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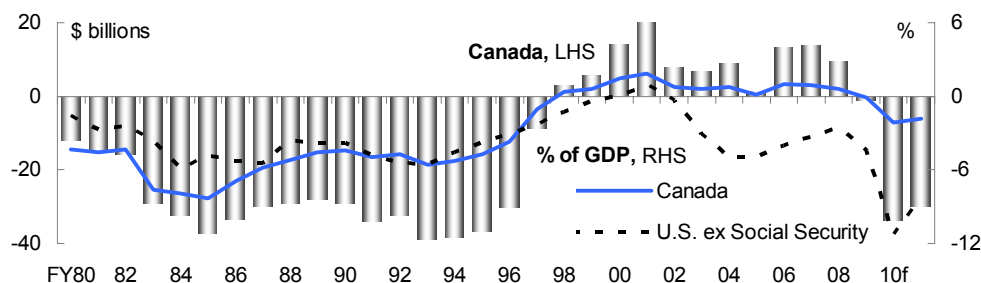
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# Fiscal Pulse

## The 2009-10 Canadian Federal Budget — Cushioning the Downturn

- Responding to financial market headwinds and the synchronized global downturn, Ottawa has stepped in with \$22.7 billion of stimulus for fiscal 2009-10 (FY10), equal to 1½% of 2009 GDP, followed by stimulus of \$17.2 billion for FY11. Adding in related provincial and municipal government funding that the federal government expects, the total stimulus for FY10 could climb towards \$30 billion.
- Following the modest \$1.1 billion deficit estimated for FY09, as pre-announced, the shortfall widens sharply to \$34 billion in FY10 and \$30 billion in FY11. In absolute dollars, the red ink in FY10 is substantially less than the record \$39 billion deficits in FY93 and FY94, and at 2.1% of GDP, a fraction of the FY83-FY85 average approaching 8.0%.
- Canada's stronger fiscal position entering this downturn is providing significant benefit. With extremely low interest rates at the present time, the debt service is projected to remain roughly 13¢ of each revenue dollar in FY10, despite expected financial requirements surpassing \$100 billion in FY09 and FY10, in stark contrast to the \$14½ billion financial source in FY08. Federal net debt is forecast to rise by \$85 billion from FY09 to FY13 before a return to balanced books is anticipated by Ottawa in FY14.
- Ottawa is projecting a return to a small surplus by FY14. It does so by assuming a more negative near-term outlook than the consensus of forecasters (and hence more in line with our view). However, it assumes a relatively more rapid and stronger recovery into 2010 and beyond than we think is probable.
- In addition to fiscal stimulus, Ottawa came through on major initiatives designed to address impaired domestic credit markets. Major non-conventional measures to aid credit markets include: an expanded Insured Mortgage Purchase Program; a new Canadian Secured Credit Facility to purchase asset-backed securities (similar to the Federal Reserve's TALF); a new Canadian Life Insurers Assurance Facility modeled along the Canadian Lenders Assurance Facility; an extended deadline for the Canadian Lenders Assurance Facility; increased business financing activity through Crown corporations; all of the measures from the November Fall statement; a national securities regulator; CDIC ability to own shares in member institutions; and federal powers to inject capital into financial institutions.
- Ottawa also appears to have opened the door to broader consultations on bank entry into auto leasing markets, and generally broader leasing powers of federally regulated financial institutions.
- Markets should be pleased by the nonconventional policies addressing credit market problems, and the focus upon temporary stimulus that allays fears regarding the return to structural budgetary deficits.

Federal Budget Balances — Canada's Current Advantage



Source: Finance Canada; Nominal GDP forecast: Scotia Economics.

### Scotia Economics

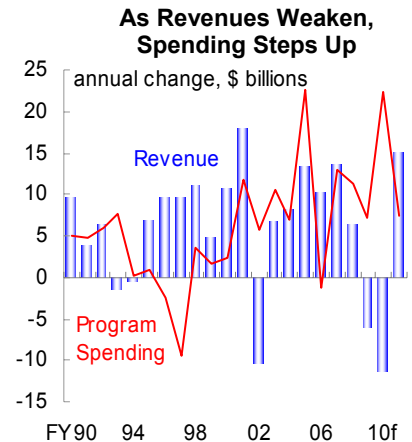
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### The Stimulus Package

In the projected \$22.7 billion FY10 stimulus package for FY10, the share to spending is more than 70%, some \$16½ billion. Of the proposed \$6.2 billion of tax relief for FY10, \$5.8 billion relates to personal income tax. The plan is multi-faceted, attempting to balance diverse regional and industrial needs.

**For business, the changes are significant.** A temporary 100% capital cost allowance (CCA) rate will be offered on computers purchased from January 28 to January 21, 2010. The 50% straight-line accelerated CCA rate for machinery & equipment investment undertaken by manufacturers and processors will be extended from 2009 to 2011, not gradually phased out. Tariffs on a range of equipment will be permanently eliminated, saving firms in Canada \$440 million over the next five years. Acknowledging current global headwinds, the interest deductibility constraints previously introduced will be repealed. Targeted industry assistance includes \$170 million for the forest products sector, \$550 million for agri-food, and Coast Guard vessel contracts totaling \$175 million to aid shipyards.



Source: Finance Canada.

**Infrastructure commands a significant share of the new funding,** as broadly anticipated, building on Ottawa's Budget 2007 commitment of \$4.7 billion in FY09 and \$5.4 billion in FY10 (and some subsequent monies announced for areas such as transit and the environment). The roll-out of the 2007 Building Canada Plan will be accelerated to cover priorities across Canada such as Toronto's Union Station project, Quebec City road upgrades, Vancouver's Evergreen transit line and Summerside Wind Energy in P.E.I. In this Budget, to renew infrastructure, a \$4 billion, two-year Infrastructure Stimulus Fund is proposed, alongside \$500 million for smaller communities' infrastructure projects and \$500 million for community recreation facilities. Over five years, \$1 billion is set aside for the Green Infrastructure Fund to support projects such as sustainable energy.

**To stimulate housing construction,** Ottawa introduced a number of measures, summing to \$7.8 billion in tax relief and funding. Of that amount, \$530 million came through initiatives that impacted FY2008-09, \$3.9 billion is focused upon 2009-10, \$1.4 billion is oriented towards 2010-11, and the remainder thereafter.

The centrepiece is a \$3 billion Home Renovation Tax Credit. Home renovations made over the period from January 27th 2009 to February 1st 2010 will be entitled to a 15% tax credit on eligible spending beyond \$1,000 and under \$10,000. The maximum credit is \$1,350 and individuals can claim it on their 2009 tax return. Whether houses, cottages, or condos, eligible renovation spending excludes furnishings.

An additional \$300 million over two years for the ecoENERGY retrofit program was also unveiled. The first-time home buyer limit on accessing RRSP savings has been increased to \$25,000 from \$20,000. Furthermore, first-time home buyers will get up to \$750 in tax relief.

Ottawa is also making \$2 billion available for low-cost loans to municipalities to finance improvements to housing related infrastructure. Several other initiatives were pre-announced in recent days including investments in social housing.

**To help Canadians and stimulate spending,** a number of tax relief and training measures have been introduced, with a \$695 million impact estimated for FY09, \$5.9 billion in FY10, and almost \$7.0 billion in FY11.

Personal income tax relief is spread over five years. Retroactive to January 1st, 2009, the basic personal exemption and the two lowest personal income tax bracket ceilings have been increased by 7.5% above 2008 levels. The tax relief associated with the Working Income Tax Benefit has been doubled. The Age Credit amount has been increased by \$1,000. Furthermore, the National Child Benefit supplement for low-income families and the Canada Child Tax Benefit phase-out ceilings have been raised to the tune of \$436 for a family of four.

### Economic and Interest Rate Assumptions

	Finance Canada**				Scotia Economics	
	January Budget				January 27, 2009	
	2008e	2009f	2010f	2011-14f	2009f	2010f
	annual % change except where noted					
Canada: Real GDP	0.7	-0.8	2.4	3.0	-1.6	1.6
GDP Deflator	4.1	-0.4	1.7	2.2	-1.0	1.3
Nominal GDP: Survey	4.8	-1.2	4.2	5.2	-2.5	3.0
Risk Adjusted	4.4	-2.7	4.3	5.7	-	-
Unemploy. Rate, %	6.1	7.5	7.7	6.4	8.0	8.2
CPI- All Item	2.4	0.7	1.9	2.0	-0.1	1.4
Oil Price, US\$/bbl	99.9	50.2	63.8	82.9	50	65
3-Month T-Bills, %	2.3	0.8	1.7	4.0	0.5	1.3
10-Year Bonds, %	3.6	2.8	3.4	5.0	2.7	3.3
Cdn Dollar, C\$/USD	94.1	81.2	85.5	94.4	81	88
U.S.: Real GDP	1.2	-1.8	2.1	3.1	-2.5	1.6

\* All data are annual averages. \*\* Private-sector average except for risk-adjusted nominal GDP used in budget estimates.

Initiatives for Canadian workers include extending for two years the EI benefit entitlements by five extra weeks and an increased maximum benefit duration to 50 weeks from 45 weeks. More funding for EI income benefits to those on longer-term training, and broadening access for self-employed individuals to access EI maternity and parental benefits are among a variety of other measures. A variety of new training initiatives are particularly focused upon a \$1 billion increase in training delivered through the Employment Insurance program. EI premium rates have been frozen at \$1.73 per \$100 for both 2009 and 2010.

Action is promised on several files. For example, for hard-pressed pension plans, for example, the Office of the Superintendent of Financial Institutions is charged with providing flexibility to supplement the November Statement measure that extended the solvency funding period from five years to ten for solvency deficiencies as of December 2008. Permanent legislative and regulatory federal pension reform is promised by the end of 2009.

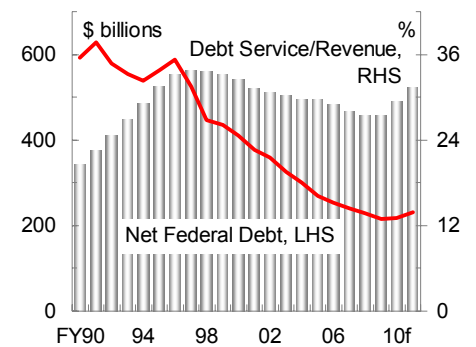
### Credit Market Measures

The budget contained a number of positive measures designed to help restore proper functioning to particularly impaired segments of Canadian credit markets. They place Canada on a more even footing with other countries like the U.S. and UK in the pursuit of such measures. Many of the measures had been expected or hoped for, with several being re-introduced from the Fall statement. There was, however, no mention of changes to legislation affecting income trusts, and no mention of programs focused upon Canadian corporate bond markets.

An over-arching Extraordinary Financing Framework will envelope a variety of credit market initiatives with up to \$200 billion backing existing and new measures. It is designed to address market failures in segments of the credit markets, mitigate systemic risks, and put Canadian financial institutions on a more even keel with initiatives being undertaken by foreign governments. Major highlights of this framework are as follows:

- ❑ Insured Mortgage Purchase Program: This has been expanded by an extra \$50 billion in insured mortgage purchases in the first half of FY10. The total program is now \$125 billion.
- ❑ Canadian Secured Credit Facility: A new, relatively modest program that will purchase up to \$12 billion in term asset-backed securities backed by loans and leases on vehicles and equipment purchased by consumers and businesses. The mixture of ABS that is purchased will depend upon the market response. Federally regulated financial institutions will be allowed to sell into the program, and provincially regulated financial institutions will require approval of the Minister of Finance. This facility will be priced on commercial terms, and is expected to generate a positive return for the government.
- ❑ The Government stated that it will consult market participants on the potential merits of changing the legislative and regulatory regime governing leasing activities by federally regulated financial institutions. This would appear to leave the door open on possible entry by banks and others into the auto leasing business as a more stable funding solution.
- ❑ Canadian Life Insurers Assurance Facility: This is a new facility that is designed to guarantee wholesale term borrowings for life insurers. It is to be modeled on the Canadian Lenders Assurance Facility.
- ❑ The deadline for issuing guaranteed instruments under the CLAF is extended to December 31st, 2009 from April 30th.
- ❑ National Securities Regulator: The Federal government will work with willing partners to establish a securities regulator.
- ❑ The Government will seek standby authority to inject capital into federally regulated financial institutions if needed.
- ❑ The CDIC will be allowed to hold or own shares in its member institutions subject to the approval of the Minister of Finance.
- ❑ A bridge bank—designed to absorb the failure of a sizeable financial institution—will be created under the auspices of the Canada Deposit Insurance Corporation.
- ❑ \$13 billion for incremental financing through financial Crown corporations such as Export Development Canada, the Business Development Bank of Canada, and low-cost CMHC loans to municipalities. Of the \$13 billion total, at least \$5 billion will be delivered through enhanced cooperation between these Crown corporations and private financial institutions under the new Business Credit Availability Program. The authorized capital limits of EDC and BDC have each been increased by \$1.5 billion, with associated increases in borrowing limits. The EDC's contingent liability limit has been increased to \$45 billion, and the Canada Account Limit has been increased from \$13 billion to \$20 billion.

### Low Interest Rates Restrain Current Debt Service



Source: Finance Canada, nominal GDP forecasts Scotia Economics.

- ❑ Canada Small Business Financing Program: The maximum eligible loan amount under this existing program will be raised from \$250,000 to \$350,000, and to \$500,000 for loans made for acquiring real property.
- ❑ The government proposes to allow the CDIC to establish a bridge bank.
- ❑ The CDIC's borrowing limit will be increased from \$6 billion to \$15 billion in order to reflect the growth of insured deposits, and the CDIC will receive broader authorities to resolve a failure, take specific action to prevent adverse effects on financial stability, and more powers regarding preparatory exams
- ❑ The Government will require a minimum grace period on new purchases made with a credit card, and move to improve debt collection practices of federally regulated financial institutions. An increased focus upon financial literacy will also be undertaken.

### Debt Management

**After a financial source of \$14½ billion in FY08, Ottawa's financial requirement in FY09 and again in FY10 tops \$100 billion.** The large increase reflects the borrowing undertaken to strengthen the financial system, notably the \$74.6 billion raised for the Insured Mortgage Purchase Program in FY09 and the subsequent \$45.2 billion in FY10. The increase in market debt does not impact the budget balance or federal net debt as the borrowings and associated interest costs are matched by a rise in revenue-earning assets. Borrowing required for the federal Crown corporation averages \$25 billion annually in FY09 and FY10. Acknowledging the potential uncertainties involved in the Extraordinary Financing Framework, flexibility has been built into the FY10 debt management strategy, presented in the *Budget*.

**Gross issuance of domestic marketable bonds in FY10** is expected to be \$82 billion, up from \$76 billion in FY09 and \$35 billion in FY08. Net issuance is projected to climb from \$27 billion in FY08 to \$71 billion this year to \$80 billion in FY10. By March 2010, domestic marketable bonds outstanding are expected to approach \$350 billion.

**For current benchmark maturities,** issuance will be either maintained or increased in FY10, and a 3-year maturity will be re-introduced, with a March/September auction cycle under consideration. For the new three-year bond, a target benchmark size of \$7 to \$10 billion is planned. The regular bond buyback program is expected to be \$2.4 billion in FY10, down from an estimated \$5 billion in FY09 and \$7 billion in FY08, and it will be conducted on a switch basis only.

**Treasury bills o/s are expected to reach \$194 billion by March 2009, up \$77 billion over the year,** with a further \$29 billion increase anticipated in FY10 to \$223 billion. The average size of bi-weekly Treasury bill auctions for 3-month, 6-month and one-year terms is expected to expand.

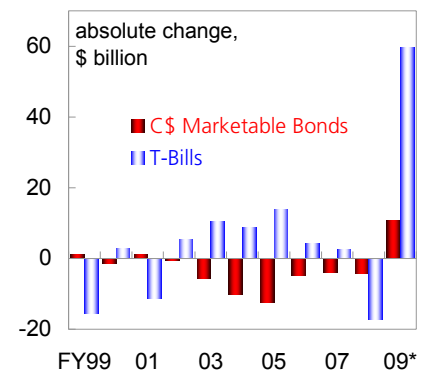
### Market Impact

This *Budget* is likely to be favourably interpreted by markets. The fact that Ottawa has met our hopes for expanded nonconventional monetary policies oriented towards challenges facing financial institutions should be a plus to equity markets and some elements of corporate fixed income markets.

The further impact upon fixed income markets is two-fold. One is a favourable effect upon the asset backed securities market stemming from the expanded IMPP and the new Canadian Secured Credit Facility.

Second is that concerns with respect to the direction of Canadian government finances are likely to be more muted post-budget. Canada still retains its strong fiscal advantage compared to most of its peers among industrialized economies. Ottawa has presented a plan—with risks—to get back to balanced budgets over the next five fiscal years. The fact that most of the stimulus measures are temporary in nature will help to allay the fear that Canada is returning to the structural deficits of the 1970s through to the mid-1990s. Furthermore, market issuance is likely to occur within the context of lower private debt issuance thereby mitigating concerns that government issuance will crowd out other borrowers and push interest rates higher.

Ottawa's Canadian Dollar Debt



\*April to December 2008.  
Source: Finance Canada.



### Fiscal Details

**Before stimulus, building in its risk-adjusted nominal GDP assumptions**, Finance Canada estimates balanced books this year, followed by a \$16 billion shortfall in FY10 and a \$14 billion gap in FY11. The stimulus affecting the budget bottom line adds \$18 billion and \$15½ billion to the FY10 and FY11 deficits, respectively.

**The erosion in revenue growth witnessed this year is expected to continue through FY10**, with total receipts down 7.2%. The sharp 7.2% decline projected for tax revenues in FY10 reflects both \$6.2 billion of proposed tax relief and an underlying 3½ % correction. Corporate income tax revenues, that have boosted receipts in recent years, are expected to drop by more than a third over FY09 and FY10. Total tax receipts are forecast to drop to just 11.6% of GDP, the lowest level in over four decades.

**Conversely, program spending** in FY10 is projected to climb to 14.6% of GDP, substantially higher than the 12.1% share in FY01. The 10.8% jump in program outlays for FY10, boosted by the stimulus package, follows an 18% increase over the prior three years. Underlying the spending estimates is significant restraint in public-sector compensation, with commitment to put legislation outlining a 2.3% wage increase in FY08 followed by annual 1.5% rises for the following three years.

**The stimulative spending lasts through FY11**, and amounts not spent will not be rolled forward past FY11. As program spending growth flattens in FY12, higher market interest rates and Ottawa's increased borrowing raise the debt service from the estimated low of \$29½ billion in FY10 to more than \$37 billion by FY12.

**The risk** in the current highly uncertain environment is that Canada's economy does not stage the healthy pick-up Ottawa assumes in 2010, leaving revenue growth short of the 6.7% projected for FY11. This potential shortfall would subsequently place the 8.1% revenue gain assumed for FY12 at some risk. Scotia Economics looks for real GDP growth of just 1.6% in 2010, significantly softer than the private sector's 2.4% average. Finance Canada's sensitivity estimates indicate that our forecast would shave a further \$2½ billion from the bottom line.

**The challenge in a softer-than-expected economic recovery** will be covering any revenue shortfalls with increased program expenditure restraint. The silver lining in the possible intensification of budgetary pressures is the incentive to seriously reassess existing programs and tax expenditures during the FY12-FY14 period, creating the opportunity for modernizing and enhancing government service delivery in the "post-downturn" period.

**A fuller version of this Fiscal Pulse Report with additional details on individual measures will be posted to [www.scotiabank.com](http://www.scotiabank.com) on Wednesday, January 28, 2009.**

### Ottawa's Budget Arithmetic

\$ billions unless otherwise noted

	FY09		FY10		FY11	FY14*
	Bud.	Rev.	Bud.	Bud.		Fcst
Personal Income Tax (PIT)	118.6	117.1	110.3	117.9		146.0
Corporate Income Tax (CIT)	36.8	31.8	26.4	30.8		39.5
Goods & Services Tax (GST)	27.6	26.4	25.8	27.3		33.0
Employment Insurance Premiums	16.5	16.6	16.8	17.3		20.4
Other Revenue	42.4	44.5	45.7	46.7		55.5
<b>Total Revenue</b>	<b>241.9</b>	<b>236.4</b>	<b>224.9</b>	<b>239.9</b>		<b>294.3</b>
Transfers: Persons	60.5	60.9	66.4	68.1		72.6
Transfers: Other Cdn Gov'ts	46.2	46.3	50.1	52.1		59.7
Direct Program Expenditures	101.5	99.6	112.7	116.3		121.8
<b>Total Program Spending</b>	<b>208.1</b>	<b>206.8</b>	<b>229.1</b>	<b>236.5</b>		<b>254.1</b>
Debt Service	31.5	30.7	29.5	33.3		39.6
<b>Total Expenditure</b>	<b>239.6</b>	<b>237.4</b>	<b>258.6</b>	<b>269.7</b>		<b>293.7</b>
Reserve		0				
<b>Budget Balance</b>	<b>2.3</b>	<b>-1.1</b>	<b>-33.7</b>	<b>-29.8</b>		<b>0.6</b>
Non-Budgetary Transactions	-17.7	-102.6	-67.5	-0.9		46.6
<b>Financial Source/Requirement</b>	<b>-15.4</b>	<b>-103.7</b>	<b>-101.2</b>	<b>-30.7</b>		<b>47.3</b>
<b>Federal Debt</b>	<b>454.8</b>	<b>458.7</b>	<b>492.4</b>	<b>522.2</b>		<b>541.8</b>
<b>Annual Change, %</b>						
Personal Income Tax (PIT)	4.9	3.6	-5.8	6.9		7.4
Corporate Income Tax (CIT)	-9.3	-21.9	-16.9	16.6		8.6
Goods & Services Tax (GST)	-7.9	-11.9	-2.2	5.9		6.5
Total Tax Revenue	-0.2	-3.9	-7.2	7.8		7.1
<b>Total Revenue</b>	<b>-0.2</b>	<b>-2.5</b>	<b>-4.8</b>	<b>6.7</b>		<b>7.0</b>
Transfers: Persons	4.0	4.7	9.0	2.6		2.1
Transfers: Other Cdn. Gov'ts	0.1	0.3	8.2	4.1		4.6
Direct Program Expenditures	6.6	4.6	13.1	3.2		1.5
<b>Total Program Spending</b>	<b>4.3</b>	<b>3.6</b>	<b>10.8</b>	<b>3.2</b>		<b>2.4</b>
<b>Memo Items, %</b>						
Tax Revenue / GDP*	12.6	12.1	11.6	12.1		13.0
Total Revenue / GDP	15.0	14.7	14.3	14.8		15.9
Program Spending / GDP	12.9	12.8	14.6	14.6		13.7
Budget Balance / GDP	0.1	-0.1	-2.1	-1.8		0.0
Net Debt / GDP	28.2	28.5	31.4	32.3		29.2
Debt Service / Revenue	13.0	13.0	13.1	13.9		13.5

Source: Finance Canada; Nominal GDP forecasts: Scotia Economics.