



CANADA

2012 ARTICLE IV CONSULTATION

February, 2013

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 2012 Article IV consultation with Canada, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 18, 2012, with the officials of Canada on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 25, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice (PIN)** summarizing the views of the Executive Board as expressed during its February 11, 2013 discussion of the staff report that concluded the Article IV consultation.

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

Selected Issues Paper

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

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**International Monetary Fund
Washington, D.C.**



CANADA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

January 25, 2013

KEY ISSUES

Context. Growth slowed in 2012, as fiscal consolidation and high levels of debt weighed on households consumption, while external headwinds depressed exports and business spending. Growth is expected to accelerate again from mid 2013 as the global economy improves, but the balance of risks remains tilted to the downside as concerns linger over the external environment and the unwinding of domestic imbalances.

Policy mix. The return to more neutral interest rates should be delayed until there are signs of a sustainable acceleration in growth. There is some space to cut rates if activity were to weaken significantly. The pace of fiscal consolidation is appropriate under the baseline scenario. Automatic stabilizers should be allowed to operate if growth disappoints, while temporary fiscal stimulus could be considered in the event of a large adverse shock, especially at the federal level. It will be important to continue to address long-term spending pressures from population ageing and increasing health-care costs.

Containing domestic imbalances. The high level of household debt makes the Canadian economy more vulnerable to adverse shocks. The macro-prudential measures adopted by the authorities seem to have reduced some of the exuberance in mortgage credit and the housing sector. But more measures may be needed if the household debt-to-disposable-income ratio continues to rise.

Structural reforms. Increasing labor productivity remains a priority, to help support structural adjustment in the economy associated with a growing commodity sector and a strong currency. It will be important to continue pursuing measures that boost innovation, promote trade, and attract foreign direct investment.

Policy response to past advice. In recent years the authorities have taken several measures to support the long-term stability of the housing market and limit the increase of household debt. These measures have been consistent with policy recommendations contained in past reports, in particular the introduction of macro-prudential measures and enhancements to the governance and oversight of CMHC. The authorities' progress in fiscal consolidation has been supported by staff, which saw it as a necessary step to rebuild the fiscal space. Continued efforts at the federal and provincial level to introduce a single security regulator are also in line with past staff advice.

Approved By
**Gian Maria
 Milesi-Ferretti and
 Tamim Bayoumi**

Discussions took place in Toronto and Ottawa during December 3–18, 2012. The team comprised Roberto Cardarelli (head), Paulo Medas, and Julien Reynaud (all WHD), Ivo Krznar (MCM) and Mika Saito (SPR). Mr. Gian Maria Milesi-Ferretti joined the mission for the policy meetings in Ottawa.

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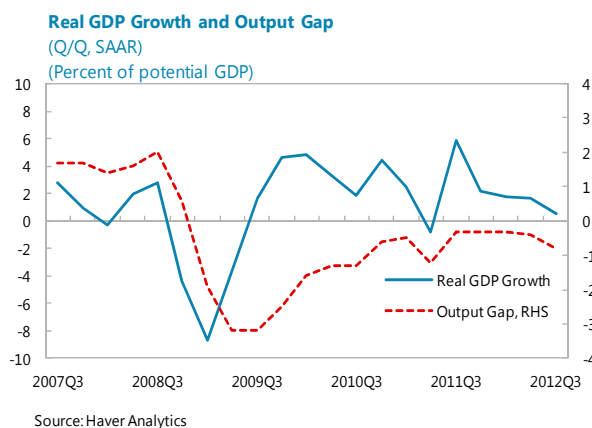
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RECENT DEVELOPMENTS

1. After recovering rapidly from the Great Recession, the Canadian economy slowed in 2012. Supported by the strong monetary and fiscal policy response and a quick rebound in the terms of trade, the Canadian economy grew well above potential in 2010–11. However, growth weakened in the first three quarters of 2012 (Chart) and recent indicators suggest the pace of economic expansion remained subpar in the fourth quarter, with growth estimated to have fallen to 2 percent on average for the whole year.



2. The weaker economic momentum reflects lower growth of private domestic demand. Private consumption weakened on the back of slower disposable income growth, owing to lower net transfers from government, and the lackluster growth of real wages, reflecting low productivity growth and unemployment still hovering around 7¼ percent in 2012 (Figure 1). Private consumption was also dampened by sluggish consumer credit growth, as the record-high household debt induced more caution in borrowing, while access to home equity lines of credit was tightened by the authorities (Figure 2). The housing sector also cooled off over the past few months, especially in the large metropolitan areas of Toronto and Vancouver, with home sales and construction activity moderating since the summer of 2012 (Figure 3 and Box 1). Business investment, a key driver of growth after the 2008–09 recession, retrenched somewhat in the second half of 2012, reflecting increased uncertainty on the global outlook.

3. External demand hasn't picked up the slack, and the current account continued to deteriorate. After growing strongly in 2011, exports contracted in the first three quarters of 2012, owing to weaker external demand and the strong currency, boosted by capital inflows attracted by Canada's safe haven status (Figure 4). Weaker export growth and the worsening of the terms of trade led to a rise in the external current account deficit to 4 percent of GDP in the first nine months of 2012.

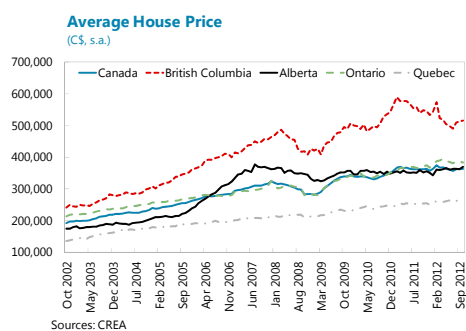
Box 1. Canada's Housing Sector: A Soft Landing Scenario

House price growth moderated in 2012, although with some regional variation. National house prices fell 1.2 percent over the second half of 2012, driven mainly by the sharp retrenchment in British Columbia (Chart). In turn, this was mainly the consequence of a sharp correction of prices in the Vancouver area, where condos prices were down to their 2010 levels as of December 2012. On a yearly basis, national house prices index is still up by about 3.5 percent in 2012, slightly down from the 6 percent growth in 2011, with Toronto, Calgary and in particular Regina posting the largest increases.

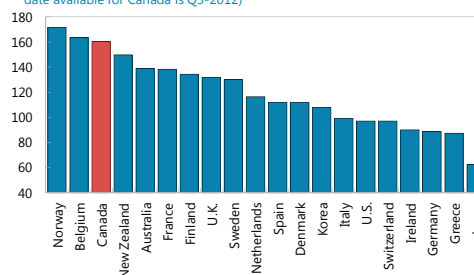
Simple indicators suggest house prices are still on the strong side. As of December 2012, at a national level house prices were still almost 30 percent above their January 2009 trough. In Q3:2012, the house price-to-rent ratio was 60 percent above its historical average in Canada, more than in any other advanced economies with the only exception of Norway and Belgium (Chart). Price-to-income ratios also look high, and at almost 40 percent above their long-term average are among the highest (Chart).

Staff econometric analysis suggests that Canadian house prices are above levels consistent with fundamentals. Following models used in previous Canada's Article IV consultations (see Tsounta, 2009 (www.imf.org); and Celasun et al., 2011 (IMF Country Report No. 11/365)) we regressed Canadian house prices on a set of variables that are commonly believed to influence the demand and supply of housing (including immigration growth, real disposable income per capita, real mortgage rates, and the terms of trade). Using different model specifications suggests that, as of Q3:2012, national house prices are 10–15 percent above the level consistent with fundamentals (Chart).

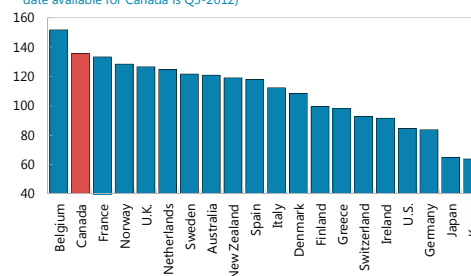
There is also some evidence of overbuilding. Despite falling in real terms since the second quarter of 2012, residential investment continued to increase as a share of GDP and reached a two-decade high of about 7 percent. After a sharp contraction during the 2009 recession, housing starts have rebounded sharply to early 2000s levels, at a pace faster than household formation. Using different metrics, Chapter 2 of the Selected Issues Paper finds a relatively modest excess housing supply at the national level in Canada. Most of the excess supply is concentrated in Ontario and Quebec.



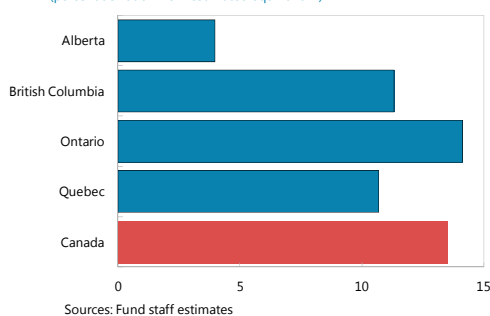
Price-to-rent Ratio: Level Relative to Long-term Average
(Average from 1980, or earliest available, to latest quarter available = 100, latest date available for Canada is Q3-2012)



Price-to-income Ratio: Level Relative to Long-term Average
(Average from 1980, or earliest available, to latest quarter available = 100, latest date available for Canada is Q3-2012)



Estimated house prices overvaluation
(percent deviation from estimated equilibrium)



Box 1. Canada's Housing Sector: A Soft Landing Scenario (concluded)

We anticipate a gradual adjustment of these excesses in our baseline scenario. In this scenario, Canada's terms of trade will remain relatively flat over the next five years, employment will grow at about 1 percent per year, and mortgage rates will begin to increase gradually since late 2013. Based on these assumptions, a 1 percent yearly decline in real house prices would be enough to absorb the estimated current overvaluation by the end of the forecast horizon (2017). Based on this path for house prices, our housing stock model predicts the number of housing starts to fall over the next three years to around 165 thousand new units per year. This is consistent with residential investment falling below 6 percent of GDP over the next three years, before picking up again and setting to a level above the historical average (6.5 percent of GDP) by the end of our forecast horizon.

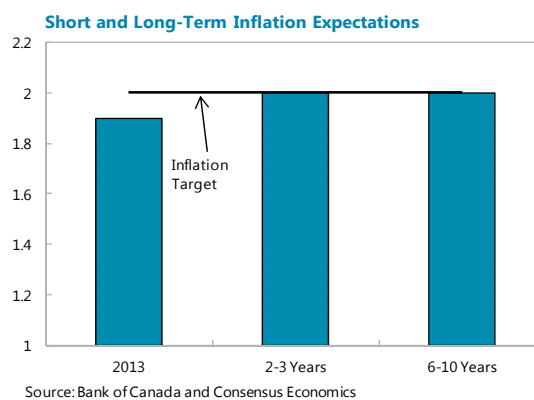
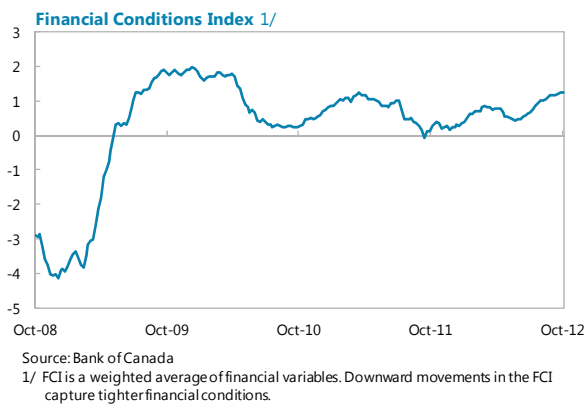
The weaker housing sector is expected to subtract about 0.4 pp to GDP growth yearly over the next five years. Lower residential investment will subtract 0.1 pp to GDP growth in both 2013 and 2014. Based on staff estimates of the wealth effect in Canada (IMF Country Report No. 11/365), the projected cumulative -11.5 percent reduction in real house prices over the next five years would subtract 0.3 pp to private consumption (about 0.2 pp to GDP growth). This is likely to underestimate the impact on consumption though, as weaker house prices would also limit households' ability to access liquidity using their homes as collateral, and thus the role of home equity extraction in financing consumption. Bank of Canada (2011) shows that 2 percent of aggregate consumption was financed by home-equity extraction at the end of 2010. Assuming that our projected decline in house prices will reduce home-equity extraction by one half, private consumption will decline -0.5 pp per year, corresponding to a 0.3 pp decline in GDP.

A worse scenario is also possible if labor market turned out weaker than expected. Under a relatively mild alternative scenario in which employment is kept at its 2012 level, staff estimates that house prices would decline by almost 3 percent per year over the next five years, a cumulative decrease of about 18 percent by 2017. In such a scenario, the subtraction to GDP growth would be as high as $\frac{2}{3}$ pp yearly.

4. Fiscal policy has also continued to be a drag on growth, as the stimulus is being withdrawn. Fiscal consolidation continued in 2012, with the federal government leading the effort and most provinces proceeding with their consolidation plans. As a result, the contribution to growth from government consumption and public investment is expected to have turned negative in 2012, for the first time since 1997. The general government cyclically-adjusted fiscal deficit fell by a cumulative estimated $1\frac{3}{4}$ percentage points between 2010 and 2012, mainly reflecting cuts in spending (Figure 5). Net public debt is estimated to have reached $34\frac{1}{2}$ percent of GDP in 2012 (with gross debt at about 85 percent of GDP), but remains below many other advanced economies.¹

¹ The difference between gross and net debt is accounted by financial assets, predominantly held by sub-national governments (about 35 percent of GDP). At the federal level, financial assets are mainly government claims on Crown enterprises (loans to state-owned enterprises, equity, and foreign exchange reserves kept at the Central Bank). At the sub-national level, about half of the assets are financial investments (e.g., securities, domestic and foreign shares). See 2011 Staff Report and Selected Issues for more details.

5. These headwinds have been only partly offset by an improvement in financial conditions in 2012 (Chart). Canadian financial markets have benefited from improved global financial conditions and credit conditions remaining highly favorable, with credit spreads on corporate bonds continuing to narrow and some further easing in business lending conditions in 2012 (Figure 6). The policy rate has remained exceptionally accommodative, at 1 percent since September 2010 (Figure 7), in a context of well-behaved inflation expectations (Chart) and significant external headwinds. Headline and core inflation are well below the 2 percent target, partly reflecting the persistence of some slack in economic activity (with the output gap estimated at about 1 percent as of end 2012) and the strength of the currency.



OUTLOOK AND RISKS

6. Growth is expected to gain new momentum over 2013. We expect economic activity to grow at a pace slightly above potential (estimated at about 2 percent) from the second half of the year, thanks to the strengthening of the U.S. economy from mid-2013 as envisaged by the January 2013 update of the *World Economic Outlook*. However, the negative carry-over from a weak second half of 2012 means that the average rate of growth for 2013 is expected to be a modest 1.8 percent. After 2013, annual output is expected to accelerate to slightly below 2½ percent, a pace consistent with a gradual absorption of the output gap and a gradual convergence of unemployment to its natural rate (estimated by staff at about 6¾ percent).

7. This forecast is based on a smooth rotation over the medium term of the main drivers of growth away from private consumption and residential investment, and toward net exports and business investment. Canada's rapid recovery from the Great Recession was built in part on the resilience of private consumption and residential construction. But with elevated house prices and both residential construction-to-GDP ratio and the household debt-to-income ratio at historically high levels, the prospects for both sources of demand have weakened. Staff projections are based on the assumption that domestic imbalances will unwind gradually and that domestic demand will return to a more sustainable pace of growth while the slack in the external sector is gradually reabsorbed as the United States closes its output gap. In particular we assume that:

- **As external conditions gradually improve, activity will receive a boost from net exports.** After subtracting from growth for the last decade, the net export contribution to annual GDP growth is expected to turn positive and average 0.3 pp over 2014–18. The current account deficit

is expected to gradually improve to 2¾ percent of GDP over the medium term, on the back of stronger demand from the United States.

- **Business investment will be a key driver of domestic demand, with consumption remaining subdued as household leverage stabilizes.** Business investment is expected to strengthen, sustained by reduced global uncertainty, strong capital spending in the energy sector, still easy financial conditions, and relatively cheap imported capital goods. As discussed in Box 1, we expect national house prices to grow slightly below inflation over the medium term, and household savings to gradually rise as macro-prudential measures and higher interest rates curb the demand for housing credit. Private consumption and residential investment are therefore likely to grow at a more moderate pace than before the 2008–09 recession.
- **Fiscal policy will continue to hamper growth, although less so than in 2012, while monetary policy will remain highly accommodative.** Fiscal policy will remain a drag on growth as the federal and provincial governments implement their consolidation plans. In particular, the annual fiscal impulse is envisaged to be around -0.6 percent through 2015, with a drag on yearly GDP growth of about 0.5 pp. Policy rates are expected to increase in Q3:2013, and to return to more neutral levels only very gradually over the next 4 years.

8. The balance of risks is tilted to the downside, as near-term uncertainty remains elevated. Canada is particularly vulnerable to three possible external shocks:

- **Continued uncertainty over fiscal policy in the United States.** The United States is Canada's largest trading partner, absorbing about two thirds of total Canadian merchandise exports, and with significant financial linkages to Canada. Even if an agreement has been reached in the United States to avoid the full materialization of the "fiscal cliff", failure to raise the debt ceiling expeditiously may bring back the risk of heightened uncertainty and financial market disruption. Stronger U.S. fiscal consolidation than currently envisaged in our baseline, for example through a materialization of the "sequester" in early 2013, could also subtract to growth.
- **Further distress in European sovereign debt markets.** Canadian banks' direct exposure to European countries is moderate, representing about 5 percent of their overall assets. However, a deterioration of the euro area debt crisis could have significant indirect spillovers to Canada, through its impact on the U.S. economy and global financing conditions. Reduced credit availability and higher funding costs would affect both Canadian non-financial businesses (about ½ of their funding comes from abroad) and Canadian banks, which have a non-negligible dependence on wholesale funding (Annex I).
- **A fall in global commodity prices, particularly if driven by stress in emerging markets.** While China accounts for less than 5 percent of Canada's total exports, a hard landing in China could have a material impact if it were to lead to a generalized fall in commodity prices (Annex I).

9. Domestic imbalances make Canada more vulnerable to these possible shocks. While the risk exists that the unwinding of domestic imbalances will prove less gradual than we anticipate in

our baseline (see Box 1 and Selected Issues, Chapter 1), Canada is unlikely to suffer from a house boom-and-bust similar to the one that occurred in the United States. This reflects Canadian banks' more conservative lending practices, relatively high levels of housing equity, and the government-backed insurance for mortgages with high loan-to-value (LTV) ratios. But high household debt and an exuberant housing market make Canada more vulnerable to adverse macroeconomic shocks, particularly to a tail-risk downside global scenario in which external demand weakens, commodity prices fall, and global financial conditions tighten at the same time. The impact on economic activity from these shocks could be exacerbated by the distress among some highly indebted Canadian households, with a negative impact on banks' balance sheets, house prices and construction, and the potential for a negative feedback loop into the real economy.

Canada—Risk Assessment Matrix

Nature/Source of Threats	Likelihood	Expected Impact on Economy
Intensification of the euro area crisis	<i>Medium</i>	A spike in global risk aversion and counterparty risk would tighten financial conditions and weaken demand (Annex I). Lower interest rates and fiscal automatic stabilizers would sustain demand. If contagion were severe, authorities could alleviate financial market disruptions by providing liquidity support and could buffer the economy through a new fiscal stimulus.
Uncertainty over fiscal policy in the U.S. (debt ceiling negotiations; sequester)	<i>Low-Medium</i>	Uncertainty over raising the U.S. debt ceiling could lead to tighter financial conditions, and larger-than-currently projected spending cuts would hurt growth. For example, the "sequester" would subtract between $\frac{1}{4}$ and $\frac{1}{2}$ of a percentage point to Canada's growth in 2013 (or about three-fourths of the expected U.S. impact).
Weaker growth in Emerging Markets leading to lower commodity prices	<i>Low</i>	A significant fall in commodity prices would hurt Canada's terms of trade and trigger a fall in income, employment, and house prices. The impact would likely be partially softened by a weakening of the Canadian dollar, whereas lower interest rates and fiscal automatic stabilizers would sustain demand (Annex I).
Sharp fall in house prices	<i>Low</i>	A sharp fall in house prices is unlikely to provoke financial system stress or induce large direct fiscal losses from CHMC insurance outlays. But given the high level of household debt, it could weaken consumption growth and residential investment. For example, in a scenario where the adjustment in the housing market is more abrupt than assumed in the baseline (and involves a 10 percent fall in house prices in one year), private consumption would be around $\frac{3}{4}$ percent weaker in 2013 (Selected Issues, Chapter 1)

POLICY DISCUSSIONS

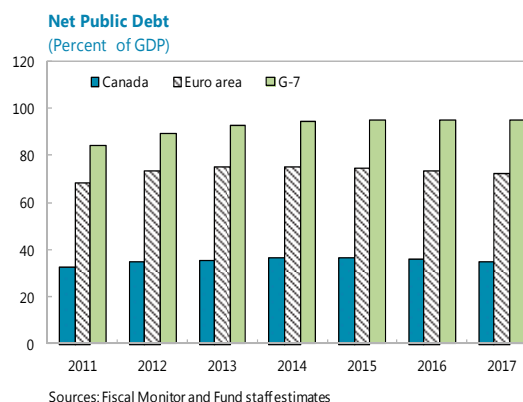
The policy discussion focused on the need to sustain growth in the short term while gradually unwinding domestic imbalances, maintaining the fiscal position on stable footing, and progressing with the financial regulatory reform agenda. The discussions also touched on policies to boost Canada's external competitiveness and take into account the macro-economic and fiscal impact of commodity price volatility.

A. Monetary Policy: A Gradual Normalization of Rates

10. The discussion on monetary policy focused on the appropriate stance in the face of a weaker economy and domestic imbalances. Staff argued that the beginning of the tightening cycle should be made conditional to growth regaining a stronger momentum, and therefore should be delayed towards late 2013 (in line with staff's baseline scenario). The authorities noted that monetary policy will react as usual to the changes in the economic outlook but will also take into account the evolution of domestic imbalances, although monetary policy should be seen as a last line of defense against the risk of financial instability. While supporting the highly accommodative monetary policy stance, the mission noted there is some space for further easing if the economy were to weaken further. The authorities emphasized that maintaining rates at the current low levels already provides stimulus to economic activity. But staff and authorities agreed that in the event of a significant negative economic shock there would be room for conventional monetary easing and that, if needed, other tools could be used, including forward guidance and liquidity support.

B. Fiscal Policy: Striking The Right Balance Between Rebuilding Fiscal Space And Supporting Growth

11. Although Canada is in a stronger fiscal position than many other advanced economies, the ongoing consolidation effort is important to rebuild the fiscal buffer against future adverse shocks. While the federal government is likely to achieve a balanced budget by 2016, the consolidation process for some of the largest provinces is likely to be more demanding. In some cases, their consolidation plans mainly rely on ambitious spending cuts, including freezes on wages that will be difficult to sustain in the medium term. Hence, there will be increased pressure to raise revenues (some provinces have already started to do so). The general government gross debt is expected to fall below 80 percent of GDP by 2017, with the net debt-to-GDP ratio declining by 2015, in line with the 2010 Toronto G-20 commitments (Chart).



12. The mission noted that the authorities have the policy space to adjust to a deterioration in the economic outlook. While the pace of the consolidation is appropriate under

the broadly benign medium-term scenario, staff noted that the federal government and provinces with stronger fiscal positions have room to allow the full impact of automatic stabilizers if the economy proves weaker than expected. While this could delay achieving the government timetable for a return to a nominal (as opposed to a structural) balanced budget, it would provide important support to activity while having only a modest impact on debt levels. The federal authorities agreed there was policy room for a flexible response and noted that the budget already includes a margin to take into account the risk of slower economic growth and weaker revenues. Both staff and authorities agreed that fiscal measures could be considered in the event of a large adverse shock.

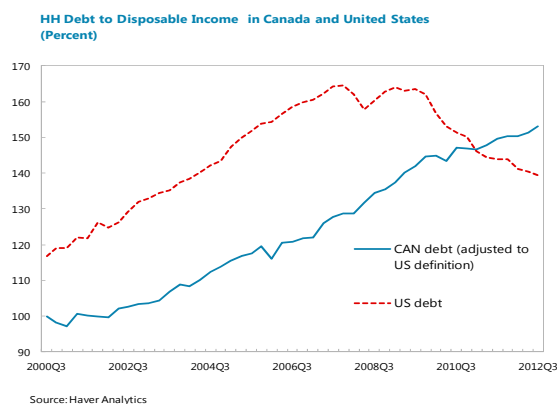
13. Canada will need to make further headway in addressing spending pressures from population aging and the rising cost of providing health care. The federal authorities have taken several measures to contain future pension costs and announced nominal growth caps to their transfers to provinces, including on those that finance health-care spending. Also as a result of these measures, the federal government's finances are on a solid path (Annex II). But placing the general government debt on a sustainable long-term path will require renewed efforts to contain health-care costs. The authorities argued that the burden rests with provinces as they have the responsibility for providing health care. While acknowledging that provinces will have to shoulder the main burden of the adjustment, staff argued that achieving long-term fiscal sustainability should be considered as an objective for Canada as a whole, as failing to do so would have negative consequences for the economy and all levels of government. In this context, staff encouraged the authorities to publish a comprehensive fiscal sustainability report for the general government, for example every 3–5 years, which would review the progress achieved at each level of government and include a discussion of policy options to help gain the necessary public support for reforms. In 2012 the federal government published a fiscal sustainability report for the federal level. Federal authorities noted that the federal government is not accountable for the fiscal situation of the provinces, and that it would continue to publish long-term fiscal analyses for the federal government annually.

C. Addressing Domestic Imbalances

14. House price growth and residential investment have moderated somewhat recently but remain high relative to fundamentals. Residential investment was about 7 percent of GDP as of Q3:2012, well above its historical average, and there is evidence of some modest overbuilding (Selected Issues, Chapter 2). At the national level, house price growth has decelerated somewhat in recent months, but staff estimates suggest prices are still above levels justified by fundamentals, although with significant variation across provinces (Figure 3 and Box 1). The strong housing market has been fuelled by the very low interest rates and abundant supply of mortgage credit, which was still expanding at a robust pace as of Q3:2012, although well below the double digit pace of growth achieved right before the 2008–09 recession. The authorities agreed there has been some exuberance in the housing sector, with evidence of modest overbuilding and stretched house valuations in some markets, but noted that the adjustment was already ongoing and that absent a severe shock on economic activity (involving a large and persistent increase in unemployment), the correction would likely proceed gradually over the next few years.

15. Staff welcomed the measures taken over the last few years to moderate the expansion of mortgage credit and house prices. Research by staff (Selected Issues, Chapter 3) suggests that the macro-prudential measures taken since 2008 to tighten eligibility rules for government-backed mortgage insurance have had some effect. A new round of macro-prudential measures was introduced in July 2012, and was complemented by a tightening of lending mortgage standards (effective by end of fiscal year 2012); a strengthening of the governance and oversight framework of the Canada Mortgage and Housing Corporation (CMHC), a major provider of government-backed mortgage insurance; and the decision to prohibit the issuance of covered bonds backed by government-backed insured mortgages. At the same time, CMHC has limited the availability of insurance for loans with low LTV ratios, used primarily for securitization purposes. While noting that it was too early to assess the impact of these measures, the authorities were confident that they would help support the long-term stability of the housing market over time.

16. Staff noted that additional policy action may be needed if household imbalances continue to rise. Despite the measures adopted, the household debt-to-income ratio has continued to increase in 2012 and reached a new record high of about 162 percent in Q3:2012 (equivalent to 153 percent when adjusted to U.S. definition, Chart). The mission stressed that a tighter macro-prudential regime might need to be considered if household leverage kept rising, in order to reduce Canada's vulnerability to adverse shocks. These measures could include higher down-payment requirements (tighter LTV limits for first buyers), lower caps on debt-service-to-income ratios, and tighter LTV ratios on refinancing. Staff recommended that a gradual approach would be most appropriate in this case, as a further tightening of the rules for government-insured mortgages could have stronger-than-desirable effects. The authorities reported that they continue to monitor developments in the housing market and would consider further action if necessary. Staff enquired whether authorities would consider differentiating measures across provinces, so as to target areas with more buoyant housing sectors. The federal authorities noted that regional supervisors could tighten underwriting standards if they considered it necessary. While staff suggested there could be room to improve the macro-prudential framework by giving a clear mandate to a committee of regulators chaired by the Bank of Canada, the authorities stressed that the current framework (with multiple agencies exchanging information through several committees, and the Department of Finance ultimately accountable for financial stability) has worked well and fits better in Canada's overall institutional framework.



D. Canada's Financial System: Outlook and Reforms

17. With the Canadian financial system remaining sound, the discussion focused on the risks from an intensification of stress in global financial markets and the low interest rates environment.

- Canada's banking system is well capitalized, profitable, and continues to show low nonperforming loans.** Canadian banks reported solid earnings in the first three quarters of 2012, driven by consumer and commercial loan volumes, improved capital markets results, and higher fees. Tier 1 capital levels have remained above 13 percent, while leverage has increased slightly in 2012, but is still below pre-crisis levels. Going forward, however, pressures on margins from low interest rates and lower growth in household loans may induce banks to increase their exposure to more volatile capital market operations and expand more aggressively abroad (Chart). The authorities indicated that there is little evidence of excessive risk taking so far and noted that banks' expansion abroad helps diversify risks and is primarily in sectors where they have a comparative advantage.
- Stress-testing scenarios developed by the authorities show manageable losses for the financial system under adverse scenarios.** Authorities noted that their stress tests are based on a severe deterioration of macroeconomic conditions, although existing models do not yet fully capture second-round effects from loss of confidence and liquidity dry outs. The favorable test results reflect the strong position of Canadian banks, their conservative lending practices under strong supervision, and the broad extension of government-backed insurance for mortgages with high LTV ratios. As a result, while mortgages and home equity lines of credit represent their single largest exposure, Canadian banks are largely protected from a house price downturn and would suffer greatly only in case of a large and persistent increase in unemployment. The mission argued that Canadian banks would be affected by increased global financial turbulence mainly through a squeeze in wholesale funding, as in the 2008–09 crisis, and underscored the importance of banks having appropriate liquidity buffers. The authorities agreed and noted they stand ready to provide liquidity support in case of spillovers from severe distress in international financial markets. Staff argued in favor of publishing the results of the stress tests, as this would promote a better awareness of the risks, induce more realistic risk pricing, and enhance market discipline. OSFI believes, among other matters, that markets should be doing their own credit assessments (not relying on regulatory stress tests, which creates moral hazard), and that publicly disclosing stress test scenarios and results could undermine

Canadian Largest Banks: Source of Profits by Geographical Region
(Billions of Canadian Dollars)



their effectiveness, as doing so might incent regulators to limit the scope or severity of the scenarios.

- **Low interest rates have also continued to put pressures on the balance sheets of institutions with long-duration liabilities.** Canadian pension plans are facing solvency deficits, partly as a result of low long-term yields and more challenging equity markets, and in some cases have received relief from provincial governments. Pension funds are trying to reduce their exposure to interest rate risk by using liability-driven investment strategies, in a few cases involving leveraged positions (e.g., interest rate swaps and repurchase agreements). The life insurance sector is equally being affected by the low interest rates environment, and is posting financial results below historical averages. Life insurance companies are trying to mitigate those risks mainly by re-pricing and redesigning products, but also by investing more in alternative, non fixed income, assets. The authorities highlighted that they are closely monitoring whether actions taken in response to low interest rates could expose pension plans and life insurance companies to new risks.

18. Canada continued to push ahead with financial reforms, including the transition to Basel III (Box 2). The authorities decided for an early implementation of new Basel III capital requirements, by January 2013, and noted that the new guideline provides an option for implementing countercyclical capital buffers. Capital surcharges for domestically systemically important banks could be also introduced possibly in 2013. Moreover, a few provinces are planning to introduce Basel III capital standards for provincially-regulated financial institutions. Staff argued this would be a positive development, and that more in general it would be important to increase cooperation across federal and provincial regulators to ensure similar regulatory standards and a level playing field between federally regulated and large non-federally regulated institutions.

19. Staff and the authorities agreed that it would be important to adopt a single securities regulator. The authorities noted that efforts to adopt a single securities regulator for Canada are continuing, after a proposal in this direction was rejected by the Supreme Court of Canada. Staff supported the idea, arguing that a single regulator would reduce compliance costs, simplify the monitoring of systemic risk, and facilitate coordination with other agencies and policy intervention.

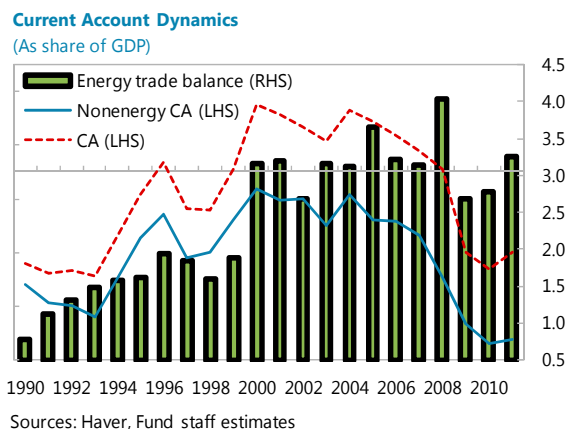
Box 2. Progress on Financial Reforms

The implementation of the financial reform has progressed well since the last Article IV mission. The authorities advanced on a number of regulatory initiatives, notably the implementation of new international capital standards, the development of central counterparties for clearing repo contracts, the definition of a credible resolution and recovery framework for major financial institutions, as well as the publication of proposals to improve the transparency of over-the-counter (OTC) derivative markets.

- Basel standards:** While Basel II.5 framework became effective on January 2012, OSFI has recently published guidelines to implement Basel III capital standards from January 1, 2013. The regulator is expecting all institutions to achieve target capital ratios equal to or greater than the 2019 minimum ratios (plus a conservation buffer) from January 2013. With regard to liquidity, OSFI plans to implement Basel III standards once they are finalized, and has implemented liquidity risk management guidelines in line with the BCBS principles in February 2012. Finally, to facilitate the adjustment to the new leverage requirement, the amount of total capital used to calculate the asset-to-capital multiple is expected to be calculated using transitional Basel III definitions.
- Repo markets:** To underpin the resilience of Canada's most important source of market-based financing, a new central counterparty (CCP) service for the Canadian repo markets has been introduced. The first phase, launched in February 2012, involved bilateral repo trades for government securities only. The clearing of cash trades and repo transactions negotiated by intermediaries is planned for implementation starting in early 2013. Reforms in this area will continue in 2013-2014, and will involve clearing general repo transactions in which any security can serve as collateral.
- OTC derivatives markets:** Canadian authorities are working to implement the G-20 commitments to reform OTC derivatives markets, so as to reduce counterparty risk and enhance transparency. In October 2012, the authorities announced that Canadian market participants will be allowed to centrally clear OTC derivatives at any central counterparty recognized by Canadian authorities, including global CCPs. In an effort to coordinate and harmonize the regulatory framework for OTC derivatives across provinces, the Canadian Securities Administrators laid several proposals to improve regulatory oversight of OTC derivatives transactions, including recommending mandatory CCP clearing and reporting to a trade repository.
- Resolution plans:** Federal authorities are making collaborative efforts to enhance the resolution framework for major banks by implementing resolution and recovery methods consistent with the FSB guidelines. The first generation resolution plans for the largest banks were completed by the end of 2012 and revised recovery plans are expected to be submitted in 2013. The implementation of Basel III is expected to further enhance Canada's bank intervention and resolution frameworks through the implementation of non-viability contingent capital.
- Regulation of credit rating agencies (CRAs):** In April 2012 a regulatory framework for the oversight of credit rating organizations was introduced. Under this framework, CRAs that apply for designation in Canada would have to: (i) maintain, enforce and comply with a code of conduct that is compatible with the International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals for Credit Rating Agencies; (ii) implement policies and procedures to identify and manage conflicts of interest in connection with the issuance of ratings and (iii) prohibit the issuance of ratings in the event of certain conflicts of interest.
- Reporting standards:** Canadian financial institutions, including banks and life insurance companies, moved to International Financial Reporting Standards (IFRSs) and Auditing Standards for fiscal years commencing in 2011.

E. Canada's External Stability and Competitiveness

20. The sharp decline in the current account over the past few years partly reflects Canada's large exposure to the U.S. business cycle. Canada's current account position has moved from a 2 percent surplus in the early 2000s to a 4 percent of GDP deficit in Q3:2012 (Chart). The deterioration reflects in part Canada's stronger recovery from the Great Recession relative to its main trade partners, and the United States in particular. Canadian exporters have also suffered disproportionately from the Great Recession, given their heavy exposure to some of the U.S. sectors hardest hit by the crisis (e.g., housing and automotive). While the recovery of the U.S. economy will help strengthen Canada's trade balance over time, staff argued that the full absorption of the U.S. output gap would still leave Canada's current account balance about 2–3 percentage points below its "norm".



21. Staff noted that the weaker external position also reflects more secular factors, including Canada's increased dependence on commodities.² The Canadian dollar has appreciated sharply over the past 10 years, reflecting to a large extent the increase in commodity prices over the same period (Selected Issues, Chapter 4). Based on staff estimates, Canada's real effective exchange rate is between 5 and 15 percent above the level consistent with long-term fundamentals (Annex III). The authorities emphasized that the currency's strength most recently owes to the strong capital inflows attracted by Canada's "safe haven" status. Staff's analysis shows that the stronger currency and the emergence of China as a trade competitor contributed to the decline of Canada's manufacturing market share in the United States over the last decade. The authorities only partially agreed with this view, and underscored that the shrinking manufacturing sector is a trend that Canada shares with all advanced economies. They also noted that while Canada's exchange rate has fluctuated over the past several decades, it is near the same level as it was in the mid-1970s, and therefore can not explain the secular decline in Canada's manufacturing sector.

22. In this context, both the authorities and staff agreed it would be essential to increase the competitiveness of Canadian firms and reduce their dependence on U.S. markets. Low productivity growth remains a major challenge for Canada—over the last decade, labor productivity growth was less than $\frac{1}{3}$ of the United States. While recognizing that this is a complex issue, and that

² Mining and oil/gas exploration rose from about 4 to about 10 percent of GDP between 1999 and 2008, while manufacturing fell from 19 to 11 percent of GDP in the same period. Also, the share of commodity (energy and metals) exports has doubled (to 40 percent of good exports) since 2000.

much has already been done (including through large cuts in corporate taxes and improvements in the employment insurance program and immigration system), staff and authorities agreed that further reforms are needed. In particular, there is room for a better, more targeted, public support to investment in research and development, and for measures aimed at increasing labor mobility and retrain the workforce towards sectors experiencing labor shortages. It will also be important to keep a favorable business environment for domestic and foreign investors, given Canada's large investment needs and potential benefits from increased competition. Continued efforts in opening up new markets, through multilateral and bilateral trade agreements, could also boost competition and innovation and further diversify trade towards markets with higher growth potential. Canada will also need to undertake large investments and address environmental challenges to fully benefit from its large energy reserves.

23. Staff suggested that a new fiscal framework could better manage the volatility associated with commodity prices. While Canada's flexible exchange rate regime provides an important buffer to external shocks, fiscal policy could also help manage the volatility associated with commodity prices. With oil-gas production and related tax receipts expected to more than double over the next decades, the mission argued it would be useful to start considering a fiscal framework designed to better mitigate the macro-economic and fiscal impact of commodity price volatility, including by adopting fiscal indicators that exclude revenues from the most volatile commodities (Box 3). Such framework could help stabilize the economy including by setting aside stabilization savings during commodity booms.³ The authorities agreed that this approach could be considered for resource-rich provinces, but was not appropriate for the federal government given its lack of resource royalties.

³ About 40 percent of commodity-related fiscal revenues (oil/gas and metals) go to the federal government. See reports from The Mining Association of Canada (Facts and Figures of the Canadian Mining Industry, 2011) and Canadian Energy Research Institute for more details.

Box 3. Policy Framework to Manage Nonrenewable Resources

Canada's energy sector is expected to become an increasingly important driver of the country's exports, economic activity and fiscal revenues. The non-energy trade deficit has grown significantly, backed by large net exports of energy. Commodity revenues are already a significant share of fiscal receipts for some provinces and are scheduled to grow for all levels of government, if Canada successfully develops its large energy reserves. This poses new policy challenges for Canada, mainly from the increased exposure to large swings in commodity prices.

Fiscal policy plays a key role in managing the macroeconomic impact of commodity revenues. In general, mining and oil exploration tends to be a separate "enclave", largely isolated from the domestic economy but for the government's use of its share of natural resources. Commodity related revenues tend to be highly uncertain and volatile and, as they originate from exhaustible sources, involve delicate inter-temporal considerations, as today's choices are likely to have significant long-term implications. Moreover, they largely originate from abroad and can thus have a significant impact on the exchange rate.

As a result, resource-rich countries typically face unique challenges to their macro and fiscal management (Medas and Zakharova, 2009 (www.imf.org)) and in particular need to:

- *Accurately assess the macro-fiscal stance in order to ensure well informed policy decisions.* The special nature of commodity revenues complicates the evaluation of the macro-fiscal stance and the impact of fiscal policy on the domestic economy. In particular, conventional fiscal indicators, such as the overall and primary balances, and debt sustainability analysis, are not sufficient for an appropriate assessment of the short-term fiscal stance and longer-term fiscal sustainability. Canadian governments (resource-rich provinces and federal) could complement the fiscal analysis with various non-commodity indicators (or indicators/targets that explicitly correct for commodity price volatility) and comprehensive measures of government net wealth—as done by other countries (e.g., Norway and Chile).
- *Avoid transmitting volatility to public expenditure and the economy in general.* In particular, a key issue is to mitigate spillovers from 'boom and bust' commodity cycles. During boom periods, rapidly rising expenditures could lead to overheating, appreciation pressures, and unsustainable levels of spending. A sudden fall in commodity revenue could require a drastic reduction in expenditure with subsequent negative effects on economic activity and the provision of crucial public services (e.g., public spending growth in Alberta has fluctuated significantly with commodity prices). Good planning and management during boom times can reduce the need for large spending cuts later on. Medium-term fiscal frameworks, that include risk analysis, could help Canadian governments to assess the appropriate size of fiscal buffers and design robust policies over commodity cycles.
- *Address financial sustainability and intergenerational equity issues.* Given the exhaustibility of reserves, countries need to decide how to allocate commodity wealth across generations. This has implications not only for long-term fiscal sustainability, but also for intergenerational equity. The particular choices (e.g., how much to save) will depend on country circumstances, but it will be important that today's policies take into account their long-term consequences (e.g., by including such discussion in budgets)—this is particularly relevant for Canadian provinces with high dependence on commodity-related revenue.
- *Develop fiscal institutions that are better suited to help manage commodity related revenues.* Given the challenges mentioned above, it is important to develop institutions that can help to address them. In addition, political economy considerations may require strengthening the accountability framework. When oil revenue is seen as a rent and not a tax, pressures may arise to increase spending without safeguards or accountability, since there is no direct cost for most taxpayers. Some countries have adopted special fiscal institutions (e.g., oil funds, fiscal rules) with mixed success (Ossowski, Villafuerte, Medas, and Thomas, 2008 (www.imf.org)). In particular, it is important to ensure that such institutions are transparent and fully consistent with overall policy objectives (e.g., like the Norwegian oil fund).

STAFF APPRAISAL

24. The main challenge for Canada's policymakers is to support growth in the short term while reducing the vulnerabilities that may arise from external shocks and domestic imbalances. The Canadian authorities have to balance several objectives: preventing the economic momentum from slowing further amid the heightened degree of external uncertainty; rebuilding the policy buffers that may be needed in case of further shocks; and managing the transition to a less leveraged household sector while supporting the long-term stability of the housing market.

25. The beginning of the monetary tightening cycle should be delayed until growth strengthens again. The current monetary policy stance is appropriately accommodative given the negative output gap, well-anchored inflation expectations, and a challenging global environment. Under our baseline scenario, a gradual monetary tightening should start in late 2013, when growth is expected to accelerate. If household imbalances continue to build up in the context of modest growth, further macro-prudential measures should be taken into account before considering an earlier start of monetary tightening. On the other hand, there is some space for further monetary easing if the economy were to weaken significantly.

26. The timing and pace of the ongoing fiscal consolidation process are appropriate, with room for supporting activity if the economy were to weaken. Progressing with fiscal consolidation is essential to rebuild a fiscal buffer against future adverse shocks. The ongoing fiscal adjustment is expected to reduce the deficit of the general government in 2013 by around $\frac{3}{4}$ percent of GDP, with an estimated drag on economic growth of about $\frac{1}{2}$ percentage point. While the consolidation plans of the federal government are well advanced and a budgetary balance by 2015 is well within reach, balancing the budget may require further efforts in some of the largest provinces, where the current consolidation plans rely on ambitious spending cuts. If the economy weakened further, the federal and some provincial governments should allow the full operation of automatic stabilizers. In the event of a large adverse shock, the federal authorities could also consider a new temporary fiscal stimulus package, given the available policy space.

27. At the same time, it will be important to continue to address long-term spending pressures. Canada has a relatively low net public debt ratio compared to most other advanced economies. Still, it is not immune to long-term spending pressures from population aging and rising health costs. Staff analysis suggests that placing the general government debt on a sustainable long-term path would require reforms that durably contain these pressures, as well as higher revenues. Renewed efforts at the provincial level to slow the growth of health care spending would be particularly important in this regard, with progress measured against a long-term fiscal sustainability benchmark. In addition, publishing a comprehensive fiscal sustainability report covering all levels of government and including a discussion of policy options would help gain the necessary public support for reforms.

28. The authorities' gradual tightening of mortgage insurance rules was appropriate, but further macro-prudential measures should be considered if household leverage continues to rise. Household debt in relation to income reached new historical highs in 2012, and remains

high in relation to assets. Moreover, staff analysis suggests that real house prices and residential investment as a share of GDP remain above levels consistent with economic fundamentals. In this context, staff welcomed the introduction of a new round of measures in the second half of 2012, which tightened the rules for government-backed mortgage insurance and lending mortgage standards. While it is too early to ascertain the full impact of the latest round, staff believes that the cumulative effect of all measures taken since 2008 has slowed the growth of household indebtedness and the housing sector. However, should the household debt to income ratio continue to rise, additional measures may be needed. Higher down payment requirements, lower caps on debt-service-to-income ratios, and tighter LTV ratios on refinancing are some of the possible options.

29. The Canadian banking system is healthy, but it is important to remain vigilant against the risk of contagion from adverse shocks. Canada's banking system is well capitalized, has posted another year of strong profits, and continues to show low nonperforming loans, also owing to high prudential standards and rigorous supervision. Going forward, however, pressures on margins from low interest rates and slowing growth in household loans may result in a more challenging environment for banks, and induce them to increase their exposure to more volatile capital market operations and expand their operations abroad. Moreover, despite the significant strength of the system, Canadian banks are not immune to the risk of increased global financial turbulence, which would reduce their access to wholesale funding. Stress-testing scenarios developed by the authorities show manageable losses for the financial system under adverse scenarios. Consideration could be given to publishing the results of the tests, especially as this would promote a better awareness of the risks and enhance market discipline.

30. It is also important to continue monitoring the risks to financial stability from the non-bank sector, particularly from the low interest rate environment. Persistently low interest rates have continued to challenge the financial positions of institutions with long-duration liabilities, such as defined-benefit pension plans and life insurance companies. This challenging environment increases the risks of underfunding for pension funds, and may require higher contributions. To reduce interest rate risk and achieve a better matching of assets and liabilities, many pension plans have adopted liability-driven investment strategies, but this may expose them to a new configuration of risks in the cases where it involves the use of leverage. Life insurance companies have reacted by redesigning and re-pricing their products but also by investing into alternative (non-fixed income) assets. While there is little evidence that the search for yield has led to excessive risk taking so far, it is essential to remain vigilant.

31. An appropriate response to these risks is to take further steps to enhance the resilience of the financial system. Staff welcomes Canadian authorities' strong determination to move ahead with the international financial reform agenda, often taking a leadership role among other jurisdictions. In particular, staff supports the decision by the authorities to implement Basel III capital requirements by January 2013, and their plan to implement liquidity standards once they are finalized. Staff also welcomes the establishment in 2012 of a central counterparty service for fixed-income repos, which will increase the resilience of this important core funding market by mitigating counterparty risk. Efforts to establish a single securities regulator for Canada should continue to

further strengthen the robustness of the financial system. Finally, staff welcomes the intention of the authorities to undertake an update of the Financial Sector Assessment Program (FSAP) in 2013.

32. Over the medium term, a key challenge for Canadian policymakers is to manage the structural changes in the economy associated with the growing commodity sector. Higher productivity growth is essential for Canadian firms to respond to persistent competitive pressures from a strong currency and the opening of global trade markets to emerging and developed economies. While recognizing that this is a complex issue and that the authorities have done much to address the problem more can be done. For example, there is room for a better, more targeted, support to investment in research and development and for measures aimed at increasing labor mobility and retrain the workforce towards sectors experiencing labor shortages. Continued efforts in opening up new markets, through multilateral and bilateral trade agreements, could also boost competition and innovation. Finally, consideration could be given to adopting a fiscal framework that mitigates the macro-economic and fiscal impact of commodity price volatility, for example by excluding revenues from the most volatile commodities. This would allow a better assessment of the underlying fiscal stance and the identification of the appropriate level of stabilization savings during commodity price booms, particularly for resource-rich provinces.

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

Table 1. Canada: Selected Economic Indicators, 2009–13

Nominal GDP (2011): CAD 1720.7 billion (US\$ 1739.0 billion) Quota (in millions): SDR 6,369
 GDP per capita (2011): US\$ 50,496 Population (2011): 34.4 million
 Unemployment rate (September 2012): 7.4 percent
 Main exports: Petroleum products, autos and auto parts, lumber, aluminum.

	2009	2010	2011	Projections	
				2012	2013
(Percent change)					
Output and Demand					
Real GDP	-2.8	3.2	2.6	2.0	1.8
Total domestic demand	-2.9	5.2	2.9	2.3	1.9
Private consumption	0.2	3.4	2.4	2.0	2.0
Total investment	-15.0	12.2	5.7	5.4	3.0
Net exports, contribution to growth	0.1	-2.1	-0.4	-0.4	-0.2
(Percent)					
Unemployment and Inflation					
Unemployment rate	8.3	8.0	7.5	7.3	7.3
CPI inflation	0.3	1.8	2.9	1.6	1.7
(In percent of GDP)					
Saving and Investment					
Gross national saving	18.8	19.7	20.6	20.6	20.8
General government	0.0	-0.3	0.5	1.3	1.4
Private	18.8	20.0	20.1	19.3	19.4
Personal	6.3	5.5	5.0	4.3	4.3
Business	12.6	14.6	15.1	15.0	15.1
Gross domestic investment	21.8	23.3	23.6	24.6	24.9
General Government Fiscal Indicators (NA basis)					
Revenue	38.7	37.8	37.6	37.7	37.6
Expenditures	43.5	43.0	41.6	40.9	40.5
Overall balance	-4.8	-5.3	-4.1	-3.2	-2.9
Gross Debt	81.4	83.0	83.4	85.5	86.3
Net debt	27.7	29.7	32.3	34.5	35.5
Money and Credit (Annual average)					
Household Credit Growth 1/	7.7	7.4	6.4	5.3	...
Business Credit Growth 1/	1.6	1.2	5.4	7.0	...
Three-month treasury bill 2/	0.4	0.6	0.9	1.0	1.0
Ten-year government bond yield 2/	3.2	3.2	2.8	1.9	2.1
Balance of Payments					
Current account balance	-3.0	-3.6	-3.0	-4.0	-4.0
Merchandise Trade balance	-0.4	-0.6	0.1	-0.7	-0.6
Export volume	-14.6	8.0	5.1	2.1	2.4
Import volume	-14.4	14.1	6.0	2.7	2.8
Terms of trade 3/	-9.3	5.2	3.6	-1.4	0.4
Memorandum item					
Real GDP in United States 3/	-3.1	2.4	1.8	2.3	2.0

Sources: Haver Analytics and Fund staff calculations.

1/ 2012 credit numbers refer to Q3 Y/Y growth rate.

2/ In percent

3/ Percent change

Table 2. Canada: Medium-Term Scenario 2011-18

(In percent change, unless otherwise indicated)

	Projections							
	2011	2012	2013	2014	2015	2016	2017	2018
National Accounts in constant prices								
Real GDP	2.6	2.0	1.8	2.3	2.4	2.5	2.4	2.2
Q4/Q4	2.4	1.3	2.2	2.3	2.4	2.4	2.3	2.1
Net exports 1/	-0.4	-0.4	-0.2	0.1	0.3	0.4	0.4	0.5
Final domestic demand	2.7	1.8	1.6	2.2	2.2	2.1	2.0	1.7
Private consumption	2.4	2.0	2.0	2.1	2.1	2.0	2.0	1.7
Public consumption	1.0	-0.2	0.2	0.7	1.0	1.0	0.9	1.1
Private fixed domestic investment	7.1	5.1	2.5	4.0	3.5	3.2	2.9	2.2
Private investment 2/	19.1	19.9	20.0	20.3	20.6	20.7	20.8	20.8
Public investment	-3.3	-6.1	-0.9	0.9	2.3	2.4	2.2	2.2
Change in inventories 1/	0.2	0.5	0.3	0.0	0.0	0.0	0.0	0.0
Nominal GDP	5.9	3.3	3.8	4.4	4.5	4.5	4.4	4.2
Employment and inflation								
Unemployment rate 3/	7.5	7.3	7.3	7.2	7.1	6.9	6.8	6.8
Employment	1.5	1.1	1.0	1.0	1.0	1.1	1.0	0.9
CPI inflation	2.9	1.6	1.7	1.9	2.0	2.0	2.0	2.0
Core CPI inflation (y/y)	1.7	1.8	1.8	1.9	2.0	2.0	2.0	2.0
GDP deflator	3.2	1.3	2.0	2.1	2.0	2.0	2.0	2.0
Potential output growth	1.7	1.9	2.0	2.1	2.1	2.1	2.1	2.1
Output gap 4/	-1.1	-1.0	-1.2	-1.1	-0.8	-0.4	-0.1	0.0
Indicators of fiscal policies (NA basis)								
Federal fiscal balance	-1.8	-1.3	-1.1	-0.7	-0.4	-0.1	0.1	0.3
General government fiscal balance 5/	-4.1	-3.2	-2.9	-2.2	-1.6	-1.1	-0.7	-0.4
General government gross debt	83.4	85.5	86.3	83.7	82.1	80.6	78.8	76.9
General government net debt	32.3	34.5	35.5	36.3	36.3	35.8	34.9	33.9
Three-month treasury bill 2/	0.9	1.0	1.0	1.8	2.8	3.9	4.2	4.2
Ten-year government bond yield 2/	2.8	1.9	2.1	3.1	4.1	5.1	5.5	5.5
External indicators								
Current account balance 2/	-3.0	-4.0	-4.0	-3.7	-3.3	-3.1	-3.0	-2.8
Merchandise trade balance 2/	0.1	-0.7	-0.6	-0.4	-0.2	0.2	0.5	0.9
Export volume	5.1	2.1	2.4	5.4	5.8	6.0	5.7	5.4
Import volume	6.0	2.7	2.8	4.8	4.7	4.7	4.4	3.8
Terms of trade	3.6	-1.4	0.4	0.2	0.1	0.1	0.0	0.1
Real effective exchange rate	1.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Saving and investment								
Gross national saving	20.6	20.6	20.8	21.4	22.0	22.3	22.5	22.6
General government	0.5	1.3	1.4	1.9	2.4	2.7	2.9	3.0
Private	20.1	19.3	19.4	19.5	19.6	19.7	19.5	19.6
Gross domestic investment	23.6	24.6	24.9	25.1	25.3	25.4	25.5	25.4
Personal Savings 6/	3.8	3.3	3.3	3.4	3.4	3.7	3.9	4.3
Memorandum item								
Real GDP in United States	1.8	2.3	2.0	3.0	3.3	3.4	3.2	3.0

Sources: Haver Analytics and Fund staff estimates.

1/ Contribution to growth.

2/ In percent of GDP

3/ In percent

4/ In percent of potential output

5/ Includes the balances of the Canada Pension Plan and Quebec Pension Plan.

6/ In percent of disposable income

Table 3. Canada: General Government Fiscal Indicators, 2011–18 1/
(Percent of GDP unless otherwise indicated)

	2011	Projections						
		2012	2013	2014	2015	2016	2017	2018
Federal Government								
Revenue	13.8	13.6	13.6	13.8	13.9	14.0	14.2	14.4
Income taxes	8.6	8.6	8.6	8.7	8.8	8.9	9.0	9.0
Expenditures	15.6	14.9	14.7	14.5	14.3	14.2	14.1	14.1
Program spending	13.9	13.8	13.5	13.2	13.0	12.7	12.5	12.4
Transfers	9.1	8.7	8.8	8.7	8.6	8.6	8.6	8.5
Interest payments	1.6	1.5	1.4	1.4	1.4	1.4	1.5	1.6
Budgetary balance	-1.8	-1.3	-1.1	-0.7	-0.4	-0.1	0.1	0.3
Cyclically adjusted balance 2/	-1.7	-1.1	-0.9	-0.6	-0.3	-0.1	0.1	0.3
Provincial and Local Governments								
Revenue	25.3	25.1	25.0	25.0	25.0	25.1	25.2	25.1
Income taxes	5.5	5.6	5.7	5.7	5.8	5.8	5.8	5.8
Expenditures	28.1	27.6	27.4	27.1	26.8	26.6	26.4	26.3
Interest payments	1.9	1.9	1.9	1.8	1.8	1.8	2.0	1.9
Budgetary balance	-2.8	-2.5	-2.3	-2.0	-1.7	-1.5	-1.2	-1.1
Cyclically adjusted balance 2/	-2.5	-2.3	-2.0	-1.7	-1.5	-1.4	-1.2	-1.1
Canada/Quebec Pension Plans								
Revenue	3.1	3.2	3.2	3.2	3.3	3.3	3.2	3.2
Total spending	2.5	2.6	2.6	2.7	2.7	2.7	2.7	2.8
Budgetary balance	0.6	0.6	0.6	0.6	0.6	0.5	0.5	0.5
Consolidated General Government 3/								
Revenue	37.6	37.7	37.6	37.8	38.1	38.3	38.6	38.7
Expenditure	41.6	40.9	40.5	40.0	39.6	39.4	39.2	39.1
Public consumption	21.9	21.6	21.3	20.9	20.6	20.3	20.1	19.8
Public investment	4.4	4.1	4.0	3.9	3.9	3.9	3.9	3.9
Overall balance	-4.1	-3.2	-2.9	-2.2	-1.6	-1.1	-0.7	-0.4
Primary balance	-3.6	-2.9	-2.4	-1.9	-1.3	-0.9	-0.4	-0.1
Cyclically adjusted balance 2/	-3.6	-2.8	-2.4	-1.8	-1.2	-0.9	-0.6	-0.4
Fiscal impulse	-0.9	-0.8	-0.4	-0.6	-0.5	-0.3	-0.3	-0.2
Net public debt	32.3	34.5	35.5	36.3	36.3	35.8	34.9	33.9
Gross public debt	83.4	85.5	86.3	83.7	82.1	80.6	78.8	76.9
Memorandum Items								
Real GDP growth	2.6	2.0	1.8	2.3	2.4	2.5	2.4	2.2
Nominal GDP growth rate	5.9	3.3	3.8	4.4	4.5	4.5	4.4	4.2
Three-month treasury bill rate	0.9	1.0	1.0	1.8	2.8	3.9	4.2	4.2
Ten-year government bond rate	2.8	1.9	2.1	3.1	4.1	5.1	5.5	5.5

Sources: Department of Finance Canada Budget, Department of Finance Canada Fiscal Update, Haver

1/ National Accounts basis

2/ In percent of potential GDP.

3/ Includes federal, provincial, territorial, and local governments; and Canada and Quebec pension

Table 4. Canada: Balance of Payments, 2008-18

(In percent of GDP, unless otherwise indicated)

	2008	2009	2010	2011	Projections						
					2012	2013	2014	2015	2016	2017	2018
Current Account											
Current Account Balance	0.1	-3.0	-3.6	-3.0	-4.0	-4.0	-3.7	-3.3	-3.1	-3.0	-2.8
Merchandise Trade Balance	2.7	-0.4	-0.6	0.1	-0.7	-0.6	-0.4	-0.2	0.2	0.5	0.9
Exports, goods	29.6	23.5	24.2	25.9	25.4	24.7	24.9	25.2	25.6	26.0	26.5
Export Volume Growth (percentage change)	-5.3	-14.6	8.0	5.1	2.1	2.4	5.4	5.8	6.0	5.7	5.4
Imports, goods	27.0	23.9	24.9	25.9	26.0	25.4	25.3	25.3	25.4	25.6	25.6
Import Volume Growth (percentage change)	0.3	-14.4	14.1	6.0	2.7	2.8	4.8	4.7	4.7	4.4	3.8
Services Balance	-0.9	-1.0	-1.3	-1.3	-1.3	-1.3	-1.3	-1.2	-1.1	-1.0	-0.8
Investment Income Balance	-1.6	-1.5	-1.7	-1.7	-2.0	-2.1	-2.0	-2.0	-2.2	-2.5	-2.9
Capital and Financial Accounts											
Direct Investment, net	-1.1	-1.2	-0.3	-0.5	0.3	0.2	0.2	0.0	0.1	0.1	0.0
Portfolio Investment, net	2.6	6.6	5.9	4.5	3.7	4.0	3.7	3.5	3.2	3.1	3.1
Other Investment, net 1/	-1.2	-1.6	-1.9	-0.3	0.0	-0.1	-0.2	-0.2	-0.2	-0.1	-0.2
Capital Account Balance	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
International Reserves	-0.1	-0.7	-0.2	-0.5	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Statistical Discrepancy	-0.3	0.0	0.2	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items											
Terms of Trade (percent change)	4.3	-9.3	5.2	3.6	-1.4	0.4	0.2	0.1	0.1	0.0	0.1
Net International Investment Position 2/ 3/	-7.3	-13.2	-15.6	-15.7	-16.4	...	...	...	...	...	...
Assets	109.3	128.4	131.2	123.7	126.5	...	...	...	...	...	...
FDI	47.7	58.9	59.2	52.1	52.6	...	...	...	...	...	...
Portfolio 2/	35.4	41.2	44.7	42.4	44.8	...	...	...	...	...	...
Other	22.9	24.7	23.9	25.5	25.4	...	...	...	...	...	...
Reserves	3.2	3.7	3.4	3.8	3.7	...	...	...	...	...	...
Liabilities	116.6	141.6	146.9	139.4	142.9	...	...	...	...	...	...
FDI	46.1	58.0	58.6	50.6	51.7	...	...	...	...	...	...
Portfolio 2/	46.5	59.6	65.9	66.2	69.0	...	...	...	...	...	...
Other	23.9	24.0	22.4	22.6	22.2	...	...	...	...	...	...
Gross External Debt 3/	63.1	68.9	69.0	72.2	73.2	...	...	...	...	...	...
Real Effective Exchange Rate 4/	-3.2	-4.3	9.3	1.4	n.a.	...	...	...	...	...	...

Sources: Haver Analytics and Fund staff calculations.

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

2/ Based on market valuation of portfolio stocks and official international reserves. 2012 represents stocks at Q3 for all components of IIP.

3/ 2012 represents stock at Q3.

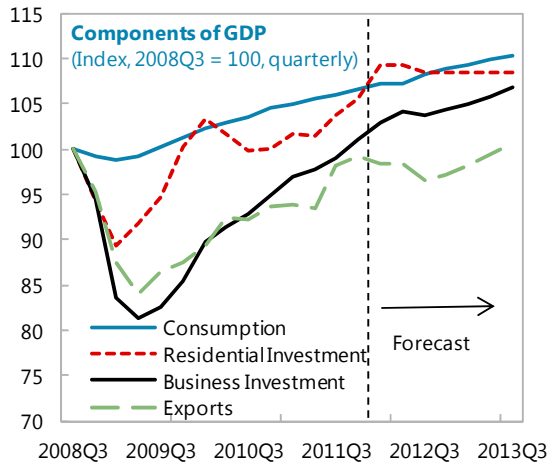
4/ Percentage change. 2012 data refers to the change from 2011 Q4 to 2012 Q3. A minus sign indicates a depreciation in the Canadian dollar.

Table 5. Canada: Indicators of External and Financial Vulnerability

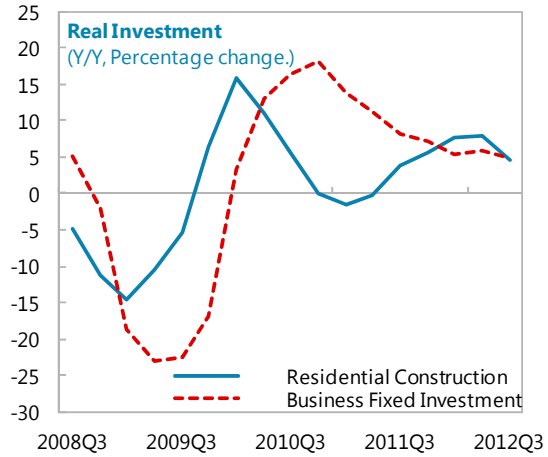
	2009	2010	2011
	(In percent of GDP, unless otherwise indicated)		
External Indicators			
Exports of Goods and Services 1/	-26.7	20.1	16.4
Imports of Goods and Services 1/	-18.8	21.8	13.7
Terms of Trade 1/	-9.3	5.2	3.6
Current Account Balance	-3.0	-3.6	-3.0
Capital and Financial Account Balance	3.0	3.4	3.2
Of which:			
Net Portfolio Investment	6.6	5.9	4.5
Net Foreign Direct Investment	-1.2	-0.3	-0.5
Net Other Investment	-1.6	-1.9	-0.3
Central Bank Foreign Currency Liabilities	0.0	0.0	0.0
Net International Investment Position 2/	-13.2	-15.6	-15.7
Of which:			
General Government Debt held by non-residents	15.9	16.9	18.5
Official Reserves 2/	3.7	3.4	3.8
in months of imports	1.7	1.4	1.4
External Debt-to-Exports Ratio	242	238	236
Nominal Effective Exchange Rate 1/	-4.1	9.8	2.0
Real Effective Exchange Rate 1/	-4.3	9.3	1.4
	(In percent of GDP, unless otherwise indicated)		
Financial Market Indicators			
General Government Gross Debt	81.4	83.0	83.4
Average Maturity of General Public Holdings of Federal Debt (months) 3/	73	74	72
Federal Total Unmatured Debt Maturing Within One Year 4/ 5/	151	225	206
Three-Month Treasury Bill Yield 6/	0.4	0.6	0.9
Real Three-Month Treasury Bill Yield 6/ 7/	1.2	0.3	0.3
Equity Market Index (S&P/TSX Composite) 1/	30.7	14.4	-11.1
	(In percent, unless otherwise indicated)		
Banking Risk Indicators			
Total Assets 4/	2857	3085	3663
Total Loans to Assets 8/	53.3	54.0	58.6
Total Loans to Deposits	80.8	82.3	94.6
Total Loans to Retail Deposits	183.6	189.2	222.7
Nonperforming Loans to Total Loans	1.3	1.2	0.7
Nonperforming Assets to Assets	0.7	0.6	0.4
Provisioning Ratio to: 9/			
Total Loans	1.0	0.9	0.6
Nonperforming Loans	78.8	73.2	84.6
Return On Equity	18.2	22.9	22.5
Return On Assets	0.7	1.1	1.1
Total Capital to Risk-Weighted Assets	14.7	15.6	15.9
Tier 1 Capital Ratio	12.1	13.1	13.4
Assets to Capital Multiple	15.5	15.8	15.4
Interest Rate Margin to Gross Income	46.4	48.6	49.3
Liquid Assets to Short Term Liabilities	55.3	52.0	58.1
Sources: IMF Financial Stability Indicators, IMF International Financial Statistics, Haver Analytics, Joint External Debt Hub, Office of the Superintendent of Financial Institutions, Public Works and Government Services Canada: Public Accounts of Canada, and Fund staff calculations.			
1/ Percent change. 2/ Portfolio investment and official international reserves valued at market prices. 3/ Government of Canada direct and guaranteed securities and loans. 4/ Billions of Canadian dollars. 5/ Reported in the prior fiscal year for the current year end. 6/ Percent. 7/ Deflated by CPI. 8/ Loans include reverse repurchase agreements. 9/ Provisioning includes individual and collective allowances.			

Figure 1. Economic Growth is Slowing

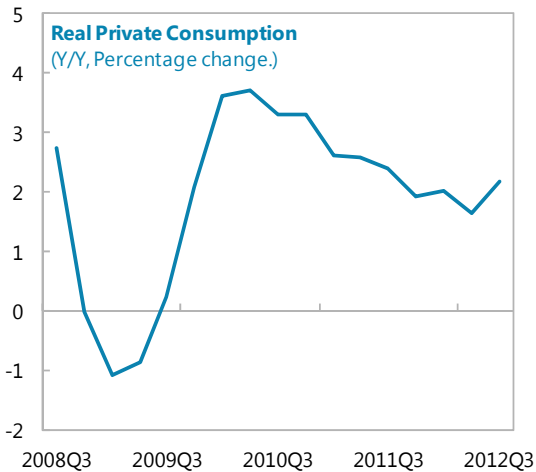
Consumption and residential investment drove the recovery from 2008/09 recession.



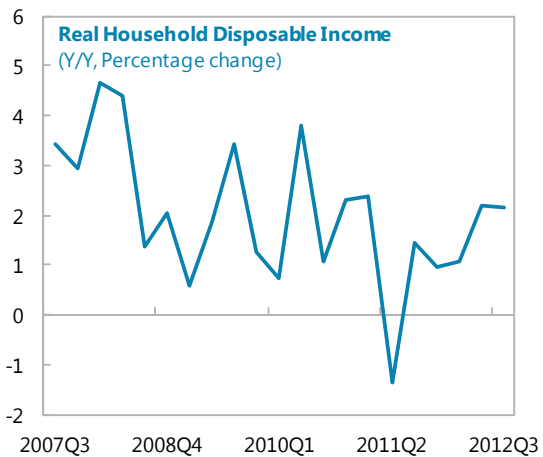
But business investment has slowed further in 2012 and residential investment is starting to weaken.



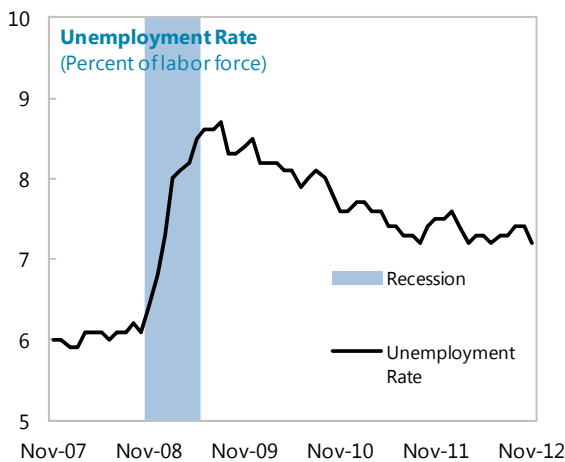
Private consumption growth has also moderated in 2012...



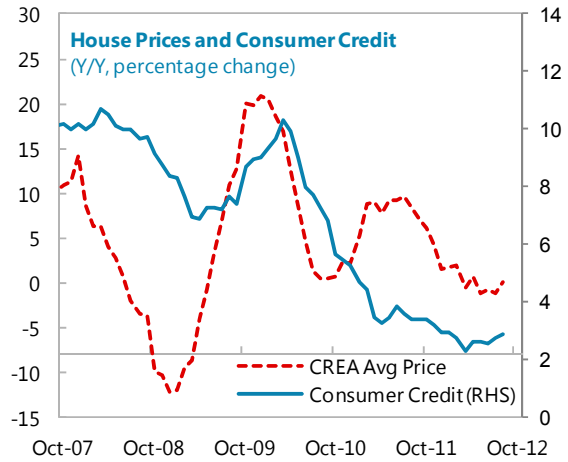
...partially reflecting modest disposable income growth of disposable income...



...as the unemployment rate remains above pre-crisis levels...

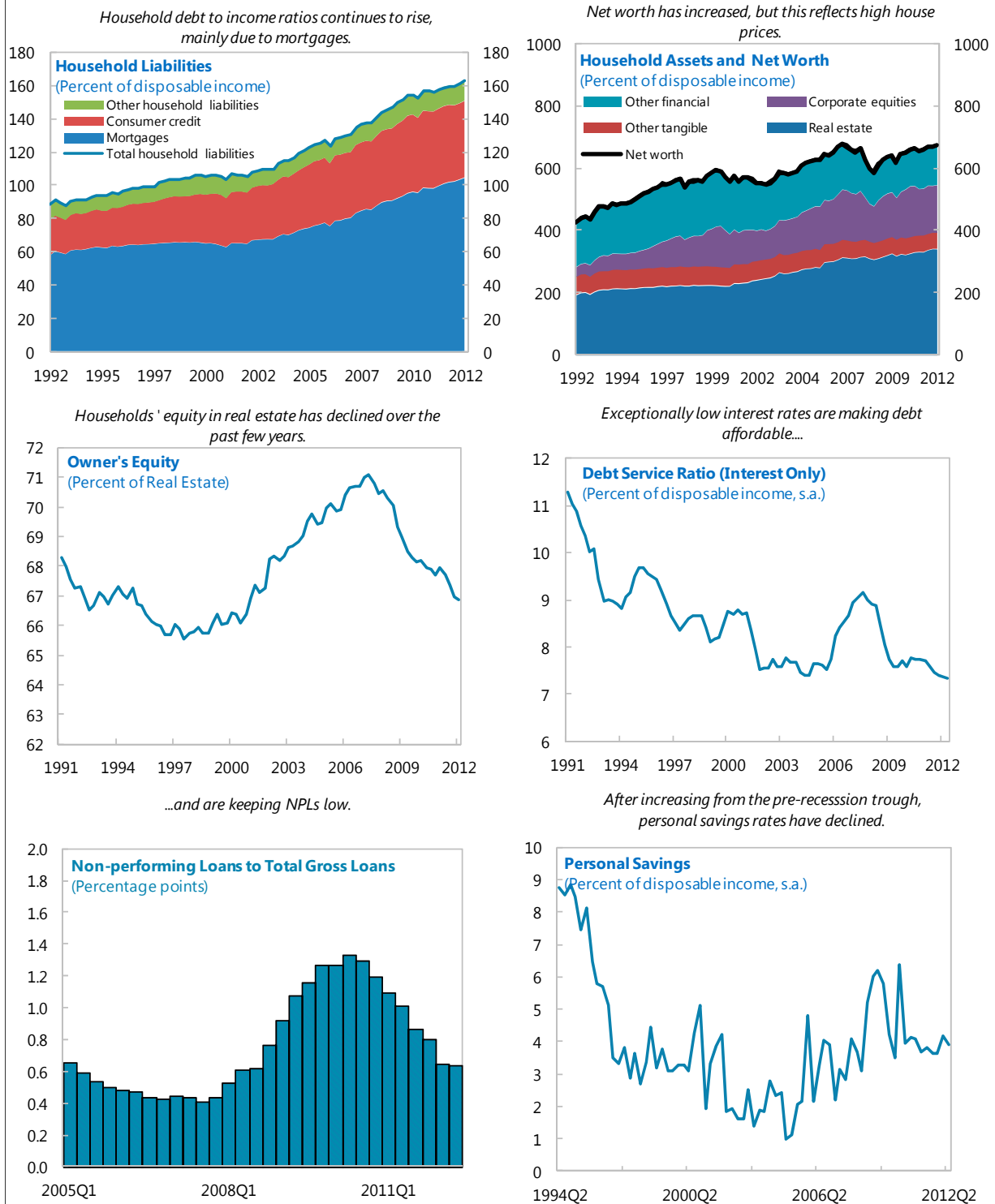


...and credit and house prices growth slowed from their post-crisis peaks.



Sources: Haver Analytics and Fund staff calculations.

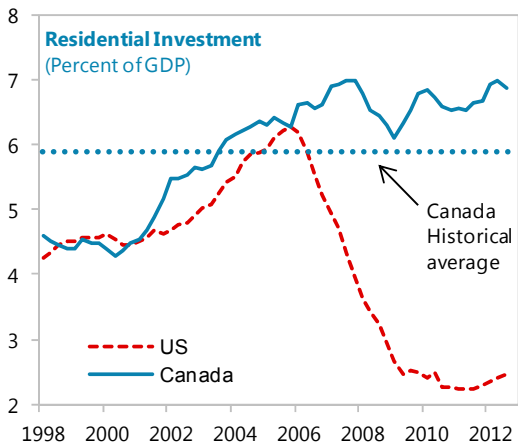
Figure 2. Household Debt Kept Rising



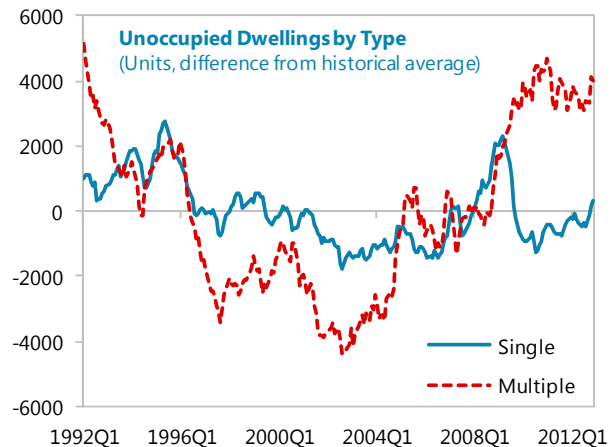
Sources: Bank of Canada, Canadian Office of the Superintendent of Financial Institutions, Haver Analytics, and Fund staff calculations.

Figure 3. Is Canada's Housing Market Cooling?

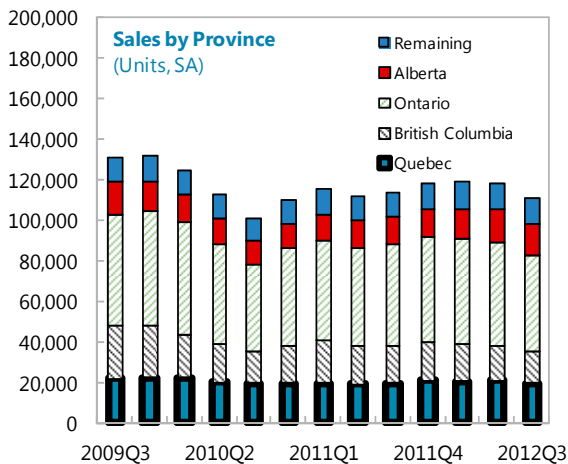
Residential investment is way above its historical average...



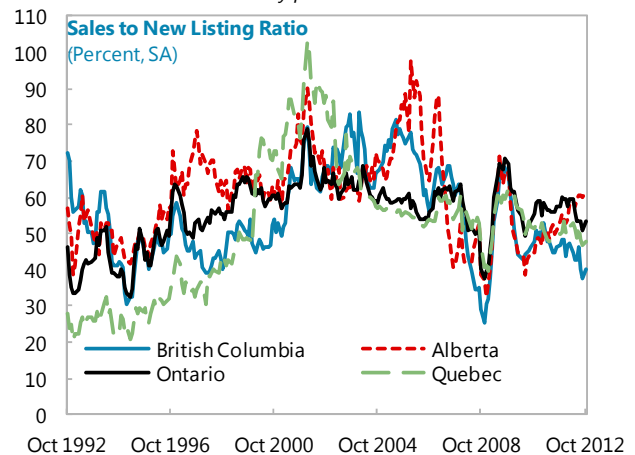
...and vacant units remain high in the condo market.



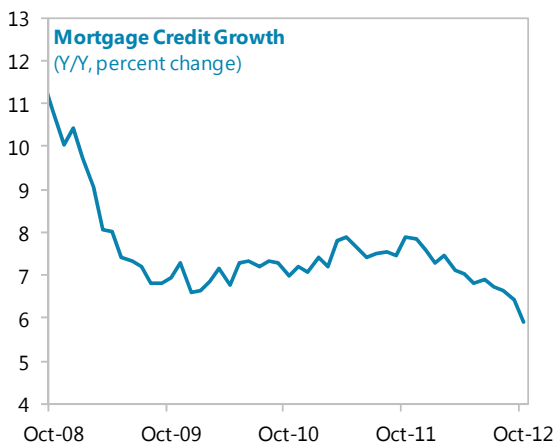
House sales have lost steam in 2012...



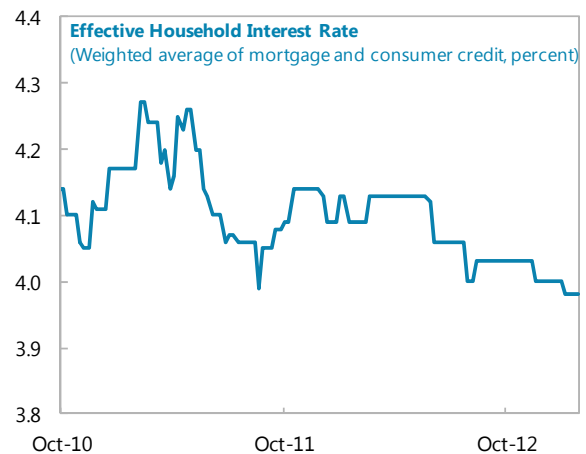
...as sales-to-new listings ratios have contracted in many provinces.



The growth of residential mortgage credit moderated only slightly in 2012...

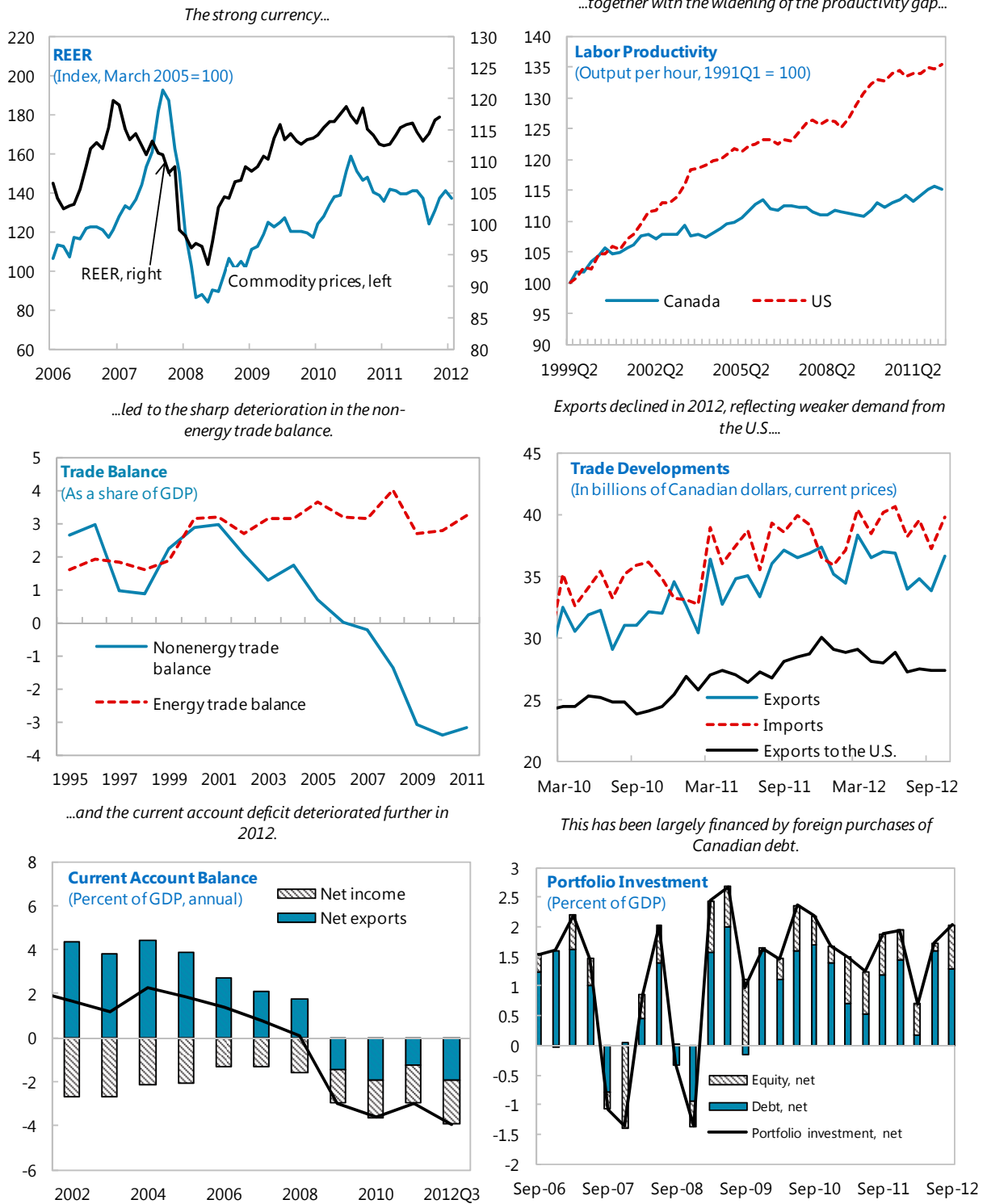


...as borrowing costs have been loosened further.



Sources: Haver Analytics, Statistics Canada, Bank of Canada, Canadian Real Estate Association, and Fund staff calculations.

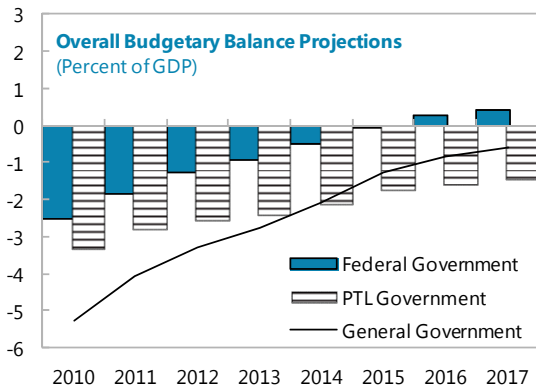
Figure 4. The External Position Deteriorated



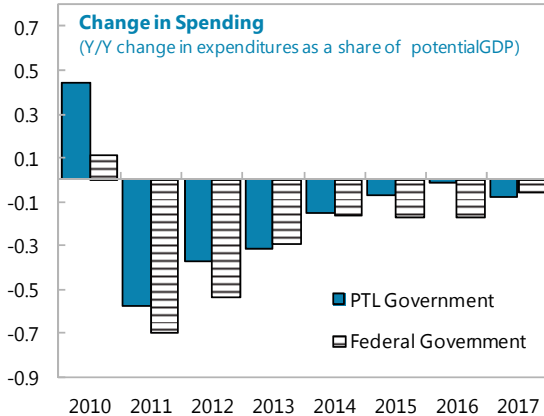
Sources: Haver Analytics, IMF International Financial Statistics, IMF World Economic Outlook, Joint External Debt Hub (most recent data), and Fund staff calculations.

Figure 5. Fiscal Policy: The Plan to Balance

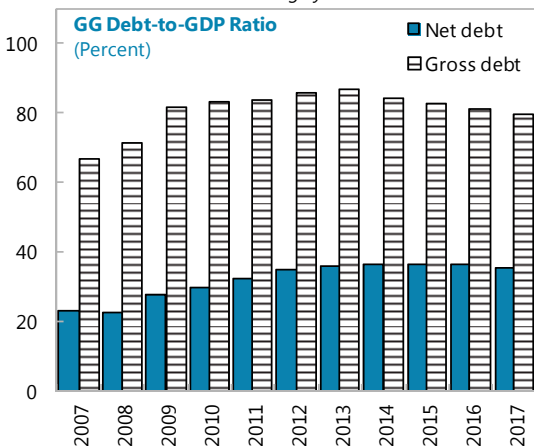
Fiscal consolidation is ongoing, especially at the federal level...



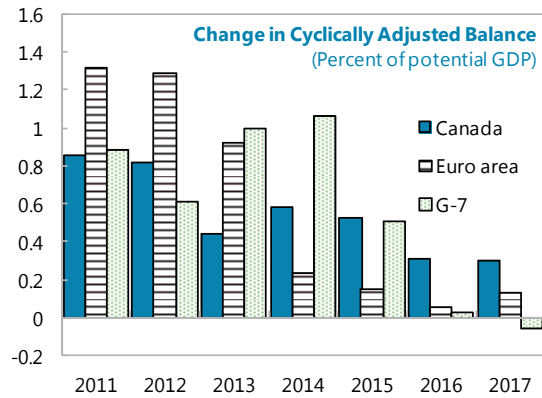
Most of the adjustment comes from lower spending growth...



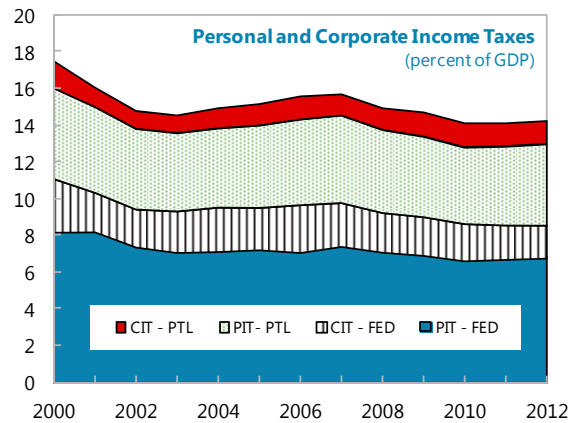
At the General Government level, gross and net debt will start declining by mid decade.



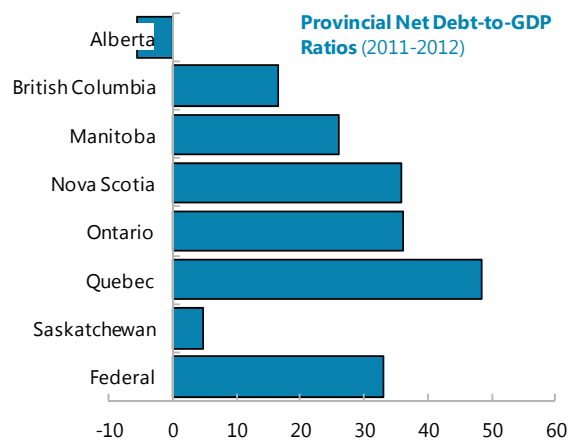
...but is less frontloaded than in other countries.



...while tax revenues are on a downward trend.



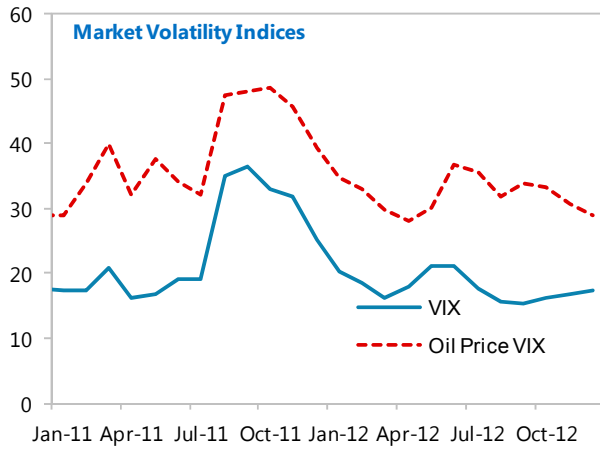
Some provinces will need greater adjustment.



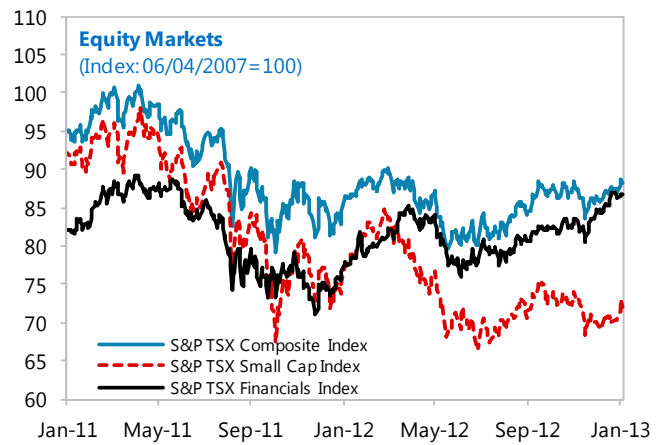
Sources: Department of Finance, 2012 Federal Budget, Canadian Provincial Budgets, Parliamentary Budget Office, IMF World Economic Outlook, Haver Analytics, OECD, 2010 Parliamentary Budget Officer Study, Statistics Canada, TD Economics, and Fund staff projections

Figure 6. Financial Conditions Remain Favorable

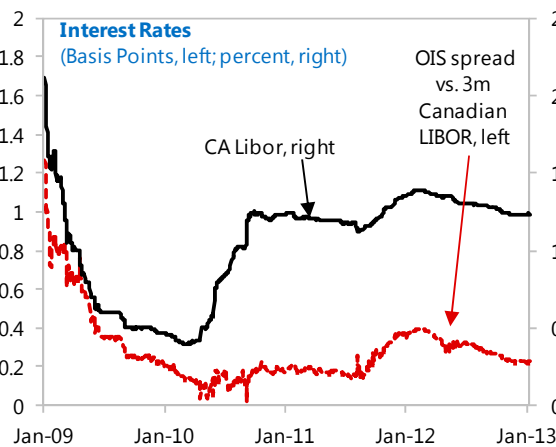
Volatility has declined in the second half of 2012...



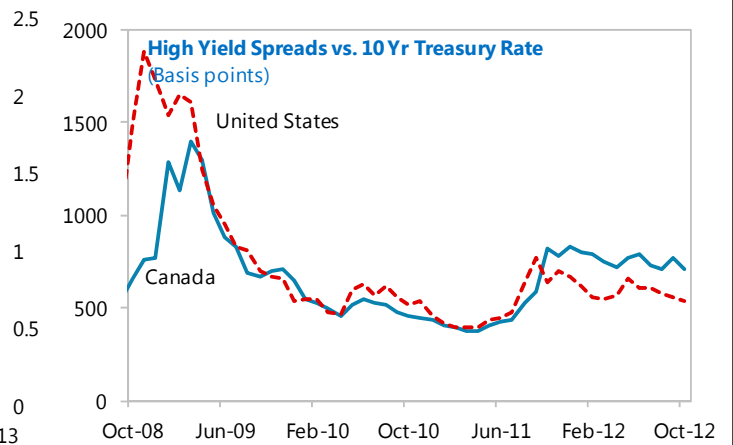
...while equity prices have increased.



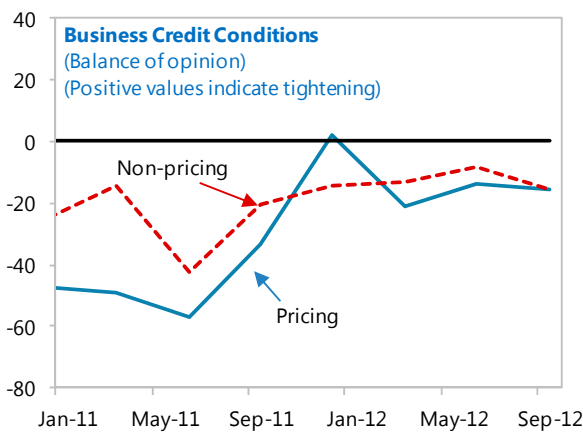
Spreads narrowed in interbank markets in 2012...



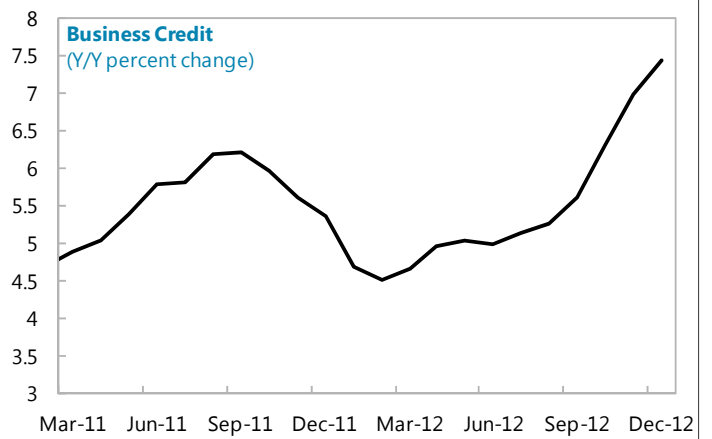
...as well as in corporate bond markets.



Credit conditions for Canadian businesses have eased in 2012...



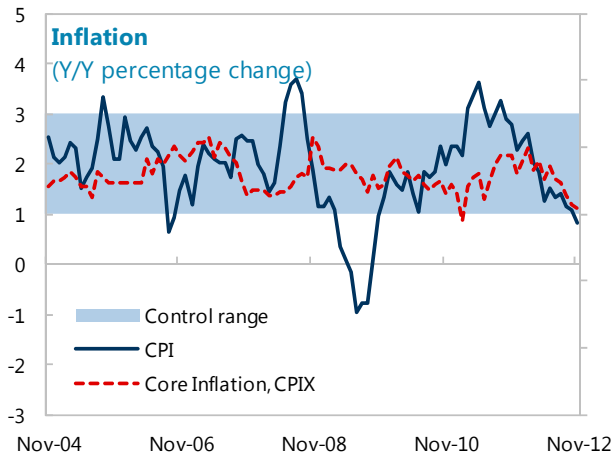
...and business credit growth accelerated.



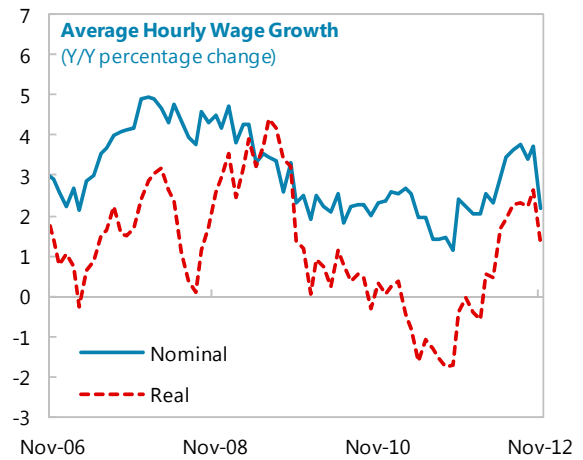
Sources: Bank of Canada, Bloomberg LLP, Haver Analytics, and Fund staff calculations.

Figure 7. Monetary Policy Remains Accommodative

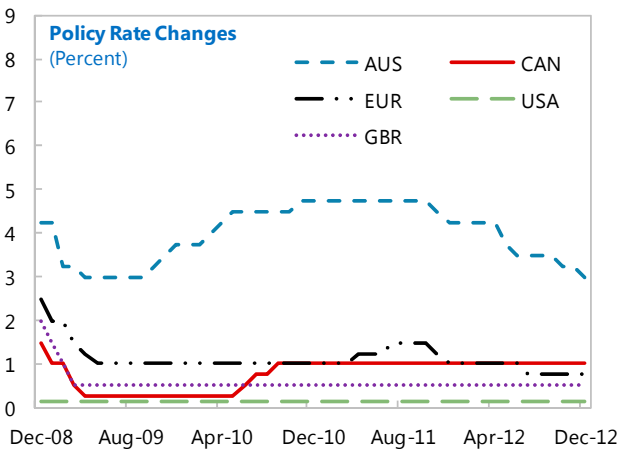
The inflation rate fell to the bottom of the target band at end 2012.



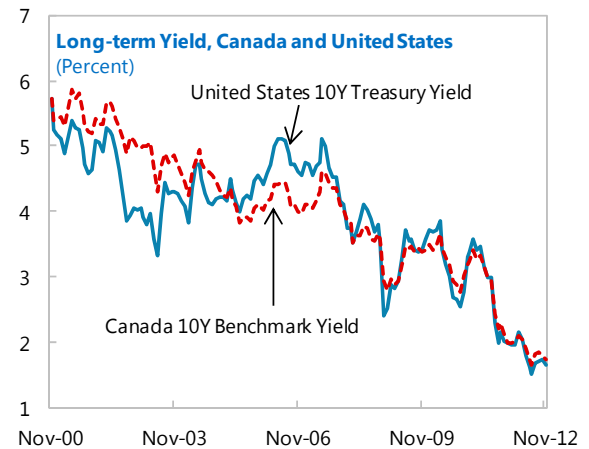
Wage pressures have been relatively subdued.



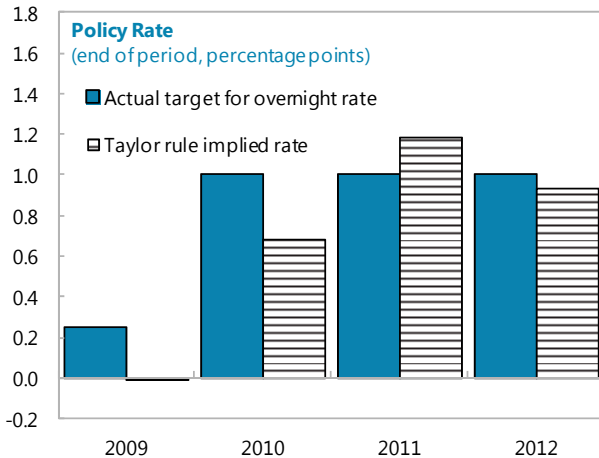
The policy rate remains at very low levels, as in most other advanced economies.



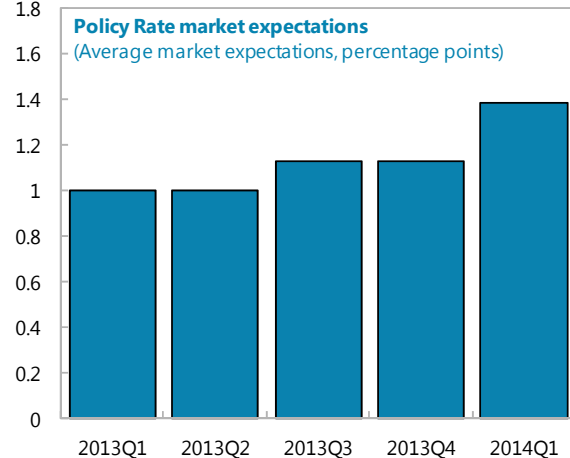
Long term rates are closely influenced by U.S. developments.



Policy rates are in line with what suggested by a Taylor Rule.



Markets are expecting policy rates to increase from the second half of 2013.



Sources: Bloomberg L.P., Haver Analytics, Statistics Canada, and Fund staff calculations.

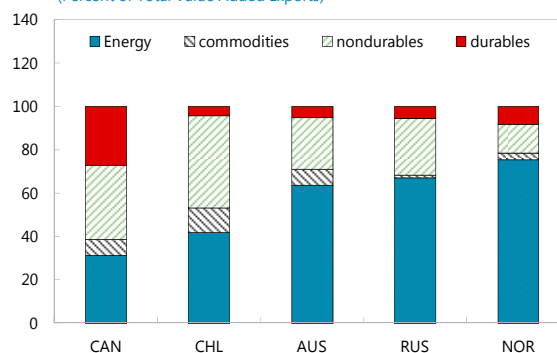
ANNEX I. CANADA'S TRADE AND FINANCIAL LINKAGES AND RISKS SCENARIOS¹

Inward spillovers to Canada predominantly come through the United States. In addition to the large trade exposure, financial spillovers could be nontrivial, as many Canadian businesses and banks derive a non-negligible share of their funding from abroad. However, the greater dependence on commodity exports and production means that spillovers from large swings in global commodity prices could also be significant. Model simulations confirm Canada's exposure to U.S. and oil price (EMs) shocks, and show that domestic imbalances greatly amplify the vulnerability to these shocks.

A. Inward Spillovers: Trade Channels

1. Both geographical and product composition of Canada's trade has changed over the last decade. The share of Canada's exports to the United States has fallen by about 15 percentage points (pps) since 2000, though at about 75 percent is still by far the highest. Over the same period, the share of exports to Europe doubled, while China's share quadrupled, but both remain relatively low, at 15 and 4 percent respectively. The energy-related share of goods exports has increased from 20 percent in 2000 to above 30 percent in 2011.² In terms of value added exports, the contribution of the energy sector is even higher, and reached 30 percent in 2011 from just over 20 percent in 2000, although this is still a relatively low number compared to other economies (Chart).

Energy/Commodity Sector's Value Added Exports
(Percent of Total Value Added Exports)



Sources: OECD, Fund staff estimates.

2. As a result of these changes, Canada has become more exposed to emerging markets and the commodity price cycle. Having become a large consumer of a broad range of primary commodities, China has come to play a dominant role in their global markets. IMF analysis suggests that an increase of 1 percent of China's GDP tend to lead to a rise in the prices of crude oil and copper of about 6 percent after six months, and the effect is persistent given the slow supply response (IMF "Spillover Report", 2011 (www.imf.org)). In particular, given its high commodity-intensity, fluctuations in China's fixed asset investment could affect Canada, though a decline in commodity prices as well as of export demand. IMF analysis suggests that a 1 percent reduction in

¹ Prepared by Mika Saito (SPR) and Ivo Krznar (MCM). The section on GIMF simulations is from Keiko Honjo (RES).

² The energy-related exports here include the mining sector, the manufacture of refined petroleum products, and electricity (OECD Bilateral Trade Database).

China's fixed investment growth has a peak effect on Canada's GDP growth of about ¼ percentage points (IMF "Spillover Report", 2012 (www.imf.org)).

B. Inward Spillovers: Financial Channels

3. Spillovers through financial channels, especially from the United States, are also important.

A global adverse financial shock can be transmitted to Canada *directly*, through a reduction in the total amount of foreign borrowing that Canadian firms derive from abroad and losses on foreign assets; and *indirectly* through a tightening of financial conditions in Canada.

4. **The importance of *direct* financial channels is not surprising given the size of debt raised abroad by Canada's non-financial private sector.** As of Q3:2012, external debt is about one quarter of total debt outstanding of Canada's non-financial private sector, mostly bonds (about 60 percent) and inter-company lending (about 20 percent). This figure however could understate the true dependence on external funding, as it ignores loans extended to Canadian businesses by subsidiaries of foreign banks. Adding the local claims of foreign affiliates of all BIS reporting banks (most of which is likely to fund Canadian businesses) raises the share of total Canada's non-financial private sector credit financed by external sources to about 30 percent.

5. Canada's banking sector holds nontrivial liabilities and claims vis-à-vis nonresidents.

Looking at the asset side, as of Q3:2012, around 30 percent of Canadian banks' overall assets are claims vis-à-vis nonresidents. The vast majority of this exposure is to the United States and mainly consists of "local" claims in foreign currency (i.e., local claims of subsidiaries abroad). This has increased over the last few years, reflecting Canadian banks' acquisitions of U.S. financial institutions. On the liability side, close to one quarter of banks total liabilities are vis-à-vis nonresidents (this includes deposits held by subsidiaries of Canadian banks abroad). Moreover, Canadian banks have always had a non-negligible dependence on wholesale funding denominated in foreign currency. About half on non-retail liabilities (which accounts for about two third of Canadian banks' total liabilities) is in foreign currency.

6. **Canadian banks weathered the 2008–09 crisis well and remain healthy, but a few changes are worth noting.** Canadian banks had ample capital and large buffers of highly liquid assets which allowed them to bridge temporary cash flow shortfalls. Moreover, relative to their size of loans and mortgages, Canadian banks had a relatively stable source of long-term funding (retail and non-retail deposits from small and medium businesses that tend to be relatively sticky) and could access official funding programs designed to ease liquidity strains. While Canadian banks have increased their capital and liquidity buffers since 2008, the U.S. debt market has become a more important source of their funding—as of November 2012, U.S. Money Market Mutual Funds exposure to Canadian banks was three times greater than at the end of 2007. Also, a greater share of loans to households and businesses is now funded by non-retail deposits.

7. **Indirect financial channels are also an important source of inward spillovers.** Tighter financial conditions in the United States tend to lead to tighter financial conditions in Canada. Canadian lending standards (from the Bank of Canada's Senior Loan Officer's Survey, SLOS) are strongly correlated with those in the United States. Corporate bond spreads in the United States and

Canada are also tightly linked (with a 0.9 correlation for the period between 1996 and 2009), and similar ties can be found for prime and interbank rates.

8. Several studies found that spillovers from financial channels could be significant.

Duttagupta and Barrera (2010) found that a shock to U.S. lending standards reduces Canadian growth (y-o-y) by close to $\frac{1}{2}$ pp in six quarters, more than a similar increase in Canadian lending standards. The larger effect likely reflects the indirect effects of U.S. lending standards through lower U.S. growth, as well as tighter Canadian lending standards. Klyuev, 2008 (www.imf.org), finds that a percentage point increase in the U.S. 3-month T-bill rate leads to a decline of more than one percentage point in Canada's real GDP growth after 3 quarters. When the impact of the U.S. financial shock is decomposed into trade and financial channels, the latter channel appears to be larger. Swiston and Bayoumi, 2008 (www.imf.org), find that a one percent shock to U.S. real GDP shifts Canadian real GDP by $\frac{3}{4}$ of a percentage point in the same direction, with financial spillovers more important than trade in recent decades. Beaton et al., 2010 (Bank of Canada) found that while the transmission of U.S. financial shocks to Canada occurs mainly through real channels (trade, commodity prices and exchange rate), financial channels are also important, in particular through the large reliance of Canadian firms on U.S. sources of lending.

C. Outward Spillovers

9. Canada economic conditions have significant spillovers to Caribbean countries. These spillovers could materialize primarily under three different channels:

- **Tourism.** A 1 percent increase in OECD average unemployment causes a 4 percent fall in tourist arrivals in Caribbean economies (Regional Economic Outlook, WHD, October 2010 (www.imf.org)). Hence, Canada's relatively strong performance during the Great Recession was an important buffer for some of these countries (e.g., Jamaica).
- **Financial links.** Canadian banks are particularly active in the Caribbean countries, partly for historical reasons.³ As of June 2012, Canadian banks' claims accounted for about 70 percent of total foreign claims in Trinidad and Tobago, about 35 percent of GDP.
- **Remittances.** Direct spillovers through this channel are limited, as typically only a small fraction of total remittances in Caribbean countries is from Canada (e.g., under 5 percent in Jamaica).

D. Risks Scenarios for Canada

10. Strong trade and financial linkages make Canada particularly exposed to external shocks. We assess the impact on Canada of several global risk scenarios, using the IMF Global Integrated Monetary and Fiscal Model (GIMF) and the G35 Model. Because these models do not have any role for house prices and household leverage, they may underestimate the impact of the shocks on Canada. We thus augment the response of private consumption in GIMF by adding the

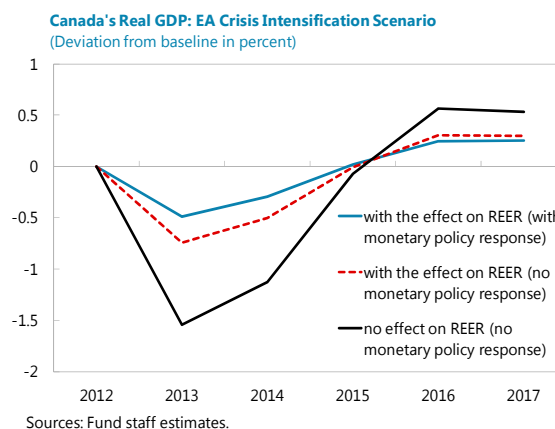
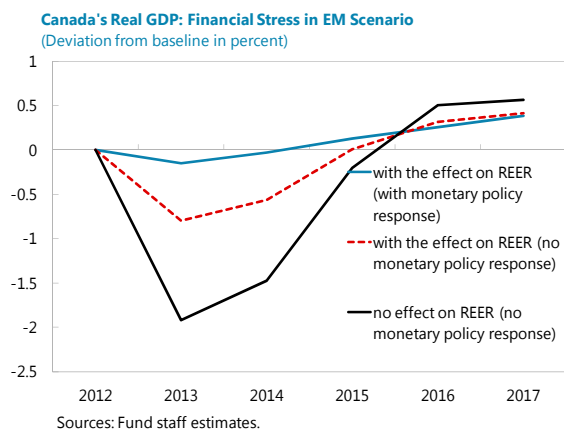
³ Many Canadian banks were drawn to the West Indies by the flourishing trade with the Canadian Maritimes (i.e. Nova Scotia) in the early 1900s.

additional impact that the same shocks have on consumption in a model with housing and financial frictions, calibrated on Canada (Selected Issue Paper, Chapter 1). Moreover, GIMF is tweaked so as to capture the impact of oil prices on Canada's real effective exchange rate—a 10 percent reduction in oil prices leads to a 1½ percent depreciation in Canada's real effective exchange rate. We consider two scenarios:

- **A worsening of the euro area debt crisis.** In this scenario, deleveraging by euro area banks leads to a sharp credit contraction in periphery countries. Concerns over fiscal sustainability raise periphery sovereign spreads 300 basis points in 2013, forcing them to an ever more front-loaded fiscal consolidation (a 2 pps improvement in cyclically adjusted fiscal balances over 2013, gradually returning to baseline by 2017). The euro area core countries are assumed to experience milder credit contractions and lower sovereign risk premia (the U.S. the spread also decreases by around 50 bps), as they benefit from a flight to quality. Risk concerns are assumed to spill over into all other regions, with corporate risk premium rising by 50bps in advanced countries and 100bps in emerging countries in 2013. Relative to the October 2012 *World Economic Outlook* baseline, GDP falls in 2013 by 3 pps in Advanced Europe, ¾ pp in the United States, and 1¼ pp for the world.⁴
- **Increased financial stress in emerging market economies.** In this scenario, concerns about the viability of private investment projects, particularly in the tradable good sectors, lead to a tightening in private financial conditions in emerging market economies. The corporate risk premium peaks in 2014 at 400 bps above baseline in the tradable sector, and 250 bps in the non-tradable sector of these economies. Real GDP falls in 2013 by about 3 pps in emerging markets, and less than 1 percent in both the United States and euro area. World GDP declines by about 1½ pp.

11. The results suggest that Canada is particularly vulnerable to EM shocks through the commodity price channel. Assuming no monetary response from the Bank of Canada the simulation results show that heightened euro area stress would subtract about ¾ pp from Canada's GDP in 2013 (the red dashed line in the Charts). The initial impact on Canada's GDP from financial stress in emerging markets is also about ¾ pp. This is somewhat surprising, given that both Canada's major trading partners (the United States and euro area) are hit less in this scenario. The main reason is that oil prices fall more in this case (about 15 percent in 2013, against 10 percent in the euro area stress scenario). With many emerging market economies' demand being more energy intensive (notably China), falling demand in those regions has a greater impact on oil prices.

⁴ Monetary policy is constrained at the ZIF in the G3 countries for the first two years, while elsewhere monetary policy eases to help offset the impact on market interest rates of rising risk premium.

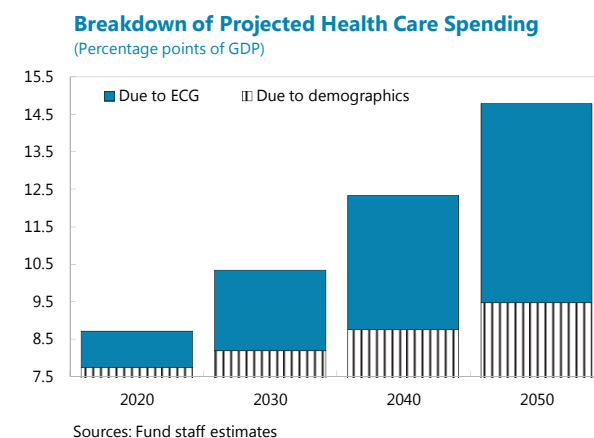
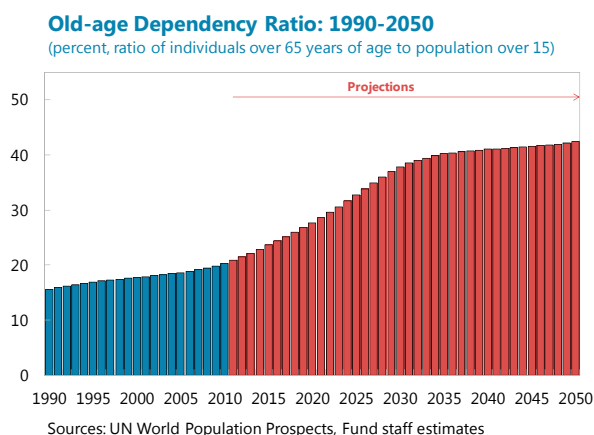


12. Flexible exchange rates, as well as having room for a conventional monetary policy response, are an important buffer against these shocks. In the absence of a monetary response, the depreciation of the Canadian dollar following lower oil prices halves the impact of the shocks on real exports in both scenarios. Without the depreciation, real GDP would have fallen by about 1½ pps and 2 pps over 2013 in the euro area and EM shock scenarios, respectively (the black line in the Charts). Not surprisingly, when monetary policy can respond by stimulating domestic demand with lower interest rates, the impact of the shocks would be largely offset: GDP would decline by about ½ pp relative to the baseline in the euro area shock, and even less in the EM shock (the blue line in the Charts). Much of the offset in this case would come from a muting of the initial decline in external demand via additional currency depreciation.

ANNEX II. LONG-TERM FISCAL SUSTAINABILITY¹

1. This Appendix provides an assessment of the long-term sustainability of Canada's public finances, at the general government level (defined as federal, provincial, territorial and local governments, and the Canada and Quebec Pension Plans). It relies on the staff's medium-term fiscal projections for General Government (Table 4) and mainly on Canada Parliamentary Budget Office's (PBO) projections for the long term. In particular:

- Health care spending** projections are based on IMF (2010).² These projections are obtained assuming that the current structure of spending per age group is constant over the forecasting horizon. Each age cohort is assumed to grow based on the "medium-growth" scenario of the 2010 United Nations World Population Prospects. Based on these projections, Canada's elderly population will increase rapidly over the next 20 years, with the old age dependency ratio projected to increase from 20 percent in 2010 to around 40 percent afterwards. Finally, health spending per each age cohort is assumed to grow in real terms at an annual rate that is 1 percentage points above productivity growth. This excess cost growth (ECG) is slightly above the average for Canada over the 2002–2011 period. Based on these assumptions, health spending is projected to grow from 7½ percent of GDP in 2010 to about 14 percent by 2050. Population aging and the health care ECG are expected to contribute equally to the increase until 2030, while about two thirds of the increase from 2030 to 2050 is due to the ECG.



- Pension projections** are based on the latest actuarial reports (2010) of the Offices of the Chief Actuary for the CPP and QPP. For the CPP, they show that the legislated contribution rate of 9.9 percent is sufficient to fund future outlays while accumulating assets worth \$275 billion (i.e., 4.7 times the annual expenditures) up until 2020. The results for QPP show that the contribution rate needs to increase in order to ensure long-term funding. We follow the recommendation of the report and assume that contribution rates would be increased by 1.12 percentage points.

¹ Prepared by Julien Reynaud (WHD).

² "Macro-Fiscal Implications of Health Care Reform in Advanced and Emerging Economies", IMF, 2010 (www.imf.org).

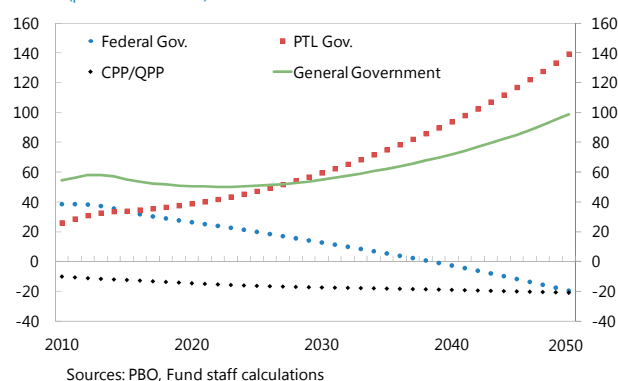
Based on PBO projections, old-age security (OAS) spending is expected to reach 2.5 percent of GDP by 2050 from 2.2 percent in 2010, after peaking at 2.9 percent in the mid 2040s.

- **Other.** Spending on education and unemployment benefits is projected following the PBO, and is set to decrease slightly over the long run given Canada's population aging. Education spending is expected to go from 5.5 percent of GDP in 2011 to 4.9 percent by 2050, while unemployment benefits are set to reach 0.9 percent of GDP by 2050, from 1.1 percent currently. Other spending chapters are assumed to remain constant as a share of GDP over the forecasting horizon. Total general government revenues are projected to remain constant as a share of GDP over the forecasting horizon, at about 37 percent of GDP.

2. Based on these assumptions, the general government's overall balance will deteriorate from 2017 and the net-debt-to GDP ratio will reach 100 percent of GDP by end 2050. This is

entirely caused by the dynamic of the provincial-territorial-local (PTL)'s balance, as the federal government's balance is expected to turn positive by 2015 and to remain so over the whole forecasting horizon. Assuming that primary balances are applied to the previous year debt and debt servicing costs, and that the effective interest rate on net government debt will be 5.3 percent (as in the PBO), it is possible to simulate a path for the net debt-to-GDP ratio. While the string of primary surpluses is expected to allow the federal government to start accumulating assets by late 2030, the net-debt-to GDP ratio at the PTL level is expected to reach about 140 percent of GDP in 2050. CPP and QPP are expected to accumulate assets of about 20 percent of GDP over the forecasting horizon. As a result, Canada's general government net debt is expected to reach 100 percent of GDP by the end of the forecasting horizon.

Projected Net Debt-to-GDP ratios
(percent share GDP)



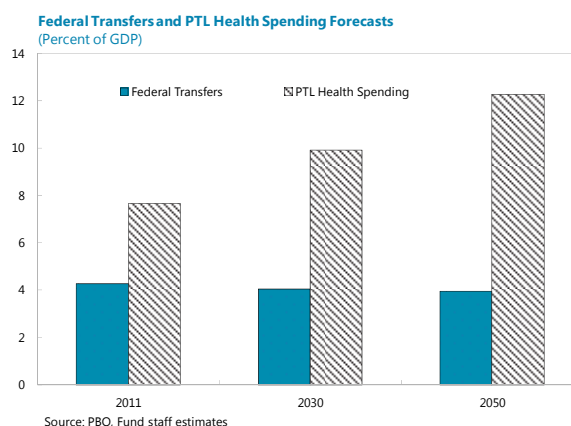
3. The immediate and permanent increase in the primary balance needed to bring the general government net debt to GDP ratio back to the current level by 2050, the so called "fiscal sustainability gap", is about 1.1 percent of GDP as of end 2011. Again, this is entirely the result of a gap at PTL level (about 2.4 percent of GDP), as the estimate of the gap at the federal government level is negative (-1.3 percent of GDP). This means that the federal government could actually maintain its 2050 net debt ratio at the current level even if its primary balance were to be reduced by 1.3 percent of GDP relative to the baseline projections every year in our forecast horizon.

4. Making Canada's net debt dynamics sustainable over the long run will require containing health care spending growth. The projected fiscal deficit at the PTL level is mainly explained by the increase in health care spending. As of 2011, PTL are responsible for 95 percent of overall public health care spending. The Federal government provides funding for health care on an equal per capita basis through the Canada Health Transfer (CHT)—the largest federal transfer program to provinces and territories. While CHT transfers are set to grow at 6 percent until 2016–17,

starting from 2017–18 they will grow in line with the three-year moving average growth of nominal GDP, with a minimum guaranteed increase by at least 3 percent per year. Given that long-term nominal GDP growth is set to be around 4 percent for Canada, provinces will not only face rising health costs but also lower growth in CHT.

As said above, to a great extent the acceleration of health spending as a ratio to GDP is the result of an increase in health care costs, rather than of population aging. Eliminating that extra cost, and therefore maintaining health care spending as ratio to GDP to approximately end-2020s levels, would drastically reduce the PTL fiscal sustainability gap. Canada's general government net debt dynamics would become sustainable, with the net debt-to-

GDP ratio stabilizing at around 50 percent of GDP by the end of the forecasting horizon.



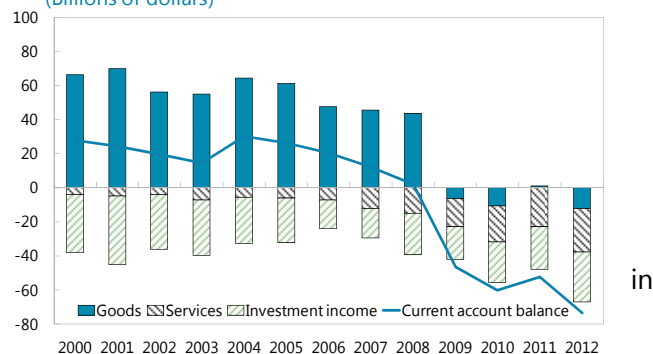
ANNEX III. CANADA: EXTERNAL STABILITY ASSESSMENT¹

1. Canada's current account balance has shifted to a sizable deficit following the 2008–09 recession.

After posting surpluses in the 2000s, the current account has reached a 4 percent of GDP deficit in the first nine months of 2012 (Chart). This turnaround reflected both cyclical and structural factors. In particular, it is partially the results of Canada's stronger recovery from the Great Recession relative to its main trade partners. Canada's domestic demand (and hence imports) rebounded relatively more quickly than many other advanced economies, supported by the fiscal stimulus as reflected in a sharp drop in net public savings (Chart). On the other hand, Canadian exporters were hit harder given the high degree of reliance on the United States, the destination of three quarters of Canadian exports, and in particular to some of the sectors that were most hit during the Great Recessions—e.g., lumber and auto exports remain 28 and 15 percent below end-2006 levels respectively. But the 2008–09 crisis only exacerbated the secular decline in Canada's merchandise trade balance over the last decade.

Current Account Balance

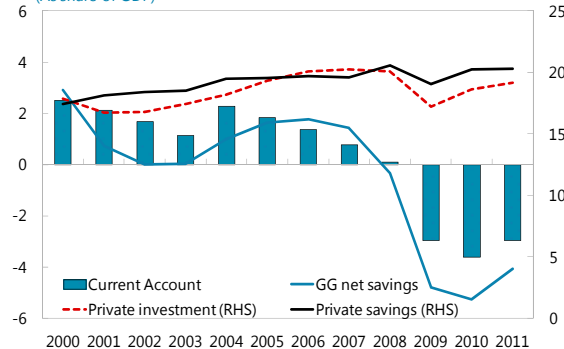
(Billions of dollars)



Source: Statistics Canada

Savings-Investment Balance

(As share of GDP)

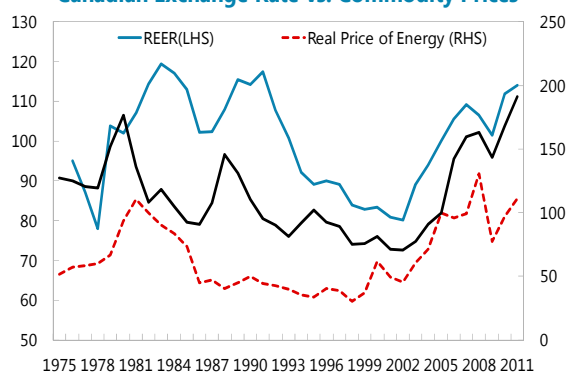


Sources: Haver and staff estimates

2. The sharp appreciation of the Canadian dollar contributed to Canada's weak export performance over the last decade.

The correlation between the Canadian exchange rate (in real effective terms) and commodity prices has increased over time (Chart). Staff analysis (Selected Issues, Chapter 4) shows that the surge in commodity prices accounts for three fourths of the 25 percent appreciation of the Canadian real effective exchange rate between 2000 and 2007, and that this appreciation has been the primary driver of the large loss of market share in the United States, especially on manufacturing, over that period.

Canadian Exchange Rate vs. Commodity Prices



Sources: IMF, Bank of Canada, Haver Analytics

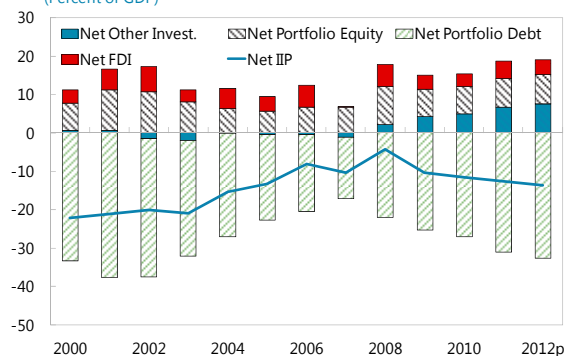
¹ Prepared by Mika Saito (SPR) and Paulo Medas (WHD).

3. Increased competition from emerging markets has also been one of the key reasons for Canada's loss of market share in the United States. Increased competition from China (Selected Issues, Chapter 4), in particular, hindered the ability of Canadian exporters to sustain its market share abroad. In more recent years, Mexico is also becoming a stiffer competitor in some areas, like autos. Canada's response to these competitive pressures has been complicated by the widening of the productivity gap relative to both advanced economies (e.g., the United States and Germany) and emerging markets (e.g., China and Mexico). At the same time, energy exports have been growing at a steady pace, but infrastructure constraints (e.g., limited pipeline capacity) have put limits on volumes exported and on prices received for Canadian oil—the spread between WTI and Canadian oil prices has increased substantially.

4. Large portfolio inflows have helped finance the deficit and may have also contributed to sustain the Canadian dollar. Average net portfolio outflows from 2000–07 turned into inflows of some 4 percent of GDP as of Q3:2012. The recent net

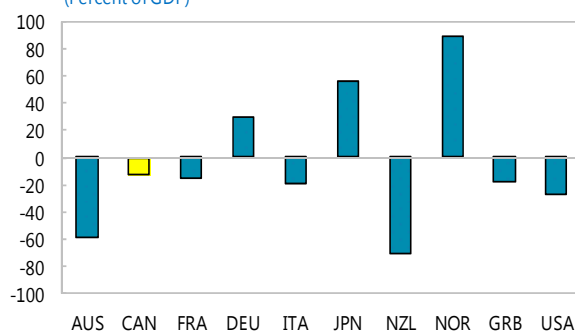
portfolio inflows has been comprised mainly of purchases of Canadian debt securities, as Canada's solid public finances made it an attractive investment destination, especially in the current highly uncertain low-yield global environment. In particular, since summer 2011, when financial stress in Europe heightened, U.S. financial institutions have reduced claims on countries in the euro area periphery and increased exposure to Canadian banks, as well as to federal and provincial government bonds. These "safe-haven capital inflows" might help explain why Canada's exchange rate remained broadly unchanged despite the deterioration in the current account deficit since the second quarter of 2011. Canada's overall net international investment position is expected to deteriorate by around 4 percentage points to close to -20 percent of GDP in 2012 (Chart), a relatively low level compared to other advanced economies (Chart), with positive net portfolio equity and FDI positions partially offsetting the negative net portfolio debt position.

Canada: Net International Investment Position
(Percent of GDP)



Sources: Statistics Canada, WEO.

Canada and Other Countries: Net IIP, 2011
(Percent of GDP)



Source: World Economic Outlook

5. Staff analysis indicates that the current account is weaker and the real exchange rate is stronger than implied by medium-term fundamentals and policies. Based on the methodologies used in the IMF's new External Balance Assessment (EBA) (IMF, 2012 (www.imf.org)), staff estimates that in the medium-term Canada's current account (CA) should be between -1 and 1 percent of GDP, while the exchange rate is between 5 and 15 percent above levels consistent with long-term fundamentals. In particular

- The EBA CA *norm* is estimated to be a *surplus* of 1 percent of GDP. This would imply a required adjustment of about 5 percent of GDP, with about 1 percent attributed to the gap between "recommended" and actual policies. At the same time, staff expects that the gradual U.S. economic recovery will induce a 1¼ percent of GDP improvement in Canada's CA position over the medium term.
- But a CA *deficit* of close to 1 percent of GDP would be enough to stabilize Canada's NFA over the medium term. To be sure, Canada has been able to sustain relatively large CA deficits for long periods of its history, with the CA balance averaging -1½ percent of GDP over 1961–2010. A modest CA deficit is also consistent with the traditional CGER model.



CANADA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 25, 2013

Prepared By

The Western Hemisphere Department
(in consultation with other departments)

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FUND RELATIONS

(As of November 30, 2012)

I. Membership Status: Joined 12/27/1945; Article VIII

II. General Resources Account:	SDR Million	Percent of Quota
Quota	6,369.20	100.00
Fund holdings of currency	4,473.58	70.24
Reserve position in Fund	1,895.66	29.76
Lending to the Fund		
New Arrangements to Borrow	894.96	

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	5,988.08	100.00
Holdings	5,682.97	94.90

IV. Outstanding Purchases and Loans: None.

V. Financial Arrangements: None.

VI. Projected Obligations to Fund:
(SDR Million; based on existing use of resources and present holdings of SDRs):

	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.31	0.31	0.31	0.31	0.31
Total	0.31	0.31	0.31	0.31	0.31

VII. Implementation of HIPC Initiative: Not applicable.

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable.

IX. Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable.

X. Exchange Rate Arrangements: The authorities maintain a "free floating" exchange rate regime. The exchange rate regime is free from exchange restrictions and multiple currency practices. The Canadian authorities do not maintain margins with respect to exchange transactions. However, the authorities may intervene to maintain orderly conditions in the exchange market. There are no taxes or subsidies on purchases or sales of foreign exchange.

Canada has accepted the obligations of Article VIII, Sections 2, 3, and 4 (a) and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Canada maintains exchange restrictions for security reasons, based on UN Security Council Resolutions, that have been notified to the Fund for approval (most recently in December 2007) under the procedures set forth in Executive Board Decision No. 144-(52/51).

XI. Last Article IV Consultation: The Staff Report for the 2011 consultation with Canada was considered by the Executive Board on December 19, 2011 (IMF Country Report No. 11/364). Canada is on a 12-month consultation cycle.

XII. The 2012 Article IV discussions were conducted in Ottawa and Toronto from December 3–December 18 by Roberto Cardarelli (head), Paulo Medas, Julien Reynaud (all WHD), Ivo Krznar (MCM), and Mika Saito (SPR). Mr. Gian Maria Milesi-Ferretti joined the mission for the concluding meeting with Minister of Finance Flaherty and Bank of Canada Governor Carney in Ottawa on December 18. Mr. Antoine Brunelle-Cote (Senior Advisor) attended the meetings and Mr. Thomas Hockin (Executive Director) participated in some of the meetings. A press conference was held on December 19 in Toronto. Outreach activities included discussions with the private sector and think tanks.

XIII. FSSA Participation and ROSC Assessments

***Canada–Financial System Stability Assessment–
Volume II: Report on Observance of Standards in
the Financial System***

www.imf.org

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

- Introducing capital requirements for the guarantees in life insurance segregated fund (completed by end-2001);
- Tabling legislation granting the Office of the Superintendent of Financial Institutions (OSFI) powers to remove a financial institution’s director or senior officer if the person is deemed not suitable to hold that office based on a number of criteria. The latter legislation brought Canada into broad compliance with the Basel Core Principles;

Making significant progress in harmonizing securities regulation and improving coordination among provincial securities regulators, including through a newly created association of securities regulators, the Canadian Securities Administrators. Although

there remain multiple regulators at the provincial level, a Senate commission was created to develop specific recommendations on further harmonization and streamlining of securities regulation.

Canada: Report on the Observance of Standards and Codes—Fiscal Transparency Module

IMF Country Report No. 02/51,
03/12/02

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

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

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

Canada: Report on the Observance of Standards and Codes—Data Module

IMF Country Report
No. 03/328, 10/23/03

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

good frequency on a timely basis, and readily accessible to users, who trust them as objective.

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

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

Canada: Report on the Observance of Standards and Codes—FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism

IMF Country Report
No. 08/372, 12/11/08

Summary: Canada underwent a detailed FATF evaluation of its anti-money laundering and combating the financing of terrorism (AML/CFT) framework in 2007. Shortcomings were identified with respect to the scope of customer due diligence, AML/CFT supervision, and the Canadian financial intelligence unit. Since then, a number of steps have been taken to strengthen the framework in these three areas, resulting in significant improvements.

Canada: Financial System Stability Assessment-Update

IMF Country Report
No. 08/59, 02/13/08

Summary: The FSSA update concluded that Canada's financial system is mature, sophisticated, and well-managed. Financial stability was underpinned by sound macroeconomic policies and strong prudential regulation and supervision, and well-designed deposit insurance and arrangements for crisis management and failure resolution. The banking system appeared sound, with stress tests showing that the major banks could withstand sizeable shocks, although they did face some challenges related to the global financial turmoil that started in mid-2007. Also, there were some concerns about bank attempts to build on their secure domestic position, to enter highly competitive foreign markets or complex activities.

The update reiterated the advantages of moving towards a single securities regulator, including the streamlining of policy development, reductions in compliance costs, and improved enforcement. However, it also recognized the significant improvements to the regulatory system from the creation of the Canadian Securities Administrators (CSA), and the implementation of the passport system.

XIV. Technical Assistance: Not applicable.

XV. Resident Representative: Not applicable.

STATISTICAL ISSUES

The quality, coverage, periodicity, and timeliness of Canada's economic data are considered to be excellent both in the context of the Article IV consultation and for purposes of ongoing surveillance. Canada has subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (DSBB). The data ROSC was published on October 23, 2003.

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

Fiscal Sector. Statistics Canada provides quarterly data (a Statement of Government Operations along with a Balance Sheet) on the consolidated general government and its subsectors following the *Government Finance Statistics Manual, 2001 (GFSM 2001)* recommendations. In addition, the Department of Finance Canada provides monthly and annual data on the federal government's budget, tax policies, rules and regulations for Canada's banks and other financial institutions, according to the national presentation. The provided data enable adequate assessment of the impact of fiscal policy measures on Canada's economic performance.

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

External Sector. Statistics Canada provides timely information on a quarterly frequency on the balance of payments, external debt, and the international investment position (IIP). Finance Canada provides monthly data on Official International Reserves in a format comparable to the IMF's reserve data template, thus enabling adequate surveillance. Data are published at http://www.fin.gc.ca/finsearch/finresults_e.asp?Who=News.

CANADA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶	Memo Items:	
						Data Quality – Methodological soundness ⁷	Data Quality – Accuracy and reliability ⁸
Exchange Rates	Same day	Same day	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Jan 15, 2013	Jan 16, 2013	W	W	W		
Reserve/Base Money	Nov 2012	Dec 2012	W	W	W	LO, O, LO, LO	O, O, O, O, O
Broad Money	Nov 2012	Dec 2012	M	M	M		
Central Bank Balance Sheet	Dec 26, 2012	Jan 11, 2013	W	W	W		
Consolidated Balance Sheet of the Banking System	Oct 2012	Dec 2012	M	M	M		
Interest Rates ²	Same day	Same day	D	D	D		
Consumer Price Index	Nov 2012	Dec 2012	M	M	M	O, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	2012 Q1	Jun 2012	Q	Q	Q	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	Oct 2012	Dec 2012	M	M	M		
External Current Account Balance	2012 Q3	Jan 2013	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Nov 2012	Jan 2013	M	M	M		
GDP/GNP	2012 Q3	Nov 2012	Q	Q	Q	O, O, O, LO	O, O, O, O, O
Gross External Debt	2012 Q3	Nov 2012	Q	Q	Q		
International Investment Position ⁵	2012 Q3	Nov 2012	Q	Q	Q		

¹ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

² Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁶ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

⁷ Reflects the assessment provided in the data ROSC published on October 23, 2003 and based on the findings of the mission that took place during January 22-February 5, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), not observed (NO); and not available (NA).

⁸ Same as footnote 8, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.



INTERNATIONAL MONETARY FUND

Public Information Notice

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Public Information Notice (PIN) No. 13/17
FOR IMMEDIATE RELEASE
February 14, 2013

International Monetary Fund
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IMF Executive Board Concludes 2012 Article IV Consultation with Canada

On February 11, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.¹

Background

After a strong rebound in 2010–11, the Canadian economy slowed in 2012 reflecting lower growth of private domestic demand, continued external headwinds, and ongoing fiscal adjustment. Slower growth of disposable income and consumer credit put pressure on consumption. The housing sector cooled off somewhat, albeit from very high levels, and the uncertain external environment weighed on business investment. The authorities moved ahead with plans to return to balanced budgets over the medium term, so fiscal policy also held growth in check. At the same time, weak external demand and the strong currency depressed exports. Together with lower commodity prices, this caused a sharp widening of the current account deficit, to around 4 percent of gross domestic product (GDP).

Economic growth is expected to pick up again later in 2013, accelerating to around 2½ percent by 2014–15. Private consumption and residential investment are expected to contribute less to growth than in the recent past, as households deleverage and the housing sector continues to cool off. But business investment and net exports will benefit from the expected strengthening of the U.S. economy. However, near-term adverse risks remain elevated, in particular from continued uncertainty on U.S. fiscal policy, further turbulence from Europe, and a decline in commodity prices driven by an economic slowdown in emerging markets. While high household debt and still elevated house prices leave Canada more vulnerable to external shocks, a less gradual unwinding of domestic imbalances than in staff forecasts could also lead to lower growth.

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. An explanation of any qualifiers used in the summing up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

With regard to policy, fiscal consolidation continued in 2012. The federal government has led the effort, but most provinces are also moving ahead with plans to restrain spending. As a result, the general government's cyclically-adjusted fiscal deficit fell by a cumulative estimated 1¾ percentage points over the last two years and net debt, at around 34½ percent of GDP, is below most of its international peers. The federal authorities are targeting a balanced budget by mid-decade with some policy flexibility in case the downside risks materialize.

With economic growth faltering, major downside risks still lingering, and well-anchored inflationary expectations, monetary policy has remained accommodative. The inflation rate fell to the bottom of the Bank of Canada target band in late 2012, reflecting weaker economic activity, lower commodity prices, and the stronger currency. The target for the overnight rate has remained unchanged at 1 percent since September 2010, and market expectations are for monetary tightening to begin later in 2013.

Canadian financial markets have benefited from improved global financial conditions. Credit conditions remains highly favorable and should help support business investment going forward. Canada's banks are well capitalized and profitable, but remain exposed to potential spillovers from renewed distress in global financial markets which could lead to higher funding costs and liquidity strains.

Executive Board Assessment

Executive Directors commended the authorities for their sound macroeconomic and financial sector management. They noted that, after recovering rapidly from the 2009 recession, economic growth slowed in 2012. While growth is expected to pick up later in 2013, the balance of risks remains tilted to the downside as the high level of household debt may amplify the impact of adverse external shocks. In this regard, Directors noted that Canada's main challenge is to support growth in the short term while reducing the vulnerabilities that may arise from external shocks and domestic imbalances.

Directors agreed that the current monetary policy stance is appropriately accommodative. They noted that, given the negative output gap, well-anchored inflation expectations, and a challenging global environment, the tightening cycle should start only when growth strengthens again. Most Directors also agreed that there remains scope for further monetary policy easing to support economic activity should growth prospects weaken significantly. A few Directors believed, however, that further easing is unlikely to be effective and would exacerbate financial risks posed by prolonged low interest rates. Directors concurred that further macro-prudential measures are the first line of defense against the risks from high household leverage.

Directors supported the authorities' medium-term fiscal consolidation plans, as this will allow rebuilding key buffers against future adverse shocks. They agreed, however, that automatic stabilizers should be allowed to work fully in the event economic growth weakens. Directors stressed the importance of moving ahead with fiscal consolidation in some of the largest provinces.

Directors noted that placing the general government debt on a sustainable long-term path would require reforms that durably contain spending and boost revenues. Renewed efforts at the provincial level to slow the growth of health care spending would be particularly important in this regard. Publishing a comprehensive fiscal sustainability report covering all levels of government and including a discussion of policy options would help gain the necessary public support for reforms.

Directors considered the housing sector to be an important source of vulnerability, noting the rising household debt-to-income ratio. They welcomed the authorities' tightening of the rules for government-backed mortgage insurance and mortgage lending standards, which has helped slow the pace of increase in household leverage and house prices. Directors concurred that, should the household debt-to-income ratio continue to rise, additional measures may be needed.

Directors commended Canada's strong financial regulation and supervision system, which has helped maintain a well-capitalized and profitable banking system. They stressed the need to remain vigilant against the risk of contagion from external shocks and the build-up of financial vulnerabilities from the prolonged period of low interest rates. Directors welcomed the authorities' continued commitment to implement the international financial reform agenda, and their decision to undertake an update of the Financial Sector Assessment Program in 2013.

Directors concurred that the strong endowment of commodities presents both opportunities and challenges. They noted that the sustained improvement of Canada's terms of trade, driven by higher commodity prices, had a positive impact on economic growth and government revenues. At the same time, structural changes associated with the growing commodity sector should be managed by increasing productivity and opening up new markets. More generally, improvements in productivity will be needed to increase Canada's external competitiveness. They also agreed that it would be useful for the authorities or resource-rich provinces to consider adopting a fiscal framework that mitigates the transmission of commodity price volatility to the broader economy.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2012 Article IV Consultation with Canada is also available.

Canada: Selected Economic Indicators 1/

(Annual change in percent, unless otherwise noted)

	2009	2010	2011	Est. 2012	Proj. 2013
Real GDP	-2.8	3.2	2.6	2.0	1.8
Net exports 2/	0.1	-2.1	-0.4	-0.4	-0.2
Total domestic demand	-2.9	5.2	2.9	2.3	1.9
Final domestic demand	-2.0	4.9	2.7	1.8	1.6
Private consumption	0.2	3.4	2.4	2.0	2.0
Public consumption	3.4	3.0	1.0	-0.2	0.2
Private fixed domestic investment	-16.0	10.8	7.1	5.1	2.5
Private investment rate (as a percent of GDP)	16.9	18.1	18.9	19.5	19.6
Public investment	8.7	9.3	-3.3	-6.1	-0.9
Change in inventories 2/	-0.8	0.3	0.2	0.5	0.3
GDP (current prices)	-4.9	6.4	5.9	3.3	3.8
Employment and inflation					
Unemployment rate	8.3	8.0	7.5	7.3	7.3
Consumer price index	0.3	1.8	2.9	1.6	1.7
GDP deflator	-2.2	3.1	3.2	1.3	2.0
Exchange rate (period average)					
U.S. cents/Canadian dollar	87.5	97.1	101.1	100.0	...
Percent change	-7.1	9.9	3.9	-1.0	...
Nominal effective exchange rate	-4.1	9.8	2.0	0.9	...
Real effective exchange rate	-4.3	9.3	1.4	0.02	...
Indicators of financial policies (national accounts basis, as a percent of GDP)					
Federal fiscal overall balance	-2.1	-2.5	-1.8	-1.3	-1.1
Provincial fiscal overall balance 3/	-3.4	-3.3	-2.8	-2.5	-2.3
General government fiscal balance 4/	-4.8	-5.3	-4.1	-3.2	-2.9
Three-month treasury bill	0.4	0.6	0.9	1.0	1.0
Ten-year government bond yield	3.2	3.2	2.8	1.9	2.1
Balance of payments					
Current account balance (as a percent of GDP)	-2.6	-3.5	-3.0	-4.0	-4.0
Merchandise trade balance (as a percent of GDP)	-0.4	-0.6	0.1	-0.7	-0.6
Export volume	-14.6	8.0	5.1	2.1	2.4
Import volume	-14.4	14.1	6.0	2.7	2.8
Invisibles balance (as a percent of GDP)	-2.2	-2.9	-3.1	-3.3	-3.4
Saving and investment (as a percent of GDP)					
Gross national saving	18.8	19.7	20.6	20.6	20.8
General government	0.0	-0.3	0.5	1.3	1.4
Private	18.8	20.0	20.1	19.3	19.4
Personal	6.3	5.5	5.0	4.3	4.3
Business	12.6	14.6	15.1	15.0	15.1
Gross domestic investment	21.8	23.3	23.6	24.6	24.9

Sources: Statistics Canada and IMF staff estimates.

1/ Data as available on December 21, 2012.

2/ Contribution to growth.

3/ Includes local and territorial governments.

4/ Includes Canadian Pension Plan and Quebec Pension Plan.