

**FOR  
AGENDA**

SM/10/304

November 29, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Canada—Staff Report for the 2010 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2010 Article IV consultation with Canada, which is tentatively scheduled for discussion on **Friday, December 10, 2010**. Unless an objection from the authorities of Canada is received prior to the conclusion of the Board's consideration, the document will be published. Any requests for modifications for publication are expected to be received two days before the Board concludes its consideration.

Questions may be referred to Mr. Kramer (ext. 38491) and Ms. Batini (ext. 38568) in WHD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, December 7, 2010; and to the Caribbean Development Bank and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (<http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm>) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

CANADA

**Staff Report for the 2010 Article IV Consultation**

Prepared by the Western Hemisphere Department  
(In consultation with other departments)

Approved by Rodrigo Valdés and Tamim Bayoumi

November 24, 2010

**EXECUTIVE SUMMARY**

- **Focus.** The pace of exit from macro stimulus, cementing fiscal stabilization, and financial sector reform in the context of international initiatives.
- **Background.** Canada has performed well compared with its G-7 counterparts, thanks to its more resilient financial system, but was hit harder than other commodity exporters, due to its strong ties with the U.S. The economy continues to recover on the back of a substantial policy stimulus and strong domestic demand, but the recovery is now moderating.
- **Economic Outlook.** Growth is expected to be muted in the second half of 2010 and in 2011 as household debt has run up to high levels, housing markets are cooling and fiscal stimulus is waning. Risks are tilted to the downside, with a key risk that the global recovery stalls.
- **Monetary Policy.** Given the benign inflation outlook, forthcoming fiscal drag, and the mounting challenges to domestic growth, the Bank has appropriately put further rate hikes on hold for now; going forward, accommodation should be withdrawn cautiously. The authorities are considering a shift to price-level path targeting (PLPT) in 2012; the staff sees the existing inflation targeting framework as serving Canada well, while the benefits in practice of PLPT are uncertain.
- **Fiscal Policy.** The recession and large stimulus ended an 11-year string of federal surpluses. The authorities appropriately target a return to balance at the federal level over the medium run, with an ambitious and growth-friendly plan. The near-term adjustment is substantially frontloaded despite the steps taken by the authorities to smooth it; in light of the heightened risks to the outlook, a smoother adjustment could have been contemplated. For the long run, stabilizing health-care costs will pose challenges.
- **Financial Sector.** The Canadian financial system remains resilient, but near-term risks have increased, including from stretched household balance sheets and U.S. exposures. Canadian financial institutions are well positioned to adapt to the international post-crisis reform agenda; a national securities regulator remains an important priority.
- **Analytical Work.** Background studies explore the dynamics of the exchange rate during the crisis; recent trends in the housing market; the framework for housing finance; potential growth in the post crisis era; and the outlook for the Canadian auto-sector vis-à-vis NAFTA partners.

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## I. MACROECONOMIC AND FINANCIAL DEVELOPMENTS, PROSPECTS, AND RISKS

*Canada has weathered well the global recession, reflecting a strong position at the onset of the crisis, a sizeable macro policy response, and a healthy banking sector. However, the recovery is slowing and near-term external risks are mounting. In the absence of a double-dip recession in the United States and/or a new rapid deterioration of global financial conditions from renewed sovereign credit strains, Canada should enjoy a comfortable, if not exuberant, rate of growth in the near term.*

### A. Canada's Rapid Recovery

1. **The Canadian economy emerged from the recession in the second half of 2009** (Figure 1). The recession ended in 2009Q2 and GDP recovered its pre-crisis level by end 2010Q2, growing by a cumulative 3.4 percent (non-annualized, compared with a peak-to-trough decline of about 3¼ percent). Growth was particularly strong in late 2009 and early 2010, leading to a faster recovery than in other G-7 countries as well as advanced commodity exporters. As a result, Canada is the only G-7 country that virtually recouped the loss in employment (apart from Germany) and output during the recession by mid 2010, and the first to record year-over-year increases in employment by mid 2010Q1.

2. **Domestic demand has been buoyant, in part because bank credit continued to flow thanks to a resilient financial system.** Indeed, household debt rose to a new high of 143.6 percent of disposable income (vis-à-vis 148.6 percent in the United States on a comparable basis), supporting consumption. Meanwhile residential and business investment gained momentum, on the back of favorable financing conditions.

3. **The rapid turnaround of activity and vigorous domestic demand owes much to the government's rightly-sized and well-targeted macroeconomic stimulus.** In January 2009, the federal and provincial authorities launched a major fiscal stimulus—one of the largest among advanced economies—totaling about 4 percent of one year's GDP over two years, including measures targeted at credit, housing, and labor markets.<sup>1</sup> Meanwhile, the federal government pumped liquidity into the economy through the purchase of insured mortgages.<sup>2</sup> The Bank of Canada slashed its policy rate to an all-time low of ¼ percent, and committed to keep rates at that level until mid-2010, conditional on inflation developments. Simultaneously, the Bank injected liquidity in short-term markets to alleviate pressures on

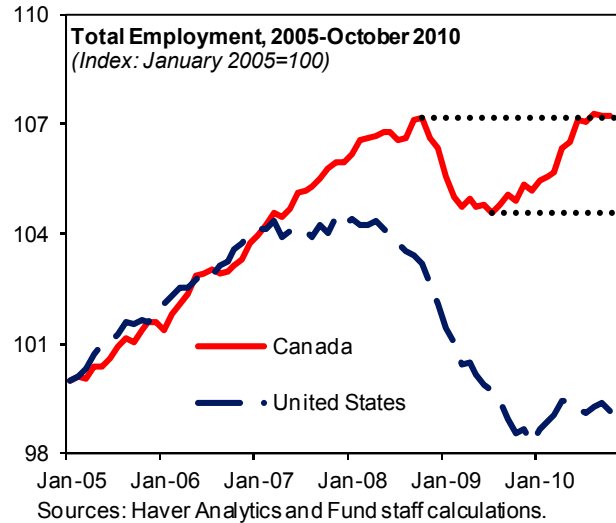
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<sup>1</sup> Canada's stimulus is around 2 percent of GDP per year in 2009 and 2010, and includes the effects of phased revenue measures included in the *2007 Economic Statement* (amounting to a total 1 percent of GDP over two years) and policies announced in the *Economic Action Plan* of 2009. Staff estimates exclude financing measures to support the auto sector of around 0.9 percent of GDP.

<sup>2</sup> The Insured Mortgage Purchase Programme (IMPP) allowed the government to buy up to CAD 125 billion of insured mortgage pools to support the liquidity of the Canadian Mortgage Housing Corporation—a Crown corporation—with the goal of adding liquidity to Canada's mortgage market.

financial institutions (though the expansion of its balance sheet was small by international comparisons, given the resilience of the Canadian financial system). As the recovery progressed, the Bank wound down liquidity operations and partly withdrew accommodation, raising the policy rate to 1 percent in September 2010.

4. **The labor market has been a relatively bright spot in the recovery.** Some 270,000 jobs were lost in 2009 (proportionally less than in prior recessions),<sup>3</sup> but job creation has been swift in 2010. However, the unemployment rate remains elevated at 7.9 percent (compared with a peak of 8¾ percent in August 2007, and 9½ percent in the United States)—well above the 6-percent pre-crisis rate and staff's estimate of NAIRU. In addition, a significant share of job creation has been in part-time and temporary work. Canada's labor market, however, has proved more resilient, in part because, since the past two recessions, Canada's job growth has become more reliant on industries linked to domestic demand.



Thus, the labor market has benefited from the relative strength of Canadian domestic spending (notably construction and services) during the recession and the early stages of recovery. In turn, this has helped to support household consumption.

5. **However, the recovery is now moderating.** Q2 GDP expanded by only 2 percent (q/q, s.a.a.r) and the average real GDP growth over July and August was near zero. Real consumer spending growth has softened owing to the accumulation of debt and rising financing costs. By contrast, business investment in inventories and machinery and equipment (+30 percent in 2010Q2) remains an area of strength. Residential investment stalled following the expiration of the Federal Home Renovation Tax Credit at end-January 2010, the strengthening of mortgage insurance qualification rules in April 2010, and the introduction of Harmonized Sales Tax (HST) in Ontario and British Columbia in July. House prices remain elevated and are on the high side of model-based estimates of fundamentals, but do not indicate a bubble in housing markets (see Box 1 and Chapter 1 of the Selected Issues Paper).

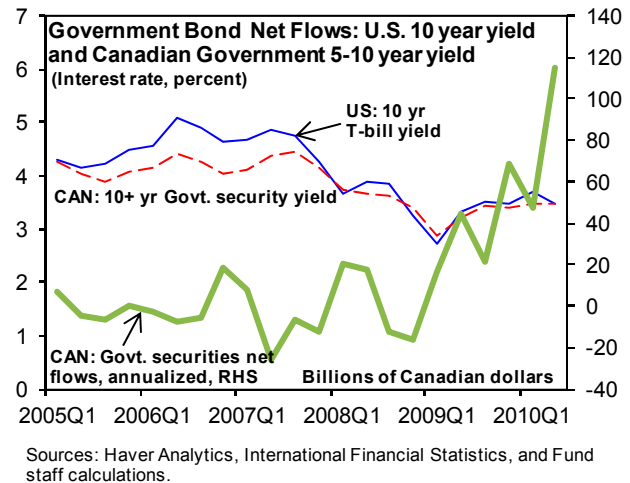
<sup>3</sup> Employment fell by just 2.3 percent in the recent recession, compared with 3.4 percent in 1990–92 and 5.4 percent in 1981–82.

**6. Trade flows are recovering, but the external current account remain in deficit.**

Following a contraction in exports and imports, trade flows have rebounded. However, exports remain well below pre-crisis

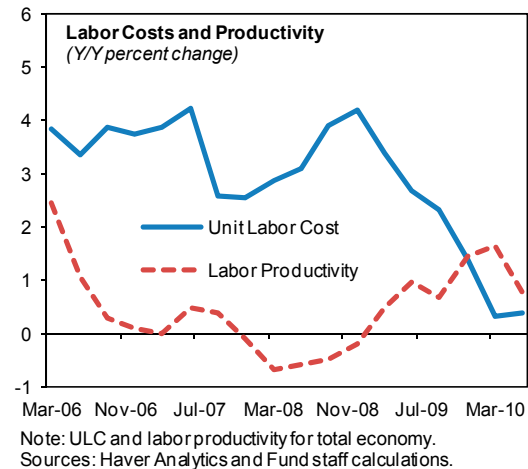
levels, notwithstanding that commodity prices have more than doubled since the trough. With import volumes growing briskly, Canada's current account remained negative for a seventh straight quarter (in 2010 Q2, at  $-2\frac{3}{4}$  percent of GDP, compared with pre-crisis surpluses averaging around  $1\frac{3}{4}$  percent of GDP ) (Figure 2). The negative net income contribution from crisis-related losses on portfolio investment in the United States has narrowed, while capital inflows have shifted from FDI (predominantly into

energy and metals) into portfolio investment in government and corporate securities. This shift seems to reflect a combination of factors, such as growing uncertainty about commodity prices, strong confidence in Canada's macroeconomic policies and financial resilience, and ample global liquidity.



**7. Despite considerable economic slack, core inflation remains around the middle of the target range.**

Against the backdrop of high unemployment and a wide output gap (estimated by staff at around  $2\frac{1}{2}$  percent), headline Consumer Price Index (CPI) has recently trended around  $1\frac{3}{4}$  percent, while core inflation has averaged around  $1\frac{1}{2}$  percent. Surveys indicate that inflation expectations remain well anchored at the center of the Bank's 1 to 3 percent inflation-control target range. Growth in unit labor costs has been sluggish, although it picked up slightly in 2010Q1, reflecting a pause in the upward trend in labor productivity since the recovery began.



**8. Financial markets have largely recovered from the turmoil.** The stock market has rebounded by almost 50 percent since March 2009, despite recent volatility related to rising uncertainties about the U.S. outlook and concerns about contagion from European sovereign debt strains (Figure 5). The 3-month CAD LIBOR-OIS spread—an indicator of counterparty risk—has narrowed to pre-Lehman levels. Overall financial conditions remain stimulative, as reflected in banks' wholesale funding costs, corporate bond spreads, and effective household and business borrowing rates.

9. **Canadian banks were resilient to the global crisis.** Banks have remained profitable, with adequate provisioning and sound asset quality. Nonperforming loans rose to only 1.3 percent of total loans, compared with 5.4 percent in the United States, 3.5 percent in the United Kingdom and 3 percent in the euro area (Figure 8). Capital adequacy has improved to about 15½ percent (total regulatory capital/risk-weighted assets), after banks raised private capital. Sound regulation and supervision helped maintain stability, as did the government liquidity injections in 2008–2009 (see Box 3 and Table 1). Major banks' Credit Default Swaps (CDS) spreads have declined sharply from crisis highs and are around pre-Lehman levels.

10. **Staff estimates suggest that the Canadian dollar is on the firm side, but there are no signs of a strong overvaluation.**<sup>4</sup> During the crisis, the Canadian dollar depreciated sharply both against the U.S. dollar and in real effective terms, but gained ground as sentiment toward Canadian assets improved, interest rate differentials with the United States widened, and especially as commodity prices recovered (commodity prices have historically been a major driver of Canada's currency; see Chapter 2 of the Selected Issue Paper). Currently, the real effective exchange rate (REER) is slightly above what is suggested by medium-term fundamentals according to the Staff's CGER analysis, although within a reasonable margin of uncertainty.<sup>5</sup>

Exchange Rate Assessment: Baseline  
Results  
(In percent)

	REER Overvaluation
Macroeconomic balance	7
Equilibrium real exchange rate	3
External sustainability	3

Source: IMF staff estimates.

11. **Corporate balance sheets remain healthy.** Corporate leverage ratios have fallen, and profits have rebounded, but they remain below pre-crisis levels. The Senior Loan Officer Survey points to a widespread easing in business-lending conditions during 2010Q3. For corporate borrowers, borrowing conditions eased for the fifth consecutive quarter thanks to a better outlook for these firms and the economy, as well as growing competition among lenders. However, small business lending conditions were unchanged, following a modest easing in the second quarter.

<sup>4</sup> The authorities maintain a freely-floating exchange rate regime. The exchange regime is free of exchange restrictions and multiple currency practices.

<sup>5</sup> The modest REER misalignment signals a deviation of the actual real exchange rate from the model's estimated real exchange rate equilibrium given the relative weakness of underlying fundamentals (strong terms of trade and reduced external liabilities but weak relative productivity growth). The projected CA balance is weaker than both the current account norm and the NFA-stabilizing current account balance, implying a moderate macro-balance and a small external-sustainability misalignment.



## B. The Outlook: Elevated Domestic and External Risks

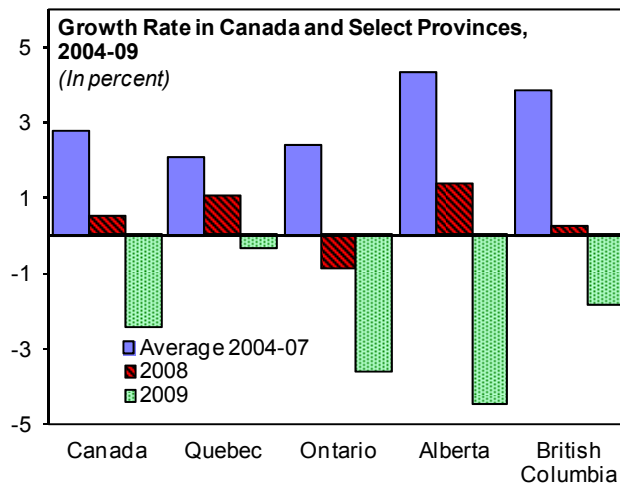
12. **The staff's outlook is for a continued gradual recovery** (Figure 3). Staff projects GDP growth to rebound from  $-2\frac{1}{2}$  percent in 2009 to 3 percent in 2010, then to slow to around  $2\frac{1}{3}$  in 2011 (broadly in line with the Bank of Canada's projection and the consensus). GDP would be driven by the second year of fiscal stimulus in 2010, (staff estimates that the stimulus will add 1 percentage point to growth in 2010)<sup>6</sup> and by business investment growth on the back of accommodative credit conditions, while net exports would remain a source of restraint reflecting buoyant imports along with soft exports. While consumption momentum will likely fade significantly in the second half of 2010 and into 2011 as household debt has run up to high levels and housing markets are cooling, prospects for continued respectable job growth and the positive outlook for commodity prices will soften the adjustment; staff's analysis suggests that the positive impact on domestic demand from rising commodity prices is only partially mitigated by an appreciating Canadian dollar, with larger effects on domestic demand observed in the resource-rich western provinces (Figure 4). Stronger growth in the United States and continued momentum in consumption spending in Canada would lift growth in 2012. Inflation is expected to remain contained throughout the projection period thanks to a slowly-closing output gap.

### 13. The outlook for provinces will

#### depend on the evolution of

**commodity prices and trade.** The resource-rich western provinces enjoyed above-potential growth rates during the commodity boom, but suffered large output losses following the retrieval in commodity prices. British Columbia was able to weather the crisis better than other western provinces given the large capital investments related to the Winter 2010 Olympic Games. In contrast, the manufacturing-hub Ontario was

severely by the economic downturn, particularly in light of the stresses on the auto sector. Moving forward, the outlook for western provinces appears favorable given the ongoing strength of commodity prices, while Ontario's outlook would be more closely linked to U.S. economic developments given the high reliance on U.S. exports.



Sources: Haver Analytics and Fund staff calculations.

<sup>6</sup> In 2010–11, the Economic Action Plan is on track to deliver a further CAD22 billion in federal stimulus spending, complemented by CAD 7 billion in stimulus funding from provinces, territories, municipalities and other partners. Funding for the Action Plan in 2010–11 is 98 per cent committed. (In its first year of implementation, the Economic Action Plan has delivered over CAD 33 billion in stimulus to the economy).

14. **Potential growth would recover gradually to around 2 percent** (see Chapter 3 of the Selected Issue Paper). Staff estimates that the crisis shaved 2 percentage points from the trend level of Canada's GDP, owing to the sharp decline in investment in 2009. The upward trend in potential growth over the medium term largely reflects the expected recovery in investment spending. Staff's estimates imply an output gap of about 2 ½ percent at 2010Q3, which would close in 2015.

Canada: Potential GDP Growth Rate, 2007-2014  
(Percent)

	2007	2008	2009	2010	2011	2012	2013	2014
<b>IMF</b>	2.3	2.1	1.5	1.6	1.8	1.9	1.9	1.9
Department of Finance Canada	2.8	1.8	1.8	1.4	1.5	1.7	1.9	2.0
Bank of Canada	1.8	1.7	1.2	1.6	1.8	2.0	2.1	...
PBO	2.1	2.1	1.9	2.0	2.0	1.9	1.8	1.7
OECD	2.3	2.2	1.8	1.7	1.9	...	...	...

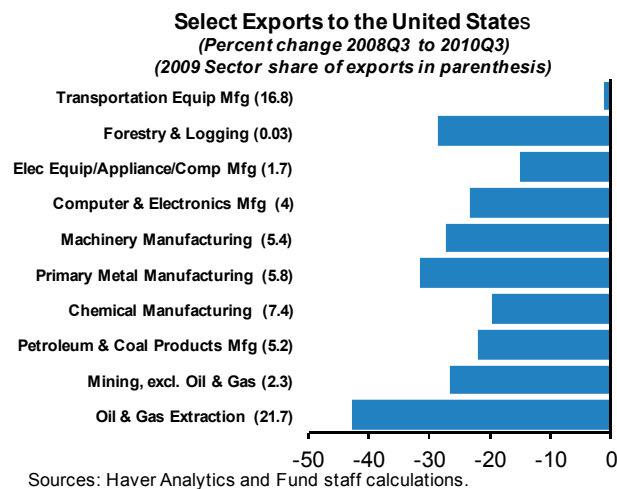
Sources: Parliamentary Budget Officer, Bank of Canada, Finance Canada, OECD, and Fund staff calculations.

15. **Staff sees risks to real GDP growth as tilted to the downside.** Stretched household balance sheets are the main domestic risk although the Canadian debt imbalance is currently not as great as that experienced in the U.S. (expressed on a comparable basis, the debt to income ratio stands at 143.6 in Canada and 148.6 in the United States). Housing markets pose some risks as well, as price-to-income and price-to-rent ratios are at the highest level in over 30 years, while model-based estimates suggest a moderate overvaluation in some key provinces (Figure 3). However, the markets are now cooling, and overheating seems to have mainly been a regional phenomenon (see Box 1). Under the staff's baseline, housing activity will moderate in the second half of 2010 and early 2011, taking into account pent-up demand, the moderate overvaluation in some provinces, and the effects of rising mortgage rates (which remain low by historical standards). However, a stronger than expected correction in the housing market could have sizeable spillovers to the rest of the economy.<sup>7</sup> Risks to other components of private domestic demand are balanced.

<sup>7</sup> A 10-percent house price correction would deduct CAD148.2 billion from household balance sheets-non - trivial taking into account a marginal propensity to consume of around 6 percent (Pichette, L., 2004, "Are Wealth Effects Important for Canada?" Bank of Canada Review): the crisis had initially deducted CAD 24.6 billion in aggregate households' residential wealth, and since the trough in 2009Q1 real estate household wealth increased by around CAD 90 billion. In the event that residential investment grew at half the rate projected in the staff's baseline scenario in the second half of 2010, this would deduct some 0.2 percentage points from 2010 average growth rate.

16. **A weaker U.S. outlook and worsening global financial conditions (if overseas sovereign strains intensified) pose the largest downside external risks.** With the United States accounting for three-fourths of Canadian exports, a further worsening in the U.S. outlook could have major implications for Canada's growth (staff estimates that a 1 percentage point drop in U.S. growth reduces Canada's growth by  $\frac{1}{2}$  to  $\frac{3}{4}$  of 1 percentage point). Sovereign debt strains limited to a few European countries would have limited output, trade and financial effects on Canada, though output losses could be more serious in a worst case scenario (see Box 4). On the upside, unexpectedly stronger momentum in the emerging market world, notably Asia, would exert positive but modest effects on Canada as increases in commodity prices that raise terms of trade and domestic demand are partially offset by a stronger currency (see Chapter 2 of the Selected Issues Paper).

17. **Specific U.S.-related risks include subdued U.S. auto demand and financial contagion from non-performing assets.** The outlook for U.S. construction and consumer durables—both key to Canadian exports to the United States—is particularly uncertain, after the expiration of U.S. policy measures that supported demand for housing and autos, and given remaining fragilities in the U.S. housing market. The U.S. demand for Canada's production of light vehicles is crucial; automotive products represented 12 percent of Canadian goods exports in 2009, down from about 20 percent in the last decade (the sector employed directly and indirectly almost 660,000 Canadians, i.e., 4 percent of total employment; see Chapter 4 of the Selected Issue Paper). In addition, anemic growth performance in the United States, coupled with persistently high U.S. delinquency ratios for mortgage and consumer loans, could also have implications for some Canadian banks with large exposure in the U.S. retail banking sector.

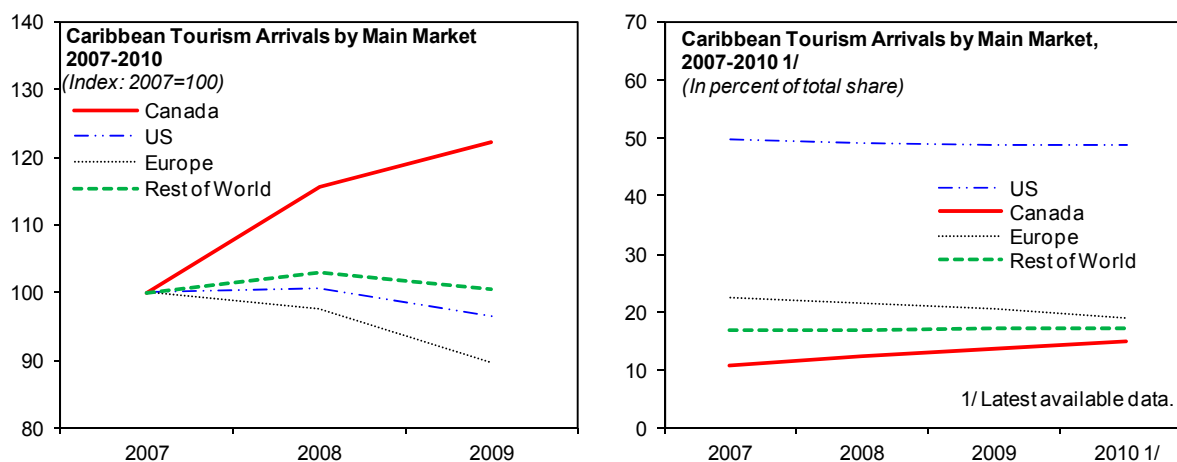


18. **In addition, Canada's economic performance has important spillovers for small countries in the Western Hemisphere.<sup>8</sup>** Canada is one of the world's main recipients of immigrants—accounting for almost one fifth of its population. Weak activity in Canada can thus significantly affect remittances to other countries.<sup>9</sup> It can also affect adversely the

<sup>8</sup> For more details please refer to the 2009 Staff Report.

<sup>9</sup> Government data shows that in 2008 about 4 in 10 Canadians wired money back home to family and/or friends. The majority of these funds are going to the Philippines and Haiti. Pre-crisis, Haiti's flow of remittances was approximately 25 percent of its GDP, whereas the Philippines received an amount of remittances equivalent to 13 percent of their GDP.

exports of some developing countries, for example the Caribbean islands, where Canadian tourism remains an important source of growth—Canadians accounted for around 17 percent of arrivals in the Caribbean so far in 2010. Finally, strains in Canada’s banking system could have important repercussions abroad as a result of the strong presence of Canadian banks in the Caribbean and Latin America, and that of Canadian insurance companies in North America (two Canadian banks are the first and second largest in the Caribbean).



Sources: Caribbean Tourism Organization and Fund staff calculations.

## II. POLICY DISCUSSIONS

*Discussions focused on measures to cement Canada’s strong macroeconomic and financial policies, and to deal with the deteriorated risk scenario. The pause in the reduction of monetary stimulus is appropriate given the risks to the outlook. On the fiscal front, the near-term adjustment is substantially frontloaded, while the authorities’ sensible plan to return to balance over the medium term relies inter alia on significant compression of program spending. Sound regulation and supervision helped maintain financial stability during the crisis, and Canada is playing an important role in shaping the international debate and initiatives on regulatory reform—which in turn will have important implications for Canada.*

**19. Against the backdrop of heightened risks to the outlook, discussions focused on three areas:**

- ***Pacing the exit from extraordinary monetary and fiscal stimulus***, to strike the right balance between Canada’s relatively advanced cyclical position (and the risk of rising domestic imbalances) and hedging downside risks to the outlook;

- ***Cementing fiscal stabilization***, to put Canada's net debt-to-GDP ratio (already low by international perspective) on a declining path over the medium term, to both bolster fiscal prudence and prepare for coming demographic pressures; and
- ***Adapting financial regulation in light of the lessons from the crisis***, with the key objective to strengthen securities regulation through further progress toward the creation of a national regulator.

20. **The authorities and mission team broadly agreed on the priorities.** On the exit, it was agreed that the pause in the pace of monetary tightening struck the right balance. Fiscal policy is appropriately set to shift from expansion to consolidation next year, albeit with a front-loaded adjustment, while both monetary and fiscal policy have room to respond to downside risks if they materialize. Monetary policy should be the first line of defense if the outlook deteriorates, given the room to ease quickly, although fiscal policy has room to respond as well in a downside scenario. On financial sector regulatory reforms, staff and the authorities concurred that Canada is well positioned to adapt to emergent international initiatives and is appropriately focused on strengthening financial system infrastructure and institutions, including through the creation of a single-entity securities regulator.

#### **A. What is the Right Pace of Exit From Extraordinary Stimulus?**

##### **Monetary Policy—A Pause in Tightening**

21. **Staff saw as appropriate the cautious pace of return to a neutral stance.** At its policy meeting during the mission, the Bank of Canada decided to maintain its target for the overnight rate at 1 per cent. Staff considered that the weakening global recovery, the deceleration in Canadian household spending coupled with the elevated household debt (including taking into account that variable and adjustable rate mortgages are about 30 percent of the total),<sup>10</sup> and softening inflation warranted this pause in tightening. Bank officials noted that deflationary risks were quite low, and inflation expectations well anchored, and that any further reduction in monetary policy stimulus would need to be carefully considered. Meanwhile, they added, the stance of monetary policy remained appropriately accommodative, although room existed for further monetary stimulus if the outlook deteriorated.

22. **Uncertainties about the neutral level of the policy rate in the near term, along with a globally accommodative monetary environment, further argued for caution in tightening.** Uncertainties about the rate of potential growth going forward could point to a lower neutral rate. Moreover, persistent interest differentials between Canada and world

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<sup>10</sup> Canadian Association of Accredited Mortgage Professionals (CAAMP, 2010), Annual State of Residential Mortgage Market in Canada.

markets could attract capital inflows and put additional upward pressure on the currency, a particular concern in an environment of sustained global monetary accommodation.

23. **At the same time, domestic financial imbalances warranted close monitoring given the still-accommodative monetary stance.** Staff supported the Bank's vigilance regarding developments in the housing market and the use of regulation, rather than monetary policy, as a first line of defense against financial imbalances. In line with staff, the authorities saw regional evidence that house prices were on the dear side, but emphasized uncertainties about estimates of house price misalignment in the wake of the crisis. Bank officials stressed that they will continue to monitor carefully developments in the housing market and household balance sheets.<sup>11</sup> In addition, they were reflecting on lessons from the crisis for the conduct of monetary policy in light of macro-financial linkages, including the relevant transmission channels, and refining their models and analysis to ensure that due weight was put on financial developments in formulating policy decisions.<sup>12</sup>

24. **The mission also discussed the monetary framework, noting that the current framework serves Canada well, whereas the practical benefits of a more strict regime are uncertain.** The discussions centered on the 2011 review of the Bank's framework and ongoing research on the pros and cons of Price-Level-Path-Targeting (PLPT). Bank officials and staff agreed that price-level targeting offered a number of theoretical benefits relative to inflation targeting, especially in a low inflation environment like the current one. In particular, PLPT could combat disinflationary pressures by committing to offset any temporary undershooting of the desired inflation rate. However, the mission argued that given the lack of experience with PLPT, the benefits in practice were less clear, particularly in light of the potential challenges in communicating the objectives and direction of policy over the medium run. While these challenges would be lessened if policy targeted a stable price level, this could require sizeable volatility in both the policy rate and inflation, and eventually in output. On balance, the mission considered that current inflation targeting framework had served Canada well, while the gains from shifting to a new framework were unclear. The authorities noted that they would continue to research the pros and cons of PLPT in the run up to the 2011 review, with any revisions to the framework becoming operational in 2012.

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<sup>11</sup> In the December 2009 Financial System Review (FSR), the Bank of Canada conducted a stress-test simulation to assess a scenario of sustained growth in household indebtedness in relation to income and an environment of rising interest rates over the medium term. Results indicated that system-wide stress remains unlikely, although the likelihood of this risk materializing in the medium term was judged to have risen in the June FSR as a result of higher levels of household indebtedness.

<sup>12</sup> "Reflections on Monetary Policy After the Crisis," Remarks by Tiff Macklem, Senior Deputy Governor, October 5, 2010.

## **Fiscal Policy—From Stimulus to Consolidation**

25. **The mission praised the fiscal response to the crisis during 2009-10 and supported the authorities' medium-term plans under the budget.** Staff noted that the March 2010 Budget was appropriately focused on balancing the budget over the medium term (Box 2). It also followed through on the second year of Canada's Economic Action Plan as anticipated, building on the 2009 stimulus and earlier permanent tax relief. The 2010 stimulus package—which the authorities confirmed was on track and 98 percent committed by end September—included for FY 2010–11 a sizeable dose of infrastructure capital investments, tax relief, employment insurance (EI) and training measures, along with industry specific measures and support for research and development.

26. **Consolidation plans under the budget for FY 2010–11/FY 2014–15 remained largely unchanged following the Update of Economic and Fiscal Projections released during the mission, although the pending withdrawal is now less frontloaded.** The profile includes a slightly smaller deficit in FY 2010–11 (by 0.1 percent), but marginally worse deficits in outer years (by around 0.35 percentage points of GDP from FY 2011–12 through FY 2013–14), due to a combination of upward revisions to near-term revenues since March, recent changes to Employment Insurance (EI) program funding, downward revisions to real GDP growth in 2010 and 2011 from a worsened global scenario, and accounting adjustments<sup>13</sup> that pushed up slightly the fiscal deficit for 2009–10. In structural terms, however, the accounting adjustments largely contribute to a bigger fiscal withdrawal in 2010 but a slightly smaller withdrawal in 2011 than anticipated in the March Budget both at the federal and general government levels. The authorities now expect to balance the budget by FY 2015–16 with a slight surplus (0.1 percent of GDP).

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<sup>13</sup> These include CAD 5.9 billion in HST transition payments (CAD 4.3 billion to Ontario and CAD 1.6 billion to BC) originally allocated to FY 2010–11 and FY 2011–12 that in the Update were brought forward to FY 2009–10 relative to the March Budget, as well as adjustments for an over-accrual of employee pension costs affecting the bottom line in FY 2009–10 and following years.

Staff Estimates of Fiscal Impulse, Pre and Post Fiscal Update, 2009-15 1/

<b>General Government (Calendar year, NA basis)</b>	2009	2010	2011	2012	2013	2014	2015
Pre-Fiscal Update	3.2	0.1	-1.3	-0.3	-0.4	-0.6	-0.5
Post-Fiscal Update	3.3	1.3	-1.1	-0.5	-0.5	-0.5	-0.4
Change in Impulse between Pre and Post Update	0.0	1.2	0.3	-0.2	0.0	0.1	0.1
<i>of which:</i>							
<b>Federal Government (Fiscal year, PA basis)</b>	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Pre-Fiscal Update	2.0	0.3	-1.0	-0.3	-0.3	-0.2	-0.2
Post-Fiscal Update	2.3	-0.3	-0.8	-0.3	-0.3	-0.4	-0.2
Post-Fiscal Update (without accounting change)	2.0	0.3	-0.9	-0.4	-0.3	-0.4	-0.2
Change in Impulse between Pre and Post Update	0.3	-0.6	0.2	0.1	0.0	-0.1	0.0
<i>of which due to:</i>							
Accounting change	0.4	-0.6	0.1	0.1	0.0	0.0	0.0
Other (incl. E.I. Premium reduction)	0.0	0.0	0.1	0.0	0.0	-0.1	0.0
<b>Provincial Governments (Calendar year, NA basis)</b>	2009	2010	2011	2012	2013	2014	2015
Adjustment	-0.3	1.7	0.1	-0.3	0.0	0.2	0.1

Sources: Finance Canada, *Fall Fiscal and Economic Update* and Fund staff estimates and projections.

1/ Numbers may not add up due to rounding.

**27. The mission noted that the budget entailed a substantially front-loaded adjustment:**

- Staff estimated the fiscal down payment for FY 2011–12 at about  $\frac{3}{4}$  percentage point of GDP at the federal level, and at about  $\frac{1}{3}$  of a percentage point of GDP per year in subsequent years up to FY 2014–15.<sup>14</sup> On a calendar year basis, the change in the structural balance, at a general government level, amounted to 1.1 percentage points of GDP in 2011, compared to an overall adjustment of 2 percentage points of GDP through 2015. In light of the heightened risks to the outlook, the mission considered that a smoother adjustment could have been contemplated.
- The authorities disagreed, as they saw risks less skewed to the downside than staff; in addition, they put considerable stress on the need to return to balance in a timely manner. Notwithstanding Canada's strong fiscal position and track record from an international perspective, they noted that memories of the 1990s fiscal strains remained fresh. Moreover, they remarked that Canada's adjustment would have limited international spillovers, given relatively modest multipliers (in light of Canada's openness), and the fact that Canada is much smaller than its main trading partner. That said, the government's recent steps to delay hikes in the EI premium until after 2011 and allow flexibility in funding ongoing infrastructure projects moved in the direction of smoothing the up-front adjustment.

<sup>14</sup> The "fiscal down payment" or "fiscal impulse" is the change in the "fiscal stance" and is roughly equal to the change in the cyclically adjusted fiscal balance (in percent of GDP).



28. **It was agreed that fiscal policy had room to respond should downside risks materialize.** The mission noted that this could involve a front-loading of infrastructure spending planned under Building Canada (scheduled to imply outlays equal to about  $\frac{1}{3}$  percent of GDP per year for FY 2010–11 up to FY 2013–14) or bringing forward corporate income tax (CIT) cuts planned over the next 2 years (staff estimates that a  $\frac{1}{2}$  percentage point decrease in the CIT rate reduces revenues by roughly 0.1 percent of GDP). The authorities noted that they would revisit their plans if the outlook deteriorated to an extent that warranted a fiscal response.

## B. Cementing Fiscal Stabilization

29. **From an international point of view, Canada's overall fiscal outlook in the aftermath of the crisis stands out as among the best in the G-20** (Figure 5). Net debt is the lowest in the G-7, reflecting an 11-year string of federal surpluses prior to the crisis. In addition, Canada's combined federal-provincial budget shortfall<sup>15</sup> and Canada's projected net debt accumulation between 2007 and 2015 are among the lowest of the group, and the projected general government budgetary position for 2015 is the best in the G-7 after Germany.

Selected Fiscal Indicators, Canada and G-20

	G20 ADV 4/ 5/	AUS	CAN	UK	USA
Debt increase, 2007-2015 1/	38.0	11.9	14.9	40.0	48.6
Peak deterioration of overall balance 2/	-8.0	-6.1	-7.5	-7.6	-10.2
2010 Net Debt, percent GDP 3/	69.5	5.4	33.4	68.8	65.8
2015 Projected General Government Fiscal Balance, percent GDP 5/	-4.6	0.7	-1.6	-2.4	-6.5

Sources: IMF World Economic Outlook and Fund staff calculations.

1/ Debt increase is the percentage point increase in general government gross debt-to-GDP ratio, 2007-2015.

2/ General government balance relative to 2007.

3/ General government, G20 average excludes Korea.

4/ PPP weighted.

5/ November 2010 Fiscal Monitor data in GFSM 2001. Data for Canada reflect Fall Fiscal Update 2010.

30. **The mission supported the authorities' aim to return to balance over the medium term, given the impending long-term costs of aging and healthcare costs.** Staff saw the plan as credible, in light of Canada's strong track record and modest imbalances, notwithstanding the effects of the crisis and large stimulus. The plan centered on a bold reduction of non-transfer government payments while protecting major transfers to persons and other levels of government. In line with the authorities' overall strategy, the budget envisages no hikes in taxes on consumption or personal or corporate income. Indeed, plans

<sup>15</sup> Within Canada, about three-fifths of the aggregate deficit was at the federal level, with the remaining two-fifths at the provincial level.

for spending restraint were ambitious, implying zero real future program spending growth to return that spending to its historically low pre-crisis ratio to GDP.<sup>16</sup> In the event this adjustment proved difficult to implement, other steps would need to be considered, including steps to restrain growth in transfers to provinces or to enhance revenues including increases in taxes. Staff added that downward revisions to public debt charges in the Update relative to assumptions in the March Budget were subject to the risk that interest rates in Canada could trend upwards in the medium run on the back of higher U.S. yields from higher U.S. debt.<sup>17</sup>

31. **The mission noted the significant risks to long-term fiscal sustainability from the budgetary impact of population ageing and health-care inflation.**<sup>18</sup> The mission stressed the importance of increasing transparency and communication about these challenges and their long-run implications, to increase public awareness and contribute to a debate about possible solutions. Given that responsibility for implementation lay with the provinces (with the federal government covering around 15 percent of total program expenses via the Canada Health Transfer, which accounts for about 17 percent of all provincial and territorial revenues), one option would be to develop arrangements for provinces to share experiences in managing costs and reaping efficiency gains (some provinces, notably Ontario and Québec, had already moved to contain costs). This option could be taken up in the context of renewing federal transfers to provinces and territories in support of health care (current arrangements expire on April 1, 2014).

32. **The mission welcomed the “growth-friendly” nature of the adjustment plans, which included measures to boost productivity and long-run growth potential** (Table 2). In line with Canada’s commitments under G20 MAP to promote strong, sustainable and balanced world growth, Budget 2010 introduced a number of targeted actions that will provide additional support to economic potential and boost productivity growth that has been in structural decline. The intention to continue reducing marginal effective tax rates on capital accumulation and further strengthen infrastructure were particularly welcome. The mission also welcomed the authorities’ intention to eliminate all remaining tariffs on

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<sup>16</sup> At the federal level, total program spending growth under the Update is expected to average 2.3 percent per annum starting in FY 2012–13, which is well below the recent trend rate of about 7 percent per year, bringing the program spending ratio in line with spending ratios in the FY 2006–07 to FY 2008–09 period.

<sup>17</sup> Budget 2010 estimates that a sustained increase in the yield curve by 100 basis points decreases the budgetary balance by CAD 1 billion in the first year, CAD 2.1 billion in the second year and CAD 3.0 billion by the fifth year (implying a cumulative total impact on the federal balance of about -0.3 percentage points of GDP).

<sup>18</sup> Using a relatively conservative assumption for gross public debt charges (based in turn on a gross effective interest rate around 7 percent from FY 2013–14 onwards), the Parliamentary Budget Officer estimates a steep climb in the federal net-to-GDP ratio over the long term due to healthcare inflation and ageing. Specifically, under the baseline scenario the federal net debt-to-GDP ratio climbs from about 33¾ percent in FY2013–14 to a projected 100 percent of GDP in 2050–51, reaching 365 percent of GDP by FY 2084–85. Lower debt charges assumptions (based for example on a gross effective interest rate of around 5 percent from FY 2013–14 onwards) halve the projected debt-to-GDP ratio by the end of the horizon, although this remains sizeable.

manufacturing inputs and machinery and equipment, which was noteworthy in light of heightened risks of protectionism internationally. Other priorities to boost growth potential could include strengthening the business environment by phasing out restrictions on foreign direct investment, increasing the flexibility of the immigration system, and continuing to eliminate interprovincial barriers to trade in goods and labor mobility.

**33. The mission also welcomed the return to prudent budgets charted at the provincial level, with the intention to stay the course on announced stimulus in the near term.** The crisis brought about an overall deterioration of provincial fiscal positions but with significant underlying variations. Provinces east of Manitoba saw their deficits and debt increase substantially, and within these, Ontario (hit particularly hard by the U.S. recession) has the largest deficit. Meanwhile, Québec and Nova Scotia have smaller deficits but higher debts. Western provinces enjoy lower debt burdens, and savings from resource royalties helped to cap the deterioration in their budget balances during the crisis. Faced by an escalation of health spending costs—which in Canada fall largely on provincial finances—most provinces schedule a gradual reduction of the fiscal shortfall, based on caps on spending growth by freezing salaries and curbing health care expenditure (e.g., through measures that facilitate lower generic drug prices, increase the efficiency of the health care system and establish accountability systems for hospitals). Provinces also envision measures to increase revenues, notably via hikes in indirect taxes, excises and utilities rates (see Box 2).

Fiscal Accounts 2010/11–2015/16  
(Percent of GDP unless otherwise indicated) 1/

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
<b>Federal Government PA basis</b>							
Budgetary balance	-3.6	-3.1	-2.0	-1.5	-1.0	-0.5	-0.3
Primary balance	-1.7	-1.1	0.0	0.5	1.0	1.4	1.7
Structural budgetary balance 2/	-2.5	-2.3	-1.4	-1.1	-0.8	-0.4	-0.2
Gross federal debt	57.8	57.7	57.1	55.8	54.3	52.4	50.4
Net federal debt	34.0	35.2	35.6	35.3	34.7	33.7	32.5
Fiscal impulse	2.3	-0.3	-0.8	-0.3	-0.3	-0.4	-0.2
<b>Memorandum items</b>							
Fiscal Update 2010 Balance 4/	-3.6	-2.8	-1.8	-1.2	-0.6	-0.1	0.1
Fiscal Update 2010 Net Federal Debt 4/	34.0	34.9	35.3	34.8	33.7	32.3	30.8
	2009	2010	2011	2012	2013	2014	2014
<b>General Government, NA basis</b>							
Balance	-5.5	-6.1	-4.6	-3.6	-2.9	-2.1	-1.6
Structural balance 2/	-3.2	-4.5	-3.3	-2.9	-2.4	-1.9	-1.6
Gross public debt 3/	82.5	84.0	84.8	84.4	83.4	81.9	80.1
Net public debt 3/	28.9	33.4	36.5	38.4	39.5	39.9	39.8
Fiscal impulse	3.3	1.3	-1.1	-0.5	-0.5	-0.5	-0.4
<b>Memorandum items</b>							
Real GDP growth	-2.5	3.0	2.3	2.7	2.4	2.4	2.2
Nominal GDP growth rate	-4.5	5.9	4.7	5.1	4.7	4.6	4.4
Three-month treasury bill rate	0.4	0.6	1.4	2.7	3.6	4.2	4.3
Ten-year government bond rate	3.2	3.3	4.2	5.2	5.7	5.7	5.7

Sources: Finance Canada: 2010 Fiscal Update and Fund staff calculations.

1/ Federal government data is fiscal year (which starts April 1) and general government numbers are calendar year.

2/ Ratio over potential GDP.

3/ OECD consistent.

4/ Ratio over Fiscal Update 2010 GDP forecasts.

### C. Adapting Financial Regulation to the Lessons of the Crisis

34. **The mission noted that Canada's financial stability arrangements had served the country well through the crisis.** These arrangements included strong regulation, including a prudent leverage ratio that included off-balance-sheet exposures; low reliance on wholesale funding (reflecting a robust retail deposit base); a well regulated mortgage market, including incentives to maintain low loan-to-value (LTV) ratios, and comprehensive mortgage insurance coverage (most securitized loans and those with LTVs above 80 percent made by regulated depository institutions (75 percent prior to April 2007 must be insured for the full amount, but typically, lower LTV loans are also insured given the lower risk weight under the Basel framework for insured mortgages); and consolidated supervision of wholesale and retail banking activities (see Chapter 5 of the Selected Issues Paper). In addition, cooperation among the relevant authorities, including the Office of the Superintendent of Financial Institutions, the Bank of Canada, the Department of Finance, and the Canadian Deposit Insurance Corporation was facilitated via participation in forums such as the Financial Institutions Supervisory Committee and Senior Advisory Group, with regular exchanges of information and views on financial stability issues.

Regulatory Bank Capital, 2006-Current

		2006	2007	2008	2009	2010Q2
Canada	Total Regulatory Capital	12.5	12.1	12.2	14.7	15.4
	Tier 1 Capital 1/	10.4	9.9	9.9	11.3	12.9
France	Total Regulatory Capital	10.9	10.2	10.5	12.4	...
	Tier 1 Capital 2/	...	...	8.4	10.1	...
Germany	Total Regulatory Capital	12.5	12.9	13.6	14.8	...
	Tier 1 Capital 3/	8.2	...	9.6	10.4	10.8
Italy	Total Regulatory Capital	10.7	10.4	10.8	12.1	..
	Tier 1 Capital 4/	...	7.6	7.6	9.0	...
United Kingdom	Total Regulatory Capital	12.9	12.6	12.9	14.8	...
	Tier 1 Capital 5/	6.1	6.0	7.0	8.7	...
United States	Total Regulatory Capital	13.0	12.8	12.8	14.3	15.1
	Tier 1 Capital 6/	10.7	10.3	10.0	11.2	12.4

Sources: Banca D'Italia, Bank of England, Deutsche Bundesbank, European Central Bank, IMF Global Financial Stability Report (Oct. 2010), OSFI, SNL Financial, and Fund staff

Notes: Total regulatory and Tier 1 capital as a percentage of risk-weighted assets.

1/ Office of the Superintendent of Financial Institutions of Canada (OSFI).

2/ European Central Bank, average of four quarters.

3/ Deutsche Bundesbank.

4/ Banca D'Italia.

5/ Bank of England Financial Stability Report 2010, median core tier 1 for major U.K. banks.

6/ SNL Financial.

35. **Nevertheless, the authorities and mission agreed that there was no room for complacency.** Key risks included elevated household debt, a potential housing market correction, and international exposures, with staff emphasizing the importance of continuing to stress-test financial institutions for these risks:

- The low level of interest rates had helped to contain debt-service ratios, but debt service would rise as interest rates returned to more normal levels. The authorities saw exposure to rising interest rates as significant, and as having increased in the first half of the year, but still manageable, with the Bank pointing to its recent stress tests for this risk. Similarly, banks faced significant interest rate risk on their trading books, but overall interest-rate risks that were around pre-crisis levels.<sup>19, 20</sup>
- Officials also agreed that housing markets warranted monitoring, although the risk of systemic stress was seen as moderate, given that about two thirds of all mortgages were insured, and origination followed prudent practices. However, in a worst case scenario, a housing correction could impose fiscal pressures given CMHC's contingent liabilities to the housing market.<sup>21</sup>
- Banks also had significant exposures to U.S. markets (118 CAD billion as of March 2010 according to the BIS), which would come under pressure in the event of a double-dip recession. The authorities reported that their stress tests implied a modest impact from a simulation of a post-Lehman type recession.
- On exposures to Europe, the consequences of the sovereign stress had so far been minimal for Canadian banks, and Canadian banks and investors did not appear to hold significant amounts of debt issued by the most stressed countries. The direct exposure of Canadian banks to smaller European economies is modest (see Box 4). That said, a contagion scenario could pose larger risks.

36. **The authorities saw Canada as well positioned to adapt to emerging regulatory changes on the international front.** They supported the development of stronger international capital and liquidity standards, pointing to the Bank's analysis that found

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<sup>19</sup> Bank of Canada, *Financial System Review*, June 2010.

<sup>20</sup> Bank of Canada analysis suggests that by 2012Q2, the proportion of households with a debt service ratio exceeding 40 percent—a threshold above which households are considered to be financially vulnerable—would rise from 5 percent in 2010Q1 to 7.4 percent, assuming that the overnight rate rose to 4.5 by 2012Q2 and credit grew at its current robust rates.

<sup>21</sup> CHMC insurance in force amounted to CAD\$ 473 billion at year-end 2009, with CAD\$ 141 million put aside as allowances for losses (compared to CAD\$ 99 million during the housing boom year of 2007 on CAD\$334 billion insured amount).

substantial net benefits from measures under consideration by the Basel Committee,<sup>22</sup> and did not anticipate adverse effects on credit extension or liquidity conditions. Authorities noted that care is required in implementing G-20 commitments stated at the Pittsburgh Summit that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012, to avoid unintended consequences for smaller jurisdictions (in particular to ensure that these jurisdictions can access the central counterparties). They also did not favor the use of financial sector taxation, on the basis of economic efficiency reasons and of the absence of noticeable fiscal costs imposed on Canada by its financial institutions during the crisis. Authorities saw the use of countercyclical capital buffers and contingent capital, rather than capital surcharges, as the optimal approach to deal with systemic risks, stressing concerns about the moral hazard that could be associated with identifying particular institutions as too big to fail. The authorities also put due emphasis on improving cross-border resolution, and are actively involved in international committees on this front. Staff agreed that emergent regulatory standards did not pose high hurdles for the Canadian financial system, which came from a position of strength, including high regulatory requirements.<sup>23</sup>

37. **The mission saw continued progress toward establishing a national securities regulator as an essential ingredient in the financial stability framework.** A key lesson from the crisis was the importance of strong securities markets regulation, integrated into an overall perspective on financial stability. The experience with the non-bank asset backed commercial paper market in Canada, which collapsed amid concerns about the quality of underlying collateral, underscored this point. Authorities confirmed that the move to a single-entity regulator was on track, with the Transition Office working swiftly toward the mid-2012 deadline for launch. The authorities remained confident that they could make continued progress on this front, and agreed that the national regulator should have a stability mandate and work closely with other relevant national authorities on financial stability issues.

### III. STAFF APPRAISAL

38. **Thanks to a strong policy response and a resilient financial system, the Canadian economy exited the crisis on a strong footing.** Output recovered forcefully at end-2009 and early 2010, following the extraordinary monetary and fiscal stimuli—with policy rates cut to virtually zero, emergency liquidity facilities launched, and a set of timely, targeted and temporary fiscal injections implemented by the federal and provincial governments. The recovery has also been aided by firm commodity prices and the resilience of the financial system. More generally, Canada's strong performance owed to a credible and time-tested

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<sup>22</sup> <http://www.bankofcanada.ca/en/publication/strengthening.html>.

<sup>23</sup> Private analysts estimate that the major Canadian banks will have enough capital to meet the new Basel III rules in their entirety by 2012 (even though they will not be fully applied until 2019).

framework for macroeconomic policy management, including the Bank's inflation targeting regime, and prudent fiscal planning.

39. **Incoming data reveal that the pace of the expansion has slowed over recent months.** The recovery decelerated in the second quarter of 2010, in the context of slowing global demand and a strengthening Canadian dollar. Household spending growth has also eased, as the effect of the policy stimulus diminished, while the housing market has cooled. In addition, risks to the outlook have increased, including from increasingly stretched household balance sheets in Canada, and elevated housing market fragilities in the United States.

40. **Monetary policy should remain highly accommodative absent inflationary pressures.** A pause in the Bank's interest rate hike until the global and domestic outlook improve significantly will continue to support growth against the backdrop of fiscal withdrawal, and avoid undue upward pressure on the currency given the globally accommodative monetary environment. With rates now above zero, monetary policy has room to respond if conditions warrant. Regulation should continue to serve as the first line of defense for dealing with emergent financial imbalances.

41. **On fiscal stabilization, the government appropriately charts a course to fiscal balance over the medium term.** This would put net debt-to-GDP ratio on a downward trajectory from already low levels, maintaining Canada's standing as the strongest fiscal position in the G-7. The plan includes welcome, growth-friendly measures to support Canada's long-run economic potential, notably infrastructure spending and cuts in the corporate income tax rate. For the longer-run, and as in many advanced countries, restraint in health care spending will be an essential ingredient in fiscal stability.

42. **The medium-term consolidation plans are appropriately ambitious, and include growth-friendly measures.** In the event that freezing program spending in inflation-adjusted terms proves difficult, other steps would need to be considered, such as steps to restrain program spending (notably transfers to provinces) or enhance revenues. Meanwhile, continued public infrastructure spending will strengthen the backbone of Canada's economy, while ongoing steps to further reduce the marginal effective tax rate on capital formation will encourage private investment. In this context, Canada's intention to eliminate all remaining tariffs on manufacturing inputs and machinery and equipment is noteworthy, and shows leadership at a time of heightened risks of protectionism internationally. Complementary structural reforms could include further steps to reduce interprovincial barriers, as well as stepped-up efforts to liberalize FDI.

43. **For the longer-run, restraint in health care spending will be an essential ingredient in fiscal stability.** Like many advanced countries, Canada faces the twin long-run fiscal challenges of population ageing and health-care inflation. Left unchecked, growth in health-care spending would put increasing and unsustainable pressure on the fiscal positions

of Canada's governments. Increasing transparency and communication about these challenges and their long-run implications would help to increase public awareness and contribute to the debate about possible solutions. Options could include developing arrangements for provinces to share experiences in managing costs and reaping efficiency gains when renewing federal transfers to provinces and territories in support of health care.

44. **However, the near-term budgeted adjustment is substantially front-loaded, and a smoother adjustment could have been contemplated in light of the elevated risks to the outlook.** Recent proposals to reduce the rise in EI premia and allow some flexibility around the deadlines for unfinished infrastructure projects appropriately move in the direction of smoothing. If downside risks materialize, fiscal policy has ample room to respond, including through providing additional fiscal support for labor markets, bringing forward infrastructure spending under the Building Canada program, and frontloading planned cuts in corporate income taxes.

45. **Canada's financial stability arrangements continue to serve it well.** Unlike a number of its peers, Canada's financial system maintained the ability to intermediate funds during the crisis, and avoided the systemic strains evident elsewhere. While measures of financial stress such as arrears and nonperforming loans have risen, they remain at modest levels, and capitalization is strong by international comparison. This good performance reflects a sound approach to financial stability, with strong cooperation among the relevant agencies, high prudential standards, strict supervision, and a proactive policy response to the crisis. Looking ahead, the authorities are rightly alert to potential risks surrounding elevated household debt in Canada and financial institutions' exposures to the U.S. economy; continued stress-testing for downside risk scenarios is desirable. They have also rightly responded to emerging risks in the housing market by tightening mortgage standards in 2008 and earlier this year.

46. **Canada is well positioned to update its financial regulatory framework in line with emerging international initiatives.** The transition to the Basel III framework of higher capital and liquidity standards should be smooth, given the already high requirements and the sound balance-sheet positions of the banks. Indeed, the factors underlying Canada's resilience to financial strains that emerged during the crisis—including a well-regulated mortgage market, limited reliance on wholesale funding, consolidated supervision of commercial and investment banking activities, a conservative leverage ratio, and close cooperation among entities responsible for financial stability—have been key inputs in the international debate on financial regulatory reform. Going forward, Canada's emphasis is appropriately on strengthening the infrastructure for OTC derivatives markets, improving the resolution mechanism via contingent capital, and calibrating macroprudential tools, such as countercyclical capital buffers.



47. **The initiative toward national securities regulation is another essential part of this framework.** In this connection, the steady progress toward this goal is welcome. The creation of a national securities regulator will both bridge potential gaps in the supervision and regulation of what are essentially national markets, and create a venue for bringing securities regulation into the ambit of national coordinating initiatives for promoting financial stability.
48. **It is recommended that the next consultation occur on the usual 12-month cycle.**

Table 1. Monetary Stimulus and Liquidity Facilities

	Monetary Measures 1/								
	end-2007	end-2008	end-2009	May 2010	Jun 2010	Jul 2010	Aug 2010	Sep 2010	Oct 2010
Target Rate (in percent) 2/	4.25	1.50	0.25	0.25	0.50	0.75	0.75	1	1
BoC Balance Sheet (asset, in billions, C\$)	55	79	71	67	59	59	58	58	58
(1) Securities purchased under resale agreements (inc. Term PRA)	4	35	25	15	6	3	0	0	0
(2) Advances (inc. term loans advanced under the Term Loan Facility instituted on Nov 20, 2008.)	0	2	0	0	0	0	0	0	0
(3) Foreign exchange swap arrangement with FRB 3/	0	0	0	0	0	0	0	0	0
Programs in support for financing (in billions, C\$) 4/	Liquidity Measures								
	Financing Available			Financing Provided Until end-2009					
(1) Insured Mortgage Purchase Program			125			66			
(2) New 10-year Canada Mortgage Bond			10			9			
(3) Canadian Lenders Assurance Facility			N/A			0			
(4) Canadian Life Insurers Assurance Facility			N/A			0			
(5) Crown corporation new flexibilities, inc. Business Credit Availability Program			13			8			
(6) Canadian Secured Credit Facility			12			12			
(7) Bank of Canada: Extraordinary Liquidity Facilities.			40			40			
<b>Total</b>			<b>200</b>			<b>135</b>			

Sources: Haver Analytics, Fourth Report to Canadians (December 2009), and Fund staff calculations.

1/ Term PRA and Term Loan Facility were introduced to ease the domestic liquidity. Operations on both measures are now discontinued. Expansions of eligible collateral for term PRA and standing liquidity facility are still in effect. End of the period.

2/ On September 8, 2010, Bank of Canada further increased overnight rate target to 1 percent.

3/ In 2008, the swap arrangement was set up to provide the Bank of Canada with additional flexibility amid the financial crisis. In May 2010, in response to the re-emergence of strains in U.S.-dollar short-term funding markets in Europe, the Bank of Canada—in coordination with other central banks—reinstated its temporary U.S.-dollar swap facility with the Federal Reserve. As of now, this facility has not been used.

4/ All fiscal measures are now expired.

Table 2: Evaluating Advantage Canada: Structural Reform Agenda

	Objective	Implementation Status	Staff's Assessment
<b>Tax Advantage</b>	Reducing taxes for all Canadians and establishing the lowest tax rate on new business investment in the G-7.	<p>Tax relief for individuals and families totaling \$220 billion over 2008-14. Measures already undertaken include:</p> <ul style="list-style-type: none"> <li>a) A new Tax-Free Savings Account that allows Canadians to invest up to \$5,000 a year in eligible investments.</li> <li>b) Implementation of a Working Income Tax Benefit (WITB) to make work more rewarding for low-and-modest income Canadians.</li> <li>c) Reduction of personal income taxes to attract and retain highly skilled workers.</li> </ul> <p>In 2010 Canada has the lowest overall tax rate on new business investment (METR) in the G-7, following the elimination of general capital taxes and reductions in corporate income tax rates; it is legislated that the federal general corporate income tax rate would decline from 22 percent in 2007 to 15 percent in 2015.</p>	Significant progress has been made and Canada already enjoys the lowest overall tax rate on new business investment in the G-7. However, non-neutralities in the business tax system could be reduced by eliminating the tax preferences for small firms, and move the tax base further toward a consumption base. In addition, the Employment Insurance system could be reformed by introducing a firm-level employer experience rating or scaling back access to unemployment insurance for seasonal and temporary workers, and by eliminating regionally differentiated provisions.
<b>Fiscal Advantage</b>	Eliminating Canada's general government net debt in less than a generation	<p>Canada has the lowest net debt-to-GDP level in the G-7.</p> <p>Canada is committed to restoring fiscal balance; returning to balanced budgets without increasing taxes or cutting transfer payments to persons and provinces.</p>	Canada's medium term fiscal consolidation plan is appropriate, but more planning, transparency and consideration is needed in addressing the long-term challenges of population aging and rising health costs.
<b>Entrepreneurial Advantage</b>	Reducing unnecessary regulation and red tape, and lowering taxes to unlock business investment.	<p>Budget 2010 creates a Red Tape Commission to review federal regulation burdens and eliminates all tariffs on machinery and equipment and manufacturing inputs.</p> <p>Canada signed several bilateral free trade arrangements and implemented unilateral tariff reductions, including making Canada a tariff-free zone for manufacturers.</p> <p>Provincial governments have agreed to reduce inter-provincial barriers to labor mobility.</p> <p>The Economic Action Plan (stimulus) has improved access to financing for Canadian households and businesses.</p> <p>Canada is taking steps to establish a Canadian Securities Regulator by 2012.</p> <p>Canada has committed to implement the recommendations of the Competition Policy Review Panel, including putting in place improved competition and investment laws and policies for encouraging new foreign investment.</p> <p>Canada is having consultations to reform federally regulated private pension plans.</p>	There has been no significant progress in implementing the recommendations of the Competition Policy Review Panel, including putting in place improved competition in network industries, such as postal services, telecommunication and electricity. Restrictions on foreign direct investment remain higher than in the majority of OECD countries, in particular in telecommunications, broadcasting and air transport. Renewed efforts are needed to fully implement the Agreement on Internal Trade, which committed to remove inter-provincial barriers by April 2009. The move towards a Canadian Securities Regulator is welcome, a long-standing Fund recommendation.

Continued.

Table 2: Evaluating Advantage Canada: Structural Reform Agenda

	Objective	Implementation Status	Staff's Assessment
<b>Knowledge Advantage</b>	Creating the best-educated, most skilled and most flexible workforce in the world.	<p>Canada Skills and Transition Strategy provides \$8.3 billion to improve labor market outcomes of underrepresented groups and resources for short and long-term skills upgrading.</p> <p>Modernization of the immigration system and streamlining the process for temporary foreign workers.</p> <p>Federal government provided funds for provinces and territories to strengthen the quality and competitiveness of their post secondary system; and over \$2.7 billion to fund research and development in post-secondary institutions.</p> <p>Actions taken to make the system of student financial assistance more effective.</p>	Private spending in Research and Development remains low among OECD comparators.
<b>Infrastructure Advantage</b>	Building a modern, world-class infrastructure.	<p>In 2007, a seven year, \$33 billion Building Canada Plan was put in place.</p> <p>In 2008, the federal government made the Gas Tax Fund a permanent measure to provide stable, long-term funding for municipal infrastructure.</p> <p>The Economic Action Plan expands infrastructure investment by \$12 billion over 2009-10, including modernization of federal infrastructure and research and information infrastructure in Canadian institutions.</p>	The emphasis on infrastructure spending is appropriate.

Sources: Finance Canada; OECD; Fund staff analysis.

Table 3. Medium-Term Scenario 2007–15  
(In percent change, unless otherwise indicated)

	Projections								
	2007	2008	2009	2010	2011	2012	2013	2014	2015
<b>National Accounts in constant prices</b>									
Real GDP	2.2	0.5	-2.5	3.0	2.3	2.7	2.4	2.4	2.2
Q4/Q4	2.5	-0.9	-1.1	2.8	2.7	2.6	2.4	2.4	2.2
Net exports 1/	-1.5	-1.9	0.2	-2.1	-0.7	-0.1	0.0	0.3	0.4
Total domestic demand	3.9	2.5	-2.6	5.1	3.0	2.7	2.4	2.1	1.8
Final domestic demand	4.0	2.8	-1.8	3.9	2.7	2.8	2.4	2.1	1.8
Private consumption	4.6	2.9	0.4	3.3	2.5	2.8	2.2	1.8	1.5
Public consumption	2.7	3.9	3.5	3.1	1.5	1.1	1.7	1.8	2.0
Private fixed domestic investment	3.1	0.8	-16.0	5.1	5.9	5.1	3.9	3.2	2.8
Machinery and equipment	4.2	-0.9	-20.3	9.6	11.8	7.4	5.9	5.3	4.8
Residential construction	2.8	-3.7	-8.2	10.3	-0.6	1.4	1.6	1.6	1.6
Private investment (in percent of GDP)	20.7	20.8	17.9	18.3	18.9	19.3	19.6	19.8	19.9
Public investment	6.5	5.6	15.0	11.5	-3.2	0.5	1.2	1.6	1.7
Change in inventories 1/	-0.1	-0.2	-0.9	0.9	0.3	0.0	0.0	0.0	0.0
GDP (current prices)	5.5	4.6	-4.5	5.9	4.7	5.1	4.7	4.6	4.4
<b>Employment and inflation</b>									
Unemployment rate (percent)	6.0	6.2	8.3	8.1	7.9	7.4	7.0	6.6	6.1
Employment	2.3	1.5	-1.6	1.6	1.5	1.8	1.7	1.6	1.6
CPI inflation	2.1	2.4	0.3	1.7	2.0	1.9	2.0	2.0	2.0
Core CPI inflation (y/y)	2.1	1.7	1.8	1.7	1.6	1.9	2.0	2.0	2.0
GDP deflator	3.2	4.1	-2.1	2.9	2.3	2.3	2.2	2.2	2.1
Potential output growth	2.3	2.1	1.5	1.6	1.8	1.9	1.9	1.9	2.0
Output gap (in percent of potential output)	1.7	0.1	-3.8	-2.5	-2.0	-1.2	-0.7	-0.3	0.0
<b>Indicators of fiscal policies</b>									
(NA basis, in percent of GDP)									
Federal fiscal balance	1.0	0.2	-2.6	-2.8	-2.2	-1.7	-1.2	-0.8	-0.5
Provincial fiscal balance 2/	-0.4	-0.7	-3.7	-4.0	-3.1	-2.6	-2.3	-2.0	-1.8
General government fiscal balance 2/	1.4	0.0	-5.5	-6.1	-4.6	-3.6	-2.9	-2.1	-1.6
General government net debt (OECD Consistent)	23.1	22.4	28.9	33.4	36.5	38.4	39.5	39.9	39.8
Three-month treasury bill (percent)	4.2	2.4	0.4	0.6	1.4	2.7	3.6	4.2	4.3
Ten-year government bond yield (percent)	4.3	3.6	3.2	3.3	4.2	5.2	5.7	5.7	5.7
<b>External indicators</b>									
Current account balance (in percent of GDP)	0.8	0.4	-2.8	-3.1	-3.5	-3.3	-3.2	-2.9	-2.4
Merchandise trade balance (in percent of GDP)	3.1	2.9	-0.3	-0.5	-0.7	-0.3	0.0	0.5	1.0
Export volume	1.3	-5.1	-15.3	7.4	3.2	5.9	5.4	5.2	4.8
Import volume	5.5	1.0	-15.2	14.0	5.7	5.9	5.2	4.1	3.4
Balance on invisibles (in percent of GDP)	-2.3	-2.5	-2.6	-2.6	-2.8	-3.0	-3.2	-3.4	-3.5
Terms of trade	2.9	4.7	-9.7	6.3	1.5	1.2	0.9	0.7	0.5
<b>Saving and investment (in percent of GDP)</b>									
Gross national saving	24.1	23.6	18.1	18.9	19.3	19.5	19.7	20.0	20.4
General government	4.5	3.2	-1.5	-1.9	-0.6	0.2	1.0	1.6	2.1
Private	19.6	20.4	19.6	20.8	19.9	19.3	18.8	18.4	18.3
Personal	4.6	5.2	6.2	7.1	6.9	6.1	5.5	5.4	5.3
Business	14.5	15.1	13.1	13.7	13.0	13.2	13.3	13.0	13.0
Gross domestic investment	23.2	23.1	21.0	22.1	22.7	22.8	22.9	22.9	22.8
Personal Savings (in percent of DI)	2.8	3.6	4.6	4.8	4.6	4.4	4.1	3.8	3.8
<b>Memorandum item</b>									
Real GDP in United States	1.9	0.0	-2.6	2.6	2.3	3.0	2.9	2.8	2.6

Sources: Haver Analytics; and Fund staff estimates.

1/ Contribution to growth.

2/ Includes local governments and hospitals.

Table 4. Fiscal Indicators 2009/10–2015/16

	Staff Projections						
	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
<b>Federal government (PA basis) 1/</b>	(In billions of Canadian dollars)						
Revenue	218.6	229.4	242.6	256.3	271.7	286.5	301.0
Program spending	244.8	247.7	243.1	246.7	252.7	258.5	266.9
Interest payments	29.4	31.4	33.1	36.0	37.3	38.1	39.5
Budgetary balance	-55.6	-49.7	-33.6	-26.4	-18.3	-10.1	-5.4
Primary Balance	-26.2	-18.3	-0.5	9.6	19.0	28.0	34.1
Gross federal debt 3/	883.3	933.0	966.6	993.0	1011.3	1021.4	1026.8
Net federal debt 3/	582.5	632.2	665.8	692.2	710.5	720.6	726.0
	(In percent of GDP)						
Revenue	14.3	14.2	14.3	14.4	14.6	14.7	14.8
Program spending	16.0	15.3	14.4	13.9	13.6	13.3	13.1
Interest payments	1.9	1.9	2.0	2.0	2.0	2.0	1.9
Budgetary balance	-3.6	-3.1	-2.0	-1.5	-1.0	-0.5	-0.3
Primary Balance	-1.7	-1.1	0.0	0.5	1.0	1.4	1.7
Structural budgetary balance 2/	-2.5	-2.3	-1.4	-1.1	-0.8	-0.4	-0.2
Gross federal debt 3/	57.8	57.7	57.1	55.8	54.3	52.4	50.4
Net federal debt 3/	34.0	35.2	35.6	35.3	34.7	33.7	32.5
	2009	2010	2011	2012	2013	2014	2014
<b>General government (NA Basis) 4/</b>	(In billions of Canadian dollars)						
Revenue	584.7	606.0	630.2	667.8	706.6	747.8	786.2
Expenditure	669.0	704.4	708.2	732.7	759.7	789.3	819.8
Balance	-84.3	-98.4	-78.1	-64.9	-53.1	-41.6	-33.6
Structural balance 2/	-50.6	-74.3	-57.9	-51.6	-44.9	-37.9	-32.7
Gross public debt (OECD Consistent) 3/	1260.0	1358.4	1436.5	1501.4	1554.5	1596.1	1629.7
Net public debt (OECD Consistent) 3/	441.4	539.8	617.9	682.8	735.9	777.5	811.1
	(In percent of GDP)						
Revenue	38.3	37.5	37.2	37.5	37.9	38.4	38.6
Expenditure	43.8	43.5	41.8	41.2	40.8	40.5	40.3
Balance	-5.5	-6.1	-4.6	-3.6	-2.9	-2.1	-1.6
Structural balance 2/	-3.2	-4.5	-3.3	-2.9	-2.4	-1.9	-1.6
Gross public debt (OECD Consistent) 3/	82.5	84.0	84.8	84.4	83.4	81.9	80.1
Net public debt (OECD Consistent) 3/	28.9	33.4	36.5	38.4	39.5	39.9	39.8
<b>Memorandum items</b>	(In percent of GDP)						
Real GDP growth	-2.5	3.0	2.3	2.7	2.4	2.4	2.2
Nominal GDP growth rate	-4.5	5.9	4.7	5.1	4.7	4.6	4.4
Three-month treasury bill rate	0.4	0.6	1.4	2.7	3.6	4.2	4.3
Ten-year government bond rate	3.2	3.3	4.2	5.2	5.7	5.7	5.7

Sources: Department of Finance: *Canada 2010 Fiscal Update*, Haver Analytics, and Fund staff estimates.

1/ On a fiscal year basis, which starts on April 1.

2/ In percent of potential GDP.

3/ Assuming all deficit/surplus is added/subtracted from debt.

4/ On a national accounts and calendar year basis. Includes federal, provincial, territorial, and local governments; and Canada and Quebec pension plans.

Table 5. Balance of Payments 2007–15  
(In percent of GDP)

	2007	2008	2009	Projections					
				2010	2011	2012	2013	2014	2015
Current account balance	0.8	0.4	-2.8	-3.1	-3.5	-3.3	-3.2	-2.9	-2.4
Merchandise trade balance	3.1	2.9	-0.3	-0.5	-0.7	-0.3	0.0	0.5	1.0
Exports, goods	30.3	30.6	24.2	25.0	25.2	26.0	26.7	27.4	27.8
Imports, goods	27.2	27.7	24.5	25.5	25.9	26.3	26.7	26.9	26.8
Services balance	-1.2	-1.4	-1.5	-1.4	-1.4	-1.4	-1.3	-1.3	-1.2
Investment income balance	-0.9	-1.0	-0.9	-1.1	-1.2	-1.4	-1.6	-1.9	-2.1
Transfer balance	-0.1	0.0	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Capital and financial accounts balance	-0.8	-0.4	2.8	3.1	3.5	3.3	3.2	2.9	2.4
Direct investment, net	4.0	-1.7	-1.5	0.5	1.1	1.2	1.4	2.0	2.1
Portfolio investment, net	-5.2	2.7	6.7	4.6	3.7	3.3	2.9	1.8	1.1
Other investment, net 1/	0.3	-1.3	-1.8	-2.2	-1.6	-1.5	-1.5	-1.2	-1.1
Capital account balance	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Transactions in official									
International reserves	-0.3	-0.1	-0.8	...	...	...	...	...	...
Statistical discrepancy	0.1	-0.3	0.0	...	...	...	...	...	...
<b>Memorandum item:</b>									
Net international investment position	-8.5	-1.9	-10.0	-12.3	-14.9	-17.2	-19.2	-20.9	-22.1

Sources: Haver Analytics; and Fund staff calculations.

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

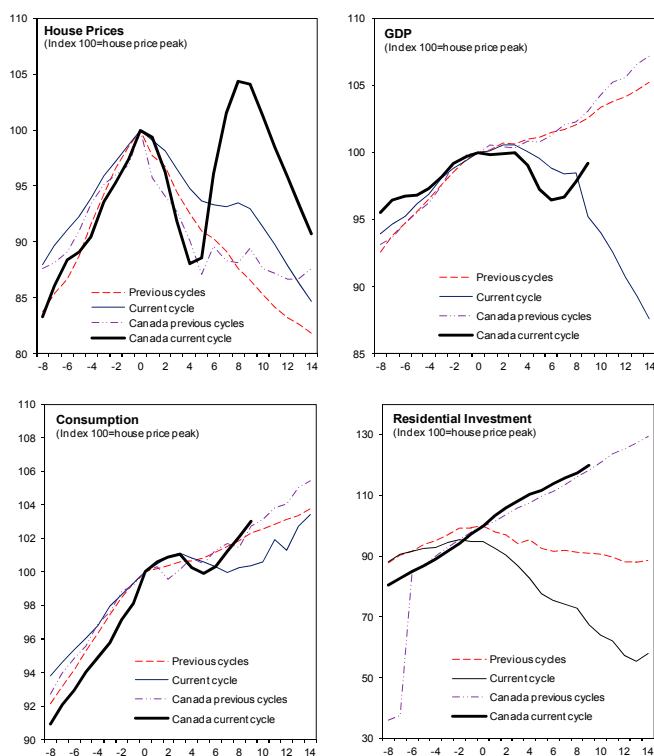
### Box 1. How Vulnerable is Canada's Housing Market?

**The residential real estate cycle may have reached its long-predicted peak in Canada.** Sales volumes fell as summer moved in while the pace of price increases moderated. The surge in late 2009 and early 2010, following the decline through 2008, appears to have been due to buyers rushing to beat deadlines before stricter mortgage rules and additional sales taxes were implemented. Indeed, in 2010 Q2, residential investment (+1.3 percent) basically stalled as a drop off in renovation activity offset a sharp 30 percent gain in new homebuilding. The decline in renovation activity was largely expected, and likely related to the expiration of the Federal Home Renovation tax credit.

**Going forward, several factors may indicate further downward pressure on house prices.** First, price-to-income and price-to-rent ratios remain 1 standard deviation above historical averages. Second, staff's model-based estimates from the Early Warning Exercise (EWE) and Vulnerability Exercise for Advanced Countries (VEA) suggest an overvaluation around 13 percent, exceeding the 10 percent threshold. (The EWE real estate model combines these three indicators to create a heat map for house price valuation.) Moreover, the predicted path of house prices based on WEO income projections suggest a decline of almost 6 percent through 2015.

**These indicators put Canada among the advanced countries where a house price correction is most likely to take place.** Yet, the point estimate for the house price disequilibrium (the difference between actual prices and estimated equilibrium or long-run prices) is not large by historical standards, and Canada ranks only 7<sup>th</sup> among 22 advanced economies in the VEA sample in terms of potential overvaluation. Furthermore, other components of residential real estate vulnerability (namely, potential impact on GDP, household balance sheets, and mortgage market characteristics) remain moderate or low in Canada, compared to other advanced economies. That said, with most mortgages being “rollover” mortgages with terms of at most five years, any future interest rate increases could put additional strains on already highly indebted households.<sup>1</sup>

Advanced Economies: Previous versus Current Housing Cycles



Sources: IMF International Financial Statistics, OECD, Haver Analytics.

<sup>1</sup> CAAMP reports that 66 percent of mortgage borrowers reported having a term of four to five years; just 8 percent have terms of more than 5 years, and the remaining borrowers (26 percent) have terms of less than 5 years.



## **Box 2. Federal and Provincial Budget 2010's Plans for Deficit Elimination**

**Canada plans a return to balance over the medium term.** With a deficit estimated at CAD 53.8 billion in 2009-10 and the economy starting to recover from the recession, the federal government has laid out a detailed plan to return to a virtually zero deficit in FY 2014-15.

**Canada's new budget plan reaffirms the authorities' pledge in the G-20 context in June on the need to halve budget deficits by 2013 and stabilize debt-to-GDP ratios by 2016.** As a result of measures in Budget 2010, the government projects that the deficit will decline by almost half over the next two years to CAD 27.6 billion in FY 2011-12, and by two-thirds to CAD 17.5 billion in FY 2012-13. In 2014-15, the deficit is projected to be CAD 1.8 billion. The debt-to-GDP ratio is expected to peak at 35.4 percent in FY 2010-11 and then fall to 31.9 percent by FY 2014-15. Program spending as a share of GDP is expected to decline from 15.6 percent in FY 2009-10 to 13.2 percent in FY 2014-15.

**The plan rules out increases in corporate, personal, income, or consumption taxes while allowing built-in automatic hikes in EI premiums.** It also envisages a protection of major transfers to persons and other governments (i.e., CST, CHT, and equalization transfers), relying instead in significant part on a series of expenditure compression measures, namely:

- Letting temporary fiscal stimulus measures elapse after fiscal 2010-11.
- Implementing targeted measures (worth about CAD 18 billion over 5 years) to constrain spending growth, in particular (i) restraining national defence spending; (ii) capping international assistance at CAD 5 billion from next year onwards; (iii) containing public administration costs by freezing operational budgets; and (iv) implementing strategic program reviews.

**Provincial governments' 2010 budgets also plan a return to balance in the medium term, although at different paces.** In general, the size of the deficit faced by a jurisdiction informed the pace of consolidation, with Ontario at the high end (8 years), followed by Manitoba and Saskatchewan opting for timetables of 5 years.

**At the provincial level, deficit reduction strategies vary.** While all provinces but Alberta and Saskatchewan will postpone program and capital spending restraint until post-2010 to aid recovery, all governments have committed to: (i) keeping program expenditure growth near or below 2 percent while protecting core services (health and education); (ii) flat-lining or outright cutting departments' operational budgets and non-core program spending; and (iii) curtailing civil service (i.e., compensation, headcount / attrition). From the revenue side, main provincial deficit reduction measures include: (iv) increasing value-added consumption taxes (Nova Scotia, Quebec); (v) raising fuel/ tobacco/liquor taxes (Quebec, Manitoba, Saskatchewan); (vi) raising user fees (water, tuition) and health premium (Quebec); (vii) deferring previously announced tax relief (Manitoba, Saskatchewan); (viii) raising personal income taxes for higher earners (Nova Scotia).

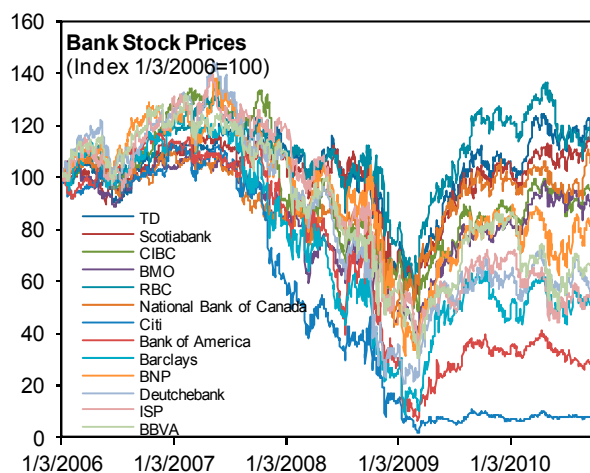
### Box 3. Canada's Financial System Resilience: What Can Others Learn?

**Canada's financial system displayed remarkable stability during the global turbulence.** The system has avoided systemic pressures: no financial institution failed or required public capital injections (banks raised capital in markets, albeit at elevated cost owing to higher global risk aversion).

**Key factors behind this relatively strong performance included:**

*Sound supervision and regulation:* The 2008 FSSA Update found that the regulatory and supervisory framework meets best practice in many dimensions, including with regard to the revised Basel Core Principles for banking supervision.

*Stringent capital requirements:* Solvency standards apply to banks' consolidated commercial and securities operations. Tier 1 capital generally significantly exceeds the required 7 percent target (which in turn exceeds the Basel Accord minimum of 4 percent). The leverage ratio is limited to 5 percent of total capital. The Canadian leverage cap is calculated on total (Tier 1 and 2) capital, versus Tier 1 capital in the U.S. Canada also includes some off-balance sheet exposures in its definition of assets (such as include credit derivatives, financial standby letters of credit, guarantees, and surety arrangements), whereas the U.S. leverage calculation does not.



Source: Bloomberg, LC and Fund staff calculations.

*Low risk tolerance and conservative balance sheet structures:* Banks have a profitable and stable domestic retail market, and (like their customers) exhibit low risk tolerance. Banks had smaller exposures to “toxic” structured assets and relied less on volatile wholesale funding than many international peers.

*Proactive response to financial strains:* The authorities quickly reacted to the crisis by expanding liquidity facilities, providing liability guarantees, and purchasing mortgage-backed securities (all of those facilities have now expired) and other credit support to specific markets. In addition, the resolution framework was reformed providing authority for public capital injections and other transactions to support financial stability. More recently, the authorities had again acted proactively by restricting mortgage rules for government insured mortgages to help prevent a housing bubble.

*Effective coordination between supervisory agencies:* Officials meet regularly in the context of the Financial Institutions Supervisory Committee (FISC) and other fora to discuss issues and exchange information on financial stability matters.<sup>1</sup>

*Regulation reviews:* To keep pace with financial innovation, federal authorities review financial sector legislation every five years—next review to be completed in 2012 (Ontario has a similar process for securities market legislation).

*Conservative residential mortgage markets:* Only 5 percent of mortgages are nonprime and only 25 percent are securitized (compared with 25 percent and 60 percent, respectively, in the U.S.); all of which are effectively unconditionally government guaranteed. About two-thirds of residential loans are guaranteed, since almost all loans that are securitized, plus those with a loan-to-value ratio (LTV) above 80 percent held by regulated depository institutions must be insured for the full loan amount (rather than the portion above the 80 percent LTV, as in the U.S.). Also mortgage interest is nondeductible, encouraging borrowers to repay quickly, and mortgages are recourse.

<sup>1</sup> The FISC comprises officials from the Office of the Superintendent of Financial Institutions (OSFI), Finance Canada, Bank of Canada (BoC), Canada Deposit Insurance Corporation (CDIC), and the Financial Consumer Agency of Canada.

#### Box 4. Should Canada Be Concerned of Adverse Inward Spillovers from Europe?

**So far Europe's sovereign debt turmoil had modest financial and trade effects on Canada.** While Canada's stock and credit market volatility increased as the crisis erupted in early 2010, corporate bond spreads have increased modestly since early May, and Canadian short-term funding markets have been largely unaffected, owing to the economy's relatively strong fundamentals. In addition, Canadian government yields have declined benefitting from investors' flight to quality. Likewise, Canada's trade account has not been significantly impacted by the European crisis due to its limited exposure to European trade.

**Going forward, a scenario of increased financial market stress in Europe, however, could trigger larger effects.** With only 9 percent of Canadian total exports going to the EU, Canada's direct trade exposure is small. However, spillovers of Europe to the rest of the world may affect Canada's exports indirectly. Further developments could increase uncertainty of the global recovery, soften the U.S. demand for Canadian exports, and dampen global demand for commodities.

##### Canada: Exports to Europe (Percent of GDP, goods and services, unless otherwise noted)

	2009
Euro area	1.04
Greece	0.01
Ireland	0.04
Portugal	0.01
Spain	0.07
United Kingdom	0.80

Sources: IMF Direction of Trade Statistics and Fund staff estimates.

**At present, financial exposures to Europe are contained,** given relatively strong fundamentals of Canada's financial institutions, and there have been no material dislocations in Canadian financial markets. Canada's banks' total financial claims on smaller European economies are modest as a share of assets and Tier-1 capital. Claims on larger European economies, including the U.K., are significantly larger, however.

##### Canadian Banks' Total Financial Claims on European Countries in 2010Q2 1/

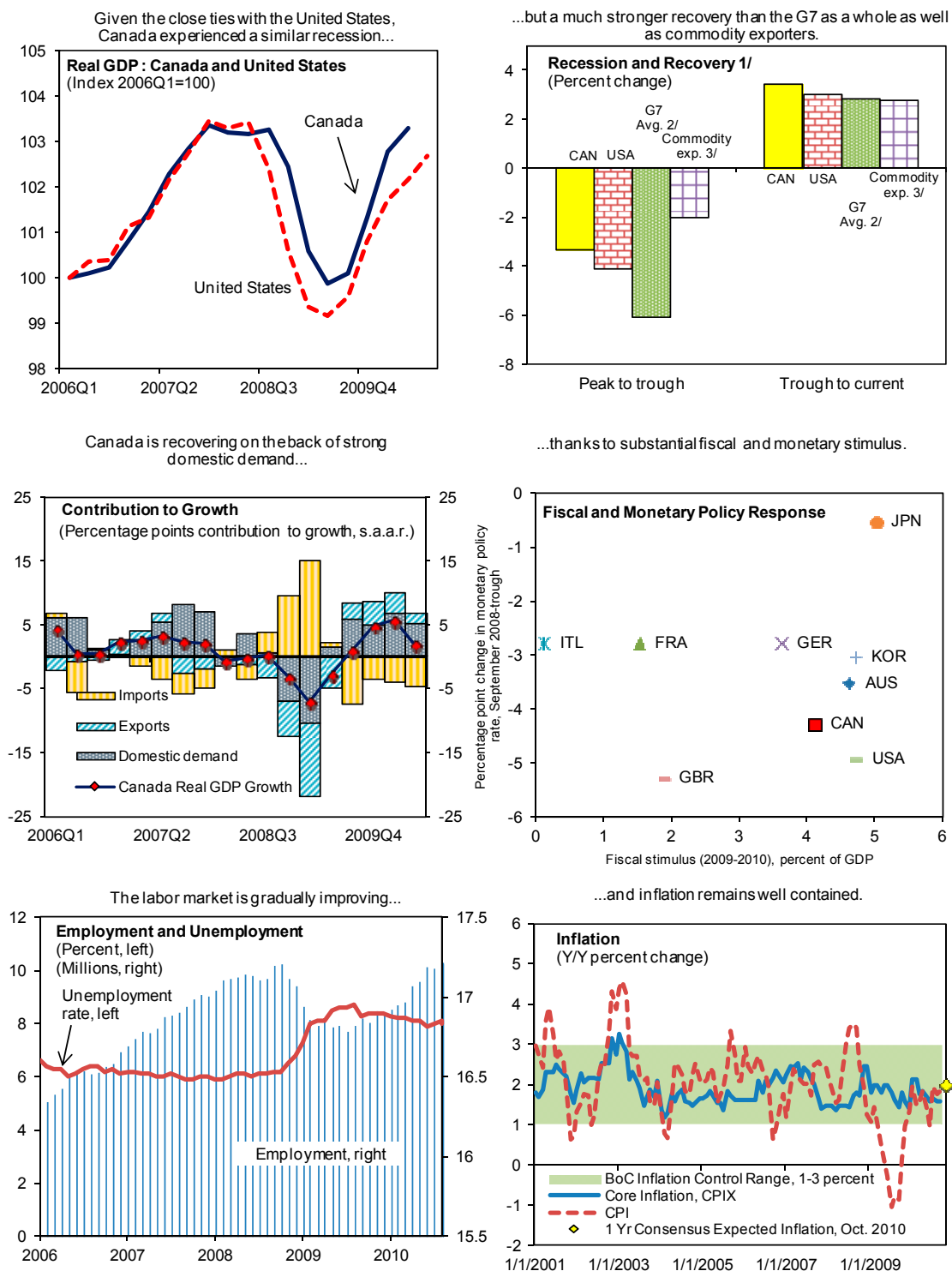
	Billions of dollars	Percent of total assets	Percent of tier 1 capital
Ireland	10.0	0.3	7.4
Portugal	0.4	0.0	0.3
Spain	3.3	0.1	2.5
Other continental Europe 2/	62.5	2.1	46.2
United Kingdom	73.5	2.5	54.3

Sources: Bank of International Settlements (Consolidated Foreign Claims of Reporting Banks, Ultimate Risk Basis, as of 2010Q1 release), OSFI (total assets and tier 1 capital as of 2010Q2), and Fund staff estimates.

1/ Includes derivatives, unused credit commitments, and guarantees.

2/ Austria, Belgium, Denmark, France, Germany, Italy, Luxembourg, Netherlands, and Switzerland. Data for Greece is not available from BIS.

Figure 1. Canada's Rapid Recovery



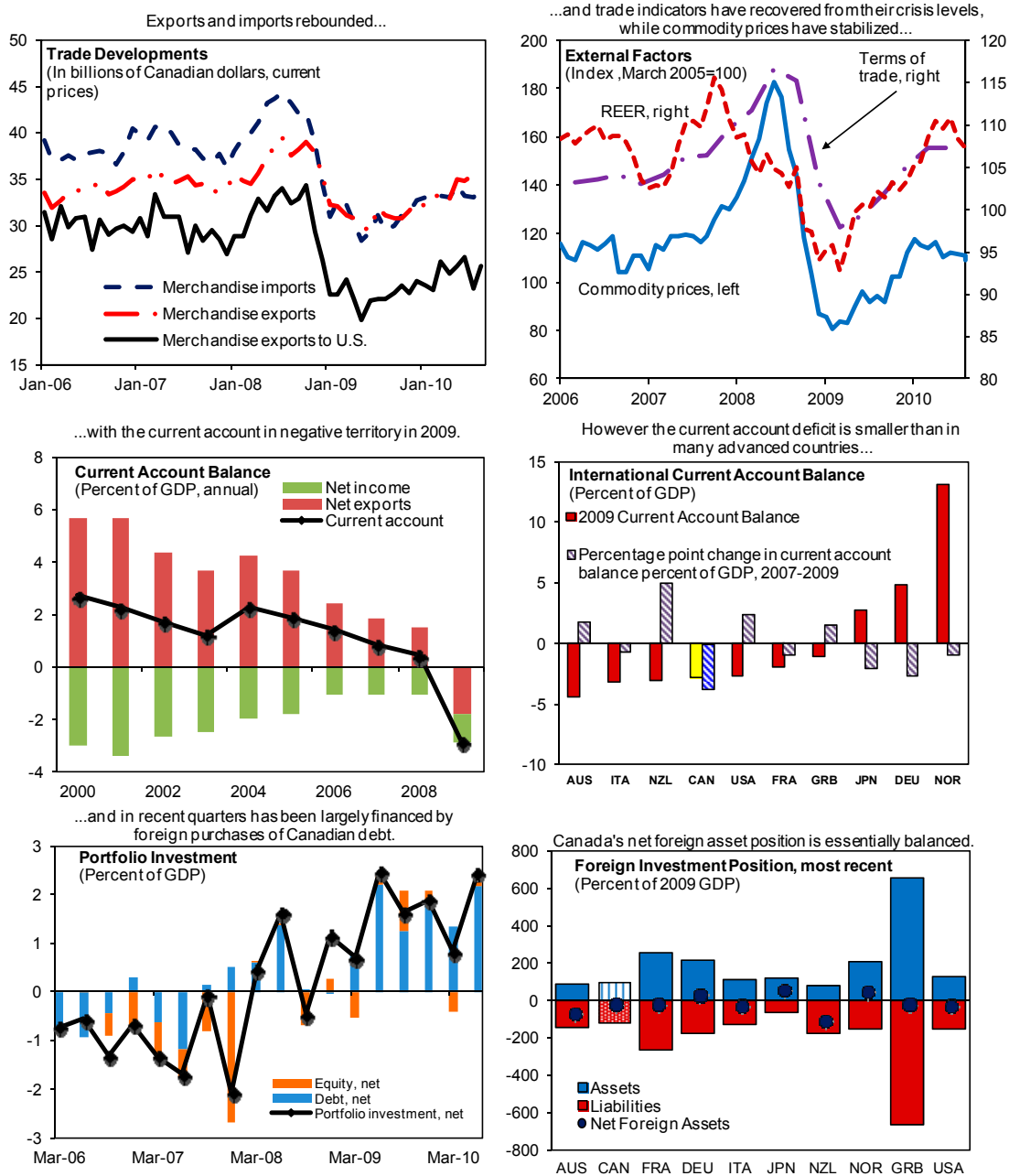
Sources: Haver Analytics, IMF Fiscal Monitor 2010, and Fund staff calculations.

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 2010Q2.

2/ Excluding Canada, simple average.

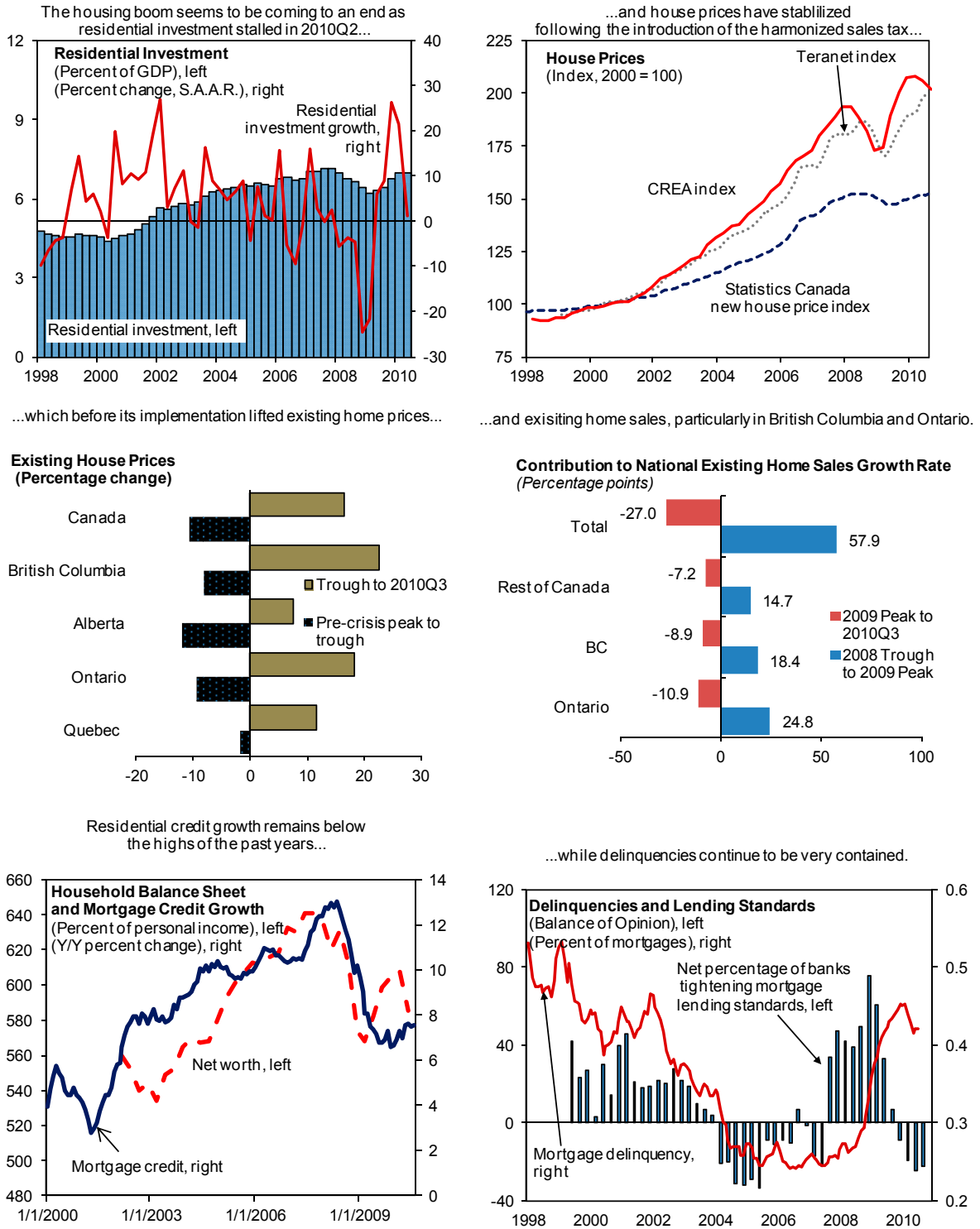
3/ Commodity exporters are Australia, New Zealand, and Norway, simple average.

Figure 2. External Developments



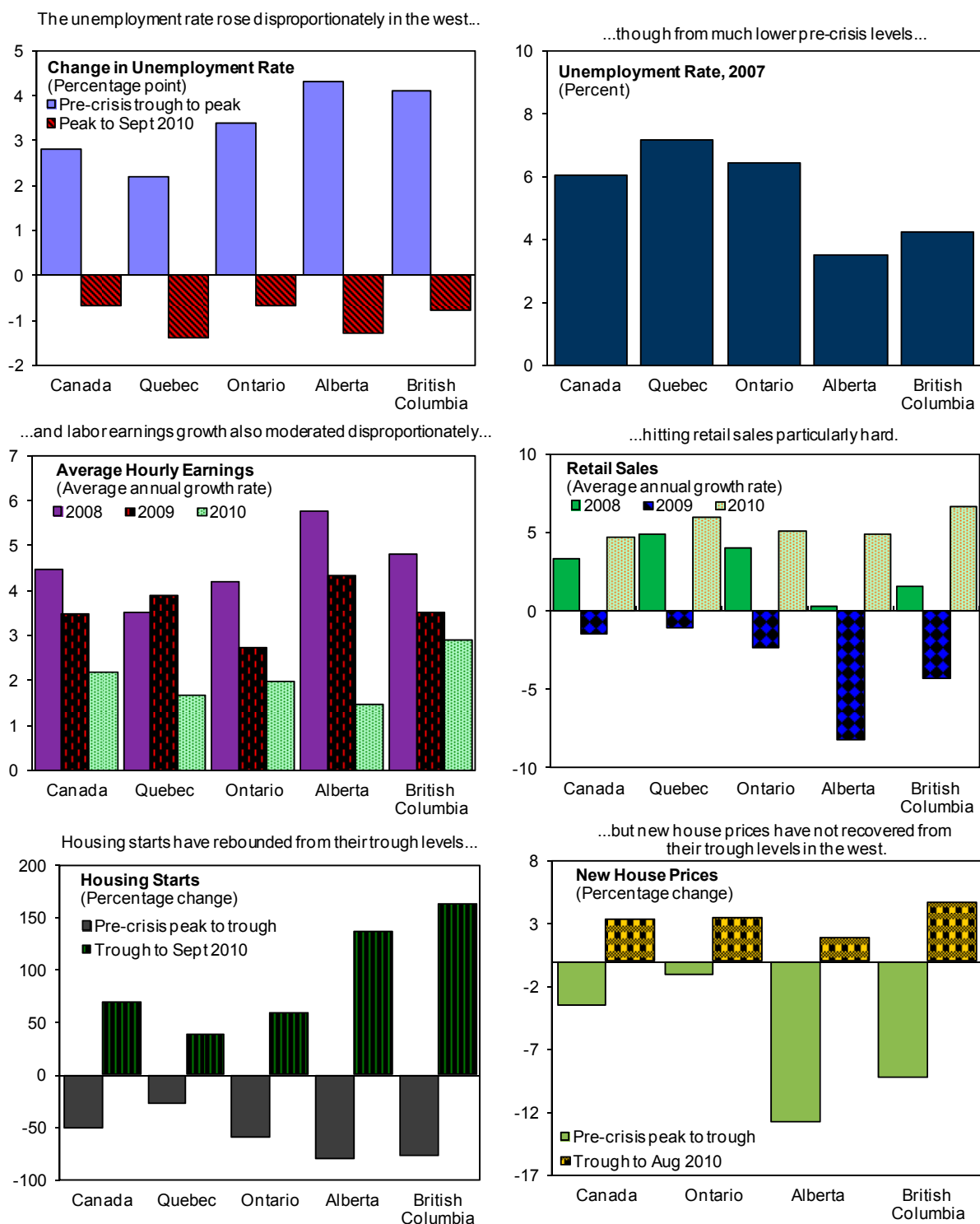
Sources: Haver Analytics, IMF International Financial Statistics, IMF World Economic Outlook, and Fund staff calculations.

Figure 3. Housing Boom and Correction



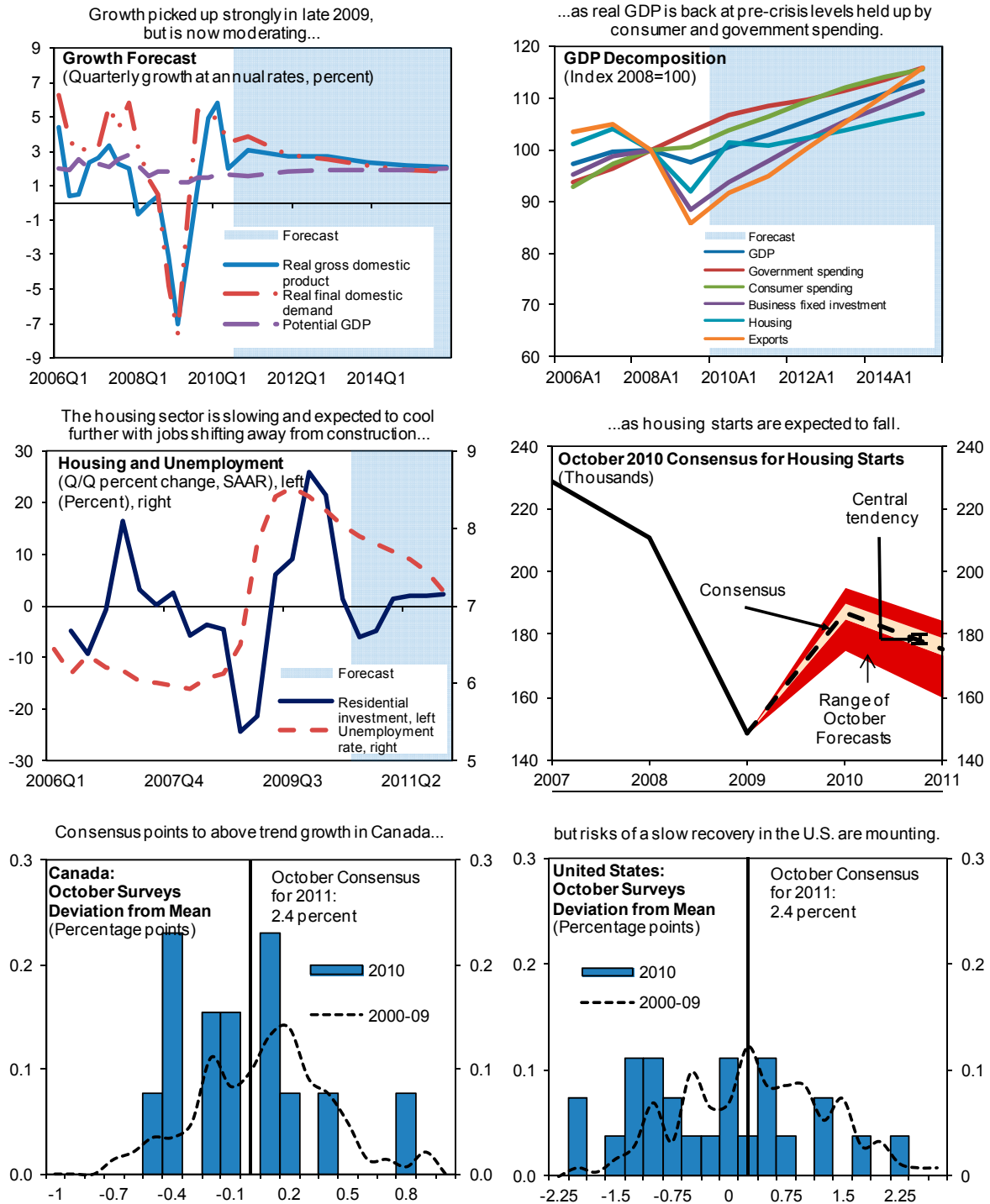
Sources: Canadian Real Estate Association, Haver Analytics, Teranet, and Fund staff calculations.

Figure 4. Regional Developments



Sources: Haver Analytics and Fund staff calculations.

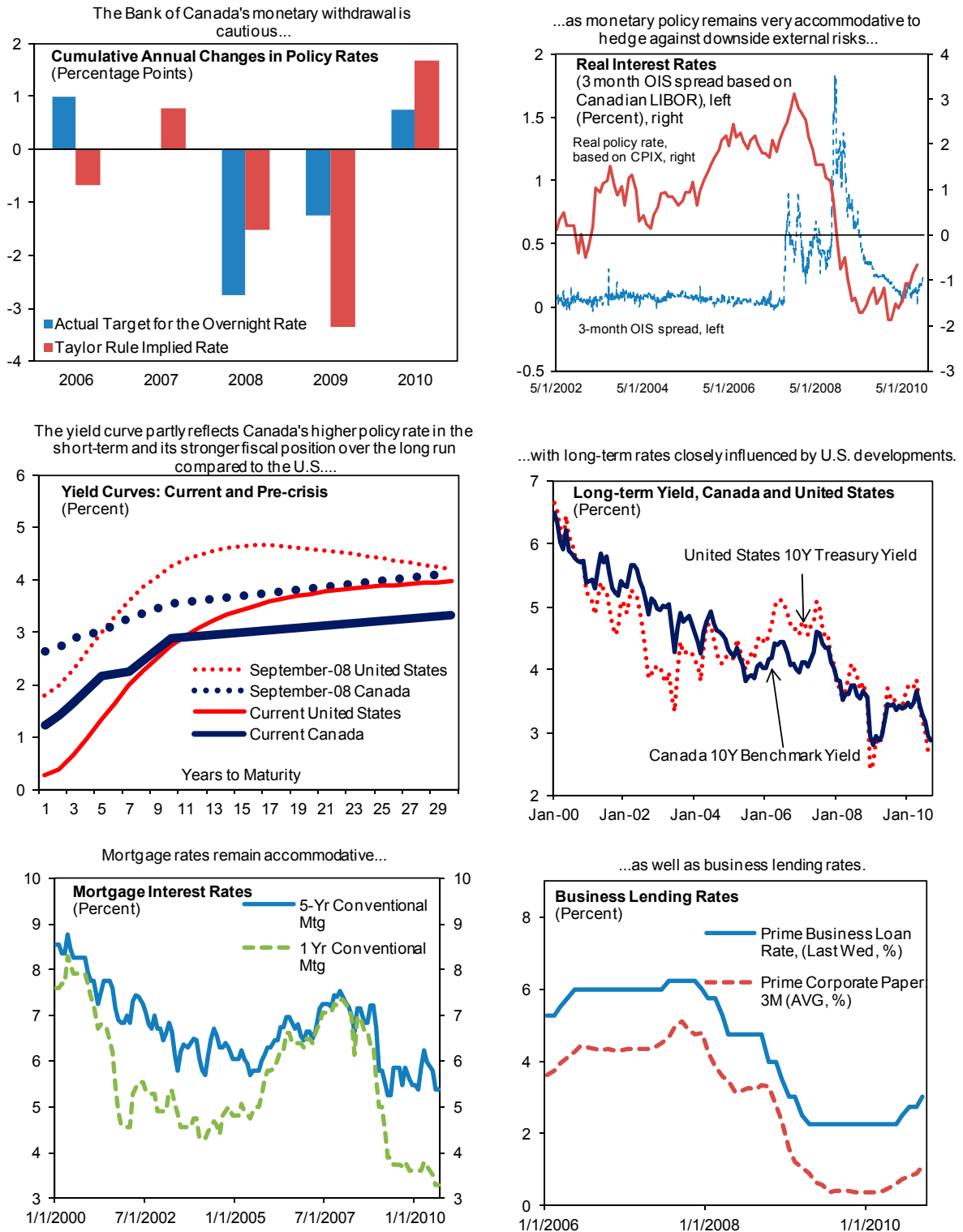
Figure 5. Macroeconomic Outlook



Sources: Haver Analytics, IMF World Economic Outlook, Consensus Forecasts, and Fund staff projections.

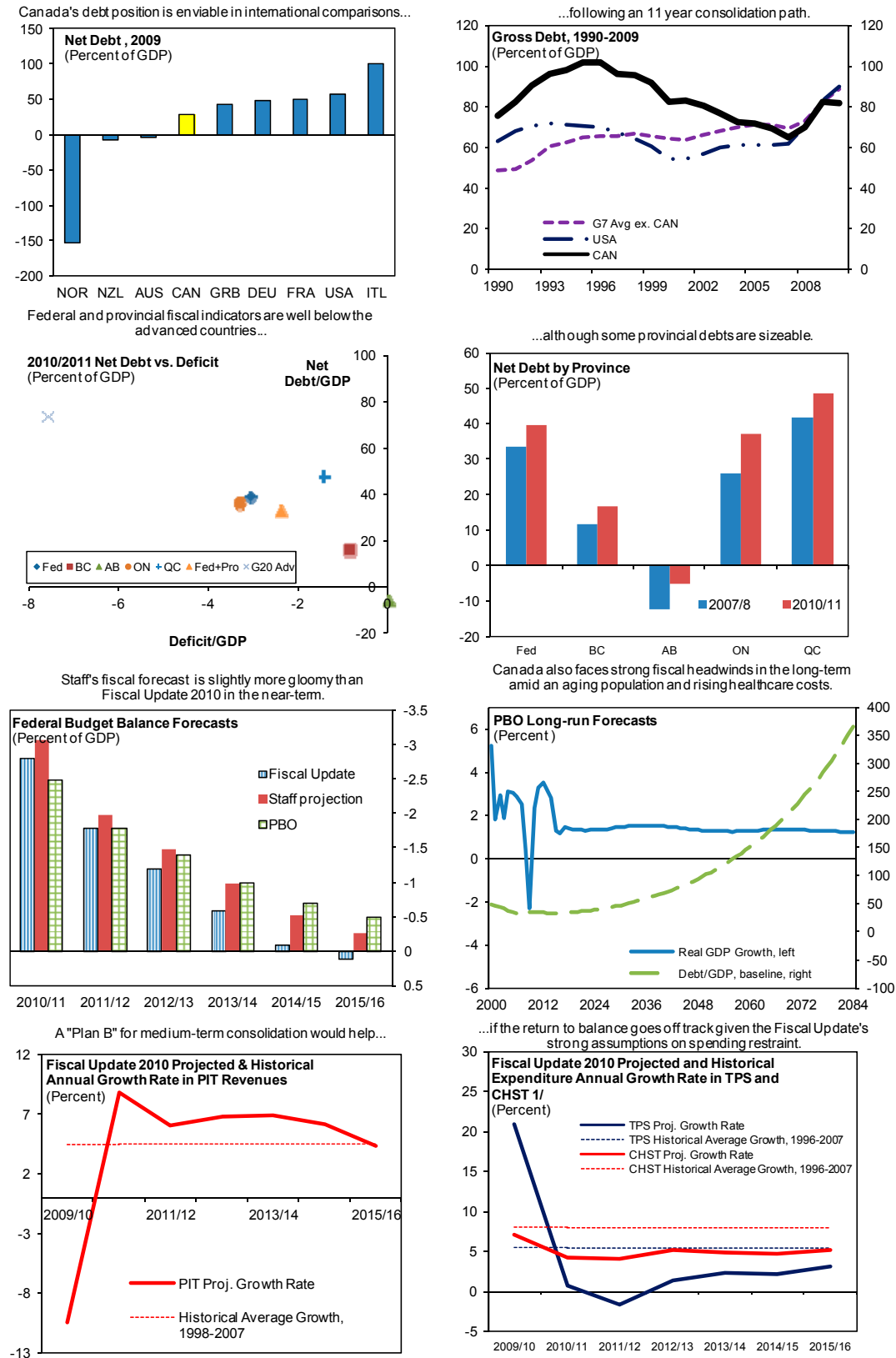


Figure 6. Monetary Policy: Business as Usual or Not?



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

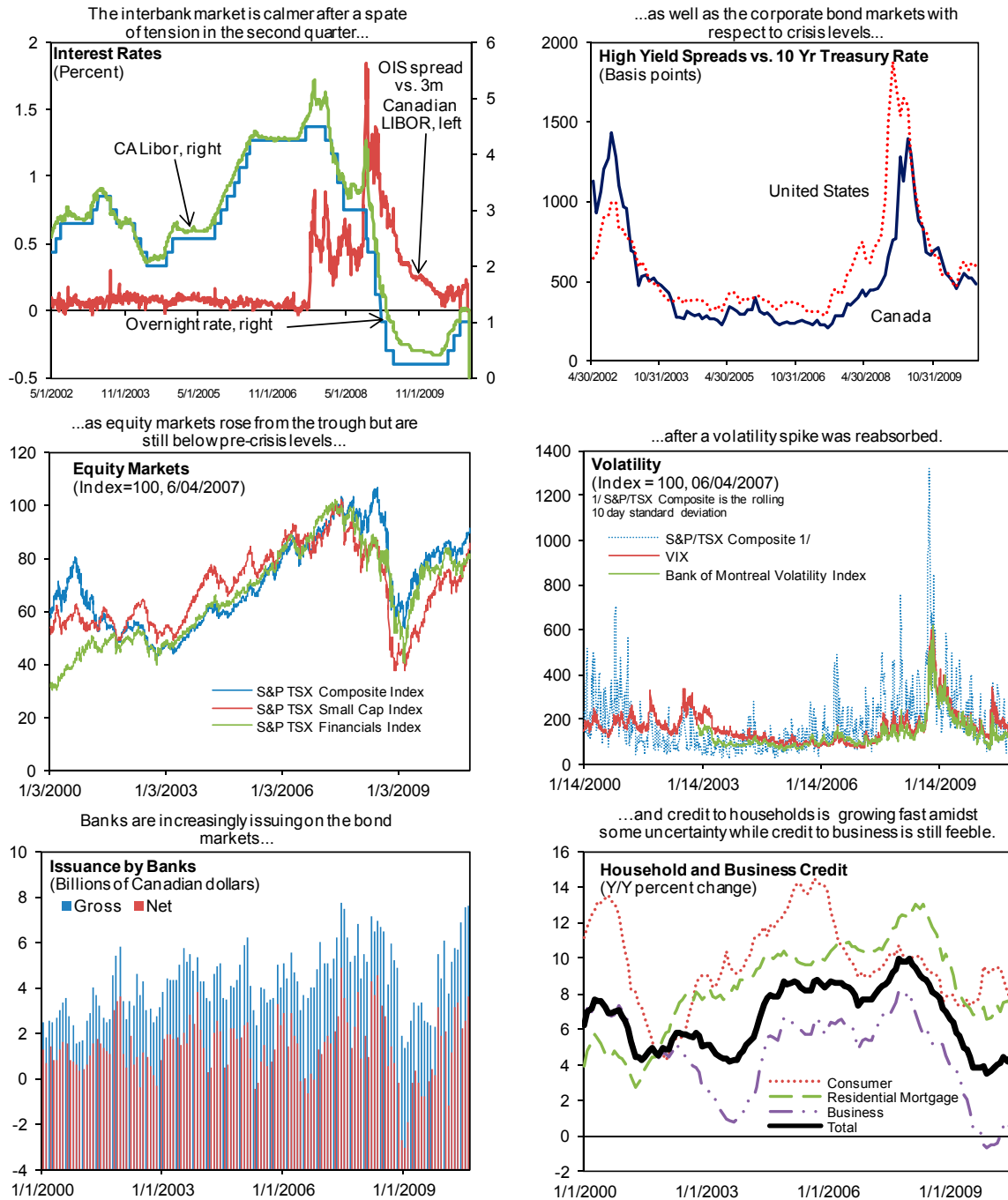
Figure 7. Fiscal Policy: The Plan to Balance



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

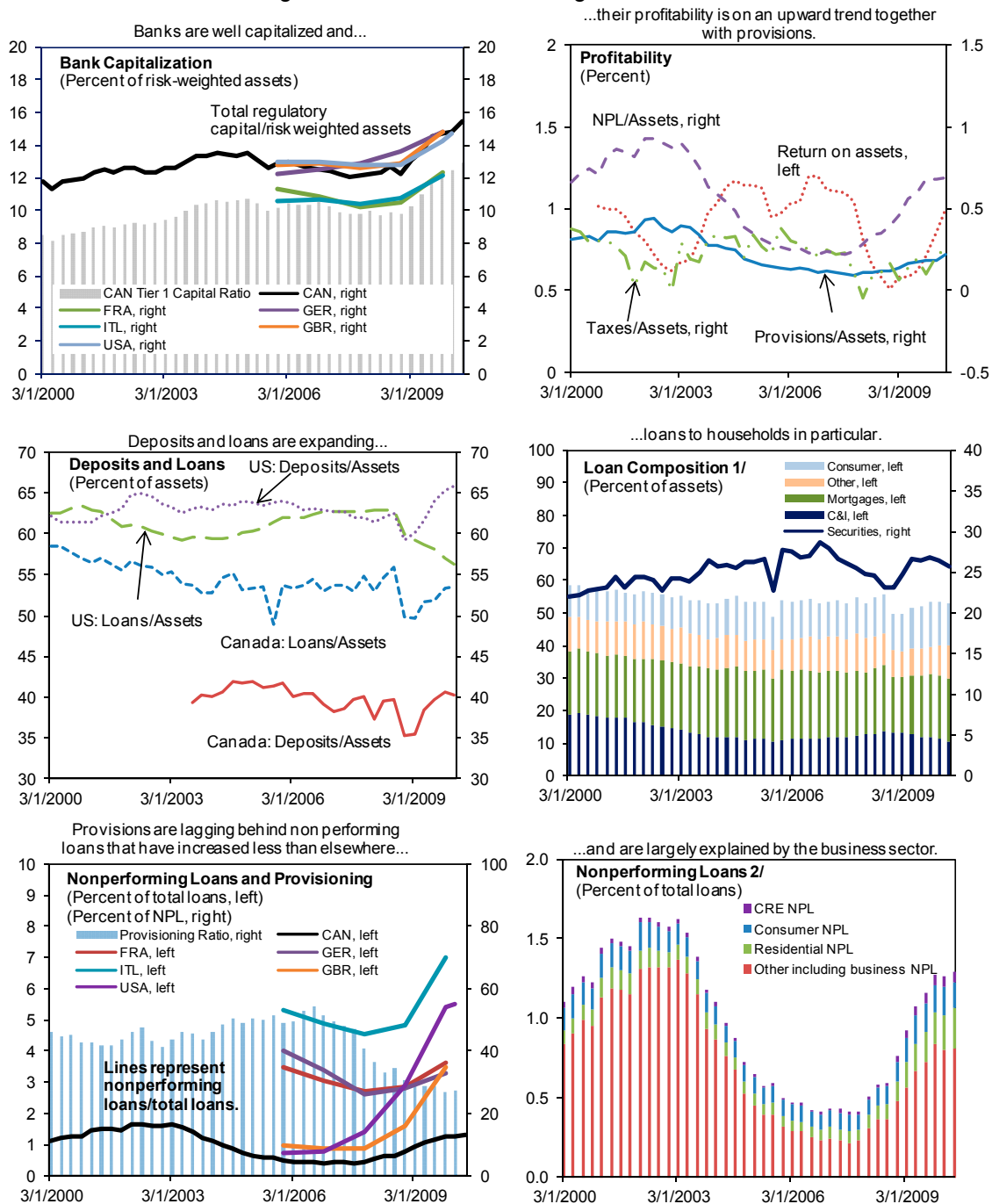
1/ Total Program Spending (TPS), Canadian Health and Social Transfer (CHST).

Figure 8. Financial Markets Have Largely Normalized



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

Figure 9. Banks Are Delivering Robust Results

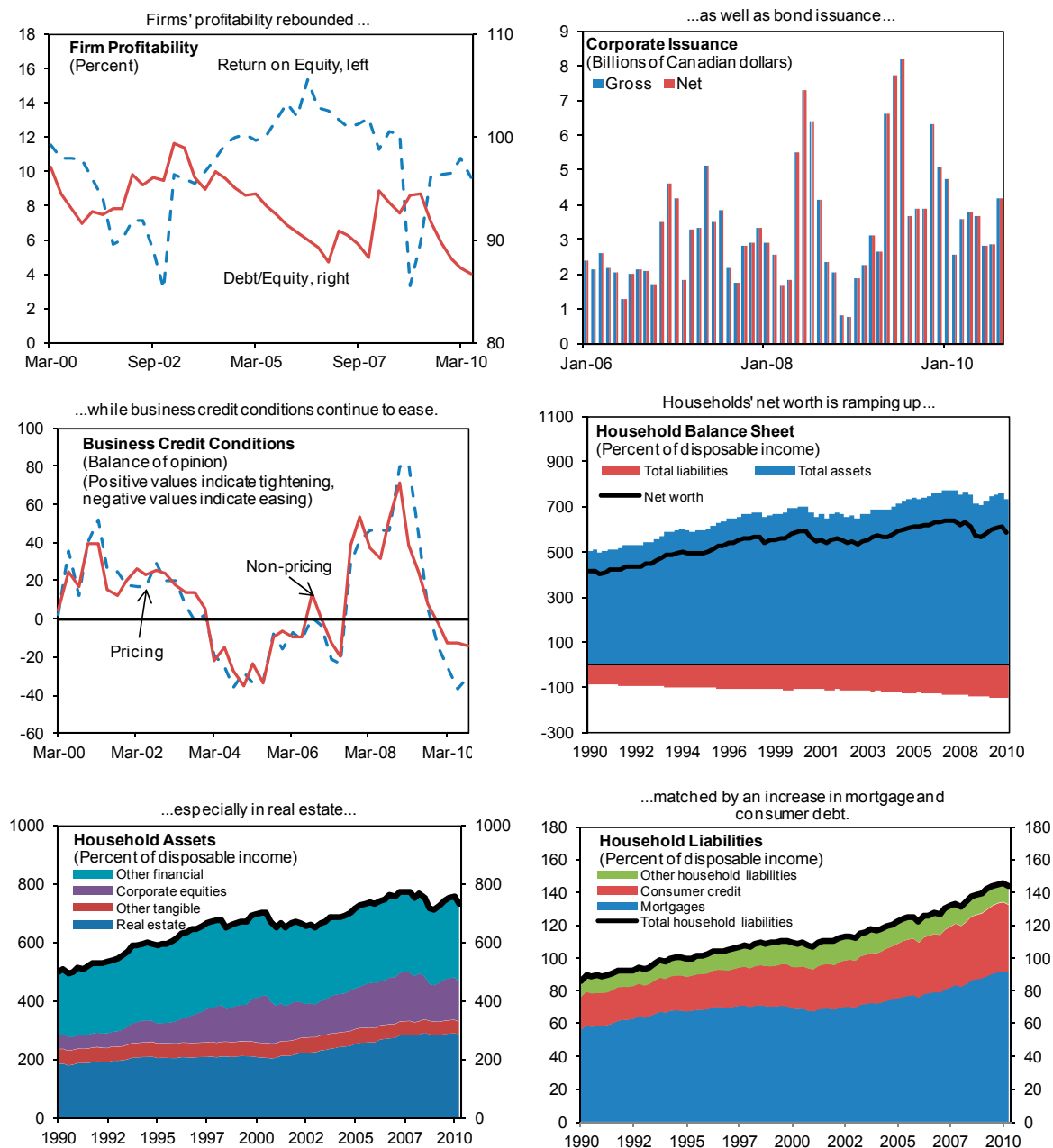


Sources: Bank of Canada, Bloomberg LLC., Canadian Office of the Superintendent of Financial Institutions, Haver Analytics, and Fund staff calculations.

1/ Banks' consumer loans, banks' mortgage loans, banks' commercial and industrial loans, banks' other loans, and securities held by banks respectively, as a percentage of banks' total assets.

2/ For other including business non performing loans, rise appears to mainly reflect deterioration in US loan portfolio, particularly on acquired assets.

Figure 10. Firms' Issuance is Picking Up, While Household Indebtedness Remains High But Appears to Have Plateaued



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



INTERNATIONAL MONETARY FUND

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EXTERNAL  
RELATIONS  
DEPARTMENT

ANNEX I

Public Information Notice (PIN) No. 10/xx  
FOR IMMEDIATE RELEASE  
[Month, dd, yyyy]

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2010 Article IV Consultation with Canada**

On [December 10, 2010], the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.<sup>1</sup>

### **Background**

Canada has weathered well the global recession, reflecting a strong economic and financial position at the onset of the crisis and a sizeable macro policy response. The large fiscal stimulus (totaling about 4 percent of one year's GDP over two years) and prompt accommodation in monetary conditions strengthened domestic demand, and the economy posted robust growth rates in late 2009 and early 2010. Labor markets have been a particularly bright spot in the recovery, with Canada the only G-7 country that virtually recouped the loss in employment (apart from Germany) during the recession by mid 2010, and the first to record year-over-year increases in employment by mid 2010Q1.

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<sup>1</sup> 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>.

During the recovery, the Canadian current account deficit expanded on the back of brisk import growth, subdued exports to the United States—Canada's main trading partner—and an appreciating Canadian dollar, given recovering commodity prices and capital flows. The financial system has avoided systemic pressures amid the global turbulence, thanks in good part to strong supervision and regulation. Financial markets have largely recovered from the turmoil and overall financial conditions remain accommodative.

However, the economic recovery is moderating and the outlook remains uncertain. In particular, domestic demand is slowing, amid stretched household balance sheets and a cooling housing market, following the introduction of tighter mortgage standards earlier this year in response to emerging risks. Net exports continue to be a drag on growth. Inflation has remained contained, with core inflation around the middle of the Bank of Canada's target range. Looking ahead, risks are elevated and tilted to the downside with high household debt levels the main domestic risk, and a weaker U.S. outlook the largest external risk.

Macroeconomic policies are set to remain accommodative in the near term. In particular, monetary tightening has paused following rate increases between June and September that brought the target for the overnight rate to 1 percent and the phasing out of most of the extraordinary liquidity facilities. More recently, the Bank of Canada put further hikes on hold.

On fiscal policy, the authorities tabled a return to budgetary balance over the medium term with an ambitious and growth-friendly plan, while remaining committed to deliver the last year of stimulus. The near-term adjustment remains substantially frontloaded despite the steps taken to smooth the near-term adjustment in September. These steps included a postponement of the normalization of Employment Insurance premia and the announcement of more flexibility with the 2011 Q1 deadlines for the completion of infrastructure projects under the Economic Action Plan.

Canada's financial system continues to display resilience, partly reflecting strong supervision and regulation. Financial soundness indicators are at strong levels. However, near-term risks have increased, including from stretched household balance sheets and U.S. exposures.

## Executive Board Assessment

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**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.



Canada: Selected Economic Indicators 1/  
(Annual change in percent, unless otherwise noted)

	2005	2006	2007	2008	2009	Proj. 2010	Proj. 2011
<b>Real GDP</b>	3.0	2.8	2.2	0.5	-2.5	3.0	2.3
Net exports 2/	-1.6	-1.4	-1.5	-1.9	0.2	-2.1	-0.7
Total domestic demand	5.0	4.4	3.9	2.5	-2.6	5.1	3.0
Final domestic demand	4.4	4.6	4.0	2.8	-1.8	3.9	2.7
Private consumption	3.7	4.2	4.6	2.9	0.4	3.3	2.5
Public consumption	1.4	3.0	2.7	3.9	3.5	3.1	1.5
Private fixed domestic investment	9.0	7.1	3.1	0.8	-16.0	5.1	5.9
Private investment rate (as a percent of GDP)	18.6	19.5	19.7	19.6	17.6	17.5	17.9
Public investment	11.4	6.8	6.5	5.6	15.0	11.5	-3.2
Change in inventories 2/	0.5	-0.2	-0.1	-0.2	-0.9	0.9	0.3
GDP (current prices)	6.4	5.6	5.5	4.6	-4.5	5.9	4.7
<b>Employment and inflation</b>							
Unemployment rate	6.8	6.3	6.0	6.2	8.3	8.1	7.9
Consumer price index	2.2	2.0	2.1	2.4	0.3	1.7	2.0
GDP deflator	3.3	2.7	3.2	4.1	-2.1	2.9	2.3
<b>Exchange rate (period average)</b>							
U.S. cents/Canadian dollar	0.83	0.88	0.93	0.94	0.87	...	...
Percent change	7.4	6.8	5.6	0.7	-6.7	..	...
Nominal effective exchange rate	8.3	5.9	1.2	-3.2	-3.4	...	...
Real effective exchange rate	7.7	5.3	0.5	-4.9	-3.8	...	...
<b>Indicators of financial policies (national accounts basis, as a percent of GDP)</b>							
Federal fiscal balance	0.1	0.8	1.0	0.2	-2.6	-2.8	-2.2
Provincial fiscal balance 3/	0.7	0.0	-0.4	-0.7	-3.7	-4.0	-3.1
General government fiscal balance	1.5	1.6	1.4	0.0	-5.5	-6.1	-4.6
Three-month treasury bill	2.7	4.0	4.2	2.4	0.4	0.6	1.4
Ten-year government bond yield	4.1	4.2	4.3	3.6	3.2	3.3	4.2
<b>Balance of payments</b>							
Current account balance (as a percent of GDP)	1.9	1.4	0.8	0.4	-2.8	-3.1	-3.5
Merchandise trade balance (as a percent of GDP)	4.5	3.4	3.1	2.9	-0.3	-0.5	-0.7
Export volume	2.0	0.8	1.3	-5.1	-15.3	7.4	3.2
Import volume	7.5	5.1	5.5	1.0	-15.2	14.0	5.7
Invisibles balance (as a percent of GDP)	-2.7	-2.0	-2.3	-2.5	-2.6	-2.6	-2.8
<b>Saving and investment (as a percent of GDP)</b>							
Gross national saving	24.0	24.4	24.1	23.6	18.1	18.9	19.3
General government	4.4	4.6	4.5	3.2	-1.5	-1.9	-0.6
Private	19.6	19.8	19.6	20.4	19.6	20.8	19.9
Personal	4.2	5.0	4.6	5.2	6.2	7.1	6.9
Business	15.4	14.9	14.5	15.1	13.1	13.7	13.0
Gross domestic investment	22.1	23.0	23.2	23.1	21.0	22.1	22.7

Sources: Statistics Canada; and Fund staff estimates.

1/ Data as available on November 18, 2010.

2/ Contribution to growth.

3/ Includes local governments and hospitals.