



Economic and Fiscal Monitor

February 2019



OFFICE OF THE PARLIAMENTARY BUDGET OFFICER
BUREAU DU DIRECTEUR PARLEMENTAIRE DU BUDGET

Ottawa, Canada
12 February 2019
www.pbo-dpb.gc.ca

The Parliamentary Budget Officer (PBO) supports Parliament by providing economic and financial analysis for the purposes of raising the quality of parliamentary debate and promoting greater budget transparency and accountability.

This report provides an in-year estimate of Canada's gross domestic product (GDP) in 2018 and the Government of Canada's budgetary balance in 2018-19, based on data released since our October 2018 Economic and Fiscal Outlook, up to and including 8 February 2019. All rates are reported at annual rates unless otherwise noted.

Lead Analysts:

Kristina Grinshpoon, Financial Analyst
Caroline Nicol, Economic Analyst

Contributors:

Tessa Devakos, Research Assistant
Eskandar Elmarzougui, Financial Analyst
Sarah MacPhee, Financial Analyst
Nora Nahornick, Economic Analyst
Tim Scholz, Economic Advisor-Analyst
Nigel Wodrich, Research Assistant

This report was prepared under the direction of:

Chris Matier, Senior Director
Trevor Shaw, Director

Nancy Beauchamp and Jocelyne Scrim assisted with the preparation of the report for publication.

For further information, please contact pbo-dpb@parl.gc.ca.

Yves Giroux
Parliamentary Budget Officer

Table of Contents

| | |
|------------------------------|---|
| Executive Summary | 1 |
| 1. Economic developments | 2 |
| 2. 2018-19 budgetary balance | 5 |
| Notes | 8 |

Executive Summary

Following solid performance through the first three quarters of 2018, growth in the Canadian economy slowed in the fourth quarter.

- PBO estimates that real GDP advanced by 1.0 per cent (at an annual rate) in the fourth quarter of 2018, half of its third quarter pace.
- We expect real GDP growth to remain sluggish at 1.0 per cent in the first quarter of 2019, mainly due to declines in both residential and business investment.

The projected slowdown in the Canadian economy stems, in part, from developments in the oil sector. During the last quarter of 2018, prices for global crude oil benchmarks tumbled. Barrels of Western Canadian Select sold at prices as low as US\$14 but then recovered sharply following the Government of Alberta's mandatory production limit that was introduced in early December.

Given our expectations for both lower real GDP growth and inflation, we project that nominal GDP—the broadest single measure of the Government's tax base—will amount to \$2.2 trillion in 2018 for the year as a whole. After adjusting for historical revisions, this is \$2.1 billion or 0.1 per cent lower than projected in our October 2018 Economic and Fiscal Outlook.

Based on the most recent year-to-date financial results, PBO projects that the Government's budgetary balance for 2018-19 will be a deficit of \$16.0 billion (0.7 per cent of GDP).

- The revised budgetary deficit of \$16.0 billion in 2018-19 is \$3.4 billion lower than projected in our October 2018 outlook.
- PBO's revised estimate of the budgetary deficit is \$2.1 billion lower than the \$18.1 billion deficit projected by Finance Canada in the 2018 Fall Economic Statement, which included a \$3.0 billion adjustment for risk.

The revision to PBO's projected budgetary deficit for 2018-19 reflects a \$2.6 billion increase in our estimate for revenues and a \$0.8 billion decrease in our estimate for expenses.

Despite including additional measures since Budget 2018, as well as those announced in the Government's Fall Economic Statement, our estimate of the budgetary deficit in 2018-19 was revised down significantly due to stronger-than-expected growth in income tax revenues. Given downward revisions to our nominal GDP projection, this suggests higher tax yields than we anticipated at the time of our October outlook.

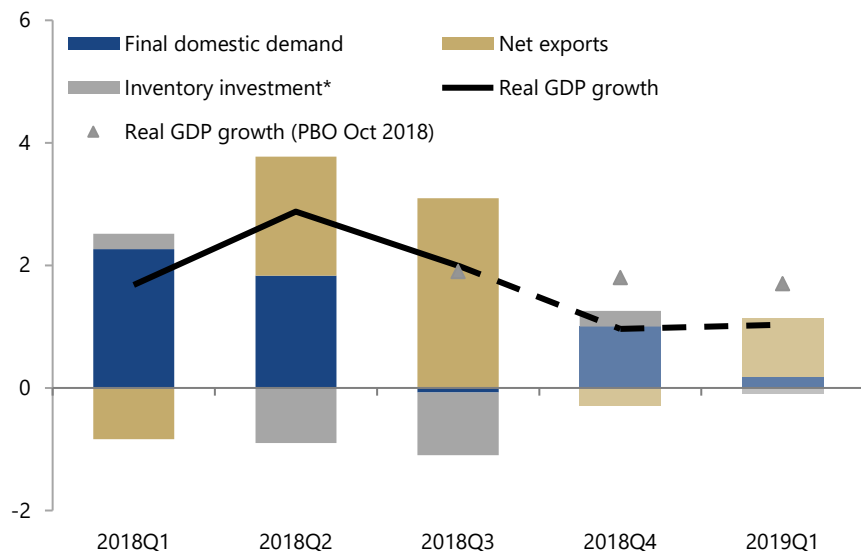
1. Economic developments

Following solid performance through the first three quarters of 2018, growth in the Canadian economy slowed in the fourth quarter. PBO estimates that real GDP advanced by 1.0 per cent (at an annual rate) in the fourth quarter of 2018, half of its third quarter pace. The slowdown in growth largely reflects a decline in export volumes, particularly in energy exports.

We expect real GDP growth to remain sluggish at 1.0 per cent in the first quarter of 2019, mainly due to declines in both residential and business investment (Figure 1-1).

Figure 1-1 Near-term economic outlook

Contributions to real GDP growth, percentage points



Sources: Statistics Canada and Parliamentary Budget Officer.

Note: *Inventory investment includes the contribution from the statistical discrepancy.

The projected slowdown in the Canadian economy stems, in part, from developments in the oil sector. With the collapse of Western Canadian Select (WCS) oil prices in the fourth quarter, the Government of Alberta introduced a mandatory production limit ("curtailment") on companies to address excess supply and lack of export capacity in early December.

We estimate that the curtailment of oil production in Alberta will reduce real GDP growth by 0.5 percentage points in the first quarter of 2019.

Weakness in first quarter growth also reflects the impact of the partial shutdown of the U.S. government. We estimate that the U.S. government shutdown subtracted 0.2 percentage points from Canadian real GDP growth in the first quarter of 2019.

Projected real GDP growth in 2018Q4 and 2019Q1 is 0.8 percentage points lower, on average, compared to our October outlook (Table 1-1). The downward revision reflects weaker export growth and business investment in the oil sector.

Table 1-1 Quarterly real GDP growth

| % , quarter-over-quarter at annual rates | 2018Q1 | 2018Q2 | 2018Q3 | 2018Q4 | 2019Q1 |
|--|--------|--------|--------|--------|--------|
| PBO October 2018 | 1.7 | 2.9 | 1.9 | 1.8 | 1.7 |
| PBO February 2019 | 1.4 | 2.9 | 2.0 | 1.0 | 1.0 |

Sources: Statistics Canada and Parliamentary Budget Officer.

Note: Highlighted values represent PBO estimates/projections. Differences in historical values reflect data revisions.

During the last quarter of 2018, prices for global crude oil benchmarks tumbled, falling by over US\$20 per barrel. Barrels of WCS sold at prices as low as US\$14 but recovered sharply following the introduction of the Government of Alberta's curtailment. WCS oil prices averaged US\$32 in December and US\$41 in January—only US\$10 per barrel lower than the price of West Texas Intermediate.

The steep decline in oil prices combined with decreases in non-energy commodity prices pushed the GDP price index (a measure of economy-wide prices) lower in the fourth quarter. We estimate that the GDP price index declined by 2.1 percent in 2018Q4 (Table 1-2). Assuming oil prices remain near current levels, we expect GDP inflation to rebound to 2.5 per cent in the first quarter.

Table 1-2 Quarterly GDP inflation

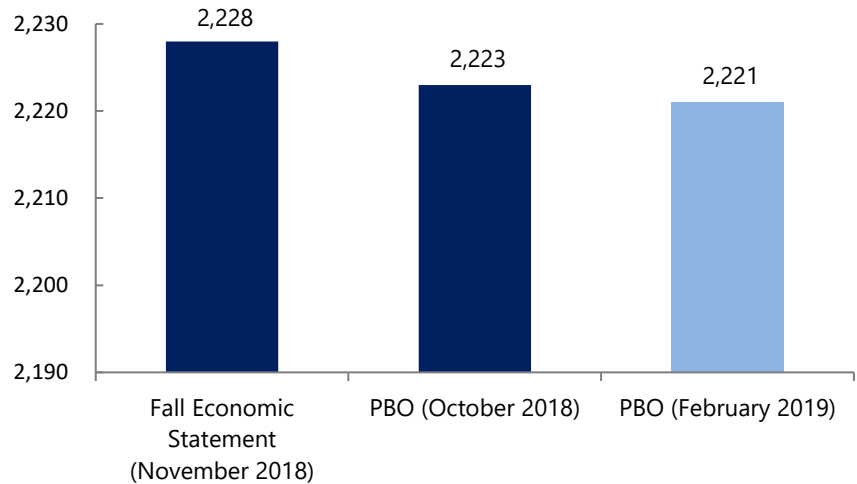
| % , quarter-over-quarter at annual rates | 2018Q1 | 2018Q2 | 2018Q3 | 2018Q4 | 2019Q1 |
|--|--------|--------|--------|--------|--------|
| PBO October 2018 | 1.6 | 2.2 | 1.6 | 1.3 | 2.3 |
| PBO February 2019 | 1.2 | 1.7 | 2.9 | -2.1 | 2.5 |

Sources: Statistics Canada and Parliamentary Budget Officer.

Note: Highlighted values represent PBO estimates/projections. Differences in historical values reflect data revisions.

Given our expectations for both lower real GDP growth and inflation in the fourth quarter, we project that nominal GDP—the broadest single measure of the Government’s tax base—will amount to \$2.2 trillion in 2018 for the year as a whole.¹ After adjusting for historical revisions, this is \$2.1 billion or 0.1 per cent lower than projected in our October outlook (Figure 1-2). The downward revision to our estimate of nominal GDP in 2018 is dampened by the higher-than-expected GDP inflation in 2018Q3.

Figure 1-2 Nominal GDP level in 2018 (\$ billions)



Sources: Finance Canada and Parliamentary Budget Officer.

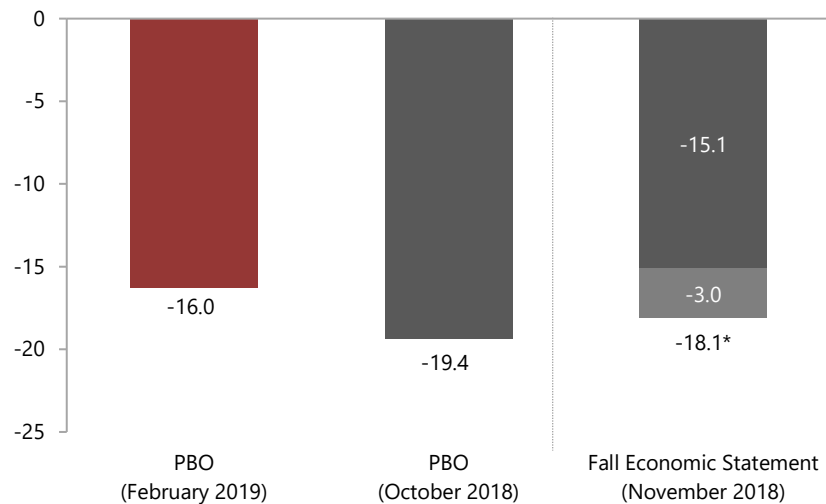
Note: Fall Economic Statement and PBO (October 2018) nominal GDP levels have been restated for historical revisions.

2. 2018-19 budgetary balance

We project that the Government's budgetary balance for 2018-19 will be a deficit of \$16.0 billion (0.7 per cent of GDP). In comparison, our current projection for the 2018-19 budgetary deficit is:

- \$3.4 billion lower than our estimate in the October 2018 Economic and Fiscal Outlook (Figure 2-1).
- \$2.1 billion lower than Finance Canada projected in its 2018 Fall Economic Statement (FES). Excluding the Government's risk adjustment, our current projection is \$0.9 billion higher than the FES.

Figure 2-1 Budgetary balance in 2018-19 (\$ billions)



Sources: Finance Canada and Parliamentary Budget Officer.

Note: *Finance Canada's 2018-19 budgetary balance includes a \$3.0 billion adjustment for risk.

The revision to PBO's projected budgetary deficit for 2018-19 reflects a \$2.6 billion increase in our estimate for revenues and a \$0.8 billion decrease in our estimate for expenses (Table 2-1).

Revenues have been revised upward due to stronger-than-expected year-to-date income tax revenues. In particular, corporate income tax revenues are \$3.0 billion higher compared to our October outlook. Despite the \$6.9 billion downward revision to our estimate of nominal GDP in 2018-19, upward revisions to income tax revenues suggest higher tax yields over this period than we anticipated at the time of our October outlook.

Table 2-1 Fiscal monitoring for 2018-19

| \$ billions | Prior PBO Oct. 2018 | Change | Current PBO Feb. 2019 | Finance Canada Nov. 2018 | PBO vs. Finance |
|--|---------------------------|--------|-----------------------------|--------------------------------|-----------------------|
| Income taxes | | | | | |
| Personal income tax | 160.1 | 0.5 | 160.6 | 161.9 | -1.3 |
| Corporate income tax | 45.8 | 3.0 | 48.8 | 49.5 | -0.7 |
| Non-resident income tax | 8.4 | 0.1 | 8.5 | 8.7 | -0.2 |
| Total income tax | 214.3 | 3.6 | 217.8 | 220.1 | -2.3 |
| Excise taxes/duties | | | | | |
| Goods and Services Tax | 37.7 | 0.2 | 38.0 | 38.5 | -0.5 |
| Custom import duties | 6.8 | 0.0 | 6.8 | 6.0 | 0.8 |
| Other excise taxes/duties | 12.5 | -0.2 | 12.3 | 12.4 | 0.1 |
| Total excise taxes/duties | 57.0 | 0.1 | 57.1 | 57.0 | 0.1 |
| EI premium revenues | 22.4 | -0.0 | 22.4 | 22.0 | 0.4 |
| Other revenues | 31.7 | -1.0 | 30.6 | 29.8 | 0.8 |
| Total budgetary revenues | 325.3 | 2.6 | 327.9 | 328.9 | -1.0 |
| Major transfers to persons | | | | | |
| Elderly benefits | 53.4 | -0.1 | 53.3 | 53.4 | -0.1 |
| Employment Insurance | 20.8 | -1.4 | 19.3 | 20.1 | -0.8 |
| Children's benefits | 23.7 | -0.0 | 23.6 | 23.9 | -0.3 |
| Total | 97.8 | -1.5 | 96.2 | 97.5 | -1.3 |
| Major transfers to other levels of government | | | | | |
| Canada Health Transfer | 38.6 | 0.0 | 38.6 | 38.6 | 0.0 |
| Canada Social Transfer | 14.2 | 0.0 | 14.2 | 14.2 | 0.0 |
| Equalization | 19.0 | 0.0 | 19.0 | 19.0 | 0.0 |
| Territorial Formula Financing | 3.8 | 0.0 | 3.8 | 3.8 | 0.0 |
| Gas Tax Fund | 2.2 | 0.0 | 2.2 | 2.2 | 0.0 |
| Home care and mental health | 0.9 | 0.0 | 0.9 | 0.9 | -0.1 |
| Other fiscal arrangements | -4.9 | -0.1 | -5.0 | -4.7 | -0.3 |
| Total | 73.5 | -0.1 | 73.4 | 73.8 | -0.4 |
| Direct program expenses | | | | | |
| Transfer payments* | 49.4 | -0.9 | 48.6 | 48.6 | 0.0 |
| Operating and capital expenses | 100.3 | 1.6 | 101.9 | 100.9 | 1.0 |
| Total direct program expenses | 149.7 | 0.7 | 150.4 | 149.0 | 1.4 |
| Total program expenses | 321.0 | -1.0 | 320.1 | 320.2 | -0.1 |
| Public debt charges | 23.7 | 0.2 | 23.8 | 23.8 | 0.0 |
| Total expenses | 344.7 | -0.8 | 343.9 | 344.1 | -0.2 |
| Budgetary balance | -19.4 | 3.4 | -16.0 | -18.1* | 2.1* |

Sources: Finance Canada and Parliamentary Budget Officer.

Note: *Finance Canada's projection for the 2018-19 budgetary balance includes a \$3.0 billion adjustment for risk. Transfer payments include \$0.6 billion in fuel charge proceeds.

Program expenses are expected to be lower due to reduced spending on Employment Insurance benefits, reflecting a lower-than-expected level of unemployment. The downward revision to Employment Insurance benefits is partly offset by higher direct program spending.

Within direct program spending, operating and capital expenses were revised higher due to additional policy actions following Budget 2018, as well as measures announced in the 2018 Fall Economic Statement.² This upward revision is partly offset by lower-than-anticipated transfer payments in support for the steel and aluminum sector. The timing of these payments remains somewhat uncertain.

PBO's October outlook assumed that revenues collected from steel and aluminium tariffs would be fully offset through transfers within the same year. However, we now expect that these revenues would be offset on a multi-year basis.

PBO's February projection includes \$3.8 billion of new policy actions and measures since the 2018 budget and including the Fall Economic Statement. Incorporating these measures increases our October 2018 outlook for the budgetary deficit from \$19.4 billion to \$23.2 billion (Table 2-2).

Table 2-2 2018-19 budgetary balance revisions (\$ billions)

| \$ billions | Budgetary balance |
|---|--------------------------|
| PBO October 2018 projection | -19.4 |
| <i>Additional policy measures since Budget 2018 including 2018 Fall Economic Statement measures</i> | -3.8 |
| PBO October 2018 projection, with policy actions | -23.2 |
| <i>Economic and fiscal developments since the October 2018 Economic and Fiscal Outlook</i> | 7.2 |
| PBO February 2019 projection | -16.0 |

However, accounting for recent economic and fiscal developments significantly lowers our estimate of the budgetary deficit in 2018-19 to \$16.0 billion. More than half of the \$7.2 billion revision to our estimate of the budgetary balance reflects stronger-than-expected income tax revenues.

The Government's Fall Economic Statement projection for the 2018-19 budgetary balance included a \$3.0 billion adjustment for risk. Given the recent strength in the year-to-date financial results, we do not expect that this adjustment for risk will be needed in its entirety in 2018-19.

Notes

1. For the year as a whole, nominal GDP growth in 2018 is estimated to be 3.9 per cent. This reflects annual real GDP growth of 2.0 per cent and GDP inflation of 1.8 per cent.

On a fiscal-year basis, our outlook for the level of nominal GDP in 2018-19 is \$6.9 billion lower compared to our October outlook, after adjusting for historical revisions.

2. PBO's 2018-19 estimate includes all new measures up to and including the Government's 2018 Fall Economic Statement.