February 2007
IMF Country Report No. 07/51

Canada: 2007Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Canada, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 8, 2006, 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 December 22, 2006. 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; and

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 12, 2007 discussion of the staff report that concluded the Article IV consultation.

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

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Canada

Approved by Christopher Towe and Anthony Boote

December 22, 2006

- ***Discussions for the 2007 Article IV consultation with Canada were held in November and December 2006***. The team comprised T. Bayoumi (Head), R. Balakrishnan and V. Klyuev (all WHD). Mr. Jenkins, Senior Advisor (OED) participated, while Mr. Towe (WHD) and Mr. Fried, the Executive Director, joined the concluding session.
- ***The team met with public and private sector representatives***. Discussions were held with Finance Minister Flaherty and Bank of Canada Governor Dodge, as well as senior officials from Finance Canada, the Bank of Canada, the Office of the Superintendent of Financial Institutions, Industry Canada, Human Resources and Social Development Canada, the government of Ontario, and the Ontario Securities Commission. The team also met with three major banks, the PEAP forecasting group, the C.D. Howe Institute, the Conference Board of Canada, the Canadian Chamber of Commerce, and the Canadian Labour Congress.
- ***Past Fund advice***. The adoption of a medium-term debt target in the FY 2004–05 budget and steady increase in monetary transparency have been in line with staff recommendations. The authorities have been less receptive to calls for reforming the Employment Insurance system, and moves toward more transparent regulations for bank mergers and a national securities regulator have been slow.
- ***Past background work***. A summary of analytic work in recent years appeared in the Fund's December 15 *Research Bulletin* (http://www.imf.org/External/Pubs/FT/irb/2006/eng/04/index.pdf).
- ***Relations with the authorities***. Canada has been a strong supporter of quota reforms and a stronger surveillance mandate, including integration of financial analysis into country reviews and a greater focus on multilateral surveillance, and exchange rates. Recent work by the Bank of Canada has also provided suggestions for improving governance and risk management at the Fund.
- ***ROSCs***. An Update to the 2000 FSAP has been requested by the authorities for mid-2007. A Fiscal ROSC was published in March 2002, and a Data ROSC in October 2003. Canada is a party to the Financial Action Task Force (FATF) and the convention on Combating Bribery of Foreign Public Officials in International Business Transactions.
- **Canada has accepted Article VIII obligations**, but maintains some restrictions for security reasons.

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EXECUTIVE SUMMARY

Background: The strong economic performance is likely to continue despite a recent slowing, but risks are on the downside as Canada is particularly vulnerable to a sharper-than-expected U.S. slowdown. Large movements in commodity prices have exacerbated regional disparities, necessitating resource shifts across industries and regions, complicating monetary policy, and widening provincial differences in fiscal capacity.

Key Policy Issues: Sound monetary and fiscal frameworks have delivered macroeconomic stability:

- **Monetary policy** remains the first line of defense against macroeconomic shocks, and the Bank of Canada has adroitly balanced competing growth and inflation risks, including by keeping the policy rate on hold since May. Going forward, the current stance appears appropriate, although much will depend on incoming data. The renewal of the inflation targeting framework is welcome, as is the intention to continue analysis of possible future improvements.

- **Fiscal policy** is appropriately focused on further reducing debt, lowering taxes, and reforming federal-provincial transfers. However, reducing effective marginal tax rates on investment would provide larger efficiency gains than further cuts to the Goods and Services Tax.

- The **financial sector** is stable and well-capitalized, leaving it well positioned to cope with a turning of the global credit cycle. At the same time, there seems to be scope to improve financial sector efficiency and innovation by reducing regulatory impediments to bank entry and consolidation, as well as by establishing a national securities regulator.

- The government's focus on **enhancing productivity** is timely. In addition to cutting high marginal effective tax rates on investment and improving financial intermediation, the business environment could be improved by phasing out restrictions to foreign direct investment, increasing the flexibility of the immigration system, and eliminating interprovincial barriers to trade in goods and labor mobility.

I. Introduction

1. ***Over the last year, the Canadian economy has remained close to potential and inflation has been contained despite significant external shocks*** (Tables 1 and 2). The boost to activity from rising commodity prices has been largely offset by the headwinds from a roughly 35 percent nominal effective appreciation of the exchange rate over the last few years. Headline inflation, which was earlier boosted by higher energy prices, has fallen below the 2 percent mid-point of the target range recently, while the core rate has remained close to target. More recently, however, the economy has slowed, partly owing to weaker U.S. activity.

2. ***In view of Canada's strong macroeconomic and policy performance, this year's consultation discussions were streamlined.*** Past Fund advice and the authorities' views are summarized in the table on the next page, and discussions this year focused on:

- *Vulnerabilities*. Given close economic ties, Canada's growth, financial market conditions, and fiscal prospects are especially vulnerable to U.S. spillovers.
- *The fiscal framework*. The new government has refined its debt reduction goals and is committed to overhauling the system of federal "equalization" payments to provinces.
- *The business environment and productivity*. In November, the government issued *Advantage Canada* (available at http://www.fin.gc.ca/ec2006/plan/pltoce.html) outlining an ambitious structural agenda.

II. Macroeconomic and Financial Risks

3. ***Macroeconomic prospects remain broadly favorable.*** Staff projects growth recovering to around potential of 2¾ percent by mid-2007 and inflation close to target (after adjusting for the recent GST cut). The slowing of domestic demand as a result of earlier interest rate hikes would be offset by a diminished drag from net exports as the effects of the earlier exchange rate appreciation and slower U.S. activity wane. With the output gap around zero, inflation would remain close to the mid-point of the 1–3 percent band.

4. ***Staff viewed spillovers from the United States as tilting growth risks to the downside, while inflation risks were smaller and more balanced*** (Figure 1). Various estimates suggested that a percentage point fall in U.S. growth reduced Canadian activity by 0.3–0.7 percentage points (see following Table). The effect was likely to be in the upper part of this range given that the lower estimates come from macroeconomic models, which might not capture well financial spillovers, and key linkages to the vulnerable U.S. auto sector.

Canada: Fund Policy Advice

Issue	Staff Position	Authorities' Position
	Monetary Policy	
The Bank of Canada is considered one of the most transparent central banks, but its Monetary Policy Report receives low international ratings.	Even given recent improvements, further progress could be made in communicating key assumptions, including the risks to the outlook.	The Monetary Policy Report (MPR) is now explicit about assumptions for the exchange rate and more specific about the interest rate path consistent with its base case projection, both as recommended by Fund staff. The Bank of Canada considers the MPR to be equivalent to the publication of minutes.
	Fiscal Policy	
The agreement to lock in federal health transfers over the next 10 years provides provinces with opportunities to improve the efficiency and quality of health care.	Allowing provinces greater flexibility in using price and other market-based mechanisms could help align the demand and supply for health care and reduce costs over time.	The Canada Health Act allows for private service delivery, and provinces are actively exploring different approaches to improve competition.
	Financial Policy	
Harmonizing securities regulation would reduce compliance and administrative costs while simplifying rule making and supervision.	We support a national securities regulator, as is typical in most other industrial countries and was proposed in the report by the Wise Persons' Committee.	The federal government will continue working with the provinces to create a common securities regulator and advance an approach to securities regulations founded on principles, with strong enforcement.
The funding of Canada's defined benefit plans has deteriorated over the past several years, but has stabilized over the past year.	Entry into public consultation on reform is welcome and early action is warranted to better align the incentives of plan sponsors and members.	The federal government recently implemented temporary relief measures to re-establish full funding in an orderly fashion. The federal government will continue to examine the broader challenges facing defined benefit pension plans.
	Labor Markets	
Canada has high labor participation rates, but the boom in the commodity and construction sectors has led to tight labor markets especially in the Western provinces.	Priorities are reducing welfare walls, amending immigration systems to address skills shortages, and simplifying recognition of occupational qualifications.	The federal government has committed to improving labor market efficiency, including through a working income tax benefit. Progress has also been made in removing obstacles to labor mobility under the Agreement on Internal Trade.
Canada maintains an Employment Insurance system that offers generous seasonal, regional, and family leave benefits, funded by a payroll tax.	Consideration could be given to funding social benefits of the Employment Insurance system through general revenues and to curbing extended regional benefits.	Recent reforms to the Employment Insurance System have improved the system's funding. No significant changes in benefits are currently being considered.
	Trade Policy	
Canada can play an important leadership role in the Doha negotiations.	Canada needs to widen market access for agricultural goods, including those subject to "supply management" schemes.	Canada is pursuing an ambitious Doha outcome and will continue to support supply management.

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

		Projections			2006				2007 Projections			
	2005	2006	2007	2008	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	2.9	2.8	2.5	3.0	3.8	2.0	1.7	2.4	2.6	2.7	2.8	2.9
Net exports (contribution)	-1.6	-1.3	-0.3	0.0	-0.8	-3.4	-0.1	-0.4	-0.1	0.0	-0.1	-0.1
Total domestic demand	4.8	4.1	2.9	3.1	4.7	5.6	1.9	3.1	2.8	2.8	3.0	3.0
Final domestic demand	4.3	4.2	2.9	3.1	5.6	3.6	2.8	2.9	2.8	2.8	3.0	3.0
Private consumption	3.9	3.8	3.1	2.9	4.8	3.8	4.2	3.1	2.5	2.6	3.0	3.1
Private fixed investment	7.1	6.0	3.6	3.7	10.3	1.6	1.2	3.9	4.3	4.2	3.8	3.8
Inventories (contribution)	0.3	0.0	0.0	0.0	-1.0	2.1	-1.0	0.0	0.0	0.0	0.0	0.0
Unemployment rate (percent)	6.8	6.3	6.3	6.3	6.4	6.2	6.4	6.3	6.3	6.3	6.3	6.3
Consumer price index	2.2	2.1	1.7	2.0	2.0	3.0	0.1	1.5	2.0	2.0	2.0	2.0
Federal fiscal balance/GDP	0.1	0.4	0.3	0.3	...	...	...	...	...	...	...	...
Current account balance/GDP	2.3	1.8	1.4	1.6	2.9	1.3	1.4	1.5	1.7	1.3	1.1	1.6
Memorandum items:												
Partner country growth 1/	3.3	3.5	2.8	3.1	3.7	3.6	3.0	2.8	2.6	2.7	2.9	3.1
Oil prices ($/Barrel)	53.4	64.4	63.3	64.3	61.0	68.3	69.0	59.3	61.8	63.0	64.0	64.3

Sources: Haver Analytics; and Fund staff estimates.

1/ An export-weighted average of growth in trade partners.

Bank officials also suggested that spillovers from slower U.S. residential investment might be particularly large, while Finance Canada and most private sector analysts saw the spillovers from housing as similar to other types of U.S. demand. Officials remained concerned that a disorderly unwinding of global imbalances involving a U.S. dollar depreciation, weaker U.S. activity, and lower commodity prices, would weigh especially heavily on Canada (as discussed in the 2006 *Staff Report*).

Various Estimates of Contemporaneous Spillovers from a One Percentage Point Fall in U.S. Growth
(percentage point fall in Canadian growth)

OLS regressions since 1995	
Growth over last year	0.6
Growth over last quarter	0.4
WEO forecast errors since 1995	
Current year	0.6
A year ahead	0.7
Macroeconomic models	
IMF's Global Economic Model	0.3
Oxford Economics' Global Macroeconomic Model	0.3

Source: Fund staff calculations.

5. ***Staff and officials agreed that the floating exchange rate had acted as a useful shock absorber in recent years*** (Figure 2 and Table 3). While the desk exchange rate equation and some staff multilateral analysis suggested that the Canadian dollar could be modestly (0–10 percent) above equilibrium (possibly reflecting investment inflows associated with oil sands), it was agreed that the rapid appreciation of the Canadian

currency since 2002 mainly reflected the world commodity boom. This was consistent with experience and macroeconomic models, which suggested that the short-term impact on domestic investment from changes in commodity prices tended to be offset by the effect on external demand of the exchange rate response. That said, given capacity constraints in Alberta (where oil sands are concentrated), the impact of further oil price increases could be modestly negative.

6. ***It was agreed that there was a risk that the recent revival of labor productivity growth could be transitory***. The staff forecast assumed that higher investment and greater competitive pressures in industries exposed to external competition would support productivity. However, in light of weak productivity performance earlier in the decade, less optimistic scenarios could be envisaged.

7. ***Prospects for domestic demand and balance sheets were seen as strong***:

- *Households* (Figure 3). Robust real income growth and rising household wealth ratios had supported consumption, even with near-zero household saving. Indeed, given that house prices were less inflated than in other cyclically-advanced countries, and that a near-prime mortgage market was beginning to develop, residential investment and consumption could be more buoyant than anticipated.
- *Corporates* (Figure 4). As in some other advanced countries, profit margins had risen and financing conditions were comfortable, suggesting a favorable outlook for business investment, particularly as exchange rate strength had lowered prices of imported equipment.

8. ***It was agreed that the financial sector was sound*** (Figure 5). Bank profitability and capital were high by historical (and, for the latter, international) standards, and risks from the housing market relatively limited. The financial sector appeared well positioned to cope with weaker U.S. activity—even though U.S. exposures had traditionally been a major source of volatility in earnings (one of the issues that will be pursued in the upcoming FSAP update) (Figure 6).

III. Macroeconomic Policies

9. ***Monetary policy should remain the first line of defense in response to macroeconomic shocks***. The inflation targeting framework has provided more than adequate scope for the Bank of Canada to provide countercyclical support. Fiscal policy has appropriately focused on achieving steady debt reduction, and, while the fiscal framework does not preclude deficits in the face of significant shocks, officials stressed the strong social consensus for avoiding such an outcome.

10. ***After a period of gradual monetary tightening, the Bank has appropriately left rates at 4¼ percent since May*** (Figure 7). While much will depend on incoming data, staff observed that it appeared apposite at present to maintain the current stance (in line with market expectations) given symmetric inflation risks, real short-term interest rates around neutral, well-anchored inflation expectations, and moderate labor cost increases. Officials broadly agreed and noted that the Bank was especially alert to the possibility that the continuing shift of resources from the manufacturing-based center to the commodity-rich

west had lowered productivity temporarily (Figure 8). Partly in recognition of the risk this posed to inflation, the Bank had lowered its estimate of potential output growth.

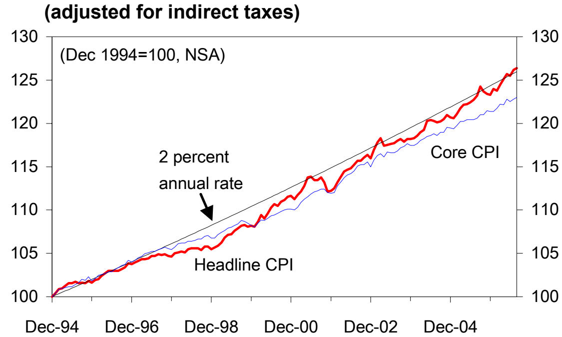
11. ***The team welcomed the renewal of the inflation targeting framework for a further five years, given its success in keeping inflation expectations well anchored***. Bank officials explained, however, that they now had greater flexibility to announce adjustments to the 6–8 quarter time frame for returning inflation to the target. This would allow adjustments for the apparent decline in inflation persistence, which might suggest a faster response, or for the possibility that some shocks—for example to asset prices—could be more persistent. Staff welcomed the Bank's intention to continue to analyze the benefits and costs of a lower inflation target and price level targeting (PLT) in time for the next renewal (Box).

Box: Price Level Targeting—Evolution Rather than Revolution?

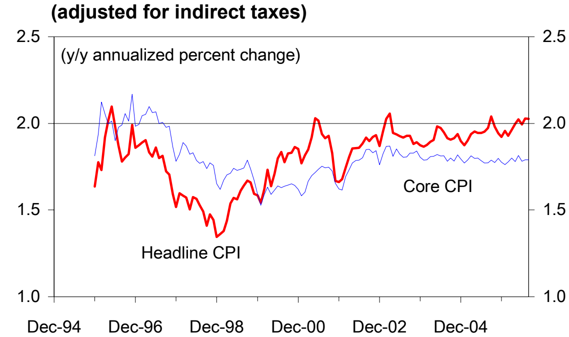
In price level targeting (PLT), the central bank targets a path for the price level (which will generally rise to ensure nominal flexibility). In contrast to inflation targeting (IT), high inflation now implies lower inflation at some point in the future. Analysts have come to mixed conclusions about the relative performance of IT and PLT, with a "hybrid" strategy containing elements of both generally working best.

Some practitioners have suggested that differences between IT and PLT are overstated. Governor King of the Bank of England has observed that IT is in many ways equivalent to PLT if an average inflation target is adopted. Inflation has averaged 2 percent since the adoption of a 2 percent IT target in December 1995, although Governor Dodge has emphasized this need not transpire in the future. This suggests that a "hybrid" regime could be introduced in a relatively evolutionary manner by adding a criterion that inflation should average the target rate over the medium term in the policy agreement between the Bank and the government.

Price level since December 1994 (adjusted for indirect taxes)



Average inflation since December 1994 (adjusted for indirect taxes)



Source: Haver Analytics.

12. ***The November* Fiscal Update *underscored the strong fiscal position.*** FY2005–6 saw another larger-than-anticipated federal surplus—1 percent of GDP and 0.4 percentage points higher than projected in the May Budget—as program expenses fell in nominal terms for the first time since FY1996–97. The Update also projected somewhat higher future surpluses than projected in the Budget. Provincial fiscal positions have also improved, in some cases due to resource revenues.

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

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Revenue	16.4	16.4	16.2	15.9	15.8	15.5	15.3	15.1
Outlays	15.6	16.3	15.2	15.5	15.5	15.2	15.1	14.9
Budget balance	0.8	0.1	1.0	0.4	0.3	0.2	0.2	0.3
Planned debt reduction	...	...	1.0	0.2	0.2	0.2	0.2	0.2
Planning surplus 2/	0.8	0.1	0.0	0.2	0.1	0.1	0.0	0.1
Net lending	0.0	0.4	0.1	0.4	0.3	0.3	0.2	0.2
Net debt 3/	40.9	38.3	35.1	33.2	31.6	29.9	28.3	26.8

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

1/ The projections are based on the baseline provided by the authorities' 2006 Economic and Fiscal Update adjusted for staff macro assumptions. It includes a GST cut of 1 percentage point in 2010/11.

2/ Planning surplus = budget balance minus debt reduction.

3/ Assuming future planned debt reduction is achieved.

13. ***The team welcomed the* Update's *focus on fiscal prudence*** (Figure 9). This included continued targeting of debt reduction of C$3 billion, the advancement of the commitment for lowering the federal debt ratio to 25 percent by a year to FY 2012–13, and allocating unanticipated surpluses to further lowering debt. Given spending pressures from population aging, fiscal sustainability required a steady and significant decline in debt in coming decades, as well as further steps to contain public health spending growth. The *Update's* goal to eliminate general government net debt by 2021 appropriately highlighted the role of asset accumulation by public pension plans and balanced budgets by provincial-territorial governments (which deliver health services). This could be further buttressed by a regular assessment of long-term sustainability, a point that officials acknowledged.

14. ***Officials emphasized the government's intention to reduce the tax burden, supported by steady reductions in spending as a ratio to GDP***. To bolster the social consensus for debt reduction, the *Update* had committed to use savings from debt service to lower personal income taxes. Staff welcomed these plans, but suggested that reducing Canada's high marginal effective income tax rates (particularly on investment) would provide greater efficiency benefits than the proposed further cut to the Goods and Services Tax (GST). Indeed, with population aging steadily eroding the ratio of workers in the population, there was a case for bolstering consumption taxes. Promised further GST cuts could provide fiscal room for remaining provinces to harmonize their sales taxes with the GST. Harmonization to a VAT would eliminate provincial taxes on business inputs, lowering marginal effective rates on investment, and a GST cut could help cushion the effect of higher sales taxes on consumption needed to offset revenue losses.

15. ***It was agreed that reforms to federal equalization transfers that reduce differences in provincial fiscal capacities should make them more rules-based and predictable***.[1] Differences in provincial fiscal capacity had been widened by elevated commodity prices, prompting ad hoc bilateral arrangements. Staff supported the O'Brien panel's recommendations to partially include resource revenues from all provinces in the standard for

[1] The system is described at http://www.fin.gc.ca/FEDPROV/eqpe.html.

equalization transfers and to cap transfers so no receiving province would have a higher fiscal capacity than a nonreceiving one. Federal officials observed that the panel's proposals provided a useful starting point for negotiations and there seemed to be general, although by no means unanimous or enthusiastic, acceptance of its main recommendations by provinces.

IV. Structural Agenda

16. ***Sustained productivity growth is essential to raise living standards in the face of an aging population*** (Figure 10). Indeed, the theme of *Advantage Canada* is particularly timely against a background of modest business investment ratios for machinery and equipment and R&D, as well as a widening productivity gap with the United States.

17. ***Reflecting previous staff analysis, the team emphasized the importance of measures to enhance the business environment***:[2]

- ***The tax system could be made friendlier for saving and investment***. Canada's effective marginal tax rates on investment are among the highest in the world, partly reflecting provincial sales and capital taxes. While the team welcomed the decision to end the tax advantage for income trusts, other aspects of the tax system, including the differential between rates applying to large and small firms, could distort capital allocations. There was also scope to support personal saving through lowering taxes on dividends and capital gains, and by raising contribution limits on tax-advantaged retirement plans.

- ***While Canada's federal regulatory system was generally given high marks internationally, specific reforms could encourage product market efficiency***. In particular, regulations on foreign direct investment—especially for network industries such as airlines, communications, and the media—as well as public ownership in the electricity sector appeared outmoded. Interprovincial barriers to trade remained high despite the welcome Alberta-British Columbia Trade, Investment, and Labour Mobility Agreement.

- ***Lowering regulatory impediments to bank entry and consolidation could increase the efficiency and dynamism of the financial sector*** (Figure 11). Against a backdrop of a rapidly changing global environment, greater clarity on the basis for ministerial approval of bank mergers and liberalizing bank ownership rules would lower uncertainty, increase contestability in the banking system, and help stimulate innovation.

- ***Employers' access to skilled workers could be improved***. The difficulty in adapting the immigration system to skill shortages created by Alberta's boom underlined the potential for attuning the system more to the needs of employers. Limited recognition of professional qualifications across provinces also remained an important constraint. Recent research comparing outcomes between New Brunswick and Maine also highlighted the continuing costs of the Employment Insurance system for labor market participation.

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[2] See Box 5 of the 2006 *Staff Report*.

18. ***Officials noted that* Advantage Canada *was a comprehensive plan covering all levels of government, to raise prosperity, and included many of the staff's priorities***. They stressed the importance of provinces harmonizing sales taxes and eliminating capital taxes for achieving the objective of attaining the lowest marginal effective tax rate on investment in the G-7. *Advantage Canada* had also committed to reducing the regulatory burden on firms and to creating a dynamic and globally competitive financial system (separately, Bank officials observed that realizing scale economies could increase efficiency in the banking system). In addition, incentives to work and save would be enhanced through lower personal income taxes, including a Working Income Tax Benefit for the working poor. The need to reform the immigration system, improve post-secondary education, and encourage greater interprovincial labor mobility were also stressed.

V. STAFF APPRAISAL

19. ***The strong recent performance of the Canadian economy is likely to continue, although risks are tilted to the downside***. Staff projects that growth will rebound to potential, estimated at around 2¾ percent, by mid-2007 and inflation will stay around 2 percent. The main risk is the possibility of a larger-than-expected U.S. slowdown.

20. ***The Bank of Canada has adroitly balanced competing growth and inflation risks, including by keeping rates on hold since May***. While much will depend on incoming data, with policy rates in the neutral range and inflation pressures contained, the current stance appears appropriate moving forward. The decision to leave the highly successful inflation targeting framework unchanged, coupled with continued analysis of possible future improvements, is also welcome.

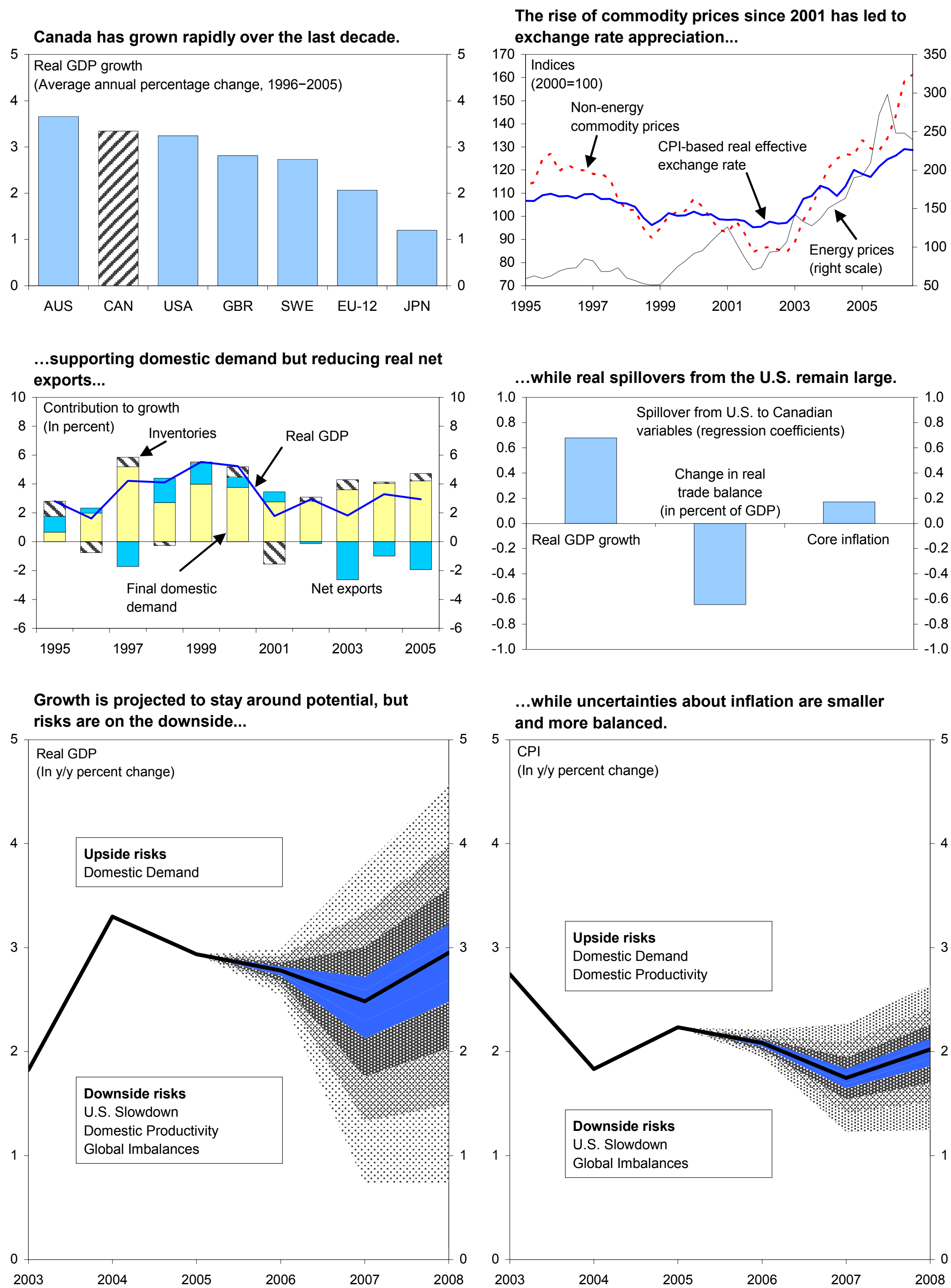
21. ***The financial sector is well positioned to cope with a turning of the global credit cycle***. The banks are profitable, well-capitalized, and risks from the housing market are more limited than in other cyclically-advanced countries. At the same time, there seems to be scope to improve financial sector efficiency and innovation by reducing regulatory impediments to bank entry and consolidation, as well as by moving toward establishing a national securities regulator.

22. ***Fiscal policy is appropriately focused on reducing debt, lowering taxes, and reforming the equalization system***. While great strides have been made in lowering government indebtedness, long-term fiscal sustainability requires further debt reduction as well as steps to curb increases in public health spending. We welcome the government's commitment to using interest savings from debt reduction to lower personal income taxes and to reducing effective marginal tax rates on investment, which would provide larger efficiency gains than further cuts to the GST. The reforms suggested by the O'Brien panel would appropriately make the equalization system more rules-based and predictable.

23. ***With sound frameworks delivering macroeconomic stability, we welcome* Advantage Canada's *theme of enhancing prosperity***. In addition to cutting tax rates on capital (including through promoting actions by provinces) and improving financial market competition, the business environment could be enhanced by phasing out restrictions to foreign direct investment, increasing the flexibility of the immigration system, and eliminating interprovincial barriers to trade in goods and labor mobility.

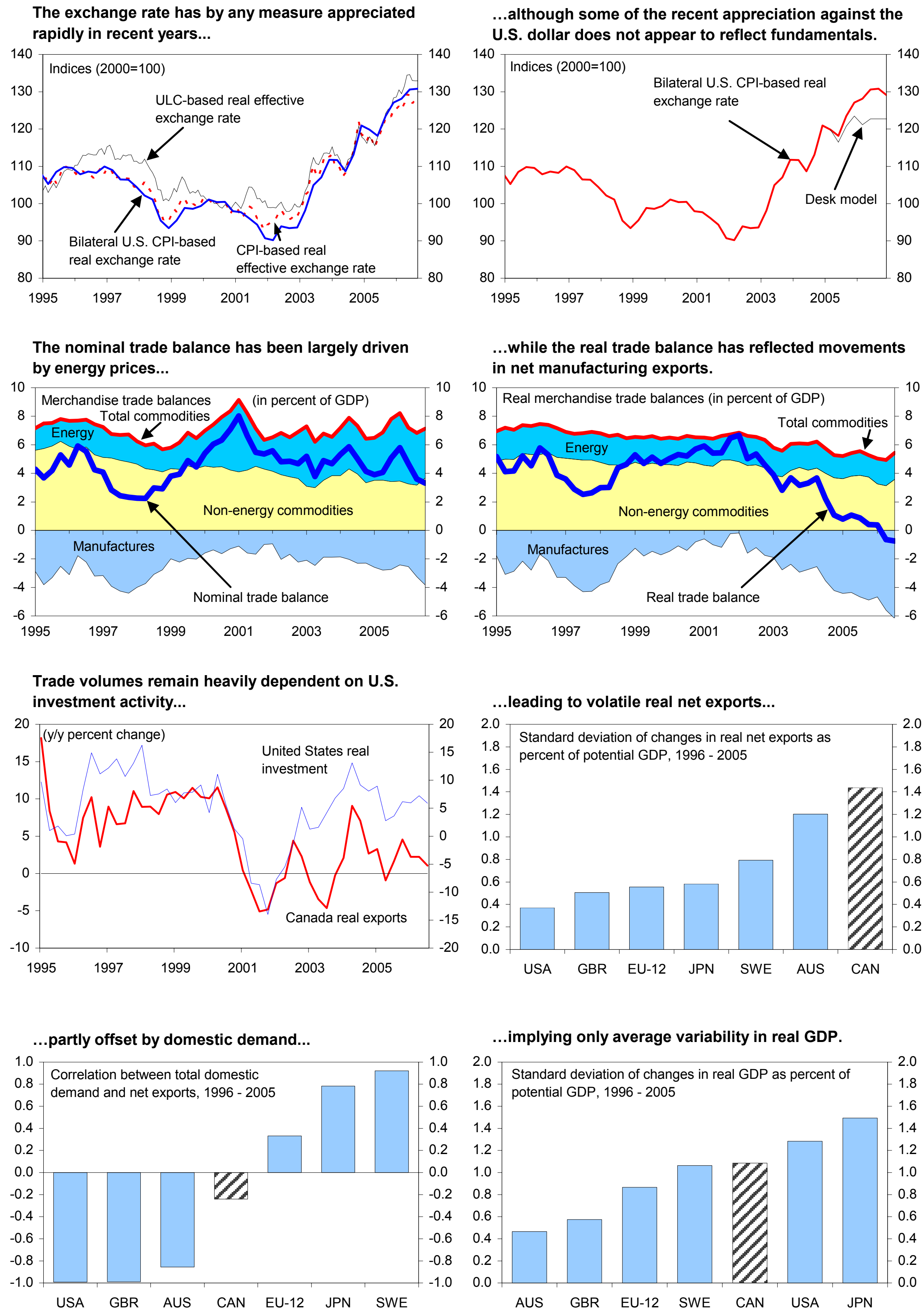
24. It is recommended that the next consultation occur on the usual 12-month cycle.

Figure 1. Overview



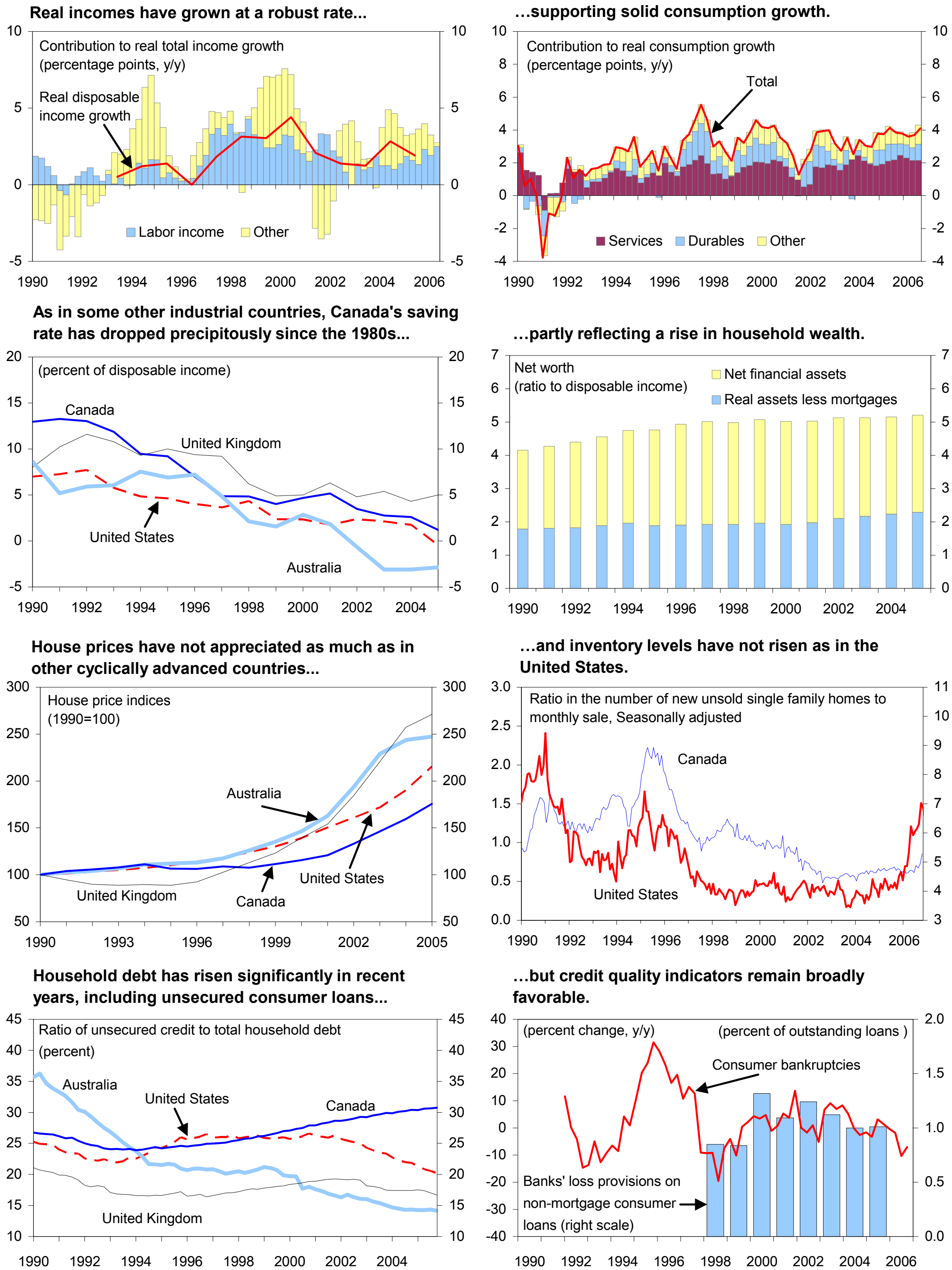
Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook;* and Fund staff estimates.

Figure 2. External Developments



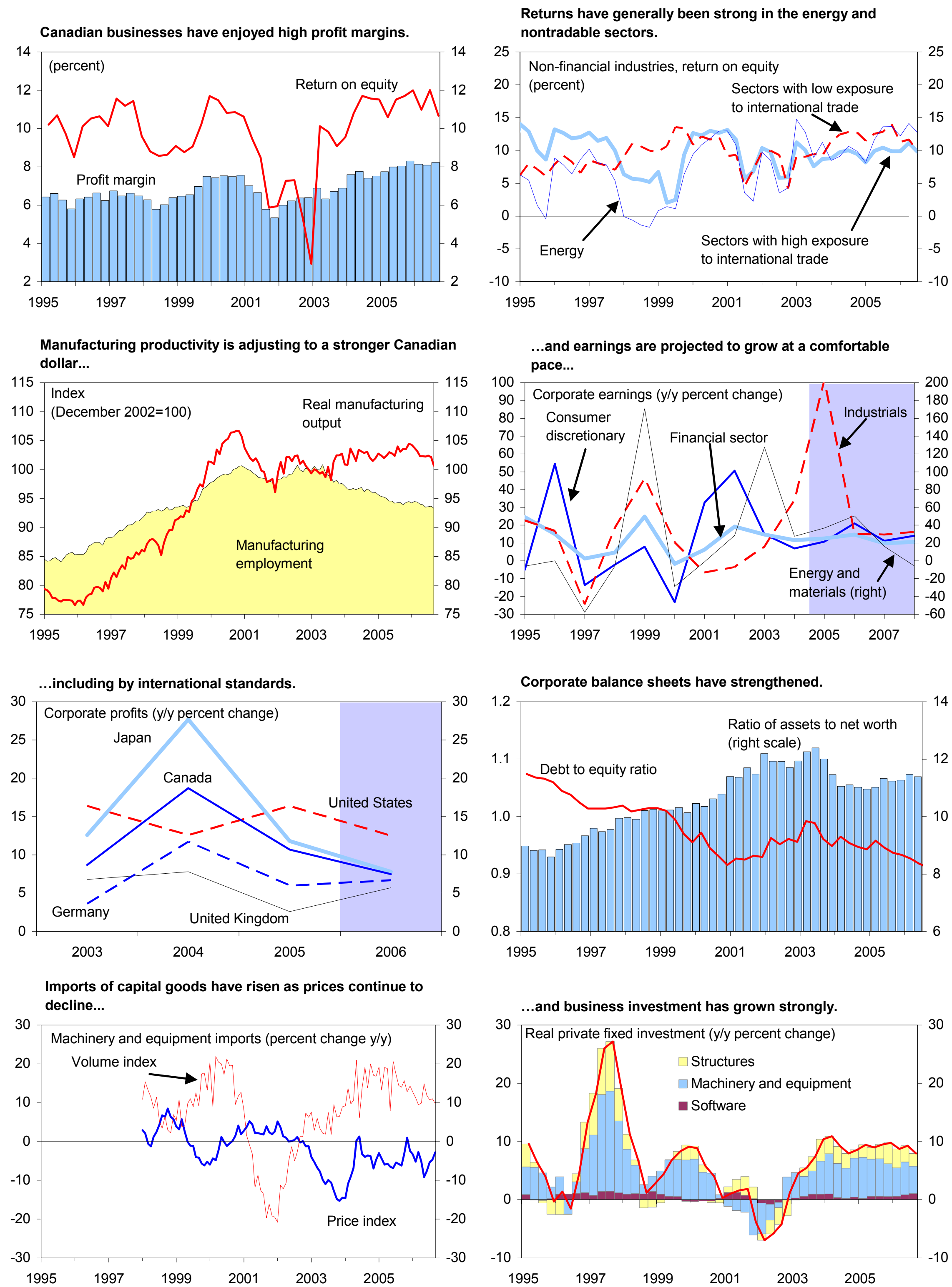
Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook*; and Fund staff estimates.

Figure 3. Household Activity and Balance Sheets



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

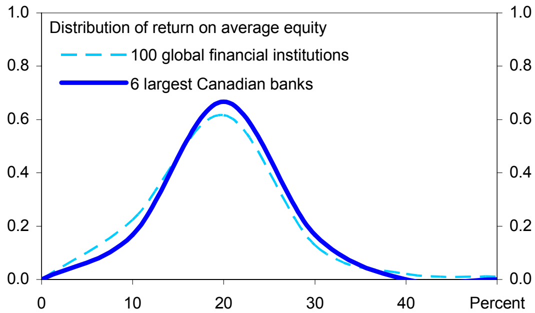
Figure 4. Corporate Sector Indicators



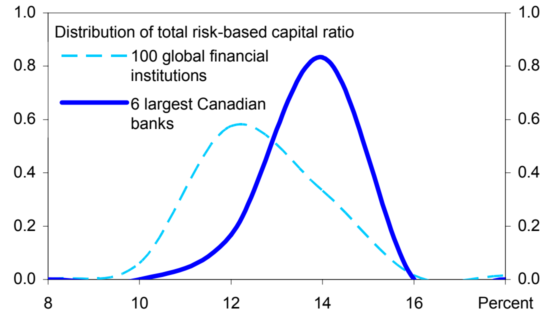
Sources: Haver Analytics; Thomson One Analytics; Consensus Forecasts; and Fund staff calculations.

Figure 5. Financial Market Trends

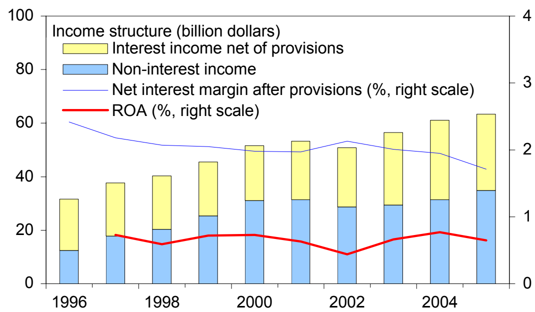
In 2005, Canadian banks were as profitable as their global competitors...



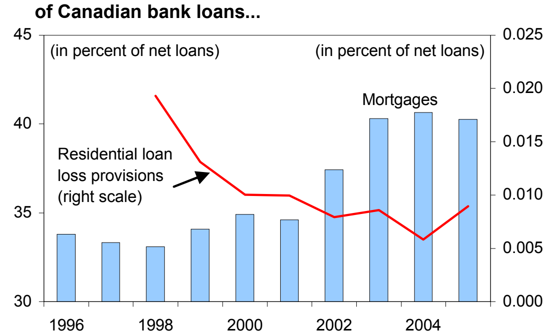
...while capitalization remained exceptionally high.



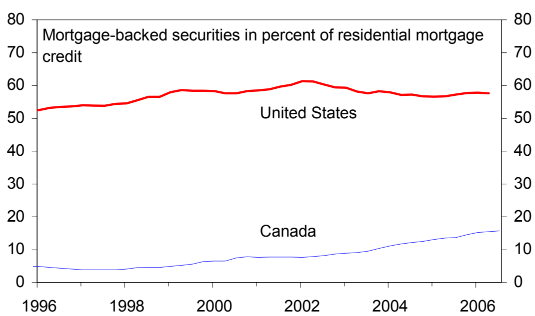
Bank profits were boosted by rising fee income and a decline in loan loss provisions.



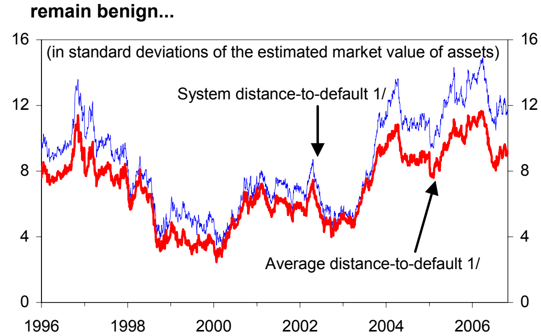
Mortgage lending accounts for a substantial share of Canadian bank loans...



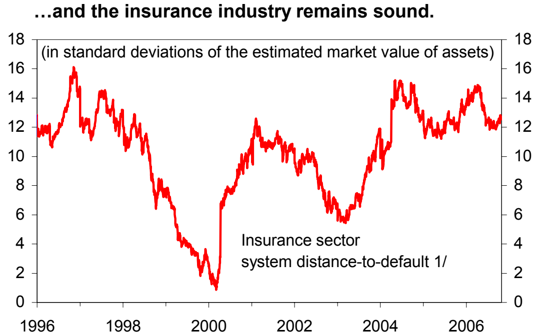
...and banks keep a larger share of mortgages on their balance sheets than in the United States.



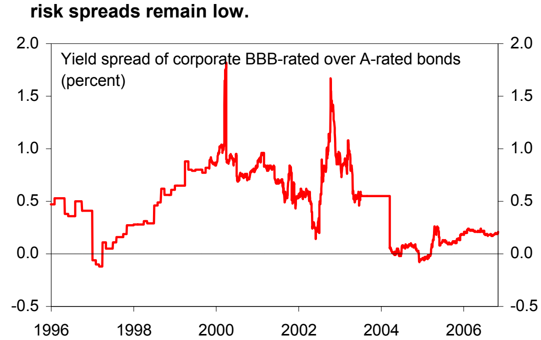
Distance-to-default measures for the banking system remain benign...



...and the insurance industry remains sound.

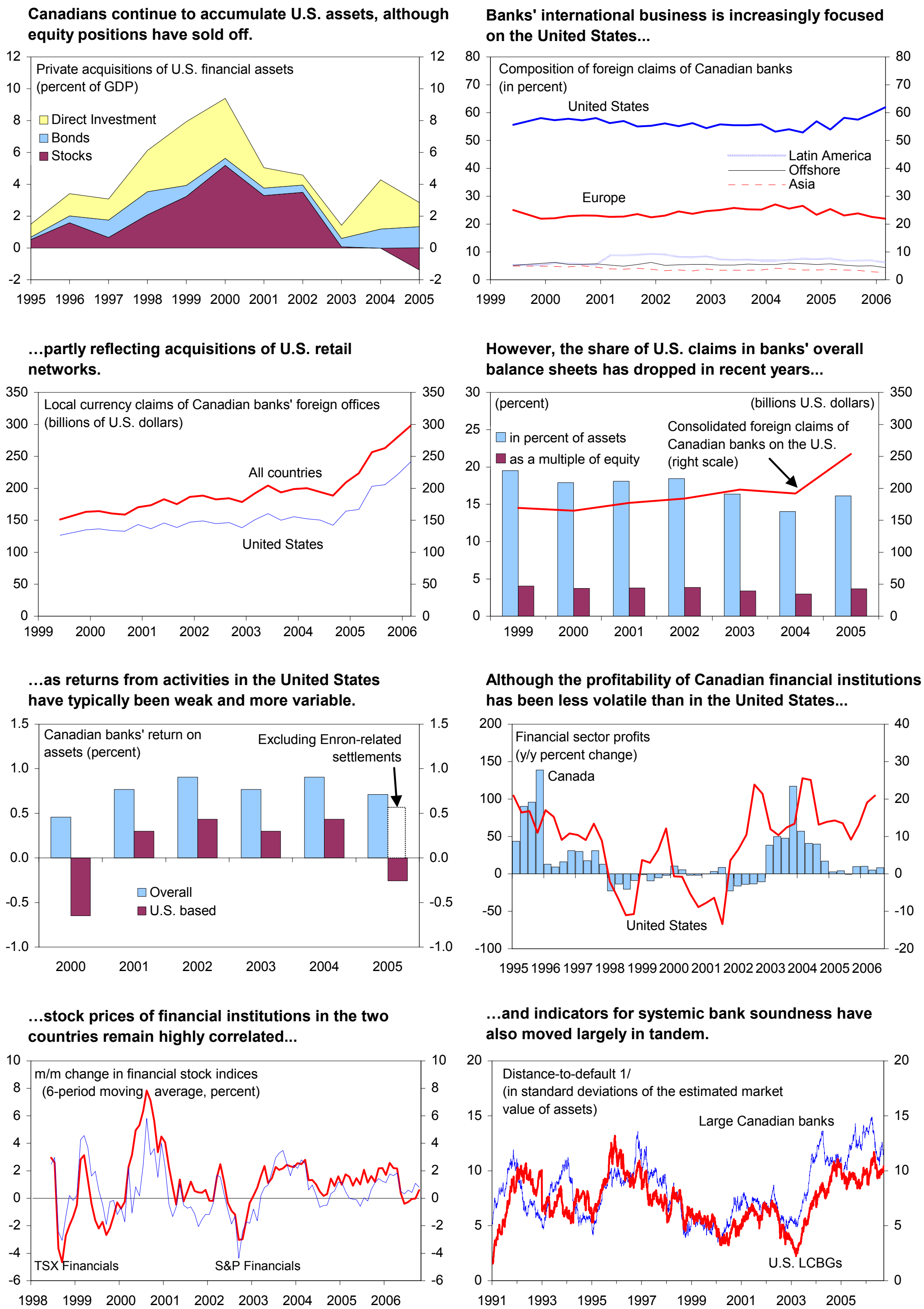


Consistent with strong balance sheets, corporate risk spreads remain low.



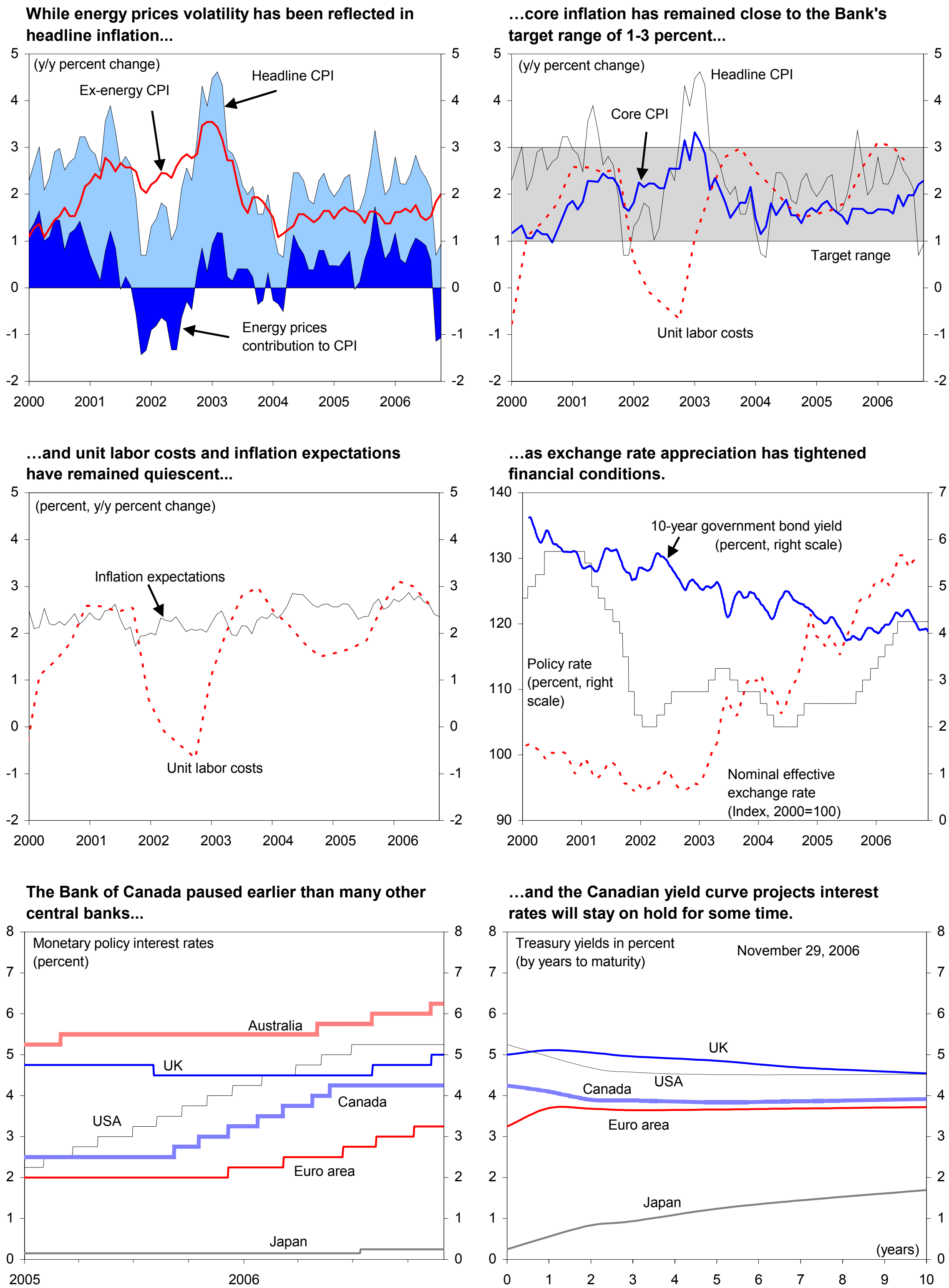
Sources: Annual Reports of 6 largest Canadian banks; Bankscope; Haver Analytics; Moody's; RBC; and Fund staff estimates.
1/ For a discussion of distance-to-default measures, see Chapter 6 of *Canada: Selected Issues* (IMF Country Report 05/116).

Figure 6. Linkages to U.S. Financial Markets



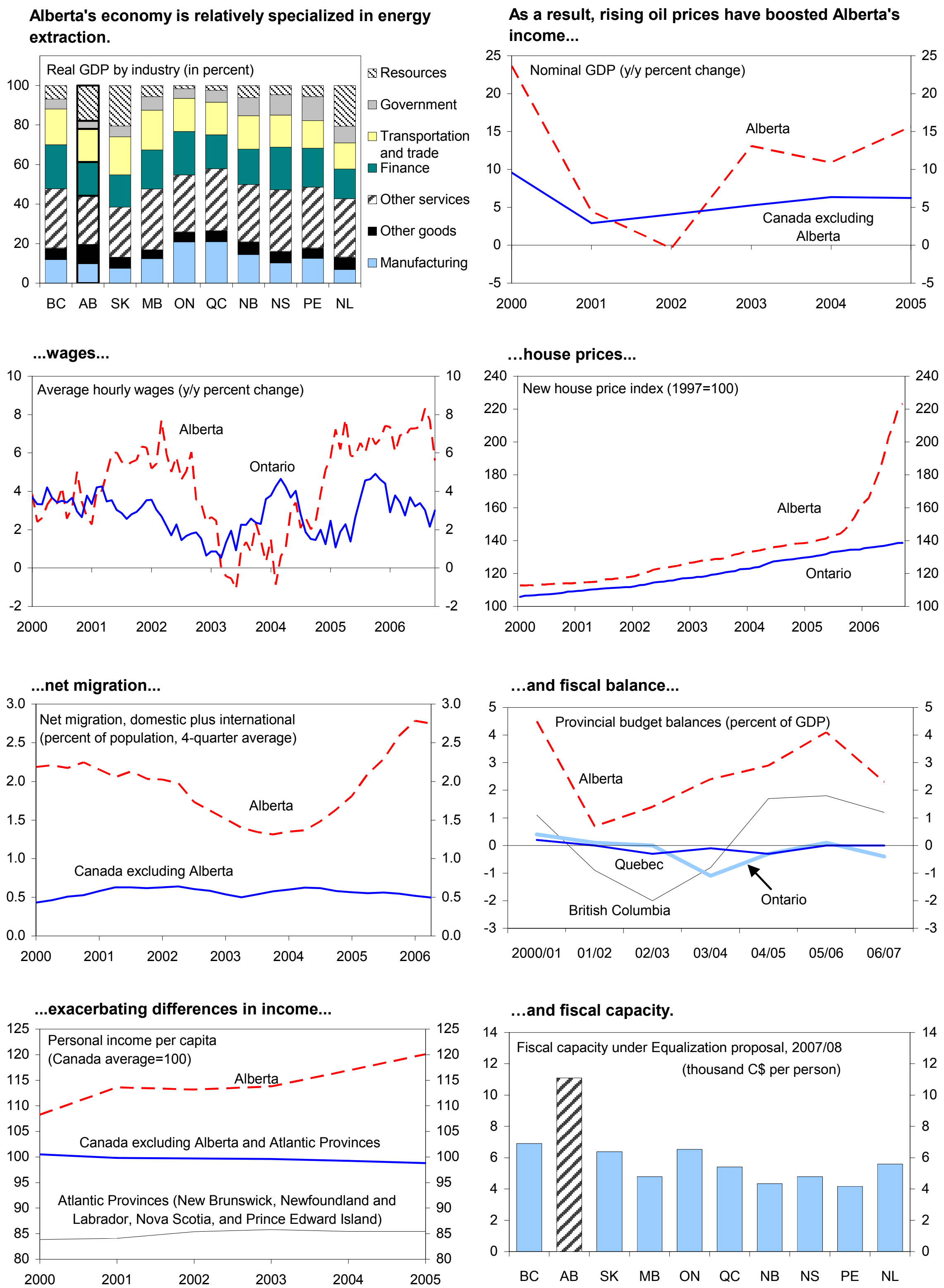
Sources: Annual Reports of 6 largest Canadian banks; Bank for International Settlements; Haver Analytics; International Monetary Fund, *World Economic Outlook*; Statistics Canada; U.S. Federal Reserve Board, Flow of Funds; and Fund staff estimates.
1/ For a discussion of distance-to-default measures, see Chapter 6 of *Canada: Selected Issues* (IMF Country Report 05/116).

Figure 7. Monetary Policy Indicators



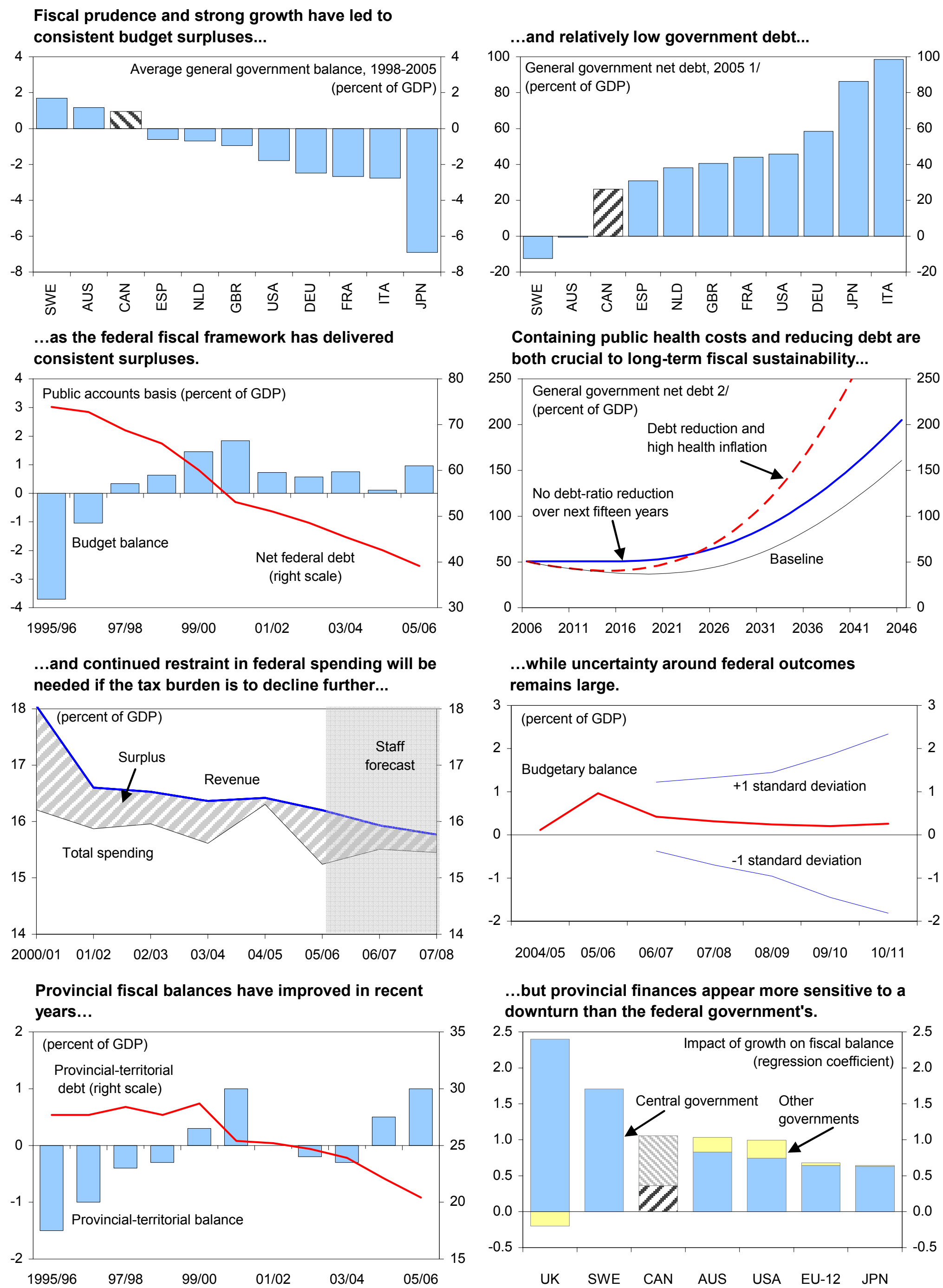
Sources: Bloomberg L.P.; Haver Analytics; and Fund staff calculations.

Figure 8. The Regional Divide



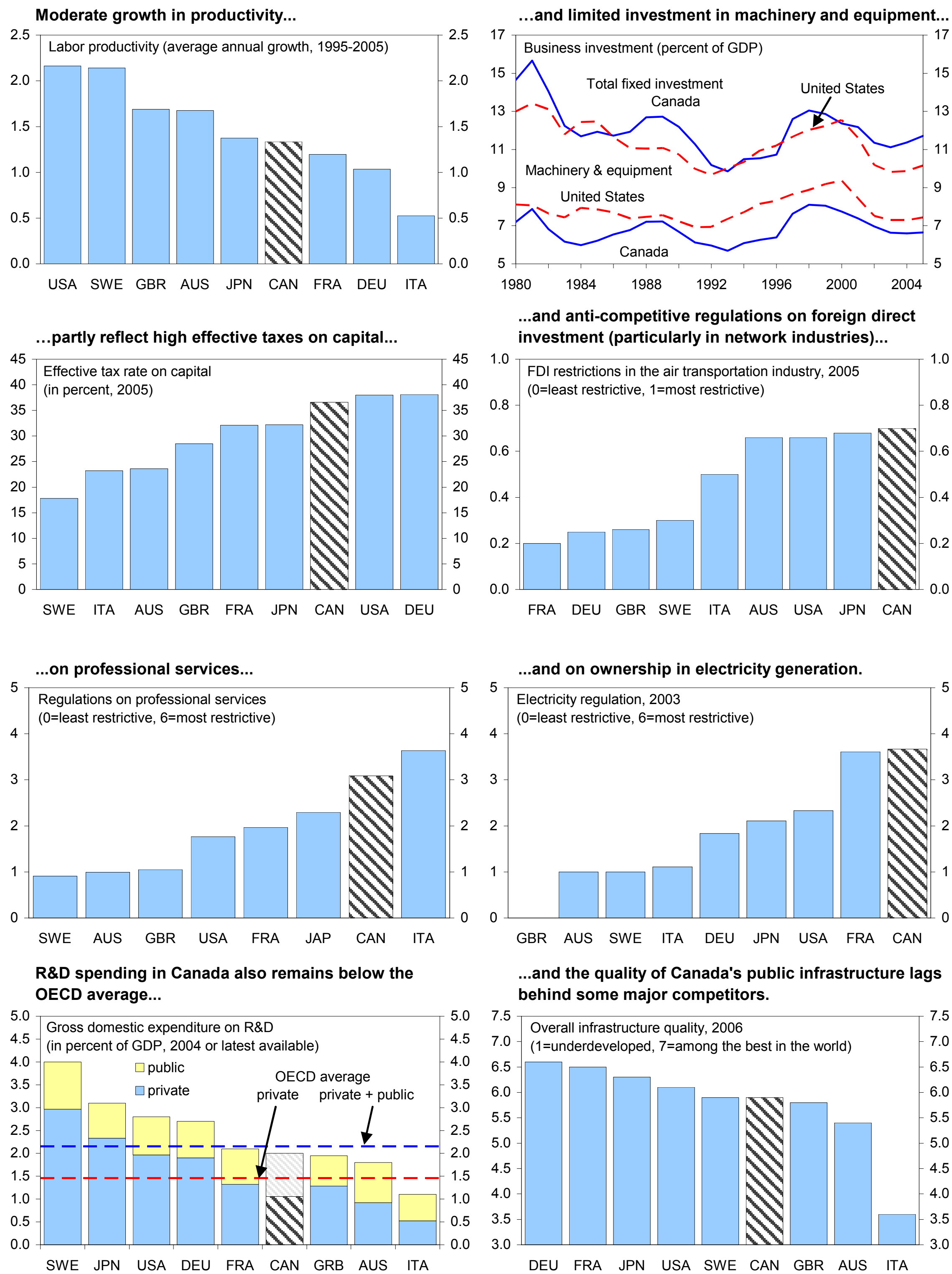
Sources: Haver Analytics; Expert Panel on Equalization and Territorial Formula Financing; and Fund staff calculations.

Figure 9. Fiscal Policy Indicators



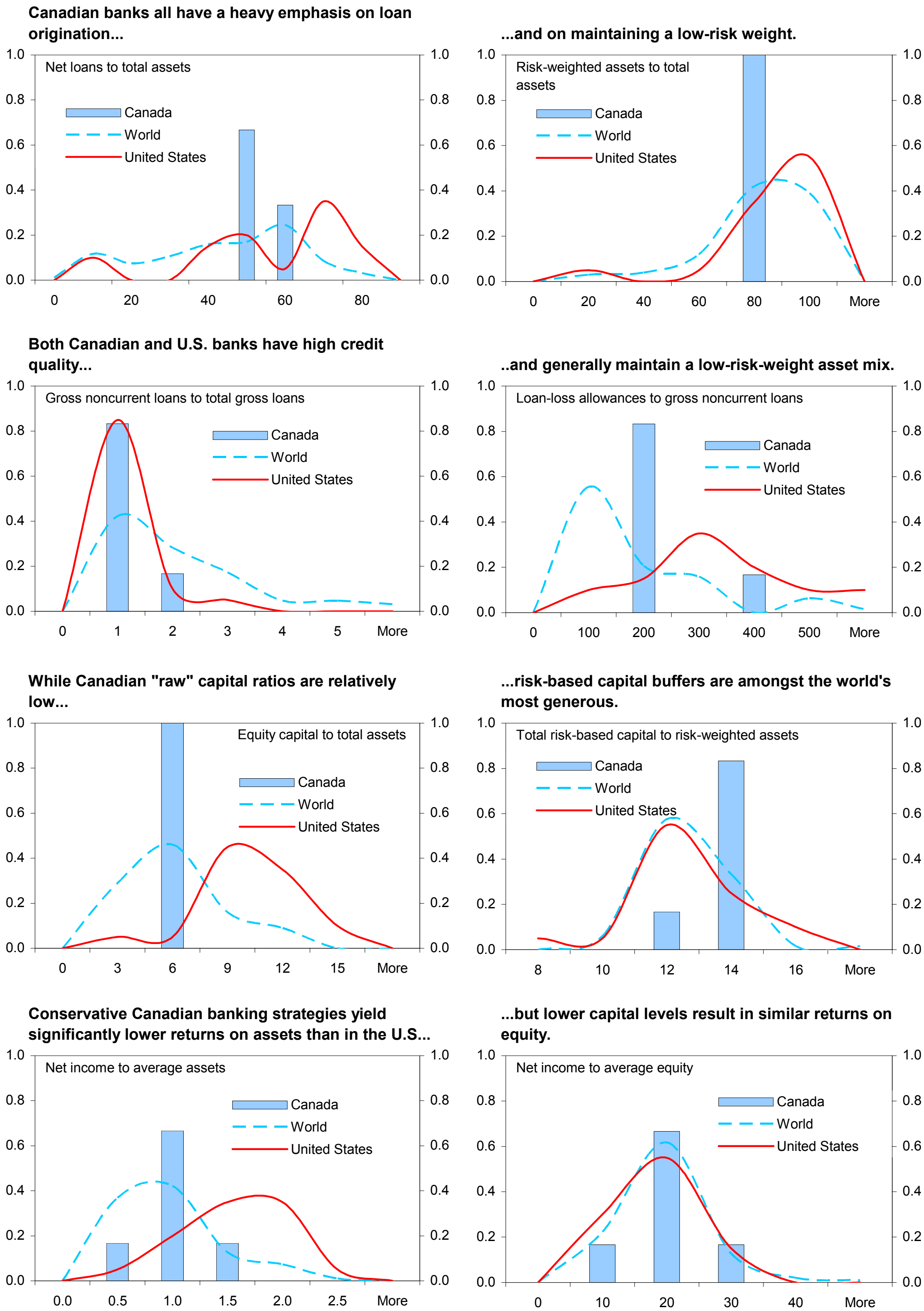
Sources: Haver Analytics; International Monetary Fund, *World Economic Outlook*; OECD Economic Outlook; and Fund staff estimates.
1/ The OECD measure of general government net financial liabilities.
2/ The difference with the OECD measure mainly reflects the inclusion of government employee unfunded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

Figure 10. Structural Indicators



Sources: OECD; Koyama and Golub, 2006; Conway and Nicoletti, 2006; Haver Analytics; C.D. Howe Institute; World Economic Forum, *Global Competitiveness Report*, 2006/07.

Figure 11. Canadian Banking Indicators in Global Context 1/



Sources: Bankscope; and Fund staff estimates.

1/ Frequency distributions on vertical axes; indicator values in percent on horizontal axes. Canada: 6 largest banks. United States: 20 largest bank holding companies. World: 100 largest banks. All data for end-2005.

Table 1. Canada: Indicators of Economic Performance

		Average 1996–2005	2000	2001	2002	2003	2004	2005	Est. 2006	Proj. 2007
		(In annual percent change)								
Per capita real GDP	Canada	2.3	4.3	0.7	1.8	0.8	2.3	1.9	1.8	1.5
	United States	2.1	2.5	-0.3	0.6	1.5	2.9	2.3	2.5	1.9
	Euro Area	1.6	3.5	1.5	0.4	0.2	1.4	0.8	2.1	1.6
	Japan	1.0	2.7	0.1	-0.1	1.6	2.2	2.6	2.7	2.1
	United Kingdom	2.4	3.5	2.0	1.7	2.3	2.8	1.2	2.2	2.2
	Australia	2.4	2.1	0.9	2.9	1.9	2.3	1.3	1.8	2.2
	Sweden	2.5	4.2	0.8	1.7	1.3	3.3	2.3	3.6	1.8
Real GDP	Canada	3.3	5.2	1.8	2.9	1.8	3.3	2.9	2.8	2.5
	United States	3.2	3.7	0.8	1.6	2.5	3.9	3.2	3.4	2.9
	Euro Area	2.1	3.9	1.9	0.9	0.8	2.1	1.3	2.4	2.0
	Japan	1.2	2.9	0.4	0.1	1.8	2.3	2.6	2.7	2.1
	United Kingdom	2.8	3.8	2.4	2.1	2.7	3.3	1.9	2.7	2.7
	Australia	3.7	3.3	2.2	4.1	3.1	3.5	2.5	3.1	3.5
	Sweden	2.7	4.3	1.1	2.0	1.7	3.7	2.7	4.0	2.2
Real domestic demand	Canada	3.7	4.7	1.2	3.3	4.7	4.3	4.8	4.1	2.9
	United States	3.7	4.4	0.9	2.2	2.8	4.4	3.3	3.4	2.9
	Euro Area	2.0	3.4	1.2	0.4	1.4	2.0	1.5	2.2	2.1
	Japan	0.9	2.5	1.2	-0.6	1.2	1.5	2.4	2.3	2.3
	United Kingdom	3.4	3.9	2.9	3.2	2.7	3.8	1.8	2.9	2.9
	Australia	4.5	2.4	1.0	6.4	5.7	5.6	4.2	4.0	3.4
	Sweden	2.0	3.8	-0.2	0.7	1.7	1.6	2.9	3.8	2.1
GDP deflator	Canada	2.0	4.1	1.1	1.1	3.4	3.0	3.2	2.1	1.9
	United States	2.0	2.2	2.4	1.7	2.1	2.8	3.0	2.9	2.0
	Euro Area	1.9	1.5	2.7	2.6	2.1	1.9	1.9	2.0	2.0
	Japan	-1.0	-1.7	-1.2	-1.6	-1.6	-1.2	-1.3	0.0	0.5
	United Kingdom	2.6	1.3	2.2	3.1	3.1	2.6	2.2	2.9	2.7
	Australia	2.6	4.1	4.0	2.6	3.2	3.4	4.5	3.8	2.5
	Sweden	1.3	1.4	2.1	1.6	2.0	0.8	1.1	1.6	1.8
		(In percent of GDP)								
General government financial balance	Canada	0.4	2.9	0.7	-0.1	-0.4	0.5	1.4	1.1	1.1
	United States	-1.7	1.6	-0.4	-3.8	-4.8	-4.6	-3.7	-3.1	-3.2
	Euro Area	-2.4	-1.0	-1.9	-2.6	-3.0	-2.7	-2.2	-2.0	-1.9
	Japan	-6.5	-7.7	-6.4	-8.2	-8.1	-6.3	-5.6	-5.2	-4.9
	United Kingdom	-1.4	1.7	1.0	-1.6	-3.3	-3.2	-3.3	-3.2	-2.8
	Australia	0.9	1.4	0.1	0.3	1.1	1.7	2.3	2.2	2.0
	Sweden	1.0	5.0	2.6	-0.5	-0.1	1.0	1.4	0.7	1.1
Gross national saving	Canada	21.3	23.6	22.2	21.0	21.2	22.9	23.8	23.9	23.9
	United States	15.9	18.0	16.4	14.2	13.3	13.2	12.9	13.7	13.5
	Euro Area	21.0	21.3	21.1	20.6	20.4	21.0	20.7	21.0	21.2
	Japan	27.7	27.8	26.9	25.9	26.2	26.4	26.9	27.6	27.8
	United Kingdom	15.7	14.9	15.0	15.2	15.1	15.3	14.9	15.2	15.5
	Australia	19.9	20.4	19.9	20.0	20.4	19.6	20.3	21.0	21.0
	Sweden	21.8	22.3	21.9	21.7	23.7	23.0	23.1	23.9	24.5
Fixed investment	Canada	19.6	19.2	19.6	19.5	19.6	20.2	20.7	21.3	21.7
	United States	19.1	20.2	19.5	18.3	18.3	18.8	19.5	19.8	19.8
	Euro Area	20.5	21.4	21.0	20.2	20.1	20.1	20.5	20.9	21.2
	Japan	25.0	25.2	24.7	23.3	22.9	22.9	23.2	24.0	24.4
	United Kingdom	16.7	16.9	16.6	16.5	16.1	16.5	16.8	17.2	17.5
	Australia	24.1	23.5	22.2	24.1	25.1	25.3	26.0	26.3	26.1
	Sweden	16.5	17.5	17.3	16.5	16.0	16.1	17.0	17.8	18.3
Current account balance	Canada	1.1	2.7	2.3	1.7	1.2	2.1	2.3	1.8	1.4
	United States	-3.8	-4.2	-3.8	-4.5	-4.8	-5.7	-6.4	-6.6	-6.9
	Euro Area	0.1	-1.4	-0.3	0.7	0.5	0.8	-0.4	-0.1	-0.1
	Japan	2.8	2.6	2.1	2.9	3.2	3.8	3.6	3.7	3.5
	United Kingdom	-1.5	-2.6	-2.2	-1.6	-1.3	-1.6	-2.2	-2.4	-2.3
	Australia	-4.5	-3.9	-2.1	-3.9	-5.6	-6.3	-6.0	-5.6	-5.3
	Sweden	4.9	4.1	4.4	5.1	7.3	6.8	6.0	5.8	5.6

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

Table 2. Canada: Selected Economic Indicators

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

								Est.	Projections			
	2005				2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NIPA in constant prices												
Real GDP	2.2	3.4	3.2	2.6	3.8	2.0	1.7	2.4	2.6	2.7	2.8	2.9
Net exports 1/	-0.7	0.6	-0.6	-1.8	-0.8	-3.4	-0.1	-0.4	-0.1	0.0	-0.1	-0.1
Total domestic demand	3.2	2.9	3.8	4.5	4.7	5.6	1.9	3.1	2.8	2.8	3.0	3.0
Final domestic demand	5.1	3.5	4.1	4.7	5.6	3.6	2.8	2.9	2.8	2.8	3.0	3.0
Private consumption	5.6	3.4	2.6	3.6	4.8	3.8	4.2	3.1	2.5	2.6	3.0	3.1
Personal saving ratio (in percent of DI)	1.2	1.0	1.3	1.3	3.1	1.2	1.5	...	...	...	...	...
Public consumption	1.9	2.6	3.0	4.4	3.3	4.9	0.7	1.4	2.1	2.1	2.2	2.3
Private fixed domestic investment	5.9	4.4	9.8	7.2	10.3	1.6	1.2	3.9	4.3	4.2	3.8	3.8
Machinery and equipment	12.2	1.3	13.4	10.8	7.9	7.4	8.9	7.0	6.0	5.7	5.5	5.5
Residential construction	-4.5	6.4	5.5	0.0	14.2	-4.8	-8.2	0.0	3.0	3.0	2.0	2.0
Private investment (in percent of GDP)	18.2	18.3	18.2	18.2	18.6	18.7	18.8	18.9	19.0	19.1	19.2	19.2
Public investment	13.5	5.0	8.1	13.4	6.7	3.4	0.5	2.6	2.4	2.4	2.4	2.4
Change in inventories 1/	-1.3	-1.0	0.2	-0.1	-1.0	2.1	-1.0	0.0	0.0	0.0	0.0	0.0
GDP (current prices)	4.0	6.1	10.4	8.3	3.7	1.6	2.3	4.8	5.5	4.3	4.2	6.8
Employment and inflation												
Unemployment rate (percent)	7.0	6.8	6.8	6.5	6.4	6.2	6.4	6.2	6.2	6.2	6.2	6.2
Employment	0.9	1.7	1.5	2.4	1.6	3.1	0.4	1.9	0.9	0.9	0.9	0.9
CPI inflation (y/y)	2.1	1.9	2.7	2.3	2.5	2.6	1.6	1.6	1.7	1.4	1.9	2.0
Core CPI inflation (y/y)	1.8	1.6	1.6	1.6	1.7	1.8	2.1	...				
GDP deflator	1.7	2.4	7.0	5.5	0.0	-0.3	0.7	2.2	2.8	1.6	1.3	3.8
Potential output growth	2.7	2.7	2.7	2.7	2.7	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Output gap (in percent of potential output)	-0.2	0.0	0.1	0.1	0.3	0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Interest rates 2/												
Three-month treasury bill (percent)	2.5	2.5	2.7	3.2	3.6	4.1	4.2	4.2	4.2	4.2	4.2	4.2
Ten-year government bond yield (percent)	4.3	4.0	3.9	4.1	4.1	4.4	4.3	4.3	4.3	4.3	4.3	4.4
External indicators												
Current account balance (in percent of GDP)	1.4	1.7	2.3	3.7	2.9	1.3	1.4	1.5	1.7	1.3	1.1	1.6
Merchandise trade balance (in percent of GDP)	3.9	4.1	5.1	5.8	4.7	3.6	3.4	3.4	3.5	3.4	3.1	3.5
Export volume	6.7	-1.9	10.3	7.2	-3.9	-2.7	5.0	3.3	3.6	4.0	4.0	4.2
Import volume	10.3	-5.2	13.0	13.1	-3.6	9.2	6.1	4.9	4.0	4.3	4.4	4.5
Balance on invisibles (in percent of GDP)	-2.4	-2.3	-2.7	-2.1	-1.71	-2.28	-1.96	-1.92	-1.8	-2.1	-2.1	-1.9
Exchange rate 2/	0.81	0.80	0.83	0.85	0.87	0.89	0.89	0.88	...	...	...	...
Nominal effective exchange rate (q/q) 2/	-1.3	-0.9	4.0	3.0	1.2	2.6	-0.1	...	...	...	...	...
Real effective exchange rate (q/q) 2/	-1.4	-1.1	3.9	2.5	1.3	2.2	-0.6	...	...	...	...	...
Terms of trade 2/	-0.7	-1.4	15.7	13.0	-9.9	-2.2	-2.4	1.9	1.7	-1.5	-2.0	4.7
Saving and investment (in percent of GDP)												
Gross national saving	22.8	23.2	23.9	24.3	23.3	23.3	23.3	...	...	...	...	...
General government	3.5	3.8	4.0	4.6	3.2	3.9	3.5	...	...	...	...	...
Private	19.3	19.4	19.9	19.7	20.1	19.4	19.8	...	...	...	...	...
Personal	3.7	3.5	3.6	3.6	4.7	3.6	3.8	...	...	...	...	...
Business	15.7	15.9	16.3	16.1	15.4	15.8	16.0	...	...	...	...	...
Gross domestic investment	21.7	21.5	21.4	21.5	21.7	22.3	22.2	...	...	...	...	...

Table 2. Canada: Selected Economic Indicators (concluded)

(In percent change, unless otherwise indicated)

				Est.	Projections				
	2003	2004	2005	2006	2007	2008	2009	2010	2011
NIPA in constant prices									
Real GDP	1.8	3.3	2.9	2.8	2.5	3.0	2.9	2.8	2.8
Q4/Q4	1.5	3.7	2.8	2.5	2.7	3.0	2.9	2.8	2.8
Net exports 1/	-2.6	-0.8	-1.6	-1.3	-0.3	0.0	0.0	0.0	0.0
Total domestic demand	4.7	4.3	4.8	4.1	2.9	3.1	3.0	2.9	2.9
Final domestic demand	3.8	4.2	4.3	4.2	2.9	3.1	3.0	3.0	2.9
Private consumption	3.0	3.3	3.9	3.8	3.1	2.9	2.9	2.9	2.7
Personal saving ratio (in percent of DI)	2.8	2.6	1.2	1.9	2.0	2.1	2.2	2.3	2.4
Public consumption	3.5	3.0	2.7	3.3	2.0	3.0	2.7	2.5	2.8
Private fixed domestic investment	6.6	8.6	7.1	6.0	3.6	3.7	3.6	3.6	3.6
Machinery and equipment	7.9	10.3	10.5	8.7	6.5	5.2	5.0	4.9	4.9
Residential construction	6.0	7.8	3.2	2.4	0.3	2.1	2.0	2.0	2.0
Private investment (in percent of GDP)	17.1	17.8	18.2	18.7	19.1	19.4	19.7	20.0	20.4
Public investment	5.8	3.3	6.8	6.2	2.3	3.2	3.7	3.7	4.1
Change in inventories 1/	0.8	0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
GDP (current prices)	5.2	6.4	6.2	5.0	4.4	5.2	4.9	4.8	4.8
Employment and inflation									
Unemployment rate (percent)	7.6	7.2	6.8	6.3	6.2	6.2	6.2	6.2	6.2
Employment	2.4	1.8	1.4	1.9	1.2	0.9	0.8	0.8	0.8
CPI inflation	2.7	1.8	2.2	2.1	1.7	2.0	2.0	2.0	2.0
GDP deflator	3.4	3.0	3.2	2.2	1.9	2.2	1.9	1.9	2.0
Potential output growth	2.8	2.7	2.7	2.7	2.8	2.8	2.8	2.8	2.8
Output gap (in percent of potential output)	-0.7	-0.2	0.0	0.0	-0.2	-0.1	0.0	0.0	0.0
Indicators of fiscal policies (NIA basis, in percent of GDP)									
Federal fiscal balance	0.0	0.4	0.1	0.4	0.3	0.3	0.2	0.2	0.2
Provincial fiscal balance 3/	-1.2	-0.7	0.6	0.1	0.1	0.0	0.0	0.0	0.0
General government fiscal balance 3/	-0.4	0.5	1.4	1.1	1.1	0.9	0.8	0.8	0.7
General government net debt	54.7	50.1	45.2	41.9	39.1	36.3	33.8	31.5	29.3
Three-month treasury bill (percent)	2.9	2.2	2.7	4.0	4.2	4.4	4.4	4.4	4.4
Ten-year government bond yield (percent)	4.8	4.6	4.1	4.3	4.3	4.6	5.0	5.1	5.1
External indicators									
Current account balance (in percent of GDP)	1.2	2.1	2.3	1.8	1.4	1.6	1.5	1.4	1.4
Merchandise trade balance (in percent of GDP)	4.6	5.1	4.7	3.8	3.4	3.5	3.4	3.3	3.2
Export volume	-2.2	5.5	2.5	1.7	3.5	4.3	4.6	4.6	4.5
Import volume	3.6	8.4	7.9	5.4	4.9	4.6	4.8	4.8	4.7
Balance on invisibles (in percent of GDP)	-3.5	-2.9	-2.4	-2.0	-2.0	-1.9	-1.9	-1.8	-1.8
Terms of trade	5.9	4.1	4.0	0.8	0.1	0.6	0.0	0.0	0.0
Saving and investment (in percent of GDP)									
Gross national saving	21.2	22.9	23.8	23.9	23.9	24.3	24.5	24.8	25.0
General government	2.2	3.1	4.0	3.7	3.7	3.4	3.3	3.3	3.3
Private	19.0	19.8	19.8	20.2	20.2	20.8	21.2	21.4	21.7
Personal	4.6	4.5	3.6	6.0	5.9	6.4	6.7	7.1	7.4
Business	14.6	15.3	13.9	14.1	14.3	14.5	14.4	14.3	14.3
Gross domestic investment	20.0	20.7	21.5	22.1	22.5	22.7	23.0	23.3	23.7

Sources: Haver Analytics; and Fund staff estimates.

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

Table 3. Canada: Balance of Payments

(In billions of Canadian dollars, unless otherwise indicated)

					Est.	Projections				
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Current account balance	19.8	14.1	27.6	31.8	25.6	21.1	24.7	24.9	25.1	25.1
In percent of GDP	1.7	1.2	2.1	2.3	1.8	1.4	1.6	1.5	1.4	1.4
Merchandise trade balance	57.3	56.3	65.5	64.9	54.2	50.9	55.1	56.2	57.2	58.4
Exports, goods	414.0	399.0	429.1	453.1	457.3	476.6	501.9	525.4	549.9	575.7
Imports, goods	356.7	342.7	363.6	388.2	403.1	425.7	446.8	469.2	492.7	517.3
Services balance	-7.2	-11.8	-12.7	-13.7	-16.9	-17.9	-19.0	-20.3	-21.6	-22.9
Investment income balance	-30.3	-29.9	-24.8	-18.8	-12.5	-13.4	-12.9	-12.7	-12.3	-12.1
Transfer balance	0.0	-0.4	-0.3	-0.5	0.8	1.5	1.5	1.6	1.7	1.8
Capital and financial accounts balance	-17.2	-15.7	-32.5	-29.2	-25.6	-21.1	-24.7	-24.9	-25.1	-25.1
Direct investment, net	-7.2	-19.5	-54.3	-0.3	20.9	23.5	26.7	30.1	34.5	39.2
In Canada	34.8	10.7	2.0	41.0	38.3	41.0	44.0	48.4	52.9	58.1
Abroad	-42.0	-30.1	-56.3	-41.3	-17.3	-17.5	-17.3	-18.3	-18.5	-18.9
Portfolio investment, net	-10.7	0.3	29.9	-43.2	-42.7	-49.2	-53.1	-57.9	-62.2	-67.3
Canadian securities	18.6	19.4	54.3	8.5	-37.7	-36.8	-41.6	-46.5	-51.3	-57.0
Bonds	18.3	7.5	19.0	-1.2	...	...	...	...	...	...
Stocks	-1.5	13.5	35.7	9.1	...	...	...	...	...	...
Money market	1.8	-1.6	-0.4	0.5	...	...	...	...	...	...
Foreign securities	-29.3	-19.1	-24.4	-51.7	-4.9	-12.3	-11.5	-11.4	-10.9	-10.3
Bonds	-6.2	-8.0	-15.3	-27.6	...	...	...	...	...	...
Stocks	-21.3	-7.7	-8.1	-21.9	...	...	...	...	...	...
Other investment 1/	-4.5	-5.4	-16.0	10.0	-9.5	-1.3	-4.4	-3.6	-4.1	-4.0
Assets	-12.6	-21.8	-10.8	-20.5	...	...	...	...	...	...
Liabilities	8.1	16.4	-5.2	30.6	...	...	...	...	...	...
Capital account balance	4.9	4.2	4.4	5.9	5.6	5.8	6.1	6.4	6.8	7.1
Transactions in official International reserves	0.3	4.7	3.4	-1.7	...	...	...	...	...	...
Statistical discrepancy	-2.6	1.6	4.9	-2.6	...	...	...	...	...	...
Memorandum item:										
Net international investment position	-208.7	-211.6	-174.6	-168.5	-137.3	-110.3	-79.5	-48.2	-16.3	15.9
In percent of GDP	-18.1	-17.4	-13.5	-12.3	-9.5	-7.3	-5.0	-2.9	-0.9	0.9

Sources: Haver Analytics; and Fund staff calculations.

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

Table 4. Canada: Fiscal Indicators

					Prel.	Staff Projections				
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Federal government (PA basis) 1/					(In billions of dollars)					
Revenue	183.9	190.6	198.6	211.9	222.2	229.3	237.0	244.9	253.6	263.0
Program spending	136.2	146.7	153.7	176.4	175.2	188.6	197.3	205.8	214.7	222.6
Interest payments	39.7	37.3	35.8	34.1	33.8	34.6	35.0	35.2	35.6	35.9
Budgetary balance (accruals basis)	8.0	6.6	9.1	1.5	13.2	6.1	4.8	3.9	3.3	4.5
Net lending (calendar year basis) 2/	12.0	9.4	-0.4	5.7	1.9	5.1	5.1	4.1	3.5	4.3
Structural budgetary balance	6.9	7.1	10.9	2.0	13.2	6.1	5.2	4.0	3.3	4.4
Structural net lending	10.8	9.8	1.4	6.3	1.9	5.1	5.6	4.3	3.4	4.1
Planned debt reduction	...	...	...	...	13.2	3.0	3.0	3.0	3.0	3.0
Remaining surplus	...	...	...	...	0.0	3.1	1.8	0.9	0.3	1.5
Net federal debt 4/	511.9	505.3	496.2	494.7	481.5	478.5	475.5	472.5	469.5	466.5
					(In percent of GDP)					
Revenue	16.6	16.5	16.4	16.4	16.2	15.9	15.8	15.5	15.3	15.1
Program spending	12.3	12.7	12.7	13.7	12.8	13.1	13.1	13.0	12.9	12.8
Interest payments	3.6	3.2	2.9	2.6	2.5	2.4	2.3	2.2	2.1	2.1
Budgetary balance (accruals basis) 2/	0.7	0.6	0.8	0.1	1.0	0.4	0.3	0.2	0.2	0.3
Net lending 2/	1.1	0.8	0.0	0.4	0.1	0.4	0.3	0.3	0.2	0.2
Structural budgetary balance 3/	0.6	0.6	0.9	0.2	1.0	0.4	0.3	0.3	0.2	0.2
Structural net lending	1.0	0.9	0.1	0.5	0.1	0.4	0.4	0.3	0.2	0.2
Planned debt reduction	...	...	...	...	1.0	0.2	0.2	0.2	0.2	0.2
Remaining surplus	...	...	...	...	0.0	0.2	0.1	0.1	0.0	0.1
Net federal debt 4/	46.2	43.8	40.9	38.3	35.1	33.2	31.6	29.9	28.3	26.8
General government 5/					(In billions of dollars)					
Revenue	469.3	471.4	492.5	519.7	555.1	576.1	600.5	626.0	651.3	679.4
Expenditure	462.1	472.5	496.8	512.7	535.8	559.6	583.9	612.6	638.5	665.8
Balance	7.3	-1.1	-4.4	7.0	19.3	16.4	16.6	13.5	12.8	13.6
Structural balance	4.6	-1.9	-0.1	8.5	19.4	16.1	18.0	14.1	12.9	13.4
Net public debt	675.9	686.6	663.8	646.1	620.2	603.8	587.2	573.7	560.9	547.3
					(In percent of GDP)					
Revenue	42.4	40.9	40.6	40.3	40.5	40.0	39.9	39.6	39.3	39.1
Expenditure	41.7	41.0	40.9	39.7	39.1	38.9	38.8	38.7	38.5	38.3
Balance	0.7	-0.1	-0.4	0.5	1.4	1.1	1.1	0.9	0.8	0.8
Structural balance 3/	0.4	-0.2	0.0	0.7	1.4	1.1	1.2	0.9	0.8	0.8
Net public debt	61.0	59.6	54.7	50.1	45.2	41.9	39.1	36.3	33.8	31.5
Memorandum items										
Real GDP growth	1.8	2.9	1.8	3.3	2.9	2.8	2.5	3.0	2.9	2.8
Nominal GDP growth rate	2.9	4.0	5.2	6.4	6.2	5.0	4.4	5.2	4.9	4.8
Three-month treasury bill rate	3.9	2.6	2.9	2.2	2.7	4.0	4.2	4.4	4.4	4.4
Ten-year government bond rate	5.5	5.3	4.8	4.6	4.1	4.3	4.3	4.6	5.0	5.1

Sources: Department of Finance Canada *The 2006 Econmic and Fiscal Update*; Haver Analytics; and Fund staff estimates.

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

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FOR IMMEDIATE RELEASE
February 13, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Canada

On January 12, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.[1]

Background

After surging in the first quarter of 2006, real GDP growth in Canada slowed subsequently, in part reflecting a cooling in the United States, and 2006 growth is estimated to have eased to 2¾ percent. Nonetheless, employment gains have been significant, and the unemployment rate fell to 6.1 percent, its lowest level in more than 30 years. This has partly reflected large regional disparities in economic performance, with output, wages, and prices, especially housing prices, growing much faster in the resource-rich western provinces, particularly Alberta, than in the rest of the country.

Domestic demand remained the main driver of the economy, with private consumption expanding a robust 3¾ percent and business investment growing 8 percent. Residential investment, however, started declining in the second quarter, finishing the year as a whole only 2½ percent above its 2005 level. Net exports continued to be a drag on activity, reflecting the effects of past currency appreciation and a slowdown in the United States, especially on the manufacturing sector.

[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.

A sharp decline in natural gas prices and a fall in real net exports combined to reduce the estimated 2006 current account surplus to 1¾ percent of GDP. In recent months, the Canadian dollar has also weakened somewhat, partly in response to the decline in world energy prices and diminished market expectations of a narrowing of the interest rate differential vis-à-vis the United States, but the currency still remains roughly 35 percent higher against its U.S. counterpart than it was in late 2002.

After seven ¼ percentage-point hikes through May 2006, the Bank of Canada has since left its target rate unchanged at 4¼ percent, reflecting a view that the overnight rate was consistent with achieving the 2 percent inflation target over the medium term. Indeed, the more recent decline in energy prices has helped lower headline inflation below 2 percent, and wage pressures appear modest, despite a deceleration of productivity growth.

Financial sector performance remained strong in 2006, largely reflecting continuing benign global market conditions. Long-term interest rates remained low despite monetary tightening, as did spreads on private instruments, reflecting default rates that continue to be low. Bank profitability and capital are high by historical and international standards, and distant-to-default rates suggest this strength is also reflected in the rest of the financial sector.

The federal government delivered a larger-than-anticipated surplus of 1 percent of GDP in FY2005/06, as program spending fell in nominal terms for the first time since FY1996/97. Higher-than-expected surpluses are also projected for the current fiscal year, enabling the government to advance its target for lowering the federal debt to GDP ratio to 25 percent by one year to FY2012/13, even while cutting the federal Goods and Services Tax from 7 percent to 6 percent on July 1. Provincial fiscal positions also improved, in some cases due to resource revenues.

Executive Board Assessment

Directors commended the Canadian authorities for their sound monetary and fiscal frameworks, which have delivered enviable macroeconomic and policy performance since the mid-1990s.

The strong recent performance of the Canadian economy is likely to continue, although growth risks are tilted to the downside given the possibility of a larger-than-expected U.S. slowdown. Directors welcomed the envisaged policy measures, which build on the strength and flexibility of the macroeconomic framework, and seek to achieve durable improvements in productivity and competitiveness.

Directors commended the Bank of Canada for adroitly balancing the competing concerns regarding growth and inflation, including by keeping policy rates on hold since May. With rates in the neutral range and inflationary pressures contained, the current stance appears appropriate moving forward. Directors considered that the current inflation targeting framework has served the economy very well, and welcomed the authorities’ decision to renew it without change for a further five years. They noted the Bank’s intention to continue to analyze the pros and cons of possible further refinements.

Directors observed that the financial sector is well positioned to cope with a turning of the global credit cycle. At the same time, Directors saw some scope to improve financial sector efficiency and innovation by reducing regulatory impediments to bank entry and consolidation, as well as by moving toward establishing a national securities regulator. They looked forward to a further analysis of financial sector issues in the planned Financial Sector Assessment Program update.

Directors agreed that fiscal policy is appropriately focused on reducing debt, lowering taxes, and reforming the equalization system. However, long-term fiscal sustainability will require continued debt reduction as well as steps to contain public spending on health care. Directors welcomed the government's commitment to using interest savings from debt reduction to lower personal income taxes, and also to reduce effective marginal tax rates on investment. Most Directors viewed these steps as likely to provide larger efficiency gains than further cuts to the Goods and Services Tax (GST), although a few noted that the reduction of the GST could support a harmonization of provincial sales taxes with the GST, thus lowering marginal effective rates on investment. The reforms suggested by the O'Brien panel on reforming the equalization transfer system would appropriately make the system even more rules-based and predictable.

Directors welcomed the emphasis on enhancing productivity growth and prosperity in the government's plans, published recently in *Advantage Canada*. In addition to cutting effective tax rates on capital (which would be helped by action by provinces) and improving financial market competition, they noted that the business environment could be enhanced by phasing out restrictions relating to foreign direct investment, eliminating interprovincial barriers to trade in goods and to labor mobility, and increasing the flexibility of the immigration system.

Directors encouraged Canada to work towards increasing access to its markets for agricultural goods.

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 2006 Article IV Consultation with Canada is also available.

Table 1. Canada: Selected Economic Indicators 1/

(Annual change in percent, unless otherwise noted)

	1999	2000	2001	2002	2003	2004	2005	est. 2006
Real GDP	5.5	5.2	1.8	2.9	1.8	3.3	2.9	2.8
Net exports 2/	1.4	0.6	0.7	-0.1	-2.6	-0.8	-1.6	-1.3
Total domestic demand	4.2	4.7	1.2	3.3	4.7	4.3	4.8	4.1
Final domestic demand	4.2	4.0	2.9	3.0	3.8	4.2	4.3	4.2
Private consumption	3.8	4.0	2.3	3.6	3.0	3.3	3.9	3.8
Public consumption	2.1	3.1	3.9	2.5	3.5	3.0	2.7	3.3
Private fixed domestic investment	6.2	4.8	3.0	1.3	6.6	8.6	7.1	6.0
Private investment rate (as a percent of GDP)	17.4	16.9	17.1	17.1	17.1	17.8	18.2	18.7
Public investment	15.6	3.8	11.5	3.7	5.8	3.3	6.8	6.2
Change in business inventories 2/	0.1	0.8	-1.7	0.3	0.8	0.1	0.3	0.0
GDP (current prices)	7.4	9.6	2.9	4.0	5.2	6.4	6.2	5.0
Employment and inflation								
Unemployment rate	7.6	6.8	7.2	7.6	7.6	7.2	6.8	6.3
Consumer price index	1.7	2.7	2.5	2.3	2.7	1.8	2.2	2.1
GDP deflator	1.7	4.2	1.1	1.1	3.4	3.0	3.2	2.2
Exchange rate (period average)								
U.S. cents/Canadian dollar	0.67	0.67	0.65	0.64	0.71	0.77	0.83	0.88
Percent change	-0.1	0.0	-4.1	-1.4	12.1	7.7	7.5	6.8
Nominal effective exchange rate	-0.8	0.8	-2.9	-1.5	10.5	6.2	7.0	6.6
Real effective exchange rate	-1.2	0.5	-2.9	-0.8	11.1	5.4	6.1	5.9
Indicators of financial policies (national accounts basis, as a percent of GDP)								
Federal fiscal balance	0.9	1.9	1.1	0.8	0.0	0.4	0.1	0.4
Provincial fiscal balance 3/	0.6	0.7	-0.9	-1.6	-1.2	-0.7	0.6	0.1
General government	1.6	2.9	0.7	-0.1	-0.4	0.5	1.4	1.1
Three-month treasury bill	4.7	5.5	3.9	2.6	2.9	2.2	2.7	4.0
Ten-year government bond yield	5.6	5.9	5.5	5.3	4.8	4.6	4.1	4.3
Balance of payments								
Current account balance (as a percent of GDP)	0.3	2.7	2.3	1.7	1.2	2.1	2.3	1.8
Merchandise trade balance (as a percent of GDP)	4.3	6.2	6.4	5.0	4.6	5.1	4.7	3.8
Export volume	11.7	9.2	-3.4	0.8	-2.2	5.5	2.5	1.7
Import volume	8.5	8.6	-5.7	1.7	3.6	8.4	7.9	5.4
Invisibles balance (as a percent of GDP)	-4.0	-3.5	-4.1	-3.3	-3.5	-2.9	-2.4	-2.0
Saving and investment (as a percent of GDP)								
Gross national saving	20.7	23.6	22.2	21.0	21.2	22.9	23.8	23.9
General government	3.6	5.1	3.0	2.3	2.2	3.1	4.0	3.7
Private	17.1	18.5	19.2	18.7	19.0	19.8	19.8	20.2
Personal	5.3	5.6	6.0	5.0	4.6	4.5	3.6	6.0
Business	11.7	12.9	13.2	13.8	14.6	15.3	13.9	14.1
Gross domestic investment	20.3	20.2	19.3	19.3	20.0	20.7	21.5	22.1

Sources: Statistics Canada; and Fund staff estimates.

1/ Data as available at the time of the Executive Board Discussion on January 12, 2007.
2/ Contribution to growth.
3/ Includes local governments and hospitals.