June 2006
IMF Country Report No. 06/230

Canada: 2006 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

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 2006 Article IV consultation with Canada, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 17, 2006, 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 April 14, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of May 19, 2006, updating information on recent economic developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its May 22, 2006 discussion of the staff report that concluded the Article IV consultation.

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.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Canada

Approved by Christopher Towe and Anthony Boote

April 14, 2006

- ***Discussions for the 2006 Article IV Consultation were initially held in November 2005, concluding in March 2006 after the election of a new government***. The staff team comprised T. Bayoumi (Head), M. Mühleisen, J. Roldos, C. Schnure, V. Klyuev, R. Balakrishnan, and E. Tsounta (all WHD). Mr. Jenkins, Senior Advisor (OED), participated in the discussions. Mr. Towe attended some of the meetings in Ottawa, and the concluding discussions in March. Mr. Singh and Mr. Lynch, the then Executive Director, joined the November concluding session with the previous government.

- ***The team met with public and private sector representatives***. Discussions were held with Bank of Canada Governor Dodge and previous Finance Minister Goodale, as well as senior officials from Finance Canada, the Bank of Canada, the Office of the Superintendent of Financial Institutions, Industry Canada, Health Canada, Human Resources Canada, Statistics Canada, the Treasury Board of Canada Secretariat, the provinces of Alberta and Ontario, and the Ontario Securities Commission. The team also met with three major banks, the PEAP forecasting group, the C.D. Howe Institute, the Conference Board of Canada, and energy analysts in Alberta.

- ***Canada subscribes to the Fund's Special Data Dissemination Standard***. The quality, coverage, periodicity, and timeliness of Canadian economic data are considered excellent, and metadata have been posted on the Fund's Data Standard Bulletin Board.

- ***ROSCs***. A Data ROSC was published in October 2003, an FSAP was issued to the Board in January 2000, and a Fiscal ROSC was published in March 2002 (see Appendix I).

- ***Canada is a party to the convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the Financial Action Task Force (FATF)***.

- ***Annex I contains summaries, including policy implications, of four Working Papers produced by staff as background work for the consultation***.

Contents Page

EXECUTIVE SUMMARY

Canada's macroeconomic and policy performance has continued to outshine most other industrial countries and its outlook remains favorable. Fiscal and monetary policy implementation has been enviable and, although the economy continues to face risks, including of a possible disorderly unwinding of global imbalances, growth is projected to remain at around its 3 percent potential and inflation to stay near its 2 percent target.

The Bank of Canada will need to balance evidence that slack is eroding against the drag from an appreciated exchange rate and the potential for a disorderly unwinding of global imbalances. Although further modest increases in the overnight rate will likely be required, the Bank's credibility allows a flexible response to macroeconomic developments. The success of the inflation targeting framework suggests no need for significant amendments when it is renewed later this year, but there is some room to enhance policy communication.

The new government has pledged to maintain the strong social consensus in favor of fiscal surpluses—including debt reduction by C$3 billion (about ¼ percent of GDP) per year—while aiming at enhancing incentives to save and invest. The emphasis on limiting government spending seems appropriate, and the challenge will be to translate this into specific measures. Planned cuts in corporate rates and the early elimination of the federal capital tax are warranted. Cutting the consumption tax rate would also provide economic benefits, although personal income tax cuts could be a more effective use of resources.

The new budget will need to ensure that a prudent fiscal framework is maintained. There would be considerable merit in raising the size of budgetary reserves, anchoring policies on a debt objective over a 5-10 year horizon, and providing an annual analysis of long-term budget prospects by an independent body to emphasize the need for debt reduction.

Addressing fiscal pressures at the provincial level will also be necessary to support longer-term fiscal sustainability. There remains a case for allowing provinces greater flexibility in using price and other market-based mechanisms to help align the demand and supply for health care. Any new allocation formula for the Equalization system (which addresses horizontal imbalances across provinces) should take resource-based revenues into account.

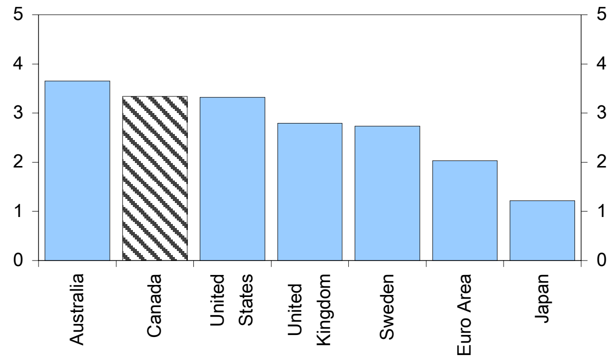
The favorable domestic and external environment provides the new government an important opportunity to boost the economy's long-term growth potential. Despite robust growth, Canada's productivity performance has been less impressive. In addition to lowering the tax burden, reforms could include: in the *labor market*, reducing welfare walls, making immigration systems more flexible, and restoring reforms of the Employment Insurance system; in *product markets*, reducing barriers to foreign direct investment and reforming the electricity sector; in *trade and agriculture*, widening market access for agricultural goods.

While the financial system appears well placed to support growth, there is still room to furthering its efficiency and resilience. Priorities include providing greater clarity on the regulatory framework governing *bank mergers*, establishing a *national securities regulator*, and better aligning incentives of *defined benefit pension plan* sponsors and members.

I. Introduction

Strong institutions and structural reforms have helped spur growth over the last decade.

Real GDP growth, average annual percent change, 1996 - 2005

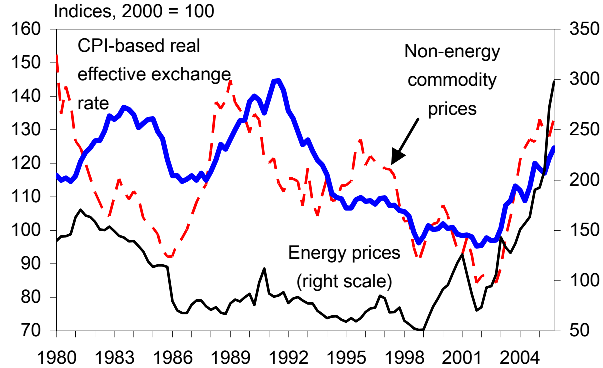


Source: World Economic Outlook.

1. ***Canada's macroeconomic performance remained favorable over the last year despite the challenge posed by the rapid appreciation of its currency*** (Table 1). With core inflation contained, output still below potential, and net exports weakening, the Bank of Canada maintained a stimulative monetary policy stance through September 2005. Subsequently, rising capacity utilization and strong employment growth have prompted a resumption of rate hikes. Benefiting from a surge in personal and corporate incomes, the strong fiscal framework again delivered a federal budget surplus.

Surging energy prices and rising non-oil commodity prices are supporting the exchange rate.

Indices, 2000 = 100



Source: Haver Analytics; and IMF Information Notice System.

2. ***The boom in global commodity prices has significantly improved Canada's economic prospects but also complicates macroeconomic management***. High world oil prices have improved the financial viability of Canada's enormous oil sands, boosting the country's role as a major energy exporter (Box 1 and Annex I). However, the attendant significant appreciation of the real exchange rate required a shift of resources toward the oil and gas sector in the western provinces, creating economic frictions and widening gaps in fiscal capacity between resource-rich and resource-poor provinces.

3. ***The Conservative Party formed a minority government following the January 23 general election***. The new government has promised to focus on "five priorities," including raising accountability in government, reducing crime, lowering consumption taxes, providing choice and support for child care, and reducing wait times for medical procedures. It also pledged to reduce the role of government and work toward reducing federal-provincial "fiscal imbalances." However, its minority status in parliament may limit the room for policy maneuver.

Box 1. Canada as an Energy Exporter[1]

Canada's oil sands—located almost exclusively in Alberta—contain one of the world's largest known hydrocarbon deposits. The cost of extracting much of the oil had been prohibitively expensive, but improved technology and higher oil prices have made them economical. Recoverable oil is estimated at about one sixth of global reserves.

Capital spending on oil sands projects is projected to continue to increase sharply, but there are obstacles to exploiting oil sands deposits:

- *Limited infrastructure and difficulties in attracting skilled labor* have boosted costs.
- *Canada's natural gas output* is expected to peak in about 10 years' time. With natural gas a key input for oil sands production, this could pose a serious long-term cost problem.
- *Greenhouse gas emissions* created by oil sands production are likely to conflict with Canada's Kyoto Accord commitments.

Most forecasters assume that projects will come on stream gradually. Production projections tend to imply a tripling of oil sands production volume to 2½–3 million barrels per day (mb/d) over 10 years. With conventional oil output already past its peak, Canada's total oil production would increase from 2.5 mb/d in 2003 to about 4 mb/d by 2015.

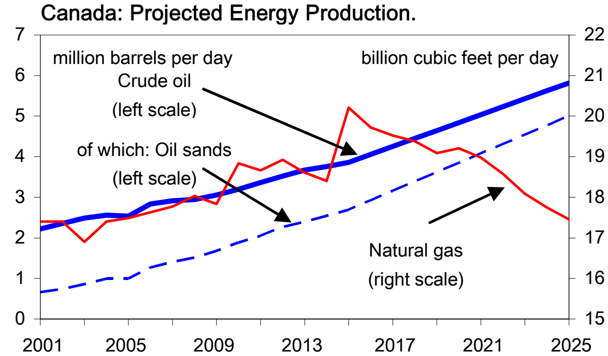
Rising oil production will affect the domestic economy in a number of important ways:

- *Domestic demand*. Extraction of oil sands uses large amounts of capital and labor, which should push up demand and income outside the energy sector as well as outside Alberta.
- *Government revenues*. While royalties and resource taxes accrue primarily to Alberta, the federal government and other provinces would benefit from higher sales tax and corporate income tax revenue.
- *Balance of Payments*. At current energy prices, Canada's current account balance could improve by about ½ percent of GDP by 2015.

Staff analysis suggests, however, that the impact on Canada's real effective exchange rate would be small. The staff's model also indicates that most of the recent appreciation of the Canadian dollar against the U.S. dollar has been driven by fundamentals.

Although oil output will rise in coming years, Canada's future as an energy-exporting country will depend on finding technological solutions to overcome production obstacles. Gas exports are expected to fall sharply after 2015 as reserves are exhausted. Therefore, oil sands production would need to increase rapidly to maintain Canada's energy trade balance. This will require significant investments in public and private infrastructure, improvements in extraction techniques, curbing the use of natural gas in oil sands production, and limiting greenhouse gas emissions.

Canada: Projected Energy Production.



Sources: National Energy Board; Canadian Association of Petroleum Producers; and Fund staff projections.

[1] Written by M. Mühleisen. See also Annex I.

4. ***Against this background, the mission focused on the challenges of maintaining a balanced expansion and supporting economic flexibility and long-term growth in the face of population aging***:[1]

- Following a series of interest rate increases since the fall, the monetary stance has become less accommodative, and while further modest increases in the overnight rate will be required, the Bank of Canada will need to weigh carefully signs that slack has eroded against the drag from currency appreciation and risks from global imbalances.
- The new government will need to demonstrate its commitment to budget discipline as it delivers on promised tax relief. In addition, reform of the health care system remains key to long-term fiscal sustainability.
- On the structural front, the challenge will be to boost productivity as labor-intensive growth from rising participation over the last decade slows. While the Canadian economy remains highly flexible, there seems scope to streamline FDI, trade, and labor market regulations with a view to encourage foreign investment and boost domestic competition.

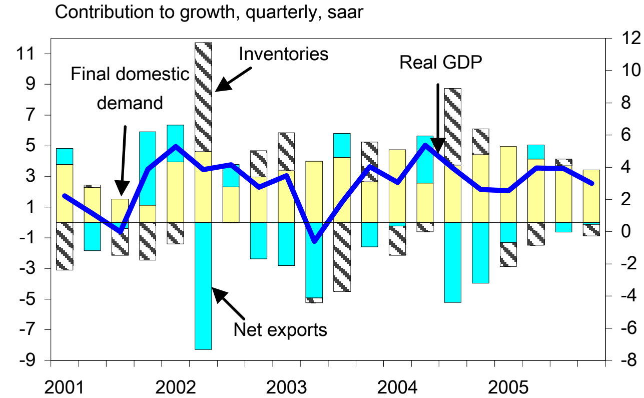
II. Recent Developments

5. ***The economy has maintained momentum even in the face of last year's rapid currency appreciation*** (Table 2). Real GDP growth was close to 3 percent during 2005 (Q4/Q4 basis), reflecting a strong expansion in construction, services, and resource industries. Final domestic demand rose a robust 4½ percent, which more than offset a drop in inventory investment and net exports:

- *Private consumption expanded by 3¾ percent*. Strong employment growth has bolstered household incomes, while solid gains in equity and housing prices (where there is little evidence of a bubble) have kept household wealth as a ratio to income close to historical highs despite a record-low saving rate.
- *Private fixed investment rose by 7½ percent.* Residential construction growth has moderated but purchases of machinery and equipment accelerated through the year, supported by rising corporate profits, low long-term interest rates, and a booming energy sector in the west.

Final domestic demand remains robust, while the drag from net exports has declined...

Contribution to growth, quarterly, saar



Source: Haver Analytics.

1 Box 2 summarizes the role of the Fund in Canada in recent years.

Box 2. Effectiveness and Role of Fund Surveillance

- ***Past Fund advice***. Staff have been highly supportive of Canada's strong institutional framework and continuing structural reforms. Although the authorities have resisted suggestions to reform the Employment Insurance system, policies in general—and the adoption of a medium-term debt target in the FY 2004–05 budget and recent increases in monetary policy transparency, in particular—have been in line with staff recommendations.

- ***A recent academic study—based on interviews with Department of Finance officials—came to mixed conclusions on the effectiveness of Fund surveillance***.[1] The study found that Fund staff came with "sophisticated expertise and technical advice," "demonstrated intellect and insight about the Canadian economy," and had the "big picture." However, Fund reports were generally found to be less valuable than those by the OECD because they were less "user-friendly," contained more limited use of cross-country comparisons, and were less focused on issues of immediate interest to policy makers.

- ***Targeted advice***. Staff have recently provided focused analyses in response to specific requests by Canadian authorities:

  - ***Fiscal forecasting***. At the authorities' request, last year the staff prepared an international comparison of fiscal forecasting procedures and outcomes, utilized by an independent report on the same topic, which in turn was cited in the November 2005 Budget Update.

  - ***Review of Bank of Canada research and analysis***. At the authorities' request, staff has provided the Board of Governors of the Bank of Canada with bi-annual assessments of the Bank's research and communications strategy. This year, the presentation was also given to Governor Dodge and Senior Deputy Governor Jenkins. In addition, the Bank of Canada has been actively involved in both using and developing the Fund's Global Economic Model.

- ***The Role of the Fund***. Senior Canadian policymakers have recently offered a number of suggestions for strengthening Fund surveillance. Bank of Canada Governor Dodge and Finance Minister Flaherty both called on the Fund to focus more on multilateral surveillance, better integrate financial sector analysis into country reviews, put more emphasis on exchange rates, and define the roles of the Board, management, and staff more concretely.[2] They suggested that the Fund's primary role should be to promote a market-based international monetary order, acting as a forum for developing the "rules of the game" and as an "umpire" making impartial calls as to whether the rules were being followed.

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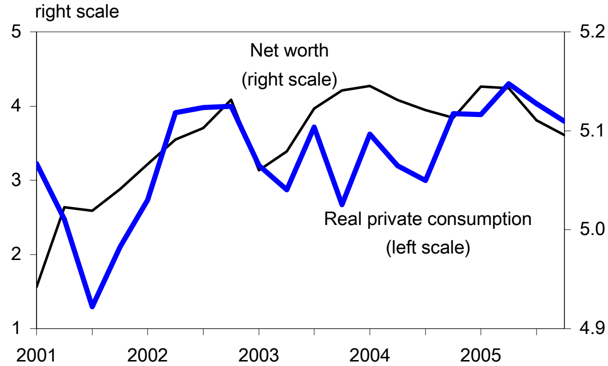
[1] Momani, B., 2005, "Assessing the Utility of and Measuring Learning from Canada's IMF Article IV Consultations," Department of Political Science and History, University of Waterloo.

[2] See, for example, Dodge, D., 2006, "The Evolving International Monetary Order and the Need for Evolving IMF," Lecture to the Woodrow Wilson School of Public Affairs, Princeton University.

...solid gains in housing and equity wealth have boosted household spending...

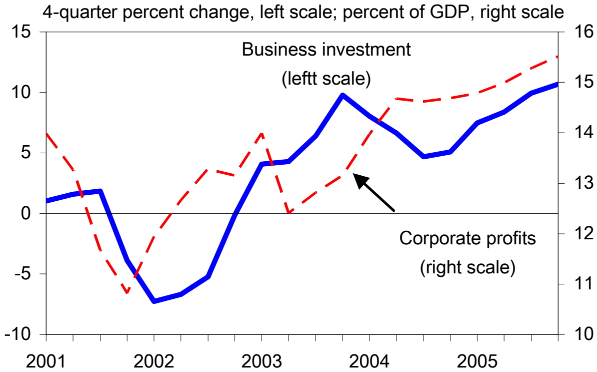
4-quarter percent change, left scale; ratio to disposable income, right scale



Source: Haver Analytics.

...and business investment has picked up, supported by healthy corporate profits.

4-quarter percent change, left scale; percent of GDP, right scale



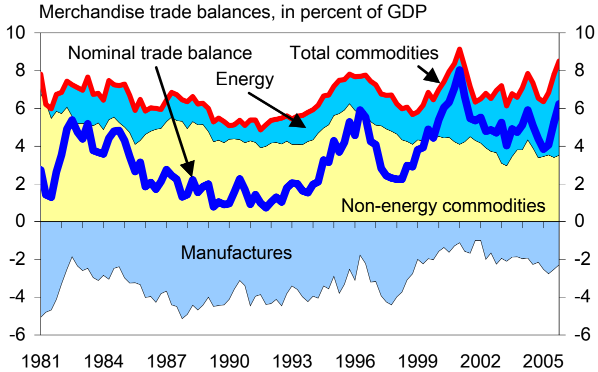
Source: Haver Analytics.

- *The growth of government consumption and investment was more moderate*, reflecting discipline in final spending at both the federal and provincial level.

6. ***Net exports continued to be a drag on activity*** (Table 3). Real exports, supported by strong external demand, expanded almost 5 percent over the course of 2005, but this was more than offset by a 6½ percent increase in real imports, which were spurred by a strong currency. Nonetheless, soaring energy prices buoyed the nominal trade balance and the current account.

Commodity prices move the nominal trade balance...

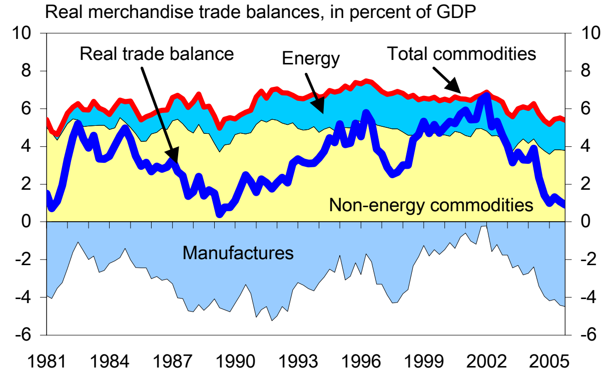
Merchandise trade balances, in percent of GDP



Source: Haver Analytics.

...while trade volumes depend more on manufactures.

Real merchandise trade balances, in percent of GDP



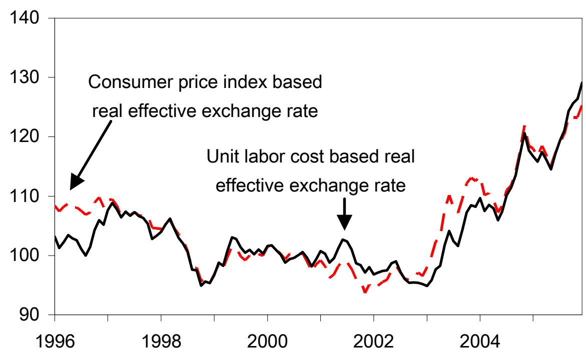
Source: Haver Analytics.

7. ***After a modest retreat in the early months of 2005, the Canadian dollar has resumed its appreciation***. The dollar has gained some 30 percent in real effective terms since early 2003 and has risen to highs not seen since the early 1990s, partly reflecting market responses to growing actual and expected energy export revenues and foreign investment in Canada's oil and gas sector. Assessing Canada's competitiveness is complicated by movements in the terms of trade as well as growing penetration of low cost producers in the U.S. and domestic markets. However, while the currency's strength has crimped manufacturing employment, the exchange rate appears largely in line with underlying

fundamentals, with much of the recent appreciation reflecting the boom in energy and other commodity prices (staff analysis is summarized in Annex I).[2] Multilateral analysis conducted by the IMF's Research Department suggests that the exchange rate is up to 15 percent undervalued when compared with equilibrium saving-investment balances. However, the gap is smaller using the methodology that calculates purchasing power parities and takes the improvement in the terms of trade into account.

The exchange rate has been appreciating...

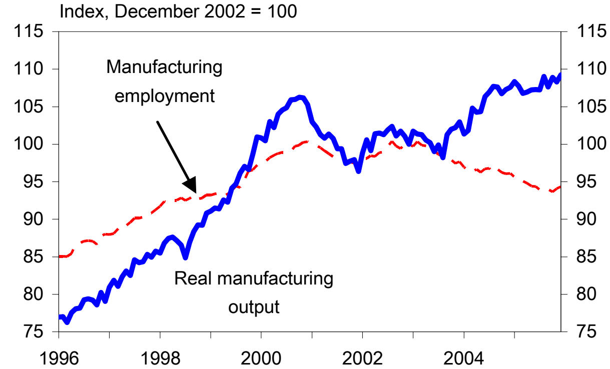
Indices 2000=100. An increase signifies appreciation.



Sources: IFS; and IMF Information Notice System.

...imposing adjustment on the manufacturing sector.

Index, December 2002 = 100

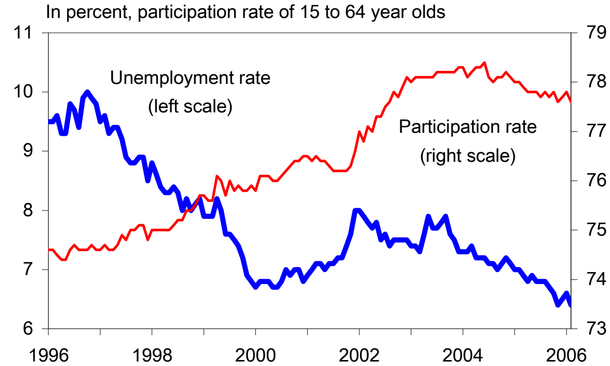


Source: Haver Analytics.

8. ***Most indicators suggest that the economy is operating at around potential.*** The unemployment rate has fallen to 6¼ percent—a 31-year low—reflecting employment growth in the commodity-producing western provinces but also in the central provinces, where losses in export industries have been offset by gains in construction and services. Both the staff and the Bank of Canada estimate a negligible output gap.

The unemployment rate has fallen, while labor force participation has remained high.

In percent, participation rate of 15 to 64 year olds



Source: Haver Analytics.

9. ***Nonetheless, inflation remains tame.***[3] As the upward pressure from higher energy prices has dissipated, headline inflation has fallen back to 2.2 percent, close to the center of the Bank of Canada's 1-3 percent target range, while the core measure has stayed below 2 percent since January

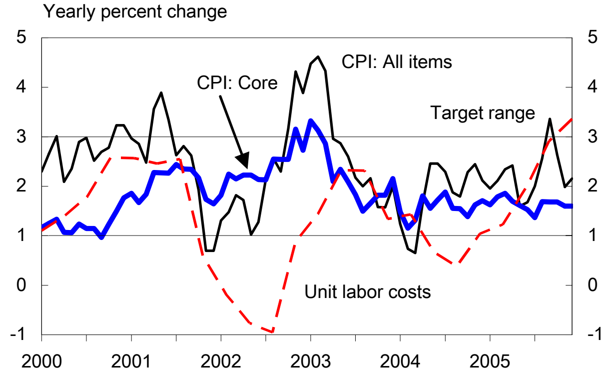
[2] Since 2002, the Bank of Canada's composite commodity price index has increased by 90 percent, compared to a 30 percent appreciation of Canada's real effective exchange rate.

[3] See Chapter 3 of the April 2006 *World Economic Outlook* for a discussion of international inflation trends.

2004. However, wage increases accelerated during 2005 and, despite a pickup in productivity, unit labor costs rose by 3½ percent driven largely by the service sector.

Although unit labor costs have risen recently, core inflation has been stable in the bottom half of the Bank of Canada's target range.

Yearly percent change

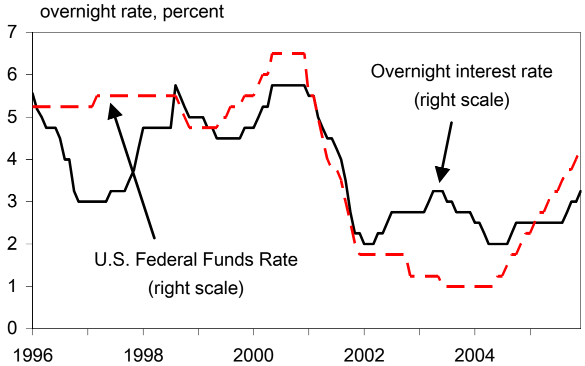


Source: Haver Analytics.

10. ***After pausing for almost a year, the Bank of Canada resumed withdrawing monetary stimulus in the fall of 2005***. Reflecting the assessment that the economy was operating near capacity, the Bank has raised its target for the overnight interest rate to 3¾ percent in five consecutive ¼ percentage point steps starting in September. In its March 2006 statement, the Bank indicated that "modest" further tightening may be needed, which was interpreted by financial markets as suggesting that rates would rise by only a further 25-50 basis points through end-2006. As in the rest of the world, yields on long-term government bonds remain close to historic lows in real and nominal terms, even after modest recent rises.

Monetary tightening resumed in September after being interrupted by exchange rate appreciation...

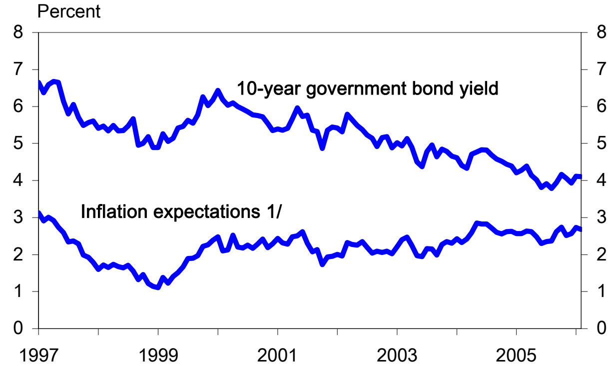
overnight rate, percent



Source: Haver Analytics.

... while inflation expectations remain contained and nominal bond yields have fallen.

Percent

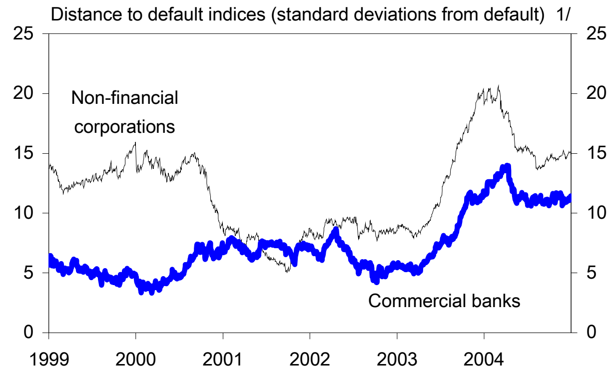


Sources: Bloomberg; and Haver Analytics.

1/ Inflation expectations use bonds maturing in 2021.

11. ***The fiscal outlook remains very favorable***. Buoyant personal income tax collections and large corporate income tax payments are expected to lead to a surplus in FY2005/06 (ending in March). The disposition of projected budget surpluses was a key focus of the pre-election debate. The new government has pledged a range of tax cuts and spending restraint that—if fully implemented—would be consistent with their commitment to pay down federal debt by at least C$3 billion (about ¼ percent of GDP a year).

Bank and corporate finances remain healthy.



Source: IMF staff calculations.
1/ Greater distance to default indicates an improvement in financial soundness. For definition, see Chapter VI of *Canada: Selected Issues*, IMF Country Report 05/116.

12. ***Financial and corporate sectors remain sound*** (Table 4). In the financial sector, high profitability, robust balance sheets, a benign provisioning environment, and strong distance-to-default indices—which combine measures of financial performance and market uncertainty—do not suggest systemic risks. In addition, staff analysis (summarized in Annex I) finds the gradual trend to greater direct financing has strengthened the monetary transmission mechanism. The corporate sector also enjoys strong balance sheets and profitability, although the funding situation of many of Canada's defined benefit (DB) pension plans has deteriorated as declines in long-term interest rates and increases in life expectancy have boosted the present value of liabilities.

III. Outlook and Risks

13. ***The staff and most other forecasters expected the economy to stay close to capacity, growing at around 3 percent in 2006 and 2007***. Although real net exports are expected to decline in 2006 as a result of the recent currency appreciation, Canada's improved terms of trade would lend continued support to domestic demand.

14. ***Short-term risks to the outlook are evenly balanced***:

- *On the upside, higher energy and other commodity prices could further support incomes and domestic demand*. Recent increases in energy prices and associated exchange rate appreciation had spurred a reallocation of resources from the east to the emerging center of activity in the west, from consumption to business investment, and from export-based manufacturing to import-intensive services, which officials observed had gone remarkably smoothly (Chapter 1 of the *Selected Issues* paper reports staff analysis of the regional impact of oil prices and other shocks on the Canadian economy). Officials agreed that a further appreciation of the currency could not be ruled out, given the strength of commodity prices and global current account imbalances. Nonetheless, they were confident that the economy was flexible enough to facilitate smooth further adjustment.

- *On the downside, the economy is vulnerable to a sharper-than-expected slowdown in U.S. activity*. With exports to the United States accounting for about 35 percent of GDP, a slowing of the U.S. housing market and subsequent drop in U.S. consumer demand would weigh heavily on Canada. Also, a sharp drop in commodity prices

Economic Outlook

(In annualized percent change from previous period; unless otherwise indicated)

			Projections		2005				Projections 2006			
	2004	2005	2006	2007	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	2.9	2.9	3.1	3.0	2.1	3.6	3.5	2.5	3.2	3.1	3.0	3.0
Net exports (contribution)	-0.9	-1.5	-0.3	0.2	-1.3	0.9	-0.7	-0.2	-0.6	-0.3	0.2	0.2
Total domestic demand	4.0	4.6	3.5	3.0	3.4	2.6	4.5	3.0	4.0	3.6	3.0	2.9
Final domestic demand	3.9	4.3	3.7	2.9	5.4	3.9	4.2	4.3	3.8	3.4	2.9	2.9
Private consumption	3.4	4.0	3.3	2.6	6.1	3.8	2.4	2.9	4.0	3.7	2.8	2.7
Private fixed investment	6.9	6.9	5.9	4.3	6.5	5.2	9.5	8.6	4.8	4.4	4.3	4.3
Inventories (contribution)	0.0	0.3	-0.2	0.1	-1.5	-1.5	0.4	-0.8	0.2	0.2	0.1	0.1
Unemployment rate (percent)	7.2	6.8	6.6	6.6	7.0	6.8	6.8	6.5	6.6	6.6	6.6	6.6
Consumer price index	1.8	2.2	1.8	2.0	1.0	2.8	3.9	1.4	0.6	2.0	2.0	2.0
Federal fiscal balance/GDP	0.6	0.4	0.3	0.2	...	...	...	...	...	...	...	...
Current account balance/GDP	2.2	2.2	3.1	2.9	1.3	1.5	2.2	3.8	3.3	3.1	3.0	3.1
Memorandum items:												
Partner country growth	4.2	3.5	3.4	3.3	3.3	3.4	3.5	3.5	3.5	3.4	3.4	3.4
Oil prices ($/Barrel)	37.8	53.4	61.3	63.0	46.1	50.8	60.0	56.5	61.0	60.0	61.5	62.5

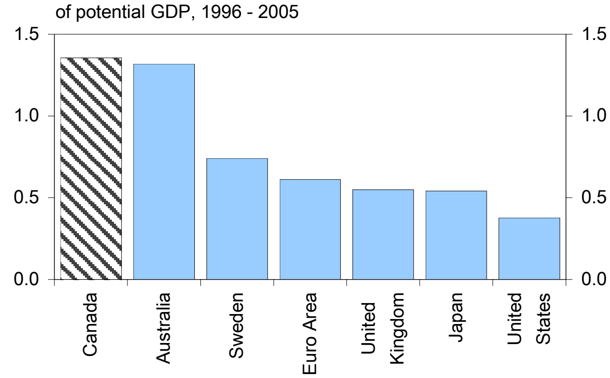
Sources: Haver Analytics; and Fund staff estimates.

would reverse recent gains in the terms of trade, dampening income growth and domestic demand.

15. ***Looking beyond 2006, Canadian officials viewed an abrupt unwinding of global current account imbalances as a key risk facing Canada***. In particular, a disorderly adjustment would fall most heavily on countries such as Canada with flexible exchange rates and close U.S. trade linkages. They emphasized that Canada had already taken on a disproportionate burden by allowing the exchange rate to appreciate and real net exports to contract, and called on the Fund to push harder for an orderly resolution of global external imbalances. An alternative scenario by the staff indeed suggests that a major decline in U.S. activity, a large drop in commodity prices, and a sharp appreciation of the Canadian dollar against the U.S. currency could combine in a "perfect storm" that would pose intense challenges both to the economy and financial sector (Appendix III).

The volatility of Canada's real trade balance illustrates its vulnerability to external shocks.

Standard deviation of change in real trade balance as percent of potential GDP, 1996 - 2005

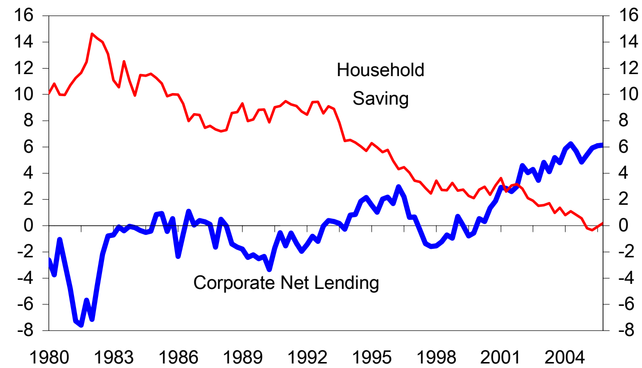


Source: World Economic Outlook.

16. ***The staff cautioned that domestic saving-investment balances also posed risks***. As in other cyclically advanced countries, a rise in household wealth has coincided with strong consumption growth, leaving the personal saving rate close to zero. At the same time, strong

As households have reduced saving, corporations have become net lenders.

Percent of GDP



Source: Haver Analytics.

profits, particularly in commodity-producing industries, have turned the corporate sector into a net lender to the rest of the economy.[4] Although Canada's fiscal and current account surpluses, and declining government and net foreign debt ratios, imply no issues of sustainability (Appendix IV), staff suggested that interest rate or other shocks could lead the household saving rate to adjust abruptly.

17. ***Officials and private sector participants were more sanguine about the household saving rate***. Given buoyant household wealth, they saw little risk of a sharp contraction in private consumption. Moreover, vulnerabilities associated with the Canadian housing market were limited by the fact that refinancing and home equity withdrawals had not played a major role in financing consumption, and that the sub-prime loan market was less developed than in the United States.

18. ***The staff shared the authorities' concern about trends in labor productivity, which had slowed since 2000 because of a sharp decrease in capital deepening***. As a result, and also reflecting the frictions associated with the shift of resources into the booming energy sector, the Bank of Canada had shaded down its estimate of potential output growth in 2005 and 2006. However, there were emerging signs that the drop in the price of imported capital goods associated with the strong exchange rate was boosting business investment, providing a potential upside risk to productivity growth.

IV. Monetary Policy and the Exchange Rate

19. ***Bank of Canada officials and staff agreed that some further increases in short-term interest rates would likely be needed, given that monetary policy remained mildly accommodative***. At the same time, officials noted that medium- to longer-term risks were tilted to the downside, owing to the possibility of a disorderly unwinding of global current account imbalances. Indeed, as a small open economy closely integrated with the United States, Canada was particularly vulnerable to the risk of a U.S. dollar depreciation or a broader global slowdown. Against this background, the Bank had been careful to emphasize that it was being more cautious in raising interest rates than otherwise, accepting the possibility that domestic output could rise somewhat above potential in the near term. Staff agreed that the Bank's firm commitment to price stability afforded room to maintain a policy

[4] See Chapter 4 of the April 2006 *World Economic Outlook* for a discussion of international trends in corporate saving and net lending.

stance that took into account risks beyond the Bank's usual 6–8 quarter horizon without unduly jeopardizing the inflation target.

20. ***Officials viewed the recent appreciation of the Canadian dollar as consistent with the need to rebalance external and domestic demand in the face of improving terms of trade***. Although the exchange rate had gained somewhat more in strength than officials had expected in the fall of 2005, an appreciating currency was consistent with strong demand for Canadian exports and the surge in energy and other commodity prices. Staff agreed with this assessment, noting that the mission's background analysis (summarized in Annex I) confirmed preliminary work by Bank of Canada staff that found energy prices having a greater impact on the exchange rate than earlier believed.

21. ***The team commended the Bank's commitment to transparency but suggested that there could be room to further improve communication***. For example, best practice at other central banks suggested scope for providing greater detail on assumptions and risks, particularly on those "fixed action dates" that were not followed by a Monetary Policy Report (MPR).[5] Officials responded that the Bank had steadily expanded the scope of MPRs, but they preferred not to publish detailed forecasts—including of interest rates and exchange rates—since these could be misinterpreted by markets as targets. Moreover, adding detail would make it difficult to publish MPRs just two days after fixed action dates.

22. ***Canada's inflation targeting framework is due for renewal later in 2006***. Bank of Canada officials indicated a range of issues had been reviewed, including modifying the definition of core inflation, reducing the inflation target, and shifting to a form of price-level targeting as a way of lowering nominal interest rate volatility.[6] Consideration was also being given to lengthening the horizon for achieving the inflation target, especially in the presence of asset price disturbances. However, officials did not expect significant changes in the present round, concurring with the team that the success of the current framework suggested the burden of proof for adopting different arrangements would be high (the role played by inflation targeting and credibility in strengthening the monetary transmission mechanism is discussed in Chapter 2 of the *Selected Issues* paper).

V. Fiscal Policy

23. ***Canada has achieved eight consecutive years of federal surpluses and falling government debt, creating a strong social consensus for prudent fiscal policies*** (Table 5). This reflected an informal fiscal rule maintained by the previous government that included commitments to "balanced budgets or better" each year, the maintenance of a ¼ percent of GDP contingency reserve as well as a macroeconomic prudence factor that rose by

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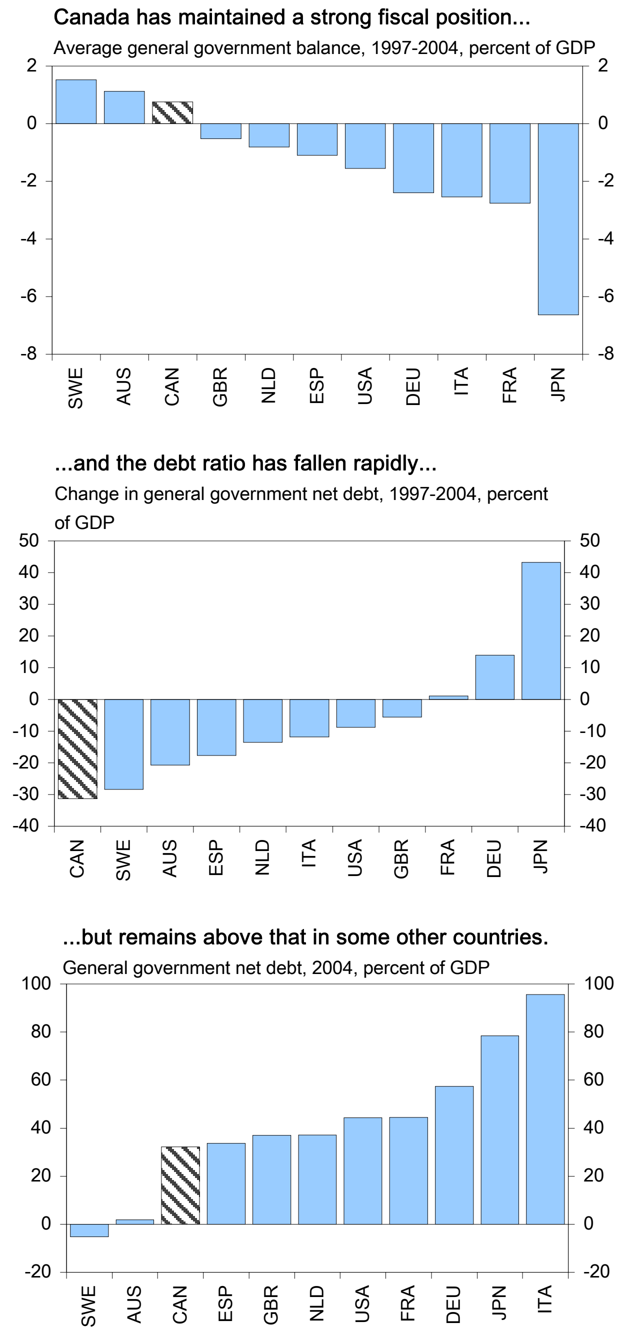
[5] The Bank typically has eight fixed action dates—i.e., dates on which interest announcements occur—each year, but only four such announcements are followed by full MPRs or MPR Updates.

[6] Under price level targeting, higher-than-anticipated inflation lowers future inflation expectations, thereby raising the expected real interest rate even without nominal hikes.

0.1 percent of GDP a year over the forecast horizon.[7] Two years ago, the authorities also established the objective of reducing the federal debt/GDP ratio to below 25 percent by FY 2014–15, and in November 2005 this target was extended to 20 percent by 2020. Most provinces have also adopted balanced budget rules, and the aggregate provincial debt ratio is falling.



Sources: OECD; and World Economic Outlook.

24. ***Officials explained that the specifics of the new government's policies were still being developed—to be presented in the forthcoming FY 2006/07 Budget—but that the authorities were committed to reducing the tax burden while maintaining fiscal prudence***. In particular, tax cuts pledged during the campaign included a 2 percentage point reduction in the goods and services tax (GST), with the first percentage point to be implemented immediately, and cuts in a range of taxes on business over the coming five years. The campaign platform also called for limiting direct "program spending" (other than on defense or Indian affairs) to inflation plus population growth, with the objective of paying down federal debt by at least C$3 billion a year.

25. ***The team inquired about the efficiency implications of the new government's revenue proposals***. In particular, a reduction in corporate tax rates and the elimination of the capital tax seemed appropriate given Canada's relatively high corporate tax burden and the need to support investment. However, staff analysis, reported in Chapter 3 of the *Selected Issues* paper

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[7] These arrangements were analyzed in Chapter 5 of *Canada: Selected Issues*, IMF Country Report 05/116.

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

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Revenue	15.3	15.4	14.8	14.4	14.3	14.1	13.9	13.7
Outlays	14.6	15.3	14.3	14.2	14.1	13.9	13.7	13.5
Operating balance	0.7	0.1	0.5	0.2	0.2	0.2	0.2	0.2
Reserves	...	...	0.2	0.2	0.2	0.2	0.2	0.2
Planning balance	0.7	0.1	0.3	0.0	0.0	0.0	0.0	0.0
Net lending	0.1	0.6	0.4	0.3	0.2	0.2	0.2	0.2
Net debt	41.2	38.7	36.0	33.7	32.0	30.4	28.8	27.3

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

[1] The projections are based on the baseline provided by the authorities' November 2005 Update. Revenues would grow at an annual average of around 4 percent over the planning horizon, partly resulting from high energy prices, and spending is expected to grow by an annual average of 4.5 percent. Staff projections adjust this base case for differences in macroeconomic assumptions and for the measures from the new government's platform, including two 1-percentage point cuts in the GST (one taking place immediately and the second one in FY 2010/11); cuts in a range of business taxes; a new child care allowance of C$1200 a year for every child under six (at a cost of C$1.9 billion per year); and reductions in direct program spending growth excluding defense and Indian affairs to inflation plus population growth. Any part of the projected annual budgetary surplus (annual average of about C$7.5 billion) above the C$3 billion earmarked for debt reduction is assumed to lead to extra spending and tax cuts in equal measure.

suggested that a cut in personal income tax rates and lowering taxes on saving would be more likely to stimulate labor supply, as well as saving and investment, than a lowering of the GST rate, a result also consistent with earlier work by the Department of Finance.[8] The consumption tax rate was low by international standards and maintaining its current level would also help to protect the tax base as the retiree population rose. Officials responded that any tax cut—including the GST—would lead to efficiency gains, and noted that the GST was highly unpopular.

26. ***On the spending side, staff noted that difficult decisions would be needed to achieve the planned expenditure containment***. These goals seemed ambitious given that they would be over and above the cuts already identified in the ongoing Expenditure Review, and in view of the agreed increase in transfers to the provinces. The team also noted that some targeting of the proposed child care allowance (a blanket C$1,200 per child under six) could lower the fiscal cost. Officials agreed that it would be a challenge to achieve the government’s limits on spending growth, but emphasized that the government’s approach would be disciplined and pragmatic, and that the limits were an appropriate response to the large increase in outlays that had occurred in recent years. As for the new child allowance, officials noted that the government’s goal was to provide parents with resources to choose the appropriate form of child care, and that means testing could exacerbate already high effective marginal income taxes at lower income levels.

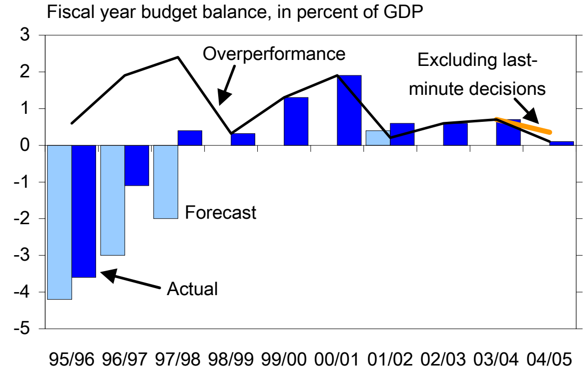
[8] In December 2005, the previous government passed two small personal income tax cuts. The government has yet to announce whether these cuts will be repealed.

27. ***It was still not clear how much of the previous fiscal framework would be retained, but officials underscored the new government's commitment to paying down debt***. In particular, they pointed to the plan to pay down C$3 billion in debt each year and noted that the previous framework had led to biased fiscal forecasts—e.g., persistently higher-than-expected surpluses—undermining both transparency and parliamentary oversight. Moreover, with government accountability a key priority of the new government, it had pledged to establish a new Parliamentary Budgetary Authority and require more accurate and timely budget forecasts.

28. ***The team responded that, given the uncertainties surrounding budget forecasts, achieving the new debt reduction objective would require a significant increase in budgetary reserves***. The O'Neill Report—commissioned by the previous government and written with input from Fund staff—argued that a cushion of about C$9 billion (¾ percent of GDP; 2–3 times the amount of past contingency reserves) would be needed to be reasonably certain of avoiding a budget deficit. A similarly high cushion will be needed to assure a C$3 billion minimum debt repayment.

Surpluses have consistently been larger than expected.

Fiscal year budget balance, in percent of GDP



Sources: Finance Canada; and Fund staff projections.

29. ***With the retirement of the baby boom generation imminent, the mission suggested elevating the role of public debt reduction as a fiscal policy objective***.[9] The staff argued that adopting a debt objective over a 5–10 year horizon would help anchor policies in the face of unexpected events that might make it difficult to achieve planned debt reduction in a given year. In addition, the team suggested further solidifying the social consensus for prudent fiscal policies by regular publication of an annual analysis of long-term budget prospects, thereby highlighting the fiscal challenges of an aging population.

30. ***Staff and officials agreed that it was essential to control the growth of health care spending*** (Box 3). Federal officials pointed out that spending increases in recent years had to some extent made up for large cuts in the early 1990s, which had helped Canada to become the only large industrial country to keep growth in health spending close to nominal GDP growth for more than a decade. The new government would adhere to the federal-provincial Health Accord of September 2004, which had fixed a 10-year path for federal funding of provincial health plans. The government would also work with provinces to establish wait

[9] Staff analysis emphasizing the role of debt reduction for long-term fiscal sustainability was presented in last year's Staff Report (IMF Country Report 05/118).

Box 3. Canada's Health System[1]

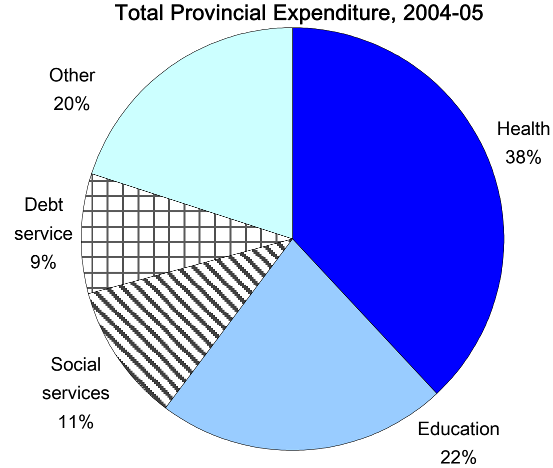
Canada's health care system involves both federal and provincial governments. While delivery is the responsibility of provincial governments, the Canada Health Act (CHA) establishes the following principles:

- ***Public administration***. Health plans are operated by provincial and territorial governments;
- ***Comprehensiveness***. Plans must cover all CHA services;
- ***Universality***. All residents are entitled to insured health services;
- ***Portability***. Coverage is not restricted by place of residence; and
- ***Accessibility***. Provinces and territories may not restrict access to insured health services, including by ability to pay.

These principles have been interpreted as precluding charges for medically necessary services covered by the Act. Moreover, provisions under the CHA require a cut in federal transfers to provinces that permit such changes.

While health care is the largest provincial expenditure, the federal government covers a significant part of the costs. Federal transfers to provinces include direct payments under the Canada Health Transfer (separated from transfers for social spending in 2004). In response to increasing frictions with provinces over federal support, in September 2004 the Prime Minister announced C$41 billion of new federal transfers over the next 10 years.

Total Provincial Expenditure, 2004-05



Source: Dominion Bond Rating Service.

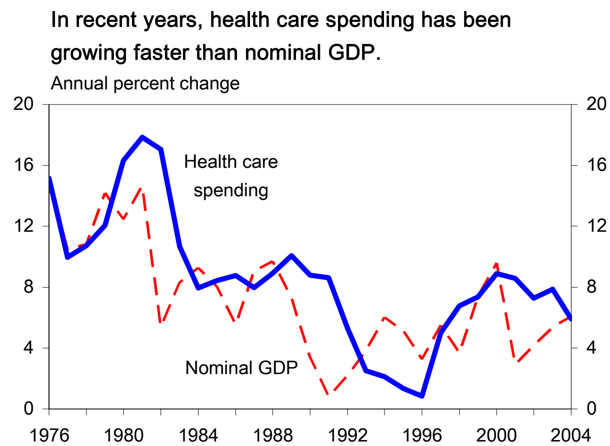
Even with increased funding, however, the public health system faces a range of challenges. With CHA's services provided free, demand has been contained in recent years through rising wait times, while provincial support for rapidly growing spending on prescription drugs (not covered under the CHA) has added to budget strains. Partly as a result, the proportion of total health spending covered by individuals has increased steadily to around 30 percent.

Recent court cases and reform plans underline strains on the existing public health system. Last year, the Supreme Court ruled that Quebec's policy prohibiting private insurance and restricting access to hospitals by doctors who have opted out of medicare violated the Quebec Charter of Human Rights and Freedoms. In a more recent case, an Ontario tribunal ruled that the province must reimburse a Toronto woman for a hip replacement surgery performed in Florida after it found the long expected wait time for the procedure in Canada would cause "medically significant irreversible tissue damage."

[1] Written by C. Schnure.

time guarantees for necessary medical services, while provincial measures to contain medical spending and establish and publish medical service benchmarks were expected to yield significant efficiency benefits.[10]

31. ***The new government has pledged to allow a mix of private and public health care delivery, so long as health care remains publicly funded and universally accessible***. In this context, officials suggested that greater flexibility in service delivery would increase efficiency, and noted that the rapid increase in private spending on health care expenses (e.g., on dental care and pharmaceuticals) suggested that there was more room for service innovation under the Canada Health Act (CHA) than was generally realized. In response to the team's suggestion that opening the system to more market mechanisms, including to user charges, could help better equilibrate supply and demand, officials observed the only strict mandate under the CHA was to prohibit charges for medically necessary services.



Sources: Canadian Institute of Health Information; and Haver Analytics.

32. ***The new government was committed to addressing vertical and horizontal financial imbalances between the federal and provincial governments***. Encouragingly, officials suggested that concerns over an unequal distribution of fiscal resources and responsibilities between the center and the provinces seemed to have dissipated as most of the latter were now running budget surpluses. As for horizontal imbalances, an expert panel was to provide recommendations this year for amending the system of equalization payments, which was designed to reduce differences in revenue bases across provinces. The mission questioned whether the current system was adequately taking account of disparities in natural resource endowments, especially given last year's decision to largely exempt royalties from offshore oil and gas production for some provinces. Officials responded that the authorities were committed to maintaining these earlier agreements and that the reforms would likely focus on reducing the complexity of the existing system and the volatility of payments.

33. ***During discussions with Alberta officials, the team mentioned Norway as a successful example for using investment funds to share windfall fiscal gains with future generations***. Benefiting from its natural resource base, Alberta has become essentially debt-free in 2005, and its tax rates are considerably lower than in other provinces. Concerning the future use of government surpluses, officials noted that C$1 billion had recently been

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[10] The Conference Board recently published a study using such data to rank provincial health systems which, along with similar publications, could support convergence toward best practices.

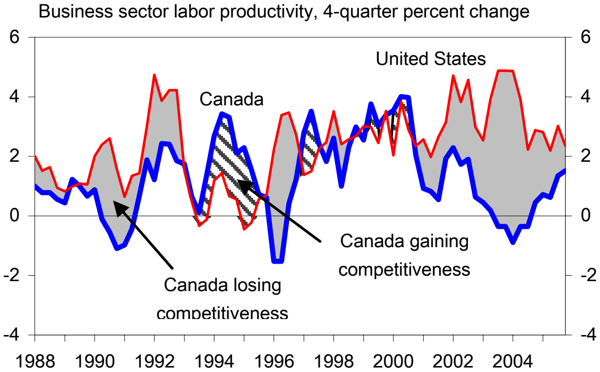
invested in Alberta's Heritage Savings Trust Fund—the first such deposit since 1987.[11] They did not rule out similar deposits going forward, but explained that the government was now focused on improving infrastructure and education to boost the province's production potential in future years, consistent with the nonrenewable nature of its resources.

VI. Policies to Increase Economic Efficiency and Flexibility

34. ***Canada's productivity performance in recent years has been somewhat disappointing***. Fast growth has chiefly stemmed from an increase in labor participation, and both investment and total factor productivity growth have lagged behind U.S. rates. While this trend continues to present somewhat of a puzzle, the most convincing explanation relates to a lack of capital deepening during the 1990s, a consequence of labor costs being low relative to the costs of mostly imported capital goods. However, especially in light of demographic trends that will significantly reduce the share of the working age population, and the importance of a flexible response of labor and capital to the opportunities presented by the sharp improvement in Canada's terms of trade, the team focused the discussions on policies that could help sustain growth and incomes.

Productivity growth has fallen short of that in the United States in recent years…

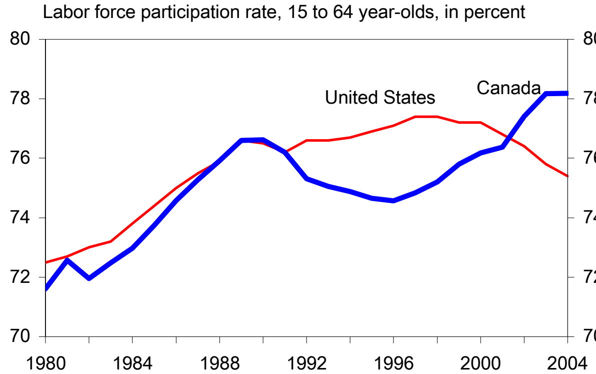
Business sector labor productivity, 4-quarter percent change



Source: Haver Analytics.

…but labor force participation has risen to levels well above those in the United States.

Labor force participation rate, 15 to 64 year-olds, in percent



Source: Haver Analytics; and OECD.

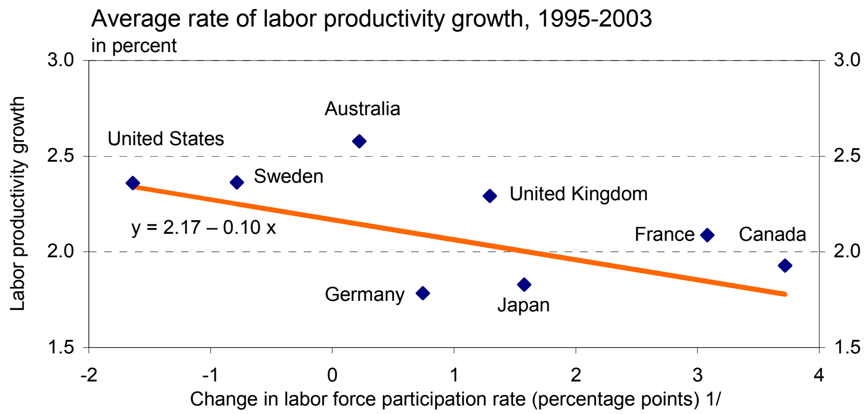
A. Taxes, Benefits, and Domestic Regulation

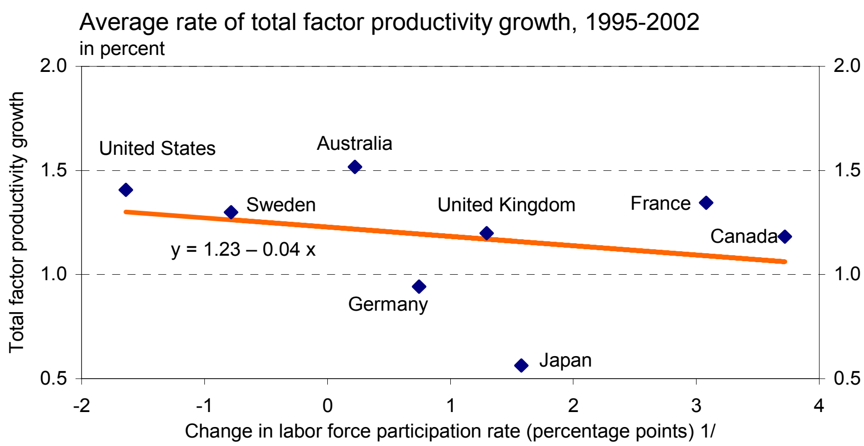
35. ***A key focus of the new government is to "reward effort" including by lowering taxes and reducing regulatory impediments to entrepreneurs***. As the corporate tax burden in Canada remains relatively high, both the corporate income tax surtax and the federal capital tax would be eliminated as of 2006, followed by cuts in marginal corporate tax rates. In order to stimulate job creation and innovation, the tax treatment of small businesses would be made more favorable, tax credits would be provided for the establishment of

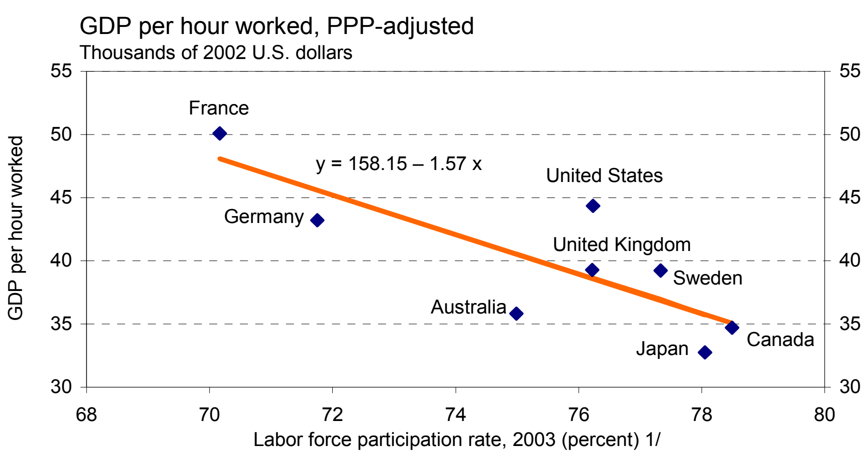
[11] Before the additional deposit, the fair value of the Fund stood at about C$14 billion at end-2005. Subsequent to these discussions, the FY 2006/07 budget pledged a further C$1 billion investment in the Heritage Fund.

Labor Force Participation and Productivity

Higher labor force participation growth tends to be associated with lower measured productivity growth, both in levels and in growth rates. Adjusted for this effect, Canada's productivity performance since the mid-1990s has been closer to the international experience.







Sources: OECD; Groningen Growth and Development Center; and Fund staff calculations. U.S. data is through 2002 only.

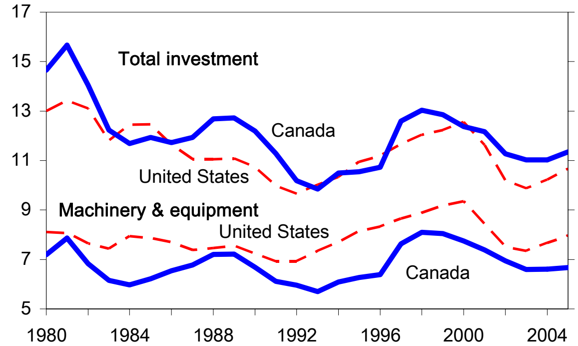
1/ Labor force participation rate is defined relative to working age population (15-64 years old).

apprenticeships, and options for expanding tax credits for R&D would be explored. On the personal income tax side, the government was sympathetic to raising the pension income amount eligible for tax relief and providing additional tax relief for capital gains when resources allowed.

36. ***Staff welcomed the emphasis on reducing the overall tax burden, but observed that Canada's marginal effective corporate tax rates would still be relatively high***. Indeed, U.S. rates could be a misleading benchmark, since these were well above those in countries such as Sweden and Australia.[12] Officials replied that Canada's close economic linkages implied that the highest priority was to avoid a loss of tax competitiveness vis-à-vis the United States, and that driving rates below U.S. levels was of limited effectiveness in attracting capital since the United States taxed its firms on the basis of global incomes. They also noted that marginal effective rates would fall significantly by 2010 when further tax reductions would be in place.

Business investment in machinery and equipment has been weak.

Business investment, in percent of GDP



Source: Haver Analytics.

Corporate income tax rates remain high.

Marginal Effective Tax Rate on Capital for Large and Medium-Sized Corporations, 2005

Source: Mintz, J.M. and others (2005), "The 2005 Tax Competitiveness Report: Unleashing the Canadian Tiger," Commentary, C.D. Howe Institute.

37. ***The mission voiced concern about the rollback in recent years of earlier reforms in the Employment Insurance (EI) program***. While staff analysis (summarized in Annex I) suggested Canadian labor markets were relatively efficient by international standards, the elimination of the intensity rule and the introduction of new pilot projects aimed at enhancing benefits in high unemployment areas could hinder labor market flexibility, and there was scope for reducing social benefits provided through the EI program. Officials observed that it had been important to raise benefits to ensure fairness for the most vulnerable regions, and cited a recent Supreme Court ruling that had supported the federal government's right to provide social benefits under the program.[13] They also noted that premiums had been lowered significantly and were now being set in a transparent manner,

[12] Effective tax rates on capital are discussed in J. Mintz and others, 2005, "The 2005 Tax Competitiveness Report: Unleashing the Canadian Tiger," C.D. Howe Institute Commentary No. 216 (Toronto).

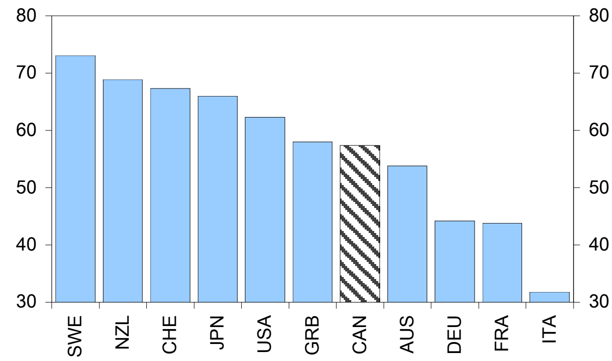
[13] The Supreme Court of Canada overruled in October 2005 an earlier Quebec Court of Appeal decision regarding the unconstitutionality of provision of maternity and parental benefits under the EI program.

and that the recent response of the labor market to the terms-of-trade shock illustrated its flexibility.

38. ***The team asked about the scope for reforms to improve labor market attachment***. As summarized in Box 4 and Annex I, staff analysis suggested that tax and benefit policies had helped boost female participation over the last decade. However, rapid clawbacks of provincial benefit programs had created high "welfare walls" and there also seemed scope for amendments to the formulas for calculating benefits under the Canada Pension Plan (CPP) to make retirement decisions actuarially neutral. Officials agreed that adjusting CPP benefits along these lines could improve labor market attachment among the elderly, although provincial agreement would be needed to make such changes.

The elderly labor force participation rate is average by international standards.

Labor force participation rate of 55 to 64 year olds, in percent



Source: OECD.

39. ***Officials agreed that a more flexible immigration policy could help ease current labor shortages, particularly in the west***. The key priority was not necessarily to encourage larger numbers of immigrants, but to increase the number of those whose skills matched the demand of the economy. At the same time, many immigrants seemed to be finding it difficult to succeed in the labor market, suggesting the need for increased settlement and integration services of the type pledged by the new government.

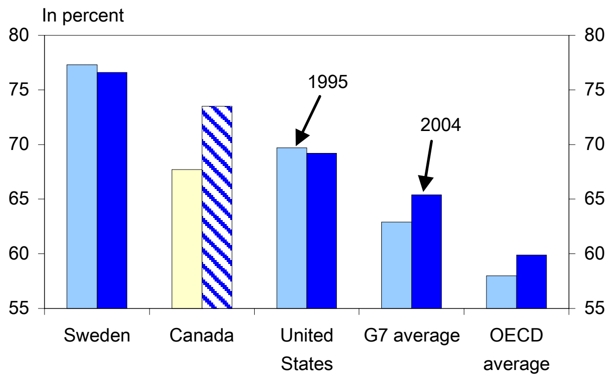
40. ***Officials agreed with staff on the necessity to remove the remaining restrictions on internal trade and facilitate internal labor mobility***. Provinces had achieved progress on a dispute settlement process, and negotiations on energy had reached an advanced stage, coupled with plans to develop a pan-Canadian energy strategy this summer. A federal initiative was launched in April 2005 to advance the recognition of foreign credentials, and provinces had made the elimination of other barriers to labor mobility a key priority.

41. ***The mission suggested that there was room for more ambitious product market reform, including by improving the attractiveness of Canada as an investment destination*** (Box 5). OECD indicators imply that Canada's product market regulation has reverted to the (GDP-weighted) average of the G-7 since the late 1990s. By contrast, Australia—another highly successful economy over the last decade—has moved further ahead of this yardstick, including by reforming its electricity sector. As regards foreign investment, the Investment Canada Act's restrictions on foreign ownership in network industries and thresholds for review appeared restrictive and might be discouraging resource and technology transfer. While some officials were sympathetic with this view, others responded that the investment screening requirements provided a rarely used but necessary safeguard.

Box 4. Rising Labor Participation and the Tax and Benefit System[1]

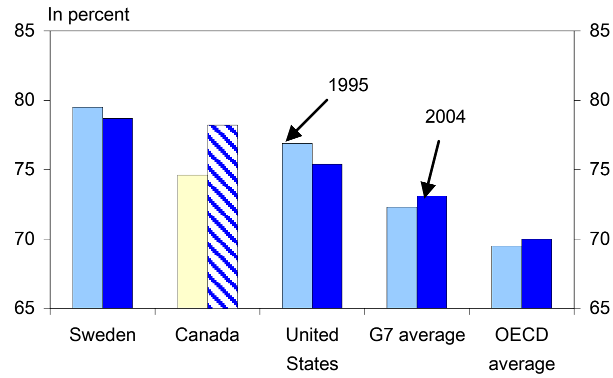
The Canadian participation rate has risen rapidly over the last decade, driven by greater female participation. Canada's participation rate has surpassed that of the United States and is now approaching that of Sweden.

Female labor force participation rates, 1995 - 2004



Source: OECD.

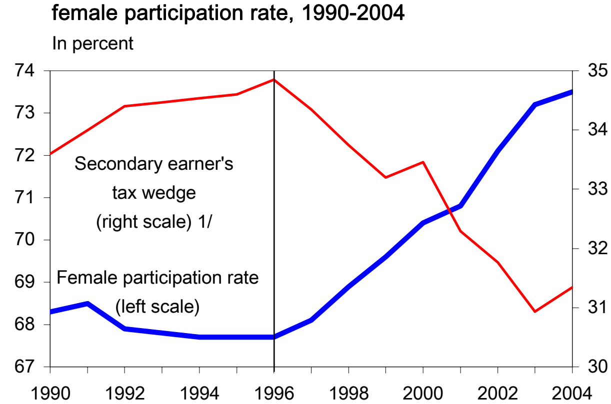
Total labor force participation rates, 1995 - 2004



Source: OECD.

This remarkable achievement partly reflects the effects of falling tax wedges on secondary earners. While the wedge on primary workers has stayed relatively stable since 1996, that on secondary earners has fallen steadily. This divergence reflects policies such as the enhancement of the child credit in 1997 and the introduction of the working income supplement for working poor in the 1996/97 budget.

Canada: Tax wedge for secondary earners and female participation rate, 1990-2004



Sources: Jaumotte (2003); OECD; and Fund staff calculations.

1/ Excluding social security contributions due to data limitations. Assuming secondary earner receives 67 percent of average production worker's wage.

In addition, child care reforms have supported female labor market participation. Federal maternity and parental leave benefits have been expanded and provision of publicly provided childcare has improved. At the provincial level, Quebec has introduced a comprehensive family support policy in 1997 while elsewhere fee subsidization is available for low-income and other needy groups, and there is an implicit subsidy through the Child Care Expense Deduction.

The staff's cross-country analysis indicates that at least one-third of the last decade's increase in female participation could be explained by the reforms in the tax and child care system. The secondary earner's tax wedge acts as a disincentive to labor participation while childcare benefits encourage women to enter the labor market. Further reforms to reduce the tax wedge on secondary earners would help further support female participation, although the proposed family allowance unrelated to labor market activity is unlikely to have a significant effect. More generally, the analysis underlines the potential role of policies in supporting participation of the aged and the poor, where Canada's performance is average by international standards.

[1] Written by E. Tsounta. See also Annex I.

Box 5. Structural Reforms and Economic Growth: Canada and Australia[1]

Both Canada and Australia have grown rapidly over the last decade, supported by sound macroeconomic frameworks and structural reform programs. As major commodity producers, both countries are relatively exposed to external shocks. Nonetheless, inflation targeting has yielded near price stability in both countries, and prudent fiscal frameworks have delivered significant reduction in public debt—Australia's net government debt is negligible, and debt has fallen to under 40 percent of GDP in Canada. Concomitantly, average economic growth since 1995 has increased in both countries relative to the 1981–1994 period and to the GDP-weighted average growth of the "G-6" (i.e., G-7 nations excluding Canada).

Period	Real GDP Per Capita			Labor Productivity		Labor Utilization	
	Canada	Australia	G-6	Canada	Australia	Canada	Australia
1995-2004	2.15	2.32	2.02	1.28	1.76	0.93	0.23
1981-1994	1.04	1.49	1.78	1.15	1.20	-0.23	0.16

1/ Average annual growth rates.

- ***However, the rise in Australia's per capita GDP growth reflects an increase in labor productivity growth, while in Canada the faster growth largely reflects higher labor utilization***. Consistent with this observation, OECD structural reform indicators, which are derived from measures of competitiveness in specific market segments, suggest that Australia has moved ahead of Canada and the GDP-weighted G–6 in the product markets, while Canada continues to have a more flexible labor market. Specifically:

- *Product market reform.* Commencing in the mid-1980s, Australia's "National Competition Policy" gradually reformed product markets toward OECD 'best practice' status in the electricity, airlines, post, and road sectors—surpassing Canada's overall benchmark index by the mid-1990s.[2] By contrast, Canada has reverted to the G–6 average, and the OECD has noted that Canada could undertake further reforms in its electricity and rail sectors. In addition, corporate effective tax rates remain high.

Relative Structural Reform Indices and Tax Rates

	Canada		Australia	
	1995	2004	1995	2004
Structural reform indices 1/				
Product markets 2/	1.18	1.00	1.28	1.34
Labor markets	1.10	1.09	0.73	0.74
Average Effective Tax Rates				
Labor	27%	25%	24%	24%
Corporate	39%	31%	28%	18%

Sources: OECD; C.D. Howe Institute; and Fund staff estimates.
1/ Relative to a PPP-weighted average of the same indicators for the G-6.
2/ For 1998 and 2003.

- *Labor markets*. Canada's continuing advantage rests in the labor market, despite some rolling back of reforms to Canada's Employment Insurance system in recent years. Australia passed important labor reforms in the mid-1990s, which linked wages more closely to productivity by greatly decentralizing the wage-setting process. In late 2005, legislation was approved to reduce dismissal costs for small companies, narrow the range of minimum working conditions, and establish a new commission to determine minimum wage increases.

With gains from higher labor market participation likely to diminish in Canada, Australia's experience suggests that further product market reforms could help improve Canada's labor productivity. Of particular benefit would be the removal of restrictions on inter-provincial trade and FDI. In particular, provincial governments could aim to increase competition in sectors dominated by government-owned firms (e.g., electricity), possibly through privatization as occurred in Australia and in the Canadian gas industry.

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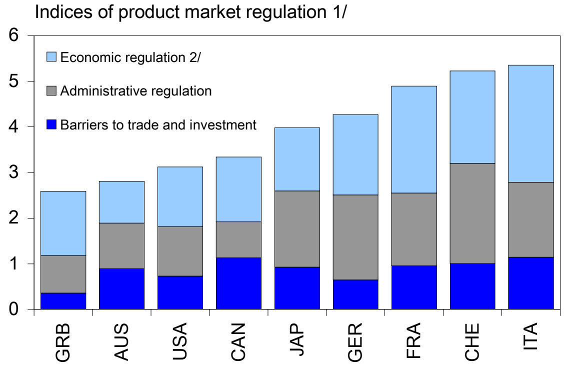
[1] Written by S. Ouliaris.

[2] "The Benefits of Liberalizing Product Markets and Reducing Barriers to International Trade and Investment in the OECD," Economics Department Working Paper No. 463, December 2005.

While overall product market regulation is not too pervasive, there is scope to reduce impediments to trade and investment...

Indices of product market regulation 1/



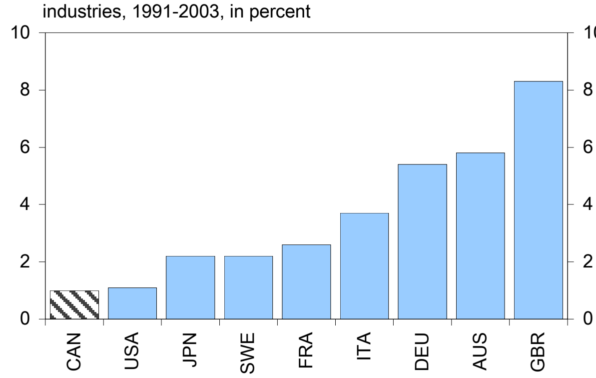
Source: Conway, P., V. Janod, and G. Nicoletti (2005), "Product Market Regulation in OECD Countries, 1998 to 2003," OECD Economics Department Working Paper, No. 419.

1/ The scale of the indicators is 0-6 from least to most restrictive.

2/ Includes barriers to competition and state control.

… and boost productivity growth in utilities.

Labor productivity growth in electricity, gas and water supply industries, 1991-2003, in percent



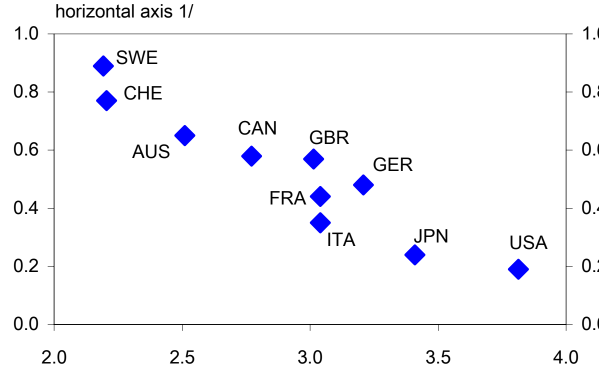
Source: OECD, 2004, "Canada Country Survey."

B. Financial Sector Policies

42. ***Officials were pleased with overall conditions in Canada's financial sector***. They noted that aggregate bank capital and credit quality were extremely high, providing banks with a comfortable financial buffer. Some limited credit risks were seen from a combination of high energy prices, exchange rate appreciation, and competition from Asia that placed significant financial stress on sectors such as auto that were collectively owing about 12 percent of corporate debt. On the regulatory front, officials noted that a forthcoming Legislation Review would aim at eliminating some regulatory overlap and simplifying the rules on foreign bank entry. The authorities also agreed in principle to conduct an FSAP update in conjunction with a 2007 FATF review of Canada.

Canada's banking system does not seem overly concentrated relative to the size of its economy.

Bank concentration, in percent, vertical axis; log PPP GDP, horizontal axis 1/



Source: Beck, T. and others, 2003, "Bank Concentration and Crises," Policy Research Working Paper #WPS 3041, World Bank.

1/ Concentration is calculated as the fraction of assets held by the largest three banks in each country from 1988 to 1997.

43. ***Staff expressed concern about the lack of progress in addressing regulatory issues related to bank mergers and securities markets***:

- *Bank mergers*. Officials reported that there was still a considerable debate on the size of efficiency gains that might result from mergers among Canada's large financial institutions, and how these might be weighed against competition and other considerations.
- *Securities market regulation*. Although most provinces continued to oppose the introduction of a national securities regulator, officials explained that the need to harmonize regulatory regimes across provinces was widely recognized. Provinces had agreed on key objectives, including better enforcement of existing regulations and representation on the international scene, but progress had been hampered by disagreements over the final regulatory setup.

44. ***Given the underfunding of many defined benefit (DB) plans, staff welcomed progress on reforming regulation of corporate pension plans***. Officials noted that the decline in solvency ratios had largely been a consequence of the low interest rate environment and an upward revision of average life expectancy in actuarial assumptions, although the incentives for sponsors to maintain financial contributions needed to be strengthened. Measures under discussion included extending tax preferences for plan overfunding, addressing perceived asymmetries in the distribution of plan surpluses, and an extension of the period over which pension funds had to restore solvency. Such initiatives would also help maintain a system where DB and defined contribution plans both remained viable options.

45. ***Officials reported that significant harmonization of corporate governance rules with the United States had taken place***. The focus had been on strengthening enforcement, improving financial reporting and disclosure, enhancing the quality of the audit process and strengthening management accountability. However, the Canadian Securities Administrators had decided against requiring auditor certification of internal controls over financial reporting, in part reflecting the high cost of reporting particularly for smaller firms.

46. ***Officials explained that the string of fiscal surpluses was increasingly affecting the government's ability to maintain depth and liquidity in benchmark bond issues***. Annual bond issuance had fallen quite dramatically, and the government was running out of bonds to buy back without "cannibalizing" some key benchmark issues. Staff agreed that converting Crown Corporation debt—which is backed by the full faith and credit of the government—to government bonds could boost liquidity of the government's benchmark issues and save up to 10–15 basis points in liquidity premium.[14]

C. Trade and International Assistance

47. ***Officials observed that progress had been made during the Hong Kong Ministerial Conference, but acknowledged that more had to be done***. They viewed the outcome of the

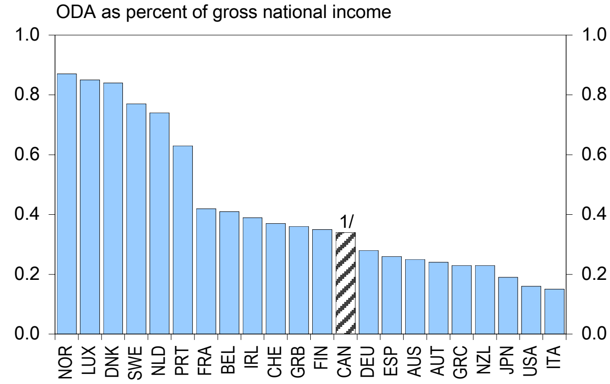
[14] Crown Corporation debt amounts to about one tenth of outstanding government debt and, at C$11 billion, new issuance would significantly deepen the government's current C$30–35 billion issuance of new securities.

Doha Round as largely dependent on a compromise between the larger players in the process. In response to the mission's call for Canadian leadership in liberalizing access to agricultural markets, officials reiterated the government's commitment to protecting Canada's supply management systems.

48. ***Officials noted that progress had been made in addressing the Canada-U.S. softwood lumber dispute***. The recent reduction in the U.S. anti-dumping duty had been helpful, and officials cautiously welcomed the U.S. decision to rescind the Byrd amendment going forward. However, they expressed frustration that dispute settlement procedures appeared to have been relatively ineffective in this case, an issue that had broader ramifications for a rules-based international trading system. However, they did not see the WTO and NAFTA dispute settlement mechanisms as providing an incentive for "forum shopping," but rather viewed these processes as mutually reinforcing.

Canada ranks in the middle of ODA contributors.

ODA as percent of gross national income



Source: OECD.

1/ 2004 data, except 2005 for Canada.

49. ***Officials reiterated their commitment to double the International Assistance Envelope by the end of the decade***. They noted that half of this additional funding would be targeted to Africa, further strengthening Canada's role in the G–8 Action Plan for Africa. Canada also announced the cancellation of all debt held by Senegal, Madagascar, Ghana, and Ethiopia.

VII. Staff Appraisal

50. ***Canada's macroeconomic and policy performance has continued to exceed most other industrial countries and its outlook remains favorable***. Employment continues to expand at a solid pace and the boom in energy prices has provided considerable support to domestic incomes, while taking the external current account surplus to a record high. Fiscal and monetary policy implementation in recent years has been enviable, underpinned by firm commitments to avoiding fiscal deficits and to an inflation target. Although the economy continues to face risks, including those related to the low household saving rate and a possible disorderly unwinding of global imbalances, growth is expected to remain at around its underlying potential of 3 percent through 2007, with inflation returning to the 2 percent target.

51. ***The favorable domestic and external environment provides the new government an important opportunity to boost the economy's long-term growth potential***. Despite a robust expansion in recent years and unemployment dropping to a 31-year low, productivity growth has been less impressive. In addition to maintaining prudent fiscal and monetary policies—

and especially in the face of the coming retirement of the baby boom generation and global competition—there remains a need to further improve the economy's flexibility.

52. ***The Bank of Canada has appropriately continued to withdraw stimulus in recent months***. Looking forward, the support to activity from high commodity prices will need to be balanced against the drag from an appreciated exchange rate—which remains valued in line with fundamentals, including favorable terms of trade—and the potential for an abrupt unwinding of global current account imbalances. Although further modest increases in the overnight rate will likely be required to bring inflation back to target, the Bank's credible commitment to price stability provides scope to respond flexibly to macroeconomic developments. While Canada's inflation targeting framework is due for renewal this year, the success achieved thus far does not suggest the need for significant amendments. The Bank is highly transparent but further progress could be made in communicating key assumptions underlying policy decisions, including the risks to the outlook.

53. ***The new government has declared a welcome commitment to lowering the tax burden, maintaining fiscal surpluses, and continuing debt reduction***. The emphasis on limiting government spending is appropriate, but the challenge will be to identify areas where cuts can be implemented to accommodate the new government's priorities. Planned reductions in corporate rates and the early elimination of the federal capital tax are also warranted given the relatively high level of Canada's marginal effective corporate tax rates. However, rather than cutting the GST rate, reducing marginal personal income tax rates and increasing tax-deferred saving limits would seem a more effective use of scarce fiscal resources. In particular, shifting the tax burden from income toward consumption would improve incentives to save and invest, while supporting revenues as the population ages.

54. ***The new budget will also need to ensure that a prudent fiscal framework is maintained***. To be sure, under the previous budget rule fiscal outturns surprised on the upside, although this partly reflected the unexpected strength of commodity prices and growth whose permanence is uncertain. Given the significant uncertainties surrounding budget forecasts and the federal debt ratio still around 40 percent of GDP, there would seem merit in raising budgetary reserves and anchoring policies on a debt objective over a 5–10 year horizon. The social consensus for prudent fiscal policies could be further supported by an annual analysis of long-term budget prospects by an independent body, providing a regular reminder that debt reduction is needed to face the challenges of population aging.

55. ***Addressing fiscal stresses at the provincial level will also be necessary to support longer-term fiscal sustainability:***

- Provincial/territorial health outlays are rising at a rapid rate and the system remains under considerable pressure. The agreement to lock in federal health transfers over the next 10 years provides provinces with appropriate incentives and opportunities to improve both the efficiency and quality of health care systems. However, there remains a case for allowing provinces greater flexibility in using price and other market-based mechanisms to help align the demand and supply for health care.

- The forthcoming review of the Equalization system offers the opportunity to ensure that regional disparities in fiscal capacity are not exacerbated by the boom in oil and gas revenues. It would be appropriate to ensure that any new allocation formula takes resource-based revenues into account.

56. ***Although Canada has been among the fastest growing industrial countries in recent years, its productivity performance has been less encouraging***. Looking ahead, economic potential could be boosted by placing priority on the following areas:

- *Labor markets*. There is a need for continuing to place priority on reducing welfare walls to improve labor participation among low income groups, amending immigration systems to help address skills shortages, and simplifying the recognition of occupational qualifications across provinces. Consideration could also be given to funding the Employment Insurance system's parental and other social benefits through general revenues, rather than the payroll tax, and to curbing extended regional benefits, in order to reduce the system's adverse effects on employment and economic efficiency.

- *Product markets*. Sector-specific constraints and thresholds for review under the Investment Canada Act seem outmoded and may discourage foreign direct investment. Regulatory reform is also needed in the electricity sector, where productivity growth has been lower and markups higher than in many other industrial countries.

- *Trade and agriculture*. Canada can play an important leadership role in completing the Doha Round, particularly by widening market access for agricultural goods, including those subject to "supply management" schemes.

57. ***The financial system appears well placed to support growth***. Profitability and balance sheet positions are favorable, and the system is effectively supervised and regulated. However, especially in the context of increased global competition for financial services, the system's efficiency and resilience could be improved by measures in the following areas:

- *Bank mergers.* Greater clarity regarding the public interest criterion would allow a more transparent examination of potential benefits and costs of merger proposals.

- *Securities regulation.* Harmonizing securities regulation would reduce compliance and administrative costs while simplifying rule making and supervision. We support the establishment of a national securities regulator, as is typical in most other industrial countries and was proposed in the report by the Wise Persons' Committee.

- *Defined benefit pension plans*. The funding situation of Canada's defined benefit plans—which are largely concentrated in shrinking traditional sectors—appears to have deteriorated further over the past year. The recent decision to enter into a public consultation on regulatory reform is welcome and early action is warranted to better align the incentives of plan sponsors and members to improve funding of the system.

58. ***It is recommended that the next consultation occur on the usual 12-month cycle***.

Table 1. Canada: Indicators of Economic Performance

		Average							Projections	
		1996–2005	2000	2001	2002	2003	2004	2005	2006	2007
					(In annual percent change)					
Per capita real GDP	Canada	2.3	4.3	0.7	1.9	1.0	1.9	2.0	2.0	2.1
	United States	2.2	2.5	-0.3	0.6	1.7	3.2	2.6	2.4	2.3
	Euro Area	1.6	3.3	1.5	0.4	0.2	1.5	0.8	1.7	1.6
	Japan	1.0	2.7	0.1	-0.1	1.6	2.2	2.7	2.7	2.1
	United Kingdom	2.4	3.7	1.8	1.6	2.1	2.7	1.3	2.0	2.2
	Australia	2.4	2.1	0.9	2.9	1.9	2.3	1.2	1.6	1.9
	Sweden	2.5	4.1	0.8	1.6	1.3	3.3	2.3	3.1	2.0
Real GDP	Canada	3.3	5.2	1.8	3.1	2.0	2.9	2.9	3.1	3.0
	United States	3.3	3.7	0.8	1.6	2.7	4.2	3.5	3.4	3.3
	Euro Area	2.0	3.8	1.9	0.9	0.7	2.1	1.3	2.0	1.9
	Japan	1.2	2.9	0.4	0.1	1.8	2.3	2.7	2.8	2.1
	United Kingdom	2.8	4.0	2.2	2.0	2.5	3.2	1.8	2.5	2.7
	Australia	3.7	3.3	2.2	4.1	3.1	3.6	2.5	2.9	3.2
	Sweden	2.7	4.3	1.1	2.0	1.7	3.7	2.7	3.5	2.4
Real domestic demand	Canada	3.7	4.7	1.2	3.5	4.7	4.0	4.6	3.5	3.0
	United States	3.8	4.4	0.9	2.2	3.0	4.7	3.6	3.4	3.1
	Euro Area	2.0	3.3	1.2	0.4	1.3	2.0	1.5	2.0	1.8
	Japan	1.0	2.4	1.2	-0.6	1.2	1.6	2.6	2.3	2.1
	United Kingdom	3.4	4.1	2.8	3.2	2.7	3.8	1.8	2.5	2.8
	Australia	4.5	2.4	1.0	6.4	5.7	5.6	4.1	4.0	3.2
	Sweden	2.0	3.9	-0.2	0.8	1.6	1.3	2.7	3.2	2.4
GDP deflator	Canada	2.0	4.1	1.1	1.0	3.3	3.1	3.1	3.0	1.7
	United States	2.0	2.2	2.4	1.7	2.0	2.6	2.8	2.4	2.0
	Euro Area	1.9	1.5	2.7	2.5	2.0	1.9	2.0	2.1	2.1
	Japan	-1.0	-1.7	-1.2	-1.6	-1.6	-1.2	-1.3	0.0	0.4
	United Kingdom	2.5	1.2	2.3	3.1	2.9	2.1	2.1	2.7	2.6
	Australia	2.6	4.1	4.0	2.6	3.2	3.4	4.5	3.5	2.5
	Sweden	1.3	1.4	2.1	1.6	2.0	0.8	1.1	2.1	2.2
					(In percent of GDP)					
General government financial balance	Canada	0.8	2.9	0.7	-0.1	0.0	0.7	1.7	1.3	1.1
	United States	-2.0	1.3	-0.7	-4.0	-5.0	-4.7	-4.1	-4.3	-4.0
	Euro Area	-2.4	-1.0	-1.9	-2.6	-3.0	-2.7	-2.5	-2.5	-2.3
	Japan	-6.5	-7.7	-6.4	-8.2	-8.1	-6.6	-5.8	-5.7	-5.4
	United Kingdom	-1.4	1.5	0.9	-1.5	-3.2	-3.2	-3.0	-2.9	-2.7
	Australia	0.7	1.4	0.1	0.3	1.1	1.1	0.8	0.6	0.6
	Sweden	1.0	5.0	2.6	-0.5	-0.1	1.0	1.4	0.7	1.1
Gross national saving	Canada	21.3	23.6	22.2	21.3	21.7	22.9	23.4	24.5	24.7
	United States	15.9	18.0	16.4	14.2	13.4	13.4	13.6	14.1	14.4
	Euro Area	21.1	21.3	21.1	20.7	20.4	21.1	21.0	21.3	21.6
	Japan	27.7	27.8	26.9	25.9	26.2	26.4	26.8	26.9	26.9
	United Kingdom	15.5	15.0	15.0	15.2	14.8	14.9	14.7	14.8	15.1
	Australia	19.8	19.8	20.0	20.1	20.2	19.5	20.1	20.5	20.6
	Sweden	21.9	22.4	22.0	21.7	23.7	23.1	23.4	23.2	23.4
Fixed investment	Canada	19.6	19.2	19.6	19.5	19.6	20.1	20.5	20.8	21.2
	United States	19.2	20.2	19.5	18.3	18.3	19.1	19.9	20.2	20.6
	Euro Area	20.4	21.4	20.9	20.1	19.9	20.0	20.4	20.8	21.1
	Japan	25.0	25.2	24.7	23.3	22.9	22.9	23.3	24.0	24.3
	United Kingdom	16.7	17.0	16.6	16.5	15.9	16.4	16.6	16.9	17.2
	Australia	24.1	23.5	22.2	24.1	25.1	25.3	25.6	25.4	25.3
	Sweden	16.6	17.5	17.3	16.5	16.0	16.1	17.1	17.7	18.2
Current account balance	Canada	1.1	2.7	2.3	1.8	1.5	2.2	2.2	3.1	2.9
	United States	-3.8	-4.2	-3.8	-4.5	-4.7	-5.7	-6.4	-6.5	-6.5
	Euro Area	0.1	-1.3	-0.3	0.7	0.5	0.7	-0.4	-0.1	0.1
	Japan	2.8	2.6	2.1	2.9	3.2	3.8	3.6	3.2	2.9
	United Kingdom	-1.6	-2.6	-2.2	-1.6	-1.4	-2.0	-2.2	-2.2	-2.2
	Australia	-4.5	-3.9	-2.1	-3.9	-5.6	-6.3	-6.0	-5.6	-5.5
	Sweden	5.0	4.1	4.4	5.1	7.3	6.8	6.1	5.1	4.5

Sources: Fund staff estimates; and IMF, World Economic Outlook.

Table 2. Canada: Selected Economic Indicators

(In percent change at annual rates and seasonally adjusted, unless otherwise indicated)

					Projections							
	2005				2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NIPA in constant prices												
Real GDP	2.1	3.6	3.5	2.5	3.2	3.1	3.0	3.0	3.0	3.0	3.0	3.0
Net exports 1/	-1.3	0.9	-0.7	-0.2	-0.6	-0.3	0.2	0.2	0.2	0.2	0.2	0.1
Total domestic demand	3.4	2.6	4.5	3.0	4.0	3.6	3.0	2.9	2.9	2.9	2.9	3.0
Final domestic demand	5.4	3.9	4.2	4.3	3.8	3.4	2.9	2.9	2.9	2.9	2.9	3.0
Private consumption	6.1	3.8	2.4	2.9	4.0	3.7	2.8	2.7	2.4	2.4	2.5	2.7
Personal saving ratio (in percent of DI)	-0.3	-0.6	-0.1	0.3	...	...	...	...	...	...	...	...
Public consumption	2.3	3.2	4.4	3.6	2.1	1.5	1.5	1.6	2.6	2.6	2.6	2.6
Private fixed domestic investment	6.5	5.2	9.5	8.6	4.8	4.4	4.3	4.3	4.3	4.3	4.2	4.2
Machinery and equipment	11.8	2.9	15.3	13.3	6.0	6.0	5.9	5.9	5.7	5.7	5.5	5.5
Residential construction	-2.2	6.7	2.5	1.4	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Private investment (in percent of GDP)	17.8	17.9	17.9	17.9	18.0	18.1	18.2	18.3	18.4	18.5	18.6	18.7
Public investment	8.0	1.8	5.0	11.1	5.4	5.4	5.4	5.4	4.3	4.3	4.3	4.3
Change in inventories 1/	-1.5	-1.5	0.4	-0.8	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.0
GDP (current prices)	3.4	6.2	10.5	8.3	4.9	4.4	4.5	5.1	4.9	3.9	4.8	5.8
Employment and inflation												
Unemployment rate (percent)	7.0	6.8	6.8	6.5	6.6	6.6	6.6	6.6	6.6	6.6	6.6	6.6
Employment	0.9	1.7	1.5	2.4	0.5	0.9	0.9	0.9	0.9	0.9	0.9	0.9
CPI inflation (y/y)	2.1	1.9	2.7	2.3	2.2	2.0	1.5	1.7	2.0	2.0	2.0	2.0
Core CPI inflation (y/y)	1.5	1.9	1.1	2.0	...	...	...	...				
GDP deflator	1.4	2.8	6.6	5.5	1.6	1.3	1.5	2.1	1.8	0.9	1.7	2.7
Potential output growth	2.8	2.8	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9	3.0	3.0
Output gap (in percent of potential output)	-0.4	-0.3	-0.1	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Interest rates 2/												
Three-month treasury bill (percent)	2.5	2.5	2.7	3.2	3.6	3.8	4.0	4.1	4.2	4.3	4.3	4.3
Ten-year government bond yield (percent)	4.3	4.0	3.9	4.1	4.1	4.4	4.6	4.9	5.1	5.2	5.3	5.4
External indicators												
Current account balance (in percent of GDP)	1.3	1.5	2.2	3.8	3.3	3.1	3.0	3.1	3.1	2.8	2.8	3.0
Merchandise trade balance (in percent of GDP)	3.9	4.1	5.2	6.2	6.0	5.8	5.6	5.6	5.6	5.4	5.3	5.5
Export volume	3.8	-0.6	9.1	10.5	3.3	3.8	5.1	5.3	5.3	5.3	5.3	5.1
Import volume	9.2	-4.5	12.4	13.0	5.9	5.4	5.3	5.3	5.2	5.2	5.2	5.3
Balance on invisibles (in percent of GDP)	-2.6	-2.6	-2.9	-2.4	-2.7	-2.6	-2.6	-2.5	3.1	2.8	2.7	3.0
Exchange rate 2/	0.81	0.80	0.84	0.85	...	...	...	...	...	...	...	...
Nominal effective exchange rate (q/q) 2/	-1.2	-0.5	4.3	3.2	...	...	...	...	...	...	...	...
Real effective exchange rate (q/q) 2/	-1.5	-0.5	4.7	4.0	...	...	...	...	...	...	...	...
Terms of trade 2/	-2.2	-0.8	16.1	13.5	0.6	-1.6	-1.5	0.4	-0.3	-2.8	-0.6	2.2
Saving and investment (in percent of GDP)												
Gross national saving	22.6	22.7	23.6	24.5	...	...	...	...	...	...	...	...
General government	3.9	4.1	4.2	5.0	...	...	...	...	...	...	...	...
Private	18.8	18.6	19.4	19.5	...	...	...	...	...	...	...	...
Personal	2.7	2.6	2.8	3.1	...	...	...	...	...	...	...	...
Business	16.0	16.0	16.6	16.5	...	...	...	...	...	...	...	...
Gross domestic investment	21.5	21.1	21.1	21.0	...	...	...	...	...	...	...	...

Table 2. Canada: Selected Economic Indicators (concluded)

(In percent change, unless otherwise indicated)

				Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011
NIPA in constant prices									
Real GDP	2.0	2.9	2.9	3.1	3.0	2.9	2.9	2.9	2.9
Q4/Q4	1.7	3.3	2.9	3.1	3.0	2.9	2.9	2.9	2.9
Net exports 1/	-2.4	-0.9	-1.5	-0.3	0.2	0.1	0.1	0.1	0.0
Total domestic demand	4.7	4.0	4.6	3.5	3.0	3.0	2.9	3.0	3.0
Final domestic demand	3.6	3.9	4.3	3.7	2.9	3.0	2.9	3.0	3.0
Private consumption	3.1	3.4	4.0	3.3	2.6	2.8	2.8	2.9	3.0
Personal saving ratio (in percent of DI)	2.4	1.4	-0.2	0.7	0.5	0.5	1.5	1.5	1.5
Public consumption	2.9	2.7	2.8	2.5	2.2	2.5	2.5	2.4	2.3
Private fixed domestic investment	6.2	6.9	6.9	5.9	4.3	3.8	3.6	3.6	3.6
Machinery and equipment	6.4	9.8	10.7	8.2	5.7	5.2	5.0	4.9	4.9
Residential construction	6.2	8.3	3.3	2.9	3.0	2.4	2.0	2.0	2.0
Private investment (in percent of GDP)	17.0	17.5	17.9	18.2	18.6	18.9	19.2	19.5	19.8
Public investment	4.5	4.9	4.2	6.1	4.7	4.3	4.3	4.3	4.4
Change in inventories 1/	0.9	0.0	0.3	-0.2	0.1	0.0	0.0	0.0	0.0
GDP (current prices)	5.4	6.1	6.1	6.1	4.7	4.8	4.8	4.8	4.8
Employment and inflation									
Unemployment rate (percent)	7.6	7.2	6.8	6.6	6.6	6.6	6.6	6.6	6.6
Employment	2.4	1.8	1.4	1.2	0.9	0.8	0.8	0.8	0.7
CPI inflation	2.7	1.8	2.2	1.8	2.0	2.0	2.0	2.0	2.0
GDP deflator	3.3	3.0	3.1	3.0	1.7	1.8	1.8	1.8	1.8
Potential output growth	2.8	2.8	2.8	2.9	2.9	2.9	2.9	2.9	2.9
Output gap (in percent of potential output)	-0.5	-0.4	-0.3	-0.1	0.0	0.0	0.0	0.0	0.0
Indicators of fiscal policies (NIA basis, in percent of GDP)									
Federal fiscal balance	0.1	0.6	0.4	0.3	0.2	0.2	0.2	0.2	0.2
Provincial fiscal balance 3/	-0.9	-0.7	0.7	0.4	0.3	0.0	0.0	0.0	0.0
General government fiscal balance 3/	0.0	0.7	1.7	1.3	1.1	0.7	0.7	0.6	0.6
Three-month treasury bill (percent)	2.9	2.2	2.7	3.9	4.3	4.3	4.3	4.3	4.3
Ten-year government bond yield (percent)	4.8	4.6	4.1	4.5	5.3	5.5	5.5	5.5	5.5
External indicators									
Current account balance (in percent of GDP)	1.5	2.2	2.2	3.1	2.9	2.8	2.8	2.7	2.6
Merchandise trade balance (in percent of GDP)	4.7	5.1	4.9	5.8	5.5	5.3	5.2	5.1	4.9
Export volume	-1.8	5.4	2.6	5.5	5.1	4.8	4.8	4.5	4.4
Import volume	3.6	8.3	7.7	7.1	5.2	5.0	4.8	4.8	4.8
Balance on invisibles (in percent of GDP)	-3.2	-2.9	-2.7	-2.6	-2.5	-2.5	-2.4	-2.4	-2.3
Terms of trade	5.9	3.9	3.9	4.0	-0.7	-0.3	-0.1	-0.2	-0.1
Saving and investment (in percent of GDP)									
Gross national saving	21.7	22.9	23.4	24.5	24.7	24.9	25.2	25.4	25.6
General government	2.5	3.3	4.4	3.9	3.7	3.3	3.3	3.3	3.2
Private	19.2	19.6	19.0	20.5	21.0	21.6	21.9	22.1	22.3
Personal	4.3	3.8	4.9	6.2	6.5	6.9	7.3	7.7	7.8
Business	14.8	15.6	14.1	14.3	14.6	14.7	14.6	14.5	14.5
Gross domestic investment	20.2	20.7	21.1	21.3	21.8	22.1	22.4	22.7	23.0

Sources: Haver Analytics; and Fund staff estimates.

1/ Contribution to growth.
2/ Not seasonally adjusted.
3/ Includes local governments and hospitals.

Table 3. Canada: Balance of Payments

(In billions of Canadian dollars, unless otherwise indicated)

					Forecast					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Current account balance	21.1	18.4	28.8	30.2	45.4	44.5	44.9	47.4	47.6	47.5
In percent of GDP	1.8	1.5	2.2	2.2	3.1	2.9	2.8	2.8	2.7	2.6
Merchandise trade balance	57.3	57.6	66.1	66.7	83.7	83.0	84.3	87.6	88.7	100.7
Exports, goods	414.1	400.2	429.1	453.4	492.3	514.6	538.9	567.0	594.5	623.4
Imports, goods	356.8	342.6	363.1	386.8	408.6	431.7	454.6	479.5	505.8	522.7
Services balance	-7.7	-11.4	-12.7	-13.4	-13.8	-14.6	-15.7	-16.7	-17.8	-20.2
Investment income balance	-29.4	-28.0	-24.9	-22.8	-24.5	-23.7	-23.6	-23.4	-23.2	-23.2
Transfer balance	0.9	0.2	0.3	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Capital and financial accounts balance	-13.0	-16.1	-22.5	-22.2	-45.4	-44.5	-44.9	-47.4	-47.6	-47.5
Direct investment, net	-8.2	-21.2	-53.6	2.1	10.3	14.9	16.9	18.3	20.6	23.2
In Canada	33.8	8.9	8.2	39.9	40.0	40.7	45.6	48.9	53.2	57.9
Abroad	-42.0	-30.1	-61.7	-37.8	-29.7	-25.8	-28.7	-30.6	-32.6	-34.8
Portfolio investment, net	-5.8	4.6	36.9	-26.7	-31.3	-40.6	-40.4	-44.5	-46.9	-49.8
Canadian securities	21.1	20.3	55.5	15.5	-20.2	-25.1	-26.2	-29.7	-32.3	-35.4
Bonds	18.8	8.3	20.1	2.4	...	...	...	...	...	...
Stocks	-1.5	13.5	35.8	12.7	...	...	...	...	...	...
Money market	3.8	-1.5	-0.4	0.4	...	...	...	...	...	...
Foreign securities	-26.8	-15.7	-18.5	-42.2	-11.1	-15.5	-14.3	-14.8	-14.6	-14.4
Bonds	-6.2	-8.0	-15.3	-25.6	...	...	...	...	...	...
Stocks	-18.9	-4.4	-1.6	-14.0	...	...	...	...	...	...
Other investment 1/	-4.2	-8.2	-13.7	-1.8	-29.4	-24.0	-26.8	-26.9	-27.2	-27.1
Assets	-12.8	-25.1	-6.9	-30.5	...	...	...	...	...	...
Liabilities	8.6	16.8	-6.8	28.7	...	...	...	...	...	...
Capital account balance	4.9	4.0	4.4	5.9	5.0	5.2	5.4	5.7	6.0	6.3
Transactions in official International reserves	0.3	4.7	3.4	-1.7	...	...	...	...	...	...
Statistical discrepancy	-8.1	-2.3	-6.3	-8.1	...	...	...	...	...	...
Memorandum item:										
Net international investment position	-206.9	-206.2	-181.1	-175.8	-136.0	-96.6	-56.1	-11.9	33.9	81.2
In percent of GDP	-17.9	-17.0	-14.0	-12.8	-9.4	-6.3	-3.5	-0.7	1.9	4.4

Source: Haver Analytics.

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

Table 4. Canada: Selected Vulnerability Indicators

(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	2005
External indicators							
Official reserves (in billions of U.S. dollars)	28.6	32.4	34.2	37.2	36.3	34.5	33.0
Broad money (M3) to foreign exchange reserves (ratio)	14.5	13.8	13.2	12.8	15.6	19.2	23.6
Central bank foreign liabilities (in billions of dollars)	0.2	0.2	0.2	0.2	0.2	0.1	0.1
Official reserves in months of imports	1.3	1.4	1.5	1.6	1.5	1.2	1.0
General government external debt (in billions of dollars) 1/	96.9	85.3	73.1	79.5	61.5	55.2	52.0
Net international investment position, current prices	-24.8	-19.4	-18.4	-17.9	-17.0	-14.0	-12.8
External debt to exports ratio (in percent)	57.7	42.7	42.3	43.4	44.8	36.9	34.0
External interest payments to exports (in percent) 2/	15.7	14.3	13.6	12.7	12.6	12.9	13.1
Financial markets indicators							
General government gross debt	111.6	101.5	100.3	97.4	91.9	87.9	85.0
Three-month treasury bill yield (percent)	4.7	5.5	3.9	2.6	2.9	2.2	2.7
Ten-year government note (percent)	5.6	5.9	5.5	5.3	4.8	4.6	4.1
Real three-month treasury bill yield (percent; deflated by CPI rate)	2.9	2.7	1.3	0.2	0.1	0.4	0.5
Change in stock market index (TSE 300, annual percentage change)	29.7	6.2	-13.9	-14.0	24.3	12.5	21.9
Banking sector risk indicators 3/							
Balance sheet							
Total loans to assets (percent)	59.0	58.0	56.2	55.9	54.1	54.3	53.9
Total loans to deposits (percent)	87.0	84.4	84.7	83.3	81.4	81.7	80.8
Impaired assets/total assets	0.59	0.60	0.84	0.90	0.65	0.39	0.27
Loan loss provision (in percent of total assets)	0.23	0.27	0.39	0.56	0.22	0.06	0.09
Total foreign currency assets/total assets 4/	40.2	40.5	42.7	41.4	36.2	34.1	34.7
Total foreign currency liabilities/total assets 4/	42.4	42.2	44.7	43.8	37.7	35.1	36.1
Total foreign currency deposits/total assets 4/	31.3	29.5	30.4	28.9	25.6	23.2	25.1
Profitability							
Return on total shareholders' equity (in percent)	15.7	15.2	13.9	9.3	14.7	16.7	14.9
Return on average assets (in percent)	0.71	0.71	0.66	0.44	0.69	0.79	0.67
Average intermediation spread	2.7	2.9	3.0	3.0	3.1	3.0	2.8
Net interest income (in percent of average total assets)	1.8	1.8	1.9	2.0	1.9	1.8	1.7
Capital position							
Total capital ratio	11.3	11.9	12.3	12.4	13.4	13.3	12.9
Tier 1 capital ratio	8.2	8.6	9.0	9.2	10.3	10.6	10.2
Personal sector 5/							
Net worth (in percent of disposable income)	514.2	509.0	508.9	520.4	518.6	518.3	520.4
Total liabilities (in percent of disposable income)	114.0	112.6	114.6	117.5	120.7	124.0	127.6
Total liabilities (in percent of net worth)	22.2	22.1	22.5	22.6	23.3	23.9	24.5
Household credit (growth rate, percent)	5.1	7.1	4.9	7.1	8.4	9.8	10.5
Corporate sector 6/							
Debt of private nonfinancial corporations	51.6	49.0	50.6	49.2	44.8	43.3	42.9
Debt-to-equity ratio of nonfinancial private corporations	78.5	71.8	70.0	65.8	57.5	53.4	51.3
Business credit (growth rate, percent)	6.3	7.3	5.7	3.8	1.3	4.0	5.8

Sources: Bloomberg; Canadian Bankers' Association; Haver Analytics; and Office of the Superintendent of Financial Institutions.

1/ Defined as Government of Canada securities held by nonresidents.
2/ Income payments on foreign-owned assets (other private payments plus Canada government payments).
3/ Unless otherwise indicated, based on data reported by the six largest chartered Canadian banks, which account for over 90 percent of the total market share.
4/ All chartered banks.
5/ Persons and unincorporated business.
6/ Based on total debt less trade payables, corporate claims, and other liabilities.

Table 5. Canada: Fiscal Indicators

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
						Staff Projections					
Federal government (PA basis) 1/						(In billions of dollars)					
Revenue	182.7	171.7	177.6	186.2	198.4	202.3	209.9	217.7	224.8	232.3	239.0
Program spending	118.7	125.0	133.5	141.4	162.7	161.7	172.5	179.9	187.2	194.7	201.5
Interest payments	43.9	39.7	37.3	35.8	34.1	34.0	34.4	34.8	34.6	34.5	34.4
Budgetary balance (accruals basis)	20.2	7.1	6.8	9.1	1.6	6.7	3.0	3.0	3.0	3.0	3.0
Net lending (calendar year basis) 2/	20.0	12.0	9.2	1.0	8.1	5.5	3.8	2.8	2.8	2.8	2.7
Structural budgetary balance 3/	16.0	6.0	7.0	10.6	2.6	7.2	3.1	3.0	3.0	3.0	3.1
Structural net lending 3/	15.8	10.9	9.4	2.5	9.0	6.0	4.0	2.8	2.8	2.8	2.8
Contingency reserves	...	...	...	...	...	3.0	3.0	3.0	3.0	3.0	3.0
Planning surplus	...	...	...	...	...	3.7	0.0	0.0	0.0	0.0	0.0
Net federal debt	524.5	517.5	510.5	501.5	499.9	493.3	490.3	487.3	484.3	481.3	478.3
						(In percent of GDP)					
Revenue	17.0	15.5	15.4	15.3	15.4	14.8	14.4	14.3	14.1	13.9	13.7
Program spending	11.0	11.3	11.6	11.6	12.6	11.8	11.9	11.8	11.7	11.7	11.5
Interest payments	4.1	3.6	3.2	2.9	2.6	2.5	2.4	2.3	2.2	2.1	2.0
Budgetary balance (accruals basis) 2/	1.9	0.6	0.6	0.7	0.1	0.5	0.2	0.2	0.2	0.2	0.2
Net lending 2/	1.9	1.1	0.8	0.1	0.6	0.4	0.3	0.2	0.2	0.2	0.2
Structural budgetary balance 3/	1.5	0.5	0.6	0.9	0.2	0.5	0.2	0.2	0.2	0.2	0.2
Structural net lending 3/	1.5	1.0	0.8	0.2	0.7	0.4	0.3	0.2	0.2	0.2	0.2
Contingency reserves	...	...	...	...	...	0.2	0.2	0.2	0.2	0.2	0.2
Planning surplus	...	...	...	...	...	0.3	0.0	0.0	0.0	0.0	0.0
Net federal debt	48.7	46.7	44.2	41.2	38.7	36.0	33.7	32.0	30.4	28.8	27.3
General government (NIA and calendar year basis) 4/						(In billions of dollars)					
Revenue	470.2	469.3	472.5	494.5	520.6	558.6	574.3	598.0	622.4	647.0	672.8
Expenditure	438.5	462.1	473.6	494.5	511.8	534.9	558.5	582.9	611.3	636.0	661.8
Balance	31.7	7.3	-1.1	0.1	8.7	23.7	15.8	15.0	11.1	11.1	11.0
Structural balance 3/	21.0	4.7	-2.3	3.2	11.1	25.4	16.3	15.1	11.1	11.1	11.3
Net public debt	703.4	666.6	668.2	625.1	603.2	573.9	558.1	543.1	531.9	520.8	509.8
						(In percent of GDP)					
Revenue	43.7	42.4	40.9	40.7	40.3	40.8	39.5	39.3	39.1	38.7	38.5
Expenditure	40.7	41.7	41.0	40.7	39.7	39.1	38.4	38.3	38.4	38.1	37.8
Balance	2.9	0.7	-0.1	0.0	0.7	1.7	1.1	1.0	0.7	0.7	0.6
Structural balance 3/	2.0	0.4	-0.2	0.3	0.9	1.9	1.1	1.0	0.7	0.7	0.6
Net public debt	65.3	60.2	57.9	51.4	46.8	41.9	38.4	35.7	33.4	31.2	29.1
Memorandum items											
Real GDP growth	5.2	1.8	3.1	2.0	2.9	2.9	3.1	3.0	2.9	2.9	2.9
Nominal GDP growth rate	9.6	2.9	4.2	5.4	6.1	6.1	6.1	4.7	4.8	4.8	4.8
Three-month treasury bill rate	5.5	3.9	2.6	2.9	2.2	2.7	3.9	4.3	4.3	4.3	4.3
Ten-year government bond rate	5.9	5.5	5.3	4.8	4.6	4.1	4.5	5.3	5.5	5.5	5.5

Sources: Department of Finance Canada *The Budget 2005* ; projections based on costings by the Conservative Party (www.conservative.ca/media/20060113-FiscalPlan.pdf) and *The Economic and Fiscal Update, November 2005* ; and Fund staff estimates.

1/ On a fiscal year basis, which starts on April 1.
2/ The budgetary surplus on an accruals basis measures changes in net worth, while net lending provides a better picture of the impact of fiscal policy on domestic demand.
3/ In percent of potential GDP.
4/ Includes federal, provincial, territorial, and local governments; and Canada and Quebec pension plans.

Summary and Policy Implications of Background Working Papers

Energy, the Exchange Rate, and the Economy: Macroeconomic Benefits of Canada's Oil Sands Production

by Tamim Bayoumi and Martin Mühleisen (WP/06/70)

Summary

1. ***Canada's future as an energy-exporting nation increasingly rests on the development of unconventional oil and gas production***. Despite record drilling in the Western Canada Sedimentary Basin—Canada's most important source of crude oil and natural gas—production in that area appears to have reached its peak. However, Canada still has access to large reserves of coal, and especially coal bed methane gas that, if exploitation proves commercially feasible, could boost gas production for years to come. In the near term, it is oil production from Canada's tar sands that offers the greatest potential for expanding Canada's energy exports.

2. ***Canada's tar sands—located mostly in the province of Alberta—are difficult to exploit but contain one of the largest known hydrocarbon deposits in the world***.[15] Extracting oil from tar sands requires large amounts of capital and energy, which had made most of these resources prohibitively expensive to access. However, technological progress and the tightening of global energy markets have made oil sands production profitable in many locations. It is estimated that the long-term break-even point for oil sands projects is currently around US$30–35/bbl, well below most investors' long-term oil price expectations.

3. ***Although investment in the Canadian oil sands is expected to take off sharply, a sustained increase in production levels requires an adequate supply of skilled labor as well as additional amounts of electricity, water, diluents, and other critical production inputs***. The demand for natural gas by oil sands operations is expected to roughly double by 2015, which could contribute to a tightening in the North American gas market and add to the cost of oil sands production. Finally, notwithstanding considerable improvements in the energy efficiency of oil sands projects, the anticipated production increase complicates Canada's efforts to meet its emissions reduction objectives stated under the Kyoto Protocol.

4. ***The recent appreciation of the Canadian dollar has prompted concerns that Canada's manufacturing sector could be crowded out by large improvements in the trade balance***. However, a review of the Canadian experience yields few signs that natural resource exports have persistently hurt the manufacturing sector. Although Canada's energy exports have risen steadily relative to GDP since 1980, the real effective exchange rate has declined over that period, both output and exports of manufacturing goods have been stable as a ratio to GDP, and the decline in the share of manufacturing employment has been smaller than in other resource-exporting industrial countries. Short-term fluctuations in

[15] Oil sands consist of quartz sand, silt and clay, water, and 10–12 percent bitumen.

manufacturing activity during that period were not correlated with movements in the real effective exchange rate, which only began to appreciate in 2002. The evidence instead suggests that conditions in the Canadian manufacturing sector remain largely dependent on economic developments in the United States, reflected in a strong correlation between U.S. investment and Canadian goods exports.

5. ***Although a close link between nonenergy commodity prices and the value of the Canadian dollar has been well established in earlier studies, the role of energy prices has remained less clear***. An exchange rate equation therefore relates the Canadian dollar's value to energy and nonenergy commodity trade, with a particular focus on changes in the composition of trade over time.

6. ***The results suggest that most of the recent appreciation of the Canadian dollar against its U.S. counterpart reflects underlying factors***. A dynamic projection over 2002Q1 through 2005Q2 leaves only about 5 percentage points of the 30 percent appreciation unexplained. The estimate of the gap's size is relatively insensitive to varying the starting date of the projection.

7. ***The model also implies that only a limited exchange rate appreciation would be expected to result from an increase in oil exports from Alberta's tar sands***. Such production is expected to add some 1 percent of GDP to net oil exports over 15 years, increasing net oil exports as a ratio of noncommodity imports by some 4 percentage points. This implies a real appreciation of only around 4 percent—much less than the implied appreciation since early 2002 although similar to the unexplained gap over that period.

Policy implications

8. ***The expansion of oil sands production is likely to have a small impact on the Canadian economy***. The potential gains in export revenues could result in some upward pressure on the exchange rate, but this is not expected to be large enough to significantly affect non-energy exporters. The considerable demand for labor and capital inputs from oil sands exploration and production would spread some of the gains to other provinces and provide an additional boost to domestic activity. However, even a growing energy sector will remain only one of several pillars in a well diversified Canadian economy.

9. ***Structural polices could assist the development of the oil sands' production potential***. Most importantly, immigration restrictions could be reviewed with the objective of providing relief to tight labor supply in some key professions. Moreover, there may be a need to adapt the regulatory environment for infrastructure development and the environment to ensure a sustainable production increase in the face of a sharp uptick in investor interest.

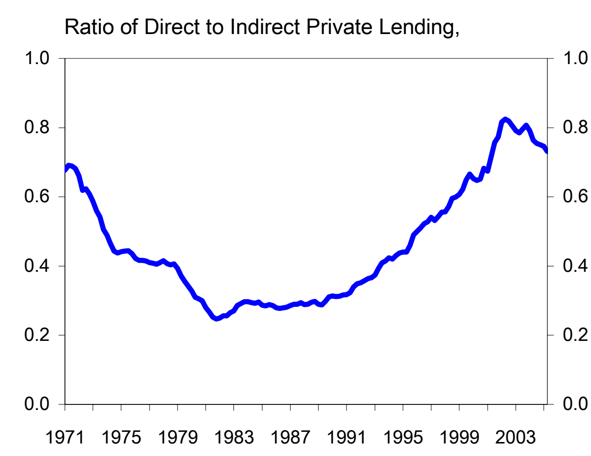
Disintermediation and Monetary Transmission in Canada
by Jorge Roldos (WP/06/84)

Summary

10. ***The financial system links monetary policy and the real economy***. Thus, events or trends that affect the financial system can also change the monetary transmission mechanism. Over the last two decades, Canada's financial system (as well as those in other industrialized countries) has been transformed by several rounds of financial deregulation, innovation, and disintermediation. This paper documents these transformations and studies their impact on the transmission of monetary policy.

11. ***Monetary transmission occurs through the impact of interest rates on components of aggregate demand, and the so-called credit channels—including constraints in the availability of loanable funds to banks and corporates***. Proponents of the credit channel argue that the traditional channel cannot explain the magnitude, timing, and compositional effects of the monetary policy actions in the U.S. economy. Credit market frictions give rise to a "financial accelerator" mechanism that *amplifies* and makes more *persistent* the impact of a monetary policy action on the economy. These credit market frictions depend on several features of the financial system, in particular the degree of securitization of the financial system (broadly understood as the development of securities markets versus banks) and the size and the state of the banking system.

12. ***The Canadian financial system has experienced two important changes over the last two decades as a result of deregulation and financial innovation***. First, after dwindling over the period of high inflation in the 1970s, the Canadian financial system has become more market-based, as corporates have increased the use of direct (or market) financing compared to indirect (or intermediated) financing. The ratio of direct to indirect finance (a measure of financial disintermediation) for the Canadian corporate sector increased steadily since the late 1980's, following a series of Bank Act amendments in 1987, 1992 and 1997 (see Figure). Second, there has been an increase in household's access to credit, reflected in a rise in consumer and mortgage credit.



Source: Bank of Canada

13. ***The paper studies changes in Canada's monetary policy transmission, associated with these changes in financial structure, using two methodologies***. First, a series of vector autoregression (VAR) models are used to characterize the dynamics of output and prices after a monetary shock. Standard VAR models used to study monetary transmission are extended with the inclusion of financial variables emphasized in the credit channel literature,

and are tested for the existence of structural breaks or parameter instability around the dates of major changes in financial sector regulation. Second, the paper studies the impact of financial variables on structural econometric models of aggregate demand increasingly used by central banks to conduct monetary policy analysis. In particular, the paper studies the impact of the ratio of direct to indirect finance on the interest rate sensitivity of aggregate demand.

14. ***The paper suggests that monetary transmission in Canada has changed markedly since the late 1980's, and also provides evidence that financial disintermediation has contributed to these changes***. Estimated VAR models show a break in monetary transmission in 1988, after changes in financial sector regulation initiated the process of financial disintermediation. Although the inclusion of financial variables in VAR models improves the characterization of monetary transmission in the period before the structural break, monetary impulses do not have a statistically significant impact on real activity in the 1990's. The paper presents evidence that suggests that this may be related to the fact that VAR models capture the impact of unexpected monetary shocks, while the systematic component of monetary policy—not captured in the impulse responses—is likely to have become more important with the improvements in the monetary framework during the 1990's.

15. ***The process of disintermediation has contributed to changes in the sensitivity of aggregate demand to real interest rates, a key parameter in the transmission of monetary policy***. Estimates of the interest rate elasticity of aggregate demand in IS equations increase in the 1990's, confirming the interpretation that the systematic component of monetary policy has become more relevant in recent years. Moreover, changes in the ratio of direct to indirect finance contribute to explaining changes in the interest rate elasticity, and suggest an increased effectiveness of monetary policy associated with a larger use of market-based sources of finance. This could be attributed to the lower interest rate sensitivity of relationship-based bank lending compared to the more price-sensitive direct or market funding.

16. ***The increased access to credit by the household sector may change monetary transmission in other ways not captured in the simple models considered in this paper***. Although the model in the paper suggests that greater credit to the household sector would lower the impact of interest rates on aggregate demand, it could also increase the role of bank balance sheets and monetary transmission.

17. ***Finally, more market-based financial systems have the additional advantage of providing more diversification opportunities and greater information on the pricing of financial risks***. These wider economic benefits will help to support financial stability and economic activity moving forward.

Policy implications

18. ***Changes in financial structure appear to have made monetary policy more effective in the 1990's, making it easier to stabilize economic activity***. As the impact of interest rate changes on aggregate demand has increased with financial disintermediation, smaller changes in rates would be needed to respond to shocks, although this process seems to have come to a halt since 2002 as financial companies have focused more on household lending.

19. ***More effective monetary policy makes it easier to cope with external shocks as a smaller increase in rates would be needed to stabilize aggregate demand***. On the other hand, lower nominal interest rates and the proximity of the zero bound would caution against a shorter policy horizon when the likelihood of large shocks increases.

Why Do Canadian Women Work So Much More? An International Perspective

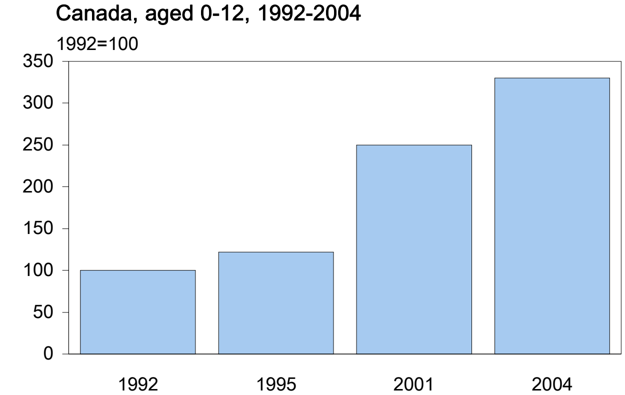
by Evridiki Tsounta (WP/06/92)

Summary

20. ***The female labor–force participation rate has received considerable attention in recent years as a potential source of faster growth and a possible answer to population aging***. A large literature has developed on the impact of policies to facilitate combining work and family life. Most of these studies are country-specific, however, and deliver varied results.

21. ***While the analysis is cross-country, the focus of the paper is the case of Canada***. In the last decade, Canada has experienced an impressive increase in its female participation rate following reforms in the tax and benefit system in the mid-1990s, including a decrease in the secondary earner's tax wedge and more generous public childcare provision (charts). Using annual panel data of 10 large industrial countries over the period 1980–2001, this study looks at the role of policy variables, in particular tax and benefit wedges, institutional factors and social norms in explaining female participation rate in Canada.[16]

Public Spending for Regulated Child Care Per Child in Canada, aged 0-12, 1992-2004



Source: Friendly and Beach, 2005.

[16] The sample comprises Australia, Canada, Denmark, Finland, France, Germany, Spain, Sweden, the United Kingdom, and the United States.

22. ***Econometric analysis suggests that economic factors, together with institutional factors and preferences, have shaped female participation decisions in Canada and other industrial countries***. Depending on the specification used, we find that the decrease in secondary earner's tax wedge, coupled with the increase in childcare benefits since the mid-1990s, could help explain 30–80 percent of the increase in Canadian women's participation rate between 1995 and 2001. Secondary earner's tax wedge acts as a disincentive to labor participation, while childcare benefits encourage women to enter the labor market. A 1 percentage point tax cut would raise female participation rate by 0.17-0.19 percentage points, while the impact of an equivalent increase in childcare benefits is similar or larger with estimates ranging from 0.14–0.99 percentage points. These results suggest that higher tax wedges raise the opportunity cost of working and thus discourage work effort, while benefits, such as affordable and available childcare, encourage women to enter the labor force by lowering the opportunity cost of work.

23. ***Non-policy variables, such as preferences and institutional factors, are also found to be important in explaining female participation rate and trends across countries***. In particular:

- The unemployment rate, which is meant to capture labor market pressures due to fluctuations in economic activity, dampens female participation, possibly due to the "discouraged worker" effect.
- Labor market regulation (e.g., union density, employment protection) has a positive impact on female participation while high wage compression discourages female participation since it raises the relative price of childcare.
- Preferences are found to be important in shaping female participation in the labor market. The decision to study, captured in years of education enrollment, and the decision to have children, both act as a disincentive to enter the labor market. The effect of parental leave on female participation is ambiguous.
- Cultural characteristics, captured by the role of women in politics and by country fixed effects, often linked to institutional characteristics, preferences and social norms not modeled explicitly, are also found to be important in understanding female participation in the labor market.

Policy implications

24. ***The analysis indicates that the reforms in the Canadian tax and benefit system in the mid-1990s have been successful in boosting female participation rate***. This suggests that policies, similar to the ones initiated in Canada to "reconcile work and family" could be used by other countries to facilitate greater female labor force participation rates. Policies that encourage young women to enter the workforce could also have positive long-term implications, due to their impact on life time participation.

25. ***Given the challenges population aging poses for the welfare, pension, and health systems, raising labor market participation further would be desirable even in Canada***. For

example, Canada's old-age participation rate is only average by international standards, and participation of low-income workers is very low. Therefore, the challenge remains to adopt policies (e.g., lower tax wedges, reforms in the pension system, etc.) to boost participation rates in these labor market segments.

Shocking Aspects of Canadian Labor Markets

by Tamim Bayoumi, Bennett Sutton, and Andrew Swiston (WP/06/83)

Summary

26. ***Labor market flexibility is an important determinant of differences in economic performance across countries***. In particular, greater flexibility of the labor market is generally regarded as one of the key factors explaining both the greater capacity of the United States to absorb adverse macroeconomic shocks compared, for example, to the euro area as well as the significant remaining difference in living standards between these two regions.[17]

27. ***Canada's susceptibility to external shocks and highly regionalized economic structure put an additional premium on economic flexibility, including in labor markets***.[18] Exchange rate flexibility helps the economy to buffer external disturbances, while its regional diversity underlines the importance of being able to shift workers within the country. Focusing on the second topic, this paper examines Canada's labor mobility from a range of perspectives, including a comparison of Canada's labor market dynamics with those of other countries. In addition, as Canadian Employment Insurance (EI) payments are more generous and easily accessible in locations where unemployment is high, a particular focus of the paper is on the degree to which labor mobility appears to differ within Canada, and how it appears to depend on prevailing regional labor market conditions.

28. ***The approach in this paper follows and extends earlier macroeconomic work on measuring labor adjustment within countries***. In particular, a 1992 paper by Blanchard and Katz analyzed U.S. labor market flexibility using data on employment, unemployment, and the participation ratio across individual U.S. states. They found that local U.S. labor markets appeared to adjust relatively rapidly to acyclical shocks, with migration playing a key role in this process. By contrast, using the same methodology, a 1995 paper by Decressin and Fatas found that labor adjustment across European regions was less flexible than in the United States. This paper compares Canada's responses to those of the United States and three euro area countries, France, Germany, and Spain, as well as comparing responses across Canadian regions.

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[17] Labor market reform, including raising participation rates to boost output, is a key component in the euro area's Lisbon structural reform agenda (European Commission, 2005). For estimates of the possible benefits from such reforms on flexibility and output, see Bayoumi, Laxton, and Pesenti (2004) and Gersbach (2003).

[18] Chapter 1 of the *Selected Issues* paper contains a discussion of regional aspects of the Canadian economy.

29. ***The results suggest that Canada has a relatively flexible labor market by international standards***. In common with the United States, migration plays a significant role in the adjustment to labor demand shocks. By contrast, this mechanism is much less important in Spain, France, and Germany. These differences in behavior are robust across a range of assumptions and appear to be the key to explaining differing levels of flexibility across countries.

30. ***Labor markets within Canada seem to become more flexible as one moves to the west***. Migration plays a much more important role in labor market adjustment in the western provinces than in the Atlantic ones. Turning to the central provinces of Ontario and Quebec, the evidence suggests that Ontario has a significantly more flexible labor market than its neighbor, consistent with microeconomic evidence on migration. Further analysis indicates that migration appears to be the main process through which labor markets adjust over time, with real wage differentials being a minor factor. Finally, the adjustment process appears relatively similar across macroeconomic disturbances. In short, labor adjustment appears very different east and west of the Ottawa River.

Policy implications

31. ***Canada's relatively flexible labor markets appear relatively well placed to respond to the recent rise in oil prices***. Oil prices tend to support activity in the raw-material rich west, while the accompanying exchange rate appreciation is likely to affect Ontario, whose manufacturing base is closely integrated with the United States. These provinces exhibit relatively flexible labor markets by international standards, facilitating a reasonably smooth adjustment to shocks.

32. ***The flexibility of Canadian labor markets could be further increased by market-oriented reforms of the Employment Insurance system***. While the macroeconomic analysis reported here cannot directly identify the reasons for the observed differences in labor market flexibility across Canadian regions, both the inter- and intra-national results suggest that the key difference in labor market flexibility are incentives for migration. Empirical research on Canada suggests that economic opportunities, cost of migration, age, and language are the most important determinants of inter-provincial migration. While EI appears to play a more minor role, eliminating differences in eligibility and benefits across localities would tend to reduce the differences in labor market flexibility across regions identified in the analysis.

Canada—Fund Relations

(As of February 28, 2006)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	6,369.20	100.00
Fund holdings of currency	5,648.46	88.68
Reserve position in Fund	720.75	11.32

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	779.29	100.00
Holdings	632.81	81.20

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

V. **Financial Arrangements:** None.

VI. **Projected Obligations to Fund:**
(SDR Million; based on existing use of resources and present holdings of SDRs):

	2006	2007	2008	2009	2010
Principal	n/a	n/a	n/a	n/a	n/a
Charges/Interest	3.77	5.03	5.05	5.03	5.03
Total	3.77	5.03	5.05	5.03	5.03

VII. **Implementation of HIPC Initiative:** Not applicable.

VIII. **Safeguards Assessments:** Not applicable.

IX. **Exchange Rate Arrangements:** The Canadian authorities do not maintain margins with respect to exchange transactions, and exchange rates are determined on the basis of demand and supply conditions in the exchange market. However, the authorities 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 lifted restrictions imposed in 1992 with respect to the Federal Republic of Yugoslavia (Serbia and Montenegro) and has replaced restrictions imposed with respect to Iraq with a new regulation, which the authorities have notified to the Executive Board under Decision 144 (52/51).

X. **Last Article IV Consultation:** The Staff Report for the 2005 consultation with Canada was considered by the Executive Board on February 16, 2005 (EBM/05/15). Canada is on a 12-month consultation cycle.

XI. **FSAP Participation and ROSC Assessments**

Canada–Financial System Stability Assessment–Volume II: Report on Observance of Standards in the Financial System FO/Dis/00/2, Sup. 1, 04/01/00

Summary: The FSSA report concluded that Canada has a stable and highly advanced financial system, which is among the soundest in the world. Moreover, it is supported by a well-developed regulatory system that shows a high degree of compliance with major international standards. Nevertheless, 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, prudence factors, and a contingency reserve for fiscal forecasting in Canada. 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), and (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.

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*).

XII. **Technical Assistance:** Not applicable.

XIII. **Resident Representative:** Not applicable

Canada—Statistical Issues

The quality, coverage, periodicity, and timeliness of Canada's economic data are considered to be excellent 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).

Real Sector. Statistics Canada provides timely and adequate data in monthly, quarterly, and annual frequency thereby facilitating the analysis of economic developments and assessment of policy proposals 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.

Fiscal Sector. The Department of Finance Canada provides monthly and annual data on the federal government's budget, tax policies, rules and regulations for Canada's banks and other financial institutions. The provided data enable adequate assessment of the impact of fiscal policy measures on Canada's economic performance.

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 (IIP).

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/finsearch/finresults_e.asp?Who=News.

Canada: Table of Common Indicators Required for Surveillance
As of March 30, 2006

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data quality – Methodological soundness[7]	Memo Items: Data quality – Accuracy and reliability[8]
Exchange Rates	2/16/06	2/16/06	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	02/08/06	02/10/06	W	W	W		
Reserve/Base Money	02/08/06	02/10/06	W	W	W	LO, O, LO, LO	O, O, O, O, O
Broad Money	Jan. 2005	Mar. 2005	M	M	M		
Central Bank Balance Sheet	02/08/06	02/10/06	W	W	W		
Consolidated Balance Sheet of the Banking System	Jan. 2005	Mar. 2006	M	M	M		
Interest Rates[2]	2/16/06	2/16/06	D	D	D		
Consumer Price Index	Dec. 2005	Jan. 2005	M	M	M	O, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q3 2005	Nov. 2005	Q	Q	Q	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Nov. 2005	Jan. 2005	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	FY 2004	Nov. 2005	A	A	A		
External Current Account Balance	Q3 2005	Nov. 2005	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Dec. 2005	Feb. 2005	M	M	M		
GDP/GNP	Q3 2005	Nov. 2005	Q	Q	Q	O, O, O, LO	O, O, O, O, O
Gross External Debt	Q3 2005	Dec. 2005	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[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, Canada Pension Plan, Quebec Pension Plan, provincial, and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); 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 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Alternative Scenario: The Perfect Storm

Given its high degree of openness, the Canadian economy remains vulnerable to swings in global economic conditions—particularly in the United States, which absorbs 90 percent of Canada's exports. The authorities remain particularly concerned that a disorderly unwinding of global current account imbalances could have a major impact on Canada, including from a possible appreciation of its exchange rate and a slowing demand for its export products.

The effects of a such a scenario have been studied in a simulation using the Oxford Economics Global Macro Model. It has been assumed that a loss of economic confidence reduces both fixed investment and consumption in the United States by 3 percent relative to baseline in 2006, with the loss expanding to 5 percent by the end of 2010. As a result of declining global demand, the price of oil would drop by 30 percent relative to baseline within two years, and a depreciation of the U.S. currency would be mirrored in a 25 percent appreciation of the Canadian dollar over the same period.

The results suggest that the Canadian economy could face a deflationary environment, with GDP falling by over 5 percent relative to baseline over the forecast horizon. The export sector would be hit hardest, reflecting the sharp exchange rate appreciation, contributing to a deterioration in the current account balance of more than 6½ percent of GDP. Although both consumption and investment would benefit from lower interest rates and reduced prices, growth would on average be 1¼ percentage points lower than in the baseline. Short-term interest rates would hit the zero bound in 2007, and the fiscal balance would also deteriorate, falling into deficit by 2008.

Alternative Scenario: The Perfect Storm

Difference between simulated model and baseline scenario (in percent unless otherwise noted)

	2006	2007	2008	2009	2010
GDP	-1.1	-2.7	-3.2	-4.1	-5.5
GDP growth (percentage points)	-1.1	-1.7	-0.5	-1.0	-1.5
Consumption	0.1	0.3	0.5	0.8	0.8
Private fixed investment	0.8	3.6	5.3	3.1	-1.0
Real net exports (contribution to growth)	-1.3	-2.9	-1.9	-1.0	-0.5
Current account balance (percent of GDP)	0.0	-2.0	-4.1	-5.6	-6.8
CPI inflation (percentage points)	-0.8	-2.8	-3.9	-4.4	-5.0
Short-term interest rate (percentage points)	-2.3	-4.6	-5.1	-4.8	-4.8
Long-term interest rate (percentage points)	-1.2	-3.3	-3.7	-3.1	-2.8
Fiscal balance (percent of GDP)	-0.1	-0.4	-0.6	-0.8	-1.1

Source: Oxford Economics; staff calculations.

Table 1. Canada: Net Foreign Liabilities Position Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**NFA-stabilizing non-income current account 6/**
1	**Baseline: Net Foreign Asset Position**	18.4	17.9	17.0	14.0	12.8	**9.4**	**6.3**	**3.5**	**0.7**	**-1.9**	**-4.4**	**0.0**
2	Change in net foreign asset position	-1.0	-0.4	-1.0	-2.9	-1.2	-3.5	-3.0	-2.8	-2.8	-2.6	-2.5	
3	Identified external liability-creating flows (4+8+9)	-4.3	-3.9	-5.9	-5.4	-4.8	-5.5	-4.2	-4.1	-4.1	-4.0	-3.9	
4	Current account deficit excluding income flows	-5.8	-4.4	-3.8	-4.2	-3.9	-4.8	-4.5	-4.3	-4.2	-4.0	-3.9	
5	Deficit in balance of goods and services	-5.7	-4.3	-3.8	-4.1	-3.9	-4.8	-4.5	-4.3	-4.2	-4.1	-3.2	
6	Exports	43.4	41.3	37.8	38.1	37.7	38.4	38.3	38.3	38.4	38.4	37.7	
7	Imports	37.7	37.0	34.0	33.9	33.8	33.6	33.8	34.0	34.1	34.3	34.5	
8	Automatic debt dynamics 1/	1.5	0.5	-2.0	-1.3	-1.0	-0.7	0.3	0.2	0.1	0.0	-0.1	
9	Contribution from nominal interest rate	1.2	1.0	0.7	0.8	0.7	0.7	0.5	0.4	0.2	0.0	-0.1	
10	Contribution from real GDP growth	-0.4	-0.6	-0.3	-0.4	-0.4	-0.4	-0.3	-0.2	-0.1	0.0	0.1	
11	Contribution from price and exchange rate changes 2/	0.6	0.1	-2.5	-1.7	-1.3	-1.0	0.0	0.0	0.0	0.0	0.0	
12	Residual, incl. change in gross foreign assets (2-3) 3/	3.3	3.5	4.9	2.5	3.7	2.0	1.2	1.3	1.3	1.4	1.4	
	Net foreign liabilities-to-exports ratio (in percent)	42.3	43.4	44.8	36.9	34.0	24.4	16.6	9.2	1.9	-5.1	-11.8	
	Scenario with key variables at their historical averages 4/						**9.4**	**6.2**	**3.3**	**0.4**	**-2.4**	**-5.1**	**0.1**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	1.8	3.1	2.0	2.9	2.9	3.1	3.0	2.9	2.9	2.9	2.9	
	GDP deflator in US dollars (change in percent)	-3.0	-0.3	16.0	10.9	10.5	8.4	1.7	2.6	2.3	2.8	2.9	
	Nominal external interest rate (in percent)	6.3	5.4	4.9	5.6	5.9	5.9	6.0	6.1	6.2	6.3	6.3	
	Growth of exports (US dollar terms, in percent)	-5.7	-2.2	8.4	14.9	12.8	13.7	4.6	5.5	5.6	5.8	4.0	
	Growth of imports (US dollar terms, in percent)	-6.3	0.8	8.8	13.8	13.5	10.9	5.6	6.0	5.8	6.4	6.5	
	Current account balance, excluding interest payments	5.8	4.4	3.8	4.2	3.9	4.8	4.5	4.3	4.2	4.0	3.9	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising GDP deflator.

3/ For projection, line includes the impact of price and exchange rate changes.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ Long-run, constant balance that stabilizes the net foreign asset ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 2. Canada: Public Sector Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	**Debt-stabilizing primary balance 9/**
1 **Baseline: Public sector net debt 1/**	60.2	57.9	51.4	46.8	41.9	**38.2**	**35.4**	**33.1**	**31.0**	**28.9**	**27.0**	**0.2**
o/w foreign-currency denominated	3.0	2.4	1.8	1.6	1.2	1.0	1.0	0.9	0.8	0.8	0.7	
2 Change in public sector debt	-5.2	-2.3	-6.5	-4.6	-4.8	-3.7	-2.8	-2.3	-2.2	-2.0	-2.0	
3 Identified debt-creating flows (4+7+12)	-4.7	-4.7	-5.6	-5.9	-6.6	-5.9	-4.9	-4.4	-4.2	-4.0	-3.8	
4 Primary deficit	-7.3	-5.7	-5.3	-5.5	-6.3	-5.6	-5.2	-4.7	-4.4	-4.2	-4.1	
5 Revenue and grants	42.4	40.9	40.7	40.3	40.8	39.6	38.9	38.7	38.3	38.1	38.1	
6 Primary (noninterest) expenditure	35.1	35.2	35.3	34.8	34.5	34.0	33.7	34.0	33.9	33.8	34.0	
7 Automatic debt dynamics 2/	2.6	1.0	-0.2	-0.4	-0.3	-0.3	0.3	0.3	0.3	0.3	0.3	
8 Contribution from interest rate/growth differential 3/	2.4	1.1	0.2	-0.2	-0.3	-0.3	0.3	0.3	0.3	0.3	0.3	
9 Of which contribution from real interest rate	3.5	2.9	1.3	1.2	1.0	0.9	1.4	1.3	1.2	1.1	1.1	
10 Of which contribution from real GDP growth	-1.1	-1.8	-1.1	-1.4	-1.3	-1.2	-1.1	-1.0	-0.9	-0.9	-0.8	
11 Contribution from exchange rate depreciation 4/	0.2	0.0	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	
12 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	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	-0.5	2.4	-0.9	1.2	1.8	2.2	2.1	2.1	2.0	1.9	1.8	
Public sector debt-to-revenue ratio 1/	142.0	141.4	126.4	115.9	102.7	96.5	91.1	85.7	80.7	76.0	70.8	
Gross financing need 6/	13.6	12.7	13.5	13.1	12.1	11.7	11.0	10.4	9.8	9.1	8.5	
in billions of U.S. dollars	97.5	93.1	117.7	130.1	136.3	148.2	145.1	146.0	143.5	141.7	139.5	
Scenario with key variables at their historical averages 7/						**38.2**	**33.5**	**28.7**	**23.7**	**18.6**	**13.4**	**0.1**
Scenario with no policy change (constant primary balance) in 2005-2010						**38.2**	**35.0**	**31.7**	**28.4**	**24.9**	**21.4**	**0.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.8	3.1	2.0	2.9	2.9	3.1	3.0	2.9	2.9	2.9	2.9	
Average nominal interest rate on public debt (in percent) 8/	6.7	6.0	5.8	5.6	5.5	5.4	5.5	5.6	5.6	5.7	5.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.6	5.0	2.5	2.6	2.4	2.4	3.9	3.8	3.8	3.9	3.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-5.8	0.8	22.2	7.4	3.4	1.2	0.1	0.8	0.5	1.0	1.1	
Inflation rate (GDP deflator, in percent)	1.1	1.0	3.3	3.1	3.1	3.0	1.7	1.8	1.8	1.8	1.8	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.2	3.5	2.3	1.4	2.2	1.4	2.1	3.9	2.6	2.7	3.4	
Primary deficit	-7.3	-5.7	-5.3	-5.5	-6.3	-5.6	-5.2	-4.7	-4.4	-4.2	-4.1	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

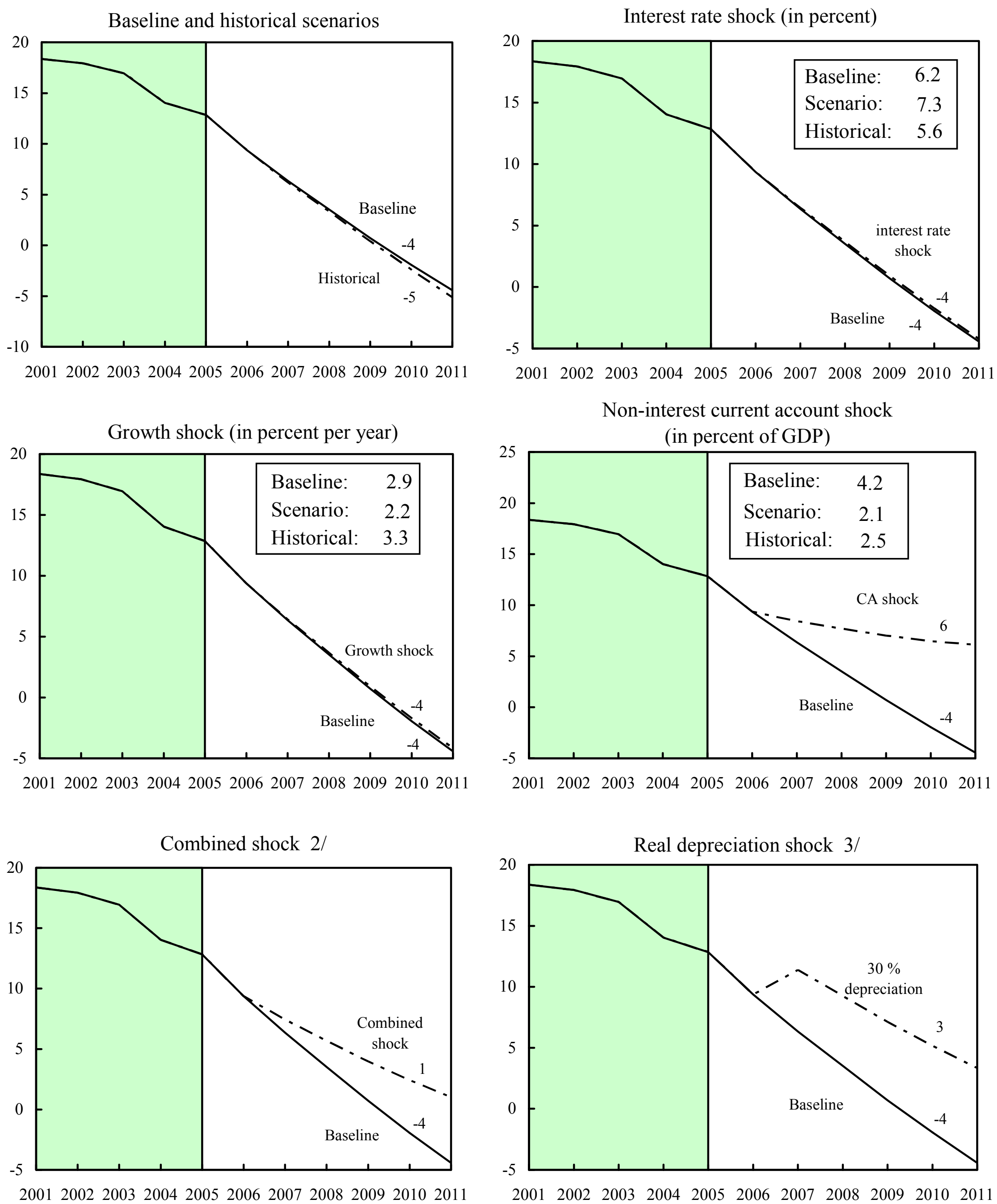
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

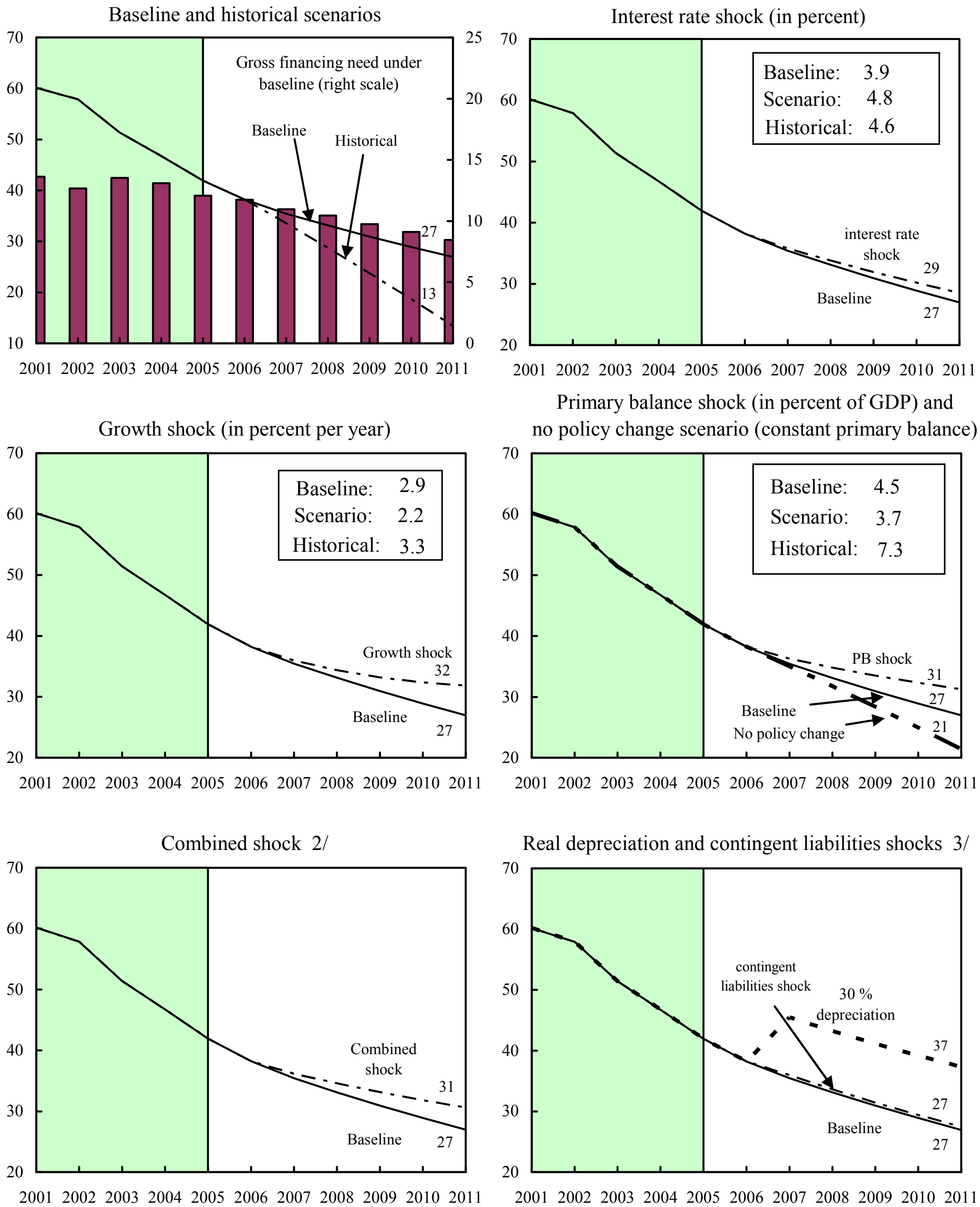
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Canada: Net Foreign Liabilities Sustainability: Bound Tests 1/
(Net foreign assets in percent of GDP)



Sources: Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2007.

Figure 2. Canada: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Source: Fund staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2007, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 2006 Article IV Consultation
Supplementary Information

Prepared by Western Hemisphere Department

Approved by Christopher Towe

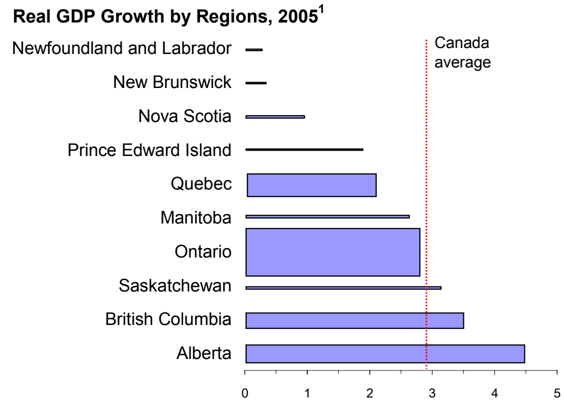
May 19, 2006

1. ***This supplement reports on recent economic and policy developments since the staff report was issued on April 17***. In particular, it provides an assessment of the federal budget for FY2006/07, which was tabled on May 2. The thrust of the staff appraisal remains unchanged.

Recent economic developments

2. ***The Canadian economy continued its strong performance in the first quarter of 2006 in line with staff's expectations***. Real GDP grew 0.2 percent in both January and February, bringing the year-on-year growth rate to 3.3 percent. Although high commodity prices have provided a stimulus to the resource-rich Western provinces, preliminary national accounts data for 2005 suggest that activity also remained strong in much of the rest of the country, despite the appreciated exchange rate. Staff continues to project growth at around 3 percent in both 2006 and 2007.

Real GDP Growth by Regions, 2005[1]



Source: Haver Analytics.
[1] width of the bars reflects provinces' share in the economy.

3. ***The trade balance recorded another strong surplus in March, and the Canadian dollar reached a 28-year high against the U.S dollar***. This largely reflected terms-of-trade gains and, with the stronger currency, export volumes retreated somewhat from robust levels recorded in the last quarter of 2005. The Canadian dollar rose above $0.90 in mid-May, 3½ percent above its level in mid-April, reflecting both the broader weakness of the U.S. currency and recent rises in commodity prices.

4. ***Canadian labor market conditions have been robust, productivity growth is now estimated to have surged in 2005, and inflation pressures have been contained***. Employment growth has averaged a solid 2¼ percent (annualized) during the first four months of 2006, although the unemployment rate rose slightly to 6.4 percent in April. Recent data revisions lifted labor productivity growth in the business sector to 2.2 percent in 2005,

twice the previous estimate and narrowing the productivity growth gap with the United States to ½ percentage point—the smallest in five years. The 12-month change in the CPI remained at 2.2 percent in March, while core inflation stayed at 1.7 percent.

Monetary policy

5. ***The Bank of Canada raised the target for the overnight rate by ¼ percentage point to 4 percent on April 25***. In the subsequent statement and *Monetary Policy Report,* the Bank's Governing Council noted that the economy had been evolving broadly in line with its expectations, and suggested diminished concern of a possible disorderly unwinding of global imbalances. The Council judged that the economy was at or just above capacity and that some modest further increase in the policy interest rate might be required. The Bank's decision was anticipated by the market and in line with staff recommendations.

Fiscal policy

6. ***Fiscal policy continues to benefit from buoyant revenue growth***. The preliminary estimate for FY 2005/06 budget outturn suggests a surplus of 0.6 percent of GDP, double the amount projected in the November 2005 Update. The improvement reflected higher-than-expected tax revenues across all major categories and unexpected savings on program spending related to the early dissolution of Parliament in November 2005. The surplus would have been even higher but for an end-year decision to boost transfers to the provinces and territories by some ¼ percent of GDP and to commit an additional C$330 million for ODA.

7. ***The FY 2006/07 budget contained welcome commitments to reduce public debt, contain expenditure growth, and lower the tax burden***. The new government implemented many of its economic priorities, including a series of tax cuts aimed at boosting saving and investment incentives. However, the budget is consistent with the government's plan to reduce federal debt by C$3 billion annually. The government also took advantage of the C$8 billion surplus in FY 2005/06 to advance the previous government's objective to lower the debt-to-GDP ratio to 25 percent by one year to FY 2013/14.

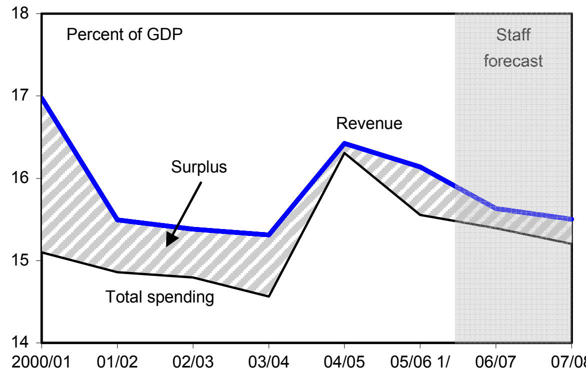
8. ***The budget's tax cuts stretch across all major revenue categories***. The government proposed to retain half of a marginal income tax cut introduced by the last government; cut the GST rate from 7 percent to 6 percent; increase the basic personal income tax exemption and provide a new C$1,000 employment credit; reduce the general corporate tax rate from 21 percent to 19 percent by 2010; and eliminate the federal capital tax in 2006 and the corporate surtax in 2008. On the spending side, the budget introduced a new child care allowance and pledged support to farmers and infrastructure projects. Overall expenditure growth is to be kept to a "sustainable" pace, including by a budget review aimed at generating C$1 billion in annual saving.

9. ***The new government also suggested that further steps would be taken to strengthen fiscal transparency***. In order to address concern that unbudgeted surpluses were being allocated inappropriately, the government suggested that a portion of the surplus above the C$3 billion already committed to debt reduction could be transferred to the Canada and

Quebec public pension plans (CPP/QPP), which could provide an opportunity to reduce payroll taxes over time. In addition, the government plans to establish a Parliamentary Budget Office, provide quarterly updates of the fiscal outlook, and improve financial reporting as recommended by the Auditor General.

10. ***On balance, the budget reflects a continuation of fiscal prudence.*** Although there is no explicit policy to avoid fiscal deficits, the budget includes C$3 billion for debt repayment and maintains small unallocated surpluses. Moreover, while other tax cuts would have been preferable to a reduction in the GST rate, and the large number of miscellaneous tax incentives that were proposed could increase the complexity of the tax code, the budget has reduced the marginal effective tax rate for the business sector. Looking forward, and as noted in the Staff Report, the small size of budgetary reserves relative to the uncertainty around Canada's fiscal projections will make it especially important to anchor fiscal policies firmly on the medium-term debt objective.

Canada: Federal Budget Balance



Sources: Haver Analytics; and Finance Canada.
1/ preliminary.

Structural issues

11. ***The budget reaffirmed the government's commitment to work with provinces and territories toward a common securities regulator***. The budget noted, however, that provinces and territories had made progress in improving the current system of securities regulation by narrowing regulatory differences and streamlining the administration of securities laws.

12. ***The budget proposed funding relief for companies sponsoring a defined benefit pension plan***. Measures include consolidating solvency payment schedules and extending solvency funding payments from 5 to 10 years, subject to a buy-in by plan members and retirees, or when the difference is secured by a letter of credit. Only plan sponsors whose payments were up-to-date would be eligible.

13. ***Canada has agreed a framework with the United States to settle their long-running trade dispute over the exports of softwood lumber for now***. The framework—which will remain effective for at least 7 years—returns to Canadian producers all but $1 billion of the approximately $5 billion in U.S.-collected duties and allows them duty-free access to the U.S. market as long as prices remain above a benchmark price.

Canada: Fiscal Indicators

						Prel.	Staff Projections				
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Federal government (PA basis) 1/	(In billions of dollars)										
Revenue	194.4	184.0	190.5	198.9	211.9	220.9	227.1	235.8	224.8	232.3	239.0
Program spending	129.2	137.6	146.2	154.2	176.3	179.2	188.8	196.5	187.2	194.7	201.5
Interest payments	43.9	39.7	37.3	35.8	34.1	33.7	34.8	34.8	34.6	34.5	34.4
Budgetary balance (accruals basis)	21.2	6.7	7.1	8.9	1.5	8.0	3.5	4.5	3.0	3.0	3.0
Net lending (calendar year basis) 2/	20.0	12.0	9.2	1.0	8.1	5.5	3.7	3.3	2.4	2.0	1.9
Structural budgetary balance 3/	16.9	5.6	7.3	10.4	2.5	8.6	3.6	4.5	3.0	3.0	3.1
Structural net lending 3/	15.6	10.9	9.4	2.5	9.1	6.1	3.8	3.3	2.4	2.0	2.0
Planned debt reduction	...	...	...	...	...	8.0	3.0	3.0	3.0	3.0	3.0
Remaining surplus	...	...	...	...	...	0.0	0.5	1.5	0.0	0.0	0.0
Net federal debt	518.6	511.8	504.8	495.9	494.4	486.4	483.4	480.4	477.4	474.4	471.4
	(In percent of GDP)										
Revenue	18.1	16.6	16.5	16.4	16.4	16.1	15.6	15.5	14.1	13.9	13.7
Program spending	12.0	12.4	12.7	12.7	13.7	13.1	13.0	12.9	11.7	11.7	11.5
Interest payments	4.1	3.6	3.2	2.9	2.6	2.5	2.4	2.3	2.2	2.1	2.0
Budgetary balance (accruals basis) 2/	2.0	0.6	0.6	0.7	0.1	0.6	0.2	0.3	0.2	0.2	0.2
Net lending 2/	1.9	1.1	0.8	0.1	0.6	0.4	0.3	0.2	0.1	0.1	0.1
Structural budgetary balance 3/	1.6	0.5	0.6	0.8	0.2	0.6	0.2	0.3	0.2	0.2	0.2
Structural net lending 3/	1.5	1.0	0.8	0.2	0.7	0.4	0.3	0.2	0.1	0.1	0.1
Planned debt reduction	...	...	...	...	...	0.6	0.2	0.2	0.2	0.2	0.2
Remaining surplus	...	...	...	...	...	0.0	0.0	0.1	0.0	0.0	0.0
Net federal debt	48.2	46.2	43.7	40.8	38.3	35.5	33.3	31.6	30.0	28.4	26.9
General government 4/	(In billions of dollars)										
Revenue	470.2	469.3	472.5	494.5	520.6	558.6	574.0	597.3	607.3	626.6	651.8
Expenditure	438.5	462.1	473.6	494.5	511.8	534.9	558.3	581.8	596.6	616.3	641.6
Balance	31.7	7.3	-1.1	0.1	8.7	23.7	15.7	15.5	10.7	10.3	10.2
Structural balance 3/	21.0	4.7	-2.3	3.2	11.1	25.4	16.1	15.5	10.7	10.3	10.5
Net public debt	703.4	666.6	668.2	625.1	603.2	573.9	558.3	542.8	532.1	521.8	511.6
	(In percent of GDP)										
Revenue	43.7	42.4	40.9	40.7	40.3	40.8	39.5	39.3	38.1	37.5	37.3
Expenditure	40.7	41.7	41.0	40.7	39.7	39.1	38.4	38.2	37.4	36.9	36.7
Balance	2.9	0.7	-0.1	0.0	0.7	1.7	1.1	1.0	0.7	0.6	0.6
Structural balance 3/	2.0	0.4	-0.2	0.3	0.9	1.9	1.1	1.0	0.7	0.6	0.6
Net public debt	65.3	60.2	57.9	51.4	46.8	41.9	38.4	35.7	33.4	31.2	29.2
Memorandum items											
Real GDP growth	5.2	1.8	3.1	2.0	2.9	2.9	3.1	3.0	2.9	2.9	2.9
Nominal GDP growth rate	9.6	2.9	4.2	5.4	6.1	6.1	6.1	4.7	4.8	4.8	4.8
Three-month treasury bill rate	5.5	3.9	2.6	2.9	2.2	2.7	3.9	4.3	4.3	4.3	4.3
Ten-year government bond rate	5.9	5.5	5.3	4.8	4.6	4.1	4.5	5.3	5.5	5.5	5.5

Source: Department of Finance Canada *The Budget 2006* ; and Fund staff estimates.

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

2/ The budgetary surplus on an accruals basis measures changes in net worth, while net lending provides a better picture of the impact of fiscal policy on domestic demand.

3/ In percent of potential GDP.

4/ NIA and calendar year basis. Includes federal, provincial, territorial, and local governments; and Canada and Quebec pension plans.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/68
FOR IMMEDIATE RELEASE
June 16, 2006

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

IMF Executive Board Concludes 2006 Article IV Consultation with Canada

On May 22, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.[1]

Background

Canada's strong macroeconomic framework helped deliver another year of strong economic performance, with GDP growth remaining close to 3 percent in 2005. High commodity prices have provided a particular stimulus to the resource-rich western provinces, but preliminary national accounts data for 2005 also suggest that activity remained strong in much of the rest of the country, despite the appreciated exchange rate. However, early national accounts data for 2006 suggest some easing of activity in January/February, with strength in the services sector having been offset by a dip in manufacturing.

As in previous years, economic activity has been supported by strong final domestic demand, which expanded 4¼ percent in 2005. Household spending was boosted by asset price appreciation and outstripped income growth causing the personal saving rate to drop into negative territory. Business investment maintained a robust pace especially in the second half of 2005, facilitated by strong corporate earnings, low interest rates, and falling prices of

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

imported capital goods. Stepped-up development of Canada's natural gas and oil sands reserves added significantly to investment demand.

Net exports continued to be a drag on economic activity in 2005, subtracting 1½ percentage points from real GDP. However, buoyed by strong gains in the terms of trade, the current account balance remained at 2¼ percent of GDP. Largely based on the strength of commodity prices, the real effective exchange rate appreciated a further 6 percent over the previous year. In nominal terms, the Canadian dollar has recently appreciated against the U.S. dollar to levels not seen since the late 1970s.

Canadian labor market conditions and productivity growth have been robust. Employment growth averaged a solid 2¼ percent (annualized) during the first four months of 2006, although the unemployment rate rose slightly to 6.4 percent in April. Recent data revisions lifted labor productivity growth in the business sector to 2.2 percent in 2005, twice the previous estimate and narrowing the productivity growth gap with the United States to ½ percentage point—the smallest in five years. At the same time, wage and unit labor cost growth has picked up, with the latter reaching 3¼ percent (year-on-year) in the fourth quarter of 2005.

Notwithstanding higher energy prices, inflation has remained subdued. Headline CPI inflation remained well within the Bank of Canada's 1 to 3 percent target band except in September 2005, when a spike in energy prices in the aftermath of hurricane Katrina caused a temporary overshoot. Core inflation has stayed below 2 percent since early 2004, with the strong currency and global competition keeping prices of imported goods low, and well-anchored inflation expectations helping to contain the spillover of energy price shocks into other prices.

After pausing for almost a year, the Bank of Canada resumed withdrawing monetary stimulus in September 2005. Reflecting the assessment that the economy was operating near capacity, the Bank has since raised its target for the overnight interest rate to 4 percent in six consecutive ¼ percentage point steps. In its April statement, the Bank observed that global competition and the past appreciation of the Canadian dollar continued to pose challenges for a number of sectors but judged the economy to be operating at, or just above, its production capacity. Against this background, it noted that some modest further increase in the policy interest rate might be required.

The FY 2006/07 budget contained welcome commitments to reduce public debt, contain expenditure growth, and lower the tax burden, including through a number of tax cuts aimed at boosting incentives for work, saving, and investment. At the same time, the budget included an explicit commitment to reduce federal debt by C$3 billion annually. The government also took advantage of the C$8 billion surplus in FY 2005/06 (the ninth consecutive federal budget surplus) to advance the earlier objective to lower the debt-to-GDP ratio to 25 percent by one year to FY 2013/14.

Executive Board Assessment

Directors commended Canada's enviable macroeconomic and policy performance since the mid-1990s, reflecting the benefits of firm commitments to debt reduction and to an inflation target. They noted that, while high commodity prices have benefited the resource-rich western provinces in particular, activity has remained strong in much of the rest of the country despite the appreciated exchange rate, which owes much to the economy's flexibility and regional diversity.

Directors agreed that the near-term macroeconomic outlook appears broadly favorable. Growth is likely to remain around most estimates of Canada's potential growth rate through 2007, in part reflecting the support that continued high commodity prices are likely to provide to incomes and domestic demand. However, Directors noted that the outlook is subject to risks, including from the potential for a rapid adjustment of global imbalances and the low household saving rate. Against this background, and in the light of the increased intensity of global competition in goods and services and for investment and given the coming retirement of the baby boom generation, Directors agreed on the importance of maintaining prudent fiscal and monetary policies and further improving the economy's flexibility.

Directors commended the Bank of Canada for continuing carefully to withdraw monetary stimulus in recent months. Further modest increases in the overnight interest rate will likely be required to bring headline inflation back to target, although the Bank's credible commitment to price stability provides scope to respond flexibly to macroeconomic developments. In particular, with the economy operating near its potential, Directors suggested that the support to activity from favorable terms of trade will need to be balanced against the drag from an appreciated exchange rate, whose strength continues to largely reflect fundamentals, including high commodity prices.

Directors considered that Canada's inflation targeting framework has been successful in keeping inflation and inflation expectations low, and that there is no need for significant amendments to it. They welcomed the Bank of Canada's commendable record of transparency.

Directors welcomed the new government's commitment to lowering the tax burden, maintaining fiscal surpluses, and continuing debt reduction. The emphasis on limiting the growth of government spending is appropriate, and the planned reductions in corporate rates and the early elimination of the federal capital tax are warranted given the relatively high level of Canada's marginal effective corporate tax rates. Most Directors considered that reducing marginal personal income tax rates and promoting tax-deferred saving would have provided greater incentives to save and invest than cutting the goods and services tax (GST) rate. Some Directors cautioned that the large number of tax deductions and credits proposed in the budget could increase the complexity of the tax code.

Directors supported the new government's prudent fiscal framework, which has benefited from steps to strengthen fiscal transparency, the decision to pay down federal debt by C$3 billion a year, and the advancement by one year of the objective of lowering the federal debt-to-GDP ratio to 25 percent. Directors agreed that the establishment of a Parliamentary Budget Officer and the medium-term debt anchor could help support the social consensus for prudent fiscal policies.

Directors called attention to the fiscal challenges to all levels of government arising from the rapid increase in provincial and territorial outlays on health care. Some Directors observed that allowing provinces greater flexibility in using price and other market-based mechanisms could help to align better the demand for and supply of health care. Directors welcomed the forthcoming review of the system of federal equalization payments to provinces, while underscoring the importance of ensuring that regional disparities in fiscal capacity are not exacerbated due to the boom in oil and gas prices.

Directors agreed that the financial system is well placed to support economic growth, but called for further improvement in the system's efficiency and resilience to better confront the increased global competition for financial services. In this respect, Directors welcomed the upcoming regular review of federal financial sector legislation as well as Canada's agreement in principle to undertake an FSAP in 2007 or shortly thereafter. Greater clarity regarding the new government's bank merger policy would allow a more transparent examination of potential benefits and costs of merger proposals. Directors welcomed the provinces' efforts toward the harmonization of securities regulation, and the federal government's intention to pursue a common securities regulator as a more effective approach. Directors supported measures to improve the funding situation of defined benefit pension plans.

Directors observed that, although Canada has been among the fastest growing industrial countries in recent years, there is scope to boost productivity through labor and product market reform. They emphasized the desirability of continuing to reduce welfare walls to improve labor participation among low-income groups, amending the immigration process to help address skills shortages, and simplifying the recognition of occupational qualifications across provinces. Consideration could also be given to funding the Employment Insurance system's social benefits through general revenues, rather than the payroll tax, and to curbing extended regional benefits to boost employment and economic efficiency.

Directors suggested that sector-specific constraints and thresholds for review under the Investment Canada Act seem outmoded and may discourage foreign direct investment. They advocated regulatory reform in the electricity sector, where productivity growth has been lower and markups higher than in many other industrial countries. Directors urged Canada to work to widen access to its markets for agricultural goods, including those subject to supply management schemes.

Directors commended the authorities for their commitment to double Canada's International Assistance Envelope by the end of the decade.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2006 Article IV Consultation with Canada is also available.

Canada: Selected Economic Indicators 1/

(Annual change in percent, unless otherwise noted)

	1998	1999	2000	2001	2002	2003	2004	est. 2005
Real GDP	4.1	5.5	5.2	1.8	3.1	2.0	2.9	2.9
Net exports 2/	1.7	1.4	0.6	0.7	-0.2	-2.4	-0.9	-1.5
Total domestic demand	2.5	4.2	4.7	1.2	3.5	4.7	4.0	4.6
Final domestic demand	2.8	4.2	4.0	2.9	3.0	3.6	3.9	4.3
Private consumption	2.8	3.8	4.0	2.3	3.7	3.1	3.4	4.0
Public consumption	3.2	2.1	3.1	3.9	2.6	2.9	2.7	2.8
Private fixed domestic investment	2.8	6.2	4.8	3.0	0.7	6.2	6.9	6.9
Private investment rate (as a percent	17.7	17.4	16.9	17.1	17.0	17.0	17.5	17.9
Public investment	-0.7	15.6	3.8	11.5	8.4	4.5	4.9	4.2
Change in business inventories 2/	-0.3	0.1	0.8	-1.7	0.4	0.9	0.0	0.3
GDP (current prices)	3.7	7.4	9.6	2.9	4.2	5.4	6.1	6.1
Employment and inflation								
Unemployment rate	8.3	7.6	6.8	7.2	7.6	7.6	7.2	6.8
Consumer price index	1.0	1.7	2.7	2.5	2.3	2.7	1.8	2.2
GDP deflator	-0.5	1.7	4.2	1.1	1.1	3.3	3.0	3.1
Exchange rate (period average)								
U.S. cents/Canadian dollar	0.67	0.68	0.67	0.64	0.64	0.72	0.77	0.83
Percent change	-6.8	0.6	-0.3	-4.2	-1.1	12.9	7.2	7.3
Nominal effective exchange rate	-5.8	-0.4	1.9	-2.8	-2.1	8.9	5.5	7.3
Real effective exchange rate	-5.5	-0.1	-0.4	-0.1	-3.2	5.4	9.2	7.9
Indicators of financial policies (national accounts basis, as a percent of GDP)								
Federal fiscal balance	0.8	0.9	1.9	1.1	0.8	0.1	0.6	0.4
Provincial fiscal balance 3/	-0.6	0.6	0.7	-0.9	-1.6	-0.9	-0.7	0.7
General government	0.1	1.6	2.9	0.7	-0.1	0.0	0.7	1.7
Three-month treasury bill	4.7	4.7	5.5	3.9	2.6	2.9	2.2	2.7
Ten-year government bond yield	5.3	5.6	5.9	5.5	5.3	4.8	4.6	4.1
Balance of payments								
Current account balance (as a percent of	0.0	0.3	2.7	2.3	1.8	1.5	2.2	2.2
Merchandise trade balance (as a percent of	0.1	4.3	6.2	6.4	5.0	4.7	5.1	4.9
Export volume	8.5	11.7	9.2	-3.4	0.8	-1.8	5.4	2.6
Import volume	6.1	8.5	8.6	-5.7	1.7	3.6	8.3	7.7
Invisibles balance (as a percent of GDP)	-0.1	-4.0	-3.5	-4.1	-3.1	-3.2	-2.9	-2.7
Saving and investment (as a percent of GDP)								
Gross national saving	19.1	20.7	23.6	22.2	21.3	21.7	22.9	23.4
General government	2.1	3.6	5.1	3.0	2.4	2.5	3.3	4.4
Private	17.0	17.1	18.5	19.2	18.9	19.2	19.6	19.0
Personal	6.1	5.3	5.6	6.0	5.0	4.3	3.8	4.9
Business	10.9	11.7	12.9	13.2	13.9	14.8	15.6	14.1
Gross domestic investment	20.4	20.3	20.2	19.3	19.4	20.2	20.7	21.1

Sources: Statistics Canada; and IMF staff estimates.

1/ Data as available at the time of the Executive Board Discussion on May 22, 2006.
2/ Contribution to growth.
3/ Includes local governments and hospitals.