March 2005
IMF Country Report No. 05/118

Canada: 2005 Article IV Consultation—Staff Report; Staff Statement; and the Public Information Notice on the Executive Board Discussion for Canada

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Canada, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 1, 2004, with the officials of Canada on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 25, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of February 16, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 16, 2005 discussion of the staff report that concluded the Article IV consultation.

The document listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 2005 Article IV Consultation

Prepared by the Western Hemisphere Department
(in consultation with other departments)

Approved by Christopher Towe and Carlo Cottarelli

January 25, 2005

- ***Discussions for the 2005 Article IV Consultation concluded in Ottawa on December 1, 2004.*** The staff team comprised T. Bayoumi (Head), M. Mühleisen, I. Ivaschenko, A. Justiniano, R. Luzio (all WHD), and K. Alexandraki (PDR). Mr. Kruger, Advisor (OED) participated in the discussions. Mr. Towe attended some of the meetings in Ottawa, including the concluding session.

- ***The team met with representatives from both the public and private sectors.*** Discussions were held with Bank of Canada Governor Dodge and Deputy Finance Minister Bennett, as well as other senior officials from Finance Canada, the Bank of Canada, the Office of the Superintendent of Financial Institutions, Health Canada, Human Resources Canada, the provinces of British Columbia and Ontario, and the Ontario Securities Commission. The team also met with three major banks, the PEAP forecasting group, the Fraser and C.D. Howe Institutes, the Toronto Stock Exchange, and the Canadian Labour Congress.

- ***The staff report for the 2004 Article IV Consultation was discussed by the Board on February 18, 2004 and was subsequently published as IMF Country Report No. 04/61.*** Executive Directors commended Canada's strong monetary and fiscal policy framework. They agreed that macroeconomic policies should remain supportive of activity, with the principal responsibility lying with monetary policy. Directors agreed that federal and provincial fiscal authorities would need to sustain debt reduction and saw scope for strengthening incentives to contain health care costs and usage.

- ***Canada subscribes to the Fund's Special Data Dissemination Standard.*** The quality, coverage, periodicity, and timeliness of Canadian economic data are considered excellent, and metadata have been posted on the Fund's Data Standard Bulletin Board.

- ***ROSCs:*** A Data ROSC was published in October 2003, an FSAP was issued to the Board in January 2000, and a Fiscal ROSC was published in March 2002 (see Appendix I).

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EXECUTIVE SUMMARY

Since the mid-1990s, Canada has benefited from a strong institutional framework and continuing structural reforms. Inflation targeting, an objective of balanced budget or better for the federal budget, and structural reforms have yielded an enviable macroeconomic performance, including the fastest growth rate and the strongest budget position in the G-7.

The outlook for the economy is broadly favorable, but external developments are creating uncertainties. After a series of shocks in 2003, the economy rebounded over the last year. Looking forward, indicators point to a sustained expansion in 2005. However, the recent further appreciation of the exchange rate, uncertainty about the strength of net exports, and commodity price volatility complicate the situation, as does the low household saving rate.

The Bank of Canada appears to have room to maintain a patient and measured approach to withdrawing stimulus. The Bank has appropriately started to increase interest rates and further interest rate hikes will likely be needed. At the same time, the risks to the outlook, the absence of wage pressures, and anchored inflation expectations warrants a cautious and pragmatic approach to tightening.

Recent agreements with the provinces have all but removed room for fiscal maneuver. Given the very limited room, it will be important to weigh carefully the merits of spending programs versus further reducing the relatively high tax burden. The new objective of lowering the federal debt-to-GDP ratio to 25 percent within ten years adds a welcome anchor to the fiscal framework that can help prepare for the fiscal challenges of aging.

More needs to be done to ensure the sustainability and efficiency of the health care system. The major challenge will be to improve the system's efficiency, including through measures that improve incentives for both health care providers and consumers. While the responsibility for such reforms lies at the provincial level, it is important that a diversity of provincial strategies to control costs and reform public systems are encouraged.

The demographic shift and the ongoing challenges from increasingly globalized markets underscore the importance of further structural reforms. Recent policies have laid a solid foundation for future growth and created a favorable environment for business, but more can be done to lower the tax burden, minimize disincentives from social transfers, and reduce barriers to trade and competition.

Further reforms to Canada's sound financial system could promote flexibility in a rapidly changing global environment. The financial system remains sound, supported by the economic recovery and buoyant financial markets. Reforms could include further clarifying the regulatory framework governing bank mergers, adopting a single national securities regulator, and harmonizing regulation of defined benefit pension plans.

I. Introduction

1. ***Canada has grown rapidly over the last decade, although last year's consultation occurred against a challenging macroeconomic environment***. Since the mid-1990s, Canada has benefited from a strong institutional framework and continuing structural reforms—consistently supported by the staff—that have yielded the fastest growth rate among major industrial countries (Box 1 and Table 1). However, in 2003, a series of unexpected shocks that largely affected the external sector—including a case of BSE and exchange rate appreciation—weighed heavily on activity.

2. ***The economy rebounded over the last year***. Until recently, net exports provided significant support to an economy in which domestic demand has also continued to grow robustly. With capacity constraints a factor, the Bank of Canada has appropriately started to withdraw stimulus at a measured pace. Despite a number of new spending measures, the recovery and the prudent fiscal framework have again delivered budgetary surpluses.

3. ***The outlook for the Canadian economy is broadly favorable, but external developments are creating significant uncertainties***.[1] Indicators point to a sustained recovery in activity, supported by a pickup in investment, rising personal incomes, and buoyant profits. However, the recent further appreciation of the exchange rate, uncertainty about the underlying strength of net exports, and commodity price volatility complicate the outlook, underlining the importance of external shocks for an open economy whose exports are concentrated on the U.S. market and contain a high proportion of commodities.

4. ***Against this background, the mission focused on sustaining a balanced recovery and boosting labor productivity and flexibility***:

- *Macroeconomic policies*. In considering the pace of monetary tightening, the Bank of Canada will need to weigh carefully risks to the outlook and the absence of wage and price pressures against indications that slack is limited, while the fiscal authorities face the challenge of maintaining the social consensus for surpluses and sustained debt reduction.

- *Structural policies*. With rapid but relatively labor-intensive growth in recent years, significant external shocks, and questions about the sustainability of the public health care system, the team focused on policies to raise underlying labor productivity growth and economic flexibility, reduce pressures on public health spending, and further strengthen Canada's strong institutional framework.

[1] Chapter 1 of the *Selected Issues* paper examines external and domestic macroeconomic disturbances.

Box 1. Canada's Performance in International Context

A sound institutional framework and structural reforms have led to an enviable macroeconomic and fiscal performance since the mid-1990s. The macroeconomic framework has rested on inflation targeting and a federal fiscal commitment to balanced budgets or better. Structural reforms included reforms of the Employment Insurance system, tax cuts, and trade liberalization.

Since 1995, Canada's real GDP has expanded at the fastest rate among the G-7 (Table). Real GDP growth averaged 3½ percent a year over this period—2½ percent on a per capita basis. As a result, income differentials (using purchasing parity exchange rates) have narrowed with respect to the United States and remained above the rest of the G-7.

Canada has also recorded the strongest fiscal performance in the G-7 over the same period. Canada was the only major industrial country to record a surplus on the general government accounts in 2003. More generally, since 1995, the general government budget has been in balance on average, contributing to a reduction in the general government net debt ratio of about 35 percentage points of GDP. This has moved Canada's net debt ratio from second highest to the lowest within the G-7.[1]

Indicators of Economic Performance, 1995−2003 1/

	Real GDP		GDP Per	General Government (as % of GDP) 3/			
				Fiscal Balance		Net Debt	
	Growth	Per Capita Growth	Capita 2/ 2003	Average	2003	Change 1995-2003	2003
Canada	**3.5**	**2.5**	**31,942**	**-0.1**	**0.6**	**-35.0**	**34.3**
France	2.2	1.8	27,047	-3.0	-4.1	5.2	44.1
Germany	1.2	1.1	28,104	-2.5	-3.8	12.3	51.9
Italy	1.5	1.5	27,480	-3.4	-2.5	-12.1	97.1
Japan	1.2	1.0	28,278	-6.2	-7.7	54.6	79.1
United Kingdom	2.8	2.4	27,777	-1.3	-3.5	-4.0	34.9
United States	3.3	2.1	38,031	-1.3	-4.6	-14.3	42.8
Unweighted average excluding Canada	**2.0**	**1.6**	**29,453**	**-3.0**	**-4.4**	**6.9**	**58.3**

Sources: IMF, *World Economic Outlook;* and OECD, *Economic Outlook.*

1/ Average 1995 - 2003 unless otherwise indicated.

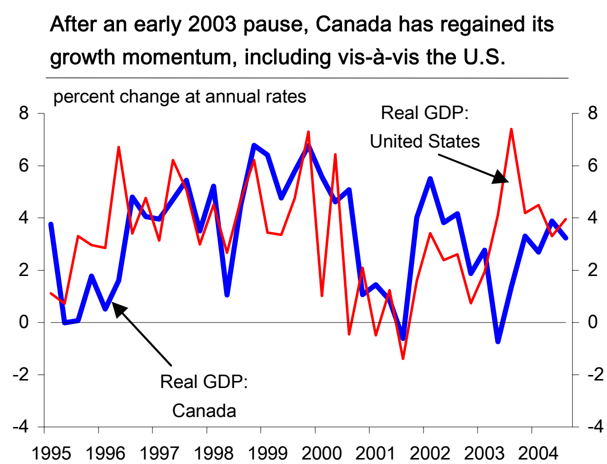
2/ In U.S. dollars at PPP exchange rates.

3/ OECD data are used in this box, as they adjust more fully for methodological differences across countries, while national data are used elsewhere in this report.

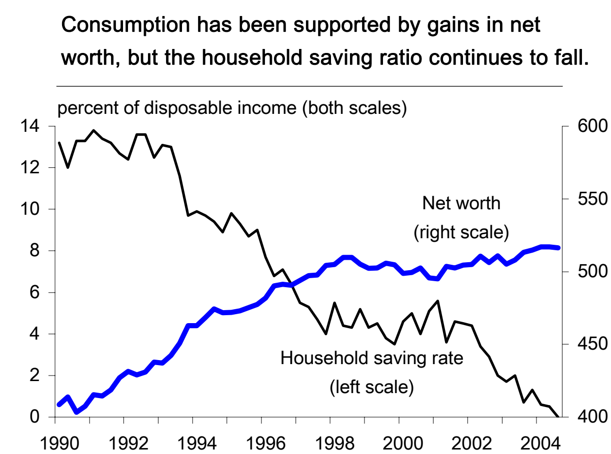
[1] Canada's gross general government debt is significantly higher than net debt, but the difference largely reflects commercial securities that earn markets rates of return, making net debt a better gauge of the fiscal position.

II. RECENT DEVELOPMENTS

5. ***General elections in June 2004 led to the formation of a minority government***. Following Paul Martin's appointment as Prime Minister in December 2003, the Liberal party won its fourth consecutive election but lost the parliamentary majority it had held since 1993. The new government subsequently laid out an ambitious policy agenda, that included commitments to invest in people, encourage innovation, improve the regulatory environment, support regional and sectoral development, and promote trade and investment. However, parliamentary opposition forced some amendments, including acknowledging the importance of financial pressures on provinces.



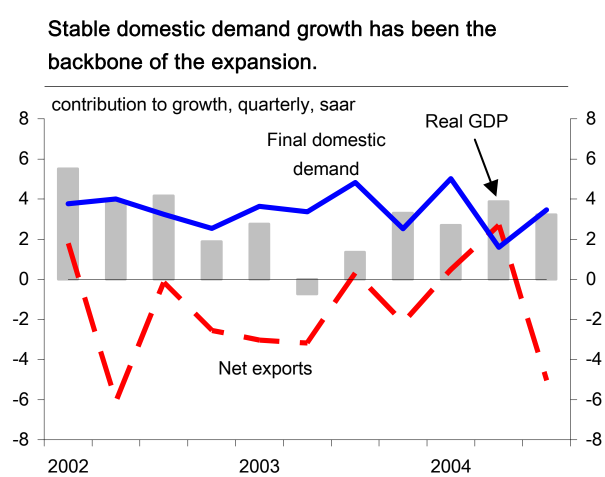
6. ***The economy regained traction in the latter half of 2003, but momentum has moderated more recently*** (Table 2). In 2003, the economy was hit by exchange rate appreciation, a SARS outbreak, forest fires, a large power outage, and a case of "mad cow" disease that significantly reduced agricultural exports. Real GDP fell in the second quarter of 2003, but has rebounded, growing at an annual rate of 3 percent over the next five quarters. Later in 2004, however, as the Canadian dollar again appreciated, there was a rapid slowing of net exports.



7. ***Domestic spending has provided the backbone for the recent expansion***. Real final domestic demand has grown at an annual rate of around 3½ percent since early 2002:

- *Household consumption has remained robust*. Spending has been supported by strong employment gains and increases in net wealth. However, the household saving rate has dropped to zero and debt has risen to over 100 percent of disposable income.

- *Business investment has responded to strong corporate earnings, low interest rates, and cheaper capital equipment imports*. Corporate profits rose 20 percent year-on-year in the third quarter of 2004. The stronger Canadian



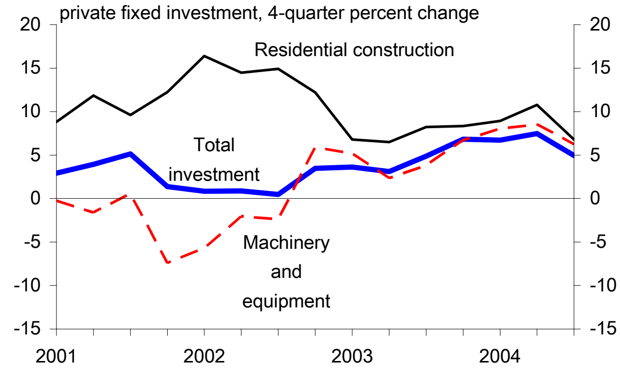
dollar has also supported investment in machinery and equipment, some 80 percent of which is imported.

- *Low interest rates continue to benefit residential investment.* Residential mortgage loans have increased at an annual rate of 9 percent since mid-2003, accompanied by similarly strong growth in construction activity. Although house prices have increased by around 7 percent per year, real values are still recovering from a decade-long slump and do not appear out of line with fundamentals.[2]

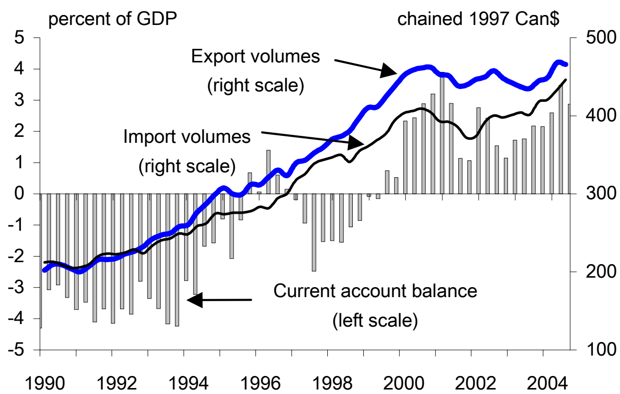
8. ***Net exports, which provided an unexpected boost in the first half of 2004, are weakening*** (Table 3). Export volumes rebounded strongly from early 2003, despite the appreciation of the Canadian dollar, in part reflecting strong U.S. private investment and robust demand for nonoil commodities, while the terms of trade further supported the current account. Beginning in the third quarter of 2004, however, exports retreated and the contribution of net exports to GDP growth turned sharply negative. With import demand growing strongly and commodity prices falling from recent highs, the trade surplus has narrowed but remains well above 5 percent of GDP.

9. ***After giving up some recent gains earlier in 2004, the Canadian dollar has appreciated rapidly since mid-year***. The Canadian dollar strengthened by almost 20 percent in real effective terms in 2003, supported by weakness in the U.S. currency

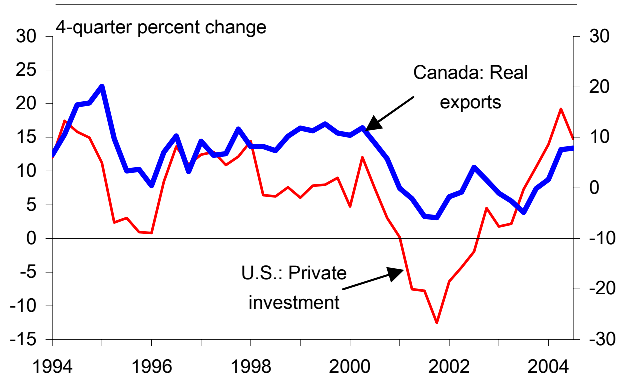
Residential and business investment remain strong.



Despite strong import volume growth, the current account surplus remains large.



Canadian exports closely track investment trends in the United States.



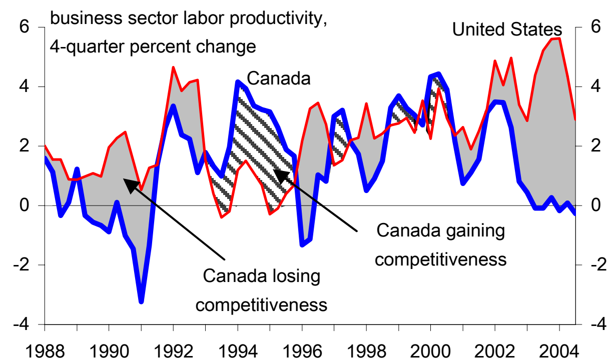
2 Analysis in the latest *World Economic Outlook* suggests Canadian house prices are close to their long-term equilibrium.

and buoyant commodity prices. Its more recent appreciation—which is less easy to explain based on domestic developments, and seems to largely reflect a correction of the overvalued U.S. dollar—has taken the currency to its highest level against its U.S. counterpart since mid-1992.[3] Staff estimates suggest that the real exchange rate is now essentially consistent with underlying fundamentals.

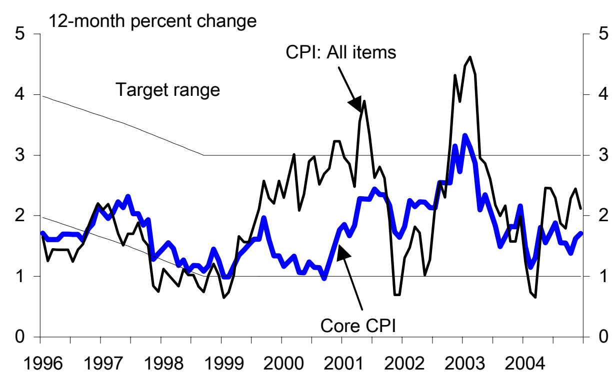
10. ***The rebound in growth has reduced economic slack***. Industrial capacity utilization rose to 85.7 percent in the third quarter, above its 2000 peak, but does not appear to be generating significant constraints except in some commodity-producing industries. Staff estimates the output gap at about ½ percent of GDP, with potential output growth at around 3 percent a year.

11. ***Wage pressures have yet to emerge, possibly reflecting the strong rise in labor supply.*** There has been a sharp increase in the participation ratio over recent years, which remains close to a record high as the economy continues to absorb increasing numbers of female and elderly workers into the labor force, apparently reflecting greater labor force attachment associated with rising education levels across cohorts. The unemployment rate is now at 7 percent—the staff's estimate of the NAIRU—but wage demands have been contained, and unit labor costs are essentially flat.

Canadian labor productivity growth has lagged that of the United States over the past 2-3 years.



Core inflation is within the bottom half of the target range and moderating.



12. ***Core inflation remains subdued***. Year-on-year inflation rose to 2¼ percent (overall) and 2 percent (core) in July, partly in response to higher energy and motor vehicle prices, but the core rate fell to 1½ percent in November. Producer price inflation has also eased while capital goods prices have benefited from exchange rate appreciation.

13. ***With slack narrowing, the Bank of Canada started withdrawing monetary stimulus in September and October but then paused in December***. The Bank raised its target for the overnight rate by 25 basis points in both September and October, to 2½ percent, and suggested that further rate hikes would be needed to keep core inflation to 2 percent at end-2005. However, while acknowledging that interest rates remain accommodative, the Bank

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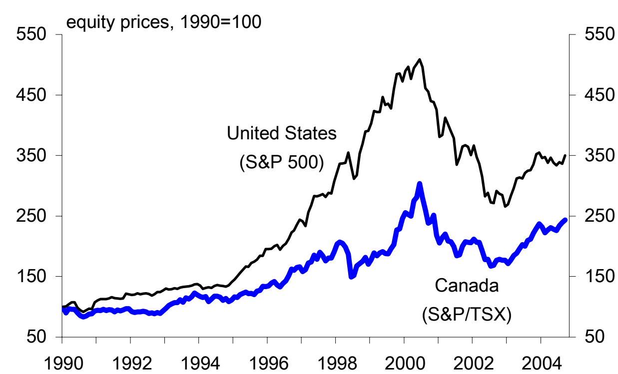
[3] Analysis of the Canadian exchange rate is contained in "The Canadian Dollar," IMF Country Report 04/60, 2004.

held rates steady in December, citing concerns about the impact of the exchange rate on economic activity. Markets expect the pause to continue through the first half of next year.

14. ***Fiscal surpluses have been maintained and debt continues to fall***. The federal budget surplus in FY 2003–04 (April to March) reached ¾ percent of GDP, well above earlier estimates despite post-budget spending measures of ¼ percent of GDP. The overachievement largely reflected tax revenue buoyancy, partly due to the rebound in activity in late 2003. Provincial government finances deteriorated slightly but budgets in aggregate remained close to balance, and the strength of federal finances left the general government with a significant surplus.

15. ***The banking sector remains sound, supported by the economic recovery and buoyant financial markets*** (Table 4). Banks' return on equity rose to a healthy 14¾ percent in FY 2002–03 (November to October) from 9¼ percent the previous year as lower provisioning, solid growth in retail business as strong lending to households have offset stagnant corporate loans, and increased fee generation offsets the compression of interest spreads caused by low nominal rates. Strong earnings allowed banks to boost already robust capital ratios to 13½ percent.

Financial markets have been supported by the global recovery and rising equity prices.



III. The Short-Term Outlook

16. ***The staff expects growth to remain close to potential over the next year-and-a-half***. Domestic demand growth is expected to remain robust with real consumer demand and investment growing at around 3 percent and 5 percent in 2005, respectively, supported by relatively easy financial conditions. Business investment would also be spurred by increasing capacity constraints and lower prices of imported machinery and equipment. However, the appreciation of the Canadian dollar and weaker external demand are expected to continue to depress exports. Growth is expected to be 3 percent in 2005, broadly consistent with private sector and official projections.

Medium-Term Projections
(In percent change from previous period; unless otherwise indicated)

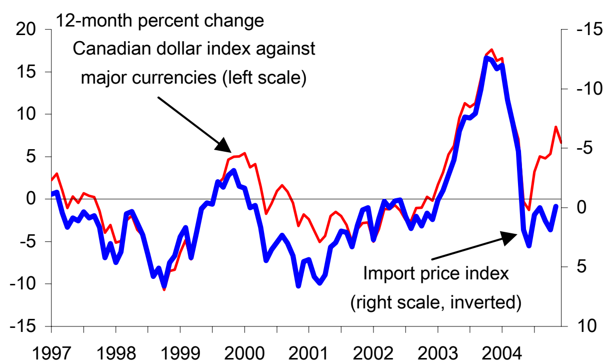
			Projections					
	2002	2003	2004	2005	2006	2007	2008	2009
Real GDP	3.4	2.0	2.7	2.9	3.0	3.2	3.0	2.9
Final domestic demand	3.1	3.6	3.6	3.3	3.2	2.8	2.9	2.8
Private consumption	3.4	3.1	3.2	2.7	2.8	2.4	2.6	2.6
Private fixed investment	1.4	4.6	6.0	4.8	4.1	4.0	4.0	4.0
Net exports (contribution)	-0.1	-2.4	-0.7	-0.6	0.2	0.3	0.2	0.2
Inventories (contribution)	0.6	0.9	-0.1	0.4	-0.2	0.1	0.0	0.0
Unemployment rate (percent)	7.7	7.6	7.3	7.2	7.1	6.9	6.9	6.8
Consumer price index	2.3	2.7	1.8	2.3	2.1	2.0	2.0	2.0
Federal fiscal balance/GDP	0.6	0.7	0.6	0.3	0.4	0.5	0.8	0.8
Current account balance/GDP	2.0	2.0	2.8	1.8	1.9	2.2	2.4	2.6
Memorandum items:								
Partner country growth	1.9	3.0	4.4	3.7	3.6	3.6	3.3	3.2
Oil prices ($/Barrel)	25.0	28.9	37.8	40.5	38.0	36.0	35.0	34.5

Sources: Haver Analytics; and Fund staff estimates.

17. ***Officials and private sector analysts viewed the exchange rate as the principal risk for the outlook.*** They noted that the vigor of net exports in the first half of 2004 had been unusual given the strong exchange rate appreciation in 2003. The benign interpretation was that Canadian industry had responded with increased flexibility and efficiency, but it was also possible that adjustment had simply been delayed. Bank of Canada analysis suggested the pickup in exports partly reflected a recovery to equilibrium. Since imports remain below levels suggested by long-term fundamentals, there was a risk that net exports could weigh heavily in the period ahead.

18. ***Staff enquired whether the apparent fall in exchange rate passthrough further complicated the impact of exchange rate movements on output and prices.*** They noted that slower or more limited passthrough could reduce the responsiveness of net exports to changes in real exchange rates.[4] Officials responded that it was not clear-cut that passthrough had fallen, with some indicators suggesting that it might simply have been delayed.

Passthrough of exchange rates to import prices has been limited recently.



[4] See Chapter 2 of the *Selected Issues* paper.

19. ***Officials and the mission agreed that global demand conditions were a major source of uncertainty***. Since 85 percent of Canadian exports were destined for the United States, a key risk was that higher oil prices could cool U.S. growth or that monetary tightening would weigh on U.S. auto and housing markets and, in turn, Canadian manufacturing and lumber exports. Officials also noted that—despite modest direct trade links—China and India were of growing relevance for the Canadian economy through global commodity markets and third countries.

20. ***Canadian forecasters saw limited risks to domestic demand***:

- *The domestic impact of high oil prices was characterized as broadly neutral*. Higher energy prices were seen as having a small negative impact in the short-term, mainly through an erosion of real spending power. However, the long-term effect of higher energy prices is likely beneficial given Canada's substantial oil and natural gas exports (Box 2).

- *Forecasters were relatively sanguine about household demand*. Notwithstanding staff concerns that the saving rate remains below equilibrium, official and private forecasters downplayed the risk of an abrupt adjustment.[5] They noted that debt service burdens remained manageable, lower interest rate volatility has reduced balance-sheet risk, and financial institutions had limited exposure to the housing sector.

- *Investment provided an upside potential*. Officials painted an upbeat picture for prospects in the energy and mining sectors, and agreed with the staff that high corporate profitability, limits to further increases in labor participation, and exchange rate appreciation were conducive to capital accumulation.

21. ***Officials acknowledged that Canada's outlook and policy making was complicated by uncertainties regarding the growth of potential output***. Recent revisions to Canadian and U.S. data, which eliminated the labor-productivity growth differential for the decade ending in 2002, suggested a less worrisome picture of the supply side of the economy, but the sharp increase in the participation ratio over the last decade further complicated assessments of potential output and the output gap.[6]

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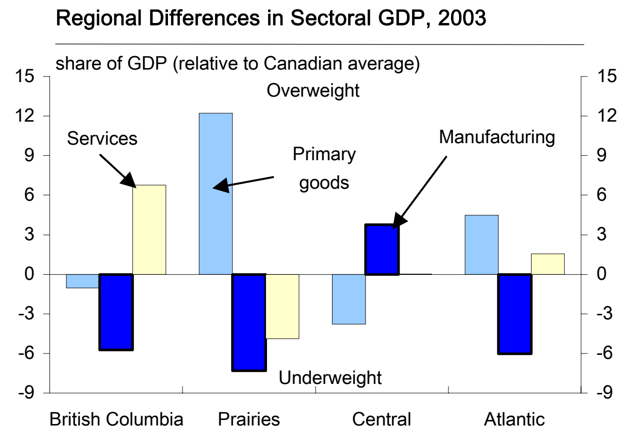
[5] See "Canadian Household Saving" in *Canada: Selected Issues* IMF Country Report 04/60, 2004.

[6] International evidence suggests participation rates are negatively correlated with the measured level of productivity (see *The Sources of Economic Growth in OECD Countries*, OECD: Paris, 2003).

Box 2: The Effect of Oil Price Fluctuations on the Canadian Economy

Oil price changes are generally viewed as broadly neutral for the Canadian economy. Even though Canada is a relatively oil-intensive economy, it is the ninth largest crude oil exporter in the world and has the second largest potential oil reserves.

Simulations using GEM, the Fund's new multi-country model, suggest that a hike in oil and natural gas prices (hereafter, simply oil prices) modestly dampens activity in Canada in the short-term.[1] An oil price increase reduces domestic spending by transferring income from more income-sensitive consumers to oil producers. Demand for Canadian exports also falls because of similar effects on spending in the rest of the world and the resulting exchange rate appreciation. Simulations suggest a sustained 25 percent increase in oil prices would lower output by up to ¼ percent after a year.



However, higher oil prices would boost output in the longer run. Increased spending on oil production facilities together with the improvement in the terms of trade caused by higher oil prices boosts domestic incomes and output. Simulations suggest that a sustained 25 percent increase in oil prices could raise real GDP by ½ percent after five years, while terms of trade benefits allow domestic spending to increase by more.

Table: Relative Output Growth Across Regions

	British Columbia		Prairies		Central Provinces		Atlantic Provinces	
Region Output Growth 1/	0.15		0.07		0.18	*	0.37	**
	(0.17)		(0.18)		(0.09)		(0.14)	
US GDP Growth	0.63	**	0.80	**	0.79	**	0.45	**
	(0.17)		(0.14)		(0.11)		(0.13)	
Real Exchange Rate Change 1/	-0.13		-0.06		-0.16	**	-0.11	**
	(0.09)		(0.08)		(0.06)		(0.05)	
Oil Price Change 1/	0.00		0.04	**	-0.02	*	-0.02	*
	(0.02)		(0.01)		(0.01)		(0.01)	

Note: Standard errors in parentheses; (*) significance at 10 percent, (**) at 5 percent.
Newey-West Heteroskedasticity-Consistent Standard Errors & Covariance.
1/ Lagged Variables.

Oil price hikes also have pronounced regional effects, benefiting the resource-rich west and hurting the central and some Atlantic provinces (Chart and Table). Oil production is concentrated in the prairie provinces, in particular Alberta. By contrast, higher oil prices raise energy costs for the central provinces—Ontario and Quebec—that are the manufacturing heart of the economy and produce 70 percent of Canada's GDP. These differences in growth would be exacerbated by any associated exchange rate appreciation.

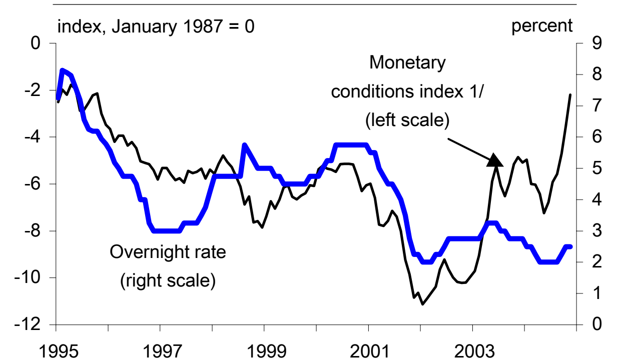
Note: The author of this box is Rodolfo Luzio.

[1] See *GEM: A New International Macroeconomic Model,* IMF Occasional Paper 239, 2004.

IV. Monetary Policy and the Exchange Rate

22. ***The inflation-targeting framework continues to be successful***. This framework—which aims to keep the 12-month change in the CPI in the middle of a 1–3 percent target band over a 18–24 month horizon—has brought down inflation and helped anchor expectations since its inception in 1991. With a review of the inflation-targeting regime scheduled to be completed by end-2006, the team asked what amendments might be considered, and whether recent deflationary pressures in partner countries might prompt reconsideration of the target range. Officials responded that substantive discussions would not take place before late 2005. Although all aspects of the system would be reviewed, the early focus would likely be on the definition of core inflation, the forecasting horizon, and the role of asset prices.

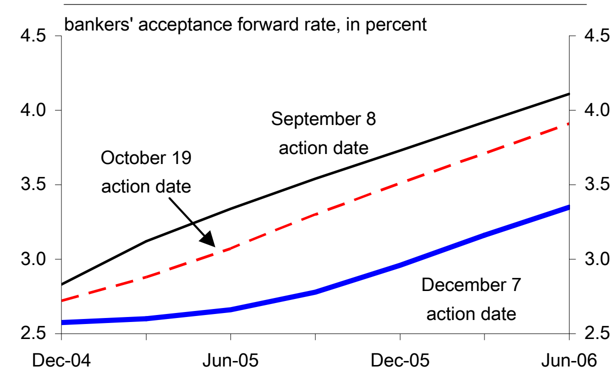
Monetary tightening has started, while recent exchange rate appreciation has also significantly reduced stimulus.



1/ Weighted average of the change in short-term interest rates and the nominal effective exchange rate.

23. ***Bank of Canada officials and staff agreed that further withdrawals of stimulus would be needed at some point***. Officials noted that real interest rates were well below neutral levels and indicators suggested that the economy was approaching capacity. Moreover, given that monetary policy operated with long and variable lags, they were mindful of the possibility of unduly delaying a return to a more neutral policy stance.

Market expectations of monetary tightening have shifted downward significantly in recent months as the exchange rate appreciated.



24. ***The mission noted that there appeared room for patience in withdrawing stimulus.*** Even though some indicators suggested slack was narrowing (Box 3), the absence of price pressure, firmly anchored expectations, and the likely impact of recent exchange rate appreciation on external demand, suggested a measured approach to tightening was appropriate. The authorities agreed that these factors—as well as the adjustment costs from moving resources from manufacturing-based provinces to resource-based regions in response to currency appreciation and commodity prices—argued for a measured approach to tightening. They

noted that future interest rate moves would be determined by evolving prospects for capacity and inflation and would be played "quarter-by-quarter."[7]

25. ***Officials noted that measures of economic slack provided important input into monetary policy decisions***. At the same time, however, the 2003 experience—when capacity indicators supported a tightening of policy that had to be reversed as activity slowed unexpectedly—had underscored the substantial uncertainty that surrounded both the nature of, and the economy's response to, macroeconomic shocks. Officials agreed that these uncertainties argued for a more gradual interest rate response to overall conditions than otherwise. They noted that the exchange rate was a major source of unpredictability for the outlook, and hence monetary policy, but emphasized that, given the wide range of potential shocks driving currency movements, the Bank no longer focused on the mechanistic monetary conditions index as a guide for policy.

26. ***Private sector participants and the team commended the Bank's communication strategy, which prepared markets well for the latest round of monetary tightening***. Staff welcomed the inclusion of more information on projections in recent *Monetary Policy Reports* (MPRs), which had been recommended in last year's consultation. However, they suggested that a richer background on policymakers' views could be provided, particularly at fixed action dates not associated with an MPR or *Update*, possibly by publishing Governing Council minutes. Officials were not convinced to publish minutes—given the Council's composition and legal framework, and the potential impact on candor—and suggested that MPRs as well as speeches by Governing Council members were adequate conduits to markets.[8]

27. ***The authorities reiterated their ongoing commitment to flexible exchange rates, but were concerned about spillovers from global current account imbalances***. Bank officials noted that, while the strengthening of the currency during 2003 was in line with Canada's fundamentals, including rapidly rising commodity prices, the recent further appreciation was more difficult to explain. Against this background, they were concerned about international imbalances, stressing that multilateral exchange rate adjustments to correct these imbalances could be significant and place an inordinate burden on industrial countries with freely-floating rates. They suggested that the Fund could usefully play more of a leadership role in this area.

[7] The Bank subsequently left rates on hold on December 7.

[8] The Governor has legal responsibility for the conduct of monetary policy, although in practice decisions have been delegated to the Bank's Governing Council, which also includes the Senior Deputy Governor and the other four Deputy Governors. The Reserve Bank of Australia, which has a similar structure, recently stopped the release of Board minutes and voting records since 2003.

Box 3. Slack and Inflation

Monetary policy decisions are being complicated by uncertainty over the level of slack in the economy and its implications for inflation. While core inflation remains below 2 percent, comparisons of real output, unemployment, and—most notably—capacity utilization with historical trends suggest tightening capacity constraints. This dichotomy could reflect lags between changes in slack and inflation, instability in the underlying relationship, or mismeasurement of capacity constraints. To investigate this issue, staff estimated an expectations-augmented Phillips curve, in which real output, unemployment, and capacity utilization were used to generate a measure of the cycle, and (say) potential real output is modeled as an unobserved variable that is inferred with error.[1]

The results suggest that there is considerable uncertainty about the level of slack. For example, the 95 percent confidence interval suggests the current NAIRU could range from below 6½ percent to over 7½ percent (Table).

An implication is that caution is needed when using measured slack to project inflation, as the Bank of Canada has recognized. While few doubt that capacity constraints affect inflation, structural changes in the economy apparently make it difficult to identify a stable reduced-form relationship. Bank of Canada analysis comes to similar conclusions, while the Bank's *Monetary Policy Reports* include a fan chart to illustrate uncertainties associated with the measured output gap.[2]

Table: Model and Results

Model

Phillips Curve: $\Delta\pi_t = \alpha_1 \Delta\pi_{t-1} + \alpha_2 \Delta\pi_{t-2} + \alpha_3 g_{t-1} + \varepsilon_t^{\pi}$

Output: $y_t = y^*_t + \beta g_t$

Capacity Utilization: $cu_t = cu^*_t + \gamma g_t + \varepsilon_t^{cu}$

Unemployment Rate: $u_t = u^*_t + \theta g_t + \varepsilon_t^{u}$

Potential Output: $y^*_t = \mu_{y^*} + y^*_{t-1} + \varepsilon_t^{y^*}$

NAIRU: $u^*_t = u^*_{t-1} + \varepsilon_t^{u^*}$

Trend Capacity: $cu^*_t = \mu_{cu^*} + cu^*_{t-1} + \varepsilon_t^{cu^*}$

Cyclical Dynamics: $g_t = \phi_1 g_{t-1} + \phi_2 g_{t-2} + \varepsilon_t^{g}$

where $\Delta\pi$ is the annualized quarterly change in the logarithm of CPI excluding food, energy, and the effect of taxes less its expectation proxied using the lagged year-on-year change, y is the logarithm output, *cu* is the logarithm of total industry capacity utilization rate, and *u* is the unemployment rate of those over 15. Variables denoted by an asterisk are underlying trends of these series, inferred through state-space methods and maximum likelihood, while ε's are error terms. Other Greek letters reflect parameters. The sample runs from 1984:Q2 until 2003:Q3.

Results

Phillips Curve

Variable	Coefficient	Standard Deviation	P - Value
Change in inflation Lag 1	0.32	0.17	0.07
Change in inflation Lag 2	-0.43	0.19	0.02
Cycle	0.01	0.06	0.82
Standard error of equation		0.007	

Cyclical Gaps and Equilibrium Levels

Variable	Estimate in 2004:Q4	Root Mean Squared Error	95 percent Confidence Interval
Output gap (percent of GDP)	0.1	0.9	-1.8 to 2.0
Capacity utilization gap 1/	0.2	1.9	-3.6 to 4.0
Unemployment gap 1/	0	0.2	-0.4 to 0.4
NAIRU	7.0	0.3	6.3 to 7.6
Trend Capacity Utilization	87.9	1.0	85.9 to 90.0

1/ Percentage points.

Note: The author of this box is Alejandro Justiniano.

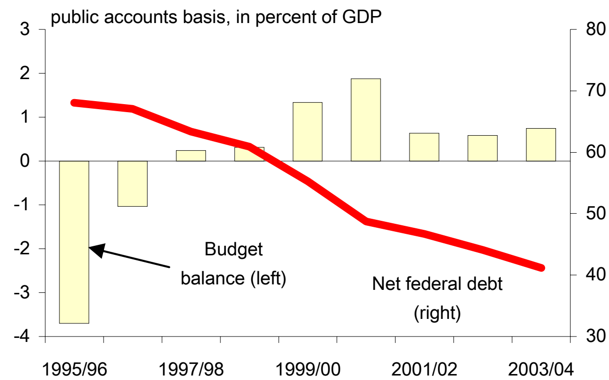
[1] For further details see "How Precise are Estimates of the Natural Rate of Unemployment?" by D. Staiger, J. Stock and M. Watson, NBER Working Paper 5477, 1996.

[2] See "The Canadian Phillips Curve and Regime Shifting," by F. Demers, Bank of Canada Working Paper 2003−32.

V. Sustainable Fiscal Policy

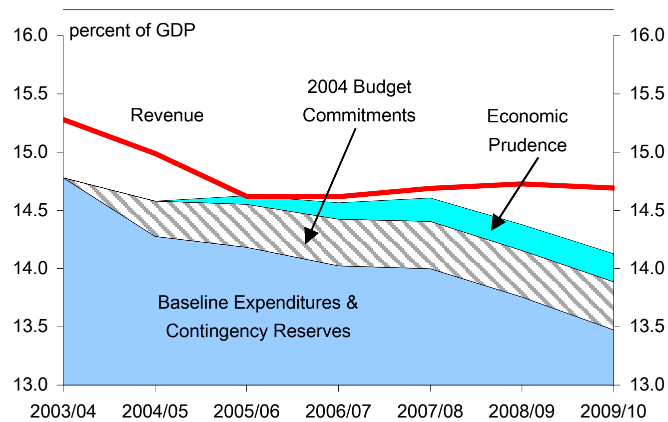
28. ***Officials and staff concurred that the federal fiscal framework had delivered a broad-based social consensus for fiscal prudence***. The two-year rolling commitment to budget balance or better had resulted in seven consecutive years of fiscal surpluses, reduced federal net debt by almost 30 percent of GDP, and still afforded sizeable tax reduction. This was an impressive record when compared with other countries' attempts to impose budget discipline. Flexibility was maintained through a C$3 billion (¼ percent of GDP) contingency reserve, an economic prudence factor that rises by C$1 billion (about 0.1 percent of GDP) each year over the forecast horizon, and conservative economic assumptions. The public pension system is actuarially sound for at least the next 75 years, and most provinces have followed the federal government in sharply reducing deficits while cutting taxes, supported in some cases by balanced budget rules.

Fiscal discipline has led to a sharp reduction in the federal debt ratio since the mid-1990s.



29. ***Officials noted that the FY 2004–05 Budget had reaffirmed the government's commitment to sound fiscal management and enshrined a debt-reduction target***.[9] The budget had restored the economic prudence factor reduced in the previous year. The new objective of lowering the federal debt ratio from 41 percent of GDP to 25 percent within ten years provided a medium-term anchor to enhance fiscal credibility and promote recognition of long-term demographic pressures. Nevertheless, officials stressed that the core commitment was to budget balance or better on a year-to-year basis, which would deliver the debt target given current estimates of potential GDP growth.

Staff projections illustrate how new spending commitments have left the federal government little room to maneuver.



30. ***Officials agreed with staff that the current room for fiscal maneuver was limited because of spending commitments, including increased transfers to provinces.*** Following an election commitment to improve

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[9] Chapter 3 of the *Selected Issues* paper analyzes the long-term benefits from lowering the debt ratio.

relations with the provinces, recent federal-provincial agreements on health and equalization had committed the federal government to increase transfers over an extended period, in order to facilitate their long-term fiscal planning (Box 4). The latest *Economic and Fiscal Update* illustrated that these measures had largely eliminated the planning surplus, which includes the contingency reserve and prudence factor, over the coming two fiscal years.

Federal Budget: Staff Projections
(In percent of GDP)

	2004/05	2005/06	2006/07	2007/08	2008/09
Revenue	15.0	14.6	14.6	14.6	14.6
Outlays	14.4	14.3	14.2	14.1	13.8
Of which : New commitments	0.3	0.4	0.4	0.4	0.4
Operating balance	0.6	0.3	0.4	0.5	0.8
Contingency Reserves	0.2	0.2	0.2	0.2	0.2
Prudence factor	-	0.1	0.1	0.2	0.2
Planning balance	0.4	0.0	0.1	0.1	0.4
Net debt (in percent of GDP)	38.1	35.8	33.6	31.5	29.2

Sources: Fund staff estimates based on *The Economic and Fiscal Update, November 2004.*

31. ***Staff and officials discussed the relative merits of adopting a five-year fiscal planning horizon.*** Presently, officials explained, budget projections are presented for two years, but given the recent medium-term spending commitments to provinces and the importance of transparency regarding the longer-term impact of measures, a longer budget horizon might be appropriate. The mission agreed, but cautioned against placing an undue weight on the planning surpluses that were expected to re-emerge from FY 2007/08. In the team's view, uncertainties increase significantly with the forecast horizon and recent medium-term spending commitments exposed the budget to increased cyclical risk (Box 5).

32. ***The team noted that the ongoing Expenditure Review provided an opportunity for the government to reassess its broader policy priorities.*** In particular, they suggested that reallocating expenditure savings from the Review would provide an opportunity to weigh carefully the merits of spending programs versus further reducing the relatively high tax burden. Officials noted that the government placed a significant weight on expanding some social transfers, but agreed that it was important to raise efficiency by maximizing the productive use of the government's scarce resources. Tax policy could be an important element in this regard, and some officials saw scope for efficiency-enhancing boosts to spending on federal infrastructure, for example, at border crossings. Finally, officials noted that consideration was being given to establishing a process to review spending on a regular basis.

Box 4: Recent Federal-Provincial Agreements

The federal government recently reached two key agreements that significantly raise transfers to the provinces over the medium term and provide a more stable source of funding for individual provinces.

New Ten-Year Plan for Health Care

In September 2004, the federal government and provinces agreed to a 10-year plan to strengthen health care. The federal government committed to boosting health care transfers to provinces by C$41 billion (3 percent of 2004 GDP) over the next 10 years. This includes a 25 percent increase to Canada Health Transfers in FY 2005–06 and a 6 percent subsequent escalator to provide predictable federal support to help future planning by provinces. These increases went well beyond the recommendations of the earlier Romanow report.

In common with previous agreements in 2000 and 2003, the new plan does not involve wide-ranging reforms of health care delivery. In the latest agreement, provinces agreed to improving service quality, accountability, and comparability by:

- *Reducing waiting times and improving access*;
- *Increasing the supply of health care professionals*;
- *Ensuring a minimum standard of home care*;
- *Sharing best practices in primary care*;
- *Developing a national pharmaceutical strategy.*

New Framework for Equalization and Territorial Financing Formula (TFF)

In October 2004, First Ministers reached agreement on a new framework for the Equalization and related programs that increase support to provinces and territories by $33 billion over the next 10 years. The Equalization program allocates federal transfers to ensure that provincial revenues meet a minimum standard. Currently, eight provinces receive funds. The new approach sets a minimum federal funding floor of C$10.9 billion for Equalization and C$2 billion for TFF for the next two years, followed by a 3½ percent growth in the base through FY 2009–10. The agreement also created a panel of experts charged with recommending a new allocation mechanism across provinces with a mandate to:

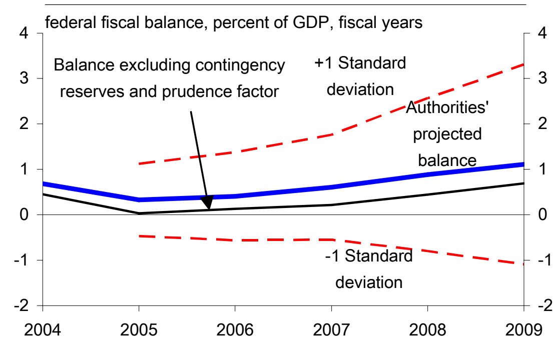
- *Examine and evaluate alternative methods of measuring fiscal disparities across provinces and territories;*
- *Propose a new allocation mechanism that reduces uncertainty of transfers.*

It is expected to report in late 2006, although the federal government retains full responsibility for decisions upon consultation with provinces.

Box 5: Uncertainty in Budget Forecasting

Uncertainty around fiscal forecasts has been an increasingly important issue in Canada. The government has a commitment to "balanced budget or better" in a framework that includes contingency and prudential reserves and economic forecasts based on private sector input. This framework has been associated with larger-than-expected budget surpluses in recent years which has raised questions about the accuracy of fiscal forecasts.[1] To provide further insight, staff used a vector autoregression involving the budget deficit as a ratio to GDP, real GDP growth, inflation, changes in the real exchange rate, and short- and long-term interest rates to examine the error bands around budget forecasts.

Fiscal forecasts are subject to a wide range of uncertainty.

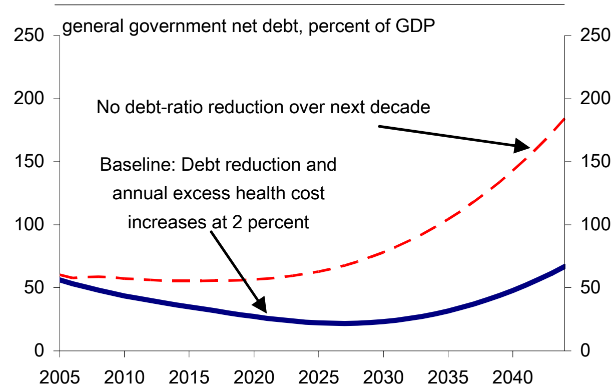


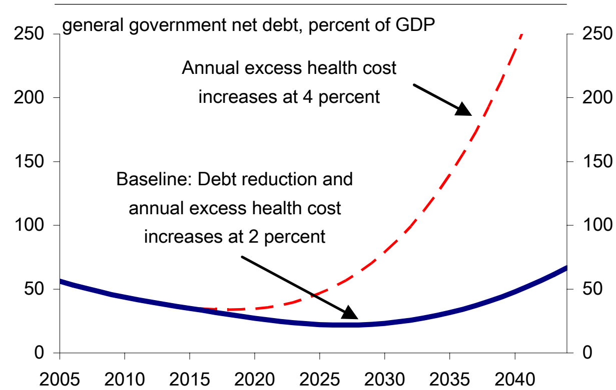
The results underscore the high level of uncertainty involved in projecting the fiscal balance. The standard deviation around a fiscal forecast is estimated at ¾ of a percent of GDP in the first year of a projection (similar to results from actual budget forecasts), rising to 2¼ percent of GDP by the fifth year. The high level of uncertainty reflects the sensitivity of the budget to changes in the macroeconomic environment. For instance, impulse response functions indicate that a shortfall in real GDP growth of one percent per annum reduces the fiscal balance by about ¼ percent of GDP in the first year. These results suggest that the fiscal framework's contingency reserves and economic prudence factors—which rose from ¼ percent of GDP in the first year to ½ percent of GDP by the fifth—may not be large enough to guarantee budget balance or better.

Note: The authors of this box are Rodolfo Luzio and Andrew Swiston.

[1] The government announced an independent review of the government's economic and fiscal forecast methods and requested staff to compared Canadian budgeting practices and experiences with other industrial countries.

Containing health costs and reducing debt are both crucial to long-term fiscal sustainability.





Source: Fund staff estimates.

Methodological note: The baseline path reports projected government debt ratios assuming that the federal government achieves its ten-year debt reduction target, provinces run approximately balanced budgets over the same period, that there are no subsequent changes to tax rates, a fixed rate of increase in spending programs, and annual excess health cost increases (i.e. the degree to which health care cost increases exceed overall inflation) is reduced to 2 percent per year. The "No debt-ratio reduction" path adjusts the baseline by assuming that spending is raised such that federal and provincial budgets are in deficit at a level that allows the debt ratio to remain unchanged over the next ten years, followed by no further changes to tax rates and the same future rate of increase in spending programs. The "Annual excess health cost increases at 4 percent" path adjusts the baseline by assuming that annual excess health cost increases continue at 4 percent per year, with the additional costs not offset by spending cuts or tax increases after 2014. More details on the model are provided in "Assessing the Long-Term Fiscal Position of Canada" in IMF Country Report No. 03/34.

33. ***Officials emphasized the long-term challenges to fiscal balances posed by population aging.*** Canada's projected increase in the old-age dependency ratio of around 20 percentage points over the next 25 years was in the upper range of G-7 countries. Reforms had made the public pension system actuarially sound, but demographic factors would weigh on health and other age-related public spending after 2010, raising concerns about the long-term sustainability of government finances. The mission noted that its analysis illustrated the importance of continuing to keep the debt-to-GDP ratio on a downward path over the next decade and beyond for preparing Canada for the long-term demographic transition, but there was also a need to curb cost increases in the health system.

34. ***In this context, officials and staff agreed on the need for fundamental reform to increase health-sector efficiency.*** As in other industrial countries, health spending has been rising at an unsustainable pace, reflecting increased utilization of health care services, population aging and rapid technological innovation. Staff suggested measures would be needed over time to improve delivery of services and curb demand, and that recent health agreements had involved larger transfers to provinces without fundamental reforms or a hardening of budget constraints.

35. ***Officials viewed the federal government's role in the health care system as ensuring access to core services and improving public accountability.*** They emphasized that provinces were responsible for health care and hence reforming the system. Few federal restrictions were placed on provinces with regard to delivery of services, and innovation in this area was welcome. However, they viewed curbing demand for core services covered under the federal Canada Health Act through user fees as detrimental to access by the poor. Recent agreements with the provinces had included mechanisms to

improve public comparability of health outcomes, which would facilitate consensus building on future efforts. Staff noted that in earlier meetings, some provincial officials had expressed frustration at prohibitions on user fees, but all had agreed on the central government's role in promoting common health care standards, priorities, and infrastructure.

36. ***Officials observed that while the recent agreement on Equalization payments provided reform opportunities, there was a risk of moving the system away from its original intent.*** By largely fixing the overall size of future federal Equalization payments over the next six years, officials noted that the agreement had eroded the underlying principal that such payments compensated for differing fiscal capacity. This, as well as two provinces' insistence that their resource revenues be exempted from the system, had increased the risk such payments would be seen as an entitlement. Staff responded that a key challenge for the upcoming review of the program's allocation mechanism would be to design a system that provided a transparent and equitable basis for payments across provinces, while avoiding the year-to-year volatility of the previous system.

37. ***Officials acknowledged that recent overshoots of projected federal budget surpluses had raised questions about the credibility of the fiscal framework.*** This over-performance was viewed as constraining the debate over how resources should be allocated between tax cuts, expenditure increases, and debt reduction. In response, the government had commissioned an independent assessment of Canada's fiscal forecasting performance, in which the staff had agreed to provide an international perspective.[10] Senior officials stressed, however, that the strong political and institutional commitment to balanced budgets remained intact, and that the only question was the appropriate size and allocation of surpluses.

38. ***Officials saw surpluses as posing growing challenges for debt management.*** With new debt issuances projected to fall, it would become increasingly difficult to maintain adequate liquidity in benchmark securities. A decision had been taken to maintain inflation-adjusted bonds, which were popular with institutional investors, and increase the proportion of short-term maturities to lower funding costs. Since short-term interest rates tended to be correlated with revenues, overall fiscal risk would be lowered despite more volatile interest payments. Staff observed that this would also tend to reduce the size of automatic stabilizers.

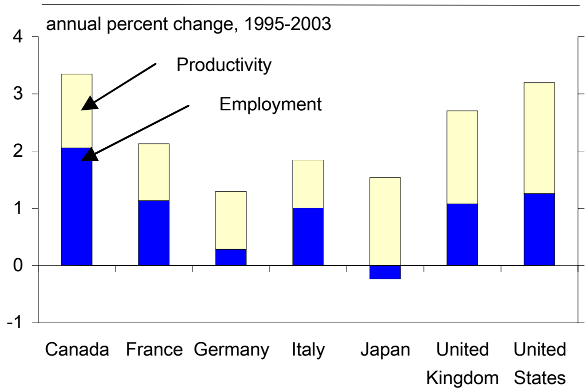
39. ***The mission welcomed the government's efforts to enhance Canada's already high level of fiscal transparency.*** Officials pointed to the recent reestablishment of the Office of the Comptroller General as a key step to strengthen financial oversight across the federal government. In addition, the latest *Fiscal Update* had added more detail on how fiscal forecasts of private forecasters were converted to be consistent with the public accounts

[10] Results are reported in Chapter 4 of the *Selected Issues* paper.

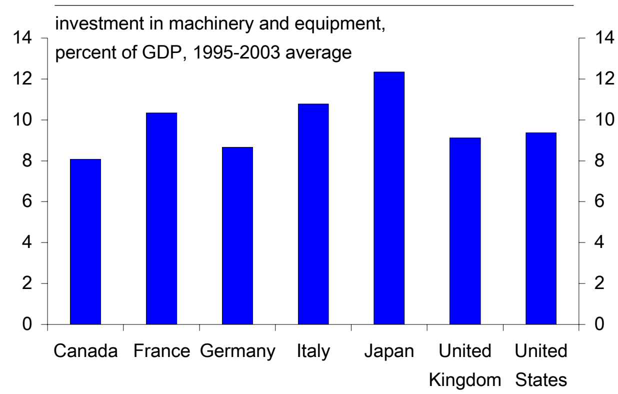
VI. POLICIES TO INCREASE ECONOMIC EFFICIENCY AND FLEXIBILITY

40. ***While Canada has been the fastest growing G-7 country since 1995, staff noted that the sources of growth provided a less favorable picture.*** In particular, Canada's strong growth had resulted in large part from the sharp increase in the participation rate. Multifactor productivity growth was comparable with that in other G-7 countries, while Canada's ratio of investment in machinery and equipment to GDP was low by international standards. With the participation rate likely to stabilize at some point, this suggested that policies to help spur productivity and investment would be needed to sustain Canada's strong growth performance. In addition, flexibility was also at a premium, given Canada's openness and resulting susceptibility to external shocks.[11]

Rapid employment growth has been associated with moderate labor productivity growth.



Investment in machinery and equipment is lower than in other advanced economies.



Source: OECD Analytic Database.

A. Taxes, Spending, and Internal Trade

41. ***Officials agreed with staff that there remains significant scope for efficiency-enhancing structural, tax, and regulatory reforms.*** The upcoming demographic shift and growing challenges from increasingly global markets made improving labor productivity and economic flexibility crucial for continued gains in standards of living. For this reason, the 2004 Budget had placed a priority on further boosting productivity and included measures to promote investment, education, innovation, and basic infrastructure. At the same time, they noted that recent tax cuts, reforms to the Employment Insurance (EI) system in the late 1990s, and trade liberalization in the context of NAFTA had already contributed to economic efficiency and flexibility.

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[11] Following last year's work on productivity ("The Canada-United States Productivity Gap" in IMF Country Report 04/60), Chapter 5 in this year's *Selected Issues* paper examines Canada's economic flexibility.

42. ***The mission pointed to the relatively high tax burden despite recent tax cuts at both the federal and provincial level.***[12] Staff and officials agreed that, given the fiscal situation, tax-reduction would need to be targeted to maximize social returns. The staff noted that the welfare analysis contained in Finance Canada's *Tax Expenditure and Evaluations* suggested priority could be given to increasing incentives to invest and save. Options included aligning depreciation allowances more closely with economic depreciation, eliminating provincial capital taxes/sales taxes on inputs, and reducing taxes on capital income.

43. ***Officials acknowledged that tax cuts in the United States and elsewhere increased pressure on Canada to follow suit.*** Officials indicted that there was pressure to lower the corporate tax rate, while the mission noted that reducing the gap in tax rates between large and small enterprises could increase incentives to exploit advantages of scale and scope.[13] While agreeing that recent (and proposed) U.S. tax cuts on saving could create pressure for similar steps in Canada, officials suggested that enhancing tax-sheltered instruments could help stimulate household saving, business investment, and productivity growth. They noted that fairness as well as efficiency considerations were important in assessing such instruments.

44. ***The mission noted that the EI program remains an uneasy combination of unemployment insurance and social assistance.*** Staff observed that recent changes to the system had diluted reforms of the late 1990s, and suggested that future modifications reinforce the program's insurance principle by reducing social benefits (which could be better funded through general revenues) and introducing experience rating of employers and employees. Officials observed it had proven difficult to resist pressures to enrich benefits in recent years but that structural and legal challenges could eventually prompt reforms.[14] However, the immediate priority was on establishing a transparent system for setting premiums so as to balance the system over the cycle and avoid procyclical adjustment.

45. ***The mission suggested that reforms in other social programs could help increase labor utilization and efficiency.*** Possible improvements included reducing incentives for early retirement in the public pension system, such as those being proposed by the Quebec Pension Plan (QPP), and by lowering "welfare walls" in the social transfer system. Officials agreed that QPP proposals to make the system more actuarially fair and curb excessive use of disability benefits could reduce disincentives for seniors to work, and that smoothing

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[12] Effective tax rates on capital are discussed in "How Canada's Tax System Discourages Investment," by D. Chen and J. Mintz; C. D. Howe Institute Backgrounder No. 68, 2003.

[13] Tax relief for small enterprises encompasses considerable smaller businesses in Canada than in the United States.

[14] A growing share of workers are ineligible for social assistance under EI (i.e., the self-employed, part-time, or contractual workers), while a recent court ruling in Quebec had questioned the constitutionality of social benefits under the program.

relatively effective marginal tax rates (EMTRs) at low income levels could improve labor market outcomes, especially for lower-skilled workers. However, there was no easy solution to high EMTRs, since they required either benefit reductions for low-income groups or extending benefits for higher income groups at a significant fiscal cost.

46. ***Officials explained that progress was being made toward facilitating internal trade.*** The Agreement on Internal Trade (AIT) had become a priority of the Council of the Federation, resulting in provincial accords on issues such as the dispute settlement process, while further reforms to the AIT in agriculture, energy, and labor mobility were being debated. The authorities also observed that significant restrictions remained in the area of professional qualifications, particularly with regard to foreign workers.

47. ***Officials noted that electricity reforms had slowed.*** Although provincial authorities continued to seek private investments in the energy sector, Ontario's decision to reverse planned reforms to privatize part of its generating assets had been a backward step. In addition, officials observed that reforms to enhance the reliability of the electricity system had been slowed by the failure to approve an energy bill in the U.S. Congress, which would set up an independent oversight board in Canada's main trading partner.

48. ***Officials explained that work on environmental regulations and legislation in pursuit of the Kyoto Protocol was well underway.*** Guidelines for emissions-intensity targets and legislation to deal with large final emitters would be in place by spring 2005, including financial sanctions for transgressors. An emissions trading mechanism was expected to be operational in 2008.

B. Financial Sector Policies

49. ***Officials expressed confidence in the stability of the financial system and effectiveness of the prudential and supervisory system***. The banking and insurance sectors had posted strong performances in recent years, capital ratios were robust, and the system was well positioned to respond to monetary tightening.[15] On the regulatory front, officials noted that the regular, five-year revision to financial services regulation would begin shortly, and that consideration might be given to streamlining the roles of some agencies, where responsibilities overlapped. Meanwhile, FINTRAC was continuing to implement earlier anti-money-laundering legislation. The authorities responded favorably to the staff's suggestion that an Update of the 2000 pilot FSAP would be useful, but requested details on the burden this would entail.

50. ***Staff noted that limited progress had been made in addressing regulatory issues related to bank mergers and securities markets***:

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[15] Chapters 6 and 7 of the *Selected Issues* paper analyze financial system soundness indicators and banking efficiency, respectively.

- *Bank mergers.* Officials acknowledged that progress had been slow in finalizing financial sector consolidation policy in Canada, including in clarifying the "public interest" criterion used for ministerial approval of bank mergers. A consultation process had concluded by end-2003 and revised merger guidelines were to have been issued in mid-2004. However, no new deadline had been set. Moreover, despite long-standing concerns that the present system impeded efficiency, officials noted that Canadian banks were profitable and able to invest in expanded operations abroad.

- *Securities market regulation.* The late-2003 report by a "Wise Persons Committee" has called for the establishment of a single securities market regulator to reduce compliance and administrative costs. However, while progress was being made on coordinating provincial regulations, staff noted that unification at a more fundamental level would be difficult to achieve in the face of continued opposition by most provinces.

51. ***Staff asked about the experience with tighter corporate governance, accounting, and disclosure standards enacted in response to U.S. accounting scandals***.[16] Officials responded that these initiatives had enhanced markets integrity and helped avoid regulatory gaps with the United States. However, some officials and regulators felt that these measures had followed U.S. legislation too closely and placed an excessive burden on small firms, which were more prevalent in Canada. Similarly, mixed views were expressed on the related issue of the benefits from further harmonizing Canada's accounting practices with the U.S. GAAP. While providing advantages for companies operating on both sides of the border, officials observed that the U.S. rules were not always in keeping with Canada's different structure of corporate governance.

52. ***Staff welcomed steps to harmonize regulation of defined benefit pension plans.*** Plans are administered at both provincial and federal levels, and the Canadian Association of Pension Supervisory Authorities (CAPSA) has recently issued for discussion a model law to harmonize regulations and simplify disclosure and compliance. The team and regulators agreed that, given underfunding issues, consideration could also be given to enhancing incentives for funding, particularly in the light of recent court cases that had reduced management's control over the disposition of funds after partial windups.

C. Trade and International Assistance

53. ***Officials welcomed the revival of the Doha Round negotiations in July 2004, although key issues remained to be negotiated.*** On agriculture, Canada had agreed to the eventual elimination of government schemes to guarantee export credits and underwrite the losses of the Canadian Wheat Board (CWB). They were planning to maintain the CWB's

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[16] These included a review of auditing practices; strengthened independence of board and audit committees; increased disclosure standards; certification of financial statements by chief executive and financial officers; increased transparency of financial statements; and stiffened penalties for corporate fraud.

monopoly status and, in common with many other countries, to ask for flexibility for certain sectors, specifically those governed by supply-management schemes. Staff responded that, as a major agricultural exporter, Canada had much to gain from the Doha round and that reducing trade barriers in the supply-managed sectors could improve efficiency and support an ambitious Doha outcome. Following the withdrawal of investment from the Doha Round agenda, Canada intends to pursue its objectives through regional or bilateral initiatives.

54. ***The authorities viewed Canada's increasing pursuit of bilateral and regional free trade agreements (RTAs) as complementary to their multilateral efforts.*** Staff pointed to drawbacks of RTAs, including the scope for trade diversion; reduced incentives for multilateral liberalization; and webs of overlapping and cumbersome administrative provisions as RTAs multiply. The authorities acknowledged that the proliferation of disparate RTAs could be seen as a concern, but did not view it as an obstacle to an ambitious multilateral agreement. They pointed to the continued interest of Canada in the Doha process, especially as key issues, such as agricultural subsidies, have remained outside the scope of RTAs.

55. ***In February 2004, Canada renewed its trade preference schemes for less developed countries for a further ten years.*** The authorities contended, however, that such schemes should be temporary, as their role was to provide breathing room to countries preparing their export sectors for global competition. They added that multilateral trade liberalization would in any case erode the value of such schemes in the medium term.

56. ***While Canada's focus remains on strengthening trade relations with the United States, parallel efforts are underway to enhance access to other markets.*** Recent Canada-U.S. bilateral initiatives focused on responding to security concerns while ensuring the smooth flow of goods and people across the common border. At the same time, parallel efforts are underway to tap the significant export-growth potential, particularly in large emerging markets such as Brazil, China, and India.

57. ***Officials presented analysis suggesting that additional gains from further integration with the United States remain to be realized.*** Further regulatory harmonization with the United States could produce significant welfare gains, as could the liberalization of NAFTA's rules-of-origin provisions.

58. ***Officials reiterated their commitment to double the International Assistance Envelope by the end of the decade***. This should raise Official Development Assistance (ODA), therefore improving Canada's ODA/GNI ratio, which, at 0.26 percent, was in the mid-range of OECD ratios in 2003. Nearly half of this additional funding will be targeted to Africa, further strengthening Canada's role in the G8 Action Plan for Africa and the U.K.-led Commission for Africa.

VII. Staff Appraisal

59. ***Canada's recent macroeconomic performance has been enviable, and has reflected the benefits of sound institutions and a strong policy framework.*** Inflation targeting has

provided a transparent basis for monetary policy while the strong commitment to "budget balance or better" has yielded welcome progress toward the debt reduction needed to cope with the fiscal pressures of an aging population. This institutional structure, as well as structural reforms, have delivered the fastest growth in the G-7 since 1995. In addition, the authorities have been receptive to past Fund advice, and have recently added a debt target to the fiscal framework and more detail on Bank of Canada forecasts in the MPR, as suggested in last year's report.

60. ***The economy is likely to continue to perform solidly in the coming year, but the challenge is to guard against the considerable uncertainties that remain.*** Growth is expected at around 3 percent into 2005 and following the Canadian dollar's recent appreciation, the exchange rate appears broadly consistent with medium-term fundamentals. However, while there are clearly upsides to the outlook, an even sharper drop in net exports cannot be ruled out, global current account imbalances could result in further significant exchange rate appreciation and a more abrupt slowing of consumer spending remains a possibility.

61. ***Looking beyond the near term, important challenges also remain.*** Exchange rate appreciation, commodity price volatility, prospective trade liberalization, and the potential spillovers from the resolution of global current account imbalances emphasize the importance of flexible labor and product markets. In addition, Canada—like other industrial countries—faces a sharp increase in the share of the elderly population in coming decades. Meeting these challenges will require sustained fiscal prudence, fundamental reform to control health care costs, and structural policies to maximize productivity.

62. ***The Bank of Canada appears to have room to maintain a patient and measured approach to withdrawing stimulus.*** The Bank has appropriately started to increase interest rates, and further tightening will likely be needed. At the same time, the absence of wage pressures, the risks to the outlook, and anchored inflation expectations, imply that a cautious and pragmatic approach to monetary tightening would be consistent with the inflation target.

63. ***The Bank's moves to strengthen further policy transparency and communication are commendable.*** The additional information on macroeconomic projections in the MPR is a welcome innovation, and the Bank's active communication strategy has been effective in preparing markets for recent shifts in policy stance. There remains scope, however, for providing a richer background on policymakers' views on the distribution of risks and related policy implications at the time of the Bank's fixed action dates, especially when these are not accompanied by an MPR or an *Update*.

64. ***Recent agreements with the provinces have all but removed room for fiscal maneuver and increased the premium on fiscal prudence.*** There is very limited room for new initiatives in the forthcoming budget and, while planning surpluses are projected to reemerge from FY 2007–08, the staff caution against placing an undue weight on these forecasts given the uncertainties around such projections.

65. ***The objective of lowering the federal debt-to-GDP ratio to 25 percent within ten years has added a welcome medium-term anchor to the fiscal framework.*** Keeping the debt-to-GDP ratio on a downward path at all levels of government over the next decade and beyond will be an important element in preparing Canada for the long-term fiscal challenge posed by population aging, and could provide a useful anchor in case a large shock required a temporary breach of the commitment to balanced budget or better.

66. ***More needs to be done to ensure the sustainability and efficiency of the health care system.*** The latest federal-provincial agreement has provided stable funding for provincial health programs and mechanisms to improve accountability and comparability across provinces. The major challenge, however, will be to improve the system's efficiency, including through measures that improve incentives for both health care providers and consumers. Permitting a diversity of provincial strategies to control costs and reform public systems will provide opportunities to test different approaches and identify best practices.

67. ***Helpful steps have been taken to enhance further Canada's already high level of fiscal transparency.*** To be sure, recent fiscal surpluses have been greater than projected. However, this partly reflects the explicitly prudent framework as well as favorable economic developments. Nonetheless, it is important to ensure that public confidence in the process remains strong and sustains the social consensus for continued debt reduction.

68. ***The demographic shift and the ongoing challenges from increasingly globalized markets underscore the importance of further structural reforms***. Recent policies have laid a solid foundation for future growth and created a favorable environment for business, but there is more to be done:

- *The tax burden remains relatively high*. Given limited fiscal room, an emphasis is needed on measures that yield the greatest efficiency gain.

- *The EI system combines unemployment insurance and social assistance*. Funding the latter function through general revenues would be more efficient and transparent, and every effort should be made to reinforce the insurance principle of the program.

- *Reforms in other social programs could help increase labor utilization and efficiency*. There remains room to reduce incentives for early retirement in the public pension system and low "welfare walls" in the social transfer system.

- *Reducing regulatory barriers to trade and competition.* Regulatory frameworks and infrastructure investment could be strengthened, particularly in the electricity sector.

- *Maintaining the momentum for multilateral trade liberalization*. Canada can play an important leadership role in efforts to complete the Doha Round, including by further relaxing trade barriers for "supply-managed" agricultural products.

69. ***Further reforms to Canada's sound financial system could promote flexibility in a rapidly changing global environment***:

- *The regulatory framework governing bank mergers could be further clarified*. Addressing this would reduce uncertainty and could enable efficiency gains.

- *Adopting a single national securities regulator would reduce compliance and administrative costs*. The upcoming review of financial sector regulation may also provide scope for reducing regulatory overlap.

- *Useful steps have been taken to harmonize the regulation of defined benefit pension plans.* Consideration could also be given to enhancing incentives for funding.

70. ***Recent commitments to promoting foreign development and assistance are commendable.*** Canada's support for African development, including the cancellation of official debt owed to Canada by several African countries, is particularly noteworthy.

71. It is recommended that the next consultation occur on the usual 12-month cycle.

Table 1. Canada: Indicators of Economic Performance

	Average							Projections	
	1987–97	1998	1999	2000	2001	2002	2003	2004	2005
	(Annual percent change)								
Per capita GDP									
Canada	1.1	3.2	4.7	4.3	0.7	2.3	1.1	1.8	1.7
United States	1.9	3.0	3.3	2.5	-0.3	0.8	2.0	3.4	2.7
Japan	2.7	-1.4	-0.2	2.2	0.0	-0.5	1.2	2.8	1.4
Germany	2.7	2.0	2.0	2.7	0.7	-0.1	-0.1	1.7	1.2
G-7 countries	2.1	2.1	2.4	2.8	0.3	0.6	1.4	2.7	2.1
Real GDP									
Canada	2.4	4.1	5.5	5.2	1.8	3.4	2.0	2.7	2.9
United States	3.0	4.2	4.4	3.7	0.8	1.9	3.0	4.4	3.7
Japan	3.1	-1.1	0.0	2.4	0.2	-0.3	1.3	2.8	1.4
Germany	3.4	2.0	2.0	2.9	0.8	0.1	-0.1	1.7	1.2
G-7 countries	2.9	2.8	3.1	3.4	1.0	1.2	2.0	3.4	2.7
Real domestic demand									
Canada	2.9	2.4	4.1	4.9	1.3	3.4	4.4	3.4	3.7
United States	3.2	5.3	5.3	4.4	0.9	2.5	3.3	4.7	3.7
Japan	3.7	-1.5	0.1	1.9	0.8	-0.9	0.8	2.1	1.3
Germany	2.5	2.4	2.8	1.9	-0.8	-1.9	0.5	0.5	0.9
G-7 countries	2.8	3.5	3.8	3.6	1.0	1.4	2.3	3.4	2.7
GDP deflator									
Canada	2.6	-0.4	1.7	4.1	1.1	1.0	3.2	3.3	2.6
United States	2.7	1.1	1.4	2.2	2.4	1.7	1.8	2.2	2.4
Japan	0.9	-0.2	-1.3	-1.5	-1.3	-1.3	-1.4	-1.5	-0.4
Germany	2.3	1.1	0.5	-0.3	1.3	1.5	1.1	0.7	0.8
G-7 countries	2.7	1.0	0.9	1.2	1.6	1.4	1.5	1.5	1.8
	(In percent of GDP)								
General government financial balance									
Canada	-5.5	0.1	1.6	2.9	1.1	0.3	0.6	1.4	1.2
United States	-3.9	0.1	0.6	1.3	-0.7	-4.0	-4.6	-4.3	-3.8
Japan	-1.2	-5.5	-7.2	-7.5	-6.1	-7.9	-8.3	-6.9	-6.7
Germany	-2.4	-2.2	-1.5	1.3	-2.8	-3.7	-3.8	-3.9	-3.4
G-7 countries	-5.3	-1.5	-1.2	-0.2	-1.8	-4.0	-4.6	-4.2	-3.9
Gross savings									
Canada	17.4	19.1	20.7	23.6	22.0	21.5	22.1	23.1	22.5
United States	16.3	18.3	18.1	18.0	16.4	14.2	13.5	13.7	15.0
Japan	32.5	29.8	28.6	28.8	27.8	26.8	27.1	27.4	27.5
Germany	23.0	21.2	20.5	20.3	19.4	19.5	19.7	21.3	22.3
G-7 countries	20.6	20.9	20.4	20.5	19.3	17.9	17.5	18.0	18.9
Fixed investment									
Canada	20.1	19.9	19.8	19.2	19.6	19.6	19.5	19.8	19.9
United States	18.3	19.4	19.9	20.2	19.5	18.3	18.4	19.0	18.7
Japan	29.9	26.8	26.4	26.4	25.7	24.2	23.9	24.1	24.5
Germany	23.4	21.4	21.6	21.7	20.3	18.6	17.8	17.4	17.7
G-7 countries	18.1	17.5	17.1	17.0	16.6	16.4	16.2	16.8	16.9
Current account balance									
Canada	-2.6	-1.2	0.3	2.7	2.3	2.0	2.0	2.8	1.8
United States	-1.6	-2.4	-3.2	-4.2	-3.8	-4.5	-4.8	-5.5	-5.7
Japan	2.4	3.0	2.6	2.5	2.1	2.8	3.2	3.6	3.1
Germany	0.8	-0.5	-1.1	-1.4	0.1	2.2	2.2	3.7	3.7
G-7 countries	-0.2	-0.3	-0.9	-1.5	-1.4	-1.5	-1.6	-1.6	-1.8

Sources: IMF, *World Economic Outlook;* and Fund staff estimates.

Table 2. Canada: Selected Economic Indicators
(Percent change at annual rates, unless othewise indicated)

		Projections										Projections			
				2003				2004				2005			
	2003	2004	2005	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NIPA in constant prices															
Real GDP	2.0	2.7	2.9	2.8	-0.7	1.4	3.3	2.7	3.9	3.2	2.5	2.8	2.8	2.9	3.0
Q4/Q4	1.7	3.1	2.9												
Net exports 1/	-2.4	-0.7	-0.6	-3.1	-3.3	0.3	-2.2	0.5	2.6	-5.1	-0.6	-0.2	0.1	0.0	0.2
Total domestic demand	4.4	3.4	3.7	6.0	2.5	0.9	5.3	2.2	1.7	8.8	3.2	3.2	2.9	3.0	2.9
Final domestic demand	3.6	3.6	3.3	4.1	3.7	5.2	2.3	5.2	2.1	3.3	3.2	3.4	3.4	3.5	3.4
Private consumption	3.1	3.2	2.7	3.1	3.2	4.4	0.7	6.0	2.1	3.0	2.2	2.7	2.8	3.0	3.0
Personal saving ratio (in percent of DI)	1.4	2.1	1.7	1.7	2.0	0.7	1.3	0.6	0.5	0.0					
Public consumption	3.8	2.8	3.8	3.7	5.9	0.4	3.9	2.8	1.2	4.0	4.3	3.8	3.8	3.8	3.8
Private fixed domestic investment	4.6	6.0	4.8	5.9	1.7	14.9	5.2	5.5	4.6	4.5	5.2	4.9	4.7	4.6	4.2
Machinery and Equipment	4.5	7.6	7.6	3.0	3.6	17.8	3.2	8.2	5.5	8.2	8.5	8.0	7.5	7.0	6.5
Residential construction	7.5	8.0	3.5	6.6	-0.7	19.7	8.6	9.0	6.3	3.3	4.0	3.5	3.0	3.0	2.0
Private investment (in percent of GDP)	16.9	17.2	17.4	16.7	16.7	17.1	17.1	17.2	17.3	17.2	17.3	17.3	17.4	17.5	17.5
Public investment	6.8	1.8	2.8	17.0	8.2	1.0	5.9	5.3	-5.8	-2.4	4.2	4.3	4.3	4.3	4.3
Change in inventories 1/	0.9	-0.1	0.2	2.1	-0.9	-3.8	2.9	-2.8	-0.4	4.8	0.1	-0.1	-0.4	-0.4	-0.4
GDP (current prices)	5.3	6.1	5.6	9.6	-2.6	4.2	4.8	7.3	10.0	7.0	5.0	5.1	5.0	4.9	5.1
Employment and inflation															
Unemployment rate	7.6	7.3	7.2	7.5	7.7	7.9	7.5	7.4	7.3	7.2	7.1	7.2	7.2	7.2	7.2
Employment	2.2	1.8	1.4	1.8	0.7	0.8	3.6	1.1	2.0	1.3	1.9	1.0	1.2	1.2	1.3
CPI inflation (y/y)	2.7	1.8	2.3	4.4	2.8	2.1	1.7	0.8	2.2	2.0	2.3	2.5	2.1	2.4	2.2
Core CPI inflation (y/y)	2.2			3.1	2.2	1.7	1.9	1.3	1.7	1.7	1.6				
GDP deflator	3.2	3.3	2.6	6.8	-1.8	2.6	1.4	4.7	5.8	3.5	2.5	2.2	2.1	2.0	2.0
Potential Output Growth	3.0	2.9	2.9	3.0	3.0	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Output gap (in percent of potential output)	-0.3	-0.5	-0.4	0.6	-0.3	-0.7	-0.6	-0.7	-0.4	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4
Indicators of fiscal policies															
(NIA basis, in percent of GDP)															
Federal fiscal balance	0.4	0.8	0.5	0.8	-0.8	0.7	0.8								
Provincial fiscal balance 2/	-0.6	-0.2	-0.1	-0.7	0.1	-0.8	-0.9								
General government fiscal balance 2/	0.6	1.4	1.2	0.9	0.1	0.7	0.8								
Three-month treasury bill (percent)	2.9	2.2	2.9	2.9	3.2	2.8	2.7	2.2	2.0	2.2	2.5	2.6	2.7	2.9	3.2
Ten-year government bond yield (percent)	4.8	4.6	4.8	5.0	4.6	4.8	4.8	4.5	4.8	4.7	4.5	4.5	4.7	4.9	5.1
External indicators															
Current account balance (in percent of GDP)	2.0	2.8	1.8	1.7	1.8	2.2	2.2	2.6	3.5	2.9	2.4	2.0	1.9	1.6	1.7
Merchandise trade balance (in percent of GDP)	4.8	5.3	4.2	5.3	4.4	4.8	4.5	5.0	5.9	5.2	4.7	4.3	4.2	4.0	4.0
Export volume	-2.2	5.8	4.1	-3.0	-4.2	-2.6	10.1	4.0	20.1	-1.6	3.2	3.7	4.2	4.4	4.4
Import volume	3.4	8.5	6.7	2.4	3.6	-4.8	16.7	2.9	15.7	16.0	4.8	5.2	4.3	5.0	4.0
Balance on invisibles (in percent of GDP)	-2.8	-2.4	-2.4	-3.5	-2.6	-2.7	-2.4	-2.5	-2.4	-2.4	-2.3	-2.3	-2.3	-2.4	-2.3
Exchange rate	0.72			0.67	0.72	0.72	0.77	0.76	0.74	0.77	0.83				
Nominal effective exchange rate (q/q)	9.8			3.1	7.4	1.3	3.7	-0.9	-2.6	3.9					
Real effective exchange rate (q/q)	12.1			3.8	8.1	1.7	4.0	-0.6	-2.3	4.2					
Terms of trade	6.0	4.1	-0.5	15.4	0.9	5.3	3.5	5.4	1.8	9.1	-2.1	-3.9	-0.4	-1.7	0.3
Saving and investment (in percent of GDP)															
Gross national saving	22.1	23.1	22.5	22.9	21.5	21.6	22.1	22.2	23.0	23.7					
General government	3.1	3.8	3.6	3.3	2.5	3.2	3.2	3.3	4.2	4.5					
Private	19.0	19.2	18.9	19.6	19.0	18.4	18.9	18.9	18.8	19.2					
Personal	3.8	5.9	5.2	3.9	4.2	3.4	3.7	3.3	3.2	3.0					
Business	15.2	13.4	13.7	15.7	14.8	15.0	15.1	15.6	15.6	16.3					
Gross domestic investment	20.1	20.2	20.7	20.7	20.5	20.0	20.7	20.0	20.0	21.0					

Sources: Haver Analytics; and Fund staff estimates.

1/ Contribution to growth.

2/ Includes local governments and hospitals.

Table 3. Canada: Balance of Payments
(In billions of Canadian dollars, unless otherwise indicated)

			Forecast					
	2002	2003	2004	2005	2006	2007	2008	2009
Current account balance	22.7	23.8	36.8	24.6	26.7	32.8	37.3	42.8
In percent of GDP	2.0	2.0	2.8	1.8	1.9	2.2	2.4	2.6
Merchandise trade balance	57.2	58.2	68.3	56.8	58.7	64.6	68.9	74.0
Exports, goods	413.8	400.0	431.8	444.9	462.1	490.2	518.9	552.6
Imports, goods	356.6	341.8	363.5	388.1	403.4	425.6	450.0	478.6
Services balance	-6.9	-10.9	-10.9	-9.8	-9.5	-9.4	-9.5	-9.9
Investment income balance	-28.7	-23.7	-21.1	-22.9	-23.0	-22.8	-22.6	-21.8
Transfer balance	1.0	0.3	0.5	0.4	0.4	0.4	0.4	0.4
Capital and financial accounts balance	-12.8	-20.7	-54.3	-20.1	-22.2	-28.3	-32.8	-38.3
Direct investment, net	-8.4	-21.0	-54.0	-20.0	-24.0	-28.8	-34.5	-41.3
In Canada	33.0	9.2	31.6	63.0	73.2	85.1	98.9	114.9
Abroad	-41.5	-30.2	-85.5	-83.0	-97.2	-113.9	-133.4	-156.2
Portfolio investment, net	-4.2	6.0	9.3	-2.6	-0.6	-1.8	-0.5	1.0
Canadian securities	20.9	18.5	39.3	22.4	23.3	24.2	25.2	26.3
Bonds	18.7	7.0	...	...	...	...	...	...
Stocks	-1.5	12.9	...	...	...	...	...	...
Money market	3.8	-1.5	...	...	...	...	...	...
Foreign securities	-25.1	-12.5	-30.0	-25.0	-23.9	-26.0	-25.7	-25.3
Bonds	-6.2	-8.1	...	...	...	...	...	...
Stocks	-18.9	-4.4	...	...	...	...	...	...
Other investment 2/	-5.5	-14.4	-14.0	-2.0	-2.1	-2.2	-2.3	-2.4
Assets	-13.5	-30.1	-32.3	-23.2	-25.0	-26.8	-28.9	-31.0
Liabilities	8.0	15.7	18.2	21.3	22.9	24.7	26.6	28.6
Capital account balance	5.0	4.0	4.5	4.5	4.5	4.5	4.5	4.5
Transactions in official international reserves	0.3	4.7	...	...	...	...	...	...
Statistical discrepancy	-9.8	-3.1	-17.5	...	...	...	...	...
Memorandum item:								
Net external investment position	-202	-218	-159	-135	-108	-75	-38	5
In percent of GDP	-17.5	-17.9	-12.3	-9.9	-7.5	-5.0	-2.4	0.3

Source: Haver Analytics.

1/ Quarterly flows are annualized.

2/ Includes bank, nonbank, and official transactions other than reserve transactions.

Table 4. Canada: Selected Vulnerability Indicators
(In percent of GDP unless otherwise indicated)

	1998	1999	2000	2001	2002	2003	2004
External indicators							
Official reserves (in billions of U.S. dollars)	23.4	28.6	32.4	34.2	37.2	36.3	34.5
Broad money (M3) to foreign exchange reserves (ratio)	17.1	14.5	13.8	13.2	12.8	15.6	...
Central bank foreign liabilities (in billions of dollars)	0.2	0.2	0.2	0.2	0.2	0.2	...
Official reserves in months of imports	1.2	1.3	1.4	1.5	1.6	1.5	...
General government debt (in billions of dollars) 1/	99.6	96.9	85.3	73.1	79.5	60.7	...
Net international investment position (current cost, billions of dollars)	-300	-244	-209	-204	-202	-218	...
External debt to exports ratio (in percent)	79.4	57.7	42.7	42.3	42.4	47.4	...
External interest payments to exports (in percent) 2/	16.4	15.7	14.3	13.6	12.5	12.3	...
Financial markets indicators							
General government gross debt	114.8	111.6	101.5	99.1	95.4	90.9	...
Three-month treasury bill yield (percent)	4.7	4.7	5.5	3.9	2.6	2.9	2.2
Ten-year government note (percent)	5.3	5.6	5.9	5.5	5.3	4.8	4.6
Real three-month treasury bill yield (percent; deflated by CPI rate)	3.7	2.9	2.7	1.3	0.2	0.1	0.4
Change in stock market index (TSE 300, annual percentage change)	4.6	4.5	36.1	-19.5	-9.0	1.8	20.7
Banking sector risk indicators 3/							
Balance sheet							
Total loans to assets (percent)	58.4	58.7	57.7	55.8	55.6	53.8	...
Total loans to deposits (percent)	90.2	86.8	84.2	84.5	83.1	81.3	...
Impaired assets/total assets	0.66	0.59	0.60	0.84	0.90	0.64	...
Loan loss provision (in percent of total assets)	0.20	0.23	0.27	0.37	0.57	0.23	...
Total foreign currency assets/total assets 4/	46.4	40.2	40.5	42.7	41.4	36.2	...
Total foreign currency liabilities/total assets 4/	47.7	42.4	42.2	44.7	43.8	37.7	...
Total foreign currency deposits/total assets 4/	32.2	31.3	29.5	30.4	28.9	25.6	...
Profitability							
Return on total shareholders' equity (percent)	13.4	15.8	15.3	13.9	9.4	14.7	...
Return on average assets	0.57	0.71	0.72	0.66	0.44	0.69	...
Average intermediation spread	2.6	2.7	2.9	3.0	3.0	3.1	...
Net interest income (in percent of average total assets)	1.8	1.8	1.8	1.9	2.0	1.9	...
Capital position							
Total capital ratio	10.6	11.3	11.9	12.3	12.4	13.4	...
Tier 1 capital ratio	7.4	8.2	8.6	9.0	9.2	10.3	...
Personal sector 5/							
Net worth in percent of disposable income	514.5	514.2	509.0	509.4	516.3	519.2	...
Total liabilities in percent of disposable income	112.0	114.0	112.6	115.0	117.2	120.2	...
Total liabilities in percent of net worth	21.8	22.2	22.1	22.6	22.7	23.1	...
Corporate sector 6/							
Debt of private nonfinancial corporations (in percent of GDP)	53.9	51.6	49.0	50.6	49.0	44.7	...
Debt-to-equity ratio of nonfinancial private corporations	82.7	78.5	71.8	70.0	65.8	57.5	...

Sources: Bloomberg; Canadian Bankers Association; Haver Analytics; and Office of the Superintendent of Financial Institutions.

1/ Defined as Government of Canada securities held by nonresidents.
2/ Income payments on foreign-owned assets (other private payments plus Canada government payments).
3/ Unless otherwise indicated, based on data reported by the six largest chartered Canadian banks, which account for over 90 percent of the total market share.
4/ All chartered banks.
5/ Persons and unincorporated business.
6/ Based on total debt less trade payables, corporate claims, and other liabilities.

Table 5. Canada: Key Fiscal Indicators

							Staff Projections				
	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Federal government (PA basis) 1/					(In billions of dollars)						
Revenue	156.1	166.1	182.7	171.7	177.6	186.2	194.0	199.4	209.5	220.3	231.2
Program spending	110.0	109.6	118.7	125.0	133.5	141.4	150.9	159.8	167.5	174.4	180.8
Interest payments	43.3	43.4	43.9	39.7	37.3	35.8	34.8	35.4	35.8	38.3	38.2
Budgetary surplus	2.8	13.1	20.2	7.1	6.8	9.1	8.3	4.2	6.2	7.6	12.2
Structural budgetary surplus 2/	3.4	10.4	15.5	5.6	6.5	10.4	9.7	5.4	6.9	7.5	11.7
Economic prudence	...	...	...	...	...	...	...	1.0	1.0	3.0	4.0
Contingency reserves	...	...	...	...	...	...	3.0	3.0	3.0	3.0	3.0
Planning surplus	...	...	...	...	...	...	5.3	0.2	2.2	1.6	5.2
Net federal debt	557.2	543.4	524.5	517.5	510.5	501.5	493.2	489.0	482.8	475.2	463.0
					(In percent of GDP)						
Revenue	17.1	16.9	17.0	15.5	15.3	15.3	15.0	14.6	14.6	14.6	14.6
Program spending	12.0	11.2	11.0	11.3	11.5	11.6	11.7	11.7	11.7	11.5	11.4
Interest payments	4.7	4.4	4.1	3.6	3.2	2.9	2.7	2.6	2.5	2.5	2.4
Budgetary surplus	0.3	1.3	1.9	0.6	0.6	0.7	0.6	0.3	0.4	0.5	0.8
Structural budgetary surplus 2/	0.4	1.0	1.5	0.5	0.6	0.8	0.7	0.4	0.5	0.5	0.7
Economic prudence	...	...	...	...	...	...	...	0.1	0.1	0.2	0.3
Contingency reserves	...	...	...	...	...	...	0.2	0.2	0.2	0.2	0.2
Planning surplus	...	...	...	...	...	...	0.4	0.0	0.2	0.1	0.3
Net federal debt	60.9	55.3	48.7	46.7	44.1	41.1	38.1	35.8	33.6	31.5	29.2
General government					(In billions of dollars)						
(NIA and calendar year basis) 3/											
Revenue	404.7	428.9	470.2	471.9	473.8	499.3	526.7	547.6	575.1	604.4	634.0
Expenditure	404.0	413.1	438.5	459.5	470.6	491.6	508.9	531.0	557.1	583.3	608.6
Balance	0.8	15.9	31.7	12.3	3.3	7.6	17.8	16.6	18.0	21.1	25.4
Structural balance 2/	4.3	12.2	19.9	8.9	0.3	9.7	20.8	19.7	20.0	21.1	24.6
Net public debt	767.2	741.0	703.4	659.1	654.1	632.6	614.8	598.2	580.2	559.1	533.7
					(In percent of GDP)						
Revenue	44.2	43.7	43.7	42.6	40.9	41.0	40.7	40.1	40.1	40.0	40.0
Expenditure	44.2	42.0	40.7	41.5	40.6	40.3	39.3	38.9	38.8	38.6	38.4
Balance	0.1	1.6	2.9	1.1	0.3	0.6	1.4	1.2	1.3	1.4	1.6
Structural balance 2/	0.5	1.3	1.9	0.8	0.0	0.8	1.6	1.4	1.4	1.4	1.6
Net public debt	83.8	75.4	65.3	59.5	56.5	51.9	47.5	43.8	40.4	37.0	33.7
Memorandum items											
Real GDP growth	4.1	5.5	5.2	1.8	3.4	2.0	2.7	2.9	3.0	3.2	3.0
Nominal GDP growth rate	3.7	7.4	9.6	2.9	4.5	5.3	6.1	5.6	5.1	5.2	5.0
Three-month treasury bill rate	4.7	4.7	5.5	3.9	2.6	2.9	2.2	2.9	3.9	4.7	4.7
Ten-year government bond rate	5.3	5.6	5.9	5.5	5.3	4.8	4.6	4.8	5.5	6.0	6.1

Sources: Department of Finance Canada; Haver Analytics; and Fund staff estimates.

1/ On a fiscal year basis, which starts on April 1.
2/ In percent of potential GDP.
3/ Includes federal, provincial, territorial, and local governments; and Canada and Quebec pension plans.

Canada—Fund Relations
(As of December 31, 2004)

I. **Membership Status:** Joined 12/27/45; Article VIII

		SDR Million	Percent of Quota
II.	**General Resources Account:**		
	Quota	6,369.20	100.00
	Fund holdings of currency	4,219.63	66.25
	Reserve position in Fund	2,149.58	33.75

		SDR Million	Percent of Allocation
III.	**SDR Department:**		
	Net cumulative allocation	779.29	100.00
	Holdings	595.19	76.38

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None.

VI. **Projected Obligations to Fund:** None.

VII. **Implementation of HIPC Initiative:** Not applicable.

VIII. **Safeguards Assessments:** Not applicable.

IX. **Exchange Rate Arrangements:** The Canadian authorities do not maintain margins with respect to exchange transactions, and exchange rates are determined on the basis of demand and supply conditions in the exchange market. However, the authorities may intervene to maintain orderly conditions in the exchange market. There are no taxes or subsidies on purchases or sales of foreign exchange. Canada has lifted restrictions imposed in 1992 with respect to the Federal Republic of Yugoslavia (Serbia and Montenegro) and has replaced restrictions imposed with respect to Iraq with a new regulation, which the authorities intend to notify to the Executive Board under Decision 144-(52/51).

X. **Last Article IV Consultation:** The staff report for the 2004 consultation with Canada was considered by the Executive Board on February 18, 2004 (EBM/04/14). Canada is on a 12-month consultation cycle.

XI. FSAP Participation and ROSC Assessments

Canada - Financial System Stability Assessment - Volume II: Report on Observance of Standards in the Financial System FO/Dis/00/2, Sup. 1, 04/01/00

Summary: The FSSA report concluded that Canada has a stable and highly advanced financial system, which is among the soundest in the world. Moreover, it is supported by a well-developed regulatory system that shows a high degree of compliance with major international standards. Nevertheless, the FSSA report made a few recommendations to further strengthening the regulatory framework and financial system's resilience, most of which have already been addressed, including:

- Introducing capital requirements for the guarantees in life insurance segregated fund (completed by end-2001);
- Tabling legislation granting OSFI powers to remove a financial institution's director or senior officer if the person is deemed not suitable to hold that office based on a number of criteria. The latter legislation brought Canada into broad compliance with the Basel Core Principles;
- Making significant progress in harmonizing securities regulation and improving coordination among provincial securities regulators, including through a newly created association of securities regulators, the Canadian Securities Administrators. Although there remain multiple regulators at the provincial level, a Senate commission was created to develop specific recommendations on further harmonization and streamlining of securities regulation.

Canada: Report on the Observance of Standards and Codes—Fiscal Transparency Module IMF Country Report No. 02/51, 03/12/02

Summary: The report found that fiscal management in Canada meets the requirements of the fiscal transparency code, and in a number of instances represents best practice. In particular, it highlighted the use of private sector economic forecasts, prudence factors, and a contingency reserve for fiscal forecasting in Canada. Fiscal management was also commended for its statistical integrity, impartial tax administration, open procurement, and a transparent regulatory process.

The report found several areas where further improvements would be desirable, including: (i) the preparation of timely, current year estimates of federal and provincial budgets on a comparable basis, (ii) a comprehensive account of the procedures for the budget cycle and expenditure management system, (iii) systematic reporting of the use of reserves for non-economic contingencies, (iv) resume publication of reconciled national and public accounts forecasts of major aggregates over the forecast horizon, and (v) publication by all governments of quasi-fiscal activities.

Many of these issues have been addressed, including: (i) the release by Statistics Canada of consolidated data for federal and provincial budgets for 2001–02 (on a Financial Management System basis), and (ii) the publication of comprehensive descriptions of budget and expenditure management procedures, including: a joint document entitled "Budgeting in Canada" by the Government and the OECD; detailed accounts of policies and procedures on expenditure management at the website of the Treasury Board Secretariat; and the explanation of the budget cycle and process in Budget and Update documents.

Canada: Report on the Observance of Standards and Codes—Data Module IMF Country Report No. 03/328, 10/23/03

Summary: Canada's macroeconomic statistics are comprehensive, timely, and accurate and thus adequate to conduct effective surveillance of economic and financial policies. Official institutions responsible for the compilation and dissemination of the macroeconomic datasets are supported by adequate legal and institutional frameworks. These frameworks protect confidentiality and ensure that statistical work is conducted within a quality assurance program and with sufficient resources. Integrity is ensured by the professionalism of the staff, transparency in statistical policies and practices, and the provision of ethical guidelines for staff. Compilers generally follow internationally accepted guidelines in the production of the macroeconomic statistics, which is well-supported by excellent efforts to develop source data that facilitate a high degree of accuracy and reliability. Statistics are generally relevant, well documented, available with good frequency on a timely basis, and readily accessible to users, who trust them as objective.

While recognizing the high quality of the macroeconomic data, the report makes recommendations to further strengthen the statistical system, most of which are already being addressed, including these priorities:

- Articulate the roles of Statistics Canada and the Bank of Canada in producing financial sector statistics and explore possibilities for more data sharing of monetary and financial statistics;
- Estimate consumption of fixed capital at replacement cost rather than historic costs now used for the corporate sector in the Canadian System of National Accounts (CSNA);
- Disseminate information on the sources and methods used in compiling quarterly public sector statistics for the quarterly CSNA; and
- Reclassify certain transactions that are not recorded in line with the 5th edition of the Balance of Payments Manual (*BPM5*).

XII. **Technical Assistance:** Not applicable.

XIII. **Resident Representative:** Not applicable.

Canada—Statistical Issues

The quality, coverage, periodicity, and timeliness of Canada's economic data are considered to be excellent both in the context of the Article IV consultation and for purposes of ongoing surveillance. Canada has subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standard Bulletin Board (DSBB).

Real Sector. Statistical Authorities of Canada (Statistics Canada) provide timely and adequate data in monthly, quarterly, and annual frequency thereby facilitating the analysis of economic developments and assessment of policy proposals within a quantitative macroeconomic framework. In May 2001, Statistics Canada effected a smooth transition from Laspeyres methodology for estimating real expenditure-based GDP to Fisher index formulae, which enabled more accurate comparison between Canada and other G-7 countries.

Fiscal Sector. The Department of Finance of Canada (Finance Canada) provides monthly and annual data on the federal government's budget, tax policies, rules and regulations for Canada's banks and other financial institutions. The provided data enable adequate assessment of the impact of fiscal policy measures on Canada's economic performance.

Monetary Sector. The Bank of Canada provides timely and adequate coverage of daily, weekly, monthly and quarterly data related to the monetary sector.

External Sector. Statistics Canada provides timely information on a quarterly frequency on the balance of payments, external debt, and the international investment position (IIP).

Finance Canada provides monthly data on Official International Reserves in a format comparable to the IMF's reserve data template, thus enabling adequate surveillance. Data are published at http://www.fin.gc.ca/finsearch/finresults_e.asp?Who=News.

Canada: Core Statistical Indicators

(as of January 25, 2005)

	Exchange Rates	International Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 2/	GDP/ GNP	External Debt 3/	Debt Service
Date of latest Observation	Same day	12/23/04	12/31/04	November 2004	November 2004	Same day	December 2004	November 2004	2004 Q3	2004 Q3	2004 Q3	2004 Q3	2004 Q3
Date received	Same day	12/24/04	1/03/05	1/07/05	1/07/05	Same day	1/19/2005	1/12/2005	11/29/2004	11/30/2004	11/30/2004	12/15/2004	11/29/2004
Frequency of data	Daily	Weekly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly
Frequency of reporting	Daily	Weekly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly
Source of Update	Various	BOC Website	BOC financial statement	BOC financial statement	BOC financial statement	Various	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted
Frequency of Publication	Daily	Monthly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly

1/Gross and net official reserve assets are available.
2/ National accounts.
3/ Net international investment position.

Public Sector Debt Sustainability Framework, 2000–2009

(In percent of GDP, unless otherwise indicated)

	Actual				Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
I. Baseline Medium-Term Projections										
1 Public sector debt 1/	65.3	59.5	56.5	51.9	**47.5**	**43.9**	**40.5**	**37.1**	**33.8**	**30.4**
o/w foreign-currency denominated	2.9	2.8	2.4	1.7	1.7	1.5	1.4	1.3	1.2	1.1
2 Change in public sector debt	-10.1	-5.9	-3.0	-4.6	-4.4	-3.7	-3.3	-3.4	-3.4	-3.4
3 Identified debt-creating flows (4+7+12)	-11.7	-5.1	-5.2	-6.0	-6.4	-5.7	-5.4	-5.4	-5.3	-5.2
4 Primary deficit (surplus is entered with a negative sign as it reduces debt)	-10.1	-7.7	-6.1	-5.9	-6.3	-5.9	-5.8	-5.9	-5.9	-5.9
5 Revenue and grants	43.7	42.6	40.9	41.0	40.7	40.1	40.1	40.0	40.0	40.0
6 Primary (noninterest) expenditure	33.6	34.9	34.9	35.0	34.4	34.2	34.3	34.2	34.1	34.1
7 Automatic debt dynamics 2/	-1.6	2.6	0.9	0.0	-0.1	0.2	0.5	0.5	0.6	0.6
8 Contribution from interest rate/growth differential 3/	-1.8	2.4	0.9	0.3	-0.2	0.3	0.5	0.5	0.6	0.6
9 *Of which:* Contribution from real interest rate	1.8	3.5	2.8	1.4	1.2	1.5	1.7	1.7	1.7	1.6
10 Contribution from real GDP growth	-3.6	-1.1	-2.0	-1.1	-1.3	-1.3	-1.3	-1.2	-1.0	-0.9
11 Contribution from exchange rate depreciation 4/	0.1	0.2	0.0	-0.3	0.1	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	...	...	...	...	...	...	...	...	...	...
13 Residual, including asset changes (2-3)	1.6	-0.7	2.2	1.4	2.0	2.0	2.0	2.0	1.9	1.9
Public sector debt in percent of revenues 1/	149.6	139.7	138.0	126.7	116.7	109.4	101.1	92.8	84.5	76.1
Gross financing 5/	-2.9	-1.1	-0.3	-0.6	-1.4	-1.2	-1.2	-1.4	-1.6	-1.8
in billions of U.S. dollars	-21.3	-7.9	-2.0	-5.4	-13.2	-12.3	-13.4	-15.9	-19.6	-23.3
Key Macroeconomic and Fiscal Assumptions										
Real GDP growth (in percent)	5.2	1.8	3.4	2.0	2.7	2.8	3.0	3.2	3.0	2.9
Average nominal interest rate on public debt (in percent) 6/	7.0	6.6	6.1	5.8	5.8	6.0	6.2	6.5	6.8	6.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.9	5.5	5.0	2.7	2.5	3.4	4.2	4.5	4.8	4.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.8	-5.8	0.8	22.2	-2.9	1.2	0.9	1.0	1.1	0.4
Inflation rate (GDP deflator, in percent)	4.1	1.1	1.0	3.2	3.3	2.6	2.0	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	2.8	5.6	3.4	2.5	1.0	2.0	3.3	2.9	2.7	2.9
II. Stress Tests										
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2005–2009					**47.5**	**43.4**	**39.3**	**35.2**	**31.1**	**26.8**
2. Real interest rate is at historical average plus two standard deviations in 2005 and 2006					**47.5**	**46.1**	**44.8**	**41.5**	**38.2**	**34.9**
3. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006					**47.5**	**44.9**	**42.5**	**39.2**	**35.9**	**32.5**
4. Primary balance is at historical average minus two standard deviations in 2005 and 2006					**47.5**	**47.7**	**48.1**	**44.8**	**41.6**	**38.3**

Historical Statistics for Key Variables (past 10 years)	**Average**	**Standard Deviation**
Primary deficit	-6.9	2.4
Real GDP growth (in percent)	3.6	1.4
Nominal interest rate (in percent) 6/	7.0	0.7
Real interest rate (in percent)	5.3	1.5
Inflation rate (GDP deflator, in percent)	1.7	1.3
Revenue to GDP ratio	42.9	1.2

Sources: Haver Analytics; and Fund staff estimates.

1/ General government net debt.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the denominator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period gross debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus percentage change in GDP deflator.

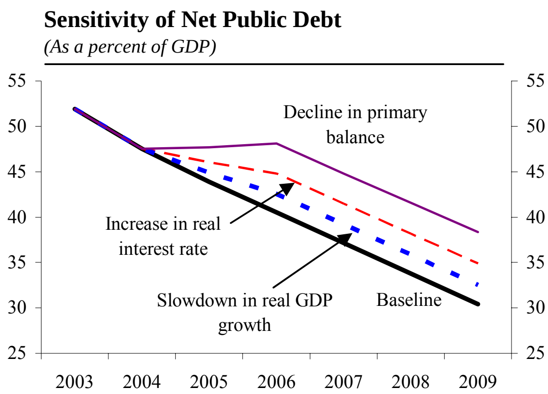
External Sustainability Framework, 2000–2009

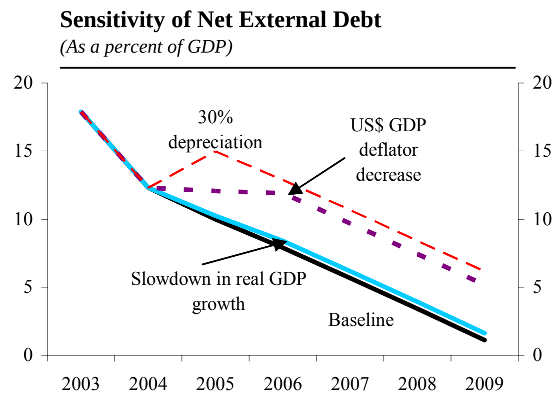
		Actual				Projections					
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
	I. Baseline Medium-Term Projections										
1	Net external liabilities/Exports of G&S	42.7	42.3	42.4	47.4	32.0	25.9	20.3	14.5	8.7	2.8
2	Net external liabilities/GDP	19.4	18.4	17.5	17.9	**12.3**	**10.0**	**7.9**	**5.7**	**3.4**	**1.1**
3	Change in net external liabilities/GDP	-5.4	-1.0	-0.9	0.4	-5.6	-2.3	-2.1	-2.2	-2.3	-2.3
4	Net liability-creating external flows/GDP (5+9)	-6.4	-4.4	-4.1	-5.8	-4.6	-2.4	-2.1	-2.2	-2.2	-2.2
5	Current account deficit/surplus excluding interest/GDP	-5.8	-5.8	-4.4	-3.9	-3.6	-2.3	-2.1	-2.2	-2.2	-2.2
6	Balance on G&S/GDP	5.7	5.7	4.3	3.9	4.8	4.3	4.1	4.0	4.0	3.9
7	Exports of G&S/GDP	45.4	43.4	41.3	37.7	38.4	38.6	38.8	39.1	39.3	39.6
8	Imports of G&S/GDP	39.7	37.8	36.9	33.9	33.6	34.2	34.7	35.1	35.4	35.7
9	(r-g-(ρ+gρ))/(1+g+ρ+gρ))debt/GDP (11/10)	-0.7	1.4	0.3	-1.9	-1.0	-0.1	0.0	0.0	0.0	0.0
10	Adjustment factor: 1+g+ρ+gρ	1.1	1.0	1.0	1.2	1.1	1.1	1.1	1.1	1.1	1.1
11	(r-g-(ρ+gρ))debt/GDP (12+13+14)	-0.7	1.4	0.4	-2.3	-1.1	-0.1	0.0	0.0	0.0	0.0
12	r (interest rate) times debt/GDP	1.7	1.1	0.9	0.9	1.0	0.7	0.6	0.5	0.4	0.2
13	minus g (real GDP growth rate) times debt/GDP	-1.3	-0.3	-0.6	-0.4	-0.5	-0.3	-0.3	-0.2	-0.2	-0.1
14	minus (ρ + gρ) (ρ = US dollar value of GDP deflator, growth rate) times debt/GDP	-1.1	0.6	0.1	-2.8	-1.6	-0.5	-0.3	-0.2	-0.2	-0.1
15	Residual, incl. change in gross foreign assets/GDP (3-4)	1.0	3.4	3.2	6.2	-1.0	0.1	0.0	0.0	-0.1	-0.1
	Memorandum Items: Key macro and external assumptions										
	Nominal GDP (in Can$ bln.)	1077	1108	1158	1219	1292	1361	1429	1499	1571	1646
	Nominal GDP (US dollars)	725	716	738	870	970	1035	1096	1161	1230	1295
	Real GDP growth (in percent per year)	5.2	1.8	3.4	2.0	2.7	2.8	3.0	3.2	3.0	2.9
	Exchange rate (LC per US dollar)	1.5	1.5	1.6	1.4	1.3	1.3	1.3	1.3	1.3	1.3
	Nominal GDP deflator (in US dollars, change in percent per year)	4.2	-3.0	-0.3	15.6	8.7	3.8	2.9	3.1	3.1	2.4
	External interest rate (percent per year)	6.7	5.8	5.1	5.0	5.7	6.0	6.3	6.3	6.3	6.3
	Growth of exports of G&S (US dollar terms, in percent per year)	15.8	-5.6	-2.1	7.9	13.6	6.9	6.6	6.7	6.7	6.0
	Growth of imports of G&S (US dollar terms, in percent per year)	10.5	-6.2	0.8	8.2	10.7	8.6	7.5	7.0	6.9	6.3
	II. Sensitivity Analysis for External Debt-to-GDP Ratio										
	1. Interest rate, real GDP growth rate, US$ GDP deflator growth, non-interest current account, and non-debt flows (in percent of GDP) are at historical averages in 2005-2009					**12.3**	**9.0**	**5.6**	**2.1**	**-1.5**	**-5.3**
	2. Interest rate is at historical average plus two standard deviations in 2005 and 2006					**12.3**	**10.2**	**8.3**	**6.1**	**3.8**	**1.5**
	3. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006					**12.3**	**10.2**	**8.4**	**6.2**	**3.9**	**1.6**
	4. US$ GDP deflator is at historical average minus two standard deviations in 2005 and 2006					**12.3**	**12.1**	**11.9**	**9.7**	**7.4**	**5.2**
	5. Non-interest current account (in percent of GDP) is at historical average minus two standard deviations in 2005 and 2006					**12.3**	**11.9**	**11.5**	**9.3**	**7.0**	**4.8**
	6. Combination of 2-5 using one standard deviation shocks					**12.3**	**11.7**	**10.9**	**8.7**	**6.5**	**4.2**
	7. One-time 30 percent depreciation in 2005 (-30% GDP deflator shock), others at baseline.					**12.3**	**15.0**	**12.9**	**10.7**	**8.4**	**6.1**

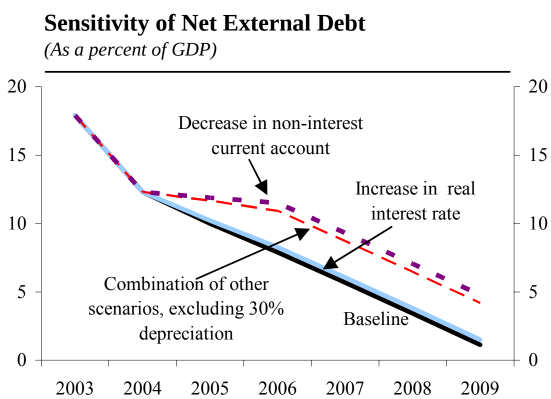
Historical Statistics for Key Variables (past 10 years)	Average	Standard Deviation
Current account balance excluding interest (percent of GDP)	-3.6	1.6
Net non-debt creating capital inflows (percent of GDP)	-1.4	1.4
Interest rate	6.3	0.8
Real GDP growth rate	3.5	1.4
Growth in GDP deflator, US dollar terms	1.0	6.1

Sources: Haver Analytics; and Fund staff estimates.

Figure 1. Canada: Debt Sustainability Analysis, 2003–2009







Statement by the IMF Staff Representative
February 16, 2005

1. ***This note reports on recent developments since the staff report was issued***. These developments do not alter the thrust of the staff appraisal.

2. ***Economic indicators have moderated somewhat in the fourth quarter***. Following an annualized 3¼ percent increase in real GDP in the third quarter of 2004, growth slowed to a 1½ percent rate in October and November. Although the manufacturing sector continued to expand and capacity utilization reached a 16-year high, job creation has been flat and business confidence declined in the last quarter of 2004. However, the unemployment rate remained around 7 percent, and core inflation inched up slightly to 1¾ percent in December 2004.

3. ***The staff continue to project 2005 growth at slightly below 3 percent***. The staff's growth projection—which is close to the January private sector consensus—is supported by the easing of the exchange rate to below the psychologically important mark of US$0.80 per Canadian dollar during the past month, the stabilization of net exports in November and December after the sharp drop in the third quarter, and the pick up in consumer confidence and other leading indicators in January.

4. ***The Bank of Canada again left its target for the overnight interest rate at 2½ percent at its January 25 fixed action date***. In the accompanying press release and *Monetary Policy Update*, the Bank noted that the economy was expected to grow 2.8 percent in 2005, somewhat slower than expected earlier, and suggested that the pace of reduction in monetary stimulus was likely to be slower than envisioned in its October report. With the output gap projected to close only in the second half of 2006, core inflation is not expected to return to the 2 percent mid-point of the Bank's target range before the end of next year.

5. ***Financial markets are currently pricing in only one 25 basis point rate increase this year, in the third quarter***. Long-term interest rates have declined by about 80 basis points since mid-2004, notwithstanding the combined 50 basis points increase in short-term interest rates in September and October. The inflation premium implicit in 30-year government inflation-linked bonds has fallen to 2 percent, almost a full percentage point lower than at the same time last year.

6. ***The FY 2005/06 Budget is to be released on February 23***. Given the relatively tight budget constraint, analysts expect no major spending or tax initiatives. Statements by Finance Minister Goodale suggest that some of last year's surplus could be used to boost federal daycare spending, while some news reports also suggest that the budget could include proposals to reduce corporate taxes.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/43
FOR IMMEDIATE RELEASE
March 29, 2005

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with Canada

On February 16, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.[1]

Background

Canada has had a remarkable macroeconomic performance since the mid-1990s, including the fastest growth rate and strongest budget position among the large industrial countries. Although the economy was hit, in 2002-03, by exchange rate appreciation, a SARS outbreak, forest fires, a large power outage, and a case of "mad cow" disease, it rebounded strongly through late 2004. In recent months, aggregate demand has softened somewhat as net exports slowed, owing partly to the dampening effects of the stronger Canadian dollar.

The economy has been supported by robust domestic spending. Final domestic demand grew at an annual rate of around 3¾ percent since mid-2003, with buoyant household spending shored up by employment gains and increases in net wealth. At the same time, business investment expanded at a robust pace, boosted by strong corporate earnings, low interest rates, and falling costs for imports of capital goods. Low interest rates continued to benefit residential investment, contributing to strong increases in construction activity.

By contrast, net exports mostly weighed on economic activity as the Canadian dollar appreciated in recent years. In 2003, net exports subtracted 2½ percentage points from real GDP growth on the back of a 13 percent foreign exchange rate appreciation in real effective terms. Strong foreign demand for Canadian products temporarily boosted export growth in the

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.
On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

first half of 2004, with favorable terms of trade also contributing to a record current account surplus. Beginning in the third quarter of 2004, however, the contribution of net exports to GDP growth turned sharply negative.

The Canadian dollar reached a 12-year high against its U.S. counterpart in late 2004, supported in part by the adjustment of currencies to global current account imbalances. More recently, short-term interest rate differentials with the United States have narrowed and pressure on the Canadian dollar has eased.

With a strengthening domestic currency and moderating aggregate demand growth, inflation in 2004 remained subdued. Despite a small increase in mid-2004, partly in response to higher energy prices, the year-on-year core inflation rate stood at 1¾ percent in December, slightly below the 2 percent mid-point of the Bank of Canada's target range. Wage pressures also remained well contained, possibly reflecting the strong rise in labor supply. The participation ratio remains close to a record high, apparently reflecting greater labor force attachment associated with rising education levels across cohorts. Despite a gradual drop in the unemployment rate, wage demands remained muted and unit labor costs were essentially flat.

As the economy rebounded in late 2003 and early 2004, economic slack narrowed, prompting the Bank to withdraw monetary stimulus. With the Bank's measure of output gap closed by the second quarter of 2004 and industrial capacity utilization approaching its 15-year peak, the Bank of Canada increased its overnight rate twice by 25 basis points to 2½ percent in September and October, noting that real interest rates were well below neutral levels. However, the Bank has since held its target rate steady, citing growing concern about the impact of the exchange rate on economic activity.

Fiscal policy continued to perform strongly in 2004, contributing to steady debt reduction. The federal budget reached its seventh consecutive surplus in FY 2003–04 (April to March) at ¾ percent of GDP, more than ½ percent of GDP higher than budgeted. The overachievement largely reflects tax revenue buoyancy, benefiting from the rebound in activity beginning in late 2003. Nonetheless, going forward, the room for fiscal maneuver is limited because of federal spending commitments, including significant increases in transfers to provinces over the medium term.

Provincial government budgets remained close to balance in aggregate. Health care spending continued to outpace revenue growth, prompting provincial demands for higher federal transfers and, in some cases, higher taxes. Nonetheless, the strength of federal finances left the general government with a FY2003-04 surplus estimated at around ½ percent of GDP.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They commended Canada's enviable macroeconomic performance since the mid-1990s, including the fastest growth rate and the strongest budget position in the G-7. Canada's performance reflects sound institutions, structural reforms, and a strong macroeconomic policy framework. In particular, Directors noted that inflation targeting has provided a solid and transparent basis for monetary policy, while the strong commitment to "budget balance or better" has yielded welcome progress toward the debt reduction needed to cope with the fiscal pressures of an aging population.

Directors agreed that the economy is likely to continue to perform solidly in the coming year, supported by robust growth in consumer demand and business investment. They noted, however, that there are important risks to the outlook. Directors warned, in particular, of the possibility of a sharper-than-expected drop in net exports, particularly given the Canadian dollar's recent appreciation against the US dollar, and a more abrupt softening of consumer spending. Directors observed that the unwinding of global current account imbalances could result in further upward pressure on the Canadian dollar. In their view, the uncertainties surrounding prospects for exchange rates, global commodity prices, and the ongoing process of trade liberalization, place an additional premium on policies to improve fiscal prudence, economic flexibility and productivity.

Directors agreed that monetary tightening in the second half of 2004 was appropriate and that further tightening could eventually be needed. They suggested, however, that there is room for a cautious and pragmatic approach to withdrawing stimulus, consistent with meeting the inflation target, particularly considering the absence of wage pressures, the risks to the outlook, and well-anchored inflation expectations.

Directors considered Canada's inflation targeting framework successful, noting that it has brought down inflation and helped to anchor expectations. They commended the Bank of Canada for further strengthening policy transparency and stepping up its communication activities. They welcomed the additional information that is now provided on macroeconomic projections in the Monetary Policy Report (MPR), and observed that the Bank of Canada has been effective in preparing markets for the recent shift in its policy stance. Some Directors suggested that more background information on policymakers' views on the distribution of risks and related policy implications would be useful to markets, while others believed that the current communications strategy strikes an appropriate balance between transparency and candor.

Directors commended the authorities' fiscal framework, which has delivered a broad-based social consensus for fiscal prudence. The commitment to budget balance or better has resulted in seven consecutive surpluses and a large reduction in federal debt, while allowing for a sizable tax reduction. In this regard, Directors welcomed the federal government's recently announced objective of lowering the federal debt-to-GDP ratio to 25 percent within ten years. The addition of such an explicit medium-term anchor to the fiscal framework could be especially useful for ensuring that the longer-term costs of budget measures are taken fully into account, and for coping with large shocks that require a temporary breach of the commitment to balanced budget or better.

Directors observed that recent spending commitments, including increased transfers to provinces, have limited the room for fiscal maneuver and meant that the forthcoming budget will need to focus on key priorities. Directors agreed that Equalization payments should not become an entitlement, and urged the authorities to use the upcoming review to design a system which provides a transparent and equitable basis for payments across provinces, while avoiding the year-to-year volatility of the previous system. Directors hoped the ongoing expenditure review will serve as the basis for a careful evaluation of the merits of spending programs versus further reducing the relatively high tax burden. In light of the medium-term commitments to provinces and the importance of transparency regarding the longer-term impact of fiscal measures, many Directors supported a longer-term budget planning horizon. However, they cautioned against placing an undue weight on the planning surpluses projected to reemerge from fiscal year 2007/08, given the uncertainties that surround the fiscal forecast.

Directors noted that there remain longer-term challenges to fiscal balances from population aging, in particular with regard to growing health care spending. They considered that, despite large increases in transfers to provincial health plans, steps are still needed to ensure the sustainability of the health care system. Directors therefore emphasized the importance of health care reform including greater focus on improving incentives for cost containment by both health care providers and consumers. In this regard, a few Directors observed that the government made a commitment to increase transfers to provinces without explicitly requiring reforms to improve the efficiency of health care spending.

Directors commended the authorities' efforts to enhance further Canada's already high level of fiscal transparency. They considered that the larger-than-anticipated federal budget surpluses in recent years reflect the transparent and prudent fiscal framework in addition to favorable economic developments. Directors emphasized that it remains important to sustain the social consensus for continued debt reduction while at the same time allowing well-informed debate on the relative merits of spending programs versus tax cuts. In this context, some Directors suggested that adopting a five-year fiscal planning horizon would be helpful in demonstrating the longer-term fiscal impact of policy measures, including recent commitments to the provinces.

Directors agreed that recent structural policies have laid a solid foundation for future growth. At the same time, they noted that further structural reforms would assist in dealing with the demographic shift, the ongoing challenges from increasingly global markets, and lowering the underlying rate of unemployment. In this context, Directors underscored the importance of sustaining fiscal prudence, continuing structural reforms to maximize productivity, and strengthening incentives to save and invest. Directors also called for controlling health care costs in order to prepare the economy for the effects of population aging. Given the limited fiscal room, tax reductions would need to be focused on measures that yield the greatest efficiency gain while preserving the prudent fiscal balance. Reforms to reduce both incentives for early retirement in the public pension system and disincentives in the social transfer system could help increase labor utilization. Many Directors noted that reinforcing the insurance principle of the Employment Insurance program and funding the social assistance component of the program through general revenues could enhance economic efficiency and transparency, as could further reductions in regulatory barriers to trade and competition.

Directors commended the strength and soundness of Canada's well-managed financial system. Capital ratios are robust, and the system is well-positioned to respond to monetary tightening. Directors noted that further reforms could enhance the system's ability to benefit from a rapidly changing global environment. They agreed that adopting a single national securities regulator would help reduce compliance and administrative costs, and that clarifying the regulatory framework governing bank mergers would reduce uncertainty and possibly allow institutions to reap efficiency gains. A number of Directors wondered whether the dominance of six large Canadian banks does not reflect a lack of competitiveness in the banking system, while others pointed out that banking system efficiency was not necessarily tied to the number of large banks in a country. Directors also encouraged the authorities to consider enhancing incentives for firms to fund their defined benefit pension plans, and to use the upcoming review of financial sector regulation as an opportunity to reduce regulatory overlap.

Directors commended Canada's support for multilateral trade liberalization and encouraged the authorities to continue its important leadership role in efforts to complete the Doha Round, including by further relaxing trade barriers for "supply-managed" agricultural products. They welcomed Canada's recent commitments to promoting foreign development and assistance—in particular, the intended doubling of its official development assistance envelope by the end of the decade and the support for African development, including the cancellation of official debt owed to Canada by several African countries.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2004 Article IV Consultation with Canada is also available.

Table 1. Canada: Selected Economic Indicators 1/

(Annual change in percent, unless otherwise noted)

	1998	1999	2000	2001	2002	2003	est. 2004
Real GDP	4.1	5.5	5.2	1.8	3.4	2.0	2.7
Net exports 2/	1.7	1.4	0.6	0.7	-0.1	-2.4	-0.7
Total domestic demand	2.4	4.1	4.9	1.3	3.4	4.4	3.4
Final domestic demand	2.8	4.2	4.0	3.2	3.1	3.6	3.6
Private consumption	2.8	3.8	4.0	2.7	3.4	3.1	3.2
Public consumption	3.2	2.1	3.1	3.7	2.8	3.8	2.8
Private fixed domestic investment	2.8	6.2	4.8	3.3	1.4	4.6	6.0
Private investment rate (as a percent of GDP)	17.7	17.4	16.9	17.2	17.1	16.9	17.2
Public investment	-0.7	15.6	3.8	10.1	9.1	6.8	1.8
Change in business inventories 2/	-0.3	0.1	0.8	-1.9	0.6	0.9	-0.1
GDP (current prices)	3.7	7.4	9.6	2.9	4.5	5.3	6.1
Employment and inflation							
Unemployment rate	8.3	7.6	6.8	7.2	7.7	7.6	7.3
Consumer price index	1.0	1.7	2.7	2.5	2.3	2.7	1.8
GDP deflator	-0.5	1.7	4.2	1.1	1.0	3.2	3.3
Exchange rate (period average)							
U.S. cents/Canadian dollar	0.67	0.68	0.67	0.64	0.64	0.72	0.77
Percent change	-6.8	0.6	-0.3	-4.2	-1.1	12.9	7.2
Nominal effective exchange rate	-5.8	-0.4	1.9	-2.8	-2.1	8.9	5.5
Real effective exchange rate	-6.0	-0.9	0.9	-3.7	-0.8	11.2	6.9
Indicators of financial policies (national accounts basis, as a percent of GDP)							
Federal fiscal balance	0.8	0.9	1.9	1.3	0.8	0.4	0.8
General government	0.1	1.6	2.9	1.1	0.3	0.6	1.4
Three-month treasury bill	4.7	4.7	5.5	3.9	2.6	2.9	2.2
Ten-year government bond yield	5.3	5.6	5.9	5.5	5.3	4.8	4.6
Balance of payments							
Current account balance (as a percent of GDP)	-1.2	0.3	2.7	2.3	2.0	2.0	2.8
Merchandise trade balance (as a percent of GDP)	2.6	4.3	6.2	6.3	4.9	4.8	5.3
Export volume	8.5	11.7	9.2	-3.5	0.7	-2.2	5.8
Import volume	6.1	8.5	8.6	-5.6	1.5	3.4	8.5
Invisibles balance (as a percent of GDP)	-3.8	-4.0	-3.5	-4.1	-3.0	-2.8	-2.4
Saving and investment (as a percent of GDP)							
Gross national saving	19.1	20.7	23.6	22.0	21.5	22.1	23.1
General government	2.1	3.6	5.1	3.4	2.7	3.1	3.8
Private	17.0	17.1	18.5	18.6	18.8	19.0	19.2
Personal	6.1	5.3	5.6	5.7	4.8	3.8	5.9
Business	10.9	11.7	12.9	12.9	14.0	15.2	13.4
Gross domestic investment	20.5	20.5	20.4	19.2	19.6	20.1	20.2

Sources: Statistics Canada; and IMF Staff estimates.

1/ Data as available at the time of the Executive Board Discussion on February 18, 2005.

2/ Contribution to growth.