DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/99/314

CONTAINS CONFIDENTIAL
INFORMATION

December 29, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **Canada—Staff Report for the 2000 Article IV Consultation**

Attached for consideration by the Executive Directors is the staff report for the 2000 Article IV consultation with Canada, which will be brought to the agenda for discussion on a date to be announced.

Mr. Goldsbrough (ext. 34735), Mr. Dunaway (ext. 37343), and Mr. Leidy (ext. 38435), are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Pursuant to the authorities' decision to participate in the pilot project for the voluntary release of Article IV consultation staff reports and in accordance with Executive Board Decision No. 11973-(99/58), adopted June 3, 1999, the attached report shall be published after the Executive Board completes its discussion of the report.

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 Friday, January 7, 2000; and to the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL
INFORMATION

INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the 2000 Consultation with Canada

Approved by Claudio M. Loser and G. Russell Kincaid

December 28, 1999

Contents Page

Boxes

Appendices

I. Introduction[1]

1. The staff report for the previous Article IV consultation discussions was considered by the Executive Board on January 22, 1999 (EBM/99/9).[2] Executive Directors welcomed the continued improvement of the budget positions at all levels of government, which offered promising prospects for a significant fall in the ratio of government debt to GDP over the next several years. The Bank of Canada's inflation targeting approach to monetary policy continued to be successful, maintaining inflation at one of the lowest levels among the major industrial countries. Directors noted, however, the relatively high ratio of personal income taxes to GDP in Canada, and recommended that, in addition to using prospective fiscal surpluses for debt reduction, priority be given to reforming income taxation to improve incentives to work and save.

II. Economic Developments and Outlook

2. ***Macroeconomic policy measures implemented during the 1990s have established a sound foundation for the Canadian economy and underpinned the current economic expansion.*** The successful implementation of an inflation targeting framework since 1991 has held inflation at low levels. Sharp fiscal consolidation at all levels of government has arrested what had been a marked increase in the ratio of government debt to GDP, and put the debt ratio on a steady downward path. Structural reforms in key areas, including changes in the employment insurance system and improvements in the financing of the public old-age support system, also have enhanced the economy's growth prospects.

3. ***The Canadian economy has bounced back strongly from the effects of the Asian financial crisis and the turmoil in world financial markets in 1998. The sharp pickup in output growth over the year to the third quarter of 1999 has reflected a rebound in commodity prices, continued robust U.S. growth, and strengthening domestic demand, particularly investment spending.*** Output growth slowed significantly in late 1997 and in the first three quarters of 1998 owing to the fallout from the Asian crisis and a few major domestic work stoppages (Table 1 and Figure 1). Growth accelerated in the final quarter of 1998, with the recovery from the effects of the domestic labor strikes, and has risen at an

---

[1] The discussions were held November 8–15 and were concluded at a meeting on November 16 with Finance Minister Martin and Governor Thiessen. The staff team comprised D. Goldsbrough, S. Dunaway, M. Leidy, M. Cerisola, P. De Masi, and A. Matzen (all WHD). Mr. Fischer and Mr. Loser participated in the meeting with the Minister and the Governor. Mr. Ingves and Mr. Johnston (MAE) participated in a meeting to discuss the main conclusions of the Financial System Stability Assessment (FSSA) for Canada. The Executive Director for Canada, Mr. Bernes, and his Advisor, Mr. Fenton, attended the meetings.

[2] SM/98/280, 12/22/98, and the selected issues paper, SM/99/3, 1/8/99.

annual rate of 4 percent during the first three quarters of 1999, with growth rising to 4¾ percent (annual rate) in the third quarter.

4. ***After hovering around 9½ percent during 1994–97, the unemployment rate declined markedly to 8¼ percent in 1998, as employment growth at 2¾ percent was the best of the decade (Figure 2).*** The gains in employment were broadly based, especially in full-time private sector jobs and the self-employed. The strength in the labor market carried into early 1999, and the unemployment rate declined to 7.8 percent by January. Employment growth slowed markedly in the middle of the year, but has since strengthened considerably, pushing the unemployment rate down to 6.9 percent by November 1999.

Figure 1. Output and Demand
(Annualized growth in percentage points)

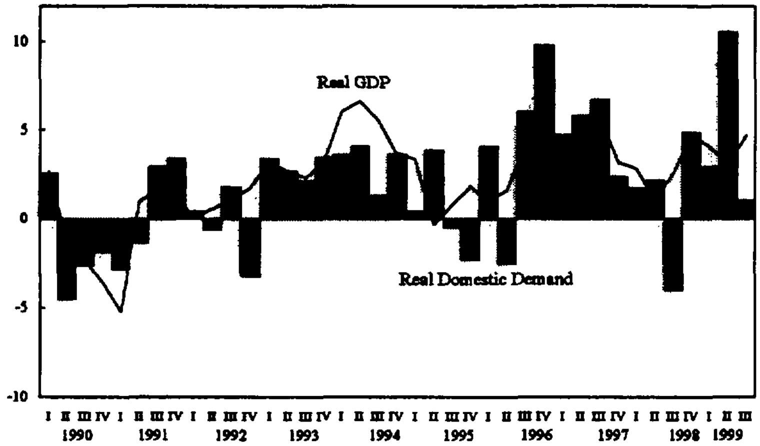


Figure 2. Unemployment
(In percent of labor force)

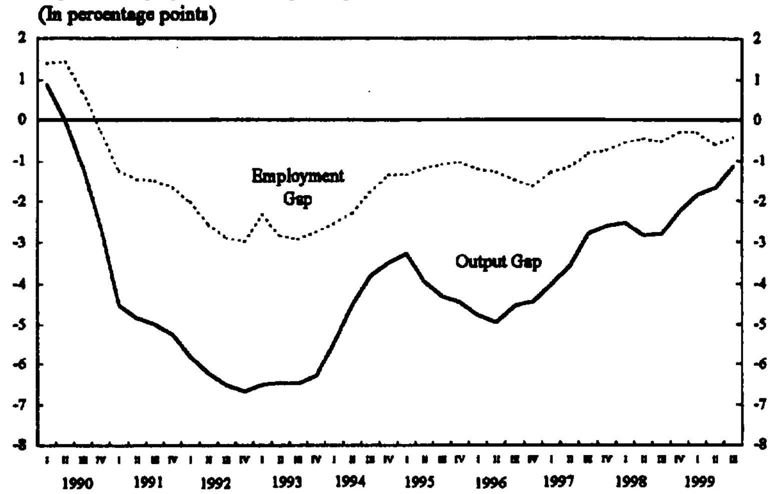
5. ***Overall, the strength of productivity growth in Canada has broadly matched that in the United States.*** During the 1990s, labor productivity has risen at an annual average rate of 1¼ percent, roughly in line with the growth experienced in the previous decade in Canada and with labor productivity growth in the United States. Multifactor productivity growth in the Canadian business sector appears to have outperformed that in the United States since the mid-1980s; although on a sectoral basis, productivity growth in manufacturing in Canada, particularly in the electrical and machinery industries, has lagged markedly behind that of the United States.[3]

---

[3] Statistics Canada has recently revised figures for multifactor productivity to incorporate revisions to the national accounts and the capital stock, which have increased the annual growth rate of multifactor productivity to roughly ¾ percent during the 1990s, compared with ½ percent during the 1980s. The forthcoming selected issues paper will examine the issue of productivity in Canada, including comparisons of Canada's performance to that in the United States.

6. ***Slack in the economy has declined significantly since the second half of 1998, but there is considerable uncertainty as to how close the economy is to full capacity*** (Figure 3). Staff estimates suggest that output in the third quarter of 1999 was about 1 percent below potential (Box 1). Based on alternative empirical methodologies, the staff estimates of the NAIRU range from 6½ percent to 8 percent.[4] A NAIRU of 6½ percent is roughly consistent, according to Okun's Law, with the staff's estimated output gap. It also would be consistent with expected effects of recent reforms in the Employment Insurance (EI) system and provincial social assistance programs which introduced important structural changes in the labor markets. In view of the gradual effects of these reforms, the staff estimates that the NAIRU will decline from around 8 percent in 1998 to 6½ percent over the medium term.

Figure 3. Employment and Output Gap
(In percentage points)



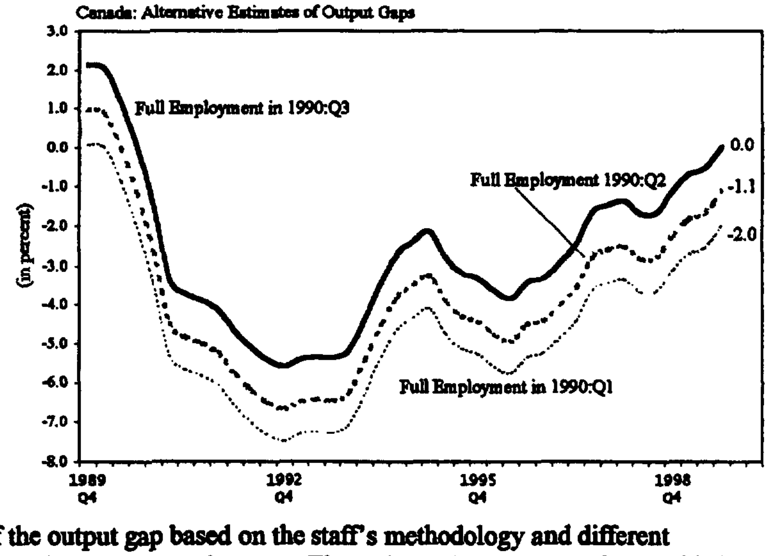
[4] See *Canada: Selected Issues,* (SM/99/3), Chapter 2 and *Canada: Selected Issues,* (SM/98/17), Chapter 1. An analysis of why structural unemployment in Canada has been higher than in the United States will be included in the forthcoming selected issues paper. Empirical evidence suggests that Canada's more generous Employment Insurance system contributed to a rise in structural unemployment in the 1980s. Recent EI reforms are expected to reduce structural unemployment over the medium term.

Box 1. The Output Gap, Potential Output, and Potential Growth

The output gap (actual minus potential output) traditionally has been an important indicator of aggregate resource utilization, foreshadowing the possible build-up of inflationary pressures. While the concept is straightforward, its empirical measurement is subject to considerable uncertainty. Although estimates of the rate of growth of potential output in Canada tend to fall in a relatively narrow range, estimates of the level of potential output differ more significantly.

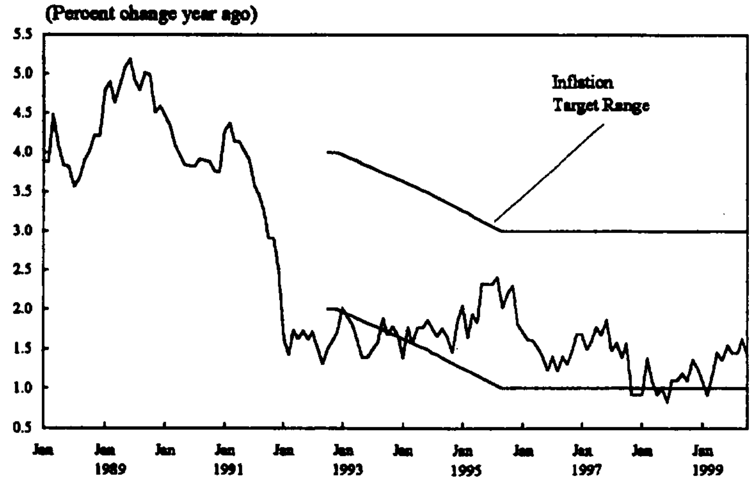
Using a variety of statistical detrending techniques and some structural approaches (such as those based on a production function), the staff estimates that potential growth in the 1990s has been about 2.4 percent, close to the Bank of Canada's estimate of about 2¼ percent. Both the staff and the Bank of Canada estimates suggest that potential growth has slowed significantly in the 1990s from the 3 percent average rate estimated for the 1980s. This slowdown is attributed to a sharp decline in the labor force participation rate at the start of the 1990s, which was accounted for by reduced labor force involvement by individuals in the 15–24 and 55–64 year age groups. The fall in the participation rate for the latter group is probably largely structural in nature, reflecting a longer-term trend toward early retirement. In the former group, it reflects both structural factors, as more individuals in this group have opted to pursue additional education and changes in eligibility requirements for employment insurance have discouraged entry, and cyclical factors, associated with less favorable job prospects for younger, less skilled workers. More recently, substantial investment in equipment embodying new technologies may have raised the rate of potential growth.

The staff's estimate of the level of potential output is extrapolated by identifying a period when the economy was judged to be near full employment and then applying the growth rate for potential in subsequent periods. Based on an assessment of cyclical peaks in Canadian economic activity, it appears that the economy was operating near potential in the first or second quarter of 1990. The Bank of Canada uses a structural model to estimate the rate of growth of potential and the level of potential output simultaneously. This model essentially uses estimates of NAIRU to help pin down the level of potential output and suggests that the economy was operating at full capacity in the third quarter of 1990. There is considerable uncertainty as to the exact point in time when the economy reached full capacity. The chart illustrates alternative estimates of the output gap based on the staff's methodology and different assumptions about when the economy was last at full employment. The estimated output gaps for the third quarter of 1999 range from -2 percent to zero.



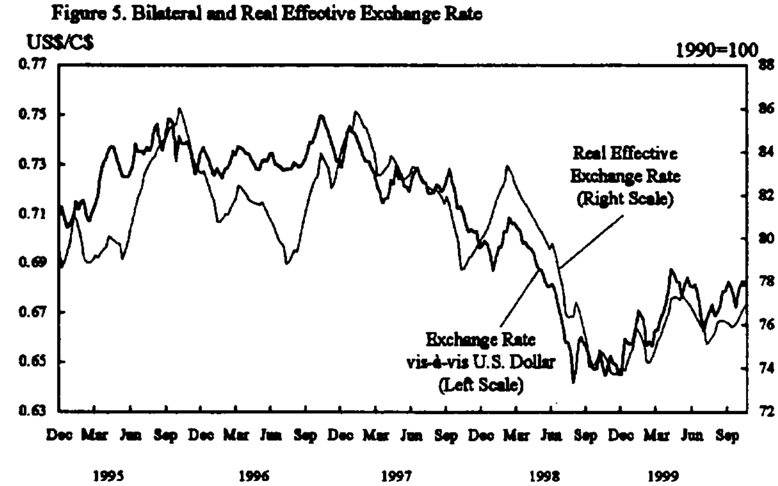
7. ***Core inflation[5] has fluctuated within a narrow range around the lower end of the 1–3 percent official target range since early 1997*** (Figure 4). Core inflation picked up in March–April 1999, and has fluctuated around 1½ percent (annual rate) through November. The overall CPI, however, has risen more rapidly, increasing at roughly a 2 percent annual rate during the first 11 months of 1999, largely reflecting movements in energy and food prices. Surveys indicate that inflation expectations are centered on 2 percent, the midpoint of the 1–3 percent official target range, suggesting a high degree of credibility underlying the authorities' inflation targets. The differential between the yields on ten-year fixed rate and inflation-indexed bonds has widened in recent months from about 150 basis points in mid-June to about 200 basis points in October–December. Although wage growth picked up somewhat during 1999, averaging about 2¼ percent through September, it remains consistent with significant gains in productivity and continuing low inflation.

Figure 4. Core CPI Inflation
(Percent change year ago)



8. ***Following the Bank of Canada's 100 basis point increase in short-term interest rates in August 1998 and reduced turmoil in world financial markets, the Canadian dollar began to recover from its sharp depreciation in the first part of the year (Figure 5).*** Subsequently, the Bank followed the U.S. Federal Reserve and reduced interest rates in September–November 1998 by a cumulative 75 basis points. The recovery in commodity prices during 1999 has further strengthened market confidence in the Canadian dollar, which recovered from its all-time low of less than

Figure 5. Bilateral and Real Effective Exchange Rate



[5] The CPI excluding food, energy, and the effects of changes in indirect taxes.

63 U.S. cents in early August 1998 and traded in late December 1999 at around 68½ U.S. cents. The Canadian dollar has appreciated in real effective terms by about 4¼ percent in 1999 through November.[6]

9. ***After reducing interest rates by 25 basis points in both March and May 1999 in order to support continued economic expansion and maintain inflation comfortably within the target range, the Bank of Canada held rates unchanged as U.S. interest rates were increased in June and August by a cumulative 50 basis points.*** The decision not to follow the Federal Reserve's rate hikes at that time reflected the Bank's assessment that monetary conditions in Canada were consistent with the inflation target (Figure 6). Subsequently, the Bank of Canada raised rates by 25 basis points in November, matching an increase by the Federal Reserve. The differential between Canadian and U.S. interest rates has generally fallen since the last quarter of 1998, turning negative in May 1999 at both the short and long end of the term structure (Figure 7), and spreads remained negative in late December.

Figure 6. Monetary Conditions Index
(1987=0)

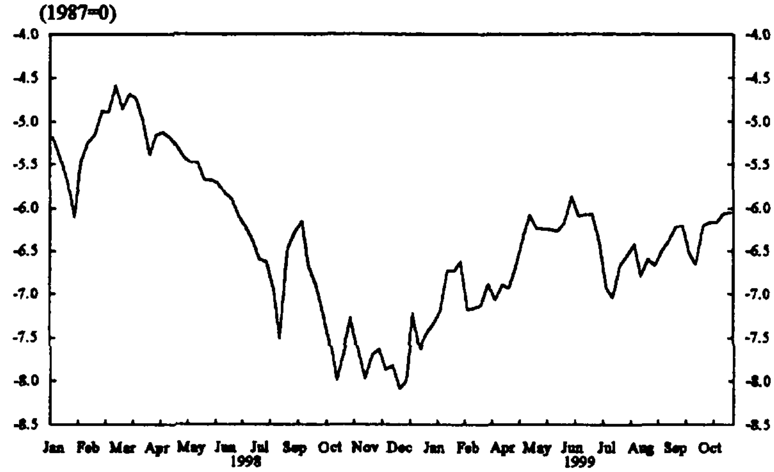
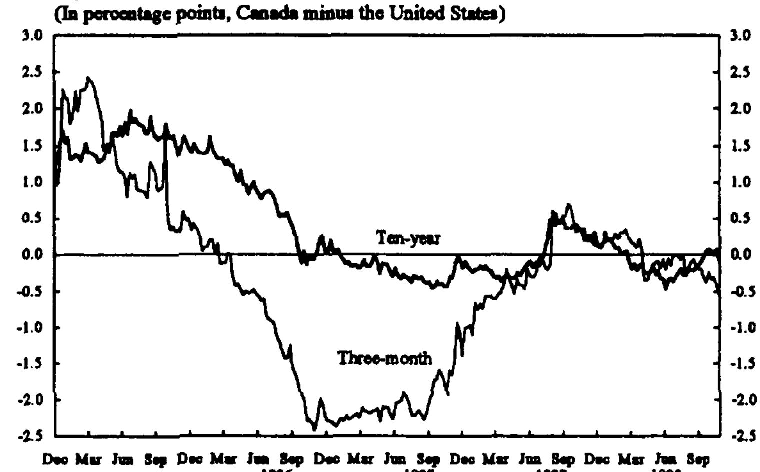


Figure 7. Interest Rate Differentials
(In percentage points, Canada minus the United States)



10. ***The current account deficit narrowed from 1¾ percent of GDP in 1998 to ½ percent in the first three quarters of 1999*** (Table 2). Export growth rebounded sharply, owing to buoyant growth in U.S.

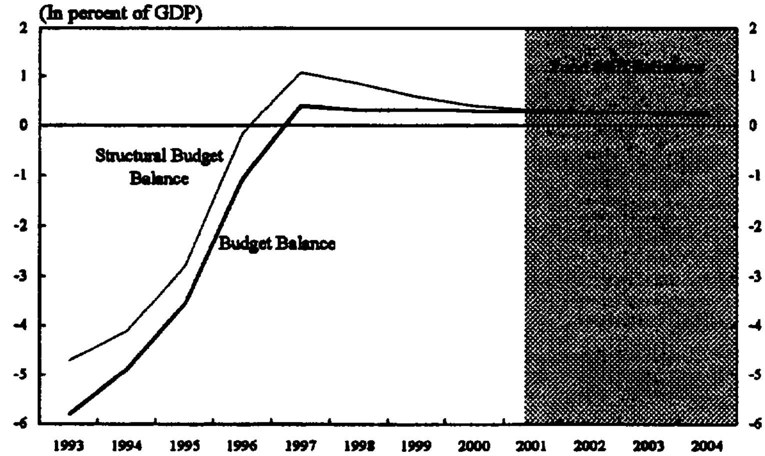
---

[6] Reflecting the high degree of integration with the U.S. economy, the U.S. dollar has a weight of 82½ percent in the IMF's real effective exchange rate calculation (based on unit labor costs) for Canada.

markets and to the recovery in commodity prices. At the same time, growth in the value of imports slowed from its relatively rapid pace in 1998, despite the pickup in domestic demand, as the strengthening Canadian dollar helped to hold down import prices (J-curve effect).

11. ***Over the past six years, decisive efforts by the Government have produced a dramatic turnaround in the federal fiscal position, which shifted from a deficit of around 5¾ percent of GDP in 1993/94 to a surplus of ¼ percent in 1998/99*** (Table 3 and Figure 8).[7] Over this period, the estimated structural balance shifted from a deficit of 4¾ percent of GDP to a surplus of about 1 percent. The improvement in the federal fiscal position has largely reflected cuts in program spending and reductions in transfers to the provinces. In the 1998 Budget, the Government introduced some measures with a relatively low fiscal cost to address its priorities in the areas of health care, education, and tax relief, and the February 1999 Budget introduced some additional measures in these areas.[8]

Figure 8. Federal Fiscal Policy Indicators
(In percent of GDP)



12. ***Fiscal consolidation has also occurred at the provincial level, helping to improve the general government balance from a deficit of more than 5 ½ percent of GDP in 1994 to a surplus of about 1 percent of GDP in 1998 (national accounts basis).***[9] Largely as a result of restraint in public consumption and controls on capital spending, the aggregate budgetary

---

[7] Fiscal years end March 31.

[8] Tax relief measures in the February 1999 Budget include a further rise in the tax-free income threshold for low-income Canadians, the elimination of the 3 percent surtax on individuals with income exceeding $50,000, and a modest increase in the National Child Tax Benefit for low- and middle-income families. Spending initiatives extend measures in the 1998 Budget, including increased transfers to the provinces through the Canada Health and Social Transfer (CHST), increased equalization payments to lower-income provinces, and outlays to support and strengthen research and development.

[9] The general government includes the federal government, the provincial governments (including the territories), hospitals, local governments, and the Canada and the Quebec Pension Plans (CPP and QPP, respectively).

balance of the provinces moved into a small surplus in 1997. However, it slipped back into a small deficit in 1998, as the Asian crisis and lower commodity prices reduced revenues in some provinces (notably Alberta and British Columbia) and other provinces used a portion of their "fiscal dividends" to cut income taxes. The rising budget deficit in British Columbia and a sharp decline in Alberta's budget surplus were, however, nearly offset by a rapid decline in Ontario's deficit and by the first balanced budget in Quebec in 40 years. Although the ratio of general government net debt to GDP has declined from a peak of 70 percent of GDP in 1995 to 62 percent in 1998 (Table 4 and Figure 9), it remains above the G-7 average (Table 5).

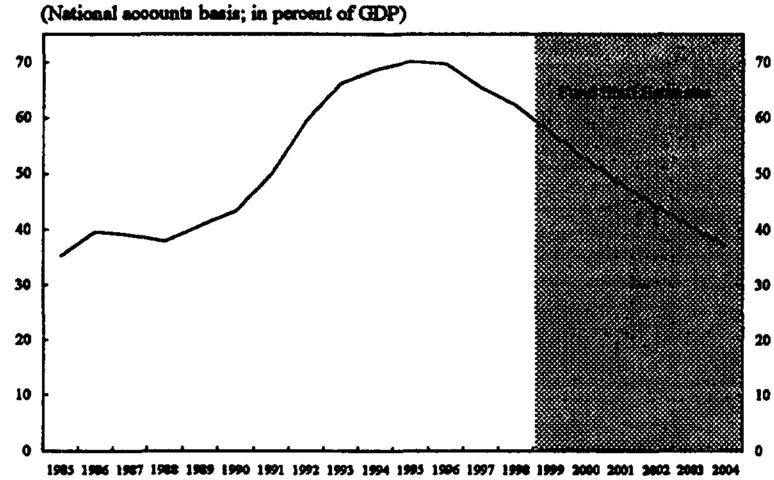


Figure 9. General Government Net Debt
(National accounts basis; in percent of GDP)

13. ***The sharp improvement in government finances has helped to increase national saving as a share of GDP despite a decline in personal saving.*** After rising by almost 5 percentage points between 1993 and 1997, gross national saving declined in relation to GDP by ¾ percentage point to 17¾ percent of GDP in 1998 amid lower corporate profits and a further decline in personal saving. The personal saving rate has declined steadily to 2¼ percent of disposable income in 1998, primarily reflecting the effects of lower inflation, fiscal consolidation, and rising household net worth, owing in part to the rise in Canadian stock prices in recent years.[10] At the same time, gross investment has rebounded sharply since 1993 in nominal and real terms. In 1998, gross investment stood at about 20 percent of GDP in real terms, slightly below its 1997 level, but well above its historical average.

14. ***The broad indicators underlying household and corporate balance sheets do not appear to suggest any major vulnerabilities, although these aggregates could mask weaknesses in particular sectors that would only become apparent in the event of a sharp downturn.*** Household net worth has risen from 400 percent of disposable income to almost 500 percent over the period 1990–98, while liabilities have increased by less than 25 percent

---

[10] Recent empirical work suggests that about 40 percent of the decline in the trend private saving rate since 1990 is explained by fiscal consolidation, 30 percent by lower inflationary expectations, and about 20 percent by rising household net worth. See Gilles Bérubé and Denise Côté (forthcoming), "Long-Term Determinants of the Personal Savings Rate: Literature Review and Some Empirical Results for Canada," Bank of Canada Working Paper.

of disposable income (94 percent to 114 percent) over this period (Figure 10). Although the personal debt-service ratio edged up in 1998 to about 9 percent of personal disposable income, it remains well below its peak in the early 1990s (almost 13 percent) and below the average of the last two decades. At the same time, the debt of nonfinancial corporations as a percent of corporate net worth has remained relatively stable (around 170 percent) since 1992 and the ratio of nonfinancial corporate debt to GDP has declined from 65 percent to 61 percent (Figure 11).

Figure 10. Household Net Worth
(As percent of disposable income)

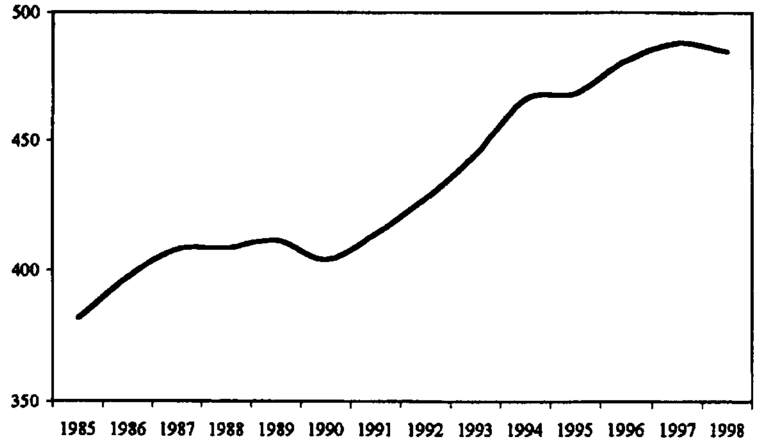
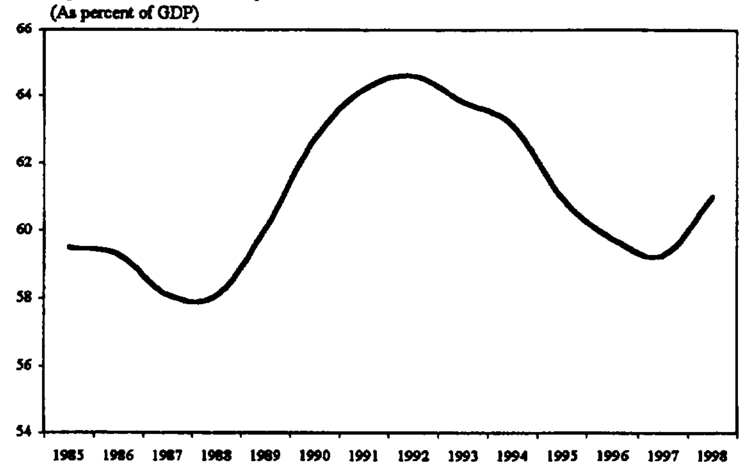


Figure 11. Nonfinancial Corporate Debt
(As percent of GDP)



15. ***The staff projects that real GDP growth will slow in the period ahead, in line with an anticipated deceleration in demand growth in the United States to a more sustainable level.*** Macroeconomic developments in the United States are central to the near-term outlook for economic activity in Canada in view of the high degree of economic integration between the two economies (Box 2). Canada's real GDP growth is expected to decline from 3¾ percent in 1999 to around 3¼ percent in 2000 (slightly above the consensus forecast). Output growth is projected to slow further to around its potential rate by 2002 as the output gap is eliminated (Table 6). Domestic demand growth in Canada would ease somewhat over most of the forecast horizon, as consumer spending would slow reflecting more moderate growth in household net worth and higher interest rates, while the pace of fixed investment spending also would decline, owing to an end to Y2K-related spending, higher interest rates, and slower consumption and export growth. The external current account is expected to improve steadily from a deficit of ½ percent of GDP in 1999 to a surplus of ¾ percent by 2004, primarily reflecting improved macroeconomic conditions in Europe and Asia, sustained but decelerating growth in the

Box 2. Canada-U.S. Economic Integration: An International Comparison

The ongoing discussion of monetary arrangements in various parts of the world, including the move toward a common currency in Europe, has rekindled interest in the issue of economic integration within groups of countries. In this context, this box summarizes the situation of Canada vis-à-vis the United States in comparison with integration among European Union countries. In general, the degree of integration between Canada and the United States is much higher than in Europe. However, there appears to have been a greater asymmetry in the nature of shocks experienced by Canada and the United States than is the case within Europe. This latter factor, together with the political commitment in Europe to move toward a full common market, probably explains the different choice of exchange rate regimes.

The Canadian economy is very open by international standards. In 1998, the degree of openness (measured by the ratio of external trade in goods and services to GDP) in Canada was 81 percent, somewhat higher than in the European Union and easily the highest among the G-7 economies (see figure).

A principal measure of integration between groups of countries is the extent of intra-regional trade. According to this measure, the integration of Canada with the United States is greater than integration among most countries in Europe. In Canada, the share of U.S. trade in total trade (85 percent) and in GDP (61 percent) are much larger than the corresponding shares in European countries (except for a few of the smaller economies; see table below).

An additional dimension of integration is the degree of labor mobility. Labor mobility between Canada and the United States, while small as a share of the total labor force, has increased in recent years, especially among skilled workers.1/ As a share of the labor force, gross annual Canada-U.S. migration is roughly the same as intra-EU migration. This is, however, in the context of smaller wage differentials than among European countries.

Canada's capital account is closely integrated with the United States. In 1998, the United States contributed 86 percent of the direct investment inflows into Canada and took in 77 percent of Canadian direct investment abroad. Its shares in Canadian portfolio inflows and outflows were 85 percent and 97 percent, respectively. While the numbers may partly reflect third countries' investments in Canada through the United States, they are significantly higher than among EU countries, where in recent years intra-European direct investment and equity capital flows have accounted for 50–55 percent and 50 percent of total flows, respectively.

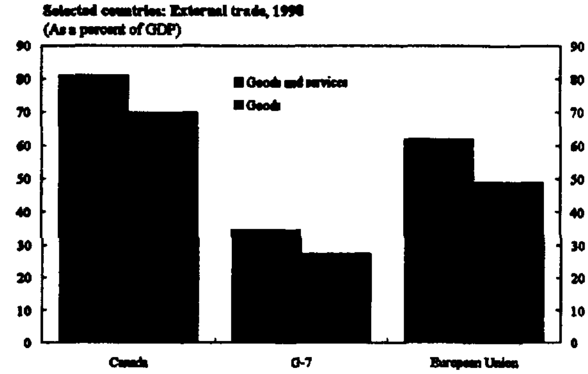
The high degree of integration between the Canadian and U.S. economies has contributed to a close correlation of macroeconomic trends. Real GDP growth and inflation in Canada have been very closely correlated with growth and inflation in the United States.2/ The correlation between Canadian and U.S. real GDP growth has been higher than among most European economies, and roughly the same as among the most closely related European economies (Austria, Belgium, France, Germany, and the Netherlands). The correlation between Canadian and U.S. inflation has historically been higher than among European economies.

However, the nature of shocks to the Canadian and U.S. economies during the past few decades has been much more dissimilar than among European countries.3/ In particular, unlike among several European economies, there does not seem to be any significant positive correlation between supply shocks in Canada and the United States. The same holds for demand shocks, although supply shocks are more informative about underlying regional patterns than demand shocks, which include the impact of monetary and fiscal policies.

External trade within regions, 1998
(in percent)

	Regional Trade/Total Trade	Regional Trade/GDP
Europe (selected countries)	With other EU countries	
Belgium-Luxembourg	52	71
France	62	25
Germany	55	26
Ireland	62	79
Italy	62	23
Netherlands	63	52
United Kingdom	51	21
EU weighted average	59	29
	With United States	
Canada	85	61

Based on aggregate merchandise trade (exports plus imports).



1/ See Stephen Tokarick, 1999, "Brain Drain From Canada to the United States," in International Monetary Fund, "Canada—Selected Issues," SM/99/3, issued January 8, 1999.
2/ See Tamim Bayoumi and Barry Eichengreen, 1994, "One Money or Many? Analyzing the Prospects for Monetary Unification in Various Parts of the World," Princeton Essays in International Finance, No.76.
3/ See Bayoumi and Eichengreen (op cit). Vivek Arora, 1999, "Exchange Rate Arrangements in Selected Western Hemisphere Countries," mimeo., International Monetary Fund, provides more recent estimates for Canada and the United States.

United States, and a continued recovery in commodity prices.[11] This shift in the external position would primarily reflect a steady rise over the forecast period in the merchandise trade surplus and some reduction in net investment income payments, owing to a decline in external debt and generally lower rates of interest paid on it. Inflation is projected to rise gradually to the midpoint of the official target range as the output gap is eliminated.

16. ***Risks to the outlook for the Canadian economy center on whether activity will settle down smoothly to a more sustainable pace of growth.*** While many of the risks to the forecast stem from the external environment, there are also uncertainties associated with domestic economic developments. With the announcement of a multiyear personal income tax cut in the 2000 budget, consumption spending may not slow as much as envisaged. If the pace of consumption does not ease, the recent buoyant growth in investment spending might also not slow as expected. Moreover, it is difficult to determine the extent to which temporary factors, such as spending to address potential Y2K problems, have boosted investment. The net result could be that domestic demand growth would be significantly faster than expected, posing some important challenges, particularly for monetary policy.

17. ***Prospective risks revolving around possible unanticipated developments in the external environment—especially in the United States—are particularly important (Box 3).*** The continued buoyancy of the U.S. economy, prospects for stronger growth in Europe and Japan, and the recent strengthening of commodity prices have significantly improved the external environment from a year ago. However, a good deal of uncertainty surrounds the outlook for the United States. Continued rapid U.S. growth would provide further stimulus to net exports and domestic demand in Canada. But such an outcome might also trigger a substantial tightening of U.S. monetary policy that could ultimately lead to a sharp deceleration in U.S. economic activity. While near-term prospects would be for stronger-than-projected Canadian growth, the economy's medium-term outlook could worsen significantly. This would be especially likely if economic activity outside North America were also to be weaker than expected, which, in combination with a sharp slowdown in the U.S. economy, could reverse the recent upturn in world commodity prices. Moreover, a slowdown in economic activity in the United States might also feed back to the Canadian economy through the financial sector, as the exposure of Canada's financial sector to the United States has increased in recent years.

---

[11] This forecast is based on the standard assumption in the World Economic Outlook (WEO) exercise of a constant real effective exchange rate.

Box 3: Key Implications of the World Economic Outlook for Canada's Bilateral Surveillance

In the view of the staff, the main risks to Canada's prospective economic performance stemming from the global economic outlook revolve around potential developments in the United States.

• ***The impact and policy response in Canada to a significant further increase in U.S. interest rates***: The United States and Canada differ somewhat in their cyclical positions, with the United States estimated to be operating close to capacity and Canada probably still experiencing some slack, although of an uncertain amount. Continued rapid growth in domestic demand in the United States raises the potential risk that inflationary pressures in the United States could build more rapidly than anticipated so that the Federal Reserve would eventually have to move aggressively to tighten monetary policy, thereby slowing U.S. growth sharply. The possibility of such a "boom-bust" scenario in the United States suggests that Canada could be faced initially with inflationary pressures stemming from the United States followed by sharply rising U.S. interest rates and a steep decline in U.S. demand. Depending on how events in the United States were to unfold over time, this could present challenges for monetary policy in Canada. Although movements in the Canadian dollar would help to cushion the economy from such adverse shocks, the required shift in the composition of aggregate demand is not likely to be seamless and thus would present downside risks to economic activity in Canada.

• ***The real-side consequences of a sharp economic slowdown in the United States***: During this decade, the Canadian economy has become increasingly integrated with the rest of the world, and particularly with the United States. Staff estimates suggest that, other things being equal, a slowdown in the rate of U.S. real GDP growth would produce a roughly equivalent deceleration in economic activity in Canada, reflecting the direct effects that such a slowdown would have on net exports and indirect effects on consumption and investment. While continued growth in the rest of the world could help to partially offset the adverse effects in Canada, any mitigating effects would be limited owing to the high degree of economic integration between Canada and the United States.

• ***The financial consequences of a sharp equity price correction and economic slowdown in the United States***: Canadian banks have become more integrated with the nonfinancial corporate and financial sectors in the United States. Canada's chartered banks have increased their on-balance sheet exposure to the United States, especially in 1998 when U.S. assets rose 3 percentage points to over 17 percent of total assets, while their off-balance sheet exposure with U.S. financial institutions also appears to have increased. At the same time, the distinctions in products across financial institutions in Canada (chartered banks, insurance, and brokerage) have been blurred by mergers and acquisitions and the introduction of new products. There is also the possibility that a sharp correction in the U.S. stock market would carry over to Canadian equity markets.

III. Policy Discussions

18. There was general agreement between the authorities and the staff on the course of macroeconomic policies in the period ahead. On structural issues, the staff pushed for further reforms in key areas, such as the employment insurance system and accelerating the pace of trade liberalization in agriculture and textiles and clothing. The discussions centered on the following issues, which are key to charting a sound macroeconomic policy course:

- ***with few signs of inflationary pressures, monetary policy should aim to permit the economy to reach its productive potential, but the challenge will be to gauge the point at which policy will need to shift toward tightening;***
- ***the appropriate mix of debt reduction, tax cuts, and higher spending on priority areas in light of prospective fiscal surpluses.***

A. Monetary Policy and the Exchange Rate

19. ***The Bank of Canada targets inflation with the aim of influencing the rate over the succeeding six to eight quarters.*** Its assessment of future inflation generally has relied on an evaluation of current and projected output gaps, unit labor costs, inflation expectations, changes in indirect taxes, and the current and expected future exchange rate. A broad range of other economic and financial indicators, including monetary and credit aggregates and the outcome of collective wage settlements, is also considered.

20. ***The authorities and the staff agreed that there was considerable uncertainty over how much slack remained in the Canadian economy, as estimates of the output and employment gaps ranged widely.*** Because of this, the Bank of Canada representatives considered that these indicators were not very useful as guides to formulating policy. The staff and the authorities agreed that substantial investment in machinery and equipment in recent years, which embodies new technologies, probably had raised the level of capacity. The Bank representatives indicated that their point estimates of the output gap for the third quarter of 1999 were close to zero, or slightly positive, but a very wide confidence interval surrounded these estimates. Although the staff's point estimate (a negative gap of a little over 1 percent) shows a somewhat higher degree of slack in the economy, it falls within the Bank's confidence interval. In the labor market, substantial reforms to the employment insurance system were seen as having improved flexibility and contributed to reducing the NAIRU. The authorities suggested that, once the effects of these reforms were fully realized, the NAIRU might decline from its current estimate of around 8 percent to as low as 6 percent. Based on the discussions and its own alternative estimates (discussed in paragraph 6), the staff has revised its estimate of the NAIRU to decline to 6½ percent by end-2002.

21. ***Given the uncertainties regarding estimates of capacity, the authorities took the view, and the staff concurred, that the near-term aim of monetary policy should be to allow the economy to seek its productive potential without compromising the official target for inflation.*** The key challenge for monetary policy was to gauge the point at which monetary conditions would have to be tightened as slack in the economy appeared to diminish and indications of inflationary pressures began to emerge. To aid in reaching this decision, the Bank of Canada officials indicated that they would place more emphasis on a broader range of inflation indicators in their effort to carefully monitor the degree of underlying inflationary pressures. These indicators included movements in core and trend inflation; data on wage settlements and surveys of expected compensation increases; indirect evidence of rising

inflation expectations from certain asset data (such as the yield differential between conventional and real return government bonds, and real estate prices); and the monetary and credit aggregates. In using the information provided by these indicators to set monetary policy, Bank officials noted that there was no fixed formula, and that this information had to be carefully interpreted.

22. ***Given the high degree of openness of the Canadian economy, current and prospective movements in the exchange rate play an important role in the Bank of Canada's assessment of monetary conditions.*** In this context, the officials from the Bank noted that the monetary conditions index (MCI) remained an important tool in assessing the near-term stance of monetary policy, but that the index had been de-emphasized somewhat in the Bank's more recent monetary policy reports.[12] The decision to de-emphasize the MCI was largely a result of a tendency of financial market participants to misinterpret movements in the index and to respond at times as if there were a fixed target path for the index.

23. ***The authorities noted that their past successes in maintaining inflation within the target range had improved the credibility of monetary policy, solidly anchoring inflation expectations.*** Survey data consistently showed that inflation expectations had remained at about 2 percent, the midpoint of the official target range. Policy credibility had also benefited from the improvements in the medium-term fiscal outlook and the commitment to further public debt reduction, highlighting the need for continued sound fiscal policy. The staff suggested that enhanced credibility would likely provide the Bank with some additional room to maneuver in testing the economy's productive limits. The representatives and the staff agreed, however, that there were inevitably questions about how much maneuvering room existed in view of the uncertainty over the extent of slack in the economy and the fact that inflation already was near the midpoint of the target range.

24. ***The authorities said that the rapid pace of output growth over the first three quarters of 1999 suggested that some additional caution might be warranted in the conduct of monetary policy.*** In testing the limits of capacity, they believed that it would be prudent to ensure that these limits were not approached at a very rapid pace of economic growth. This would help ensure that, once it became evident that capacity had been reached, tighter monetary conditions would have a chance to slow demand growth before inflationary pressures could take hold—a position that the staff strongly supported. In their forecasts, the authorities expected that the economy would continue to expand, but at a slower rate than at present, and that inflation would be contained around the midpoint of the target range. The recovery in commodity prices since early 1999, the depreciation of the Canadian dollar in

---

[12] The MCI is a weighted sum of changes in the short-term interest rate (typically the 90-day commercial paper rate) and the effective exchange rate, with weights of 3 to 1, respectively. These weights are based on the Bank of Canada's empirical work that suggests a 1 percentage point change in interest rates affects aggregate demand over time by about the same amount as a 3 percent change in the exchange rate.

1998, and the large gains in employment throughout 1998 and 1999 were seen as imparting considerable momentum to domestic demand in Canada, which was expected to carry forward. The authorities projected that GDP growth in 2000 would be in the range of 2¾–3¾ percent, and that it would slow gradually toward the authorities' estimate of potential growth (around 2¼–2½ percent) over the medium term. The stimulus from net exports was envisaged to wane in the period ahead (as it was assumed that the Canadian dollar would appreciate)[13] and a reduction in Y2K-related investment spending would hold down domestic demand in the period immediately ahead. However, the likely announcement of a multiyear cut in taxes would sustain consumer spending, and private consumption was seen as the most important source of growth going forward.

25. ***The authorities emphasized that their forecasts largely hinged on the expectation of a gradual slowdown in U.S. growth to a more sustainable pace.*** Continued rapid growth could pose considerable risks of overheating in the United States and would likely prompt the U.S. Federal Reserve to raise interest rates further. A more difficult scenario for Canadian monetary policy would emerge if U.S. monetary policy action were delayed, and there was an actual outbreak of inflation in the United States and a subsequent sharp tightening of monetary policy. Although the authorities thought that this kind of "boom-bust" scenario was unlikely given the past success of the U.S. monetary authorities, they were prepared for all contingencies.

26. ***In judging how Canadian monetary policy should respond to U.S. developments, the authorities took the view, and the staff agreed, that the key consideration would be the extent to which continued rapid U.S. growth could add to already strong demand growth in Canada and contribute to a spillover of inflationary pressures.*** If the Federal Reserve raised interest rates, the Bank of Canada had no automatic rule on how it should respond. A U.S. rate increase would be viewed in terms of its implications for the Canadian economy and financial markets, and thus for price pressures in Canada. If developments in the United States were judged to have a significant effect on Canada, potentially jeopardizing achievement of the target for inflation, the Bank would not hesitate to act. This was reflected in its decision subsequent to the mission to raise interest rates, matching the U.S. increase in mid-November.

27. ***In the event of a sharp downward correction in the U.S. stock market, the authorities considered that this would initially dampen aggregate demand in Canada through its effect on net exports and through its likely effect on Canadian equity markets.*** Canadian equities, however, appeared less exposed to a sharp correction since, after having experienced a more pronounced downturn in 1998, they had not appreciated as strongly as U.S. equities. The authorities also noted that the success of Canadian monetary and fiscal policies provided scope for a timely countercyclical policy response should that be

---

[13] Based on the May 1999 WEO projections, the latest CGER estimates suggest that the Canadian dollar would appreciate in real effective terms by 8 percent over the medium term.

warranted. Despite the increased exposure of Canadian banks to nonfinancial corporate and financial firms in the United States, the authorities did not envisage that a U.S. stock market correction would have major consequences for the Canadian banking system, although profitability would obviously suffer in the event of a generalized economic downturn.[14] In this regard, the staff noted that the Financial System Stability Assessment (FSSA) had highlighted the rapid growth of life insurance companies' segregated funds and the potential liabilities associated with the explicit capital guarantees embedded in many of these funds, which could pose difficulties should stocks fall sharply and subsequently fail to recover their pre-shock levels for a number of years.[15]

28. ***Bank of Canada officials considered that the credibility of monetary policy had diminished the prospects for a loss of confidence in the Canadian dollar.*** They noted that, in past years—and most recently in 1998—developments in the foreign exchange market had on occasion acted as a constraint on monetary policy actions. On these occasions, a loss of confidence in the currency could contribute to undesired upward pressures on long-term interest rates, which, in turn, required tactical monetary policy actions aimed at restoring confidence. This complicating factor in the conduct of monetary policy had largely receded, and the Bank felt that it could now focus its monetary policy actions more on the underlying economic fundamentals in Canada, although they were prepared to respond should such pressures arise again. Moreover, in the event that a boom-bust scenario played out in the United States, the exchange rate was seen by the authorities as potentially cushioning the real-side impact on Canada, as the Canadian dollar would tend to depreciate vis-à-vis the U.S. dollar in the near term in response to falling demand for Canadian exports and higher U.S. interest rates. As a result of the credibility of the inflation target, if U.S. inflation were to rise above that in Canada, the Canadian dollar would be likely to appreciate over the medium term, insulating Canada from price pressures in the United States.

29. ***The authorities noted that they had not intervened in the foreign exchange market since Canada's policy on intervention was revised in September 1998.*** At that time, it was decided that the practice of intervening frequently in a symmetrical fashion to ensure that there was sufficient liquidity in the market would be discontinued. Instead, intervention would be restricted to those rare instances when it was judged that the exchange rate had significantly overshot its fundamental equilibrium value and a substantial government presence in the market could significantly influence market perceptions about the currency's

---

[14] Stress and scenario tests also suggest that interest rate and exchange rate changes could have significant effects on the average operating incomes of some of the large banks, but would not be significant in terms of their capital. These issues are discussed in the forthcoming report on Canada's Financial System Stability Assessment.

[15] This issue is discussed in more detail in the forthcoming paper on Canada's Financial System Stability Assessment.

underlying value. The authorities indicated that in such cases intervention would be announced and all transactions would be fully transparent.

B. Fiscal Policy

30. ***The federal government's fiscal position remains very sound.*** In the recent Economic and Fiscal Update, the Government presented five-year budget projections derived as the average of forecasts prepared by four major private forecasting firms. After allowing for a $3 billion contingency reserve and an explicit economic prudence factor to offset the effects of potentially less favorable economic conditions, the budget surplus is estimated to rise from $5.5 billion (0.6 percent of GDP) in 2000/01 to $23 billion (2 percent of GDP) in 2004/05 (Table 7). These so-called "planning surpluses" effectively established the parameters for the public debate on feasible fiscal policy options, but the Government's yearly Budget presentation would continue to frame new measures based on the fiscal and economic outlook over the next two years. The staff's fiscal outlook, assuming current tax and spending policies, is broadly in line with that contained in the Update, with differences reflecting the staff's somewhat higher assumptions for GDP growth and interest rates. In the discussions, the staff noted that the five-year projections illustrated that available surpluses were limited; moreover, a significant part of these projected surpluses stemmed from an automatic rise in the real burden of personal income taxes owing to the lack of full indexation to inflation.[16] Therefore, difficult choices would have to be made among the many competing uses for the prospective surpluses. The staff argued that debt reduction and income tax reform were likely to produce the most significant long-term benefits for the economy and should be the top priorities.

31. ***The authorities reiterated their intention to target a balanced budget (including the contingency reserve and the allowance for economic prudence) on an ex ante basis and to use any unspent portion of the contingency reserve to pay down debt.*** In the absence of significant adverse economic shocks, the Government's approach would tend to produce annual ex post budget surpluses equal to the $3 billion contingency reserve (about ¼ percent of GDP). The staff suggested that a somewhat faster pace of debt reduction would be prudent, especially given the opportunity afforded by the present relatively favorable economic conditions. For example, the extra margin for economic prudence incorporated in the projections, as well as any additional unanticipated favorable budget outcomes, could be used, along with the unspent contingency reserve, to accelerate the pace of debt reduction. The staff acknowledged that there might not be a great deal of difference between the ratio of

---

[16] For example, assuming a 1½ percent rate of inflation, full indexation of the personal income tax system would lower the projected fiscal surplus in 2004/05 by almost ½ percent of GDP.

debt to GDP under the authorities' and the staff's proposed approaches,[17] and recognized that the economic literature provided limited guidance on what would be an optimal path for public debt. However, the staff's approach afforded the opportunity to reduce the debt ratio more quickly, especially if unanticipated favorable budget developments, like those that have occurred over the past three fiscal years, were used to reduce the debt instead of funding one-off measures. Bringing down public debt more quickly to levels comparable to most other major industrial countries would further reinforce the credibility of the Government's macroeconomic strategy. Moreover, in view of the current strength of aggregate demand, using larger surpluses in the near term for debt reduction would also reduce the burden on monetary policy. The authorities agreed that more rapid debt reduction might be desirable, but indicated that they were likely to continue with their current budget approach. There was an ongoing debate within the Government over the ex post use of the contingency reserve for debt reduction, but the authorities indicated that they had been successful in retaining this approach largely because of the importance attached by financial markets to the Government's objective of bringing down the debt-to-GDP ratio.

32. ***With respect to taxes, reducing the high burden of personal and corporate income taxes was seen by both the authorities and the staff as providing substantial gains in economic efficiency.***[18] The authorities were committed to presenting a multiyear tax reform package in the next budget, and they were grappling with how to structure this reform, given the constraints outlined by the five-year planning surpluses and a desire to provide some scope for new spending. In any event, measures would be implemented in the context of the Government's rolling two-year budget horizon, with later steps being adopted only if projected fiscal resources continued to be available. At the same time, the authorities stressed that tax reform actions taken at the federal level would have to be coordinated with the provinces to ensure that the provinces did not offset the intended effects of these reforms.

33. ***With respect to personal income taxes, there was agreement between the authorities and the staff that reductions should be focused primarily on middle-income taxpayers, who as a group faced very high effective marginal rates.***[19] Of the available options discussed

---

[17] If economic developments were to unfold as envisaged, the allowance for economic prudence, along with the contingency reserve, could be used to pay down debt. On this basis, the debt-to-GDP ratio would be 46 percent in 2004/05, compared with 47½ percent in the authorities' estimates.

[18] The forthcoming selected issues paper will provide a review of personal and corporate income tax reform options and their prospective fiscal costs.

[19] The Federal income tax structure has three rates of 17, 26, and 29 percent. Provincial income taxes vary, but the top combined average provincial and federal marginal tax rates peak at 50 percent for incomes of Can$60,000 or more, with comparable U.S. federal and state marginal rates rising gradually from 32 percent at Can$60,000 to 45 percent for incomes over Can$420,000. Moreover, the effective marginal tax rates facing middle-income

(continued...)

with the authorities, the staff favored steps to fully index the tax system to inflation; increase income thresholds at which progressive marginal tax rates apply; lower the 26 percent statutory marginal tax rate; and reduce the rate of clawback of the National Child Benefit.

34. ***The authorities stressed, and the staff agreed, that there were also substantial gains to be made for the economy from using at least a small amount of resources to make the corporate income tax system more competitive.*** Corporate tax rates in Canada, when provincial taxes were factored in, are high by international standards (particularly in key growth sectors such as services). By lowering the basic federal corporate income tax rate, the system could be made less distortionary, since the relatively higher taxation of income outside the small business and manufacturing and processing sectors would be reduced.[20] Distortions could be further diminished, while offsetting some of the costs of the reform, by broadening the tax base along the lines of the measures recommended in the 1998 Report of the Technical Committee on Business Taxation.[21] The report also recommended steps to reduce compliance costs and improve tax enforcement.

35. ***The authorities noted the considerable pressures they faced to increase spending, but that they would continue to try to limit the size of new spending initiatives, with priority continuing to be given to education and health care.*** The authorities explained that, in the medium-term projections, direct program spending was assumed to remain constant in real

---

taxpayers in Canada exceed the combined federal and provincial statutory rates as a result of the clawback of certain tax credits, including the National Child Benefit, as incomes rise. For example, for incomes around Can$30,000 the marginal effective income tax rate for a single taxpayer residing in Ontario with two children is estimated to rise to about 60 percent (federal and provincial combined, including the Employment Insurance premium, Canada Pension Plan premium, and all refundable tax credits), before falling back to about 40 percent as incomes reach Can$40,000.

[20] Corporate income tax rates vary by firm size, activity, and provincial location. The federal corporate statutory income tax rate is set at 28 percent for general business income, 21 percent for manufacturing and processing operations, and 12 percent for small businesses. Canada's combined federal-provincial corporate tax rate for general business income averages 43 percent, compared to a combined federal-state average of around 39 percent in the United States.

[21] The base-broadening measures recommended by the Committee include the elimination or reduction of certain preferences (e.g., research and development tax incentives which are among the most generous in the world), credits (e.g., recommended replacing the Atlantic Investment Tax Credit with a more cost-effective and broad-based nontax program), and deductions (e.g., proposed a general review of capital cost allowances to ensure that rates are closer to economic depreciation, along with a reduction in some accelerated classes).

per capita terms, which would provide some limited room to accommodate additional spending initiatives.

36. ***Significant progress has been made by provincial and territorial governments in balancing their budgets, and the authorities expected these governments to continue to follow sound budgetary policies in the period ahead, with all of them achieving balance or maintaining surpluses in 2000.*** The favorable performance of the economy, accompanied by rebounding commodity prices and increased federal transfers, has significantly improved the aggregate fiscal position of the provinces. Consequently, a few of them have moved to lower taxes, some ahead of previously announced schedules. The authorities suggested that these actions would not significantly affect the strong overall budget position of the provinces over the medium term. The staff, however, stressed that the provinces needed to be cautious and to sustain their fiscal efforts. In particular, all levels of government needed to factor in the potential fiscal costs associated with an aging population, especially in the area of health care, in forming their longer-term fiscal objectives.

C. Other Issues

37. ***Although the unemployment rate in Canada has come down significantly, it remains high by historical standards and relative to the United States.*** Reforms to the employment insurance (EI) system enacted during the past few years, which included tying benefit levels to the frequency of use and sharper clawback provisions for higher-income participants, have contributed to improving the efficiency and flexibility of the labor market and to reducing structural unemployment. The authorities noted that, as these reforms have become binding, significant pressures have emerged to roll them back, and that they were working hard to resist such pressures. The staff expressed concern about the Government's recent proposal to increase maternity and parental leave benefits under the EI system and to relax the eligibility requirements for these benefits. This action appeared to be a move away from the idea that the EI system should be primarily an insurance scheme. Moreover, it carried the risk of creating new incentives for casual labor force participation and heightened pressures for additional benefits. The authorities acknowledged these concerns and reiterated their commitment to resist additional demands. They explained that the change in maternity and parental leave benefits was part of the Government's overall strategy to provide more support for children, particularly in their early formative years.

38. ***In current circumstances, the authorities said that it would be difficult to extend reforms to the EI system in the areas that the staff continued to stress, specifically the introduction of experience rating in setting individual company's EI premiums and the elimination of regional extended benefits.*** Within the Government, there was no consensus on whether experience rating would yield significant net benefits. While it was recognized by some that experience rating could yield significant improvements in the functioning of the

labor market,[22] the magnitude of these benefits was questioned by others, who also suggested that such benefits could be outweighed by the higher costs of administering a more complex system. The staff noted that experience-rated unemployment insurance schemes had been administered successfully in every state of the United States for many years,[23] and that the adoption of a similar system in Canada should not pose major difficulties. Moreover, the staff pointed out that the provincial workers' compensation programs already incorporated experience rating in setting premiums. The staff also emphasized, and the authorities recognized, that an important opportunity was being lost to introduce experience rating by implementing differential reductions in EI premiums—instead of across-the-board cuts—in a manner which tied premiums for individual firms to the use of the system by their workers. On the practice of granting regional extended benefits, the staff maintained that such a policy tended to impede labor market mobility by discouraging inter-provincial job searches. The authorities emphasized the useful role of regional extended benefits in automatically marshalling additional EI resources to meet the greater need in high-unemployment regions.

39. ***Labor market flexibility has also been improved in recent years by reforms that most provinces have introduced in their social assistance programs.*** These reforms were motivated in part by the need for fiscal consolidation at both the federal and provincial level and by concerns that the indefinite availability of benefits and high benefit withdrawal rates after re-employment may have created "poverty traps," making it more attractive to remain on social assistance rather than to work.[24] Together with the National Child Benefit enacted in 1997,[25] these reforms have reduced the marginal effective tax rates associated with moving from social assistance to work. The authorities noted that social assistance caseloads had

---

[22] A Department of Finance working paper estimated that the introduction of an "ideal" experienced-rated EI premium would lower the natural rate of unemployment by 2 percentage points, compared with the current unweighted system. Introduction of a less-than-ideal system (such as those used in the United States) was estimated to lower the natural rate in Canada by 1 percentage point. See Beauséjour, Louis, Munir Sheikh, and Baxter Williams, "Potential Economic Effects of Experience-Rating the Employment Insurance System Using a Multi-Sector General Equilibrium Model of Canada," Working Paper 95–12, Canadian Department of Finance.

[23] The forthcoming selected issues paper will examine the effectiveness of using experience-rated unemployment insurance premiums, with reference to general practice and experience in the United States.

[24] The issue of "poverty traps" and social assistance reform is analyzed in *Canada: Selected Issues* (1999), IMF Staff Country Report No. 99/14.

[25] The NCB provides financial support to all low-income families with children, whether they are in the workforce or on social assistance. The benefit is gradually withdrawn as family incomes rise above about $21,000.

been falling steadily since 1994, and the staff and the authorities agreed that much of this decline was likely attributable to the changing incentives facing social assistance recipients. Nevertheless, it was still too early to draw firm conclusions about the full effects of these measures on incentives. Such an assessment would require observations over a full economic cycle in order to separate policy-induced effects from those coming from changing macroeconomic conditions.

40. ***Reforms introduced in late 1997 placed the Canada Pension Plan (CPP) on a sound longer-term financial footing.*** These reforms included an accelerated schedule for premium increases and are expected to result in surpluses in the CPP rising to about 1 percent of GDP during the next two decades, eventually producing a stock of assets equivalent to about five years of projected benefits. To increase the return on plan assets, and thereby contribute to the plan's financial soundness, CPP assets are being invested in private securities. Under the terms of its interim equity strategy, the CPP Investment Board will invest the plan's new net cash flow (current receipts less current benefits payments) in equities, following a passive investment strategy over the next three years that aims to replicate the performance of one or more broad stock market indices.[26] While the CPP Investment Board is responsible for managing the plan's new net cash flow, and not the plan's stock of existing assets (which are invested in federal and provincial government debt securities), the investment of all of the net cash flow in equities, beginning with the first purchases in March 1999, reflects the Board's decision to try to balance the CPP's overall portfolio between fixed-income assets and equity holdings. In doing so, the share of equities in total CPP assets is expected to rise to between 20 and 35 percent (1¼ to 1¾ percent of GDP) by end-2001.

41. ***In conjunction with the Article IV discussions, a Financial System Stability Assessment was conducted as part of the pilot project on extending financial sector surveillance.*** The FSSA mission found that the Canadian financial system was very sound and stable. In the context of the FSSA, an assessment of international standards and codes applicable to the financial sector found that these standards are observed to a high degree in Canada.[27] The primary challenge was to keep the system stable in the face of changes in

---

[26] The Investment Board has retained an external fund manager to invest 80 percent of the CPP's net cash flow in a Toronto Stock Exchange (TSE) 300 composite index fund, with the remainder being put into a non-Canadian equity portfolio consisting of a Standard and Poor's 500 index fund and an index fund replicating the performance of about 1,000 companies in Europe, Australia, New Zealand, and the Far East.

[27] The assessment of principles and standards covered the following areas: (i) Basel Core Principles for Effective Banking Supervision; (ii) the International Organization of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulation; (iii) the International Association of Insurance Supervisors' (IAIS) Supervisory Principles; (iv) the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies; and (v) the

(continued...)

institutional structures and financial products being driven by the evolution of financial markets worldwide. Distinctions between the traditional pillars of the Canadian system (banking, insurance, securities firms, and trust companies) had become increasingly blurred, reflecting regulatory changes driven in part by increased domestic and global competition. Canadian firms also had become more active internationally, seeking in particular new business opportunities in the United States. While such moves may yield benefits from portfolio diversification, they also increased the exposure of the Canadian system to economic shocks in the United States. New financial products (such as insurance company segregated funds, securitization, and off-balance sheet transactions) may provide new profit opportunities for financial firms, but their risk characteristics may not yet be fully understood, and they could pose considerable supervisory challenges. In this environment, it was especially important that good risk management tools be maintained and further developed. The Canadian supervisory framework with its emphasis on a consolidated, risk-centered approach was seen as being well-positioned to address the challenges that it would face. However, the complex division of tasks among federal and provincial regulators required close coordination and harmonization of regulation and supervision at all levels of government in dealing with the changing nature of the system, especially with respect to securities regulation where provincial authorities had considerable authority.

42. ***The Government recently set out a proposed framework for reforming federally regulated financial institutions, which follows most of the recommendations in the 1998 report of the Task Force on the Future of the Financial Services Sector.*** The proposed framework aims at enhancing efficiency and competition in financial services, strengthening arrangements for consumer protection, and improving the regulatory framework. The Government is also proposing to modify ownership rules, increase the structural flexibility for companies, and introduce a more transparent process for reviewing bank mergers.

43. ***Progress toward reducing interprovincial barriers to the free flow of goods, services, workers, and capital under the Agreement on Internal Trade (AIT) continued in 1999.*** The Canadian representatives indicated that there had been some progress toward harmonizing interprovincial environmental standards and some further extensions of procurement obligations.[28] In February 1999, an agreement was reached in the context of the Social

---

Committee on Payment and Settlement Systems' Core Principles for Systemically Important Payment Systems.

[28] Procurement activities of municipalities, municipal organizations, school boards and publicly funded academic, social service, and health entities (the MASH sector) were initially excluded from AIT obligations. An agreement was reached in February 1998 (except for British Columbia and the Yukon) to include the MASH sector, with these provisions entering into force in mid-1999.

Union Framework Agreement[29] to ensure that by July 1, 2001 full compliance with the labor mobility provisions of the AIT would be achieved, including mutual recognition of occupational qualifications across provinces and the elimination of residency requirements for employment. The authorities noted that although the AIT had achieved significant results, there were a number of major pieces of unfinished business, including in government procurement (where certain sectors remained excluded), energy (where an agreement was nearing completion), dispute settlement (where provisions may be too weak), and in achieving a code of conduct on provincial investment incentives.

44. ***The authorities indicated that Canada remained active in trade liberalization initiatives at the multilateral, regional, and bilateral levels, emphasizing the importance of trade to the Canadian economy (which has by far the highest ratio of trade to GDP of the G-7 countries) and its significant stake in the multilateral trading system.*** The rules-based system governing members of the World Trade Organization (WTO) established the foundation for Canada's bilateral and regional trade agreements, and the authorities viewed their activities in these fora as complementary to the goals of the multilateral trading system. The authorities felt that the time was right for a new round of multilateral trade negotiations under the auspices of the WTO. Areas of particular interest to Canada included improving market access; pursuing trade facilitation measures (such as the streamlining of customs procedures); clarifying multilateral disciplines governing antidumping and subsidies; developing a framework agreement on competition policies; improving intellectual property rights protection; continuing liberalization of trade-in services; and establishing clear ground rules enabling countries to maintain policies that promote their cultural heritage. The staff noted that although Canada was generally a strong advocate of open trade and maintained a highly open trade regime, exceptions remained in some traditionally sensitive sectors including agriculture and textiles and clothing.[30] The authorities emphasized that Canada was in full compliance with its Uruguay Round commitments and expected that these areas would be revisited in the next trade round. The staff, however, encouraged the authorities to move more quickly to reduce tariffs in these areas to improve the allocation of resources in Canada and provide a welcome boost to the economies of many developing countries.

---

[29] *A Framework to Improve the Social Union for Canadians: An Agreement between the Government of Canada and the Governments of the Provinces and Territories*, February 4, 1999.

[30] For example, out-of-quota tariff rates on certain food products (particularly dairy and poultry products) can exceed 250 percent. In textiles and clothing, high levels of protection appear principally in the form of quantitative restrictions, which are being phased out by end-2004 under the Uruguay Round Agreement. Of those products that have been "integrated" (i.e., are not subject to quotas), tariffs remain as high as 15 percent on some textiles and 25 percent on some items of clothing.

45. ***Canada's official development assistance (ODA) declined as a share of GNP from 0.46 percent in 1992 to 0.29 percent in 1998.*** The Prime Minister had recently announced that the Government intended to increase foreign aid in the next budget, and remained committed to improving the effectiveness of ODA and to moving toward an ODA target of 0.7 percent of GNP, as Canada's fiscal situation allows.

IV. Staff Appraisal

46. ***As the Canadian economy marks its eighth consecutive year of expansion, its strong performance has been underpinned by the sound macroeconomic and structural policies implemented and sustained during the 1990s.*** Inflation has been maintained at very low levels as a result of the Bank of Canada's successful inflation targeting. Sharp improvements in federal and provincial fiscal balances have resulted in a decline in the ratio of government debt to GDP in recent years, and the prospects are good for further reductions over the medium term. Important structural reforms have been adopted, including improvements in the employment insurance system, the more complete financing of the public old-age support system, the continuing removal of barriers to interprovincial trade, and a restructuring of provincial social assistance programs. These policy efforts have been reflected in low and stable inflation expectations, significant reductions in real and nominal interest rates, a stable external position—with the external current account shifting rapidly toward surplus as commodity prices recover—and a drop in the unemployment rate to its lowest level in two decades. The authorities are to be highly commended for these achievements.

47. ***Although aggregate resource utilization has risen significantly in the last year, there is considerable uncertainty as to how much slack remains in the economy.*** Estimates of the output and employment gaps range widely, and do not provide firm guidance on exactly how far the economy might be from full capacity. The high level of investments in new technologies and machinery and equipment during recent years may have raised the level of capacity. The EI reforms and changes in provincial social assistance programs also are likely to have contributed to ongoing reductions in structural unemployment. Nevertheless, the economy has been growing at a rapid pace, raising the prospect that any remaining slack might be exhausted quite quickly, although core inflation has so far remained well-contained. Prospects for growth, however, are highly dependent on changes in the external environment that Canada faces—particularly developments in the United States.

48. ***The staff agrees with the authorities that the near-term aim of monetary policy should be to allow the economy to seek its productive potential without compromising the official target for inflation.*** The authorities' success in maintaining low inflation has established the credibility of the targeting regime and provides the Bank with some room to maneuver in testing the economy's productive limits. Nevertheless, it will be important to ensure that the limits of potential output are not approached with undue speed in order to minimize the risk of hitting capacity constraints before monetary policy has sufficient time to work to rein in excess demand pressures. In judging how Canadian monetary policy should respond to developments in the United States, the main consideration will be the extent to

which continued rapid U.S. growth could add to demand growth in Canada and contribute to a spillover of inflationary pressures. In this context, the Bank of Canada's decision to match the U.S. interest rate increase in November was fully warranted. Looking forward, the Bank's careful monitoring of a range of early warning indicators, and its commitment to a prompt and firm response should signs of price and cost pressures emerge, is appropriate.

49. ***Fiscal policy needs to maintain a medium-term focus to bring down the ratio of government debt to GDP, which remains among the highest of the major industrial countries.*** The Government's presentation of five-year planning surpluses in its recent Economic and Fiscal Update is a welcome step that should help to enhance the quality of the public debate on feasible fiscal policy options. While these estimates indicate that the federal government's budgetary position is sound, it is important to bear in mind that the surpluses available are limited. Moreover, part of the projected surpluses reflect the automatic rise in the real burden of personal income taxes owing to the lack of full inflation indexation. Therefore, careful choices will have to be made in deciding the mix of policy actions to be adopted.

50. ***The staff believes that debt reduction and income tax reform should be the top priorities in allocating the prospective fiscal surpluses.*** While some additional moderate spending initiatives in the areas of education and health care would be useful, debt reduction and reform of income taxation are likely to produce significant long-term benefits for the economy. Looming uncertainties regarding the longer-term fiscal cost of an aging population (especially in the area of health care) suggest that it would be prudent to target somewhat larger government savings now in order to better prepare for these future costs. Therefore, the Government should seize the opportunity afforded by relatively favorable economic conditions to accelerate the reduction in the debt-to-GDP ratio by running somewhat larger annual surpluses than the $3 billion that would occur if the contingency reserve is not spent each year. This could be achieved, for example, by devoting to debt reduction, in addition to the unspent contingency reserve, the surplus funding available each year as a result of a stronger-than-expected economy (the "economic prudence" margin in the fiscal estimates, as well as any additional unanticipated favorable budget outcomes).

51. ***On the tax side, reducing the high burden of personal and corporate income taxes offers considerable scope for economic efficiency gains.*** The staff strongly supports the Government's intention to introduce a multiyear plan to lower taxes, although the plan will need to be carefully proportioned and phased so as to ensure that it is consistent with debt-reduction goals. Federal efforts toward reforming the income tax system should be coordinated with provincial governments to ensure that tax reductions are not offset by actions in the provinces.

52. ***High average and marginal personal income tax rates (with some of the highest effective marginal rates falling on middle-income taxpayers) have contributed to disincentives to work and save.*** Although there is an extensive menu of possible measures from which to assemble a multiyear tax-cut package, the staff's view is that the priorities for personal income tax reform should include full inflation indexation of the system; increases

in the income thresholds at which progressive marginal tax rates apply; a cut in the 26 percent statutory marginal tax rate; and a reduction in the clawback of the National Child Benefit.

53. ***The corporate income tax system imposes tax rates that are high by international standards, especially outside the small business and manufacturing and processing sectors.*** An appropriate first step would be to lower the basic federal corporate income tax rate, which would serve to make the system more neutral and less distortionary. Consideration also needs to be given to some of the recommendations in the 1998 Report of the Technical Committee on Business Taxation with respect to broadening the tax base, reducing compliance costs, and improving tax enforcement.

54. ***Significant progress has been made toward improving the budgetary position of the provincial governments since 1993, and the aggregate fiscal position of the provinces appears poised to be at least in balance in the period ahead.*** This level of fiscal effort may well need to be strengthened in coming years in order to prepare for the longer-term fiscal costs associated with an aging population.

55. ***The unemployment rate has fallen significantly; however, it remains high both by historical standards and in relation to the United States.*** Reforms in the employment insurance system have contributed to improving the efficiency and flexibility of the labor market and to reducing structural unemployment. As the reforms have become binding, pressures have mounted to roll back these changes. It will be important to preserve the EI reforms to help the economy to operate at lower average levels of unemployment without sparking inflation. Additional steps could be taken to address the employment disincentives that remain. In particular, further reductions in EI premiums could be implemented in a manner that ties premiums for individual firms to the use of the system by their workers. Moreover, phasing out the system of regional extended unemployment benefits would help reduce disincentives to labor mobility. The recent announcement of increased maternity and parental leave benefits to be funded through the EI system, together with a relaxation of the eligibility requirements, appears to be a step away from the idea that the EI system should be primarily an insurance scheme and could create new incentives for casual labor force participation and increased demands for additional benefits.

56. ***Canada has demonstrated on numerous occasions its commitment to liberal trade through unilateral, regional, and multilateral initiatives, and continues to work for trade liberalization.*** While great strides have been made in reducing trade barriers, Canada retains high rates of protection in certain sensitive sectors, such as agriculture and textiles and clothing. The staff encourages the authorities to exceed current WTO obligations on liberalizing trade in agriculture and textiles and clothing, which would enhance the efficiency of the Canadian economy as well as improve economic prospects for many developing countries.

57. ***The pilot Financial System Stability Assessment for Canada finds a very sound and stable financial system, underpinned by strengthened balance sheets of banks and nonbanks.*** Peer review by experts from other countries on banking, insurance, and securities

regulation and supervision, and on the payments system, found that there is a high degree of compliance with the major international principals and standards; indeed, Canada's experience is a source of best international practice in a number of areas. However, as in other major industrial countries with advanced banking systems, ongoing developments in financial markets will pose a number of challenges. The structure of the Canadian financial system is likely to continue to undergo rapid change, spurred by global competitive pressures, the demutualization of the life insurance industry, and the proposals for fostering domestic competition contained in the Government's Policy Paper on reforming Canada's financial services sector. The changing nature of financial instruments—including the growing reliance on derivative and other off-balance sheet transactions, the securitization of assets in order to reduce the need for regulatory capital, and the rapid growth of life insurance segregated funds—heightens the importance of maintaining and further developing good risk management tools. Increased integration with financial markets in the United States is a natural development and offers the benefits of portfolio diversification. However, it does make the Canadian financial system more susceptible to shocks originating in U.S. goods and financial markets and could entail some cross-border liquidity risks. The Canadian authorities are already substantially addressing these challenges through their well-developed supervisory framework—with its emphasis on a consolidated, risk-centered approach. In addition, the growing importance of the securities industry at both the federal and provincial levels suggests that coordinating and harmonizing the regulatory framework for the industry will require increasing attention.

58. ***The latest figures show that Canada's official development assistance (ODA) as a share of GNP has fallen to 0.29 percent in 1998.*** Therefore, the staff welcomes the Prime Minister's recent statement that the Government intends to increase foreign aid in the next budget, and encourages the authorities to move toward achieving their long-standing commitment to reach a development-assistance target of 0.7 percent of GNP.

59. Canadian economic data are excellent in terms of their quality, coverage, periodicity, and timeliness, both in the context of the Article IV consultation and for purposes of ongoing surveillance. Canada has subscribed to the Special Data Dissemination Standard and its metadata are posted on the Dissemination Standard Bulletin Board.

60. It is expected that Canada will remain on the standard 12-month Article IV consultation cycle.

Table 1. Canada: Selected Economic Indicators

	Averages 1960s	1970s	1980s	1994	1995	1996	1997	1998
	(In percent change from previous period at annual rates, unless otherwise indicated)							
Economic activity and prices								
Real GDP	5.6	4.4	2.9	4.7	2.8	1.7	4.0	3.1
Real net exports 1/	0.3	0.0	-0.3	1.5	1.0	0.1	-1.7	1.0
Real final domestic demand	5.2	4.6	3.4	2.8	0.8	2.4	4.9	2.7
Consumer spending	4.8	4.5	2.9	3.1	2.1	2.5	4.2	2.8
Nonresidential fixed investment	4.0	5.8	1.4	8.9	0.6	4.9	14.0	0.1
Labor market								
Labor force	...	...	2.0	1.1	0.7	1.5	1.3	1.8
Employment	...	...	2.0	2.1	1.6	1.2	1.9	2.8
Unemployment rate (period average)	...	...	9.4	10.4	9.5	9.7	9.2	8.3
Labor productivity	...	2.0	0.8	1.6	1.2	-0.4	2.8	0.8
Capital stock	4.6	4.3	3.7	1.9	1.9	2.1	2.7	2.7
Prices								
GDP deflator	...	...	6.0	1.3	2.4	1.5	1.0	0.0
Implicit price deflator for GDP	3.5	8.0	5.8	1.1	2.3	1.6	0.8	-0.6
Core consumer price index	...	...	...	1.6	2.3	1.5	1.5	1.2
Unit labor cost	...	7.8	6.0	-1.3	1.3	1.3	1.3	2.6
Exchange rate								
U.S. cents/Canadian dollars	94.4	96.4	79.5	73.0	73.1	73.3	72.0	67.1
Percent change	-1.2	-0.8	-0.1	-5.6	0.2	0.3	-1.8	-6.8
Nominal effective exchange rate 2/	-1.1	-1.4	-0.1	-6.2	-2.0	1.7	0.2	-6.0
Real effective exchange rate 3/	...	...	1.5	-7.6	-0.7	2.1	0.7	-8.0
Interest rates								
Three-month Treasury bill rate	...	7.0	11.3	5.5	7.1	4.2	3.2	4.7
Ten-year Treasury bond rate	...	...	...	8.4	8.1	7.2	6.1	5.3
	In percent of GDP or NDP							
Balance of payments								
Current account balance	-2.2	-2.6	-2.2	-2.3	-0.8	0.5	-1.6	-1.8
Merchandise trade balance	0.9	1.7	2.9	2.6	4.4	5.0	2.7	2.1
Invisible balance	-3.1	-4.3	-5.1	-5.0	-5.1	-4.5	-4.3	-3.9
Real net exports 4/	2.4	2.3	1.3	1.9	2.9	3.0	1.2	2.1
Fiscal indicators								
General fiscal balance (NIA)	-0.3	-1.0	-4.7	-5.6	-4.3	-1.8	0.8	0.9
Federal fiscal balance (NIA)	-0.3	-1.4	-4.6	-3.7	-3.1	-1.3	1.0	1.1
Provincial fiscal balance (NIA) 5/	-0.5	-0.7	-0.8	-1.7	-1.1	-0.3	0.1	-0.1
Saving and investment 6/								
Gross national saving	21.9	22.3	20.1	15.4	17.6	18.1	18.6	17.8
General government	4.6	3.1	-1.0	-2.8	-1.5	0.7	3.0	3.2
of which: Federal government	0.6	-0.6	-3.5	-3.0	-2.5	-0.8	1.3	1.4
Private	17.3	19.2	21.1	18.2	19.1	17.4	15.6	14.6
Personal	7.0	9.8	11.9	8.0	7.7	6.3	4.8	4.6
Business	10.3	9.4	9.2	10.2	11.4	11.1	10.8	10.1
Gross domestic investment	23.5	23.6	21.4	18.2	18.0	17.6	19.9	19.6
Private	18.9	20.0	18.6	15.6	15.5	15.3	17.8	17.6
Public	4.6	3.6	2.8	2.6	2.5	2.3	2.1	2.1
of which: Federal government	0.7	0.5	0.5	0.5	0.4	0.4	0.3	0.3
Net foreign investment	1.8	1.8	1.9	3.4	0.5	-1.0	1.9	2.4
Net national saving	13.5	14.3	10.8	3.9	6.9	7.3	8.1	6.8
Net private investment	12.1	14.0	11.6	6.9	6.7	6.0	9.0	8.7
In real terms								
Gross domestic investment	15.4	15.7	17.6	17.9	18.0	18.1	20.5	20.1
Private	12.3	13.3	15.5	15.3	15.5	15.7	18.3	17.9
Public	3.1	2.4	2.1	2.6	2.5	2.4	2.2	2.2
				Fiscal Years 1994/95	1995/96	1996/97	1997/98	1998/99
Memorandum item:								
Federal fiscal balance (public accounts)	...	...	...	-4.9	-3.5	-1.1	0.4	0.3

Sources: Statistics Canada; and Fund staff estimates.

1/ Contribution to growth.
2/ Constructed using 1989-91 trade weights.
3/ Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989-91 trade weights.
4/ Based on NIA data.
5/ Includes local governments.
6/ Gross national saving does not equal the sum of gross domestic investment and net foreign investment because of statiscal discrepancy.

Table 2. Canada: Balance of Payments

(In billions of Canadian dollars)

	1994	1995	1996	1997	1998	1999 1/
Current account balance	-17.7	-6.1	4.5	-14.3	-16.4	-3.5
In percent of GDP	-2.3	-0.8	0.5	-1.6	-1.8	-0.4
Merchandise trade balance	20.3	35.4	42.0	23.7	18.9	32.2
Exports, goods	228.2	265.3	279.9	301.4	322.3	353.9
Imports, goods	207.9	229.9	237.9	277.7	303.4	321.7
Services balance	-11.7	-10.1	-8.8	-9.1	-7.0	-6.6
Investment income balance	-25.9	-31.2	-29.4	-29.7	-29.1	-30.2
Transfer balance	-0.5	-0.2	0.7	0.8	0.8	1.1
Capital and financial accounts balance	17.8	1.3	-11.8	18.1	14.4	-15.4
Direct investment, net	-1.5	-3.0	-4.7	-14.7	-14.9	11.6
In Canada	11.2	12.7	12.8	15.9	24.5	35.0
Abroad	-12.7	-15.7	-17.6	-30.5	-39.4	-23.4
Portfolio accounts, net	14.4	17.9	-0.9	5.2	2.8	-15.2
Canadian securities	23.3	25.2	18.3	16.4	25.0	2.1
Bonds	16.0	30.7	17.6	6.1	11.8	2.3
Stocks	6.4	-4.2	8.0	7.5	13.5	14.2
Money market	0.9	-1.3	-7.3	2.8	-0.3	-14.4
Foreign securities	-8.9	-7.3	-19.2	-11.2	-22.2	-17.3
Bonds	0.4	-1.1	-2.0	-6.7	-7.1	-0.9
Stocks	-9.4	-6.2	-17.2	-4.5	-15.2	-16.4
Other investment 2/	-5.9	-16.6	-6.6	16.6	29.1	-11.0
Assets	-27.9	-11.6	-28.8	-22.0	18.0	17.3
Liabilities	22.0	-5.0	22.1	38.6	11.1	-28.4
Other flows, net	10.2	6.8	8.0	7.5	5.0	5.3
Changes in official international reserves	0.5	-3.8	-7.5	3.4	-7.5	-6.0
Statistical discrepancy	0.0	4.8	7.3	-3.8	1.9	18.9
Memorandum item:						
Net external debt	-335.6	-332.3	-324.8	-325.0	-323.6	...
In percent of GDP	-43.7	-41.2	-39.2	-37.5	-36.4	...

Source: Statistics Canada.

1/ First three quarters of the year at annual rates. Current account flows have been seasonally adjusted.
2/ Includes bank, nonbank, and nonofficial reserves transactions.

Table 3. Canada: Federal Government Budget, Public Accounts 1/

(In billions of Canadian dollars; unless otherwise indicated)

Fiscal Years	1994/95	1995/96	1996/97	1997/98	1998/99
Total revenues	**123.3**	**130.3**	**140.9**	**153.2**	**155.7**
In percent of GDP	16.1	16.1	16.9	17.5	17.4
Total spending	**160.8**	**159.0**	**149.8**	**149.7**	**152.8**
In percent of GDP	20.9	19.7	18.0	17.1	17.1
Program spending	118.7	112.0	104.8	108.8	111.4
In percent of GDP	15.5	13.9	12.6	12.4	12.4
Interest payments	42.0	46.9	45.0	40.9	41.4
In percent of GDP	5.5	5.8	5.4	4.7	4.6
Budget balance	**-37.5**	**-28.6**	**-8.9**	**3.5**	**2.9**
In percent of GDP	-4.9	-3.5	-1.1	0.4	0.3
Net public debt	**545.7**	**574.3**	**583.2**	**579.7**	**576.8**
In percent of GDP	71.1	71.2	69.9	66.3	64.4
Memorandum items:					
Structural budget balance	-31.5	-22.5	-1.4	9.5	7.6
In percent of GDP	-4.1	-2.8	-0.2	1.1	0.9
Primary balance	4.6	18.3	36.1	44.4	44.3
In percent of GDP	0.6	2.3	4.3	5.1	5.0
Structural primary balance	10.5	24.4	43.6	50.4	49.0
In percent of GDP	1.4	3.0	5.2	5.8	5.5

Sources: Department of Finance; and Fund staff estimates.

1/ On a fiscal year basis, which ends on March 31.

Table 4. Canada: Net Government Debt

(In percent of GDP)

	1980	1992	1993	1994	1995	1996	1997	1998
National accounts basis 1/	**14.4**	**59.6**	**66.2**	**68.7**	**70.2**	**69.8**	**65.5**	**62.3**
Federal	15.7	52.0	54.6	55.3	56.5	55.0	51.5	48.4
Provincial 2/	6.8	15.8	19.5	20.6	20.5	21.1	19.8	19.4
CPP and QPP 3/	-8.0	-8.2	-7.8	-7.2	-6.8	-6.4	-5.8	-5.4
Public accounts basis 4/	**37.4**	**90.7**	**96.3**	**97.9**	**98.6**	**96.5**	**94.5**	**92.6**
Federal	29.2	66.7	70.1	71.1	71.2	69.9	66.3	64.4
Provincial	8.3	24.0	26.2	26.8	27.4	26.6	28.2	28.2
Memorandum item:								
Government of Canada marketable securities held by nonresidents 5/	9.5	27.9	27.6	25.8	25.9	25.4	24.7	23.5

Sources: Statistics Canada, National Balance Sheet Accounts (13-214) and Canada's International Investment Position (67-202); Department of Finance, Canada; and Fund staff estimates.

1/ Calendar year, 1998 figures are estimates. The national accounts measure of net debt does not include government indebtedness to the public service pension plans and the Canada Pension Plan (CPP)/Quebec Pension Plan (QPP) as a government liability.

2/ Also includes local government and hospital sectors.

3/ Canadian Pension Plan and Quebec Pension Plan.

4/ Fiscal year, beginning April 1; 1998 figures are estimates. The public accounts measure of net debt includes government indebtedness to the public service pension plans, the CPP, and the QPP as a government liability. Note that data on intergovernmental holdings of net debt are not available on a public accounts basis so that the totals may be biased upward.

5/ As a percent of total marketable debt. 1998 total government of Canada debt based on data from Bank of Canada Review.

Table 5. Canada: Indicators of Economic Performance

	Average 1985-94	1995	1996	1997	1998	Projection 1999	Projection 2000
	(Annual percent change)						
Real GDP							
Canada	2.6	2.8	1.7	4.0	3.1	3.7	3.3
United States	2.6	2.3	3.4	3.9	3.9	3.7	2.6
Japan	3.3	1.5	5.0	1.4	-2.8	1.0	1.5
Germany	2.8	1.7	0.8	1.8	2.3	1.4	2.5
G-7 countries	2.6	2.2	3.0	2.9	2.2	2.6	2.4
Real fixed private investment							
Canada	3.6	-1.7	8.2	16.9	3.4	8.6	7.0
United States	2.0	5.5	8.8	8.3	11.4	9.7	5.4
Japan	4.6	2.2	11.8	1.6	-11.8	-4.8	4.0
Germany	3.3	-0.2	-0.4	1.5	2.1	3.8	2.9
G-7 countries	2.5	3.9	7.3	5.7	5.0	5.5	4.7
Consumer prices							
Canada	3.5	2.2	1.6	1.4	1.0	1.5	2.0
United States	3.6	2.8	2.9	2.3	1.6	2.2	2.5
Japan	1.6	-0.1	0.1	1.7	0.6	-0.4	0.0
Germany	2.4	1.8	1.5	1.8	0.9	0.4	0.8
G-7 countries	3.4	2.4	2.2	2.0	1.3	1.4	1.7
Unit labor cost in manufacturing							
Canada	1.2	1.2	2.6	0.9	0.6	-3.5	0.8
United States	1.2	-1.5	-1.8	-0.7	0.2	-0.4	1.5
Japan	1.8	-2.2	-1.9	-1.6	5.5	-0.3	-0.2
Germany	1.1	-0.1	-0.8	-5.4	-3.0	1.0	1.0
G-7 countries	1.5	-0.8	-0.3	-1.0	0.7	0.0	1.1
	(In percent)						
Unemployment rate							
Canada	9.7	9.5	9.7	9.2	8.3	7.6	7.2
United States	6.5	5.6	5.4	4.9	4.5	4.3	4.5
Japan	2.5	3.1	3.3	3.4	4.1	5.0	5.8
Germany	7.6	9.4	10.3	11.4	11.2	10.9	10.4
G-7 countries	6.8	6.7	6.7	6.5	6.2	6.2	6.4
	(As percent of GDP)						
General government revenues							
Canada	45.1	46.9	46.9	47.4	48.1	48.3	47.6
United States	30.0	30.6	30.9	31.5	31.9	32.3	32.5
Japan	32.4	32.1	32.0	31.7	31.7	31.8	30.8
Germany	45.6	46.6	46.3	45.9	45.6	45.4	45.8
G-7 countries	35.8	36.2	36.3	36.6	37.1	37.3	37.2
General government expenditures							
Canada	50.9	52.5	51.2	49.2	47.3	47.4	45.4
United States	33.0	32.8	32.8	32.4	31.6	31.1	30.8
Japan	31.7	34.4	35.6	35.9	35.0	37.0	38.2
Germany	47.5	49.0	49.5	49.2	48.2	47.3	47.7
G-7 countries	38.7	39.8	39.7	39.3	38.3	38.1	38.1
General government fiscal balance							
Canada	-5.7	-4.3	-1.8	0.8	0.9	2.2	1.8
United States	-2.9	-1.9	-0.9	0.4	1.3	1.6	2.0
Japan	0.6	-3.6	-4.2	-3.4	-5.3	-7.3	-7.1
Germany	-2.0	-3.2	-3.4	-2.6	-2.0	-1.9	-1.1
G-7 countries	-2.9	-3.4	-2.7	-1.2	-0.8	-0.9	-0.5
General government net debt							
Canada	48.1	70.2	69.8	65.5	62.3	57.3	52.6
United States	46.2	54.5	54.1	51.4	48.4	45.0	41.5
Japan	13.7	13.0	16.4	19.5	30.5	37.6	44.3
Germany 1/	25.6	49.4	52.1	52.8	52.4	51.9	50.9
G-7 countries	39.3	49.7	50.5	49.9	50.4	49.6	48.3
Current account balance							
Canada	-3.2	-0.8	0.5	-1.6	-1.8	-0.5	-0.4
United States	-1.9	-1.6	-1.7	-1.8	-2.6	-3.5	-3.5
Japan	2.9	2.2	1.4	2.2	3.2	3.4	3.1
Germany	2.1	-0.8	-0.2	-0.1	-0.2	0.0	0.2
G-7 countries	-0.5	-0.3	-0.2	0.0	-0.4	-0.9	-0.9

Source: Fund staff estimates. Projections for other G-7 countries are from the World Economic Outlook (October 1999).

1/ Germany's net debt starts in 1986.

Table 6. Canada: Staff Projections

	1998	1999	2000	2001	2002	2003	2004
(In percent change from previous period; unless otherwise indicated)							
NIPA in constant prices							
Real GDP	3.1	3.7	3.3	2.8	2.5	2.5	2.4
Net exports 1/	1.0	0.3	-0.4	0.2	0.2	0.1	0.2
Total domestic demand	2.2	3.7	3.6	2.7	2.4	2.5	2.3
Private consumption	2.8	3.3	3.4	2.7	2.5	2.6	2.4
Private domestic investment	3.4	8.3	4.1	2.7	1.8	2.0	2.0
Change in business inventories 1/	-0.4	-0.1	-0.1	-0.2	0.0	0.0	0.0
Final domestic demand	2.7	3.8	3.7	2.8	2.4	2.5	2.3
GDP (current prices)	2.5	5.3	5.3	4.8	4.4	4.4	4.3
Employment and inflation							
Unemployment rate (period average)	8.3	7.6	7.2	6.9	6.7	6.5	6.5
Consumer price index	1.0	1.5	2.0	2.0	2.0	2.0	2.0
GDP deflator	-0.6	1.5	1.9	1.9	1.9	1.9	1.9
Indicators of financial policies 2/							
Federal fiscal balance							
(public accounts) 3/ 4/	2.9	3.0	3.0	3.0	3.0	3.0	3.0
(as a share of GDP)	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Federal fiscal balance (NIA) 3/	9.7	6.7	7.0	6.9	7.4	7.9	8.7
(as a share of GDP)	1.1	0.7	0.7	0.7	0.7	0.7	0.7
Provincial fiscal balance (NIA) 3/ 5/	-0.6	13.5	9.6	8.2	5.8	3.3	1.8
(as a share of GDP)	-0.1	1.4	1.0	0.8	0.5	0.3	0.1
General goverment fiscal							
balance (NIA) 3/	8.0	20.4	18.2	19.4	19.7	18.3	18.5
(as a share of GDP)	0.9	2.2	1.8	1.9	1.8	1.6	1.6
General goverment net debt							
(as a share of GDP)	62.3	57.3	52.6	48.4	44.5	41.0	37.8
Three-month treasury bill rates (percent)	4.7	4.7	5.2	5.3	5.3	5.3	5.3
Ten-year government bond rates (percent)	5.3	5.5	6.3	6.3	6.3	6.3	6.3
Balance of payments							
Current account balance 3/	-16.4	-4.3	-4.2	0.3	3.9	5.8	9.2
(as a share of GDP)	-1.8	-0.5	-0.4	0.0	0.4	0.5	0.8
Merchandise trade balance 3/	18.9	31.0	31.6	38.2	42.7	45.8	50.7
(as a share of GDP)	2.1	3.3	3.2	3.7	3.9	4.0	4.3
Export volume	8.3	9.7	5.3	7.7	6.6	6.3	6.3
Import volume	-7.3	-9.6	-7.1	-7.0	-6.0	-6.3	-6.3
Invisibles, net 3/	-35.2	-35.3	-35.8	-38.0	-38.9	-40.1	-41.5
(as a share of GDP)	-3.9	-3.7	-3.6	-3.7	-3.6	-3.5	-3.5

Source: Fund staff estimates.

1/ Contribution to growth.

2/ After FY 1998/99, it is assumed that there will be budget surpluses of $3 billion (equivalent to the contingency reserve).

3/ In billions of dollars.

4/ Fiscal year (April-March).

5/ Includes local governments and hospitals.

Table 7: Canada Medium-Term Projections for Federal Government Budget

	1998-99	Projections					
		1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	(in billions of Canadian dollars)						
The 1999 Economic and Fiscal Update							
Total revenues	155.7	158.0	164.5	172.5	180.0	188.0	197.0
Total spending	152.8	153.0	155.0	159.0	161.5	164.0	167.0
Program spending	111.4	111.5	113.5	118.0	121.0	124.0	127.5
Interest payments	41.4	41.5	41.5	41.0	40.5	40.0	39.5
Underlying budgetary balance	2.9	5.0	9.5	13.5	18.5	24.0	30.0
Contingency reserve	...	3.0	3.0	3.0	3.0	3.0	3.0
Economic prudence	...		1.0	2.0	3.0	3.5	4.0
Fiscal surplus for planning	2.9	2.0	5.5	8.5	12.5	17.5	23.0
Percent of GDP	0.3	0.2	0.6	0.8	1.2	1.6	2.0
Memorandum items:							
Net public debt (percent of GDP) 1/	64.4	61.0	58.0	55.2	52.6	50.0	47.6
Three-month Treasury bill rate 2/	4.8	5.1	5.1	4.9	4.9	4.9	4.9
Ten-year government bond rate 2/	5.6	5.8	5.8	5.6	5.6	5.6	5.6
Nominal GDP growth 2/	5.1	4.6	4.6	4.5	4.5	4.5	4.5
Staff projections							
Total revenues	155.7	159.2	165.3	172.8	180.9	190.0	199.5
Total spending	152.8	152.8	154.3	158.6	161.8	164.4	167.6
Program spending	111.4	111.3	112.8	117.1	120.1	123.0	126.4
Interest payments	41.4	41.5	41.5	41.6	41.7	41.4	41.2
Underlying budgetary balance	2.9	6.4	11.0	14.2	19.1	25.6	31.9
Contingency reserve	...	3.0	3.0	3.0	3.0	3.0	3.0
Economic prudence	...		1.0	2.0	3.0	3.5	4.0
Fiscal surplus for planning	2.9	3.4	7.0	9.2	13.1	19.1	24.9
Percent of GDP	0.3	0.4	0.7	0.9	1.2	1.7	2.1
Memorandum items:							
Net public debt (percent of GDP) 1/	64.4	60.8	57.5	54.6	52.0	49.5	47.2
Three-month Treasury bill rate 2/	4.7	5.2	5.3	5.3	5.3	5.3	5.3
Ten-year government bond rate 2/	5.5	6.3	6.3	6.3	6.3	6.3	6.3
Nominal GDP growth 2/	5.3	5.3	4.8	4.4	4.4	4.3	4.3

Sources: Department of Finance, The Economic and Fiscal Update 1999; and Fund staff estimates.

1/ Based on the assumption that the contingency reserve is applied to debt reduction.
2/ Annual, in percent.

Canada - Fund Relations
(As of November 30, 1999)

I. **Membership Status:** Joined 12/27/45; Article VIII

II. General Resources Account:	SDR Million	Percent of Quota
Quota	6,369.20	100.0
Fund holdings of currency	4,054.92	63.7
Reserve position in Fund	2,314.31	36.3
Operational budget transfers (net)	67.00	

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	779.29	100.0
Holdings	372.54	47.8

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:** None

VI. **Projected Obligations to Fund:** None

VII. **Exchange Rate Arrangements**

The Canadian authorities do not maintain margins with respect to exchange transactions, and exchange rates are determined on the basis of demand and supply conditions in the exchange market. However, the authorities intervene to maintain orderly conditions in the exchange market. There are no taxes or subsidies on purchases or sales of foreign exchange. On December 13, 1999 the exchange rate of the Canadian dollar was US$0.68 per Canadian dollar.

Canada has notified the Fund, pursuant to Decision No. 144, of restrictions imposed vis-à-vis Iraq (EBD/90/279) and the Federal Republic of Yugoslavia (Serbia and Montenegro) (EDB/92/162).

VIII. **Last Article IV Consultation**

The staff report for the 1999 consultation with Canada was considered by the Executive Board on January 22, 1999 (EBM/99/9). Canada is on a 12-month consultation cycle.

Canada: Core Statistical Indicators

(as of end-November 1999)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP	External Debt/ Debt Service 2/
Date of latest Observation	Same day	November 1999	November 1999	November 1999	November 1999	Same day	October 1999	October 1999	1999 Q3	1999 Q3	1999 Q3	end-1998
Date received	Same day	12/01/99	12/01/99	12/01/99	12/01/99	Same day	11/19/99	11/18/99	11/30/99	11/30/99	11/30/99	May 1999
Frequency of data	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annual
Frequency of reporting	Daily	Monthly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annual
Source of update	Various	Finance Canada news release	BOC financial statement	BOC Financial statement	BOC financial statement	Various	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada
Mode of reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confidentiality	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted
Frequency of publication	Daily	Monthly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annually

1/ National accounts.
2/ Net international investment position.

Public Information Notice (PIN) No. 00/__
FOR IMMEDIATE RELEASE

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

IMF Concludes Article IV Consultation with Canada

On January 26, 2000, the Executive Board concluded the 2000 Article IV consultation with Canada.[1]

Background

The Canadian economy bounced back strongly from the effects of the Asian financial crisis and the turmoil in world financial markets last year, reflecting a rebound in commodity prices, continued strong U.S. growth, and strengthening domestic demand, particularly investment spending. After slowing significantly in late 1997 and in the first three quarters of 1998, output growth accelerated in the final quarter of 1998, with the recovery from the effects of some domestic labor strikes, and it rose at an annual rate of 4 percent during the first three quarters of 1999. The unemployment rate declined by a whole percentage point to an average of 8¼ percent in 1998, as employment growth picked up sharply. Subsequently, it has declined further, reaching 6.9 percent in November 1999, its lowest level in two decades. Core inflation (the CPI excluding food, energy, and the effects of changes in indirect taxes) has fluctuated within a narrow range around the lower end of the 1–3 percent official target range since early 1997. It picked up a bit in March-April 1999 and has fluctuated in a narrow range around 1½ percent (annual rate) through November. The overall CPI, however, has risen more rapidly, increasing by 2 percent annual rate during the first 11 months of 1999, largely reflecting movements in energy and food prices.

The current account deficit rose slightly to 1¾ percent of GDP in 1998, but it declined to ½ percent in the first three quarters of 1999. Export growth rebounded sharply during 1999, owing to buoyant growth in U.S. markets and to the recovery in commodity prices. At the same time, growth in the value of imports slowed from its relatively rapid pace in 1998,

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

despite the pickup in domestic demand, as the strengthening Canadian dollar helped to hold down import prices.

Following a 100 basis point increase in short-term interest rates in August 1998, the Bank of Canada matched the moves by the U.S. Federal Reserve and reduced interest rates in September–November 1998 by a cumulative 75 basis points. The Bank reduced short-term interest rates by 25 basis points in both March and May 1999 in order to support continued economic expansion and maintain inflation comfortably within the target range. Subsequently, Canadian interest rates were left unchanged, as U.S. interest rates were increased in June and August by a cumulative 50 basis points. The decision not to follow the Federal Reserve's rate hikes at that time reflected the Bank's assessment that monetary conditions in Canada were consistent with the inflation target. In November, the Bank of Canada raised rates by 25 basis points, in line with an increase by the U.S. Federal Reserve.

Over the past six years, decisive efforts by the Government produced a dramatic turnaround in the federal fiscal position, which shifted from a deficit of $42 billion (5¾ percent of GDP) in 1993/94 to a surplus of nearly $3 billion (¼ percent of GDP) in 1998/99 (fiscal year ending March 31). Substantial fiscal consolidation also occurred at the provincial level during this period, helping to shift the general government balance from a deficit of more than 5½ percent of GDP in 1994 to a surplus of about 1 percent of GDP in 1998 (national accounts basis). Largely as a result of restraint in public consumption and controls on capital spending, the aggregate budgetary balance of the provinces moved into a small surplus in 1997, before slipping back into a small deficit in 1998, as the Asian crisis and lower commodity prices reduced revenues in some provinces and other provinces used a portion of their "fiscal dividends" to cut income taxes. The ratio of general government net debt to GDP has declined from a peak of 70 percent of GDP in 1995 to about 62 percent in 1998, but at that level, it still remains above the average of all G-7 countries.

Executive Board Assessment

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Table 1. Canada: Selected Economic Indicators

	Averages							
	1960s	1970s	1980s	1994	1995	1996	1997	1998
	(In percent change from previous period at annual rates, unless otherwise indicated)							
Economic activity and prices								
Real GDP	5.6	4.4	2.9	4.7	2.8	1.7	4.0	3.1
Real net exports 1/	0.3	0.0	-0.3	1.5	1.0	0.1	-1.7	1.0
Real final domestic demand	5.2	4.6	3.4	2.8	0.8	2.4	4.9	2.7
Consumer spending	4.8	4.5	2.9	3.1	2.1	2.5	4.2	2.8
Nonresidential fixed investment	4.0	5.8	1.4	8.9	0.6	4.9	14.0	0.1
Labor market								
Labor force	...	...	2.0	1.1	0.7	1.5	1.3	1.8
Employment	...	...	2.0	2.1	1.6	1.2	1.9	2.8
Unemployment rate (period average)	...	...	9.4	10.4	9.5	9.7	9.2	8.3
Labor productivity	...	2.0	0.8	1.6	1.2	-0.4	2.8	0.8
Capital stock	4.6	4.3	3.7	1.9	1.9	2.1	2.7	2.7
Prices								
GDP deflator	...	...	6.0	1.3	2.4	1.5	1.0	0.0
Implicit price deflator for GDP	3.5	8.0	5.8	1.1	2.3	1.6	0.8	-0.6
Core consumer price index	...	...	...	1.6	2.3	1.5	1.5	1.2
Unit labor cost	...	7.8	6.0	-1.3	1.3	1.3	1.3	2.6
Exchange rate								
U.S. cents/Canadian dollars	94.4	96.4	79.5	73.0	73.1	73.3	72.0	67.1
Percent change	-1.2	-0.8	-0.1	-5.6	0.2	0.3	-1.8	-6.8
Nominal effective exchange rate 2/	-1.1	-1.4	-0.1	-6.2	-2.0	1.7	0.2	-6.0
Real effective exchange rate 3/	...	...	1.5	-7.6	-0.7	2.1	0.7	-8.0
Interest rates								
Three-month Treasury bill rate	...	7.0	11.3	5.5	7.1	4.2	3.2	4.7
Ten-year Treasury bond rate	...	...	...	8.4	8.1	7.2	6.1	5.3
	In percent of GDP or NDP							
Balance of payments								
Current account balance	-2.2	-2.6	-2.2	-2.3	-0.8	0.5	-1.6	-1.8
Merchandise trade balance	0.9	1.7	2.9	2.6	4.4	5.0	2.7	2.1
Invisible balance	-3.1	-4.3	-5.1	-5.0	-5.1	-4.5	-4.3	-3.9
Real net exports 4/	2.4	2.3	1.3	1.9	2.9	3.0	1.2	2.1
Fiscal indicators								
General fiscal balance (NIA)	-0.3	-1.0	-4.7	-5.6	-4.3	-1.8	0.8	0.9
Federal fiscal balance (NIA)	-0.3	-1.4	-4.6	-3.7	-3.1	-1.3	1.0	1.1
Provincial fiscal balance (NIA) 5/	-0.5	-0.7	-0.8	-1.7	-1.1	-0.3	0.1	-0.1
Saving and investment 6/								
Gross national saving	21.9	22.3	20.1	15.4	17.6	18.1	18.6	17.8
General government	4.6	3.1	-1.0	-2.8	-1.5	0.7	3.0	3.2
of which: Federal government	0.6	-0.6	-3.5	-3.0	-2.5	-0.8	1.3	1.4
Private	17.3	19.2	21.1	18.2	19.1	17.4	15.6	14.6
Personal	7.0	9.8	11.9	8.0	7.7	6.3	4.8	4.6
Business	10.3	9.4	9.2	10.2	11.4	11.1	10.8	10.1
Gross domestic investment	23.5	23.6	21.4	18.2	18.0	17.6	19.9	19.6
Private	18.9	20.0	18.6	15.6	15.5	15.3	17.8	17.6
Public	4.6	3.6	2.8	2.6	2.5	2.3	2.1	2.1
of which: Federal government	0.7	0.5	0.5	0.5	0.4	0.4	0.3	0.3
Net foreign investment	1.8	1.8	1.9	3.4	0.5	-1.0	1.9	2.4
Net national saving	13.5	14.3	10.8	3.9	6.9	7.3	8.1	6.8
Net private investment	12.1	14.0	11.6	6.9	6.7	6.0	9.0	8.7
In real terms								
Gross domestic investment	15.4	15.7	17.6	17.9	18.0	18.1	20.5	20.1
Private	12.3	13.3	15.5	15.3	15.5	15.7	18.3	17.9
Public	3.1	2.4	2.1	2.6	2.5	2.4	2.2	2.2
				Fiscal Years				
Memorandum item:				1994/95	1995/96	1996/97	1997/98	1998/99
Federal fiscal balance (public accounts)	...	...	...	-4.9	-3.5	-1.1	0.4	0.3

Sources: Statistics Canada; and Fund staff estimates.

1/ Contribution to growth.
2/ Constructed using 1989-91 trade weights.
3/ Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989-91 trade weights.
4/ Based on NIA data.
5/ Includes local governments.
6/ Gross national saving does not equal the sum of gross domestic investment and net foreign investment because of statiscal discrepancy.

FOR
AGENDA

SM/99/314
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

January 24, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Canada—Staff Report for the 2000 Article IV Consultation**

The following corrections have been made in SM/99/314 (12/29/99):

Page 3, para. 3, line 7: for "domestic work stoppages" read "work stoppages"

Page 6, para. 3, lines 9–13: for "model to estimate...NAIRU to help"
read "model and filters...expectations to help"

Page 11, lines 14 and 15: for "nonfinancial corporations as a percent of"
read "nonfinancial corporations (including crown corporations) as a percent of"

Page 15, para. 20, lines 3 and 4: for "Because of this,...guides to formulating policy."
read "Because of this, these indicators...capacity and inflation."

Page 22, para. 36, line 6: for "a few of them"
read "all of them"

Page. 34, under "Public accounts basis 4/, stub Provincial, last column: for "28.2"
read "28.0"

Page 35: Revised.

Corrected pages are attached.

Att: (7)

Other Distribution:
Department Heads

I. INTRODUCTION[1]

1. The staff report for the previous Article IV consultation discussions was considered by the Executive Board on January 22, 1999 (EBM/99/9).[2] Executive Directors welcomed the continued improvement of the budget positions at all levels of government, which offered promising prospects for a significant fall in the ratio of government debt to GDP over the next several years. The Bank of Canada's inflation targeting approach to monetary policy continued to be successful, maintaining inflation at one of the lowest levels among the major industrial countries. Directors noted, however, the relatively high ratio of personal income taxes to GDP in Canada, and recommended that, in addition to using prospective fiscal surpluses for debt reduction, priority be given to reforming income taxation to improve incentives to work and save.

II. ECONOMIC DEVELOPMENTS AND OUTLOOK

2. ***Macroeconomic policy measures implemented during the 1990s have established a sound foundation for the Canadian economy and underpinned the current economic expansion.*** The successful implementation of an inflation targeting framework since 1991 has held inflation at low levels. Sharp fiscal consolidation at all levels of government has arrested what had been a marked increase in the ratio of government debt to GDP, and put the debt ratio on a steady downward path. Structural reforms in key areas, including changes in the employment insurance system and improvements in the financing of the public old-age support system, also have enhanced the economy's growth prospects.

3. ***The Canadian economy has bounced back strongly from the effects of the Asian financial crisis and the turmoil in world financial markets in 1998. The sharp pickup in output growth over the year to the third quarter of 1999 has reflected a rebound in commodity prices, continued robust U.S. growth, and strengthening domestic demand, particularly investment spending.*** Output growth slowed significantly in late 1997 and in the first three quarters of 1998 owing to the fallout from the Asian crisis and a few major work stoppages (Table 1 and Figure 1). Growth accelerated in the final quarter of 1998, with the recovery from the effects of the domestic labor strikes, and has risen at an annual rate of

---

[1] The discussions were held November 8–15 and were concluded at a meeting on November 16 with Finance Minister Martin and Governor Thiessen. The staff team comprised D. Goldsbrough, S. Dunaway, M. Leidy, M. Cerisola, P. De Masi, and A. Matzen (all WHD). Mr. Fischer and Mr. Loser participated in the meeting with the Minister and the Governor. Mr. Ingves and Mr. Johnston (MAE) participated in a meeting to discuss the main conclusions of the Financial System Stability Assessment (FSSA) for Canada. The Executive Director for Canada, Mr. Bernes, and his Advisor, Mr. Fenton, attended the meetings.

[2] SM/98/280, 12/22/98, and the selected issues paper, SM/99/3, 1/8/99.

4 percent during the first three quarters of 1999, with growth rising to 4¾ percent (annual rate) in the third quarter.

Figure 1. Output and Demand
(Annualized growth in percentage points)

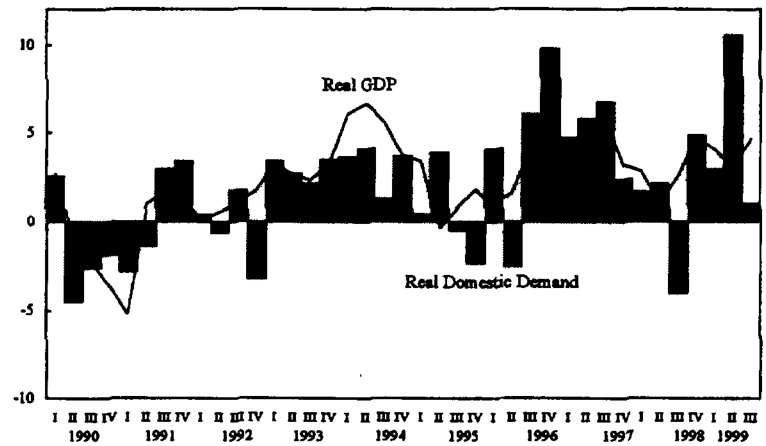
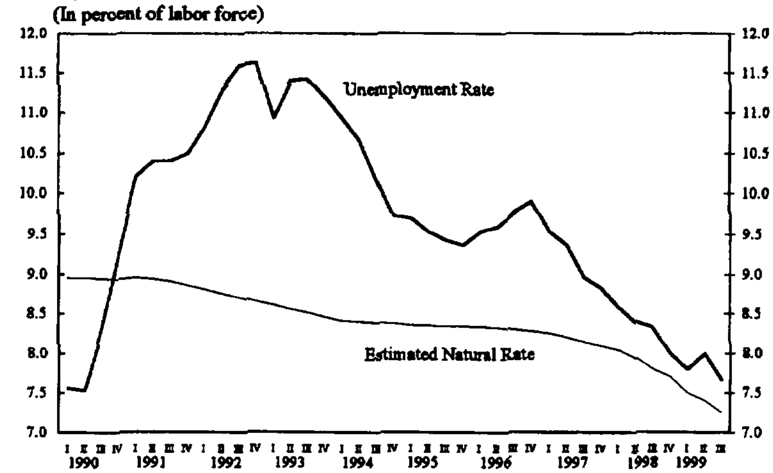


Figure 2. Unemployment
(In percent of labor force)



4. ***After hovering around 9½ percent during 1994–97, the unemployment rate declined markedly to 8¼ percent in 1998, as employment growth at 2¾ percent was the best of the decade (Figure 2).*** The gains in employment were broadly based, especially in full-time private sector jobs and the self-employed. The strength in the labor market carried into early 1999, and the unemployment rate declined to 7.8 percent by January. Employment growth slowed markedly in the middle of the year, but has since strengthened considerably, pushing the unemployment rate down to 6.9 percent by November 1999.

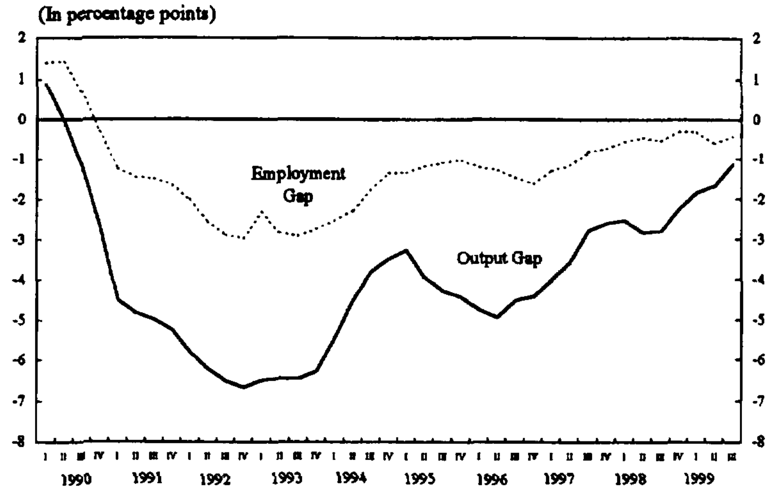
5. ***Overall, the strength of productivity growth in Canada has broadly matched that in the United States.*** During the 1990s, labor productivity has risen at an annual average rate of 1¼ percent, roughly in line with the growth experienced in the previous decade in Canada and with labor productivity growth in the United States. Multifactor productivity growth in the Canadian business sector appears to have outperformed that in the United States since the mid-1980s; although on a sectoral basis, productivity growth in manufacturing in Canada, particularly in the electrical and machinery industries, has lagged markedly behind that of the United States.[3]

---

[3] Statistics Canada has recently revised figures for multifactor productivity to incorporate revisions to the national accounts and the capital stock, which have increased the annual growth rate of multifactor productivity to roughly ¾ percent during the 1990s, compared with ½ percent during the 1980s. The forthcoming selected issues paper will examine the issue of productivity in Canada, including comparisons of Canada's performance to that in the United States.

6. ***Slack in the economy has declined significantly since the second half of 1998, but there is considerable uncertainty as to how close the economy is to full capacity*** (Figure 3). Staff estimates suggest that output in the third quarter of 1999 was about 1 percent below potential (Box 1). Based on alternative empirical methodologies, the staff estimates of the NAIRU range from 6½ percent to 8 percent.[4] A NAIRU of 6½ percent is roughly consistent, according to Okun's Law, with the staff's estimated output gap. It also would be consistent with expected effects of recent reforms in the Employment Insurance (EI) system and provincial social assistance programs which introduced important structural changes in the labor markets. In view of the gradual effects of these reforms, the staff estimates that the NAIRU will decline from around 8 percent in 1998 to 6½ percent over the medium term.

Figure 3. Employment and Output Gap
(In percentage points)



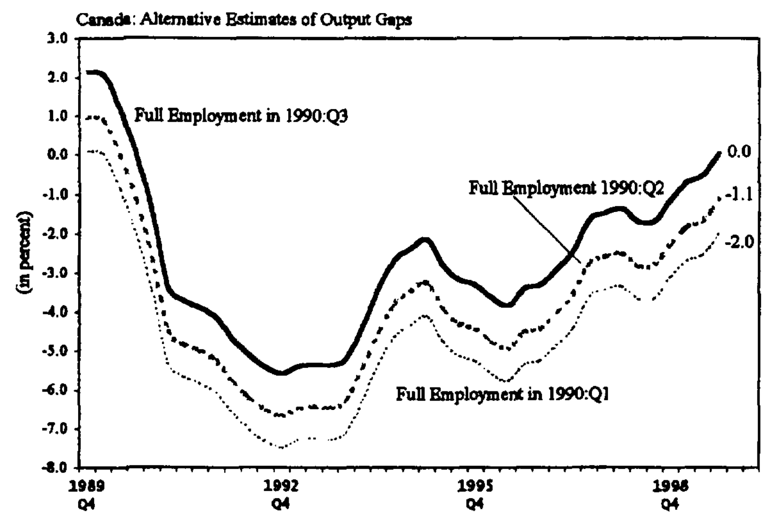
[4] See *Canada: Selected Issues,* (SM/99/3), Chapter 2 and *Canada: Selected Issues,* (SM/98/17), Chapter 1. An analysis of why structural unemployment in Canada has been higher than in the United States will be included in the forthcoming selected issues paper. Empirical evidence suggests that Canada's more generous Employment Insurance system contributed to a rise in structural unemployment in the 1980s. Recent EI reforms are expected to reduce structural unemployment over the medium term.

Box 1. The Output Gap, Potential Output, and Potential Growth

The output gap (actual minus potential output) traditionally has been an important indicator of aggregate resource utilization, foreshadowing the possible build-up of inflationary pressures. While the concept is straightforward, its empirical measurement is subject to considerable uncertainty. Although estimates of the rate of growth of potential output in Canada tend to fall in a relatively narrow range, estimates of the level of potential output differ more significantly.

Using a variety of statistical detrending techniques and some structural approaches (such as those based on a production function), the staff estimates that potential growth in the 1990s has been about 2.4 percent, close to the Bank of Canada's estimate of about 2¼ percent. Both the staff and the Bank of Canada estimates suggest that potential growth has slowed significantly in the 1990s from the 3 percent average rate estimated for the 1980s. This slowdown is attributed to a sharp decline in the labor force participation rate at the start of the 1990s, which was accounted for by reduced labor force involvement by individuals in the 15–24 and 55–64 year age groups. The fall in the participation rate for the latter group is probably largely structural in nature, reflecting a longer-term trend toward early retirement. In the former group, it reflects both structural factors, as more individuals in this group have opted to pursue additional education and changes in eligibility requirements for employment insurance have discouraged entry, and cyclical factors, associated with less favorable job prospects for younger, less skilled workers. More recently, substantial investment in equipment embodying new technologies may have raised the rate of potential growth.

The staff's estimate of the level of potential output is extrapolated by identifying a period when the economy was judged to be near full employment and then applying the growth rate for potential in subsequent periods. Based on an assessment of cyclical peaks in Canadian economic activity, it appears that the economy was operating near potential in the first or second quarter of 1990. The Bank of Canada uses a structural model and filters to estimate the level of potential output. This procedure uses information on the behavior of inflation and inflation expectations to help pin down the level of potential output and suggests that the economy was operating at full capacity in the third quarter of 1990. There is considerable uncertainty as to the exact point in time when the economy reached full capacity. The chart illustrates alternative estimates of the output gap based on the staff's methodology and different assumptions about when the economy was last at full employment. The estimated output gaps for the third quarter of 1999 range from -2 percent to zero.



of disposable income (94 percent to 114 percent) over this period (Figure 10). Although the personal debt-service ratio edged up in 1998 to about 9 percent of personal disposable income, it remains well below its peak in the early 1990s (almost 13 percent) and below the average of the last two decades. At the same time, the debt of nonfinancial corporations (including crown corporations) as a percent of corporate net worth has remained relatively stable (around 170 percent) since 1992 and the ratio of nonfinancial corporate debt to GDP has declined from 65 percent to 61 percent (Figure 11).

Figure 10. Household Net Worth
(As percent of disposable income)

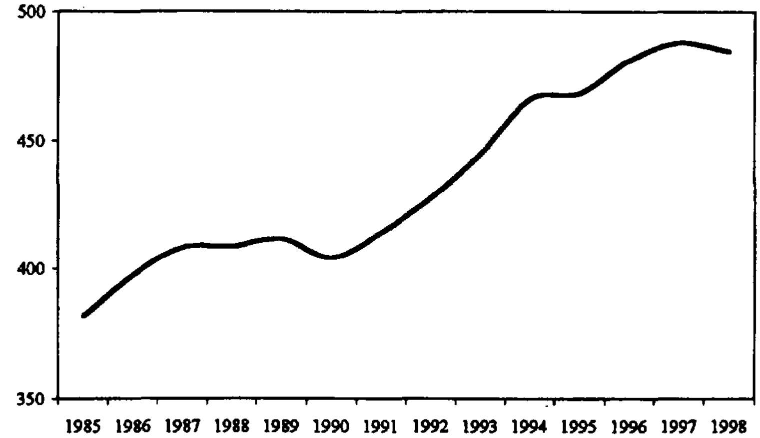
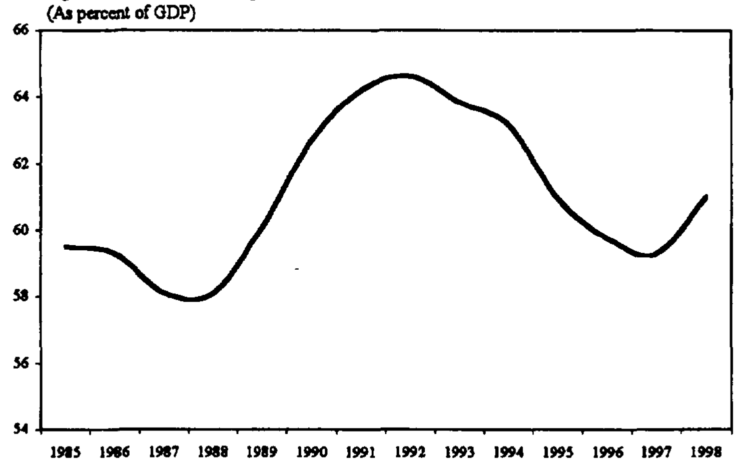


Figure 11. Nonfinancial Corporate Debt
(As percent of GDP)



15. ***The staff projects that real GDP growth will slow in the period ahead, in line with an anticipated deceleration in demand growth in the United States to a more sustainable level.*** Macroeconomic developments in the United States are central to the near-term outlook for economic activity in Canada in view of the high degree of economic integration between the two economies (Box 2). Canada's real GDP growth is expected to decline from 3¾ percent in 1999 to around 3¼ percent in 2000 (slightly above the consensus forecast). Output growth is projected to slow further to around its potential rate by 2002 as the output gap is eliminated (Table 6). Domestic demand growth in Canada would ease somewhat over most of the forecast horizon, as consumer spending would slow reflecting more moderate growth in household net worth and higher interest rates, while the pace of fixed investment spending also would decline, owing to an end to Y2K-related spending, higher interest rates, and slower consumption and export growth. The external current account is expected to improve steadily from a deficit of ½ percent of GDP in 1999 to a surplus of ¾ percent by 2004, primarily reflecting improved macroeconomic conditions in Europe and Asia, sustained but decelerating growth in the

Box 2. Canada-U.S. Economic Integration: An International Comparison

The ongoing discussion of monetary arrangements in various parts of the world, including the move toward a common currency in Europe, has rekindled interest in the issue of economic integration within groups of countries. In this context, this box summarizes the situation of Canada vis-à-vis the United States in comparison with integration among European Union countries. In general, the degree of integration between Canada and the United States is much higher than in Europe. However, there appears to have been a greater asymmetry in the nature of shocks experienced by Canada and the United States than is the case within Europe. This latter factor, together with the political commitment in Europe to move toward a full common market, probably explains the different choice of exchange rate regimes.

The Canadian economy is very open by international standards. In 1998, the degree of openness (measured by the ratio of external trade in goods and services to GDP) in Canada was 81 percent, somewhat higher than in the European Union and easily the highest among the G-7 economies (see figure).

A principal measure of integration between groups of countries is the extent of intra-regional trade. According to this measure, the integration of Canada with the United States is greater than integration among most countries in Europe. In Canada, the share of U.S. trade in total trade (85 percent) and in GDP (61 percent) are much larger than the corresponding shares in European countries (except for a few of the smaller economies; see table below).

An additional dimension of integration is the degree of labor mobility. Labor mobility between Canada and the United States, while small as a share of the total labor force, has increased in recent years, especially among skilled workers.1/ As a share of the labor force, gross annual Canada-U.S. migration is roughly the same as intra-EU migration. This is, however, in the context of smaller wage differentials than among European countries.

Canada's capital account is closely integrated with the United States. In 1998, the United States contributed 86 percent of the direct investment inflows into Canada and took in 77 percent of Canadian direct investment abroad. Its shares in Canadian portfolio inflows and outflows were 85 percent and 97 percent, respectively. While the numbers may partly reflect third countries' investments in Canada through the United States, they are significantly higher than among EU countries, where in recent years intra-European direct investment and equity capital flows have accounted for 50–55 percent and 50 percent of total flows, respectively.

The high degree of integration between the Canadian and U.S. economies has contributed to a close correlation of macroeconomic trends. Real GDP growth and inflation in Canada have been very closely correlated with growth and inflation in the United States.2/ The correlation between Canadian and U.S. real GDP growth has been higher than among most European economies, and roughly the same as among the most closely related European economies (Austria, Belgium, France, Germany, and the Netherlands). The correlation between Canadian and U.S. inflation has historically been higher than among European economies.

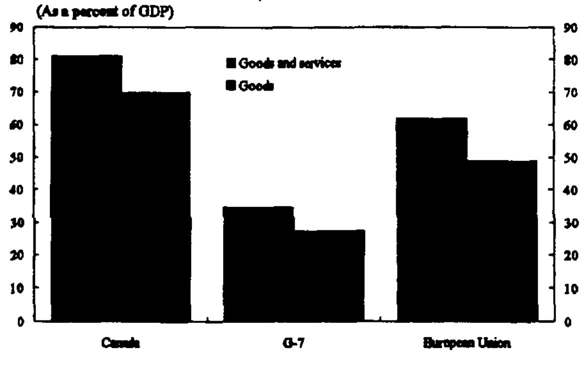
However, the nature of shocks to the Canadian and U.S. economies during the past few decades has been much more dissimilar than among European countries.3/ In particular, unlike among several European economies, there does not seem to be any significant positive correlation between supply shocks in Canada and the United States. The same holds for demand shocks, although supply shocks are more informative about underlying regional patterns than demand shocks, which include the impact of monetary and fiscal policies.

External trade within regions, 1998
(in percent)

	Regional Trade/Total Trade	Regional Trade/GDP
Europe (selected countries)	With other EU countries	
Belgium-Luxembourg	52	71
France	62	25
Germany	55	26
Ireland	62	79
Italy	62	23
Netherlands	63	52
United Kingdom	51	21
EU weighted average	59	29
	With United States	
Canada	85	61

Based on aggregate merchandise trade (exports plus imports).

Selected countries: External trade, 1998
(As a percent of GDP)



1/ See Stephen Tokarick, 1999, "Brain Drain From Canada to the United States," in International Monetary Fund, "Canada—Selected Issues," SM/99/3, issued January 8, 1999.
2/ See Tamim Bayoumi and Barry Eichengreen, 1994, "One Money or Many? Analyzing the Prospects for Monetary Unification in Various Parts of the World," Princeton Essays in International Finance, No.76.
3/ See Bayoumi and Eichengreen (op cit). Vivek Arora, 1999, "Exchange Rate Arrangements in Selected Western Hemisphere Countries," mimeo., International Monetary Fund, provides more recent estimates for Canada and the United States.

- ***with few signs of inflationary pressures, monetary policy should aim to permit the economy to reach its productive potential, but the challenge will be to gauge the point at which policy will need to shift toward tightening;***
- the appropriate mix of debt reduction, tax cuts, and higher spending on priority areas in light of prospective fiscal surpluses.

A. Monetary Policy and the Exchange Rate

19. ***The Bank of Canada targets inflation with the aim of influencing the rate over the succeeding six to eight quarters.*** Its assessment of future inflation generally has relied on an evaluation of current and projected output gaps, unit labor costs, inflation expectations, changes in indirect taxes, and the current and expected future exchange rate. A broad range of other economic and financial indicators, including monetary and credit aggregates and the outcome of collective wage settlements, is also considered.

20. ***The authorities and the staff agreed that there was considerable uncertainty over how much slack remained in the Canadian economy, as estimates of the output and employment gaps ranged widely.*** Because of this, these indicators were not very useful at present as guides to formulating policy. The Bank of Canada representatives noted that they use output gap estimates, not employment gap estimates, in their policy deliberations; however, in current circumstances, the output gap estimates had to be supplemented by a wide range of other indicators of pressures on capacity and inflation. The staff and the authorities agreed that substantial investment in machinery and equipment in recent years, which embodies new technologies, probably had raised the level of capacity. The Bank representatives indicated that their point estimates of the output gap for the third quarter of 1999 were close to zero, or slightly positive, but a very wide confidence interval surrounded these estimates. Although the staff's point estimate (a negative gap of a little over 1 percent) shows a somewhat higher degree of slack in the economy, it falls within the Bank's confidence interval. In the labor market, substantial reforms to the employment insurance system were seen as having improved flexibility and contributed to reducing the NAIRU. The authorities suggested that, once the effects of these reforms were fully realized, the NAIRU might decline significantly from its late 1980s estimate of around 8 percent. Based on the discussions and its own alternative estimates (discussed in paragraph 6), the staff has revised its estimate of the NAIRU to decline to 6½ percent by end-2002.

21. ***Given the uncertainties regarding estimates of capacity, the authorities took the view, and the staff concurred, that the near-term aim of monetary policy should be to allow the economy to seek its productive potential without compromising the official target for inflation.*** The key challenge for monetary policy was to gauge the point at which monetary conditions would have to be tightened as slack in the economy appeared to diminish and indications of inflationary pressures began to emerge. To aid in reaching this decision, the Bank of Canada officials indicated that they would place more emphasis on a broader range of inflation indicators in their effort to carefully monitor the degree of underlying inflationary pressures. These indicators included movements in core and trend inflation; data on wage settlements and surveys of expected compensation increases; indirect evidence of rising

inflation expectations from certain asset data (such as the yield differential between conventional and real return government bonds, and real estate prices); and the monetary and credit aggregates. In using the information provided by these indicators to set monetary policy, Bank officials noted that there was no fixed formula, and that this information had to be carefully interpreted.

22. ***Given the high degree of openness of the Canadian economy, current and prospective movements in the exchange rate play an important role in the Bank of Canada's assessment of monetary conditions.*** In this context, the officials from the Bank noted that the monetary conditions index (MCI) remained an important tool in assessing the near-term stance of monetary policy, but that the index had been de-emphasized somewhat in the Bank's more recent monetary policy reports.[12] The decision to de-emphasize the MCI was largely a result of a tendency of financial market participants to misinterpret movements in the index and to respond at times as if there were a fixed target path for the index.

23. ***The authorities noted that their past successes in maintaining inflation within the target range had improved the credibility of monetary policy, solidly anchoring inflation expectations.*** Survey data consistently showed that inflation expectations had remained at about 2 percent, the midpoint of the official target range. Policy credibility had also benefited from the improvements in the medium-term fiscal outlook and the commitment to further public debt reduction, highlighting the need for continued sound fiscal policy. The staff suggested that enhanced credibility would likely provide the Bank with some additional room to maneuver in testing the economy's productive limits. The representatives and the staff agreed, however, that there were inevitably questions about how much maneuvering room existed in view of the uncertainty over the extent of slack in the economy and the fact that inflation already was near the midpoint of the target range.

24. ***The authorities said that the rapid pace of output growth over the first three quarters of 1999 suggested that some additional caution might be warranted in the conduct of monetary policy.*** In testing the limits of capacity, they believed that it would be prudent to ensure that these limits were not approached at a very rapid pace of economic growth. This would help ensure that, once it became evident that capacity had been reached, tighter monetary conditions would have a chance to slow demand growth before inflationary pressures could take hold—a position that the staff strongly supported. In their forecasts, the authorities expected that the economy would continue to expand, but at a slower rate than at present, and that inflation would be contained around the midpoint of the target range. The recovery in commodity prices since early 1999, the depreciation of the Canadian dollar in

[12] The MCI is a weighted sum of changes in the short-term interest rate (typically the 90-day commercial paper rate) and the effective exchange rate, with weights of 3 to 1, respectively. These weights are based on the Bank of Canada's empirical work that suggests a 1 percentage point change in interest rates affects aggregate demand over time by about the same amount as a 3 percent change in the exchange rate.

with the authorities, the staff favored steps to fully index the tax system to inflation; increase income thresholds at which progressive marginal tax rates apply; lower the 26 percent statutory marginal tax rate; and reduce the rate of clawback of the National Child Benefit.

34. ***The authorities stressed, and the staff agreed, that there were also substantial gains to be made for the economy from using at least a small amount of resources to make the corporate income tax system more competitive.*** Corporate tax rates in Canada, when provincial taxes were factored in, are high by international standards (particularly in key growth sectors such as services). By lowering the basic federal corporate income tax rate, the system could be made less distortionary, since the relatively higher taxation of income outside the small business and manufacturing and processing sectors would be reduced.[20] Distortions could be further diminished, while offsetting some of the costs of the reform, by broadening the tax base along the lines of the measures recommended in the 1998 Report of the Technical Committee on Business Taxation.[21] The report also recommended steps to reduce compliance costs and improve tax enforcement.

35. ***The authorities noted the considerable pressures they faced to increase spending, but that they would continue to try to limit the size of new spending initiatives, with priority continuing to be given to education and health care.*** The authorities explained that, in the medium-term projections, direct program spending was assumed to remain constant in real

---

taxpayers in Canada exceed the combined federal and provincial statutory rates as a result of the clawback of certain tax credits, including the National Child Benefit, as incomes rise. For example, for incomes around Can$30,000 the marginal effective income tax rate for a single taxpayer residing in Ontario with two children is estimated to rise to about 60 percent (federal and provincial combined, including the Employment Insurance premium, Canada Pension Plan premium, and all refundable tax credits), before falling back to about 40 percent as incomes reach Can$40,000.

[20] Corporate income tax rates vary by firm size, activity, and provincial location. The federal corporate statutory income tax rate is set at 28 percent for general business income, 21 percent for manufacturing and processing operations, and 12 percent for small businesses. Canada's combined federal-provincial corporate tax rate for general business income averages 43 percent, compared to a combined federal-state average of around 39 percent in the United States.

[21] The base-broadening measures recommended by the Committee include the elimination or reduction of certain preferences (e.g., research and development tax incentives which are among the most generous in the world), credits (e.g., recommended replacing the Atlantic Investment Tax Credit with a more cost-effective and broad-based nontax program), and deductions (e.g., proposed a general review of capital cost allowances to ensure that rates are closer to economic depreciation, along with a reduction in some accelerated classes).

per capita terms, which would provide some limited room to accommodate additional spending initiatives.

36. ***Significant progress has been made by provincial and territorial governments in balancing their budgets, and the authorities expected these governments to continue to follow sound budgetary policies in the period ahead, with all of them achieving balance or maintaining surpluses in 2000.*** The favorable performance of the economy, accompanied by rebounding commodity prices and increased federal transfers, has significantly improved the aggregate fiscal position of the provinces. Consequently, all of them have moved to lower taxes, some ahead of previously announced schedules. The authorities suggested that these actions would not significantly affect the strong overall budget position of the provinces over the medium term. The staff, however, stressed that the provinces needed to be cautious and to sustain their fiscal efforts. In particular, all levels of government needed to factor in the potential fiscal costs associated with an aging population, especially in the area of health care, in forming their longer-term fiscal objectives.

C. Other Issues

37. ***Although the unemployment rate in Canada has come down significantly, it remains high by historical standards and relative to the United States.*** Reforms to the employment insurance (EI) system enacted during the past few years, which included tying benefit levels to the frequency of use and sharper clawback provisions for higher-income participants, have contributed to improving the efficiency and flexibility of the labor market and to reducing structural unemployment. The authorities noted that, as these reforms have become binding, significant pressures have emerged to roll them back, and that they were working hard to resist such pressures. The staff expressed concern about the Government's recent proposal to increase maternity and parental leave benefits under the EI system and to relax the eligibility requirements for these benefits. This action appeared to be a move away from the idea that the EI system should be primarily an insurance scheme. Moreover, it carried the risk of creating new incentives for casual labor force participation and heightened pressures for additional benefits. The authorities acknowledged these concerns and reiterated their commitment to resist additional demands. They explained that the change in maternity and parental leave benefits was part of the Government's overall strategy to provide more support for children, particularly in their early formative years.

38. ***In current circumstances, the authorities said that it would be difficult to extend reforms to the EI system in the areas that the staff continued to stress, specifically the introduction of experience rating in setting individual company's EI premiums and the elimination of regional extended benefits.*** Within the Government, there was no consensus on whether experience rating would yield significant net benefits. While it was recognized by some that experience rating could yield significant improvements in the functioning of the

Table 3. Canada: Federal Government Budget, Public Accounts 1/

(In billions of Canadian dollars; unless otherwise indicated)

Fiscal Years	1994/95	1995/96	1996/97	1997/98	1998/99
Total revenues	**123.3**	**130.3**	**140.9**	**153.2**	**155.7**
In percent of GDP	16.1	16.1	16.9	17.5	17.4
Total spending	**160.8**	**159.0**	**149.8**	**149.7**	**152.8**
In percent of GDP	20.9	19.7	18.0	17.1	17.1
Program spending	118.7	112.0	104.8	108.8	111.4
In percent of GDP	15.5	13.9	12.6	12.4	12.4
Interest payments	42.0	46.9	45.0	40.9	41.4
In percent of GDP	5.5	5.8	5.4	4.7	4.6
Budget balance	**-37.5**	**-28.6**	**-8.9**	**3.5**	**2.9**
In percent of GDP	-4.9	-3.5	-1.1	0.4	0.3
Net public debt	**545.7**	**574.3**	**583.2**	**579.7**	**576.8**
In percent of GDP	71.1	71.2	69.9	66.3	64.4
Memorandum items:					
Structural budget balance	-31.5	-22.5	-1.4	9.5	7.6
In percent of GDP	-4.1	-2.8	-0.2	1.1	0.9
Primary balance	4.6	18.3	36.1	44.4	44.3
In percent of GDP	0.6	2.3	4.3	5.1	5.0
Structural primary balance	10.5	24.4	43.6	50.4	49.0
In percent of GDP	1.4	3.0	5.2	5.8	5.5

Sources: Department of Finance; and Fund staff estimates.

1/ On a fiscal year basis, which ends on March 31.

Table 4. Canada: Net Government Debt

(In percent of GDP)

	1980	1992	1993	1994	1995	1996	1997	1998
National accounts basis 1/	**14.4**	**59.6**	**66.2**	**68.7**	**70.2**	**69.8**	**65.5**	**62.3**
Federal	15.7	52.0	54.6	55.3	56.5	55.0	51.5	48.4
Provincial 2/	6.8	15.8	19.5	20.6	20.5	21.1	19.8	19.4
CPP and QPP 3/	-8.0	-8.2	-7.8	-7.2	-6.8	-6.4	-5.8	-5.4
Public accounts basis 4/	**37.4**	**90.7**	**96.3**	**97.9**	**98.6**	**96.5**	**94.5**	**92.6**
Federal	29.2	66.7	70.1	71.1	71.2	69.9	66.3	64.4
Provincial	8.3	24.0	26.2	26.8	27.4	26.6	28.2	28.0
Memorandum item:								
Government of Canada marketable securities held by nonresidents 5/	9.5	27.9	27.6	25.8	25.9	25.4	24.7	23.5

Sources: Statistics Canada, National Balance Sheet Accounts (13-214) and Canada's International Investment Position (67-202); Department of Finance, Canada; and Fund staff estimates.

1/ Calendar year, 1998 figures are estimates. The national accounts measure of net debt does not include government indebtedness to the public service pension plans and the Canada Pension Plan (CPP)/Quebec Pension Plan (QPP) as a government liability.

2/ Also includes local government and hospital sectors.

3/ Canadian Pension Plan and Quebec Pension Plan.

4/ Fiscal year, beginning April 1; 1998 figures are estimates. The public accounts measure of net debt includes government indebtedness to the public service pension plans, the CPP, and the QPP as a government liability. Note that data on intergovernmental holdings of net debt are not available on a public accounts basis so that the totals may be biased upward.

5/ As a percent of total marketable debt. 1998 total government of Canada debt based on data from Bank of Canada Review.

Table 5. Canada: Indicators of Economic Performance

	Average 1985-94	1995	1996	1997	1998	Projection 1999	2000
		(Annual percent change)					
Real GDP							
Canada	2.6	2.8	1.7	4.0	3.1	3.6	2.6
United States	2.6	2.3	3.4	3.9	3.9	3.7	2.6
Japan	3.3	1.5	5.0	1.4	-2.8	1.0	1.5
Germany	2.8	1.7	0.8	1.8	2.3	1.4	2.5
G-7 countries	2.6	2.2	3.0	2.9	2.2	2.6	2.4
Real fixed private investment							
Canada	3.6	-1.7	8.2	16.9	3.4	8.5	4.0
United States	2.0	5.5	8.8	8.3	11.4	9.7	5.4
Japan	4.6	2.2	11.8	1.6	-11.8	-4.8	4.0
Germany	3.3	-0.2	-0.4	1.5	2.1	3.8	2.9
G-7 countries	2.5	3.9	7.3	5.7	5.0	5.5	4.6
Consumer prices							
Canada	3.5	2.2	1.6	1.4	1.0	1.5	1.7
United States	3.6	2.8	2.9	2.3	1.6	2.2	2.5
Japan	1.6	-0.1	0.1	1.7	0.6	-0.4	0.0
Germany	2.4	1.8	1.5	1.8	0.9	0.4	0.8
G-7 countries	3.4	2.4	2.2	2.0	1.3	1.4	1.7
Unit labor cost in manufacturing							
Canada	1.2	1.2	2.6	0.9	0.6	-1.5	2.0
United States	1.2	-1.5	-1.8	-0.7	0.2	-0.4	1.5
Japan	1.8	-2.2	-1.9	-1.6	5.5	-0.3	-0.2
Germany	1.1	-0.1	-0.8	-5.4	-3.0	1.0	1.0
G-7 countries	1.5	-0.8	-0.3	-1.0	0.7	0.0	1.1
		(In percent)					
Unemployment rate							
Canada	9.7	9.5	9.7	9.2	8.3	8.0	8.1
United States	6.5	5.6	5.4	4.9	4.5	4.3	4.5
Japan	2.5	3.1	3.3	3.4	4.1	5.0	5.8
Germany	7.6	9.4	10.3	11.4	11.2	10.9	10.4
G-7 countries	6.8	6.7	6.7	6.5	6.2	6.2	6.4
		(As percent of GDP)					
General government revenues							
Canada	42.7	46.9	47.4	48.1	48.3	47.6	46.4
United States	29.3	30.9	31.5	31.9	32.3	32.5	32.3
Japan	30.2	32.0	31.7	31.7	31.8	30.8	31.1
Germany	46.5	46.3	45.9	45.6	45.4	45.8	45.6
G-7 countries	35.2	36.4	36.7	37.1	37.3	37.2	37.1
General government expenditures							
Canada	49.1	51.2	49.2	47.3	47.4	45.4	44.5
United States	32.3	32.8	32.4	31.6	31.1	30.8	30.3
Japan	32.3	35.6	35.9	35.0	37.0	38.2	38.2
Germany	48.5	49.5	49.2	48.2	47.3	47.7	46.7
G-7 countries	38.8	39.8	39.4	38.3	38.1	38.1	37.6
General government financial balance							
Canada	-5.7	-4.3	-1.8	0.8	0.9	2.2	1.9
United States	-2.9	-1.9	-0.9	0.4	1.3	1.6	2.0
Japan	0.6	-3.6	-4.2	-3.4	-5.3	-7.3	-7.1
Germany	-2.0	-3.2	-3.4	-2.6	-2.0	-1.9	-1.1
G-7 countries	-2.9	-3.4	-2.7	-1.2	-0.8	-0.9	-0.5
General government net debt							
Canada	48.1	70.2	69.8	65.5	62.3	57.8	54.3
United States	46.2	54.5	54.1	51.4	48.4	45.0	41.5
Japan	13.7	13.0	16.4	19.5	30.5	37.6	44.3
Germany 1/	25.6	49.4	52.1	52.8	52.4	51.9	50.9
G-7 countries	39.3	49.7	50.5	49.9	50.4	49.6	48.3
Current account balance							
Canada	-3.2	-0.8	0.5	-1.6	-1.8	-1.0	-0.9
United States	-1.9	-1.6	-1.7	-1.8	-2.6	-3.5	-3.5
Japan	2.9	2.2	1.4	2.2	3.2	3.4	3.1
Germany	2.1	-0.8	-0.2	-0.1	-0.2	0.0	0.2
G-7 countries	-0.5	-0.3	-0.2	0.0	-0.4	-0.9	-0.9

Source: Fund staff estimates. Projections for other G-7 countries are from the World Economic Outlook (October 1999).

1/ Germany's net debt starts in 1986.

Table 6. Canada: Staff Projections

	1998	1999	2000	2001	2002	2003	2004
(In percent change from previous period; unless otherwise indicated)							
NIPA in constant prices							
Real GDP	3.1	3.7	3.3	2.8	2.5	2.5	2.4
Net exports 1/	1.0	0.3	-0.4	0.2	0.2	0.1	0.2
Total domestic demand	2.2	3.7	3.6	2.7	2.4	2.5	2.3
Private consumption	2.8	3.3	3.4	2.7	2.5	2.6	2.4
Private domestic investment	3.4	8.3	4.1	2.7	1.8	2.0	2.0
Change in business inventories 1/	-0.4	-0.1	-0.1	-0.2	0.0	0.0	0.0
Final domestic demand	2.7	3.8	3.7	2.8	2.4	2.5	2.3
GDP (current prices)	2.5	5.3	5.3	4.8	4.4	4.4	4.3
Employment and inflation							
Unemployment rate (period average)	8.3	7.6	7.2	6.9	6.7	6.5	6.5
Consumer price index	1.0	1.5	2.0	2.0	2.0	2.0	2.0
GDP deflator	-0.6	1.5	1.9	1.9	1.9	1.9	1.9
Indicators of financial policies 2/							
Federal fiscal balance							
(public accounts) 3/ 4/	2.9	3.0	3.0	3.0	3.0	3.0	3.0
(as a share of GDP)	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Federal fiscal balance (NIA) 3/	9.7	6.7	7.0	6.9	7.4	7.9	8.7
(as a share of GDP)	1.1	0.7	0.7	0.7	0.7	0.7	0.7
Provincial fiscal balance (NIA) 3/ 5/	-0.6	13.5	9.6	8.2	5.8	3.3	1.8
(as a share of GDP)	-0.1	1.4	1.0	0.8	0.5	0.3	0.1
General goverment fiscal							
balance (NIA) 3/	8.0	20.4	18.2	19.4	19.7	18.3	18.5
(as a share of GDP)	0.9	2.2	1.8	1.9	1.8	1.6	1.6
General goverment net debt							
(as a share of GDP)	62.3	57.3	52.6	48.4	44.5	41.0	37.8
Three-month treasury bill rates (percent)	4.7	4.7	5.2	5.3	5.3	5.3	5.3
Ten-year government bond rates (percent)	5.3	5.5	6.3	6.3	6.3	6.3	6.3
Balance of payments							
Current account balance 3/	-16.4	-4.3	-4.2	0.3	3.9	5.8	9.2
(as a share of GDP)	-1.8	-0.5	-0.4	0.0	0.4	0.5	0.8
Merchandise trade balance 3/	18.9	31.0	31.6	38.2	42.7	45.8	50.7
(as a share of GDP)	2.1	3.3	3.2	3.7	3.9	4.0	4.3
Export volume	8.3	9.7	5.3	7.7	6.6	6.3	6.3
Import volume	-7.3	-9.6	-7.1	-7.0	-6.0	-6.3	-6.3
Invisibles, net 3/	-35.2	-35.3	-35.8	-38.0	-38.9	-40.1	-41.5
(as a share of GDP)	-3.9	-3.7	-3.6	-3.7	-3.6	-3.5	-3.5

Source: Fund staff estimates.

1/ Contribution to growth.

2/ After FY 1998/99, it is assumed that there will be budget surpluses of $3 billion (equivalent to the contingency reserve).

3/ In billions of dollars.

4/ Fiscal year (April-March).

5/ Includes local governments and hospitals.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SM/99/314
Correction 2

CONTAINS CONFIDENTIAL INFORMATION

February 16, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Canada—Staff Report for the 2000 Article IV Consultation**

The following corrections have been made in SM/99/314 (12/29/99)

Page 7, para. 8, last line: for "of less than" read "of around"

Page 8, para. 8, line 1: for "in early August" read "in late August"

Page 10, para. 14, line 4: for "Household net worth" read "Personal sector[11] net worth"

Page 11, Figure 10, title: for "Household Net Worth" read "Personal Sector Net Worth"

Page 13, para. 16, line 2: for "commodity prices.[11]" read "commodity prices.[12]"

line 4: for "With the announcement" read "With the expected announcement"

Page 17: footnote 13 renumbered footnote 14

Page 18: footnote 14 renumbered footnote 15 and second sentence deleted
original footnote 15 deleted

Page 21, footnote 21, last line: for "…in some accelerated classes)."
read "…in some accelerated classes),...outbound investments."

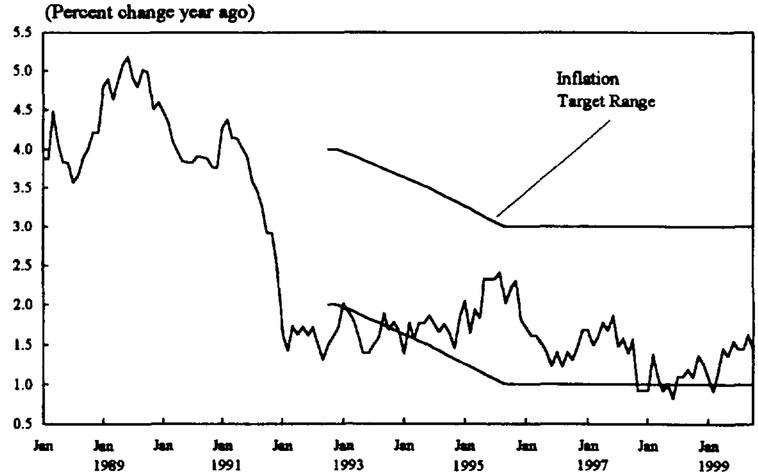
Page 22, para. 36, line 3: for "in the period ahead,...surpluses in 2000."
read "in the period ahead."

Att: (9)

Other Distribution:
Department Heads

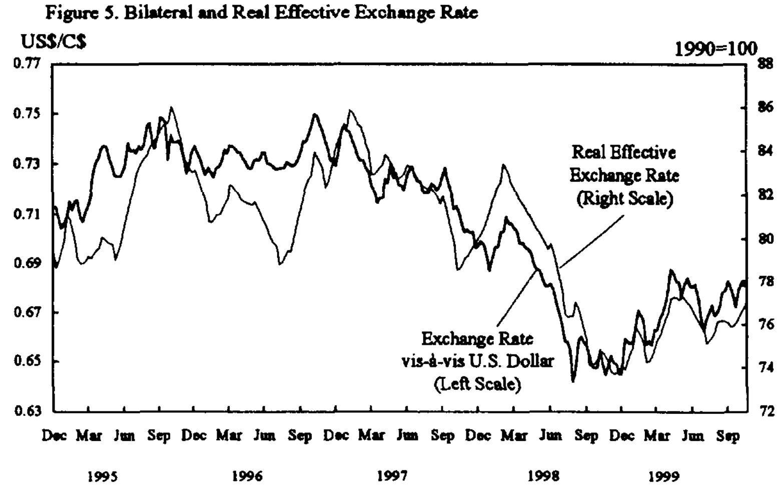
7. ***Core inflation*[5] *has fluctuated within a narrow range around the lower end of the 1–3 percent official target range since early 1997*** (Figure 4). Core inflation picked up in March–April 1999, and has fluctuated around 1½ percent (annual rate) through November. The overall CPI, however, has risen more rapidly, increasing at roughly a 2 percent annual rate during the first 11 months of 1999, largely reflecting movements in energy and food prices. Surveys indicate that inflation expectations are centered on 2 percent, the midpoint of the 1–3 percent official target range, suggesting a high degree of credibility underlying the authorities' inflation targets. The differential between the yields on ten-year fixed rate and inflation-indexed bonds has widened in recent months from about 150 basis points in mid-June to about 200 basis points in October–December. Although wage growth picked up somewhat during 1999, averaging about 2¼ percent through September, it remains consistent with significant gains in productivity and continuing low inflation.

Figure 4. Core CPI Inflation
(Percent change year ago)



8. ***Following the Bank of Canada's 100 basis point increase in short-term interest rates in August 1998 and reduced turmoil in world financial markets, the Canadian dollar began to recover from its sharp depreciation in the first part of the year (Figure 5).*** Subsequently, the Bank followed the U.S. Federal Reserve and reduced interest rates in September–November 1998 by a cumulative 75 basis points. The recovery in commodity prices during 1999 has further strengthened market confidence in the Canadian dollar, which recovered from its all-time low of around

Figure 5. Bilateral and Real Effective Exchange Rate



---

[5] The CPI excluding food, energy, and the effects of changes in indirect taxes.

63 U.S. cents in late August 1998 and traded in late December 1999 at around 68½ U.S. cents. The Canadian dollar has appreciated in real effective terms by about 4¼ percent in 1999 through November.[6]

9. ***After reducing interest rates by 25 basis points in both March and May 1999 in order to support continued economic expansion and maintain inflation comfortably within the target range, the Bank of Canada held rates unchanged as U.S. interest rates were increased in June and August by a cumulative 50 basis points.*** The decision not to follow the Federal Reserve's rate hikes at that time reflected the Bank's assessment that monetary conditions in Canada were consistent with the inflation target (Figure 6). Subsequently, the Bank of Canada raised rates by 25 basis points in November, matching an increase by the Federal Reserve. The differential between Canadian and U.S. interest rates has generally fallen since the last quarter of 1998, turning negative in May 1999 at both the short and long end of the term structure (Figure 7), and spreads remained negative in late December.

Figure 6. Monetary Conditions Index
(1987=0)

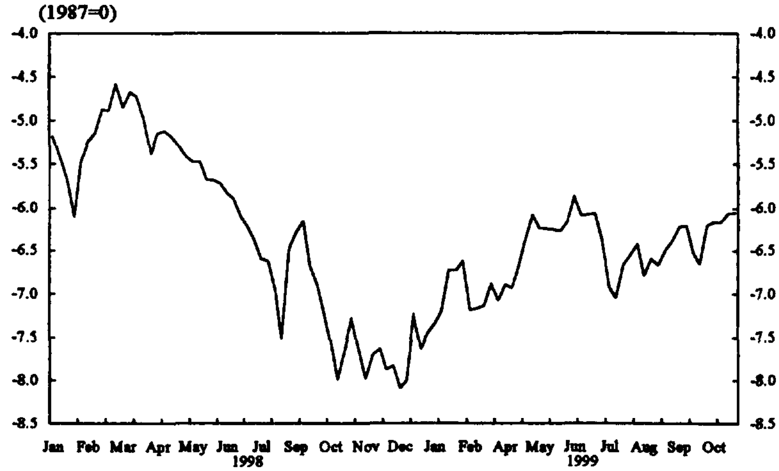
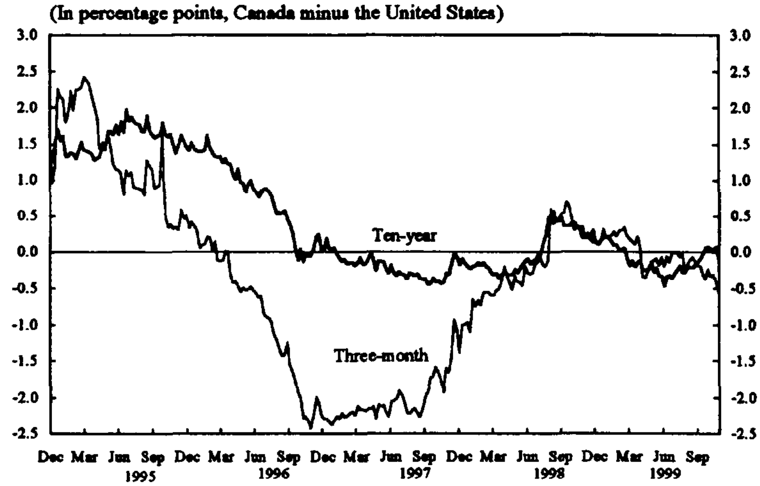


Figure 7. Interest Rate Differentials
(In percentage points, Canada minus the United States)



10. ***The current account deficit narrowed from 1¾ percent of GDP in 1998 to ½ percent in the first three quarters of 1999*** (Table 2). Export growth rebounded sharply, owing to buoyant growth in U.S.

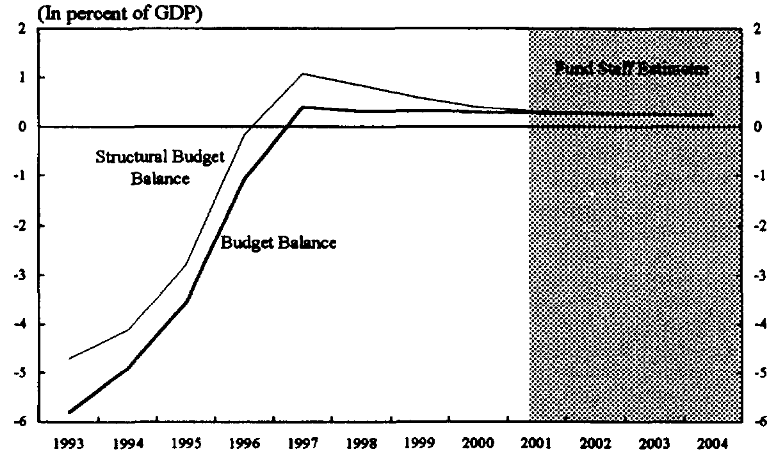
---

[6] Reflecting the high degree of integration with the U.S. economy, the U.S. dollar has a weight of 82½ percent in the IMF's real effective exchange rate calculation (based on unit labor costs) for Canada.

markets and to the recovery in commodity prices. At the same time, growth in the value of imports slowed from its relatively rapid pace in 1998, despite the pickup in domestic demand, as the strengthening Canadian dollar helped to hold down import prices (J-curve effect).

11. ***Over the past six years, decisive efforts by the Government have produced a dramatic turnaround in the federal fiscal position, which shifted from a deficit of around 5¾ percent of GDP in 1993/94 to a surplus of ¼ percent in 1998/99*** (Table 3 and Figure 8).[7] Over this period, the estimated structural balance shifted from a deficit of 4¾ percent of GDP to a surplus of about 1 percent. The improvement in the federal fiscal position has largely reflected cuts in program spending and reductions in transfers to the provinces. In the 1998 Budget, the Government introduced some measures with a relatively low fiscal cost to address its priorities in the areas of health care, education, and tax relief, and the February 1999 Budget introduced some additional measures in these areas.[8]

Figure 8. Federal Fiscal Policy Indicators
(In percent of GDP)



12. ***Fiscal consolidation has also occurred at the provincial level, helping to improve the general government balance from a deficit of more than 5½ percent of GDP in 1994 to a surplus of about 1 percent of GDP in 1998 (national accounts basis).***[9] Largely as a result of restraint in public consumption and controls on capital spending, the aggregate budgetary

---

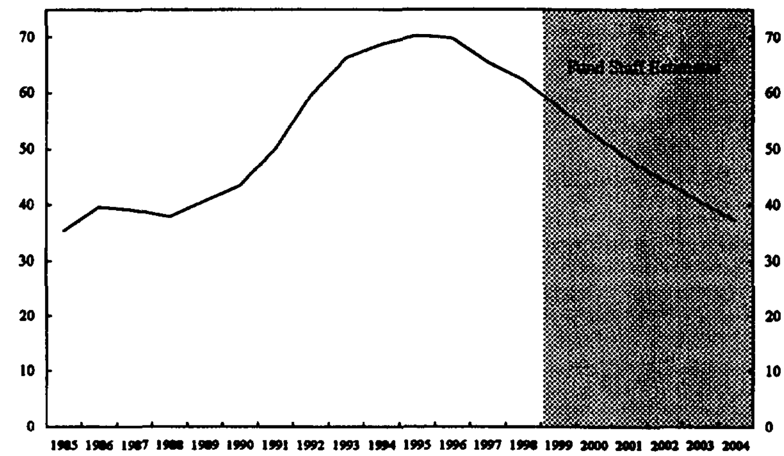
[7] Fiscal years end March 31.

[8] Tax relief measures in the February 1999 Budget include a further rise in the tax-free income threshold for low-income Canadians, the elimination of the 3 percent surtax on individuals with income exceeding $50,000, and a modest increase in the National Child Tax Benefit for low- and middle-income families. Spending initiatives extend measures in the 1998 Budget, including increased transfers to the provinces through the Canada Health and Social Transfer (CHST), increased equalization payments to lower-income provinces, and outlays to support and strengthen research and development.

[9] The general government includes the federal government, the provincial governments (including the territories), local governments, and the Canada and the Quebec Pension Plans (CPP and QPP, respectively).

balance of the provinces moved into a small surplus in 1997. However, it slipped back into a small deficit in 1998, as the Asian crisis and lower commodity prices reduced revenues in some provinces (notably Alberta and British Columbia) and the provinces used a portion of their "fiscal dividends" to cut income taxes. The rising budget deficit in British Columbia and a sharp decline in Alberta's budget surplus were, however, nearly offset by a rapid decline in Ontario's deficit and by the first balanced budget in Quebec in 40 years. Although the ratio of general government net debt to GDP has declined from a peak of 70 percent of GDP in 1995 to 62 percent in 1998 (Table 4 and Figure 9), it remains above the G-7 average (Table 5).

Figure 9. General Government Net Debt
(National accounts basis; in percent of GDP)



13. ***The sharp improvement in government finances has helped to increase national saving as a share of GDP despite a decline in personal saving.*** After rising by almost 5 percentage points between 1993 and 1997, gross national saving declined in relation to GDP by ¾ percentage point to 17¾ percent of GDP in 1998 amid lower corporate profits and a further decline in personal saving. The personal saving rate has declined steadily to 2¼ percent of disposable income in 1998, primarily reflecting the effects of lower inflation, fiscal consolidation, and rising household net worth, owing in part to the rise in Canadian stock prices in recent years.[10] At the same time, gross investment has rebounded sharply since 1993 in nominal and real terms. In 1998, gross investment stood at about 20 percent of GDP in real terms, slightly below its 1997 level, but well above its historical average.

14. ***The broad indicators underlying household and corporate balance sheets do not appear to suggest any major vulnerabilities, although these aggregates could mask weaknesses in particular sectors that would only become apparent in the event of a sharp downturn.*** Personal sector[11] net worth has risen from 400 percent of disposable income to

[10] Recent empirical work suggests that about 40 percent of the decline in the trend private saving rate since 1990 is explained by fiscal consolidation, 30 percent by lower inflationary expectations, and about 20 percent by rising household net worth. See Gilles Bérubé and Denise Côté (forthcoming), "Long-Term Determinants of the Personal Savings Rate: Literature Review and Some Empirical Results for Canada," Bank of Canada Working Paper.

[11] Includes households and unincorporated businesses.

almost 500 percent over the period 1990–98, while liabilities have increased by less than 25 percent of disposable income (94 percent to 114 percent) over this period (Figure 10). Although the personal sector debt-service ratio edged up in 1998 to about 9 percent of personal disposable income, it remains well below its peak in the early 1990s (almost 13 percent) and below the average of the last two decades. At the same time, the debt of nonfinancial corporations (including crown corporations) as a percent of corporate net worth has remained relatively stable (around 170 percent) since 1992 and the ratio of nonfinancial corporate debt to GDP has declined from 65 percent to 61 percent (Figure 11).

Figure 10. Personal Sector Net Worth
(As percent of disposable income)

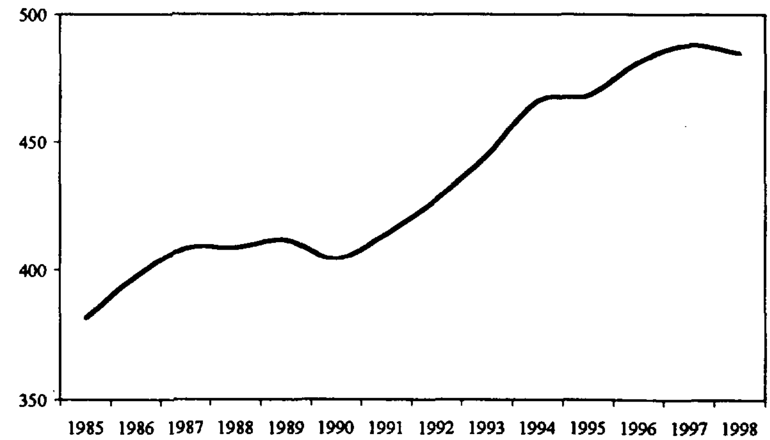
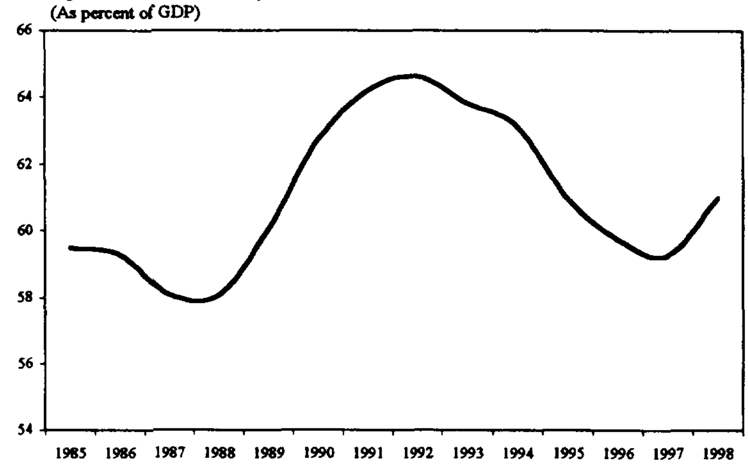


Figure 11. Nonfinancial Corporate Debt
(As percent of GDP)



15. ***The staff projects that real GDP growth will slow in the period ahead, in line with an anticipated deceleration in demand growth in the United States to a more sustainable level.*** Macroeconomic developments in the United States are central to the near-term outlook for economic activity in Canada in view of the high degree of economic integration between the two economies (Box 2). Canada's real GDP growth is expected to decline from 3¾ percent in 1999 to around 3¼ percent in 2000 (slightly above the consensus forecast). Output growth is projected to slow further to around its potential rate by 2002 as the output gap is eliminated (Table 6). Domestic demand growth in Canada would ease somewhat over most of the forecast horizon, as consumer spending would slow reflecting more moderate growth in household net worth and higher interest rates, while the pace of fixed investment spending also would decline, owing to an end to Y2K-related spending, higher interest rates, and slower consumption and export growth. The external current account is expected to improve steadily from a deficit of ½ percent of GDP in 1999 to a surplus of ¾ percent by 2004,

Box 2. Canada-U.S. Economic Integration: An International Comparison

The ongoing discussion of monetary arrangements in various parts of the world, including the move toward a common currency in Europe, has rekindled interest in the issue of economic integration within groups of countries. In this context, this box summarizes the situation of Canada vis-à-vis the United States in comparison with integration among European Union countries. In general, the degree of integration between Canada and the United States is much higher than in Europe. However, there appears to have been a greater asymmetry in the nature of shocks experienced by Canada and the United States than is the case within Europe. This latter factor, together with the political commitment in Europe to move toward a full common market, probably explains the different choice of exchange rate regimes.

The Canadian economy is very open by international standards. In 1998, the degree of openness (measured by the ratio of external trade in goods and services to GDP) in Canada was 81 percent, somewhat higher than in the European Union and easily the highest among the G-7 economies (see figure).

A principal measure of integration between groups of countries is the extent of intra-regional trade. According to this measure, the integration of Canada with the United States is greater than integration among most countries in Europe. In Canada, the share of U.S. trade in total trade (85 percent) and in GDP (61 percent) are much larger than the corresponding shares in European countries (except for a few of the smaller economies; see table below).

An additional dimension of integration is the degree of labor mobility. Labor mobility between Canada and the United States, while small as a share of the total labor force, has increased in recent years, especially among skilled workers.1/ As a share of the labor force, gross annual Canada-U.S. migration is roughly the same as intra-EU migration. This is, however, in the context of smaller wage differentials than among European countries.

Canada's capital account is closely integrated with the United States. In 1998, the United States contributed 86 percent of the direct investment inflows into Canada and took in 77 percent of Canadian direct investment abroad. Its shares in Canadian portfolio inflows and outflows were 85 percent and 97 percent, respectively. While the numbers may partly reflect third countries' investments in Canada through the United States, they are significantly higher than among EU countries, where in recent years intra-European direct investment and equity capital flows have accounted for 50–55 percent and 50 percent of total flows, respectively.

The high degree of integration between the Canadian and U.S. economies has contributed to a close correlation of macroeconomic trends. Real GDP growth and inflation in Canada have been very closely correlated with growth and inflation in the United States.2/ The correlation between Canadian and U.S. real GDP growth has been higher than among most European economies, and roughly the same as among the most closely related European economies (Austria, Belgium, France, Germany, and the Netherlands). The correlation between Canadian and U.S. inflation has historically been higher than among European economies.

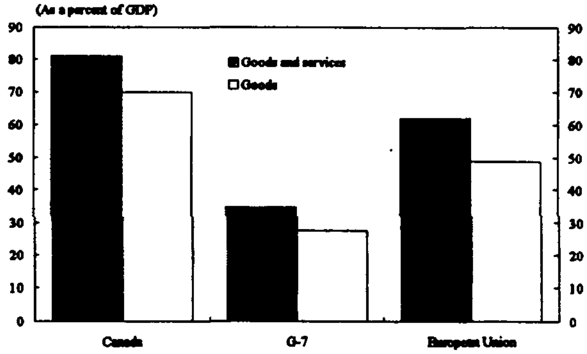
However, the nature of shocks to the Canadian and U.S. economies during the past few decades has been much more dissimilar than among European countries.3/ In particular, unlike among several European economies, there does not seem to be any significant positive correlation between supply shocks in Canada and the United States. The same holds for demand shocks, although supply shocks are more informative about underlying regional patterns than demand shocks, which include the impact of monetary and fiscal policies.

External trade within regions, 1998
(in percent)

	Regional Trade/Total Trade	Regional Trade/GDP
Europe (selected countries)	With other EU countries	
Belgium-Luxembourg	52	71
France	62	25
Germany	55	26
Ireland	62	79
Italy	62	23
Netherlands	63	52
United Kingdom	51	21
EU weighted average	59	29
	With United States	
Canada	85	61

Based on aggregate merchandise trade (exports plus imports).

Selected countries: External trade, 1998
(As a percent of GDP)



1/ See Stephen Tokarick, 1999, "Brain Drain From Canada to the United States," in International Monetary Fund, "Canada—Selected Issues," SM/99/3, issued January 8, 1999.
2/ See Tamim Bayoumi and Barry Eichengreen, 1994, "One Money or Many? Analyzing the Prospects for Monetary Unification in Various Parts of the World," Princeton Essays in International Finance, No.76.
3/ See Bayoumi and Eichengreen (op cit). Vivek Arora, 1999, "Exchange Rate Arrangements in Selected Western Hemisphere Countries," mimeo., International Monetary Fund, provides more recent estimates for Canada and the United States.

primarily reflecting improved macroeconomic conditions in Europe and Asia, sustained but decelerating growth in the United States, and a continued recovery in commodity prices.[12] This shift in the external position would primarily reflect a steady rise over the forecast period in the merchandise trade surplus and some reduction in net investment income payments, owing to a decline in external debt and generally lower rates of interest paid on it. Inflation is projected to rise gradually to the midpoint of the official target range as the output gap is eliminated.

16. ***Risks to the outlook for the Canadian economy center on whether activity will settle down smoothly to a more sustainable pace of growth.*** While many of the risks to the forecast stem from the external environment, there are also uncertainties associated with domestic economic developments. With the expected announcement of a multiyear personal income tax cut in the 2000 budget, consumption spending may not slow as much as envisaged. If the pace of consumption does not ease, the recent buoyant growth in investment spending might also not slow as expected. Moreover, it is difficult to determine the extent to which temporary factors, such as spending to address potential Y2K problems, have boosted investment. The net result could be that domestic demand growth would be significantly faster than expected, posing some important challenges, particularly for monetary policy.

17. ***Prospective risks revolving around possible unanticipated developments in the external environment—especially in the United States—are particularly important (Box 3).*** The continued buoyancy of the U.S. economy, prospects for stronger growth in Europe and Japan, and the recent strengthening of commodity prices have significantly improved the external environment from a year ago. However, a good deal of uncertainty surrounds the outlook for the United States. Continued rapid U.S. growth would provide further stimulus to net exports and domestic demand in Canada. But such an outcome might also trigger a substantial tightening of U.S. monetary policy that could ultimately lead to a sharp deceleration in U.S. economic activity. While near-term prospects would be for stronger-than-projected Canadian growth, the economy's medium-term outlook could worsen significantly. This would be especially likely if economic activity outside North America were also to be weaker than expected, which, in combination with a sharp slowdown in the U.S. economy, could reverse the recent upturn in world commodity prices. Moreover, a slowdown in economic activity in the United States might also feed back to the Canadian economy through the financial sector, as the exposure of Canada's financial sector to the United States has increased in recent years.

---

[12] This forecast is based on the standard assumption in the World Economic Outlook (WEO) exercise of a constant real effective exchange rate.

Box 3: Key Implications of the World Economic Outlook For Canada's Bilateral Surveillance

In the view of the staff, the main risks to Canada's prospective economic performance stemming from the global economic outlook revolve around potential developments in the United States.

• ***The impact and policy response in Canada to a significant further increase in U.S. interest rates*****:** The United States and Canada differ somewhat in their cyclical positions, with the United States estimated to be operating close to capacity and Canada probably still experiencing some slack, although of an uncertain amount. Continued rapid growth in domestic demand in the United States raises the potential risk that inflationary pressures in the United States could build more rapidly than anticipated so that the Federal Reserve would eventually have to move aggressively to tighten monetary policy, thereby slowing U.S. growth sharply. The possibility of such a "boom-bust" scenario in the United States suggests that Canada could be faced initially with inflationary pressures stemming from the United States followed by sharply rising U.S. interest rates and a steep decline in U.S. demand. Depending on how events in the United States were to unfold over time, this could present challenges for monetary policy in Canada. Although movements in the Canadian dollar would help to cushion the economy from such adverse shocks, the required shift in the composition of aggregate demand is not likely to be seamless and thus would present downside risks to economic activity in Canada.

• ***The real-side consequences of a sharp economic slowdown in the United States*****:** During this decade, the Canadian economy has become increasingly integrated with the rest of the world, and particularly with the United States. Staff estimates suggest that, other things being equal, a slowdown in the rate of U.S. real GDP growth would produce a roughly equivalent deceleration in economic activity in Canada, reflecting the direct effects that such a slowdown would have on net exports and indirect effects on consumption and investment. While continued growth in the rest of the world could help to partially offset the adverse effects in Canada, any mitigating effects would be limited owing to the high degree of economic integration between Canada and the United States.

• ***The financial consequences of a sharp equity price correction and economic slowdown in the United States*****:** Canadian banks have become more integrated with the nonfinancial corporate and financial sectors in the United States. Canada's chartered banks have increased their on-balance sheet exposure to the United States, especially in 1998 when U.S. assets rose 3 percentage points to over 17 percent of total assets, while their off-balance sheet exposure with U.S. financial institutions also appears to have increased. At the same time, the distinctions in products across financial institutions in Canada (chartered banks, insurance, and brokerage) have been blurred by mergers and acquisitions and the introduction of new products. There is also the possibility that a sharp correction in the U.S. stock market would carry over to Canadian equity markets.

III. Policy Discussions

18. There was general agreement between the authorities and the staff on the course of macroeconomic policies in the period ahead. On structural issues, the staff pushed for further reforms in key areas, such as the employment insurance system and accelerating the pace of trade liberalization in agriculture and textiles and clothing. The discussions centered on the following issues, which are key to charting a sound macroeconomic policy course:

1998, and the large gains in employment throughout 1998 and 1999 were seen as imparting considerable momentum to domestic demand in Canada, which was expected to carry forward. The authorities projected that GDP growth in 2000 would be in the range of 2¾–3¾ percent, and that it would slow gradually toward the authorities' estimate of potential growth (around 2¼–2½ percent) over the medium term. The stimulus from net exports was envisaged to wane in the period ahead (as it was assumed that the Canadian dollar would appreciate)[14] and a reduction in Y2K-related investment spending would hold down domestic demand in the period immediately ahead. However, the likely announcement of a multiyear cut in taxes would sustain consumer spending, and private consumption was seen as the most important source of growth going forward.

25. ***The authorities emphasized that their forecasts largely hinged on the expectation of a gradual slowdown in U.S. growth to a more sustainable pace.*** Continued rapid growth could pose considerable risks of overheating in the United States and would likely prompt the U.S. Federal Reserve to raise interest rates further. A more difficult scenario for Canadian monetary policy would emerge if U.S. monetary policy action were delayed, and there was an actual outbreak of inflation in the United States and a subsequent sharp tightening of monetary policy. Although the authorities thought that this kind of "boom-bust" scenario was unlikely given the past success of the U.S. monetary authorities, they were prepared for all contingencies.

26. ***In judging how Canadian monetary policy should respond to U.S. developments, the authorities took the view, and the staff agreed, that the key consideration would be the extent to which continued rapid U.S. growth could add to already strong demand growth in Canada and contribute to a spillover of inflationary pressures.*** If the Federal Reserve raised interest rates, the Bank of Canada had no automatic rule on how it should respond. A U.S. rate increase would be viewed in terms of its implications for the Canadian economy and financial markets, and thus for price pressures in Canada. If developments in the United States were judged to have a significant effect on Canada, potentially jeopardizing achievement of the target for inflation, the Bank would not hesitate to act. This was reflected in its decision subsequent to the mission to raise interest rates, matching the U.S. increase in mid-November.

27. ***In the event of a sharp downward correction in the U.S. stock market, the authorities considered that this would initially dampen aggregate demand in Canada through its effect on net exports and through its likely effect on Canadian equity markets.*** Canadian equities, however, appeared less exposed to a sharp correction since, after having experienced a more pronounced downturn in 1998, they had not appreciated as strongly as U.S. equities. The authorities also noted that the success of Canadian monetary and fiscal policies provided scope for a timely countercyclical policy response should that be

---

[14] Based on the May 1999 WEO projections, the latest CGER estimates suggest that the Canadian dollar would appreciate in real effective terms by 8 percent over the medium term.

warranted. Despite the increased exposure of Canadian banks to nonfinancial corporate and financial firms in the United States, the authorities did not envisage that a U.S. stock market correction would have major consequences for the Canadian banking system, although profitability would obviously suffer in the event of a generalized economic downturn.[15]

28. ***Bank of Canada officials considered that the credibility of monetary policy had diminished the prospects for a loss of confidence in the Canadian dollar.*** They noted that, in past years—and most recently in 1998—developments in the foreign exchange market had on occasion acted as a constraint on monetary policy actions. On these occasions, a loss of confidence in the currency could contribute to undesired upward pressures on long-term interest rates, which, in turn, required tactical monetary policy actions aimed at restoring confidence. This complicating factor in the conduct of monetary policy had largely receded, and the Bank felt that it could now focus its monetary policy actions more on the underlying economic fundamentals in Canada, although they were prepared to respond should such pressures arise again. Moreover, in the event that a boom-bust scenario played out in the United States, the exchange rate was seen by the authorities as potentially cushioning the real-side impact on Canada, as the Canadian dollar would tend to depreciate vis-à-vis the U.S. dollar in the near term in response to falling demand for Canadian exports and higher U.S. interest rates. As a result of the credibility of the inflation target, if U.S. inflation were to rise above that in Canada, the Canadian dollar would be likely to appreciate over the medium term, insulating Canada from price pressures in the United States.

29. ***The authorities noted that they had not intervened in the foreign exchange market since Canada's policy on intervention was revised in September 1998.*** At that time, it was decided that intervention would be conducted on a discretionary basis, for example, in those rare instances when it was judged that the exchange rate had moved significantly to the point of potentially undermining market confidence and a substantial official presence in the market could significantly influence perceptions about the underlying value of Canadian dollar assets. The authorities indicated that in such cases intervention would be announced.

---

[15] Stress and scenario tests also suggest that interest rate and exchange rate changes could have significant effects on the average operating incomes of some of the large banks, but would not be significant in terms of their capital.

with the authorities, the staff favored steps to fully index the tax system to inflation; increase income thresholds at which progressive marginal tax rates apply; lower the 26 percent statutory marginal tax rate; and reduce the rate of clawback of the National Child Benefit.

34. ***The authorities stressed, and the staff agreed, that there were also substantial gains to be made for the economy from using at least a small amount of resources to make the corporate income tax system more competitive.*** Corporate tax rates in Canada, when provincial taxes were factored in, are high by international standards (particularly in key growth sectors such as services). By lowering the basic federal corporate income tax rate, the system could be made less distortionary, since the relatively higher taxation of income outside the small business and manufacturing and processing sectors would be reduced.[20] Distortions could be further diminished, while offsetting some of the costs of the reform, by broadening the tax base along the lines of the measures recommended in the 1998 Report of the Technical Committee on Business Taxation.[21] The report also recommended steps to reduce compliance costs and improve tax enforcement.

35. ***The authorities noted the considerable pressures they faced to increase spending, but that they would continue to try to limit the size of new spending initiatives, with priority continuing to be given to education and health care.*** The authorities explained that, in the medium-term projections, direct program spending was assumed to remain constant in real per capita terms, which would provide some limited room to accommodate additional spending initiatives.

---

[20] Corporate income tax rates vary by firm size, activity, and provincial location. The federal corporate statutory income tax rate is set at 28 percent for general business income, 21 percent for manufacturing and processing operations, and 12 percent for small businesses. Canada's combined federal-provincial corporate tax rate for general business income averages 43 percent, compared to a combined federal-state average of around 39 percent in the United States.

[21] The base-broadening measures recommended by the Committee include the elimination or reduction of certain preferences (e.g., research and development tax incentives which are among the most generous in the world), credits (e.g., recommended replacing the Atlantic Investment Tax Credit with a more cost-effective and broad-based nontax program), and deductions (e.g., proposed a general review of capital cost allowances to ensure that rates are closer to economic depreciation, along with a reduction in some accelerated classes), and a review of international tax provisions as they relate to both inbound and outbound investments.

36. ***Significant progress has been made by provincial and territorial governments in balancing their budgets, and the authorities expected these governments to continue to follow sound budgetary policies in the period ahead.*** The favorable performance of the economy, accompanied by rebounding commodity prices and increased federal transfers, has significantly improved the aggregate fiscal position of the provinces. Consequently, all of them have moved to lower taxes, some ahead of previously announced schedules. The authorities suggested that these actions would not significantly affect the strong overall budget position of the provinces over the medium term. The staff, however, stressed that the provinces needed to be cautious and to sustain their fiscal efforts. In particular, all levels of government needed to factor in the potential fiscal costs associated with an aging population, especially in the area of health care, in forming their longer-term fiscal objectives.

C. Other Issues

37. ***Although the unemployment rate in Canada has come down significantly, it remains high by historical standards and relative to the United States.*** Reforms to the employment insurance (EI) system enacted during the past few years, which included tying benefit levels to the frequency of use and sharper clawback provisions for higher-income participants, have contributed to improving the efficiency and flexibility of the labor market and to reducing structural unemployment. The authorities noted that, as these reforms have become binding, significant pressures have emerged to roll them back, and that they were working hard to resist such pressures. The staff expressed concern about the Government's recent proposal to increase maternity and parental leave benefits under the EI system and to relax the eligibility requirements for these benefits. This action appeared to be a move away from the idea that the EI system should be primarily an insurance scheme. Moreover, it carried the risk of creating new incentives for casual labor force participation and heightened pressures for additional benefits. The authorities acknowledged these concerns and reiterated their commitment to resist additional demands. They explained that the change in maternity and parental leave benefits was part of the Government's overall strategy to provide more support for children, particularly in their early formative years.

38. ***In current circumstances, the authorities said that it would be difficult to extend reforms to the EI system in the areas that the staff continued to stress, specifically the introduction of experience rating in setting individual company's EI premiums and the elimination of regional extended benefits.*** Within the Government, there was no consensus on whether experience rating would yield significant net benefits. While it was recognized by some that experience rating could yield significant improvements in the functioning of the