March 2004
IMF Country Report No. 04/61

Canada: 2004 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 2004 Article IV consultation with Canada, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 19, 2003,** 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, 2004.** 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 18, 2004** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 18, 2004 discussion** of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the
2004 Consultation with Canada

Approved by Charles Collyns and G. Russell Kincaid

January 15, 2004

- ***Discussions for the 2004 Article IV consultation were held in Quebec City and Toronto during November 5-7, and in Ottawa during November 12–19, 2003.*** The staff team comprised C. Towe (Head), M. Mühleisen, R. Cardarelli, R. Luzio (all WHD), and A. Kose (RES). Mr. Singh and Mr. Collyns attended the concluding meeting on November 19. Mr. Bennett (Executive Director) and his Advisor, Mr. Kruger, participated in the discussions.

- ***The team met with representatives from both the public and private sectors.*** Discussions were held with Bank of Canada Governor Dodge and Deputy Finance Minister Lynch, as well as other senior officials from Finance Canada, the Bank of Canada, the Office of the Superintendent of Financial Institutions, Health Canada, Human Resources Canada, the provinces of Ontario and Quebec, and the Ontario Securities Commission. The team also met with the major banks, the Toronto Stock Exchange, and the Canadian Labour Congress.

- ***The staff report for the 2003 Article IV consultation was considered by the Executive Board on January 31, 2003 and was subsequently published as IMF Country Report No. 03/33.*** Executive Directors broadly endorsed the authorities' inflation targeting framework. While they saw a gradual withdrawal of monetary stimulus as the most likely course, they welcomed the commitment to act even more decisively if inflation pressures intensified. Directors commended the authorities' prudent fiscal management but cautioned that looming demographic pressures required the debt ratio be kept on a steady downward trajectory and emphasized that reforms to the health care system would need to be consistent with longer-term fiscal constraints. Directors also noted the continuing need to promote employment and productivity, including through further reforms of the Employment Insurance system, as well as agricultural and trade policies. Directors welcomed the authorities' efforts to strengthen corporate governance, with some Directors suggesting the establishment of a more unified system of securities regulation.

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

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

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I. Introduction

1. ***At the time of last year's consultation, Canada's macroeconomic performance was highly favorable and policies were broadly consistent with past Fund advice (Appendix I).*** The economy had weathered the global downturn and geopolitical uncertainties, and growth had outstripped that in other G-7 countries by substantial margins. The central bank had begun to raise interest rates in the face of signs that the output gap was closing, while fiscal policy remained geared toward sustaining surpluses and debt reduction, notwithstanding significant new spending initiatives and tax cuts.

2. ***However, the macroeconomic and policy environment during the past year has been more difficult than anticipated.*** A series of negative shocks caused the economy to slow sharply in the second half of 2002 and into 2003. These shocks, as well as increased outlays in support of the public health care system, have eroded federal fiscal surpluses. With the economy weakening, the Canadian dollar appreciating sharply, and inflation falling back to well within the 1-3 percent target range, the Bank of Canada has recently reversed course and lowered interest rates.

3. ***Although the outlook is broadly favorable, challenges remain.*** While leading indicators suggest growth will regain momentum, considerable uncertainty remains regarding the extent to which the sharp appreciation of the Canadian dollar will weigh on net exports and the economy's return to full employment. Broader questions exist, too, regarding the extent to which Canada's favorable growth performance in the face of the global IT and stock market bust of recent years reflected a durable increase in productivity growth or more transient factors such as an undervalued exchange rate, the strength of U.S. household demand, and Canada's relatively modest IT and investment boom.

4. ***Against this background, the discussions focused on the policies needed to foster the recovery while supporting fiscal sustainability and productivity growth.*** In the near term, with inflation low and limited scope for countercyclical fiscal policies given the commitment to balanced budgets, monetary policy will need to remain accommodative. The priority for fiscal policy remains to sustain debt reduction and prepare for impending demographic pressures on retirement and health care systems. At the same time, continued financial sector, labor, trade, and other structural policy reforms are needed to strengthen Canada's growth potential and to take full advantage of the increased integration of North American markets.

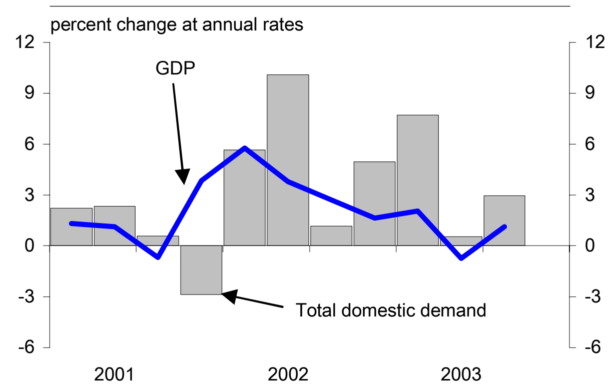
II. Recent Developments

5. ***After slowing only modestly during the global downturn, Canada's macroeconomic situation weakened during the past year.*** During 2000-2002, Canada's real GDP growth averaged 3½ percent—almost twice the G-7 average—reflecting the effects of a depreciated exchange rate and low interest rates on net external and domestic demand (Tables 1 and 2). However, the economy's momentum began to slacken late in 2002. Activity contracted by ¾ percent (annual rate) in the second quarter of 2003, and only achieved 1 percent growth

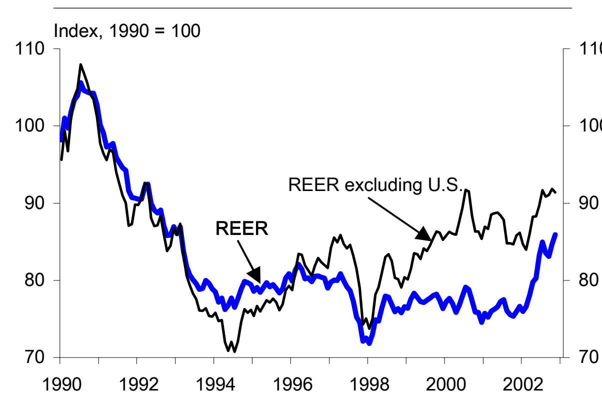
in the third quarter. Labor market conditions also deteriorated, with significant job losses registered in the manufacturing sector, labor incomes slowing in real terms, and the unemployment rate moving up to 8 percent, before dropping to 7½ percent by end-2003.

6. ***Several factors have weighed on activity.*** The SARS outbreak dampened domestic demand and tourism receipts in 2003Q2, the discovery of one case of BSE in Alberta resulted in restrictions on beef exports, and electrical power blackouts caused a significant drop in production in August. Moreover, the inventory/sales ratio rose above trend, triggering significant de-stocking, especially in the automotive sector, lowering growth by 3 percentage points (annual rate) on average in Q2 and Q3. Finally, the Canadian dollar appreciated sharply against the U.S. dollar during 2003, rising over 10 percent in real effective terms, reflecting both the broader weakness of the U.S. dollar as well as increases in world commodity prices and widening Canada-U.S. interest differentials.

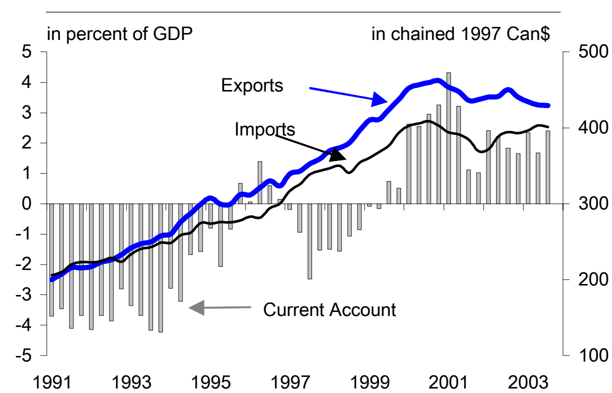
Canada: Real GDP and Domestic Demand



Canada: Real Effective Exchange Rate



Canada: External Indicators



7. ***As a result, net exports have contracted sharply while final domestic demand remained robust:***

- ***Net exports subtracted about 2½ percentage points from growth during the four quarters to 2003Q3.*** This reflected both a sharp drop in export volumes and buoyant imports of consumer goods. Nonetheless, the current account surplus has remained over 2 percent of GDP, owing to the positive effect of higher world commodity prices on the terms of trade (Tables 2 and 3).

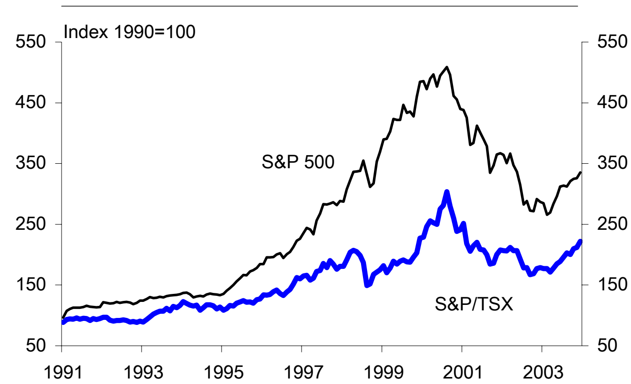
- ***Household demand remained strong.*** Personal consumption rose by 4¼ percent in 2003Q3 from the same period in 2002, taking the personal saving rate down to an extraordinarily low 1¼ percent. Low interest rates and pent up demand helped spurred exceptional levels of residential investment. While most household balance

- sheet indicators—including the debt service/income ratio—remain comfortable, the debt/income ratio has reached around 115 percent.
- ***Business fixed investment has begun to recover.*** Purchases of machinery and equipment began to pick up in early 2003 and grew by about 5¾ percent during the four quarters ending in 2003Q3, supported by an improvement in corporate profits and low interest rates (Table 4). Nonresidential structures investment also bottomed out at the end of 2002.

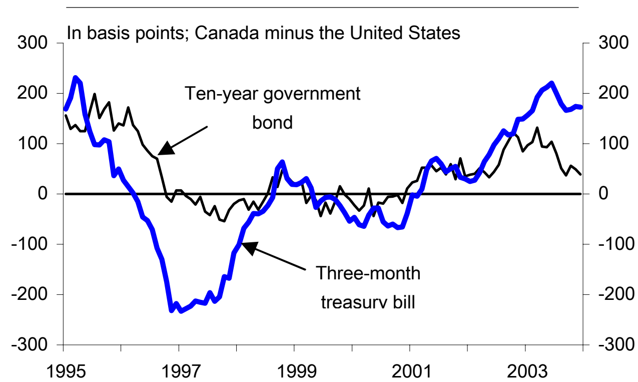
8. ***The supply side of the economy has disappointed.*** Since mid-2002, productivity has been stagnant, causing unit labor costs to accelerate even while labor income growth has slowed. Although labor productivity growth had accelerated to 2 percent during 1996–2002, this was well below the U.S. rate and the per capita income gap remains wide.

9. ***Nonetheless, financial markets have generally strengthened in 2003.*** Stock prices have risen nearly 20 percent since late 2002, broadly in line with global equity markets but still roughly 30 percent below their 2000 peak. With interest rate differentials favoring Canadian instruments, net portfolio inflows increased in the first half of 2003, but eased sharply in the third quarter as the dollar's appreciation reduced investor appetite.

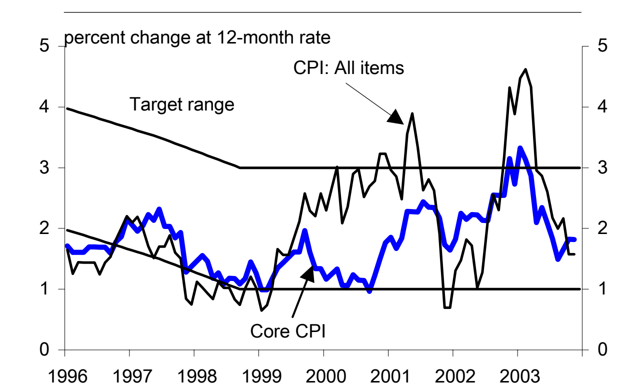
International Comparison: Stock Prices



Canada: Interest Rate Spreads



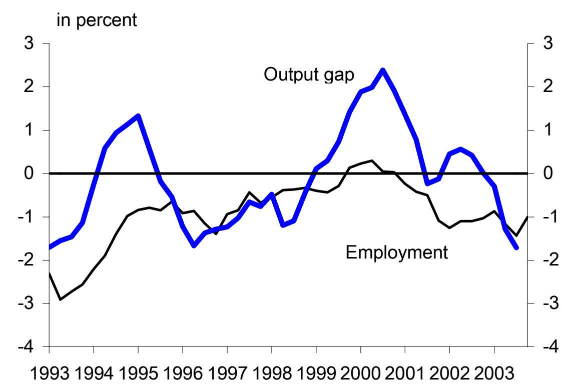
Canada: CPI Inflation



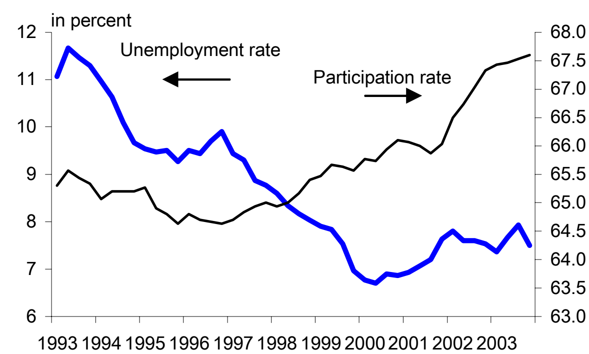
10. ***Economic slack has helped return inflation to the Bank of Canada's 1-3 percent target range.*** Staff estimates suggest that the economy was operating close to potential around the end of 2002, but that an output gap of around 1½ percent had emerged by 2003Q3. The core CPI inflation rate had surged to just over 3 percent (12-month rate) in late 2002/early 2003, partly reflecting the effects of large increases in

insurance premiums.[1] However, core inflation has since fallen to 1¾ percent as these special factors dissipated and excess capacity emerged.

Canada: Employment and Output Gaps



Canada: Labor Market Indicators



11. ***A weaker economy and declining inflation led the Bank of Canada to reverse course and ease its policy stance.*** In early 2002, with the economy operating close to potential and demand pressures threatening to push inflation above the target range, the Bank raised overnight interest rates by a cumulative 75 basis points to 2¾ percent. Although inflation breached the target range by late 2002, the Bank held off further rate increases as geopolitical risks weighed on the global outlook. As these risks moderated, the Bank tightened further in March and April 2003, taking rates to 3¼ percent. However, with demand slowing, the exchange rate tightening overall monetary conditions, and inflation falling, the Bank moved in July and September to return overnight rates to 2¾ percent.

12. ***The room for fiscal maneuver has narrowed appreciably in the last year.*** Given the weaker economic outlook, additional transfers to the provinces, and scheduled tax cuts, the federal surplus is likely to be virtually erased in 2003/04 (Table 5).[2] At the provincial level, notwithstanding balanced budget commitments in many provinces and increased federal transfers, a sizable deficit is projected for this year, reflecting pressures on the public health care system as well as costs related to the SARS/BSE outbreaks. Partly driven by balanced budget legislation, provinces have responded by delaying previously scheduled tax cuts and announcing spending cuts.

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[1] Bank of Canada estimates suggest that these special factors added 1¼ percentage points to the 12-month core inflation rate in early 2003.

[2] The shift to full accrual accounting raised measured federal surpluses by $3 billion in 2002/03, leaving room for additional spending while maintaining the commitment to balanced budgets.

III. The Short-term Outlook

13. ***Staff projections are for the economy to recover, albeit at a more modest pace.*** GDP growth is projected to pick up from around 1½ percent in 2003 to 2¾ percent in 2004, initially supported by a turnaround in inventory investment. The drag from the external sector would also wane into 2004, as a strengthening U.S. economy helps offset the lagged effect of the appreciation of the Canadian dollar. Household consumption and residential investment would continue to be supported by low interest rates and recent tax cuts, but slow to a more sustainable pace and allow a modest upward adjustment to the saving rate. Business fixed investment would benefit from low interest rates and the recovery. With the output gap starting to close in 2004, the Bank of Canada would begin withdrawing stimulus by end-year, keeping inflation close to 2 percent.

14. ***The discussions focused on the risks to the short-term outlook.*** Although the Bank of Canada's October Monetary Policy Report had envisaged growth accelerating from 2 percent in 2003 to 3¼ percent in 2004, officials acknowledged that the risks seemed skewed to the downside. The principal uncertainty was with regard to the impact of the Canadian dollar's appreciation on net exports, which both official and consensus forecasts envisaged as being more modest than would be implied by conventional elasticities. This more optimistic view was consistent with the fact that the appreciation partly reflected the effect of higher world commodity prices; the apparent weakening of pass-through of exchange rate to import prices during the past decade; and signs that businesses had viewed the Canadian dollar as having been significantly undervalued in 2002 and had anticipated a large proportion of the subsequent appreciation.[3] Nevertheless, officials recognized a sharper drop in net exports and weaker growth could still materialize, especially if the Canadian dollar appreciated further in the face of the large U.S. fiscal and external imbalances.

Medium-Term Projections

(In percent change from previous period; unless otherwise indicated)

			Projections					
	2001	2002	2003	2004	2005	2006	2007	2008
Real GDP	1.9	3.3	1.6	2.7	3.0	2.9	2.8	2.7
Total domestic demand	1.7	3.4	4.5	3.9	3.0	2.9	2.9	2.8
Private consumption	2.6	3.4	3.8	3.4	2.2	2.2	2.1	2.0
Private domestic investment	3.5	-0.2	4.5	7.9	4.5	3.9	4.0	3.8
Net exports (contribution)	0.6	-0.3	-2.6	-0.9	0.1	0.1	0.1	0.1
Unemployment rate (percent)	7.2	7.6	7.6	7.1	6.9	6.7	6.5	6.6
Consumer price index	2.5	2.3	2.7	1.5	2.0	2.0	2.0	2.0
Federal fiscal balance/GDP	0.6	0.6	0.0	0.2	0.3	0.3	0.4	0.5
Current account balance/GDP	2.4	2.0	2.0	1.5	1.5	1.4	1.4	1.4
Memorandum items:								
Partner country growth	0.4	2.4	2.9	4.1	3.6	3.4	3.2	3.1
Oil prices ($/Barrel)	24.3	25.0	29.0	28.0	25.0	24.0	23.5	23.5

Sources: Fund staff estimates; and Statistics Canada.

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[3] Choudhri, et al. ("Explaining the Exchange Rate Pass Through in Different Prices," IMF Working Paper WP/02/224) illustrate the low pass-through rate for Canada and other countries. However, simulations of the Oxford Economic Forecast model suggest that a 10 percent exchange rate shock lowers GDP by 1½ percent relative to baseline and the current account balance by 3 percent of GDP.

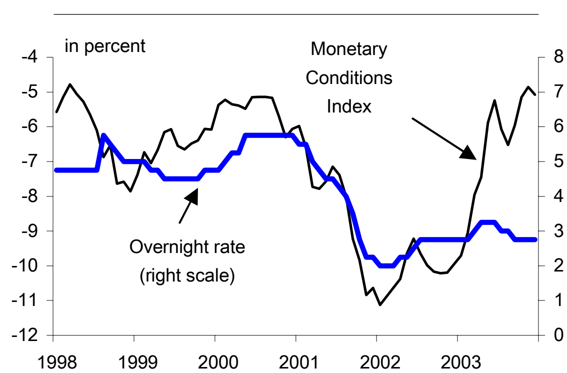
15. ***Officials were more sanguine regarding domestic risks.*** The mission questioned whether household demand could stumble, given the unusually low household saving rate, the waning stimulus from low interest rates and recent tax cuts, the weakening of labor market conditions, and a possible slowing of residential house prices (Box 1). Officials responded that household balance sheets appeared sound and that housing prices, having only just recovered from a decade-long slump, did not appear significantly out of line with demographic trends and other fundamentals. Healthy corporate balance sheets, the lower cost of capital imports, and considerable pent-up demand favored a strong rebound of investment, notwithstanding the possible effects of the dollar's appreciation and sluggish productivity on profits and investment.

16. ***Officials recognized the difficulty in gauging the degree of economic slack.*** The Bank of Canada's conventional measures placed the output gap at around ½ percent of GDP, but capacity utilization and unemployment rates, as well as the drop in inflation, suggested a larger degree of slack.[4] Officials viewed the sharp increase in the participation rate in recent years as reflecting structural rather than cyclical factors—especially the increase in lifetime participation of women—but the impact on potential output and measures of the output gap remained to be seen.

IV. MONETARY POLICY AND THE EXCHANGE RATE

17. ***Bank of Canada officials and the team agreed that the inflation targeting framework had successfully guided monetary policy and achieved low inflation, while promoting transparency and accountability.*** Officials acknowledged, however, that the uncertain macroeconomic environment had significantly complicated policymaking during the past year. In addition to the questions surrounding standard measures of the output gap, shocks to administered prices had blurred the signals provided by the core inflation index, and it was also unclear how the increased credibility of the inflation-targeting framework had affected inflation dynamics and the inflation/output tradeoff. Moreover, although exchange rate pass-through appeared to have diminished, the robustness of this result in the face of a large shock remained to be seen. Nonetheless, Bank officials stressed that these uncertainties did not argue for a less reactive monetary policy, and they were confident that the anchoring of inflation expectations and increased access by households to credit markets had increased the responsiveness of the economy to interest rates.

Canada: Monetary Policy Indicators



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

[4] The Bank of Canada's potential output measure is based on a multi-variable Hodrick-Prescott filter, and the Bank's most recent output gap estimate has a 50 percent confidence interval that spans 2 percentage points.

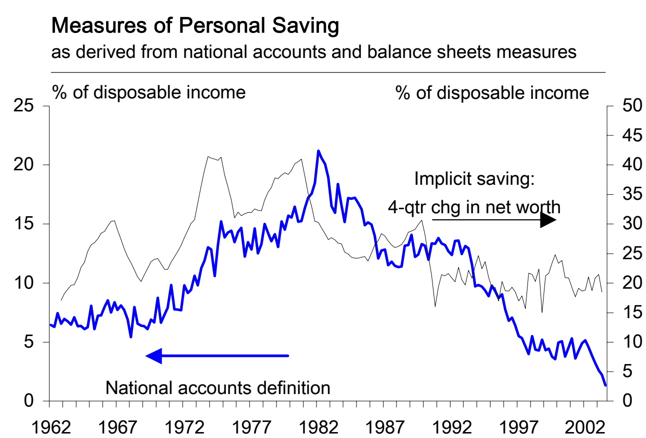
Box 1. The Decline in the Canadian Personal Saving Rate[1]

The Canadian personal saving rate has fallen sharply in recent years, raising questions about the extent to which household consumption can continue to support activity. The saving rate, which averaged 5 percent of disposable income in the first half of 2002, fell to around 1¼ percent in the third quarter of 2003—an historic low and significantly lower than even the U.S. saving rate.

The drop in the saving rate has to be seen against a secular decline that began in the mid-1980s. The saving rate had reached 20 percent of GDP in 1982, but fell steadily thereafter, which Bank of Canada estimates suggest was due to four factors:[2]

- Lower real interest rates sharply reduced the return on household wealth;
- Lower expected inflation decreased uncertainty and the need for precautionary saving;
- The improvement in the fiscal position lowered the need to save for future tax liabilities;
- The boom in asset prices during the 1990s increased household net wealth to well over 500 percent of disposable income, reducing the need for further asset accumulation.

Considering the large capital gains in recent years, however, the national accounts measure of the saving rate may be misleading. A broader measure of the saving rate, derived from the change in household net worth, is about 15 percentage points higher than the national accounts measure (see figure). This broader measure followed the same trend as the national accounts saving rate until the mid-1990s, but thereafter remained broadly stable, while the national accounts measure continued to decline. This divergence reflects the remarkable strength of returns on household assets, which have provided households with capital gains to finance current consumption while further adding to net wealth.



Nonetheless, the national accounts measure of the saving rate appears below its "equilibrium." Staff estimates suggest a long-run relationship exists between the saving rate and the wealth/income ratio, expected inflation, the real interest rate, and the general government deficit/GDP ratio. These latter variables would suggest a saving rate that is in the range of 4-5 percent, well above recent levels.

Questions remain regarding the extent to which households are adequately provisioned for retirement. A 2001 study by Statistics Canada suggested that roughly one-third of households were not saving enough to replace two-thirds of their pre-retirement income, even taking into account benefits from the Canada Pension Plan. Although many of these households were at the upper end of the income distribution, shortfalls were also significant at the low end.[3] Contrasting results have been reported by the Department of Finance, whose analysis of individual household consumption data suggest that retirees have by and large been able to maintain pre-retirement living standards, and that current saving rates among younger households have remained consistent with historical life-cycle patterns.

[1] For details see the forthcoming *Selected Issues* paper.

[2] G. Bérubé and D. Côté, 2000, "Long-Term Determinants of the Personal Saving Rate: Literature Review and Some Empirical Results for Canada," Bank of Canada Working Paper 2000-3.

[3] See Statistics Canada, 2001, "The Assets and Debts of Canadians," No. 13-596-XIE (December) and Jeremy Lise, 2003, "Is Canada's Retirement Income System Working?" Department of Finance Working Paper No. 2003-02.

18. ***The authorities agreed that there was room for further easing of interest rates if needed.*** Against the background of low inflation, significant economic slack, and a large current account surplus, an accommodative policy stance could be maintained for a considerable period, and would also be consistent with a desirable rebalancing of the economy toward domestic demand. However, officials were cognizant that exchange rate movements during 2003 had caused a significant tightening of monetary conditions and that a further appreciation would heighten downside risks to the short-term outlook.[5] Therefore, the Bank would not hesitate to lower interest rates if signs emerged that the exchange rate was being driven by extrapolative expectations rather than fundamentals, if external demand appeared to weaken significantly, or if domestic investment showed signs of slackening.

19. ***Subsequent to the discussion, the Bank opted to keep its target for the overnight rate unchanged at 2¾ percent while continuing to stress the uncertainties.*** The December 2 policy announcement stated that while third quarter growth had been disappointing and inflation was expected to ease further in the short run, domestic demand appeared buoyant, partner countries seemed to be strengthening, and Canada's economic growth was likely to rebound strongly in the fourth quarter from the effects of the August power outage and the inventory correction. However, the Bank also underscored the continued uncertainty about the likely impact of the appreciation of the Canadian dollar and whether existing monetary stimulus would be sufficient to close the output gap by early 2005.

20. ***The mission commended the transparency of the authorities' inflation targeting framework.*** However, the team noted that the more uncertain economic environment and recent shift in the Bank's policy stance suggested possible benefits in providing even greater detail regarding the Bank's macroeconomic forecast and its sensitivity to shocks. The authorities responded that they had already included a quarterly inflation forecast and additional details of other key macroeconomic aggregates in the Bank's semi-annual Monetary Policy Report and interim Update. In their view, a more quantitative presentation would not be useful and could even mislead market participants regarding the precision of the Bank's projections.

21. ***Bank of Canada officials viewed the Canadian dollar's recent strength as broadly consistent with underlying fundamentals.*** For example, versions of the Bank's exchange rate forecasting equation that included interest rate and inflation rate differentials, non-energy commodity prices, and the Canada/U.S. government debt differential suggested a C$/US$ rate that was not much weaker than current levels, following an extended period of "undervaluation." At the same time, however, the rapidity of the appreciation suggested that the broader weakness of the U.S. dollar, as well as Canada-specific factors, had played an important role.

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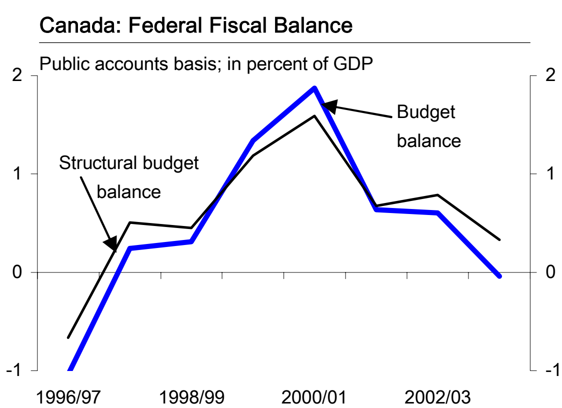
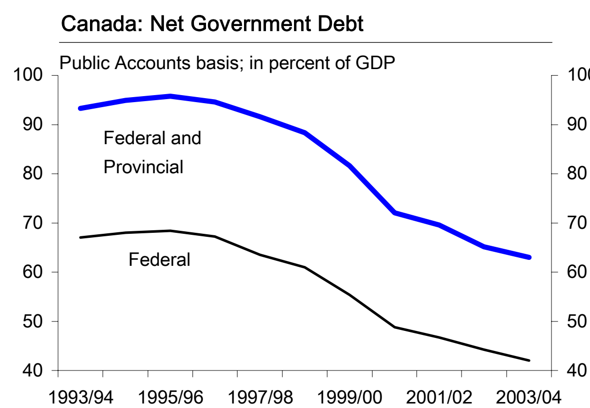
[5] Note that conventional monetary conditions indices will overstate the degree of tightening from an exchange rate appreciation to the extent that the exchange rate movement reflects a favorable supply shock—e.g., stronger world commodity prices.

22. ***The authorities agreed that Canada's flexible exchange rate policy had served it well, but expressed concern regarding spillovers from global current account imbalances.***[6] They stressed, in particular, that the multilateral exchange rate adjustments that would eventually be required to correct these imbalances could be significant and place an inordinate burden on those countries that were freely floating. Nonetheless, Canada remained committed to allowing its currency to respond to market forces, and intervention would only be considered if there were clear signs of a breakdown of market liquidity.

V. Sustainable Fiscal Policy

23. ***Canada's fiscal framework has yielded considerable success.*** The framework—which was adopted in the early 1990s when the federal deficit had reached nearly 8 percent of GDP—targets balanced budgets over a rolling two-year horizon, based on conservative fiscal assumptions and contingency reserves for unexpected macroeconomic or spending shocks.[7] This approach—which has been consistently endorsed in past Article IV reports as an appropriate strategy for preparing for the longer-term pressures of population aging—has delivered surpluses averaging 1-2 percent of GDP in recent years and lowered the net federal debt-to-GDP ratio from a peak of around 70 percent in the mid-1990s to 44 percent in 2002/03 (fiscal year begins in April).





24. ***The 2003 Budget maintained the commitment to keeping the debt-to-GDP ratio on a permanent downward path.*** The budget included substantial increases in transfers in support of provincial health care systems as well as higher outlays for low-income housing, infrastructure, and education. Tax changes included an increase in child tax benefits, higher contribution limits for tax-preferred saving plans, an increase in small business deductions,

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[6] Empirical studies typically suggest that productivity differentials and world commodity prices have explained a significant proportion of the longer-run movement in the C$/US$ exchange rate. The forthcoming *Selected Issues* paper contains an analysis of the factors underlying longer-term term trends in the exchange rate.

[7] The budget projections typically include a "macroeconomic prudence factor" of $1–2 billion and a "contingency reserve" of $3 billion.

and the phased elimination of the capital tax. Given the reserves built into the budget, surpluses of ¼–½ percent of GDP were targeted in 2003/04 and 2004/05.

25. ***Recent macroeconomic and other shocks have put pressure on the federal fiscal position.*** The slowdown has adversely affected tax revenues, and spending has been boosted by additional assistance to the provinces to help offset costs related to the SARS and BSE outbreaks and to fund health care programs. As a result, the government's November 2003 Economic and Fiscal Update indicated that the surplus was likely to be virtually exhausted in the current fiscal year. While surpluses would be re-established in subsequent years—rising gradually to around ¾ percent of GDP by FY2008/09—the normal budgetary reserves were scaled back.

Federal Budget Projections
(in percent of GDP)

			Staff Projections	
	2001/02	2002/03	2003/04	2004/05
Revenue	15.5	15.4	14.8	14.7
Primary outlays	11.3	11.5	11.9	11.6
Interest outlays	3.6	3.2	3.0	2.8
Balance	0.6	0.6	0.0	0.2
Structural balance	0.7	0.8	0.3	0.5
Net debt	46.7	44.2	42.0	40.0

Sources: Finance Canada; and Fund staff estimates.

26. ***While agreeing that the fiscal system was well placed to cope with expected pressures from population aging compared with many other G-7 countries, the mission stressed the importance of sustained debt reduction and health care reform.*** Canada's demographic profile is relatively favorable, especially given high immigration rates, while recent reforms to the Canada Pension Plan—including increases in contributions rates—have rendered this portion of the public pension system actuarially sound.[8] As a result, staff estimates suggest that federal and general government debt ratios would remain manageable over the next 50 years provided that budget discipline is maintained (Box 2).[9] Nonetheless, demands on the public health care system are set to rise rapidly—with spending projected to rise by nearly 7 percent of GDP by 2050—and fiscal sustainability would be jeopardized unless significant debt reduction is achieved ahead of the retirement of the baby boom generation and health care spending is contained.

27. ***The authorities stressed their continued commitment to maintaining the debt ratio on a downward track.*** They acknowledged that the smaller surpluses now expected in coming years left this objective vulnerable to economic and other shocks. The authorities agreed, therefore, that it would be important to rebuild the normal level of budgetary reserves at the earliest opportunity.

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[8] A 1998 reform of the Canada Pension Plan increased the contribution rate to 9.9 percent and allowed investment of surpluses in private equities and real estate.

[9] Debt sustainability analysis using the IMF's standard template does not reveal significant risks over the medium term. See Appendix III of IMF Country Report No. 03/33 for details.

Box 2. Public Debt Sustainability

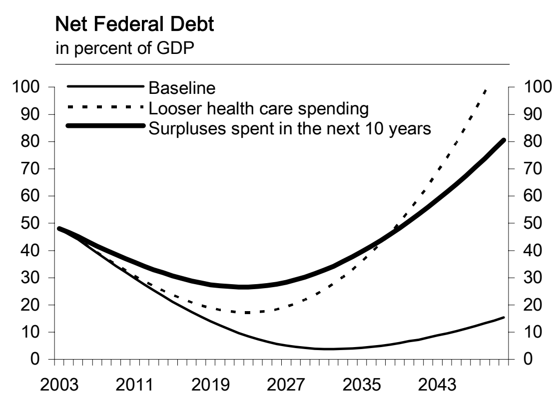
The impending retirement of the baby-boom generation is expected to result in significant fiscal pressures in Canada and most other industrial countries. Although demographic trends in Canada are relatively less severe, the old-age dependency ratio is still projected to rise to over 40 percent by 2035, roughly double its current level. As a result, some analysts have suggested that Canada's long-term fiscal position is extremely weak.[1]

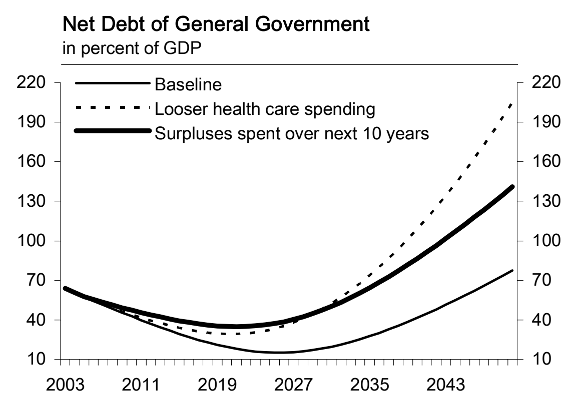
Staff has analyzed Canada's long-term fiscal position in the context of a generational accounting model. This approach utilizes estimates of the age-distribution of federal and provincial taxes and transfer programs, and constructs long-term projections of the fiscal position using demographic projections and assumptions regarding productivity growth.[2]

These estimates suggest that the federal fiscal position is sustainable provided that budgetary policies remain prudent. In the baseline scenario, health-care transfers to the provinces are assumed to increase sharply, reflecting the change in the age distribution of the population and the assumption that per capita spending rises at a rate ¼ percentage point above productivity growth (in turn reflecting continued shifts in demand and relative prices). Nonetheless, present policies appear broadly consistent with annual federal government surpluses averaging around ¾ percent of GDP over the next three decades, and the net federal debt-to-GDP ratio falling to around 5 percent by 2030. Although pressures on public pension and health care systems from population aging would result in fiscal deficits thereafter, the subsequent rise in the debt ratio would remain manageable (see figures below).

However, the projections also illustrate the importance of sustaining fiscal discipline and containing growth in health care spending over the coming decades. Two alternative scenarios were considered in which: (i) permanent federal spending increases (or tax cuts) are enacted immediately that erase the surplus during the next 10 years; and (ii) major transfers to the provinces for health care grow 2 percentage points faster than in the baseline during 2003–2050. In these cases, while the debt ratio would continue to decline over the next 20 years, the improvement would not be sufficient to avoid a sharp increase in the debt ratio thereafter.

Similar results have been obtained for the general government—i.e., including provincial governments, which are chiefly responsible for administering the public health care system. General government debt remains manageable if consolidated surpluses averaged around ¾ percent of GDP through to 2025. (Note that the calculations do not include the Canada Pension Plan, and its Quebec counterpart, since recent reforms to these programs have left these on a sustainable basis.) However, if outlays on health care were to continue to grow at the rates projected in the 2003 budget, or if other outlays were ratcheted up (or taxes cut) in a manner that eliminated the budget surplus over the next 10 years, fiscal sustainability would be jeopardized.





[1] See, for example, "In the Long Run We Are All Broke," *The Economist*, November 20, 2003.
[2] For details, see Chapter 1, *Canada: Selected Issues*, IMF Country Report 03/34, February 2003.

28. ***For this reason, the authorities indicated that a priority would be placed on expenditure reform.*** They acknowledged that direct program spending had grown rapidly last year, but noted that this partly reflected one-off measures, including the effects of shifting to accrual accounting, and that these outlays remained low at 5½ percent of GDP. Nonetheless, a major review of existing programs—similar to that in the early 1990s—was planned to enable a reallocation of resources to high priority areas, such as education, innovation, and infrastructure.[10]

29. ***The authorities agreed that there was little immediate scope for significant further reductions in tax rates.*** On the corporate tax side, recent rate reductions and the phased elimination of the federal capital tax meant that the system remained competitive with that in the United States, but officials suggested that consideration was being given to increasing depreciation allowances to align them more closely with the useful economic lives of capital assets. Officials acknowledged that Canadian marginal personal tax rates remained high at both lower and upper income levels, especially against the background of recent U.S. rate reductions (Box 3). However, there was not enough budget room presently to lower rates. Instead the focus was on more modest initiatives, such as expanding the range of tax-preferred saving vehicles.

30. ***The mission welcomed signs that consideration was being given to complementing the existing fiscal framework with a longer-run debt objective***. The new Prime Minister had, in September, called for eventually taking the government debt/GDP ratio down to around 25 percent, a goal that seemed attainable within a decade under current policies and could provide a useful anchor for annual budget decisions. The team suggested that a debt objective could be operationalized by targeting a specific fiscal balance over the cycle, enabling a more transparent and flexible response to cyclical and other shocks. Officials responded how the debt objective would be applied in practice remained to be determined, but stressed the importance of maintaining the existing two-year budget framework. The present system had proven its ability to respond flexibly to changing circumstances while delivering surpluses and sustaining social consensus for debt reduction.

31. ***Officials noted that fiscal surpluses posed challenges for debt management, especially with regard to maintaining adequate liquidity for longer-dated securities.*** For example, the government's real return bonds (RRBs) had yielded savings in recent years as inflation had fallen, but the RRB's role and cost effectiveness in an environment of a declining debt stock was unclear.[11] This concern was exacerbated by ongoing efforts to reduce the fixed-rate percentage of the debt stock, which stochastic simulations suggested would lower debt servicing costs.

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[10] This review, as well as an immediate freeze on major capital projects and the size of the civil service, was announced in December.

[11] See the forthcoming *Selected Issues* paper for a discussion of Canada's real return bond program.

Box 3. Labor and Capital Taxes in Canada

With the emergence of fiscal surpluses, significant tax reduction has taken place in Canada. The federal government launched a five-year tax reduction plan in 2000, which significantly lowered statutory tax rates on personal and corporate income, and steps have also been taken to increase contribution limits for tax-deferred retirement savings plans and to cut capital taxes. Some provinces, too, have lowered marginal income tax rates for both households and businesses.

Nonetheless, the average effective tax rate on labor in Canada remains high, especially compared to the United States.[1] The Canada-U.S. gap stems mainly from the higher marginal rates that apply to personal income—Canadian rates are estimated to be 6-10 percentage points higher—which more than offsets the lower rate paid for social security. Indeed, taking into account the higher tax rate on consumption, the total tax wedge on labor in Canada is closer to the European average than to the United States.[2] Moreover, Canada's relatively progressive personal income tax system interacts with high clawback rates on transfers and tax credits, causing high marginal tax rates on low and middle income families. For example, at certain levels of income, a single-earner with two children in Ontario faces a combined federal and provincial effective marginal tax rate slightly above 60 percent, mainly as a result of the clawback rate on child tax benefits (Chart).

Effective Average Tax Rates in Canada and Other Selected Industrialized Countries, 2002 1/

	Effective Tax Rate on Labor 2/	Total Tax Wedge on Labor 3/	Effective Tax Rate on Capital 4/
Canada	29.4%	43.7%	32.3%
United States	27.1%	34.6%	22.8%
Australia	22.3%	36.6%	33.5%
Japan	23.9%	33.5%	24.1%
United Kingdom	25.2%	38.2%	34.8%
Europe 5/	40.1%	53.0%	22.1%

1/ Estimates on Japan and USA are for 2001, for Australia are for 2000. Source: Staff estimates, based on OECD data.

2/ Personal income taxes on labor income, social security contributions and payroll taxes, over total labor cost.

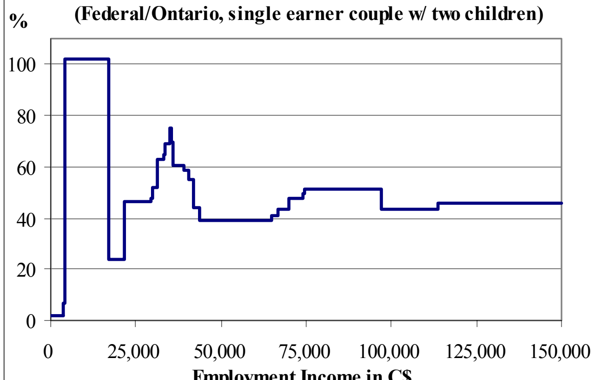
3/ Obtained as the sum of non-wage labor cost and effective personal income and consumption tax rates.

4/ Personal income taxes on capital income, taxes on corporate income and property taxes, over gross operating surplus.

5/ Unweighted average of France, Germany, Netherlands, Italy, and Sweden.

Effective tax rates on capital have been lowered but also still appear high. Using National Accounts data to calculate an effective average tax rate on capital income suggests that the burden on capital in Canada is higher than in the United States and in many other major industrialized countries. This gap, however, is expected to narrow appreciably with planned cuts in income and capital taxes at the federal and provincial levels. For example, the 2000 tax reform took the federal statutory corporate income tax rate from 28 percent in 1999 to 21 percent in 2004 and the capital tax is to be eliminated by 2008. Nonetheless, taking into account provincial income and capital taxes, investment tax credits, and depreciation allowances, Mintz and Chen (2003) estimate that Canada's effective corporate tax rate will still be 5½ percentage points higher than in United States in 2006, in large part reflecting more generous U.S. depreciation allowances.

Effective Marginal Tax Rates, 2004
(Federal/Ontario, single earner couple w/ two children)



Source: Department of Finance

[1] Effective tax rates in the Table are calculated using the methodology reported in Martinez-Mongay (2000).

[2] The Canada-U.S. gap remains even after accounting for transfer payments. See "Taxing Wages," OECD, 2003.

32. ***The mission questioned whether the February 2003 federal-provincial Health Accord would be sufficient to ensure the sustainability of the public health-care system.*** The Accord substantially increased federal transfers to the provinces (by an average of ½ percent of GDP annually) in exchange for commitments by the provinces to expand coverage on primary care, home care, and prescription drugs, and to strengthen accountability of provincial plans. However, the mission noted the already high level of spending on health care and wondered whether other reforms—such as increasing the role of the private sector in the provision of services or introducing price-based incentives, including co-payments and deductibles—were needed to increase efficiency and contain demand.[12]

33. ***Federal officials viewed the Accord as a significant step toward reforming the system.*** They stressed that shifting the emphasis from delivering services from hospitals to primary- and home-based care, enhancing access to pharmaceuticals, and establishing mechanisms for gauging the quality of health care delivery by the provinces would significantly improve the system's efficiency. Indeed, the constitutional responsibility for the administration of the system lay with the provinces, and there were no prohibitions on provinces engaging with the private sector to deliver services. Nonetheless, officials noted that the Canada Health Act prohibited deductibles and co-payments for "medically-necessary" services, consistent with the social consensus in Canada for equal access to such services. In their view, price-based incentives would not significantly affect demand, and greater savings would be reaped from reallocating resources as envisaged in the Accord.

34. ***The mission suggested that the ongoing review of equalization payments to the provinces provided an opportunity to reduce the system's complexity and avoid undue volatility of annual transfers.*** Officials responded that amendments to the system—that compensate lower-income provinces for their weaker tax bases—were being negotiated with the provinces and, hopefully, would include changes that would lead to a smoother flow of disbursements.

35. ***The team welcomed the application of full accrual accounting to the federal budget***. The officials agreed that this step enhanced the transparency of the fiscal accounts, and that reporting the amortization of physical assets as an annual expenditure would encourage a more careful management of these assets, as well as more judicious decisions on new investments. Similarly, the more complete and timely recording will encourage a risk-based approach to managing the government's financial liabilities.

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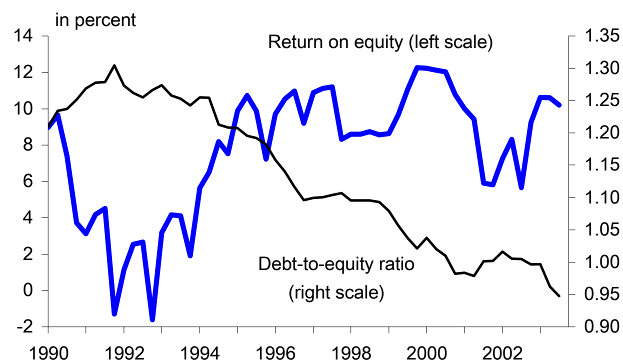
[12] The 2003 *Selected Issues* paper contains a discussion of the Canadian health care system and reform options.

VI. Financial Sector Policies in Support of Globalized Capital Markets

36. ***The authorities noted that balance sheets in the Canadian corporate and financial sectors had fared well during the recent downturn.*** Although the financial position of some industries—e.g., steel, automotive, and airlines—was still relatively fragile, the overall position of businesses was healthy, with leverage ratios at low levels. Banks continued to show strong profitability and low impaired loans, reflecting an increased emphasis on core retail operations, improvements in risk management, and their effective use of secondary markets for loans. Supervisory reviews suggested that bank exposure to risks—including with regard to exchange rate and interest rate shocks—was modest.

Canada: Corporate Balance Sheets and Profitability



37. ***The mission welcomed recent efforts to strengthen corporate governance and accounting standards.*** New rules governing financial reporting and disclosure would be issued in early 2004, a Canadian Public Accountability Board had been established to review the operations of accounting firms, and the provinces—which are responsible for securities regulation in their jurisdictions—had stiffened penalties for fraud. Ontario Securities Commission (OSC) officials explained that the OSC had begun to take on a greater role, relative to the Toronto Stock Exchange, in defining and enforcing compliance, reflecting the OSC's advantage in applying legal sanctions and its coverage of unlisted firms.

38. ***The team suggested that there was scope for further consolidating securities regulation, which presently appeared fragmented along provincial lines.*** The absence of a single national regulator seemed to result in an additional administrative burden and created room for regulatory arbitrage, while the need to achieve consensus among provincial regulators could make more difficult the response to new challenges. Many of these issues did not seem to be wholly addressed by the provinces' proposal to adopt a "passport system." The federal authorities generally agreed, but noted that the provinces were highly averse to giving up their responsibilities in this area.[13]

39. ***The mission observed that the criteria for approving bank mergers still seemed unclear.*** Legislation in 2001 had established a process for reviewing the potential impact of merger proposals on competition and the safety and soundness of the system, but proposals were still subject to ministerial review against an undefined public interest criterion. Officials responded that concerns on this front had led the authorities to publish a set of

[13] Subsequent to the discussions, a Wise Persons' Committee issued their report—titled "It's Time"—calling for the creation of a single regulator built on a joint federal-provincial model.

specific public interest criteria for large bank mergers in June 2003. Further, a revised set of merger review guidelines are expected to be finalized by June 2004. However, given that that the banking system was already highly concentrated, it would be important to gauge whether potential economies of scale resulting from mergers outweighed any impairment of access to financial services by both depositors and small- and medium-sized borrowers.

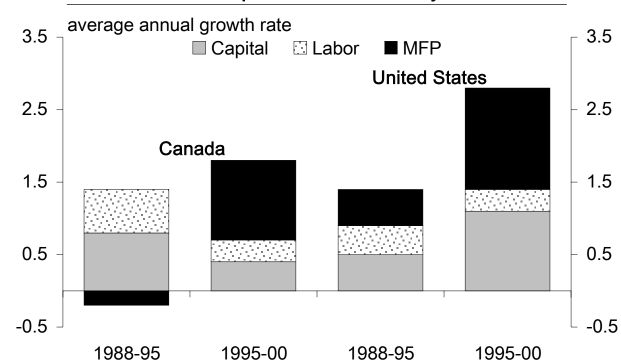
40. ***Sign of weakness have emerged among many defined benefits (DB) corporate pension plans***. As of end-2002, close to half of almost 400 DB plans supervised by the Office of the Superintendent for Financial Institutions (OSFI) reported solvency ratios below one and the number of pension plans on OSFI's watch list had grown significantly. With similar problems among provincially-supervised pension plans, the mission wondered whether the lack of a single national supervisor and pension guarantee fund was a concern.

41. ***The authorities responded that problems among DB plans did not represent a systemic risk.*** Nevertheless, supervision by the federal authorities had been stiffened, with increased stress testing on pension plans and the scope for contribution holidays having been reduced. Moreover, solvency margins would also likely benefit from the recent strengthening of stock markets. The officials did not favor consolidating provincial and federal supervision, since such steps would not materially improve the safety or soundness of the system. They also cautioned that the establishment of a national guarantee fund could raise costs to employers and discourage them from providing pension plans for employees.

VII. Policies to Support Productivity and Income Growth

42. ***Officials agreed that boosting long-term productivity growth—a long-standing topic of past discussions—was a key policy challenge.*** Although labor productivity growth accelerated during the latter half of the 1990s, its rate was still about ½ percentage point lower than in the United States, and has fallen even further behind in recent years, leaving a Canada-U.S. productivity gap in the 10-20 percent range. Officials noted that the shortfall partly reflected the greater proportion of smaller firms and self-employed persons in Canada, the lower rate of capital deepening, and a smaller high tech sector. However, Canada also appeared to have experienced a lower rate of total factor productivity growth, especially in sectors less exposed to trade.[14] Looking forward, it was hoped that the appreciation of the Canadian dollar would help spur capital deepening by

International Comparison: Productivity Growth 1/



1/ Recent data revisions, for which the detailed factor contributions are not yet available, indicate a smaller Canada-U.S. productivity gap.

[14] See T. Macklem, "Future Productivity Growth in Canada: Comparing to the United States," *The International Productivity Monitor* (forthcoming) and the forthcoming *Selected Issues* paper.

reducing the relative price of imports of machinery and equipment, but officials agreed with the team that addressing policy impediments to growth remained a key policy priority.

Labor and regulatory policies

43. ***The team asked whether the Canada/U.S. productivity gap and slower pace of IT investment reflected barriers to foreign direct investment (FDI) or lower levels of research and development (R&D).*** Officials agreed that the low level of R&D was a concern, but noted that this seemed to reflect mainly the smaller size of Canadian companies rather than policy impediments.[15] They did not view the more generous tax treatment accorded to small businesses, or limits on FDI in sectors such as telecommunication, banking, and transportation, as significant impediments to R&D or growth.

44. ***The mission suggested that the interaction between tax and social programs could weigh on labor utilization and efficiency***. For example, means-tested federal tax credits and provincial social assistance programs reduced incentives for labor market participation among lower-skilled workers, while the structure of benefits for the Canada Pension Plan (CPP) system encouraged early retirement. The team noted that gradually raising the normal retirement age from 65 presently, in line with projected increases in longevity, could provide a basis for lowering the premium rate. Officials responded that while the incentives for early retirement were a concern—and consideration was being given to recasting the benefit structure for the Canada Pension Plan—they did not view them as having a significant impact on labor supply. They also noted that at the time of the 1998 reform there had been no social consensus for raising the retirement age in order to lower contribution rates.

45. ***The team suggested that the ongoing review of Employment Insurance (EI) premiums provided scope for meaningful reforms***. In this regard, the mission reiterated the staff's longstanding concern that the EI system discouraged labor mobility and exacerbated regional disparities. The lack of experience-rated premiums and the use of the system's payroll tax to fund broader social policy objectives—such as parental leave benefits—caused substantial deadweight losses.[16] Officials noted that the focus of the current review was simply to establish a mechanism for ensuring that EI rates remained relatively stable over the cycle at a level that was sufficient to fund the system, and broader reforms were not being contemplated.

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[15] Empirical analyses have not identified large differences in regulatory burdens between Canada and the United States. See, for example, C. Gust and J. Marquez, "International Comparisons of Productivity Growth: The Role of Information Technology and Regulatory Practices," Federal Reserve Board Discussion Paper No. 727 (2002).

[16] See the analysis in the 2003 *Selected Issues* paper and Miles Corak and Wen-Hao Chen, 2003, "Firms, Industries, and Unemployment Insurance: An Analysis Using Employer-Employee Data," IZA Discussion Paper No. 811, June.

46. ***The team questioned whether restrictions on inter-provincial trade and other regulatory policies were a concern.*** Officials responded that the 1994 Agreement on Internal Trade (AIT) had addressed most constraints, but there remained a number of areas where further progress seemed warranted. For example, the AIT's dispute settlement system needed to be developed further, and restrictions on government procurement, labor certification, and the movement of energy across provincial lines remained irritants. Officials noted that provincial efforts to deregulate electricity systems had faced significant problems, with Ontario having to re-regulate consumer prices at a substantial fiscal cost. This experience pointed to the difficulty of designing incentives to ensure a reliable distribution system and adequate generation capacity, especially in the presence of low marginal cost hydro and nuclear power plants.

Trade, environmental, and other policy issues

47. ***While acknowledging the openness of Canada's trade regime, the mission encouraged further liberalization.*** In the agricultural sector, for example, while farm support amounted to only ¾ percent of GDP (half the OECD average), it still represents around 17 percent of gross farm receipts. Moreover, out-of-quota tariffs are high and Canada's dairy export practices have been challenged at the WTO.[17]

48. ***The authorities suggested that a multilateral approach was needed for significant progress in these areas.*** Although the recent Cancún ministerial meeting had been a significant disappointment, the Doha Round remained the best forum for addressing agricultural issues, expanding market access, and strengthening the rules governing anti-dumping and countervailing measures. The authorities saw little scope for a unilateral dismantling of Canada's supply-management system.

49. ***The authorities saw the North American Free Trade Agreement (NAFTA) as another cornerstone of their trade policy framework (Box 4).*** They acknowledged that some observers had called for a further deepening of economic linkages with the United States, possibly involving a customs union or a common market. Although these more ambitious proposals seemed premature, efforts were continuing to lower the cost of cross-border transactions, which was especially challenging given heightened concern regarding border security. The NAFTA partners had recently agreed to extending cooperation on several fronts, including with regard to rules governing investment, studying possible harmonization of MFN tariffs and rules of origin, and steel policy issues.

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[17] In 2003, least developed countries were provided tariff and duty free access for all goods, except over-quota supply-managed agricultural commodities.

Box 4. Canada-U.S. Trade Integration[1]

Canada and the Unites States have taken important steps to promote economic linkages during the past four decades. The 1965 Canada-U.S. auto pact freed cross-border trade in the sector and led to a significant growth in the Canadian auto industry. In 1989, the Canada-U.S. Free Trade Agreement (CUSFTA) expanded the coverage of tariff-free trade to almost all sectors, and in 1994 the North American Free Trade Agreement (NAFTA) broadened the scope of the CUSFTA by including Mexico. The CUSFTA and NAFTA were groundbreaking insofar as they covered a broad range of sectors, including services and investment, and introduced a unique dispute settlement mechanism.

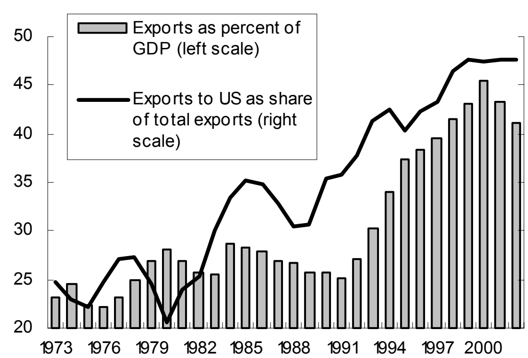
The CUSFTA and NAFTA have yielded substantial increases in trade and financial flows between the two countries. Canada's exports to the United States grew at an annual average rate of roughly 8 percent while the share of Canadian exports to the U.S. rose more than 12 percentage points between 1989 and 2002 (panel a). Gross FDI flows between the two countries rose more than fivefold during this period.

Increased trade and financial linkages led to significant changes in the dynamics of business cycles and growth in Canada. Canada-U.S. business cycles became more synchronized and the rapid growth of intra-industry trade also contributed to greater cross-country correlations of investment and imports (panel b). Moreover, exports to the United States played a much larger role in driving Canadian growth after the advent of CUSFTA (panel c).

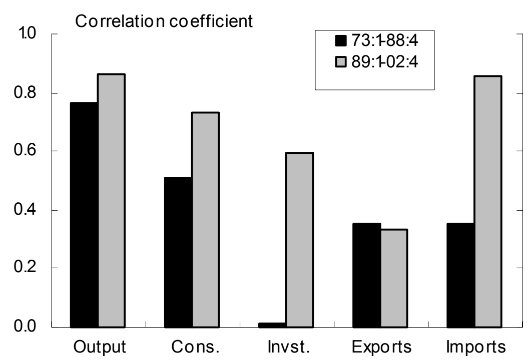
Some observers have called for deeper integration with the United States in order to eliminate remaining barriers to trade.[2] Barriers remain notwithstanding NAFTA. One study suggests, for example, that the costs to NAFTA countries of the rules of origin system are as much as 2–3 percent of NAFTA GDP. The most ambitious proposals include calls for a "grand bargain," which would couple security and defense-related policies with deeper trade integration, possibly in the context of a customs union or common market. Some of these proposals have even included calls for a monetary union. More modest proposals have suggested greater efforts toward harmonizing rules, standards, and regulations, in order to reduce the extent to which these arrangements impede trade and efficiency.

What is the next step for further integration? Recognizing the importance of secure and continuous access to each other's markets, Canada and the United States have placed an immediate emphasis on border security. For example, a Smart Border Action Plan has been implemented, which includes a Free and Secure Trade (FAST) program to harmonize procedures for clearing cross-border shipments. NAFTA partners have also recently decided to establish study groups to analyze avenues for harmonization of MFN tariffs and rules of origin requirements, and to improve rules governing investment flows. Looking further ahead, however, steps toward further integration would also need to grapple with more difficult issues, including the perennial problems regarding agricultural and natural resource policies, and different approaches to labor and environment policies.

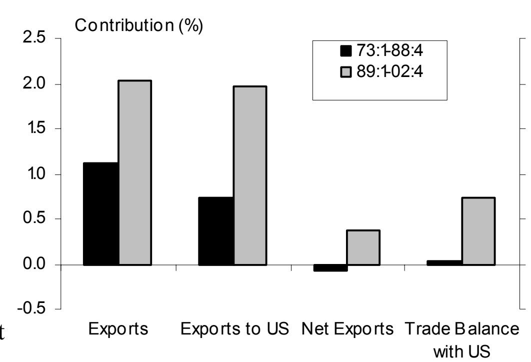
a. Growth in Exports



b. Convergence of Business Cycles



c. Contributions to GDP Growth



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[1] These issues are discussed in greater detail in a forthcoming Selected Issues paper.

[2] For a discussion of these issues, see the Policy Research Initiative, 2003, "The North American Linkages Project: Focusing the Research Agenda," Discussion Paper; Anne O. Krueger, 1997, "Free Trade Agreements versus Customs Unions," Journal of Development Economics, Volume: 54, 169-187; and Danielle Goldfarb, 2003, "Beyond Labels: Comparing Proposals for Closer Canada-U.S. Economic Relations." C.D. Howe Institute Backgrounder No: 76.

50. ***The authorities expressed concern about the ongoing negotiations for a Free Trade Area of the Americas (FTAA).*** They questioned, in particular, whether proposals by some participants at the November 2003 ministerial to shift the negotiations away from a broad-based regional agreement to one that was more narrowly focused could encourage countries to place a greater emphasis on bilateral agreements. Although Canada was active on the bilateral front too, officials noted that Canada could be at a disadvantage relative to the United States in using such agreements to gain market access, including in the area of financial services.[18]

51. ***Progress has been made toward implementing Canada's commitments under the Kyoto Protocol.*** Work has begun on a tradable permit system for green house gas (GHG) emissions, and various fiscal incentives in support of new technologies and conservation have been introduced. The team observed, however, that measures thus far did not seem sufficient to achieve the targeted 29 percent reduction in GHG emissions by 2010, and that it would be difficult to achieve this objective without significant fiscal costs or a larger output loss than the 0.4 percent drop in GDP relative to baseline in 2010 estimated by the authorities. The mission suggested, therefore, that other, possibly more efficient, instruments—such as energy-related consumption taxes—should be considered. The officials noted that such alternatives had been ruled out by the previous administration partly because of concern that their burden would fall too heavily on certain regions. However, they viewed the economic risks as manageable, especially since the U.S. decision not to ratify the Protocol would reduce pressure on the price of emissions permits in international markets and that the approach builds in contingences to ensure that Canada remains competitive and can take advantage of future technologies and technological opportunities.

52. ***The authorities have taken welcome steps to boost official development assistance (ODA).*** Canada's ODA rose to 0.28 percent of GNP in 2002, and the authorities are committed to doubling spending in dollar terms by the end of the decade. Concomitantly, spending was also being targeted at countries and projects where its effectiveness was most likely to be maximized.

53. ***The mission acknowledged the high quality of Canadian statistical systems, but noted that user charges could constrain analysis.***[19] Officials responded that the fees charged by Statistics Canada (including to other government agencies) were consistent with broader government policy, which required cost recovery by all government departments. However, the officials noted that these fees were waived for educational institutions.

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[18] The outcome of the ministerial meeting was a renewed commitment to conclude the FTAA by January 2005, but differences on sensitive issues such as agriculture and investment would allow "different levels of commitments" between countries. Canada has free trade agreements with Israel, Costa Rica, and Chile and is working toward agreements with the Central American Four (El Salvador, Guatemala, Honduras, and Nicaragua), and Singapore, and has held preliminary discussions with the Dominican Republic, CARICOM, and Andean Pact countries.

[19] See paragraph 45 of the 2003 Data ROSC (http://www.imf.org/external/pubs/ft/scr/2003/cr03328.pdf).

VIII. Staff Appraisal

54. ***The authorities' strong monetary and fiscal policy framework, as well as the structural reforms introduced since the early 1990s, have enabled the Canadian economy to respond flexibly to recent shocks and laid a solid foundation for recovery.*** Downside risks remain a concern, especially given the possibility that the dollar's strength will weigh more heavily on net exports and domestic profitability. However, near-term prospects appear broadly favorable, with growth likely to rebound next year underpinned by household spending and a pick up in business investment.

55. ***Macroeconomic policies should remain supportive, with fiscal policy continuing to focus on sustained debt reduction and structural reforms geared toward boosting productivity.***

- The principal responsibility for fostering a cyclical recovery remains with the monetary authorities, especially given the limited room for fiscal maneuver under the existing medium-term budgetary framework.
- With the erosion of budget surpluses, federal and provincial fiscal authorities need to remain focused on sustaining debt reduction and ensuring that retirement and health care systems are prepared for impending demographic pressures.
- Productivity gains will be essential for Canada to remain competitive and to generate the income and saving necessary to cope with population aging. Therefore, an emphasis is needed on financial sector, labor, trade, and other structural policy reforms to help strengthen Canada's longer-term growth potential and allow the economy to take full advantage of the increased integration of global markets.

56. ***With the recent opening of an output gap, the appreciation of the dollar weighing on activity, and core inflation expected to remain low, monetary policy can remain accommodative for some time.*** To be sure, the signals offered by inflation data have been clouded by special factors during the recent year, and considerable uncertainty attaches to estimates of the output gap. However, given the credibility won by the Bank over the past decade, and with some indicators suggesting that economic slack may be larger than conventional estimates, there is room to respond if the risks to the recovery intensify and further support to domestic demand is needed.

57. ***Canada's commitment to exchange rate flexibility has been helpful in facilitating the adjustment of global macroeconomic imbalances.*** Although the speed of appreciation of the Canadian dollar has raised concern, its strength has partly reflected the broader weakness of the U.S. dollar and does not appear to be out of line with underlying fundamentals, especially considering Canada's current account surplus and improved net foreign liability position, and world commodity price developments.

58. ***The authorities' fiscal framework has left Canada relatively well-positioned to cope with the impending fiscal pressures stemming from population aging, but the short-term fiscal outlook has become more challenging.*** With pressures on pension and health care

systems likely to grow in coming decades, sustained surpluses and debt reduction will be essential in order to ensure fiscal sustainability. However, the economic slowdown and the spending initiatives introduced with the 2003 Budget, particularly on health-care related transfers to the provinces, have used up much of the planning surpluses that were projected last year. Therefore, it will be important to ensure that the forthcoming budget demonstrates a firm commitment to achieving the planned contingency reserve set out in the recent Fiscal Update and to rebuilding the economic prudence factor at the earliest opportunity.

59. ***Difficult issues at both the federal and provincial levels still need to be tackled to keep the public debt ratio on a downward track.*** The recent federal-provincial Health Accord has been helpful in providing greater certainty regarding the funding for provincial health and social programs, but there would seem to be scope for strengthening incentives to contain costs and usage, including by expanding the role of private providers and introducing some degree of cost recovery from patients. It will be important to ensure that amendments to the system of federal-provincial equalization payments reduce its complexity, avoid excessive year-to-year swings in payments, and contain the burden on the federal budget.

60. ***The present environment suggests a policy focus on expenditure control rather than broad-based tax cuts***. Especially given the recent growth of departmental outlays, the authorities' emphasis on a comprehensive review of existing programs is welcome. Although tax rates still remain high in Canada, the more difficult budgetary situation means that any new measures in the near term would need to be relatively modest and accompanied by an offsetting broadening of the tax base or expenditure cuts.

61. ***The public pension system and other age-related programs appear sound but further reforms may still be warranted.*** For example, improving the actuarial fairness of the adjustment to CPP benefits for those who retire before or after the statutory retirement age, or gradual increases in the retirement age to take into account increases in longevity, could help encourage labor market attachment and possibly enable an eventual reduction in the CPP premium rate. Increases in the retirement age could also help reduce the burden on the old-age security system, while encouraging greater accumulation of private retirement savings.

62. ***The government's fiscal framework could usefully be complemented by a clearer longer-term anchor.*** For example, a more explicit longer-term debt objective could provide a more transparent basis for weighing the longer-term implications of policy options, or provide a basis for supplementing the existing two-year planning framework with a commitment to achieving a specific fiscal surplus over the economic cycle.

63. ***The Canadian financial system has remained resilient.*** This has reflected both the underlying strength of financial regulation and an effective response to increased global concerns regarding corporate accounting and governance standards. At the same time, however, in order to ensure that the financial system remains well placed to compete effectively in the face of the increasing integration of global capital markets, transparent guidelines will be needed to allow bank mergers to go forward in the absence of compelling public-interest concern. Harmonization of securities market regulation and legislation—and

the eventual creation of a single regulator—would also support the financial sector's ability to remain globally competitive. In addition, recent weaknesses among defined-benefit pension plans has highlighted the importance of strengthening disclosure requirements and rules governing contribution holidays, and further harmonizing federal-provincial regulation and supervision.

64. ***Ensuring that regulatory and other policies support productivity growth remains a key long-term challenge.*** In addition to ensuring that the tax and retirement systems provide appropriate incentives to save and invest, and that the financial system is well placed to intermediate capital both domestically and internationally, key priorities include:

- ***Regulatory policies:*** Deregulation in the electricity sector has proven more difficult and costly than expected, and it will be important to ensure that consumers are not inappropriately shielded from underlying costs. Similarly, achievement of the authorities' environmental objectives may require consideration of instruments such as consumption-related taxes to help minimize adverse fiscal and supply-side consequences. In addition, continued efforts are needed to remove interprovincial barriers to trade.

- ***Social policies:*** The use of the EI system to fund broader social policy objectives—including extended benefits in high unemployment regions—has resulted in significant cross-subsidization across industries and regions. The pending review of the system provides a useful opportunity to consider introducing experience-rated premiums and alternative funding options for the social objectives presently being supported by the system.

- ***Trade and agricultural policies:*** Canada's trade system remains open and transparent. However, easing import barriers further—especially in the area of agriculture—and exerting further discipline over the use of anti-dumping and countervailing duties would encourage greater competitive efficiencies and complement Canada's official development objectives. Canada can also play an important leadership role in efforts to bridge differences among the participants of the Doha Round.

65. It is recommended that the next Article IV consultation take place within the standard 12-month cycle.

Table 1. Canada: Indicators of Economic Performance

	Average 1987-97	1998	1999	2000	2001	2002	Projections 2003	2004	2005
				(Annual percent change)					
Per capita GDP									
Canada	1.2	3.2	4.7	4.3	0.9	2.2	0.7	1.5	1.8
United States	1.8	3.1	2.9	2.6	-0.8	1.4	1.9	3.2	2.6
Japan	2.7	-1.5	0.0	2.6	0.2	-0.5	2.0	1.5	1.4
Germany	-0.3	1.8	2.1	2.8	0.7	0.0	0.0	1.5	2.2
G-7 countries	1.7	2.1	2.3	2.9	0.1	0.8	1.4	2.4	2.3
Real GDP									
Canada	2.4	4.1	5.5	5.3	1.9	3.3	1.6	2.7	3.0
United States	3.0	4.3	4.1	3.8	0.3	2.4	2.9	4.3	3.6
Japan	3.1	-1.2	0.2	2.8	0.4	-0.3	2.1	1.6	1.4
Germany	2.4	2.0	2.0	2.9	0.8	0.2	0.0	1.5	2.2
G-7 countries	2.7	2.8	3.0	3.6	0.8	1.5	2.0	3.1	2.9
Real domestic demand									
Canada	2.8	2.4	4.1	5.0	1.7	3.4	4.5	3.9	3.0
United States	3.2	5.4	5.0	4.4	0.4	3.0	3.1	4.0	3.6
Japan	2.3	-1.5	0.3	2.3	1.1	-1.0	1.5	0.9	1.1
Germany	2.6	2.4	2.8	1.8	-0.8	-1.6	1.0	2.0	2.2
G-7 countries	2.6	3.5	3.7	3.6	0.8	1.6	2.4	2.9	2.9
GDP deflator									
Canada	2.6	-0.5	1.7	4.0	1.1	0.9	3.5	1.7	2.0
United States	2.8	1.2	1.4	2.1	2.4	1.1	1.6	1.3	1.7
Japan	0.9	-0.1	-1.5	-2.0	-1.5	-1.2	-2.2	-2.1	-1.2
Germany	2.5	1.1	0.5	-0.3	1.3	1.6	0.9	0.9	1.2
G-7 countries	2.7	1.1	0.9	1.2	1.5	1.1	1.2	0.9	1.3
				(in percent of GDP)					
General government financial balance									
Canada	-5.1	0.1	1.6	3.0	1.4	0.8	0.3	0.2	0.3
United States	-3.9	-0.1	0.5	1.2	-0.7	-3.7	-5.4	-5.7	-4.0
Japan	-1.1	-5.5	-7.2	-7.5	-6.1	-7.7	-8.0	-7.2	-6.9
Germany	-2.4	-2.2	-1.5	1.3	-2.8	-3.5	-3.9	-3.9	-2.9
G-7 countries	-4.3	-3.6	-2.1	-1.6	-1.2	-0.2	-1.8	-3.8	-4.9
Gross savings									
Canada	17.4	19.1	20.7	23.8	22.4	21.9	22.0	22.2	22.6
United States	17.0	18.8	18.4	18.4	16.5	15.0	13.5	13.2	14.3
Japan	32.5	29.8	28.6	28.8	27.8	26.7	27.2	27.4	27.3
Germany	23.0	21.2	20.5	20.3	19.6	20.3	19.9	20.3	20.9
G-7 countries	20.9	21.1	20.6	20.7	19.5	18.5	17.6	17.4	18.0
Fixed private investment									
Canada	17.3	17.7	17.4	17.0	17.4	17.0	16.9	17.6	17.8
United States	14.9	16.7	17.0	17.2	16.3	15.2	15.0	14.9	15.0
Japan	22.6	19.4	18.5	19.4	19.1	17.9	17.8	17.9	18.1
Germany	19.5	19.5	19.6	19.9	18.6	16.9	16.6	16.9	17.2
G-7 countries	15.9	16.1	15.7	15.3	15.1	14.5	13.8	13.3	12.9
Current account balance									
Canada	-2.6	-1.2	0.3	2.9	2.4	2.0	2.0	1.5	1.5
United States	-1.5	-2.3	-3.2	-4.2	-3.9	-4.6	-4.9	-4.4	-4.2
Japan	2.4	3.0	2.6	2.5	2.1	2.8	3.0	3.0	3.0
Germany	0.8	-0.6	-1.1	-1.4	0.0	2.3	2.4	2.1	2.2
G-7 countries	-0.2	-0.3	-0.9	-1.5	-1.4	-1.4	-1.5	-1.2	-1.2

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

Table 2. Canada: Selected Economic Indicators

(Percent change at annual rates, unless othewise indicated)

			Projections										Projections					
						2002				2003			2003	2004			
	2001	2002	2003	2004	2005	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NIPA in constant prices																	
Real GDP	1.9	3.3	1.6	2.7	3.0	5.8	3.8	2.7	1.6	2.0	-0.7	1.1	3.7	3.1	3.2	2.9	2.9
Net exports 1/	0.6	-0.3	-2.6	-0.9	0.1	0.1	-6.5	1.3	-3.1	-3.6	-3.8	0.4	-2.2	-1.0	-0.4	0.0	0.1
Total domestic demand	1.7	3.4	4.5	3.9	3.0	5.6	10.1	1.2	5.0	6.6	3.2	1.1	6.6	4.3	3.7	3.0	2.9
Final domestic demand	3.2	2.9	3.9	4.1	2.8	3.8	3.7	2.3	3.1	3.8	4.3	5.7	5.3	4.0	3.4	2.7	2.7
Private consumption	2.6	3.4	3.8	3.4	2.2	5.0	4.4	1.3	4.4	3.9	3.8	5.1	3.9	3.4	2.9	2.0	1.9
Personal saving ratio (in percent of DI)	4.7	4.2	2.1	2.8	3.6	5.2	4.6	3.8	3.2	2.6	2.2	1.3					
Public consumption	3.7	3.0	3.5	3.0	2.7	0.8	3.7	4.2	2.4	2.5	6.9	1.3	4.2	2.6	2.6	2.6	2.6
Private fixed domestic investment	3.5	-0.2	4.5	7.9	4.5	1.6	0.5	2.8	0.2	4.2	2.7	15.0	11.2	7.5	5.6	5.0	5.0
Residential construction	10.3	14.2	7.8	6.8	2.5	30.2	-3.5	15.2	11.1	1.5	5.1	18.2	10.0	5.0	4.0	2.5	2.5
Private investment rate (in percent of GDP)	17.4	17.0	16.9	17.6	17.8	17.4	17.0	16.9	16.8	16.5	16.5	17.0	17.3	17.5	17.6	17.6	17.7
Public investment	10.3	11.8	4.8	3.4	4.1	15.7	7.3	5.6	-0.2	10.1	6.4	-2.4	5.0	3.9	3.9	3.9	3.9
Change in inventories 1/	-1.6	1.8	0.1	-0.4	0.2	2.3	6.2	-0.7	1.3	2.6	-1.5	-4.6	0.9	0.3	0.4	0.3	0.2
GDP (current prices)	3.0	4.3	5.2	4.5	5.1	9.2	10.6	4.9	6.1	10.2	-2.7	4.6	4.6	5.2	5.3	5.0	5.0
Employment and inflation																	
Unemployment rate	7.2	7.6	7.6	7.1	6.9	7.8	7.6	7.6	7.5	7.4	7.7	7.9	7.5	7.2	7.1	7.0	7.0
Employment	1.1	2.2	2.1	2.1	1.7	3.1	3.6	3.5	3.2	2.2	0.4	0.4	3.3	3.1	1.8	1.6	1.6
Labor productivity (business sector)	1.0	1.9				2.9	1.1	-1.1	-2.1	0.7	-0.4	2.9					
Unit labor costs (business sector)	2.7	0.8				0.8	-1.1	2.7	5.0	1.1	3.4	1.8					
CPI inflation (y/y)	2.5	2.3	2.7	1.5	2.0	1.6	1.3	2.3	3.8	4.4	2.9	2.2	1.6	0.9	1.6	1.6	1.8
Core CPI inflation (y/y)	2.1	2.4				2.1	2.2	2.4	2.8	3.1	2.2	1.7					
GDP deflator	1.1	0.9	3.5	1.7	2.0	3.1	6.6	2.3	4.5	7.9	-2.1	3.3	1.0	2.0	2.0	2.0	2.0
Output gap (in percent of potential output)	0.4	0.4	-1.2	-1.1	-0.7	0.5	0.6	0.4	0.0	-0.3	-1.3	-1.7	-1.4	-1.3	-1.2	-1.1	-1.0
Indicators of fiscal policies (NIA basis, in percent of GDP)																	
Federal fiscal balance	1.2	1.0	0.6	0.5	0.5	0.5	0.9	0.5	1.5	1.1	-0.3	1.0					
Provincial fiscal balance 2/	-0.3	-0.9	-1.2	-1.1	-1.1	-0.8	-1.1	-0.8	-0.8	-0.3	0.2	-0.9					
General government fiscal balance 2/	1.4	0.8	0.3	0.2	0.3	0.4	0.5	0.4	1.4	1.5	0.7	1.0					
Three-month treasury bill (percent)	3.9	2.6	2.9	2.8	3.5	2.1	2.5	2.8	2.7	2.9	3.2	2.8	2.8	2.8	2.8	2.8	2.8
Ten-year government bond yield (percent)	5.5	5.3	4.8	4.8	5.1	5.5	5.5	5.1	5.1	5.0	4.6	4.8	4.8	4.8	4.8	4.8	4.9
External indicators																	
Current account balance (in percent of GDP)	2.4	2.0	2.0	1.5	1.5	2.4	2.2	1.8	1.7	2.3	1.7	2.4	1.6	1.5	1.4	1.4	1.5
Merchandise trade balance (in percent of GDP)	6.4	5.0	4.9	4.3	4.5	5.4	4.9	4.9	4.5	5.4	4.5	5.0	4.5	4.3	4.2	4.3	4.4
Export volume	-3.5	0.2	-2.9	1.8	5.3	6.5	-1.0	9.2	-10.8	-4.3	-2.3	-2.8	0.4	2.5	3.9	4.9	5.4
Import volume	-5.6	1.4	2.9	4.6	5.3	6.0	18.3	8.6	-1.8	1.3	5.7	-4.6	6.9	6.1	5.3	5.5	5.8
Invisibles balance (in percent of GDP)	-4.0	-3.0	-2.9	-2.9	-3.0	-3.0	-2.7	-3.1	-2.9	-3.0	-2.8	-2.7	-2.9	-2.8	-2.8	-2.8	-2.8
Exchange rate	0.64	0.64				0.63	0.65	0.63	0.64	0.67	0.72	0.72					
Percent change (q/q)	-4.2	-1.1				-0.6	3.7	-2.5	0.6	5.1	7.8	0.2					
Nominal effective exchange rate (q/q)	-3.0	-1.8				-0.3	1.8	-1.7	-0.5	3.1	7.4	1.3					
Real effective exchange rate (q/q)	-4.0	-0.4				-0.1	2.0	-1.3	0.2	3.8	8.1	1.7					
Terms of trade	-1.5	-2.1	7.0	1.8	0.1	2.1	10.9	-1.4	6.0	16.6	2.5	6.9	1.2	1.2	0.6	0.4	1.0
Saving and investment (in percent of GDP)																	
Gross national saving	22.4	21.9	22.0	22.2	22.6	21.5	22.3	22.0	22.0	23.2	21.5	21.7					
Gross domestic investment	19.7	19.9	20.0	20.7	21.1	19.5	20.5	20.3	20.4	20.7	20.4	19.7					
General government	3.6	3.2	2.7	2.6	2.7	2.7	2.9	3.3	3.8	3.9	3.0	3.4					
Private	18.8	18.8	19.3	19.6	19.8	18.7	19.4	18.7	18.2	19.4	18.5	18.3					
Personal	5.6	5.4	6.9	6.9	6.9	6.1	5.7	5.2	4.8	4.4	4.2	3.7					
Business	13.1	13.3	12.4	12.7	12.9	12.6	13.7	13.5	13.4	15.0	14.3	14.6					

Sources: Statistics Canada; and Fund staff estimates.

1/ Contribution to growth.

2/ Includes local governments and hospitals.

Table 3. Canada: Balance of Payments

(In billions of Canadian dollars, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	2003 1/ Q1	Q2	Q3
Current account balance	-11.4	-11.4	2.6	30.7	26.9	23.4	28.3	20.2	29.3
In percent of GDP	-1.3	-1.2	0.3	2.9	2.4	2.0	2.3	1.7	2.4
Merchandise trade balance	25.7	23.8	42.0	67.8	70.9	57.8	64.7	54.9	61.9
Exports, goods	303.4	327.2	369.0	430.0	421.5	414.3	423.2	396.6	395.3
Imports, goods	277.7	303.4	327.0	362.2	350.6	356.5	358.5	341.7	333.4
Services balance	-8.9	-6.3	-6.6	-6.6	-8.4	-8.3	-10.5	-11.9	-10.9
Investment income balance	-28.9	-29.6	-33.6	-31.8	-37.3	-27.5	-26.8	-22.7	-22.0
Transfer balance	0.7	0.8	0.8	1.3	1.7	1.4	0.9	0.0	0.3
Capital and financial accounts balance	15.8	4.5	-12.5	-25.2	-17.8	-13.1	10.0	-42.1	-16.0
Direct investment, net	-16.0	-17.1	11.1	29.9	-12.1	-12.9	-0.6	9.7	-11.5
In Canada	16.0	33.8	36.8	99.1	44.6	32.3	20.0	18.5	8.1
Abroad	-31.9	-51.0	-25.6	-69.2	-56.7	-45.2	-20.5	-8.8	-19.6
Portfolio investment, net	4.3	2.3	-19.4	-49.5	-2.9	-3.9	29.8	22.5	-47.8
Canadian securities	16.2	24.8	3.7	14.4	34.7	21.1	35.2	35.4	-37.4
Bonds	6.2	10.3	2.6	-21.7	37.4	18.7	39.6	28.1	-49.2
Stocks	7.6	14.3	14.3	35.2	4.7	-1.4	-1.1	10.3	21.3
Money market	2.4	0.1	-13.2	0.8	-7.3	3.8	-3.3	-3.1	-9.5
Foreign securities	-11.8	-22.5	-23.1	-63.8	-37.6	-25.0	-5.4	-12.8	-10.4
Bonds	-6.6	-7.1	-2.5	-4.0	-1.9	-6.2	-14.0	-10.7	0.1
Stocks	-5.2	-15.4	-20.6	-59.9	-35.7	-18.7	8.6	-2.2	-10.4
Other investment 2/	16.5	21.9	-0.5	-5.4	-5.1	-1.5	-34.0	-79.1	39.6
Assets	-22.1	13.7	15.6	-6.3	-16.4	-11.0	-110.6	23.2	27.4
Liabilities	38.7	8.2	-16.1	0.9	11.3	9.5	76.6	-102.4	12.2
Other flows, net	7.5	4.9	5.1	5.3	5.7	4.8	3.9	3.9	3.7
Transactions in official international reserves	3.4	-7.5	-8.8	-5.5	-3.4	0.3	10.8	0.9	0.0
Statistical discrepancy	-4.4	6.8	9.9	-5.5	-9.1	-10.2	-30.1	28.9	-21.0
Memorandum item:									
Net external investment position	-290	-300	-244	-197	-189	-184	...	...	...
In percent of GDP	-32.9	-32.8	-24.8	-18.3	-17.1	-15.9	...	...	...

Source: Statistics Canada.

1/ Quarterly flows are annualized.

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

Table 4. Canada: Selected Vulnerability Indicators

(In percent of GDP unless otherwise indicated)

	1998	1999	2000	2001	2002	2003 Q1	2003 Q2	2003 Q3
External indicators								
Official reserves (in billions of U.S. dollars)	23.4	28.6	32.4	34.2	37.2	35.9	36.7	36.7
Broad money (M3) to foreign exchange reserves (percent)	17.1	14.5	13.8	13.2	12.8	14.2	15.5	15.8
Central bank foreign liabilities (in billions of dollars)	0.2	0.5	0.6	0.2	0.2	0.2	0.2	0.3
Official reserves in months of imports	1.2	1.3	1.4	1.5	1.7	1.5	1.5	1.5
General government debt (in billions of dollars) 1/	99.6	96.9	85.3	73.1	78.9	82.1	80.0	63.1
Net international investment position (current cost, billions of dollars)	-300	-244	-197	-189	-184	...	...	...
External debt to exports ratio (in percent)	79.4	57.7	40.3	39.4	38.9	...	...	...
External interest payments to exports (in percent) 2/	16.4	15.7	14.2	13.3	12.5	11.9	12.0	12.0
Financial markets indicators								
General government gross debt	116.2	110.8	101.8	99.6	96.0	...	...	...
Three-month treasury bill yield (percent)	4.7	4.7	5.5	3.9	2.6	2.9	3.2	2.8
Ten-year government note (percent)	5.3	5.6	5.9	5.5	5.3	5.0	4.6	4.8
Real three-month treasury bill yield (percent; deflated by CPI rate)	3.7	2.9	2.7	1.3	0.3	1.5	3.8	2.4
Change in stock market index (TSE 300, annual percentage change)	4.6	4.5	36.1	-19.5	-9.0	0.2	4.9	8.6
Banking sector risk indicators 3/								
Balance sheet								
Total loans to assets (percent)	62.1	58.4	58.7	57.7	55.8	54.5	55.0	54.1
Total loans to deposits (percent)	90.2	86.8	84.2	84.5	83.1	82.5	84.0	81.7
Impaired assets/total assets	0.66	0.59	0.60	0.84	0.90	0.90	0.83	0.83
Loan loss provision (in percent of total assets)	0.20	0.23	0.27	0.39	0.56	0.24	0.24	0.24
Total foreign currency assets/total assets 4/	46.4	40.2	40.5	42.7	41.4	39.2	36.5	36.7
Total foreign currency liabilities/total assets 4/	47.7	42.4	42.2	44.7	43.8	41.3	38.0	38.4
Total foreign currency deposits/total assets 4/	32.2	31.3	29.5	30.4	28.9	28.5	25.8	26.2
Profitability								
Return on total shareholders' equity (percent)	13.4	15.8	15.3	13.9	9.4	14.4	10.1	17.9
Return on average assets	0.57	0.71	0.72	0.66	0.44	0.68	0.47	0.82
Average intermediation spread	2.6	2.7	2.9	3.0	3.0	3.1	3.1	3.1
Net interest income (in percent of average total assets)	1.8	1.8	1.8	1.9	2.0	1.9	1.9	1.9
Capital position								
Total capital ratio	10.6	11.7	11.8	12.2	12.2	12.4	12.5	12.5
Tier 1 capital ratio	7.3	8.4	8.4	8.8	9.0	9.2	9.4	9.4
Personal sector 5/								
Net worth in percent of disposable income	505.4	514.4	505.5	506.3	509.7	501.6	505.1	507.3
Total liabilities in percent of disposable income	112.0	114.0	112.7	114.9	115.3	113.9	115.7	117.0
Corporate sector 6/								
Debt of private nonfinancial corporations (in percent of GDP)	52.5	50.5	47.7	47.9	46.4	44.3	44.7	44.1
Debt-to-equity ratio of nonfinancial private corporations	80.7	76.8	69.9	66.3	62.1	62.1	62.0	61.8

Sources: Bank of Canada; Canadian Bankers Association; Statistics Canada; Bloomberg; Moody's; and Fund staff estimates.

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

Table 5. Canada: Key Fiscal Indicators

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
								Staff Projections					
Federal government (PA basis) 1/						(in billions of dollars)							
Revenue	140.9	152.1	156.1	166.1	182.7	171.7	177.6	180.4	186.0	195.0	203.8	213.3	223.8
Program spending	102.3	106.9	110.0	109.6	118.7	125.0	133.3	144.4	147.8	156.2	163.6	171.6	179.6
Interest payments	47.3	43.1	43.3	43.4	43.9	39.7	37.3	36.1	35.5	35.3	36.1	36.0	35.9
Budgetary surplus	-8.7	2.1	2.8	13.1	20.2	7.1	7.0	-0.1	2.8	3.5	4.1	5.7	8.4
Structural budgetary surplus 2/	-5.6	4.5	4.1	11.6	17.1	7.5	9.1	4.1	6.1	5.6	5.3	6.2	8.6
Economic prudence	...	...	...	...	...	...	...	...	...	...	1.0	3.0	4.0
Contingency reserves	...	...	...	...	...	...	...	0.3	3.0	3.0	3.0	3.0	3.0
Planning surplus	...	...	...	...	...	...	...	-0.4	-0.2	0.5	0.1	-0.3	1.4
Net federal debt	562.9	560.7	557.9	543.7	524.6	517.5	510.6	510.7	507.9	504.4	500.3	494.5	486.2
						(in percent of GDP)							
Revenue	16.8	17.2	17.1	16.9	17.0	15.5	15.4	14.8	14.7	14.6	14.6	14.5	14.5
Program spending	12.2	12.1	12.0	11.2	11.0	11.3	11.5	11.9	11.6	11.7	11.7	11.7	11.7
Interest payments	5.6	4.9	4.7	4.4	4.1	3.6	3.2	3.0	2.8	2.6	2.6	2.5	2.3
Budgetary surplus	-1.0	0.2	0.3	1.3	1.9	0.6	0.6	0.0	0.2	0.3	0.3	0.4	0.5
Structural budgetary surplus 2/	-0.6	0.5	0.4	1.2	1.6	0.7	0.8	0.3	0.5	0.4	0.4	0.4	0.6
Economic prudence	...	...	...	...	...	...	...	...	...	...	0.1	0.2	0.3
Contingency reserves	...	...	...	...	...	...	...	0.0	0.2	0.2	0.2	0.2	0.2
Planning surplus	...	...	...	...	...	...	...	0.0	0.0	0.0	0.0	0.0	0.1
Net federal debt	67.3	63.5	61.0	55.3	48.8	46.7	44.2	42.0	40.0	37.8	35.7	33.7	31.6
General Government						(in billions of dollars)							
(NIA and calendar year basis) 3/													
Revenue	363.3	390.7	404.7	428.9	469.8	471.4	475.4	489.4	506.1	527.7	551.7	576.7	603.3
Expenditure	386.7	389.0	404.0	413.1	437.1	456.0	466.5	486.2	504.1	523.8	546.1	569.2	592.9
Balance	-23.4	1.6	0.8	15.9	32.7	15.4	8.9	3.2	2.0	3.8	5.6	7.5	10.4
Structural balance 2/	-16.9	6.5	4.9	13.6	22.7	13.9	9.2	11.3	9.6	8.9	8.6	8.8	11.0
Net public debt	751.6	757.8	760.0	735.1	696.1	654.5	647.5	644.3	642.3	638.4	632.9	625.4	615.0
						(in percent of GDP)							
Revenue	43.4	44.3	44.2	43.7	43.7	42.6	41.2	40.3	39.9	39.6	39.4	39.3	39.2
Expenditure	46.2	44.1	44.2	42.0	40.6	41.2	40.4	40.0	39.7	39.3	39.0	38.8	38.5
Balance	-2.8	0.2	0.1	1.6	3.0	1.4	0.8	0.3	0.2	0.3	0.4	0.5	0.7
Structural balance 2/	-2.0	0.7	0.5	1.4	2.2	1.3	0.8	0.9	0.7	0.7	0.6	0.6	0.7
Net public debt	89.8	85.8	83.1	74.8	64.7	59.1	56.1	53.0	50.6	47.9	45.2	42.6	40.0
Memorandum items													
Real GDP growth	1.6	4.2	4.1	5.5	5.3	1.9	3.3	1.6	2.7	3.0	2.9	2.8	2.7
Nominal GDP growth rate	3.3	5.5	3.7	7.4	9.5	3.0	4.3	5.2	4.5	5.1	5.0	4.9	4.8
Three-month treasury bill rate	4.3	3.2	4.7	4.7	5.5	3.9	2.6	2.9	2.8	3.5	4.4	4.5	4.5
Ten-year government bond rate	7.2	6.1	5.3	5.6	5.9	5.5	5.3	4.8	4.8	5.1	5.5	5.5	5.5

Source: Department of Finance Canada *Economic and Fiscal Update* (November 3, 2003); and Fund staff estimates.

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

Canada—Fund Relations
(As of October 31, 2003)

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

		SDR Million	Percent of Quota
II.	**General Resources Account:**		
	Quota	6,369.20	100.0
	Fund holdings of currency	3,613.07	56.73
	Reserve position in Fund	2,756.14	43.27

		SDR Million	Percent of Allocation
III.	**SDR Department:**		
	Net cumulative allocation	779.29	100.00
	Holdings	555.54	71.29

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

V. **Financial Arrangements:** None.

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

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

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

IX. **Exchange Rate Arrangements:** The Canadian authorities do not maintain margins with respect to exchange transactions, and exchange rates are determined on the basis of demand and supply conditions in the exchange market. However, the authorities may intervene to maintain orderly conditions in the exchange market. There are no taxes or subsidies on purchases or sales of foreign exchange. Canada has notified the Fund, pursuant to Decision No. 144, of restrictions imposed vis-à-vis Iraq (EBD/90/279) and the Federal Republic of Yugoslavia (Serbia and Montenegro) (EBD/92/162).

X. **Last Article IV Consultation:** The staff report for the 2003 consultation with Canada was considered by the Executive Board on January 31, 2003 (EBM/03/6). Canada is on a 12-month consultation cycle.

XI. FSAP Participation and ROSC Assessments

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

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

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

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

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

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

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

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

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

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

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

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

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

Canada: Core Statistical Indicators

(as of December 8, 2003)

	Exchange Rates	International Reserves 1/	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 2/	GDP/ GNP	External Debt 3/	Debt Service
Date of latest Observation	Same day	October 2003	11/29/03	October 2003	October 2003	Same day	October 2003	September 2003	2003 Q3	2003 Q3	2003 Q3	end-2002	end-2002
Date received	Same day	11/29/03	12/03/03	11/29/03	11/29/03	Same day	11/19/03	11/13/2003	11/27/2003	11/28/2003	11/28/2003	May 2003	May 2003
Frequency of data	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annual	Annual
Frequency of reporting	Daily	Monthly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annual	Annual
Source of Update	Various	Finance Canada news release	BOC financial statement	BOC financial statement	BOC financial statement	Various	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada
Mode of Reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted
Frequency of Publication	Daily	Monthly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annually	Annually

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

Canada—Statistical Issues

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

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

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

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

External Sector. Statistics Canada provides timely information of on monthly, quarterly, and annual frequency of Balance of Payments and international position. Detailed coverage of data as well as frequency thereof is reported in the appendix Core Statistical Indicators.

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.

Statement by the IMF Staff Representative on Canada
February 18, 2004

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

Recent economic and financial market developments

2. ***Recent indicators point to a slower-than-expected pick up in activity in the fourth quarter of 2003.*** GDP was essentially flat in November, following only 0.1 percent growth in October. The November trade surplus also fell, owing to continued declines in exports of autos and capital goods, while imports grew strongly.

3. ***Nonetheless, household and labor market indicators remain generally favorable.*** Although retail sales fell ½ percent in November, sales excluding autos rose by 3/4 percent, and housing activity remained strong with the construction sector posting robust gains. Employment has continued to rise in recent months, accumulating gains of 50,000 new jobs in both December 2003 and January 2004. The majority of job gains were in full-time work, with private sector employment accounting for most of the increase. The unemployment rate edged down to 7.4 percent, as the labor force participation rate reached new record highs in December.

4. ***Inflation remains subdued.*** The headline CPI edged up 0.1 percent in December, and the Bank of Canada's core measure was up 0.2 percent. However, the base effects of December 2002 electricity price rebates in Ontario caused the year-over-year headline and core inflation rates to rise to 2.0 percent and 2.2 percent, respectively.

Monetary policy

5. ***On January 20, the Bank of Canada lowered its target for the overnight rate by 25 basis points to 2½ percent***. In the accompanying Monetary Policy Report update, the Bank noted that the strength of the Canadian dollar and signs of larger-than-earlier anticipated economic slack meant that additional monetary stimulus was required to support demand and return inflation to its target. In the update, the Bank scaled back its growth projection to 2¾ percent in 2004 and 3¾ percent in 2005, with the output gap expected to close only by the third quarter of 2005, and core inflation to fall below 1½ percent in early 2004, before returning to the 2 percent target by end 2005.

6. ***Financial markets appear to be pricing in a further cut in the overnight rate.*** Three-month treasury bill yields have remained about 25 bps below the Bank of Canada's overnight rate since the January 20 interest rate announcement in the context of the broader strengthening of the U.S. dollar in recent weeks—the Canadian dollar has fallen by about 4 percent against the U.S. dollar since mid-January.

Fiscal and other policy developments

7. ***The January Throne speech outlined the principal policy priorities of Prime Minister Paul Martin's government, which included the following commitments***:

- To assist local governments in funding infrastructure investment, with the government providing municipalities a rebate of their payments of Goods and Services Tax, at a cost to the federal government roughly of ½ percent of GDP annually.

- To preserve the sustainability of the health care system and work with the provinces on "the necessary reforms and long term sustainability of the health care system."

- To achieve the Kyoto Accord goals for greenhouse-gas emissions and increase funding for other environmental initiatives, including a ten-year, $3.5-billion plan to clean up contaminated sites (which has already been included in earlier budget projections.)

- To promote job training and higher education, including by calling for an overhaul of the Canada Student Loans program, creating new grants for postsecondary education, and expanding the benefits of education savings plans, especially for lower-income families.

8. ***In the period leading up to the 2005 Budget, the government has re-affirmed its commitment to preserving fiscal surpluses.*** In late December 2003, the new Finance Minister announced a freeze on large capital projects and limits on public sector employee pay rises, and introduced a Cabinet-led review of government program spending. In recent speeches, the Minister cautioned that the fiscal position will be under pressure both because of the impact of the economic situation on revenues and the need to fund new priorities, but he has stressed the government's continued commitment to fiscal surpluses and debt reduction.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/18
March 10, 2004

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

IMF Concludes 2004 Article IV Consultation with Canada

On February 18, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.[1]

Background

Canada successfully weathered the earlier global downturn, growing substantially faster than other G7 countries, but the economy softened beginning in late 2002 and growth slowed to only 1 percent during the four quarters to 2003Q3. Industrial production has been especially sluggish, with manufacturing output in November 2003 below its level a year ago. Low productivity growth, in part related to the cyclical downturn, caused unit labor costs to accelerate even in the face of modest wage increases.

Several adverse factors contributed to the slowdown: the SARS outbreak dampened domestic demand and tourism receipts in the second quarter, the discovery of one case of BSE in Alberta resulted in restrictions on beef exports, and electrical power blackouts caused a significant drop in production in August. Moreover, as the inventory/sales ratio rose above trend, significant de-stocking was triggered in 2003, especially in the automotive sector, which subtracted about 3 percentage points on average from annual growth in the second and third quarters.

In addition, the sharp and rapid appreciation of the Canadian dollar also weighed on demand. From late 2002 to end 2003, the domestic currency appreciated by over 20 percent against the U.S. dollar, and by close to 15 percent in real effective terms. This helped cause net exports to contract sharply, subtracting about 2½ percentage points from annual GDP growth during the four quarters to 2003Q3.

[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.

Nonetheless, domestic demand was supported by low interest rates and remained robust over 2003. Personal consumption rose by 4¼ percent in 2003Q3 from the same period in 2002, underpinned by a resilient labor market. Job creation was robust, especially in the service sector, and the unemployment rate edged down to 7.4 percent by end-2003, despite record high levels of labor participation. While strong consumption took the personal saving rate down to an unusual low of 1¼ percent, most household balance sheet indicators remain comfortable.

Low interest rates and pent-up demand also helped spur high levels of residential investment. In addition, following two years of decline, business fixed investment began to recover and purchases of machinery and equipment rose by over 5½ percent in real terms during the four quarters ending in 2003Q3, in response to the strength of corporate profits, low interest rates, and rising equity prices.

The opening of an output gap helped return inflation to the Bank of Canada's 1–3 percent target range. Staff estimates suggest that the economy moved from a position close to potential around the end of 2002 to roughly 1½ percent below potential by 2003Q3. The core CPI inflation rate had surged to just over 3 percent (12-month rate) in late 2002/early 2003, partly reflecting special factors including a spike in insurance premiums. However, as these special factors dissipated and excess capacity emerged, core inflation fell rapidly to 1½ percent in August, before edging up toward 2¼ percent by end 2003.

The weaker economy and lower inflation have led to a shift in the stance of monetary policy. During 2002, the Bank of Canada had begun withdrawing stimulus, reflecting concern that capacity constraints and demand pressures would push inflation above the target range. While geopolitical risks helped persuade the Bank to hold off from further interest rate hikes during late 2002 and early 2003, as these risks moderated, the Bank tightened further in March and April 2003, taking overnight rates to 3¼ percent. More recently, however, the Bank has responded to the slowdown in demand, the sharp appreciation of the exchange rate, and the drop in inflation, easing in July and September 2003, and then again in January 2004, to return overnight rates to 2½ percent.

The room for fiscal maneuver has narrowed over the last year. At the federal level, after achieving a federal surplus of C$7 billion (½ percent of GDP) in 2002/03, the economic slowdown and last year's budget initiatives—including a commitment to transfer additional funds to the provinces and territories for health care—appear likely to cause the surplus to decline appreciably in 2003/04. Nonetheless, the public debt-to-GDP ratio is expected to fall further and the federal authorities have indicated their continued commitment to rebuilding normal budgetary reserves and maintaining the debt ratio on a steady downward track. In support of this long-standing commitment, and to be able to advance on the initiatives announced in the recent Speech from the Throne, the government launched a major review of all expenditure programs, with the results of this exercise to be announced in the fall of 2004.

At the provincial level, despite the balanced budget commitments in many provinces, a sizable deficit has emerged for this year, reflecting pressures on the public health care system as well as costs related to the SARS/BSE outbreaks. Partly driven by balanced budget legislations, provinces have responded by delaying previously scheduled tax cuts and announcing spending cuts.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. In particular, they commended Canada's strong monetary and fiscal policy framework which, together with the structural reforms introduced since the early 1990s, has enabled the Canadian economy to respond flexibly to negative shocks in 2003 and provided a solid foundation for recovery.

Directors agreed that the near-term macroeconomic outlook appeared broadly favorable, with growth likely to rebound next year, underpinned by household spending and a quick pick up in business investment. Nonetheless, the recent softening of the economy underlined the downside risks, especially given the Canadian dollar's strength and the possibility that this could weigh heavily on net exports and domestic profitability.

Against this background, Directors agreed that macroeconomic policies should remain supportive. Given the limited room for fiscal maneuver under the existing medium-term budgetary framework, Directors observed that the principal responsibility for fostering a cyclical recovery lay with monetary policy.

In this regard, Directors welcomed the Bank of Canada's recent decision to lower interest rates. They acknowledged that special factors had clouded the signals provided by inflation data, and that considerable uncertainty was associated with estimates of the output gap. Nonetheless, with the apparent widening of the output gap, the appreciation of the Canadian dollar weighing on activity, and core inflation expected to remain low, Directors noted that there was room to cut interest rates further, if needed to support the ongoing recovery, especially in view of the credibility of the authorities' inflation target. They commended the transparency of the authorities' inflation targeting framework, while a few Directors saw merit in providing more detail regarding the Bank of Canada's macroeconomic forecasts.

Directors welcomed Canada's commitment to exchange rate flexibility, which had been helpful in facilitating the adjustment to global macroeconomic imbalances. Although the speed and extent of the appreciation of the Canadian dollar had raised concern, they did not view the exchange rate as significantly out of line with underlying fundamentals, especially considering Canada's current account surplus and improved net foreign liability position, and supportive world commodity prices.

Directors commended the authorities' overall fiscal framework, which had been remarkably successful in achieving substantial debt reduction over the past decade and has left Canada relatively well-positioned to cope with the fiscal burdens stemming from population aging. However, with pressures on pension and health care systems likely to grow in coming decades, they agreed that federal and provincial fiscal authorities would need to sustain debt reduction. Several Directors believed that the existing two-year budgetary planning framework could usefully be complemented by a clearer longer-term anchor, and expanded to allow for more flexibility over the cycle, though others thought the existing framework was adequate to sustain Canada's strong fiscal performance.

Directors noted that challenges had emerged in the context of the short-term fiscal outlook, especially in light of the economic slowdown and the spending initiatives introduced with the 2003 Budget, particularly on health-care related transfers to the provinces. They suggested, therefore, that the forthcoming budget demonstrate a firm commitment to rebuilding normal budgetary reserves. Directors also welcomed the authorities' recent commitment to introducing a comprehensive expenditure review and shifting fiscal priorities toward expenditure control. Although they did not see a need for broad-based tax cuts, they observed that there was still scope to improve incentives in the tax system to facilitate labor and capital market efficiency and maintain competitiveness vis-à-vis the United States. They also encouraged efforts to ensure that the withdrawal of social benefits at the low end of the income scale did not result in excessive marginal effective tax rates.

Directors cautioned that difficult spending issues at both the federal and provincial levels still need to be tackled. They supported the recent federal-provincial Health Accord as a means to provide greater certainty regarding the funding for provincial health programs, but saw scope for strengthening incentives to contain health care costs and usage. Directors highlighted the importance of ensuring that amendments to the system of federal-provincial equalization payments reduce its complexity, and contain the burden on the federal budget.

Although the public pension system and other age-related programs appear sound, Directors agreed that further reforms may still be warranted. For example, they considered that improving the actuarial fairness of the adjustment to Canada Pension Plan (CPP) benefits for those who retire before or after the statutory retirement age, or gradually rising the retirement age to take into account increases in longevity, could help encourage labor market participation and possibly enable an eventual reduction in the CPP premium rate.

Directors noted the resilience of the Canadian financial system in the face of recent shocks, and commended the authorities' sound regulatory framework and proactive efforts to strengthen corporate accounting and governance standards. In their view, the need to ensure the soundness, efficiency, and global competitiveness of the Canadian financial sector argued in favor of harmonizing securities market regulation and legislation—including in the context of the establishment of a single regulator. Similarly, the recent weaknesses of some defined-benefit pension plans illustrated the potential benefits of strengthening disclosure requirements and rules governing contribution holidays, and of further harmonizing federal-provincial regulation and supervision. With respect to bank merger proposals, Directors also welcomed efforts to increase the transparency of the process and criteria governing them in order to facilitate the Canadian financial system's response to increasing global competition.

Directors observed that the use of the employment insurance system to fund broader social policy objectives has resulted in cross-subsidization across industries and regions. They suggested, therefore, that the pending review of the system be used as an opportunity to consider experience-rated premiums and alternative funding options.

Some Directors observed that the gap in productivity between the United States and Canada has widened slightly in recent years, and they encouraged continued efforts toward reforms that would enhance the efficiency of the Canadian economy, including with regard to barriers to foreign direct investment and inter-provincial trade.

Directors remarked favorably on the openness and transparency of Canada's external trade system, and noted that easing import barriers further—especially in the area of agriculture—would encourage greater competitive efficiencies and complement Canada's overseas development objectives. They encouraged the authorities to play a leadership role in efforts to bridge differences among the participants of the Doha Round. They also welcomed Canada's commitment to achieve its goal of increasing overseas development assistance.

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

Table 1. Canada: Selected Economic Indicators 1/

(Annual change in percent, unless otherwise noted)

	1997	1998	1999	2000	2001	2002	est. 2003
Real GDP	4.2	4.1	5.5	5.3	1.9	3.3	1.6
Net exports 2/	-1.7	1.7	1.4	0.6	0.6	-0.3	-2.5
Total domestic demand	5.7	2.4	4.1	5.0	1.7	3.4	4.4
Final domestic demand	5.4	2.8	4.2	4.0	3.2	2.9	3.9
Private consumption	4.6	2.8	3.8	4.0	2.6	3.4	3.8
Public consumption	-1.0	3.2	2.1	2.6	3.7	3.0	3.5
Private fixed domestic investment	18.1	2.8	6.2	5.8	3.5	-0.2	4.3
Private investment rate (as a percent of GDP)	17.5	17.7	17.4	17.0	17.4	17.0	16.8
Public investment	-3.2	-0.7	15.6	3.4	10.3	11.8	4.8
Change in business inventories 2/	0.7	-0.3	0.1	0.8	-1.6	1.8	0.1
GDP (current prices)	5.5	3.7	7.4	9.5	3.0	4.3	5.2
Employment and inflation							
Unemployment rate	9.1	8.3	7.6	6.8	7.2	7.7	7.6
Consumer price index	1.6	1.0	1.7	2.7	2.5	2.3	2.8
GDP deflator	1.2	-0.5	1.7	4.0	1.1	0.9	3.5
Exchange rate (period average)							
U.S. cents/Canadian dollar	0.72	0.67	0.68	0.67	0.64	0.64	0.72
Percent change	-1.8	-6.8	0.6	-0.3	-4.2	-1.1	12.9
Nominal effective exchange rate	0.2	-6.0	-0.6	1.2	-3.0	-1.8	9.8
Real effective exchange rate	2.6	-6.3	-1.1	0.0	-4.0	-0.4	12.1
Indicators of financial policies (national accounts basis, as a percent of GDP)							
Federal fiscal balance	0.7	0.8	0.9	1.8	1.2	1.0	0.6
Provincial fiscal balance 3/	-0.2	-0.6	0.6	0.8	-0.3	-0.9	-1.2
General government	0.2	0.1	1.6	3.0	1.4	0.8	0.3
Three-month treasury bill	3.2	4.7	4.7	5.5	3.9	2.6	2.9
Ten-year government bond yield	6.1	5.3	5.6	5.9	5.5	5.3	4.8
Balance of payments							
Current account balance (as a percent of GDP)	-1.3	-1.2	0.3	2.9	2.4	2.0	2.1
Merchandise trade balance (as a percent of GDP)	2.9	2.6	4.3	6.3	6.4	5.0	5.0
Export volume	8.5	8.5	11.7	9.3	-3.5	0.2	-2.4
Import volume	16.5	6.1	8.5	8.6	-5.6	1.4	3.3
Invisibles balance (as a percent of GDP)	-4.2	-3.8	-4.0	-3.5	-4.0	-3.0	-2.9
Saving and investment (as a percent of GDP)							
Gross national saving	19.6	19.1	20.7	23.8	22.4	21.9	22.1
General government	2.2	2.1	3.6	5.2	3.6	3.2	2.7
Private	17.4	17.0	17.1	18.6	18.8	18.8	19.4
Personal	6.0	6.1	5.3	5.5	5.6	5.4	7.0
Business	11.4	10.9	11.7	13.1	13.1	13.3	12.4
Gross domestic investment	20.7	20.5	20.5	20.4	19.7	19.9	20.0

Sources: Statistics Canada; and IMF staff estimates.

1/ Data as available at the time of the Executive Board Discussion on February 18, 2004.
2/ Contribution to growth.
3/ Includes local governments and hospitals.