

SM/08/19
Correction 2

February 15, 2008

To: Members of the Executive Board
From: The Acting Secretary
Subject: **Canada—Selected Issues**

The attached correction to SM/08/19 (1/16/08) has been provided by the staff:

Typographical Error

Table of Contents, Title Chapter III: for “Why Canada’s Price Level is so Unpredictable?”
read “Why is Canada’s Price Level so Predictable?”

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: (1)

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Department Heads

INTERNATIONAL MONETARY FUND

CANADA

Selected Issues

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Approved by Western Hemisphere Department

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INTRODUCTION

1. **The Canadian economy has performed strongly in the last few years but weaker external conditions will likely place a toll going forward.** Output growth has been strong in the last four years and domestic economic indicators remain robust. However, with the envisaged U.S. slowdown and tighter financial conditions around the globe, an open economy such as Canada is bound to suffer. This selected issues paper addresses the following key questions: How closely linked is Canadian growth to U.S. growth? What are the main spillover channels from U.S. conditions to Canada? How well is the monetary framework operating? How adaptable is the Canadian economy to economic shocks?
2. **The first two Chapters address the risks to the Canadian economy by studying links to the U.S. economy.** Chapter I summarizes staff research indicating that spillovers from the United States to Canada have remained remarkably stable over time, with a one-percent decline in U.S. real GDP resulting in a $\frac{3}{4}$ percent reduction in Canadian output after 2 years. In addition, it seems that, while trade linkages are sizeable, financial conditions—broadly defined as changes in U.S. bond yields, equity prices, and short-term interest rates—are the largest source of U.S. spillovers to Canada. Chapter II presents the main results of staff research on the financial-spillover channel, which confirms and extends the findings in Chapter I. Financial spillovers are crucial because U.S. markets play a direct role in funding Canadian corporations, while U.S. financial conditions are key in determining financial conditions in Canada.
3. **These results suggest that Canada is unlikely to decouple from the U.S. downturn and, in particular, tighter U.S. financial conditions will probably dampen Canadian growth.** Indeed, spreads on Canadian money market borrowing have risen in tandem with U.S. rates, while problems in U.S. structured products have put pressure on Canadian bank balance sheets.
4. **The Bank of Canada has begun a research agenda on the net benefits of price-level-path-targeting (PLPT) over the current inflation-targeting framework.** Chapter III summarizes Fund staff work and indicates that the evolution of Canadian macroeconomic variables since the mid-1990s has been consistent with the inflation-targeting monetary regime including elements of PLPT. Thus, Canada may already be reaping some of the benefits from greater certainty about the future path of the price level, and possible changes toward a PLPT regime would likely be treated by the markets as an evolutionary step.
5. **To limit the fallout from U.S. developments and raise long-term growth, staff research suggests that Canadian product markets could be more flexible.** As argued in Chapter IV, dynamic small and medium enterprises may have limited access to credit,