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**Statement by Mr. Merk and Mr. Krahnke on Canada
(Preliminary)
Executive Board Meeting
March 12, 2021**

We thank staff for the informative set of reports and Ms. Levonian, Ms. Vasishtha, and Mr. Weil for their helpful Buff statement. **We broadly concur with the general thrust of the staff appraisal.**

We take positive note that the fiscal space built up in recent years has enabled Canada to respond to the crisis, but the sharp increase in debt poses risks. While emergency spending should be kept up until a sustainable recovery is on the way, we agree with staff that in order to contain risks for the trajectory of government debt proactively, a medium-term fiscal anchor would be desirable. Moreover, we want to highlight that solving the debt problem of Canadian provinces should be top priority. Despite last year's increase, the projected trajectory of the debt-to-GDP-ratio appears to be promising, thanks to the positive estimated fiscal multiplier of the crisis support (see Box 2). Nonetheless, we agree with staff that risks to the debt-to-GDP-ratio are considerable, with uncertainty in the current environment being exceptionally high.

We welcome the authorities' strong and decisive crisis support, and in particular the transfers to protect vulnerable groups. This notwithstanding, we agree with staff that the crisis has revealed gaps in the social safety net. The necessity to introduce large-scale emergency programs to prevent long-term labor market scarring has shown that reforms to the employment insurance are necessary. We also concur with staff that a modernized system could better serve as an automatic stabilizer, also in regular business cycles. In our view, the proposal to link temporary fiscal spending to a specific macroeconomic variable such as the unemployment rate – while an interesting idea – would need to be weighed carefully. While well-developed automatic stabilizers are likely best suited for the stabilization task, rules of the kind suggested by staff might prove overly rigid and in the case of the unemployment rate

misleading. During the crisis, the drop in the unemployment rate was cushioned by a strong decrease in the labor force participation. Thus, unemployment rates to a certain extent masked underlying economic developments. Moreover, we are concerned that the measure of the unemployment rate might be prone to measurement and reporting errors. This is due to the fact that the official employment statistics rely on survey results being extrapolated, with the sample currently covering approximately 0.2 % of the labor force, resulting in high standard errors.

We agree with staff's assessment that the relatively high ratio of short-term government debt may pose interest rate risk. In case financial conditions were to be less favorable when debt needs to be refinanced, the debt burden might increase considerably. Additionally, given the relatively high debt ratio of the provinces, this raises some concerns about the sustainability of provincial debt, too, which in our view would have merited greater attention in the staff report. *Could staff provide some insights on the maturity composition of provincial debt and on its sustainability in general?*

We support the authorities' data driven approach in reducing fiscal support measures. However, for its success the timeliness and disaggregation of data is critical. Additionally, we agree with staff that clear communication about the specific conditions would be necessary.

On monetary policy, we take note of the relatively large scale of the asset purchasing program and the resulting considerable increase of the central bank's balance sheet. While we acknowledge the objective to support market functioning and provide liquidity during the crisis, it is coming along with rising financial vulnerabilities. This and potential liquidity shortages on domestic bond markets might speak in favor of a potential scaling back of the APP in the coming months, which would need to be communicated as carefully as in October 2020 to prevent disorderly market movements. Clear communication of the commitment to the policy target of price stability is also crucial for monetary policy credibility, in particular in the case of any pressure to keep the government's refinancing costs low.

The adequate capitalization of the banking system should provide ample room in case of a higher number of household and corporate defaults resulting from the crisis. However, with private debt already elevated before the crisis, and crisis measures being phased out, risks to the banking system's balance sheets could rise. We agree with staff that a restructuring of loans could be necessary, especially if debt moratoria end.

We take note of the trend of increasing house prices and the apparent overvaluation of asset prices in some real estate markets. This development not only poses risks to financial stability but could also have the potential to threaten social cohesion. Housing should remain affordable and further pressure on the already elevated level of household debt may pose increasing risks to financial stability. Therefore, the movements of the real estate prices and

of household debt need close monitoring by the authorities. Furthermore, the authorities should implement the tools at hand in a coordinated manner. We note that Canada maintains real estate taxes on non-residents that are designated as capital flow management measures. We encourage the authorities to maintain a close dialogue with staff on the appropriateness of these tools and carefully consider alternative (potentially more broad-based and effective) measures.

To support medium-term growth of the economy, we agree with staff that structural reforms that increase competitiveness, overall productivity and broaden the export base are necessary. Weak business investment, lagging labor productivity and unfavorable FDI flows over many years are worrying signs in this regard. The loss in non-price competitiveness also suggests the need to guard against risks associated with a large dependence on commodity exports. We also agree that equality remains an important objective. With female workers and low-income jobs being affected in particular by layoffs and reductions in hours worked, the authorities should focus on building a more inclusive labor market. In this regard, we welcome the authorities' announced initiatives encompassed in the "build back better" plan as also laid out in the Buff statement that include a national childcare system and aim at creating opportunities for the vulnerable groups. We do, however, take note that the details are yet to be revealed and encourage the authorities to pay due regard to judicious design and effective targeting of the planned spending.

We strongly appreciate Canada's efforts in implementing climate policies and its focus on building a greener economy. The commitment to achieve net-zero emissions by 2050 is an important decision and most welcome. We agree with staff that Canada's progressive carbon pricing scheme can serve as an example to other countries.

We note that staff's preliminary assessment of Canada's external position is subject to high uncertainty. We acknowledge that staff makes quite significant adjustments to the EBA norm (a total of 2.1 percentage points of GDP) to account for some factors and to bring the staff norm closer to the observed value for the current account. This may well be justified given inter alia the likely recovery in the oil balance. At the same time, the outlook for Canada's main exports may structurally become more uncertain going forward which would suggest a need to closely monitor the overall strength of the external position.

Given the importance of oil and gas for Canada's external position, risks for Canada's oil sector rightly receive some attention in the report. *However, on the outlook we would welcome additional comments by staff on the balance of risks.* In particular, while the recent increase in global prices is providing a boost to Canada's exports, more country-specific factors (high corporate debt in the sector as well as constraints from pipeline capacity) could imply quite significant downside risks and uncertain prospects. *As crude oil production has fallen close to pipeline capacity, we would be interested to learn whether staff is expecting an increase in oil-by-rail exports or potentially some moderating in production going forward?*

Finally, we agree with staff that the quality, coverage, periodicity, and timeliness of Canada's economic data are generally adequate. With the issue of fiscal sustainability gaining importance, there might, however, be room for improvement of the periodicity of provincial and local data on government debt. Applying international accounting standards also at the provincial level could in our view also enhance the understanding of Canada's fiscal situation.