March 2002
IMF Country Report No. 02/50

Canada: 2002 Article IV Consultation—Staff Report; Staff Statement; 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 2002 Article IV consultation with Canada, the following documents have been released and are included in this package:

- the staff report for the 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 15, 2001,** with the officials of Canada on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on January 9, 2002.** 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 statement of **February 4, 2002** updating information on recent developments;

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its February 4, 2002 discussion** of the staff report that concluded the Article IV consultation.

The document listed below has been separately released.

Mission Concluding Statement

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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CANADA

Staff Report for the 2002 Article IV Consultation

Prepared by Staff Representatives for the 2002 Consultation with Canada

Approved by Claudio M. Loser and G. Russell Kincaid

January 9, 2002

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I. INTRODUCTION[1]

1. ***At the time of the last Article IV consultation in March 2001, Executive Directors commended the authorities for maintaining sound macroeconomic and structural policies over most of the past decade, which had provided a solid foundation for sustained economic expansion and put the economy in a good position to cope with major economic shocks.***[2] Monetary policy had successfully maintained low inflation, helping to establish the credibility of the inflation targeting framework. Fiscal consolidation by all levels of government had brought budgets into surplus and led to a sharp reduction in government debt as a share of GDP in recent years. Important structural reforms, including improvements in the employment insurance system and financial regulatory framework, had helped enhance economic efficiency and further strengthen the financial system. Looking ahead, Directors judged that the major uncertainty facing Canadian policymakers was the depth and duration of the U.S. economic slowdown and its impact on Canada. They agreed that monetary policy should be the main instrument used in attempting to sustain the economic expansion. The automatic fiscal stabilizers also should be allowed to work.

2. ***The global economic outlook has darkened since the Article IV consultation last March, and especially since the September 11 terrorist attacks in the United States.*** Against this background, the 2002 Article IV consultation discussions focused on the main short-term policy challenges of how to provide sufficient support to the economy in the face of what is essentially a large external shock, while sustaining a macroeconomic framework consistent with medium-term growth objectives.[3]

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[1] The discussions were held in Ottawa during November 5–9, 2001, and were concluded at a meeting on November 15 with Deputy Finance Minister Lynch and Governor Dodge that was attended by the Executive Director for Canada, Mr. Bennett. The staff also met with market participants from leading Canadian financial institutions in Toronto on November 9. The staff team comprised C. Collyns, S. Dunaway, P. De Masi, V. Arora, M. Kaufman, C. MacDonagh-Dumler, and I. Ivaschenko (all WHD). The Advisor to the Executive Director for Canada, Mr. Fenton, attended most of the meetings.

[2] The staff report (SM/01/81) and the selected issues paper (SM/01/82) were publicly released as IMF Staff Country Report Nos. 01/62 and 01/157, respectively. Canada has subscribed to the Fund's Special Data Dissemination Standard and has submitted metadata, which have been posted on the Fund's Data Standard Bulletin Board. The quality, coverage, periodicity, and timeliness of Canadian economic data are considered to be excellent both in the context of the Article IV consultation and for the purposes of ongoing surveillance.

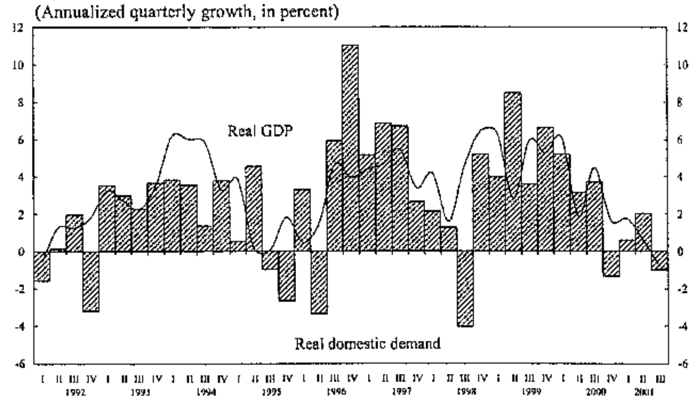
[3] With the focus on short-term policy issues post September 11, it was decided to forgo a selected issues paper. Instead, the staff's ongoing research on Canada will be issued as working papers in the course of 2002 as the work is completed. The main projects include a study of regional economic disparities and government transfer policies; an assessment of

(continued)

II. ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent Economic Developments

Figure 1. Canada: Output and Demand
(Annualized quarterly growth, in percent)



3. ***Economic activity has slowed substantially since late 2000, in large part reflecting the U.S. downturn.*** After growing at an average annual rate of 4½ percent during the year through the third quarter of 2000, real GDP growth slowed thereafter, falling to an annualized rate of ½ percent in the second quarter of 2001, and GDP declined by ¾ percent in the third quarter (Table 1, Figure 1, and Box 1). The slowdown has been sharper than originally anticipated. Slower U.S. demand growth sapped net exports, with exports of machinery and equipment (led by telecommunications) declining during the first three quarters of 2001. Reduced U.S. demand also contributed to a contraction in private investment in late 2000 and early 2001, and the underlying momentum of this investment has remained weak subsequently, reflecting a draw down in inventories and lower investment in machinery and equipment in response to increasing excess capacity, particularly in the telecommunications sector. The decline in information technology investment since the third quarter of 2000 has reduced the annual rate of GDP growth by ¾ percentage point. Moreover, public investment has weakened and consumption growth has moderated, owing to a slowing in real income growth, a softening in the employment situation, and an associated fall in consumer confidence.

4. ***Given its proximity and close integration with the United States, Canada has been heavily affected in the aftermath of the terrorist attacks.*** The immediate impact included the significant disruption of commercial traffic in the Canada-U.S. border area, a sharp decline in business confidence, and interruptions in activities such as air travel, tourism, and financial market trading.[4] Moreover, the attacks have intensified the slowdown in U.S. activity that was already underway and added to the level of uncertainty regarding economic prospects. While the economic effects are hard to measure, the Bank of Canada estimates that the attacks may have reduced Canadian GDP growth by about 1 percentage point (at an annual

future fiscal costs of health care services; and further analysis of the difference in the productivity performance of Canada and the United States.

[4] In December 2001, Canada signed two agreements with the United States aimed at bolstering border security while facilitating bilateral trade. The agreements include greater sharing of intelligence information and more uniform visa policies.

Box 1. Revisions to the National Income and Expenditure Accounts

In May 2001, the official Canadian national accounts statistics were revised to incorporate three key changes in methodology:

First, the former series for real GDP based on a fixed-weighted Laspeyres index was replaced by one based on a **"chain-weighted" Fisher index**. A Fisher index, which is a geometric average of Laspeyres and Paasche indices, is free of the biases inherent in fixed-weight series—especially the substitution bias—and is considered to provide more accurate measures of growth. Moreover, the use of fixed weights tends to overstate the level and growth of GDP when fast-growing sectors of the economy are experiencing sharp declines in relative prices. In Canada, like in the United States, the relative price of information technology has fallen since the mid-1980s, so that a shift to chain weights lowers GDP on this account.

Second, the national accounts were revised to include all **software spending by organizations as investment;** previously part of such software spending was treated as an intermediate good.

Third, while the previous real GDP series was expressed in 1992 prices, the revised series is re-based with **1997 as the reference year**. This change contributes to raising measured GDP.

The overall impact of the revisions was to raise the level of measured real GDP significantly (e.g., by 9½ percent in 2000). The change reflected mainly the re-basing from 1992 to 1997, which added to a small positive impact from the inclusion of software and more than offset a small negative impact from the shift to chain weights. Measured real GDP growth was reduced in 2000, when software price declines steepened, but was relatively unaffected in earlier years (see tabulation).

Canada: Real GDP Growth 1990–2000
(Annual percentage change)

	1990–99	2000
New series 1/	2.3	4.4
Old series 2/	2.3	4.7

1/ Chain weights. Software included.
2/ Fixed weights. Software not included.

rate) in both the third and fourth quarters of 2001, mainly reflecting production disruptions and confidence effects.[5]

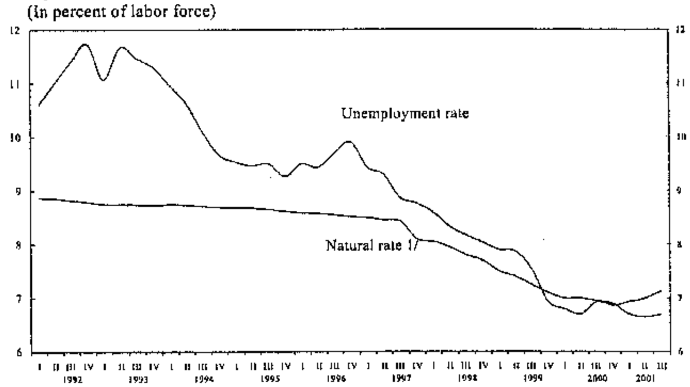
5. ***The current account surplus has continued to rise.*** In 2000, strong U.S. demand growth, together with some recovery in commodity prices, helped to raise the current account surplus to 2½ percent of GDP (Table 2). In 2001, a contraction in imports contributed to an

[5] See Bank of Canada, *Monetary Policy Report,* November 2001.

increase in the trade surplus during the early part of the year. Subsequently, the current account surplus has declined somewhat as weaker U.S. demand growth and a moderation in commodity prices have dampened exports, but it still amounted to 3½ percent of GDP in the first three quarters of 2001. In the capital account, net direct investment inflows declined markedly (and turned negative) during the first three quarters of 2001. At the same time, there were sizable net portfolio outflows as net purchases of foreign stocks rose.

6. ***Labor shortages have diminished appreciably since the beginning of the year.*** After falling to 6½ percent in June 2000 (its lowest level since the mid-1970s), the unemployment rate rose to about 7 percent in September 2000. It remained around that level before increasing to 7¼ percent in the period August–October 2001 and 7½ percent in November (Figure 2). The increases in unemployment have been broadly based across the country. Employment has been flat since May 2001, as losses in part-time jobs have broadly offset a small increase in full-time employment.

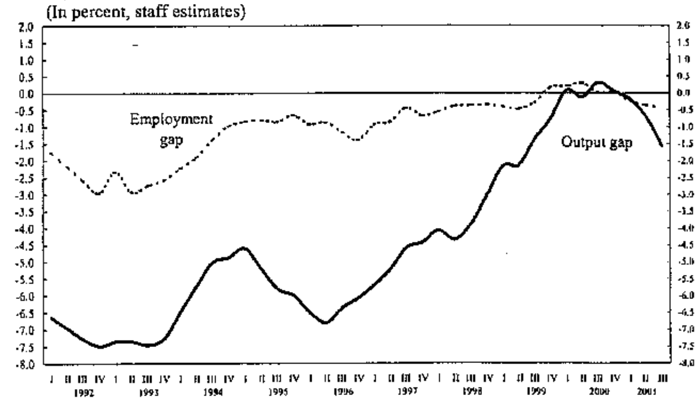
Figure 2. Canada: Unemployment
(In percent of labor force)



1/ Staff estimate.

7. ***Other indicators also suggest that the slowing in economic activity in recent quarters has led to an easing of potential resource constraints.*** The actual level of GDP is estimated to have fallen from near potential during the latter half of 2000 to around 1½ percent below by the third quarter of 2001 (Figure 3).[6] The index of capacity utilization for the nonfarm goods-producing sector shows a similar pattern of declining resource utilization (Figure 4). Although rising very rapidly between mid-1999

Figure 3. Canada: Employment and Output Gaps
(In percent, staff estimates)



[6] Estimates of potential output are uncertain owing to the comprehensive revisions to the national accounts statistics in May 2001. The staff's preliminary re-estimate using the new GDP data based on time-trend techniques leaves the potential growth rate unchanged at 2¾ percent. Once revised data on the capital stock are available, staff plan to update estimates of potential output based on a production function.

and mid-2000, capacity utilization fell sharply over the five quarters to the third quarter of 2001, largely reflecting a downturn in the manufacturing sector.

8. ***Labor productivity declined in the fourth quarter of 2000 and first quarter of 2001, before rising by 2 percent at an annual rate during the second and third quarters.*** During the period 1997–2000, labor productivity in the business sector in Canada rose by 2.2 percent annually, 0.4 percentage point below its U.S. growth rate but stronger than in other G-7 countries such as France, Italy, and Japan.[7] The differential with the United States has largely reflected slower productivity growth in Canadian manufacturing, in part because of the smaller size (relative to the United States) of the information technology sector, where productivity gains have been especially strong (Figure 5).[8]

Figure 4. Canada: Capacity Utilization Ratio

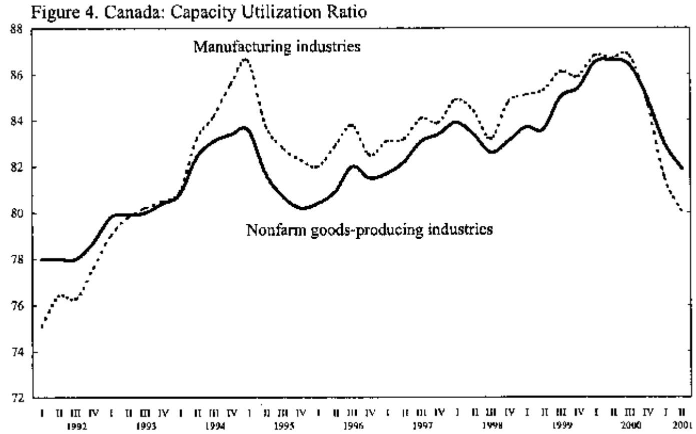
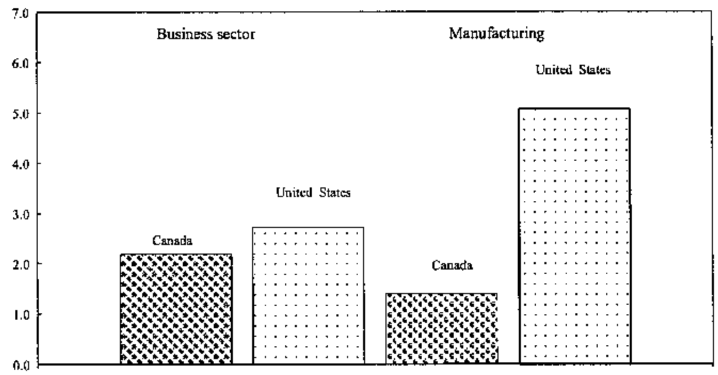


Figure 5. International Comparison: Labor Productivity Growth in Business and Manufacturing Sectors (Annual average, in percent, 1997-2000)

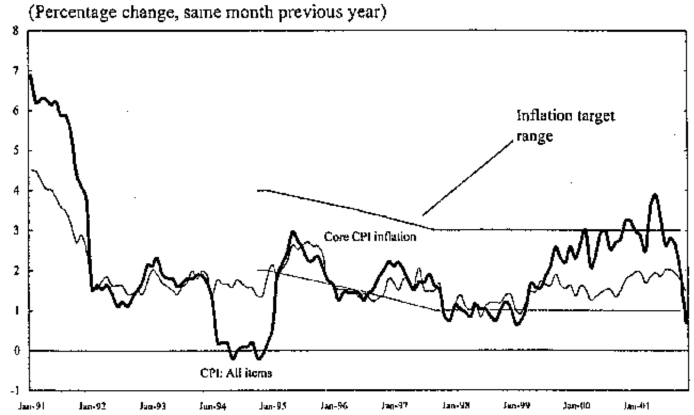


[7] Before a recent revision to the U.S. data, the gap in annual productivity growth between the two countries was 0.8 percentage points during this period. The Canadian and U.S. national accounts data are now compiled on a similar statistical basis, including "chain-based" volume indices and with business and government spending on computer software being included in investment (and GDP), improving the statistical comparability between the two countries.

[8] Although the IT sector represents a relatively small share of the Canadian economy, its contribution to GDP growth has increased considerably since the mid-1990s, rising from around 8 percent in the mid-1990s to 25 percent in 1999 (representing 0.2 and 1.1 percentage points of GDP growth, respectively). In the United States, the IT sector contributed around 30 percent of output growth on an annual basis during 1994–99, representing around 1–1½ percentage points of GDP growth. See M. Cerisola, P. De Masi, and V. Culiuc, "Labor Productivity Growth in Canada," in *Canada—Selected Issues,* IMF Staff Country Report No. 01/157, September 2001.

9. ***Inflationary pressures have subsided with the slowing in economic activity and easing of capacity constraints.*** During the latter half of 2000, when the economy seemed to be operating near full capacity, core inflation moved up toward the mid-point of the Bank of Canada's 1–3 percent target range (Figure 6).[9] By the second quarter of 2001, with growth slowing and capacity use slackening, core inflation stabilized at slightly above the 2 percent mid-point and remained at that level in subsequent months before falling to 1¾ percent in November. Headline inflation, which had moved above the target range during the second quarter due to rising energy prices, fell to ¾ percent in November. Labor compensation per person hour and unit labor costs picked up moderately, rising at annual rates of 4 percent and 2¾ percent, respectively, during the first three quarters of 2001, compared to increases of 3½ percent and 2¼ percent in 2000.

Figure 6. Canada: CPI Inflation
(Percentage change, same month previous year)



10. ***In response to the sharper-than-expected slowing in the economy, the Bank of Canada has lowered its target for the overnight rate by 350 basis points since the beginning of 2001 to 2¼ percent at present.*** It was initially expected that Canada would experience a moderate slowdown, with the downturn in Canadian growth being milder than in the United States, owing in part to the reduction in Canadian income tax rates at the beginning of the year and a smaller negative impact from the shakeout in the technology sector. In August 2001, against the background of lackluster growth in the second quarter and signs of further weakening in the United States and other parts of the world, the Bank of Canada stepped up the pace of interest rate reductions. In September, in an unscheduled move following the terrorist attacks in the United States, the Bank of Canada lowered its target overnight rate by 50 basis points, in tandem with the Federal Reserve, amid heightened concerns about consumer and business confidence. Then, at its scheduled monetary policy announcement dates on October 23 and November 27, the Bank of Canada further lowered its target rate by 75 basis points and 50 basis points, respectively. The spread between Canadian and U.S. short- and long-term interest rates has returned to positive levels, in part reflecting the differences in the timing and magnitude of the interest rate cuts in the two countries (Figure 7).

[9] The core measure of CPI inflation excludes the eight most volatile components of the CPI and adjusts the remaining components to remove the effects of changes in indirect taxes.

11. ***The Canadian dollar weakened through late 2001.*** After peaking at 67 U.S. cents at the beginning of 2001, the Canadian dollar moved erratically until mid-2001. Since that time, the currency has depreciated, trading at an all-time low below 63 cents in early November. The real effective value of the Canadian dollar has experienced a trend decline, falling at an average annual rate of 3 percent between its previous peak in June 1991 and December 2000, and it depreciated by a further 1½ percent through November 2001 (Figure 8). The real effective depreciation of the Canadian dollar has primarily reflected the trend decline in non-oil commodity prices, but it also appears to have been influenced in recent years by relatively faster labor productivity growth in the United States than in Canada.[10]

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

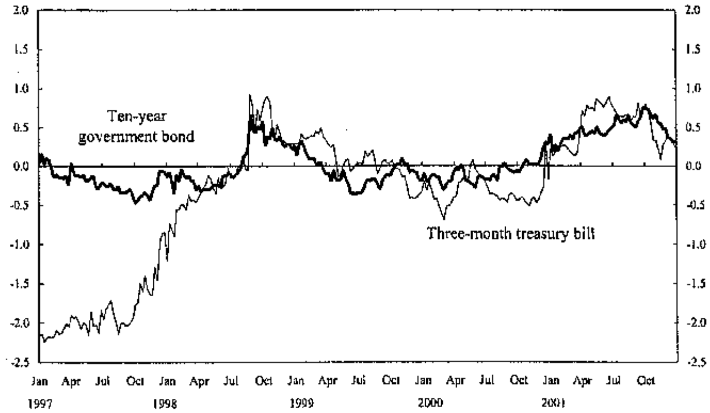
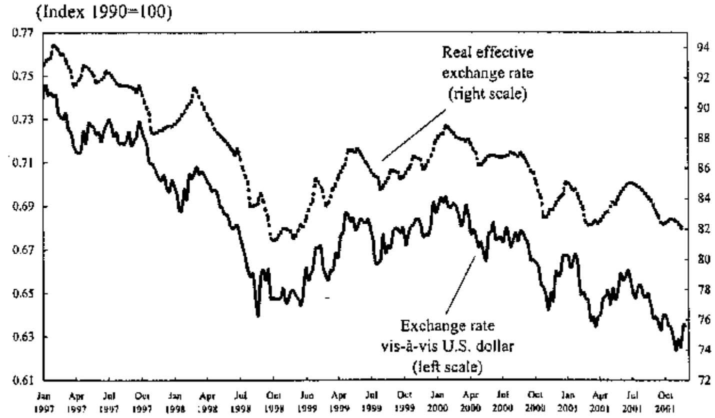


Figure 8. Canada: Bilateral and Real Effective Exchange Rates
(Index 1990=100)



12. ***The authorities' commitment to promoting fiscal discipline has been reflected in a substantial turnaround in the budget balance since 1993.*** The federal fiscal position shifted from a deficit of 5¾ percent of GDP in 1993/94 to a surplus of more than 1½ percent in 2000/01 (public accounts basis; Table 3 and Figure 9).[11] Cuts in program spending accounted for over two-thirds of this improvement. In its February 2000 Budget, the Government presented a plan for reducing personal and corporate income taxes over a five-year period, as well as modest new spending initiatives in health, education, public infrastructure, and the environment. Subsequently, the Government in its October 2000 *Economic Statement and Budget Update* expanded these tax reductions and advanced their timing, and it introduced some additional

[10] See J. Murray, "Why Canada Needs a Flexible Exchange Rate," Bank of Canada Working Paper No. 99-12, 1999, and M. Cerisola, P. Swagel, and A. Keenan, "The Behavior of the Canadian Dollar," in *Canada–Selected Issues,* IMF Staff Country Report No. 99/14, April 1999.

[11] Fiscal years in Canada start on April 1.

spending initiatives.[12] The strong fiscal performance has translated into a substantial reduction in net federal government debt, which fell from a peak of over 70 percent of GDP in 1995/96 to 52 percent in 2000/01 (Figure 10).[13]

Figure 9. Canada: Federal Fiscal Policy Indicators
(In percent of GDP)

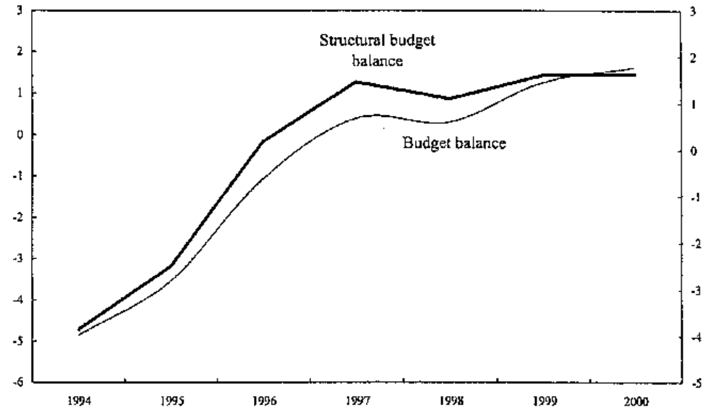
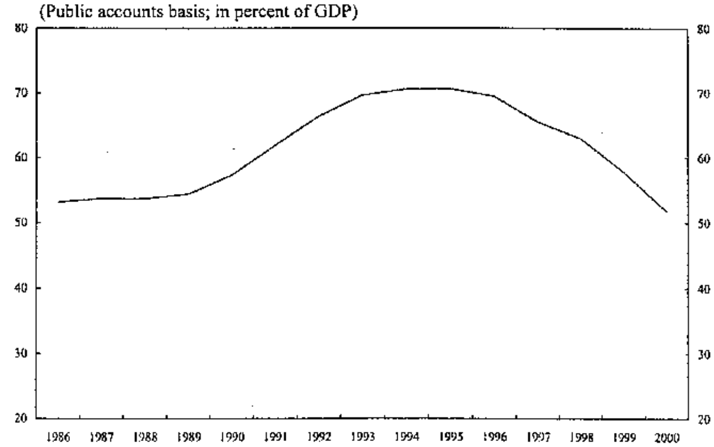


Figure 10. Canada: Federal Government Net Public Debt
(Public accounts basis; in percent of GDP)



13. ***Provincial governments also have strengthened their finances in recent years, contributing to an improvement in the general government balance from a deficit of 6¾ percent of GDP in 1994 to a surplus of 3¼ percent of GDP in 2000 (national accounts basis).*** Buoyant tax revenue and spending restraint have contributed to the improvement in the aggregate fiscal position of the provinces, which, after 30 years of continuous deficits, moved into slight surplus in 1999 and to a surplus of 1 percent of GDP in 2000.[14] In 2000, rising energy prices benefited Alberta, which accounted for nearly half of the aggregate provincial surplus. In their budgets for 2001/02, many provinces indicated a continued commitment to tax reduction and modest spending initiatives, while further reducing provincial debt. With the slowdown in economic activity, however, the

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[12] In September 2000, the federal and provincial governments signed an agreement on federal transfers for health care costs and proposed enhancements to the employment insurance scheme, the costs of which were estimated at $1.8 billion in 2000/01. Between October 2000 and March 2001, the Government announced total additional measures worth $2.7 billion, which focused on research and innovation, agriculture, and national security.

[13] In 2000/01, debt reduction was more rapid than the Government envisaged. While in October 2000 the Government committed to pay down at least $10 billion in federal debt in 2000/01, it ultimately was able to repay over $17 billion in debt.

[14] During the first three quarters of 2001, the budgetary surplus of provincial and local governments was $9½ billion (nearly 1 percent of GDP) at an annual rate.

"balanced budget" legislation that eight out of ten provinces have in place limits the scope for tax reduction and spending initiatives in the near term. The improvement in federal and provincial fiscal positions has reduced the ratio of general government net debt to GDP from 87 percent in 1994 to 66 percent in 2000 (Figure 11 and Table 4). However, the ratio of net debt to GDP in Canada remains above the average for G-7 countries (Table 5).

14. ***Fiscal consolidation since the early 1990s has helped raise the ratio of gross national saving to GDP, substantially reducing reliance on foreign saving.*** The rise in the government saving rate, together with a rise in corporate saving, has offset a decline in personal saving. The ratio of gross domestic investment to GDP in nominal terms has risen since the mid-1990s but remains below its average during previous decades. In real terms, however, gross private investment is substantially higher than its historic average reflecting the fall in the price of capital equipment, which has declined to lower levels in Canada than in other G-7 countries (except the United States) in recent years (Figure 12).

15. ***Personal and corporate sector balance sheets have remained generally sound thus far despite the weakening in economic activity and a drop in the stock market.*** A continued sell-off in the telecommunications sector has contributed to a 30 percent decline in the Toronto Stock Exchange (TSE) 300 Index since its peak in 2000, contributing to a decline in personal sector net worth as a percent of disposable income. Personal sector debt remained at over 110 percent of disposable income in 2000, reflecting

Figure 11. Canada: General Government Net Debt
(National accounts basis; in percent of GDP)

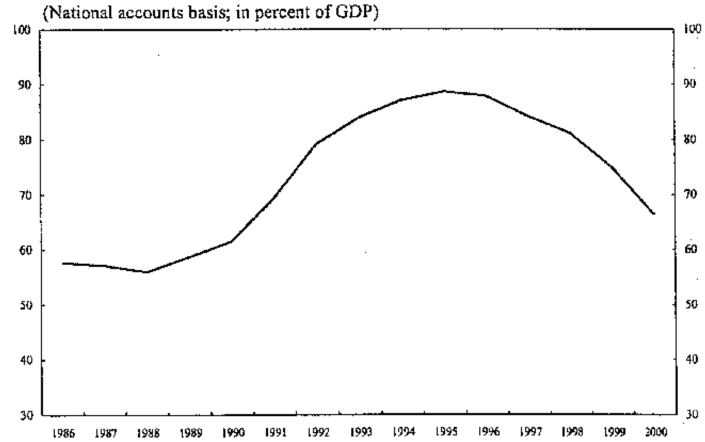


Figure 12. International Comparison: Relative Cost of Capital
(1990=100 Price index of fixed private investment relative to CPI)

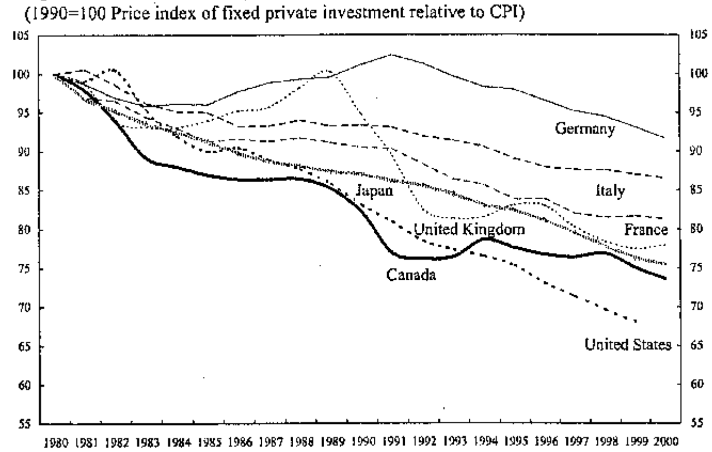
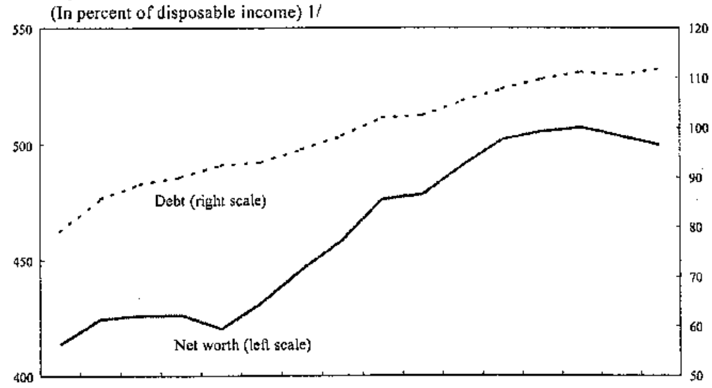


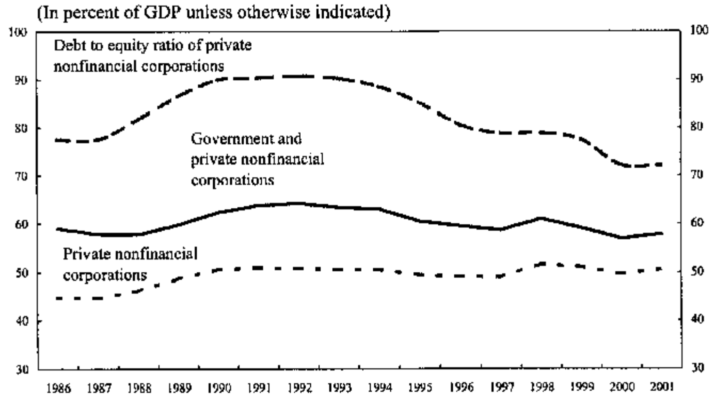
Figure 13. Canada: Personal Sector Net Worth and Debt
(In percent of disposable income) 1/



1/ Data for 2001 are constructed using quarterly flows for the first three quarters.

high mortgage borrowing as interest rates remained low, and the debt ratio rose further in the first half of 2001 (Table 6 and Figure 13). However, the ratio of personal debt service to disposable income has not increased appreciably as interest rates have declined. In the corporate sector, business bankruptcies have increased moderately relative to a year ago, chiefly concentrated in the automobile, telecommunications, and utilities sectors.[15] In the period since May 2001, the deterioration in the economic outlook and the increase in uncertainty, particularly after the September terrorist attacks, have contributed to a tightening in credit conditions for businesses, reflected in an increase in the yield spreads on corporate over government debt. The growth of business credit has, nonetheless, picked up in recent months, in part reflecting firms' increased demand for additional liquidity during a period of heightened economic uncertainty. This, along with slower growth in corporate profits, has arrested the decline in the debt of nonfinancial corporations as a ratio to GDP and in the debt-to-equity ratio (Figure 14).

Figure 14. Canada: Debt of Nonfinancial Corporations 1/
(In percent of GDP unless otherwise indicated)



1/ Data for 2001 are constructed using quarterly flows for the first three quarters.

16. ***Canadian financial institutions have been affected by the slowing in economic activity, but their overall capitalization and profitability remain high.*** [16] Major loan problems have not emerged, despite difficulties in some sectors, mainly because banks have been well diversified and provisioned. Banks' impaired loans rose from 1 percent of gross loans in 2000 to 1½ percent in the third quarter of 2001, reflecting developments in some domestic industrial sectors as well as in the U.S. economy.[17] Banks have responded by increasing loan-loss provisions; provisions for the first three quarters of 2001 were about 50 percent higher than in the same period of 2000. Banks' personal and commercial

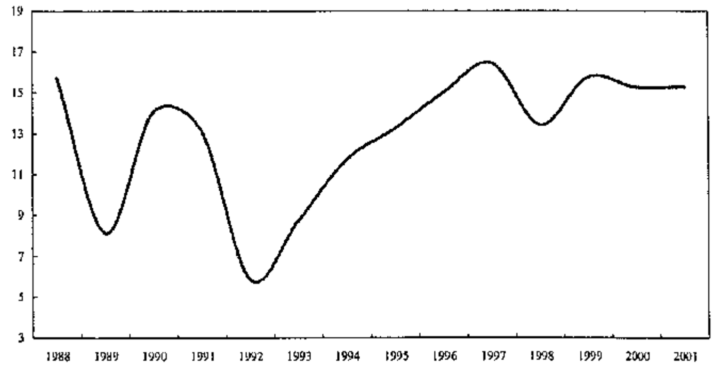
[15] The number of business bankruptcies during January–October 2001 was 3 percent higher than during the same period of 2000.

[16] In Canada, banks account for about 70 percent of total domestic assets held by the financial services sector. The six major domestic banks account for over 90 percent of the assets held by the banking industry. Data for the financial sector refer to financial years, which start on November 1.

[17] By contrast, in the early 1990s the ratio rose to 5½ percent. Canadian banks' total consolidated claims on the United States accounted for 17½ percent of their assets as of June 2001.

business lines have continued to provide a stable source of earnings growth, allowing the major banks' return on total equity to remain relatively robust at 15¼ percent (annual rate) through the third quarter of 2001 (Figure 15). The banks' total capital adequacy ratio rose to 12½ percent in the third quarter of 2001, well above the Office of the Superintendent of Financial Institutions' (OSFI) benchmark of 10 percent. Earnings growth has also declined among insurance companies and other nonbank financial institutions, but these institutions too remain well capitalized and have not encountered major difficulties.

Figure 15. Canada: Chartered Banks: Return on Total Shareholders' Equity
(In percent) 1/



1/ Based on data reported by six largest Canadian banks representing about 90 percent of all chartered banks' assets in Canada as of third quarter of 2001.

B. The Outlook

17. ***Economic activity in both Canada and the United States is expected to turn around starting in the first half of 2002 and gather pace during the year.*** Losses of output in the financial, transport, and tourism sectors, combined with the effects of declining consumer and business confidence on domestic demand are likely to contribute to a further decline in Canadian GDP during the fourth quarter of 2001. However, the substantial easing of monetary conditions in Canada, support from the tax cuts enacted in 2000 and from the working of the automatic fiscal stabilizers, and a recovery in U.S. growth are expected to contribute to a turnaround in the Canadian economy in early 2002 and a strengthening expansion during the remainder of the year and into 2003. On this basis, the staff's near-term outlook foresees GDP growth of 1½ percent in 2001, ¾ percent in 2002, and 3½ percent in 2003 (Table 7). Core inflation would fall to the lower end of the 1–3 percent target range in the near term, reflecting increased slack in the economy, and it would move back toward the middle of the range as the economy recovers.

18. ***During the rest of the medium-term forecast period through 2006, the staff envisages that GDP would grow faster than potential, with the output gap being closed by the end of the period.*** Unemployment would rise to a peak of 8 percent in 2002, before declining over the medium term to 6½ percent. The current account surplus as a percent of GDP would decline gradually as domestic activity picks up.

19. ***The main risk to the short-term outlook arises from developments in the United States (Box 2).*** In a "worse-case" scenario, a prolonged dip in U.S. consumer and business confidence would contribute to a substantial loss in private domestic demand in the United States, with knock-on effects on labor markets and second-round effects on investment and consumption that would be only partially offset by increased expenditure for reconstruction, government assistance, and defense. In this scenario, U.S. GDP would decline by ½ percent

Box 2. Canada-U.S. Economic Integration

During the 1980s and 1990s, the Canadian economy dramatically increased its exposure to the U.S. economy, primarily through greater trade integration (see tabulation). In 2000, 80 percent of Canadian merchandise trade was with the United States, up from 61 percent in 1980.[1] Even within the European Union and the euro-zone economies, trade is less integrated, despite economic and monetary union. Asian integration is even less pronounced, since a much larger share of Asian trade is with the United States.

Direct financial flows between the United States and Canada are more limited. In the balance of payments data, financial flows to and from the United States account for 54 percent of total Canadian financial flows. This statistic, however, may understate the financial linkages between the two countries. Canadian financial institutions have a sizable presence in the United States through their affiliates, and U.S. financial institutions likewise through their affiliates have a significant presence in Canada. More generally, direct investment is an important channel that ties the two economies together. The U.S. share in Canada's direct investment abroad is over 40 percent, equivalent to 12 percent of Canadian GDP, and U.S. direct investment in Canada accounts for approximately two-thirds of total foreign investment in Canada and is equivalent to 18 percent of Canadian GDP.

Close trade and financial integration have implied a strong correlation between economic developments in the two countries, with the correlation coefficients for Canada-U.S. equity price changes and real GDP growth during 1982-2000 being 0.71 and 0.88, respectively (see figures).

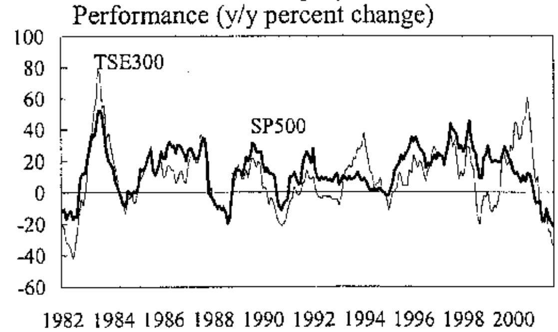
Trade and Financial Linkages, 2000

(in percent)

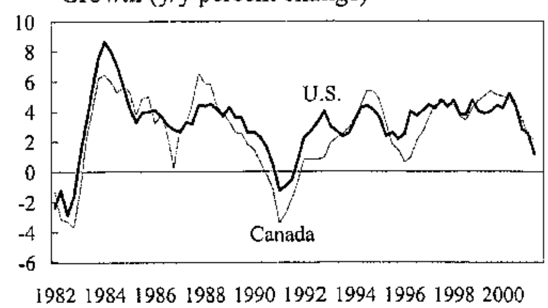
	Regional/ Total	U.S./ Total
Canada: Trade	80	80
Financial	54	54
EU: Trade	60	9
Euro-zone 1/		
Trade	49	8
Financial	31	...
Japan: Trade 2/	44	25
Australia: Trade 2/	57	15
w/ Japan	16	n.a.

Source: IMF DOTS and IFS, U.S. Bureau of Economic Analysis, Statistics Canada, and staff calculations. Trade data refer to merchandise trade.
1/ Includes Greece.
2/ Regional Asian trade includes Japan, Australia, New Zealand, and emerging Asian economies.

Canadian and U.S. Equity Market Performance (y/y percent change)



Canadian and U.S. Real GDP Growth (y/y percent change)



[1] U.S. trade shares in earlier years from V. Arora and A. Vamvakidis, "The Impact of U.S. Economic Growth on the Rest of the World: How Much Does It Matter?" IMF WP 01/119, 2001.

in 2002 before recovering in 2003. The effects on Canada would be felt mainly through the trade channel, and would be roughly similar to the decline in growth in the United States, assuming that the bilateral exchange rate is largely unchanged. In these circumstances, Canadian GDP growth would fall to around zero in 2002 before rising to 2¼ percent in 2003. The effects on GDP in Canada, however, could be cushioned to some extent by a depreciation in the Canadian dollar that would accompany a softening in commodity prices that might be associated with a further significant U.S. downturn.

20. The Canadian authorities and private sector analysts shared the staff's view that the Canadian and U.S. economies were likely to recover from their present weakness in the course of 2002, while acknowledging the unusually large degree of uncertainty in the economic outlook. They were generally more optimistic about the pace of the recovery than the staff, but expressed particular concerns about security-related problems that have adversely affected movements of goods across the U.S.-Canadian border.[18] Resolution of these problems was seen as vital for ensuring the near-term recovery of the Canadian economy and its long-term health, owing to the negative implications border traffic disruptions could have on future investment in Canadian plants to produce for the North American market.

I. Policy Discussions

21. ***In the context of the current economic slowdown and global uncertainty, the discussions focused on near-term economic prospects and policies.***

- ***The need for additional monetary actions.*** With inflationary pressures likely to remain subdued, the authorities and the staff agreed that monetary policy should be the main instrument used in attempting to limit the impact of the present downturn and that there remains scope for further easing to support economic activity should economic weakness persist.

- ***The fiscal policy actions that should be taken in response to the slowdown.*** With fiscal stimulus already being provided through the automatic stabilizers, the key issue was whether to provide additional discretionary stimulus in the budget that was to be released on December 10. The authorities felt that, beyond spending initiatives to meet national security needs, further discretionary action could undermine the hard-won credibility of the Government's medium-term commitment to continue lowering public debt.

[18] The forecasts of the authorities and private sector analysts at the time of the discussions expected real GDP growth to be around 1½ percent in 2002. Subsequently, the private consensus forecast was revised down to 1¼ percent.

22. ***The discussions also covered a number of issues affecting the medium-term evolution of the Canadian economy, including*:**

- Fiscal consequences for the federal and provincial governments stemming from the aging of the population, with particular attention being paid to health care costs.

- The need to further improve the flexibility and efficiency of the labor market in Canada, particularly through additional reforms to the Employment Insurance (EI) system.

- Further steps to liberalize international trade, particularly the removal of barriers to trade in agricultural, textile, clothing, and footwear products.

A. Monetary Policy and the Exchange Rate

23. ***The authorities and the staff agreed that monetary policy should be the main instrument used in attempting to limit the impact of the downturn and to speed the recovery of the economy.*** Although lags in the effects of policy changes on economic activity are potentially long and variable, monetary policy was seen as being able to respond more quickly and flexibly to developments in the economic situation. At this point, the authorities expected resource utilization to continue to slacken until the economy picked up strength in the latter part of 2002. Accordingly, both core and overall inflation are expected to remain below the mid-point of the 1–3 percent official target range throughout 2002 and into 2003. These circumstances afford considerable scope for monetary policy to provide support for economic activity, in the context of Canada's forward-looking inflation-targeting framework. The authorities noted that they had acted aggressively to cut rates rapidly after September 11, and with the high level of uncertainty prevailing, they emphasized that they remained ready to ease policy further should prospects remain weak. The Bank of Canada moved at its regular November 27 announcement date, after the mission, to reduce its target for the overnight rate by an additional 50 basis points.

24. ***The Governor of the Bank of Canada and the Finance Minister announced in May 2001 that the 1–3 percent inflation target range would be extended beyond its scheduled expiration in 2001 to the end of 2006.*** At the same time, several refinements to the inflation-targeting framework were introduced to strengthen its implementation and effectiveness (Box 3).[19] The staff welcomed these changes, which will enhance the conduct of monetary policy by further improving transparency, accountability, and communications with the public. The staff also noted the apparent success of the Bank of Canada's shift to a schedule of regular monetary policy announcements, introduced in late 2000. The authorities said that the announcement dates have made it easier for the Bank to operate monetary policy

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[19] See also M. Kaufman and R. Luzio, "Price Stability and the Choice of Inflation Target for Monetary Policy," in *Canada–Selected Issues*, IMF Staff Country Report No. 01/157, September 2001.

Box 3. Inflation Targeting and Monetary Policy Announcements

Inflation targeting has been the cornerstone of monetary policy in Canada over the last decade. The Bank of Canada seeks to maintain inflation around the mid-point of its target range. Using the overnight rate as its instrument, the Bank targets inflation over a 6 to 8 quarter horizon. Inflation targeting has made monetary policy actions more readily understandable to financial markets and the public, and provided a clear benchmark for evaluating the effectiveness of monetary policy.

Since the inception of inflation targeting in 1991, three reviews have been conducted by the Minister of Finance, on behalf of the Government, and the Governor of the Bank of Canada. At the last review (May 2001), the 1–3 percent inflation target range was renewed through the end of 2006, and several refinements were introduced to increase transparency and accountability. It was reaffirmed that monetary policy will continue to aim at keeping inflation near the 2 percent mid-point of the target range. The Bank, however, is not indifferent between inflation rates within the target range and would react with increasing force if inflation were expected to depart from the mid-point. To increase transparency and accountability, the Bank announced that its Monetary Policy Reports and Updates will pay special attention to explaining the sources of any deviations of actual inflation from the 2 percent target mid-point, the policy actions to bring inflation back in line, and the time horizon over which inflation would return to the mid-point.

Although overall CPI inflation is the objective of the target, the Bank uses core inflation as an operational guide. In the last review, the Bank redefined the core measure to better reflect trend inflationary pressures, excluding from the CPI the eight most volatile items and the direct effect of changes in indirect taxes.[1] The Bank has indicated that if the core and overall measures of inflation were to depart from each other for a prolonged period, the Bank would adjust policies and practices to attempt to ensure that overall inflation was at the mid-point of the target range.

In an effort to reduce uncertainty in financial markets and increase the focus of public attention on domestic economic conditions as the key factor in making monetary policy decisions, the Bank of Canada in December 2000 established a fixed schedule for announcements on policy decisions. The Bank retains the option to change policy any time between the fixed dates, although this discretion is intended to be used sparingly so as not to undermine the importance of the announcement dates. These dates were fixed primarily with reference to the release of important Canadian economic data. The move to regularly scheduled policy announcements also was prompted by the goal of avoiding the temporary market disruptions that had sometimes occurred under the previous arrangement where the Bank could potentially change interest rates on any business day.[2]

[1] The components of the CPI excluded from the new core measure are: fruit, vegetables, gasoline, fuel oil, natural gas, inter-city transportation, tobacco, and mortgage-interest costs. Previously, the core inflation measure excluded food and energy items and the effects of changes in indirect taxes.

[2] When a change in policy was anticipated, the money market would tend to stop operating for a short period in the morning around 9 a.m., the time that the Bank would usually intervene if it intended to change interest rates.

to reflect economic conditions in Canada and more independently of policy actions in the United States. Only on one occasion (following the September 11 terrorist attacks) did the Bank take a policy action between announcement dates, and this was clearly seen as involving extraordinary circumstances. Financial market participants told the staff that the fixed schedule of monetary policy announcement dates had helped reduce market uncertainty and volatility; they were generally supportive of the new regime.

25. ***Despite concerns in some quarters over the recent fall in the Canadian dollar's value, the authorities and the staff agreed that Canada's flexible exchange rate has continued to serve the country well.*** The recent depreciation of the currency primarily reflected cyclical conditions, particularly in commodity markets, and was helping to cushion Canada against the impact of the global downturn. The Bank of Canada's success in maintaining inflation near the mid-point of the target range has helped to anchor inflation expectations, allowing it to take monetary policy actions without large repercussions on the currency. Following the change in intervention policy in September 1998, Canada has not intervened unilaterally in the foreign exchange market. Market intervention is restricted to exceptional cases when the exchange rate is considered to be significantly misaligned and the Government's presence in the market is judged as being able to influence market perceptions about the currency's fundamental value.[20]

26. ***Over the medium term, Canada's strong macroeconomic fundamentals should support the value of the currency. Nevertheless, the exchange rate will continue to be influenced significantly by movements in non-energy commodity prices.***[21] A possible monetary union with the United States at some future stage remains an issue receiving some attention in the business and financial community, with proponents emphasizing the gains from a common currency and the political economy argument that a fixed exchange rate may foster greater harmonization of standards and regulations across the two countries, facilitating even closer economic integration. However, staff agreed with officials that the present flexible exchange rate regime has continued to provide a valuable degree of freedom for short-term macroeconomic management.[22]

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[20] Canada has not intervened in the foreign exchange market since September 2000, when it joined the European Central Bank and other central banks in a concerted foreign exchange market intervention to bolster the value of the euro.

[21] The estimates of the IMF's Coordinating Group on Exchange Rates (CGER), as of November 2001, suggest that the Canadian dollar would need to appreciate in real effective terms by about 10 percent on a multilateral basis to attain its medium-term equilibrium level. These estimates, however, do not incorporate the recent revisions to Canada's national income account statistics. In addition, they probably overstate the potential for a real appreciation of the Canadian dollar because they do not adequately account for the impact of non-energy commodity prices on the Canadian dollar's value.

[22] For a discussion of this issue, see V. Arora and O. Jeanne, "Economic Integration and the Exchange Rate Regime: Some Lessons from Canada," IMF Policy Discussion Paper PDP/01/1, May 2001.

B. Fiscal Policy

27. ***The Minister of Finance presented the 2001 Budget Plan on December 10.***[23] The Budget, which covers the remainder of 2001/02 and 2002/03–2003/04, seeks to support economic activity while preserving the authorities' framework of medium-term fiscal discipline (Table 8). New initiatives amount to $7 billion during 2001/02–2003/04 (¼ percent of cumulative GDP), mainly to strengthen national security as well as raise spending in other priority areas, such as skills, infrastructure, and official development assistance (ODA). The budget is expected to be roughly in balance in 2001/02–2003/04, compared to a surplus of more than 1½ percent of GDP in 2000/01. Most of the reduction in the surplus in 2001/02 reflects the effects of tax and expenditure measures enacted prior to the 2001 Budget. Any surplus that materializes in 2001/02 would be dedicated to two new funds for financing infrastructure projects and for providing aid to promote sustainable development in Africa.[24] The Government also strongly signaled its intention to continue with debt reduction in the medium term. The staff's estimates of the budget balance are roughly consistent with the authorities' estimates during 2001/02–2003/04 and suggest that there could be small "planning" surpluses after 2004/05 (Table 9).

28. ***The Budget continues with the approach taken in recent years of explicitly setting aside a "contingency reserve" to guard against unfavorable outcomes.*** (Box 4 provides a summary of the conclusions of the recent Report on the Observance of Standards and Codes (Fiscal Transparency Module) for Canada.) The contingency reserve, which previously was $3 billion annually, has been reduced to $1.5 billion in 2001/02, rising to $2.5 billion in 2003/04, and the economic prudence factor, which previously was $1–3 billion for 2001/02–2003/04, has been eliminated, reflecting the adverse economic shock. The authorities' intention is to rebuild the contingency reserve and economic prudence factor as soon as circumstances permit.

29. ***During the discussions in November, the Canadian officials agreed with the staff that the progress over the past decade in strengthening Canada's fiscal position had provided room for allowing the automatic stabilizers to function fully and for new policy initiatives in key areas like national security.*** The staff estimates that tax and expenditure measures previously enacted and those included in the 2001 Budget will provide stimulus to the economy equivalent on average to roughly 2 percent of GDP a year during the period

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[23] See Department of Finance Canada, *Budget Plan 2001*, December 10, 2001. While the budget is normally presented in February, the Government decided to advance the date this year in light of recent events and because it had not presented a formal budget in February 2001, owing to the comprehensive fiscal policy statement and initiatives introduced in its *Economic Statement and Budget Update* in October 2000.

[24] These are the Strategic Infrastructure Fund and the Africa Fund, respectively.

Box 4. Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency Module: Summary of Conclusions

The Fund's recent Report on the Observance of Standards and Codes (ROSC) Fiscal Transparency Module for Canada concluded that fiscal management in Canada meets the requirements of the fiscal transparency code and in a number of instances represents best practice.[1]

Recent reforms by federal and provincial governments continue to improve transparency. The federal government has been especially innovative in using private sector forecasts, a contingency reserve, and an economic prudence factor in its fiscal forecasts. The federal and provincial governments already extensively use accrual accounting. The federal and provincial governments use a broad definition of their economic activities by incorporating the activities of, and their investments in, noncommercial public enterprises into their balance sheets. The ROSC gives Canada high marks for statistical integrity, impartial tax administration, open procurement, and a transparent regulatory process.

The ROSC suggested a few areas where further improvements would be desirable, including:

- the preparation of timely, current year estimates of federal and provincial budgets on a comparable basis;
- the production of a comprehensive account of the procedures for the federal budget cycle and expenditure management system, including the respective roles of the authorities and the private sector in arriving at the economic and fiscal forecasts used in the budget;
- systematic reporting on the use of funds provided for contingencies in the federal budget;
- publication of the reconciliation between the federal government's national and public accounts forecasts of major fiscal aggregates.

[1] SM/01/330, October 31, 2001.

2001/02–2003/04 (Box 5). The authorities argued strongly against taking substantial additional discretionary fiscal actions. Although there have been some calls for more aggressive action, they felt that a substantial shift to stimulus in the budget would be interpreted as stepping away from a hard-won commitment to fiscal discipline and would drive up long-term interest rates, a position with which the staff agreed. The authorities thought that allowing the automatic stabilizers to work would represent a sufficient additional fiscal policy response to the economic slowdown.[25] Private sector analysts generally concurred with this view.

[25] The automatic stabilizers operate mainly on the revenue side. The authorities estimate that a 1 percentage point decline in real GDP growth reduces the fiscal balance by \$2½ billion (¼ percent of GDP) in both the current and the following year.

Box 5. Sources of Fiscal Stimulus

The tax reductions and other measures announced by the federal government in 2000 and 2001 are providing substantial stimulus to the economy. However, the stance of the general government is somewhat less expansionary than the federal government's over the next two fiscal years in part because of previously announced increases in contribution rates for the public pension plans (CPP/QPP) consistent with reforms to ensure the financial soundness of these plans.

There are several sources of fiscal stimulus. In its February 2000 Budget and October 2000 *Economic Statement and Budget Update*, the federal government announced substantial reductions in personal and corporate income taxes during the period ahead (see tabulation). The December 2001 Budget included further modest expenditure measures and some tax deferrals from 2001/02 to 2002/03. The employment insurance (EI) premium rate also is being steadily reduced, from $2.40 in 2000 to $2.10 in 2003, providing a small stimulus.

The ongoing increase in the CPP/QPP contribution rates (from 8.6 percent of taxable earnings in 2001 to 9.4 percent in 2002 and to 9.9 percent in 2003) partly offsets some of the stimulus from the federal government's budget. In addition, several provincial governments face pressure to take measures in the near term to balance their budgets consistent with balanced-budget legislation, partially offsetting tax cuts starting in 2000.[1] Overall, however, potential contractionary effects appear to be significantly smaller than the stimulus that is already in train.

Fiscal Stimulus, 2001/02–2003/04
(In billions of dollars)

	2001/02	2002/03	2003/04
Income tax cuts			
Federal government (measures in 2000)	-14.9	-20.0	-24.5
Federal government (measures in 2001 Budget)	-2.0	2.4	0.4
Other tax changes			
Cuts in EI premiums	-1.0	-0.5	-0.8
Increases in CPP/QPP contribution rates	2.6	2.4	1.4
Expenditure measures			
Federal government (December 2001 Budget)	2.7	2.6	2.7
Total tax and expenditure measures	-18.0	-18.2	-26.2
In percent of GDP	-1.7	-1.7	-2.3

[1] Tax cuts enacted by the provinces are estimated to be 1 percent of GDP in 2001/02, 1¼ percent in 2002/03, and 1½ percent in 2003/04. To balance their budgets, it is estimated that provinces would have to cut spending and/or raise revenues by ½ percent of GDP in 2001/02, ¾ percent in 2002/03, and ½ percent in 2003/04.

30. ***The staff and the authorities discussed the possibility of using some additional discretionary fiscal policy action in the event that the present downturn is expected to be significantly deeper and more persistent than is currently envisaged.*** The staff suggested that such actions should not be ruled out in such an eventuality, while emphasizing that (i) measures should be focused on boosting short-term activity, and (ii) it would have to be made clear that these measures were temporary or that offsetting actions would be taken when the economy recovers, in order to ensure that the medium-term objective of debt reduction was not compromised. The authorities expressed great misgivings about engaging in discretionary stimulus measures, even in the face of a more pronounced downturn. They

stressed that the benefits of such stimulus for an open economy like Canada facing a major external shock were likely to be limited. They were concerned that the level of government debt was still high, and they did not want to jeopardize the progress achieved over the past decade in eliminating fiscal deficits.

31. ***The 2000 Budget and the October 2000 Economic Statement and Budget Update introduced a series of reductions in personal income and capital taxes and a specific schedule for lowering the basic federal income tax rates for corporations.***[26] ***The authorities are not planning to pursue further major tax reforms at this time.*** The staff noted that combined federal-provincial personal income tax rates in Canada remain higher than comparable rates in the United States, and the previous gap between them will be largely re-established by 2006, when the U.S. tax cuts enacted in May 2001 are fully implemented. However, the authorities emphasized that Canada would have lower corporate income tax rates and capital gains taxes, which they felt were important for investment and growth.[27] Possible corporate tax measures in a new U.S. fiscal stimulus package might reduce this advantage. Nevertheless, the authorities and staff agreed that Canada should not attempt to simply match U.S. tax changes, and the authorities said that they would continue to examine ways to improve the income tax system in Canada and would act when sufficient resources were available.

32. ***The pressures arising from the economic slowdown have led some provincial governments to start taking measures to protect their fiscal positions in line with legislated balanced budget requirements.*** Such measures would only partially offset the stimulatory effects stemming from previously enacted cuts in provincial income tax rates and the easing of the federal budget position.[28] Moreover, unless the downturn were substantially worse than currently envisaged, the provinces still would have room to exercise some discretion in

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[26] For details see Department of Finance Canada, *Economic Statement and Budget Update,* October 18, 2000 and IMF, *Canada: Staff Report for the 2001 Article IV Consultation,* Country Report No. 01/62, April 2001. The measures addressed key problems in the tax system, where high marginal and average income tax rates were creating disincentives to work and save and a high variation of corporate income tax rates across industries increased economic inefficiencies and compliance costs.

[27] When the reductions announced in 2000 are fully implemented in 2004, the combined federal-provincial corporate income tax rate in Canada would be 5 percentage points below the current rate in the United States. The capital gains inclusion rate in Canada was reduced from ¾ to ½ , yielding effective tax rates that are slightly lower than in the United States.

[28] The staff estimates that, to balance their budgets in 2001/02–2003/04, the provinces would have to raise taxes or cut spending by roughly ½ percent of GDP a year, which is substantially less than the roughly 1¼ percent a year effect of the previously enacted provincial income tax reductions.

adjusting their budget positions because legislation in most (but not all) provinces provides some flexibility with regard to the period over which their budgets need to be balanced.[29]

33. ***The provinces face significant spending pressures associated with their responsibility to provide health care.***[30] Both the federal and provincial governments are concerned about improving the quality of health-care services, while recognizing that the aging of the population will increase the burden on the health care system over the medium term. The prospective population aging is relatively gradual, with the elderly population expected to peak in 2040 and then decline. However, since the outlook depends importantly on health care prices, which are very difficult to predict, the authorities agreed that measures need to be taken to prepare for the uncertainty in future costs.[31] The authorities emphasized that it was especially important that measures be taken to improve the efficiency of the provision of health care services and to control costs. While recognizing that the September 2000 agreement between the federal and provincial governments established a framework for funding health expenditures, the staff expressed concern that in the past agreed caps on federal-provincial transfers had at times been raised. The staff suggested that hardening budget constraints could provide useful incentives for reforming the health-care system, but it acknowledged the political difficulties in doing so. Several commissions are currently examining both the near- and long-term issues and are expected to recommend specific measures.[32]

34. ***Reforms to the Canada Pension Plan (CPP) introduced in late 1997 have put the plan on a sound financial footing.***[33] The reforms included a phased increase in contribution

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[29] In most provinces, a surplus in one year can provide an accounting reserve to be "drawn on" if a deficit is incurred in a subsequent year. In addition, the legislation in many provinces builds in exemptions for "special events," although these have not yet been invoked.

[30] In 2000, total health care spending in Canada was equivalent to 9 percent of GDP, of which 6½ percent of GDP represented public spending, the bulk of it by provincial governments (6 percent of GDP).

[31] The authorities estimated that provincial governments' health expenditure could rise to 10–11½ percent of GDP in 2040, which is within the range estimated by the staff. See V. Arora and C. MacDonagh-Dumler, "Aging, Health Care Costs, and Fiscal Policy in Canada," forthcoming IMF Working Paper, 2002.

[32] Five commissions are currently examining the Canadian health care system, with three of them focusing on provincial health care delivery in Alberta, Quebec, and Saskatchewan.

[33] The most recent report of the Chief Actuary indicates that the CPP remains sustainable over the long term and can meet its financial obligations without further increases in the contribution rate beyond those already scheduled to take effect. See Office of the Chief

(continued)

rates and a diversification of the plan's portfolio by investing accumulated surpluses in private assets in order to raise the rate of return. The CPP Investment Board, which is responsible for managing the plan's new net cash flow, has been allowed to follow active investment strategies in domestic equities beginning in August 2000.[34] The authorities confirmed that these investment strategies have allowed the Board to contain losses in recent months by reducing exposure to hard-hit telecommunications companies that weigh heavily in Canadian stock market indices. The authorities did not foresee major risks to the CPP's portfolio from sharp corrections in equity prices, since equities accounted for only around 23 percent of total assets, and the CPP's holdings were long term.

C. Other Issues

35. ***Notwithstanding comprehensive reforms in the 1990s to the EI system, which have improved the flexibility and efficiency of the labor market, substantial disincentives to work remain.*** In particular, frequent use of the system, along with the provision of EI benefits for high-unemployment regions for indefinite periods of time, has distorted incentives for both workers and employers, contributed to raising reservation wages, and hampered labor mobility (Box 6). With the labor market softening, the authorities noted that pressures are already emerging to extend EI benefits and further roll back some of the reforms achieved during the 1990s.[35] The staff urged the authorities to resist such pressures, given that the current system already contains a mechanism to provide for additional EI benefits in the event of cyclical downturns. Although acknowledging that current economic conditions were not conducive to attempts to tighten the system, the staff recommended, as in previous years, that attention be given to reducing frequent use of the system by implementing experience rating of the EI premium rate (which would link the rate for individual firms to the frequency

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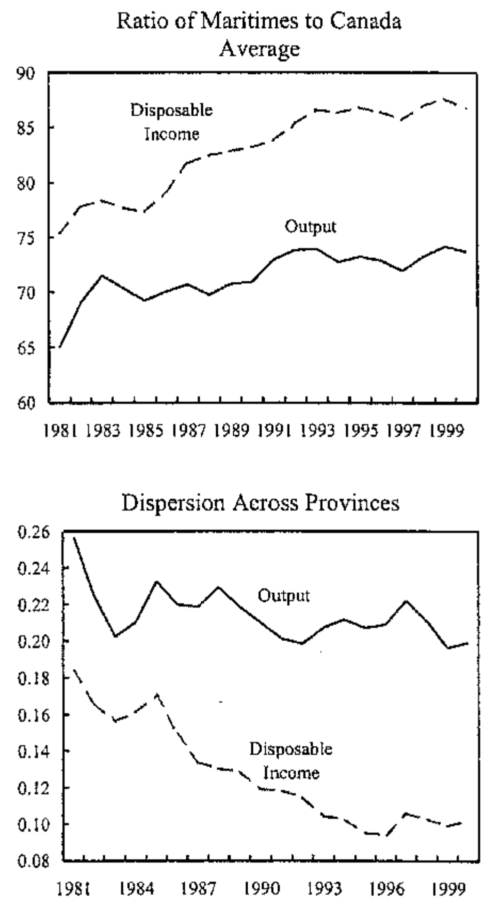
Actuary (Office of the Superintendent of Financial Institutions), *Actuarial Report (18th) on the Canada Pension Plan as at 31 December, 2000*, November 2001.

[34] For a brief discussion of the CPP Investment Board, see V. Arora and S. Dunaway, "Investing Government Assets in Private Securities: Policy Options and International Experience," in *United States–Selected Issues,* IMF Staff Country Report No. 01/149, August 2001. Fifty percent of the portfolio is now managed actively, and this is expected to increase to 100 percent in 2002.

[35] In 2000, the authorities reversed some of the EI reforms enacted in 1996, which they viewed as not having had the intended effects or as being inconsistent with their social objectives. For example, the "intensity rule" that penalized frequent users of the system was eliminated; the "clawback provision" that took back a proportion of benefits if income was above a certain level was relaxed; and maternity and parental leave benefits were made more generous.

Box 6. Transfer Payments and Convergence[1]

Inter-provincial disparities in standards of living have fallen markedly over the past two decades, with per capita disposable income in the four Maritime Provinces rising from 75 percent of the national average in 1981 to 87 percent in 2000 (figure, top panel). But there is still a marked gap in output between provinces. For example, per capita output in the Maritimes was only 74 percent of the national average in 2000, up from 65 percent in 1981.



Differences in the level and evolution of real GDP and disposable income across provinces (in per capita real dollars) can be summarized by comparing their inter-provincial dispersion as measured by the coefficient of variation. Output is far more dispersed across provinces than disposable income, suggesting that the extent of inequality is much greater in output than in the standard of living (figure, bottom panel). Moreover, the dispersion of disposable income has fallen markedly since 1981, while that of output has changed relatively little.

The lack of convergence in output compared to disposable income indicates that more equal living standards have resulted from increased transfers and not from a narrowing of differences in output. Disposable income is essentially comparable to output less taxes plus transfers. While poorer provinces would be expected to gain from transfers, the extent of the discrepancy with the richer provinces has widened since 1980. In 1999, for example, Newfoundland and Prince Edward Island received 3 to 3½ times the national average of per capita transfers from employment insurance benefits, up from 2 to 2½ times in 1980.

While the system of taxes and transfers has reduced disparities in standards of living across provinces over the past 20 years, this has been possibly at the cost of slowing down convergence in output. Aspects of the transfer system lessen incentives for individuals and firms to adjust to changes in economic circumstances and thus lower economic efficiency. Regional extended benefits under the Employment Insurance (EI) system, for example, provide disincentives for individual adjustment, either through changes in occupations or industry or through migration to areas with better employment prospects. Also, the lack of experience rating in EI allows firms to utilize repeated layoffs—including predictable seasonal layoffs—to maintain an underutilized workforce. Over the medium term, such supply-side factors translate into output divergences across provinces. Improving incentives is vital for promoting greater convergence in per capita output across the provinces.

[1] This topic is discussed further in M. Kaufman and P. Swagel, "Transfer Payments and Convergence in Canada," forthcoming IMF Working Paper, 2002.

of use of the system by their workers) and eliminating the practice of extending EI benefits for individuals in high-unemployment regions on an indefinite basis.

36. ***Representatives from the Canadian Labour Congress (CLC) took exception to the staff's views on the EI system.*** The CLC representatives expressed concerns regarding the adequacy of the current EI system, with its restrictive eligibility criteria and limited benefit period, as a social safety net in the event of a pronounced economic downturn and as a mechanism for helping workers adjust to a shifting demand for skills in the "high-tech" based economy of the future. With some important training and adjustment assistance programs currently provided through the EI system, they felt it was important to broaden EI access and benefits. The staff responded that its policy recommendations were based on its view of EI as a somewhat narrower program, which should aim to temporarily aid unemployed workers without unduly affecting incentives to find new employment. The staff thought that the system would provide an adequate safety net even in a pronounced downturn, and the staff's recommended reforms would considerably improve economic efficiency over the medium term. The staff agreed on the need, noted by the CLC representatives, for a comprehensive approach to deal with life-long education and training needs of workers, but thought that this issue could be better dealt with through broader social assistance and education programs than through the EI system. The authorities said that the Government was taking steps to deal with the issue, including by placing emphasis on lifetime learning in new education programs.

37. ***Both the authorities and private sector analysts were confident that the Canadian financial system would remain robust in the face of the anticipated slowdown.***[36] Bank revenues were under pressure from declining fee-based income and shrinking discount and brokerage lines of business, especially in the United States. Loan quality was expected to dip somewhat further, reflecting the effects of slowing activity and the greater uncertainty following the terrorist attacks. However, as long as the slowdown was not substantially greater than currently envisaged, the authorities and private sector analysts did not foresee any major problems for banks, whose profitability and capital base remained solid (Table 10). Moreover, the banks were judged to be managing their exposures well, including via appropriate forward-looking provisioning against potential bad loans, effective loan disposals, diversification of business lines, and tighter lending standards. The non-bank financial sector, including insurance companies, was also expected to weather the slowdown well. It was generally acknowledged that a more severe downturn than is envisaged could lead to a substantial drop in financial institutions' profitability and asset quality; however, it was hard to foresee exactly how and where these institutions might encounter difficulties. Nevertheless, the authorities remained alert to this prospect.

[36] A Financial Sector Stability Assessment (FSSA) was undertaken in conjunction with the 2000 Article IV consultation. See Appendix I for an update on the authorities' responses to the FSSA assessment.

38. ***New legislation to reform the financial services sector, which started being implemented in October 2001, is expected to improve the efficiency of the Canadian financial system over the longer term, but to have limited impact in the near term.***[37] The authorities expected that by reducing barriers to entry, such as minimum capital requirements for starting a bank, the legislation could lead to some increase in the competition for banking services as the number of small banks rose over time. In addition, the legislation made it easier for non-bank institutions to engage in traditional banking activities, which could also increase the competition for deposit taking and other bank-like activities. Private sector analysts believed that an opening up of the payments system to non-bank institutions would add to competition as well. However, neither the authorities nor private sector analysts expected the new, more flexible ownership rules to produce either a significant number of new entrants or foster much merger activity in the near term, in part because the current relatively high efficiency and competitiveness of the banking system would make it difficult for new firms to find profit opportunities and because the merger approval process remains somewhat cumbersome and politically sensitive.

39. ***The authorities noted that updated anti-money-laundering legislation (enacted in June 2000 and amended in June 2001) brought Canada into full compliance with all of the recommendations of the Financial Action Task Force (FATF) on money laundering that required action.*** The new law, which came into full force in November 2001, imposes anti-money laundering obligations on the full range of financial institutions, strengthens the existing legislative provisions on record keeping, and introduces mandatory reporting of suspicious transactions and of the cross-border movement of large amounts of currency and monetary instruments. To address criminal activity by terrorists, Canada tabled a new law on October 15, 2001, that is consistent with the FATF's anti-terrorist-financing recommendations announced in late October. The authorities also noted that an OECD review found Canada's anti-bribery legislation as meeting the requirements set by the Convention on Combating Bribery of Foreign Public Officials.

40. ***Inter-provincial barriers to the free flow of workers, goods, services, and capital have been steadily reduced in the context of the Agreement on Internal Trade (AIT), initiated in 1995.*** Full compliance with the labor mobility provisions of the AIT, including mutual recognition of occupational qualifications and the elimination of residency requirements, was originally scheduled for completion by July 2001, and this deadline has been met for most of the regulated occupations, covering the vast majority of workers.[38] The

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[37] For further discussion of the legislation see P. De Masi and M. Cerisola, "Financial Sector Reform," in *Canada–Selected Issues,* IMF Staff Country Report No. 01/157, September 2001.

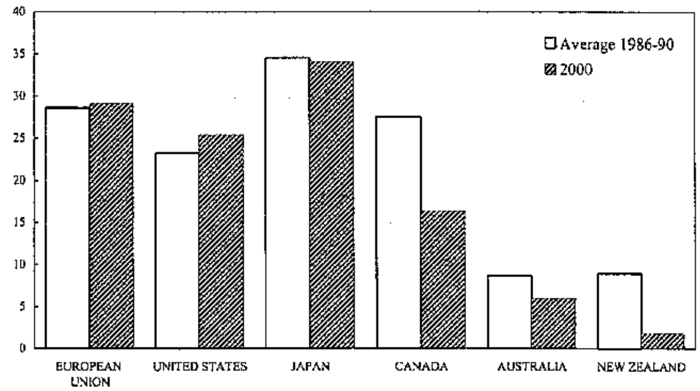
[38] Regulatory bodies representing 42 of the 51 regulated occupations (including all of the major occupations) have agreed or substantially agreed on conditions under which mobility will be facilitated (usually documented in the form of a mutual recognition agreement). The remaining nine regulated occupations have complex issues to resolve, including differences

(continued)

authorities indicated that progress has also been made in a number of other major areas, including in government procurement, a code of conduct for provincial investment incentives, and energy. The agreement on government procurement issues and the code of conduct for incentives are fully in place, and the energy agreement is nearly complete.

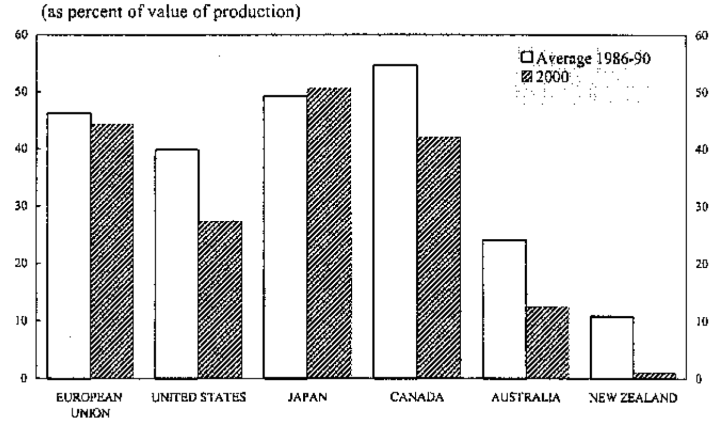
41. ***Canada is actively pursuing international trade liberalization initiatives at the multilateral, regional, and bilateral levels.*** Canada is a strong supporter of the new round of multilateral trade negotiations under the WTO and is fully engaged in the Free Trade of the Americas initiative to create a free-trade zone in the Western Hemisphere by 2005. The country has an open trade regime; however, some exceptions remain in traditionally sensitive sectors, mainly agriculture, textiles, clothing, and footwear.[39] While overall support levels for agriculture in Canada are lower than in Europe, Japan, and the United States, they are relatively high for "supply-managed products" (dairy, poultry, and eggs; Figures 16 and 17). The authorities expressed their commitment to increasing trade liberalization in these areas. While the authorities have moved to increase access for the least developed countries, including through tariff reductions in 500 lines last year and improvements in the rules of origin, the exports of these countries to the Canadian market still face quotas and high tariffs on some

Figure 16. International Comparison: Total Support Estimate for Agriculture
(as percent of value of production)



Source: OECD

Figure 17. International Comparison: Producer Support for Supply-Managed Goods
(as percent of value of production)



Source: OECD

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with respect to scope of practice, educational requirements, initial assessment of workers, continuing competence, recognition of foreign credentials, and the recognition of workers who have been licensed under a grand-parenting clause.

[39] Canada's rating on the IMF's trade restrictiveness index is 4 (on a scale ranging from 1 to 10, with 1 being the least restrictive) and has been relatively stable over the past few years. Its rating is broadly similar to most industrial countries.

products, especially textiles, clothing, and footwear.[40] The authorities indicated that the majority of textile items imported from the least developed countries are duty free and that Canada will eliminate its remaining quotas on textiles and clothing by end-December 2004.

42. ***Canada's official development assistance (ODA) as a percent of GNP has declined steadily in recent years, falling to 0.25 percent in 2000 (Table 11).*** The authorities indicated that they remained committed to moving toward the Government's long-term ODA objective of 0.7 percent of GNP as Canada's fiscal situation allows and to improving the effectiveness of ODA. The Budget announced on December 10 includes a $1 billion increase in ODA over the next three years, half of which would go to a fund for promoting sustainable development in Africa.

IV. STAFF APPRAISAL

43. ***The sound macroeconomic and structural policies implemented and sustained by the Canadian authorities during the past decade have put the economy in a good position to weather the current global economic slowdown and the uncertainty following the tragic events of last September.*** Monetary policy has successfully maintained low inflation, and the Bank of Canada's policy management over the past year has further enhanced the credibility of the monetary policy framework. In this context, the staff welcomes the authorities' decision last May to maintain the 1–3 percent inflation target range and the refinements to the framework introduced at that time. Fiscal consolidation by all levels of government has brought budgets into surplus and led to a sharp reduction in government debt as a share of GDP. Important structural reforms, including reductions in personal and corporate income taxes and improvements in the employment insurance system and the financial regulatory framework, have enhanced economic efficiency and further strengthened the financial system.

44. ***The staff believes that monetary policy should be the main instrument used in attempting to limit the impact of the current global economic downturn and to promote the economy's quick recovery.*** The Bank of Canada has responded promptly to signs of increasing economic weakness, and with inflationary pressures likely to remain subdued and little sign of sustained upward pressure on wages, there remains scope for further monetary policy easing to support economic activity. Within the context of its forward-looking inflation target framework, the Bank of Canada should use this room if economic prospects remain weak.

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[40] Most favored nation tariffs average around 30 percent for food products and in the range of 10 percent to 16 percent for textiles, clothing, and footwear. Average preference margins on these goods under the Generalized System of Preferences range from zero to 2 percentage points; for the least developed countries, preference margins average 2 to 6 percentage points.

45. ***A flexible exchange rate arrangement has continued to serve Canada well.*** The recent depreciation in the exchange rate of the Canadian dollar primarily reflects cyclical conditions and helps to cushion the impact on Canada of the U.S. slowdown and the weakness in commodity prices. Canada's strong macroeconomic fundamentals should support the value of the currency over the longer term.

46. ***Fiscal support is being provided to the economy through the working of the automatic fiscal stabilizers, as well as the previously enacted tax and expenditure measures, while the overall fiscal framework remains sound.*** The progress over the past decade in strengthening Canada's fiscal balance has provided room for continuing to allow the automatic stabilizers to function and for the new policy initiatives in priority areas, like national security, introduced in the 2001 Budget. That said, the authorities have acted prudently in resisting the temptation to add major discretionary stimulus in present circumstances, which would probably have had only a limited economic impact, and could have undermined the hard-won credibility of the authorities' commitment to fiscal consolidation. In a similar vein, the staff welcomes the authorities' strong assurances that they continue to be fully committed to the medium-term objective of bringing down the debt-to-GDP ratio.

47. ***The Fund's recent Report on the Observance of Standards and Codes provides a favorable assessment of fiscal transparency in Canada.*** It concludes that Canada's fiscal management meets the requirements of the fiscal transparency code and represents best practice in a number of instances. In this context, the staff welcomes the authorities' intention to rebuild the contingency reserve and economic prudence factor in the budget consistent with the approach used in preparing the budget in recent years.

48. ***The reductions in federal and provincial income tax burdens in recent years, including the substantial cuts in federal corporate and personal income taxes enacted in 2000, are welcome and should offer considerable efficiency gains in the period ahead.*** When the cuts are fully implemented, capital gains taxes and average corporate income tax rates will be below current levels in the United States. However, combined federal and provincial personal income tax rates in Canada will remain higher than comparable U.S. rates, and the previous gap between these tax rates will be largely re-established as the federal tax cuts enacted in the United States during 2001 go into effect. While the staff does not see a pressing case for simply matching the tax cuts in the United States, there is still scope for enhancing economic efficiency and the rewards to entrepreneurship and human capital by reducing marginal personal income tax rates and, more importantly, by increasing the income thresholds at which they apply.

49. ***Provincial and territorial governments have strengthened their finances in recent years, and they have been able to pursue tax reductions and new spending initiatives while continuing to reduce debt.*** Faced with pressures on their budgets from the current weakness in economic activity, provinces are already moving to take measures in order to meet their legislated balanced budget requirements. They also face other significant pressures, especially those associated with health care. Improving health care services is a priority of

both the federal and provincial governments in the near term, and efforts should continue to be made toward more efficient delivery and greater cost control in medical services. The aging of the baby-boom generation will increase the burden on the health care system, and steps should be taken by all levels of government to start addressing these prospective needs as soon as possible.

50. Pressures to extend EI benefits and further roll back some of the fundamental EI reforms achieved during the 1990s should be resisted. The current system already contains a mechanism to provide for additional benefits in the event of cyclical downturns. Moreover, the staff continues to believe that the Government should reduce disincentives remaining in the EI system. Frequent use of the system would be discouraged by eliminating the provision of regional extended benefits on an indefinite basis and by implementing experience rating of the EI premium rate (which would link the rate for individual firms to the frequency of use of the system by their workers). Priorities with respect to education, training, and other assistance to facilitate labor market adjustment are important and would best be addressed through other programs.

51. ***The financial system in Canada is among the most highly advanced and sound in the world, and it is supported by a well-developed regulatory and supervisory framework.*** In this context, the staff welcomes the financial system reform legislation enacted last February. Financial institutions are well capitalized and provisioned and appear well positioned to manage pressures arising from the anticipated slowdown in economic activity, including the adverse impact on corporate and household balance sheets. Nevertheless, more profound and protracted weakness in the Canadian and U.S. economies could create difficulties in parts of the financial system, and the staff agrees with the authorities that they should remain alert to any such pressures.

52. ***Canada has long been a leader in trade liberalization initiatives at the multilateral, regional, and bilateral levels, and the staff urges the authorities to continue to pursue trade liberalization vigorously.*** While Canada has an open trade regime, protection levels remain high in sensitive sectors, mainly "supply-managed" agricultural products, textiles, and clothing. Canada has provided favorable access to its market for the least developed countries, but the exports of these countries to Canada still face quotas and high tariffs on some products, especially textiles, clothing, and footwear. The staff urges the authorities to accelerate trade liberalization in these products both for Canada's benefit and that of other countries. In particular, the staff encourages quick progress toward the objective of duty- and quota-free market access for the exports of least developed countries established in the Doha Ministerial Declaration.

53. ***Canada's ODA as a share of GNP has declined by almost half since 1992 to only 0.25 percent of GNP in 2000.*** The staff encourages the authorities to begin raising ODA spending toward Canada's long-standing development-assistance target of 0.7 percent of GNP, and the new commitments in the 2001 Budget are a welcome step in this direction.

54. It is recommended that the next Article IV consultation takes place within the standard 12-month cycle.

Table 1. Canada: Selected Economic Indicators

	Averages							
	1960s	1970s	1980s	1996	1997	1998	1999	2000
(In percent change from previous period at annual rates, unless otherwise indicated)								
Economic activity and prices 1/								
Real GDP	5.6	4.4	3.1	1.6	4.3	3.9	5.1	4.4
Real net exports 2/	0.3	0.0	-0.1	0.4	-1.7	1.7	1.3	0.2
Real final domestic demand	5.2	4.6	3.0	2.0	5.5	2.6	4.1	4.0
Consumer spending	4.8	4.5	3.1	2.6	4.6	3.0	3.4	3.6
Nonresidential fixed investment	4.3	5.9	-0.2	1.8	17.7	0.4	1.8	5.3
Labor market								
Labor force	...	...	2.0	1.0	1.7	1.8	2.0	1.8
Employment	...	...	2.0	0.8	2.3	2.7	2.8	2.6
Unemployment rate (period average)	...	...	9.4	9.6	9.1	8.3	7.6	6.8
Labor productivity (business sector)	...	...	...	-0.2	2.6	2.2	2.4	1.6
Prices								
Implicit price deflator for GDP 1/	5.7	8.1	4.6	1.7	1.2	-0.4	1.4	3.7
Core consumer price index	...	...	...	1.5	1.5	1.2	1.5	1.5
Unit labor cost (business sector)	...	7.7	5.6	1.8	2.4	2.6	0.6	2.7
Exchange rate								
U.S. cents/Canadian dollars (closing spot rate)	93.5	96.4	79.5	73.3	72.0	67.1	67.5	67.3
Percent change	-1.1	-0.8	0.0	0.3	-1.8	-6.8	0.6	-0.3
Nominal effective exchange rate 3/	-1.1	-1.3	0.0	1.7	0.2	-6.0	-0.6	1.2
Real effective exchange rate 4/	...	...	1.3	1.0	2.9	-5.9	-0.7	1.0
Interest rates								
Three-month Treasury bill rate	...	7.0	11.3	4.3	3.2	4.7	4.7	5.5
Ten-year Treasury bond rate	...	...	...	7.2	6.1	5.3	5.6	5.9
(In percent of GDP or NDP)								
Balance of payments								
Current account balance	-2.2	-2.6	-2.2	0.5	-1.3	-1.3	0.2	2.5
Merchandise trade balance	0.9	1.7	2.9	5.1	2.9	2.5	3.9	5.6
Invisibles balance	-3.1	-4.3	-5.0	-4.5	-4.2	-3.8	-3.8	-3.1
Fiscal indicators								
General government fiscal balance (NIA)	-1.0	-1.9	-6.0	-2.8	0.2	0.5	1.6	3.2
Federal government fiscal balance (NIA)	-0.9	-2.2	-5.3	-2.0	0.7	1.0	0.9	1.8
Provincial government fiscal balance (NIA) 5/	-0.6	-0.9	-1.3	-0.5	-0.2	-0.4	0.7	1.0
Saving and investment 6/								
Gross national saving	21.9	22.3	20.4	18.7	19.6	19.2	20.7	23.4
General government	3.9	2.2	-2.2	-0.4	2.2	2.4	3.4	5.4
of which: Federal government	-0.2	-1.7	-4.8	-1.8	1.1	1.3	1.2	2.1
Private	18.0	20.1	22.6	19.1	17.4	16.8	17.3	18.0
Personal	7.7	10.7	13.1	7.5	6.0	5.8	5.5	5.1
Business	10.3	9.4	9.5	11.6	11.4	11.0	11.8	12.9
Gross domestic investment	23.5	23.6	21.7	18.1	20.7	20.5	20.3	20.5
Private	18.9	20.0	18.8	15.7	18.4	18.3	18.0	18.1
Public	4.6	3.6	2.9	2.5	2.3	2.2	2.3	2.3
of which: Federal government	0.7	0.5	0.5	0.4	0.4	0.3	0.3	0.3
Net foreign investment	1.8	1.8	1.9	-1.0	1.5	1.8	-0.6	-3.8
Net national saving	13.5	14.3	11.0	7.5	8.7	8.0	10.4	14.4
Net private investment	12.1	14.0	11.7	6.2	9.9	9.5	9.3	9.7
In real terms								
Gross domestic investment 1/	15.4	15.7	18.2	18.2	20.7	20.0	20.4	21.2
Private	12.3	13.3	15.9	15.7	18.4	17.9	18.0	18.8
Public	3.1	2.4	2.3	2.4	2.3	2.2	2.3	2.4
				Fiscal Years				
Memorandum item:				1996/97	1997/98	1998/99	1999/00	2000/01
Federal fiscal balance (public accounts)	...	...	...	-1.1	0.4	0.3	1.3	1.6

Sources: Statistics Canada; and Fund staff estimates.

1/ Data for the 1960s-1970s are based on the old (unrevised) national accounts statistics.
2/ Contribution to growth.
3/ Constructed using 1989-91 trade weights.
4/ Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989-91 trade weights.
5/ Includes local governments and hospitals.
6/ Gross national saving does not equal the sum of gross domestic investment and net foreign investment because of statistical discrepancy.

Table 2. Canada: Balance of Payments

(In billions of Canadian dollars)

	1996	1997	1998	1999	2000	2001 1/
Current account balance	4.6	-11.4	-12.3	1.7	26.9	37.5
In percent of GDP	0.5	-1.3	-1.3	0.2	2.5	3.4
Merchandise trade balance	42.4	25.7	22.8	38.4	59.3	68.1
Exports, goods	280.1	303.4	326.2	365.2	422.6	424.9
Imports, goods	237.7	277.7	303.4	326.8	363.3	356.8
Services balance	-9.1	-8.9	-6.6	-6.5	-6.7	-6.5
Investment income balance	-29.4	-28.9	-29.2	-31.4	-27.1	-25.5
Transfer balance	0.7	0.7	0.7	1.1	1.5	1.5
Capital and financial accounts balance	-12.2	15.8	5.0	-12.0	-15.2	-16.8
Direct investment, net	-4.7	-16.0	-17.8	10.0	28.6	-21.4
In Canada	13.1	16.0	33.5	37.4	94.1	40.3
Abroad	-17.9	-31.9	-51.3	-27.4	-65.4	-61.7
Portfolio investment, net	-0.6	4.3	2.2	-19.5	-43.0	-26.0
Canadian securities	18.7	16.2	24.7	3.6	19.6	17.0
Bonds	18.0	6.2	11.0	2.1	-17.4	24.2
Stocks	8.0	7.6	13.6	14.1	35.3	5.0
Money market	-7.3	2.4	0.1	-12.6	1.8	-12.2
Foreign securities	-19.3	-11.8	-22.5	-23.1	-62.7	-42.9
Bonds	-2.1	-6.6	-7.1	-2.5	-4.0	-3.0
Stocks	-17.2	-5.2	-15.4	-20.6	-58.7	-40.0
Other investment 2/	-7.3	16.5	23.1	1.3	-0.6	27.9
Assets	-28.6	-22.1	13.9	13.9	-1.3	14.0
Liabilities	21.3	38.7	9.1	-12.7	0.8	13.9
Other flows, net	8.0	7.5	4.9	5.0	5.3	5.6
Transactions in official international reserves	-7.5	3.4	-7.5	-8.8	-5.5	-3.0
Statistical discrepancy	7.6	-4.4	7.3	10.3	-11.7	-20.8
Memorandum item:						
Net external debt	-311.4	-304.0	-317.1	-270.7	-243.7	...
In percent of GDP	-37.1	-34.4	-34.6	-27.8	-23.1	...

Source: Statistics Canada.

1/ First three quarters of the year at annual rates, current account flows have been seasonally adjusted.
2/ Includes bank, nonbank, and official transactions other than reserve transactions.

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

(In billions of Canadian dollars; unless otherwise indicated)

	Fiscal Years						
	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01
Total revenues	123.3	130.3	140.9	153.2	155.7	165.7	178.6
In percent of GDP	16.0	16.0	16.8	17.3	17.0	17.0	16.9
Total spending	160.8	158.9	149.8	149.7	152.8	153.4	161.4
In percent of GDP	20.8	19.6	17.9	16.9	16.7	15.7	15.3
Program spending	118.7	112.0	104.8	108.8	111.4	111.8	119.3
In percent of GDP	15.4	13.8	12.5	12.3	12.2	11.5	11.3
Interest payments	42.0	46.9	45.0	40.9	41.4	41.6	42.1
In percent of GDP	5.4	5.8	5.4	4.6	4.5	4.3	4.0
Budget balance	-37.5	-28.5	-8.9	3.5	2.8	12.3	17.1
In percent of GDP	-4.8	-3.5	-1.1	0.4	0.3	1.3	1.6
Net public debt	545.7	574.3	583.2	579.7	576.9	564.5	547.4
In percent of GDP	70.6	70.7	69.5	65.5	63.0	57.9	51.8
Memorandum items:							
Structural budget balance	-29.8	-20.2	1.6	12.9	10.1	15.7	17.3
In percent of GDP	-3.9	-2.5	0.2	1.5	1.1	1.6	1.6
Primary balance	4.6	18.3	36.1	44.4	44.2	53.9	59.2
In percent of GDP	0.6	2.3	4.3	5.0	4.8	5.5	5.6
Structural primary balance	12.3	26.7	46.6	53.8	51.5	57.3	59.4
In percent of GDP	1.6	3.3	5.6	6.1	5.6	5.9	5.6

Sources: Department of Finance; and Fund staff estimates.

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

Table 4. Canada: Net Government Debt

(In percent of GDP)

	1980	1994	1995	1996	1997	1998	1999	2000
National accounts basis 1/	26.5	87.0	88.6	87.8	84.1	81.2	74.9	66.3
Federal	23.9	68.0	69.3	68.4	64.4	61.3	57.2	50.9
Provincial 2/	10.6	26.1	26.0	25.8	25.6	25.4	23.0	21.1
CPP and QPP 3/	-8.0	-7.1	-6.7	-6.4	-5.9	-5.5	-5.3	-5.7
Public accounts basis 4/	37.5	97.5	98.0	96.8	93.5	90.3	83.4	74.3
Federal	29.2	70.6	70.7	69.5	65.5	63.0	57.9	51.8
Provincial	8.3	26.9	27.3	27.3	28.0	27.3	25.5	22.5
Memorandum item:								
Government of Canada marketable securities held by nonresidents 5/	11.2	26.4	26.5	26.1	25.4	23.6	21.7	20.8

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

1/ Calendar year.
2/ Also includes local government and hospital sectors.
3/ Canada Pension Plan and Quebec Pension Plan.
4/ Fiscal year, beginning April 1. The public accounts measure of net debt includes government indebtedness to the public service pension plans, the CPP, and the QPP as a government liability. Note that data on intergovernmental holdings of net debt are not available on a public accounts basis so that the totals may be biased upward.
5/ As a percent of total marketable debt.

Table 5. Canada: Indicators of Economic Performance

	Average 1985-95	1996	1997	1998	1999	2000	Projections 2001	2002
	(Annual percent change)							
Real GDP								
Canada	2.5	1.6	4.3	3.9	5.1	4.4	1.4	0.8
United States	2.9	3.6	4.4	4.3	4.1	4.1	1.0	0.7
Japan	3.3	3.6	1.8	-1.0	0.7	2.2	-0.4	-1.0
Germany	5.2	0.8	1.4	2.0	1.8	3.0	0.5	0.7
G-7 countries	2.8	2.8	3.2	2.8	3.0	3.5	1.0	0.6
Real fixed private investment								
Canada	2.4	5.9	18.1	2.8	6.7	6.7	1.3	2.0
United States	3.1	9.3	9.6	11.4	7.8	7.6	-1.7	-0.6
Japan	4.0	6.5	5.6	-4.8	-3.4	8.6	0.3	-3.2
Germany	1.2	-0.6	1.5	3.1	4.0	2.5	-4.4	-2.8
G-7 countries	3.0	6.5	7.2	6.9	4.7	6.9	-0.9	-0.9
Consumer prices								
Canada	3.4	1.6	1.6	1.0	1.7	2.7	2.8	1.6
United States	3.6	2.9	2.3	1.5	2.2	3.4	2.9	1.6
Japan	1.4	0.3	1.7	0.7	-0.3	-0.8	-0.7	-1.0
Germany	2.4	1.2	1.5	0.6	0.7	2.1	2.4	1.0
G-7 countries	3.2	2.2	2.0	1.3	1.4	2.3	2.2	1.1
Unit labor cost in manufacturing								
Canada	2.0	2.1	-0.6	2.2	-0.3	2.2	1.9	1.0
United States	0.9	-2.1	-2.2	0.0	-0.5	-0.2	5.5	1.6
Japan	1.4	-1.9	-1.6	5.3	-4.1	-6.4	4.7	1.6
Germany	1.0	-1.2	-5.5	-2.6	-0.3	-3.6	-0.7	-0.2
G-7 countries	1.4	-0.7	-2.0	0.7	-0.8	-1.7	3.7	1.5
	(As a percent of labor force)							
Unemployment rate								
Canada	9.6	9.6	9.1	8.3	7.6	6.8	7.3	8.0
United States	6.4	5.4	5.0	4.5	4.2	4.0	4.9	6.0
Japan	2.5	3.4	3.4	4.1	4.7	4.7	5.0	5.7
Germany	6.4	8.6	9.5	8.9	8.2	7.5	7.5	7.8
G-7 countries	6.7	6.8	6.6	6.3	6.1	5.7	6.0	6.6
	(As a percent of GDP)							
General government revenues								
Canada	43.6	45.4	46.2	46.5	45.9	46.3	45.1	44.7
United States	27.8	29.0	29.3	29.8	30.1	30.6	29.6	29.4
Japan	31.8	31.0	30.8	30.5	30.1	30.3	30.2	30.3
Germany	45.7	46.8	46.6	46.6	47.4	47.1	45.6	46.2
G-7 countries	34.7	35.3	35.6	35.6	35.9	36.2	35.4	35.4
General government expenditures								
Canada	50.3	48.2	46.1	46.0	44.2	43.1	43.3	43.8
United States	32.3	31.5	30.6	29.8	29.5	29.2	29.3	29.9
Japan	31.6	35.1	34.1	35.0	36.9	38.2	37.4	37.4
Germany	47.7	50.3	49.3	48.8	48.9	45.9	48.1	48.7
G-7 countries	38.4	38.8	37.6	37.0	36.9	36.4	36.7	37.2
General government financial balance								
Canada	-6.7	-2.8	0.2	0.5	1.6	3.2	1.7	0.9
United States	-4.6	-2.4	-1.3	-0.1	0.6	1.5	0.3	-0.5
Japan	0.2	-4.2	-3.2	-4.5	-6.8	-7.9	-7.2	-7.1
Germany	-2.1	-3.4	-2.7	-2.2	-1.6	1.2	-2.5	-2.5
G-7 countries	-3.8	-3.4	-2.0	-1.4	-1.1	-0.2	-1.3	-1.8
General government net debt								
Canada	68.4	87.8	84.1	81.2	74.9	66.3	61.5	59.7
United States	52.2	59.2	57.0	53.4	48.9	43.7	42.0	41.3
Japan	13.4	16.0	17.5	29.5	35.8	42.9	50.1	57.7
Germany 1/	28.0	51.1	52.2	52.0	52.4	51.6	51.1	52.1
G-7 countries	42.8	54.1	53.3	53.3	51.7	49.1	48.9	49.7
Current account balance								
Canada	-2.9	0.5	-1.3	-1.3	0.2	2.5	3.1	2.1
United States	-1.8	-1.5	-1.7	-2.5	-3.5	-4.5	-3.8	-3.8
Japan	2.8	1.4	2.2	3.1	2.4	2.5	2.2	2.6
Germany	1.8	-0.3	-0.1	-0.3	-0.9	-1.0	0.0	0.7
G-7 countries	-0.5	-0.2	-0.1	-0.5	-1.3	-1.8	-1.4	-1.3

Source: Fund staff estimates. Projections for G-7 countries except for Canada and the United States are from the World Economic Outlook (December 2001).

1/ Germany's net debt starts in 1986.

Table 6. Canada: Personal and Corporate Financial Indicators

(In percent unless otherwise indicated)

	1995	1996	1997	1998	1999	2000	2001 1/
Personal sector 2/							
Net worth as a percent of disposable income	478.5	490.9	502.2	505.6	507.3	503.5	499.8
Debt as a percent of disposable income	102.4	105.3	107.7	109.7	111.2	110.5	111.9
Debt interest payments as a percent of disposable income 3/	10.3	8.8	8.2	8.5	9.4	10.5	10.5
Corporate sector							
Debt of private nonfinancial corporations as a percent of GDP 4/	49.5	49.1	49.0	51.6	51.1	49.6	50.6
Debt service as a percent of net worth 5/	17.4	12.7	10.8	15.1	15.3	18.3	14.7
Debt-to-equity ratio of nonfinancial private corporations 4/	85.3	80.6	78.8	78.9	77.5	72.2	72.2
Price-earnings ratio of TSE 300, percent change from a year ago 6/	-75.9	33.0	16.0	26.9	9.0	-2.9	-14.2

Sources: Statistics Canada; and Fund staff estimates.

1/ Data for 2001 are constructed using quarterly flows through the third quarter.
2/ Persons and unincorporated business.
3/ Comprises interest payments on mortgage and other types of consumer credit/bank loans. The five-year average residential mortgage rate and bank rate on consumer loans were used to calculate interest payments on mortgage and other consumer credit/bank loans, respectively.
4/ Based on total debt less trade payables, corporate claims, and other liabilities.
5/ The prime business loan rate is used to compute business credit interest payments.
6/ For 2001, the 12-month percent change for July is reported.

Table 7. Canada: Staff Projections

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

	2000	2001	2002	2003	2004	2005	2006
NIPA in real terms							
Real GDP	4.4	1.4	0.8	3.6	4.0	3.5	3.2
Net exports 1/	0.2	0.7	-0.4	0.7	0.1	0.0	0.0
Total domestic demand	4.5	0.7	1.2	3.0	4.1	3.7	3.4
Private consumption	3.6	1.8	1.3	2.9	4.2	3.8	3.3
Private domestic investment	6.7	1.3	2.0	5.0	5.2	4.9	4.8
Change in business inventories 1/	0.5	-1.2	-0.3	0.0	0.0	0.0	0.0
Final domestic demand	4.0	1.9	1.5	3.0	4.0	3.7	3.4
GDP (current prices)	8.3	2.9	1.5	5.5	5.9	5.4	5.2
Employment and inflation							
Unemployment rate (percent)	6.8	7.3	8.0	7.4	6.8	6.5	6.5
Consumer price index	2.7	2.8	1.6	1.8	2.0	2.0	2.0
GDP deflator	3.7	1.5	0.7	1.8	1.8	1.8	1.9
Indicators of financial policies 2/							
Federal fiscal balance							
(public accounts) 3/ 4/	17.1	1.5	2.0	2.5	3.0	3.0	3.0
(in percent of GDP)	1.6	0.1	0.2	0.2	0.2	0.2	0.2
Federal fiscal balance (NIA) 3/	19.4	4.0	4.5	5.0	5.5	5.5	5.5
(in percent of GDP)	1.8	0.4	0.4	0.4	0.4	0.4	0.4
Provincial fiscal balance (NIA) 3/ 5/	10.7	7.2	0.0	0.0	0.0	0.0	0.0
(in percent of GDP)	1.0	0.7	0.0	0.0	0.0	0.0	0.0
General goverment fiscal							
balance (NIA) 3/	34.0	18.7	9.5	11.2	12.9	13.3	13.5
(in percent of GDP)	3.2	1.7	0.9	1.0	1.0	1.0	1.0
General goverment net debt (NIA)							
(in percent of GDP)	66.3	61.5	59.7	55.6	51.5	47.8	44.5
Three-month treasury bill rates (percent)	5.5	3.9	2.5	3.5	5.3	5.7	5.7
Ten-year government bond rates (percent)	5.9	5.4	4.3	4.7	6.0	6.5	6.5
Balance of payments							
Current account balance 3/	26.9	33.4	22.9	24.2	21.3	19.9	20.3
(in percent of GDP)	2.5	3.1	2.1	2.1	1.7	1.5	1.5
Merchandise trade balance 3/	59.3	62.7	45.1	50.1	55.8	59.0	64.7
(in percent of GDP)	5.6	5.8	4.1	4.3	4.5	4.5	4.7
Invisibles, net 3/	-32.4	-29.3	-22.2	-25.9	-34.6	-39.1	-44.3
(in percent of GDP)	-3.1	-2.7	-2.0	-2.2	-2.8	-3.0	-3.2

Source: Fund staff estimates.

1/ Contribution to growth.
2/ Projections are based on the WEO assumption of unchanged fiscal policy. After FY 2000/01, it is assumed that new measures, aimed at reducing taxes and introducing new spending initiatives, are implemented such that the federal government would maintain budget surpluses equivalent to the contingency reserve in the budget. The consolidated fiscal projection for the provinces is assumed to be consistent with their stated medium-term targets.
3/ In billions of Canadian dollars.
4/ For fiscal years, which start on April 1.
5/ Includes local governments and hospitals.

Table 8. Canada: Federal Government 2001 Budget

	2000/01	Projections 2001/02	2002/03	2003/04
	(In billions of Canadian dollars)			
Revenue	178.6	171.3	174.7	180.7
Program spending	119.3	130.5	136.6	140.2
Interest payments	42.1	39.2	36.3	38.1
Contingency reserve	...	1.5	2.0	2.5
Budget balance	17.1	0.0	0.0	0.0
	(In percent of GDP)			
Revenue	16.9	15.8	15.9	15.5
Program spending	11.3	12.0	12.4	12.1
Interest payments	4.0	3.6	3.3	3.3
Contingency reserve	...	0.1	0.2	0.2
Budget balance	1.6	0.0	0.0	0.0
Memorandum items (calendar years, in percent):				
Net public debt 1/	51.8	50.5	49.9	47.1
Real GDP growth	4.4	1.3	1.1	3.9
Nominal GDP growth rate	8.3	2.6	1.3	5.9
Three-month Treasury bill rate	5.5	3.8	2.4	4.0
Ten-year government bond rate	5.9	5.5	5.5	5.9

Source: Department of Finance Canada *The Budget Plan 2001*.

1/ Based on the assumption in the Budget that there is no incremental debt paydown during 2001/02-2003/04.

Table 9. Canada: Medium-Term Federal Government Budget

	Actual	Staff Projections 1/					
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07
	(In billions of dollars)						
Revenue	178.6	171.3	174.1	179.5	188.2	197.0	205.4
Program spending	119.3	130.5	136.6	140.2	145.1	150.1	155.7
Interest payments	42.1	39.2	36.3	38.1	38.3	38.6	38.8
Prudence	...	1.5	2.0	2.5	4.0	5.0	6.0
Contingency reserve	...	1.5	2.0	2.5	3.0	3.0	3.0
Economic prudence	...	0.0	0.0	0.0	1.0	2.0	3.0
Remaining balance	17.1	0.0	-0.9	-1.2	0.9	3.4	4.9
	(In percent of GDP)						
Revenue	16.9	15.8	15.8	15.4	15.3	15.2	15.1
Program spending	11.3	12.0	12.4	12.1	11.8	11.6	11.4
Interest payments	4.0	3.6	3.3	3.3	3.1	3.0	2.8
Prudence	...	0.1	0.2	0.2	0.3	0.4	0.4
Contingency reserve	...	0.1	0.2	0.2	0.2	0.2	0.2
Economic prudence	...	0.0	0.0	0.0	0.1	0.2	0.2
Remaining balance	1.6	0.0	-0.1	-0.1	0.1	0.3	0.4
Memorandum items							
Net public debt 2/	51.8	50.4	49.6	47.1	44.2	41.7	39.5
Available balance (in percent of GDP) 3/							
Actual	1.6	0.1	0.1	0.1	0.4	0.6	0.8
Structural 4/	1.6	0.5	0.9	0.6	0.6	0.7	0.8
Real GDP growth 5/	4.4	1.4	0.8	3.6	4.0	3.5	3.2
Nominal GDP growth rate 5/	8.3	2.9	1.5	5.5	5.9	5.4	5.2
Three-month Treasury bill rate 5/	5.5	3.9	2.5	3.5	5.3	5.7	5.7
Ten-year government bond rate 5/	5.9	5.4	4.3	4.7	6.0	6.5	6.5

Sources: Department of Finance Canada *The Budget Plan 2001*; and Fund staff estimates.

1/ The staff assumes that the contingency reserve and economic prudence are restored to their pre-2001-Budget levels after 2003/04.

2/ Based on the staff's assumption that, starting 2004/05, the contingency reserve is applied to debt reduction.

3/ This consists of the contingency reserve and economic prudence factor plus the remaining balance.

4/ In percent of potential GDP.

5/ For calendar years, in percent.

Table 10. Canada: Indicators of Canadian Financial Institutions

	1995	1996	1997	1998	1999	2000	2001 1/
	(In percent)						
Six largest chartered banks 2/							
Return on total shareholders' equity	13.3	15.0	16.4	13.4	15.8	15.3	15.3
Return on average assets	0.7	0.7	0.7	0.6	0.7	0.7	0.7
Average intermediation spread	3.1	2.7	2.6	2.2	2.4	2.6	2.7
Net interest income (in percent of average earning assets)	2.5	2.4	2.1	1.8	1.8	1.8	1.9
Nonperforming loans as a percent of total loans	2.3	1.6	1.3	1.1	1.1	1.3	...
Loan loss provision (consolidated, in percent of total problem loans)	67.0	76.2	107.0	112.4	115.4	112.5	...
Loan loss provisions (in percent of average total assets)	0.3	0.2	0.2	0.2	0.3	0.2	...
Total capital ratio	9.8	9.4	10.3	10.6	11.3	11.7	...
Tier 1 capital ratio	7.0	6.8	7.1	7.4	8.2	8.5	...
	(In percent of total assets unless otherwise indicated)						
All chartered banks 3/ 4/							
Total assets 5/	912	1,105	1,321	1,432	1,398	1,550	1,624
Total Canadian dollar assets	67.0	61.8	58.5	53.6	59.8	59.5	57.8
Canadian dollar liquid assets	10.1	7.9	5.9	5.4	5.7	6.0	6.4
Total foreign currency assets	33.0	38.2	41.5	46.4	40.2	40.5	42.2
Banks' exposure to commercial real estate sector 6/	1.4	1.1	1.0	0.9	1.0	1.0	1.0
Banks' exposure to resource sector 7/	1.4	1.2	1.2	1.2	1.3	1.2	1.1
Total liabilities and shareholders' equity 5/	912	1,105	1,321	1,432	1,398	1,550	1,624
Of which: Total Canadian dollar liabilities	65.7	60.4	56.5	52.3	57.7	57.8	56.0
Total foreign currency liabilities	34.3	39.6	43.5	47.7	42.3	42.2	44.0
Total deposits	47.6	40.7	37.1	34.2	37.3	38.3	37.3
Total foreign currency deposits	27.8	28.0	30.7	32.2	31.3	29.5	29.6
Total international position 5/							
Claims on nonresidents	237	303	371	451	428	466	...
Claims on the U.S. residents	127	161	189	248	245	267	...
Liabilities to nonresidents	239	292	382	427	391	417	...

Sources: Bank of Canada; BankScope; and Canadian Bankers Association.

1/ Based on data for the first and third quarters for all chartered and six largest Canadian banks, respectively.
2/ For financial years, which start on November 1.
3/ For calendar years.
4/ Based on consolidated data.
5/ In billions of Canadian dollars.
6/ Proxied by nonresidential mortgages.
7/ The resource sector consists of agriculture, fishing, forestry, mining, and oil and gas.

Table 11. Canada: Official Development Assistance 1/

	1992	1993	1994	1995	1996	1997	1998	1999	2000
	(In billions of U.S. dollars)								
Total	**2.5**	**2.4**	**2.3**	**2.1**	**1.8**	**2.0**	**1.7**	**1.7**	**1.7**
Bilateral	1.7	1.6	1.5	1.4	1.4	1.2	1.2	1.2	...
Multilateral	0.8	0.8	0.8	0.7	0.4	0.8	0.5	0.5	...
	(In percent of GNP)								
Total	**0.46**	**0.45**	**0.43**	**0.38**	**0.32**	**0.34**	**0.29**	**0.28**	**0.25**
Bilateral	0.31	0.3	0.28	0.25	0.24	0.2	0.21	0.19	...
Multilateral	0.15	0.15	0.15	0.13	0.08	0.14	0.08	0.09	...
	(In percent of total ODA)								
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Bilateral	68	67	65	67	76	59	71	70	...
Multilateral	32	33	35	33	24	41	29	30	...

Source: OECD, Development Assistance Committee, Provisional data.

1/ Includes traditional ODA measured on a DAC basis, and excludes aid programs for transition economies.

Table 12. Canada: Indicators of External and Financial Vulnerability

(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000	2001 1/
External indicators						
Exports (annual percentage change)	6.3	8.5	8.2	11.0	14.6	0.5
Imports (annual percentage change)	3.9	15.2	8.8	7.1	10.5	-1.5
Terms of trade (annual percentage change)	1.7	-0.7	-4.1	1.1	4.2	-0.2
Current account balance	0.5	-1.3	-1.3	0.2	2.5	3.4
Capital and financial account balance	-1.5	1.8	0.5	-1.2	-1.4	-1.5
Of which: Inward portfolio investment (debt securities, etc.)	2.2	1.8	2.7	0.4	1.9	3.9
Inward foreign direct investment	1.6	1.8	3.7	3.8	8.9	3.7
Other investment liabilities (net)	2.5	4.4	1.0	-1.3	0.1	1.3
Official reserves (in billions of U.S. dollars)	20.6	18.0	23.4	28.6	32.4	34.2
Broad money (M3) to reserves ratio 2/	19.6	23.0	17.1	14.5	13.8	13.2
Central bank foreign liabilities (in billions of dollars)	0.1	0.2	0.2	0.5	0.6	0.1
Official reserves in months of imports	1.2	0.9	1.2	1.3	1.4	1.5
Net international investment position (in billions of dollars) 3/	-311.4	-304.0	-317.1	-270.7	-243.7	...
Of which: General government debt (in billions of dollars) 4/	117.5	109.5	100.3	97.0	85.4	85.7
External debt to exports ratio	1.0	0.9	0.8	0.6	0.5	...
External interest payments to exports (in percent) 5/	17.4	17.9	16.3	15.6	14.5	13.6
Nominal effective exchange rate (percent change) 6/	3.4	2.4	-3.7	-1.0	1.8	-0.6
Financial markets indicators						
General government gross debt	120.3	117.6	115.7	112.3	102.6	...
Three-month Treasury bill yield (percent) 6/	4.3	3.2	4.7	4.7	5.5	2.7
Three-month Treasury bill yield (percent, real) 7/	3.3	2.1	3.7	3.6	4.3	1.6
Change in stock market index (TSE 300, annual percentage change) 8/	18.8	22.6	4.6	4.5	36.1	-16.9
Banking sector risk indicators 9/10/						
Total loans to assets	63.9	61.6	61.2	59.0	57.8	56.5
Total loans to deposits	88.3	91.7	92.7	89.0	84.5	84.3
Share of nonperforming loans in total loans	1.6	1.3	1.1	1.1	1.3	...
Loans to the rest of the world as percent of total loans 11/	20.0	20.0	21.7	21.7	20.5	21.9
Return on total shareholders' equity	15.0	16.4	13.4	15.8	15.3	15.3

Sources: Bank of Canada; BankScope; Canadian Bankers Association; Department of Finance Canada; and Statistics Canada.

1/ Unless otherwise indicated data are as of third quarter of 2001. Balance of payments data have been seasonally adjusted at annual rates.

2/ Defined as ratio of M3 to foreign exchange reserves of the Bank of Canada, both in U.S. dollars.

3/ Current cost valuation.

4/ Defined as Government of Canada securities held by nonresidents; data for 2001 are for the first quarter.

5/ External interest payments: income payments on foreign-owned assets (other private payments plus Canada government payments).

6/ 2001 data refer to October.

7/ Real yield constructed using CPI for all items.

8/ For 2001, the percent change between December 2000 and November 2001 is reported.

9/ Unless otherwise indicated, based on data reported by the six largest chartered Canadian banks, representing about 90 percent of all chartered banks' assets in Canada.

10/ Ratios in percent.

11/ Data are for all chartered Canadian banks as of first quarter of 2001.

An Update on the Responses to the Recommendations of the Financial Sector Stability Assessment (FSSA)[1]

1. The FSSA concluded that Canada has a stable and highly advanced financial system, which is among the soundest in the world and is supported by a well-developed regulatory system that shows a high degree of compliance with major international standards. The FSSA noted, however, that ongoing domestic and international developments could pose challenges to the resilience of the financial system and the regulatory framework and it made a few recommendations to help meet these challenges.

2. Recognizing the need by life insurance companies in Canada to better measure and manage risk, the Office of the Superintendent of Financial Institutions (OSFI) announced in late 1999 its intention to introduce capital requirements for the guarantees in life insurance segregated funds. As planned, half of the estimated capital requirement became effective by end-2000, and the full requirement is expected to apply by end-2001.

3. While significant steps had been taken to strengthen the regulatory framework governing the securities industry, the FSSA and the Canadian authorities recognized that additional efforts were needed, particularly to establish more regular procedures for coordination between federal and provincial regulators. The approval of the Mutual Funds Dealer Association as a self-regulated organization in early 2001 has helped improve the efficiency and effectiveness of the regulatory framework and oversight of dealers in the Canadian market. There has been additional progress in coordinating federal and provincial regulations for securities broker dealers. The Ontario Securities Commission (OSC) has announced plans to decrease the number of provincial regulations on securities firms, but multiple regulations at the provincial level have not been addressed. Coordination has improved between OSFI and the Investment Dealers Association (which supervises the broker dealers).

4. The FSSA mission found substantive compliance with the Basel Committee's reports and other codes and standards. However, a peer review undertaken in the context of the FSSA concluded that there was only partial compliance with 2 principles: some minor shortcomings with regard to Core Principles 14 and 22, owing to some limits on the ability of OSFI to legally remove members of a financial institution's Board of Directors and to bar the appointment of an individual from banking once the person had been hired. These shortcomings have been addressed in recently revised legislation. In particular, the legislation (Bill C-8) now gives the Superintendent the authority to remove a director or senior officer if the Superintendent is of the opinion that the person is not suitable to hold that office based on a number of criteria.

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[1] FO/DIS/00/2 and FO/DIS/00/2 Supplement 1, and Report on the Observance of Standards and Codes (ROSC), June 2000. See also Appendix I of *Canada: 2001 Article IV Consultation–Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion,* IMF Country Report No. 01/62, April 2001.

Canada—Fund Relations
(As of November 30, 2001)

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

II.	**General Resources Account:**	**SDR Million**	**Percent of Quota**
	Quota	6,369.20	100.0
	Fund holdings of currency	4,058.75	63.7
	Reserve position in Fund	2,310.47	36.3

III.	**SDR Department:**	**SDR Million**	**Percent of Allocation**
	Net cumulative allocation	779.29	100.0
	Holdings	488.96	62.7

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

V. **Financial Arrangements:** None.

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

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

VIII. **Safeguards Assessments**:

The safeguards assessment procedures are not applicable to the Bank of Canada at this time.

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. On December 11, 2001 the exchange rate of the Canadian dollar was 64 U.S. cents per Canadian dollar.

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

X. **Last Article IV Consultation**

The staff report for the 2001 consultation with Canada was considered by the Executive Board on March 23, 2001 (EBM/01/29). Canada is on a 12-month consultation cycle.

XI. **FSAP Participation and ROSC Assessments**

Standard Assessed	**Date of Issuance**	**Document Number**
Canada - Financial System Stability Assessment - Volume II: Report on Observance of Standards in the Financial System	4/1/00	FO/Dis/00/2, Sup. 1
Report on the Observance of Standards and Codes—Fiscal Transparency Module: Canada	10/31/01	SM/01/330

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

XIII. **Resident Representative:** Not applicable.

Canada: Core Statistical Indicators

(as of end-November 2001)

	Exchange Rates	Interna-tional Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance 1/	GDP/ GNP	External Debt/ Debt Service 2/
Date of latest observation	Same day	November 2001	November 2001	October 2001	October 2001	Same day	October 2001	September 2001	2001 Q3	2001 Q3	2001 Q3	end-2000
Date received	Same day	12/05/01	11/30/01	11/30/01	11/30/01	Same day	11/20/01	11/20/2001	11/30/01	11/30/01	11/30/01	May 2001
Frequency of data	Daily	Monthly	Weekly	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annual
Frequency of reporting	Daily	Monthly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annual
Source of update	Various	Finance Canada news release	BOC financial statement	BOC financial statement	BOC financial statement	Various	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada	Statistics Canada
Mode of reporting	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic	Electronic
Confiden-tiality	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted	Unrestricted
Frequency of publication	Daily	Monthly	Weekly	Weekly	Weekly	Daily	Monthly	Monthly	Quarterly	Quarterly	Quarterly	Annually

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

Statement by the IMF Staff Representative
February 4, 2002

1. This statement reports on information that has been made available since the staff report (SM/02/14, January 10, 2001) was issued. It does not change the thrust of the staff appraisal.

2. Recently released data suggest that the economy started to stabilize during the fourth quarter of 2001. Real GDP rose by 0.2 percent in November after rising by 0.3 percent in October. After declining sharply in the third quarter (partly related to the September 11 terrorist attacks), consumer and business confidence rose during the fourth quarter. In November, retail sales and manufacturing shipments were relatively robust, and data on new house prices and building permits indicate some strength in the housing market going forward. The composite leading indicator index increased by 0.4 percent in December, following a 0.2 percent increase in November.

3. At the same time, inflationary pressures remain well contained. Core CPI inflation fell slightly to 1.6 percent (12-month rate) in December, still below the mid-point of the Bank of Canada's 1–3 percent target range. Total CPI inflation in December remained at 0.7 percent, in part reflecting continued low energy prices. Labor market conditions remain weak, with the unemployment rate rising to 8 percent in December 2001.

4. At its first policy announcement date in 2002 on January 15, the Bank of Canada cut its target for the overnight rate by 25 basis points, to 2 percent, bringing the total reduction over the past 12 months to 375 basis points. Subsequently, the Bank released a monetary policy report update which indicated that favorable recent geopolitical and economic developments increasingly point to the likelihood that economic growth in North America will gather significant momentum over the course of the year ahead. However, a major uncertainty for the outlook remains the timing and strength of the recovery in global business investment, especially in the United States.

5. The exchange rate of the Canadian dollar vis-à-vis the U.S. dollar has remained in the neighborhood of 62 U.S. cents in recent weeks, over 6 percent weaker than its level a year ago. The continuing exchange rate weakness has prompted public statements of support for the currency from senior leaders, including the Prime Minister, the Minister of Finance, and the Governor of the Bank of Canada. They noted that Canada's strong economic fundamentals are not being fully taken into account in the foreign exchange market and should eventually be reflected in the currency in the period ahead.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/28
FOR IMMEDIATE RELEASE
March 12, 2002

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

IMF Concludes 2002 Article IV Consultation with Canada

On February 4, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.[1]

Background

After ending the 1990s with a very strong performance, underpinned by the sound macroeconomic and structural policies put in place during the decade, the Canadian economy has slowed substantially since late 2000. The slowdown in large part has reflected the slowing in the U.S. economy, which has reduced growth in Canada's exports and contributed to weakening private investment. In addition, consumption growth has moderated, owing to a slowing in real income growth, a softening in the employment situation, and an associated fall in consumer confidence. Given its proximity and close integration with the United States, Canada has been significantly affected in the aftermath of the September 11 terrorist attacks. The impact on the Canadian economy has included a significant disruption of commercial traffic in the Canada-U.S. border area, a decline in business confidence, and interruptions in activities such as air travel and tourism.

The slowing in economic activity in recent quarters has led to a decline in resource utilization. Labor shortages have diminished, with the unemployment rate rising from 7 percent at the beginning of 2001 to around 8 percent in December–January. Capacity utilization in the

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[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. This PIN summarizes the views of the Executive Board as expressed during the February 4, 2002 Executive Board discussion based on the staff report.

nonfarm goods-producing sector has fallen sharply, largely reflecting a downturn in manufacturing. In turn, inflationary pressures have subsided. CPI inflation, which moved above the Bank of Canada's 1–3 percent target range in mid-2001 due to rising energy prices, has fallen back well within the range subsequently. Core inflation has remained stable at around the mid-point of the target range since mid-2001. Increases in labor compensation and unit labor costs remain contained.

The current account surplus continued to increase during the early part of 2001 despite slowing export growth, as imports declined in the early part of the year. Subsequently, the surplus has declined as export growth weakened further and non-energy commodity prices fell. In the first nine months of 2001, the surplus in the current account amounted to 3½ percent of GDP (annual rate), compared with a surplus of 2½ percent in 2000.

In response to the slowing in the economy, the Bank of Canada has lowered interest rates by 375 basis points since the beginning of 2001 to 2 percent at present. The Bank of Canada stepped up the pace of interest rate reductions after August 2001, amid signs of slower-than-expected growth in Canada and further weakness in the United States and the rest of the world. In September, following the terrorist attacks in the United States, the Bank of Canada lowered interest rates by 50 basis points, in tandem with the Federal Reserve. It lowered rates further at its regularly scheduled policy announcement dates in October and November by 75 and 50 basis points, respectively, and by 25 basis points in January 2002.

The authorities' commitment to promoting fiscal discipline over the past decade has been reflected in a substantial turnaround in the budget balance from a deficit of 5¾ percent of GDP in 1993/94 to a surplus of more than 1½ percent of GDP in 2000/01 (public accounts basis). With substantial fiscal consolidation also taking place at the provincial level during this period, the general government balance shifted from a deficit of 6¾ percent of GDP in 1994 to a surplus of 3¼ percent of GDP in 2000 (national accounts basis), leading to a decline in the ratio of general government net debt from 88½ percent of GDP in 1995 to 66 percent in 2000.

The Government's 2001 Budget, which covers the remainder of 2001/02 and 2002/03–2003/04, seeks to support economic activity while preserving the authorities' framework of medium-term fiscal discipline. New initiatives amount to $7 billion during 2001/02–2003/04 (¼ percent of cumulative GDP), mainly to strengthen national security. The budget is expected to be in balance in 2001/02–2003/04, while the Government strongly signaled its intention to continue with debt reduction in the medium term. Most of the reduction in the surplus in 2001/02 reflects the effects of previously enacted tax and expenditure measures.

Executive Board Assessment

Executive Directors commended the authorities for the sound macroeconomic and structural policies implemented and sustained over the past decade, which have put the Canadian economy in a good position to weather the current global economic slowdown and the uncertainty following the terrorist attacks in the United States last September. Monetary policy has successfully maintained low inflation, and the Bank of Canada's policy management over the past year has further enhanced the credibility of the monetary policy framework. In this context, Directors welcomed the authorities' decision in May 2001 to maintain the 1–3 percent inflation target range and the refinements to the framework introduced at that time. Fiscal consolidation by all levels of government has brought budgets into surplus and led to a sharp reduction in government debt as a share of GDP. Important structural reforms, including reductions in personal and corporate income taxes and improvements in the employment insurance system, have enhanced economic efficiency, and improvements in the financial regulatory framework have further strengthened the financial system.

Directors again strongly endorsed the inflation-targeting framework within which monetary policy is conducted. They believed that monetary policy should continue to be the main instrument used in attempting to limit the impact of the current global economic downturn and to promote the economy's quick recovery. At this point, prospects for an economic turnaround during 2002 look quite favorable. Nevertheless, with inflationary pressures likely to remain subdued, and little sign of sustained upward pressure on wages, Directors believed that there remains scope for further monetary policy easing to support economic activity should economic prospects weaken.

Directors judged that a flexible exchange rate regime has continued to serve Canada well. They agreed that the recent depreciation of the exchange rate has primarily reflected cyclical conditions and has helped to cushion the impact on Canada of the U.S. slowdown and the weakness in commodity prices. Directors felt that Canada's strong macroeconomic fundamentals should support the value of the currency over the longer term.

Directors welcomed the fiscal support that is being provided to the economy through the working of the automatic fiscal stabilizers, as well as previously enacted tax and expenditure measures. They noted that the progress over the past decade in strengthening Canada's fiscal balance has provided room for allowing the stabilizers to function and for the new initiatives in priority areas, such as national security, within the context of a sound overall fiscal framework. Directors thought that the authorities had acted prudently in refraining from a major discretionary stimulus in present circumstances, which would probably have had only a limited economic impact and could have undermined the hard-won credibility of the authorities' commitment to fiscal consolidation. However, some Directors encouraged the authorities not to rule out the possibility of additional discretionary stimulus, if the cyclical downturn proves to be deeper or more persistent than presently envisaged. Directors welcomed the authorities' continued commitment to the medium-term objective of bringing down the government debt-to-GDP ratio.

Directors lauded the authorities for the high degree of fiscal transparency in Canada, as noted in the IMF's recent Report on the Observance of Standards and Codes. In this context, they welcomed the authorities' intention to rebuild the contingency reserve and economic prudence factor in the budget consistent with the approach used in preparing the budget in recent years.

Directors welcomed the improvement in provincial and territorial government finances in recent years, which have allowed the provinces and territories to pursue tax reductions and new spending initiatives while continuing to reduce debt. However, Directors noted that in the period ahead the provinces are likely to face significant pressures on their budgets, particularly those associated with health care in view of the aging of the baby-boom generation. Directors underscored that all levels of government should start taking steps toward addressing these prospective needs as soon as possible.

In view of the continued relatively high unemployment rate and the need to promote labor mobility, Directors urged the authorities to resist pressures to extend employment insurance (EI) benefits or to further roll back some of the fundamental EI reforms achieved during the 1990s. They agreed with the staff's suggestion that the Government should reduce the disincentives to work that remain in the EI system. Frequent use of the system would be discouraged by eliminating the provision of regional extended benefits on an indefinite basis and by implementing experience rating of the EI premium rate (which would link the rate for individual firms to the frequency of use of the system by their workers). Directors recognized the importance of education, training, and other assistance to facilitate labor market adjustment, but suggested that these priorities would best be addressed through other programs.

Directors viewed the financial system in Canada as being among the most highly advanced and sound in the world and supported by a well-developed regulatory and supervisory framework. They welcomed the financial system reform legislation enacted in early 2001, which could be expected to further improve the efficiency of the Canadian financial system over the longer term. Directors noted that Canadian financial institutions are well capitalized and provisioned and appear well positioned to manage pressures arising from the current economic slowdown. However, Directors cautioned that more profound and protracted weakness in the Canadian and U.S. economies could create difficulties in parts of the financial system, and they welcomed the authorities' intention to remain alert to any such pressures.

Directors commended Canada for the lead it has taken in implementing strong legislation against money laundering and terrorist financing. In this context, they welcomed the legislation that came into full effect in late 2001 that brought Canada into full compliance with all of the recommendations of the Financial Action Task Force (FATF) on money laundering that required action. They also welcomed the new law tabled last October to address criminal activity by terrorists, which was consistent with the FATF's anti-terrorist-financing recommendations. Directors also took note of the high marks awarded by OECD to Canada's anti-bribery legislation.

Directors recognized Canada as a long-standing leader in trade liberalization initiatives at the multilateral, regional, and bilateral levels. They acknowledged that Canada has an open trade regime, but they noted that protection levels remain high in some sensitive sectors, particularly certain agricultural products, textiles, and clothing. In addition, although Canada has provided favorable market access for the least-developed countries, exports from these countries still face quotas and high tariffs on some products, particularly textiles, clothing, and footwear. Directors urged the authorities to accelerate trade liberalization in these products for the benefit of both Canada and other countries. Directors called for progress toward achieving duty- and quota-free market access for the exports of least-developed countries, consistent with the objectives of the Doha Ministerial Declaration.

Directors welcomed the actions in the 2001 Budget to increase foreign aid following several years of declining Official Development Assistance (ODA). They encouraged the authorities to continue to raise the level of ODA spending toward Canada's long-standing objective of 0.7 percent of GNP.

Directors noted that the quality, coverage, periodicity, and timeliness of Canadian economic data were excellent both in the context of the Article IV consultation and for purposes of ongoing surveillance.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2002 Article IV Consultation with Canada is also available.

Table 1. Canada: Selected Economic Indicators

	Averages 1960s	1970s	1980s	1996	1997	1998	1999	2000
	(In percent change from previous period at annual rates, unless otherwise indicated)							
Economic activity and prices 1/								
Real GDP	5.6	4.4	3.1	1.6	4.3	3.9	5.1	4.4
Real net exports 2/	0.3	0.0	-0.1	0.4	-1.7	1.7	1.3	0.2
Real final domestic demand	5.2	4.6	3.0	2.0	5.5	2.6	4.1	4.0
Consumer spending	4.8	4.5	3.1	2.6	4.6	3.0	3.4	3.6
Nonresidential fixed investment	4.3	5.9	-0.2	1.8	17.7	0.4	1.8	5.3
Labor market								
Labor force	...	...	2.0	1.0	1.7	1.8	2.0	1.8
Employment	...	...	2.0	0.8	2.3	2.7	2.8	2.6
Unemployment rate (period average)	...	...	9.4	9.6	9.1	8.3	7.6	6.8
Labor productivity (business sector)	...	...	...	-0.2	2.6	2.2	2.4	1.6
Prices								
Implicit price deflator for GDP 1/	5.7	8.1	4.6	1.7	1.2	-0.4	1.4	3.7
Core consumer price index	...	...	...	1.5	1.5	1.2	1.5	1.5
Unit labor cost (business sector)	...	7.7	5.6	1.8	2.4	2.6	0.6	2.7
Exchange rate								
U.S. cents/Canadian dollars (closing spot	93.5	96.4	79.5	73.3	72.0	67.1	67.5	67.3
Percent change	-1.1	-0.8	0.0	0.3	-1.8	-6.8	0.6	-0.3
Nominal effective exchange rate 3/	-1.1	-1.3	0.0	1.7	0.2	-6.0	-0.6	1.2
Real effective exchange rate 4/	...	...	1.3	1.0	2.9	-5.9	-0.7	1.0
Interest rates								
Three-month Treasury bill rate	...	7.0	11.3	4.3	3.2	4.7	4.7	5.5
Ten-year Treasury bond rate	...	...	...	7.2	6.1	5.3	5.6	5.9
	(In percent of GDP or NDP)							
Balance of payments								
Current account balance	-2.2	-2.6	-2.2	0.5	-1.3	-1.3	0.2	2.5
Merchandise trade balance	0.9	1.7	2.9	5.1	2.9	2.5	3.9	5.6
Invisibles balance	-3.1	-4.3	-5.0	-4.5	-4.2	-3.8	-3.8	-3.1
Fiscal indicators								
General government fiscal balance (NIA)	-1.0	-1.9	-6.0	-2.8	0.2	0.5	1.6	3.2
Federal government fiscal balance (NIA)	-0.9	-2.2	-5.3	-2.0	0.7	1.0	0.9	1.8
Provincial government fiscal balance (NIA)	-0.6	-0.9	-1.3	-0.5	-0.2	-0.4	0.7	1.0
Saving and investment 6/								
Gross national saving	21.9	22.3	20.4	18.7	19.6	19.2	20.7	23.4
General government	3.9	2.2	-2.2	-0.4	2.2	2.4	3.4	5.4
of which: Federal government	-0.2	-1.7	-4.8	-1.8	1.1	1.3	1.2	2.1
Private	18.0	20.1	22.6	19.1	17.4	16.8	17.3	18.0
Personal	7.7	10.7	13.1	7.5	6.0	5.8	5.5	5.1
Business	10.3	9.4	9.5	11.6	11.4	11.0	11.8	12.9
Gross domestic investment	23.5	23.6	21.7	18.1	20.7	20.5	20.3	20.5

Private	18.9	20.0	18.8	15.7	18.4	18.3	18.0	18.1
Public	4.6	3.6	2.9	2.5	2.3	2.2	2.3	2.3
of which: Federal government	0.7	0.5	0.5	0.4	0.4	0.3	0.3	0.3
Net foreign investment	1.8	1.8	1.9	-1.0	1.5	1.8	-0.6	-3.8
Net national saving	13.5	14.3	11.0	7.5	8.7	8.0	10.4	14.4
Net private investment	12.1	14.0	11.7	6.2	9.9	9.5	9.3	9.7
In real terms								
Gross domestic investment 1/	15.4	15.7	18.2	18.2	20.7	20.0	20.4	21.2
Private	12.3	13.3	15.9	15.7	18.4	17.9	18.0	18.8
Public	3.1	2.4	2.3	2.4	2.3	2.2	2.3	2.4
				Fiscal Years				
Memorandum item:				1996/97	1997/98	1998/99	1999/00	2000/01
Federal fiscal balance (public accounts)	...	...	...	-1.1	0.4	0.3	1.3	1.6

Sources: Statistics Canada; and IMF staff estimates.

1/ Data for the 1960s–1970s are based on the old (unrevised) national accounts statistics.
2/ Contribution to growth.
3/ Constructed using 1989–91 trade weights.
4/ Defined in terms of relative normalized unit labor costs in manufacturing, as estimated by the IMF's Competitiveness Indicators System, using 1989–91 trade weights.
5/ Includes local governments and hospitals.
6/ Gross national saving does not equal the sum of gross domestic investment and net foreign investment because of statistical discrepancy.