February 2008
IMF Country Report No. 08/69

Canada: 2008 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

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 2008 Article IV consultation with Canada, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 17, 2008, 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 15, 2008. 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 6, 2008 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 6, 2008 discussion of the staff report that concluded the Article IV consultation.

The document listed below has 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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CANADA

Staff Report for the 2008 Article IV Consultation

Prepared by Western Hemisphere Department
(In consultation with other departments)

Approved by Caroline Atkinson and Anthony Boote

January 15, 2008

EXECUTIVE SUMMARY

- **Scope and focus**. Against the backdrop of slowing U.S. growth, currency appreciation, and global financial strains, the mission focused on near-term outlook risks and policy responses. The discussions also covered the enhancing of productivity and financial sector efficiency.
- **Background**. Canada has enjoyed an enviable macroeconomic performance over the past decade. Reflecting prudent macroeconomic policies and favorable external conditions, real GDP has grown faster than in other G-7 countries, inflation has been low and stable, and fiscal balances have been in surplus (Table 1 summarizes previous policy positions not discussed).
- **Outlook**. The baseline anticipates growth moderation through mid-2008, reflecting weaker external demand and tighter credit conditions. The balance of risks is on the downside given concerns about U.S. growth and unsettled global financial markets, although domestic demand could slow by less than expected.
- **External currency value**. At near parity against the U.S. dollar and with oil prices of $90–100 a barrel, the Canadian dollar seems broadly in line with fundamentals, although some measures suggest modest overvaluation.
- **Monetary policy**. The Bank of Canada appropriately shifted from tightening to easing in response to the evolving balance of risks. Future moves will depend on incoming information.
- **Financial sector**. The Canadian banking system is conservatively regulated, but has not been immune to spillovers from the global liquidity squeeze, including via a shutdown in parts of the asset-backed commercial paper market that was recently resolved in principle. While Canadian banks appear better placed to weather balance sheet problems than those in other major markets, their resilience partly reflects barriers to market contestability that likely hamper access to finance.
- **Fiscal policy**. A prudent policy framework aims at achieving budget surpluses and reducing public debt ratios further. The 2007 *Economic Statement* appropriately emphasizes tax relief, although lowering the federal GST tax rate has limited efficiency benefits.
- **Macro-structural policies**. The recent policy focus on enhancing productivity growth is timely in view of pressures from real dollar appreciation and an aging population. Besides tax reforms and improving financial intermediation, the focus should be on product market reform.
- **Analytical work**. Background studies examine financial and other spillovers, labor churning, Canada’s inflation targeting framework, and access of small borrowers to finance.

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I. Macroeconomic and Financial Prospects and Risks

A. Overview

1. **Canada has enjoyed high growth while adjusting smoothly to commodity price gains, currency appreciation, and, more recently, slowing U.S. demand**. Over the past five years, the commodity boom has strengthened the external position and boosted domestic demand (Tables 2 and 3). There has been some offset from real net exports, as the real exchange rate has appreciated sharply in response to rising terms of trade and the resulting pressures on resources (Figure A). Reflecting strong domestic demand, the unemployment rate remains close to its recent 33-year low and staff and most analysts view the economy as currently operating above potential. Having been in the upper half of the Bank of Canada's 1–3 percent target range since the fall of 2006, however, core CPI inflation recently dropped below the midpoint on stronger-than-expected exchange rate passthrough.

Economic Outlook 1/
(Annualized percent change from previous period unless otherwise indicated)

			Est.	Proj.		2007		Est.		2008 Projections		
	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	3.1	2.8	2.6	2.0	3.5	3.8	2.9	1.8	1.3	1.6	2.1	2.5
Net exports (contribution)	-1.7	-1.4	-1.1	-1.7	0.3	-1.4	-5.0	-2.2	-1.3	-1.1	-0.4	-0.2
Total domestic demand	5.1	4.4	3.8	3.7	3.3	5.5	8.1	4.0	2.7	2.7	2.5	2.7
Final domestic demand	4.5	4.7	3.8	3.4	2.8	4.9	4.6	3.8	3.1	3.0	2.7	2.8
Private consumption	3.8	4.2	4.1	3.0	3.4	5.9	3.0	3.1	3.1	2.7	2.2	2.3
Private fixed investment	8.1	7.1	4.2	5.0	2.3	4.4	7.6	6.5	3.9	4.3	4.3	4.3
Inventories (contribution)	0.3	-0.2	0.0	0.4	0.6	0.5	2.9	0.3	-0.4	-0.2	-0.1	0.0
Unemployment rate (percent)	6.8	6.3	6.0	6.2	6.1	6.1	6.0	5.9	6.1	6.2	6.3	6.3
Consumer price index (y-o-y)	2.2	2.0	2.1	1.4	1.9	2.0	2.1	2.5	1.5	1.1	1.6	1.6
Federal fiscal balance/GDP	0.1	0.6	0.4	-0.1	...	...	...	...	...	...	...	...
Current account balance/GDP	2.0	1.6	1.0	0.1	1.7	1.7	0.3	0.3	0.3	0.3	0.0	-0.1
Memorandum items:												
Partner country growth 2/	3.1	3.0	2.5	1.8	2.3	2.4	1.9	1.4	1.2	1.4	1.9	2.4
Oil prices ($/Barrel) 3/	53.4	64.3	71.1	86.3	57.2	66.1	73.6	87.6	87.3	86.5	86.0	85.3

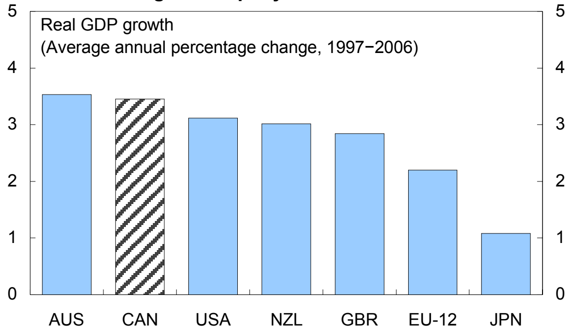
Sources: Haver Analytics; IMF, *World Economic Outlook*; and Fund staff estimates.
1/ As of January 15, 2008.
2/ An export-weighted average of growth in trade partners.
3/ Simple average of prices of UK Brent, Dubai, and west Texas intermediate crude oil.

2. **Looking forward, however, officials and private analysts agreed with the staff that near-term prospects are less favorable**. With the U.S. downturn now expected to be more severe than earlier assumed and last year's strong upward momentum in the Canadian dollar, the drag from real net exports will intensify. At the same time, domestic demand growth is forecast to moderate from its recent rapid pace, as the boost to real income growth from rising commodity prices dissipates and tighter financial conditions limit credit availability.

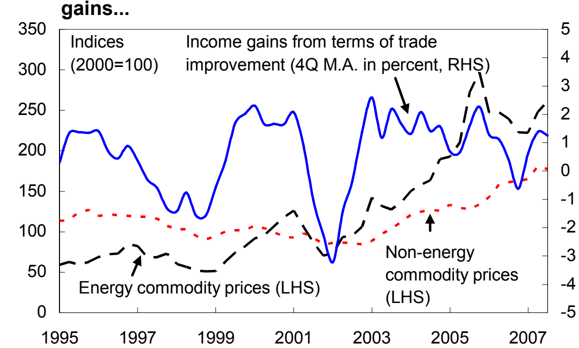
3. **It was also generally agreed that external factors tilted the risks to the near-term outlook to the downside**. In particular, there is a clear risk that the slowdown in the United

Figure A. Overview

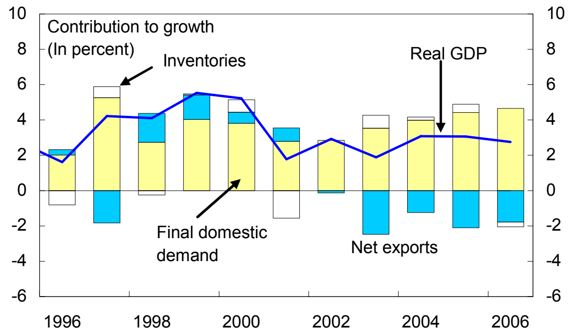
Canada has grown rapidly over the last decade.



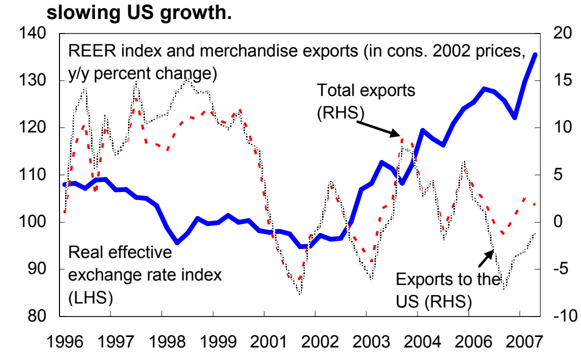
Rising commodity prices have led to terms of trade gains...



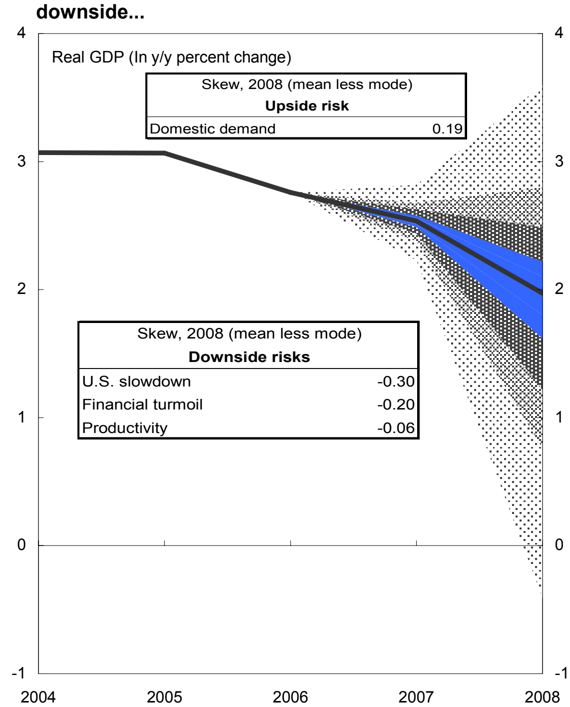
...supporting domestic demand, but real net exports have suffered from...



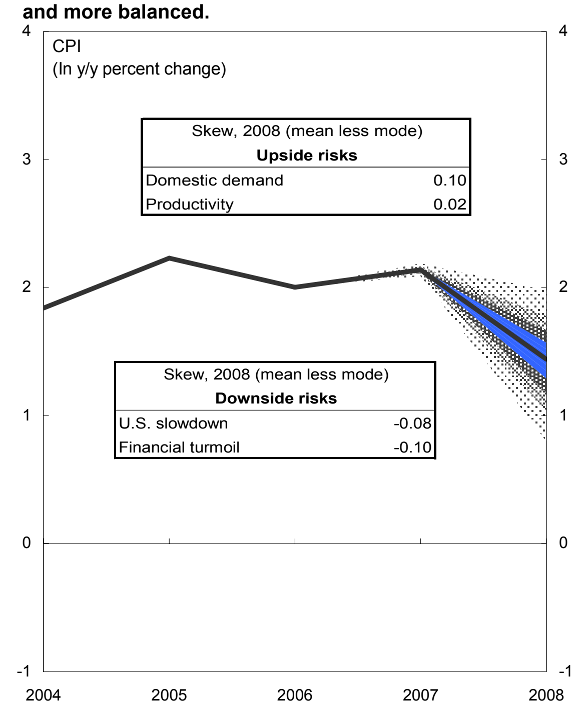
...the attendant real appreciation as well as slowing US growth.



Growth is projected to slow and risks are on the downside...



...while uncertainties about inflation are smaller and more balanced.



Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook;* and IMF staff estimates.

States could be deeper than currently anticipated. A further tightening of financial conditions is also very possible given unsettled global financial markets. That said, domestic demand growth could slow by less than expected, particularly given recent buoyancy in some commodity prices.

4. **Risks from extremely unfavorable external conditions are illustrated in the alternative scenario used for stress tests reported in the accompanying FSSA Update**. While highly unlikely, a "perfect storm" involving a combination of a significant U.S. recession, associated U.S. dollar depreciation, and falling commodity prices could put the Canadian financial sector and economy under greater strain than the sharp recession of the early 1990s, when real GDP fell by 2 percent in 1991.

Stress test scenario

(year-on-year percent change, deviations from baseline)

	2008	2009	2010
U.S. real GDP	-4.7	-4.8	0.2
U.S. core CPI	-1.4	-3.8	-1.9
Real exchange rate, US$ per C$	4.3	2.0	-0.6
Canada real GDP	-3.3	-3.8	0.4
Canada core CPI	-0.9	-2.3	-1.1

B. How Much Will Domestic Demand Growth Slow?

5. **Consumption has been buoyant since 2002, driven by commodity-related terms of trade improvements**. This boost to real income and net worth (Figure 1) has been reinforced by rising employment and accommodative credit conditions. Going forward, staff and most analysts project that consumption growth will decelerate moderately from recent exceptionally high rates, reflecting tighter financial conditions and a moderation in household real income growth as external demand slows and the terms of trade stabilize.

6. **Strong housing demand is expected to moderate somewhat**. House prices have recently started to decelerate. While overall residential investment remains buoyant, private sector analysts observed that there were signs of slowing in the exceptionally strong Alberta market where most of Canada's oil field development is occurring. Going forward, Bank of Canada and Finance Canada officials agreed with staff that residential investment growth is expected to decelerate as income growth moderates and affordability decreases.

7. **Most analysts were cautious regarding prospects for business investment**. Reflecting strong dependence of some capital expenditure on U.S. cyclical developments, investment growth has been moving in tandem with U.S. real GDP growth (Figure 2). Thus, the impending slowdown in the U.S. economy and tightening financial conditions temper investment prospects despite high profitability, healthy corporate balance sheets, and lower prices of capital goods (that are mainly imported).

8. **Looking forward, it was generally agreed that domestic demand is likely to slow, although there are upside risks given its unexpected strength over the past two years**. Private consumption and residential investment in particular could continue their current momentum, reflecting robust income growth, wealth increases, and favorable consumer confidence, as well as the recent increases in some commodity prices and tax cuts announced in the October 2007 *Economic Statement*. The boost to real incomes from recent greater-than-anticipated exchange rate passthrough into prices could also stimulate demand.

9. **Staff and officials also agreed that the risk of a rapid downturn in the housing market of the type seen in the United States and feared elsewhere is small**. This view was echoed by market professionals, who pointed out that while there might be some localized signs of speculative behavior, the strength of the broad housing market reflects fundamentals. House price appreciation has lagged relative to many other industrial countries, inventories are still below average, and recent readings of housing starts and building permits suggest continued favorable housing market conditions.

C. How much of a Risk is a Weaker U.S. Economy?

10. **There is widespread skepticism that Canada can decouple from a U.S. slowdown**. Staff observed that trade and financial linkages between the United States and Canada are among the strongest in industrial countries, with the U.S. receiving ¾ of Canada's exports and financing about ¼ of the capital raised by Canadian corporations. Consistent with previous analysis, Chapter 1 of the *Selected Issues* paper suggests that on average a one-percentage point shock to U.S. GDP changes Canada's growth by between ½ to ¾ of a percentage point, operating through trade, financial, and commodity price channels. Most interlocutors saw this as a reasonable estimate of U.S. spillovers to Canada.

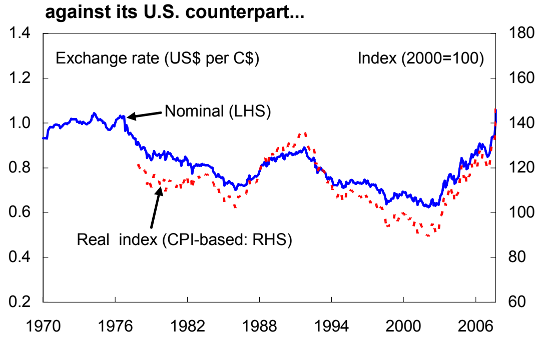
11. **Staff and officials agreed that the impact of the U.S. slowdown on Canada is likely to rise as the U.S. slowdown moves beyond the housing sector**. With U.S. weakness through the third quarter primarily reflecting a housing downturn, spillovers have continued to be limited. The direct impact has been confined largely to building material-related industries, especially lumber. As the U.S. slowdown broadens to consumption, it is likely to generate more general trade effects. Officials stressed the importance of U.S. demand for automobiles, whose production is highly integrated (autos and parts represent one-third of Canadian goods exports). In addition, the tightening in U.S. financial conditions is also likely to slow the Canadian economy significantly as discussed in Section E—*Selected Issues* Chapter 2 analyzes these financial linkages in more detail.

D. Is the Strong Canadian Dollar Consistent with External Stability?

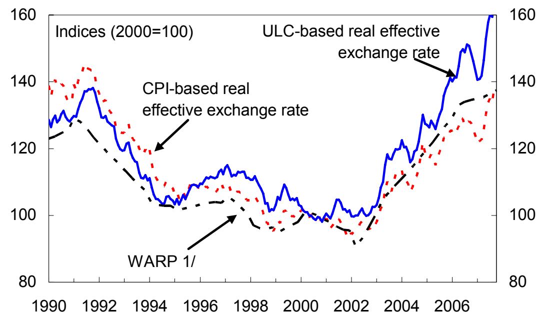
12. **Responding to higher commodity prices, the freely floating Canadian dollar has appreciated by almost half in real effective terms between early 2002 and end-2007**. As Canada is susceptible to external shocks in general, commodity price hikes (falls) have traditionally led to exchange rate appreciation (depreciation) against the United States and other trading partners (Figure B). Indeed, the Canadian dollar is widely considered a commodity currency. By offsetting pressures on domestic demand, currency fluctuations generally support macroeconomic stability by acting as shock absorbers.

Figure B. External Competitiveness

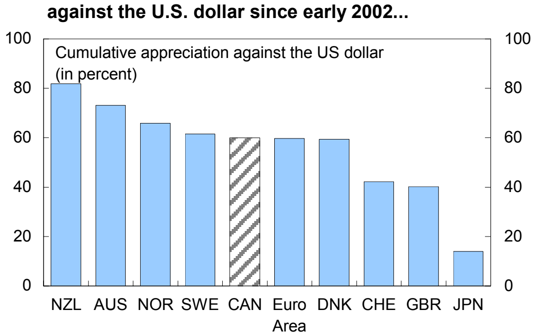
Since 2002, the Canadian dollar has been appreciating against its U.S. counterpart...



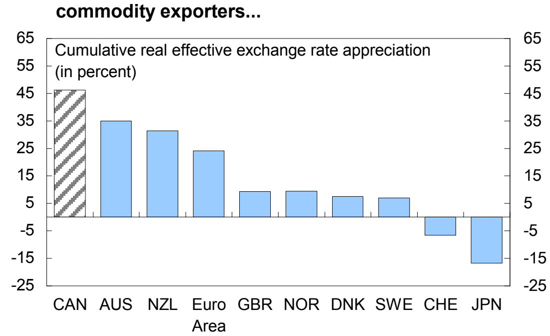
...as well as on a real effective basis.



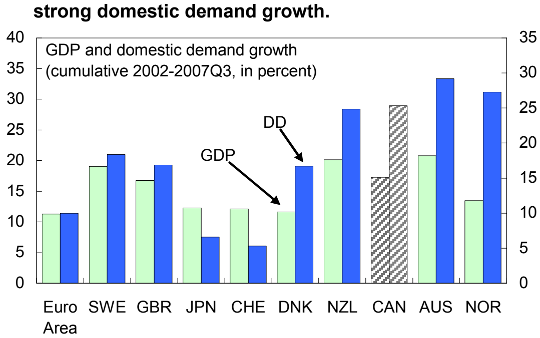
Most industrial country currencies have appreciated against the U.S. dollar since early 2002...



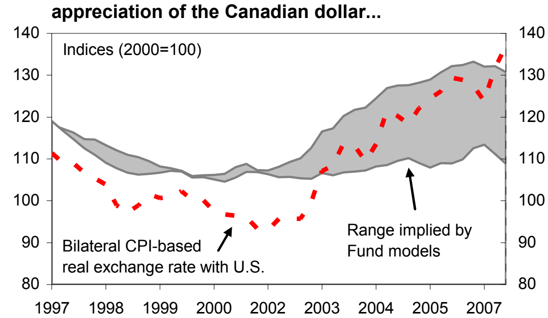
...but real appreciation has been greater in commodity exporters...



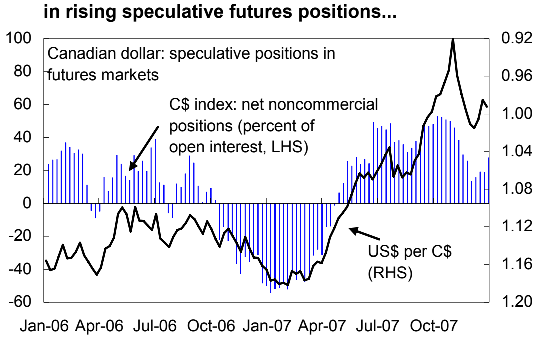
...reflecting terms of trade gains and the resulting strong domestic demand growth.



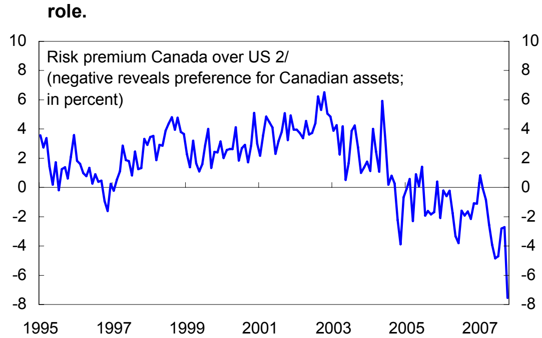
Commodity fundamentals explain most of the appreciation of the Canadian dollar...



...but in 2007, a strong buying momentum, as seen in rising speculative futures positions...



...and a falling risk premium, have also played a role.



1/ Weighted average relative prices.
2/ Based on Balakrishnan and Tulin, "U.S. Dollar Risk Premiums and Capital Flows." (2006)
Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook;* and IMF staff estimates.

13. **Strong appreciation during 2007, however, has intensified earlier concerns about the economic cost of rapid currency movements**. Even after plunging some 10 percent from November's record high of US$1.10—partly reflecting changing expectations about the course of monetary policy—the Canadian dollar appreciated about 20 percent against its U.S. counterpart in 2007, more than other major U.S. trading partners. Given the dominance of the United States in Canada's trade, this reinforced officials' earlier concerns that Canada has borne a disproportionate share of U.S. dollar adjustment with associated pressures on exposed sectors. Staff estimate that roughly one-half of last year's appreciation against the U.S. dollar reflects higher oil prices (non-energy commodity price changes have been modest), and that recent ups and downs have also reflected momentum trading.

14. **Background work using exchange rate models suggests that much of the appreciation since 2002 has reflected the global commodity boom**. At near parity against the U.S. dollar and with oil prices of $90-100 a barrel, the currency currently appears broadly in line with fundamentals, although some measures suggest modest overvaluation. More specifically, the team's analysis using several exchange rate models suggests there could be a small overvaluation by the end of 2007, as does the Consultative Group on Exchange Rate Issues (CGER) equilibrium exchange rate approach. However, CGER analysis based on external balances suggest that the currency is fully consistent with fundamentals. This diversity corresponded to the views of most analysts, who pegged the equilibrium value against the greenback at between 90 cents and parity. In early January, Governor Dodge said that a value in the "low to mid 90s" was justified by historical relationships.

15. **Staff and officials agreed that real net exports are likely to be a major drag on activity through at least the first half of 2008 (Figure C and Table 4)**. Past currency appreciation and weakening U.S. activity are projected to lead to a significant deterioration in exports of manufactures and services, which remain the bulk of Canadian exports. This weakness has been exacerbated by the recent spike in cross-border shopping as the currency surged to parity against the U.S. dollar, which made price comparison easier.

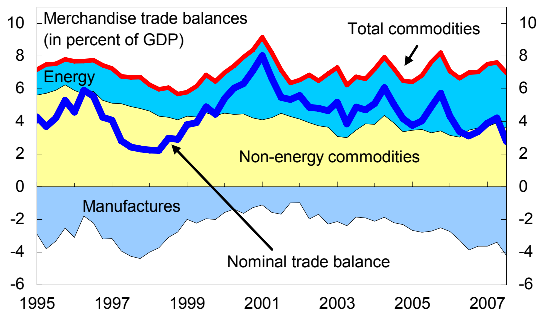
16. **Staff noted that, at a constant real exchange rate, the current account surplus is expected to continue to narrow despite high projected commodity prices**. Officials agreed that the favorable effects of elevated commodity prices, further modest increases in fuel export volumes, and declining net income payments would only partly offset weaker exports of manufactures and services.

17. **Reflecting flexible labor markets, the domestic adjustment to currency appreciation and rising commodity prices has been remarkably smooth**. Unemployment rates have steadily declined, including in the more manufacturing-oriented central provinces, as employment gains in services, construction, and mining as well as interprovincial migration have more than offset manufacturing job losses (Figure 3).

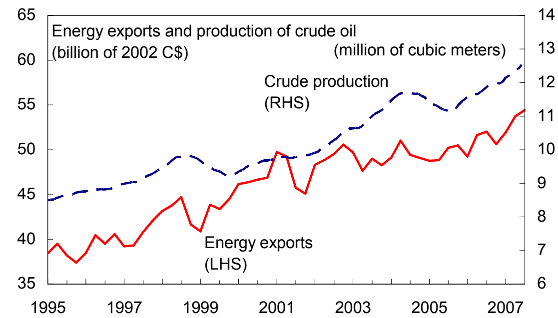
18. **Rising labor demand in the resource-rich provinces has been partly met through net migration from elsewhere in Canada, as local wages have been bid up**. At current exchange rates, staff suggested that this relatively smooth adjustment is likely to continue.

Figure C. External Developments

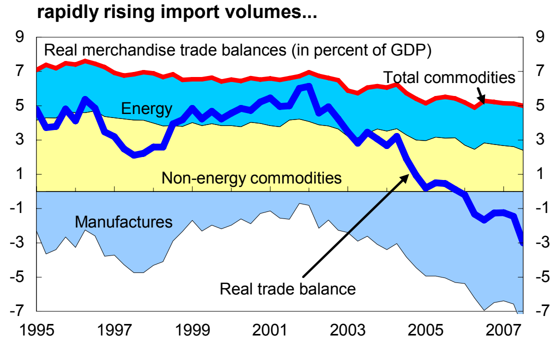
The nominal trade balance has largely been driven by commodity prices...



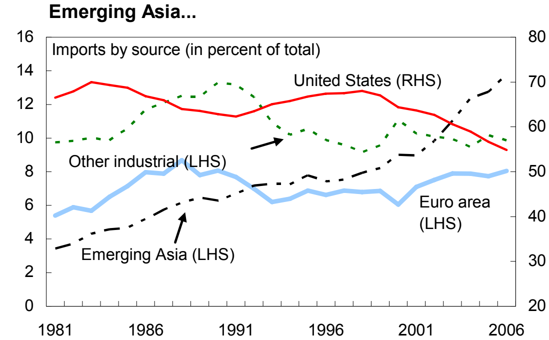
...as well as increasing net energy export volumes...



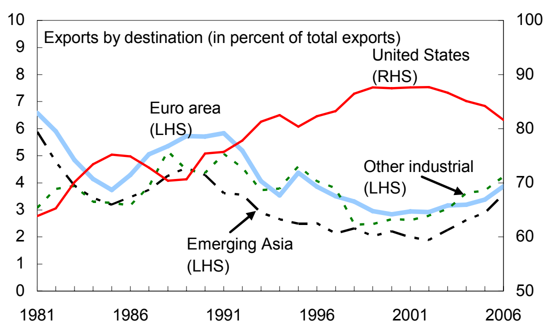
...but the real trade balance has deteriorated with rapidly rising import volumes...



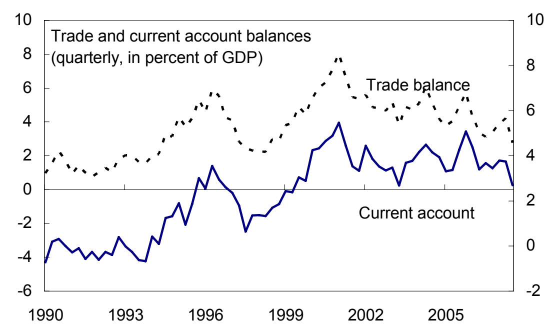
...partly reflecting a larger share of imports from Emerging Asia...



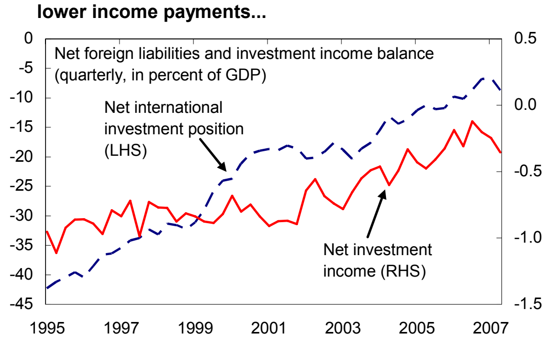
...while the U.S. has remained the dominant export destination.



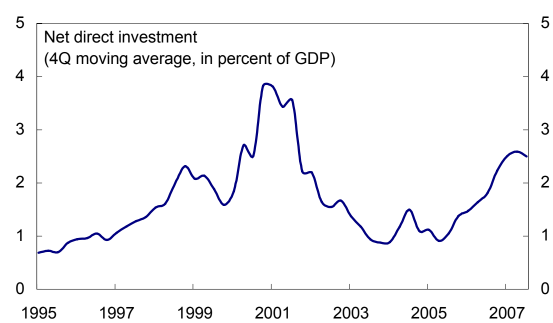
Strong commodity prices have led to a turnaround in the current account balance...



...leading to declining net foreign liabilities and lower income payments...



...while the commodity boom has boosted net direct investment inflows.



Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook*; and IMF staff estimates.

Senior officials broadly agreed, while noting that activity in parts of manufacturing and forestry may well lead to local difficulties.

E. Will Financial Strains Feed Through to the Real Economy?

19. **Bank balance sheets have deteriorated in response to global financial problems, although strains appear smaller than in other major markets**. While the size of current financial vulnerabilities is inevitably subject to much uncertainty and varies from bank to bank, estimated exposures to asset-backed securities and related products appear more limited than in the United States or Europe. As a result, while synthetic credit default insurance spreads have risen significantly since the late summer, they remain lower than in the United States. This is consistent with stress tests conducted for the accompanying FSSA Update that suggest that the major banks have sufficient capital to withstand large shocks.

20. **As elsewhere, interbank money markets remain under strain**. Interbank spreads for major Canadian banks have risen and remained elevated, albeit generally at lower levels than in the United States and Europe (Figure D). Indeed, Canadian interbank rates have been particularly highly correlated with U.S. rates since financial strains emerged in August, reflecting their close integration with U.S. wholesale financial markets. This illustrates one channel through which global financial turmoil is affecting the financial sector.

21. **Staff and Bank officials agreed that overall financial conditions had tightened noticeably since the summer**. The October *Monetary Policy Report* had estimated that the average cost of borrowing for households and businesses had risen by some 25 basis points, while the availability and terms of credit had also tightened modestly. It was agreed that financial conditions had continued to deteriorate subsequently and that strains were likely to persist, with staff suggesting that in early December the increase in the cost of borrowing might well be double that estimated in October.

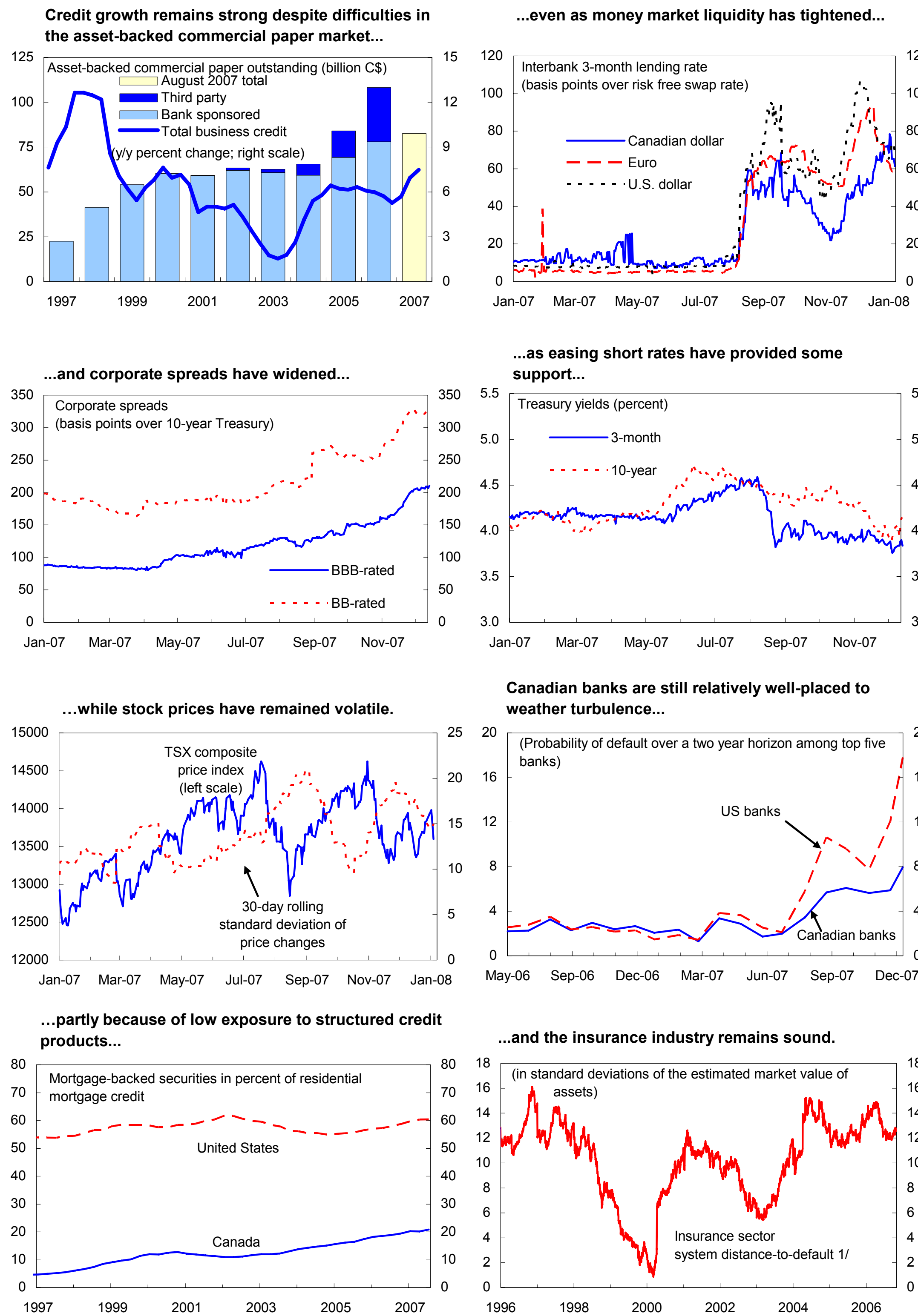
22. **Staff observed that in the face of balance sheet strains, recent strong growth in credit is likely to decelerate, slowing future activity**:

- Officials responded that the increase in domestic credit risk will likely remain limited, given relatively low household debt ratios and high commodity prices that support incomes (see Table 5). This view was largely mirrored by private sector analysts.

- Officials suggested that writedowns to date have fairly accurately reflected the likely scale of losses and that comfortable risk-adjusted capital ratios allow banks to absorb these developments.

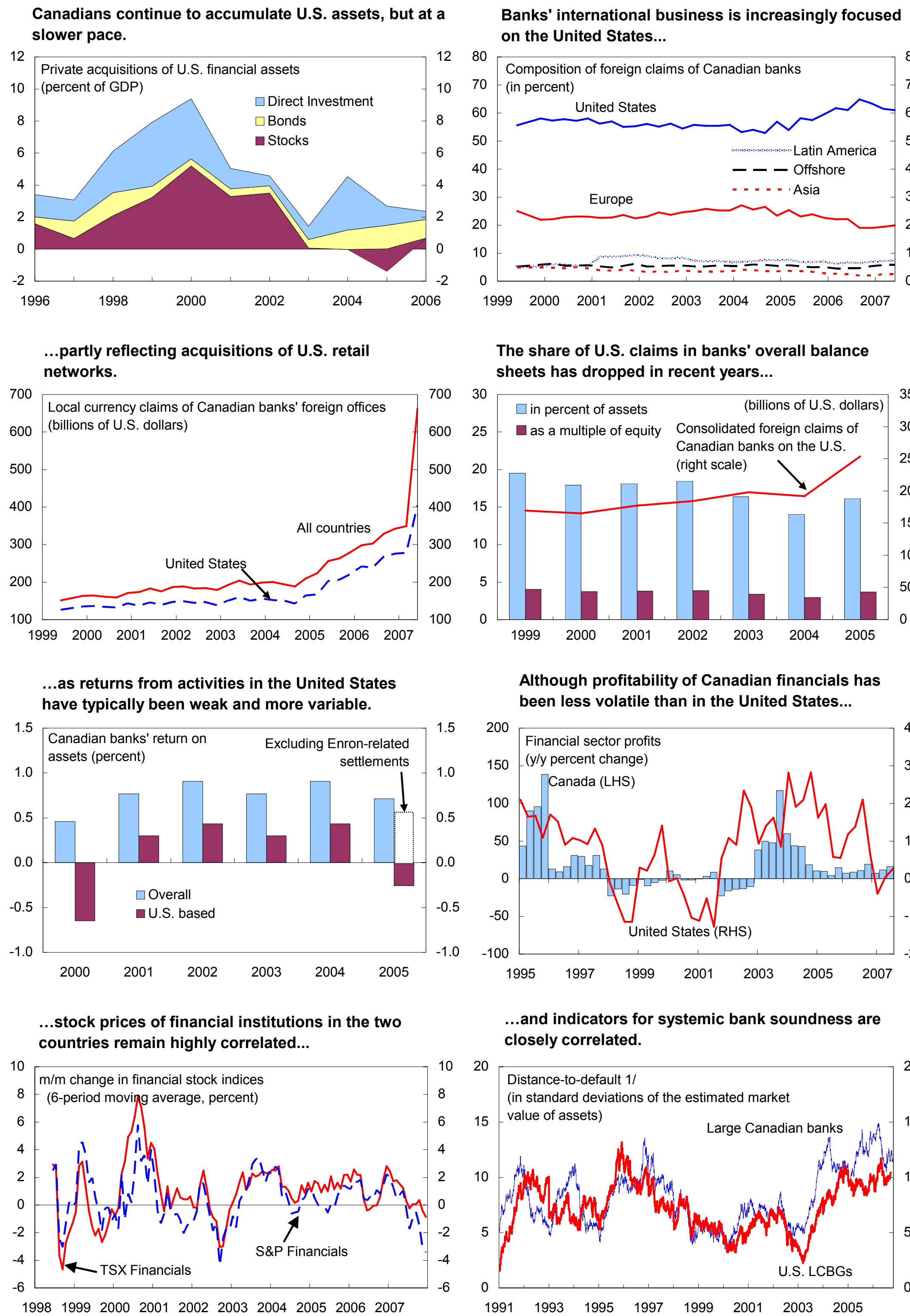
- Officials agreed with staff that uncertainties related to banks' foreign exposures were greater and less predictable, following an historical pattern. A further deterioration in U.S. market conditions is a particular concern, given significant U.S. operations and exposures of some Canadian banks (Figure E).

Figure D. Financial Market Trends



Sources: Bankscope; Bloomberg, L.P.; Haver Analytics; Merrill Lynch; Moody's; and IMF staff estimates.
1/ For a discussion of distance-to-default measures, see Chapter 6 of *Canada: Selected Issues* (IMF Country Report 05/116).

Figure E. Linkages to U.S. Financial Markets



Sources: Annual Reports of 6 largest Canadian banks; Bank for International Settlements; Haver Analytics; International Monetary Fund, *World Economic Outlook*; Statistics Canada; U.S. Federal Reserve Board; and IMF staff estimates.

1/ For a discussion of distance-to-default measures, see Chapter 6 of *Canada: Selected Issues* (IMF Country Report 05/116).

23. **Prior to a late-December agreement, staff and officials saw the shutdown of one-third of the asset-backed commercial paper (ABCP) market as posing contagion risks**. The team observed that the shutdown of the market for paper sponsored by non-banks reflected regulations that gave incentives to provide only limited support. With foreign banks refusing backstop liquidity, there was a risk of a fire sale of assets. By contrast, the remaining two-thirds of ABCP (backed by the main domestic commercial banks) remained liquid, reflecting better quality underlying assets and reputation-induced liquidity support. However, higher rates and shorter maturities indicate some strains.

24. **After delays and difficult negotiations, an agreement in principle was reached on December 23, 2007, to restructure almost all of the 2½ percent of GDP of frozen ABCP**. The agreement between all of the main parties, including the major Canadian banks, has substantially reduced the risks of contagion. It converts the commercial paper into longer-term notes, whose maturity corresponds to the underlying assets. The difficulties in obtaining an agreement partly reflected the reduction in value of U.S. and other foreign assets underlying the ABCP, illustrating another way that global financial strains have been feeding through to Canadian markets.

F. Is Core Inflation Likely to Rebound?

25. **The recent downward pressure on inflation from exchange rate passthrough has come as a surprise**. The limited passthrough of currency appreciation since 2002 has been abruptly reversed since October, as parity with the U.S. dollar has simplified comparison of Canadian and U.S. prices and cross-border shopping (including through the internet) has spiked up. As a result, core inflation has fallen abruptly to below the 2 percent mid-point of the target range despite strong domestic demand and tight labor markets that had earlier boosted inflationary pressures (Figure 4).

26. **Staff and Bank of Canada officials concurred that core inflation is likely to remain below the 2 percent target for some time**. Bank officials emphasized that the size and length of this current downward adjustment in Canadian prices relative to U.S. prices remains highly uncertain, as does the associated downward pressure on inflation. Staff agreed, noting that, at one extreme, some private analysts had indicated that core inflation (which will be adjusted to exclude the impact of January 1 indirect tax cuts) could fall to the bottom of the 1–3 percent target range. Like the Bank, staff see core inflation as moderating more modestly, with downside risks from financial strains and weaker-than-expected external demand and upsides from stronger domestic demand and weaker productivity growth.

II. Policy Discussions

27. **With a minority government in place, the policy agenda is being shaped against the possibility of an early election**. The Conservative party won the January 2006 election and formed a minority government, led by Prime Minister Harper. With Canadian minority governments having historically had short lifespans, there is widespread discussion of the potential timing of the next election.

28. **The discussions focused on policies to mitigate the impact of increased near-term risks to macroeconomic stability, and to enhance productivity growth**. The main near-term issue is the appropriate monetary policy stance given large competing risks, involving possible downsides from unsettled financial conditions and U.S. growth, and upsides from strong domestic demand. The discussions on key longer-term structural issues took place against the background of the October 2007 *Economic Statement,* which proposed a range of tax cuts. Table 1 summarizes previous policy positions not highlighted in this report.

A. Balancing Strong Domestic Demand with Risks to External Stability

29. **Bank of Canada officials explained that monetary policy has shifted in response to increasing downside risks to output and inflation**. The inflation-targeting Bank, which focuses on the output gap and core inflation as indicators of future inflationary pressures, had tightened through July 2007 on concerns about the upward creep in core inflation from strong domestic demand and tight labor markets. Monetary policy subsequently paused in the fall despite continuing domestic pressures, on concerns about the impact of slowing U.S. activity and global financial strains on the outlook. As these concerns intensified, the policy rate was cut in early December, using the room afforded by the fall in core inflation from strengthened exchange rate passthrough. Staff supported this decision, which took into account the evolving balance of risks.

30. **Staff agreed with officials that large upsides and downsides around the current forecast made the future path of monetary policy particularly difficult to chart**. Officials emphasized that the Bank was content with the current level of monetary conditions, and that there was no presumption about the direction of the next move in rates. Staff observed that, looking forward, strong recent exchange rate passthrough could complicate policy decisions by temporarily lowering inflation even though underlying inflationary pressures may not have dissipated.

31. **Bank officials agreed that worsening financial conditions had been a factor in the easing of monetary policy in December and remain a concern**. The estimate that financial strains were equivalent to a 25bp rise in spreads, published in the October *Monetary Policy Report*, was based on average market rates over a range of instruments and maturities. They were comfortable with this approach even though several observers, who had focused on selected markets where tightening was more substantial, had suggested the estimate was too low.

32. **Staff asked if the Bank's statutory limitations to liquidity provision were hampering its response to term money market strains**. Officials responded that the current facilities have been adequate to deal with evolving market strains. The initial focus on overnight open market operations had largely reflected concerns about the effectiveness of term operations rather than statutory limits. Recently, though, the Bank participated in term interventions with the Federal Reserve, ECB, Bank of England, and Swiss National Bank, as coordinated action was more likely to have an impact on term money market spreads. Staff view this as an appropriate response to current financial strains, as is the recently-announced expansion of the list of eligible securities for some forms of liquidity provision.

33. **While the floating currency is generally a shock absorber, it was agreed that monetary policy should respond to disequilibrating exchange rate movements**. Such a response is consistent with the Bank of Canada's exchange rate assessment framework. Staff and officials agreed that, in hindsight, the Bank has relatively successfully distinguished currency movements that rebalance external and internal demand from those that do not, thereby keeping output fairly close to potential.

34. **Staff agreed with Bank officials that foreign exchange interventions are generally ineffective**. Officials observed that the Bank started with the presumption that exchange rate movements reflect fundamentals. Indeed, the Bank had not intervened even when the currency briefly hit US$1.10 in November, and had limited its communication at that time to clarifying its assessment of economic and financial conditions and risks to markets. Subsequently, however, Governor Dodge has been much more specific about the Bank's views on the appropriate value of the currency.

35. **Officials observed that the Bank had adopted a gradual approach to increased transparency, in part because such changes are difficult to reverse**. They pointed to greater discussion in *Monetary Policy Reports* of risks around the forecast and to an increasing range of issues covered in speeches. At the same time, given that decisions were made by the governor and staff who reported directly to him, the Bank continued to present a uniform public view, and therefore focused on the consensus assessment while avoiding publishing minutes.

36. **Responding to a staff suggestion that further increases in transparency could be beneficial, officials observed that they monitored other central banks' practices closely**. Possible innovations included publishing minutes, providing the projected path of interest rates in the forecast, and increasing use of probabilities of outcomes or alternative scenarios to illustrate risks around the forecast.

37. **In light of recent events, the team inquired about the appropriate role of domestic asset prices in monetary policy**. It asked whether the Bank's relatively sophisticated exchange rate assessment framework could be adapted to include domestic asset prices. Officials responded that assessing appropriate asset price levels is extremely difficult, and that it is best to include the expected consequences of domestic asset price movements directly in economic forecasts rather than to provide public assessments of their relationship to fundamentals.

38. **Officials noted arguments in favor of price level targeting and a lower inflation target, but emphasized that the bar is high for changing the current regime**. The initial results of the Bank's research program on these issues suggested that the benefits of reducing nominal distortions from inflation and reducing uncertainty about the future price level could outweigh the costs. However, in their view the evidence would need to be compelling before altering the successful current policy regime. The team concurred, and outlined the analysis in Chapter 3 of the *Selected Issues* paper suggesting that Canada—as well as some other inflation targeters who have kept average inflation close to target—may already be reaping some of the benefits of price level targeting in terms of anchoring expectations about the future price level.

B. Safeguarding Financial Stability and Fostering Bank Competition

39. **The accompanying *FSSA Update* finds that Canada's financial system is stable, conservatively regulated, and relatively well capitalized**. The regulatory and supervisory framework meets best practice in many dimensions, including with regard to the revised Basel Core Principles for effective banking supervision. The Basel II capital adequacy framework started to come into effect in November and will be fully operational in February 2008.

40. **Staff observed that the ABCP shutdown (now resolved in principle) reflected the interaction between Canada-specific regulation and insufficient investor due diligence**:

- Conditional liquidity in Canada (triggered only by general market disruption)—which was absent in other markets—reflected regulation aimed at bank stability that provided incentives for such arrangements. In particular, domestic banks faced a capital charge for unconditional liquidity support but not for conditional support.

- As in the U.S. subprime market, lax ratings and insufficient investor due diligence were central to eventual financial problems. The local rating agency gave a top rating to Canadian ABCP with conditional liquidity support even though Moody's and S&P refused, while large investors used such paper despite the lack of a second rating.

- Officials responded that Canadian capital charges had reflected international best practice. In addition, Canadian capital charges had only covered domestic banks, which in the event had provided backstop liquidity, while the foreign banks that had not provided such liquidity were subject to home-country regulation.

- It was agreed that recent changes in market behavior have ensured no near-term repetition of the problems seen in third-party ABCP conduits. All continuing bank-sponsored conduits now have unconditional liquidity support, and the local rating agency is no longer rating paper with conditional support.

41. **Officials and staff discussed the lessons from Canada's experience with ABCP conduits**. It was agreed that these included the interaction between the reputation of banks and the support they provide for nonbank entities, the appropriate charges for unconditional and conditional support, the transparency of unregulated entities, and whether Basel II should allow regulated institutions to limit and scale credit risk exposure based on only one rating. Officials observed that these issues were being actively discussed, largely in international forums.

42. **Officials explained that they had supported an orderly private-sector resolution of third-party ABCP to avoid a fire sale of structured assets**. In the absence of a standstill, third-party conduits would have been forced to sell assets rapidly into illiquid markets, causing further market disruption and significant losses for Canadian investors. Staff agreed that the risk of a fire sale had made it appropriate for the government to support an orderly workout.

43. **Staff and officials observed that the "passport plus" system of provincial securities market regulation under implementation is a significant step forward**. While the federal and Ontario governments pushed for a single securities regulator, the other provinces have developed a passport system. The result is an agreement in which regulators in every province except Ontario are bound to accept the rulings of other provinces, while Ontario (which contains the vast majority of securities markets and hence regulatory expertise) can opt out of any decision. This is an improvement over the previous system in which all provinces had independent powers.

44. **Staff agreed with federal and Ontario officials that a single securities regulator would promote timely policy responses, lower costs, and consistent enforcement**. While provincial authorities contend that a passport system ensures that province-specific issues are adequately taken into account, federal officials observed that this could also be largely achieved through a well-designed single regulator. They also noted that maintaining multiple jurisdictions raises costs for issuers operating across provinces, complicates elements of investor protection, and delays policy development by requiring cumbersome negotiations.

45. **Staff suggested that increased competitive pressures across banks would support more dynamic firms and individuals, boosting economic flexibility and productivity**. While banks' conservative practices have proved helpful in the face of current financial strains, eliminating barriers to large-scale foreign bank entry would widen access to finance:

- The rule that major banks (which control 85 percent of bank assets) be widely-held guards against takeovers, including from abroad, while mergers, which require the approval of the finance minister, are at present effectively prohibited.

- With limited competitive pressures, banks maintain low-risk balance sheets and achieve high returns on equity. Stress tests performed for the *FSSA Update* suggest that systemic banking sector problems are unlikely even when faced with a large adverse shock.

- Against this, the team suggested that, while performing classic intermediation reasonably efficiently, banks appear to shy away from pricing risk. This underserves high-growth enterprises, as discussed in Chapter 4 of the *Selected Issues* paper. Increasing contestability would raise competitive pressures, supporting financial innovation and fostering efficient capital allocation.

- This is particularly important given the underdevelopment of other sources of financing for small firms—there is no high yield bond market and the venture capital market is inefficient, likely reflecting the large role of tax-advantaged labor-sponsored venture capital corporations.

46. **Finance officials responded that standard measures suggested that the banking system appears competitive and responds appropriately to changes in costs**:

- Unlike a blanket FDI restriction, foreign banks were only prohibited from buying large Canadian institutions. Foreign subsidiaries, together with smaller domestic companies, provide a competitive fringe that could introduce innovation.

- Studies find that Canadian banks' response to changes in costs is consistent with a high level of competition.

- Even if the system has limited competition, it is not clear that allowing takeovers (foreign or domestic) would improve contestability, as a takeover would not increase the number of banks competing in the market.

- That said, an expert panel examining competition in Canada has shown an interest in studying the financial sector.

47. **Staff answered that foreign ownership of core financial institutions is more likely to promote innovation than ownership of marginal ones**. Representatives of small businesses have amassed considerable evidence that banks do not serve this sector well, while a range of private sector analysts—including some economists in the financial sector—view the banking system as uncompetitive and lacking innovation. While it is difficult to prove conclusively that innovation is wanting, the evidence points in that direction.

48. **Staff expressed concern that government guarantees associated with the housing sector could be distorting behavior**. As the Bank of Canada has observed, the significant government support provided to induce private sector entry to compete with the government-owned mortgage insurer, and government guarantees of mortgage-backed securities arranged by the Canada Mortgage and Housing Corporation, could provide artificial incentives for risk taking. Officials responded that this issue is being examined.

C. Improving Tax Efficiency within a Sound Fiscal Framework

49. **A prudent fiscal policy framework has underpinned ten consecutive years of federal budget surpluses**. In 1997, Canada adopted a framework based on the principle "budget balance or better," which was modified in 2006 to target an annual reduction of C$3 billion in federal government debt (around ¼ percent of 2007 GDP), buttressed by a medium-term target to reduce federal debt to 25 percent of GDP. Within the framework, budgeting has been conservative, with actual surpluses typically exceeding projections. At 1 percent of GDP, the FY 2006/7 surplus was a half percentage point above the budget forecast, owing largely to buoyant corporate income tax revenue (Figure 5 and Table 6).

Federal Budget: Staff Projections 1/
(In percent of GDP)

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Revenue	16.4	16.4	16.2	16.3	15.9	15.3	15.2	15.2
Outlays	15.6	16.3	15.2	15.4	15.2	15.1	15.0	14.8
Budget balance	0.8	0.1	1.0	1.0	0.7	0.1	0.2	0.4
Planned debt reduction	...	...	1.0	1.0	0.7	0.2	0.2	0.2
Planning surplus 2/	0.8	0.1	1.0	0.0	0.0	0.0	0.0	0.3
Net lending	0.3	0.8	0.1	0.6	0.4	-0.1	-0.2	0.0
Net debt 3/	40.9	38.3	35.0	32.3	30.0	28.6	27.2	25.7

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

1/ The projections are based on the baseline provided by the authorities' 2007 Economic Statement adjusted for staff macro assumptions.
2/ Planning surplus = budget balance minus debt reduction.
3/ Assuming future planned debt reduction is achieved.

50. **This year's budgetary overperformance is to be used for tax relief and debt reduction**. With higher-than-expected nominal GDP growth and corporate income tax revenue, the budget surplus based on current policies is again expected to be substantial (¾ percentage points of GDP) this fiscal year. In the *Economic Statement*, the government proposes to use this overperformance to finance tax relief (¼ percentage point of GDP) and a one-off additional debt reduction (½ percentage points of GDP). Next fiscal year, the overperformance would be used to finance the full annual cost of the tax relief measures, and the projected surplus remains around the debt reduction target.

51. **The mission agreed with officials that the comfortable projected fiscal position provides room for permanent tax relief**. Indeed, given the worsening of the economic outlook, the fiscal stimulus in 2008 appears fortuitously timed. However, staff observed that there was a risk that some recent revenue gains (particularly from commodity industries) may be more temporary than expected. This underscores the importance of expenditure restraint, particularly given relatively rapid recent spending growth. While acknowledging the risk, officials emphasized that the *Statement* incorporated private economic and budget forecasts and that the assumed tax buoyancy appeared appropriately conservative, particularly in the light of past revenue overperformance.

52. **The major short-term uncertainty for the budget is the economic outlook given that the current fiscal framework does not encompass discretionary policy**. Staff calculations suggest that, given the size of automatic stabilizers, nominal GDP would need to slow by 1 percentage points more than in the baseline to push the federal government into deficit in fiscal year 2008–09. This implied either significantly lower real growth or a large fall in commodity prices. Senior officials emphasized that the current fiscal framework incorporated a fixed target surplus but did not exclude the possibility of running a deficit under unexpectedly adverse circumstances.

53. **Staff viewed the reduction in the federal GST tax rate (the Canadian value added tax) by a percentage point to 5 percent in the *Statement* as a missed opportunity**. As has been noted in previous consultations, larger gains in efficiency could have been

obtained by cutting other taxes (see also Chapter 6 of *Northern Star*, IMF Occasional Paper 258).

54. **Staff suggested that the priority for tax relief should be to reduce high marginal effective rates (METRs) on capital, saving, and labor income (in that order)**:

- Accordingly, staff welcomed the 1 percentage point cut in the general corporate income tax rate in 2008 and its further reduction to 15 percent tax rate by 2012. This will have the added benefit of making corporate taxes more neutral with regard to firm size.

- Staff and federal officials agreed that harmonizing remaining provincial sales taxes with the GST base, thereby exempting business inputs, is also central to lowering METRs on capital. Senior officials observed that the government has stated its willingness to work with provinces on harmonization. Staff suggested that a more explicit offer of assistance—as had occurred in earlier efforts to harmonize sales taxes and to eliminate provincial capital taxes—might be a more effective approach.

- The team noted that marginal effective taxes on most forms of saving remain high. Additional measures, such as protecting all types of saving from taxes up to a cap, could help support wealth creation by moving personal income taxes closer to a consumption tax. Senior officials were sympathetic, while pointing out that it was also important to ensure neutrality of taxation across saving vehicles, and that there had recently been a significant rise in the pension income amount eligible for tax relief.

- Staff welcomed the reduction in the lowest personal income tax rate by half a percentage point to 15 percent and the introduction of the Working Income Tax Benefit (a negative income tax).

55. **The team suggested that increasing the relative importance of indirect to direct tax revenues is one way of lowering high marginal tax rates on income**. This proposal, which has also been suggested by some think tanks, would also help maintain the tax base in the face of commodity cycles and population aging. One option for creating room for income tax relief would be to follow the example of British Columbia and explore introducing a carbon tax. Officials responded that the government had chosen to reduce carbon emissions through other means.

56. **While generally supporting the reformed system of equalization transfers to provinces, the mission noted some areas where transparency is still lacking**. Among the key elements of the system are a return to including all provinces in the formula determining transfer payments, the partial inclusion of revenue resources, and a cap on Equalization transfers so that no receiving province has a higher fiscal capacity than a nonreceiving one. Staff observed, however, that agreements allowing some provinces to obtain additional transfers implied by the old system increased complexity. As with the previous Offshore Accords agreed in 2005, this could gradually undermine the rules-based approach.

57. **The team welcomed the renewed commitment in the October *Statement* to eliminate net general government debt by 2021**. They noted that Fund analysis finds that fiscal surpluses have helped ensure that Canada is closer to long-term budget sustainability than other G-7 countries. Staff and officials agreed that it was important to continue to run surpluses and lower federal and general government debt to help prepare for the costs associated with population aging and health innovation. Staff looked forward to the early publication of the long-term fiscal sustainability analysis that had been promised for the recent *Statement*. Officials responded that work continues on the report.

58. **Staff suggested that on current policies public health care spending would likely continue to expand rapidly, driving a rise in general government debt after 2021**. While provinces are responsible for health care delivery, the federal budget is also involved given this is an area of national priority and there is a constitutional requirement to provide federal support to help ensure that provincial governments provide reasonably comparable levels of public services at reasonably comparable levels of taxation.. Officials explained that they were supporting provincial and territorial efforts to make health care delivery more efficient, including developing indicators that allowed outcomes to be compared across jurisdictions, but observed that there was little case for reducing services given that academic studies suggested that the social return on health spending is high.

D. Promoting Rapid Productivity Growth

59. **The government's structural reform agenda focuses on boosting productivity**. Canada's productivity performance in recent years has been disappointing. Fast growth has primarily reflected increased labor participation, while both business investment and total factor productivity growth have lagged behind U.S. rates. Looking forward, the government's structural policy blueprint *Advantage Canada,* released in late 2006, is aimed at raising productivity. Staff observed that this is particularly pertinent given pressures from dollar appreciation as well as gradual population aging.

60. **The team agreed with officials that measures proposed in *Advantage Canada* address many key impediments to higher productivity growth**. In particular, the structural policy blueprint recognizes the importance of reducing high marginal effective tax rates—to which some of the tax relief measures proposed in the *Statement* would contribute—and creating a dynamic and globally competitive financial system that would provide broader access to finance. In addition, the blueprint includes plans to encourage interprovincial labor mobility and to facilitate immigration of skilled labor.

61. **Staff emphasized the importance of lowering product market barriers for improving productivity growth**. Previous staff analysis has highlighted that Canada has a relatively efficient labor market by international standards, but that product market restrictions remain relatively high compared to other industrial countries, most notably in the financial sector (discussed earlier) and network industries (airlines, telecommunication, utilities, and media) (Figure 6). These constraints on the efficient allocation of resources lower productivity (see Chapter 3 of *Northern Star*, IMF Occasional Paper 258). In addition, Chapter 5 of the *Selected Issues* paper finds that labor market churning through firm creation and destruction is significantly lower in Canada than in the United States.

62. **Accordingly, the team suggested that product markets should be a focus of structural reform**:

- Current restrictions on inward foreign direct investment should be lowered, most notably in network industries, thereby stimulating competition and the international transfer of best practices. Officials responded that they recognized this was an issue, and had formed an expert panel that, as part of its mandate, would report on the impact of FDI restriction on competition by mid-2008.

- Senior officials agreed with staff that barriers to interprovincial trade in goods and services, and to mobility in regulated professions, also hamper competition and innovation. The recent Trade, Investment, and Labor Mobility Agreement (TILMA) between Alberta and British Columbia is a particularly important development as it is based on a presumption that mobility is free unless specifically excluded, which is breathing new life into a policy issue where progress had been slow. For example, Ontario and Quebec have started discussions on their own trade deal.

63. **The gradual transition from labor abundance to scarcity puts particular focus on participation by older workers and successful integration of foreign immigrants**. Staff agreed with officials that the main disincentive to older workers was the lower expected income for older retirees from the Canada/Quebec Pension Plans and the structure of many private pension plans. Turning to immigration, staff suggested that the current approach to economic migration is too inflexible in the face of changing demands for labor. Officials responded that provinces with particular skill needs were increasingly using established mechanisms to facilitate hiring of needed workers and that the existing system represented a long-term social contract that would be difficult to alter.

III. Staff Appraisal

64. **After five years of strong growth, the economy is forecast to slow in the next few quarters**. A weakening U.S. economy and recent currency appreciation are likely to reduce external demand for Canadian goods and services, while domestic demand is expected to moderate as financial conditions tighten and real income growth normalizes.

65. **The balance of risks to growth is tilted to the downside**. This reflects external risks, particularly those coming from a possible U.S. recession and global financial strains. However, domestic demand could slow by less than expected given its recent strength, particularly if recent upward momentum in commodity prices continues.

66. **Monetary policy has appropriately shifted to guarding against increasing near-term downside risks, and the December interest rate cut was welcome**. As financial conditions tightened, the external environment weakened, and currency passthrough pushed down core inflation, the Bank nimbly repositioned its policy stance while communicating the implications of the changes in near-term risks to markets and the public. Given strains in money markets that are likely to persist, the Bank's measures to inject term liquidity in coordination with other central banks and to expand eligible collateral are welcome.

67. **At near parity against the U.S. dollar and with oil prices of $90-100 a barrel, the currency appears broadly in line with fundamentals, although some measures suggest modest overvaluation**. The floating exchange rate continues to support macroeconomic stability by generally acting as a shock absorber to changes in the terms of trade. While most of the appreciation since 2002 has reflected booming commodity prices, the rapid appreciation in 2007 partly reflected momentum buying and general U.S. dollar weakness. Subsequently, the Canadian dollar has fallen from November's record high against the U.S. dollar, when it was modestly overvalued by most measures.

68. **Reflecting flexible labor markets, domestic adjustment to currency appreciation has been remarkably smooth**. Employment gains in services, construction, and mining as well as interprovincial migration have more than offset manufacturing job losses in the central provinces. Nevertheless, competitiveness has suffered, underlining the importance of increasing flexibility and productivity growth.

69. **Staff support the government's structural policy agenda outlined in *Advantage Canada***. In staff's view, boosting productivity requires greater focus on product market reform. Regulations and restrictions on inward foreign direct investment, especially in network industries, weigh on productivity growth. Barriers to interprovincial trade in goods and services and labor mobility also hamper competition and innovation. The recent Trade, Investment, and Labor Mobility Agreement (TILMA) between Alberta and British Columbia provides a model for progress elsewhere.

70. **The financial system appears to be in a position to weather further turbulence, but balance sheet strains are likely to slow financing and growth**. Current capital positions allow Canadian banks to absorb substantial balance sheet losses, and the banking system's exposure to the U.S. subprime market and structured credit products is generally considered more limited than in other major markets. However, as elsewhere, funding conditions have tightened, while credit risk from a slowing domestic economy and banks' exposure to U.S. markets will put pressure on balance sheets.

71. **The agreement in principle to restructure the frozen third-party ABCP has lowered a major risk to financial conditions**. The ABCP shutdown reflected a combination of weak investor due diligence, ratings that neglected liquidity risks, and a lack of transparency in a market environment where capital adequacy regulation had provided incentives for conditional liquidity support. Given the risk of a fire sale of illiquid assets, staff welcome the agreement in principle, and the support for this private-sector process provided by the government.

72. **While bank regulation and supervision largely meet best practice, securities markets would benefit from a single regulator**. The automatic interjurisdictional recognition of decisions of the home regulator (except for Ontario) under the proposed passport system is a significant step forward. Nonetheless, as in past years, staff believe that a single regulator is the most effective way to ensure timely policy responses, as well as lower costs and foster consistent enforcement. More broadly, regulators should address new challenges from financial innovation, including establishing adequate transparency for new products, issues that are being discussed in a range of international fora.

73. **Banks' resilience to balance-sheet risk is a benefit in current times, although it partly reflects a lack of contestability**. The "widely-held" rule prevents market entry on a large scale, leading to low-risk balance sheets and high returns on equity. It also limits incentives for financial innovation and for serving higher risk borrowers, including dynamic small- and medium-sized enterprises that contribute to productivity growth. Removing barriers to acquisition of large banks, including by foreign entities, would foster contestability and innovation in the financial system.

74. **A sound fiscal framework policy has produced an enviably strong fiscal position that makes eliminating general government net debt by 2021 feasible**. Canada is closer to long-term budget sustainability than other major industrial countries but, with public health care spending by provinces set to increase rapidly, the federal government's reaffirmation of its objective to eliminate general government net debt by 2021 is welcome. This, together with health care reform, will help to alleviate long-term spending pressures from population aging.

75. **The budgetary overperformance provides room for tax relief while maintaining small budget surpluses**. While recognizing the risk that some of the recent revenue gains may not be permanent, staff welcome this proposed tax relief as well as planned one-off additional debt reduction. Even though small in size, the related demand stimulus in 2008 is fortuitous, given weaker growth prospects.

76. **To foster efficiency, the fiscal room should be used to reduce high marginal effective tax rates on capital, saving, and labor (in that order)**. Instead, the main tax relief measure in the *Statement* is a one percentage point cut in the federal GST rate to 5 percent. That said, staff welcome progress in reducing high marginal effective tax rates on business investment, particularly the federal corporate tax rate cut which will gradually bring the rate to 15 percent by 2012. Harmonization of some provincial sales tax bases with the federal GST would further reduce marginal effective tax rates on capital, and justify more explicit incentives than the government's existing commitment to work with provinces.

77. **It is expected that the next Article IV consultation with Canada will be held on the regular 12-month cycle**.

Table 1. Canada: Fund Policy Advice

Issue	Staff Position	Authorities' Position
	Fiscal Policy	
The agreement to lock in federal health transfers over the next 10 years provides provinces with opportunities to improve the efficiency and quality of health care.	Allowing provinces greater flexibility in using price and other market-based mechanisms could help align the demand and supply for health care and reduce costs over time.	The Canada Health Act allows for private service delivery, and provinces are actively exploring different approaches to improve competition. Even low user fees could significantly reduce access to health care by the poor.
	Financial Policy	
The funding of Canada's defined benefit plans has deteriorated over the past several years, but has stabilized over the past year.	Entry into public consultation on reform is welcome and early action is warranted to better align the incentives of plan sponsors and members.	In 2006, the federal government implemented temporary relief measures to re-establish full funding in an orderly fashion. The federal government will continue to examine the broader challenges facing defined benefit pension plans.
	Labor Markets	
Canada has high labor participation rates, but the boom in the commodity and construction sectors has led to tight labor markets especially in the Western provinces.	Priorities are reducing welfare walls, amending immigration systems to address skills shortages, and simplifying recognition of occupational qualifications.	The federal government has committed to improving labor market efficiency, and has enacted a working income tax benefit and is studying plans for phased retirement. Progress has also been made in removing obstacles to labor mobility under the Agreement on Internal Trade.
Canada maintains an Employment Insurance system that offers generous seasonal, regional, and family leave benefits, funded by a payroll tax.	Consideration could be given to funding social benefits of the Employment Insurance system through general revenues and to curbing extended regional benefits.	Recent reforms to the Employment Insurance System have improved the system's funding. No significant changes in benefits are currently being considered.
	Trade Policy	
Canada can play an important leadership role in the Doha negotiations.	Canada needs to widen market access for agricultural goods, including those subject to “supply management” schemes.	Canada is pursuing an ambitious Doha outcome and will continue to support supply management.

Table 2. Canada: Indicators of Economic Performance

		Average 1997–2006	2001	2002	2003	2004	2005	2006	Est. 2007	Proj. 2008
		(In annual percent change)								
Per capita real GDP	Canada	2.4	0.7	1.8	0.9	2.0	2.1	1.7	1.5	0.6
	United States	2.0	-0.3	0.6	1.5	2.7	2.1	1.9	1.0	0.9
	Euro Area	1.7	1.5	0.4	0.2	1.3	1.0	2.3	2.0	1.7
	Japan	0.9	-0.1	0.1	1.2	2.7	1.9	2.2	2.0	1.7
	United Kingdom	2.4	2.0	1.7	2.4	2.8	1.2	2.3	2.5	2.0
	Australia	2.3	0.4	1.5	0.9	1.2	0.8	0.7	1.6	1.3
	New Zealand	1.9	2.0	3.7	1.7	3.0	1.7	0.6	1.7	1.2
Real GDP	Canada	3.5	1.8	2.9	1.9	3.1	3.1	2.8	2.6	2.0
	United States	3.1	0.8	1.6	2.5	3.6	3.1	2.9	2.2	1.6
	Euro Area	2.2	1.9	0.9	0.8	2.0	1.5	2.8	2.5	2.1
	Japan	1.1	0.2	0.3	1.4	2.7	1.9	2.2	2.0	1.7
	United Kingdom	2.8	2.4	2.1	2.8	3.3	1.8	2.8	3.1	2.3
	Australia	3.5	2.1	4.1	3.1	3.7	2.8	2.7	4.4	3.8
	New Zealand	3.0	2.7	5.2	3.5	4.4	2.7	1.6	2.8	2.3
Real domestic demand	Canada	4.0	1.2	3.2	4.6	4.3	5.1	4.4	3.8	3.7
	United States	3.6	0.9	2.2	2.8	4.1	3.1	2.8	1.6	1.0
	Euro Area	2.2	1.2	0.4	1.5	1.9	1.7	2.6	2.1	2.4
	Japan	0.7	1.0	-0.4	0.8	1.9	1.7	1.4	1.2	1.6
	United Kingdom	3.4	2.9	3.1	2.8	3.8	1.6	3.0	3.4	2.3
	Australia	4.4	0.5	6.6	5.7	5.6	4.3	3.5	5.8	3.0
	New Zealand	3.6	1.6	5.9	6.1	7.1	4.1	0.7	4.3	1.9
GDP deflator	Canada	2.1	1.1	1.1	3.3	3.2	3.4	2.4	3.0	1.9
	United States	2.2	2.4	1.7	2.1	2.9	3.2	3.2	2.6	1.6
	Euro Area	1.9	2.4	2.6	2.2	2.0	1.9	1.9	2.0	1.9
	Japan	-1.0	-1.2	-1.5	-1.6	-1.1	-1.3	-0.9	-0.6	0.1
	United Kingdom	2.5	2.2	3.1	3.1	2.6	2.3	2.6	3.1	2.8
	Australia	2.9	4.0	2.5	3.4	3.5	4.6	4.7	3.4	1.8
	New Zealand	2.1	3.8	0.6	2.4	3.1	2.1	2.5	4.1	3.5
		(In percent of GDP)								
General government financial balance	Canada	0.9	0.7	-0.1	-0.1	0.8	1.6	1.0	0.8	0.5
	United States	-1.7	-0.4	-3.8	-4.8	-4.4	-3.6	-2.6	-2.6	-2.9
	Euro Area	-2.2	-1.9	-2.6	-3.1	-2.9	-2.6	-1.6	-0.9	-1.1
	Japan	-6.2	-6.3	-8.0	-8.0	-6.2	-4.8	-4.1	-3.9	-3.8
	United Kingdom	-1.3	0.9	-1.8	-3.5	-3.4	-3.3	-2.7	-2.5	-2.3
	Australia	1.3	0.8	1.0	1.6	2.0	2.4	1.6	0.8	1.0
	New Zealand	2.2	1.3	1.5	2.6	3.8	4.9	4.2	2.2	1.6
Gross national saving	Canada	21.8	22.2	21.0	21.2	22.9	23.8	24.2	23.9	24.0
	United States	15.8	16.4	14.2	13.3	13.8	14.0	14.1	13.5	12.8
	Euro Area	21.4	21.3	20.8	20.8	21.6	21.1	21.6	21.9	21.9
	Japan	27.6	26.9	25.9	26.1	26.8	27.0	28.0	28.6	28.4
	United Kingdom	16.0	15.6	15.8	15.7	15.9	15.0	14.8	15.0	15.0
	Australia	20.2	20.1	20.0	20.6	20.1	20.8	20.8	22.2	21.7
	New Zealand	16.9	18.5	19.0	18.8	18.0	15.9	14.1	14.6	14.1
Fixed investment	Canada	20.1	19.6	19.5	19.6	20.3	21.0	22.0	22.4	23.2
	United States	19.3	19.5	18.3	18.3	18.9	19.6	19.7	18.7	17.9
	Euro Area	20.6	20.9	20.2	20.1	20.3	20.6	21.2	21.5	21.7
	Japan	24.5	24.7	23.3	22.8	22.7	23.1	23.8	23.9	23.9
	United Kingdom	17.3	17.1	17.1	16.7	17.1	17.2	17.9	18.2	18.3
	Australia	24.5	22.0	24.1	25.2	25.4	26.2	26.7	27.5	27.3
	New Zealand	21.7	20.2	21.5	22.1	23.5	23.8	22.9	22.4	21.8
Current account balance	Canada	1.2	2.3	1.7	1.2	2.3	2.0	1.6	1.0	0.1
	United States	-4.2	-3.8	-4.4	-4.8	-5.5	-6.1	-6.2	-5.6	-5.3
	Euro Area	0.1	-0.3	0.8	0.4	0.8	0.0	-0.2	-0.1	-0.3
	Japan	3.0	2.1	2.9	3.2	3.7	3.6	3.9	4.5	4.3
	United Kingdom	-1.8	-2.2	-1.6	-1.3	-1.6	-2.5	-3.2	-3.5	-3.6
	Australia	-4.5	-2.0	-3.8	-5.4	-6.0	-5.8	-5.5	-5.7	-5.6
	New Zealand	-5.6	-2.8	-3.9	-4.3	-6.4	-8.6	-8.7	-8.5	-8.6

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

Table 3. Canada: Selected Economic Indicators

(In percent change at annual rates and seasonally adjusted, unless otherwise indicated)

				Est.	Projections							
	2007				2008				2009			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NA in constant prices												
Real GDP	3.5	3.8	2.9	1.8	1.3	1.6	2.1	2.5	2.9	3.1	3.2	3.2
Net exports 1/	0.3	-1.4	-5.0	-2.2	-1.3	-1.1	-0.4	-0.2	0.1	0.1	0.1	0.2
Total domestic demand	3.3	5.5	8.1	4.0	2.7	2.7	2.5	2.7	2.8	3.0	3.1	3.1
Final domestic demand	2.8	4.9	4.6	3.8	3.1	3.0	2.7	2.8	2.8	3.1	3.1	3.1
Private consumption	3.4	5.9	3.0	3.1	3.1	2.7	2.2	2.3	2.3	2.7	2.8	2.8
Personal saving ratio (in percent of DI)	2.8	1.6	1.3	...	...	...	...	...	...	...	...	...
Public consumption	2.3	3.2	5.8	3.3	2.3	2.3	2.3	2.3	2.8	2.8	2.8	2.8
Private fixed domestic investment	2.3	4.4	7.6	6.5	3.9	4.3	4.3	4.3	3.9	4.0	4.0	4.0
Machinery and equipment	-3.2	5.8	15.4	11.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	4.9
Residential construction	8.2	5.8	5.2	4.0	2.0	3.0	3.0	3.0	3.0	3.1	3.2	3.2
Private investment (in percent of GDP)	19.5	19.4	19.7	20.0	20.1	20.3	20.5	20.6	20.7	20.8	20.9	20.9
Public investment	-2.0	0.8	6.5	2.3	3.8	3.8	3.8	3.8	4.9	4.9	4.9	4.9
Change in inventories 1/	0.6	0.5	2.9	0.3	-0.4	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0
GDP (current prices)	10.5	9.4	1.9	2.8	4.2	4.4	3.6	4.4	6.1	4.6	4.1	5.1
Employment and inflation												
Unemployment rate (percent)	6.1	6.1	6.0	5.9	6.1	6.2	6.3	6.3	6.3	6.2	6.2	6.1
Employment	3.9	1.3	1.7	3.0	0.1	0.7	0.6	1.1	1.3	1.3	1.3	1.2
CPI inflation (y/y)	1.9	2.0	2.1	2.5	1.5	1.1	1.6	1.6	2.0	2.0	2.0	2.0
Core CPI inflation (y/y)	2.3	2.4	2.2	...	...	...	...	...	...	...	...	...
GDP deflator	6.9	5.3	-1.0	1.1	2.8	2.7	1.5	1.8	3.1	1.5	0.8	1.9
Potential output growth	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Output gap (in percent of potential output)	0.1	0.3	0.4	0.2	-0.2	-0.5	-0.6	-0.7	-0.6	-0.5	-0.4	-0.3
Interest rates 2/												
Three-month treasury bill (percent)	4.2	4.3	4.3	3.9	3.8	3.8	3.9	4.0	4.1	4.3	4.5	4.7
Ten-year government bond yield (percent)	4.1	4.4	4.5	4.2	4.0	4.0	4.1	4.2	4.3	4.5	4.7	4.9
External indicators												
Current account balance (in percent of GDP)	1.7	1.7	0.3	0.3	0.3	0.3	0.0	-0.1	0.2	0.1	-0.1	0.0
Merchandise trade balance (in percent of GDP)	3.9	4.3	2.9	2.2	2.2	2.2	1.9	1.8	2.1	2.0	1.7	1.7
Export volume	1.1	3.3	2.9	-7.2	-4.7	-1.4	-0.7	2.0	3.2	3.5	3.8	4.0
Import volume	1.0	5.7	21.9	-0.6	-0.5	2.1	0.4	2.7	3.3	3.7	3.9	4.0
Balance on invisibles (in percent of GDP)	-2.2	-2.6	-2.6	-2.0	-2.0	-1.9	-1.9	-2.0	-1.9	-1.8	-1.8	-1.8
Exchange rate (USD/C$) 2/	0.85	0.91	0.96	1.02	...	...	...	...	...	...	...	...
Nominal effective exchange rate (q/q) 2/	-2.9	6.4	4.8	...	...	...	...	...	...	...	...	...
Real effective exchange rate (q/q) 2/	-2.8	6.2	4.4	...	...	...	...	...	...	...	...	...
Terms of trade 2/	6.1	8.8	-0.8	-1.6	4.2	2.3	-1.4	-0.5	3.5	-1.0	-2.9	0.2
Saving and investment (in percent of GDP)												
Gross national saving	23.8	23.9	23.8	...	...	...	...	...	...	...	...	...
General government	3.9	4.4	4.4	...	...	...	...	...	...	...	...	...
Private	19.9	19.5	19.4	...	...	...	...	...	...	...	...	...
Personal	4.6	3.8	3.7	...	...	...	...	...	...	...	...	...
Business	15.3	15.6	15.7	...	...	...	...	...	...	...	...	...
Gross domestic investment	22.4	22.2	23.4	...	...	...	...	...	...	...	...	...

Table 3. Canada: Selected Economic Indicators (concluded)

(In percent change, unless otherwise indicated)

				Est.	Projections					
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
NA in constant prices										
Real GDP	3.1	3.1	2.8	2.6	2.0	2.7	3.1	2.7	2.6	2.5
Q4/Q4	3.5	3.2	1.9	3.0	1.9	3.1	2.9	2.6	2.6	2.6
Net exports 1/	-1.0	-1.7	-1.4	-1.1	-1.7	-0.1	0.1	0.1	0.0	0.0
Total domestic demand	4.3	5.1	4.4	3.8	3.7	2.8	3.0	2.6	2.6	2.8
Final domestic demand	4.1	4.5	4.7	3.8	3.4	2.9	3.0	2.7	2.6	2.6
Private consumption	3.4	3.8	4.2	4.1	3.0	2.5	2.7	2.4	2.5	2.4
Personal saving ratio (in percent of DI)	2.9	1.6	2.3	1.8	1.5	2.0	2.1	2.2	2.3	2.3
Public consumption	2.5	2.2	3.3	3.1	3.0	2.6	2.6	2.3	2.2	2.3
Private fixed domestic investment	8.1	8.1	7.1	4.2	5.0	4.1	3.9	3.4	3.2	3.1
Machinery and equipment	9.3	10.8	7.4	4.4	7.4	5.0	4.9	4.5	4.1	3.8
Residential construction	7.5	3.5	2.1	2.8	3.4	3.1	3.1	2.7	2.6	2.5
Private investment (in percent of GDP)	17.8	18.4	19.2	19.7	20.4	20.8	21.1	21.3	21.5	21.6
Public investment	5.0	10.9	8.1	1.7	3.7	4.5	4.9	4.7	4.5	4.5
Change in inventories 1/	0.1	0.3	-0.2	0.0	0.4	0.0	0.0	0.0	0.0	0.0
GDP (current prices)	6.4	6.5	5.2	5.6	3.9	4.8	4.8	4.4	4.3	4.3
Employment and inflation										
Unemployment rate (percent)	7.2	6.8	6.3	6.0	6.2	6.2	6.1	6.1	6.1	6.1
Employment	1.8	1.4	2.0	2.3	1.2	1.1	1.1	1.0	0.9	0.9
CPI inflation	1.8	2.2	2.0	2.1	1.4	2.0	2.0	2.0	2.0	2.0
GDP deflator	3.2	3.4	2.4	3.0	1.9	2.0	1.7	1.7	1.7	1.9
Potential output growth	2.7	2.6	2.6	2.7	2.7	2.7	2.7	2.6	2.6	2.5
Output gap (in percent of potential output)	-0.3	0.2	0.3	0.2	-0.5	-0.4	-0.1	0.0	0.0	0.0
Indicators of fiscal policies										
(NA basis, in percent of GDP)										
Federal fiscal balance	0.8	0.1	0.6	0.4	-0.1	-0.2	0.0	0.2	0.3	0.3
Provincial fiscal balance 3/	-0.7	0.7	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
General government fiscal balance 3/	0.8	1.6	1.0	0.8	0.5	0.4	0.5	0.7	0.8	0.8
General government net debt	34.4	30.1	27.6	25.3	23.9	22.5	20.9	19.3	17.7	16.2
Three-month treasury bill (percent)	2.2	2.7	4.0	4.2	3.9	4.4	4.8	4.8	4.8	4.8
Ten-year government bond yield (percent)	4.6	4.1	4.2	4.3	4.1	4.6	5.1	5.1	5.1	5.1
External indicators										
Current account balance (in percent of GDP)	2.3	2.0	1.6	1.0	0.1	0.1	0.1	0.1	0.1	0.1
Merchandise trade balance (in percent of GDP)	5.1	4.6	3.5	3.3	2.0	1.9	1.9	1.9	1.9	1.8
Export volume	5.2	2.4	1.0	1.6	-2.0	2.6	4.4	4.4	4.0	0.9
Import volume	8.8	8.1	5.2	5.2	3.2	3.0	4.3	4.2	4.0	1.0
Balance on invisibles (in percent of GDP)	-2.8	-2.6	-1.9	-2.3	-1.9	-1.8	-1.8	-1.9	-1.8	-1.8
Terms of trade	4.7	4.0	0.9	2.4	1.4	0.2	-0.2	-0.2	0.0	0.0
Saving and investment (in percent of GDP)										
Gross national saving	22.9	23.8	24.2	23.9	24.0	24.4	24.6	24.8	24.9	25.1
General government	3.3	4.4	4.0	3.7	3.4	3.3	3.4	3.6	3.7	3.7
Private	19.6	19.4	20.2	20.1	20.6	21.1	21.2	21.2	21.2	21.4
Personal	4.6	3.8	6.2	5.9	6.3	6.8	7.0	7.0	7.0	7.2
Business	14.9	13.9	14.0	14.2	14.3	14.3	14.1	14.2	14.2	14.2
Gross domestic investment	20.7	21.7	22.5	22.9	23.9	24.3	24.5	24.7	24.9	25.0

Sources: Haver Analytics; and Fund staff estimates.

1/ Contribution to growth.
2/ Not seasonally adjusted.
3/ Includes local governments and hospitals.

Table 4. Canada: Balance of Payments

(In billions of Canadian dollars, unless otherwise indicated)

						Est.	Projections				
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Current account balance	19.8	14.7	29.1	27.9	23.6	14.8	1.5	1.2	1.6	1.2	1.2
In percent of GDP	1.7	1.2	2.3	2.0	1.6	1.0	0.1	0.1	0.1	0.1	0.1
Merchandise trade balance	57.3	56.4	65.8	63.5	51.3	50.7	32.4	31.3	32.8	34.9	35.8
Exports, goods	414.0	399.1	429.1	451.8	455.7	468.0	454.0	464.2	483.9	504.5	524.0
Imports, goods	356.7	342.7	363.3	388.3	404.4	417.3	421.6	432.9	451.1	469.6	488.1
Services balance	-7.2	-11.5	-12.0	-12.2	-15.2	-18.3	-19.7	-19.0	-19.6	-21.4	-22.6
Investment income balance	-30.3	-30.0	-24.3	-22.5	-11.8	-17.7	-11.9	-11.8	-12.4	-13.2	-12.9
Transfer balance	0.0	-0.2	-0.4	-0.9	-0.7	0.2	0.7	0.8	0.8	0.8	0.9
Capital and financial accounts balance	-17.2	-15.7	-32.8	-32.3	-18.5	-14.8	-1.5	-1.2	-1.6	-1.2	-1.2
Direct investment, net	-7.2	-21.6	-57.3	-5.6	27.0	3.6	0.6	7.6	8.8	14.2	19.3
In Canada	34.8	10.5	-0.5	35.0	78.3	50.2	63.2	69.6	80.2	90.7	103.3
Abroad	-42.0	-32.1	-56.8	-40.6	-51.3	-46.6	-62.6	-62.0	-71.4	-76.5	-84.0
Portfolio investment, net	-10.7	0.7	30.4	-43.7	-46.2	-52.3	-50.3	-67.1	-83.5	-104.4	-129.6
Canadian securities	18.6	19.7	54.8	9.6	32.5	-72.3	-90.4	-104.3	-126.9	-150.5	-180.0
Bonds	18.3	7.9	19.4	-0.1	18.0	...	...	...	...	...	...
Stocks	-1.5	13.5	35.7	9.1	10.8	...	...	...	...	...	...
Money market	1.8	-1.6	-0.4	0.5	3.7	...	...	...	...	...	...
Foreign securities	-29.3	-19.1	-24.4	-53.3	-78.7	20.0	40.2	37.2	43.3	46.1	50.4
Bonds	-6.2	-8.0	-15.3	-29.2	-43.6	...	...	...	...	...	...
Stocks	-21.3	-7.7	-8.1	-22.0	-28.3	...	...	...	...	...	...
Other investment 1/	-4.5	-3.7	-13.8	12.7	-2.6	28.3	42.4	52.2	66.9	82.5	102.3
Assets	-12.6	-21.2	-9.7	-20.5	-34.3	...	...	...	...	...	...
Liabilities	8.1	17.6	-4.1	33.2	31.7	...	...	...	...	...	...
Capital account balance	4.9	4.2	4.5	5.9	4.2	5.5	5.7	6.0	6.3	6.6	6.9
Transactions in official International reserves	0.3	4.7	3.4	-1.7	-1.0	...	...	...	...	...	...
Statistical discrepancy	-2.6	1.1	3.8	4.4	-5.0	...	...	...	...	...	...
Memorandum item:											
Net international investment position	-208.7	-216.7	-180.1	-166.4	-99.0	-78.6	-71.4	-64.1	-56.2	-48.5	-40.4
In percent of GDP	-18.1	-17.9	-14.0	-12.1	-6.8	-5.1	-4.5	-3.9	-3.2	-2.7	-2.1

Sources: Haver Analytics; and Fund staff calculations.

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

Table 5. Canada: Selected Vulnerability Indicators

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005	2006	2007 7/
External indicators									
Official reserves (in billions of U.S. dollars)	28.6	32.4	34.2	37.2	36.3	34.5	33.0	35.1	39.4
Broad money (M3) to foreign exchange reserves (ratio)	14.9	13.7	12.9	12.7	16.8	20.8	24.6	24.8	27.9
Central bank foreign liabilities (in billions of dollars)	0.2	0.2	0.2	0.2	0.2	0.1	0.1	...	...
Official reserves in months of imports	1.3	1.4	1.6	1.6	1.4	1.1	1.0	1.0	1.9
General government external debt (in billions of dollars) 1/	96.9	85.3	73.1	78.9	60.9	54.7	49.1	52.1	45.7
Net international investment position, current prices	-24.8	-19.4	-18.4	-18.1	-17.9	-14.0	-12.1	-6.8	-8.7
External debt to exports ratio (in percent)	57.7	42.7	42.3	43.7	47.0	36.5	32.1	18.9	48.8
External interest payments to exports (in percent) 2/	15.7	14.3	13.6	12.7	12.9	12.7	13.6	14.0	14.8
Financial markets indicators									
General government gross debt	101.0	91.1	91.5	89.4	85.2	80.2	78.4	73.5	68.8
Three-month treasury bill yield (percent)	4.7	5.5	3.9	2.6	2.9	2.2	2.7	4.0	4.2
Ten-year government note (percent)	5.6	5.9	5.5	5.3	4.8	4.6	4.1	4.2	4.3
Real three-month treasury bill yield (percent; deflated by CPI rate)	2.9	2.7	1.3	0.3	0.1	0.4	0.5	2.0	1.9
Change in stock market index (TSE 300, annual percentage change)	29.7	6.2	-13.9	-14.0	24.3	12.5	21.9	14.5	7.2
Banking sector risk indicators 3/									
Balance sheet									
Total loans to assets (percent)	59.0	58.0	56.2	55.9	54.1	54.3	55.1	53.8	53.9
Total loans to deposits (percent)	87.0	84.4	84.7	83.3	81.4	81.7	81.0	81.7	82.3
Impaired assets/total assets	0.59	0.60	0.84	0.90	0.65	0.39	0.27	0.22	0.22
Loan loss provision (in percent of total assets)	0.23	0.27	0.39	0.56	0.22	0.06	0.09	0.10	0.13
Total foreign currency assets/total assets 4/	40.2	40.5	42.7	41.4	36.2	34.1	34.7	38.8	36.1
Total foreign currency liabilities/total assets 4/	42.4	42.2	44.7	43.8	37.7	35.1	36.1	39.8	37.9
Total foreign currency deposits/total assets 4/	31.3	29.5	30.4	28.9	25.6	23.2	25.1	26.8	26.5
Profitability									
Return on total shareholders' equity (in percent)	15.7	15.2	13.9	9.3	14.7	16.7	14.6	21.7	22.6
Return on average assets (in percent)	0.71	0.71	0.66	0.44	0.69	0.79	0.67	0.96	0.93
Average intermediation spread	2.7	2.9	3.0	3.0	3.1	3.0	2.7	2.7	0.0
Net interest income (in percent of average total assets)	1.8	1.8	1.9	2.0	1.9	1.8	1.7	1.5	1.5
Capital position									
Total capital ratio	11.3	11.9	12.3	12.4	13.4	13.3	12.9	12.5	12.07
Tier 1 capital ratio	8.2	8.6	9.0	9.2	10.3	10.6	10.2	10.5	9.8
Personal sector 5/									
Net worth (in percent of disposable income)	507.0	502.2	503.2	512.7	516.1	519.1	535.0	549.1	...
Total liabilities (in percent of disposable income)	114.1	112.6	114.1	117.1	120.6	123.1	126.8	128.8	...
Total liabilities (in percent of net worth)	22.5	22.4	22.7	22.8	23.4	23.7	23.7	23.5	...
Household credit (growth rate, percent)	5.1	7.1	4.8	7.1	8.5	10.0	10.5	10.5	...
Corporate sector 6/									
Debt of private nonfinancial corporations	52.7	50.5	52.8	51.2	46.3	44.4	43.1	43.8	...
Debt-to-equity ratio of nonfinancial private corporations	80.2	74.0	73.6	68.5	59.3	54.8	52.3	51.4	...
Business credit (growth rate, percent)	6.2	7.1	5.3	4.4	1.9	4.5	6.3	5.8	...

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 for the six largest chartered Canadian banks, which account for over 90 percent of the total market.

4/ All chartered banks.
5/ Persons and unincorporated business.
6/ Based on total debt less trade payables, corporate claims, and other liabilities.
7/ 2007 calculations until July 2007

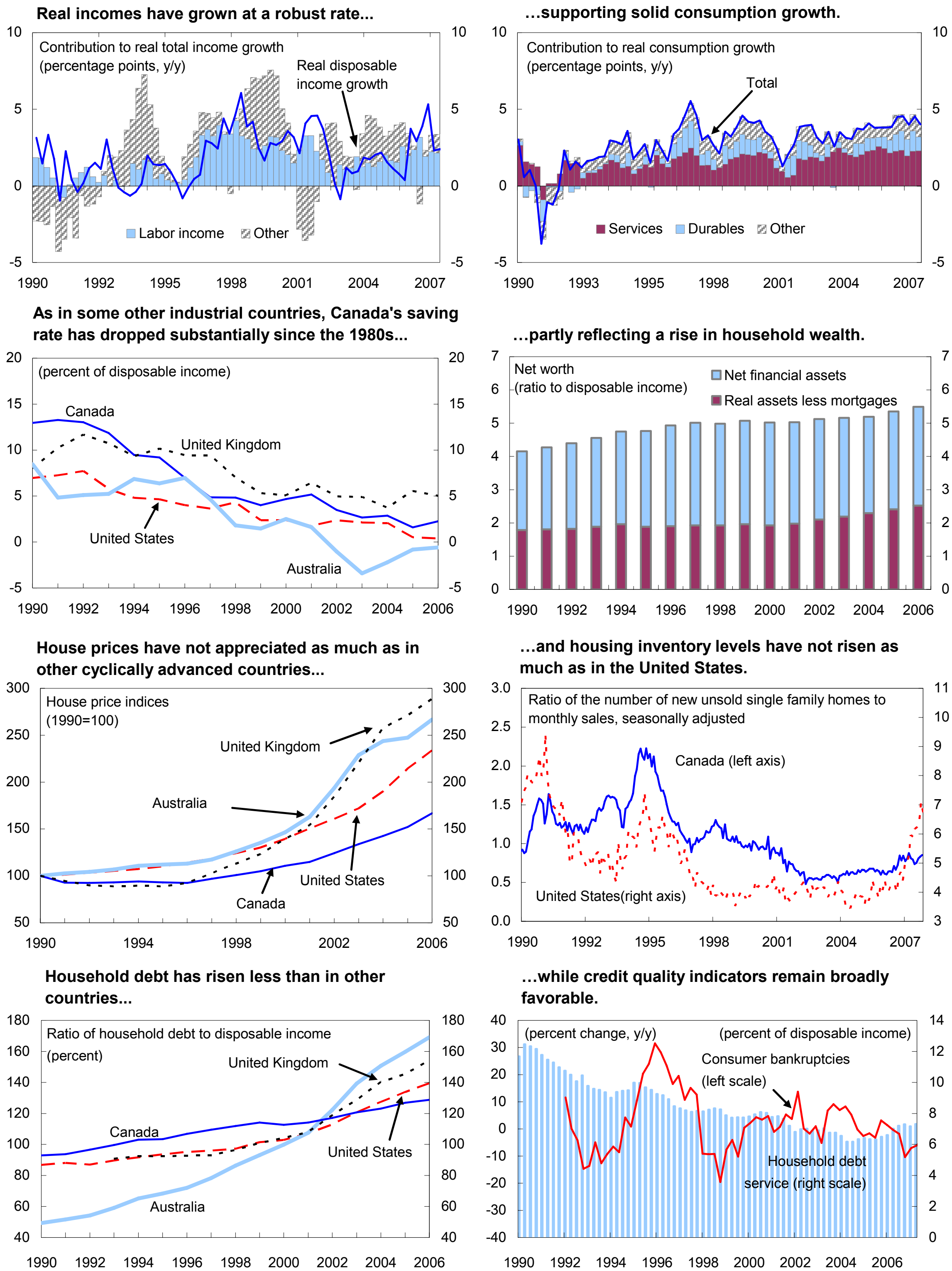
Table 6. Canada: Fiscal Indicators

	2001/02	2002/03	2003/04	2004/05	2005/06	Est. 2006/07	Staff Projections 2007/08	2008/09	2009/10	2010/11
Federal government (PA basis) 1/					(In billions of dollars)					
Revenue	183.9	190.6	198.6	211.9	222.2	236.0	242.5	242.4	252.3	265.0
Program spending	136.2	146.7	153.7	176.4	175.2	188.3	198.1	207.2	216.4	224.6
Interest payments	39.7	37.3	35.8	34.1	33.8	33.9	33.8	32.9	33.0	32.9
Budgetary balance (accruals basis)	8.0	6.6	9.1	1.5	13.2	13.8	10.6	2.3	2.9	7.5
Net lending (calendar year basis) 2/	12.0	9.4	4.1	9.8	2.0	8.5	6.0	-1.1	-2.9	0.5
Structural budgetary balance	6.9	7.0	10.9	2.1	12.7	12.8	10.3	3.7	4.3	8.8
Structural net lending	10.8	9.8	5.9	10.5	1.5	7.5	5.7	0.3	-1.5	1.8
Planned debt reduction	...	...	...	...	13.2	13.8	10.0	3.0	3.0	3.0
Remaining surplus	...	...	...	...	0.0	0.0	0.6	-0.7	-0.1	4.5
Gross general debt 4/	703.0	699.0	700.1	705.0	688.7	678.7	675.7	672.7	669.7	666.7
Net federal debt 4/	511.9	505.3	496.2	494.7	481.5	467.7	457.7	454.7	451.7	448.7
					(In percent of GDP)					
Revenue	16.6	16.5	16.4	16.4	16.2	16.3	15.9	15.3	15.2	15.2
Program spending	12.3	12.7	12.7	13.7	12.7	13.0	13.0	13.0	13.0	12.9
Interest payments	3.6	3.2	2.9	2.6	2.5	2.3	2.2	2.1	2.0	1.9
Budgetary balance (accruals basis) 2/	0.7	0.6	0.8	0.1	1.0	1.0	0.7	0.1	0.2	0.4
Net lending 2/	1.1	0.8	0.3	0.8	0.1	0.6	0.4	-0.1	-0.2	0.0
Structural budgetary balance 3/	0.6	0.6	0.9	0.2	0.9	0.9	0.7	0.2	0.3	0.5
Structural net lending	1.0	0.9	0.5	0.8	0.1	0.5	0.4	0.0	-0.1	0.1
Planned debt reduction	...	...	...	...	1.0	1.0	0.7	0.2	0.2	0.2
Remaining surplus	...	...	...	...	0.0	0.0	0.0	0.0	0.0	0.3
Gross federal debt 4/	63.4	60.6	57.7	54.6	47.6	44.4	42.6	40.4	38.4	36.6
Net federal debt 4/	46.2	43.8	40.9	38.3	35.0	32.3	30.0	28.6	27.2	25.7
General government 5/					(In billions of dollars)					
Revenue	469.3	471.4	494.7	522.1	557.8	580.6	611.1	627.0	651.4	682.3
Expenditure	462.1	472.5	495.7	512.1	536.2	565.7	598.8	619.3	645.4	672.9
Balance	7.3	-1.1	-1.0	9.9	21.6	14.9	12.4	7.7	6.0	9.4
Structural balance	4.5	-1.9	3.0	12.0	20.8	12.7	10.5	11.0	9.3	11.8
Gross public debt 6/	1014.0	1030.9	1034.0	1035.5	1063.3	1051.0	1043.3	1037.3	1027.9	1015.5
Net public debt 6/	484.4	491.7	467.7	444.3	399.5	387.2	379.5	373.5	364.1	351.6
					(In percent of GDP)					
Revenue	42.4	40.9	40.8	40.4	40.6	40.1	40.0	39.5	39.2	39.1
Expenditure	41.7	41.0	40.9	39.7	39.0	39.1	39.2	39.0	38.8	38.6
Balance	0.7	-0.1	-0.1	0.8	1.6	1.0	0.8	0.5	0.4	0.5
Structural balance 3/	0.4	-0.2	0.2	0.9	1.5	0.9	0.7	0.7	0.6	0.7
Gross public debt 6/	91.5	89.4	85.2	80.2	73.5	68.8	65.7	62.4	58.9	55.8
Net public debt 6/	43.7	42.6	38.6	34.4	27.6	25.3	23.9	22.5	20.9	19.3
Memorandum items										
Real GDP growth	1.8	2.9	1.9	3.1	3.1	2.8	2.6	2.0	2.7	3.1
Nominal GDP growth rate	2.9	4.0	5.2	6.4	6.5	5.2	5.6	3.9	4.8	4.8
Three-month treasury bill rate	3.9	2.6	2.9	2.2	2.7	4.0	4.2	3.9	4.4	4.8
Ten-year government bond rate	5.5	5.3	4.8	4.6	4.1	4.2	4.3	4.1	4.6	5.1

Sources: Department of Finance Canada *The 2007 Economic Statement*; Haver Analytics; and Fund staff estimates.

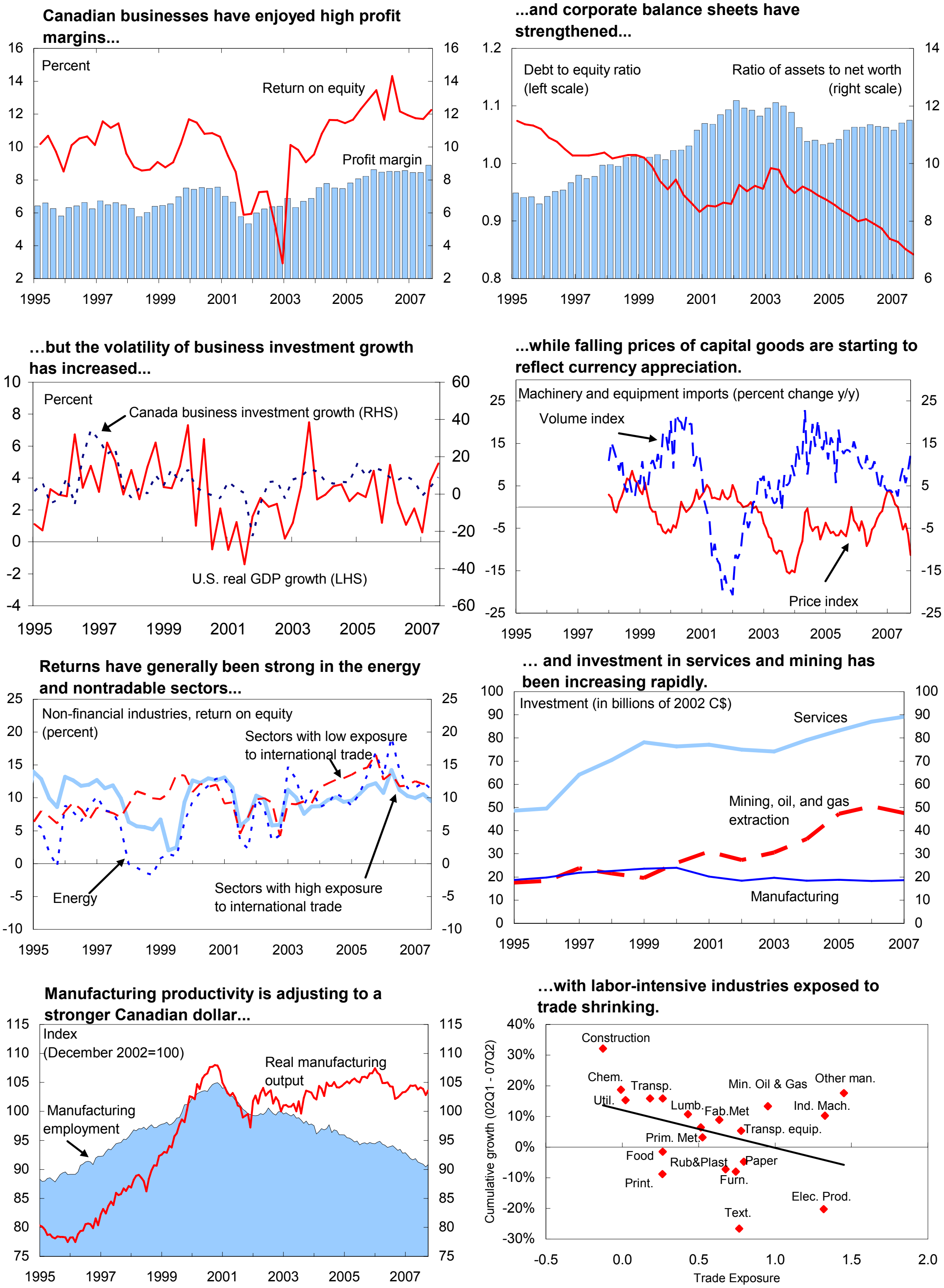
1/ On a fiscal year basis, which starts on April 1.
2/ The budgetary surplus on an accruals basis measures changes in net worth, while net lending provides a better picture of the impact of fiscal policy on domestic demand.
3/ In percent of potential GDP.
4/ Assuming future planned debt reduction is achieved.
5/ On a national accounts and calendar year basis. Includes federal, provincial, territorial, and local governments; and Canada and Quebec pension plans.
6/ OECD measure that excludes government employee unfunded pension liabilities.

Figure 1. Household Activity and Balance Sheets



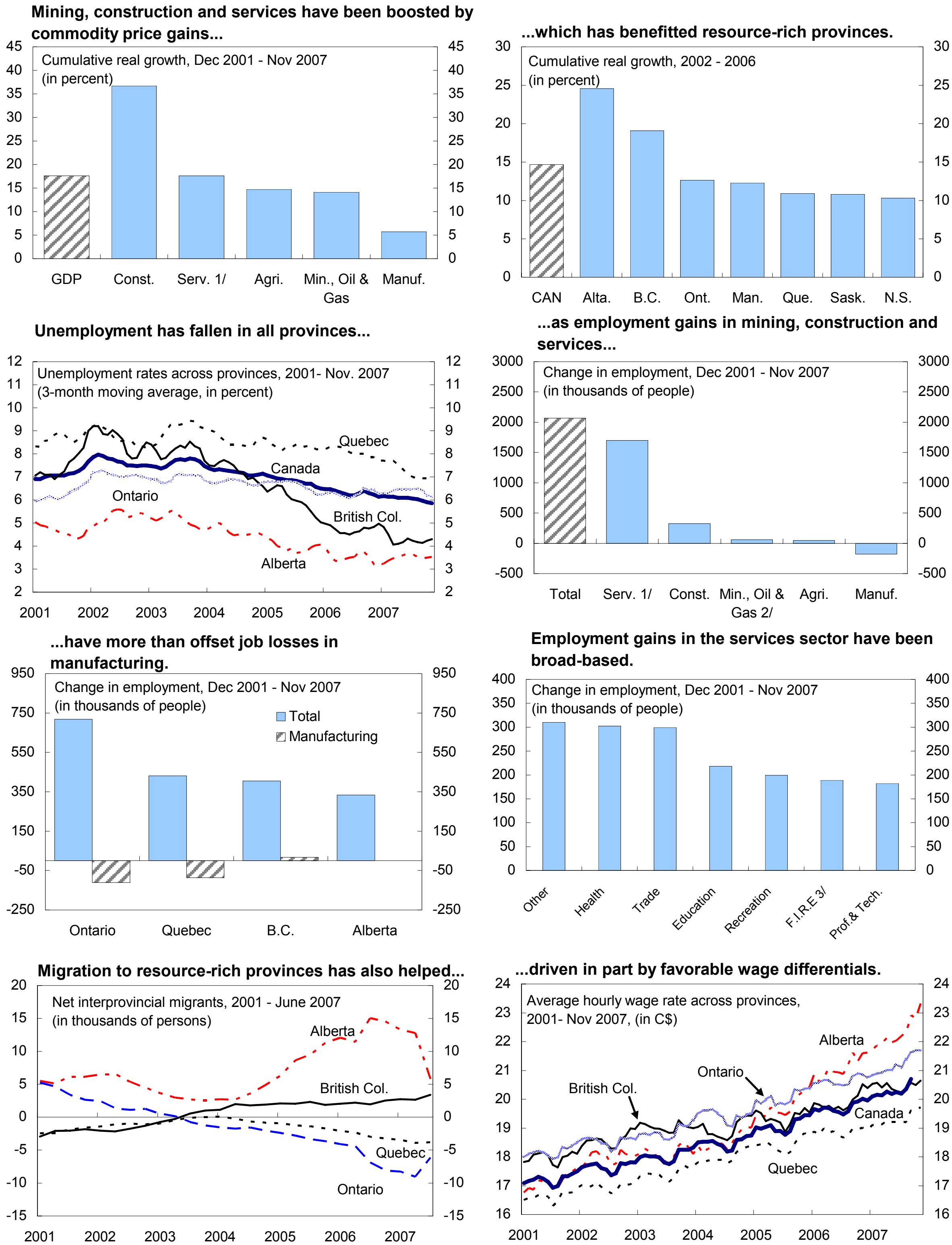
Sources: Annual Reports of the 6 largest Canadian Banks; Canada Real Estate Association; Haver Analytics; IMF staff calculations; Klyuev, V., Mills, P. S. "Is Housing Wealth an 'ATM'? The Relationship Between Household Wealth, Home Equity Withdrawal, and Saving Rates", IMF Working Paper No. 06/162, National Bank Financial, *Weekly Economic Letter*, September 22, 2006.

Figure 2. Corporate Sector Indicators



Sources: Haver Analytics; Thomson One Analytics; Consensus Forecasts; and IMF staff calculations.

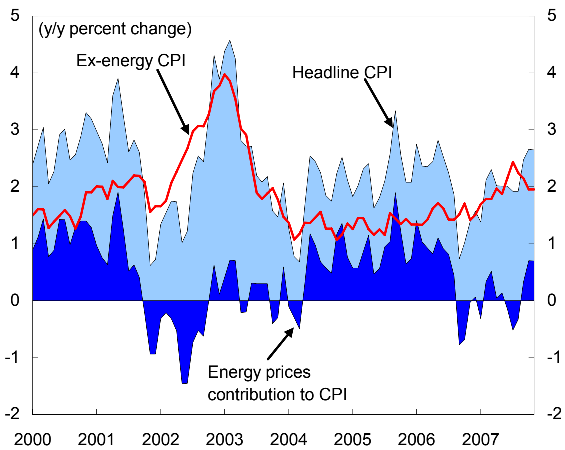
Figure 3. Adjustment to Commodity Price Gains and Real Appreciation



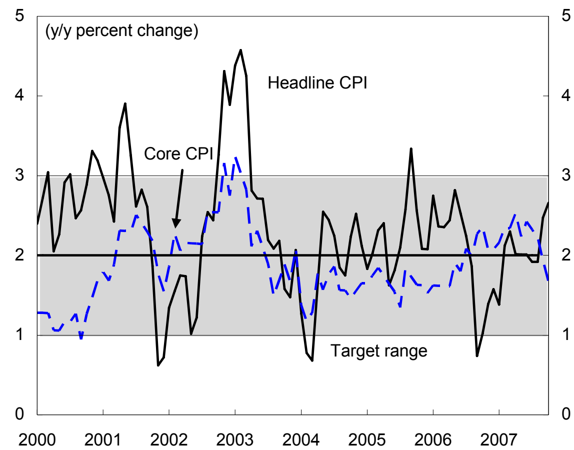
1/ Excludes public administration
2/ Includes forestry and fishing.
3/ Finance, insurance, and real estate.
Source: Haver Analytics and IMF staff calculations.

Figure 4. Monetary Policy Indicators

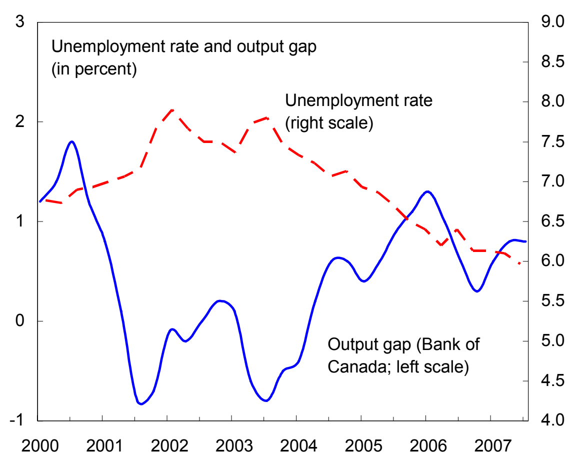
Energy price volatility has subsided...



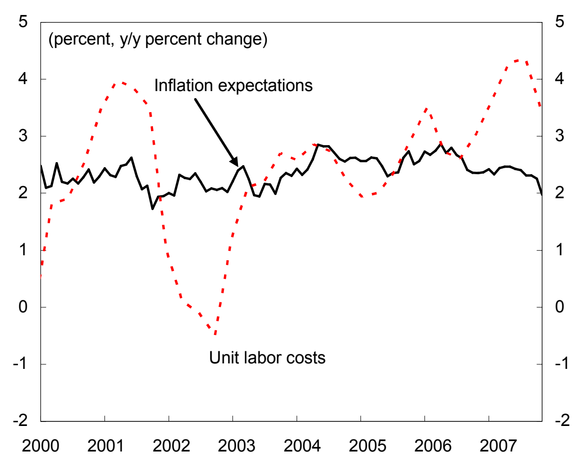
...and core inflation has declined recently...



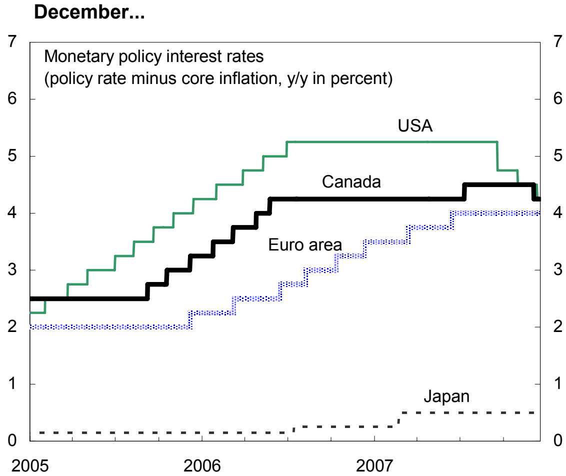
...despite low unemployment and a positive output gap...



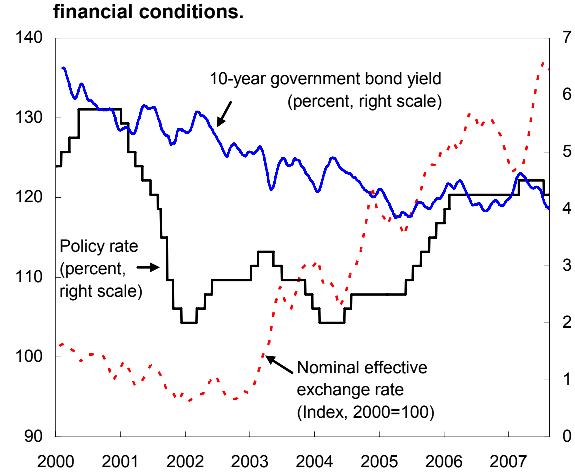
...and while unit labor costs are high, inflation expectations have remained well anchored.



The Bank of Canada reversed its July hike in December...

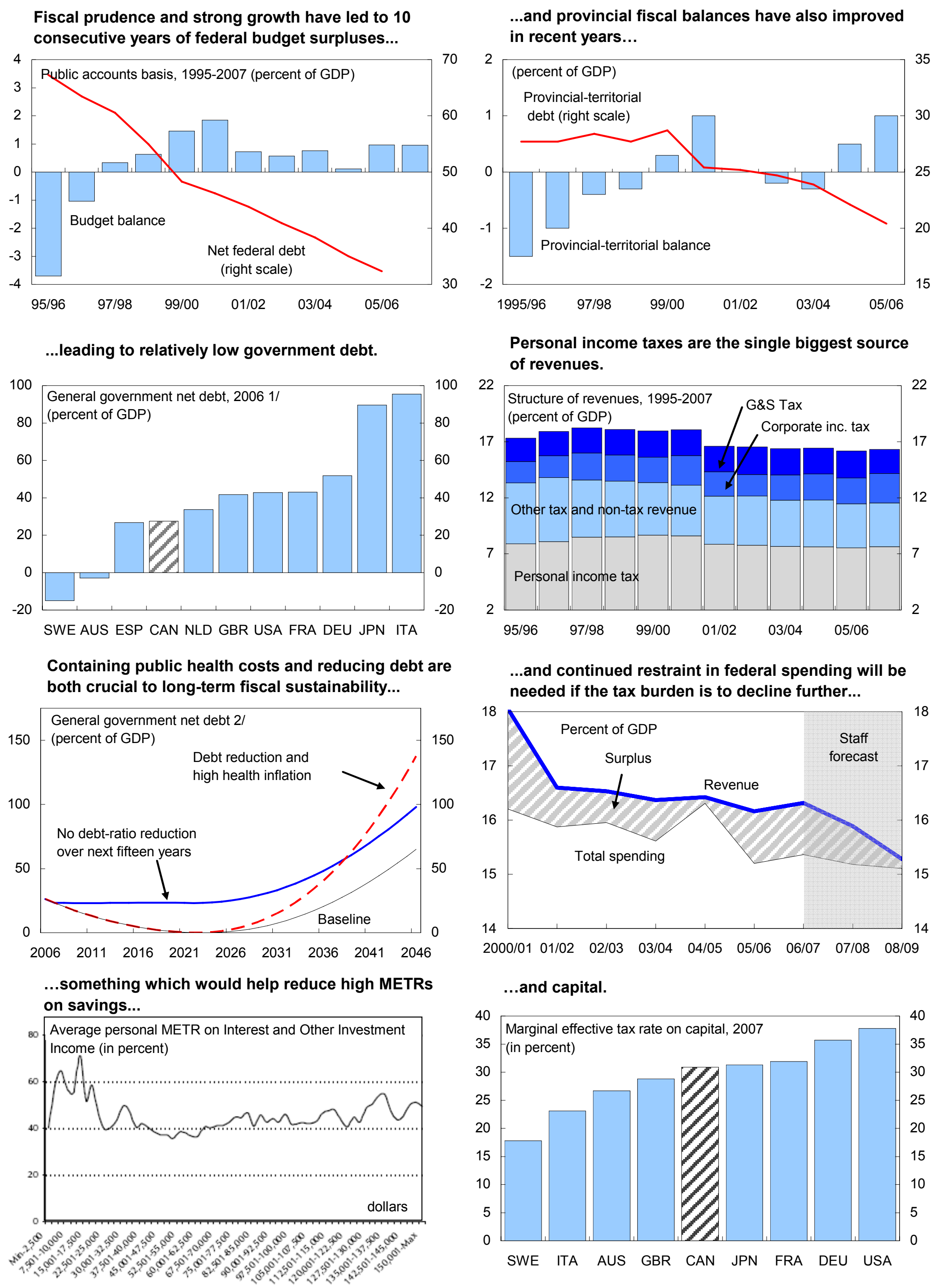


...as exchange rate appreciation has tightened financial conditions.



Sources: Bloomberg L.P.; Haver Analytics; and IMF staff calculations.

Figure 5. Fiscal Policy Indicators

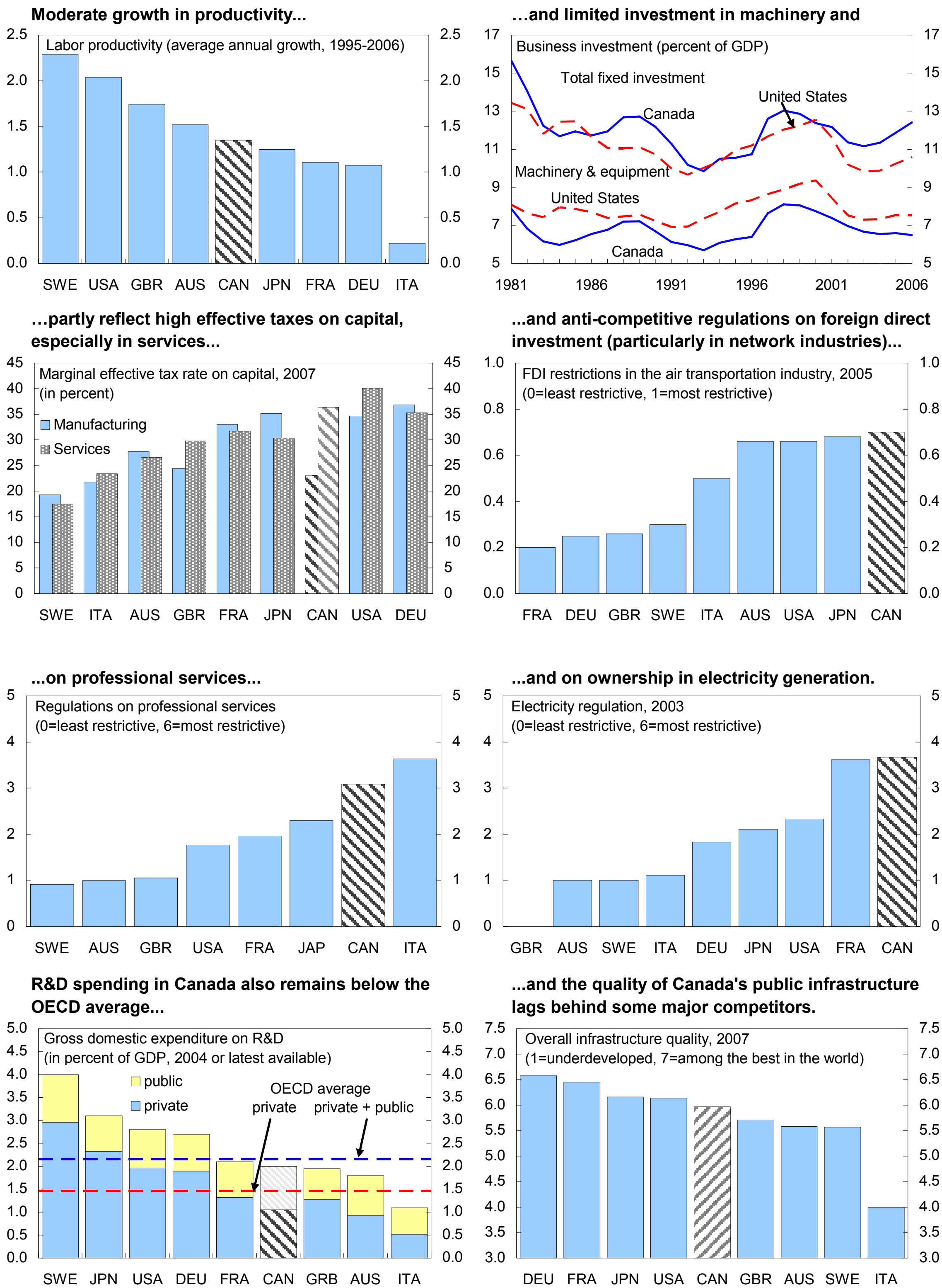


Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook*; OECD Economic Outlook; 2007 Tax Competitiveness Report, C.D. Howe Institute, and IMF staff estimates.

1/ The OECD measure of general government net financial liabilities.

2/ The difference with the OECD measure mainly reflects the inclusion of government employee unfunded pension liabilities in Statistics Canada definition of general government National Balance Sheet Accounts. Net debt is not adjusted for Financial assets of Social Security Funds. The "Baseline" path reports projected government debt ratios assuming for the first ten years that the federal government achieves its ten-year debt reduction target, provinces run balanced budgets, and public health care inflation equals the growth in all prices through 2046. The "No-debt ratio reduction" path assumes that federal and provincial debt ratios remain unchanged over the next ten years. The "Debt reduction and high health inflation" path illustrates the impact of public medical costs rising 2 percent per year faster than all prices, with the additional costs offset only though 2016. In all cases, the fiscal system is assumed unchanged after 2016. More details on the model are provided in "Assessing the Long-Term Fiscal Position of Canada" in IMF Country Report No. 03/34.

Figure 6. Structural Indicators



Sources: OECD; Koyama and Golub, 2006; Conway and Nicoletti, 2006; Haver Analytics; C.D. Howe Institute; World Economic Forum, *Global Competitiveness Report* , 2007/08.

INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by Western Hemisphere Department
(In consultation with other departments)

January 16, 2008

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Annex I. Canada—Fund Relations

(As of September 30, 2007)

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

II. **General Resources Account:**	SDR Million	Percent of Quota
Quota	6,369.20	100.00
Fund holdings of currency	5,938.38	93.24
Reserve position in Fund	430.83	6.76

III. **SDR Department:**	SDR Million	Percent of Allocation
Net cumulative allocation	779.29	100.00
Holdings	642.75	82.48

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

V. **Financial Arrangements:** None.

VI. **Projected Obligations to Fund:**

(SDR Million; based on existing use of resources and present holdings of SDRs):

	2007	2008	2009	2010	2011
Principal	n/a	n/a	n/a	n/a	n/a
Charges/Interest	1.36	5.21	5.21	5.21	5.21
Total	1.36	5.21	5.21	5.21	5.21

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. The Canadian dollar is a freely floating currency, with exchange rates determined on the basis of demand and supply conditions in the foreign 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 accepted the obligations of Article VIII, Sections 2, 3, and 4(a) and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Canada maintains exchange restrictions for security reasons, based on UN Security Council Resolutions, that have been notified to the Fund for approval (most recently EBD/07/121, 11/1/07) under the procedures set forth in Executive Board Decision No. 144-(52/51).

X. **Last Article IV Consultation**: The Staff Report for the 2007 consultation with Canada was considered by the Executive Board on January 12, 2007 (EBM/07/03). Canada is on a 12-month consultation cycle.

XI. The 2008 Article IV discussions were conducted in Ottawa and Toronto from December 3-11 by T. Bayoumi (head), T. Helbling, R. Balakrishnan, V. Klyuev, and H. Tong (all WHD). An advance mission team visited British Columbia. Mr. Perrault (Senior Advisor) attended the meetings. Mr. Singh and Ms. Atkinson (both WHD) and Mr. Fried (Executive Director) participated in the concluding meeting with Minister of Finance Flaherty and Bank of Canada Senior Deputy Governor Jenkins in Ottawa on December 17. A press conference was held on December 19. Outreach included discussions with the private sector, labor unions, academics, and think tanks.

XII. **FSSA 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 strengthen 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 the Office of the Superintendent of Financial Institutions (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. 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) resumption of 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); (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; and (iii) publication of reconciled national and public accounts forecasting.

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*).

XIII. **Technical Assistance**: Not applicable.

XIV. **Resident Representative**: Not applicable

Annex II. 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 Standards Bulletin Board (DSBB).

Real Sector. Statistics Canada provides 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 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: Table of Common Indicators Required for Surveillance

(As of January 15, 2008)

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]
Exchange rates	same day	same day	D	D	D
International reserve assets and reserve liabilities of the monetary authorities[1]	Jan. 1, 2008	Jan. 4, 2008	W	W	W
Reserve/base money	Dec. 1, 2007	Dec. 3, 2007	W	W	W
Broad money	Nov. 2007	Jan. 2008	M	M	M
Central bank balance sheet	Dec. 1, 2007	Dec. 3, 2007	W	W	W
Banking system's consolidated balance sheet	Oct. 2007	Dec. 2007	M	M	M
Interest rates[2]	Same day	Same day	D	D	D
Consumer price index	Dec. 2007	Jan. 2008	M	M	M
Revenue, expenditure, balance and composition of financing[3] – general government[4]	2007 Q3	Nov. 2007	Q	Q	Q
Revenue, expenditure, balance and composition of financing[3] – central government	Oct. 2007	Dec. 2007	M	M	M
Stocks of central government and central government-guaranteed debt	FY 2006	Nov. 2007	A	A	A
External current account balance	2007 Q3	Dec. 2007	Q	Q	Q
Exports and imports of goods and services	Nov. 2007	Jan. 2008	M	M	M
GDP/GNP	2007 Q3	Nov. 2007	Q	Q	Q
Gross External Debt[5]	2007 Q3	Dec. 2007	Q	Q	Q

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2]Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3]Foreign, domestic bank, and domestic nonbank financing.
[4]The general government consists of the central government, Canada Pension Plan, provincial and local governments.
[5]Including currency and maturity composition.
[6]Daily (D), Weekly(W), Biweekly(B), Monthly(M), Quarterly (Q), Annually (A); NA: Not Available.

Statement by the IMF Staff Representative on Canada
February 6, 2008

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

2. **Signs of slowing activity and inflation from weaker external conditions are emerging**. Payroll employment fell 0.1 percent in November, real GDP growth decelerated to 0.1 percent from 0.2 percent the previous month, although strong retail sales suggest continued momentum in consumption. The leading indicator index fell in December, for the first time since 2001, housing starts dropped, and manufacturers expect to lower production and employment in the first quarter of 2008. Despite continuing strong wage growth, both headline and core inflation declined in December, the latter to 1.5 percent—the lowest rate in two years—likely reflecting continued exchange rate passthrough.

3. **The Bank of Canada lowered its target for the overnight interest rate by 25 basis points to 4 percent at its January 22 meeting and adopted an easing bias**. In the accompanying *Monetary Policy Report Update*, the Bank noted a further tightening in the prices, terms, and availability of credit in the last three months and a deteriorating outlook for the United States. The Bank also lowered Canadian real GDP growth projection for 2008 from 2.3 to 1.8 percent. The Bank noted the strong downward pressure on retail prices since the exchange rate against the U.S. dollar reached parity.

4. **Staff revised down the growth rate projections for 2008 and 2009 in the January WEO Update**. 2008 growth was revised from 2.0 to 1.8 percent and 2009 growth from 2.7 to 2.4 percent. The revision primarily reflects the downgrading of the staff's U.S. forecast, which exacerbates the drag from net exports, as well as the recent tightening of Canadian financial conditions. With the revision reflecting the realization of the downside risks specified in the Staff Report, the risks to the current forecast are now more balanced. Staff's growth projections are: (i) somewhat below the January private sector consensus; (ii) in line with the Bank of Canada's forecast for this year; (iii) but more pessimistic for 2009, with the Bank expecting a faster recovery both in Canada and in the United States.

5. **Several major Canadian banks have announced significant further write-downs on their holdings of structured products, including ABCP, CDOs and RMBSs.** These actions reflect both reductions in the value of underlying assets and the downgrading of some of the banks' hedging counterparties (e.g., financial guarantors). Canadian banks are exposed to market turbulence through a variety of channels, including liquidity support commitments, participation in LBO transactions, and the management of SIVs. Still, they remain well capitalized. One of the banks has raised additional capital from domestic and international investors.

Canada: Selected Economic Indicators

(Annual change in percent, unless otherwise noted)

				Est.	Projections	
	2004	2005	2006	2007	2008	2009
Real GDP	3.1	3.1	2.8	2.6	1.8	2.4
Net exports 1/	-1.0	-1.7	-1.4	-1.1	-1.7	-0.2
Final domestic demand	4.1	4.5	4.7	3.8	3.2	2.6
Private consumption	3.4	3.8	4.2	4.1	2.9	2.3
Public consumption	2.5	2.2	3.3	3.1	2.8	2.3
Private fixed domestic investment	8.1	8.1	7.1	4.2	4.2	3.3
Private investment rate 2/	17.8	18.4	19.2	19.7	20.3	20.6
Public investment	5.0	10.9	8.1	1.7	3.6	4.2
Change in business inventories 1/	0.1	0.3	-0.2	0.0	0.4	0.0
GDP (at current prices)	6.4	6.5	5.2	5.6	3.8	4.4
Employment and inflation						
Unemployment rate	7.2	6.8	6.3	6.0	6.4	6.3
Consumer price index	1.8	2.2	2.0	2.2	1.5	2.0
GDP deflator	3.2	3.4	2.4	3.0	1.9	2.0
Exchange rate (period average)						
Real effective exchange rate	5.5	6.1	5.9	...	...	...
Nominal effective exchange rate	6.2	7.0	6.8	...	...	...
Bilateral exchange rate with United States	7.7	7.5	6.8	6.0	...	...
Level (in U.S. dollars)	0.77	0.83	0.88	0.93	...	...
Indicators of financial policies (national accounts basis)						
Federal fiscal balance 2/	0.8	0.1	0.6	0.4	-0.1	-0.2
Provincial fiscal balance 2/ 3/	-0.7	0.7	-0.2	-0.2	0.0	0.0
General government 2/ 4/	0.8	1.6	1.0	0.8	0.5	0.4
Net federal debt (public accounts basis) 2/	38.3	35.0	32.3	30.0	28.7	27.3
General government net debt 2/ 5/	34.4	30.1	27.6	25.3	23.9	22.6
Three-month treasury bill (in percent)	2.2	2.7	4.0	4.2	3.3	3.4
Ten-year government bond yield (in percent)	4.6	4.1	4.2	4.3	3.8	4.0
Balance of payments						
Current account balance 2/	2.3	2.0	1.6	1.0	0.2	0.1
Merchandise trade balance 2/	5.1	4.6	3.5	3.3	2.1	1.9
Export volume	5.2	2.4	1.0	1.6	-2.4	1.6
Import volume	8.8	8.1	5.2	5.1	2.9	2.5
Invisibles balance 2/	-2.8	-2.6	-1.9	-2.3	-1.9	-1.8
Saving and investment 2/						
Gross national saving	22.9	23.8	24.2	23.9	24.0	24.2
General government	3.3	4.4	4.0	3.7	3.4	3.3
Private	19.6	19.4	20.2	20.2	20.6	20.9
Personal	4.6	3.8	6.2	5.9	6.3	6.7
Business	14.9	13.9	14.0	14.2	14.3	14.3
Gross domestic investment	20.7	21.7	22.5	22.9	23.8	24.1

Sources: Statistics Canada; and Fund staff estimates.

1/ Contribution to growth.
2/ In percent of GDP.
3/ Includes local governments and hospitals.
4/ Includes the balances of the Canada Pension Plan and Quebec Pension Plan.
5/ Includes local governments and hospitals.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 08/19
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2008 Article IV Consultation with Canada

On February, 6, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.[1]

Background

Canada's strong economic performance of the past decade continued in 2007. Real GDP growth was around 2½ percent in 2007, driven by robust growth in domestic demand—particularly private consumption and residential investment—of close to 4 percent. Domestic demand was boosted by large terms-of-trade gains and by improvement in employment—as the unemployment rate fell below 6 percent to its lowest level in 33 years.

Growth slowed toward the end of the year, and is expected to decelerate further to 1.8 percent in 2008 reflecting a sharp downturn in the United States, past currency appreciation, and a tightening of financial market conditions. Core inflation, which had been on the rise earlier in the year, declined in the second half of 2007 owing to stronger-than-expected exchange rate pass-through, although headline remained elevated due to rising gasoline prices.

Despite strong gains in the terms of trade, the external current account surplus narrowed to 1 percent of GDP in 2007 as real net exports declined sharply. The latter largely reflected a sharp deterioration in the manufacturing trade balance in response to the currency appreciation and the slowing U.S. economy, but also increasing imports. The Canadian dollar has

[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.

appreciated by 45 percent in real effective terms since 2002, although domestic adjustment to the appreciation has been very smooth thanks to the flexible labor markets.

After maintaining a neutral monetary policy stance for most part of 2007, the Bank of Canada (BoC) reduced its policy rate to 4 percent—in two consecutive cuts of 25 basis points in December 2007 and January 2008—in response to the deteriorating economic prospects and declining core inflation. In its January statement, the BoC noted that the weak U.S. economic outlook and tighter credit conditions in Canada would likely continue to pose challenges for the Canadian economy, in response to which further monetary easing might be needed in the near term.

Financial conditions have been modestly affected by the spillovers from the global liquidity crunch in the money markets. Interbank spreads for major Canadian banks rose, although not as much as in other major markets. The extent of financial vulnerabilities has so far been limited owing to relatively low exposures to asset-backed securities, but uncertainties remain with respect to the impact of further deterioration in U.S. financial market conditions. An agreement in principle in late December to restructure the local frozen third-party ABCP has reduced contagion risks in other domestic financial markets. In its January 2008 *Monetary Policy Report Update*, the BoC noted that the average cost of borrowing for households and businesses had risen by 15-25 basis points relative to October 2007, and credit conditions could tighten further.

A prudent fiscal policy framework for the last decade has provided for 10 consecutive years of budget surpluses, and public debt ratios have declined. The budget surplus for fiscal year 2006/07 was estimated at 1 percent of GDP, half a percentage point above the budget forecast, reflecting buoyancy of corporate income tax revenue. In its October 2007 *Economic Statement*, the government emphasized tax relief (the federal goods and services tax rate was cut by 1 percentage point to 5 percent, effective January 1, 2008, and the corporate and personal income taxes have also been reduced), and debt reduction to be the key priorities for the use of budget over performance.

The government's structural policy blueprint—*Advantage Canada*, released in late 2006—emphasized boosting productivity as a high priority in the structural reform agenda. Key measures identified in the blueprint include: enhancing business productivity by reducing the high marginal effective tax rates (which was supported by the tax relief measures proposed in the *Economic Statement*), creating a dynamic and globally competitive financial system, and enhancing interprovincial labor mobility.

Executive Board Assessment

Executive Directors commended Canada's impressive macroeconomic track record since the mid-1990s, which has been underpinned by sound monetary and fiscal policies and favorable external conditions. They welcomed, in particular, the strong GDP growth and declining unemployment, low and stable inflation, and consecutive fiscal surpluses with attendant reductions in the federal debt-to-GDP ratio achieved during this period.

Looking ahead, Directors observed that the near-term economic outlook would be affected by a potential sharp slowing of the U.S. economy, the effects of past currency appreciation, and tighter credit conditions--although domestic demand would likely remain solid. Against this background, Directors welcomed the recent measured easing of policies, noting that Canada's strong monetary framework, as well as exemplary budgetary performance, have provided room for supportive policy actions. More generally, Directors considered that the economy, grounded in strong fundamentals, is well poised to meet the near-term challenges. At the same time, they welcomed the authorities' recognition of the uncertainties in the evolution of both domestic and external demand. Directors also supported the authorities' continued attention to medium-term considerations of productivity growth and policy reforms.

Directors commended the Bank of Canada's recent move to reduce policy rates in December and January. In light of a potential further deterioration of the economic outlook, Directors welcomed the authorities' intention to monitor developments closely and act as required. Some noted that there may be room for further reductions in the overnight rate in the near term. Directors took note of the Bank's ongoing examination of possible refinements to its monetary policy framework. In view of the proven success of the present inflation targeting framework, they concurred with the authorities and staff that there must be compelling evidence in support of price level path targeting before changing the monetary regime. Directors welcomed the Bank's commitment to increasing the transparency of its decision-making process.

Turning to fiscal policy, Directors considered it appropriate to allow automatic stabilizers to operate. They agreed that the budgetary over-performance projected for the current year had provided room for the tax relief, and noted that this would be timely given weaker economic prospects. Directors pointed out, however, that some of the revenue gains underlying the budget surplus could prove temporary, which underscored the importance of maintaining expenditure restraint over the medium term.

Directors commended the government's objective of lowering the tax burden and continuing debt reduction as highlighted in the 2007 *Economic Statement*. In particular, they welcomed the authorities' objective to eliminate general government debt by 2021, and agreed that this would help provide the fiscal space needed to meet impending costs related to population aging.

In light of the relatively high level of Canada's marginal effective corporate tax rates, Directors welcomed the reduction in the general corporate income tax rate in January, and planned further reductions over the medium term. Several Directors noted that lowering marginal effective tax rates on saving and capital could provide greater efficiency benefits rather than lowering consumption taxes. Directors welcomed the steps taken to reform the equalization system by moving to a more rules-based system for equalization transfers.

Directors agreed that the Canadian dollar is broadly in line with the economy's fundamentals given high commodity prices. They observed that the domestic adjustment to the 45 percent appreciation in the real effective exchange rate since 2002 has so far been remarkably smooth, reflecting flexible labor markets--although some Directors noted that the appreciation has posed increasing challenges for many exporters.

Directors were reassured by the findings of the recent *Financial Sector Assessment Program Update,* which indicated that the Canadian banking system is sound, profitable, and largely robust to adverse shocks. The agreement in principle to restructure the non-bank ABCP market has mitigated a major risk to financial market conditions.

Directors welcomed the relative resilience of Canadian banks to financial market strains compared with many other countries, while stressing the importance of continuing vigilance in this area. At the same time, a number of Directors noted that a further opening of the Canadian banking system to takeovers would boost market flexibility, support financial innovation, and widen access to finance. Some Directors, however, felt that the benefits from such a policy were outweighed by benefits of the current system in terms of resilience.

While noting that the "passport plus" system of provincial market regulation under implementation is a significant improvement in securities market regulation compared with the current fragmented system, Directors believed that there would be benefits in embracing a single securities regulator, as in many other industrialized countries, to improve further the efficiency and effectiveness of securities' market regulation

Directors supported the authorities' focus on structural reforms to boost productivity, as outlined in *Advantage Canada*. There was scope for further product market reform, by reducing restrictions on inward foreign direct investment in network industries and removing barriers to interprovincial trade in goods and services. Directors welcomed the creation of a Competition Policy Review panel to examine possible changes to enhance competition.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with Canada is also available.

Canada: Selected Economic Indicators 1/
(Annual change in percent, unless otherwise noted)

	2000	2001	2002	2003	2004	2005	2006	est. 2007
Real GDP	5.2	1.8	2.9	1.9	3.1	3.1	2.8	2.5
Net exports 2/	0.6	0.7	-0.1	-2.5	-1.0	-1.7	-1.4	-1.2
Total domestic demand	4.8	1.2	3.2	4.6	4.3	5.1	4.4	3.9
Final domestic demand	4.0	2.9	3.0	3.7	4.1	4.5	4.7	3.9
Private consumption	4.0	2.3	3.6	3.0	3.4	3.8	4.2	4.2
Public consumption	3.1	3.9	2.5	3.1	2.5	2.2	3.3	3.1
Private fixed domestic investment	4.8	3.0	1.3	6.3	8.1	8.1	7.1	4.2
Private investment rate (as a percent of GDP)	16.9	17.1	17.1	17.2	17.8	18.4	19.2	19.7
Public investment	3.8	11.5	3.7	5.4	5.0	10.9	8.1	1.7
Change in business inventories 2/	0.8	-1.7	0.2	0.8	0.1	0.3	-0.2	0.0
GDP (current prices)	9.6	2.9	4.0	5.2	6.4	6.5	5.2	5.8
Employment and inflation								
Unemployment rate	6.8	7.2	7.6	7.6	7.2	6.8	6.3	6.0
Consumer price index	2.7	2.5	2.3	2.7	1.8	2.2	2.0	2.2
GDP deflator	4.2	1.1	1.1	3.3	3.2	3.4	2.4	3.1
Exchange rate (period average)								
U.S. cents/Canadian dollar	0.67	0.65	0.64	0.71	0.77	0.83	0.88	0.93
Percent change	0.0	-4.1	-1.4	12.1	7.7	7.5	6.8	6.0
Nominal effective exchange rate	0.8	-2.9	-1.5	10.5	6.2	7.0	6.8	...
Real effective exchange rate	0.5	-2.9	-0.8	11.1	5.5	6.1	5.9	...
Indicators of financial policies (national accounts basis, as a percent of GDP)								
Federal fiscal balance	1.9	1.1	0.8	0.3	0.8	0.1	0.6	0.6
Provincial fiscal balance 3/	0.7	-0.9	-1.6	-1.2	-0.7	0.7	-0.2	-0.2
General government	2.9	0.7	-0.1	-0.1	0.8	1.6	1.0	1.1
Three-month treasury bill	5.5	3.9	2.6	2.9	2.2	2.7	4.0	4.2
Ten-year government bond yield	5.9	5.5	5.3	4.8	4.6	4.1	4.2	4.3
Balance of payments								
Current account balance (as a percent of GDP)	2.7	2.3	1.7	1.2	2.3	2.0	1.6	1.0
Merchandise trade balance (as a percent of GDP)	6.2	6.4	5.0	4.6	5.1	4.6	3.5	3.4
Export volume	9.2	-3.4	0.8	-2.1	5.2	2.4	1.0	1.5
Import volume	8.6	-5.7	1.7	3.1	8.8	8.1	5.2	5.3
Invisibles balance (as a percent of GDP)	-3.5	-4.1	-3.3	-3.4	-2.8	-2.6	-1.9	-2.3
Saving and investment (as a percent of GDP)								
Gross national saving	23.6	22.2	21.0	21.2	22.9	23.8	24.2	23.9
General government	5.1	3.0	2.3	2.3	3.3	4.4	4.0	4.0
Private	18.5	19.2	18.7	18.9	19.6	19.4	20.2	20.0
Personal	5.6	6.0	5.0	4.5	4.6	3.8	6.2	5.7
Business	12.9	13.2	13.8	14.5	14.9	13.9	14.0	14.2
Gross domestic investment	20.2	19.3	19.3	20.0	20.7	21.7	22.5	22.9

Sources: Statistics Canada; and IMFstaff estimates.
1/ Data as available on January 31, 2007.
2/ Contribution to growth.
3/ Includes local governments and hospitals.