WEEKLY COMMENTARY

The Impending Economic Slowdown Puts Federal Finances on a Precarious Path

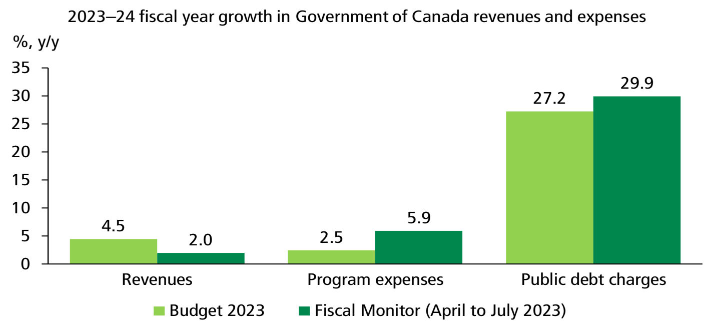
By Randall Bartlett, Senior Director of Canadian Economics

Higher-for-longer interest rates are clearly weighing on the Canadian economy. While 2023 annual real GDP growth is likely to be higher than assumed in Budget 2023, it came in well below projections for the second quarter of this year. And now, Q3 is expected to underperform private sector and Bank of Canada forecasts from just a couple of months ago. We think this is a harbinger of further weakness to come, which convinced us to meaningfully revise down our economic forecast for this year and next in our most recent *Economic and Financial Outlook*.

This souring of the economic outlook doesn't bode well for the Government of Canada. Surging revenues on higher growth and inflation coming out of the pandemic allowed it keep program spending high despite rising debt service costs. But the momentum in the tax take is clearly fading. Looking at the federal government's July 2023 Fiscal Monitor, two things stand out. First, revenues are coming in at less than half the pace that was projected in Budget 2023, mostly due to lower-than-expected corporate income and sales taxes (graph 1). Second, and more importantly, program expenses are growing at more than double the pace projected in the budget, largely because of higher operating expenses and other transfer payments. By and large, these are spending measures that directly relate to the day-to-day workings of the federal government. At the same time, public debt charges are coming in higher than expected too. Taken together, federal finances are tracking a worse annual outcome than at this time last year.

Of course, this data is backward looking. It just barely overlaps with the federal public service strike that occurred in May of this year and therefore largely doesn't include the higher wage increases that were negotiated. It also doesn't account for the unexpected increase in industrial subsidies for electric vehicle and

GRAPH 1
Growth in Federal Government Expenses Is Outpacing Revenue Growth



Sources: Finance Canada and Desjardins Economic Studies

battery production in Ontario. This will add to the drag from our worsening economic and higher interest rate outlooks, as we outlined in our June 2023 federal fiscal forecast. But the fiscal circumstances could get even worse. If the federal government doesn't generate the revenues or savings from measures outlined in Budget 2023, the budget deficits could be larger by an average of about $5B annually. This would put the debt-to-GDP ratio on a higher, albeit still eventually falling, track (graph 2 on page 2).

Our analysis suggests this dismal fiscal outlook would still leave the federal government with room of nearly 0.4% of GDP annually to cut revenues and/or raise spending while keeping the debt-to-GDP ratio from rising in every year of the forecast (graph 2 on page 2). This is equivalent to about $13B on average every year. But keep in mind that this doesn't account for measures announced since the House of Commons rose for its summer recess. These include foregoing the GST on

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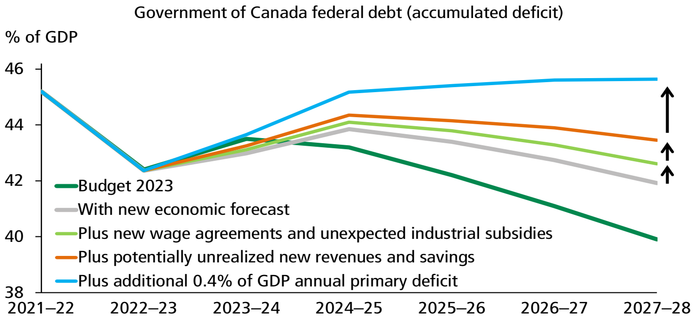
GRAPH 2
Federal Debt Will Undoubtedly Be Higher than in Budget 2023

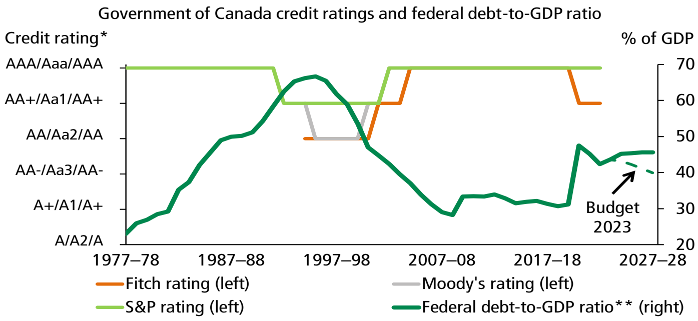


Sources: Finance Canada and Desjardins Economic Studies

purpose-built rentals (which we recommended in our recent note on increasing the housing supply in Canada), the change to the Canada Emergency Business Account repayment profile, and additional unplanned industrial subsidies. As such, some of this fiscal room has already been spent. And while a 0.4% of GDP annual change in the deficit may seem like a lot, we saw similar moves as recently as the time between the Fall Economic Statement 2022 and Budget 2023. Spending more than this risks putting the federal debt on an unsustainable path.

So what does this all mean for the federal government? It means that it needs to apply genuine spending restraint. And given the ballooning size of the federal public service, this could require staff reductions if savings can't be found elsewhere. It's unfortunate, but it may be the only way to ensure that long-term fiscal sustainability is maintained and the risk of further debt downgrades is reduced (graph 3).

GRAPH 3
The Government of Canada's Credit Quality Remains High for Now



*End of fiscal year; **Worst case scenario from Graph 2.
Sources: Bloomberg, Finance Canada and Desjardins Economic Studies

What to Watch For

By Randall Bartlett, Senior Director of Canadian Economics, Tiago Figueiredo, Associate – Macro Strategy, Marc Desormeaux, Principal Economist, Marc-Antoine Dumont, Economist, and Francis Généreux, Principal Economist

UNITED STATES

MONDAY October 2 - 10:00

September	Index
Consensus	47.8
Desjardins	47.7
August	**47.6**

ISM Manufacturing index (September) – In August, the ISM Manufacturing index registered its highest reading since February 2023, rising from 46.4 to 47.6, which also marked its biggest monthly gain since March 2021. Yet it remains below 50, suggesting that the manufacturing sector's woes aren't over. Looking at the subindexes, the readings for new orders (46.8) and backlog of orders (44.1) remain relatively low. Based on the mixed signals we're still getting from the regional indexes, we don't anticipate much change in September's print.

WEDNESDAY October 4 - 10:00

September	Index
Consensus	53.5
Desjardins	54.0
August	**54.5**

ISM Services index (September) – Compared to its manufacturing counterpart, the ISM Services index remains relatively high. It even improved in August, coming in at 54.5, its highest reading since February. We expect it will have dipped slightly in September. The regional non-manufacturing indexes are showing mixed but modest results, and consumer confidence indexes have gone down. We're forecasting an ISM Services index reading of 54.0.

FRIDAY October 6 - 8:30

September	
Consensus	165,000
Desjardins	180,000
August	**187,000**

Job creation according to the establishment survey (September) – Net hires have picked up over the past two months, growing from 105,000 in June to 157,000 in July and 187,000 in August. But even that's well below the average for the first 5 months of the year (287,000). We expect something similar to August's number for September. Jobless claims were down quite a bit as of the week of the monthly jobs survey, and household confidence in the labour market has been flat this month. We don't expect the autoworkers' strike to have much impact on September's print, since most affected workers put in hours during the week of the survey. We expect around 180,000 jobs to be added and the unemployment rate to stay put at 3.8%.

FRIDAY October 6 - 15:00

August	In US$B
Consensus	11,300
Desjardins	16,000
July	**10,399**

Consumer credit (August) – Consumer credit slowed somewhat in July, registering an annualized increase of US$10.4 billion following June's US$14.0 billion gain. Still, it's surprising to see this kind of growth in the current high-interest-rate environment. That said, July's gain came primarily from an increase in revolving credit, which could be a sign that consumers are struggling to pay off the full amount of their monthly credit card and line of credit balances. We could be in for more of the same from August's print. There are also the effects of rising gasoline prices to factor in, not to mention the return of student loan payments. We're forecasting a US$16.0 billion increase in consumer credit.

CANADA

THURSDAY October 5 - 8:30

August	$B
Consensus	-1.41
Desjardins	-1.20
July	**-0.99**

International merchandise trade (August) – Canada's trade deficit is expected to have widened in August. After July's sharp fall due to the British Columbia port strikes and Nova Scotia rail disruptions, imports should have partially recovered last month. This rebound is expected to have outpaced export growth, which was probably driven largely by higher oil prices. OPEC+ supply cuts coincided with the end of the US refinery maintenance season, which should support higher Canadian crude exports in September and especially October.

FRIDAY October 6 - 8:30

September	
Consensus	29,600
Desjardins	15,000
August	**39,900**

Labour Force Survey (September) – Employment likely rose by 15K in September, helping to fill the still-elevated number of job vacancies. That said, the working-age population is growing so quickly that a gain of that magnitude is unlikely to have been enough to keep the unemployment rate from rising 0.2% to 5.7%. According to the September CFIB small business survey, the number of respondents planning to hire workers slowed materially during the month. So while wage growth probably remained strong in September, the ongoing normalization of the labour market means slower wage gains might be on the horizon.

MONDAY October 2 - 5:00
August

Consensus	6.4%
July	**6.4%**

OVERSEAS

Eurozone: Unemployment rate (August) – The eurozone's unemployment rate is at an all-time low, coming in at 6.2% in June and July. But it's starting to tick up again in some countries, such as France. It's also surprising to see such a low rate in Germany (2.9%) despite the clear difficulties in its economy. We'll be curious to see if August's print shows signs of weakness starting to appear in the eurozone labour market.

Economic Indicators

Week of October 2 to 6, 2023

Date	Time	Indicator	Period	Consensus	Desjardins	Previous reading
UNITED STATES						
MONDAY 2	10:00	Construction spending (m/m)	Aug.	0.6%	0.2%	0.7%
	10:00	ISM Manufacturing index	Sept.	47.8	47.7	47.6
TUESDAY 3	---	Total vehicle sales (ann. rate)	Sept.	15,400,000	15,400,000	15,040,000
WEDNESDAY 4	10:00	ISM Services index	Sept.	53.3	54.0	54.5
	10:00	Factory orders (m/m)	Aug.	0.2%	0.4%	-2.1%
THURSDAY 5	8:30	Initial unemployment claims	Sept. 25–29	210,000	225,000	204,000
	8:30	Trade balance – goods and services (US$B)	Aug.	-65.2	-57.6	-65.0
FRIDAY 6	8:30	Change in nonfarm payrolls	Sept.	165,000	180,000	187,000
	8:30	Unemployment rate	Sept.	3.7%	3.8%	3.8%
	8:30	Average weekly hours	Sept.	34.4	34.4	34.4
	8:30	Average hourly earnings (m/m)	Sept.	0.3%	0.2%	0.2%
	15:00	Consumer credit (US$B)	Aug.	11,300	16.000	10.399
CANADA						
MONDAY 2	---	Bond markets closed (National Day for Truth and Reconciliation)				
TUESDAY 3	---	---				
WEDNESDAY 4	---	---				
THURSDAY 5	8:30	International trade ($B)	Aug.	n/a	-1.20	-0.99
FRIDAY 6	8:30	Net change in employment	Sept.	n/a	15,000	39,900
	8:30	Unemployment rate	Sept.	n/a	5.7%	5.5%

Note: Each week, Desjardins Economic Studies takes part in the Bloomberg survey for Canada and the United States. Approximately 15 economists are consulted for the Canadian survey and a hundred or so for the United States. The abbreviations m/m, q/q and y/y correspond to month-over-month, quarter-over-quarter and year-over-year change respectively. Following the quarter, the abbreviations f, s and t correspond to first estimate, second estimate and third estimate respectively. Times shown are Eastern Daylight Time (GMT - 4 hours). Desjardins Economic Studies forecast.

Economic Indicators

Week of October 2 to 6, 2023

Country	Time	Indicator	Period	Consensus m/m (q/q)	Consensus y/y	Previous reading m/m (q/q)	Previous reading y/y
OVERSEAS							
SUNDAY 1							
Japan	19:50	Tankan Large Manufacturers Index	Q3	6		5	
Japan	20:30	Manufacturing PMI – final	Sept.	n/a		53.9	
MONDAY 2							
United Kingdom	2:00	Nationwide house prices	Sept.	-0.4%	-5.6%	-0.8%	-5.3%
Italy	3:45	Manufacturing PMI	Sept.	45.9		45.4	
France	3:50	Manufacturing PMI – final	Sept.	43.6		43.6	
Germany	3:55	Manufacturing PMI – final	Sept.	39.8		39.8	
Eurozone	4:00	Manufacturing PMI – final	Sept.	43.4		43.4	
United Kingdom	4:30	Manufacturing PMI – final	Sept.	44.2		44.2	
Eurozone	5:00	Unemployment rate	Aug.	6.4%		6.4%	
Australia	23:30	Reserve Bank of Australia meeting	Oct.	4.10%		4.10%	
TUESDAY 3							
Japan	20:30	Composite PMI – final	Sept.	n/a		51.8	
Japan	20:30	Services PMI – final	Sept.	n/a		53.3	
New Zealand	21:00	Reserve Bank of New Zealand meeting	Oct.	5.50%		5.50%	
WEDNESDAY 4							
Italy	3:45	Composite PMI	Sept.	n/a		48.2	
Italy	3:45	Services PMI	Sept.	50.1		49.8	
France	3:50	Composite PMI – final	Sept.	43.5		43.5	
France	3:50	Services PMI – final	Sept.	43.9		43.9	
Germany	3:55	Composite PMI – final	Sept.	46.2		46.2	
Germany	3:55	Services PMI – final	Sept.	49.8		49.8	
Eurozone	4:00	Composite PMI – final	Sept.	47.1		47.1	
Eurozone	4:00	Services PMI – final	Sept.	48.4		48.4	
United Kingdom	4:30	Composite PMI – final	Sept.	46.8		46.8	
United Kingdom	4:30	Services PMI – final	Sept.	47.2		47.2	
Eurozone	5:00	Producer price index	Aug.	0.6%	-11.6%	-0.5%	-7.6%
Eurozone	5:00	Retail sales	Aug.	-0.5%	-0.9%	-0.3%	-1.0%
THURSDAY 5							
Germany	2:00	Trade balance (€B)	Aug.	14.1		16.0	
France	2:45	Industrial production	Aug.	-0.5%		0.8%	2.7%
United Kingdom	4:30	Construction PMI	Sept.	50.0		50.8	
FRIDAY 6							
India	0:30	Reserve Bank of India meeting	Oct.	6.50%		6.50%	
Germany	2:00	Factory orders	Aug.	1.5%	-7.9%	-11.7%	-10.5%
France	2:45	Trade balance (€M)	Aug.	n/a		-8,089	
France	2:45	Current account (€B)	Aug.	n/a		-2.0	
Italy	4:00	Retail sales	Aug.	0.0%		0.4%	2.7%

NOTE: Unlike release times for US and Canadian economic data, release times for overseas economic data are approximate. Publication dates are provided for information only. The abbreviations m/m, q/q and y/y correspond to month-over-month, quarter-over-quarter and year-over-year change respectively. Times shown are Eastern Daylight Time (GMT - 4 hours).