

Federal Fall Economic Statement

Competitiveness: Takin' Care of Business

Douglas Porter, Chief Economist • douglas.porter@bmo.com • 416-359-4887;

Michael Gregory, Deputy Chief Economist • michael.gregory@bmo.com • 416-359-4747

Ottawa's Fall Economic Statement reveals a brighter federal fiscal picture than the Budget of nine months ago, opening the door for some new policy measures. And, as widely expected, the centrepiece of the update was a major-league ramping up of depreciation allowances on business capital spending. This big-ticket item (which will alone cost almost \$5 billion in FY19/20), along with a sprinkling of other measures, will more than absorb the moderate revenue windfall, with the budget deficit now expected to tick up slightly in the next fiscal year (which begins next April). Notably, buried in the fine print is the fact that the budget estimates include \$1.75 billion of "non-announced measures" in this fiscal year, that cumulate to \$9.5 billion over six years, which may possibly include—among other items—provisions for compensation for farmers.

Real GDP growth for this year is actually tracking a tad below the initial Budget plan, but next year's outlook has been upgraded largely due to less uncertainty on the NAFTA/USMCA front. While the recent pronounced weakness in oil prices is a concern, the 2018 Budget had been based on WTI prices close to today's levels. Finance now expects the deficit to come in at \$18.1 billion this year and \$19.6 billion next (both a bit less than 1% of GDP), versus the initial estimate of \$18.3 billion on average. There is still no intention to aim for a return to balance in the foreseeable future. **The major focus of today's Statement, however, was not on the finer points of the fiscal outlook; instead, it was on the steps taken to help support business competitiveness.**

The policy changes: As largely expected, Ottawa's big response to the aggressive U.S. corporate tax package was accelerated depreciation for business investment. It will be immediate expensing (100%) for manufacturing and processing machinery and equipment, along with clean energy equipment (these had 25% depreciation rates before). The depreciation rate for computer software will be doubled from the current 50%; so it, too, becomes 100%. All other depreciation rates will be tripled. For example, the previous 27.5% for computers will be raised to

Fiscal Outlook

(C\$ billions, unless otherwise indicated)

	17/18	18/19	19/20	20/21
			forecast	
Revenues	313.6	328.9	339.2	352.1
Expenditures	332.6	344.1	355.8	367.2
Program Spending	310.7	320.2	328.3	337.3
Public Debt Charges	21.9	23.8	27.5	29.9
Adjustment for Risk		(3.0)	(3.0)	(3.0)
Budgetary Balance	(19.0)	(18.1)	(19.6)	(18.1)
(% of GDP)	(0.9)	(0.8)	(0.8)	(0.8)
Federal Debt	671.3	687.7	707.3	725.5
(% of GDP)	31.4	30.9	30.5	30.3
Budgetary Balance	(19.0)	(18.1)	(19.6)	(18.1)
Previous Estimate ¹	(19.9)	(18.8)	(17.8)	(16.5)
Change	0.9	0.7	(1.8)	(1.6)

¹ From 2018 Budget; After accounting changes Source: Federal forecasts () = deficit

Economic Assumptions

(percent)

	— 2018 —			— 2019 —		
	Budget	Current	BMO	Budget	Current	BMO
Real GDP Growth	2.2	2.0	2.1	1.6	2.0	2.0
Nominal GDP Growth	4.0	4.2	4.3	3.5	4.1	4.2
3-month T-Bill	1.4	1.4	1.4	2.0	2.1	2.2
10-year GoC	2.3	2.3	2.3	2.8	2.8	2.7

82.5%; on freight-hauling trucks and tractors, the new rate will be 60%, up from 20%. The new depreciation rates apply to investments made after November 20th. They will be gradually phased out starting in 2024, and will no longer be in effect after 2027. The cost to the government is estimated to be \$0.5 bln in the remaining four months of the current fiscal year (ending March), which jumps to \$5.0 bln next year. The cumulative cost by FY23/24 is projected at \$14.4 billion.

This measure, along with the lifting of NAFTA uncertainty (once the USMCA is signed by November 30) could combine to meaningfully spark investment. After a strong 6.4% average gain in real business fixed investment this year, we were forecasting it to ebb to about 3% in 2019 and 2020. There's now some upside risk to our forecast, which could provide at least a partial counterweight to the rising pressure from weak domestic oil prices.

Nothing Personal: With the intense focus on business competitiveness, there was no mention of another important competitive issue—our world-topping personal marginal tax rates. With top marginal rates of more than 53% in the two largest provinces, attracting top talent is a strain, especially in a world of tight job markets.

Economic outlook lifted on trade relief: A slightly firmer economic outlook for next year, even with the recent market volatility and slide in oil prices, provided Ottawa with some fiscal wiggle room. Real GDP growth for 2019 is now expected to come in at 2.0% versus the Budget expectations of just 1.6%. The medium-term forecast, however, has not increased despite some indications that potential growth has stepped up on strong population growth—real GDP is expected settle down to 1.8% between 2019 and 2023. Nominal GDP growth is similarly expected to come in well above initial expectations for next year at above 4%, boosting tax revenues, while a better labour market has pulled down program spending (lower EI benefits and other transfers). Notably, the biggest source of improvement in Ottawa's finances this fiscal year has flowed from much higher-than-expected income taxes, both of the corporate and personal variety.

Debt tracking slightly higher: Total debt is now pegged at \$688 billion this fiscal year, up from \$670 billion in the Budget plan, with the difference almost entirely due to a restating of the government's finances a few months ago. As a share of GDP, debt will actually dip slightly to 30.9% this year from 31.4% last year, and the revised deficit path will still allow that ratio to keep falling through the forecast horizon (to below 30% by FY 21/22). The prevailing assumption is that a stable net debt-to-GDP ratio is the de facto fiscal anchor.

The Bottom Line: Today's measures will provide important support to business capital spending, which should already find some foundation from reduced uncertainty on the Canada-U.S. trade outlook. Will today's steps be enough to quell the rising tide of competitiveness concerns? In a word: Probably not, at least not by themselves. **Today's announcement is a good first step in strengthening the business climate in Canada—but we would encourage an even more forceful response in coming months to the multitude of competitive challenges now facing the economy.** While Ottawa will get yet another chance in next year's pre-election Budget, we suspect the focus will revert back to some key social policy goals (say, pharmacare?) and away from business challenges at that time.

General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site <http://economics.bmocapitalmarkets.com>. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Corporation Limited, used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

© Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group