FOR AGENDA

SM/08/17
Correction 2

February 5, 2008

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Canada—Staff Report for the 2008 Article IV Consultation**

The attached corrections to SM/08/17 (1/16/08) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 14, para. 28, line 6: for "which proposed modest tax"
read "which proposed a range of tax"

Page 19, para. 51, line 3: for "outlook, the modest fiscal stimulus"
read "outlook, the fiscal stimulus"

Questions may be referred to Mr. Bayoumi, WHD (ext. 36333).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (2)

Other Distribution:
Department Heads

23. **Prior to a late-December agreement, staff and officials saw the shutdown of one-third of the asset-backed commercial paper (ABCP) market as posing contagion risks**. The team observed that the shutdown of the market for paper sponsored by non-banks reflected regulations that gave incentives to provide only limited support. With foreign banks refusing backstop liquidity, there was a risk of a fire sale of assets. By contrast, the remaining two-thirds of ABCP (backed by the main domestic commercial banks) remained liquid, reflecting better quality underlying assets and reputation-induced liquidity support. However, higher rates and shorter maturities indicate some strains.

24. **After delays and difficult negotiations, an agreement in principle was reached on December 23, 2007, to restructure almost all of the 2½ percent of GDP of frozen ABCP**. The agreement between all of the main parties, including the major Canadian banks, has substantially reduced the risks of contagion. It converts the commercial paper into longer-term notes, whose maturity corresponds to the underlying assets. The difficulties in obtaining an agreement partly reflected the reduction in value of U.S. and other foreign assets underlying the ABCP, illustrating another way that global financial strains have been feeding through to Canadian markets.

F. Is Core Inflation Likely to Rebound?

25. **The recent downward pressure on inflation from exchange rate passthrough has come as a surprise**. The limited passthrough of currency appreciation since 2002 has been abruptly reversed since October, as parity with the U.S. dollar has simplified comparison of Canadian and U.S. prices and cross-border shopping (including through the internet) has spiked up. As a result, core inflation has fallen abruptly to below the 2 percent mid-point of the target range despite strong domestic demand and tight labor markets that had earlier boosted inflationary pressures (Figure 4).

26. **Staff and Bank of Canada officials concurred that core inflation is likely to remain below the 2 percent target for some time**. Bank officials emphasized that the size and length of this current downward adjustment in Canadian prices relative to U.S. prices remains highly uncertain, as does the associated downward pressure on inflation. Staff agreed, noting that, at one extreme, some private analysts had indicated that core inflation (which will be adjusted to exclude the impact of January 1 indirect tax cuts) could fall to the bottom of the 1–3 percent target range. Like the Bank, staff see core inflation as moderating more modestly, with downside risks from financial strains and weaker-than-expected external demand and upsides from stronger domestic demand and weaker productivity growth.

II. Policy Discussions

27. **With a minority government in place, the policy agenda is being shaped against the possibility of an early election**. The Conservative party won the January 2006 election and formed a minority government, led by Prime Minister Harper. With Canadian minority governments having historically had short lifespans, there is widespread discussion of the potential timing of the next election.

28. **The discussions focused on policies to mitigate the impact of increased near-term risks to macroeconomic stability, and to enhance productivity growth**. The main near-term issue is the appropriate monetary policy stance given large competing risks, involving possible downsides from unsettled financial conditions and U.S. growth, and upsides from strong domestic demand. The discussions on key longer-term structural issues took place against the background of the October 2007 *Economic Statement,* which proposed a range of tax cuts. Table 1 summarizes previous policy positions not highlighted in this report.

A. Balancing Strong Domestic Demand with Risks to External Stability

29. **Bank of Canada officials explained that monetary policy has shifted in response to increasing downside risks to output and inflation**. The inflation-targeting Bank, which focuses on the output gap and core inflation as indicators of future inflationary pressures, had tightened through July 2007 on concerns about the upward creep in core inflation from strong domestic demand and tight labor markets. Monetary policy subsequently paused in the fall despite continuing domestic pressures, on concerns about the impact of slowing U.S. activity and global financial strains on the outlook. As these concerns intensified, the policy rate was cut in early December, using the room afforded by the fall in core inflation from strengthened exchange rate passthrough. Staff supported this decision, which took into account the evolving balance of risks.

30. **Staff agreed with officials that large upsides and downsides around the current forecast made the future path of monetary policy particularly difficult to chart**. Officials emphasized that the Bank was content with the current level of monetary conditions, and that there was no presumption about the direction of the next move in rates. Staff observed that, looking forward, strong recent exchange rate passthrough could complicate policy decisions by temporarily lowering inflation even though underlying inflationary pressures may not have dissipated.

31. **Bank officials agreed that worsening financial conditions had been a factor in the easing of monetary policy in December and remain a concern**. The estimate that financial strains were equivalent to a 25bp rise in spreads, published in the October *Monetary Policy Report*, was based on average market rates over a range of instruments and maturities. They were comfortable with this approach even though several observers, who had focused on selected markets where tightening was more substantial, had suggested the estimate was too low.

32. **Staff asked if the Bank's statutory limitations to liquidity provision were hampering its response to term money market strains**. Officials responded that the current facilities have been adequate to deal with evolving market strains. The initial focus on overnight open market operations had largely reflected concerns about the effectiveness of term operations rather than statutory limits. Recently, though, the Bank participated in term interventions with the Federal Reserve, ECB, Bank of England, and Swiss National Bank, as coordinated action was more likely to have an impact on term money market spreads. Staff view this as an appropriate response to current financial strains, as is the recently-announced expansion of the list of eligible securities for some forms of liquidity provision.

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

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Revenue	16.4	16.4	16.2	16.3	15.9	15.3	15.2	15.2
Outlays	15.6	16.3	15.2	15.4	15.2	15.1	15.0	14.8
Budget balance	0.8	0.1	1.0	1.0	0.7	0.1	0.2	0.4
Planned debt reduction	...	...	1.0	1.0	0.7	0.2	0.2	0.2
Planning surplus 2/	0.8	0.1	1.0	0.0	0.0	0.0	0.0	0.3
Net lending	0.3	0.8	0.1	0.6	0.4	-0.1	-0.2	0.0
Net debt 3/	40.9	38.3	35.0	32.3	30.0	28.6	27.2	25.7

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

1/ The projections are based on the baseline provided by the authorities' 2007 Economic Statement adjusted for staff macro assumptions. It includes a GST cut of 1 percentage point in 2010/11.
2/ Planning surplus = budget balance minus debt reduction.
3/ Assuming future planned debt reduction is achieved.

50. **This year's budgetary overperformance is to be used for tax relief and debt reduction**. With higher-than-expected nominal GDP growth and corporate income tax revenue, the budget surplus based on current policies is again expected to be substantial (¾ percentage points of GDP) this fiscal year. In the *Economic Statement*, the government proposes to use this overperformance to finance tax relief (¼ percentage point of GDP) and a one-off additional debt reduction (½ percentage points of GDP). Next fiscal year, the overperformance would be used to finance the full annual cost of the tax relief measures, and the projected surplus remains around the debt reduction target.

51. **The mission agreed with officials that the comfortable projected fiscal position provides room for permanent tax relief**. Indeed, given the worsening of the economic outlook, the fiscal stimulus in 2008 appears fortuitously timed. However, staff observed that there was a risk that some recent revenue gains (particularly from commodity industries) may be more temporary than expected. This underscores the importance of expenditure restraint, particularly given relatively rapid recent spending growth. While acknowledging the risk, officials emphasized that the *Statement* incorporated private economic and budget forecasts and that the assumed tax buoyancy appeared appropriately conservative, particularly in the light of past revenue overperformance.

52. **The major short-term uncertainty for the budget is the economic outlook given that the current fiscal framework does not encompass discretionary policy**. Staff calculations suggest that, given the size of automatic stabilizers, nominal GDP would need to slow by 1 percentage points more than in the baseline to push the federal government into deficit in fiscal year 2008–09. This implied either significantly lower real growth or a large fall in commodity prices. Senior officials emphasized that the current fiscal framework incorporated a fixed target surplus but did not exclude the possibility of running a deficit under unexpectedly adverse circumstances.

53. **Staff viewed the reduction in the federal GST tax rate (the Canadian value added tax) by a percentage point to 5 percent in the *Statement* as a missed opportunity**. As has been noted in previous consultations, larger gains in efficiency could have been

obtained by cutting other taxes (see also Chapter 6 of *Northern Star*, IMF Occasional Paper 258).

54. **Staff suggested that the priority for tax relief should be to reduce high marginal effective rates (METRs) on capital, saving, and labor income (in that order)**:

- Accordingly, staff welcomed the 1 percentage point cut in the general corporate income tax rate in 2008 and its further reduction to 15 percent tax rate by 2012. This will have the added benefit of making corporate taxes more neutral with regard to firm size.

- Staff and federal officials agreed that harmonizing remaining provincial sales taxes with the GST base, thereby exempting business inputs, is also central to lowering METRs on capital. Senior officials observed that the government has stated its willingness to work with provinces on harmonization. Staff suggested that a more explicit offer of assistance—as had occurred in earlier efforts to harmonize sales taxes and to eliminate provincial capital taxes—might be a more effective approach.

- The team noted that marginal effective taxes on most forms of saving remain high. Additional measures, such as protecting all types of saving from taxes up to a cap, could help support wealth creation by moving personal income taxes closer to a consumption tax. Senior officials were sympathetic, while pointing out that it was also important to ensure neutrality of taxation across saving vehicles, and that there had recently been a significant rise in the pension income amount eligible for tax relief.

- Staff welcomed the reduction in the lowest personal income tax rate by half a percentage point to 15 percent and the introduction of the Working Income Tax Benefit (a negative income tax).

55. **The team suggested that increasing the relative importance of indirect to direct tax revenues is one way of lowering high marginal tax rates on income**. This proposal, which has also been suggested by some think tanks, would also help maintain the tax base in the face of commodity cycles and population aging. One option for creating room for income tax relief would be to follow the example of British Columbia and explore introducing a carbon tax. Officials responded that the government had chosen to reduce carbon emissions through other means.

56. **While generally supporting the reformed system of equalization transfers to provinces, the mission noted some areas where transparency is still lacking**. Among the key elements of the system are a return to including all provinces in the formula determining transfer payments, the partial inclusion of revenue resources, and a cap on Equalization transfers so that no receiving province has a higher fiscal capacity than a nonreceiving one. Staff observed, however, that agreements allowing some provinces to obtain additional transfers implied by the old system increased complexity. As with the previous Offshore Accords agreed in 2005, this could gradually undermine the rules-based approach.