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CANADA

2011 ARTICLE IV CONSULTATION

December 2011

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 2011 Article IV consultation with Canada, the following documents have been released and are included in this package:

- **Staff Report** for the 2011 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 24, 2011, 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 November 23, 2011. 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**
- **Staff Statement** of December 13, 2011
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its December 19, 2011 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

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INTERNATIONAL MONETARY FUND

CANADA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION

November 23, 2011

KEY ISSUES

Context. With the recovery well advanced, policies have gradually moved to a tightening stance. The pace of the policy tightening must be balanced, with a need to sustain economic growth under possibly significant external headwinds.

Monetary policy. The supportive monetary policy stance remains appropriate given a negative output gap, well-anchored inflationary expectations, the ongoing fiscal consolidation, and a challenging global environment. The monetary authority has some room to adjust policies in response to a deterioration in the outlook or renewed turbulence in international markets.

Fiscal policy. The authorities have appropriately shifted toward fiscal consolidation. The federal government is leading the initial fiscal effort, and regional governments are expected to follow suit. Canada has room to respond flexibly to changes in the economic outlook, including by allowing full operation of automatic fiscal stabilizers should the recovery falter. A temporary stimulus could also be considered in a major downside scenario.

Managing elevated household debt and housing prices. The authorities are closely monitoring the housing market and have adopted macro-prudential measures to curb mortgage growth; however, additional measures may be needed in the event of further sustained increases in household debt and house prices, currently at historically high levels.

Financial Sector. The Canadian banking sector is in a solid position and has weathered well the recent volatility in international financial markets. External headwinds pose the main risk to the financial system, especially if they were to lead to a protracted period of high unemployment. The authorities have appropriate instruments to quickly provide liquidity in response to distress in global markets.

Approved By
Gilbert Terrier and Tamim Bayoumi

Discussions took place in Toronto and Ottawa during October 11–24, 2011. The team comprised Gian Maria Milesi-Ferretti (head), Oya Celasun, Paulo Medas, and Jihad Dagher (all WHD); Alejo Costa (MCM); and Guilhem Blondy (FAD). Mr. Gilbert Terrier joined the mission for the meetings in Ottawa and Mr. Nicolas Eyzaguirre for the concluding meeting.

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RECENT DEVELOPMENTS AND OUTLOOK

A. Context: The Economic Recovery is Well Advanced

1. **The Canadian economy recovered strongly in 2010, thanks to a decisive policy response, a resilient financial sector, and high commodity prices**. The economy expanded well above its potential rate in 2010, and GDP returned to pre-crisis levels in Q3 2010 (Figure 1). Unemployment has declined from its 2009 peak, reflecting rising public and private employment, but is still above 2008 levels. Both monetary and fiscal policies have remained accommodative, reflecting in large measure the effective response to the crisis.

2. **A key challenge facing Canada will be to set the appropriate policy mix going forward, at a time of high uncertainty and significant external headwinds**. Given the advanced stage of the recovery, a still-large budget deficit, and the need to address long-term fiscal challenges, fiscal policy has moved toward a tightening stance. At the same time, faced with an uncertain external environment and extraordinarily low levels of U.S. interest rates likely for a prolonged time, monetary policy is expected to remain accommodative. A key challenge is how to calibrate the policy response should external conditions deteriorate further, taking a toll on the outlook for Canada. At the same time, the policy toolkit may need to include macro-prudential measures, since further sustained increases in household debt and house prices would increase risks to macroeconomic stability.

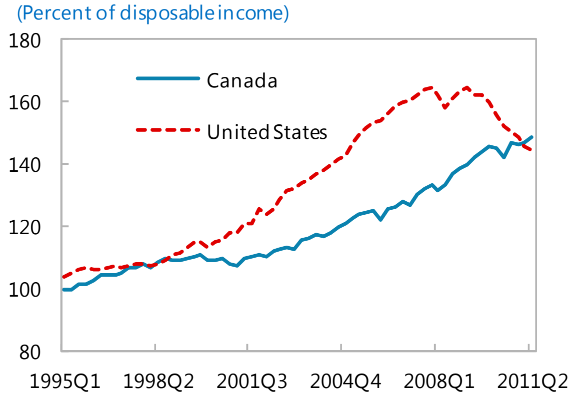
B. The Current Conjuncture

3. **Economic growth is cooling off in 2011, reflecting an adverse external environment and more subdued domestic demand**. After a strong first quarter, the expansion stalled in Q2 2011, partly due to transient factors (Japan's earthquake and other factors hampering energy exports) and a weaker external environment. Domestic demand remained the driver of growth, but at a more moderate pace given a slowdown in government spending and private consumption. Business investment, on the other hand, continued to boom, reflecting low funding costs, cheaper imports of capital goods, and elevated commodity prices.

4. **After surging in 2010, growth in private consumption and residential construction has moderated, reflecting slower growth in household incomes and consumer credit as well as tighter mortgage rules**. Resilient household credit helped sustain private consumption and the construction sector during the crisis. However, it also led to an increase in household debt to record levels—now standing at close to

150 percent of disposable income, higher than in the U. S.[1] Private consumption growth decelerated markedly in the first half of 2011, reflecting both weaker growth in real disposable income and a sharp deceleration in consumer credit. In addition, since 2008, the government has implemented macro-prudential policies to tighten mortgage lending standards by adjusting the rules for government-backed insured mortgages. These measures have helped tame mortgage growth from very high rates in 2007–08 to a still robust pace of 6.7 percent (s.a.a.r.) in August of 2011 (Figure 2). Residential investment also decelerated sharply in the second quarter of 2011 after a strong increase in the previous quarter, as the latest mortgage measures took effect.

Household Debt
(Percent of disposable income)



Sources: Haver Analytics and Fund staff calculations.

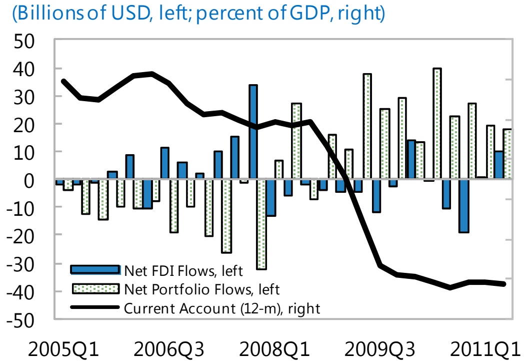
5. Unemployment has been falling steadily, but weaknesses in some segments of the economy are impeding a more robust expansion of private sector employment and wages. Driven by growth in the public sector and private services, total employment has expanded by about 1½ percent relative to 2008, helping to sustain the economic recovery. The unemployment rate, which fell from a high of 8¾ percent in August 2009 to 7.3 percent in October 2011, still remains above pre-crisis levels and estimates for the long-run NAIRU (around 6 percent). The recovery in private sector employment has been hampered by large job losses in manufacturing (where employment remains 10 percent below 2008 levels), and to a lesser degree, agriculture, and forestry (Figure 3). The lackluster performance of these sectors is also linked to their heavy exposure to the U.S. markets that suffered the most during the crisis (e.g., housing and auto). Wage growth has been modest, with no real gains in the first half of 2011 relative to same period in 2010.

6. The external current account balance deteriorated sharply in recent years, reflecting the effects of the crisis (particularly in the U.S.) and a gradual loss of external competitiveness over the last decade. After a decade of surpluses, the current account balance shifted to a deficit of 3 percent of GDP in 2009–10, mostly reflecting much weaker export volumes after the crisis (Figure 4). Exports of autos, machinery, and lumber were particularly affected by the collapse in U.S. demand, the strength of the

[1] To ensure comparability with Canadian data, U.S. household sector debt data include the debt of noncorporate, nonfinancial businesses.

Canadian dollar, and competition from emerging markets. The deterioration in the external accounts also reflects a structural loss of external competitiveness over the last decade that was exacerbated by the crisis—export volumes in 2010 remain below 2000 levels (Box 1). Foreign purchases of government and corporate debt securities have been the main source of large net capital inflows.

Current Account and Capital Flows
(Billions of USD, left; percent of GDP, right)



Sources: IMF International Financial Statistics, Haver Analytics and Fund staff calculations.

7. Core inflation remains contained and inflationary expectations are well anchored around the target. Twelve-month headline inflation has been hovering around 3 percent, the upper limit of the Bank of Canada control range of 1–3 percent, mainly reflecting higher fuel prices and, to a lesser degree, food prices. Core inflation, the main guide for monetary policy, remains close to the 2 percent target. The policy rate has been kept constant at 1 percent since September 2010, in a context of well-behaved inflationary expectations, existing economic slack, and an uncertain global outlook (Figure 5).

8. The corporate and financial sectors have weathered well the recent volatility in international financial markets. As of late November, the stock market is some 10 percent lower relative to end-2010, as fears of a European crisis and uncertainty about the U.S. have mounted. Despite some recent tightening, credit conditions remain highly favorable, with firms taking advantage of funding costs well below historical averages. Lending to households has slowed, but credit growth to businesses rebounded to 6 percent y/y in the third quarter of 2011, with the Senior Loan Officer Survey pointing to still-easy lending conditions (Figure 6). The 3-month CAD Libor-OIS spread has remained low and banks have been accessing funding at historically low rates.

9. The Canadian banking sector is in a solid position. Profits have returned to pre-Lehman levels, in line with sound asset quality and an adequate level of capital and provisions. Average returns on equity have remained at high levels since 2010, above 15 percent. Despite the rapid expansion in credit, with residential mortgage loans as the main driver, nonperforming loans (NPLs) have remained below 1.2 percent of total loans. Provisioning ratios average 73 percent of NPLs for the main financial institutions. Tier 1 capital levels are above 13 percent under Basel II definitions, while common equity ratios adjusted for Basel III deductions are above 7 percent. Liquidity levels are adequate, with banks funded for the remaining of 2011 and most of 2012. The market for covered bonds is developing rapidly, with total issuance by Canadian financial institutions reaching C$40 billion by 2011.

C. Outlook and Risks

10. The economy is expected to grow at a moderate pace over the next quarters, with easy financial conditions and still-high commodity prices supporting domestic demand. Recent indicators point to a rebound in the second half of this year, as some of the transitory factors that led to a contraction in Q2 dissipate. However, the outlook remains uncertain. Consumer confidence is at the lowest levels in two years and business sentiment is less positive than earlier in 2011. Staff projects growth to decelerate to around 2 percent on average in 2011 and 2012, constrained by weak external demand and ongoing fiscal adjustment. Private demand will remain the driving force behind growth, with investment expected to play a key role. Several large projects in the energy and mining sector are in the pipeline and firms are expected to take advantage of very favorable funding conditions and cheaper imports of capital goods (due to a strong Canadian dollar).

11. With weaker terms of trade, the current account deficit is projected to deteriorate to 3¾ percent of GDP in 2012. With foreign demand remaining lackluster in the near term and weaker oil prices and terms of trade, the current account deficit is projected to remain around 3½ percent of GDP over the 2011–13 period. The recovery in the U.S. economy is expected to lead to a stronger trade balance over time, but rebalancing would be eased by a weaker Canadian dollar, which staff assesses to be on the strong side of medium-term fundamentals (Box 2). This would help offset slower growth of domestic demand needed to raise domestic savings, as the envisioned fiscal consolidation is implemented.

12. While the baseline medium-term scenario is broadly positive, risks are tilted to the downside. The main risks are external, associated with negative spillovers from Europe and the U.S., as well as lower commodity prices.

- *External headwinds from a weaker U.S. economy and distress in European debt markets*. A worsening of U.S. growth prospects or financial conditions would likely have a substantial negative impact on Canada given the close trade and financial links, although arguably lower than typical, given already-depressed U.S. demand for autos and housing.[2] Further financial turmoil in Europe is considered by the Canadian authorities as the main source of risk for Canada. Spillovers could be transmitted via trade, financial, and

[2] The U.S. remains by far the largest trade partner (accounting for over 70 percent of exports) and is an important funding source for banks and firms.

confidence channels. While direct trade and financial linkages are relatively modest, indirect spillovers could be significant, operating through a decline in equity prices, falling consumer and business confidence, and higher funding costs and lower liquidity for banks leading to tighter financial conditions.

- *Lower commodity prices*. These could result from weaker activity in Europe and/or the United States, but also from a slowdown in emerging markets, especially in China. A large deterioration in the terms of trade in a context of weak global demand would imply a widening in the current account deficit[3] and would affect Western provinces—where house prices, investment in commodity projects, and fiscal revenue linked to commodities are particularly high—most severely. However, the impact of a decline in commodity prices on the economy and the external accounts would likely be cushioned by a depreciating currency, as the Canadian dollar has historically been strongly correlated with commodity prices.

- On the upside, a successful resolution of Europe's sovereign debt crisis and quicker resumption of solid growth in the U.S. would likely lead to a rebound in Canadian exports and boost consumer and business confidence.

13. On the domestic front, a key vulnerability comes from high and rising household debt and housing prices. Following a further tightening of mortgage standards in January 2011, the rate of growth of mortgage credit has slowed. Nevertheless, the high level of household indebtedness (Figure 7) and elevated housing prices are a source of vulnerability. Adverse macroeconomic shocks, such as a faltering global environment and declining commodity prices, could result in significant job losses, tighter lending standards, and declines in house prices, triggering a protracted period of weak private consumption as households reduce their debt. The effects on economic growth could be exacerbated by weaker external demand and slowing construction activity. For example, a staff downside scenario featuring an external shock[4] triggering a decline in house prices by 15 percent accompanied by a severe downturn of construction activity could result in a GDP decline of some 2½ percent over a period of two years relative to the baseline.

[3] The 2011 current account evaluated at the 2005 terms of trade would show a deficit of 5¾ percent of GDP.

[4] The external shock, centered in Europe, lowers world GDP by around 2 percent after two years relative to the WEO baseline.

POLICY DISCUSSIONS

Discussions centered on the challenges to manage the transition to a neutral macroeconomic policy stance in an unsettled external environment, while pressing ahead with the reforms needed to address long-term fiscal challenges; the potential risks posed by elevated household debt in the context of buoyant house prices and an uncertain economic outlook; and how to move forward with the domestic and international reform agenda for financial regulation and supervision.

A. Monetary Policy Remains Accommodative

14. The monetary policy stance remains highly supportive of economic activity given the negative output gap and challenging global environment. Well-behaved inflationary expectations, together with the ongoing fiscal tightening, give further policy flexibility to the Bank of Canada. The Bank has kept the policy rate at 1 percent since late 2010 and has recently indicated that this level, near historical lows, leaves considerable monetary stimulus in place. The authorities also noted that in an environment of heightened external headwinds, the policy rate does not necessarily have to return to neutral at the same time as the output gap closes. Staff agrees that it is appropriate to keep the policy rate exceptionally low for some time, provided core inflation and inflation expectations remain quiescent.[5] On the other hand, should the recovery be accompanied by further sustained increases in mortgage debt as a share of disposable income spurred by low interest rates, a tightening of macro-prudential policies by the government may be needed (see below).

15. The authorities stand ready to quickly respond to a deterioration in the economic outlook and/or to spillovers from increased turbulence in global markets. Staff argued that interest rate cuts could provide some support in response to a worsening outlook (a 75 bps rate cut could raise growth by about 0.3 percentage point). The authorities agreed and noted that, in the event of a severe external shock, the Bank of Canada could deploy additional measures, as it did during the 2008–09 financial crisis. They also noted that, while banks have high levels of liquidity, the Bank of Canada could quickly activate instruments to provide liquidity if pressures were to arise due to further stress in international financial markets.[6]

[5] Taylor-rule estimates also suggest that the current monetary policy stance is appropriate.

[6] The US$30 billion swap facility with the U.S. Federal Reserve was extended in June 2011 through August 2012.

16. The authorities noted that the inflation targeting regime has served the Canadian economy well, with the crisis highlighting the need to react flexibly in the face of risks to economic and financial stability. The Government and the Bank of Canada have just agreed to renew the inflation targeting framework ("Inflation-Control Target") for a further five-year period. In the discussions, the authorities stressed the importance of a credible and flexible approach, noting that monetary policy may in exceptional circumstances be used to support financial stability, including by varying the horizon over which inflation is expected to return to the target. Staff welcomed the renewal of the inflation-control target and agreed with the authorities' emphasis on a flexible approach that takes into account the evolution of risks to the outlook and financial stability.

B. Fiscal Policy: Path to a Balanced Budget over the Medium Term

17. Fiscal consolidation in now under way, as the policy stimulus is being gradually removed. The federal government, which recently updated its adjustment plans to reflect a worsening of the outlook, is leading the initial fiscal effort with a federal budget deficit reduction of some 1 percent of GDP in structural terms between 2010 and 2012, including by unwinding the stimulus measures.[7] For provincial and local governments, staff expects a broadly stable deficit in 2011, on the basis of the outturn in the first half of the year and the extension of some stimulus measures, and some deficit reduction in 2012. Overall, staff projects a reduction in the general government structural deficit of around 0.3 percent of GDP in 2011 and 0.8 percent of GDP in 2012. The latter would imply a drag on economic growth of almost ½ percentage point, broadly appropriate under our baseline scenario, in light of relatively high gross debt levels, the still-large external current account deficit, and resilient private domestic demand.

18. In an uncertain global economic environment, the authorities noted that they will be flexible and pragmatic, and adjust policy as needed. Staff concurred that macroeconomic policies should respond to significant changes in the economic outlook. Specifically, in the event that the economic expansion would falter, the full operation of automatic fiscal stabilizers and a reduction in the monetary policy rate should be the first line of response—particularly in the case of lower external demand (the recent update of federal fiscal plans goes in this direction). In a scenario where domestic demand would

[7] The "Update of Economic and Fiscal Projections" (November 8, 2011) features somewhat slower consolidation than initially planned. Staff projections take this update into account.

weaken significantly, there is some space to further loosen the fiscal stance, and temporary stimulus would be appropriate in a major downside scenario. The authorities and staff agreed that any temporary stimulus program, if needed, should not derail efforts to identify the fiscal savings required to achieve the medium-term fiscal consolidation goals.

19. The authorities are strongly committed to return to a stronger fiscal position over the medium term. This is important to reverse the increase in gross and net debt that took place during the crisis (Figure 8). General government gross debt expanded by almost 19 percentage points of GDP between 2007 and 2010, to 85 percent of GDP at end-2010, reflecting both the stimulus measures and government loans to Crown corporations (Box 3 and Selected Issues paper, Chapter III), while net debt rose to 30 percent of GDP. Reversing the increase in public debt would also help deal with long-term spending pressures from population ageing and the rise in health-care costs. It will also contribute to preserve Canada's strong fiscal reputation and help provide a buffer from stress in international sovereign debt markets. The consolidation plans of the federal government aim at a budgetary balance by 2015/16, relying on the expiration of stimulus measures, bringing spending levels as share of GDP down to pre-crisis years, and higher revenues as the output gap closes. The authorities stressed their commitment to fiscal consolidation, noting that savings expected from the Deficit Reduction Action Plan will support a return to budget balance. The exceptional funding provided to the Canada Mortgage Housing Corporation (CMHC) to purchase insured mortgages during the financial crisis will also be entirely repaid by 2014–15.

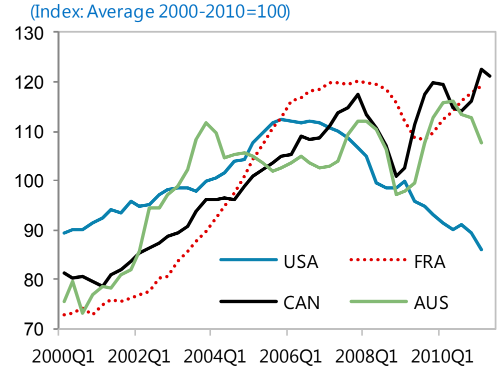
20. Provincial governments have also announced their intention to reach balanced budgets over the next several years. The size and length of the adjustment plans vary, reflecting the heterogeneity of the fiscal situation across provinces, with those with the largest deficits (such as Ontario) taking longer to reach a balanced budget. Following recent elections in several provinces, provincial administrations will need to define how they intend to achieve their medium-term targets. As most provinces do not intend to raise taxes, restraining operational spending growth will be critical to reducing public debt while allowing space to implement infrastructure projects. Further specificity on the measures to underpin their ambitious consolidation goals would help enhance the credibility of their plans.

21. Addressing the longer-term fiscal challenges posed by rising health costs and the impact of ageing will require a joint effort by all levels of government. Sub-national governments have the main responsibility for health spending, with the federal government providing funding support via transfers. However, given the size of the challenges posed by rising health costs and the impact of ageing population, it will be critical to step up coordinated efforts between the federal and regional governments. Staff noted that the review of federal government transfers to the provinces, which must be completed by 2014/15, would provide an opportunity to make progress on this front, and that regular and comprehensive fiscal sustainability reporting covering all levels of government would help build consensus around the need for reforms. In this respect, staff welcomed the recent fiscal sustainability studies prepared by the Parliamentary Budget Office (PBO), alerting to the significant fiscal challenges that Canada would face over the longer term (Box 4).

C. Household Debt and Housing Prices: Managing the Risks

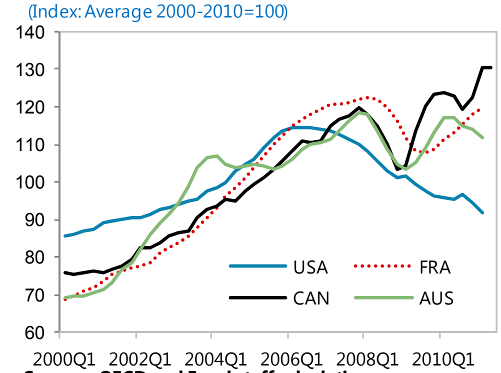
22. The authorities have adopted macro-prudential measures to rein in the build-up of household debt. While households' net worth has been boosted by rising house prices, their debt is at a historical high relative to disposable income, mainly due to rising mortgages. In addition, several housing price indicators are significantly above historical averages and high by international comparisons. Specifically, the price-to-rent and price-to-income ratios are 29 percent and 20 percent above their averages for the last decade, respectively. While there are structural factors that can explain increases in such ratios, their elevated level and other empirical evidence suggest that house prices may be higher than justified by underlying fundamentals, at least in some provinces—staff estimates indicate an average price overvaluation of around 10 percent, with significant regional differences (Selected Issues paper, Chapter I).[8] To ensure the long-term stability of housing markets, authorities have increased public awareness of the risks and, as noted, tightened mortgage insurance standards several times since 2008 (Table 1).

House Price to Income
(Index: Average 2000-2010=100)



Sources: OECD and Fund staff calculations.

House Price to Rent
(Index: Average 2000-2010=100)



Sources: OECD and Fund staff calculations.

[8] Rapid price increases in certain regional markets (e.g., Vancouver and Toronto) are commonly attributed to strong demand from foreign investors, but lack of data hampers a quantitative assessment of this channel.

Those measures, together with rising uncertainty because of global financial market turmoil, have led to some reduction in the pace of mortgage credit growth.

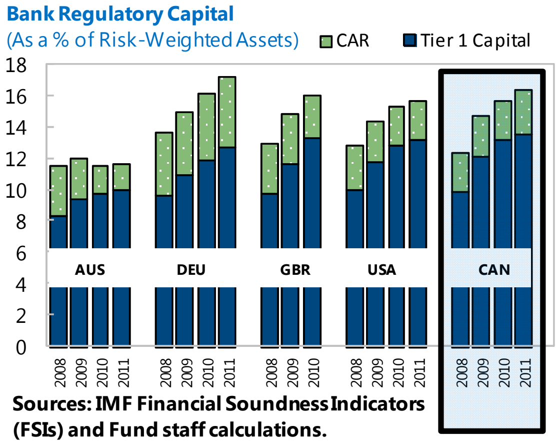
23. The authorities and staff discussed the scope for further macro-prudential measures should household debt and house prices continue to rise much more rapidly than disposable income. While structural features of the Canadian market (high household equity in housing, recourse loans, prudent lending practices, tight financial supervision) make a U.S.-style bust unlikely, a correction in the housing market would weigh on consumption and construction activity. Staff estimates suggest that a 15 percent decline in house prices would reduce the ratio of household net worth to disposable income by 45 percentage points, and could trigger a decline in private consumption by over 1½ percent (Selected Issues paper, Chapter I). The authorities noted that there was no evidence of large mismatches between supply and demand in the residential sector. Nevertheless, they stressed that, should the slowdown in the growth of mortgage debt prove temporary, they would be ready to consider additional measures. Staff and the authorities agreed that the introduction of such measures, if required, would need to be well timed and appropriately balanced to avoid pro-cyclical effects. Staff suggested that, to minimize these risks, such measures could include larger down-payment requirements for new mortgages and requiring lower debt service-to-income ratios. Staff also inquired whether measures could target housing markets in specific provinces where prices have increased most rapidly. The authorities noted that they were not considering regulations differentiated across provinces. Continued tight supervision of financial institutions would also ensure conservative underwriting standards and strict adherence to the existing regulations.

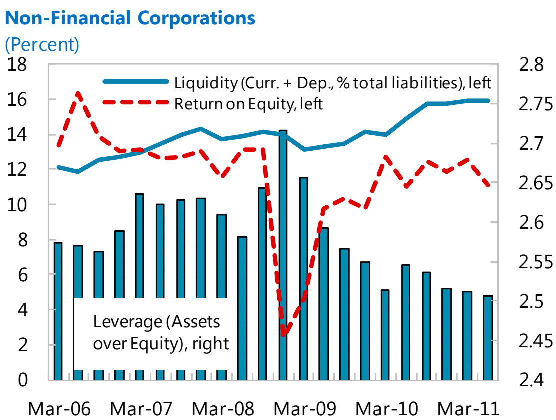
24. In light of the Canada Mortgage and Housing Corporation's central role in the growing housing sector, the authorities and staff agreed it will be important to continue to ensure that it has an appropriate governance structure and supervision framework. CMHC is the largest provider of mortgage insurance in Canada, accounting for more than two-thirds of the market. As a Crown corporation, it benefits from explicit government backing (Selected Issues paper, Chapter II). Stress tests conducted by CMHC suggest that its insurance business is well positioned to weather severe economic scenarios, with the most significant risks stemming from protracted episodes of high unemployment. Staff estimates also suggest that in a downside scenario with housing market distress such as the one sketched in ¶13 losses to government net worth arising from higher CMHC insurance outlays would be relatively modest, with the deterioration in fiscal accounts arising primarily from the worsened macroeconomic situation in that scenario. However, since CMHC is now one of the largest financial institutions in Canada and the key backstop to the housing market it would be useful to undertake a review aimed at ensuring that CMHC has a modern and effective governance structure and supervision, and assessing the scope for further strengthening its risk management.

D. Financial Stability: Managing External Risks and Moving Ahead With the Regulatory Reforms

25. The Canadian banking system was able to withstand the international crisis well, and the authorities have continued to monitor risks closely. They stressed that banks are well capitalized and have prudent management; nevertheless they remain vigilant, given the high external and domestic risks.

- The authorities noted that while direct exposures of Canadian banks to Europe are estimated to be limited, further financial turmoil in the region could affect the Canadian financial system through higher funding costs, a re-pricing of assets, and lower liquidity. In this context, the authorities and staff agreed on the importance of banks having appropriate liquidity buffers, which have increased recently. Liquidity shortages could be alleviated by prompt and coordinated policy action, including central bank assistance, as during 2008–09.
- Stress-testing scenarios developed by the authorities indicate the financial system would face manageable losses under adverse scenarios, including a significant deterioration in households' ability to service debt—in part reflecting the large share of mortgages insured by CMHC and private insurers. Stress tests also suggest that only a protracted period of high unemployment (around 10 percent or higher) would lead to significant losses in the financial sector. At the same time, the authorities recognized that elevated household indebtedness does carry new policy challenges, as households are more vulnerable to an adverse shock.
- When assessing resilience, the authorities also noted that, while corporate credit has accelerated in recent quarters, firms have relatively low leverage and banks are not heavily exposed to the sectors that were hit the hardest by the crisis (e.g., auto).





Sources: Haver Analytics and Fund staff calculations.

26. A prolonged period of low interest rates would also pose challenges to financial institutions and supervision. There is a risk, in particular, that such a scenario could encourage excessive borrowing by economic agents and risk-taking by banks. In addition, the authorities recognized that institutions with a large fixed-income portfolio, such as insurance companies and pension funds, would be negatively affected, and could be forced to change their business structure. They indicated that they were working closely with these institutions to assess the best policy response to such a scenario.

- Insurance firms, while well capitalized and hedged, have reacted by reallocating part of their portfolio to non-fixed income securities, as well as changing pricing strategies and product menus, and expanding abroad. Pension funds with defined benefits have fewer options and may need to increase contributions or reassess benefits over time.

- With high levels of capital and profitability, banks are better prepared to withstand lower interest rates. However, persistently low rates could put pressure on banks' margins, leading to changes in their business model. The expansion abroad of some Canadian banks in recent years (Selected Issues paper, Chapter IV) poses new challenges for supervision. The authorities noted that banks had expanded abroad cautiously and that geographical diversification should help keep risks manageable. However, the authorities are in close contact with supervisors in destination countries to jointly assess and monitor risks.

Consolidated Foreign Claims of Canadian Banks
(Ultimate risk basis, billions of USD)

	International claims		Local claims	
	2007Q2	2011Q1	2007Q2	2011Q1
United States	104	102	273	466
Euro Area	61	88	13	6
Other advanced econ.	48	75	54	71
Offshore centers	21	20	18	22
Emerging markets	21	35	42	60
Latin America	10	15	38	52
Total	260	329	401	622

Sources: Bank of International Settlements and Fund staff calculations.

27. Canada is moving forward steadily with the international financial reform agenda. The authorities are moving ahead with the action plan to adopt the Basel III capital and liquidity requirements, including with the publication of regulatory guidance relating to non-viability contingent capital and transitioning for non-qualifying instruments. The combination of sound capital management and international guidance on prudent earnings retention should result in Canadian banks meeting the 2019 Basel III capital requirements early in the transition period which starts on January 1, 2013. The authorities consider the current Assets to Capital Multiple (ACM) rule to have served Canada well and will be considering whether changes to the ACM are appropriate in the future to simplify dual reporting of leverage and to adapt the ACM to elements of the Basel III leverage ratio. Adoption of the liquidity standards under Basel III may prove to be more challenging, although these standards have not yet been fully defined. The authorities have endorsed both the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), but considered it prudent to await the completion of an observation period for subsequent revisions of existing domestic regulations. Their expectation is that Canadian banks should be able to gradually satisfy the rules over the internationally agreed transition period, even though the implementation of the NSFR will likely require them to gradually increase their base of retail deposits funding. The authorities have indicated their agreement in principle for an FSAP-Update, which has been penciled in for 2013. In addition, the authorities also indicated that they are continuing to strengthen compliance with AML/CFT international standards in areas such as customer due diligence.

28. The authorities are committed to keeping the adoption of a national securities regulator on track, as well as to the development of CCPs for repo and OTC derivatives. A draft proposal for a national securities regulator was referred to the Supreme Court for review and a decision is still pending. The eventual adoption of the draft will require substantial coordination across provinces and the federal authorities, and a transitional office is currently in charge of harmonizing provincial rules. The authorities expect to launch the national regulator in 2012, with most provinces expected to join. Progress toward the establishment of a central counterparty (CCP) for repo markets is on track, which will help reduce counterparty risk and enhance transparency. For OTC derivatives, authorities are evaluating a shift towards global clearing houses. They noted that these may provide a lower-cost alternative compared to domestic CCPs, but could also present access challenges, particularly for mid-sized financial institutions and those not based in the CCP home jurisdiction, and may imply higher systemic risk.

29. There has also been substantial progress with the development of recovery and orderly resolution plans for Canada's

largest banks, a key component of the crisis resolution framework. A large Canadian bank was selected in 2009 to develop "living will" documents, outlining the steps the bank would follow in case of a failure. The remaining large banks were subsequently included in this exercise, and the resolution plan is now being modified on the basis of the findings of the exercise.

E. Improving External Competitiveness

30. **A key structural challenge for Canada will be to strengthen its export performance after a weak decade**. While the 2008 crisis has triggered a sharp deterioration in the external trade balance, Canada's export growth had been weak for over a decade. The authorities pointed out that exchange rate appreciation had played a key role in constraining export growth, but lagging productivity growth and increased competition from emerging economies in the U.S. market also contributed (Box 1). They noted that the manufacturing sector had been undergoing an adjustment period, becoming better prepared to face the new competitive environment and stronger currency. Looking forward, they saw robust business investment as a key factor to strengthen labor productivity and competitiveness. The recovery in the U.S., particularly in sectors severely affected by the crisis such as autos and housing, should also provide a boost to exports over the next years. The Canadian government is engaged in reaching new bilateral trade agreements to help diversify Canadian exports, given slow progress in multilateral trade discussions. There is also an ongoing review of the government's strategy toward improving business R&D, an area where Canada lags its main trade partners. Large investment projects in energy and mining also help improve export growth prospects, although some face legal and environmental challenges.

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31. **After a strong recovery from the crisis, growth in Canada is moderating**. Thanks to a decisive policy response, a resilient financial sector, and high commodity prices, the economy expanded well above its potential growth rate in 2010. However, a substantially weaker and more uncertain external environment has taken its toll on short-run growth prospects, posing new policy challenges.

32. **A key challenge will be to unwind the exceptional policy support at the right pace in a more adverse external environment**. While the medium-term baseline scenario is broadly favorable, near-term uncertainty remains high. The domestic private sector is expected to drive growth as fiscal consolidation takes hold and foreign demand remains weak. Investment is expected to remain buoyant, but the outlook for private consumption is clouded by rising household

indebtedness and fragile consumer confidence. Important downside risks remain, including external headwinds from financial market turmoil in Europe; a weaker U.S. economy; and lower commodity prices under a scenario of weaker global activity. The domestic impact of significant adverse external shocks could be amplified by elevated household debt and house prices.

33. **With modest core inflation, well-anchored inflation expectations, and ongoing economic slack, an accommodative monetary policy stance will likely remain appropriate for some time**. There is some space for further monetary easing if the economy were to weaken, and the Bank of Canada is prepared to quickly respond to liquidity strains in a scenario of heightened international financial turbulence by redeploying the tools it successfully used during the crisis. Staff also welcomes the renewal of the inflation-targeting framework, whose flexible implementation has served the Canadian economy well.

34. **Fiscal policy is appropriately shifting toward consolidation in the aftermath of the effective stimulus program**. The federal government is leading the initial fiscal effort, as spending is gradually being brought to pre-crisis levels as a share of GDP. It will also be important for provincial governments to move ahead with their own fiscal consolidation efforts, given their large share of public spending and fiscal deficit. Overall, the projected reduction in the general government structural deficit in 2012 is appropriate under our baseline scenario of resilient domestic demand and a somewhat higher external current account deficit.

35. **Macroeconomic policies have room to adjust in response to significant changes in the economic outlook**. Full operation of automatic fiscal stabilizers and a reduction in the monetary policy rate should be the first line of response if the recovery were to falter. In particular, should the outlook for domestic demand weaken materially, there is some space to loosen the fiscal stance relative to plans, and a temporary stimulus would be appropriate in a major downside scenario, while maintaining the medium-term consolidation plans.

36. **Staff supports the authorities' objective of returning to a stronger fiscal position in the medium term.** This is necessary to put gross and net public debt on a declining path relative to GDP, thus placing public finances on a stronger footing to deal with the long-term spending pressures from population ageing and rising health-care costs. As the provinces' consolidation plans rely heavily on expenditure restraint for broad programs, further specificity on the measures to underpin these ambitious goals would enhance the transparency and credibility of their plans.

37. **The federal government and the provinces will also need to undertake a**

concerted effort to deal with the longer-term fiscal challenges posed by rising health costs in an ageing society. The review of transfers of the federal government to the provinces, which must be completed by 2014/15, would provide an opportunity in this regard. Regular and comprehensive fiscal sustainability reporting covering all levels of government would also help build consensus around the need for reforms. The recent long-term fiscal sustainability studies prepared by the PBO are an important first step forward.

38. **The authorities have appropriately adopted macro-prudential measures to curb the build-up of mortgage debt**. Household debt is at an historical high relative to disposable income, and various indicators suggest that house prices in some regions are above levels consistent with economic fundamentals. To ensure the long-term stability of housing markets, the authorities have increased public awareness of the risks and tightened mortgage insurance standards which, together with rising uncertainty because of global financial market turmoil, have slowed mortgage credit growth.

39. **However, additional macro-prudential measures may be needed in the event of further sustained increases in household debt and house prices**. In an environment of very low interest rates, there is a risk that household debt will continue to rise faster than personal disposable income. In such a scenario, further macro-prudential measures may be needed to prevent a more disruptive adjustment in the future, with due consideration to the overall cyclical position. It will also be important to continue with tight supervision of financial institutions to ensure conservative underwriting standards and strict adherence to regulations.

40. **It would be useful to undertake a review of CMHC to assess the scope for modernizing its governance structure and supervision, given its key role as housing sector backstop**. CMHC plays a key role in the residential mortgage sector by being the main provider of mortgage insurance and by implementing public policy in this area. CMHC is now one of the largest financial institutions in Canada and the largest federal Crown enterprise. Given elevated house prices and household debt and the potential fiscal risks associated with its balance sheet in a stress scenario, a review of CMHC's governance structure and supervision would be very timely.

41. **With the Canadian banking sector well supervised and in a solid position to manage risks, the authorities stand ready to quickly respond to spillovers from increased turbulence in international markets**. Banks are well capitalized and the authorities maintain high prudential standards and tight supervision. The authorities' stress tests also indicate banks are well prepared to manage most adverse scenarios, given their high level of capital. A sharp and prolonged increase in unemployment would represent

the main risk to the financial system. In the event of increased international financial turbulence, one of the sources for potential stress to Canadian banks could be through reduced access to wholesale funding, underscoring the need for prudent liquidity buffers. Canada's institutional arrangements are also supportive of an appropriately coordinated response from the authorities if necessary, as evidenced by their proactive approach during the crisis.

42. At the same time, a scenario of low interest rates for a prolonged period also requires close monitoring of possible negative effects on financial institutions and excessive risk taking. Such a scenario could encourage excessive borrowing by economic agents and risk-taking by banks, underscoring the need for continued close supervision. The insurance sector and pension funds would also face significant challenges if such an environment where to persist for a prolonged period of time.

43. Canada is well placed to advance with the financial reform agenda. The Canadian authorities are committed to a swift adoption of the Basel III capital and liquidity requirements, and staff welcomes progress in developing recovery and orderly resolution plans for Canada's largest banks, a key element of the crisis resolution framework. Progress towards the establishment of a central counterparty for repo markets is on track, as is progress in the area of OTC derivatives, which will help reduce counterparty risk and enhance transparency. Staff also welcomes the government's intention to launch a national securities regulator in 2012, which would be another tool to further strengthen oversight and the existing strong institutional financial stability framework.

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

Box 1. A Decade of Waning External Competitiveness

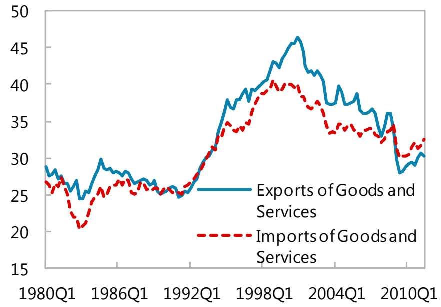
The external trade balance has been deteriorating gradually over the last decade, after reaching a record high surplus in 2000–01. In the 1990s, Canada faced a boom in external trade, benefiting from a large depreciation of the currency and bilateral trade agreements (CUSFTA/NAFTA), leading to a trade surplus close to 6 percent of GDP. After 2001, however, exports declined sharply as a share of GDP, even though Canada faced very favorable terms of trade in 2003–08. Since 2009, the trade balance has reverted to a deficit.

Although non-energy exports were hit the hardest during the recent crisis, weak export performance started well before 2007. Between 2000 and 2007, merchandise exports excluding energy grew at an average annual rate of 0.4 percent. Subsequently, exports collapsed with the crisis and have remained well below pre-2008 levels. Non-energy export volumes are more than 10 percent below 2000 levels, while total merchandise exports are about 6 percent lower than a decade ago.

Several factors seem to be at play in explaining the weak export performance:

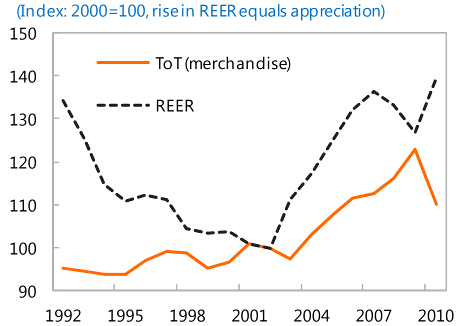
- A large appreciation of the currency since 2001.
- Weak labor productivity growth vis-à-vis foreign peers such as the U.S., U.K., and Japan. There are several possible explanations for the productivity lag, including abundant labor supply (and low incentives to invest in human capital), low investment in business R&D, and excess capacity built in the 1990s in the manufacturing sector as firms expected to keep a solid presence abroad.
- The weaker export performance in some key markets in the U.S. (the largest trade partner by far) also coincided with gains from emerging economies, especially China. Since 2000, Canada's market share of U.S. imports has dropped by 40–50 percent in key sectors such as machinery, transportation, and manufacturing goods—suggesting that increased competition from low-cost countries also contributed to Canadian firms' poor performance abroad.

External Trade
(Percent of GDP, s.a.a.r.)



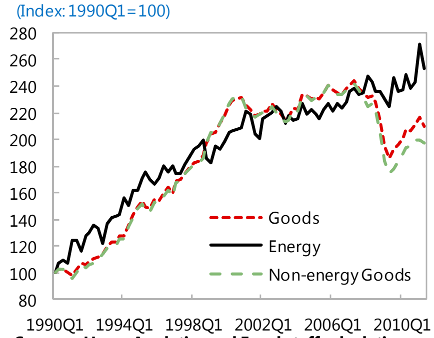
Sources: Haver Analytics and Fund staff estimates.

Terms of Trade and Real Effective Exchange Rate
(Index: 2000=100, rise in REER equals appreciation)



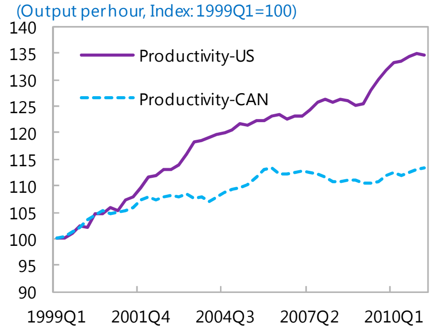
Sources: Haver Analytics and Fund staff calculations.

Export Volumes
(Index: 1990Q1=100)



Sources: Haver Analytics and Fund staff calculations.

Labor Productivity
(Output per hour, Index: 1999Q1=100)



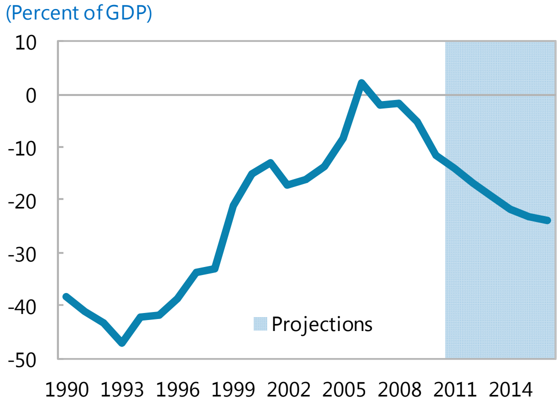
Sources: Haver Analytics and Fund staff calculations.

Box 2. Exchange Rate Assessment

Staff assesses the Canadian dollar—which is some 10 percent above its 1980–2011 average as of end-October—to be on the strong side of fundamentals. Export performance has been weak, Canada has been losing market shares, and the current account deficit exceeds 3 percent of GDP, despite strong terms of trade. These factors notwithstanding, staff sees no risk to Canada's external stability: the current account deficit is projected to decline as the U.S. economy recovers, net external liabilities (some 12 percent of GDP as of 2011Q2) are modest, and gross external debt (67 percent of GDP as of 2011Q2) is low relative to other advanced economies and reflects mostly domestic-currency liabilities (particularly foreign holdings of government and corporate bonds).

The exchange rate assessment is consistent with the quantitative estimates provided in the CGER. The most recent CGER exercise found the Canadian dollar somewhat above equilibrium (9 percent above according to the Macroeconomic Balance approach, 8 percent above according to the Equilibrium Real Exchange Rate approach, and 4 percent above according to the External Sustainability approach, as of the WEO reference period of July–August 2011). Since that period, the real effective exchange rate has depreciated by some 3 percent, while commodity prices have weakened slightly—on balance, the assessment would remain broadly unchanged.

Net International Investment Position, 1990-2016
(Percent of GDP)



Sources: Haver Analytics and Fund staff calculations.

Gross External Debt, 2011Q2
(Percent of GDP)

United Kingdom	410.3
France	196.2
Germany	152.2
Italy	118.0
United States	98.0
Australia	84.8
Canada	66.9
Japan	47.5

Sources: IMF International Financial Statistics, Joint External Debt Hub, and Fund staff calculations.

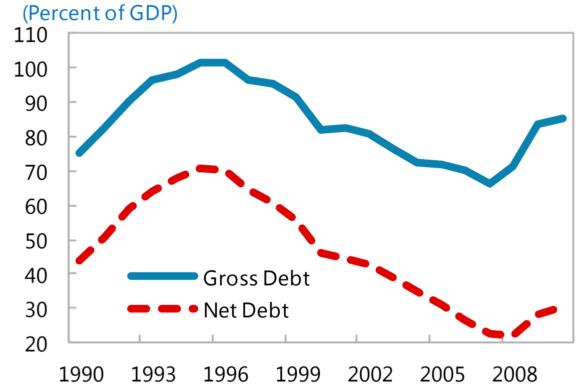
Box 3. General Government Gross and Net Debt

Canada has the lowest general government (GG) net debt among G-7 economies, reflecting substantial holdings of financial assets. At end-2010, gross debt of the GG amounted to 85 percent of GDP, while net debt amounted to only 30 percent. Less than half of the debt is owed by the federal government and the remainder by the provinces and local governments. From 2007–10, gross debt of the GG rose by almost 20 percentage points and net debt by 7 percentage points, as government claims on Crown corporations (mainly loans and equity on SOEs, and foreign exchange reserves) rose significantly. At present, these claims account for 40 percent of total GG financial assets.

The increase in the gross debt of the federal government in recent years reflects both fiscal deficits and loans to Crown corporations. At the federal level, gross debt reached 41¼ percent of GDP in 2010, while net debt was 25½ percent of GDP. The difference is mainly explained by large loans to Crown corporations since the beginning of the crisis. Of these, government loans to the Canada Mortgage Housing Corporation (CMHC) now represent about 30 of its total financial assets. The CMHC loans provided support to the mortgage market through the purchase of mortgage pools (the so-called IMPP program), which are expected to be repaid by 2015. Other sizable financial assets at the federal level include accrued tax receipts not yet collected and loans to international institutions.

The provinces and local governments have relatively high financial assets. While their total gross debt amounted to 52 percent of GDP in 2010, their net debt was only 16 percent of GDP. The substantial financial assets of sub-national governments include: (i) investments in domestic and foreign bonds and shares (around half of total assets, in part reflecting Alberta's oil fund); (ii) government claims for about 20 percent of total; and (iii) receivables (mainly accrued tax revenues to be distributed by the federal government), loans, and cash reserves.

General Government Debt
(Percent of GDP)



Sources: OECD, Statistics Canada, and Fund staff calculations.

Canada: GG Financial Assets and Liabilities, 2007-10
(Percent of GDP)

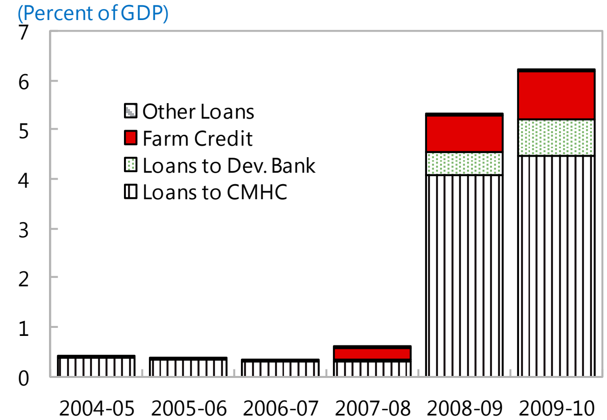
	2007	2008	2009	2010
Gross GG debt	66.5	71.1	83.6	85.1
Financial assets	43.6	48.8	55.3	54.6
Government claims	14.0	17.5	22.3	21.9
Cash and deposits	2.1	3.6	2.8	2.1
Securities	6.3	6.1	6.1	6.4
Loans	3.6	3.6	3.8	3.9
Shares	6.4	4.0	5.1	5.6
Other 1/	11.2	13.9	15.1	14.8
Net GG debt	22.9	22.4	28.3	30.4

Sources: Finance Canada, OECD, and Fund staff calculations.

1/ Government claims on Crown Corporations, mainly loans and equity.

2/ Includes accrued corporate income taxes less collection, deferred interests, among others.

Government Loans to Crown Corporations
(Percent of GDP)



Sources: Finance Canada and Fund staff calculations.

Box 4. Rising Health Care Spending Pressures

The health care system in Canada is predominantly publicly-financed and decentralized to the provinces. Public health care expenditures, representing about 70 percent of total health expenditures, are estimated to have increased to around 8½ percent of GDP in 2009–10. Health expenditures have increased rapidly in the 2000s mainly reflecting high health care inflation (due in part to rising earnings of health care professionals), technological changes (which contributed to rising hospital and prescription drug costs), and to a lesser degree demographic factors (ageing).[1] The cash component of the "Canada Health Transfer" from the federal government to the provinces and territories finances about 20 percent of provincial public health spending.

The rise in public health expenditures is the most important long-term fiscal challenge faced by Canada, as in other advanced economies. The share of health spending in provincial budgets has been steadily rising and accounts for close to 40 percent of total program spending. The Canadian Parliamentary Budget Office (PBO) projects that health and other ageing-related expenditures will rise substantially over the next decades as a consequence of health care inflation and as the effects of population ageing intensify. The annual contribution of ageing factors to public health spending growth would rise from 0.9 percentage points in 2010 to 1.2 percentage points by 2032, and decline gradually after that. Even abstracting from ageing, the PBO assumes that health spending would grow faster than nominal GDP (0.4 percent a year, in line with the 1976–2010 average). As a consequence, public health expenditures would reach 13 percent of GDP around 2050 and 15 percent of GDP by 2085. In addition, annual federal elderly benefits are projected to rise by 1 percent of GDP by 2035/36 under the PBO study. The pressures from health and other ageing-related spending would hence lead to a substantial increase in the deficit and public debt over the long term if no compensatory spending or revenue measures were taken.

Public Expenditure on Health Care, 1980–2009

(Percent of GDP)

	1980	1990	2000	2009	Change 2000–2009
Canada	5.1	6.3	6.2	8.1	1.8
France	6.5	7.4	8.0	9.2	1.2
Germany	6.6	6.3	8.2	8.9	0.7
Italy	n.a.	6.1	5.8	7.4	1.5
Japan 1/	4.8	4.7	6.2	6.9	0.6
United Kingdom	4.6	4.6	5.6	8.2	2.7
United States	3.7	4.8	5.9	8.3	2.4

Sources: OECD Health Database and Fund staff calculations.

1/ 2009 data for Japan refers to 2008.

[1] "Health Care Cost Drivers: The Facts," Canadian Institute for Health Information (2011).

Table 1. Tightening of Minimum Standards for Government-Backed Insured Mortgages Since 2008

July 2008	Fixing the maximum amortization period for new government-backed insured mortgages with loan-to-value ratios of more than 80 percent to 35 years. Requiring a minimum down payment of five percent for new government-backed insured mortgages Establishing a consistent minimum credit score requirement. Introducing new loan documentation standards to ensure that there is evidence of reasonableness of property value and the borrower's sources and level of income.
February 2010	Requiring that borrowers meet the standards for a five-year fixed-rate mortgage even if they choose a mortgage with a lower interest rate and shorter term. Lowering the maximum amount Canadians can withdraw in refinancing their mortgages to 90 percent from 95 percent of the value of their homes. Requiring a minimum down payment of 20 percent on non-owner-occupied properties purchased for speculation.
January 2011	Reduce the maximum amortization period to 30 years from 35 years for new government-backed insured mortgages with loan-to-value ratios of more than 80 percent. Lower the maximum amount Canadians can borrow in refinancing their mortgages to 85 percent from 90 percent of the value of their homes. Withdraw government insurance backing on lines of credit secured by homes, such as home equity lines of credit, or HELOCs.

Source: Finance Canada.

Table 2. Canada: Selected Economic Indicators, 2008–11

Nominal GDP (2010): CAD 1,624.6 billion (US$ 1577.0 billion)
GDP per capita (2010): US$ 46,302
Unemployment rate (October 2011): 7.3 percent
Main exports: Petroleum products, autos and auto parts, lumber, aluminum.

	2008	2009	2010	Projections 2011
Output and Demand (percent change)				
Real GDP	0.7	-2.8	3.2	2.2
Total domestic demand	2.8	-2.8	5.2	3.6
Private consumption	3.0	0.4	3.3	1.9
Total investment	0.8	-15.4	13.8	10.2
Net exports, contribution to growth	-2.1	0.2	-2.2	-1.3
Unemployment and Inflation (percent)				
Unemployment rate	6.2	8.3	8.0	7.4
CPI inflation	2.4	0.3	1.8	2.9
Saving and Investment (in percent of GDP)				
Gross national saving	23.6	17.9	19.1	19.9
General government	2.9	-0.9	-1.2	-0.6
Private	20.7	18.8	20.3	20.4
Personal	5.4	6.2	6.2	5.5
Business	15.1	12.1	13.4	14.9
Gross domestic investment	23.2	20.9	22.2	23.4
General Government Fiscal Indicators (NA basis, in percent of GDP)				
Revenue	39.7	39.2	38.3	38.3
Expenditures	39.5	44.1	43.8	43.1
Overall balance	0.1	-4.9	-5.6	-4.8
Gross Debt	71.1	83.3	85.1	85.8
Net debt	22.3	28.3	30.4	33.8
Money and Credit (Annual average)				
Household Credit Growth 1/	11.3	7.7	7.3	6.0
Business Credit Growth 1/	5.8	1.6	1.2	6.2
Three-month treasury bill (percent)	2.4	0.4	0.6	0.9
Ten-year government bond yield (percent)	3.6	3.2	3.2	2.8
Balance of Payments (in percent of GDP)				
Current account balance	0.3	-3.0	-3.1	-3.5
Merchandise Trade balance	2.8	-0.3	-0.6	-0.7
Export volume	-5.3	-15.0	6.9	3.3
Import volume	1.3	-14.9	13.9	7.5
Terms of trade, percentage change	5.1	-9.3	6.0	3.6
Memorandum item				
Real GDP in United States, percent change	-0.3	-3.5	3.0	1.5

Sources: Haver Analytics and Fund staff calculations.
1/ 2011 credit numbers refer to the August Y/Y growth rate.

Table 3. Canada: Medium-Term Scenario, 2010–16

(In percent change, unless otherwise indicated)

		Projections					
	2010	2011	2012	2013	2014	2015	2016
National Accounts (in constant prices)							
Real GDP	3.2	2.2	1.9	2.5	2.5	2.4	2.3
Q4/Q4	3.3	1.6	2.5	2.5	2.5	2.3	2.3
Net Exports 1/	-2.2	-1.3	-0.2	0.2	0.2	0.3	0.5
Total Domestic Demand	5.2	3.6	2.1	2.2	2.2	2.1	1.8
Final Domestic Demand	4.5	2.9	1.8	2.2	2.3	2.1	1.9
Private Consumption	3.3	1.9	1.6	2.4	2.2	2.2	2.0
Public Consumption	2.4	0.8	-0.2	0.4	0.6	0.8	0.9
Private Fixed Domestic Investment	8.4	9.3	5.3	5.0	4.8	3.4	2.4
Private Investment (percent of GDP)	17.9	18.7	19.2	19.7	20.1	20.3	20.3
Public Investment	17.9	0.6	-2.5	-3.0	-1.0	1.5	1.7
Change in Inventories 1/	0.6	0.5	0.4	0.0	0.0	0.0	0.0
GDP (current prices)	6.3	5.3	3.9	4.7	4.6	4.6	4.5
Employment and Inflation							
Unemployment Rate (percent)	8.0	7.4	7.2	7.0	6.7	6.4	6.2
Employment	1.4	1.7	1.8	1.6	1.5	1.5	1.5
CPI Inflation	1.8	2.9	2.0	2.0	2.0	2.0	2.0
Core CPI Inflation (y/y)	1.7	1.7	1.9	2.0	2.0	2.0	2.0
GDP Deflator	2.9	3.0	1.9	2.1	2.1	2.1	2.1
Potential Output Growth	1.6	1.7	1.9	1.9	1.9	2.0	2.0
Output Gap (in percent of potential output)	-2.4	-2.0	-2.0	-1.4	-0.9	-0.4	-0.1
Indicators of Fiscal Policies (NA basis, in percent of GDP)							
Federal Fiscal Balance	-2.6	-1.9	-1.5	-1.0	-0.6	-0.2	-0.1
General Government Fiscal Balance	-5.6	-4.8	-4.0	-2.9	-2.0	-1.5	-1.1
General Government Gross Debt	85.1	85.6	86.4	83.3	81.4	79.6	77.4
General Government Net Debt	30.4	33.8	36.5	37.8	38.2	38.0	37.5
External Indicators							
Current Account Balance (in percent of GDP)	-3.1	-3.5	-3.8	-3.5	-3.4	-2.7	-2.2
Merchandise Trade Balance (in percent of GDP)	-0.6	-0.7	-1.0	-0.7	-0.5	-0.2	-0.1
Export Volume	6.9	3.3	3.7	5.7	5.9	6.0	6.1
Import Volume	13.9	7.5	4.6	4.8	5.2	5.1	4.7
Balance on Invisibles (in percent of GDP)	-2.6	-2.8	-2.8	-2.8	-2.9	-2.5	-2.1
Terms of Trade	6.0	3.6	-0.3	0.3	0.2	0.2	0.1
Saving and Investment (in percent of GDP)							
Gross National Saving	19.1	19.9	20.4	20.9	21.3	22.1	22.4
General Government	-1.2	-0.6	0.1	0.9	1.7	2.2	2.5
Private	20.3	20.4	20.3	20.0	19.6	19.9	19.9
Gross Domestic Investment	22.2	23.4	24.1	24.3	24.6	24.7	24.7
Personal Savings (in percent of DI)	4.7	4.3	4.0	4.2	4.7	5.0	5.2
Memorandum Item							
Real GDP in United States	3.0	1.5	1.8	2.5	3.1	3.4	3.4

Sources: Haver Analytics and Fund staff calculations.
1/ Contribution to growth.

Table 4a. Canada: Federal Government Fiscal Indicators, 2009/10–2016/17

			Staff Projections					
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
	(In billions of Canadian dollars)							
Federal Government (PA basis) 1/								
Revenue	219	237	245	256	271	286	300	313
Income taxes	140	149	157	164	175	185	194	204
Goods and services tax	27	28	29	31	32	34	36	38
Other	52	60	59	61	64	67	70	72
Expenditures	274	270	274	278	284	289	299	307
Transfers to subnational governments	57	53	57	58	60	63	66	69
Transfers to persons	69	68	69	72	75	78	81	84
Interest payments	29	31	31	32	33	35	37	38
Budgetary balance	-56	-33	-29	-22	-13	-3	1	6
Structural budgetary balance	-40	-22	-20	-14	-6	2	3	6
Gross federal debt 2/	883	921	950	972	945	942	947	941
Net federal debt 3/	519	550	579	602	614	617	616	610
	(In percent of GDP)							
Revenue	14.3	14.6	14.3	14.4	14.6	14.7	14.7	14.7
Income taxes	9.1	9.1	9.2	9.2	9.4	9.5	9.5	9.6
Goods and services tax	1.8	1.7	1.7	1.7	1.7	1.8	1.8	1.8
Other	3.4	3.7	3.5	3.4	3.4	3.4	3.4	3.4
Expenditures	17.9	16.6	16.0	15.6	15.3	14.8	14.7	14.5
Transfers to subnational governments	3.7	3.3	3.3	3.2	3.2	3.2	3.2	3.2
Transfers to persons	4.5	4.2	4.0	4.1	4.0	4.0	4.0	3.9
Interest payments	1.9	1.9	1.8	1.8	1.8	1.8	1.8	1.8
Budgetary balance	-3.6	-2.1	-1.7	-1.3	-0.7	-0.1	0.0	0.3
Structural budgetary balance	-2.5	-1.3	-1.1	-0.8	-0.3	0.1	0.2	0.3
Gross federal debt 2/	57.8	56.7	55.5	54.7	50.8	48.4	46.5	44.3
Net federal debt 3/	34.0	33.9	33.9	33.9	33.0	31.7	30.3	28.7

Sources: Department of Finance Canada Budget, Department of Finance Canada Fiscal Update, Haver Analytics, and Fund staff estimates.
1/ On a fiscal year basis, which starts on April 1.
2/ Authorities' definition includes unfunded pension liabilities.
3/ Authorities' definition is an accumulated deficit concept.

Table 4b. Canada: General Government Fiscal Indicators, 2009–2016 1/

			Staff Projections					
	2009	2010	2011	2012	2013	2014	2015	2016
	(In percent of GDP)							
Federal Government								
Revenue	14.6	14.1	14.2	14.3	14.5	14.7	14.8	14.8
Spending	16.8	16.7	16.1	15.8	15.5	15.3	15.1	14.9
Interest payments	1.8	1.7	1.6	1.6	1.6	1.6	1.6	1.6
Budgetary balance	-2.2	-2.6	-1.9	-1.5	-1.0	-0.6	-0.2	-0.1
Structural balance 2/	-1.1	-1.9	-1.4	-1.0	-0.6	-0.3	-0.1	0.0
Provincial and Local Governments								
Revenue	25.6	25.7	25.3	25.2	25.1	25.3	25.3	25.4
Total spending	29.0	29.2	28.8	28.3	27.7	27.3	27.1	27.0
Capital spending	3.4	3.8	3.7	3.5	3.3	3.2	3.2	3.1
Interest payments	2.1	2.0	1.9	1.9	1.8	1.8	2.0	2.1
Budgetary balance	-3.5	-3.5	-3.5	-3.1	-2.5	-2.1	-1.8	-1.6
Structural Balance 2/	-2.1	-2.7	-2.8	-2.4	-2.1	-1.8	-1.7	-1.6
Canada/Quebec Pension Plans								
Revenue	3.4	3.2	3.2	3.2	3.2	3.3	3.3	3.3
Total spending	2.6	2.6	2.6	2.6	2.6	2.7	2.7	2.7
Budgetary balance	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Consolidated General Government 3/								
Revenue	39.2	38.3	38.3	38.3	38.6	38.9	39.2	39.2
Expenditure	44.1	43.8	43.1	42.3	41.5	41.0	40.6	40.4
Overall Balance	-4.9	-5.6	-4.8	-4.0	-2.9	-2.0	-1.5	-1.1
Structural balance 2/	-2.5	-4.0	-3.6	-2.9	-2.1	-1.5	-1.2	-1.0
Primary Balance	-4.0	-4.9	-4.3	-3.4	-2.5	-1.6	-1.0	-0.6
Gross public debt	83.6	85.1	85.6	86.4	83.3	81.4	79.6	77.4
Net public debt	28.3	30.4	33.8	36.5	37.8	38.2	38.0	37.5
Fiscal Impulse	2.1	1.6	-0.3	-0.8	-0.8	-0.6	-0.4	-0.2
Memorandum Items								
Real GDP growth	-2.8	3.2	2.2	1.9	2.5	2.5	2.4	2.3
Nominal GDP growth rate	-4.6	6.3	5.3	3.9	4.7	4.6	4.6	4.6
Three-month treasury bill rate	0.4	0.6	0.9	1.0	1.8	2.6	3.6	4.1
Ten-year government bond rate	3.2	3.2	2.8	2.5	3.2	4.0	5.0	5.2

Sources: Department of Finance Canada Budget, Department of Finance Canada Fiscal Update, Haver Analytics, OECD, and Fund staff estimates.

1/ National Accounts basis.

2/ In percent of potential GDP.

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

Table 4c. Canada: General Government Operations (GFSM 2001 Format), 2006–2010

	2006	2007	2008	2009	2010
			(Percent of GDP)		
Revenue	41.0	40.7	39.5	39.4	38.5
Taxes	28.8	28.7	27.3	27.5	26.7
Social Contributions	4.7	4.6	4.5	4.9	4.6
Other Revenue	7.5	7.4	7.6	7.0	7.1
Expense	38.3	38.2	38.6	42.8	42.1
Compensation of Employees	11.5	11.5	11.7	13.0	12.8
Use of Goods and Services	9.0	9.0	9.3	10.4	10.3
Consumption of Fixed Capital	1.8	1.9	2.0	2.2	2.2
Interest	4.3	4.2	3.9	3.8	3.7
Grants	2.7	2.7	2.9	3.1	3.2
Social Benefits	7.4	7.4	7.4	8.5	8.2
Other Expense	0.5	0.4	0.4	0.6	0.5
Net/Gross Operating Balance	4.5	4.4	2.9	-1.2	-1.4
Net Acquisition of Nonfinancial Assets	1.0	1.1	1.3	1.5	1.9
Net Lending/Borrowing	1.6	1.4	-0.4	-4.9	-5.6
Net Acquisition of Financial Assets	2.8	2.5	6.3	4.1	1.5

Balance Sheet

	2006	2007	2008	2009	2010
			(Percent of GDP)		
Net Worth	-5.5	0.1	-0.4	-2.6	-5.0
Nonfinancial Assets	37.7	38.9	41.3	45.2	44.1
Financial Assets	45.9	45.1	47.4	55.1	55.1
Currency and Deposits	2.1	2.1	3.6	2.9	2.1
Securities Other Than Shares	10.3	10.4	9.2	10.3	10.6
Loans	3.6	3.6	3.6	3.8	3.9
Shares and Other Equity	6.9	6.4	4.0	5.1	5.6
Other Accounts Receivable	23.0	22.6	26.9	32.9	32.9
Liabilities 1/	89.2	83.9	89.1	102.9	104.2
Currency and Deposits	0.3	0.3	0.3	0.3	0.3
Securities Other Than Shares	53.6	48.4	53.6	63.8	65.2
Loans	1.5	1.5	1.4	1.5	1.6
Insurance Technical Reserves	13.6	13.3	13.0	14.0	13.6
Other Accounts Receivable	20.2	20.5	20.8	23.3	23.5

Sources: IMF International Financial Statistics and Fund staff calculations.

1/ Includes pension liabilities not included in gross debt.

Table 5. Canada: Balance of Payments, 2008–16

				Projections					
	2008	2009	2010	2011	2012	2013	2014	2015	2016
	(In percent of GDP)								
Current Account									
Current Account Balance	0.3	-3.0	-3.1	-3.5	-3.8	-3.5	-3.4	-2.7	-2.2
Merchandise Trade Balance	2.8	-0.3	-0.6	-0.7	-1.0	-0.7	-0.5	-0.2	0.2
Exports, goods	30.5	24.2	24.9	25.8	25.5	25.8	26.1	26.6	27.1
Export Volume Growth (percentage change)	-5.3	-15.0	6.9	3.3	3.7	5.7	5.9	6.0	6.1
Imports, goods	27.7	24.5	25.5	26.5	26.5	26.5	26.6	26.8	26.9
Import Volume Growth (percentage change)	1.3	-14.9	13.9	7.5	4.6	4.8	5.2	5.1	4.7
Services Balance	-1.3	-1.4	-1.4	-1.4	-1.3	-1.2	-1.1	-0.9	-0.8
Investment Income Balance	-1.1	-1.0	-1.0	-1.2	-1.3	-1.4	-1.6	-1.3	-1.4
Capital and Financial Accounts									
Direct Investment, net	-1.5	-1.5	-1.0	0.0	0.2	0.2	0.1	0.1	0.2
Portfolio Investment, net	2.7	6.7	6.3	4.4	4.1	3.8	3.5	2.6	1.7
Other Investment, net 1/	-1.6	-2.5	-2.6	-1.2	-0.8	-0.8	-0.5	-0.3	0.1
Capital Account Balance	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
International Reserves	-0.1	-0.8	-0.2	-0.2	0.0	0.0	0.0	0.0	0.0
Statistical Discrepancy	-0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items									
Terms of Trade (percent change)	5.1	-9.3	6.0	3.6	-0.3	0.3	0.2	0.2	0.1
Net International Investment Position 2/	-1.5	-5.2	-11.3	-12.5	.	.	.	.	.
Assets	103.1	111.6	108.5	105.4	.	.	.	.	.
FDI	40.0	40.6	38.0	36.3	.	.	.	.	.
Portfolio Investment 2/	36.4	42.2	41.9	40.3	.	.	.	.	.
Other Investment	23.4	25.1	25.1	25.4	.	.	.	.	.
Reserves	3.3	3.7	3.5	3.5	.	.	.	.	.
Liabilities	104.7	116.8	119.8	117.9	.	.	.	.	.
FDI	33.8	35.8	34.6	33.7	.	.	.	.	.
Portfolio Investment 2/	45.4	56.0	62.0	61.8	.	.	.	.	.
Other Investment	25.4	25.0	23.3	22.4	.	.	.	.	.
Gross External Debt 3/	58.5	68.6	66.9	66.9	.	.	.	.	.
Real Effective Exchange Rate 4/	-3.2	-4.3	9.3	1.8	.	.	.	.	.

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. 2011 represents stocks at Q2 for all components of IIP.

3/ 2011 represents stock at Q2.

4/ Percentage change. 2011 data refers to January-October average. A minus sign indicates a depreciation in the Canadian dollar.

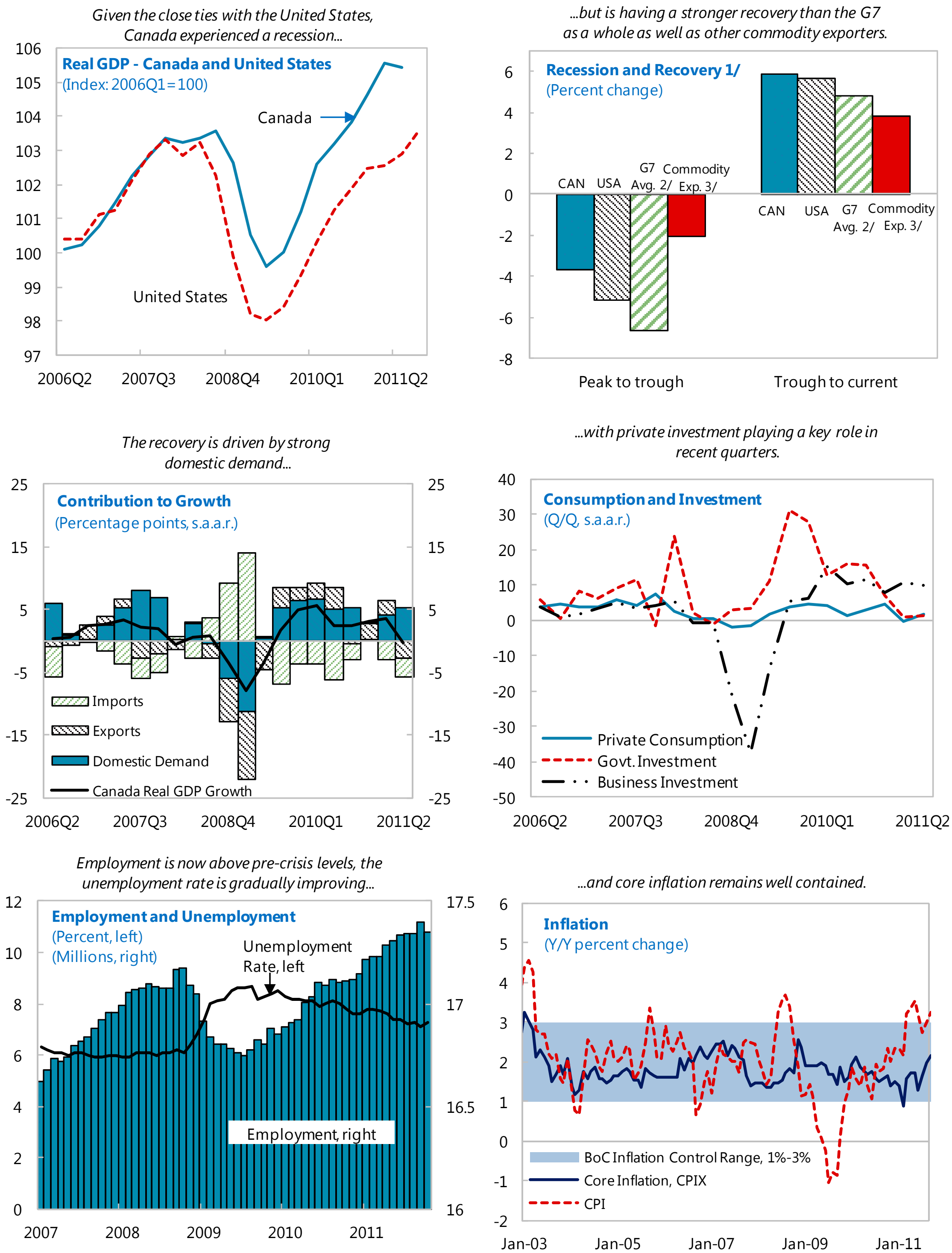
Table 6. Canada: Indicators of External and Financial Vulnerability

	2006	2007	2008	2009	2010
External Indicators	*(in percent of GDP, unless otherwise indicated)*				
Exports of Goods and Services 1/	0.9	2.0	5.3	-21.9	8.8
Imports of Goods and Services 1/	4.1	3.6	6.7	-13.6	9.3
Terms of Trade 1/	1.1	2.9	5.1	-9.3	6.0
Current Account Balance	1.4	0.8	0.3	-3.0	-3.1
Capital and Financial Account Balance	-1.6	-1.0	-0.1	3.0	3.1
Of which:					
Net Portfolio Investment	-3.3	-5.2	2.7	6.7	6.3
Net Foreign Direct Investment	1.1	4.0	-1.5	-1.5	-1.0
Net Other Investment	0.3	0.0	-1.6	-2.5	-2.6
Central Bank Foreign Currency Liabilities	0.0	0.0	0.0	0.0	0.0
Net International Investment Position 2/	2.0	-2.1	-1.5	-5.2	-11.3
Of which:					
General Government Debt held by non-residents	11.6	9.5	10.8	14.1	16.7
Official Reserves 2/	2.8	2.7	3.3	3.7	3.5
in months of imports	1.0	1.0	1.2	1.5	1.3
External Debt-to-Exports Ratio	155	154	183	238	232
Nominal Effective Exchange Rate 1/	6.4	4.0	-1.0	-5.1	10.3
Real Effective Exchange Rate 1/	5.7	3.3	-2.4	-4.8	10.2
Financial Market Indicators	*(in percent of GDP, unless otherwise indicated)*				
General Government Gross Debt	70.3	66.5	71.1	83.6	85.1
Average Maturity of General Public Holdings of Federal Debt (months) 3/	82	85	84	73	74
Federal Total Unmatured Debt Maturing Within One Year 4/ 5/	160	164	166	151	225
Three-Month Treasury Bill Yield 6/	4.0	4.2	2.4	0.4	0.6
Real Three-Month Treasury Bill Yield 6/ 7/	1.0	1.0	0.0	0.2	-0.7
Equity Market Index (S&P/TSX Composite) 1/	14.5	7.2	-35.0	30.7	14.4
Banking Risk Indicators	*(in percent, unless otherwise indicated)*				
Total Assets 4/	2122	2371	2727	2882	2914
Total Loans to Assets	58.1	57.6	57.6	53.1	56.6
Total Loans to Deposits	78.5	80.2	79.8	81.3	81.7
Nonperforming Loans to Total Loans	0.4	0.4	0.8	1.3	1.2
Nonperforming Assets to Assets	0.0	0.0	0.0	0.1	0.1
Provisioning Ratio to:					
Total Loans	0.1	0.1	0.1	0.1	0.1
Nonperforming Loans	181.8	156.4	98.9	78.8	73.3
Return On Equity	30.6	28.4	15.0	18.2	22.9
Return On Assets	1.3	1.1	0.5	0.7	1.1
Total Capital to Risk-Weighted Assets	15.4	14.8	12.2	14.7	15.6
Tier 1 Capital Ratio	11.6	10.8	9.8	12.1	13.1
Assets to Capital Multiple	17.7	18.1	17.7	15.5	15.8
Interest Rate Margin to Gross Income	42.2	43.0	54.7	46.4	48.6
Liquid Assets to Short Term Liabilities	34.4	30.5	41.1	55.3	52.0

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 following year end. 6/ Percent. 7/ Deflated by CPI.

Figure 1. The State of Canada's Recovery



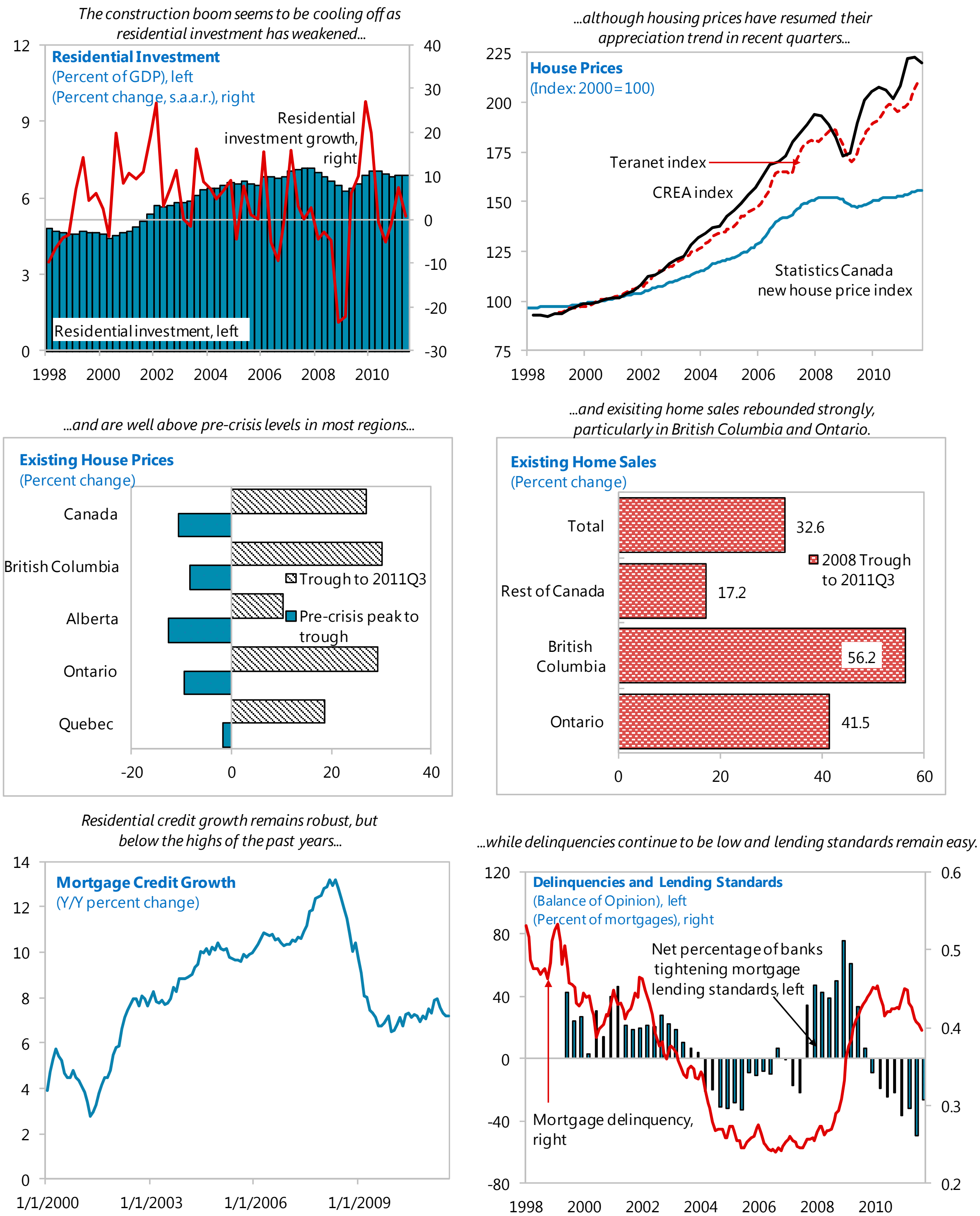
Sources: Haver Analytics and Fund staff calculations.

1/ Peak is defined as the highest quarterly GDP level between 2005 and 2008. Trough is the lowest quarterly GDP level 2008–2010. Current is 2011Q1 except UK and US which is 2011Q2.

2/ Excluding Canada, simple average.

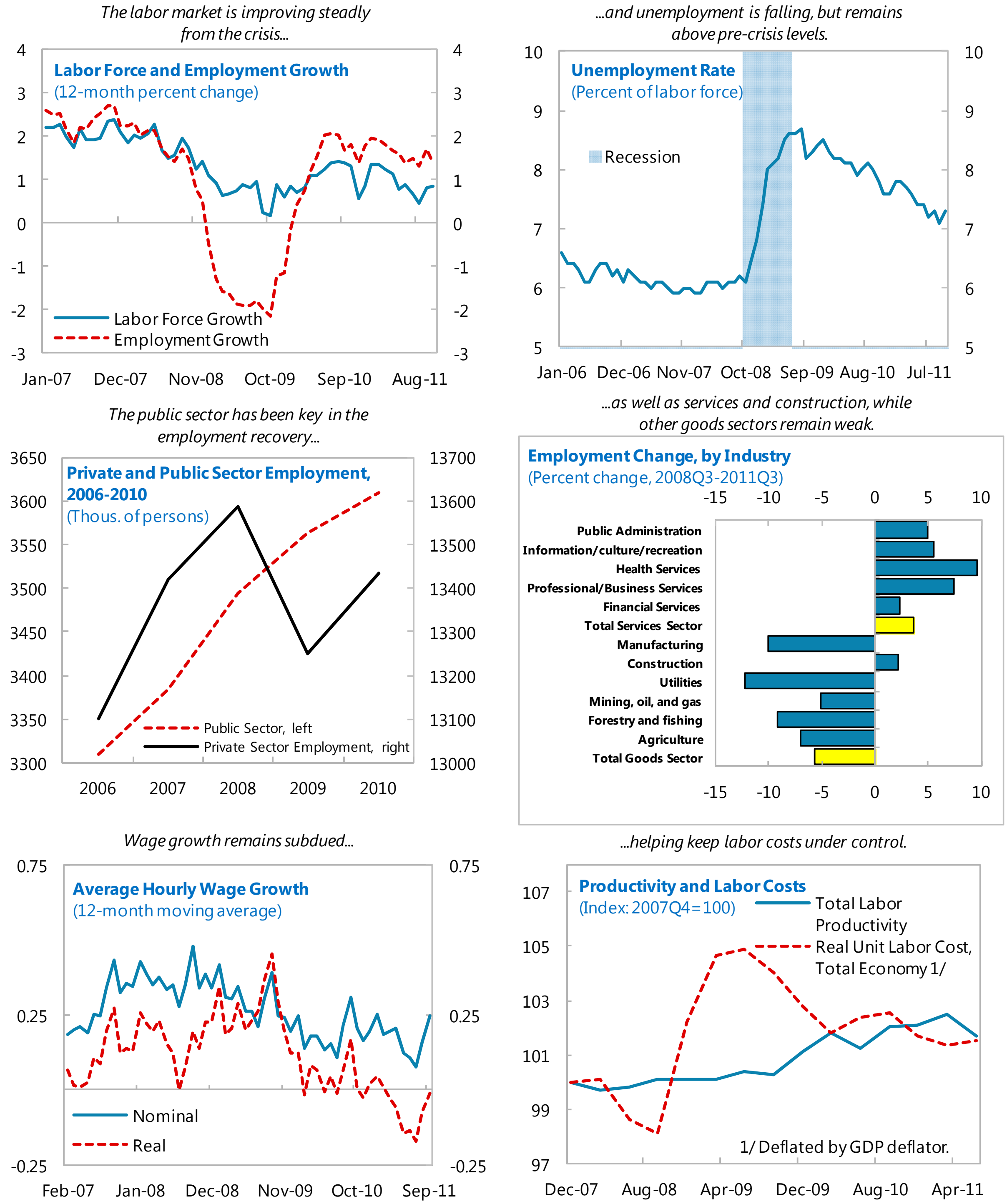
3/ Commodity exporters are Australia, New Zealand, and Norway, simple average.

Figure 2. Canada's Housing Boom



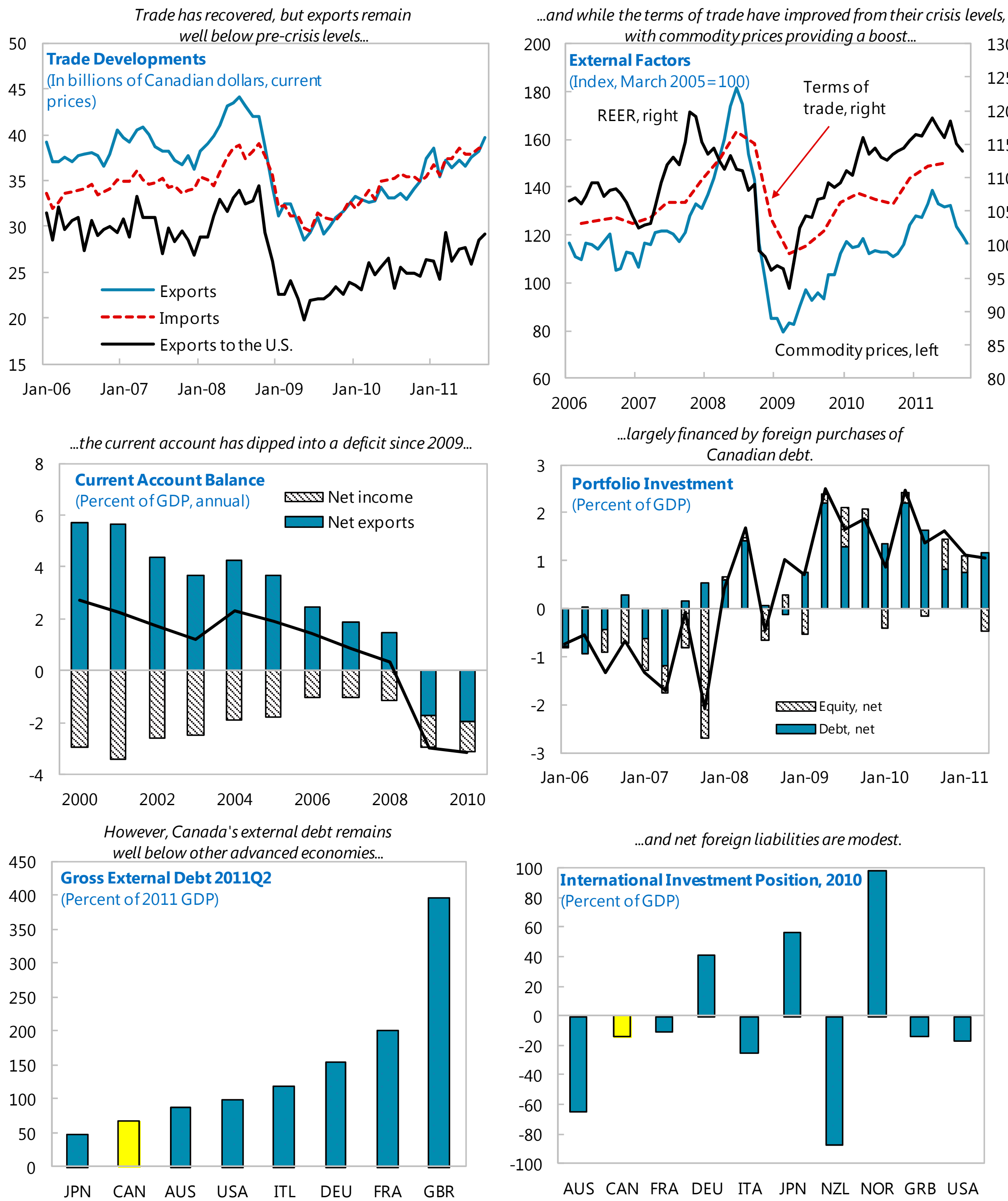
Sources: Canadian Real Estate Association, Haver Analytics, Teranet, and Fund staff calculations.

Figure 3. The Labor Market is Gradually Recovering



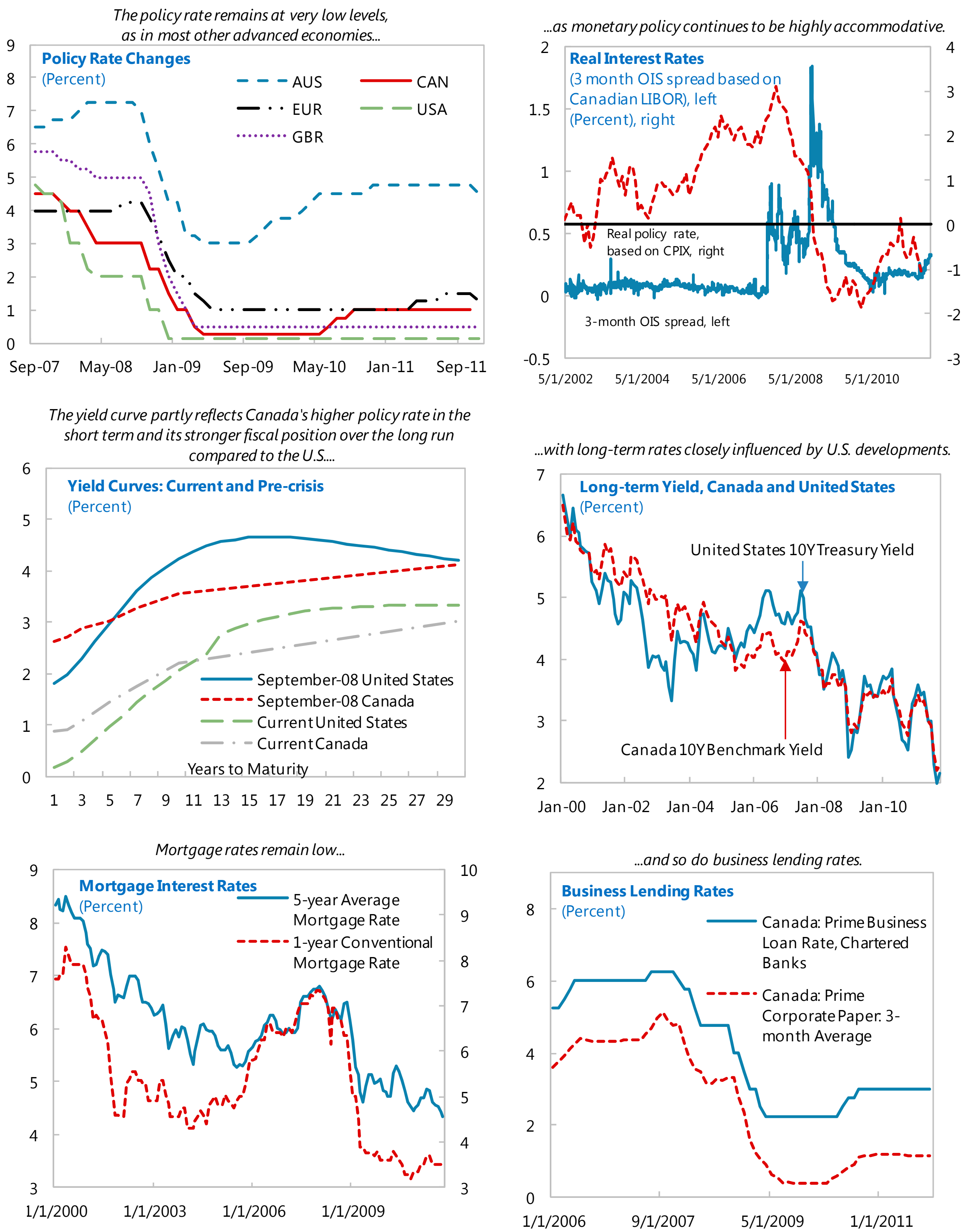
Sources: Haver Analytics, Statistics Canada, and Fund staff calculations.

Figure 4. External Developments



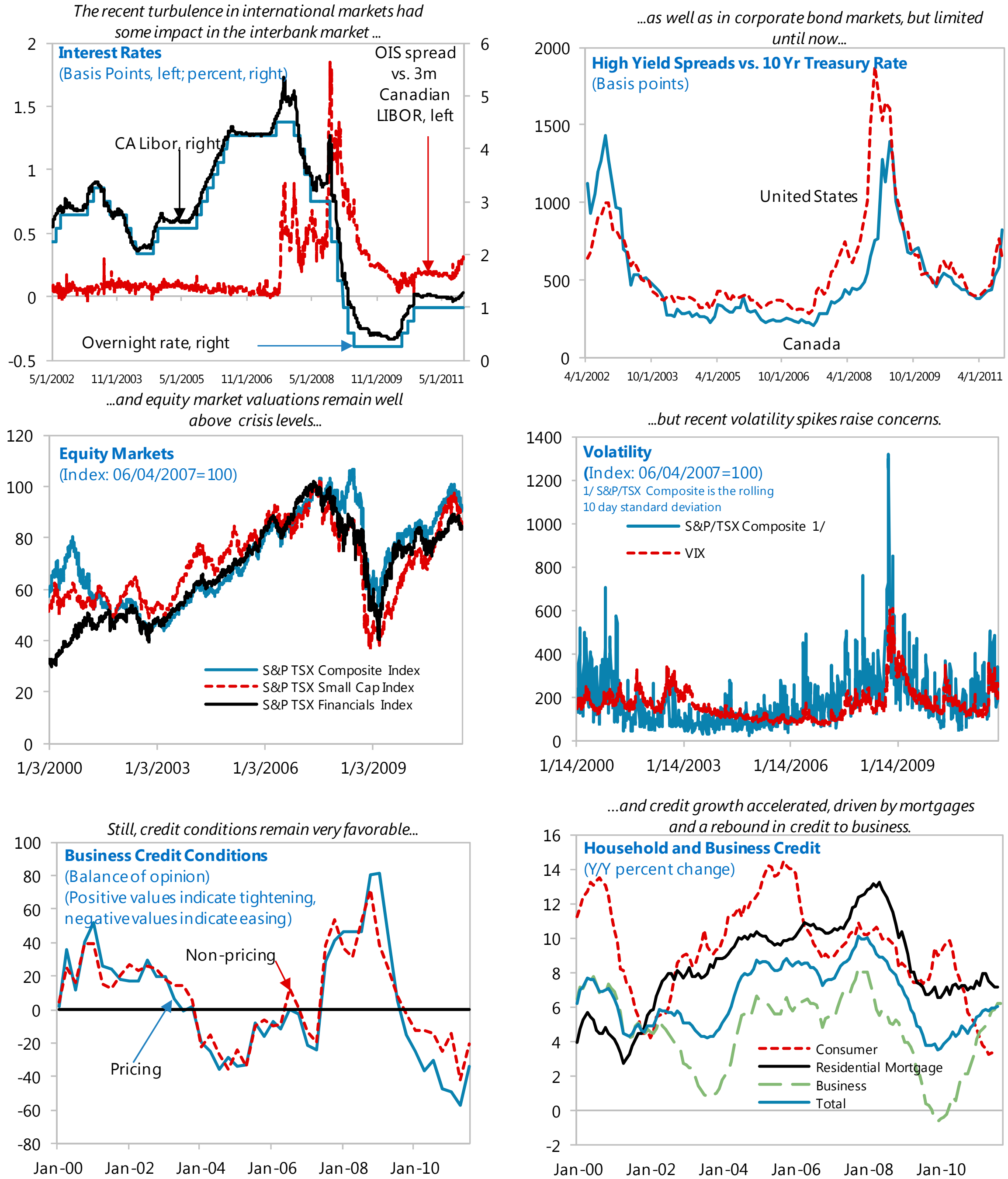
Sources: Haver Analytics, IMF International Financial Statistics, IMF World Economic Outlook, Joint External Debt Hub (most recent data), and Fund staff calculations.

Figure 5. Monetary Policy Remains Accommodative



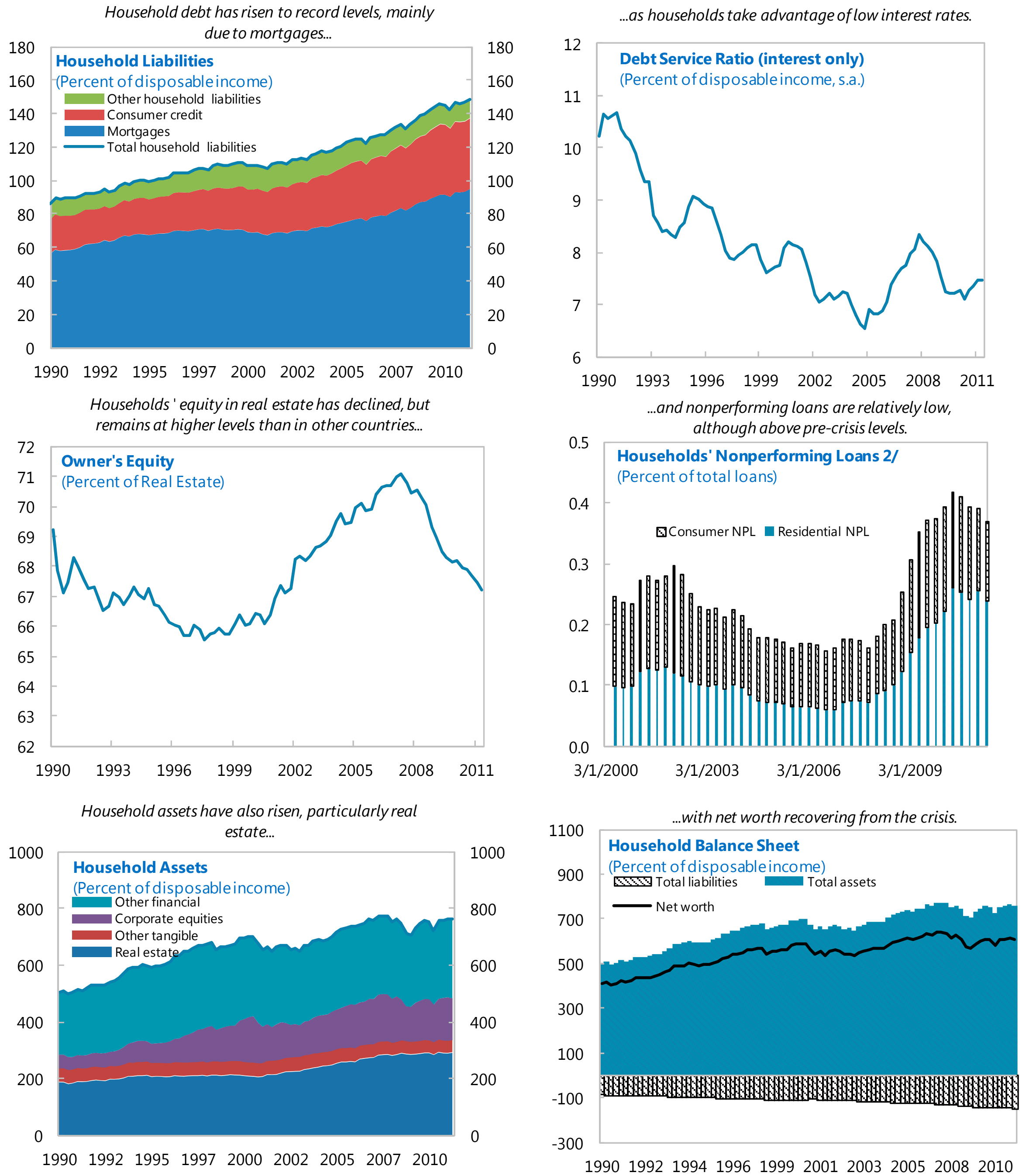
Sources: Bloomberg L.P., Haver Analytics, Statistics Canada, and Fund staff calculations.

Figure 6. Financial Markets Continued to Face Bouts of Volatility, but Credit Conditions Remain Favorable



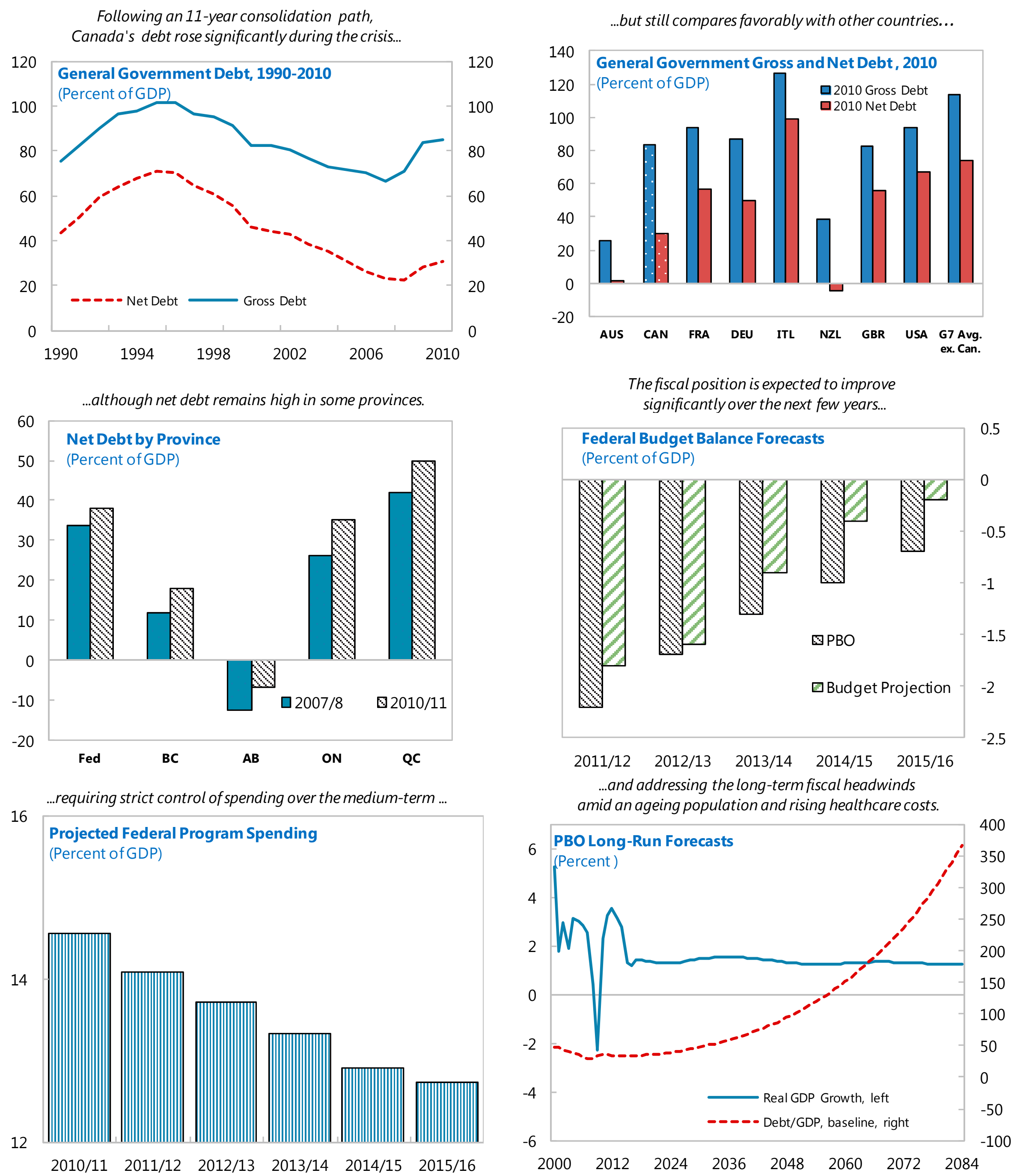
Sources: Bank of Canada, Bloomberg LLC., Canadian Office of the Superintendent of Financial Institutions, Haver Analytics, and Fund staff calculations.

Figure 7. High Household Indebtedness is a Key Domestic Vulnerability



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

Figure 8. Fiscal Policy: The Plan to Balance



Sources: Finance Canada Update of Economic and Fiscal Projections 2011, Canadian Provincial Budgets, IMF World Economic Outlook, Haver Analytics, OECD, 2010 Parliamentary Budget Officer Study, Statistics Canada, TD Economics, and Fund staff calculations.

INTERNATIONAL MONETARY FUND

CANADA

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 23, 2011

Prepared By

The Western Hemisphere Department
(in consultation with other departments)

CONTENTS

I. FUND RELATIONS

(As of October 31, 2011)

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	4,708.78	73.93
Reserve position in Fund	1,660.48	26.07
Lending to the Fund	742.86	

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	5,988.08	100.00
Holdings	5,880.37	98.20

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):

	2010	2011	2012	2013	2014
Principal					
Charges/Interest	0.09	0.41	0.41	0.41	0.41
Total	0.09	0.41	0.41	0.41	0.41

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 2010 consultation with Canada was considered by the Executive Board on December 22, 2010 (IMF Country Report No. 10/377). Canada is on a 12-month consultation cycle.

XII. The 2011 Article IV discussions were conducted in Ottawa and Toronto from October 11–24 by G. Milesi-Ferretti (head), O. Celasun, P. Medas, J. Dagher (all WHD), G. Blondy (FAD), and A. Costa (MCM). Mr. Gilbert Terrier joined the mission for the meetings in Ottawa and Mr. Nicolas Eyzaguirre for the concluding meeting with Minister of Finance Flaherty and Bank of Canada Governor Carney in Ottawa on October 24. Ms. Beaton (Senior Advisor) attended the meetings and Mr. Hockin (Executive Director) participated in some of the meetings. A press conference was held on October 31. 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 faces 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.

II. STATISTICAL ISSUES

The quality, coverage, periodicity, and timeliness of Canada's economic data are considered to be excellent both in the context of the Article IV consultation and for purposes of ongoing surveillance. Canada has subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (DSBB). 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]	Memo Items: 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]	Nov 3, 2011	Nov 5, 2011	W	W	W		
Reserve/Base Money	Oct 2011	Oct 2011	W	W	W	LO, O, LO, LO	O, O, O, O, O
Broad Money	Sep 2011	Oct 2011	M	M	M		
Central Bank Balance Sheet	Oct 21, 2011	Oct 27, 2011	W	W	W		
Consolidated Balance Sheet of the Banking System	Aug 2011	Sep 2011	M	M	M		
Interest Rates[2]	Same day	Same day	D	D	D		
Consumer Price Index	Sep 2011	Oct 2011	M	M	M	O, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2011 Q2	Sep 2011	Q	Q	Q	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	July 2011	Aug 2011	M	M	M		
External Current Account Balance	2011Q2	Oct 2011	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Aug 2011	Oct 2011	M	M	M		
GDP/GNP	2011 Q2	Sep 2011	Q	Q	Q	O, O, O, LO	O, O, O, O, O
Gross External Debt	2011 Q2	Aug 2011	Q	Q	Q		
International Investment Position[5]	2011 Q2	Oct 2011	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.

Statement by the IMF Staff Representative on Canada
December 19, 2011

1. **This note reports on information that has become available after the staff report (SM/11/319) was issued and does not alter the thrust of the staff appraisal**.

2. **Recent data points to a mixed picture, with stronger-than-expected GDP rebound in Q3 but increasing signs the economy is now decelerating**. Real GDP grew by 3½ percent (s.a.a.r.) in Q3, after a small contraction in the previous quarter due to one-off factors. This growth reflected a strong rebound in net exports, while the growth of final domestic demand weakened. On the other hand, rising unemployment (7.4 percent in November) and recent activity surveys (such as the October and November manufacturing PMI) suggest the economy is decelerating. The rebound in net exports led to a decline in Canada's current account deficit to 2.8 percent of GDP in the third quarter. However, external trade developments remain volatile, with exports falling by 3 percent in October, partially reversing the improvement observed in previous months. Inflation fell slightly in October, with core inflation remaining around the Bank of Canada's 2 percent target. The fiscal outturn for Q3 suggests that the general government fiscal deficit is broadly in line with staff projections.

3. **On December 6, as anticipated, the Bank of Canada left the overnight rate unchanged at 1 percent**. In its statement, the Bank noted that the weaker external outlook was expected to dampen GDP growth in Canada through the financial, confidence, and trade channels. While inflation has been somewhat higher than envisaged, inflationary pressures in the quarters ahead are expected to remain subdued, especially given the existing slack in the economy.

4. **On November 30, several central banks, including the Bank of Canada, took further coordinated actions to enhance their capacity to provide liquidity support to the global financial system**. The Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank agreed to lower the pricing on the existing temporary U.S. dollar liquidity swap arrangements by 50 basis points. These swap arrangements have been extended to February 1, 2013. As a contingency measure, these central banks have also agreed to establish temporary bilateral liquidity swap arrangements, so that liquidity can be provided in each jurisdiction, in any of their currencies, should market conditions so warrant. The Bank's December *Financial System Review* noted that risks to Canada's financial system have increased over the last six months, mainly due to the external environment.

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

IMF Executive Board Concludes 2011 Article IV Consultation with Canada

On December 19, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.[1]

Background

Thanks to a decisive policy response, a resilient financial sector, and high commodity prices, the economy expanded well above its potential rate in 2010 and early 2011, with gross domestic product (GDP) returning to pre-crisis levels in the second half of 2010. The expansion stalled in the 2nd quarter of 2011, partly due to temporary factors and unfavorable external conditions, although indicators point to a pick-up in the 3rd quarter. Domestic demand remains the driver of growth. While government spending and private consumption have slowed, business investment remains buoyant reflecting low funding costs, cheaper imports of capital goods, and elevated commodity prices. Unemployment has declined steadily from its 2009 peak, but remains above pre-crisis levels.

The external current account balance deteriorated sharply in recent years, reflecting the effects of the crisis and a loss of external competitiveness over the last decade, with a deficit of 3 percent of GDP in 2009–10. Exports of autos, machinery, and lumber were particularly affected by the collapse in U.S. demand, the strength of the Canadian dollar, and competition

[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 summing ups can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

from emerging markets. The weak export sector has also hampered a stronger recovery in private sector employment, especially in manufacturing where employment remains 10 percent below 2008 levels.

Economic growth is expected to be moderate in the near term, with significant uncertainty related to the unsettled external environment. While interest rates remain low, growth in personal consumption and real estate investment is expected to be relatively subdued, in light of high household debt and measures taken to contain mortgage credit growth. With weak net exports and ongoing fiscal adjustment, business investment is anticipated to play a key role in sustaining growth. Threats outside Canada—including further turbulence from Europe and its impact on global financial markets—are the main source of risk. On the domestic front, high household debt levels, coupled with elevated house prices, are the main vulnerability.

Monetary policy continues to be highly accommodative given ongoing economic slack and well-managed inflationary expectations. The policy rate remains at exceptionally low levels—the target for overnight rate has been kept at 1 percent since September 2010, and no hikes are expected in the near future given that core inflation has remained around the inflation target, inflationary expectations are well anchored, and external risks are high.

Fiscal consolidation is now under way with the federal government leading the efforts. The authorities envisage a return to budgetary balance by 2015–16 with an ambitious plan to bring spending as a share of GDP back to pre-crisis levels, while remaining flexible to changes in the economic outlook.

Canada’s corporate and financial sectors continue to display resilience amid the recent turbulence in international financial markets, also reflecting strong supervision and regulation. Despite some recent tightening, credit conditions remain highly favorable, with both firms and banks taking advantage of funding costs well below historical averages. Banks’ financial soundness indicators are at strong levels, with near-term risks stemming primarily from potential spillovers from European markets.

Executive Board Assessment

Executive Directors commended the authorities’ exemplary macroeconomic management and financial sector oversight, which have enabled Canada to weather the global crisis well. Directors noted that the pace of the recovery has slowed, after a strong rebound in 2010. While Canada’s medium term outlook remains broadly favorable, near term downside risks are high due to the financial market turmoil in Europe and rising household indebtedness. Accordingly, policymaking should remain flexible and pragmatic in the period ahead.

Directors endorsed the Bank of Canada's conduct of monetary policy. They agreed that, with the prevailing economic slack and with core inflation and expectations well within the target range, monetary policy should continue to be accommodative at present. Most Directors agreed that there is scope for further monetary easing if the economy weakens. Directors welcomed the Bank of Canada's preparedness to respond quickly to liquidity strains in the event of increased financial turbulence from Europe.

Directors supported the authorities' intention to gradually remove fiscal stimulus and return to fiscal balance over the medium term. They stressed that provincial governments also need to move ahead with fiscal consolidation. Most Directors agreed that, within the medium term consolidation plans, there is space for countercyclical fiscal support if the economic outlook deteriorates, given the low level of government net debt.

Directors welcomed the authorities' adoption of macro prudential measures to curb the build up of mortgage debt. With household debt at a historical high and various indicators suggesting house price levels above fundamentals in some regions, Directors called for continued vigilance in this area. Strengthening oversight of the Canadian Mortgage and Housing Corporation will be particularly important. Directors welcomed the authorities' willingness to take additional action should prices and household indebtedness continue to rise.

Directors commended Canada's strong financial regulation and supervision. This has resulted in a stable and resilient banking sector, which has resisted the international financial crisis well and remains well prepared to deal with most adverse scenarios. Nonetheless, Directors called for continued close monitoring of spillover risks, as well as risks associated with a prolonged period of exceptionally low global interest rates. Directors welcomed Canada's leadership in implementing the international financial reform agenda, and its valuable contributions to developing new global regulatory standards.

Directors highlighted a gradual loss of external competitiveness over the years and the importance of reversing this trend, particularly through efforts to improve the business environment and boost productivity. Directors also stressed the need for a concerted effort to contain the rising health care costs associated with population aging. The forthcoming review of transfers from the federal government to the provinces provides an opportunity to address this issue.

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 2011 Article IV Consultation with Canada is also available.

Canada: Selected Economic Indicators 1/

(Annual change in percent, unless otherwise noted)

	2006	2007	2008	2009	2010	Proj. 2011	Proj. 2012
Real GDP	2.8	2.2	0.7	-2.8	3.2	2.2	1.9
Net exports 2/	-1.4	-1.5	-2.1	0.2	-2.1	-1.3	-0.2
Total domestic demand	4.4	3.9	2.8	-2.8	5.2	3.6	2.1
Final domestic demand	4.6	4.0	3.0	-2.1	4.5	2.9	1.8
Private consumption	4.2	4.6	3.0	0.4	3.3	1.9	1.6
Public consumption	3.0	2.7	4.4	3.6	2.4	0.8	-0.2
Private fixed domestic investment	7.1	3.1	1.2	-16.6	8.4	9.3	5.3
Private investment rate (as a percent of GDP)	20.5	20.7	20.8	17.9	18.8	20.1	20.7
Public investment	6.8	6.5	7.7	8.8	17.9	0.6	-2.5
Change in inventories 2/	-0.2	-0.1	-0.2	-0.8	0.6	0.5	0.4
GDP (current prices)	5.6	5.5	4.8	-4.6	6.3	5.3	3.9
Employment and inflation							
Unemployment rate	6.3	6.1	6.2	8.3	8.0	7.4	7.2
Consumer price index	2.0	2.1	2.4	0.3	1.8	2.9	2.0
GDP deflator	2.7	3.2	4.1	-1.9	2.9	3.0	1.9
Exchange rate (period average)							
U.S. cents/Canadian dollar	88.2	93.1	93.7	87.5	97.1	..	..
Percent change	6.4	5.3	0.7	-7.1	9.9	..	..
Nominal effective exchange rate	6.7	3.7	-0.9	-5.2	10.5	..	..
Real effective exchange rate	9.3	6.4	-2.3	-7.8	7.9	..	..
Indicators of financial policies (national accounts basis, as a percent of GDP)							
Federal fiscal balance	0.8	1.0	0.2	-2.2	-2.6	-1.9	-1.5
Provincial fiscal balance 3/	0.0	-0.4	-1.0	-3.5	-3.5	-3.5	-3.1
General government fiscal balance	1.6	1.6	0.1	-4.9	-5.6	-4.8	-4.0
Three-month treasury bill	4.0	4.2	2.4	0.4	0.6	0.9	1.0
Ten-year government bond yield	4.2	4.3	3.6	3.2	3.2	2.8	2.5
Balance of payments							
Current account balance (as a percent of GDP)	1.4	0.8	0.3	-3.0	-3.1	-3.5	-3.8
Merchandise trade balance (as a percent of GDP)	3.4	3.1	2.8	-0.3	-0.6	-0.7	-1.0
Export volume	0.8	1.3	-5.3	-15.0	6.9	3.3	3.7
Import volume	5.1	5.5	1.3	-14.9	13.9	7.5	4.6
Invisibles balance (as a percent of GDP)	-2.0	-2.3	-2.5	-2.6	-2.6	-2.8	-2.8
Saving and investment (as a percent of GDP)							
Gross national saving	24.4	24.1	23.6	17.9	19.1	19.9	20.4
General government	4.6	4.5	2.9	-0.9	-1.2	-0.6	0.1
Private	19.8	19.6	20.7	18.8	20.3	20.4	20.3
Personal	5.0	4.6	5.4	6.2	6.2	5.5	5.1
Business	14.9	14.5	15.1	12.1	13.4	14.9	15.3
Gross domestic investment	23.0	23.2	23.2	20.9	22.2	23.4	24.1

Sources: Statistics Canada and IMF staff estimates.

1/ Data as available on November 15, 2011.

2/ Contribution to growth.

3/ Includes local governments and hospitals.