1. The United States, Canada, and the World: Outlook and Policy Challenges

Global activity strengthened in the second half of 2013 and is expected to pick up further in 2014–15, on account of a faster recovery in the advanced economies. In contrast, the growth momentum in emerging markets remains subdued, reflecting tighter external financing conditions and homemade weaknesses in some cases. Risks around the outlook for global growth have diminished somewhat, but remain tilted to the downside.

Global Backdrop: Strengthening Growth, but Downside Risks Remain

Global activity has picked up since mid-2013, led by the advanced economies. The recovery in the United States has been broad-based, with strong contributions from private consumption, investment, and inventory accumulation. The euro area has emerged from recession, but growth remains uneven, as some countries continue to grapple with high debt burdens and financial fragmentation. In Japan, private consumption was robust, even though wages and private investment have yet to rise decisively. In emerging market and developing economies, domestic demand has generally slowed, reflecting tighter financial conditions, supply bottlenecks, and policy or political uncertainties.

A new bout of financial market volatility hit emerging markets in January, affecting equities, bond yields, and currencies. The sell-off seems to have been triggered by a reassessment of the growth outlook for several large economies and rising political tensions in some parts of the world. By contrast, financial conditions have eased in the advanced economies, and long-term bond yields are generally below their mid-2013 highs.

Looking ahead, the outlook is for a further strengthening of the recovery. Global growth is expected to increase from 3 percent in 2013 to slightly above 3½ percent in 2014 and nearly 4 percent in 2015 (Figure 1.1; see IMF, 2014a, the April 2014 *World Economic Outlook*, for more detail). The advanced economies will continue to lead the expansion as fiscal headwinds ease in most countries while monetary conditions generally remain supportive, notwithstanding the challenge posed by very low inflation rates, especially in the euro area and Japan. Emerging market and developing economies continue to account for the bulk of global growth. However, the momentum of activity remains subdued, with growth expected to strengthen only marginally from 4¾ percent in 2013 to 5 percent in 2014, as the boost provided by stronger exports will be offset by continued softness in domestic demand. The projections assume that capital inflows to emerging market economies will be somewhat lower in 2014 than in 2013, before recovering modestly in 2015. They also assume that the recent repricing of emerging market assets represented largely a one-off increase in risk premiums.

In the euro area, growth is projected to move to positive territory and exceed 1 percent in 2014, supported by a smaller fiscal drag and stronger external demand. Nonetheless, growth in domestic demand is expected to remain weak against a background of continued financial fragmentation and high corporate debt burdens. Persistently large output gaps in many countries are expected to keep inflation below the European Central Bank's target of close to, but below, 2 percent, with risks to the downside.

In the United States, real output growth in 2014–15 is projected to be above trend, supported by a

Note: Prepared by Dora Iakova, Deniz Igan, and Lusine Lusinyan. Madelyn Estrada, Tim Mahedy, Anayo Osueke, and Carlos Rondon provided excellent research assistance.

Figure 1.1

Global growth is expected to strengthen in 2014, led by a pickup in advanced economies, most of which will see reduced fiscal drag.

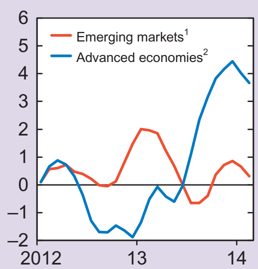
Real GDP Growth

(Percent)

	2012	2013	2014	2015
			Projections	
World	**3.2**	**3.0**	**3.6**	**3.9**
Advanced economies	1.4	1.3	2.2	2.3
United States	2.8	1.9	2.8	3.0
Euro area	–0.6	–0.4	1.2	1.5
Japan	1.4	1.5	1.4	1.0
Emerging market and developing economies	5.0	4.7	4.9	5.3
China	7.7	7.7	7.5	7.3

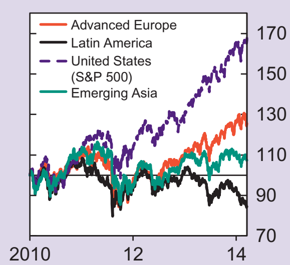
Manufacturing Purchasing Managers' Index

(Deviations from 50, three-month moving average)



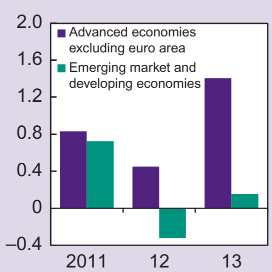
Equity Markets3

(Index; Jan. 1, 2010 = 100)



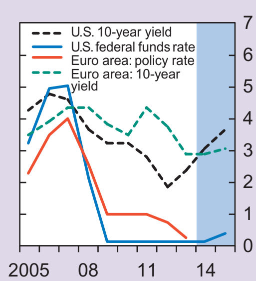
Fiscal Impulse4

(Percent of GDP)



Policy Rates and Bond Yields

(Percent)



Sources: Bloomberg L.P.; Haver Analytics; IMF, *International Financial Statistics* and World Economic Outlook database; MSCI Indexes; and IMF staff calculations.

1 U.S. dollar GDP-weighted average of Brazil, China, Hungary, India, Indonesia, Mexico, Poland, Russia, Turkey, and Vietnam.

2 U.S. dollar GDP-weighted average of Australia, Canada, Czech Republic, Denmark, the euro area, Israel, Japan, New Zealand, Singapore, South Korea, Switzerland, the United Kingdom, and the United States.

3 Data as of March 26, 2014.

4 Change in structural balance.

slower pace of fiscal consolidation, still highly accommodative monetary policy, and a continued recovery of household balance sheets and the housing sector.

In Japan, growth in 2014 is projected to remain at about 1½ percent. Stronger private investment and exports should provide support to activity, but consumption could be negatively affected by the increase in the consumption tax rate.

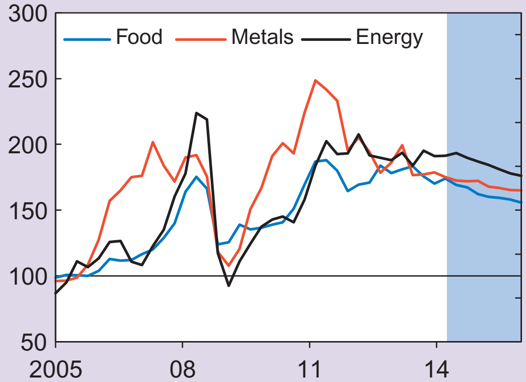
Growth in China is expected to ease to 7½ percent in 2014, as measures to slow credit growth and raise the cost of capital affect investment. A further gradual deceleration of activity, accompanied by rebalancing from investment to consumption, is projected for the medium term.

Under the baseline scenario, most commodity prices are projected to continue declining over the next two years (Figure 1.2). Energy prices are expected to fall by about 5 percent by the end of 2015 as oil production is increasing in countries that are not members of OPEC (the Organization of the Petroleum Exporting Countries). Metal prices, including copper and iron, are also projected to continue to soften on expanded supply capacity and lower demand from China. The near-term outlook for agricultural products varies by commodity, with soybean prices moderating, and coffee and wheat prices projected to rise further.

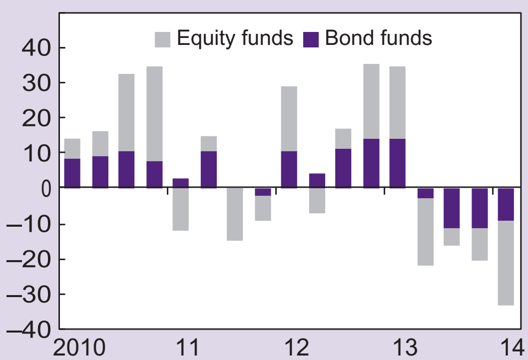
Overall, the balance of risks to the outlook for global growth has improved, on account of lower risks to the outlook for the advanced economies. Still, risks remain tilted to the downside, including because of new geopolitical risks that have come to the fore. In the emerging markets, higher capital flow volatility remains a key concern. Large capital outflows could cause financial market disruptions and weigh on real activity. This risk is larger in economies with weak external positions and where private sector leverage has increased substantially in recent years. In the advanced economies, a prolonged period of low inflation might de-anchor long-term inflation expectations and depress activity.

Figure 1.2
Commodity prices are expected to continue moderating. Tighter external financing conditions and capital flow volatility may result in fresh headwinds for emerging markets.

Commodity Prices
(Index; 2005 = 100)



Net Flows into Emerging Market Funds
(Billions of U.S. dollars)



Sources: Emerging Market Portfolio Research; Haver Analytics; and IMF staff estimates.

The United States: Recovery Gaining Ground, Momentum to Continue

Growth in the United States was stronger than anticipated in 2013, spurred by a pickup in consumer spending and business inventories, and solid export growth in the second half of the year. Although the unusually harsh winter weighed on activity in early 2014, the economy is expected to regain its momentum during the rest of the year, thanks to personal consumption and private investment growth, along with a smaller fiscal drag.

In 2013, the U.S. economy grew at an annual rate of 1.9 percent. This exceeded the October 2013 *World Economic Outlook* (IMF, 2013) projection of 1.6 percent growth, as momentum picked up during the course of the year: GDP grew at an average annualized rate of 3.5 percent in the second half of 2013 compared with 1.2 percent in the first half. Notably, this acceleration occurred against the backdrop of the temporary setback from the partial government shutdown in October, which is estimated to have subtracted 0.3 percentage points, in annualized terms, from growth in the fourth quarter. Strong inventory accumulation and export growth were key factors in helping offset the effect of the shutdown. Considering 2013 as a whole, domestic demand was held back by a fiscal drag estimated at 1¼–1½ percent, reflecting the expiration of the payroll tax cut, higher rates on upper-income taxpayers, and cuts in discretionary spending. Despite this, there were clear signs of a firming recovery, with accommodative monetary policy and favorable financial conditions playing their part. Increases in house and stock prices supported the pickup in consumer spending while household deleveraging progressed, with household debt as a share of disposable income continuing its decline (Figure 1.3). The labor market continued to improve, with the unemployment rate falling to 6.7 percent in February 2014. This fall, however, was accompanied by a further decline in the labor force participation rate, which stood at 63 percent in February, close to the lowest level in more than 35 years (see Box 1.1). With still-ample slack in the economy, price pressures remain subdued, and headline consumer price index inflation stood at 1.1 percent (year over year) in February. Increased domestic energy production helped lower oil imports and narrow the external current account deficit to 2.3 percent of GDP at end-2013—the lowest in 15 years.

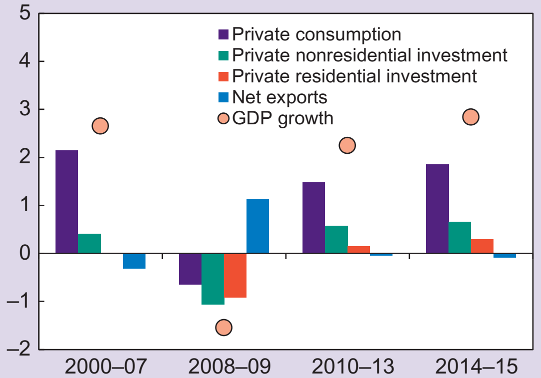
Real GDP growth is projected to rise in 2014 and 2015, despite the drag from the harsher-than-usual weather in early 2014. Residential investment is projected to contribute significantly, as household formation returns to normal, boosting housing starts. Gains in house values are expected to moderate but will further bolster household balance sheets. Consumer spending will remain solid and

Figure 1.3

The U.S. recovery is gathering pace as household balance sheets continue to improve. Unemployment has fallen markedly, partly owing to lower labor force participation.

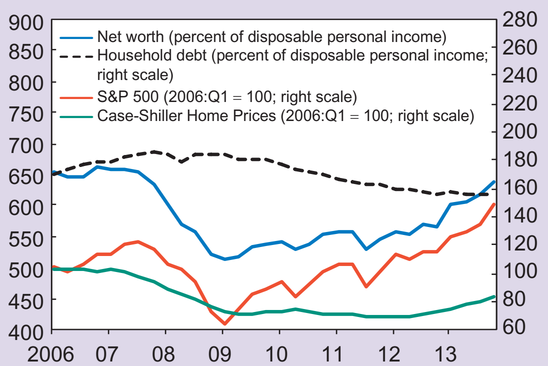
United States: Real Activity Indicators

(Average annual percent change)



Sources: Haver Analytics; IMF, World Economic Outlook database; and IMF staff calculations.

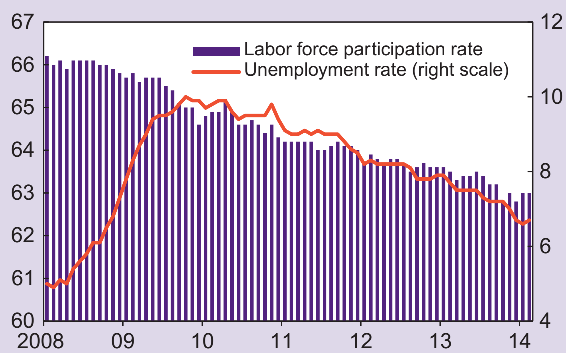
United States: Asset Prices and Household Balance Sheets



Sources: Haver Analytics; and IMF staff calculations.

United States: Labor Market

(Percent)



Sources: Haver Analytics; and IMF staff calculations.

nonresidential fixed investment growth will pick up as consumer and business confidence improves. Meanwhile, the fiscal drag in 2014 is projected to decline to ¼–½ percentage point, thanks in part to the December 2013 Bipartisan Budget Act, which provided some relief from the automatic spending cuts in fiscal years 2014 and 2015 in exchange for back-loaded savings (Figure 1.4). In addition, fiscal policy uncertainty is considerably lower after the act was passed and the debt ceiling was suspended in February 2014, which has effectively eliminated the risk of a partial government shutdown, such as the one in October 2013, for the next year or so.

Even with lower fiscal policy uncertainty, the balance of risks to the U.S. outlook remains slightly tilted to the downside. Slower-than-projected growth in the euro area, potentially exacerbated by disinflationary pressures and renewed financial stress, poses an external risk. In addition, a synchronized slowdown in emerging market economies, analyzed in detail in the April 2014 *World Economic Outlook* (IMF, 2014a), may lower U.S. growth by up to 0.2 percentage points. Turning to domestic risks, private domestic demand could lose steam if long-term Treasury yields were to rise sharply without a concomitant improvement in the growth outlook. Over the medium term, the risks stemming from the lack of a credible fiscal consolidation plan remain. In that scenario, sustainability concerns lead to a loss of confidence and to rising sovereign risk premiums and government bond yields, which slow private domestic demand. A persistent downward trend in labor force participation is another medium-term risk. A much lower participation rate would further dent potential output, lower effective slack in the economy, and may prompt an earlier-than-expected tightening of monetary policy. On the upside, a virtuous cycle could emerge in the housing market as favorable trends in lending conditions, balance sheets, private demand, and confidence feed on each other. Greater confidence in the economy's prospects could also induce firms to start using their cash balances for new investment.

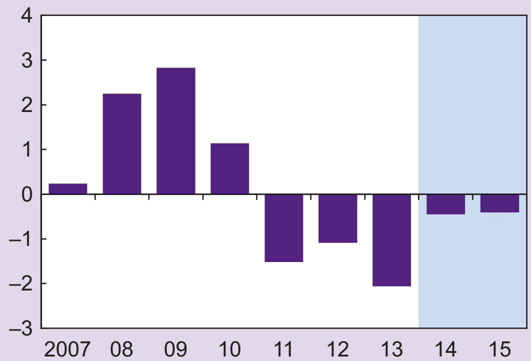
Despite the significant reduction in the fiscal deficit since 2011, U.S. public finances remain on

Figure 1.4

A lower fiscal drag and accommodative monetary policy will help the recovery gain traction, as will pent-up housing demand.

United States: Fiscal Impulse[1]

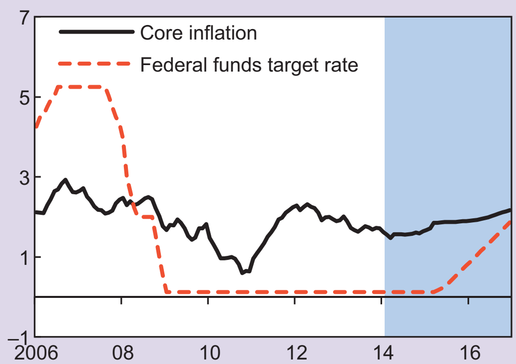
(Percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff estimates.
[1] The fiscal impulse is the negative of the change in the primary structural balance.

United States: Policy Rate and Inflation

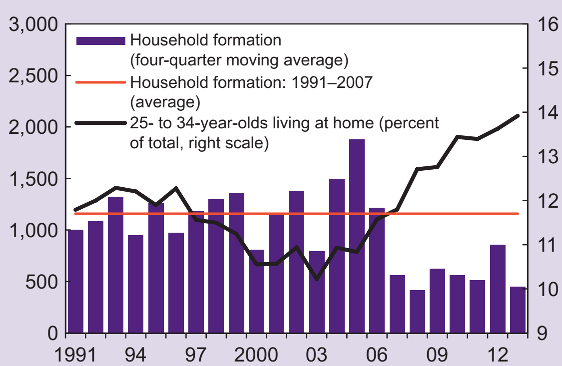
(Percent)



Sources: Haver Analytics; and IMF staff calculations.

United States: Pent-Up Housing Demand

(Thousands of units, unless otherwise indicated)



Sources: Haver Analytics; and IMF staff calculations.

an unsustainable long-term trajectory. Moreover, while the drivers of deficits in the medium term are health care and pension spending, consolidation measures so far have relied on discretionary spending cuts—including through inefficient and abrupt across-the-board cuts ("sequester")—and modest tax increases. Hence, a balanced, gradual, and credible fiscal plan that puts public debt on a firmly downward path should continue to be the main policy priority. Such a plan would have to be multifaceted, balancing the objective of protecting the recovery in the short term with the need to tackle sustainability concerns in the longer term. Necessary components of this plan include changes to entitlement programs to rein in health care and pension spending, a base-broadening tax reform to raise revenues, and replacement of the sequester cuts with back-loaded new revenues and mandatory savings (the Bipartisan Budget Act of December 2013 is a modest step in this direction).

On the monetary front, the growth momentum justifies the ongoing measured reductions in the U.S. Federal Reserve's asset purchase program. Yet, the case for an overall accommodative monetary policy stance remains valid, considering the sizable slack, low current and projected inflation, and steady inflation expectations. Further asset purchases over the next several months, albeit in somewhat smaller amounts, will continue to put downward pressure on longer-term interest rates and contribute to maintaining monetary policy accommodation. The revised forward guidance that indicates that the policy rate can remain low for a "considerable time" after the asset purchase program ends will also help. IMF staff expects that the lift-off of policy interest rates from the zero lower bound will start during the second half of 2015 and be followed with a gradual tightening thereafter, in line with the U.S. Federal Reserve's guidance that economic conditions may warrant policy rates staying below their normal longer-term level for some time. In achieving the appropriate accommodative stance, the additional flexibility provided by the

Federal Reserve's return to qualitative forward guidance in March 2014 may prove helpful. Looking ahead, and as the date of the lift-off of policy rates gets closer, the Federal Reserve will need to communicate clearly its assessment of the progress made in reaching its employment and inflation goals to reduce the risk of excessive market volatility.

On the financial side, notable progress has been made in the implementation of the Dodd-Frank Act and the international capital framework. Moreover, banks' capital ratios remain strong and credit conditions continue to improve, albeit at a slower pace for residential mortgages. However, more remains to be done to increase the resilience of the U.S. financial system. The Volcker Rule, now finalized, needs to be carefully implemented; regulation of money market mutual funds should be strengthened, and systemic risk in the tri-party repo market should be reduced. The bolstering of regulatory policies should continue to be coordinated with the global financial reform agenda. In this context, it will be important to ensure that the implementation of the recently finalized rule on foreign banking organizations, which should help enhance the resilience of their operations in the U.S. financial system and therefore support global financial stability, does not impose undue costs on internationally active banks. In addition, pockets of financial vulnerability appear to be building up in the high-yield bond and leveraged loan markets, and municipal bond markets have been stressed by Detroit's bankruptcy filing and concerns about Puerto Rico's debt sustainability. Although their potential systemic impact seems limited, strong macroprudential oversight and supervision remain essential.

Canada: Facing a Challenging Rebalancing in Growth

Economic activity in Canada firmed up in the course of 2013 on the back of strong growth in consumption and business inventories during the second half of the year. Annual growth is expected to strengthen further in 2014, with the projected recovery in the United States boosting Canada's exports and business investment. Policies should sustain the acceleration of activity, while remaining vigilant to vulnerabilities related to high household leverage and house prices.

Economic growth in Canada strengthened to 2 percent in 2013, after a subdued performance in 2012. Net exports contributed positively for the first time since 2001, but the expected rebalancing from consumption and residential construction toward exports and business investment has yet to fully materialize (Figure 1.5).

Rising household wealth and still-easy financial conditions supported private consumption growth in 2013, and the household debt-to-income ratio reached a historical high of 153. The unemployment rate declined to about 7 percent in 2013, but the pace of job creation slowed in recent quarters.

Growth in business investment has weakened since mid-2012, affected by uncertainty about the strength of the recovery. Residential investment also slowed in 2013, as the housing market cooled in part because of macroprudential measures adopted earlier. Nonetheless, house prices remain overvalued (especially in Ontario and Québec), although with important regional differences.

Canada's external current account deficit improved slightly in 2013 as the energy balance strengthened. However, the nonenergy trade balance continued to worsen, despite a real exchange rate depreciation of about 7 percent over the year. Nonenergy exports remain well below precrisis levels, reflecting not only the slow recovery in external demand, but also weak competitiveness related to low productivity growth and a still-overvalued exchange rate.

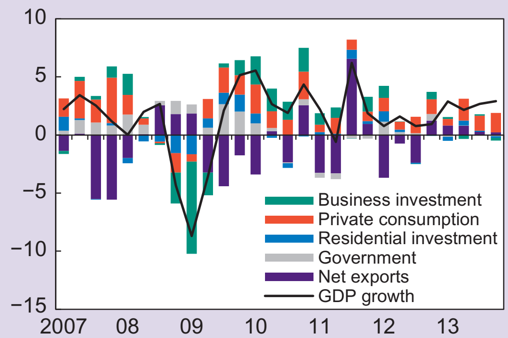
Fiscal consolidation continued to weigh on economic activity, though at a slower pace than in the past, subtracting about ¼ percentage points from GDP growth in 2013. The federal government fiscal deficit declined at a faster-than-expected pace on the back of stronger spending restraint, but a number of provinces (including Alberta and Québec) announced that they would

Figure 1.5

Growth in Canada firmed up in 2013 as private consumption strengthened, while fiscal consolidation slowed. Household debt remains high.

Canada: Contributions to GDP Growth[1]

(Percentage change)

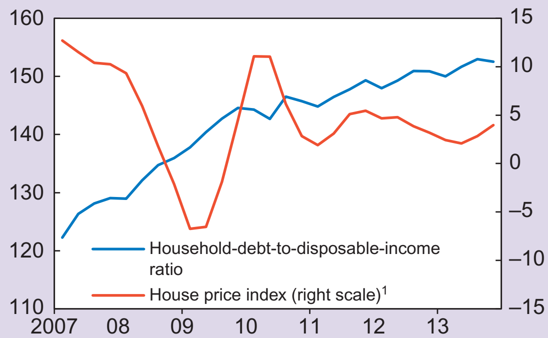


Sources: Statistics Canada; and IMF staff calculations.

[1] The difference between GDP growth and contributions reflects change in inventories and statistical discrepancy.

Canada: Household-Debt-to-Disposable-Income Ratio and House Price Growth

(Percent, unless otherwise indicated)

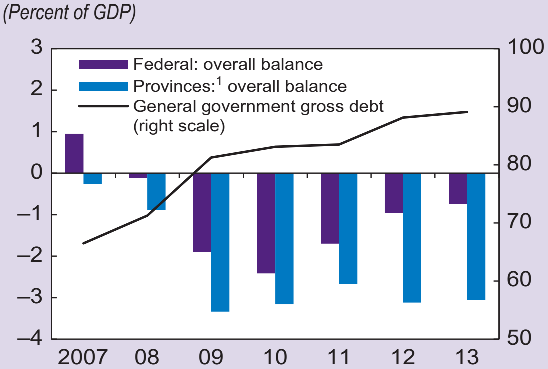


Sources: Haver Analytics; and IMF staff calculations.

[1] Year-over-year percentage change.

Canada: Fiscal Balance and Gross Debt

(Percent of GDP)



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

[1] Includes provinces, territories, and local governments.

return to a balanced budget position with some delay relative to the previously announced schedule. The Bank of Canada maintained the policy interest rate at 1 percent while increasing the emphasis on downside risks to the inflation outlook in its announcements since October.

In 2014, growth is expected to rise to 2¼ percent, somewhat above the estimated potential growth rate. The projected pickup in U.S. activity is expected to boost Canada's export growth and stimulate business investment. Inflation is projected to pick up as economic slack diminishes, and to approach the Bank of Canada's target rate of 2 percent by end-2015.

Although external demand may surprise on the upside, downside risks to the outlook continue to dominate. External demand may recover less than expected, reflecting a slower U.S. growth resulting from a sharper-than-expected increase in U.S. long-term interest rates, as well as risks of renewed financial turbulence or more protracted weakness in the euro area, and lower-than-expected growth in emerging markets. Even with strong external growth, Canada's export performance could remain subdued owing to competitiveness challenges. An unwinding of domestic imbalances, including elevated household leverage and house prices, would also pose risks to growth. Over the medium term, risks to the performance of the energy sector are two-sided, depending to a large extent on the removal of infrastructure bottlenecks (see Box 1.2).

With inflation close to the floor of the Bank of Canada's target and downside risks looming, monetary policy should remain accommodative until the recovery is firmly established. Fiscal policy, in turn, has to strike the right balance between supporting growth and rebuilding fiscal buffers. The federal government is expected to reach its balanced budget target in fiscal year 2015–16, but has room to slow the planned adjustment if growth weakens. In contrast, some provinces are facing challenges in their consolidation plans and may need to consider further measures, including on the revenue side, to meet deficit reduction goals.

Measures should also be taken to address longer-term challenges facing Canada's economy. These include reining in health care spending growth to ensure long-term fiscal sustainability, gradually reducing the government's involvement in mortgage insurance, raising productivity growth and external competitiveness, and further strengthening Canada's financial system in line with the recommendations of the 2013 Financial Sector Assessment Program update.

Box 1.1

Recent Trends in the U.S. Labor Force: The Role of the Hispanic Population

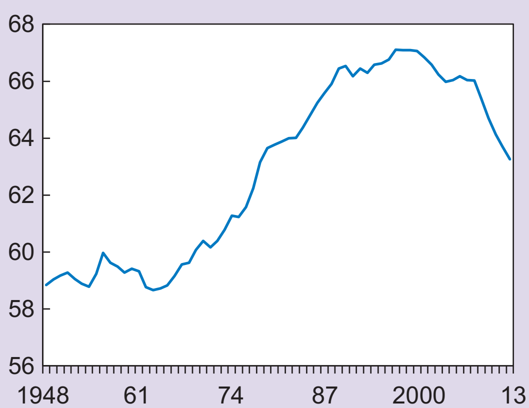
Since the 1940s, the U.S. labor force has experienced important changes that mirror developments in American society, in particular increasing numbers of working women and the life cycle of the baby boom generation. These developments brought the aggregate participation rate—the ratio of people employed or seeking jobs divided by the noninstitutional civilian population older than 16—to a historical high of 67.1 percent in 1997. However, as baby boomers started to retire in the new millennium, the participation rate began an inexorable decline (Figure 1.1.1). The decline accelerated during the Great Recession and has continued since: the rate now stands at about 63 percent—a level not seen since the late 1970s. Many studies have focused on the impact of the age-gender dimension on the participation rate. This box examines the impact of changes within ethnic groups, paying particular attention to the role played by the Hispanic population.[1]

Table 1.1.1 shows that the participation rates of all ethnic groups have declined since 2000. However, changes in the population shares of each group have also affected the evolution of the overall rate. For instance, since the participation rate of Hispanics tends to be higher than that of other groups, their increasing population share has helped to slow the decline of the aggregate participation rate.[2]

Figure 1.1.1

United States: Labor Force Participation Rate

(Percent; seasonally adjusted)



Source: Haver Analytics.

Table 1.1.1. United States: Labor Force Statistics, by Ethnicity[1]

	Overall Participation Rate	Hispanic		Black		Other[2]	
		(a)	(b)	(a)	(b)	(a)	(b)
2000	67.1	11.3	69.7	11.7	65.5	77.0	66.9
2007	66.0	13.5	68.8	11.9	63.7	74.6	65.9
2009	65.4	13.9	68.0	12.0	62.4	74.1	65.4
2013	63.3	15.3	66.0	12.4	61.2	72.4	63.0

Sources: Bureau of Labor Statistics, Household Employment Survey; and IMF staff estimations.
[1] (a) population share; (b) participation rate.
[2] Comprises all other ethnic groups, including non-Hispanic whites and Asians.

Note: This box was prepared by Juan Solé, with research support from Jeremy Zook.
[1] See, for instance, Toosi (2013) and Aaronson and others (2006).
[2] The aggregate figure masks a difference between Hispanic men and women. Hispanic men have higher participation rates than the average male in the U.S. population (76.3 percent versus 69.7 percent in 2013), but Hispanic women have slightly lower participation rates than the average female in the population (55.7 percent versus 57.2 percent in 2013).

Box 1.1

To quantify the relative importance of changes in the population shares and participation rates of each ethnic group, we calculated a shift-share decomposition where the total change in the participation rate with respect to a base year can be approximated as the sum of changes in the population share of each group weighted by their base-year participation rate, and changes in the participation rate of each group weighted by their base-year population share.[3] Table 1.1.2 shows the results of this decomposition by ethnic group.

Table 1.1.2. United States: Compositional Analysis of Changes in Labor Force Participation, by Ethnicity (changes between 2000 and 2013 in percentage points)[1]

	Overall Participation Rate Change	Hispanic											
		Mexican American[2]		Puerto Rican		Cuban		Other Hispanics		Black		Other (Non-Hispanic)[3]	
		(a)	(b)	(a)	(b)	(a)	(b)	(a)	(b)	(a)	(b)	(a)	(b)
2000–13	–3.8	1.6	–0.3	0.2	0.0	0.1	0.0	0.9	–0.1	0.4	–0.5	–3.1	–3.0

Sources: Bureau of Labor Statistics, Household Employment Survey; and IMF staff estimations.
[1] (a) population share shift; (b) participation rate shift.
[2] The cumulative interaction term for this group is –0.1 in 2013.
[3] Comprises all other ethnic groups, including non-Hispanic whites and Asians. The cumulative interaction term for this group is 0.18 in 2013.

Notably, since 2000, all Hispanic groups made positive contributions to the aggregate participation rate via higher population shares. However, Mexican Americans and "other Hispanics" have contributed negatively via declining participation rates, although the decline in the aggregate participation rate has been driven by the "Other" group. This group has seen both the population share and participation rates decline since 2000. Because they represent three-fourths of the population, changes in this group dominate the evolution of the aggregate rate.

In the future, the participation rate will likely continue to decline, reflecting primarily the retirement of baby boomers. In addition, the slow economic recovery has led to rising numbers of long-term unemployed and discouraged workers. The increase in the latter group has been exerting further downward pressure on participation. On the positive side, the increasing population share of certain ethnic groups could offset to some extent the secular decline in participation. Hispanics are projected to double their share in the U.S. population to about 30 percent by 2060.[4] If their higher-than-average participation rates are sustained throughout this period, this will have a positive effect on the aggregate participation rate. More generally, migration trends will remain an important factor in determining U.S. labor force dynamics.

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[3] Data on population and labor force are from the Household Employment Survey, which does not distinguish the legal status of respondents. Hence, it is not possible to estimate the relative weight of illegal immigrants. According to the Pew Hispanic Center, illegal immigrants accounted for 3.7 percent of the population and 5.2 percent of the labor force in March 2010.
[4] The labor force will also be affected by the evolution of hours worked. The Congressional Budget Office forecasts that potential hours worked in the nonfarm business sector will increase 0.6 percent per year in 2014–24 (compared with 1.3 percent per year in 1950–2013).

Box 1.2

Unconventional Energy Boom in North America: Macroeconomic Implications and Challenges

A boom in unconventional oil and natural gas production has been transforming the energy landscape in North America, with important implications for global energy markets and the broader competitiveness outlook. As a major positive supply shock, the boom carries broad economic benefits but also creates some challenges that need to be addressed.

The Boom

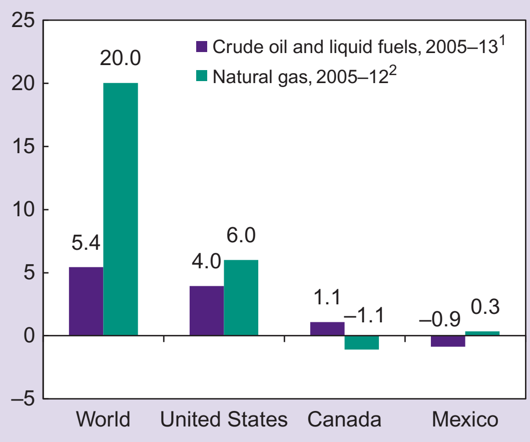
The increase in crude oil production in the United States and Canada during 2005–13 nearly matched the increase in global oil production in those years (Figure 1.2.1). In contrast, Mexico's oil production has been on a steady decline since peaking in 2004, owing to limited investment in exploration, especially in offshore fields, and in secondary recovery techniques. In 2013, more than one-fifth of the world's total crude oil was produced in North America. Within the region, Canada's oil exports, boosted by oil sands production, have gained a substantial market share in the United States at the expense of other traditional exporters such as Mexico, Nigeria, and Venezuela (Figure 1.2.2).

The region also produces more than one-fourth of the world's natural gas, but the U.S. shale gas revolution has significantly shifted the balance in favor of the United States, as Canada's gas production and exports to the United States—its only export market—declined since the mid-2000s. Mexico's gas production has remained relatively flat in recent years, after increasing prior to 2007.

The boom is expected to continue, supported by ongoing improvements in technologies. As a result, the United States is expected to become a net exporter of natural gas in 2018, with domestic production increasing steadily by about 50 percent over the next two decades, while Canada's share in the world's crude oil production is expected to increase from the current 4¾ percent to 5¾ percent by 2030. Current projections also point to the potential for a significant increase in oil and gas production in Mexico, as the 2013 energy reform will fundamentally transform the country's hydrocarbon sector. In particular, the reform opens the door for private participation in upstream and downstream operations.

Figure 1.2.1

Change in Crude Oil and Natural Gas Production

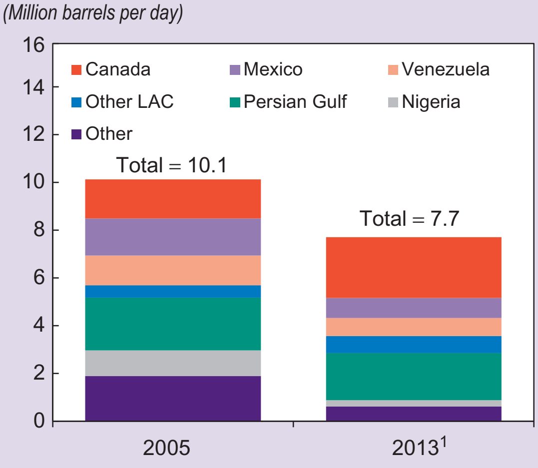


Sources: U.S. Energy Information Administration; and International Energy Agency (2013).
[1] Million barrels per day.
[2] Trillion cubic feet.

Figure 1.2.2

United States: Crude Oil Imports, 2005 vs. 2013

(Million barrels per day)



Source: U.S. Energy Information Administration.
Note: LAC = Latin America and the Caribbean.
[1] Average over January to November for 2013.

Note: This box was prepared by Lusine Lusinyan.

Box 1.2

Macroeconomic Impact

The energy boom in the United States and Canada has had positive effects on both economies, but the potential macroeconomic impacts vary, reflecting in part the relative size and interconnectedness of the respective energy sectors:

- In the *United States*, where oil- and gas-related sectors account for about 1½ percent of total GDP, the direct benefits to the economy of the ongoing boom are estimated to have been relatively small, contributing only 0.1 percentage points to real GDP growth in 2012. However, the low domestic price of natural gas (about one-third of the gas price in Europe and one-fourth of that in Asia) has helped support consumer demand and provided a competitive advantage to domestic energy-intensive industries. IMF staff analysis also suggests that the energy boom in the United States (together with greater energy efficiency) is likely to halve the U.S. energy trade deficit by about 1 percent of GDP by the mid-2020s (Hunt and others, 2013).
- In *Canada*, because of the rapid development of oil sands, the energy sector represents close to 10 percent of GDP and 25 percent of total exports. Although high energy prices have contributed to the real appreciation of the Canadian dollar since the early 2000s, intensifying competitiveness challenges in nonenergy sectors, Canada has benefited from the energy boom through both direct and spillover effects. The positive effects from the energy boom could be even greater once the infrastructure capacity is expanded. IMF staff estimates suggest that eliminating infrastructure bottlenecks and allowing full market access to Canadian energy products would increase Canada's total GDP by about 2 percent over a 10-year horizon (Lusinyan and others, 2014).

Challenges

Nonetheless, the energy sector in North America faces important challenges. Constraints on U.S. exports of natural gas could keep North American gas prices depressed, potentially discouraging further investment in the sector. Canada would benefit from exporting natural gas to other countries besides the United States, but this would require building large-scale facilities close to the Canadian coast. In addition, infrastructure constraints for transporting Canadian heavy oil to U.S. refineries situated in the Gulf Coast or Canada's eastern provinces, and restrictions on U.S. exports of crude oil, have resulted in an oil glut in the center of North America and increased volatility in the market. Unless Canada's share of U.S. oil imports doubles by 2030 from the current 30 percent, it would be essential for Canada to diversify its crude oil export markets to benefit from the growing supply of oil. For Mexico, it would be important to follow through on the energy reform by promptly adopting and implementing legislation and regulations to provide clarity to the private sector and stimulate investment. Among other things, this will require detailing the exact nature of contracts with the private sector and the tax regime applying to new oil.

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