinking

The fourth in a string of balanced budgets, more surpluses projected ahead in the five-year forecast, and permanent debt reduction of $2bn this year, puts Québec on track to lowering its gross debt-to-GDP ratio to 45% by 2025/26. A bi-target requires that debt representing accumulated deficits not exceed 17% of GDP as well. At March 31, 2018, gross debt is projected to be around $204.5bn or 49.6% of GDP. While the debt ratio is down from around 51.5% last year, gross debt will climb slightly from $203bn. The bottom line is that capital investments will continue to drive up gross debt, which is projected to reach $216.9bn by March 31, 2023; but as a share of the economy, it will decline.

We expect the rating agencies and debt investors to be satisfied with today's budget, but we believe that ratings are likely at appropriate levels for the time-being. S&P rewarded the Province with an upgrade to AA- from A+ positive last year. While today's budget will be supportive for credit spreads, the upcoming general election scheduled for October 1st will likely restrain further gains.

On the Generations Fund, the Province plans to drawdown $2bn annually over five years for debt reduction. This action is prudent and provides greater certainty about Québec's intention to reduce its debt over time through concrete action. As the Generations Fund's assets are invested in units of a fund managed by La Caisse de dépôt et placement du Québec — the provincial pension fund — the approach reduces the investment risks that could potentially interfere with the Province's over-arching objective.

Table 3	Financing Plan			
$Billions	2017/18E	2018/19F	2019/20F	2020/21F
Net Financial Requirements[1]	0.0	5.0	2.6	3.6
Maturities and Calls[2]	5.8	8.3	8.2	7.7
Change in Cash	-7.9	-9.3	-	-
Transactions Under Credit Policy[3]	-0.6	-	-	-
Deposit to Pensions Sinking Fund	1.5	-	-	-
Sinking Fund Contributions[4]	1.7	-	-	-
Use of Gen Fund to Repay Debt	-	-2.0	-2.0	-2.0
General Fund Subtotal	**0.5**	**1.9**	**8.8**	**9.3**
Pre-Financing	9.3	-	-	-
Financing Fund[5]	7.2	10.1	7.5	7.4
Province of Québec Borrowings	**17.0**	**12.0**	**16.3**	**16.7**
Financement-Québec[6]	0.9	1.4	2.3	1.4
Total Program (Incl. Fin-Q)	**17.9**	**13.4**	**18.6**	**18.1**
Net of Maturities	6.6	-3.1	4.5	6.5

1. Excl requirements for consolidated org'ns covered via Financing Fund; takes into account non-receipt of RPSF income/funds dedicated to future benefits
2. General fund maturities only, excludes Financing Fund & Fin-Q
3. Payments to/(from) counterparties to reduce exposure
4. Special contributions to increase prudential liquidity
5. Borrowings by Québec for consolidated orgs./corps. (excl. Hydro-Québec)
6. Borrows in own name with provincial guarantee

The Generations Fund was created in 2006 to reduce public debt. The $10bn drawdown and debt repayment is expected to reduce cumulative debt service by $1.1bn over five years. Debt service currently stands close to $10bn annually and is the third largest expenditure item after health and education. Notwithstanding the withdrawals, the Generations Fund's assets are expected to be balanced through inflows from dedicated revenues (i.e. water power royalties, mining revenues, consumption taxes on alcoholic beverages, and other), which are projected to be greater than the withdrawals. For example, deposits to the Generations Fund are expected to total $2.5n in 2018/19. Investment returns on the roughly $13bn fund should produce further growth. The Province projects that the fund will grow to almost $18bn by 2022/23.

Québec's 10-year capital spending program, referred to as the 2018-2028 Québec Infrastructure Plan (QIP), calls for $100.4bn in cumulative investments. This is a record amount, up $9.3bn relative to the 2017-2027 QIP. Investments will be carried out by giving priority to public safety, replacement of outdated infrastructure and economic development. The QIP confirms the government's support of major public transit projects in the metropolis and the Capitale-Nationale region.

The financing program for 2018/19 will amount to $13.4bn, which is understated by the pre-funding of $9.3bn in the outgoing year. These amounts include funding for Financement- Québec. The level of pre-funding is elevated compared with the $6.6bn 10-year average. As this is an election year which could keep Québec on the side-lines as they approach the October 1st election date, the Province is taking prudent measures to get ahead of its program.

Ahead of the budget, provincial energy crown corporation, Hydro-Québec, announced their 2017 results showing net income of $2.846bn, almost flat to 2016 results. The crown utility continues to benefit from record volumes of net electricity exports. It plays a vital role in the Province as the sole energy provider and pays a regular dividend. In 2017, it will pay a dividend of over $2bn to the Government of Québec for the fifth consecutive year.

Credit Ratings: DBRS A(high), Fitch AA-, S&P AA-, Moody's Aa2, All Stable outlooks