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FEDERAL BUDGET
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Douglas Porter, CFA, Deputy Chief Economist

Robert Kavcic, Economic Analyst

1-800-613-0205

www.bmonesbittburns.com/economics

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Highlights

- **New Tax-Free Savings Accounts: \$5,000 annual limit, starting in 2009**
- **Only modest additional stimulus, as advertised**
- **No further changes on personal rates**
- **No new moves on direct capital gains relief, dividend tax credit will slip**
- **Factories get a small break, as expected**
- **Only small surpluses in next two years, after \$10 billion this year**

Overview—There Will be Savings

The centrepiece of the third budget by the Conservative government is clearly the new Tax-Free Savings Accounts (TFSA). This program will start in 2009 and allow all Canadians 18 and over to invest up to \$5,000 per year in a registered account, which can grow tax-free (for a full description, see page 5). This is a relatively low-cost move (Ottawa estimates it will cost \$3 billion annually when fully mature in about 20 years), which may be partially aimed at alleviating any disappointment over the lack of broad-based direct relief on capital gains. Other than this high-profile step, this year’s budget was nearly devoid of major new crowd-pleasing measures due to the combination of a darkening economic backdrop in North America and Ottawa’s decision to cut taxes broadly last October. Even the ever-present possibility of a snap election this spring prompted only modest new initiatives aside from the tax-free savings plan.

The main themes in this budget were reinforcing the earlier tax relief, providing some support for the battered manufacturing sector, introducing modest new measures for the environment and increased infrastructure outlays. Finance Minister Flaherty projects an increase of just 3.4% in program spending in the coming fiscal year, half the 6.8% rise in FY07/08, keeping outlays broadly stable as a share of the economy at just over 13% (*Chart 1*).

CHART 1
Spending restraint
 Program Spending – Canada (y/y % chng)

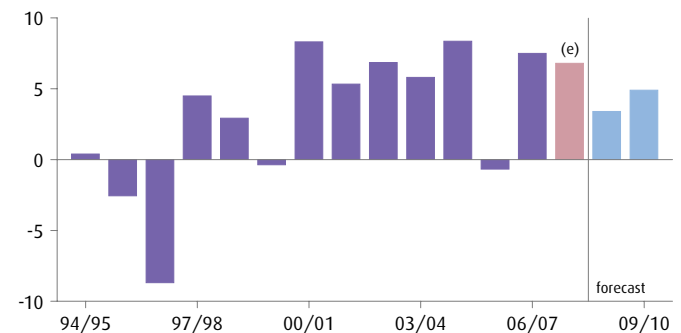
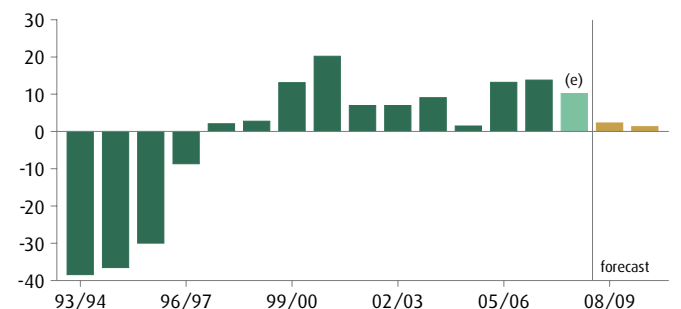


CHART 2
Federal budget balances
 Canada (C\$ blns)



11 years of surplus and counting...

The one notable wrinkle on the economic and fiscal projection side was that Finance is now expecting very small surpluses of just \$2.3 billion and \$1.3 billion over the coming two fiscal years (*Chart 2*). That's a far cry from a three-year string of surpluses north of \$10 billion. There are two possible conclusions: 1) after a stream of large surpluses, Ottawa simply does not view debt reduction as a high priority, or 2) given the string of high-side budget surpluses in recent years, these forecasts may prove overly conservative yet again. Note that even with \$2.7 billion of new measures in today's budget for the current fiscal year (including the earlier announcement of \$1 billion for traditional industries), Ottawa still expects a \$10.2 billion surplus for FY07/08 (*Table 1*).

Despite the absence of direct capital gains relief, the budget should be greeted favourably by Canadian investors, as the tax-free savings accounts offer a new, flexible alternative. The budget is broadly neutral for the Canadian dollar, as the major stimulus measures were long ago put in place, and there were no major surprises in terms of the overall fiscal thrust. However, there could be some mild concern over how close Ottawa will be to a deficit in the next few years, especially at a time when the other half of the twin surpluses (current account) is fading rapidly. Bond markets may also raise an eyebrow over the big shift in Ottawa's net borrowing requirements from being a net "source" of funds this year of \$17 billion, to net requirements of \$15.4 billion in the coming fiscal year. Still, the ongoing improvement in Ottawa's debt position versus the renewed deterioration in Washington's finances is a relative plus for both the loonie and long-term interest rates. Of course, this is all based on the assumption that the budget will be passed by the minority parliament—it appears that the Liberals are not keen to force an election at this point, which may well see this budget through.

Key Measures—Atonement

1. Tax-Free Savings Accounts: This is a welcome addition to the choices available to Canadian savers (see next section for the full details). Given the prolonged period of low interest rates, which doesn't seem poised to go away anytime soon, this step should encourage a modest rise in Canada's low savings rate (just 1.7% in 2007) in the years ahead.

2. Capital Gains Relief—not here, not now: In contrast to the good news on savings, there was no direct relief for capital gains in the budget. This will be a small disappointment. As well, to counter the positive impact of corporate tax cuts, Ottawa will trim the dividend tax credit starting in 2010, boosting the effective rate of taxation on dividend income, another moderate setback.

3. Depreciation Allowance for Manufacturing: Ottawa is extending 50% depreciation allowances for manufacturers for another year, and then slightly less rapid allowances in the next two

TABLE 1

Fiscal outlook

(C\$ billions, unless otherwise indicated)

	actual 06/07	estimate 07/08	forecast	
			08/09	09/10
Revenues	236.0	244.5	241.9	252.0
Expenditures	222.2	234.3	239.6	250.7
Program Spending	188.3	201.2	208.1	218.3
Public Debt Charges	33.9	33.1	31.5	32.4
Budgetary Surplus	13.8	10.2	2.3	1.3
Planned Debt Reduction	14.2	10.2	2.3	1.3
Remaining Surplus	-0.4	—	—	—
Net Public Debt	467.3	457.1	454.8	453.5
Debt/GDP (percent)	32.3	29.9	28.7	27.5

Note: Totals may not add due to rounding.

Source: Federal forecasts

years. This is the most significant move to support battered factories in the budget. While an important step, this likely falls well short of what the sector was looking for in terms of overall relief. Given the widespread pressures manufacturing faces, Ottawa simply does not have the resources to fully cushion the blow for factories.

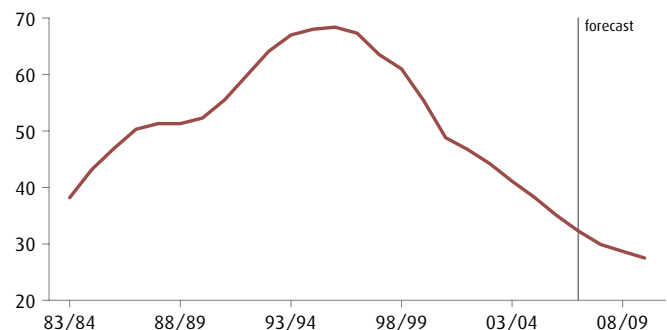
- 4. Infrastructure spending:** Faced with a still-large surplus for the fiscal year ending in March, Ottawa front-loaded a few key measures. Notably, Finance will set aside \$500 million for capital spending on public transit. Longer term, Ottawa announced that it will make the \$2 billion Gas Tax Fund for municipalities permanent.
- 5. The Environment:** While this certainly wasn't billed as a green budget, it did contain at least a few measures aimed at protecting the environment. For instance, \$250 million was allocated for commercializing carbon capture and storage.
- 6. Crime:** Ottawa set aside \$400 million to recruit 2,500 new police officers.
- 7. Debt Reduction:** The \$10 billion net debt pay-down for the current fiscal year will cut the debt/GDP ratio to just below 30% as of the end of March (*Chart 3*). This key ratio is expected to drop below the medium-term target of 25% by FY11/12 (just four years from now).

Tax Free Savings Account

The major item in today's budget was the introduction of the Tax Free Savings Account, which will allow Canadians to invest up to \$5,000 (indexed to inflation in increments of \$500) tax free outside of their RRSP starting in 2009. Similar to the U.S. Roth IRA, the TFSA allows savings to accumulate free of taxes on interest, dividends and capital gains. Unused contributions can be carried forward to future years, while withdrawals can be returned to the account without affecting contribution room.

Importantly for retirees and low income Canadians, and unlike RRSP withdrawals, income derived from the TFSA will not impact calculations for other Federal programs like OAS, GIS and EI. While TFSA contributions will be made in after-tax dollars and won't allow for a RRSP-like tax deduction, withdrawals will not be treated as taxable income and can be made at any time. This will offer an additional simple and effective planning mechanism for Canadians, and should provide a boost to overall savings in a low interest rate environment. Younger investors in low tax brackets expecting to make a large purchase down the road (i.e. a house or car) will likely be big users, as will retirees with investment income outside their RRIF. More generally, the TFSA will offer an after-tax return advantage over RRSPs when an

CHART 3
Federal debt-to-GDP ratio still sliding
Canada (percent)



individual's income tax rate is relatively low (i.e. not fully reaping the benefit of the RRSP deduction).

The new plan will bear little cost in its early years as plan assets accumulate—fitting given the current backdrop of heightened economic uncertainty. Estimated costs are just \$5 million in 2008/09 and \$50 mln in 2009/10, and are ultimately projected to grow to \$3 billion annually in twenty years. To put that number in perspective, it's equal to the fiscal cost of about a half-point cut in the GST.

Debt Management Strategy

The budget includes the FY08/09 Debt Management Strategy. Beginning this year (and as announced in last year's budget), the borrowing requirements of Business Development Bank of Canada, Canada Mortgage and Housing Corporation and Farm Credit Canada will be consolidated into Government of Canada (GoC) requirements. This will increase GoC debt issuance by \$15 billion in FY08/09, with \$10 billion allocated to Treasury bill issuance and \$5 billion to bonds.

The fixed-rate share of the debt is expected to remain at 62% in 2008/09, down from two-thirds in FY02/03, but higher than the 60% anticipated last year. This is the result of a larger-than-expected financial source and reduced Treasury bill issuance. For the coming fiscal year, there will be a \$23 billion increase in Treasury bills outstanding to \$140 billion by March 2009, while the stock of bonds will fall \$1 billion to \$252 billion. Within the bond program, net issuance for the four nominal benchmarks and the 30-year Real Return Bond will remain little-changed from the prior year.

Economic Assumptions—Sticking to the Script

Ottawa stuck to the recent convention of basing the economic assumptions on the latest private sector consensus (*Table 2*). This strategy has the benefit of allowing the federal government to employ a neutral forecast, neither overly rosy nor overly cautious. As is typically the case, we thus have no major quarrel with the economic forecast. We are a shade less upbeat on GDP growth this year at 1.5% versus the budget's projection of 1.7%, but are a shade more upbeat next year at 2.5% versus the budget's assumption of 2.4%. Yesterday's IMF report on Canada called for growth of 1.8% this year. Three-month interest rates are expected to average 3.2% this year and 3.8% next year, only slightly different from our call of 3.1% and 3.9%. However, their assumption for 10-year bond yields is slightly lower than ours, at 3.6% this year and 4.2% in 2009, and may prove low for a change.

The perennial high-side surplus surprises from Ottawa in recent years—regardless of the political stripe of the prevailing government—have been due to the multiple layers of prudence built into the forecasts. This government has previously stressed that it has no interest in continuing to run large-scale

TABLE 2
Economic assumptions
(percent)

	2007	Ottawa 2008	2009	BMO Capital Markets 2008	2009
Real GDP Growth	2.6	1.7	2.4	1.5	2.5
Nominal GDP Growth	5.7	3.5	4.3	4.1	5.4
3-Month T-Bill Yield	4.2	3.2	3.8	3.1	3.9
10-Month GoC Yield	4.3	3.6	4.2	3.9	4.4

surpluses, and yet the FY07/08 surplus will still be north of \$10 billion. Last year's budget called for GDP growth of 2.3% in 2007 and average 3-month interest rates of 4.2%—they were a bit high on rates, and a tad cautious on growth. But while the economic forecasts were close, revenues came in almost \$4 billion above expectations and program spending was almost \$1 below expectations. Booming resource revenues and low long-term interest rates again helped Ottawa post yet another hefty surplus.

This year's economic forecasts appear broadly appropriate. But with commodity prices holding up remarkably well in recent weeks even amid a clear softening in U.S. growth, there is a good chance revenues will surprise to the high side yet again in the coming year.

Market Impact—Year of the Loonie Was So Last Year

Canadian dollar: Today's budget is unlikely to make a major impact on the Canadian dollar. The net new stimulus is trivial at roughly 0.2% of GDP, and largely as expected. Canada's rock-solid fiscal backdrop sets it aside from other major industrialized economies, although there will no doubt be at least some concern over the very modest projected surpluses over the next two years. From a larger perspective, record commodity prices, even with a weakening U.S. economy, will provide important support for the Canadian dollar, likely keeping it close to parity through this year. However, the steady erosion in Canada's trade surplus threatens to erase one of the twin surpluses (current account), and a deeper U.S. downturn could ultimately remove the other twin as well (the budget surplus), eventually weighing more heavily on the loonie later this year.

Bonds: The modest new fiscal stimulus measures, largely anticipated beforehand, and the heavy-duty tax cuts already in place should support continued strength in domestic demand. However, this budget should make no impression on the odds of further near-term easing by the Bank of Canada. We expect a moderate back-up in long-term interest rates in the second half of the year, assuming a mild U.S. recovery and some lingering concerns about global inflation pressures. We also look for Canadian/U.S. spreads to dip back into the red (as Canadian bonds relatively outperform their Treasury counterparts), despite the emergence of a \$15 billion borrowing requirement by the federal government in the coming fiscal year. The ace in the hole for Canadian bonds is that the net supply backdrop remains a major positive; the debt-to-GDP ratio has dropped below 30%, even as it threatens to start backing up again in the United States.

Stocks: The major focus for equity markets from this year's budget is the trade-off between the new tax-free savings plan versus a lack of specific relief for capital gains. While the latter is a disappointment, stocks are, in any event, much more focused on the cloudy outlook for the U.S. economy, and the amazing resiliency of commodities in this uncertain environment.