IMF Country Report No. 15/22

CANADA

January 2015

2014 ARTICLE IV CONSULTATION—STAFF REPORT; STAFF STATEMENT; AND PRESS RELEASE

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV consultation with Canada, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 28, 2015, following discussions that ended on November 26, 2014, with the officials of Canada on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 15, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Staff Statement** of January 28, 2015 updating information on recent developments.
- A **Press Release** summarizing the views of the Executive Board as expressed during its January 28, 2015 consideration of the staff report that concluded the Article IV consultation with Canada.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

CANADA

January 15, 2015

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

KEY ISSUES

Economic outlook: The Canadian economy has expanded at a solid pace since 2013, but rebalancing of growth away from household consumption and residential investment remains incomplete, owing mainly to weak business investment. Growth momentum is expected to continue alongside a strengthening U.S. recovery despite substantially lower oil prices. Risks to the outlook are modestly tilted to the downside given sluggish global growth, effects unfolding from sharply lower oil prices, and housing market risks. Key domestic vulnerabilities in housing markets and the household sector remain elevated but contained from a financial stability perspective.

Policies for balanced and sustained recovery: An appropriate *policy mix* should help facilitate rebalancing to generate a broader and more durable recovery, reduce domestic vulnerabilities, and further strengthen financial system resilience:

- ***Macro policies***: Monetary policy can remain accommodative for now given that inflation expectations are well-anchored, stronger business investment is still a missing link, risks to an export-led recovery are to the downside, and housing markets are expected to cool as U.S. interest rates rise and with lower oil prices. Fiscal consolidation should proceed in light of longer-term challenges at the provincial level, but federal authorities should consider adopting a neutral stance going forward, using available fiscal resources for targeted measures to support growth. Structural policies to improve productivity in the economy would increasingly need to complement this policy mix.

- ***Housing sector and financial sector policies****:* Further macro-prudential policy action may be needed to guard against risks to financial stability if household balance sheet vulnerabilities resume rising. Reforms to limit government exposure to housing markets and encourage appropriate risk retention by the private sector should continue. Improving complex coordination across federal and provincial authorities in supervision and stress-testing of depository institutions and strengthening macro-prudential and crisis management frameworks will reinforce the resilience of Canada's financial system.

Policy response to past advice: Since the 2013 Article IV Consultation mission, the authorities have taken some further steps to limit taxpayer exposure to the housing sector and strengthen mortgage insurance underwriting practices. Some work on FSAP recommendations has also started to enhance stress testing, address data gaps, and towards establishing a cooperative capital markets system. The authorities have also intensified their efforts towards addressing interprovincial trade barriers and export diversification.

Approved By
Krishna Srinivasan (WHD) and Tamim Bayoumi (SPR)

Discussions took place in Montreal, Toronto, Victoria, Vancouver, and Ottawa during November 10–25, 2014. The team comprised Hamid Faruqee (head), Lusine Lusinyan, Andrea Pescatori, Rania Papageorgiou (all WHD), Minsuk Kim (SPR), Tidiane Kinda (FAD), and Ivo Krznar (MCM). Messrs. Werner and Srinivasan (both WHD) joined the mission for concluding meetings in Ottawa. Mr. Parent (OED) accompanied the mission, and Mr. Dupont (OED) attended the concluding meetings. The mission met with Finance Minister Oliver, Deputy Finance Minister Rochon, Bank of Canada Senior Deputy Governor Wilkins, other senior officials, provincial government, finance industry, academic, business sector, and trade union representatives, and held a press conference.

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RECOVERY CONTINUES BUT REMAINS UNBALANCED

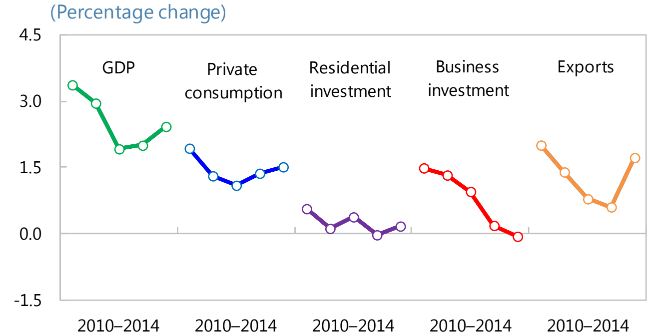
Canada's recent growth performance has been solid alongside a stronger U.S. recovery. The awaited pickup in exports is encouraging although it has yet to translate into strong investment and hiring. Thus, the composition of growth has not yet rebalanced away from private consumption and residential investment to generate a broader, more durable recovery. Substantially lower crude oil prices will be a drag on activity, mainly through weaker investment in the energy sector. Risks to the outlook are modestly tilted to the downside, mainly reflecting external risks including weaker global growth and still-unfolding effects from the unusually large fall in oil prices. Domestic vulnerabilities in housing markets and the household sector remain elevated but contained from a financial stability perspective. Risks of faster-than-expected tightening in financial conditions associated with U.S. monetary normalization or weaker terms of trade could also interact with domestic risks and vulnerabilities—mainly, elevated house prices and high indebtedness of Canadian households.

1. **The Canadian economy has been expanding at a solid pace since 2013** (Figure 1). Growth remained slightly above potential, averaging 2½ percent in the first three quarters of 2014. Regionally, a multi-speed recovery was led by resource-rich Alberta, while the pickup in activity was more modest in other large provinces, driven in part by non-energy exports. CPI inflation has been running over 2 percent since April 2014, up from very low readings in 2013, reflecting largely temporary factors and the effects of exchange rate pass-through, despite a still-negative output gap and pressures from retail competition (Figure 2).

2. **Despite the welcome pickup in exports, rebalancing of growth remains incomplete—owing mainly to weak investment** (Chart, Figure 1).

- *Stronger exports*. U.S. recovery momentum, exchange rate depreciation (about 10 percent in real terms since early 2013), and high energy demand in early 2014 have provided a needed push to Canada's exports. In real terms, exports expanded on average 4½ percent (y/y) over the last four quarters, led by non-energy exports. Although the rebound in most sectors remains modest, a

Canada: GDP Growth and Contributions from Main Components
(Percentage change)

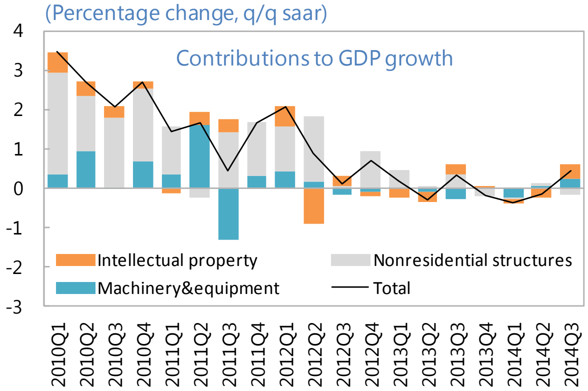


Sources: Statistics Canada; and IMF staff estimates.
1/ Data for 2014 are based on staff's estimates of 2014:Q4.

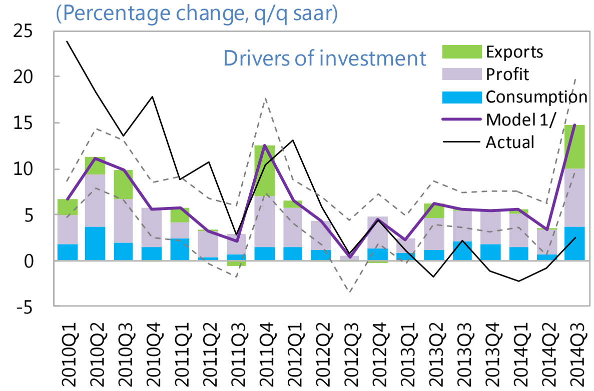
few (including the transportation sector) are performing strongly relative to external demand growth.[1] Energy exports (in volume terms) have also been strong, and Canadian crude oil continued gaining market share in the United States amid some easing in infrastructure bottlenecks associated with transporting crude oil to U.S. Midwest to Gulf Coast refineries.[2]

- *Weaker-than-expected investment*. Business nonresidential investment has slowed in recent years (following a strong rebound initially after the crisis). The slowdown has been widespread—including both the energy sector and broader spending on machinery and equipment (Charts). Companies focused on upgrading or replacing existing capital, in part owing to uncertain future demand, despite higher corporate profits since mid-2013, resilient domestic consumption, and strengthening external demand. Moreover, there are indications that lower oil prices will dampen investment in the energy sector. However, business investment outside the energy sector could provide some offset, especially in the sectors benefiting most from the U.S. recovery, and given rising capacity utilization rates.

Real Private Nonresidential Fixed Investment
(Percentage change, q/q saar)



Real Private Nonresidential Fixed Investment
(Percentage change, q/q saar)



Sources: Statistics Canada; and IMF staff estimates.
1/ Estimates are derived from a regression model where the changes in real private nonresidential fixed investment are explained by lagged changes in real private consumption, lagged changes in real goods exports, and a lag of profit rate. Dashed lines denote the 95% confidence interval. The negative constant term is subtracted from the reported coefficient estimates.

- *Resilient private consumption amid a steady labor market*. Consumers—benefiting from rising household wealth and disposable income and exceptionally easy financial conditions—increased their spending on housing-related goods and automobiles. Labor markets have been relatively

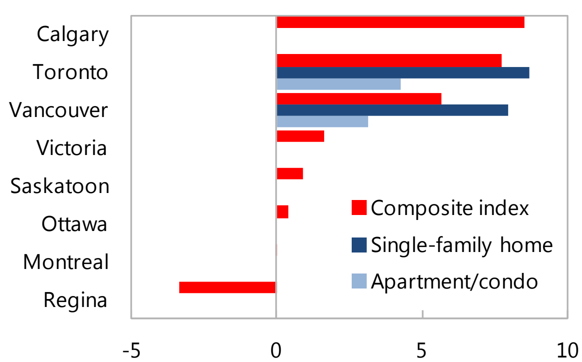
[1] Staff analysis suggests that about one-third of non-energy exports (including passenger cars) outperformed their model benchmarks over 2009–2013. However, large sectors such as industrial machinery/equipment and intermediate metal products grew slower and/or remained below their model-predicted levels by end-2013 (Selected Issues). The analysis suggests that the recent pick-up in non-energy exports is predominantly driven by U.S. business investment, with some industries (like passenger cars) benefiting also from recent Canadian dollar depreciation.

[2] For energy exports, despite declining U.S. oil imports, Canadian crude oil exports to the U.S. continued steadily rising (reaching about 2.8 million barrels per day on average in January–October 2014 and recording all-time highs in recent months), reflecting gains in U.S. market share (from 22 percent in 2009 to about 40 percent in 2014).

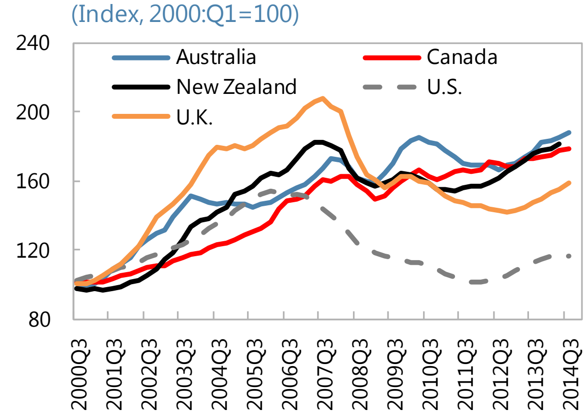
static until recently. Echoing tentativeness in business investment, the pace of hiring has been modest with a composition focused on adding temporary capacity (e.g., half of jobs added in 2014 were part-time—a share above its historical average). The unemployment rate had been hovering around 7 percent since end-2012, before edging down to a post-2008 low in recent months (about 6½ percent in October-December). The unemployment gap persisted while labor force participation rate has been largely flat, unlike the declining trend in the United States (Figure 3).

- *Housing markets strong with signs of overvaluation to differing degrees.* After a brief pause, Canada's housing market rebounded in 2014, fueled by low and declining interest rates (Figure 4). House prices have been rising at 5–6 percent (y/y) nominally through most of 2014 (almost twice the average pace in 2013). Most of the appreciation has been driven by Calgary's housing market and single-family homes in Toronto and Vancouver (Charts).[3] Since 2001, house prices have risen significantly—similar to other Commonwealth commodity-exporter countries—though Canada's cycle seems to be lagging and relatively smoother. Staff analysis suggests a national real house price overvaluation (relative to levels justified by long-run fundamentals) between 7–20 percent, although with significant differences across regions and market segments.[4]

CREA House Price Index Across MSAs
(Percentage change, Nov 2014 vs. Nov 2013)



Real House Price Indices
(Index, 2000:Q1=100)



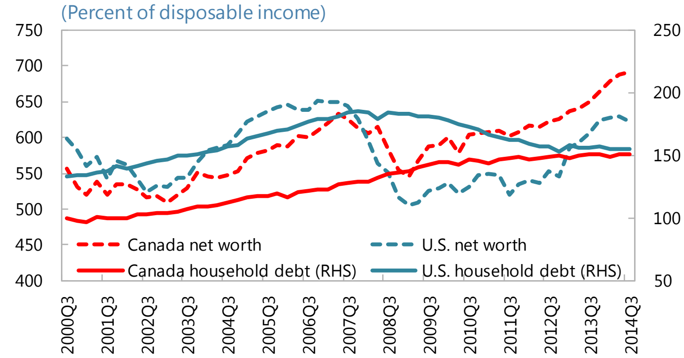
Sources: Haver Analytics; CREA; and IMF staff calculations.

[3] Regionally, Calgary and Toronto recorded the fastest price gains followed by Vancouver, while Montreal and Ottawa registered near zero growth over the last four quarters. Housing starts though appear to have settled down close to their 2013 average and below 2012 levels. Home sales have not been particularly strong suggesting that price increases may be due to supply constraints rather than demand factors (Figure 4).

[4] Research by the Bank of Canada staff suggests estimates for overvaluation in Canadian housing markets range from 10–30 percent (*Financial System Review*, December 2014).

- *Stable household debt, albeit at high levels.* Total mortgage borrowing and household indebtedness have broadly stabilized in recent quarters—albeit the latter at record high levels (over 150 percent of disposable income), while household net worth continued rising on the back of rising housing and equity market valuations (Chart).

Household Net Worth and Debt
(Percent of disposable income)



Sources: Haver Analytics; Statistics Canada; and IMF staff estimates.

3. **Public finances continued improving in 2014, reflecting federal and some provincial consolidation efforts** (Figure 5). The general government fiscal deficit is expected to narrow from about 2¾ percent of GDP in 2013 to 1½ percent in 2014, representing a ¾ percent of GDP improvement in structural terms.

- *The federal government is essentially on track to achieving its balanced budget target in FY2015/16*. This reflects better-than-expected revenue because of stronger-than-projected growth, one-off measures (including ¼ percent of GDP from an auction of broadband spectrum license), and lower spending ahead of planned restraint initiatives. Recently introduced income tax cuts and enhanced child care benefits, as well as lower oil prices that will affect nominal tax revenues, are not expected to materially delay reaching budgetary balance in FY2015/16.[5]

- *Provinces, while remaining committed to their balanced budget targets, continue struggling with consolidation*. Headline and cyclically-adjusted deficits at the provincial level are expected to improve in 2014 by about ½ percent of GDP (given the outturn in the first three quarters of 2014). Fiscal situations vary across provinces. Ontario and Québec are facing challenges with consolidation while expecting to return to balanced budget by FY2017/18 and FY2015/16, respectively (Box 1). Fiscal positions in Western provinces are relatively strong, but a sharp and persistent drop in the crude oil prices will impact public finances, especially in Alberta, directly through lower royalties and lower corporate profits and household incomes.[6]

[5] On October 30, 2014, a number of fiscal measures were announced, including (i) the Family Tax Cut, a federal tax credit (capped at Can$2,000) that will allow a transfer of up to Can$50,000 of taxable income to a spouse in a lower tax bracket, for couples with children under the age of 18, effective for the 2014 tax year; (ii) increasing the Child Care Expense Deduction limits effective for the 2015 tax year; (iii) increasing the Universal Child Care Benefit (UCCB) for children under the age of 6, from Can$100 to Can$160 per month starting from January 1, 2015; and (iv) expanding the UCCB by introducing a new benefit of Can$60 per month for children aged 6–17 from January 1, 2015, while repealing the existing Child Tax Credit for children under the age of 18 years. These measures have been incorporated in the fall budget update, and are estimated to cost about 0.2 percent of GDP per year in FY2014/15 and over the medium term. A further significant decline in oil prices relative to staff's baseline may keep the fiscal balance in a slightly negative territory in CY2015.

[6] For Alberta, non-renewable resource revenue, mostly from bitumen and crude oil royalties, represents about 20 percent of total provincial revenue.

- *Gross public debt ratio remains high but should continue declining after 2015.* General government gross debt, as a share of GDP, has risen from 67 percent in 2007 to nearly 90 percent of GDP in 2012–13, but is expected to decline after 2015.

4. Canada's external position has improved and is broadly consistent with medium-term fundamentals and desirable policy settings (Annex I). The trade balance has tended to improve and the currency has weakened since 2013. Based on staff's External Balance Assessments (EBA), the cyclically-adjusted current account (CA) balance in 2014 is estimated at -1.8 percent of GDP, implying a narrower CA gap of 1.6 percent of GDP according to the latest EBA CA approach (against 3.4 percent CA gap for 2013). Staff assesses the 2014 CA gap to be smaller than the EBA estimate, ranging between 0 to 1 percent of GDP, closing which would require policy actions aimed at boosting productivity and addressing energy infrastructure bottlenecks (see below). Reflecting exchange rate depreciation over the past year (up to end-October 2014[7]), the Canadian dollar is estimated at 0–5 percent above the level consistent with medium-term fundamentals and desirable policy settings in 2014 (compared to 5–10 percent REER gap for 2013). In the last two months of 2014, the exchange rate depreciated further by an estimated one percent in real effective terms, less than what would be implied by its past relationship with real energy prices.[8]

[7] The real effective exchange rate (REER) assessment refers to its average level over January–October 2014.

[8] Real energy prices fell by an estimated about 30 percent in November–December 2014. Staff estimates of a long-run equilibrium relationship between the Canadian REER and commodity prices suggest that a one-percent decrease in the real price of energy would lead to about 0.1 percent real depreciation (see, IMF Country Report 13/41). This is broadly consistent with the EBA methodology on the relation between real exchange rates and the terms of trade.

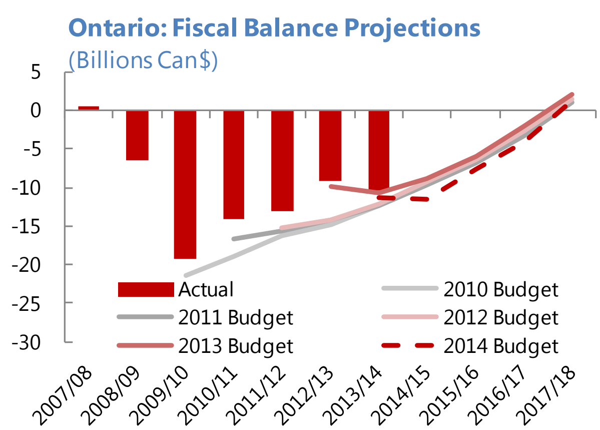
Box 1. Fiscal Consolidation Challenges at the Provincial Level: Ontario and Québec

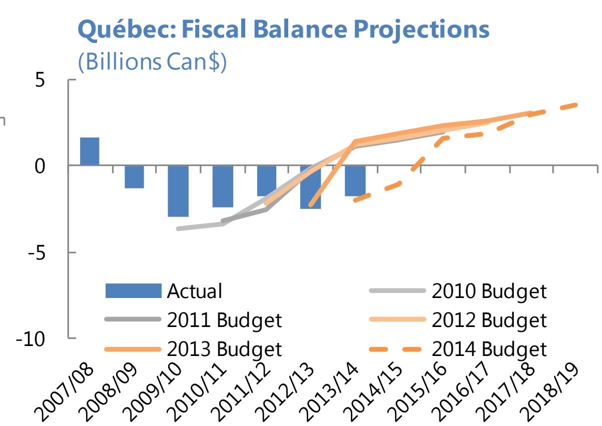
Ontario and Québec—the two largest provinces in Canada—face important fiscal challenges. Combined, they account for about two-thirds of Canada's population, near 60 percent of its GDP, and over half of its exports given a large presence in manufacturing. At the same time, Ontario and Québec are the most challenged provinces when it comes to their public finances—with Québec having the highest stock of public debt and Ontario the highest budgetary deficit among all Canadian provinces. This box describes provincial authorities' recent efforts to place public finances on a sounder footing and the prospects over the short and medium term.

Fiscal consequences of the Great Recession

The 2008–09 recession abruptly interrupted healthy debt reduction that started in the mid-1990s. Loss of fiscal revenues, automatic stabilizers, and higher discretionary spending led to wide budgetary deficits and higher public debt.

- Ontario was hit harder by the global recession with its GDP falling cumulatively between 2007 and 2009, about 5 percent more than Québec's. A rapid deterioration of the fiscal balance is mainly accounted by a large discretionary increase in program spending (beyond health care and education) in FY2009/10 and lower revenues (revenues returned to pre-crisis levels only in FY2011/12). After an initial rapid improvement in the fiscal position, the progress slowed, and in 2013–14 the deficit is estimated to stand at about Can$10.5 billion (1½ percent of Ontario's GDP).
- The loss of tax revenues in Québec was milder with revenues reaching pre-crisis levels already in FY2010/11. Similarly, the increase of program spending was mainly driven by structural factors such as health care spending (growing at almost 7 percent between FY2007/08 and FY2009/10). In FY2013/14, the deficit is estimated to stand at Can$1.7 billion (½ percent of Québec's GDP).
- As a consequence, gross-debt-to-GDP ratio increased in these provinces. The bond yield spread between the two provinces and federal government has widened and remained around 100 basis points, twice the level before the crisis.





Sources: Ontario and Québec budget reports.

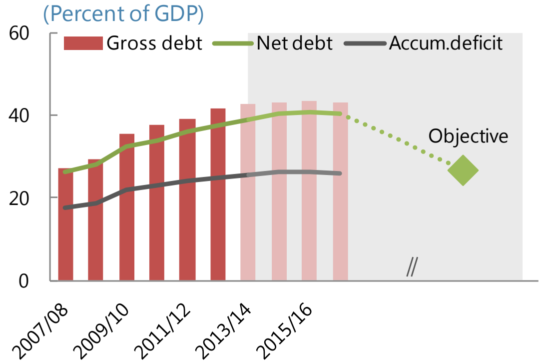
Box 1. Fiscal Consolidation Challenges at the Provincial Level: Ontario and Québec (concluded)

Policy commitments and prospects for balanced budgets 1/

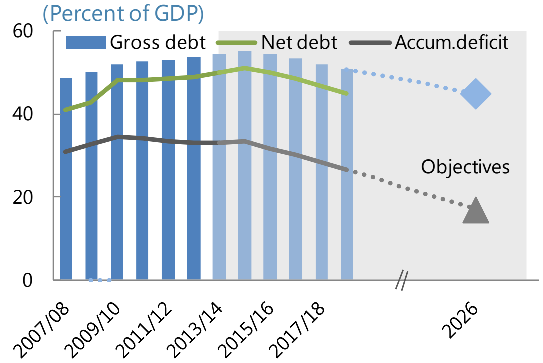
The Ontario government is committed to balancing the budget in FY2017/18. Provincial authorities also aim to reduce net debt to its pre-recession level of 27 percent of GDP (though without a specific date). After increasing to Can$11.8 billion in FY2014/15, the deficit is projected to gradually narrow before reaching a surplus in FY2017/18.2/ Overall, an improved economic outlook and health care cost containment seem crucial for Ontario to meet its fiscal targets. The burden of the adjustment will be mainly on program spending which is projected to grow well below CPI inflation.3/ Since the two-year wage freeze for public servants will have only modest impact on spending, much will depend on the ability to further contain health care costs.4/ In addition, steps are being taken to improve provincial asset management, including by considering options to divest non-core assets. Such actions, as identified by the Premier's Advisory Council on Government Assets, could yield Can$2–3 billion for potential investments in Ontario's infrastructure. The Council's final recommendations are expected to help inform Ontario's 2015 budget.

The Québec government is committed to balancing the budget in FY2015/16. Over a longer horizon, authorities aim to reduce gross debt and accumulated deficits to 45 percent and 17 percent of GDP in 2025–2026, respectively. The return to budget balance, however, has been postponed for the last two years, and fiscal outturns have consistently disappointed over the last four years. The slippages were related to lower-than-expected revenues and especially higher-than-expected spending. According to the Fall 2014 budget update, the government has identified about 85 percent measures (from the total of Can$7.3 billion) needed for FY2015/16 to meet the balanced budget target. Most of the effort is focused on restraining expenditure growth, by increasing savings from ministries and government organizations, freezing public service hiring for two years, and reducing tax expenditures and subsidies. In comparison to Ontario, Québec's fiscal challenges appear more structural, related to slower potential economic growth, a greater role of the government, and structurally higher health care spending growth (in part related to demographic differences despite Québec's lower health expenditure in per capita terms).

Ontario: Debt and Accumulated Deficit
(Percent of GDP)



Québec: Debt and Accumulated Deficit
(Percent of GDP)



Sources: Ontario and Québec budget reports.

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1/ Ontario's fiscal framework is legislated in the "Fiscal Transparency and Accountability Act" (2004), which prohibits forecasting ex ante deficits in each of the 3-year ahead budget planning horizon. Québec's "Balanced Budget Act" (2009) prohibits ex post deficits but it has been amended to allow temporary deficits in specific years.

2/ The budget figures are before accounting for the contingency reserve and, thus, represent the most likely scenario. The government's objective is, however, expressed with prudence taking into account the use of the contingency reserves.

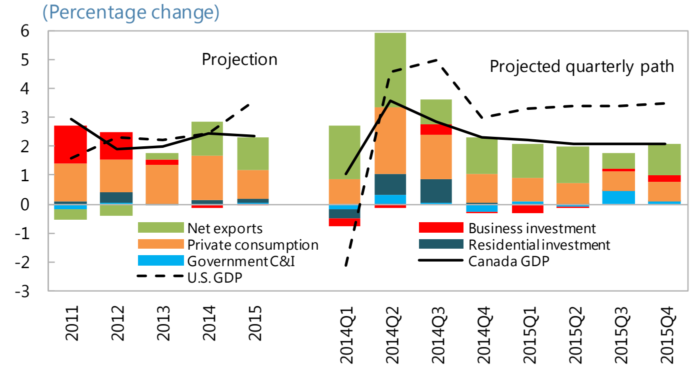
3/ It is worthwhile noting that in Ontario's program spending already declined from 18 percent of Ontario's GDP in FY2009/10 to almost 16½ percent in FY2013/14. This makes Ontario the province with the lowest program spending per capita.

4/ For discussion of trends in health care spending, see IMF Country Report, No. 14/27.

OUTLOOK AND RISKS

5. Recovery momentum is expected to continue, gradually reabsorbing remaining slack in the economy. Above-potential GDP growth is envisaged for 2014 and 2015, as exports and non-energy investment benefit from the U.S. recovery where growth momentum remains strong (Chart). As a drag on growth, the adverse impact of significantly lower oil prices will especially dampen near-term investment in the energy sector. Headline CPI inflation is expected to decelerate in 2015 as a result of lower oil prices, but core CPI inflation will likely remain close to the Bank of Canada's target rate of 2 percent (y/y) as output and unemployment gaps gradually close.

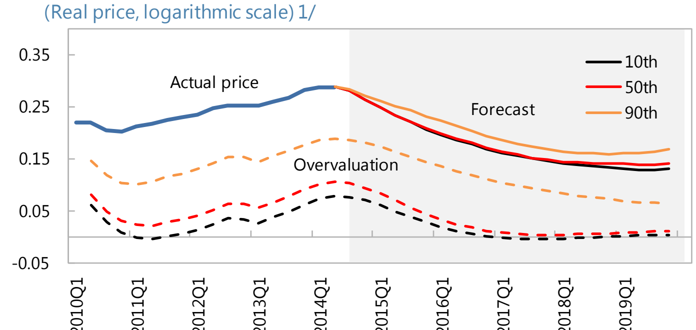
Canada: Contributions to GDP Growth
(Percentage change)



Sources: Statistics Canada; and IMF staff estimates.

6. Growth is expected to become more balanced going forward, along with a cooling housing market. Spurred by the stronger U.S. recovery, which is expected to continue, stronger exports and non-energy investment should mostly offset an expected moderation of private consumption and residential and energy investment with rising interest rates, much lower oil prices, and high household indebtedness. Looking beyond the recent strength and overvaluation in Canada's housing market, staff continues to expect a "soft-landing" (Chart) as higher interest rates and weaker terms-of-trade prospects would temper housing demand, especially in those markets where signs of overvaluations are stronger and where the regional economy is more reliant on the energy sector.

Estimates of House Price Overvaluation
(Real price, logarithmic scale) 1/



Source: IMF staff estimates.
1/ 10th, 50th, and 90th percentiles of estimates and residuals (overvaluation) from reverse recursive regressions.

7. A transition to more balanced and sustainable growth is not without risks (Risk Assessment Matrix, Box 2). Risks to growth are modestly tilted to the downside—led by external risks that could also interact with domestic risks and vulnerabilities.

- *Key external risks facing Canada's economy involve tighter global financial conditions and effects from substantially weaker oil prices*. Moreover, external risks—e.g., tighter-than-expected global financial conditions or weaker terms of trade on a sustained basis—could further harm domestic demand by interacting with vulnerabilities in the housing sector and high household indebtedness. In the energy sector, substantially lower global oil prices, if they persist, and concerns about still-unresolved prospects for major infrastructure projects would pose risks for domestic investment and energy production (Box 3).[9]

- *Given house price overvaluation, the housing sector is the main domestic risk—alongside high household debt*. A sharper-than-expected correction of house prices would have an adverse impact on household wealth and access to finance, reducing domestic demand and output, but risks to financial stability are likely to be limited. It remains, however, unlikely that a sharp house price correction could take place in the absence of external demand triggers.

- *Downside risks could occur in unison.* A deeper downside scenario would have key external risks and a housing market correction occurring together.

- On the *upside*, external demand (U.S. investment and housing) may be stronger than expected, and a faster resolution of infrastructure bottlenecks could support energy exports and investment.

8. Both monetary and fiscal policy have space to respond if adverse shocks materialize or intensify. The federal government and some provinces have fiscal space for automatic stabilizers to operate fully. A further fiscal loosening for these governments could be considered in the event of a larger and/or more persistent adverse shock, complemented by greater reform efforts aimed at improving productivity and addressing energy infrastructure bottlenecks over the medium term. Monetary policy has room to ease if downside risks materialize or intensify.

9. Canada is heading towards general elections in 2015. The general election to elect members to the House of Commons of the Canadian Parliament is tentatively scheduled for October 19, 2015. At the provincial level, with most elections over, including the 2014 elections in Ontario and Québec, some policy uncertainty remains especially in Québec relating to potential fiscal policy changes as a result of (needed) ongoing expenditure and tax system reviews.

[9] Compared to the October 2014 WEO, in the January 2015 WEO baseline, the projected oil prices are about 43 percent lower in 2015 (down from US$100 per barrel to below US$ 57 per barrel) and 30 percent lower over 2015–19. Projections for partner-country demand growth remain largely unchanged, however, mainly reflecting stronger U.S. growth.

Canada: Risk Assessment Matrix 1/

Source of Risks	Relative Likelihood	Expected Impact	Policy Response
Surges in global financial market volatility, resulting in tightening of global financial conditions	High	**Medium/High** Potential triggers could include market displacement from asynchronous policy normalization (e.g., QE exit, "money shock"). The impact of this shock (without stronger growth in the U.S.) on Canadian output would be negative, and more so if the increase in U.S. interest rates were to lead to a sharp and persistent increase in mortgage rates in Canada as well as a faster decline in house prices than currently in our baseline scenario.	・Provide greater fiscal accommodation at the federal level; some provinces also have fiscal space to respond. ・Maintain monetary policy accommodation.
Protracted period of slower growth in advanced economies or in emerging economies	High	**Medium** This could impact Canada mainly through trade channels, including through a negative impact on the terms of trade (as commodity prices would fall). Domestic demand would also be affected through negative confidence effects and tighter financial conditions. However, the weakening of the Canadian dollar (if energy prices fall) would soften the impact.	・Maintain monetary policy accommodation. ・Allow automatic stabilizers to operate fully at the federal level (and for provinces which have fiscal space), or consider fiscal loosening in the event of a larger shock. ・Intensify reforms to improve productivity.
Sharper correction in house prices	Medium	**Medium** An abrupt correction in house prices would have an adverse impact on household wealth and access to finance, reducing domestic demand and output. Canada's strong financial regulatory and supervisory framework, together with a credible federal system of safety nets, would be a mitigating factor.	・Banks have capacity to recapitalize. ・CMHC and the federal government have space to respond. ・BOC to stand ready to provide liquidity support in the event of substantial credit losses and severe liquidity shortages for Canadian financial institutions.

1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Box 2. Risk Scenarios and Spillovers 1/

Main external risks. Canada can be adversely affected by unexpectedly sharp monetary normalization in the United States, a more protracted period of slow growth in advanced and emerging market economies, and a further decline in oil prices.

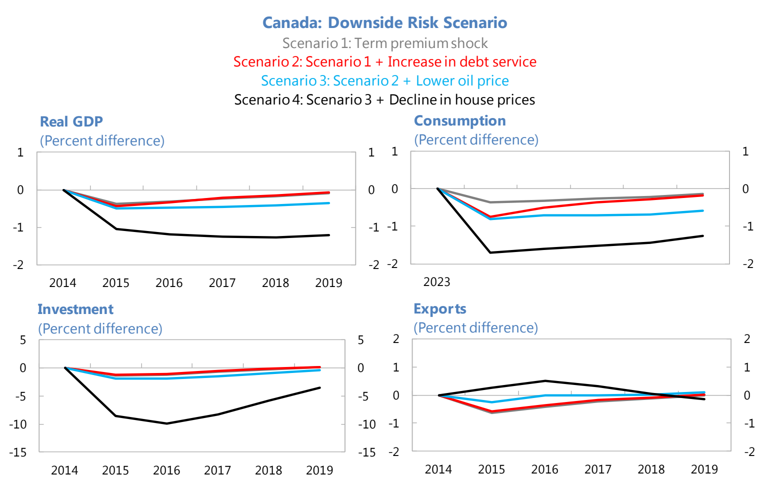
- ***Sharper U.S. monetary normalization***. Monetary conditions could tighten unexpectedly in the United States and the United Kingdom (with a 100 basis point rise in term premium in 2015), triggered by market fears over a sooner-than-expected policy rate hike reflecting financial stability concerns (*2014 Spillover Report)*. Even assuming a quick policy response to address market misperception and lowered short-term interest rates, the output loss for Canada could still be significant in the near term. On the other hand, if tightening is accompanied by a private domestic demand-driven expansion in the U.S., Canada's higher net exports and depreciation against the U.S. dollar are expected to more than offset the negative impact of financial tightening in Canada due to spillovers. In this case, Canada's output would rise, or stay around the baseline after accounting for a likely house price correction (IMF Country Report, No. 14/27, Annex I).

- ***Slower growth in advanced and emerging economies***. A protracted period of slow growth in advanced and emerging markets could also hurt Canada over the medium term, mainly through weaker U.S. demand and lower prices for commodities, including oil. The impact on Canada, however, from further downward pressure on energy prices would be smaller if the additional shock is primarily driven by weaker demand outside the U.S. (and/or supply factors in oil markets).

Main domestic risk

- ***Housing shock***. House price correction can be more abrupt than expected, triggered by, for example, an overreaction to factors affecting fundamentals, such as an increase in mortgage rates and deterioration in the terms of trade. Model estimates suggest that a 10 percent decline in house prices could lead to about 0.1 percent decline in Canada's private consumption. The rise in interest rates would further subtract from consumption through higher mortgage debt service, with a 100 basis point increase in interest rates translating into about 0.3 percent decline in private consumption in one year.

Combined risk scenario. Given interconnections between external and domestic risks, some could materialize together. A deeper downside scenario would include tighter financial conditions, amplified by a debt-service channel, a further deterioration in the terms of trade (for example, from an additional 10 percent decline in oil prices), and a housing market correction occurring in unison, where, for example, financial tightening would increase debt service costs while lower commodity prices would trigger a reassessment of house price fundamentals. The combined effect on real GDP would be about 1 percent drop in the first year, rising to about 1¼ percent reduction over the medium term. Consumption and especially investment would be significantly hurt, while exports would increase as monetary policy is expected to react by easing its stance (Chart).



Source: IMF staff estimates.

Box 2. Risk Scenarios and Spillovers 1/ (concluded)

Inward spillovers. Canada remains mainly exposed to spillovers from the United States through trade and financial linkages. Canada's merchandise exports are predominantly directed to the United States, although the U.S. share has declined from about 85 percent in 2003 to 75 percent in 2013. Reflecting this tight trade link, export growth is highly synchronized with the U.S. business cycle and especially with U.S. business investment (through imports of manufacturing goods).2/ Meanwhile, Canada has become more exposed to emerging markets over recent years, mainly through commodity prices.3/ On the financial side, Canadian banks' consolidated claims on non-residents as of 2014Q2 stood at about 70 percent of GDP, of which two-thirds were vis-à-vis the United States. While Canada's liabilities to foreign banks is relatively small (about 20 percent of GDP) compared to other advanced economies, Canada's financial and non-financial sectors could be affected by the materialization of the risk of runs on U.S. mutual funds in the event of an interest rate shock.

Outward spillovers. External effects on the Caribbean could be substantial given Canadian banks' dominant presence in the region and large tourist and remittance flows from Canada. A network analysis based on BIS banking statistics indicates significant cross-border financial linkages to the region and could be a potential source of significant spillovers for a number of Caribbean islands where Canadian financial institutions have a dominant market position. For example, Canadian banks account for about 60 percent of the ECCU's banking system assets. Changes in Canada's economic conditions can also affect the Caribbean islands through tourism and remittance flows. In 2013, Canadian tourists accounted for about 12 percent of total arrivals in the region, which is the second after the United States (*Caribbean Tourism Organization, 2014*). Remittance inflows from Canada are also sizeable for countries such as Guyana and Jamaica, amounting to about 3 and 2 percent of their GDP in 2012, respectively.

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1/ The discussion on assessing macroeconomic implications of shocks has benefited from inputs by Benjamin Hunt, Keiko Honjo, and Dirk Muir (all RES).

2/ Staff estimates that a one percentage point increase in U.S. business investment growth is associated with ½ percentage point increase in Canada's real exports of goods and services growth after one year.

3/ Canada is particularly exposed to fluctuations in China's fixed asset investment given its high commodity-intensity: a one-percentage point decline in China's fixed asset investment growth could reduce Canada's export growth by up to ¼ percentage point (IMF Country Report, No.13/40).

Box 3. Lower Oil Prices: Implications for Canada

Energy sector in Canada

Energy sector plays an important role in Canada's economy. The sector accounted for almost 10 percent of GDP (over half of which oil and gas extraction) and over 25 percent of exports in 2013–14. Capital expenditure in Canada's oil and gas sector comprises about ¼ of total non-housing private investment, about equally split between conventional oil/gas and unconventional oil extraction. While the sector's direct contribution to GDP and employment has been small, it has notable spillovers to other sectors linked to unconventional oil extraction activities. Overall, Canada has benefited from the boom in the unconventional oil production from oil sands (see, IMF Country Reports No. 14/27 and No. 14/28).

Fiscal exposure at the federal level to oil is limited but important for oil-rich provinces, mainly through royalties. At the general government level, direct revenues from oil amount to about 1½ percent of total revenue or ½ percent of GDP (over two-thirds of which in Alberta). Corporate income tax from oil- and oil-related companies is also an important source of revenue. Other effects would work through indirect taxes and other revenues affected by the reduction in the tax base (lower nominal growth). To this end, the Fall 2014 update of the federal budget introduced an adjustment to largely account for the sharp decline in oil prices, lowering the level of nominal GDP over the medium term.

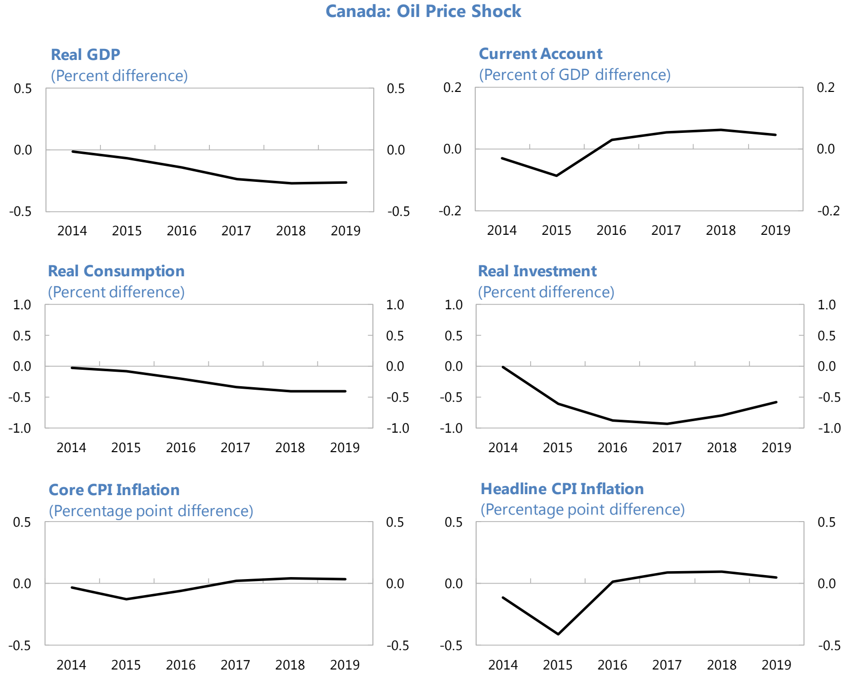
Implications of persistently lower crude oil prices

A persistent and sizeable decline in oil prices dampens Canada's growth through a number of channels. The adverse direct effects would be on investment and employment in the energy sector. Breakeven prices for Canadian oil sands are believed to be wide ranging from US$50 per barrel to over US$85 per barrel; more advanced projects would be able to expand even at lower prices, but further increases in investment would more likely be delayed if low oil prices were to persist.1/ Canadian equity prices would decline as energy companies represent an important share of the Canadian stock market. Deteriorating terms of trade, weaker domestic income, and lower financial wealth would negatively affect private consumption–more so, if the housing market was negatively affected as well. Public consumption in oil-producing provinces may also be negatively affected (assuming they do not adjust their fiscal balance targets). Interprovincial trade and labor mobility (which increased alongside the energy boom in Canada's western provinces) would also be negatively affected. The historically strong relationship between oil prices and the Canadian exchange rate would indicate a weaker currency that would help cushion the growth effects through non-energy exports. Lower energy costs could also benefit consumers and help increase exports, investment, and employment in non-energy sectors and provinces, especially in the context of a slightly stronger U.S. growth.

Simulations suggest that typically a 10 percent decline in oil prices, driven largely by supply factors, reduces Canada's GDP growth by less than 0.1 percentage point per year, cumulating to about ¼ percent lower level of GDP over the medium term (Chart). The output losses would, however, be noticeably larger if demand factors increasingly drive lower oil prices. The effects on headline inflation are felt on impact while the pass-through to core inflation is small. The effects of falling energy prices would in part be offset by exchange

Box 3. Lower Oil Prices: Implications for Canada (concluded)

rate depreciation (and monetary policy would ease to react). The deterioration in the current account is small and short-lived. Overall, the effects would be smaller if U.S. demand remains strong, oil price decline is perceived as temporary, and/or there is meaningful progress on important energy infrastructure projects which would support exports and investment and keep the margin between WCS and WTI narrow.2/



Source: IMF staff estimates.

Preliminary reactions from the industry

Canadian oil sands producers are taking a long-term view of the global oil market but have indicated spending cuts in the near term in response to the current low crude price environment. Typically, oil sands projects are based on long-term price expectations and decades-long production profiles. Suncor Energy, the largest Canadian energy company by market capitalization, plans to cut capital spending by $1 billion in 2015 from previously planned $7.2–$7.8 billion while keeping average production of 540,000–585,000 barrels of oil equivalent per day, compared to $7.8 billion capital spending and 565,000–610,000 barrels of oil production planned for 2014. Canadian Natural Resources, the largest oil and gas producer and the second largest energy company by market capitalization, plans a somewhat lower production in the short term along with a large cut in its 2015 capital budget (from $8.6 billion to $6.2 billion). The companies expect major projects that are already underway for oil sands and heavy oil to move forward as planned but new projects will be deferred. Over a longer run, pipeline capacity remains the main issue for Canada's crude oil production.3/

1/ According to Alberta's government, most projects have already committed large amounts of capital and are increasingly shifting to the production phase. More broadly, investment decisions are also linked to infrastructure issues, and progress on any major infrastructure projects to export oil would likely help sustain investment.
2/ The price discount between the Canadian oil sands price (WCS) and WTI, which has varied between US$15–20 per barrel recently, is only in part driven by quality differentials.
3/ While approval or implementation of major pipeline projects continue to face significant resistance, other projects have become operational in 2014 enhancing pipeline capacity to and from the U.S. refining center in Cushing (such as Keystone XL's southern leg, Enbridge's Flanagan South pipeline, Seaway twinning). In addition, transporting crude oil by rail remains an important alternative.

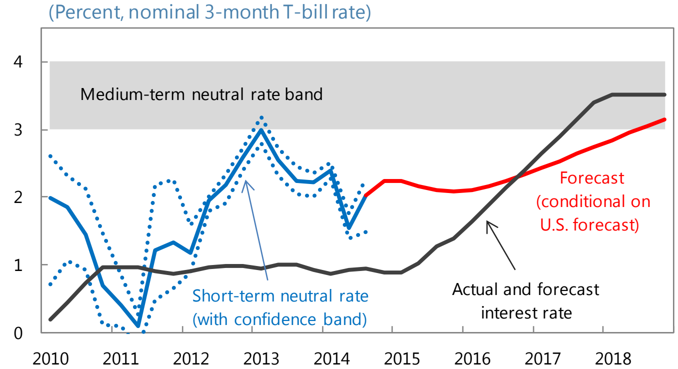
POLICIES FOR BALANCED AND SUSTAINED RECOVERY

The authorities should continue pursuing a combination of macroeconomic and structural policies that would facilitate the rebalancing of growth from consumption and residential investment towards exports and business investment, further strengthen the resilience of the financial system, improve the composition of fiscal policy, and boost the economy's growth potential. To secure a broader and more durable recovery, maintaining monetary accommodation along with gradual fiscal consolidation at the general government level would be conducive for achieving a growth composition with stronger exports and, thereby, investment in the economy, while targeted macro-prudential policies would help address housing sector vulnerabilities.

A. Monetary Policy: Gradual Normalization Ahead

10. Monetary policy remains accommodative given slack in the economy and stable inflation outlook. The policy rate has been on hold at 1 percent since September 2010. Overall financial conditions have been easing until recently, with interest rates across maturities declining since end-2013 and business credit growth picking up (Figure 6). Staff estimates of the (time-varying) neutral rate of interest suggest that monetary policy has been supportive throughout the recovery, and currently, with a negative interest rate gap (i.e., actual policy rate below the neutral rate) (Chart, Selected Issues).[10]

Neutral Interest Rate Estimates and Projections
(Percent, nominal 3-month T-bill rate)



Sources: Bank of Canada; and IMF staff estimates.

11. Monetary normalization is expected to begin later in 2015. Looking forward, the short-term neutral rate should eventually rise from current low levels reflecting the normalization in the U.S. monetary policy and solid economic activity in Canada driven by external factors (mainly, the U.S. recovery) and domestic factors (pickup in non-energy business investment). In this setting, a gradual increase in policy rates starting in the second half of 2015 is suggested by staff analysis toward a medium-term neutral rate estimated to be between 3 and 4 percent over the medium

[10] Cyclical conditions (both domestic and external) may make the short-term neutral rate deviate from the longer-term neutral rate. The short-term neutral rate is useful to help assess the appropriateness of the current policy rate as well as the adjustment path to the neutral rate over the medium term. Specifically, the interest rate gap provides a measure of policy accommodation (tightness).

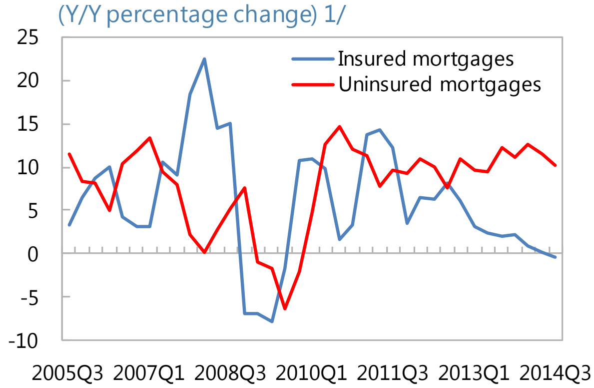
term. Market expectations of policy tightening more towards the end of 2015 have increased recently.

12. Monetary policy can afford to stay accommodative for now. With well-anchored inflation expectations and downside external risks to growth, the Bank of Canada (BOC) can embark on policy tightening after firmer signs emerge of a more balanced and durable recovery led by stronger investment. Also, a negative impact on domestic growth and inflation from the recent decline in oil prices provides additional room for maintaining monetary accommodation. Moreover, given the strong co-movement between Canadian and U.S. long-term interest rates, an expected gradual increase in U.S. rates around mid-2015 along with terms-of-trade deterioration should help cool down the housing sector.

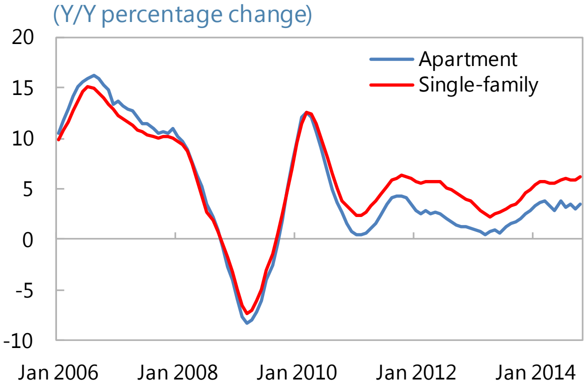
B. Macro-Prudential Policies: Options for Further Targeted Action

13. Further macro-prudential policy action may be needed if household balance sheet and housing market vulnerabilities resume rising. Evolving risks to the financial system and the ability of macro-prudential tools to influence these developments need to be monitored closely. Measures introduced over the past few years have been effective in significantly lowering growth of insured mortgage loans (Chart). At the same time, however, uninsured mortgages—loans with the maximum loan-to-value (LTV) ratio of 80 percent—which recently comprise more than two-thirds of mortgage originations have been rising noticeably (on average, 10 percent per year since mid-2010) alongside house price increases, especially in high-end, single-family housing markets (Chart). With some of this new lending, particularly by smaller and less regulated financial institutions, going to non-prime borrowers, it may partly reflect greater use of borrowed funds for larger down payments to avoid insurance premiums or tighter conditions on insured mortgages.

Insured and Uninsured Mortgage Loans
(Y/Y percentage change) 1/



House Price Index
(Y/Y percentage change)



Sources: OSFI; and CREA.
1/ For insured mortgages over the period of 2011Q4–2012Q4, four-quarter rolling average Q/Q growth rates are used to adjust for a structural break in 2011Q4 due to classification of securitized mortgages.

- As an initial step to address evolving risks in mortgage markets, low-LTV mortgage loans to be insured on a portfolio basis could be subject to the same mortgage insurance rules applied to high-LTV mortgage loans, especially since the largest proportion of uninsured low-LTV loans have LTVs in the upper range between 75–80 percent and given the fact that down payments can be borrowed. Data on borrowed down payments would help assess possible avoidance from tighter mortgage insurance rules.

- Additional actions targeted at uninsured mortgages to consider may include tighter amortization and lower LTV limits for market segments where they remain relatively high and caps on debt-service-to-income (DSTI) ratios that would also address the issue of borrowed down payments.[11] These measures would also have a particularly dampening effect on the most overheated regional markets.[12]

14. Policies should aim at further limiting exposure of taxpayers to the housing market and encouraging appropriate risk retention by the private sector, as recommended by the 2013 FSAP. Staff welcomes the tightening mortgage insurance measures implemented by the Canada Mortgage and Housing Corporation (CMHC) over the past year, CMHC's plans to increase capital, and a new guideline issued by the Office of the Superintendent of Financial Institutions (OSFI) to strengthen mortgage insurance underwriting practices.[13] The elimination of some CMHC's mortgage insurance products will marginally limit the federal government's exposure to the housing market since they represent a small proportion of CMCH's business and can still be insured by private mortgage insurers.[14]

- In the near term, the authorities will need to implement current plans to prohibit the use of government-backed insured mortgages in non-CMHC securitization programs and gradually limit portfolio insurance that will be tied to CMHC securitization. Further reduction of portfolio insurance for both CMHC and private mortgage insurers and changes to introduce more risk-sharing should also be considered, which would complement current prudential measures in cooling off the housing market.

- To help encourage market alternatives to insured mortgage related instruments, the 4 percent threshold on covered bonds' share in total assets (one of the lowest among Canada's peers), could be increased as the issuance of National Housing Act Mortgage-Backed Securities (NHA

[11] These measures have been used by many jurisdictions to address risks stemming from housing and mortgage credit markets. While some countries have used a single instrument to deal with the risks (e.g., India and Indonesia used LTVs), many other countries have used them in combination (e.g., Israel used amortization periods and LTVs; Korea, Malaysia, Netherlands used LTVs in combination with DSTI ratios whereas Hong Kong and Singapore used all three instruments).

[12] In past consultations, staff raised the issue of considering differentiated macro-prudential measures across provinces to target areas with more buoyant housing sectors (see, IMF Country Report 13/40), however such policies come under the jurisdiction of provincial or municipal authorities (e.g., property taxes and transaction fees).

[13] This is broadly in line with recommendations of the Basel Committee on Banking Supervision.

[14] The federal government guarantees 100 percent of CMHC's insured loans and 90 percent of those insured by private companies.

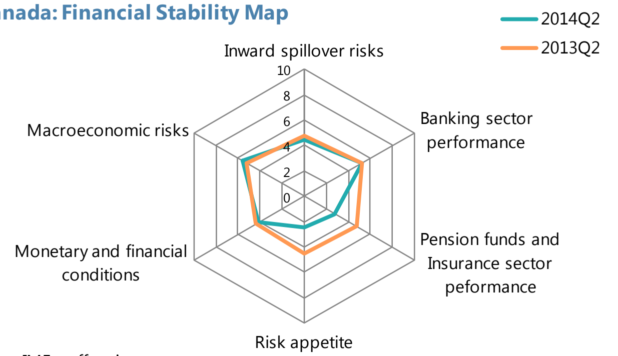
MBSs) and Canada Mortgage Bonds (CMBs) is further reduced.[15] More broadly, re-examining the dimensions of extensive government-backed mortgage insurance should remain on the authorities' longer-term agenda, including managing a transition from financial market reliance on government-backed instruments as the public sector role recedes.

C. Financial Sector Policies: Reform Agenda and FSAP Recommendations

15. Banking sector performance improved over the past year (Figure 6, Chart).

- *Canadian banks are profitable and well capitalized.* Canadian banks reported record profits despite stable interest rate margins as non-interest income increased. Loan quality has remained favorable, with nonperforming loans (NPLs) below ½ percent of total loans and falling. D-SIBs are well capitalized but report CET1 ratios below the average capital ratios of G-SIB (by 1 percentage point). Banks are well positioned to meet the new Basel III Liquidity Coverage Ratio (LCR) and leverage requirements in advance of their implementation.

Canada: Financial Stability Map



Source: IMF staff estimates.
Note: Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

- *Financial stability risks appear contained.* Given Canadian banks' strong capital position and stable funding sources as well as extensive government-guaranteed mortgage insurance, the impact on financial stability of a tail risk shock characterized by the worst three-year recession in the last 35 years would be limited, as reported in stress tests conducted for the 2013 FSAP Update. The stress test scenario also includes a 50 percent decline in oil prices, in line with recent market developments, though banks' exposures to the energy sector and foreign exchange are small. However, risks from operations abroad where Canadian banks have less competitive advantage and increasing reliance on capital markets and wealth management that are more volatile sources of income warrant close attention, including through conducting a possible cross-sectoral review of banks with exposure to tax haven countries and money laundering risks.

16. Risks outside of standard banking activity appear limited. Performance of life insurance and pension funds has improved noticeably. Life insurance companies have reported higher capital

[15] NHA MBSs are securities that are backed by distinct pools of insured mortgages. The timely payment of NHA MBS principal and interest is guaranteed by the CMHC backed by the Government of Canada. The CMHC also guarantees non-amortizing CMBs issued by a special-purpose trust, the Canada Housing Trust (CHT). CHT uses the proceeds of its bond issuance to finance the purchase of NHA MBSs.

and profits due to insurance sales and wealth management activities. The average defined benefit pension fund has become fully funded for the first time since 2007 mainly due to strong equity returns. Financial intermediation in terms of "shadow banking" activity remains relatively limited, with banks (and other regulated institutions) playing the prominent role in all major segments.[16] Overall, Canada's robust financial regulatory and supervisory framework, together with a credible system of federal safety nets, adds to financial system strength.

17. Steady progress has been achieved on key parts of the financial reform agenda since the last Article IV consultation (Text Table).[17] Progress has been made on implementing the Basel III Liquidity Coverage Ratio and leverage standards. Resolution and recovery frameworks would be enhanced if the proposed bail-in regime is implemented. The harmonized rules for reporting certain derivatives data to trade repositories will enhance transparency in the OTC derivatives market, and help detect possible systemic risks. Staff welcomed OSFI's draft guideline for derivatives sound practices which will strengthen the OTC derivatives markets. A new market transaction reporting system for debt securities, including all repo transactions, will allow the BOC to monitor activity and potential financial stability risks in the repo market.

[16] According to the BOC's activity-based definition (different from the Financial Stability Board's entity-based definition), "shadow-banking" is estimated at 40 percent of GDP and includes government-insured mortgage securitization, private-label securitization (ABCP and ABS), repos (predominantly in government securities), money market mutual funds (MMMFs), bankers' acceptances, and commercial paper (IMF Country Report No. 14/29).

[17] Canadian banks have already adopted Basel III capital adequacy standards in 2013. For the 6 designated D-SIBs, a capital surcharge will also be coming into effect from January 2016. The minimum LCR requirement for Canadian institutions is set at 100% beginning January 1, 2015, without any phase-in period. While there is a deterioration in the share of liquid assets to total assets since 2011 (Table 4), the LCR numbers for D-SIBs remain robust and above the supervisory threshold that came into force on January 1, 2015. Federally regulated deposit-taking institutions will be expected to have Basel III leverage ratios that exceed three per cent. The capital measure used for the leverage ratio is the all-in Tier 1 capital of the institution. OSFI will continue to set authorized leverage ratios on an institution-by-institution basis and will update their guideline on liquidity adequacy requirements with Basel III regulations on Net Stable Funding Ratios based on the final guidance issued by the Basel Committee for Banking Stability.

Canada: Progress on Financial Reform Agenda

Area	Progress on implementation
Basel standards	Basel III Liquidity Coverage Ratio (LCR) and leverage standards have been implemented and will take effect in January 2015.
Resolution and recovery of D-SIBs	Third generation resolution plans for the D-SIBs are expected to be completed by the end-FY2014, and the fifth generations of recovery plans are expected to be submitted in 2016. The government has also concluded public consultations on the proposed bail-in regime. This regime will help ensure bank shareholders and creditors bear losses (rather than taxpayers) when a bank fails, thereby giving them stronger incentives to monitor the bank's risk-taking activities and addressing moral hazard.
OTC derivatives	The largest provincial securities regulators have implemented harmonized rules for reporting certain derivatives data to trade repositories. OSFI's draft guideline for derivatives sound practices sets OSFI's expectations for central clearing of OTC derivatives and reporting to a trade repository and OSFI's plans to establish margin requirements for non-centrally cleared derivatives in the near future. OSFI implemented credit valuation adjustment (CVA) capital charge for bilateral (not applying to centrally-cleared) OTC derivatives in January 2014, which should encourage central clearing of OTC derivatives.
Financial market infrastructures	The BOC, jointly with largest provincial regulators, published a list of the Canadian-domiciled central counterparties (CCPs) that can be considered qualifying CCPs under the Basel III capital standards. The authorities also published draft guidelines on risk management standards for designated financial market infrastructures. The guidelines will provide clarity on certain aspects of most international standards related to the risk-management, efficiency and transparency of systemically important FMIs in the Canadian context.
Repo markets	A new market transaction reporting system for debt securities, including all repo transactions. The authorities are encouraging some of the largest and most active pension funds in the repo market to become direct clearing members of the central counterparty.

18. Progress has been made on some FSAP recommendations (Annex II). Welcome progress has been made on reducing government exposure to mortgage insurance; the federal authorities' stress-testing framework for banks; and to identify financial sector data gaps, as well as toward enhancing the cooperative capital markets system. Moreover, the OSFI has increased contact with provincial regulators to harmonize regulation and improve supervisory cooperation. The OSFI and the BOC have also started discussions with some provincial regulators to help the latter enhance their stress testing capabilities. Addressing financial sector data gaps will improve the BOC's research, analyses, and systemic risk monitoring capacity for the financial system. The recent memorandum of agreement among five provinces and the federal government setting out the terms and conditions to establish a cooperative capital markets system could prove a useful step in harmonizing provincial capital markets legislation, enhancing systemic risk monitoring, and enforcement.

19. Addressing other key FSAP recommendations would further strengthen the resilience of the Canadian financial sector. Most FSAP recommendations on financial sector oversight, safety nets, and macro-prudential framework are outstanding. In particular:

- *Enhanced supervisory cooperation across federal and provincial authorities and harmonized stress-testing are important to bolster financial system soundness.* Subjecting all systemic federally- and provincially-regulated entities to common stress-testing frameworks would involve a heightened degree of collaboration. While discussions on supervisory cooperation between federal and some provincial authorities have started, two-way communication and protocols to share supervisory information on regulated entities (especially for the financial groups spanning federal and provincial regulatory boundaries) and planned guidelines should be enhanced within respective mandates, including to reduce possible regulatory fragmentation and ensure that supervision remains intensive and effective across all systemic institutions.

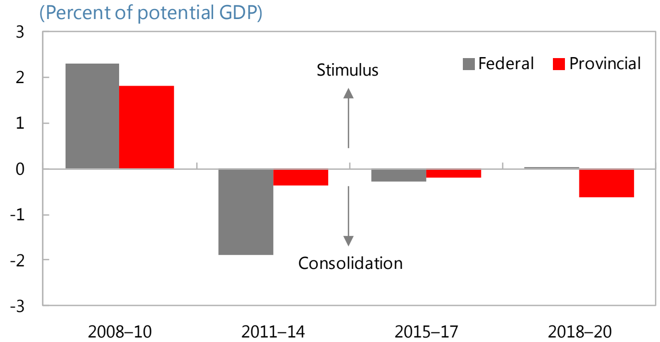
- *Strengthening macro-prudential and crisis management frameworks will increase the resilience of the financial system.* Staff argued that providing a mandate for macro-prudential oversight to a single entity would strengthen accountability and the capacity and willingness to act, as well as reinforce Canada's ability to identify and respond to future crises. Such an entity should have participation broad enough to allow for a complete and integrated view of systemic risks, and powers to collect all necessary data for systemic risk analysis. To this end, staff welcomed the authorities' recent efforts to identify financial sector data gaps. For crisis preparedness, a mandate should be given to an entity that could operationalize a coordination framework to support timely and effective decision-making in a crisis situation and test the capacity of the authorities (federal and provincial) to respond to crisis scenarios.

- *Other recommendations* include: (i) providing more clarity around the legal independence of the OSFI, (ii) formalizing banks' reporting and notification obligations in some areas (such as on the acquisition and ownership of banks and related-party transactions and large exposures), (iii) adopting a transparent and consistent regulatory regime for group-wide insurance supervision, (iv) extending the scope of OSFI's oversight of the CMHC; and (v) expanding financial sector data collection and dissemination.

D. Fiscal Policy: Changing Composition of Fiscal Adjustment

20. Fiscal consolidation should proceed at the general government level. The general government deficit is expected to gradually narrow from an estimated 1½ percent of GDP in 2014 to near balance over the medium term, with gross debt declining and remaining relatively resilient to a series of macro and fiscal shocks (Annex III). After nearly complete removal of earlier stimulus, the federal government is still projected to provide some contribution to fiscal adjustment at the general government level in 2015–17 (Chart). However, with key fiscal challenges concentrated at the provincial level, particularly arising from looming aging-related spending

From Fiscal Stimulus to Consolidation 1/
(Percent of potential GDP)



Source: IMF staff estimates.
1/ Change in structural balance: improvement/deterioration=consolidation/stimulus.

pressures, it is critical that the composition of fiscal adjustment shifts more substantially towards the provinces.[18]

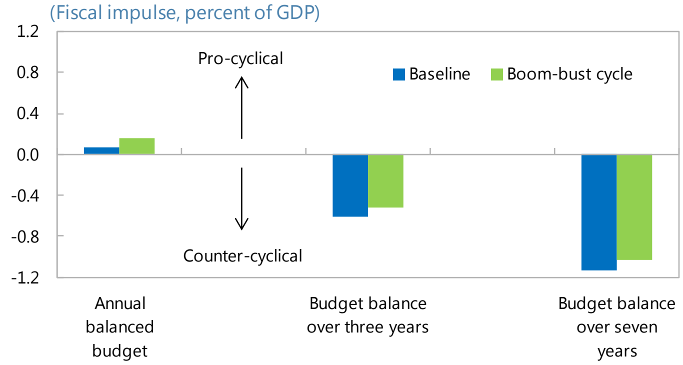
Federal government

21. **Federal authorities should consider adopting a neutral stance going forward**. Given the strong deficit reduction achieved in recent years (about 2 percent of GDP cumulative improvement in structural balances in 2011–14), the federal authorities should consider a slower pace of adjustment after 2014. Adopting a cyclically-neutral stance would imply a small fiscal easing in the near term but still be consistent with achieving their low public debt objectives by 2021.[19] As the economy gradually approaches potential, this would still allow automatic stabilizers to operate fully if growth were to weaken should further downside risks materialize. Moreover, in terms of the policy mix, a neutral fiscal stance would help monetary policy to rebuild policy space further as the recovery proceeds.

22. **Available fiscal resources could be used for targeted growth-friendly measures**. Against the backdrop of lackluster business investment (despite very low interest rates) and productivity, such measures could focus on providing further support for R&D, SMEs, venture capital, and strategic infrastructure projects, with little risk of crowding out private investment. Reducing federal taxes could provide more space to raise revenue at the provincial level, given that federal and provincial governments 'co-occupy' the same tax base.

23. **Fiscal policy at the federal level can benefit from a stronger medium-term anchor**. To lock in the gains from consolidation and increase effectiveness of fiscal policy, a medium-term fiscal framework at the federal level can be beneficial. This would be broadly in line with the authorities' intention to introduce balanced budget legislation.[20] If the federal authorities were to introduce balanced budget legislation, it would be important for a new rules-based framework to be transparent, easy-to-communicate, and ensure convergence towards the authorities' medium-term

Pro-cyclicality of Fiscal Rules
(Fiscal impulse, percent of GDP)



Source: IMF staff estimates.

[18] For a discussion of long-term fiscal sustainability and aging-related challenges, see Annex III of IMF Country Report No. 14/27.

[19] Relative to current policies, maintaining a cyclically-adjusted primary surplus (at the federal level) broadly constant at its 2014 level would amount to some 0.3 percent of GDP fiscal impulse over 2015–17, but would still be consistent with the authorities' debt reduction target of 25 percent debt-to-GDP ratio by 2021.

[20] Discussions center on a federal balanced budget legislation that will "require balanced budgets during normal economic times and concrete timelines for returning to balance in the event of an economic crisis."

objectives, while allowing for flexibility in the face of shocks to avoid pro-cyclicality (Selected Issues). Implications for pro-cyclical fiscal policy vary depending on how the balanced budget rule is defined (Chart). In addition, key design features for an effective fiscal rules framework would also include a legal basis to buttress the credibility of the new rules, and well-defined escape clauses to deal with exceptional events. The Parliamentary Budget Office could play a role in monitoring implementation of the new rule.

Provincial governments

24. Fiscal space is much more limited at the provincial level, in light of mixed progress on consolidation and long-term sustainability challenges. Provincial consolidation plans would need to proceed, and efforts stepped up, especially in the provinces with the highest levels of public debt (Québec and Ontario). For the adjustment plans to deliver, in a sustainable manner, a balanced budget, spending measures may need to be supplemented with additional measures on the revenue side, especially if the fiscal stance turns more neutral at the federal level.

25. Progress in containing health care spending should continue to ensure long-term sustainability of provincial public finances. The growth rate in health care spending has slowed in the last few years relative to historical trends and it is currently below nominal GDP growth.[21] Part of this slowdown, however, is driven by temporary cost compression though more permanent structural adjustments are taking place in some provinces. Demographic factors, however, are still expected to exert a strong upward pressure on costs, and even under optimistic scenarios, health spending is projected to rise from 8 percent to almost 12 of GDP by 2050.

26. Fiscal frameworks at the provincial level should also be strengthened. Regular spending reviews should become an integral part of provincial budgetary frameworks, with a possible role for independent fiscal agencies. A permanent framework for strategic spending reviews could particularly support provinces in delivering on their consolidation needs and feed into binding medium-term ceilings that could be designed to support the implementation of balanced budget rules currently in place in most provinces. Ontario's plan last year to establish a budget office (Financial Accountability Office) was a positive step, and it would be important for the office to become operational soon. Recent decline in oil prices once again underscores the need for the energy-abundant provinces, but also at the federal level, to revisit their fiscal frameworks (as was done in Alberta in 2013) to better manage the volatility associated with commodity prices.

27. There is scope for improving coordination of fiscal policy between different levels of government. Long-term challenges to contain aging-related spending call for extending long-term

[21] Recent reforms to move away from global budgeting (based on historical levels) toward more patient- or activity-based funding models for hospitals, increasing out-of-hospital care, and consolidating purchases of drugs, medical supplies, and equipment are helping contain health care costs and increasing efficiency on a sustainable basis, but further effort would be needed to ensure long-term fiscal sustainability of provincial debt (see, IMF Country Report, No. 14/27).

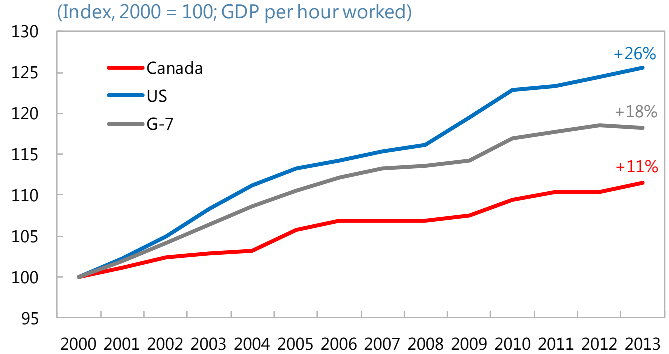
fiscal forecasts at the provincial level and publishing consolidated general government fiscal forecasts in consultation with provinces. This would help raise the public awareness of the challenges ahead and help build the necessary consensus behind the efforts needed to contain aging-related spending. To this end, a useful step could include a data sharing mechanism for long-term fiscal assumptions and forecasts.

E. Policies to Boost Productive Capacity

28. Structural measures to improve Canada's productivity would play an increasingly important role in boosting growth over the medium term. The authorities' policies, including in the context of the G-20 commitments, cover many reform areas, and should be fully implemented.

- *Productivity and innovation*. Further efforts are needed to strengthen (lagging) labor productivity (Chart), such as through improving skills-job matching and fostering business R&D. The authorities' recent initiatives to invigorate venture capital market and provide targeted R&D support to SMEs through the pilot Business Innovation Access Program are encouraging but more could be done to support innovative start-ups and firm growth.

Labor Productivity
(Index, 2000 = 100; GDP per hour worked)



Source: OECD.

- *Infrastructure, trade, and competition*. Enhancing international transportation networks (such as through the planned construction of a new Windsor-Detroit International Crossing), opening up to international trade (e.g., implementation of the Canada-EU trade agreement), addressing energy infrastructure bottlenecks, and removing barriers to FDI would also be key to boosting Canada's exports and growth potential. There is scope to improve competition in network sectors, reduce the barriers to interprovincial trade and labor mobility (by deregulating professions and skilled trades), and make the immigration system more responsive to labor market conditions. The challenges of increasing growth potential appear more pressing in some provinces than others.

AUTHORITIES' VIEWS

29. The authorities broadly shared staff's assessment of the recovery and outlook and the need for rebalancing. Noting Canada's relatively better post-crisis performance than other advanced economies, including in terms of growth, business investment, and job creation, they emphasized the importance of external demand for the remaining rotation towards exports and business investment to take place. A weaker Canadian dollar over the past year was seen as helpful for exports. The moderation in investment growth in recent years was not seen as a surprise by the authorities given its strong performance earlier in the recovery and the repeated downgrades to global economic prospects. The authorities noted unused capacity in non-energy export sectors and uncertainty about the strength of the recovery as potential factors holding back business investment despite accommodative financial conditions and healthy corporate balance sheets.

30. The balance of risks was deemed to be on the downside but less so than in previous years. Staff and the authorities generally agreed on the key sources of risk facing the Canadian economy. The authorities noted weaker oil prices in the near term, slower growth in advanced and emerging economies, and a housing market correction in Canada as key risks, but emphasized that these shocks would be manageable (including through a monetary policy response) if they were to materialize on their own—provided that the U.S. recovery remained on track. They also noted that a strong external trigger and much weaker labor markets, however, would be more important than higher interest rates for domestic housing sector risks to materialize.

31. A deeper downside scenario with correlated shocks was deemed unlikely at this juncture. The authorities concurred that the recent fall in oil prices appeared mainly supply driven, but also reflected weaker oil demand excluding the United States. Thus, risks of lower oil prices and higher interest rates together could not be ruled out. They maintained that there are a number of policy options to respond in the event that combined downside risks materialize. These include further delaying monetary normalization or easing the policy rate. In the event that the policy rate reached its lower bound, the use of alternative monetary policy instruments such as forward guidance may be considered. On the fiscal side, the federal government and some provinces have fiscal room to let automatic stabilizers fully operate.

32. Given that the fall in oil prices was judged to be largely driven by supply factors and demand outside the U.S., the impact on Canada's real GDP is expected to be modest. There was an overall consensus during the mission that, barring further significant declines in oil prices, Canada's oil production would likely be only modestly affected in the near term given large investments in oil sands already made in recent years, increasing pipeline capacity, and longer-term views typically adopted by large energy companies. However, the authorities noted the risk that lower oil prices will have a negative impact on oil and gas sector investment. The fall in crude oil prices is in part compensated by depreciation in the Canadian exchange rate and a stronger U.S. economy, benefiting non-energy exports. However, the authorities noted that the impact on nominal GDP would be significant, through lower export prices and energy-sector profits.

33. The authorities concurred that there is a need to maintain accommodative monetary policy. Underlying inflation remains below 2 percent and inflation expectations are well anchored. In turn, higher long-term interest rates driven by expected U.S. monetary normalization could facilitate a needed moderation in Canada's housing sector. Were concerns about household imbalances to intensify, the Bank of Canada noted that their flexible inflation targeting framework allowed them to consider using monetary policy as a last line of defense to support financial stability.

34. A shared view was that housing market imbalances would likely resolve through a "soft-landing." Noting the "two-tiered" nature of Canada's housing market, authorities agreed with staff's assessment of mortgage and housing market dynamics. However, they did not see large risks from strong growth of uninsured mortgages which are less risky by nature than insured mortgages given larger down payments and limited scope of borrowed down payments. OSFI and the Bank of Canada are monitoring bank credit closely, and authorities are monitoring housing market vulnerabilities in the insured and uninsured mortgage segments.

35. Housing finance measures. Recent mortgage insurance changes by CMHC are consistent with the Government's long term goal to reduce its exposure to the housing market. Since meeting with staff, the Government took further steps to reduce its exposure to the housing market. On December 1, 2014, CMHC notified industry that it is increasing guarantee fees for its securitization programs, effective April 1, 2015. These changes are being made in support of the Government's efforts to enhance the Canadian housing finance framework by encouraging greater reliance on alternative mortgage funding options in the private market by mortgage lenders.

36. Authorities noted that reform of government-backed mortgage insurance needs to be gradual and deliberate. Staff indicated a deductible for mortgage insurance could be an incremental step to introduce risk-sharing with the private sector and reduce taxpayer exposure. Authorities indicated that there are significant implications that require thorough assessment when considering measures to reform the housing finance system, including with respect to a possible mortgage insurance deductible.

37. The authorities continue monitoring changes in risk appetite in the banking and life insurance sectors, including the risks stemming from their operations abroad where they face more competition.

38. Existing informal macro-prudential and crisis management frameworks and supervisory approaches are deemed appropriate and effective in safeguarding stability of the Canadian financial sector. Based on their evaluation of FSAP recommendations the authorities noted in particular that they will continue enhancing cooperation with provincial regulators to coordinate on regulatory and supervisory issues and to strengthen stress testing capacity of provincial regulators. They acknowledged the risk of regulatory fragmentation but argued that the current delineation of responsibilities between federal and provincial regulators is appropriate. They reiterated their view that introducing more formal coordination might undermine the incentives for provincial regulators to oversee, supervise, and provide a backstop to provincially-regulated financial institutions. In that context, the Bank of Canada plans to provide provincially-regulated deposit taking institutions access to its emergency lending facility, provided the institution is systemically important, has credible recovery and resolution plans, and the respective province has provided full indemnity to potential losses.

39. The federal government's resolve to achieve its balanced budget target in FY2015/16 is firm. The authorities believe that there is scope at the federal level to maintain a neutral stance going forward, using the available resources for growth-friendly measures. Indeed, the federal government has already announced tax relief and enhanced benefits for Canadian families.

40. The federal government is committed to introducing balanced budget legislation given the thrust of the fall 2013 Speech from the Throne. The authorities favor a balanced budget rule in headline terms that would cover all fiscal aggregates because such a rule is transparent, simple and easy to communicate and implement.

41. While fiscal consolidation at the provincial level is mixed and long-term sustainability challenges remain, progress toward their budget targets was expected. Achieving budget balance at the overall provincial level over the medium term is considered manageable under current consolidation plans. The Ontario authorities stressed their commitment to return to budget balance by FY2017/18 mainly by stabilizing real spending growth. In British Columbia, the authorities have put in place a new fiscal regime for the LNG sector to make the province internationally competitive for new LNG investments and enhance fiscal revenues.

42. There are a number of policy initiatives underway which should help boost Canada's potential growth and productivity but challenges remain. For example, the authorities have stepped up the efforts to address barriers to interprovincial trade and promote export diversification, including by signing a free trade agreement with Korea and a reciprocal currency agreement with China. As well, the government is implementing its ten-year New Building Canada Plan focusing on broadband networks, public transportation, and support for innovation. There are, however, some structural issues which could help explain Canada's persistent productivity gap with the United States. For example, investment in Information Communication Technology per worker in Canada is half that in the United States, with ¾ of the gap explained by investment in software, and most of the gap coming from the financial sector, professional services, and the telecommunication sector.

STAFF APPRAISAL

43. Canada's economy experienced solid growth over the past year but rebalancing toward exports and investment remains incomplete. Exports are benefiting from the firming U.S. recovery but have not yet translated into a meaningful pick-up in business investment, as firms remained cautious about the demand outlook. Substantially lower oil prices will likely be a drag on growth mainly through weaker investment in the energy sector. Higher household wealth, rising disposable incomes, and relaxed financial conditions have continued supporting relatively strong private consumption. Housing has regained momentum but with important differences across regions and markets.

44. Solid growth is envisaged to continue while becoming more balanced. Stronger non-energy exports and business investment, spurred by the U.S. recovery, should sustain Canada's growth above potential in the near term. Rising long-term interest rates and weaker terms-of-trade mostly due to significantly lower oil prices would moderate private consumption and residential investment, with an expected 'soft-landing' in housing markets. Core inflation is expected to remain close to the Bank of Canada's target rate of 2 percent as the remaining slack in the economy is gradually reabsorbed and inflation expectations remain well anchored.

45. Balance of risks is modestly tilted to the downside for the Canadian economy. A faster-than-expected tightening of global financial conditions, effects from substantially lower crude oil prices, and sluggish global growth are the key downside risks facing Canada. While continued U.S. growth and a depreciating Canadian dollar would help dampen the adverse impact of these shocks, the net outcome for Canada can be negative. Deeper downside risks to growth involve a combination of external shocks that are amplified by high household balance sheet vulnerabilities and a sharper-than-expected correction in house prices. On the upside, U.S. demand may be stronger than expected, and a faster resolution of infrastructure bottlenecks could support activity in the energy sector.

46. Lower crude oil prices present a challenge but also an opportunity. Canada has benefited from the boom in oil sands production despite intensified challenges to competitiveness in non-energy sectors. Substantially lower oil prices would likely cool activity in oil-rich provinces, an engine of Canada's growth in recent years, but benefit provinces reliant on manufacturing and services. The Canadian economy's ability to deliver productivity gains in non-energy sectors will be increasingly important.

47. Monetary policy can afford to stay accommodative for now. Given well-anchored inflation expectations and downside risks to export-driven growth, a monetary policy tightening cycle can await firmer signs to emerge of a more balanced and durable recovery with stronger business investment in non-energy sectors. Further macro-prudential policy action may be needed if household balance sheet and housing market vulnerabilities resume rising, such as tighter standards for uninsured mortgages.

48. Action to further limit exposure of taxpayers to the housing market and encourage appropriate risk retention by the private sector would be desirable. These would include changes to collateral used in securitization, tightening portfolio insurance limits, and changes to mortgage insurance products to introduce more risk-sharing. Any structural change to mortgage insurance and the transition to a different regime would need to proceed gradually to avoid any unintended consequences on financial stability.

49. Financial sector performance remains strong. Canadian banks' performance has improved, and stress tests suggest that banks are resilient to credit, liquidity, and contagion risks arising from a tail risk scenario. However, it is essential to remain vigilant against the potential risks from housing and banks' increasing exposure to capital markets and foreign operations. Performance of life insurance and pension funds, meanwhile, has improved noticeably.

50. The international financial reform agenda has advanced, and some work on FSAP recommendations has started though key steps are still needed. Basel III Liquidity Coverage Ratio and leverage standards have been implemented and will take effect in January 2015, and banks are well positioned to meet the new requirements. Staff welcomes OSFI's draft guideline for Derivatives Sound Practices and progress made on the federal authorities' stress-testing framework, as well as the recent steps taken toward establishing a cooperative capital markets system. However, outstanding FSAP recommendations on financial sector oversight, safety nets, and macro-prudential frameworks remain to be addressed.

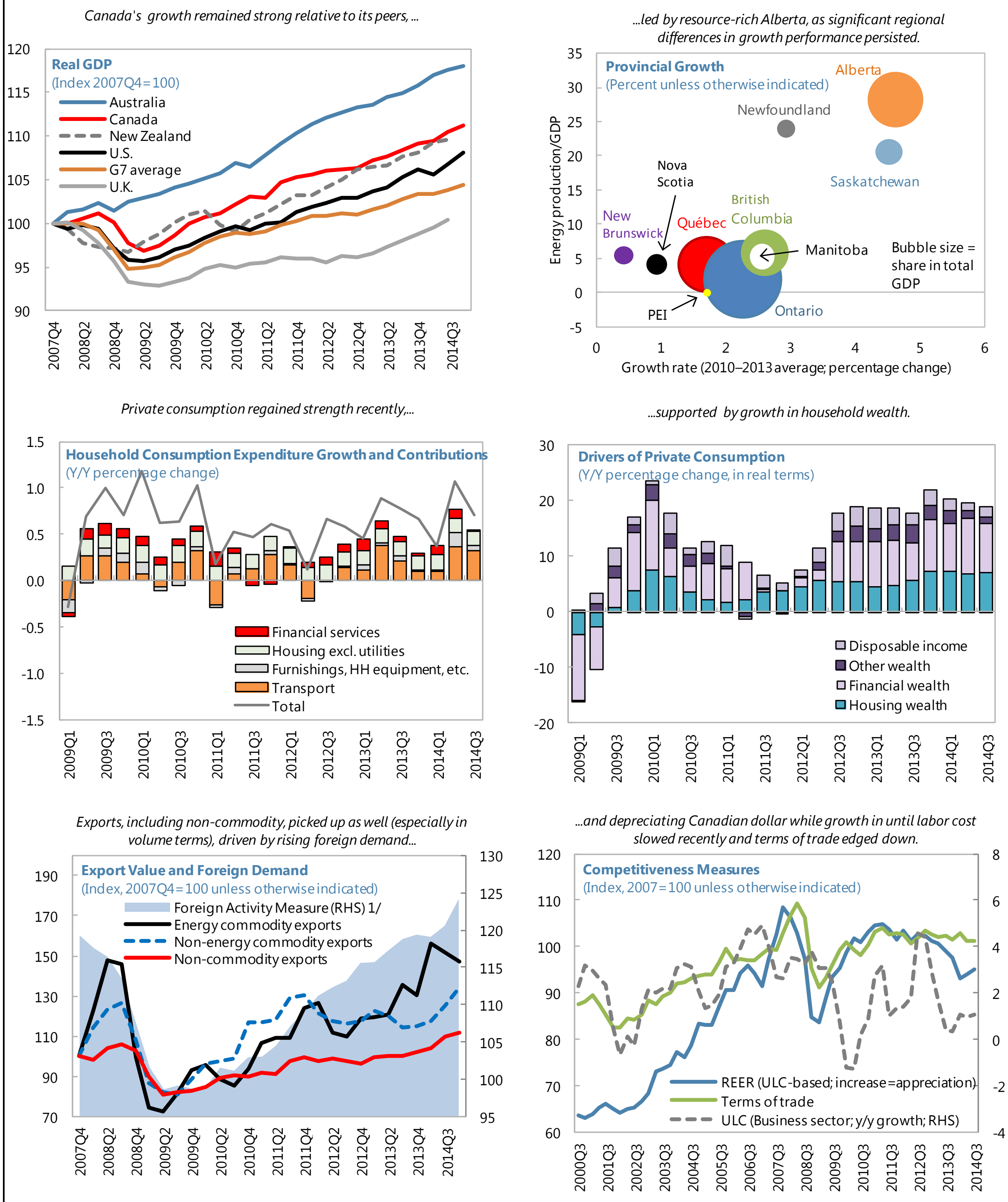
51. Fiscal consolidation should proceed at the general government level, but the federal government should consider adopting a neutral stance going forward. With key fiscal challenges concentrated at the provincial level, particularly from aging-related spending pressures, it is critical that the composition of fiscal adjustment shifts from the federal government towards the provinces.

52. Strengthening medium-term fiscal frameworks would support sound public finances at different levels of government. If the federal authorities were to introduce balanced budget legislation, the new rules-based framework should be transparent, easy-to-communicate, and ensure convergence towards the authorities' medium-term objectives, while allowing for sufficient flexibility in the face of shocks to avoid pro-cyclicality. Long-term challenges to contain aging-related spending call for extending long-term fiscal forecasts at the provincial level and publishing consolidated general government fiscal forecasts in consultation with provinces.

53. Further advancing structural policies is increasingly important to address lagging productivity. The authorities' policies, including in the context of G-20 commitments, cover many reform areas. Reform efforts to increase productivity in non-energy sectors should continue—focusing on improving skills-job matching, promoting penetration of information and communication technologies, and fostering business investment in R&D. Enhancing interprovincial and international trade, including through implementation of major trade agreements, improving competition in network sectors, and addressing infrastructure constraints in energy exports would also play a key role in boosting Canada's growth over the medium term.

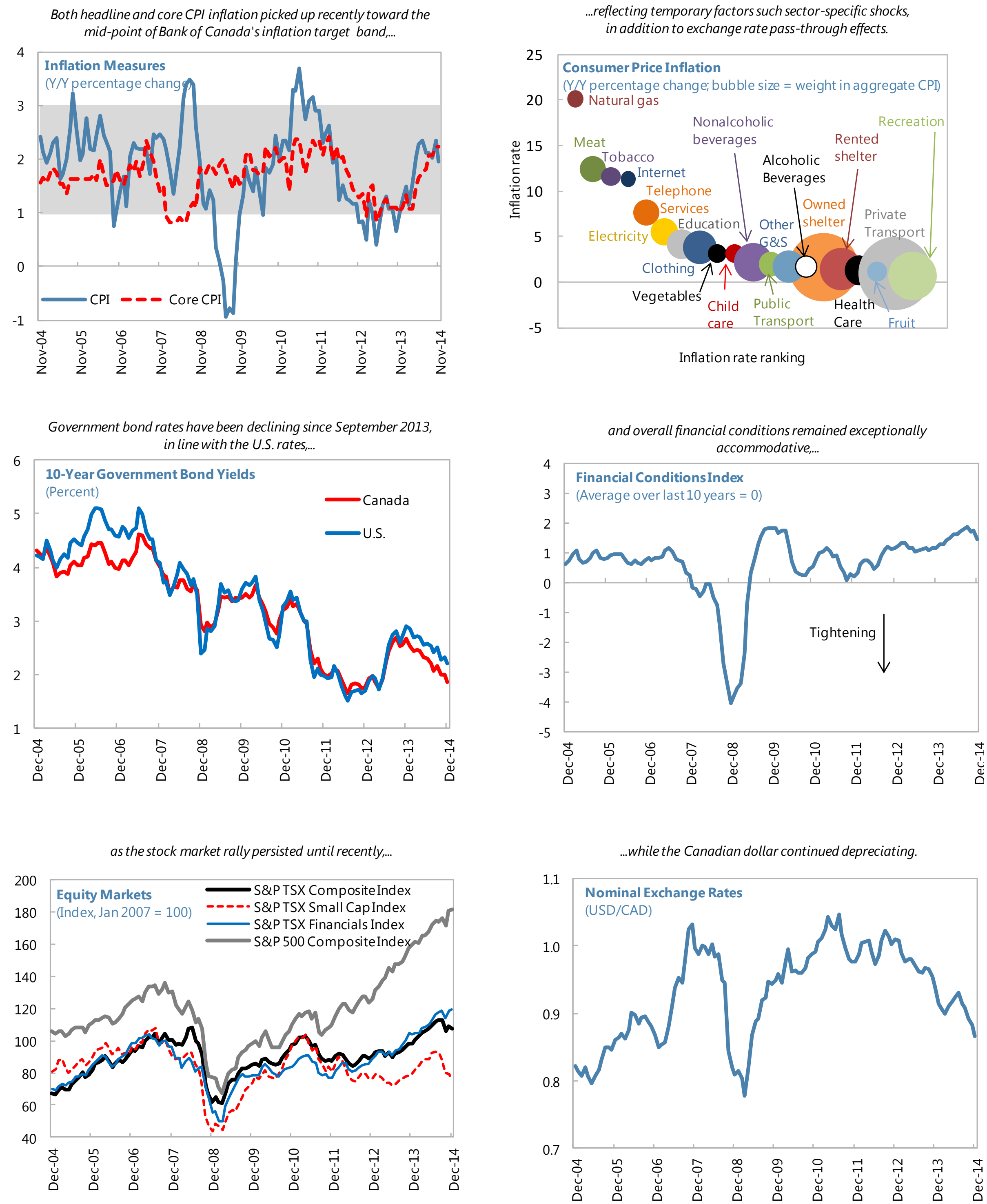
54. It is expected that the next Article IV consultation take place on the standard 12-month cycle.

Figure 1. Solid Growth Driven by Private Consumption and Exports



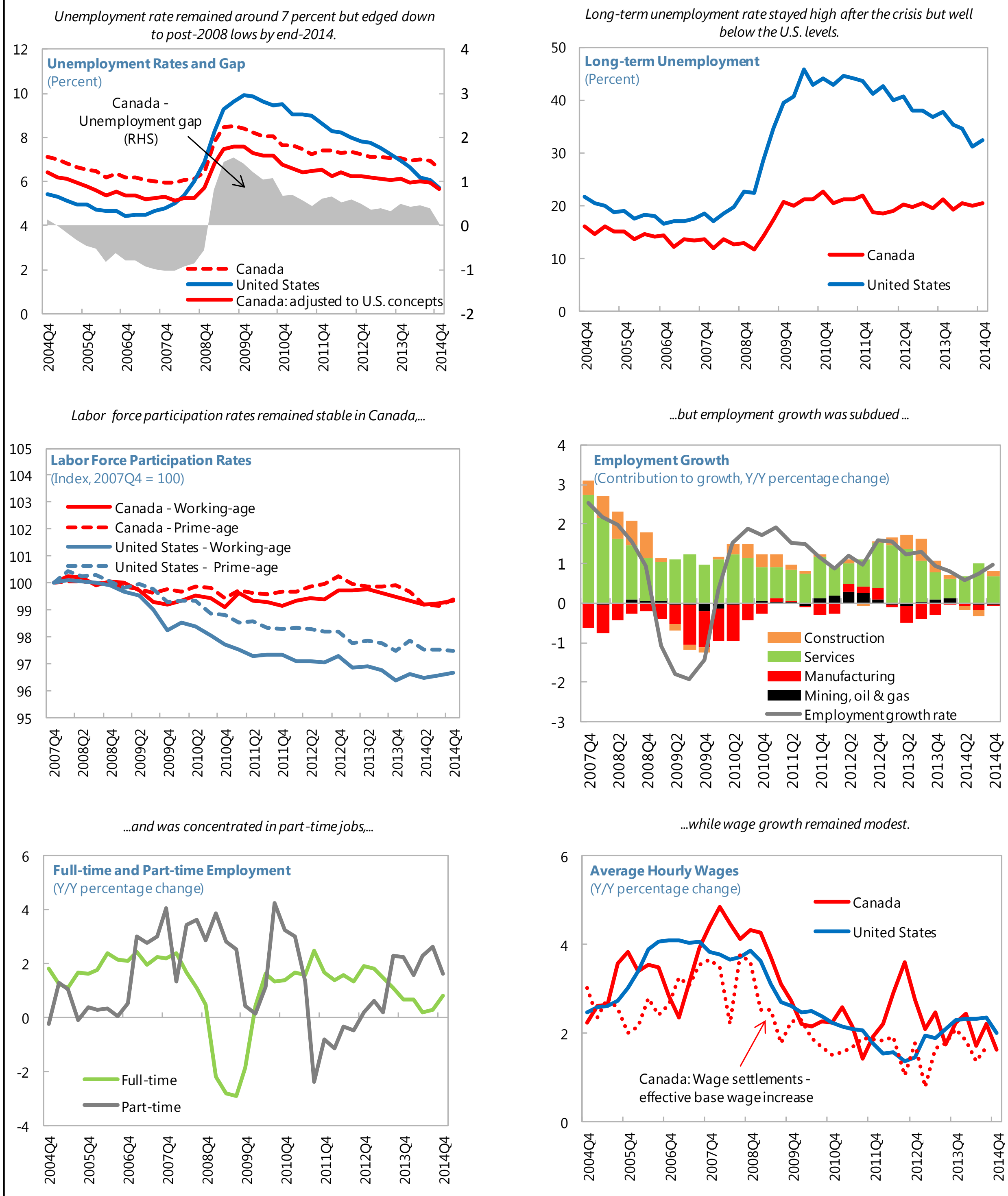
Sources: Statistics Canada; Haver Analytics; Bank of Canada; and IMF staff estimates.
1/ The Bank of Canada's foreign activity measure captures the composition of foreign demand for Canadian exports by including components of U.S. private final domestic demand and economic activity in Canada's other trading partners.

Figure 2. Monetary Conditions Remain Accommodative



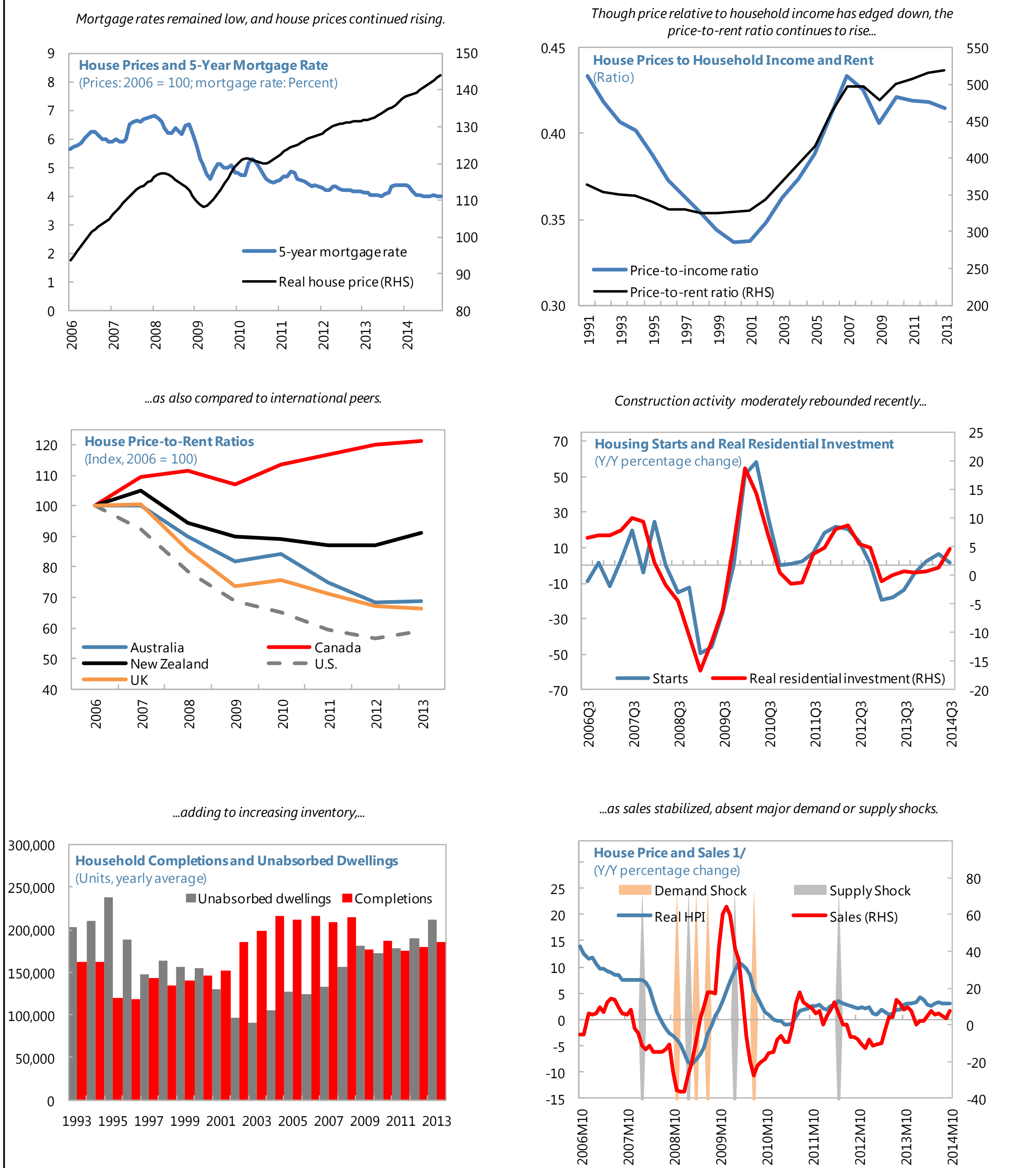
Sources: Statistics Canada; Haver Analytics; Bloomberg; and IMF staff calculations.

Figure 3. Canada's Labor Market Has Fared Relatively Well



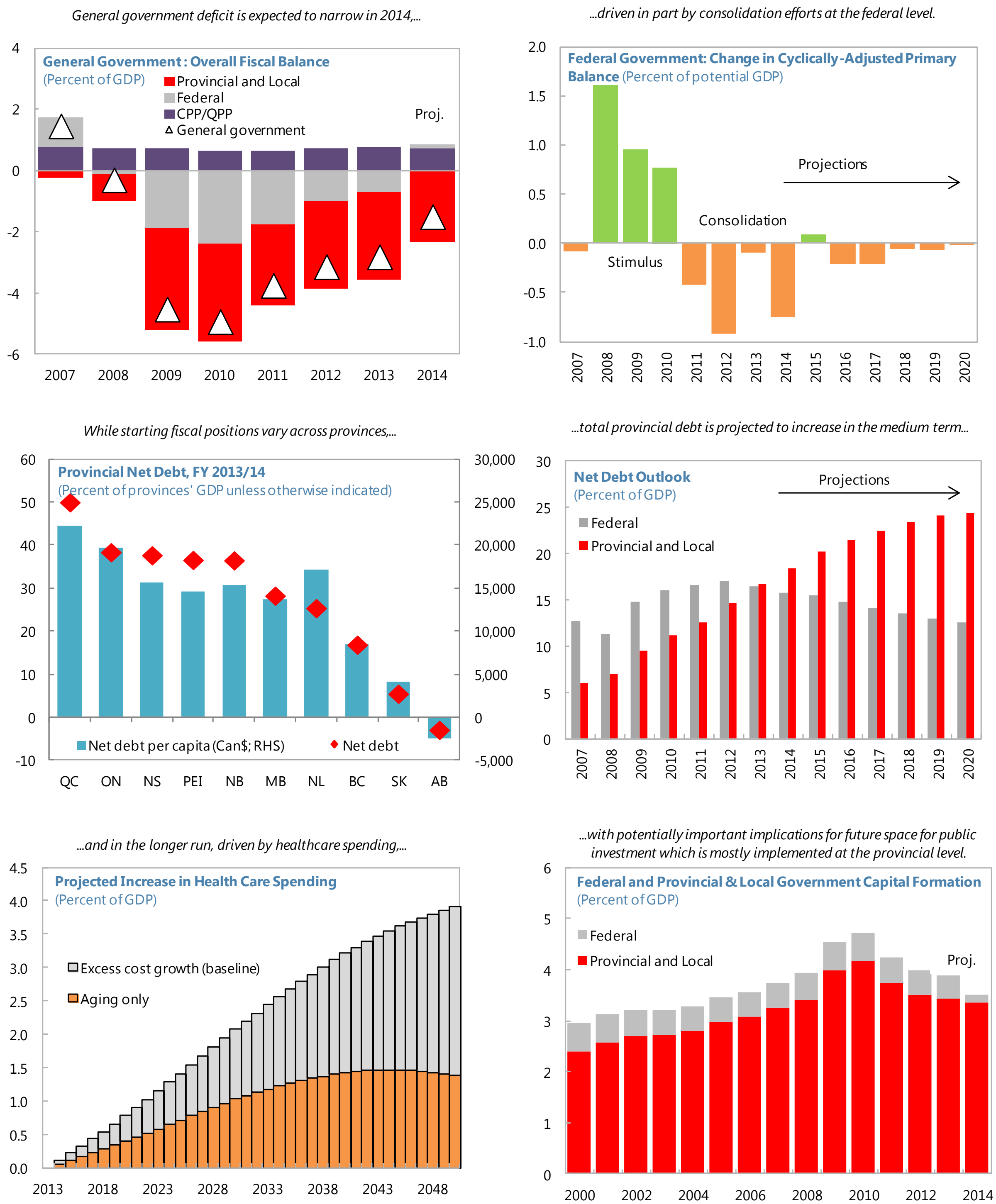
Sources: Statistics Canada; Haver Analytics; and IMF staff estimates.

Figure 4. Housing Sector Remained Strong



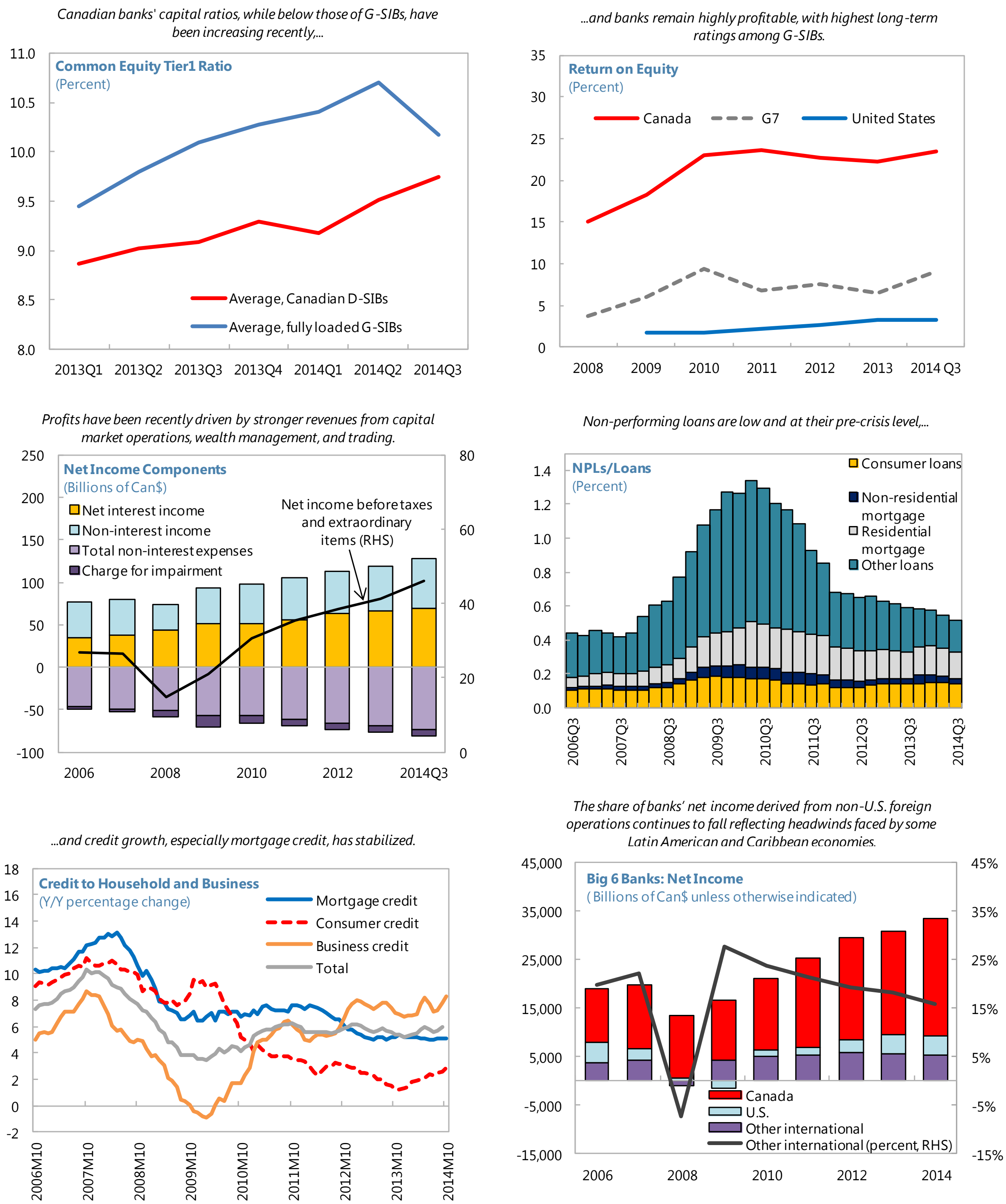
Sources: CREA; CMHC; Haver Analytics; Statistics Canada; and IMF staff estimates.
1/ The demand (supply) shock in the housing market is defined based on whether house prices and sales move by at least one standard deviation in the same (opposite) direction.

Figure 5. Fiscal Consolidation Proceeds but Provinces Continue Facing Challenges



Sources: Budget documents; Statistics Canada; Royal Bank of Canada; Institute de la Statistique Québec; and IMF staff estimates.

Figure 6. Financial Sector Remains Resilient



Sources: Bank of Canada; Haver Analytics; Banks' Annual Reports; and IMF staff estimates.

Table 1. Canada: Medium-Term Scenario 2012–2020

(Percentage change, unless otherwise indicated)

			Projections						
	2012	2013	2014	2015	2016	2017	2018	2019	2020
National Accounts in constant prices									
Real GDP	1.9	2.0	2.4	2.3	2.1	2.0	1.9	1.9	1.9
Q4/Q4	1.0	2.7	2.4	2.1	2.1	1.9	1.9	1.9	1.9
Net exports 1/	-0.4	0.2	1.2	1.2	0.4	0.2	0.1	0.0	0.0
Final domestic demand	2.5	1.5	1.6	1.2	1.6	1.8	1.9	2.0	1.9
Private consumption	1.9	2.5	2.7	1.8	1.8	1.8	1.9	2.1	2.2
Public consumption	1.2	0.4	0.0	0.2	1.3	1.4	1.4	1.4	1.4
Private fixed domestic investment	6.9	0.8	0.6	0.6	1.7	2.4	2.3	2.1	1.8
Private investment 2/	20.2	20.0	19.9	20.1	19.9	20.0	20.0	20.0	20.0
Public investment	-4.8	-1.6	-1.2	0.2	0.9	1.6	1.5	0.8	0.8
Change in inventories 1/	-0.2	0.3	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Nominal GDP	3.5	3.4	4.4	2.2	4.5	4.5	4.2	4.1	4.0
Employment and inflation									
Unemployment rate 3/	7.3	7.1	6.9	6.8	6.8	6.7	6.7	6.6	6.6
Employment	1.2	1.3	0.8	0.8	1.0	1.0	0.9	1.0	0.9
CPI inflation	1.5	1.0	2.0	1.1	1.9	2.2	2.1	2.1	2.1
Core CPI inflation (y/y)	1.7	1.2	1.8	1.9	2.0	2.0	1.9	2.0	2.0
GDP deflator	1.5	1.4	1.9	-0.1	2.4	2.5	2.3	2.2	2.1
Potential output growth	2.0	1.9	1.9	1.8	1.8	1.8	1.9	1.9	1.9
Output gap 4/	-1.3	-1.2	-0.7	-0.3	0.0	0.1	0.0	0.0	0.0
Indicators of fiscal policies									
Federal fiscal balance	-1.0	-0.7	0.1	0.0	0.1	0.3	0.3	0.3	0.3
General government fiscal balance 5/	-3.1	-2.8	-1.5	-1.6	-1.2	-0.9	-0.7	-0.6	-0.1
General government gross debt	87.9	87.7	86.5	86.8	84.9	83.0	81.4	80.0	78.7
General government net debt	36.4	37.1	37.1	37.8	37.4	36.6	35.9	35.0	33.8
Three-month treasury bill 3/	1.0	1.0	0.9	1.1	2.0	3.0	3.5	3.5	3.5
Ten-year government bond yield 3/	1.9	2.3	2.2	2.5	3.6	4.3	4.7	4.7	4.7
External indicators									
Current account balance 2/	-3.3	-3.0	-2.1	-2.6	-2.1	-1.9	-1.7	-1.6	-1.6
Merchandise trade balance 2/	-0.6	-0.4	0.3	-0.5	0.3	0.7	0.9	0.9	1.0
Export volume	2.3	2.1	6.5	7.1	5.5	4.9	4.4	3.9	3.6
Import volume	3.1	1.9	2.3	3.2	4.1	4.5	4.3	4.1	3.8
Terms of trade	-1.1	0.0	-1.4	-5.7	1.6	0.9	0.6	0.3	0.3
Real effective exchange rate	0.0	-3.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Saving and investment									
Gross national saving	21.6	21.5	21.8	21.5	21.9	22.1	22.3	22.3	22.3
General government	1.2	1.5	2.6	2.4	2.7	2.8	2.8	2.8	3.1
Private	20.4	20.1	19.3	19.1	19.2	19.3	19.5	19.5	19.2
Gross domestic investment	24.9	24.5	24.0	24.2	24.0	24.0	24.0	24.0	23.9
Personal savings 6/	5.2	5.2	4.7	4.0	4.5	4.7	4.8	4.8	4.9

Sources: Haver Analytics; and IMF staff estimates.

1/ Contribution to growth.
2/ Percent of GDP.
3/ Percent.
4/ Percent of potential GDP.
5/ Includes the balances of the Canada Pension Plan and Quebec Pension Plan.
6/ Percent of disposable income.

Table 2. Canada: General Government Fiscal Indicators, 2012–2020 1/

(Percent of GDP, unless otherwise indicated)

			Projections						
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Federal Government									
Revenue	13.9	13.9	13.9	14.1	14.2	14.4	14.4	14.4	14.4
Income taxes	8.7	8.7	8.7	9.0	9.1	9.1	9.1	9.1	9.0
Expenditures	14.9	14.6	13.7	14.1	14.1	14.1	14.1	14.1	14.1
Program spending	13.5	13.2	12.9	13.1	13.0	12.8	12.7	12.6	12.4
Transfers	5.0	4.9	4.8	4.9	5.0	5.0	5.1	5.1	5.2
Interest payments	1.4	1.4	1.2	1.2	1.3	1.3	1.3	1.3	1.2
Budgetary balance	-1.0	-0.7	0.1	0.0	0.1	0.3	0.3	0.3	0.3
Cyclically-adjusted balance 2/	-0.8	-0.5	0.2	0.0	0.1	0.3	0.3	0.3	0.3
Provincial and Local Governments									
Revenue	24.9	24.8	24.9	24.9	24.8	24.8	24.7	24.7	24.9
Income taxes	5.7	5.7	5.7	5.7	5.7	5.8	5.8	5.8	5.9
Expenditures	27.8	27.7	27.2	27.2	26.9	26.7	26.5	26.3	26.2
Interest payments	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.0	2.0
Budgetary balance	-2.9	-2.9	-2.3	-2.3	-2.1	-1.9	-1.8	-1.6	-1.3
Cyclically-adjusted balance 2/	-2.5	-2.5	-2.1	-2.2	-2.1	-2.0	-1.8	-1.6	-1.3
Canada/Quebec Pension Plans									
Revenue	3.3	3.4	3.4	3.5	3.5	3.5	3.6	3.6	3.8
Total spending	2.6	2.6	2.6	2.7	2.8	2.8	2.8	2.9	2.9
Budgetary balance	0.7	0.8	0.7	0.7	0.8	0.8	0.7	0.7	0.9
Consolidated General Government 3/									
Revenue	41.7	41.6	41.6	41.9	42.1	42.2	42.2	42.2	42.6
Expenditure	44.8	44.4	43.1	43.5	43.2	43.1	42.9	42.8	42.7
Overall balance	-3.1	-2.8	-1.5	-1.6	-1.2	-0.9	-0.7	-0.6	-0.1
Primary balance	-2.6	-2.4	-1.2	-1.3	-0.8	-0.4	-0.2	0.0	0.4
Cyclically-adjusted balance 2/	-2.6	-2.3	-1.2	-1.5	-1.2	-0.9	-0.7	-0.6	-0.1
Net public debt	36.4	37.1	37.1	37.8	37.4	36.6	35.9	35.0	33.8
Gross public debt	87.9	87.7	86.5	86.8	84.9	83.0	81.4	80.0	78.7
Memorandum Items									
Real GDP growth (percentage change)	1.9	2.0	2.4	2.3	2.1	2.0	1.9	1.9	1.9
Nominal GDP growth (percentage change)	3.5	3.4	4.4	2.2	4.5	4.5	4.2	4.1	4.0
Three-month treasury bill (percent)	1.0	1.0	0.9	1.1	2.0	3.0	3.5	3.5	3.5
Ten-year government bond (percent)	1.9	2.3	2.2	2.5	3.6	4.3	4.7	4.7	4.7

Sources: Statistics Canada; Department of Finance Canada; provincial budget reports; Haver Analytics; and IMF staff estimates.

1/ National Accounts basis.

2/ Percent of potential GDP.

3/ Includes federal, provincial, territorial, and local governments; and Canada and Quebec pension plans.

Table 3. Canada: Balance of Payments, 2012–2020

(Percent of GDP, unless otherwise indicated)

			Projections						
	2012	2013	2014	2015	2016	2017	2018	2019	2020
Current Account									
Current Account Balance	-3.3	-3.0	-2.1	-2.6	-2.1	-1.9	-1.7	-1.6	-1.6
Merchandise Trade Balance	-0.6	-0.4	0.3	-0.5	0.3	0.7	0.9	0.9	1.0
Exports, goods	25.3	25.3	26.6	25.0	25.8	26.3	26.7	26.9	27.0
Export Volume Growth (percentage change)	2.3	2.1	6.5	7.1	5.5	4.9	4.4	3.9	3.6
Imports, goods	25.9	25.7	26.3	25.5	25.5	25.7	25.9	26.0	26.1
Import Volume Growth (percentage change)	3.1	1.9	2.3	3.2	4.1	4.5	4.3	4.1	3.8
Services Balance	-1.2	-1.2	-1.1	-0.9	-0.8	-0.7	-0.6	-0.6	-0.6
Investment Income Balance	-1.1	-1.2	-1.1	-1.1	-1.5	-1.7	-1.7	-1.8	-1.8
Capital and Financial Accounts									
Direct Investment, net	-0.8	1.1	0.7	0.4	0.2	0.3	0.2	0.2	0.2
Portfolio Investment, net	2.6	0.7	1.1	1.5	1.4	1.1	1.1	1.0	1.1
Other Investment, net 1/	1.5	1.4	0.3	0.7	0.5	0.5	0.4	0.4	0.3
Capital Account Balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
International Reserves	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Statistical Discrepancy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items									
Terms of Trade (percent change)	-1.1	0.0	-1.4	-5.7	1.6	0.9	0.6	0.3	0.3
Net International Investment Position 2/	-16.7	1.2	...	...	...	...	...	...	...
Assets	129.6	151.8	...	...	...	...	...	...	...
FDI	52.1	62.6	...	...	...	...	...	...	...
Portfolio	48.5	59.7	...	...	...	...	...	...	...
Other	25.3	25.5	...	...	...	...	...	...	...
Reserves	3.7	4.0	...	...	...	...	...	...	...
Liabilities	146.3	150.6	...	...	...	...	...	...	...
FDI	52.3	53.5	...	...	...	...	...	...	...
Portfolio	69.3	71.3	...	...	...	...	...	...	...
Other	24.7	25.8	...	...	...	...	...	...	...
Gross External Debt	77.0	77.0	81.9	85.3	87.0	88.1	88.4	88.3	88.1
Real Effective Exchange Rate 3/	0.0	-3.4	...	...	...	...	...	...	...

Sources: Haver Analytics; and IMF staff calculations.

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

2/ Based on market valuation of portfolio stocks and official international reserves.

3/ Percentage change. A minus sign indicates a depreciation in the Canadian dollar.

Table 4. Canada: Financial Soundness Indicators 2009–2014Q3

(Percent, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014Q3
Total Assets						
Total Assets 1/	2,800.7	3,019.2	3,265.4	3,682.2	3,854.1	4,083.5
Percent of GDP	178.7	181.6	184.5	201.1	203.5	205.0
Capital Adequacy						
Total Capital Ratio	14.7	15.6	15.9	16.2	14.3	14.0
Tier 1 Ratio	12.1	13.1	13.3	13.4	11.7	11.9
Capital to Assets	4.5	4.7	4.9	4.9	5.0	4.9
Credit Risk						
NPLs Net of Provisions to Capital	11.2	10.4	6.6	6.4	6.2	4.6
NPLs to Gross Loans	1.3	1.2	0.8	0.7	0.6	0.4
Provisions (Individual) to NPL	26.9	25.4	30.1	22.3	16.3	16.5 2/
Sectoral Distribution of Loans						
Residents	77.4	74.9	76.7	74.3	73.7	72.4
Nonresidents	22.6	25.1	23.3	25.7	26.3	27.6
Profitability						
Return on Assets	0.7	1.1	1.1	1.1	1.1	1.2
Return on Equity	18.2	23.0	23.6	22.7	22.3	23.4
Interest Margin on Gross Income	46.4	48.6	49.4	52.0	52.5	51.0
Trading Income to Gross Income	8.7	6.9	4.2	5.3	4.5	4.4
Non-interest Expenses to Gross Income	73.4	65.3	63.8	63.3	62.6	61.8
Liquidity						
Liquid Assets to Total Assets	15.4	15.5	15.2	11.9	11.3	10.9
Liquid Assets to Short-Term Liabilities	54.4	51.2	54.1	51.8	47.8	44.8
Customer Deposits to Loans	113.7	113.6	114.2	96.3	98.2	99.0
FX and Derivative Risk						
FX Assets to Total Assets	33.0	32.0	35.0	37.0	41.0	45.8
FX Loans to Total Loans	25.9	27.4	28.2	26.8	27.7	29.8
FX Liabilities to Total Liabilities	33.0	33.0	36.0	39.0	43.0	47.6

Sources: IMF FSI database; and IMF staff calculations.
1/ Billions of Canadian dollars.
2/ Data is for 2014Q1.

Annex I. Canada: External Sector Assessment Report

	Canada	Overall Assessment
Foreign asset and liability position and trajectory	**Background**. After hovering at about -15 percent of GDP in 2009–12, Canada's net international investment position (NIIP) turned slightly positive by end-2013 (1½ percent of GDP) and stood at 1 percent of GDP in 2014Q3, as foreign equity markets outperformed the domestic market and the currency weakened. Canada has a positive net equity position and a negative net debt position, reflecting sizable FDI and portfolio equity investment overseas. Gross external assets and liabilities are each around 160 percent of GDP. The NIIP is projected to remain largely unchanged amid projected decline in current account deficits. **Assessment**. Gross external debt, at about 80 percent of GDP (2014Q3), is low relative to other advanced economies, and is a modest vulnerability.	**Overall assessment**: *The external position is broadly consistent with medium-term fundamentals and desirable policy settings.* Non-energy export performance has been disappointing in recent years, and while the depreciation of the Canadian dollar is likely to help, boosting Canada's exports would require addressing the productivity gap with trading partners and energy export constraints. The general government (especially, provincial) fiscal position has deteriorated after the Great Recession, and the ongoing fiscal consolidation would contribute to improving the national saving-investment balance. **Potential policy responses**: Policies that could help gradually bring Canada's current account closer to the level implied by fundamentals include measures to improve labor productivity (such as budget programs aimed at improving labor skills and job matching, and fostering research and innovation); to promote investments in infrastructure to transport and export natural resources; and to further facilitate inter-provincial and international trade; as well as policies to restore stronger fiscal position (through the planned and sustained fiscal adjustment at the provincial level).
Current account	**Background**. Canada's current account (CA) shifted from a surplus of 2½ percent of GDP in 2000 to a deficit of 3.0 percent of GDP in 2013 and is projected at 2.1 percent of GDP in 2014. The deterioration reflects Canada's stronger rebound from the last recession relative to the United States, but also the significant real appreciation of the Canadian dollar and weak productivity growth. At the same time, limited refining capacity and lack of transportation infrastructure curbed the positive impact on the current account from the boom in unconventional energy production. In terms of the savings-investment (S-I) balance, the current account deterioration largely matches the worsening of the general government S-I balance, while the private S-I balance is back to its slightly negative pre-recession levels. **Assessment**. The EBA CA regression approach estimates a CA gap of 1.6 percent of GDP for 2014 (down from 3.4 percent of GDP for 2013). This, however, likely overstates the desirable external adjustment, including because it underestimates the cyclical nature of the current account deficit (given Canada's smaller output gap relative to the United States and the lower market price for Canadian oil relative to global oil prices).1/ Staff assesses that the 2014 cyclically-adjusted current account is between 0 to 1 percentage points of GDP weaker than the value implied by medium-term fundamentals and desirable policies.	
Real exchange rate	**Background**. Canada's exchange rate is correlated with oil prices, and the real effective exchange rate (REER) appreciated by 30 percent between 2000 and 2010 as energy prices surged. In recent years, the interest rate differential with the United States and safe-haven capital inflows have become increasingly important for Canada's exchange rate movements. Reflecting rising market U.S. interest rates, weaker capital inflows, and flatter energy prices, Canada's REER depreciated by about 10 percent since end-2012. **Assessment**. The EBA REER regression approach estimates a REER gap of 3 percent for the 2014 average REER level (against 10 percent for 2013).2/ Translating staff's assessment of the CA gap suggests an average 2014 REER overvaluation of between 0 and 5 percent relative to medium-term fundamentals and desirable policy settings (down from the estimated range of 5–10 percent overvaluation reported in the July 2014 Pilot External Sector Report).	

Capital and financial accounts: flows and policy measures	**Background**. The CA deficit of recent years has been financed primarily by net portfolio inflows. Average net portfolio outflows from 2000–07 turned into inflows of some 4 percent of GDP as relatively strong growth prospects, sound fiscal position, and high interest rates made Canada a safe-haven and carry trade destination, putting upward pressure on the exchange rate (along with high commodity prices). **Assessment**. Canada has a fully open capital account. Vulnerabilities are limited by a credible commitment to a floating exchange rate and a strong fiscal position.	
FX intervention and reserves level	**Background**. Canada has a free floating exchange rate regime, and the central bank has not intervened in the foreign exchange market since September 1998 (with the exception of participating in concerted intervention for other purposes). The Government of Canada has moderate reserves and the Bank of Canada has standing U.S. dollar and foreign currency liquidity swap arrangements with the Federal Reserve and four other major central banks (it has not drawn on these swap lines in the past). **Assessment**. Policies in this area are appropriate to the circumstances of Canada.	
Technical Background Notes	1/ First, the EBA may overestimate the CA norm for Canada as the adjustment for the business cycle is done using Canada's output gap relative to the world (GDP-weighted average) output gap, while a more relevant measure for Canada is the gap relative to the United States. As the latter is currently larger, EBA likely underestimates Canada's CA improvement as the U.S. output returns to potential. Second, the oil trade balance and the terms of trade variables are both likely to be biased upward for Canada, as the EBA uses the WEO global oil prices rather than the lower market price for Canadian oil, particularly, heavy crude oil from western Canada's oil sands (the lower price reflects lower quality, transportation costs, and more recently also the impact of limited pipeline and refinery capacity). To the extent the difference is due to infrastructure bottlenecks, adding transportation capacity over the medium term should help close the CA gap. 2/ Staff's REER assessment refers to the average January–October 2014 level and assumes unchanged REER at that level for the rest of the year. Canada's REER depreciated by an estimated one percent in November–December 2014.	

Annex II. Canada: Key FSAP Recommendations and Implementation

Recommendation	Implementation Time frame	Assessment of progress
Expand financial sector data collection and dissemination with a view to enhancing coverage, regularity, and availability of time-series to facilitate analysis.	Short term	• CMHC have established an internal "data gaps" working group to address data gaps related to housing markets, housing finance, social housing, as well as gaps related to research; unveiled the Housing Market Information Portal, which allows for easy access to housing market data; published some new data on condominium ownership in Toronto and Vancouver. • CMHC started publishing a supplement to its Quarterly Financial Reports that enables greater transparency and clarity with respect to its insurance underwriting practices. • CMHC plans to add further information and functionality to the Portal, introduce a new tool that examines a number of risk factors of problematic house price conditions (Housing Price Analysis and Assessment framework or HPAA) and possibly publish its stress testing results • OSFI has implemented a new data system that allows for easier extraction of time series data from the regulatory returns.
Reduce the government's exposure to mortgage insurance gradually.	Long term	• CMHC mortgage loan insurance for the financing of multi-unit condominium construction discontinued in June 2014. • CMHC aligned its low ratio insurance with its high ratio product by establishing maximum house prices, amortization periods, and debt servicing ratios (effective July 31, 2014). • CMHC discontinued its Second Home and Self-Employed Without 3rd Party Income Validation mortgage insurance products (effective May 30, 2014). • CMHC increased its mortgage loan insurance premiums for homeowner and 1 – 4 unit rental properties (effective May 1, 2014) by approximately 15%, on average, for all loan-to-value ranges. • CMHC implemented changes to its portfolio insurance product (effective January 1, 2014). • CMHCs mortgage loan insurance business became subject to a risk fee payable to the Government of Canada of 3.25% of premiums written and an additional 10 basis points on new portfolio insurance written (effective January 1, 2014). • For 2014, the Minister of Finance authorized CMHC to provide up to Can$80 billion of new guarantees of NHA MBS and up to Can$40 billion of new guarantees for CMB. • For 2014, CMHC reduced its annual issuance of portfolio insurance from Can$11 billion to Can$9 billion.
Augment OSFI's top-down stress testing framework for banks with risk-sensitive concepts of key credit risk input parameters and econometric, model-based approaches using longer time series.	Short term	• OSFI has started to augment its stress testing framework with econometric models that are used for projections based on longer time series.

Recommendation	Implementation Time frame	Assessment of progress
Include major regulated entities at federal and provincial level in a regular, common stress testing exercise, which would involve a degree of collaboration between relevant federal and provincial authorities.	Short term	• OSFI and the BOC have begun discussions with some provincial regulators to help them enhance their stress testing capabilities, including by providing detailed scenarios used in stress testing of D-SIBs and possible technical assistance going forward.
Equip OSFI with powers to make its own enforceable rules by administrative means, supplementing the use of guidelines and government regulations; amend legislation on statutory decisions to give OSFI sole decision- making authority on prudential criteria.	Medium term	• No progress.
Replace certain informal and ad hoc reporting requirements by FRFIs with more formal requirements.	Medium term	• OSFI is currently assessing which reporting requirements should be formalized.
Adopt a transparent and consistent regulatory regime for group-wide insurance supervision; give OSFI the authority to take supervisory measures at the level of the holding company.	Medium term	• No progress.
Address shortcomings in risk identification and enforcement in securities regulation.	Short term	• The provincial Ministers responsible for securities regulation in British Columbia, Ontario, Saskatchewan, New Brunswick, and Prince Edward Island, and the Minister of Finance Canada signed a memorandum of agreement setting out the terms and conditions to establish a Cooperative Capital Markets Regulatory System. • Consultation drafts of uniform provincial capital markets legislation and complementary federal legislation were released for public comment (in September 2014).
Enhance supervisory cooperation among federal and provincial supervisors and subject all systemically significant financial institutions to intensive supervision.	Short term	• OSFI has increased contact with provincial regulators with an aim to harmonize regulation and improve supervisory cooperation. The current discussions are focused on delineating the key touch points between federal and provincial regulators.
Provide a clear mandate to an entity (i) to monitor systemic risk to facilitate macro-prudential oversight, and (ii) to carry out system-wide crisis preparedness.	Short term	• Work has begun to address financial sector data gaps that will improve the BOC's research, analysis, and systemic risk monitoring capacity for the financial system. While the initial step of identifying data gaps is completed, next steps include determining the best options for closing the key data gap based on priorities and feasibility analysis, concrete steps in collecting and obtaining the data, and agreeing upon which agency would take the lead in the implementation phase. • The new systemic risk assessment committee chaired by the BoC (a sub-committee of the non-statutory Senior Advisory Committee) was set up, but the responsibility for systemic risk remains with the SAC.
Increase the ex-ante funding of CDIC and enhance its data collection and analysis of depositor profiles.	Medium term	• The government has announced a review of the deposit insurance framework that will consider the size of the ex-ante fund of the Canada Deposit Insurance Corporation (CDIC), among other issues.

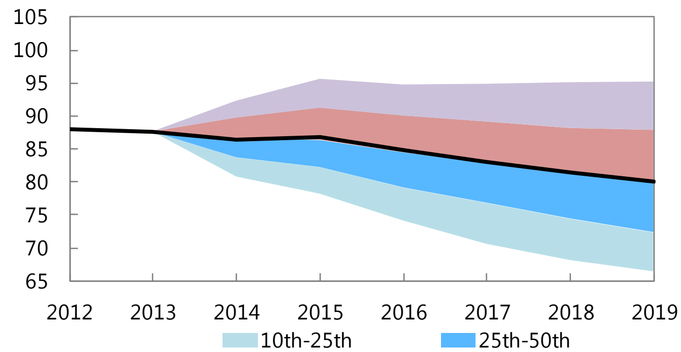
Annex III. Canada: Public Debt Sustainability Analysis

Canada's general government gross debt peaked at about 88 percent of GDP in 2012 and is expected to decline over the medium term under staff's baseline scenario. Government financial assets are sizeable in Canada and represent about 50 percent of GDP, of which about 20 percent are highly-liquid assets, which put the net debt-to-GDP ratio at below 40 percent of GDP in 2013. Gross financing needs are relatively large, but are expected to be below 15 percent of GDP after 2016. The general government debt position is relatively resilient to a series of macro and fiscal shocks in the medium term.

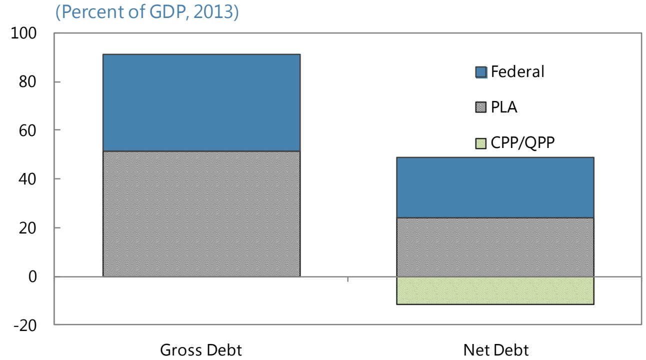
Stress tests

- *Baseline scenario*. In staff's baseline scenario, the general government gross debt-to-GDP ratio is expected to decline to 86½ percent in 2014, after peaking at about 88 percent in 2012, and continue declining to 80 percent in 2019. Canada's effective interest rate is expected to reach a historical low just below 4 percent in 2014 and then rise towards its historical average of 6 percent by 2018. Net debt stands currently at 37 percent of GDP—or at 67 percent if only highly-liquid asset are used, and is expected decline over the medium term after peaking in 2015.

Fan Chart: Debt Outlook
(Percent of GDP)



General Government: Gross and Net Debt 1/
(Percent of GDP, 2013)



Source: Finance Canada
1/ Net debt includes all financial assets

- *Primary balance shock*. A scenario involving a deterioration of the structural primary balance of about 1 percent of GDP raises the gross debt-to-GDP ratio by about 3 percentage points over the projection period. The risk premium on sovereigns is assumed to increase by 25 basis points (bps) for each 1 percent of GDP deterioration in primary balance, with little effects on the debt path.

- *Growth shock*. A lower real output growth by 1 standard deviation for 2 years starting in 2015 would have a significant impact on the level of gross debt, which will reach 91½ percent of GDP in 2016, but would revert to a downward path over the projection period.

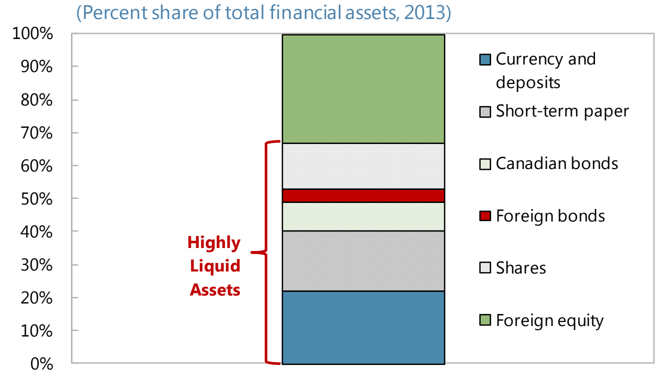
- *Interest rate shock*. An increase in sovereign risk premia by 200 bps for two years would raise the government's interest bill by about ½ percent by 2016 (about 95 percent of outstanding marketable debt is in fixed coupon bonds). Higher borrowing costs would slow the decrease in the debt-to-GDP ratio, which ends up 1½ percentage points higher than in the baseline in 2019, at about 81½ percent.

- *Exchange rate shock*. If the exchange rate depreciates by about 15 percent, the fiscal impact is minimal—almost 90 percent of Canada's outstanding marketable debt instruments are in Canadian dollar, and both federal and sub-national governments usually hedge their FX exposures.

- *Commodity price shock*. Lower than expected commodity prices, by 10 percent on average over the forecasting horizon would increase the gross debt to 91 percent of GDP in 2016 and decline to 85 percent by 2019.

The sizable general government liquid financial assets represent a mitigating factor for Canada's high gross debt and financing needs. In at least two of the above scenarios, Canada's gross debt rises above 90 percent of GDP and the gross financing needs go above 25 percent of GDP in at least one of the following years (see the heat map below). However, general government's financial assets stood at about 50 percent of GDP in 2013, of which 40 percent (20 percent of GDP) is highly-liquid assets (deposits, short-term papers, and bonds) (Chart).

Canada: Financial Assets Composition
(Percent share of total financial assets, 2013)



Source: Finance Canada

In addition, Canada's gross and net public debt have increased in recent years due to Canadian government policy to fund public sector employee pension plans by raising market debt. Unfunded pension liabilities of the public sector are excluded here from Canada's general government debt, to improve consistency with other countries that do not report these liabilities. However, because Canada has funded part of its pension liabilities since 2000, those liabilities are reflected in its public debt.

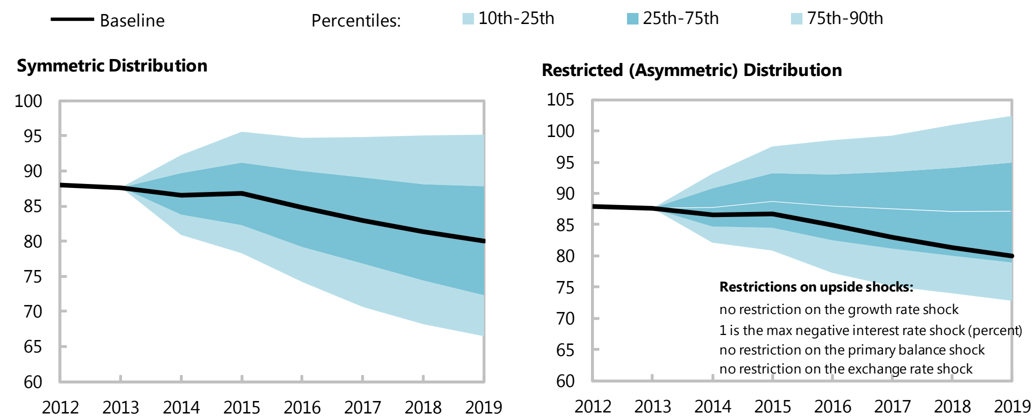
Canada Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

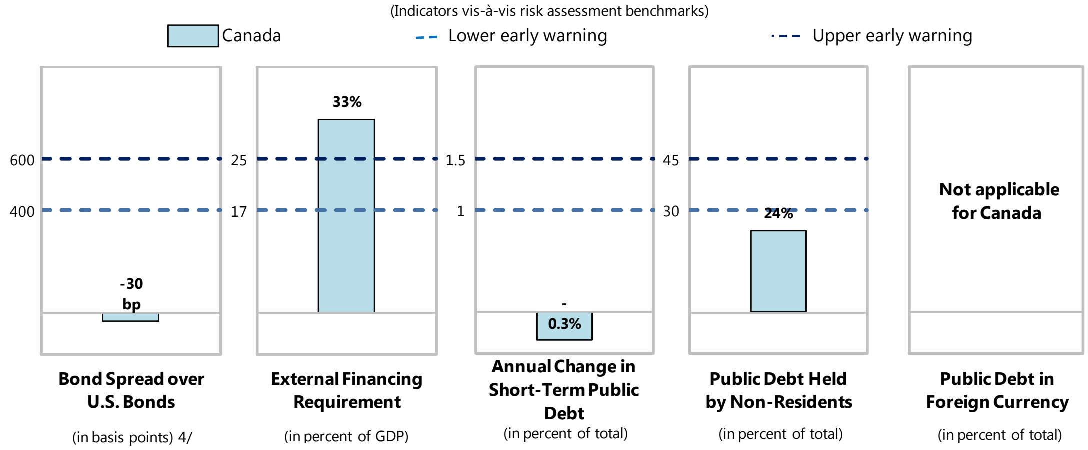
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

In the case of Canada, staff estimate that liquid financial asset represent about 25% of GDP, in which case the 85% benchmark will not be exceeded

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

In the case of Canada, staff estimate that gross financing will pass below the 20% benchmark by 2015.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ An average over the last 3 months, 14-Oct-14 through 12-Jan-15.

Canada Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

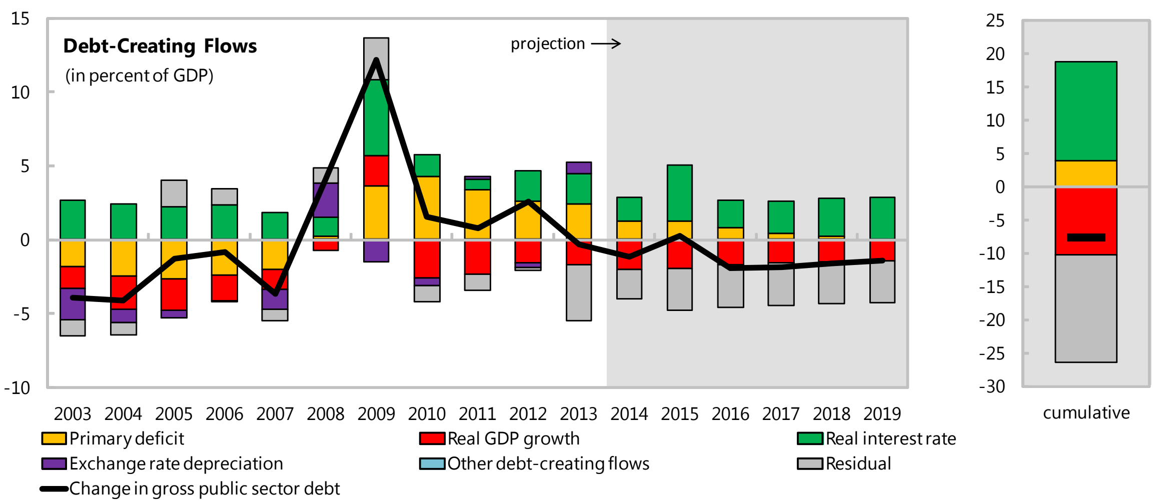
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	75.7	87.9	87.7	86.5	86.8	84.9	83.0	81.4	80.0
Public gross financing needs	n.a.	21.5	22.0	18.7	18.3	16.0	12.6	10.6	9.3
Net public debt	58.9	69.9	67.6	66.7	66.9	65.4	64.0	62.8	61.7
Real GDP growth (in percent)	2.0	1.9	2.0	2.4	2.3	2.1	2.0	1.9	1.9
Inflation (GDP deflator, in percent)	2.6	1.5	1.4	1.9	-0.1	2.4	2.5	2.3	2.2
Nominal GDP growth (in percent)	4.7	3.5	3.4	4.4	2.2	4.5	4.5	4.2	4.1
Effective interest rate (in percent) [4/]	5.8	4.1	3.8	3.8	4.4	4.7	5.2	5.5	5.9

As of January 12, 2015		
Sovereign Spreads		
Spread (bp) 3/		-31
CDS (bp)		49
Ratings	Foreign	Local
Moody's	Aaa	Aaa
S&Ps	AAA	AAA
Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.5	2.61	-0.29	-1.2	0.3	-1.9	-1.9	-1.6	-1.4	-7.6	
Identified debt-creating flows	0.3	2.78	3.54	0.8	3.1	1.0	1.0	1.3	1.4	8.5	
Primary deficit	0.0	2.6	2.4	1.2	1.3	0.8	0.4	0.2	0.0	4.0	1.3
Primary (noninterest) revenue and gra	39.8	38.8	38.7	38.8	39.0	39.2	39.4	39.4	39.5	235.3	
Primary (noninterest) expenditure	39.8	41.4	41.1	40.0	40.3	40.0	39.8	39.6	39.5	239.2	
Automatic debt dynamics [5/]	0.3	0.2	1.1	-0.4	1.8	0.2	0.6	1.0	1.4	4.6	
Interest rate/growth differential [6/]	0.8	0.5	0.3	-0.4	1.8	0.2	0.6	1.0	1.4	4.6	
Of which: real interest rate	2.2	2.1	2.0	1.6	3.8	1.9	2.2	2.5	2.9	14.9	
Of which: real GDP growth	-1.4	-1.6	-1.7	-2.0	-2.0	-1.7	-1.6	-1.5	-1.5	-10.3	
Exchange rate depreciation [7/]	-0.5	-0.3	0.8	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	0.2	-0.2	-3.8	-2.0	-2.8	-2.9	-2.9	-2.9	-2.8	-16.1	



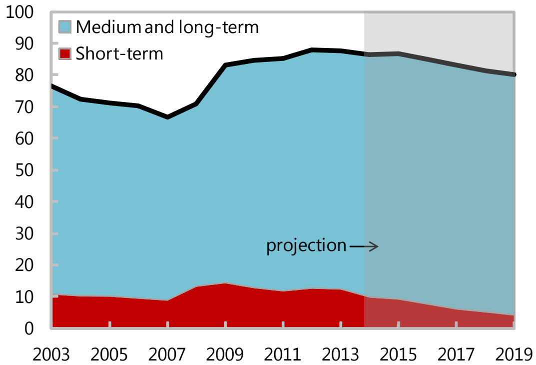
Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Bond Spread over U.S. Bonds.
4/ Defined as interest payments divided by debt stock at the end of previous year.
5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate;
a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.
7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
8/ Includes asset changes and interest revenues; the latter explains most of the projected residuals. For projections, includes exchange rate changes during the projection period.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Canada Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

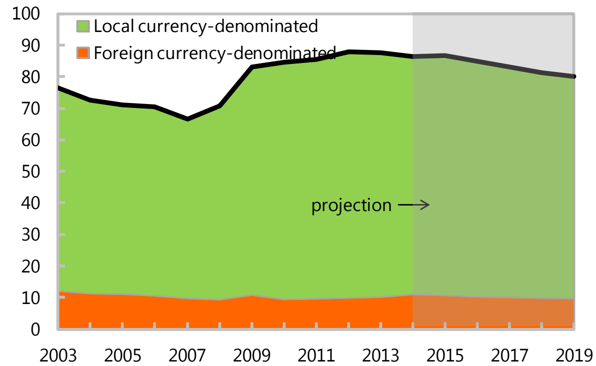
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

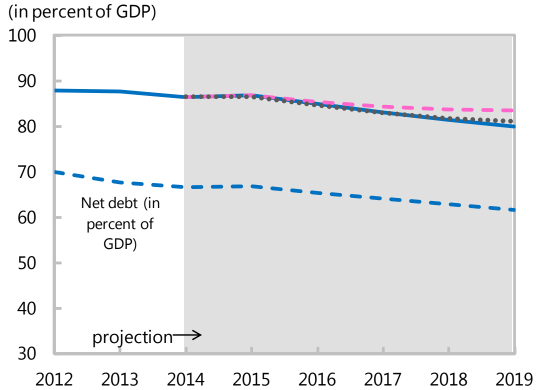


Alternative Scenarios

Baseline　Historical　Constant Primary Balance

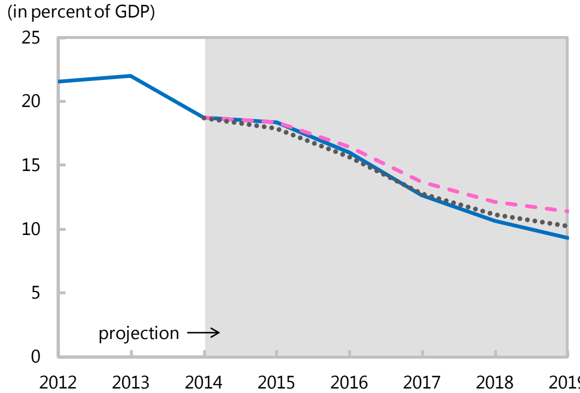
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.4	2.3	2.1	2.0	1.9	1.9
Inflation	1.9	-0.1	2.4	2.5	2.3	2.2
Primary Balance	-1.2	-1.3	-0.8	-0.4	-0.2	0.0
Effective interest rate	3.8	4.4	4.7	5.2	5.5	5.9
Constant Primary Balance Scenario						
Real GDP growth	2.4	2.3	2.1	2.0	1.9	1.9
Inflation	1.9	-0.1	2.4	2.5	2.3	2.2
Primary Balance	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
Effective interest rate	3.8	4.4	4.7	5.2	5.5	5.8

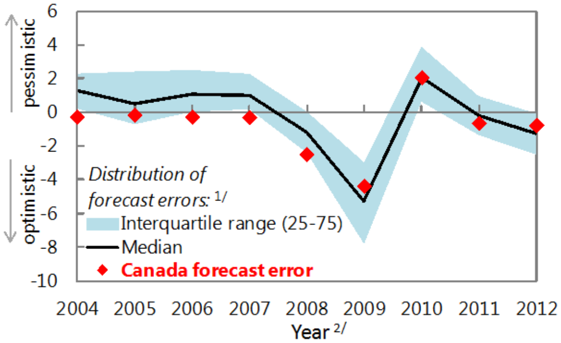
Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.4	2.0	2.0	2.0	2.0	2.0
Inflation	1.9	-0.1	2.4	2.5	2.3	2.2
Primary Balance	-1.2	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	3.8	4.4	4.7	5.2	5.5	5.9

Source: IMF staff.

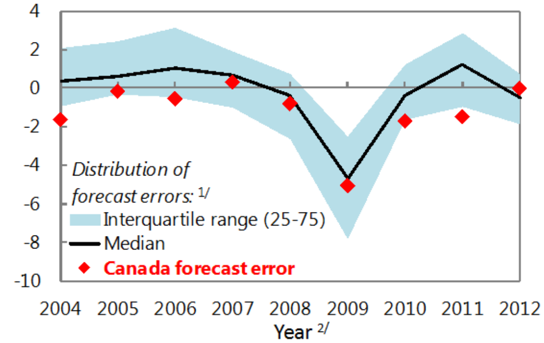
Canada Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries

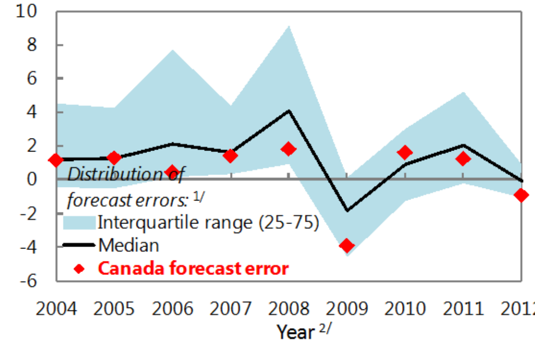
Real GDP Growth
(in percent, actual-projection)
Canada median forecast error, 2004-2012: **-0.29**
Has a percentile rank of: **30%**



Primary Balance
(in percent of GDP, actual-projection)
Canada median forecast error, 2004-2012: **-0.80**
Has a percentile rank of: **31%**

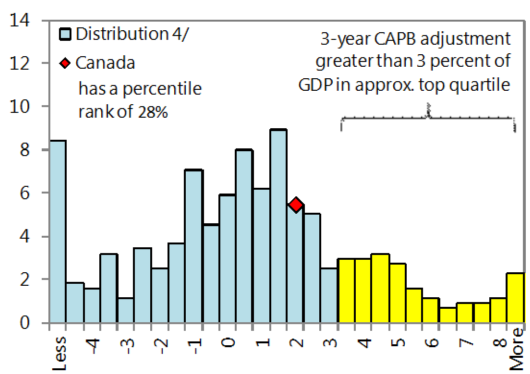


Inflation (Deflator)
(in percent, actual-projection)
Canada median forecast error, 2004-2012: **1.25**
Has a percentile rank of: **48%**

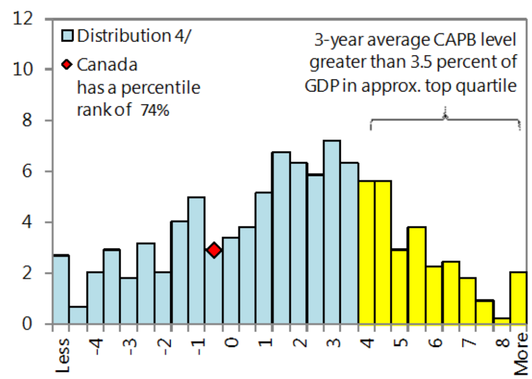


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

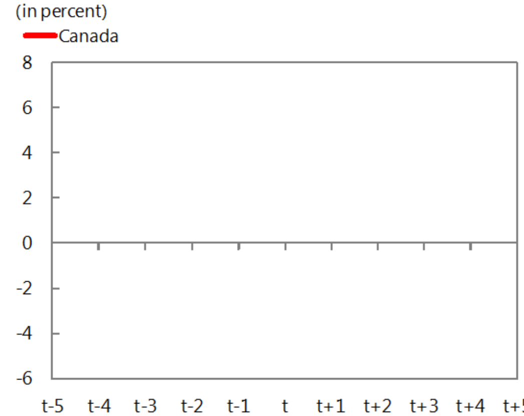


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

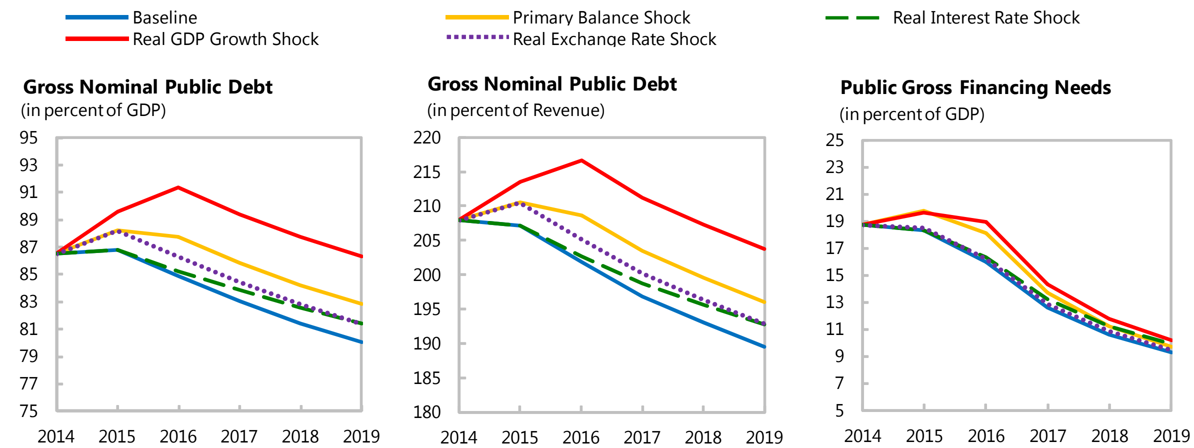
Real GDP growth
(in percent)



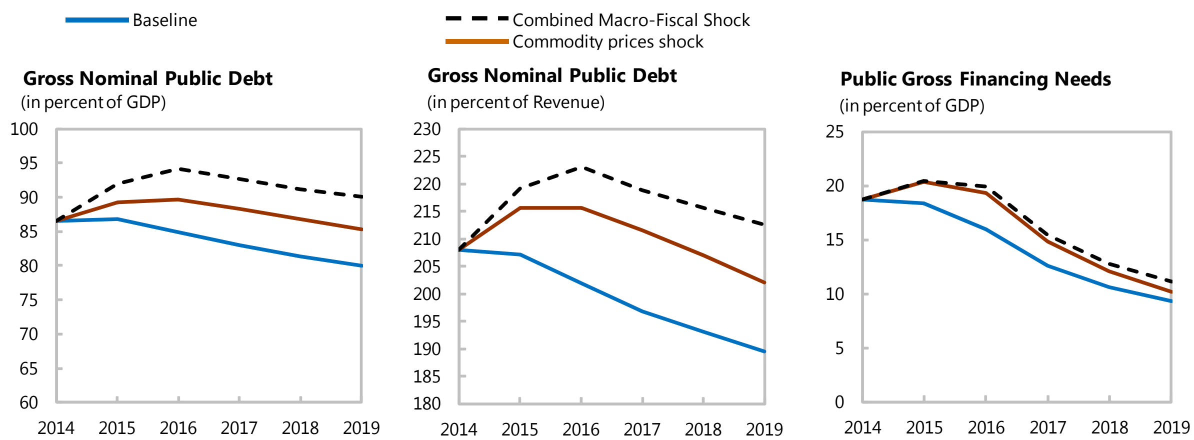
Source : IMF Staff.
1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Canada.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Canada Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	2.4	2.3	2.1	2.0	1.9	1.9
Inflation	1.9	-0.1	2.4	2.5	2.3	2.2
Primary balance	-1.2	-2.7	-2.2	-0.4	-0.2	0.0
Effective interest rate	3.8	4.4	4.7	5.1	5.5	5.8
Real Interest Rate Shock						
Real GDP growth	2.4	2.3	2.1	2.0	1.9	1.9
Inflation	1.9	-0.1	2.4	2.5	2.3	2.2
Primary balance	-1.2	-1.3	-0.8	-0.4	-0.2	0.0
Effective interest rate	3.8	4.4	5.2	5.8	5.9	6.2
Combined Shock						
Real GDP growth	2.4	0.6	0.3	2.0	1.9	1.9
Inflation	1.9	-0.6	2.0	2.5	2.3	2.2
Primary balance	-1.2	-2.7	-2.6	-0.4	-0.2	0.0
Effective interest rate	3.8	4.4	5.1	5.6	5.8	6.1

Real GDP Growth Shock	2014	2015	2016	2017	2018	2019
Real GDP growth	2.4	0.6	0.3	2.0	1.9	1.9
Inflation	1.9	-0.6	2.0	2.5	2.3	2.2
Primary balance	-1.2	-2.2	-2.6	-0.4	-0.2	0.0
Effective interest rate	3.8	4.4	4.7	5.2	5.5	5.9
Real Exchange Rate Shock						
Real GDP growth	2.4	2.3	2.1	2.0	1.9	1.9
Inflation	1.9	0.4	2.4	2.5	2.3	2.2
Primary balance	-1.2	-1.3	-0.8	-0.4	-0.2	0.0
Effective interest rate	3.8	4.4	4.7	5.2	5.5	5.9
Commodity prices shock						
Real GDP growth	2.4	2.3	2.0	1.9	1.9	1.9
Inflation	1.9	-0.7	2.4	2.5	2.3	2.2
Primary balance	-1.2	-3.2	-3.1	-0.9	-0.5	0.0
Effective interest rate	3.8	4.4	4.7	5.0	5.4	5.7

Source: IMF staff.

INTERNATIONAL MONETARY FUND

CANADA

January 15, 2015

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The Western Hemisphere Department
(in consultation with other departments)

CONTENTS

FUND RELATIONS

(As of November 30, 2014)

Membership Status: Joined 12/27/1945; Article VIII

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	6,369.20	100.00
Fund holdings of currency	4,481.92	70.37
Reserve Tranche Position	1,887.28	29.63
Lending to the Fund		
New Arrangements to Borrow	970.92	

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	5,988.08	100.00
Holdings	5,635.19	94.11

Outstanding Purchases and Loans: None.

Latest Financial Arrangements: None.

Projected Obligations to Fund:

(SDR Million; based on existing use of resources and present holdings of SDRs):

			Forthcoming		
	2014	2015	2016	2017	2018
Principal					
Charges/Interest		0.22	0.22	0.22	0.22
Total		0.22	0.22	0.22	0.22

Implementation of HIPC Initiative: Not Applicable.

Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable.

Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable.

Exchange Rate Arrangements: The authorities maintain a “free floating” exchange rate regime. The exchange rate regime is free from exchange restrictions and multiple currency practices. The Canadian authorities do not maintain margins with respect to exchange transactions. However, the authorities may intervene to maintain orderly conditions in the exchange market. There are no taxes or subsidies on purchases or sales of foreign exchange. Canada has accepted the obligations of Article VIII, Sections 2, 3, and 4 (a), and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Canada maintains exchange restrictions for security reasons, based on UN Security Council Resolutions, that have been notified to the Fund for approval (most recently in June 10, 2014) under the procedures set forth in Executive Board Decision No. 144–(52/51).

Last Article IV Consultation: The Staff Report for the 2013 consultation with Canada was considered by the Executive Board on January 29, 2014 (IMF Country Report No. 14/27). Canada is on a 12-month consultation cycle.

The 2014 Article IV discussions took place in Montreal, Toronto, Victoria, Vancouver, and Ottawa during November 10–25, 2014. The team comprised Hamid Faruqee (head), Lusine Lusinyan, Andrea Pescatori, Rania Papageorgiou (all WHD), Minsuk Kim (SPR), Tidiane Kinda (FAD), and Ivo Krznar (MCM). Messrs. Werner and Srinivasan (both WHD) joined the mission for concluding meetings in Ottawa. Mr. Parent (OED) accompanied the mission, and Mr. Dupont (OED) attended the concluding meetings. The mission met with Finance Minister Oliver, Deputy Finance Minister Rochon, Bank of Canada Senior Deputy Governor Wilkins, other senior officials, and provincial government representatives. A press conference was held on November 26 in Ottawa. Outreach activities included discussions with finance industry, academic, business sector, trade union representatives, and think tanks.

FSSA Participation and ROSC Assessments

Canada–Financial System Stability Assessment–Volume II: Report on Observance of Standards in the Financial System	www.imf.org June 30, 2000

Summary: The FSSA report concluded that Canada has a stable and highly advanced financial system, which is among the soundest in the world. It is supported by a well-developed regulatory system that shows a high degree of compliance with major international standards. The FSSA report made a few recommendations to further strengthen the regulatory framework and financial system's resilience, most of which have already been addressed, including:

- Introducing capital requirements for the guarantees in life insurance segregated fund (completed by end-2001);
- Tabling legislation granting the Office of the Superintendent of Financial Institutions (OSFI) powers to remove a financial institution's director or senior officer if the person is deemed not suitable to hold that office based on a number of criteria. The latter legislation brought Canada into broad compliance with the Basel Core Principles;
- Making significant progress in harmonizing securities regulation and improving coordination among provincial securities regulators, including through a newly created association of securities regulators, the Canadian Securities Administrators. Although there remain multiple regulators at the provincial level,

a Senate commission was created to develop specific recommendations on further harmonization and streamlining of securities regulation.

Canada: Report on the Observance of Standards and Codes—Fiscal Transparency Module	IMF Country Report No. 02/51, 03/12/02

Summary: The report found that fiscal management in Canada meets the requirements of the fiscal transparency code, and in a number of instances represents best practice. In particular, it highlighted the use of private sector economic forecasts. Fiscal management was also commended for its statistical integrity, impartial tax administration, open procurement, and a transparent regulatory process.

The report found several areas where further improvements would be desirable, including: (i) the preparation of timely, current year estimates of federal and provincial budgets on a comparable basis, (ii) a comprehensive account of the procedures for the budget cycle and expenditure management system, (iii) systematic reporting of the use of reserves for non-economic contingencies, (iv) resumption of publication of reconciled national and public accounts forecasts of major aggregates over the forecast horizon, and (v) publication by all governments of quasi-fiscal activities.

Many of these issues have been addressed, including: (i) the release by Statistics Canada of consolidated data for federal and provincial budgets for 2001–02 (on a Financial Management System basis); (ii) the publication of comprehensive descriptions of budget and expenditure management procedures, including a joint document entitled "Budgeting in Canada" by the Government and the OECD, detailed accounts of policies and procedures on expenditure management at the website of the Treasury Board Secretariat, and the explanation of the budget cycle and process in Budget and Update documents; and (iii) publication of reconciled national and public accounts forecasting.

Canada: Report on the Observance of Standards and Codes—Data Module	IMF Country Report No. 03/328, 10/23/03

Summary: Canada's macroeconomic statistics are comprehensive, timely, and accurate and thus adequate to conduct effective surveillance of economic and financial policies. Official institutions responsible for the compilation and dissemination of the macroeconomic datasets are supported by adequate legal and institutional frameworks. These frameworks protect confidentiality and ensure that statistical work is conducted within a quality assurance program and with sufficient resources. Integrity is ensured by the professionalism of the staff, transparency in statistical policies and practices, and the provision of ethical guidelines for staff. Compilers generally follow internationally accepted guidelines in the production of the macroeconomic statistics, which is well-supported by excellent efforts to develop source data that facilitate a high degree of accuracy and reliability. Statistics are generally relevant, well documented, available with good frequency on a timely basis, and readily accessible to users, who trust them as objective.

While recognizing the high quality of the macroeconomic data, the report makes recommendations to further strengthen the statistical system, most of which are already being addressed, including these priorities:

- Articulate the roles of Statistics Canada and the Bank of Canada in producing financial sector statistics and explore possibilities for more data sharing of monetary and financial statistics;
- Estimate consumption of fixed capital at replacement cost rather than historic costs now used for the corporate sector in the Canadian System of National Accounts (CSNA);
- Disseminate information on the sources and methods used in compiling quarterly public sector statistics for the quarterly CSNA; and
- Reclassify certain transactions that are not recorded in line with the 5th edition of the Balance of Payments Manual (*BPM5*).

Canada: Report on the Observance of Standards and Codes—FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism — IMF Country Report No. 08/372, 12/11/08

Summary: Canada's anti-money laundering and combating the financing of terrorism (AML/CFT) framework was last assessed by the Financial Action Task Force (FATF) and the Asia Pacific Group on Money Laundering (APG) in March 2007. Shortcomings were identified in particular with respect to the scope of customer due diligence, the implementation of AML/CFT supervision, and the effectiveness of the financial intelligence unit (FINTRAC). Since 2007, Canada submitted six follow-up reports to the FATF, the last one in February 2014, and took a number of steps to strengthen the framework in these areas. The next mutual evaluation of Canada will be conducted by the Fund and is scheduled in the fourth quarter of 2015.

Canada: Financial System Stability Assessment-Update — IMF Country Report No. 08/59, 02/13/08

Summary: The FSSA update concluded that Canada's financial system is mature, sophisticated, and well-managed. Financial stability was underpinned by sound macroeconomic policies and strong prudential regulation and supervision, and well-designed deposit insurance and arrangements for crisis management and failure resolution. The banking system appeared sound, with stress tests showing that the major banks could withstand sizeable shocks, although they did faces some challenges related to the global financial turmoil that started in mid-2007. Also, there were some concerns about bank attempts to build on their secure domestic position, to enter highly competitive foreign markets or complex activities. The update reiterated the advantages of moving towards a single securities regulator, including the streamlining of policy development, reductions in compliance costs, and improved enforcement. However, it also recognized the significant improvements to the regulatory system from the creation of the Canadian Securities Administrators (CSA), and the implementation of the passport system.

Canada: Financial System Stability Assessment-Update	IMF Country Report No. 14/29, 02/03/14

Summary: The FSSA Update found that Canada's financial system successfully navigated the global financial crisis, and stress tests suggest that major Canadian financial institutions are resilient to credit, liquidity, and contagion risks arising from a severe stress scenario. Elevated house prices and high household debt remain an area of concern (despite the substantial level of government-guaranteed mortgage insurance), though targeted prudential and macro-prudential measures are proving to be effective. The regulatory and supervisory framework demonstrates strong compliance with international standards. Nevertheless, the Update called for more clarity around the legal independence of OSFI and for assigning stronger prudential responsibilities to this regulator. In the securities markets, provincial regulators and the federal government have made significant progress in implementing a robust and harmonized framework, but challenges remain in enforcement, risk identification, and timely policy making. The FSSA Update argued that the federal system of safety nets is credible, although there is no single body with an explicit mandate to take a comprehensive view of systemic risks or to undertake crisis preparedness. Improving cooperation between federal and provincial authorities would further reinforce system-wide oversight arrangements.

Technical Assistance: Not Applicable.

Resident Representative: Not Applicable.

STATISTICAL ISSUES

The quality, coverage, periodicity, and timeliness of Canada's economic data are considered to be adequate both in the context of the Article IV consultation and for purposes of ongoing surveillance. Canada has subscribed to the Fund's Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board (DSBB). The data ROSC was published on October 23, 2003.

Real Sector. Statistics Canada provides timely and adequate data in monthly, quarterly, and annual frequency thereby facilitating the analyses of economic developments and policy assessments within a quantitative macroeconomic framework. In May 2001, Statistics Canada effected a smooth transition from Laspeyres methodology for estimating real expenditure-based GDP to Fisher index formulae, which enabled more accurate comparison between Canada and other G-7 countries. In October 2012, Statistics Canada started aligning the Canadian System of National Accounts (CSNA) with the SNA2008 international standard. The changes introduced in the CSNA2012 included, among others, capitalization of research and development, move to replacement cost-based valuation of consumption of fixed capital, and valuing equity more consistently at market price. Reflecting resource constraints and data availability, the SNA2008 is planned to be implemented in a staggered way. Additional changes have been planned with the 2014 release of the CSNA, which however for the most part would not have a significant impact on GDP and represent the development of new accounts, improved integration between the CSNA and Government Finance Statistics, additional detail, and presentational changes that better align with international standards (see, Statistics Canada). As well, in November 2014, the Statistics Canada published revisions, (statistical in nature) to the Gross Domestic Product by Income and by Expenditure Accounts for the period from 2011 to 2013 and 2014Q1–Q2, incorporating the most current data sources, including survey results, administrative data, public accounts and the annual input-output tables (see, Statistics Canada). As a result, annual growth rate of real GDP was revised up by 0.5 and 0.2 percentage points in 2011 and 2012, respectively. The main source of the revisions for the three years is the revision to the value of gross operating surplus. Among the GDP components, in particular, business gross fixed capital formation (especially nonresidential construction) and exports (especially services) were revised upward for 2011–13.

Fiscal Sector. Statistics Canada provides quarterly data (a Statement of Government Operations along with a Balance Sheet) on the general government and its subsectors following the *Government Finance Statistics Manual 2001* (*GFSM 2001*) recommendations. In November 2014, Statistics Canada published the provisional (unconsolidated) data on Canadian Government Finance Statistics (CGFS) for 2008–2012 (see, Statistics Canada). This is the first of three releases covering the statement of operations for all components of general government, as well as federal and provincial and territorial government business enterprises. Data on the functional expenses were also released, to be followed by the publication of financial assets and liabilities in early 2015. Future steps include publication of consolidated accounts and integration of capital estimates. In addition, the Department of Finance Canada provides monthly and annual data on the federal government's budget (according to the national presentation) and tax policies. The provided data enable adequate assessment of the impact of fiscal policy measures on Canada's economic performance.

Financial Sector. The Bank of Canada and OSFI provide monthly and quarterly data on the broad range of financial variables. However, the 2013 FSSA Update recommended that financial sector data collection and dissemination should be expanded with a view to enhancing coverage, regularity, and availability of time-series to facilitate analysis.

Monetary Sector. The Bank of Canada provides timely and adequate coverage of daily, weekly, monthly, and quarterly data related to the monetary sector.

External Sector. Statistics Canada provides timely information on a quarterly frequency on the balance of payments, external debt, and the international investment position. Department of Finance Canada provides monthly data on Official International Reserves in a format comparable to the IMF's reserve data template, thus enabling adequate surveillance. Data are published at http://www.fin.gc.ca/pub/oir-ro-eng.asp.

Canada: Table of Common Indicators Required For Surveillance

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	Same day	Same day	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec 23, 2014	Dec 23, 2014	W	W	W		
Reserve/Base Money	Dec 23, 2014	Dec 23, 2014	W	W	W	LO, O, LO, LO	O, O, O, O, O
Broad Money	Dec 23, 2014	Dec 23, 2014	M	M	M		
Central Bank Balance Sheet	Dec 23, 2014	Dec 23, 2014	W	W	W		
Consolidated Balance Sheet of the Banking System	Dec 23, 2014	Dec 23, 2014	M	M	M		
Interest Rates[2]	Same day	Same day	D	D	D		
Consumer Price Index	Nov 2014	Dec 19, 2014	M	M	M	O, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2014 Q3	Dec 2014	Q	Q	Q	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	23/12/14	Oct 2014	M	M	M		
External Current Account Balance	2014 Q3	Nov 27, 2014	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Nov 2014	Jan 7, 2015	M	M	M		
GDP/GNP	2014 Q3	Nov 28, 2014	Q	Q	Q	O, O, O, LO	O, O, O, O, O
Gross External Debt	2014 Q3	Dec 11, 2014	Q	Q	Q		
International Investment Position[5]	2014 Q3	Dec 11, 2014	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC published on October 23, 2003 and based on the findings of the mission that took place during January 22–February 5, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), not observed (NO); and not available (NA).
[8] Same as footnote 8, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative on Canada

January 28, 2015

1. **This note reports on information that has become available since the staff report (SM/15/10) was issued and does not alter the thrust of the staff appraisal.**

2. **The Bank of Canada unexpectedly lowered its policy rate by 25 basis points on January 21**. In the wake of substantially lower oil prices and increased uncertainty around an otherwise solid economic outlook, the Bank revised down its projections for GDP growth by 0.3 percentage points to 2.1 percent for 2015, mostly reflecting slower growth in the first half of the year. Headline CPI inflation was also revised down below the target range of 1–3 percent in 2015. In a context of higher uncertainty, the Bank stated that monetary easing is "intended to provide insurance" against downside risks to the inflation profile and financial stability, support the sectoral adjustment needed to strengthen investment and growth, and bring the Canadian economy back to full capacity and inflation to target within the projection horizon (end-2016). In response to the interest rate cut by the Bank of Canada, on the day of the announcement, the Canadian dollar depreciated further, falling by about 2 percent vis-à-vis the U.S. dollar, stock prices rose by almost 2 percent, and short-term bond yields fell sharply (by about 30 basis points) while long-term yields edged down slightly.

3. **Downside risks have risen in light of further oil price declines**. Since the staff report was issued, oil price projections for 2015 have declined further by about 12 percent based on market futures. This poses further downside risks to staff's growth and inflation forecasts for 2015, mainly through weaker investment in the energy sector. *In this context, the central bank's policy action is in line with staff advice to use available monetary policy space to mitigate the unfolding effects of downside risks to the outlook that have intensified.*

4. **There are welcome signs that activity in the Canadian housing sector may be cooling, especially in some overheated markets**. Against the back drop of weaker oil prices and terms of trade, home sales fell in December (-5.8 percent, m/m) on the back of muted growth during the second half of 2014. The number of newly listed homes fell nationally (-6.8 percent, m/m), with Calgary and Edmonton registering much larger declines. Residential construction activity continued to moderate, with starts declining to around 180,000 units in 2014, slightly down from 2013 levels. The number of completed and unabsorbed dwellings continued its downward trajectory in 2014, reaching 201,000 by the end of the year. House prices though rose 5.4 percent (y/y) in December (close to the 5.3 percent pace in November), led by increases in Calgary and the Greater Toronto Area. House price appreciation in Calgary, however, has moderated slightly to 8.8 percent in December, down from 9.2 percent (y/y) in the previous month.

5. **Recent indicators still suggest solid activity continues in the non-energy sector**. The Bank of Canada's winter Business Outlook Survey continues to provide signs of strengthening demand, especially among export-oriented firms and manufacturers. However, the outlook for businesses linked directly or indirectly to the energy sector has deteriorated. Firms anticipating a positive impact from the U.S. economic outlook are more optimistic than others. Furthermore, hiring intentions and investment plans are more robust for manufacturing than other sectors. Canadian manufacturing sales though decreased by 1.4 percent in November, below consensus estimates. The decline was widespread but mostly driven by motor vehicles, which fell on a monthly basis, but total year-to-date sales were still 5.2 percent higher than in the first eleven months of 2013.

Press Release No. 15/25
FOR IMMEDIATE RELEASE
January 30, 2015

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

IMF Executive Board Concludes 2014 Article IV Consultation with Canada

On January 28, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada. [1]

Canada's recent growth performance has been solid, alongside a stronger U.S. recovery. U.S. growth momentum, exchange rate depreciation, and high energy demand in early 2014, all led to a pickup in exports, although it has yet to translate into strong investment and hiring. In particular, the slowdown in business investment has been widespread in recent years. Thus, the composition of growth has not yet shifted away from private consumption and residential investment to generate a broader, more durable recovery. Substantially lower oil prices will be a drag on growth through weaker investment in the energy sector. Private consumption has continued to grow thanks to rising household wealth and exceptionally easy financial conditions. Indeed, after a brief pause, Canada's housing market rebounded in 2014, fueled by low and declining interest rates although there are some welcome signs of cooling especially in overheated markets. IMF staff analysis suggests a national real house price overvaluation between 7–20 percent although with important regional differences.

Growth momentum is expected to continue this year, despite substantially lower oil prices, and become more balanced with a cooling housing market. The stronger U.S. recovery, which is expected to continue, is leading to higher non-energy exports and supporting investment. These factors should mostly offset a moderation of private consumption and residential and energy investment as U.S. interest rates rise, low oil prices persist and households remain highly indebted. Looking beyond the recent past strength in housing markets, staff continues to expect a "soft-landing" as higher interest rates and weaker terms-of-trade prospects would temper housing demand. Downside risks to the outlook have risen in light of further oil price declines, adding to the risks of weaker global growth and still-unfolding effects from the unusually large fall in oil prices. Domestic vulnerabilities in housing markets and the household sector remain elevated but contained from a financial stability perspective. Given interconnections between external and domestic risks, some risks could occur together.

[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.

Public finances continued improving in 2014, reflecting federal and some provincial consolidation efforts. The general government fiscal deficit is expected to narrow from about 2¾ percent of GDP in 2013 to 1½ percent in 2014, with the federal government essentially on track to achieving its balanced budget target in FY2015/16 despite lower oil prices. Federal authorities should consider adopting a neutral stance given past consolidation gains and downside risks to growth. Such a stance would still be consistent with achieving the longer-term goals on public debt reduction. Provinces remain committed to their balanced budget targets, but, for some, fiscal adjustment continues posing challenges. They will need to sustain their efforts to strengthen public finances, especially in light of longer-term aging-related fiscal pressures.

In the wake of substantially lower oil prices and increased uncertainty around an otherwise solid economic outlook, the Bank of Canada cut its policy rate by 25 basis points and revised down its projections for GDP growth and headline inflation, on January 21. The Bank's policy action is in line with staff advice to use available monetary policy space should adverse shocks intensify given the deeper drop in oil prices. Overall, maintaining monetary accommodation along with gradual fiscal consolidation at the general government level would be conducive to achieving a growth composition with stronger exports and, thereby, investment in the economy, while targeted macro-prudential policies would help address housing sector vulnerabilities as needed.

Canadian banks remain highly profitable, with favorable loan quality, low nonperforming loans, and improving capitalization. Stress tests suggest that banks are resilient to credit, liquidity, and contagion risks due to their strong capital position, stable funding sources, and low exposures to the energy sector, as well as extensive government-guaranteed mortgage insurance. Steady progress has been achieved on key parts of the financial reform agenda, such as on implementing the Basel III Liquidity Coverage Ratio and leverage standards. Enhanced coordination across federal and provincial authorities in supervision and stress-testing will further bolster financial system soundness. Also, strengthening macro-prudential and crisis management frameworks will reinforce the overall resilience of the financial system.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Canada's continued solid growth performance, underpinned by the authorities' sound macroeconomic policy management. Directors noted that while the outlook remains favorable and growth is expected to become more balanced with a cooling housing market, risks are tilted to the downside because of tighter global financial conditions, effects from substantially lower oil prices, and persisting vulnerabilities in housing market and household sector. Directors agreed that continued well-calibrated policies should facilitate the needed rebalancing and sustain the growth momentum. Structural reforms to boost productivity and business investment will also be important to support medium-term growth.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors agreed that monetary policy should remain accommodative given well-anchored inflation expectations, sluggish business investment, lower oil prices, and until there are firm signs of durable recovery with stronger business investment. They supported the Bank of Canada's decision to lower the policy rate as it would help further support the economy in light of the likely adverse effects of the oil price shock. However, they encouraged the authorities to continue monitoring the impact of monetary policy on household debt and house prices.

Directors acknowledged that macro-prudential measures have been effective in containing growth of insured mortgage loans, but noted significant rise in uninsured mortgages alongside still-strong segments of housing markets. They generally agreed that additional macro-prudential policy action may be needed if household balance sheet and housing market vulnerabilities resume rising, in particular tighter standards for uninsured mortgages. Directors welcomed the authorities' recent initiatives to limit the government's exposure to the housing sector. They encouraged further action gradually to ensure appropriate risk retention by the private sector and, in the longer run, to re-examine the dimensions of extensive government-backed mortgage insurance.

Directors welcomed the authorities' commitment to fiscal targets and that the federal government is essentially on track to achieve a balanced budget in 2015. They agreed that fiscal consolidation should continue at the general government level, but the composition of the fiscal adjustment would need to shift from the federal government to the provinces. Most Directors saw scope for the federal government to adopt a neutral stance going forward, given strong adjustment efforts in recent years. They encouraged using the available fiscal resources for growth-friendly measures and strengthening the medium-term fiscal frameworks.

Directors agreed that fiscal adjustment at the provincial level would need to proceed, including through sustained progress in containing aging-related spending and supported by regular spending reviews. They generally noted that long-term fiscal sustainability challenges call for extending long-term fiscal forecasts at the provincial level and publishing consolidated general government fiscal forecasts in consultation with provinces.

Directors noted that Canada's financial sector continues to be sound and stable and commended the authorities for the progress on the international reform agenda. They welcomed the progress made in implementing several recommendations of the 2013 update of the Financial Sector Assessment Program (FSAP) and generally encouraged the authorities to move forward with the outstanding FSAP recommendations. In general, Directors noted that further enhancing supervisory cooperation across federal and provincial authorities, harmonized stress-testing of systemically-important depository institutions, and strengthening macro-prudential and crisis management frameworks would reinforce the resilience of Canada's financial system. A few Directors observed that focusing more on outcomes with respect to financial sector performance and allowing greater flexibility as regards frameworks or structures to achieve them could be beneficial.

Canada: Selected Economic Indicators

(Percentage change, unless otherwise indicated)

	2011	2012	2013	2014 Proj.	2015 Proj.
National Accounts in constant prices					
Real GDP	3.0	1.9	2.0	2.4	2.3
Q4/Q4	3.0	1.0	2.7	2.4	2.1
Net exports 1/	-0.4	-0.4	0.2	1.2	1.2
Final domestic demand	2.5	2.5	1.5	1.6	1.2
Private consumption	2.3	1.9	2.5	2.7	1.8
Public consumption	0.8	1.2	0.4	0.0	0.2
Private fixed domestic investment	7.8	6.9	0.8	0.6	0.6
Private investment 2/	19.2	20.2	20.0	19.9	20.1
Public investment	-7.1	-4.8	-1.6	-1.2	0.2
Change in inventories 1/	0.8	-0.2	0.3	-0.3	0.0
Nominal GDP	6.5	3.5	3.4	4.4	2.2
Employment and inflation					
Unemployment rate 3/	7.4	7.3	7.1	6.9	6.8
CPI inflation	2.9	1.5	1.0	2.0	1.1
GDP deflator	3.4	1.5	1.4	1.9	-0.1
Exchange Rate					
U.S. dollar / Canadian dollar	1.01	1.00	0.97	0.91	n.a.
Percentage change	4.1	-1.0	-3.0	-6.8	n.a.
Nominal effective exchange rate	2.0	0.9	-2.4	n.a.	n.a.
Real effective exchange rate	1.4	0.0	-3.4	n.a.	n.a.
Indicators of fiscal policies		*(Percent of GDP)*			
Federal fiscal balance	-1.8	-1.0	-0.7	0.1	0.0
Provincial fiscal balance	-2.6	-2.9	-2.9	-2.3	-2.3
General government fiscal balance 4/	-3.7	-3.1	-2.8	-1.5	-1.6
Three-month treasury bill 3/	0.9	1.0	1.0	0.9	1.1
Ten-year government bond yield 3/	2.8	1.9	2.3	2.2	2.5
External indicators					
Current account balance 2/	-2.7	-3.3	-3.0	-2.1	-2.6
Merchandise trade balance 2/	0.0	-0.6	-0.4	0.3	-0.5
Export volume	5.0	2.3	2.1	6.5	7.1
Import volume	5.9	3.1	1.9	2.3	3.2
Terms of trade	3.5	-1.1	0.0	-1.4	-5.7
Saving and investment		*(Percent of GDP)*			
Gross national saving	21.5	21.6	21.5	21.8	21.5
General government	0.8	1.2	1.5	2.6	2.4
Private	20.7	20.4	20.1	19.3	19.1
Gross domestic investment	24.1	24.9	24.5	24.0	24.2

Sources: Haver Analytics; and IMF Staff estimates.
1/ Contribution to growth.
2/ Percent of GDP.
3/ Percent.
4/ Includes the balances of the Canada Pension Plan and Quebec Pension Plan.