2025

Federal Budget Preview

Turning Over a New Leaf

Major Spending Reallocation

Budget 2025, set to be released on November 4, will include a major reallocation of funding. The government plans to boost capital expenditures that stimulates public and private sector capital investment and reduce day-to-day operational costs. The details of this reallocation will be outlined according to the new capital budgeting framework introduced by Finance Canada in early October.

This spending reallocation is driven by two key factors. First, geoeconomic shifts and lagging business investment in Canada make it necessary to build new supply capacity in strategic and productive areas. Second, the federal government has a responsibility to keep away fiscal jitters observed in global bond markets tied to unsustainable paths in the U.S., U.K., France and Japan.

In a nutshell, the federal government has chosen the IMF's approach detailed in its most recent edition of the Fiscal Monitor: *Spending Smarter: How Efficient and Well-Allocated Public Spending Can Boost Economic Growth approach.*

Font-Loaded Consolidation of Day-to-Day Operational Spending

The federal government has already planned a cumulative 15% reduction over three years to approximately $180–$200 billion identified as operational spending. Federal transfers to persons and health care transfers are expected to be maintained, meaning a reorganization of how other public services are delivered may be required to find savings. As a result, staffing levels could decline based on the number of full-time equivalents.

The government intends to cut operational spending by 7.5% in FY 2026–27, half of the cumulative 15% reduction planned by FY 2028–29. The intention to find savings quickly suggests the FY 2025–26 deficit may be very large, possibly in the range of $90–$100 billion. It may also imply the federal government will do everything it can to ensure such deficit remains a temporary blip. By front-loading savings in FY 2026–27—rather than waiting until years 3, 4, or 5 of the usual 5-year fiscal plan—the government aims to reassure credit rating agencies. Earlier this year, Fitch commented on a shift in spending priorities under Prime Minister Carney, specifically the de-prioritization of social spending; however, the agency was uncertain about the extent of the planned cuts.

Capital Budget Expenditures: Budget Success will Depend on the Economic Multiplier

The federal government's capital expenditures will be divided into six categories. The central objective of Budget 2025 is to offer the right fiscal incentives to increase housing supply, strengthen national defence, improve supply chains, unlock untapped natural resources potential, and diversify trade toward markets outside the U.S.

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Ultimately, the success of Budget 2025 will depend on how businesses respond. It all comes down to economic multipliers. These are difficult to estimate with precision. According to the World Bank, public investment multipliers are slightly above 1. In contrast, the U.K.'s Office for Budget Responsibility estimates that a 1% increase in public investment could raise potential output by only 0.5% after five years.

In Canada, the Parliamentary Budget Officer estimates fiscal multipliers of 0.6%–0.7% over five years for business and infrastructure measures. Given the new commitment to strategic defence spending, it's worth noting that the multiplier associated with military spending is close to or below 1, with larger shorter-run effects and generally a smaller GDP impact relative to non-military fiscal easing.

Existing research on the multipliers of large-scale projects is limited; however, the five large-scale projects recently identified by the Major Projects Office may deliver a multiplier effect greater than 1.

Furthermore, business sentiment remains low due to economic uncertainty—another key factor influencing multipliers. The IMF explains economic uncertainty can reduce the multiplier when the private sector becomes more cautious. However, if the federal government finds the right dose of stimulus, it could improve the private sector's expectations about the economic outlook, unlocking a stronger economic response.

Lastly, the monetary policy stance is another key factor to consider. In contrast to the 2008–09 and the pandemic periods, monetary policy is unlikely to be as supportive this time. Fiscal stimulus is less effective when interest rates are not near 0% and without quantitative easing.

Spending Smarter to Reinforce Fiscal Sustainability

With intended savings to day-to-day operational spending, Ottawa could free up to $15 billion in FY 2026–27 and a recurring annual amount of $30 billion in the medium term. Part of these savings will be redirected to capital budget expenditures, while the rest will contribute to ensuring the reduction of the deficit over time. In turn, the amount allocated to capital expenditures—and the resulting economic multiplier—will shape the future path of fiscal sustainability notably derived from the deficit-to-NGDP and net debt-to-NGDP ratios.

The federal budget's economic forecasts are usually based on the average projection made from private sector economists. These projections for variables like NGDP were made prior to Budget 2025 and thus without fully accounting for—and possibly underestimating—the scale of the new fiscal impulse coming from capital expenditures. One possibility is that Budget 2025 could include an upside adjustment to NGDP, based on transparent multipliers assumptions.

The NGDP path assumed in Budget 2025 may be sufficiently solid to bring down the deficit-to-NGDP and net debt-to-NGDP ratios over time. As such, these metrics could look better in Budget 2025 relative to the latest forecast made by the Parliamentary Budget Officer. The PBO notably projected the net debt-to-NGDP ratio to rise slightly, from 41.7% in FY 2024–25 to 43.7% over time, although this projection did not factor in the NATO commitment to boost defence spending and 15% intended operational spending cuts.

$90B–$100B Deficit in FY 2025–26, Then What?

The PBO also projects a FY 2025–26 deficit of $68.5B (2.2% of NGDP). If some of the new capital formation incentives take effect before the end of FY 2025–26, the shortfall could be larger. A $90B–$100B deficit—close 3% of NGDP—should not threaten Canada's AAA credit rating if it is temporary. Since significant savings on day-to-day operational spending are set to begin in FY 2026–27, there is a chance the deficit could decline materially and quickly enough to ease fiscal sustainability concerns.

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The new capital budget framework will allow market participants to see how much of the deficit each component will represent. Ideally, Budget 2025 should show a declining share of the annual deficit coming from operational spending over time, possibly reaching zero by FY 2028–29. The remaining structural deficit—possibly ranging between $50B–$70B—would be driven only by capital expenditures. These deficits would represent less than 2% of NGDP, a manageable figure that avoids a surge in the net debt-to-NGDP ratio.

This new layer of transparency provided by this capital spending framework reduces the needs for fiscal anchors. The previous unachieved fiscal anchor under the Trudeau–Freeland era aimed to keep the annual deficit at 1% of NGDP. Having the same fiscal anchor today would require almost unattainable levels of spending restraint in the short run. Moreover, it would be illogic to introduce a new fiscal anchor before the USMCA negotiations are concluded in 2026.

International Fiscal Discrepancy: Keeping Bond Market Stress Away from Canada

Maintaining strong market perception of Government of Canada bonds is imperative. A temporary FY 2025–26 deficit of $90B–$100B would represent close to 3% of NGDP—far below the deficits-to-NGDP ratios of 5%-6% of the U.S., U.K. and France. The IMF recently estimated global fiscal deficit to be the persistently high at 5% of NGDP.

Canada is not part of this group and Budget 2025 must deliver to prevent stepping onto such slippery slope. For example, in the U.S., the real interest rate is no longer lower than the real growth rate. Staff at the Dallas Federal Reserve has found that the rising U.S. debt-to-GDP ratio is pushing up long-term interest rates through a higher term premium. Long gone are the days when an annual primary deficit of 1% only cost governments a few basis points on the yield curve.

Budget 2025 must also maintain the federal debt servicing ratio close to the current manageable figure of 2% (compared to 3% in the U.S. and 3.7% in the U.K.). Otherwise, Canada would become more exposed to market jitters in the form of higher long-term rates. This, in turn, would offset the stimulus effect of the federal government's well-intended capital formation policies.

The fiscal challenges faced by the U.K. and France serve as dire warnings. In the U.K., Chancellor Rachel Reeve is widely expected to raise taxes for a second year in a row in Budget 2025, to be released at the end of November. In France, proposed deep spending cuts and tax hikes for 2026 have triggered social and political unrest, contributing to supress the economic multiplier.

Debt Management Strategy: Thoughts on FY 2026–27

A fall budgetary cycle focusing on FY 2026–27 should ideally incorporate the release of a detailed debt management strategy (DMS) for FY 2026–27. Fundamentally, the long process of capital formation is better supported with additional issuance of 5s/10s than 2s. For instance, defence investment requires predictable funding.

However, this could be offset by the steeper yield curve. As a result, the average term to maturity of Government of Canada (GoC) bonds may not change materially. In fact, it has remained stable over the past decade. As of June 2025, the weighted average maturity (WAM) of GoC debt was about eight years—higher than other AAA countries like Australia and Germany.

The GoC 30-year bond yield, close to a 3-year high of 3.60% as of mid-October, has been lifted this year by the international spillover effect related to fiscal jitters in the U.S., France, the U.K. and Japan, in addition to lower structural demand for 30-year bonds from U.K., Japanese and Dutch pension funds. Combined with the Bank of Canada's most recent easing adjustment, the 2s–30s Canadian yield curve has steepened by about 30 basis points since the mid-July release of the FY 2025–26 DMS, reaching 1.29%

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A steeper yield curve doesn't automatically justify issuing more short-term bonds. For instance, when the 2024 federal budget was released in April, the yield curve was slightly inverted. Yet, the FY 2024–25 DMS called for a $26B increase in combined issuance of 5-year and 10-year bonds, while the 30-year sector saw only a modest $2B increase.

Granted, the FY 2025–26 DMS incorporated higher issuance increases of 2s and 5s relative to 10s and 30s. This choice may have been made for two reasons, still valid for the upcoming FY 2026–27 DMS. First, to slow the rise in the average effective interest rate on GoC marketable debt, which was 2.9% in FY 2023–24 and likely slightly above 3% today. Second, Canada faces limits in issuing 30-year bonds given that the U.S. 30-year bond yield is about 100 basis points higher.

Regarding the topic of bonds labeling, Prime Minister Mark Carney announced the launch of the Defence Investment Agency in September to oversee rebuilding assets in the Canadian Armed Forces. Despite this, the odds of launching defense bonds in Budget 2025 remain low in our view. These defense bonds appear more suitable for the E.U. shift toward a war economy. The first European 5-year defense bond was launched last September, generating $2.8 billion in orders from 140 institutional investors. Luxembourg released its defence bond framework a few days ago.

The odds related to an increase green bond issuance in FY 2026–27 are higher than launching defense bonds. One objective of the five major nation-building projects is to "*unlock new markets, and position Canada as both a clean-energy and conventional-energy superpower*". This could lead to a $1-$2 billion bump in annual green bond issuance. Annual green bond issuance has been stable at $4 billion in recent years but has declined from 2% to 1.3% relative to the total size of GoCs issuance ($204B in FY 2023–24; $241B in FY 2024–25; $315B in FY 2025–26).

Finally, Real Return Bonds (RRBs) may return in the next DMS. The federal government stopped the issuance of RRBs in November 2022. Earlier this summer, the Global Risk Institute reported potential risks associated with this cancellation, such as higher debt servicing costs and a reduced toolkit for investors looking to hedge inflation. The world is moving into a regime plagued with more frequent and severe supply-induced inflation shocks, as recently cited by the BoE and BoC, an environment suitable for inflation-linked bonds. The Pension Investment Association of Canada has also called for the reinstatement of RRBs.

Takeaway

Budget 2025 could be one of the most significant in our lifetime. Financial markets will be watching to see how the federal government respects the fine line of propelling economic gains and maintaining fiscal sustainability. The telegraphed reallocation of spending and the new capital spending framework suggests this balance will be a cornerstone of Budget 2025.

Financial markets and credit agencies will wait to see how the federal government follows through on its plans. A fiscally sustainable outcome is not guaranteed. Overcoming today's economic uncertainty with fiscal incentives won't be an easy feat.

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