1. A Shifting Global Landscape and the Outlook for the United States and Canada

Against the backdrop of lackluster global growth in 2016, the world economy is seeing underlying shifts in its economic and policy landscape. Since last October, the outlook for advanced economies for 2017–18 has improved, reflecting better growth prospects in the United States, Europe, and Japan—alongside some rebound in manufacturing and trade and likely U.S. fiscal stimulus. With the anticipated change in the U.S. policy mix, including faster monetary tightening and a stronger U.S. dollar, market sentiment in advanced economies has improved and equity markets have been buoyant. Domestic financial conditions initially tightened in emerging markets, where growth prospects have worsened slightly, but market conditions have since noticeably improved. On balance, global growth is expected to rise modestly in 2017 and 2018 but with widely dispersed risks around this baseline. Longer-term uncertainty surrounds the direction and extent of shifts in U.S. policies. Global vulnerabilities include a rising tide of economic nationalism in major advanced economies—marked by higher antipathy toward trade, immigration, and globalization.

Global growth in 2016 was the weakest since 2008–09. However, economic momentum improved in the second half of last year, notably in major advanced economies. Recent signals—including global indicators of manufacturing activity and trade flows—indicate improved growth momentum in 2017. With this momentum, global growth is expected to rise modestly from 3.1 percent in 2016 to 3.4 percent in 2017 and 3.6 percent in 2018 (Figure 1.1; see also Chapter 1 of the April 2017 *World Economic Outlook*). This forecast envisages a stronger rebound in advanced economies since last October, while weaker-than-expected activity in some emerging market economies has led to small downward revisions to their overall growth prospects for 2017–18.

The improved outlook for advanced economies for 2017–18 reflects a somewhat stronger pace of activity in the second half of 2016, an assumed fiscal stimulus and improved confidence in the United States, and better growth prospects in Europe and Japan associated with a manufacturing and trade rebound. Since last November's elections, expectations of looser fiscal policy in the United States have contributed to a stronger dollar and higher interest rates, pushing up bond yields elsewhere. Market sentiment and risk appetite have also strengthened—generating appreciable gains in equity markets—although financial risks in emerging markets remain elevated amid higher volatility. Growth prospects worsened marginally for emerging market and developing economies, including in Latin America, as growth outcomes in the latter half of 2016 were generally slower than expected. Better growth performance, however, is expected this year and next for these economies. China's growth in 2017, for example, has been marked up owing to stronger-than-expected policy support. Also, conditions in commodity exporters with macroeconomic strains should gradually improve as a result of firming commodity prices since last October.

Risks to global growth have risen and are slanted to the downside, largely reflecting uncertainty about policies. Buoyant markets and sentiment portend a tangible upside for near-term growth. However, risks to the medium-term outlook for growth appear more negative. Policy support for growth in the United States and China will have to be unwound or reversed down the road. More generally, uncertainty stems from risks of an inward shift in policies, including trade or immigration restrictions; the possibility that U.S. fiscal stimulus will trigger a quicker tightening in global financial conditions; and factors including geopolitical tensions, domestic political discord, and terrorism and security concerns. These risks are interconnected. For instance, more insular policies could be associated with heightened

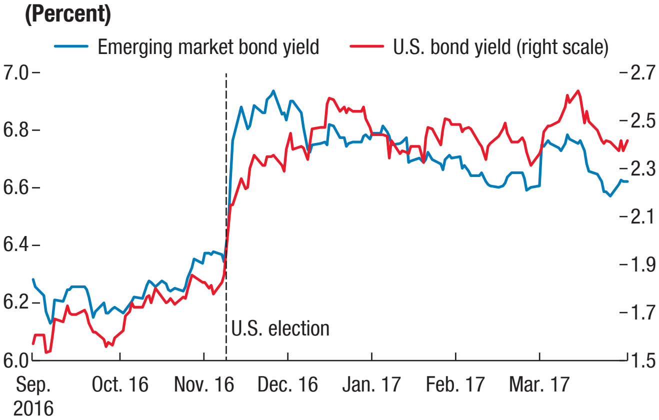
This chapter was prepared by Hamid Faruqee with Kotaro Ishi and Emanuel Kopp. Genevieve Lindow provided excellent research assistance.

Figure 1.1. Global Growth, Financial Conditions, and Commodity Markets

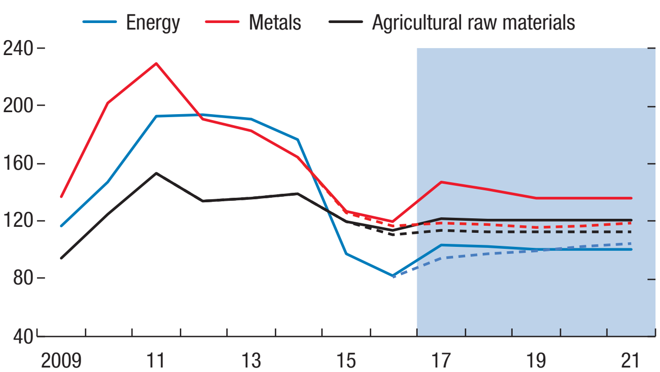
1. Real GDP Growth (Percent; annual rate)

	2015	2016	Projections 2017	Projections 2018
World	**3.4**	**3.1**	**3.5**	**3.6**
Advanced economies	2.1	1.7	2.0	2.0
United States	2.6	1.6	2.3	2.5
Euro area	2.1	1.8	1.7	1.6
Japan	1.2	1.0	1.2	0.6
Emerging market and developing economies	4.2	4.1	4.5	4.8
China	6.9	6.7	6.6	6.2
Russia	–2.8	–0.2	1.4	1.4

2. Ten-Year Bond Yields[1] (Percent)



3. Global Commodity Prices[2] (Index: 2005 = 100)



Sources: Bloomberg L.P.; and IMF, World Economic Outlook database.
[1]Bond yield for emerging markets refers to J.P. Morgan Government Bond Index–Emerging Markets (GBI-EM).
[2]Dotted lines refer to the October 2016 *World Economic Outlook* global assumptions.

geopolitical tensions as well as heightened risk aversion and tighter financial conditions.

Shifts in the Global Landscape

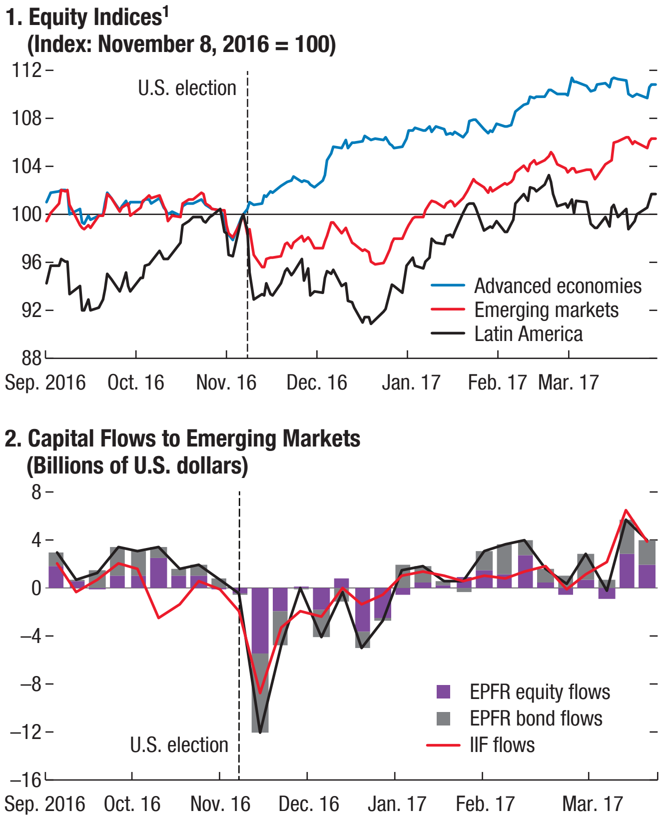
In a setting of disappointing global growth over the past several years, important shifts are taking place in the economic and policy landscape affecting the outlook. A key assumption underlying the forecast is a *changing policy mix* in the United States and its possible global spillovers. Following the November elections, near-term fiscal stimulus and a faster pace of monetary policy normalization are now assumed relative to previous forecasts. See the U.S. section in this chapter for details of potential policy changes and Chapter 2 for a discussion of the regional implications.

Other developments include *commodity markets* where agriculture, metals, and energy commodity prices have firmed (Figure 1.1). For example, the latest forecasts incorporate higher oil prices following the agreement among members of the Organization of the Petroleum Exporting Countries and several other major producers to limit supply. However, the medium-term outlook for oil markets is broadly unchanged around "lower for longer" oil prices (Figure 1.1).[1] In many emerging markets, previous downward pressures on headline inflation have receded, in part owing to the recent firming of commodity prices and a pickup in growth. An exception is Latin America, where inflation has been easing, as discussed in Chapter 2.

In *financial markets*, a significant repricing of assets ensued in the wake of the U.S. presidential elections, with an initial divergence seen in equity prices between advanced and emerging market economies (Figure 1.2). Notable market developments included a steepening of the U.S. yield curve and upward movements in the U.S. dollar as term premiums decompressed. Portfolio

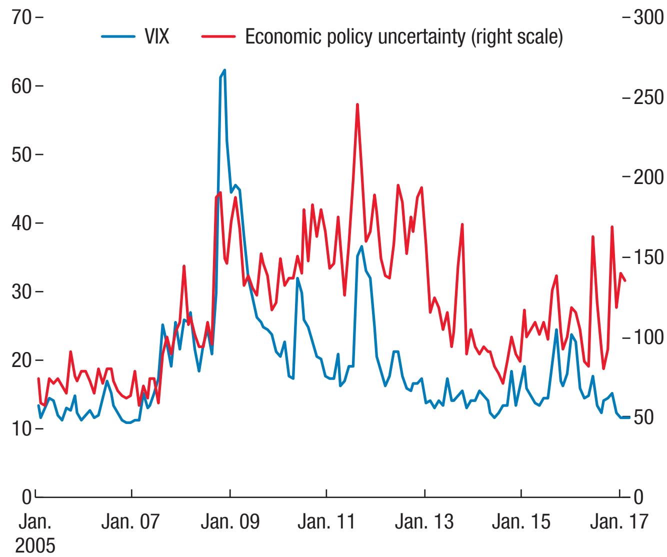
[1]See the April 2016 *Regional Economic Outlook: Western Hemisphere* for a discussion of global trends in oil demand and supply and factors behind lower-for-longer oil prices, including the role of unconventional oil producers.

Figure 1.2. Global Equity Markets and Capital Flows



Sources: Bloomberg L.P.; Haver Analytics; and Institute of International Finance (IIF) database.
Note: EPFR = Emerging Portfolio Fund Research.
[1]Refers to Morgan Stanley Capital International (MSCI) local currency indices.

Figure 1.3. Policy Uncertainty and Stock Market Volatility
(Index)



Sources: Bloomberg L.P.; and Haver Analytics;
Note: The economic policy uncertainty index for the United States was developed by Scott Baker and Nicholas Bloom of Stanford University and Steven Davis of the University of Chicago (2012). VIX = Chicago Board Options Exchange Volatility Index.

reallocation produced a selloff in U.S. Treasury markets and a rally in equity markets in advanced economies, where market-based measures of inflation expectations have risen from low levels.

At the same time, equity prices in emerging markets broadly retreated in late 2016 as their currencies weakened, especially in Mexico, but stock prices and currency values have largely recovered since. In parallel, high-frequency indicators of capital flows suggest a recovery in financial flows to emerging markets following their initial drop in November 2016. Uncertainty remains, however, about the economic outlook—including the nature and extent of possible changes to U.S. tax, trade, and immigration policy, as well as to financial and business regulation.

Indicators of global policy uncertainty, for example, have risen noticeably over the past year, seemingly at odds with declining measures of volatility in major equity markets (Figure 1.3 and Chapter 1 of the April 2017 *Global Financial Stability Report*). Policy uncertainties create risks and possible spillovers.

Wider Range of Global Risks

The range of risks around the global forecast is thus wider than usual:

- Although a moderate pace of *U.S. interest rate hikes* is envisaged in line with achieving the Federal Reserve's price stability mandate, changes to the policy mix entail risks, depending on the supply side of the economy. If fiscally driven increases in demand collide with more rigid capacity constraints, a steeper path for interest rates will be necessary to contain stronger incipient inflation pressures. Sharp movements in U.S. term premiums tend to spill over into other financial markets and may produce an abrupt tightening of global financial conditions. With tighter financial conditions, the U.S. dollar would appreciate more sharply, which may create difficulties for economies that manage their currencies to closely align with the dollar. In turn, a stronger dollar could contribute to widening U.S. external deficits and larger global imbalances.

- At the global level, *policy uncertainty* has risen appreciably—including from the potentially far-reaching changes in the direction of U.S. policies, which are not yet known. In Europe, the terms of Britain's exit from the European Union and the single market remain unsettled. Pervasive sources of policy uncertainty can trigger heightened risk aversion in markets and a reversal of recent market trends. Other key risks include building vulnerabilities in China's financial system as policy stimulus is extended and continued, and balance sheet weaknesses and currency mismatches in other emerging market economies that could amplify tightening financial conditions.
- Vulnerabilities globally include the rise of *economic nationalism*, accompanied by higher antipathy toward trade, immigration, and globalization in Europe and the United States. Risk associated with protectionist measures and retaliatory responses would lower global growth through reduced trade, migration, and cross-border investment flows. These risks also heighten policy uncertainty and imply a potential sharper-than-expected tightening of global financial conditions, with possible stress on many emerging market economies and some low-income countries.

Policy choices and a reduction in policy uncertainty will therefore be crucial in shaping the outlook and reducing risks. At a global level, IMF staff continue to recommend a *three-pronged* policy approach that relies on fiscal and structural policies alongside monetary policy and is tailored to country circumstances to strengthen growth prospects (Chapter 1 of the April 2017 *World Economic Outlook*). Safeguarding an open, rules-based, multilateral trading system will also be critical for preserving the global economic expansion. At the same time, governments will need to do more to ensure that gains from technological progress and economic integration are shared more widely through redistributive policies and investments in skills and high-quality education, and by facilitating labor market adjustment.

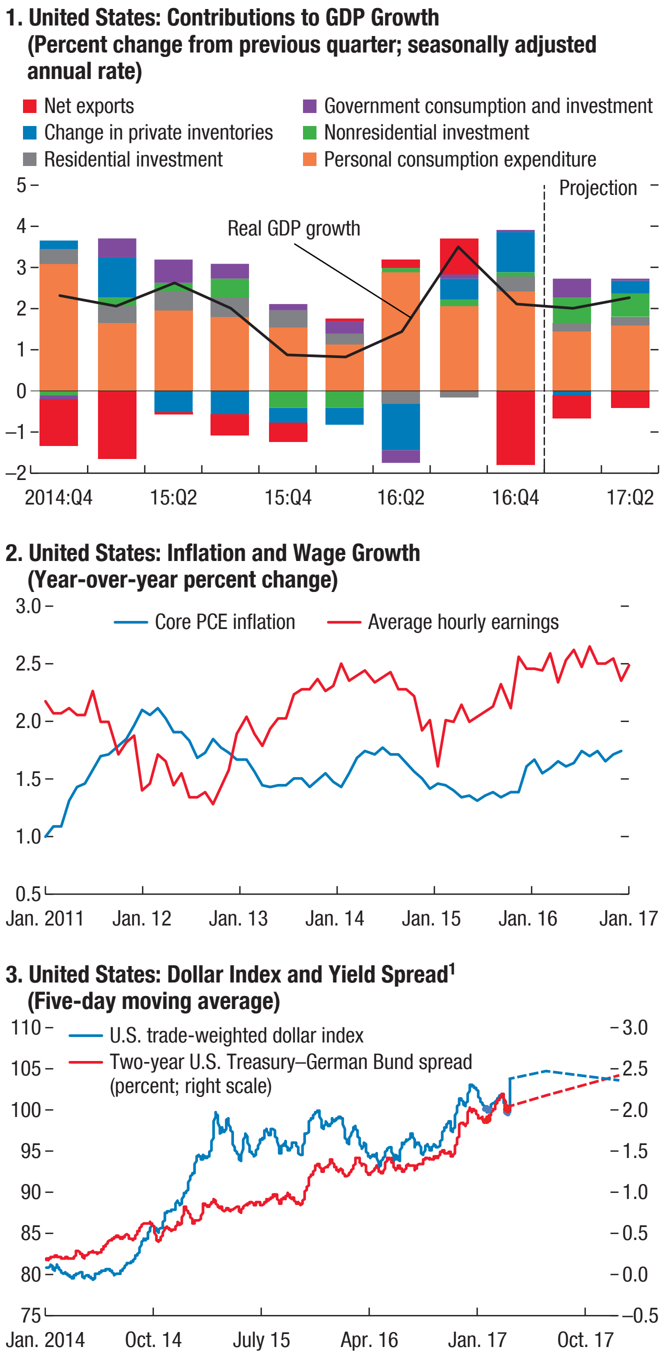
U.S. Outlook: More Growth, Higher Risks

The U.S. economy regained momentum in the second half of 2016, with strong job creation, solid growth in disposable income, and robust consumer spending. Real GDP growth settled at 1.9 percent (seasonally adjusted annual rate) in the last quarter of 2016, after substantial quarterly volatility during the course of the year (largely tied to swings in inventories). Throughout the year, consumption remained the engine of growth, while a stronger dollar and restructuring in the oil sector weighed on business investment (Figure 1.4).[2]

Headline inflation has been slowly rising, although at 1.8 percent, core personal consumption expenditure inflation is still running below the Federal Reserve's 2 percent objective. Past U.S. dollar appreciation and a drag from non-oil import prices have kept inflation pressures subdued, but those effects are now waning. The economy is approaching full employment, and tightening labor markets allowed average hourly earnings to rise by 2.7 percent over the past 12 months, while labor force participation continues to drop. As economic slack continues to diminish, core inflation is projected to gradually pick up and reach the Federal Reserve's target by mid-2018.

[2]In recent years, corporate profits have been used to a large extent for dividend growth, share buy-backs, and mergers and acquisitions. Since 2015, corporate payouts have been exceeding earnings—a phenomenon observed around the time of the last three recessions, but not during expansions.

Figure 1.4. U.S. Growth and Inflation, Dollar Index, and Interest Differentials



Sources: Bloomberg L.P.; Haver Analytics; U.S. Bureau of Economic Analysis; U.S. Bureau of Labor Statistics; and IMF staff calculations.
Note: PCE = personal consumption expenditure.
[1]Dashed lines based on median private sector forecasts of U.S. dollar index and calculated forward rates of the U.S. Treasury and the German Bund.

U.S. economic activity is projected to expand solidly by 2.3 and 2.5 percent in 2017 and 2018, respectively. Private consumption and fixed investment should benefit from actual and anticipated fiscal stimulus. IMF staff forecasts assume a fiscal expansion over 2017–19, mainly from a reduction in taxes on both households and firms. Over time, the U.S. current account deficit is projected to widen (to about 3 ½ percent of GDP by 2020), and public finances are expected to worsen (with debt held by the public approaching 110 percent of GDP by 2022). Although near-term prospects appear favorable, there are sizable longer-horizon uncertainties from the possible shifts in the direction of U.S. policies.

Changes in U.S. Policy Direction

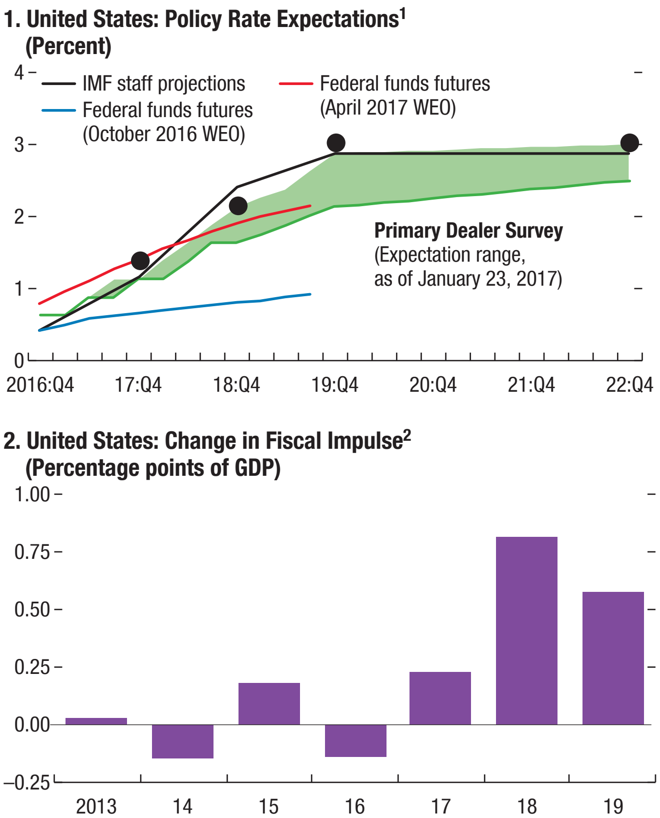
Policy Mix

Under the new administration, a shift in the U.S. *policy mix*—with more fiscal stimulus and a faster pace of monetary policy normalization—is assumed under the baseline projection. These anticipated policy changes appear to be largely priced in by markets, with a steepening yield curve, higher equity prices, and an appreciation of the U.S. dollar since November.

- On the *fiscal* side, the direction of existing proposals points to expansionary policies through personal income and estate tax cuts, reform of the corporate income tax, and, possibly, public or government-supported private infrastructure investment. Accordingly, IMF staff expect a higher fiscal impulse relative to the October *World Economic Outlook* forecasts (Figure 1.5). Specifically, IMF staff assume a 1.2 percent GDP increase in the federal primary deficit in cyclically adjusted terms from 2017–19, driven by personal and corporate income tax cuts.[3] Previous forecasts

[3]The baseline projection includes several policy assumptions. Relative to the October baseline, fiscal stimulus is estimated at 2 percent of GDP, cumulated over the period 2017–19, and consisting of personal income tax rate cuts equivalent to 1.1 percent of GDP over three years and corporate tax cuts equivalent to 0.9 percent

Figure 1.5. Changing U.S. Policy Mix



Sources: Bloomberg L.P.; Federal Reserve Board; IMF, World Economic Outlook (WEO) database; and IMF staff calculations.
[1]Black markers refer to the December 2016 Federal Open Market Committee median dots.
[2]Difference in fiscal impulse in April 2017 versus October 2016 WEO forecasts. The fiscal impulse is the negative change in the structural primary balance.

envisaged steady consolidation. While stimulating growth, such a fiscal expansion would likely cause a durable increase in the budget deficit and rising public debt, adding to existing budgetary pressures caused by population aging.

- With regard to *monetary policy*, a more assertive pace of policy rate increases by the Federal Reserve is assumed to keep inflation contained. Specifically, IMF staff forecasts assume three policy rate hikes in 2017 and five hikes in 2018, in line with the most recent guidance from Federal Open Market Committee members (Figure 1.5). Futures markets now also expect a steeper path for the central bank's policy rate compared with last October. Inflation is expected to rise modestly above 2 percent and then converge, from above, to the Fed's medium-term goals—a broadly unchanged inflation path relative to IMF staff's October 2016 forecast.

Finally, for *near-term risks*, the combination of fiscal expansion and monetary tightening may well induce further upward pressure on the U.S. dollar, especially if fiscal stimulus turns out to be larger than currently anticipated or if inflation pressures become evident more quickly.

Strategic Shifts and Two-Way Risks

Beyond a new policy mix, potentially far-reaching changes in the underlying direction of U.S. policies are being considered. Depending on how they are executed, they represent both upside and downside risks to the U.S. outlook over the medium term.

- *Corporate tax reform*. A structural overhaul of the U.S. corporate income tax is expected to involve a simplification of the tax system with lower average tax rates and a broader base. This change should be positive for long-term growth and, insofar as it is revenue losing, would also provide near-term demand stimulus. One key proposal under consideration is the destination-based cash-flow tax (DBCFT), which, if implemented, would likely boost business investment and economic growth domestically and encourage corporations to shift income or production from other tax jurisdictions to the United States (see Box 1.1). However, the border adjustment inherent in a DBCFT may create tensions with existing World Trade Organization rules, which could precipitate trade disputes and possible retaliation from partner countries. If such a move from the current open trading system were to occur,

of GDP. Other policy measures have not been included in the projection because of uncertainty around their final format and parameterization.

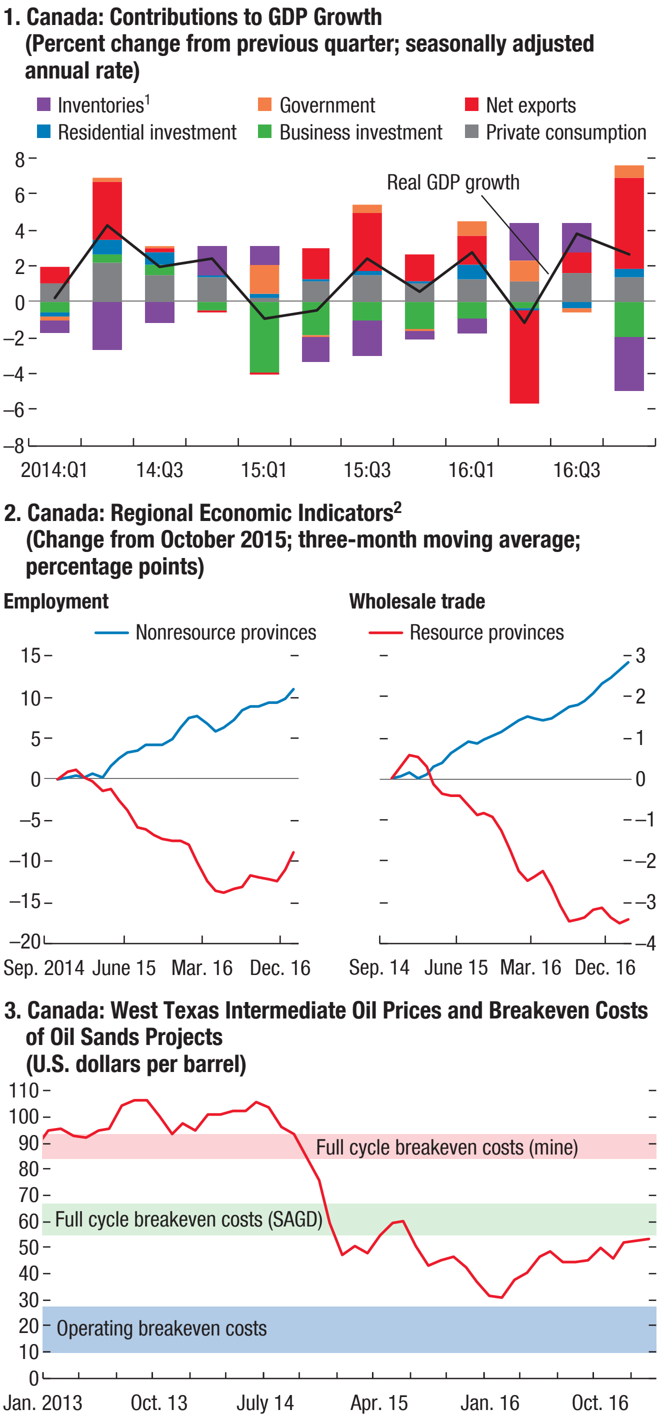
it would represent a negative risk to the U.S. outlook.

- *Business regulation*. The new administration has ordered a reexamination of existing federal regulations affecting businesses across a range of areas, with a view to scaling them back. Targeted deregulation that leads to simplification and streamlining of existing rules, harmonization of regulations across states, or better coordination of tax reform with regulatory reform could present an upside to the outlook by stimulating efficiency, growth, and job creation. Unintended negative side effects from deregulation efforts could occur for the environment, workplace safety, or protections for those with lower incomes.
- *Financial regulation*. The administration also plans to pursue changes in regulation of the financial industry, including reconsidering some aspects of the Dodd-Frank Act. There appears to be scope to make such legislation less burdensome, particularly for smaller financial institutions—including by adapting some elements of the current regulatory framework (for example, higher asset size thresholds in the application of enhanced prudential standards) or granting regulatory relief for small and community banks. However, many provisions of the existing regulatory rules have helped make the U.S. and global financial system considerably safer and more resilient. Diluting these provisions may lead to stronger near-term growth but would weaken the financial system's ability to manage stability risks and cope with financial stress, thus raising the likelihood of future economic dislocation.
- *Trade policy*. The United States has recently declared its intentions to reopen existing trade agreements, including renegotiation of the North American Free Trade Agreement (NAFTA). If well executed, cooperative efforts to update NAFTA (for example, in areas such as e-commerce and financial and other services) could potentially generate growth dividends for all the signatories. However, unilateral imposition of tariffs or other trade barriers on imports would prove damaging for both the United States and its trading partners—especially given the predominance of intermediate goods trade and established value chains across borders. Implications from trade restrictions would be manifested through weaker trade, higher production costs, more expensive imported consumer goods, and lower potential growth (see Chapter 2). Tariff retaliation by trading partners would deepen these adverse effects.
- *Immigration reform*. Currently, about 1.3 million immigrants enter the United States legally each year, supporting the workforce and positively affecting productivity. Skills-based immigration reform could create an upside for U.S. potential growth by increasing human capital, labor force participation, and productivity. However, a more restrictive approach to U.S. immigration policy, if broadly applied, would slow the influx of both skilled and unskilled workers, potentially depress innovation and productivity growth, and reinforce demographic trends of an aging population. These outcomes would have untoward effects on potential growth. Depending on the scale of the restrictions, they could also create upward pressure on U.S. production costs including wages (although this would be beneficial for low-income households). These restrictions would create negative spillovers for countries that rely on remittances from, and migration flows to, the United States (see Chapters 2 and 5).

U.S. Policy Priorities

Over the longer term, U.S. *public finances* are on an unsustainable path given future increases in health and pension outlays as the population ages and potential output slows. A credible deficit- and debt-reduction strategy continues to be absent. By tackling medium-term fiscal imbalances, the United States could create more room for policies

Figure 1.6. Canada Growth, Sectoral Shifts, and Lower Oil Prices



Sources: Haver Analytics; IHS Markit; and Statistics Canada.
Note: SAGD = steam-assisted gravity drainage.
[1]Includes statistical discrepancy.
[2]Nonresource provinces are British Columbia, Ontario, and Quebec; resource provinces are Alberta and Saskatchewan.

that improve the nation's infrastructure, boost the labor force, and improve human capital.

Structural policies should prioritize those measures that can lift potential output and reduce poverty rates. These measures include infrastructure investment, education spending, stronger social safety nets (such as expanded earned income tax credits), tax and pension reform, and a higher minimum wage. Measures to expand the pool of skilled labor include skills-based immigration reform, job training, and child care assistance. U.S. immigration system reforms would need to balance being skills-based to raise the human capital of the workforce with being sufficiently broad-based to reverse underlying demographic trends toward a rising elderly dependency ratio. The path of future health care costs also needs to be lowered, particularly for vulnerable groups, to secure the sustainability of public finances.

Canada: Promising Prospects, Higher Uncertainty

In a year of transition, Canada's economy has undergone important structural shifts. Investment and employment have been reallocated from the resource sector to other areas of the economy, most notably services. Quarterly GDP was volatile in 2016 in the aftermath of severe Alberta wildfires and swings in oil production over the course of the past year. Overall, the economy posted modest growth of 1.4 percent for 2016, up from 0.9 percent in 2015, as the drag from lower commodity prices dissipated. Personal consumption remained resilient, supported by fiscal stimulus and expansion of the Canada Child Benefit program. However, business investment continued to be a drag on growth, while exports were lackluster, reflecting external competitiveness challenges for nonresource goods sold in the U.S. market. Nonetheless, signs of economic momentum have emerged since the second half of 2016 (Figure 1.6), and GDP growth is projected to strengthen to 1.9 percent in 2017 and 2 percent in 2018. After the IMF forecast was made, the release for January GDP and March housing starts were stronger than expected.

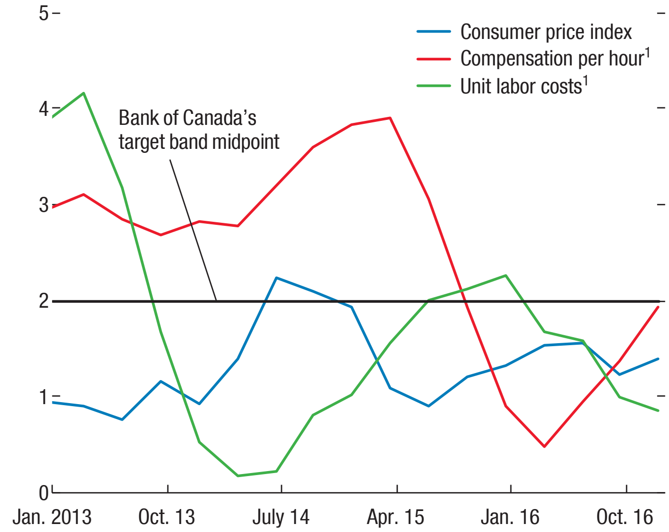
From the supply side, the services sector (accounting for about 70 percent of GDP) has been expanding steadily. Finance and real estate activities have also been boosted by the boom in housing markets. Reorientation toward nonresource sectors has proceeded gradually,[4] supported by accommodative monetary and fiscal policy as well as flexible labor markets (which facilitate interprovincial migration). At the provincial level, divergent regional indicators underscore an underlying sectoral shift in the economy (Figure 1.6). Resource-rich provinces have contracted but have shown signs of stabilizing more recently, and higher oil prices since mid-2016 are now well above operating costs for many oil sands producers (though still below their full-cycle breakeven costs). Market sentiment and corporate stress indicators related to energy firms have improved noticeably.

Turning to prices, inflation pressures remain subdued. For most of last year, headline consumer price index inflation was in the range of 1 to 1.5 percent, below the midpoint of the Bank of Canada's target band of 1 to 3 percent, although it has risen to about 2 percent more recently due to gasoline price increases. Core inflation measures have remained below 2 percent since late 2016, because of the diminishing effects of exchange rate pass-through, lasting excess capacity in the economy, and weak growth in unit labor costs (Figure 1.7). With business productivity running about 1 to 1.5 percent over the past year, growth of unit labor costs has hovered around 1 percent, posing little upward price pressure.

[4]Canada's initial weakened competitiveness position in the U.S. market helps explain the slow export response of nonresource goods to a more competitive exchange rate, as evidenced by stagnant Canadian goods exports in recent years (see also Chapter 3). Consistent with "Dutch disease," the oil boom of the past decade was accompanied by a significant rise in the value of the Canadian dollar, which partly explains an erosion of external competitiveness for its nonresource-exporting industries. Canada's share of nonresource goods exports dropped from nearly 20 percent in the mid-1990s to about 10 percent during the oil boom period.

Figure 1.7. Subdued Inflation and Cost Pressures

Canada: Inflation and Labor Costs (Year-over-year percent change)



Source: Statistics Canada.
[1]Business sector; three-quarter moving average.

Elevated Macro-Financial Vulnerabilities

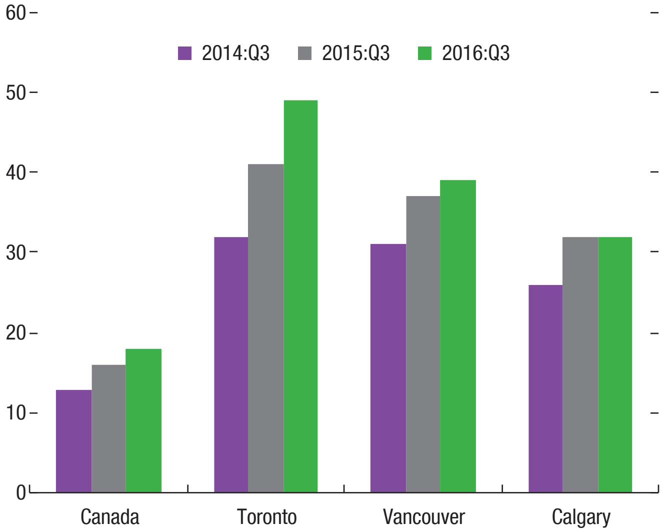
The housing sector continues to pose risks to macro-financial stability. High or rising house prices in key real estate markets have driven an increased number of borrowers to acquire larger mortgages with higher loan-to-income ratios.[5] The highly leveraged mortgage borrowers tend to be concentrated in the most expensive metropolitan housing markets (Figure 1.8). Overall, household indebtedness continued to rise (approaching a historic high of nearly 170 percent of disposable income). Households' total debt-service ratio has been broadly unchanged, with lower interest payments (reflecting lower rates) offsetting higher principal repayments (reflecting larger debt) (Figure 1.9).

Although the banking system is sound and profitability is high, banks' exposures to highly indebted households has risen. Mortgage and

[5]The share of mortgage borrowers with loan-to-income ratios greater than 450 percent increased from 32 percent in 2014 to 49 percent in 2016 in Toronto, and from 31 percent in 2014 to 39 percent in 2016 in Vancouver. See Bank of Canada (2016).

Figure 1.8. Increased Mortgage Borrowing

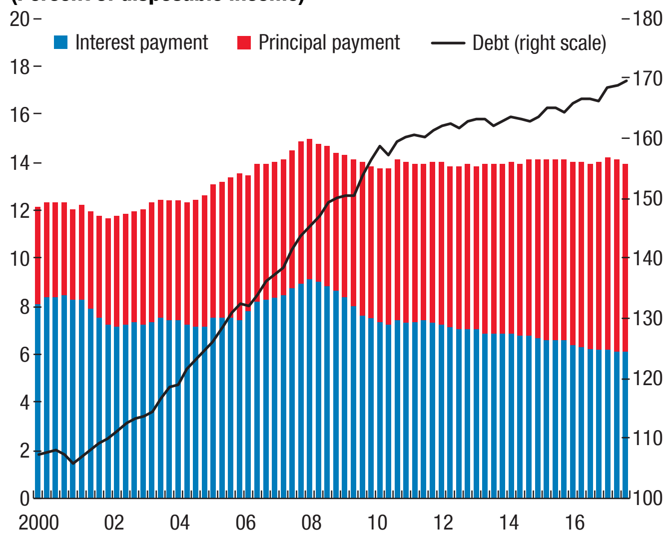
Canada: Share of Borrowers with High Mortgage Debt
(Percentage share of mortgages with loan-to-income ratio over 450 percent)



Source: Bank of Canada 2016.

Figure 1.9. High and Rising Household Debt

Canada: Household Debt and Debt Service Ratios
(Percent of disposable income)



Source: Statistics Canada.

consumer loans account for about one-third of bank assets. If risks were not sufficiently addressed, a plausible (but tail) risk scenario would involve a severe recession and a large and persistent rise in unemployment that could trigger a negative macro-financial spillover, resulting in an increase in mortgage defaults and a deep correction in house prices. Banks' profitability and capital positions would be hurt, leading to a credit crunch, magnifying the negative spillovers.

The authorities remain proactive in containing housing sector vulnerabilities. Over the past year, they have introduced new macroprudential policy measures—including requiring lenders to subject all insured borrowers to mortgage rate stress tests, tightening eligibility criteria of low loan-to-value ratio mortgages for portfolio insurance, and implementing tighter supervisory expectations for mortgage underwriting standards and strengthened bank capital requirements.[6] Some housing markets have recently shown signs of cooling. In Vancouver, for example, house prices and home sales have both fallen, likely reflecting the macroprudential tightening measures that have been taken, as well as new tax measures at the provincial and municipal level introduced in the past year (Figure 1.10).[7]

Higher Upside and Downside Risks

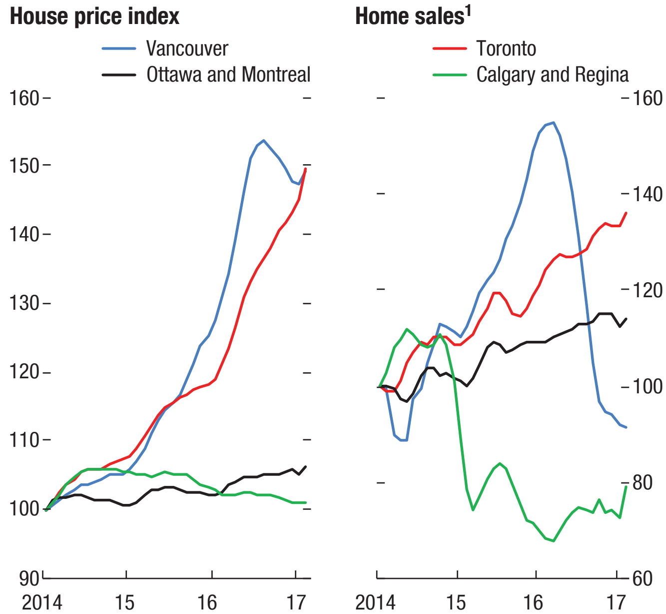
The medium-term outlook for the Canadian economy is somewhat clouded by uncertainty about external demand, the new U.S. administration's policies, and the lack of a clear driver for growth as sectoral shifts continue. Also, population aging is set to accelerate, albeit from a relatively low level compared with other advanced economies, with working-age individuals (ages 15–64) already starting to fall as a share of the total population. Both upside and downside risks to the outlook are significant:

[6]Other announced measures included closing tax loopholes pertaining to capital gains tax exemptions for principal residences and launching consultations on lender risk sharing (which would require mortgage lenders to bear a portion of loan losses on insured mortgages).

[7]In 2016, the British Columbia government introduced a 15 percent property transfer tax for foreign buyers in the Greater Vancouver area, and Vancouver city introduced a new empty-home tax.

Figure 1.10. Cooling in Some Housing Markets

Canada: Regional Housing Markets
(Index: January 2014 = 100)



Source: Canadian Real Estate Association.
[1]Three-month moving average.

- *Higher uncertainty about the U.S. policy stance and its spillover impact.* The United States is Canada's dominant trading partner (receiving about 75 percent of Canada's goods exports), and U.S. fiscal stimulus could benefit growth in Canada, depending on how changes in the U.S. policy mix are implemented. If the United States were to move ahead with protectionist trade measures, foreign demand would be reduced, putting a drag on Canadian exports and business investment.
- *A sharp correction in domestic housing markets.* This correction could be triggered by a sharper-than-expected increase in mortgage interest rates, along with tighter global financial conditions, or a sudden shift in price expectations, especially in the booming housing markets. Financial stability risk could emerge if the housing market correction were to be accompanied by a severe recession with a sharp and persistent rise in unemployment.

Policy Priorities in Canada

Given the still-weak economy, the key policy challenge is to bolster near-term growth while preventing the further buildup of imbalances, strengthening resilience to shocks, and vigorously pursuing structural reform to enhance external competitiveness and long-term growth.

From the standpoint of *macroeconomic policies*, the current policy mix is appropriate. The Bank of Canada has maintained an accommodative stance, with the policy rate at 0.5 percent since July 2015, given persistent economic slack, and markets assume that the rate will be kept unchanged until mid-2018. The federal government has fiscal space and is committed to expansionary policy to support the economy. The 2017 federal budget expects the deficit to widen slightly from 1.1 percent of GDP in FY2016/17 to 1.4 percent of GDP in FY2017/18, largely due to higher infrastructure spending. At the provincial level, the deterioration of fiscal balances is expected to come to an end, with economies in resource-rich provinces stabilizing. If downside risks materialize, there is scope for monetary and fiscal policy to provide additional stimulus, but more fiscal and less monetary support would help discourage households from taking on more debt.

The impact of recent *macroprudential policy measures* should be carefully watched before deciding on another move. If housing imbalances continue to grow, additional macroprudential policy measures, possibly targeting regional imbalances, may be needed. In contrast, if housing markets start correcting much faster than expected, and raise financial stability concerns, there may be a case for easing macroprudential measures.

With regard to *structural policy*, the authorities should continue to take bold actions to improve productivity and external competitiveness. Building on recommendations put forward by the Advisory Council on Economic Growth,[8] the

[8]In March 2016, the Minister of Finance established the Advisory Council on Economic Growth. In October, this council put forward its initial set of recommendations: (1) establishment of a new infrastructure bank to attract private infrastructure financing, (2) creation

2017 federal budget proposed detailed measures to enhance innovation, upgrade labor skills, and empower women in the workplace. The government is also committed to establishing a new infrastructure bank by late 2017 to leverage private sector expertise and capital. Beyond these measures, further efforts to diversify Canada's trade partners (including by implementing its free trade agreement with the European Union) and reduce non-tariff barriers across provinces would be beneficial to boost productivity.

of an Investment in Canada Hub to strengthen federal-provincial coordination to attract foreign direct investment, and (3) creation of a global skills strategy to help companies hire highly skilled immigrants more quickly. In February 2017, the council published a second set of recommendations, including measures to boost innovation, labor skills, and trade.

Box 1.1. The Destination-Based Cash Flow Tax

The U.S. House of Representatives' proposal for fundamental tax reform seeks to replace the corporate income tax with a *cash flow tax with border adjustment* and a lower tax rate for U.S. firms. The idea is to reduce the tax burden and relevant distortions by transforming the current 35 percent corporate income tax rate—which is the highest among Organisation for Economic Co-operation and Development economies—to a 20 percent destination-based cash flow tax (DBCFT) to encourage investment and employment in the United States.

How would it work? The tax has two basic components.[1] As a *cash flow tax*, corporate taxes would be paid on revenues less expenses—including wages, investment, and intermediate inputs used for production. Thus, the existing system of depreciation allowances and net interest payment deductions would be eliminated and replaced by immediate expensing of capital investment. This strategy would help eliminate tax bias for U.S. firms toward debt finance (since interest costs would no longer be tax deductible) and would tax economic rents rather than the normal return to capital (and, in so doing, remove an existing tax distortion on investment decisions).

Second, the *destination-based* component would mean "border adjusting" the tax by exempting exports and taxing imports (or equivalently, not allowing imports to be a deductible expense when calculating the firm's tax liability). Together, this would shift corporate taxation from a source basis (place of production) to a destination basis (place of consumption) analogous to a value added tax (VAT). Essentially, moving to a DBCFT is equivalent to raising the VAT and reducing payroll taxes or subsidizing wages:

$$\underbrace{\textit{Revenue} - \textit{intermediate purchases} + \textit{imports} - \textit{exports}}_{\textit{VAT base}} - \textit{wages}$$

Moving to a tax on a destination basis would, in effect, remove incentives for corporations to shift income or production from the United States to lower-tax jurisdictions (including through relocating intellectual property, transfer pricing, and thin capitalization). This change would limit problems of tax-base erosion and profit-shifting out of the United States.

If adopted, what are the broader implications of the DBCFT? The *macroeconomic effects* for the U.S. economy would depend on the precise specification of the tax and its impact on the fiscal deficit. Under an assumption of revenue neutrality, the proposed tax system should boost U.S. investment and induce a reallocation of productive capacity to the United States (see Box 1.1 of the *April 2017 Fiscal Monitor*). Benefits would largely stem from removing existing tax distortions on investment. However, any tax change of this magnitude would face numerous legal, practical and political hurdles. For example, adoption of the tax would require designing transition rules for existing capital and debt of firms, solving complications linked to taxation of the financial sector, and addressing how to provide refunds to sectors that are likely to face persistent tax losses. The change would also have uncertain distributional effects on income depending on implementation and the uniform tax treatment across all sectors and transactions might be hard to sustain in the face of lobbying pressures.

The proposal also carries significant *spillover implications*. Moving to a DBCFT could generate significant appreciation of the U.S. real exchange rate through a stronger dollar. A potentially large shift in the dollar's value would affect balance sheets, particularly for those economies that have unhedged and leveraged dollar positions. Nevertheless, many of the effects remain uncertain and difficult to assess, including the impact on exchange rates and prices. From a design standpoint, a potential inconsistency of the border adjustment

This box was prepared by Emanuel Kopp with input from the U.S. team.
[1]See Auerbach and others (2017) for a detailed discussion.

Box 1.1 *(continued)*

with World Trade Organization principles and existing tax treaties may open the door for retaliatory measures by trading partners. Furthermore, many countries would face the challenge of attracting foreign direct investment, as well as controlling tax-base erosion and profit-shifting to the United States from their home jurisdictions.

References

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