

# CANADA: 2013 Article IV Consultation



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## 2013 ARTICLE IV CONSULTATION

February 2014

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 2013 Article IV consultation with Canada, the following documents have been released and are included in this package:

- The **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF for Executive Board's consideration on January 29, 2014, following discussions that ended on November 26, 2013, with the officials of Canada on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 15, 2014.
- **Staff Statement** of January 24, 2014 updating information on recent developments.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its January 29, 2014 consideration of the staff report that concluded the Article IV Consultation with Canada.
- A **Statement by the Executive Director** for Canada.

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

### Selected Issues Paper

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

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# CANADA

## STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

January 15, 2014

### KEY ISSUES

**Economic Outlook:** Strong private consumption and residential investment helped Canada recover quickly from the last recession but left a legacy of elevated household debt and high house valuations. The transition to more balanced economic growth, with stronger contribution from exports and business investment, has proved elusive, and economic activity remained modest in 2013. Staff expects growth to accelerate above potential in 2014, following a stronger recovery in the United States, but the balance of risks remains on the downside.

**Policy Mix:** Low inflation, downside risks around the pickup in activity over the near future, and the moderation in the housing sector since mid-2012 suggest the Bank of Canada has more time to wait before starting to normalize interest rates than we anticipated in the 2012 Article IV Consultation Staff Report. With strong post-crisis fiscal consolidation and low levels of net debt, the federal government has room to delay the planned return to a balanced budget in 2015 absent a meaningful pickup in growth. There is limited room for maneuver for those provinces that have made less progress in reducing the fiscal deficits and face long-term fiscal sustainability challenges.

**Housing sector, macro-prudential policies, and mortgage insurance:** Household leverage remains high, and while house price and construction growth have come off their post-crisis peaks, high valuations and excess supply in a number of housing markets are a source of vulnerability. If maintained, the ongoing moderation in the housing market suggests little need for additional macro-prudential measures but it is important to remain vigilant. Over the longer term, rethinking the role of government-backed mortgage insurance may reduce the government exposure to housing sector risks and lead to a more efficient allocation of resources.

**Financial sector policies:** While Canada's financial supervisory and regulatory framework is strong, there is room to strengthen it further along the lines indicated by the 2013 FSAP Update mission.

**Policy response to past advice:** Since the 2012 Article IV Consultation mission, authorities have continued to take measures to ensure a sustainable development of the housing market, which the mission emphasized as a source of vulnerability last year. Recent progress in moving towards a less fragmented regulation of securities markets is also in line with past staff advice. At the provincial level, efforts to contain health care spending, the establishment of an independent fiscal council in Ontario, and the introduction of a new fiscal framework in Alberta are all consistent with recommendations contained in previous staff reports.

Approved By  
**Gian Maria Milesi-Ferretti (WHD) and  
 Vivek Arora (SPR)**

Discussions took place in Toronto, Calgary, and Ottawa during November 12–26, 2013. The team comprised Roberto Cardarelli (head), Lusine Lusinyan, and Julien Reynaud (all WHD), Ivo Krznar (MCM), and Minsuk Kim (SPR). Messrs. Alejandro Werner and Gian Maria Milesi-Ferretti (both WHD) and Simon Gray (MCM) joined the mission for concluding meetings in Ottawa.

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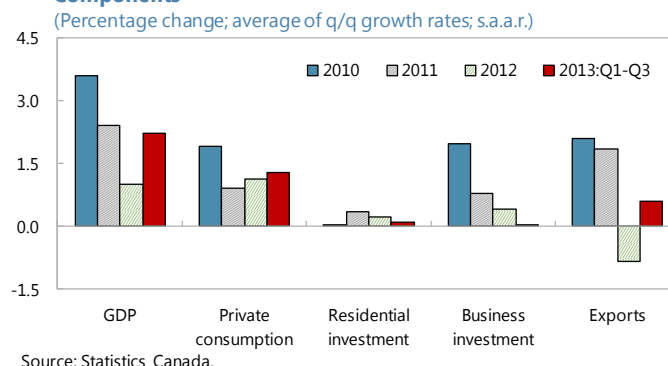
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## BACKGROUND: A CHALLENGING TRANSITION

### 1. The Canadian economy accelerated in 2013 but underlying growth remains modest

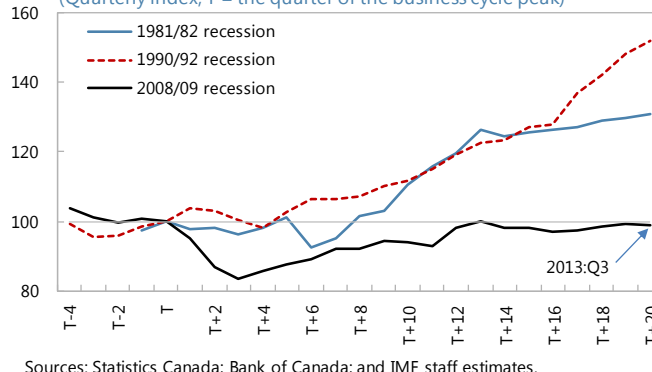
(Figure 1). Quarterly growth averaged 2.2 percent (annualized) over the first three quarters of 2013. But to a large extent this reflects the unwinding of disruptions in the energy sector that had depressed production, investment, and exports in the second half of 2012, when GDP grew at a mere 0.8 percent (Chart). The composition of growth does not yet point to the much needed rebalancing from household consumption and residential construction towards exports and business investment:

**Canada: GDP Growth and Contributions from Main Components**  
(Percentage change; average of q/q growth rates; s.a.a.r.)



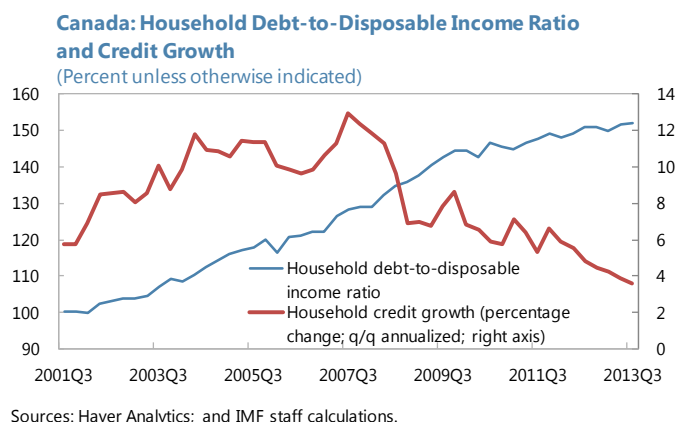
- Despite the rebound, export growth remained subdued in 2013.* Canada's exports have barely recovered from the Great Recession and are well below the levels reached after earlier recessions (Chart). The weakness can be only partially attributed to the tepid recovery of the U.S. economy, Canada's largest trading partner, but it also reflects the declining trend for non-energy exports that began about a decade ago, as low productivity growth, increased competition from emerging markets, and the appreciation of the currency eroded Canada's external competitiveness, particularly in the manufacturing sector (IMF Country Report No. 13/41). By contrast, energy exports volumes surged in recent years, thanks to strong growth in crude oil exports, which in late 2013 were 30 percent above the 2008 levels, while growth in natural gas exports has slowed significantly following the sharp increase in U.S. production since mid-2000s.

**Canada: Evolution of Real Exports after Recessions**  
(Quarterly index; T = the quarter of the business cycle peak)



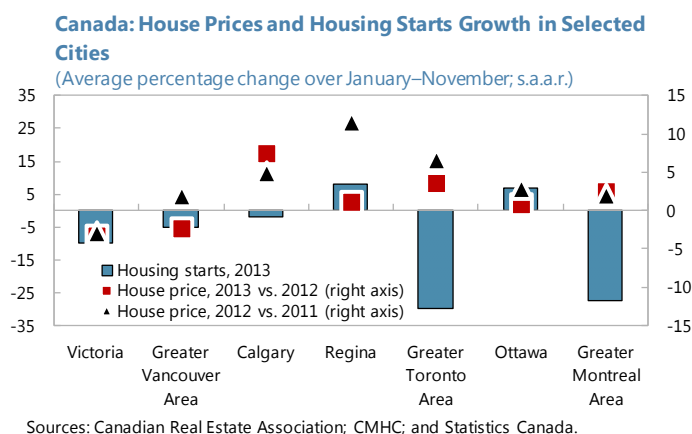
- After rebounding strongly from the depth of the financial crisis, business investment growth has weakened since mid-2012* (Figure 1). The slowdown has been particularly concentrated in non-residential structures (mainly energy-related) and machinery and equipment, which provided no contribution to growth in the first three quarters of 2013. Growth in residential investment picked up somewhat in 2013 but after slowing sharply from high levels, partly in response to the last round of measures (including stricter mortgage insurance rules and tighter mortgage underwriting standards) introduced to stabilize the housing market in 2012.

- Private consumption continued to support growth in 2013, boosted by higher household net worth and still easy financial conditions, despite the almost 80 basis point increase in long-term interest rates between May and December 2013 (Figure 2). However, despite an uptick in mortgage credit since the summer of 2013, household debt accumulation has slowed, with overall household credit growing at an annualized pace of about 4 percent in the first three quarters of 2013, the slowest pace since mid-1990s (Chart), and the personal saving rate trending upward. But with disposable income growth easing somewhat in 2013, the household debt-to-income ratio has continued to climb, reaching a new historical high of 152 percent as of 2013:Q3.*



## 2. **Canada's housing market has cooled but house prices remain overvalued, although with important regional differences** (Figure 3). Despite picking up somewhat in mid-2013, in

line with renewed strength in resale activity, Canada's house price inflation and residential investment growth have slowed (Chart). On average across Canada, house prices grew about 4 percent (y/y) in November 2013, up from 2 percent in April but about half the pace two years ago. The slowdown involved all large metropolitan areas except Calgary, particularly Vancouver (where house prices in the first eleven months of



2013 were about 3 percent lower than a year ago). Housing starts have also picked up since April 2013, but are on a declining trend: as of November 2013, their 6-month moving average was about 10 percent below last year's peak, mainly owing to weaker construction of multiple units, especially in Ontario.<sup>1</sup> Despite the downward trend in growth, a few simple indicators continue to suggest overvaluation in the Canadian housing market. In particular, house prices are high relative to both income and rents, compared to historical averages (Chart) and many other

<sup>1</sup> Still, inventories in the Greater Toronto Area condominium market remain relatively high, due to past years' overbuilding, and the excess supply is likely to increase over the near future despite the moderation in construction activity. At the current rate of sales, staff estimates that it would take about six months to completely liquidate the inventory.

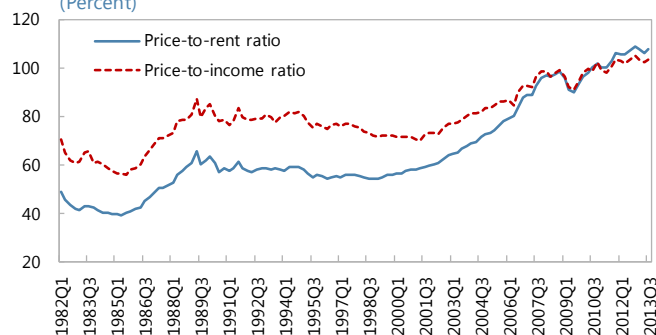
advanced economies. Staff estimates that, in real terms, average house prices in Canada are about 10 percent above what would be justified by fundamentals, with most of the gap coming from the real estate markets in Ontario and Québec.<sup>2</sup>

### 3. Fiscal consolidation weighed on growth, though at a slower pace than in the past.

The general government overall deficit is expected to improve to 3.1 percent of GDP in 2013 (from 3.4 percent of GDP in 2012), with different dynamics for the federal and provincial governments (Figure 4). In particular:

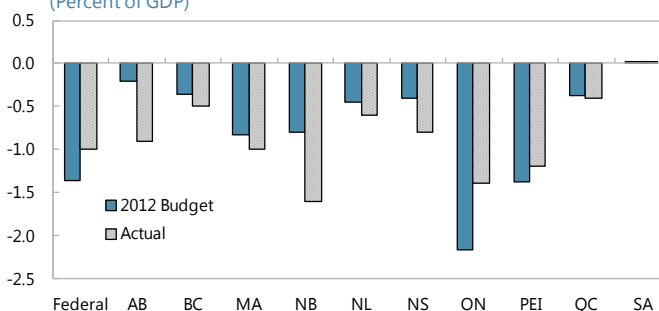
- The federal government's deficit for the fiscal year 2012–13 (ending in March) was 1 percent of GDP, ½ percent of GDP smaller than anticipated in the March 2013 Budget, mainly on account of a larger-than-expected spending restraint by departments. In the 2013 *Fall Economic and Fiscal Update*, the federal government confirmed the intention to return to a balanced budget in the fiscal year 2015–16, largely on the back of continued program spending restraint. Staff estimates the annual deficit for 2013 to be around ¾ percent of GDP, down from 1 percent in 2012, implying a modest 0.1 percentage point of GDP drag on growth in 2013 compared to about ½ percentage point in 2012.
- In contrast, the fiscal stance has generally deteriorated at the provincial level (Chart). While most provinces were able to adhere to their spending plans, slower nominal GDP growth and lower commodity prices (especially in Alberta) reduced revenues in 2012–13. Half of the provinces (including Alberta and Québec) announced delays in their planned return to a balanced budget, while others relied on further spending cuts and one-off measures to offset lower revenues. Ontario's fiscal deficit was about ¾ percentage points of GDP better than estimated in the budget, thanks to one-time savings, revenue windfalls, and the drawing down of the contingency reserve. Staff estimates

Canada: House Price-to-Rent and Price-to-Income Ratios (Percent)



Sources: OECD; and IMF staff calculations.

Canada: Overall Fiscal Balances in 2012–13—Actual vs. Forecasts in 2012 Federal and Provincial Budgets (Percent of GDP)



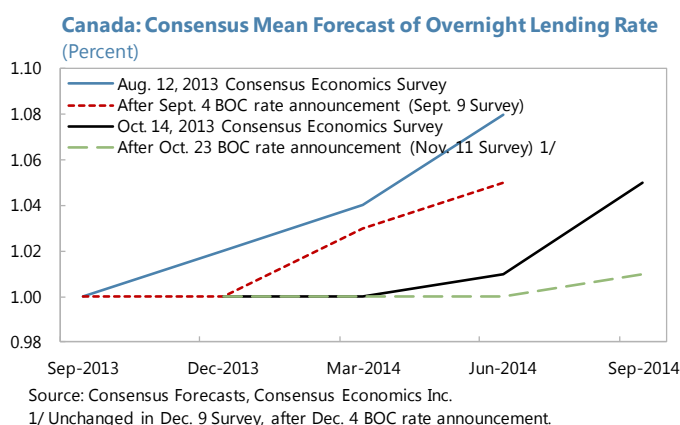
Sources: Budget documents.

<sup>2</sup> This estimate is obtained from a series of models that regress real house prices on a set of variables that affect housing supply and demand (net immigration growth, terms of trade, real disposable income, household formation, labor force participation, and real mortgage rates). See also IMF Country Report, 41/2013).



that the overall deficit for provinces, municipalities, and territorial authorities remained broadly unchanged in 2013, at about 3 percent of GDP.

**4. As the output gap increased and inflation fell, the Bank of Canada kept its policy rate at 1 percent and adopted a more dovish stance.** Five quarters of below-potential growth since 2011 have increased the estimated size of the output gap, which staff calculates at about 1.3 percent as of 2013:Q3. The higher size of economic slack, heightened competition in the retail sector, lower food prices, and lower imported inflation have all contributed to downward pressure on price levels. As of November 2013, annual headline CPI inflation was 1 percent (y/y), at the lower end of the 1–3 percent Bank of Canada’s target band, while core inflation slowed to 1.1 percent from about 2 percent at the beginning of 2012. Against this background, the Bank of Canada has kept the policy rate at 1 percent, the same level since September 2010, and in its most recent announcements stressed the increased importance of downside risks to inflation. Markets reacted to the change in language by postponing the expected timing of the first increase in policy rates (Chart), and in December 2013 the Canadian dollar fell to the lowest level in over three years against the U.S. dollar.



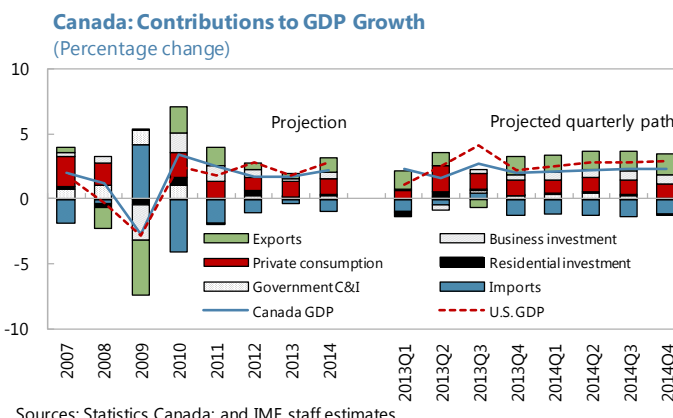
## OUTLOOK AND RISKS

**5. Annual growth is expected to accelerate to 2¼ percent in 2014, up from an estimated 1¾ percent in 2013.** With output growing at just above the potential rate of about 2 percent, the remaining spare capacity would gradually be absorbed with the unemployment rate projected to converge to its natural rate of close to 6½ percent over the medium term. As the economic slack is reabsorbed, headline CPI inflation would pick up in 2014, approaching the Bank of Canada’s target rate of 2 percent (y/y) by end-2015.

**6. Monetary policy is expected to remain accommodative, while fiscal policy will continue to be a modest headwind to growth.** In staff’s baseline, the policy interest rate is projected to increase starting in early 2015, gradually reaching 4 percent by the end of the forecast horizon, while long-term interest rates are forecast to increase gradually, in line with those in the United States. Continued fiscal consolidation, at both federal and provincial levels, would subtract about ¼ percentage points of GDP growth per year over the next three years.

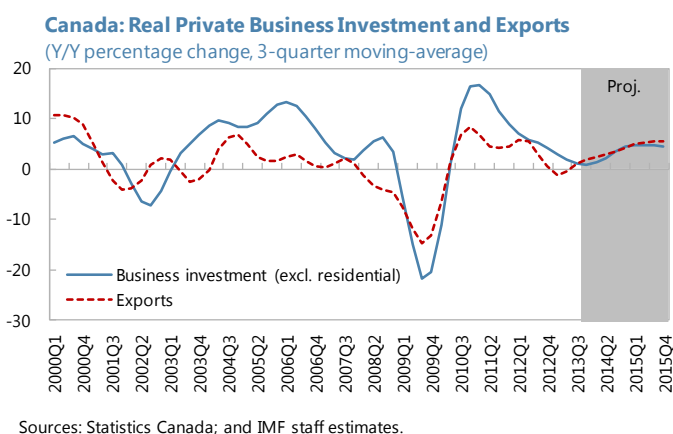
**7. The baseline scenario envisages a rotation in demand towards investment and exports** (Chart). In particular:

- With U.S. and global GDP growth expected to accelerate in 2014, as described in the January 2014 *World Economic Outlook Update*, Canada's *export growth* is expected to pick up to about 5¼ percent (average quarterly rate, annualized) over the 2014–15 period, from about 2½ percent in the first three quarters of 2013. In this scenario, the implied elasticity of Canadian exports to external demand is



lower than suggested by standard trade equations estimated over a long period of time, as we assume that the loss of competitiveness experienced over the last decade will continue to drive a wedge between non-energy exports and foreign demand over the projection period.

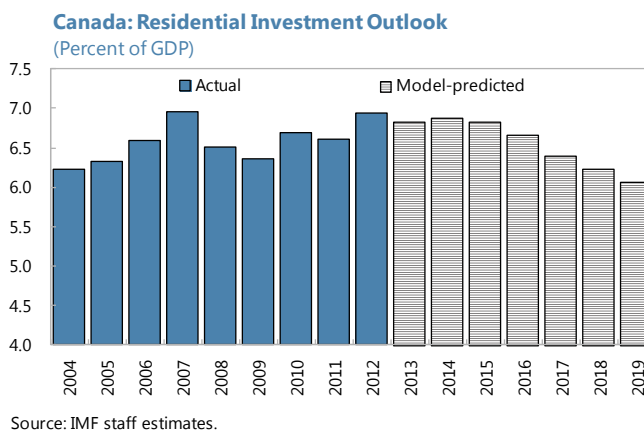
- Non-residential business investment* is also expected to accelerate, as the more favorable and less uncertain external outlook, as well as still relatively favorable financial conditions (including strong cash balances, see Selected Issue Paper), should induce Canadian businesses to resume spending and expand capacity to meet future demand growth. There is a strong historical correlation between business non-residential investment and export growth in Canada (Chart), with staff analysis suggesting that a 1 percentage point increase in export growth is typically associated with a 0.3–0.4 percentage point increase in business investment growth after one year.<sup>3</sup> Greater demand for energy should sustain investment in non-residential structures, which is largely linked to energy and mining sectors, although global commodity prices are projected to remain relatively flat (Box 1).



<sup>3</sup> The Bank of Canada finds that a pickup in exports tends to be followed by an acceleration of business investment with a lag of about two to four quarters.

- In contrast, *residential investment* is projected to continue to decline over the next 5 years, to levels more consistent with medium-term fundamentals. Staff estimates from a construction activity model suggest a gradual slowdown of the residential investment-to-GDP ratio from 6¾ percent in 2013:Q3 to about 6 percent (in line with the historical average) by the end of the forecasting horizon (Chart).<sup>4</sup>

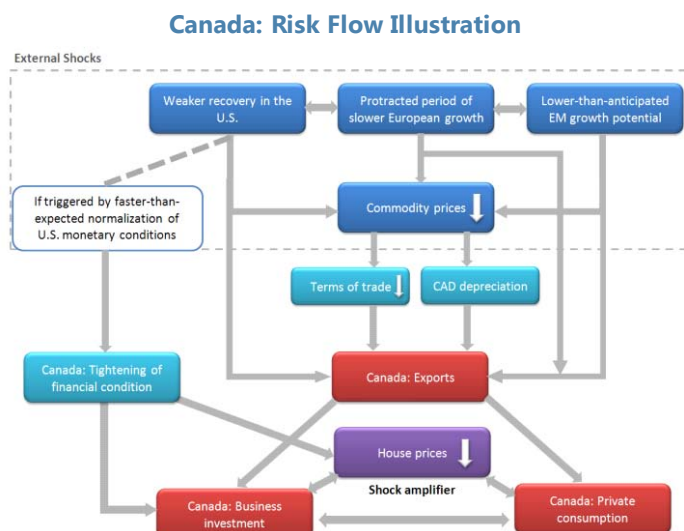
While housing supply is projected to moderate gradually, continued employment and immigration growth are expected to support housing demand, partly offsetting the negative impact from the increase in mortgage rates. As a result, we expect the overvaluation in house prices to be corrected gradually over the next five years, with house prices growing at slightly below inflation over most of this period.



- *Private consumption* growth is also expected to be somewhat slower, as the elevated level of debt in the context of higher interest rates and slower house price growth is expected to induce households to become increasingly cautious with their spending. Still, private consumption is expected to continue to be supported by improvements in labor market conditions and to remain the main contributor to GDP growth going forward, adding about 1.1 percent to growth on average over the medium term, compared to close to 2 percent on average over the decade before the Great Recession.

<sup>4</sup> Construction activity is modeled as a function of household formation, construction costs, household disposable income, mortgage rate, and house price growth (see, IMF Country Report No. 13/41).

**8. Risks to this outlook are mainly on the downside and stem primarily from external sources** (Chart, and Table 1). An overshooting of long-term interest as the Fed's exit from quantitative easing (QE) could negatively affect the U.S. recovery and hence Canada's exports. *Protracted weakness in the euro area economic recovery* could hurt Canada mainly through confidence and financial channels, as well as through indirect trade links, while *lower-than-anticipated growth in emerging markets* would affect Canada mainly through a decline in commodity prices, although a weakening of the Canadian dollar could soften the impact. At the same time, a faster recovery in the U.S. pose upside risks to our baseline forecasts, together with a stronger than currently envisaged performance of Canada's housing sector, although the latter would also increase risks to domestic financial stability down the road.



**9. In addition to being a risk per se, elevated household leverage and house prices could amplify the growth impact of adverse external shocks.** A sharper correction of house prices than in our baseline scenario could reduce household net worth, tighten lending conditions, and hurt confidence, with negative repercussions on domestic demand, output and employment. In a scenario where the U.S. economic recovery accelerates and initial steps taken by the Fed to normalize monetary policy conditions result in an abrupt increase in the term premium, financial conditions would likely tighten in Canada, too. The simulations contained in the IMF 2013 *Spillover Report* show that the net impact on Canada from such scenarios is likely to be positive, as the boost to exports (helped also by a lower Canadian dollar) would more than offset the negative impact of tighter financial conditions on domestic demand. However, staff simulations contained in Annex I indicate that if the sharper increase in long-term interest rates were to trigger a greater and more rapid fall of house prices and household deleveraging than currently factored in the baseline scenario, the net gains from the stronger U.S. recovery could dissipate.

**10. The energy sector is a source of both downside and upside risks to the outlook.** A more rapid growth in U.S. production of unconventional energy and/or delays in the expansion of transportation capacity would limit the demand for Canadian energy, put downward pressure on Canadian energy prices, and adversely affect exports and investment. At the same time, however, there are upside risks, especially in the natural gas sector: faster progress in solving the infrastructure bottlenecks could widen access of Canadian energy resources to international

(including non-U.S.) and domestic (including Canada's eastern provinces) markets, boost production, and raise the price of Canadian energy (Box 1).

**11. The authorities have room to respond to these negative shocks and buffer the economy against some of their consequences.** If the removal of unconventional monetary support in the United States were to cause a more rapid-than-anticipated increase of interest rates, the Bank of Canada would have room to at least partly offset the tightening of financial conditions by cutting the policy rate. If a more abrupt adjustment of housing imbalances were to cause substantial credit losses and severe shortages of liquidity for Canadian financial institutions, the authorities could effectively intervene by providing guarantees on bank loans or directly injecting liquidity, as occurred during the 2008–09 recession. If negative shocks were to reduce growth further below potential, the federal government would have room for a countercyclical policy reaction, thanks to the relatively low level of net debt and strong fiscal consolidation over the past few years.

## POLICY DISCUSSIONS

*The policy discussions focused on the appropriate policy mix to sustain the acceleration of economic activity and protect it against the downside risks, as well as longer-term issues, including how to achieve long-term fiscal sustainability for the general government, scale back government involvement in mortgage insurance, and further strengthen the financial sector.*

### A. Outlook and Policies to Boost Growth Potential

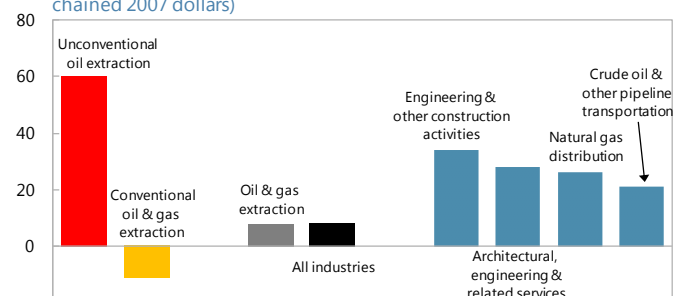
**12. The authorities concurred with staff that a pickup in export and business investment is needed to generate a more balanced and sustainable growth.** The authorities agreed that weakening global demand has resulted in a slowdown in business investment recently after a strong performance earlier in the recovery, but they expect that the necessary and anticipated rotation toward exports and a return to stronger business investment growth should take place when U.S. economic growth accelerates. They also argued that while the recession has caused a sharp reduction of the number of firms, especially in the export sector, those that survived the crisis are competitive and ready to expand capacity once they see more concrete signs of stronger demand. The authorities agreed that the balance of risks was tilted to the downside, and that a slower-than-expected recovery in the United States as well as a more protracted period of slower growth or financial turbulence in the euro area would have spillovers to Canada. However, they expressed confidence that private consumption would continue to sustain growth, given that the consumption-to-GDP ratio is not out of line with historical average, and that a better balance between domestic and foreign demand would be achieved over time.

### Box 1. Canada's Energy Sector and Outlook

**Canada's energy sector has grown strongly and presents both benefits and challenges for Canada's growth and competitiveness.** Mainly

thanks to the rapid development of unconventional oil extraction (oil sands), energy accounted for about 10 percent of GDP and 25 percent of overall exports in 2012. As discussed in the Selected Issues paper, in addition to the direct contribution to growth, the energy boom had positive spillovers to other sectors and provinces of the Canadian economy, despite the geographical concentration of energy resources in the western provinces.

**Canada: Output in Energy and Related (Selected) Industries**  
(Percentage change 2007–13 1/; GDP at basic prices, chained 2007 dollars)



Sources: Statistics Canada; and IMF staff calculations.  
1/ January–September, 2013.

#### **Growing U.S. energy production and infrastructure constraints have adversely affected Canada's energy exports in recent years.**

Canada is almost entirely dependent on the U.S. for its energy exports. While U.S. oil imports have declined over the last decade, Canada's oil exports to the United States have continued to rise, with Canada's share of U.S. oil imports doubling to 33 percent in 2013, at the expense of other oil exporters. But growing oil production in the U.S. since 2008 has put pressure on pipeline transportation and refinery capacity, lowering the price of Canadian oil (particularly, Western Canadian Select, WCS) relative to the U.S. benchmark (West Texas Intermediate, WTI)—the gap between WCS and WTI prices reached an historical high of US\$35 per barrel in 2012. After falling to US\$15 per barrel in mid-2013 as the increased reliance on rail managed to relieve transportation bottlenecks, the gap widened again to US\$35 per barrel by November 2013. Estimates suggest that Canada is losing at least ½ percent of GDP because of market access limitations. In contrast to crude oil, Canada's natural gas exports to the U.S. have been on a declining path since mid-2000s, as the U.S. production of natural gas has significantly increased in this period. Going forward, U.S. production of natural gas is expected to increase further, with the U.S. becoming a net gas exporter after 2020 (U.S. EIA, 2013 *Annual Energy Outlook*).

**In our medium-term baseline scenario, we expect Canada's crude oil exports to the U.S. to grow at a somewhat slower pace than in recent years.** Crude oil export volumes are projected to increase at about 5½ percent (quarterly average) over 2014–19, compared to the average 8 percent over 2009–13. The increase is projected to come mainly from unconventional oil production (already comprising 60 percent of Canada's total crude oil production). The assumptions behind our forecasts are:

- The WSC discount of about US\$23 per barrel in 2013:Q3 is taken as a basis, and is expected to evolve in line with the projected crude oil price growth in the January 2014 WEO Update. The latter forecasts oil prices to decline by about 20 percent between end-2013 and 2019.
- More use of rail transportation, reversing existing pipeline flows, and completing conversion works at major U.S. refineries to process heavy Canadian crude oil is expected to be sufficient to accommodate the projected increase of Canada's oil exports to the U.S. in the next couple of years. After that, we assume that additional capacity will be in place to bring Canada's heavy oil to regions with the greatest refinery capacity, such as the U.S. Midwest and, especially, the Gulf Coast (Chart). There are currently a number of major projects under consideration, with total takeaway capacity of almost the same size as Canada's current oil production (about 3 million barrels per day), and the implementation of any of these major projects would provide a significant increase in transportation capacity (see Selected Issues paper).



### Box 1. Canada's Energy Sector and Outlook (Concluded)

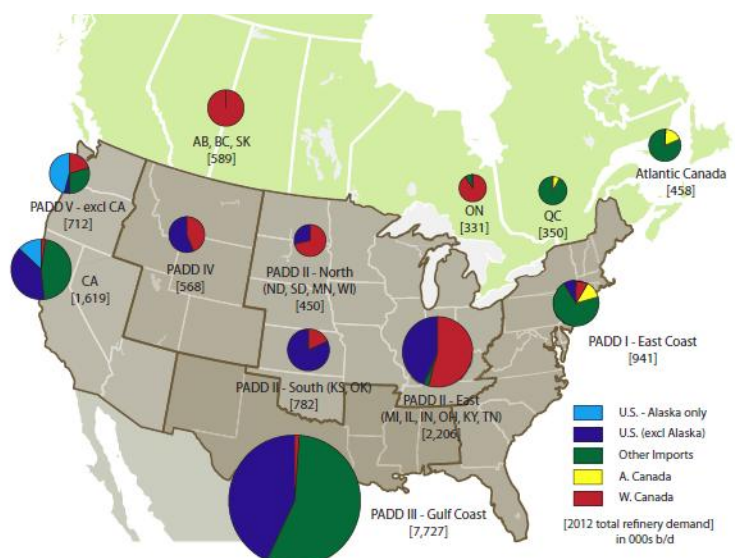
- U.S. demand will remain robust, with Canada gaining market share in the U.S. oil market. Supply-side projections from Canadian, U.S., and international energy organizations suggest that Canada's share in U.S. oil imports would rise from the current 30 percent to about 50 percent by 2020.

**By contrast, our baseline scenario assumes that natural gas exports would continue to decline over the medium term.** Production is expected to fall, as greater domestic consumption is likely to only partly offset lower demand from the United States.

Exporting natural gas to non-

U.S. markets would revive the sector's prospects and reverse the downward trend, but it would require building large-scale facilities close to the Canadian coast that could liquefy natural gas and ship it overseas.

Canada and the U.S.: Crude Oil Demand by Market Region, 2012



Source: Canadian Association of Petroleum Producers, "Crude Oil: Forecast, Markets & Transportation," June 2013.

Note: Circles indicate total refinery demand for crude oil in 2012 (also reported in square brackets in thousand barrels per day), with a breakdown by the origin of imports, including from Alaska and other U.S., Atlantic and Western Canada, and other imports. U.S. is divided into five Petroleum Administration for Defense Districts (PADDs).

### 13. The authorities and staff agreed that raising productivity growth and broadening market access to Canada's energy resources would be essential to boost growth potential.

- The authorities noted that the widening productivity gap with the U.S. can be attributed to a number of factors, including insufficient capital deepening, underinvestment in innovation technologies and R&D, and remaining barriers to inter-provincial competition. While a number of policy initiatives have been taken in recent years to boost productivity (such as cuts in corporate taxes and a more flexible immigration system), the authorities said that more remains to be done consistent with the government's Economic Action Plan. For example, funding was announced in Economic Action Plan 2013 for a new pilot program for small- and medium-size enterprises (SMEs). This program will be rolled out in 2014, and will provide SMEs with voucher-like credit notes to pay for research, technology and business development services from universities, colleges and other not-for-profit institutions of their choice.
- On the prospects for the energy sector, staff noted it would be essential to relieve existing transportation bottlenecks, maintain an open regime for inward foreign direct investment (FDI), and address potential skills shortages in resource-rich provinces. The authorities said they expect the transportation capacity constraints to be resolved over time, and agreed on

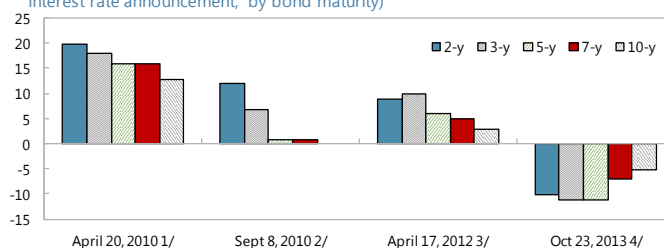
the need to diversify exports to non-U.S. markets. Entering into new free trade agreements would help Canada diversify its export market base more broadly. In this context, staff welcomed Canada's recent progress on a framework agreement with the European Union on establishing a comprehensive free trade zone.

**14. These policies would also increase Canada's external competitiveness and help close external imbalances.** Canada's current account deficit has hovered around 3¼ percent of GDP in 2013 and is projected to improve to 2½ percent over the next few years, mainly as stronger external demand fuels export growth. In staff's views, however, Canada's current account would still be somewhat weaker than the level consistent with medium-term fundamentals (see Annex II). A reduction of the productivity gap with major trading partners, a smaller gap between the price of Canadian heavy oil and international benchmark prices for crude oil, and a lower exchange rate as safe-haven capital inflows abate (in the context of stronger U.S. growth and a lower Canada-U.S. interest rate differential), would all contribute to strengthening the current account balance and move it closer to the estimated norm. Despite falling by over 3 percent in the first three quarters of 2013, the real effective exchange rate remains about 10 percent above its long-term average, and in staff's view is overvalued, with the gap relative to estimates of "equilibrium" real exchange rates in the 5–15 percent range. The authorities argued that they see the value of the Canadian dollar as market determined, and that its flexibility acts as an important buffer against external shocks.

## B. Monetary Policy: Substantial Policy Stimulus Remains Appropriate

**15. There was broad agreement that the policy interest rate could stay low for a longer period of time.** Staff saw room to maintain the current highly accommodative monetary policy stance for a longer period than anticipated a year ago, given the greater output gap, looming downside risks, and the moderation of the housing market. The authorities agreed, and also flagged growing concerns about the deceleration of inflation below the lower end of the Bank of Canada's target band, which may reflect not only the size of economic slack but also more persistent factors than previously anticipated, most notably the effects of heightened competition in the retail sector. Staff noted that despite recent signs of moderation, still-elevated household debt and remaining house price overvaluation reduce the room for lowering the policy rate. The authorities also argued that further evidence is needed before concluding that the recent pickup in the housing market is a temporary phenomenon. Finally, the discussion touched on the extent to which the monetary policy cycle would need to take into account the evolution of monetary policy conditions in the United States, given the high co-movement of

**Change in Canada-U.S. Government Bond Yield Spread After Selected Bank of Canada Interest Rate Announcements**  
(Basis points; difference between one day after and one day before the interest rate announcement; by bond maturity)



Sources: Haver Analytics; Bank of Canada; and IMF staff calculations.  
Bank of Canada (BOC) interest rate announcements: 1/ Conditional commitment to keep target overnight rate unchanged conditional on inflation outlook is removed; 2/ Target rate is increased by 25 bps to 1 percent; 3/ BOC says that some modest withdrawal of monetary stimulus may become appropriate; 4/ Tightening bias is dropped.



Canadian and U.S. long-term interest rates. Staff and the authorities agreed that monetary policy would continue to be effective through its impact on interest rates—particularly at short to medium maturities (Chart)—and the exchange rate. The authorities noted that a smooth exit from QE accompanying strengthening private demand in the United States would benefit the rebalancing of Canadian economy away from housing and toward exports.

### C. Fiscal Policy: Pursuing Growth-Friendly Fiscal Consolidation

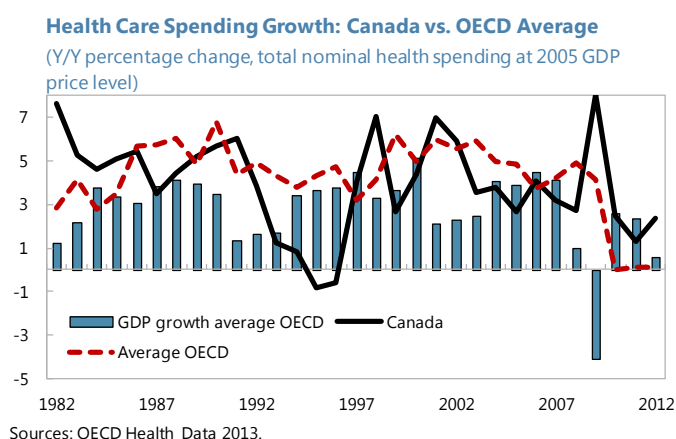
**16. The discussion on fiscal policy focused on the appropriate pace of fiscal consolidation.** The authorities noted that they were somewhat surprised at the better-than-expected federal budget deficit for 2012–13, to the extent that it reflected departments spending less than the budget they had been appropriated at the beginning of the year. They attributed this result to efficiency gains achieved at the departmental level, which would suggest a relatively small drag on growth from fiscal restraint. Staff noted that, given the low level of debt and good progress in fiscal consolidation since the peak of the crisis, there is room to relax the fiscal stance if economic growth fails to pick up above potential over the next few quarters.<sup>5</sup> The authorities responded that the adjustment needed to return to a balanced budget was relatively small and largely underway, and that excessively fine-tuning fiscal policy at this stage would be counter-productive. They saw more merit in sticking to the announced fiscal targets, and thus return to a balanced budget by 2015, as this would also have a positive impact on business and consumer confidence. With regard to fiscal policy stances at the provincial level, staff argued that provinces facing headwinds in their fiscal consolidation plans might need to consider additional measures to ensure their deficit reduction timetable is met. Ontario's authorities noted that additional measures were considered to ensure the deficit returns to balance in fiscal year 2017–18.

**17. Staff called for continued efforts to ensure long-term fiscal sustainability at the general government level.** Extrapolating recent fiscal trends into the next four decades yields a relatively steep increase of the net debt-to-GDP ratio at the general government level—from around 35 percent in 2012 to 60 percent in 2050 (Annex III). To a large degree, this acceleration reflects the increase in health care spending at the provincial level mainly caused by the projected aging of the Canadian population. To be sure, growth in health care spending has slowed in many Canadian provinces after the last recession, but it is not entirely clear whether this trend can be maintained in the future (Box 2). The authorities noted that the recent significant reduction observed in the growth of health-care spending suggested health care providers were re-organizing the way health care was funded and delivered, and thus were confident that at least some of the recent moderation could be sustained going forward. Staff noted that population aging would lead to a sharp increase in health care spending even if the recent gains were to be maintained, and that more efforts would therefore be needed to maintain the general government net debt-to-GDP ratio on a sustainable long-term path. To raise the public awareness of the challenges ahead and build the necessary consensus behind

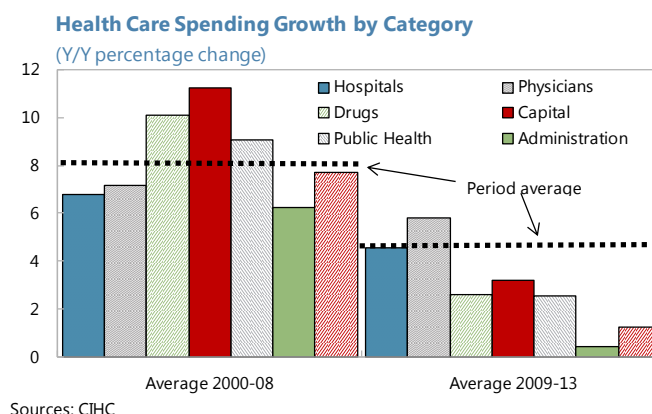
<sup>5</sup> Annex IV shows that, over the next few years, Canada's general government fiscal position is relatively resilient to a series of macroeconomic and fiscal shocks.

## Box 2. Recent Trends in Canada's Health Care Spending

**Health care spending slowed sharply in Canada after the last recession** (Chart). After growing at an average annual rate of about 7 percent in nominal terms over the last 3 decades, health care spending in Canada grew at an average 4 percent over the 2009–2012 period. While the average growth before the recession is in line with the average of OECD countries, Canada's health care spending grew significantly below that average during the mid-1990s, when stringent caps on public health spending (which represents about 70 percent of total health spending in Canada) were imposed as part of a significant fiscal consolidation effort. In contrast, the more recent slowdown in health care spending growth is common to several OECD economies—where health care growth has actually slowed even more.<sup>1</sup> This suggests that common factors may be at play across these economies, and in particular that the lower spending on health care could be a temporary byproduct of the Great Recession. But over the last few years many countries, including Canada, have also started reforms to change the way health care is funded and provided, which suggests the post-crisis slowdown in spending could be a more durable phenomenon.



**The decline in Canada's health care spending since 2009 has been broad-based.** Average spending growth for hospitals and physicians, the two largest categories, fell from about 7 percent before the crisis to 5 percent after (Chart). This in part reflects budgetary restraints, as greater fiscal deficits led many provinces to freeze hospital budgets and physician compensations (for example, British Columbia and Ontario). Partly as a reaction to the tighter budget constraints, some provinces have also put in place structural reforms aimed at increasing the efficiency and reducing the costs of providing health care on a more sustainable basis:



- A few provinces—notably Alberta, British Columbia, and Ontario—have started to move away from global budgeting (which attributed yearly budgets to hospitals based on historical levels) toward more patient or activity based funding models for hospitals.
- Many provinces are increasing out-of-hospital care as part of the move to more decentralized delivery systems. In particular, there has been heavier use of non-institutional care for seniors with chronic conditions. Québec moved to a greater reliance on out-of-hospital care system as early as in 2003, with the reform that put in place the *Centres de Santé et de Services Sociaux*. Efforts have also been devoted to increasing the coordination between primary care and hospital care providers, for example, in Ontario through the creation of 19 Health Links. Moreover, nurse practitioners and pharmacists are being allowed to provide services currently performed by more expensive physicians.

### Box 2. Recent Trends in Canada's Health Care Spending (Concluded)

- Many provinces have agreed in 2010 to consolidate purchases of common drugs, medical supplies, and equipment. In 2012, generic drugs were also added to the agreement. In 2011, British Columbia changed the eligibility rule for its provincial drug benefit program from age-based to income-based.

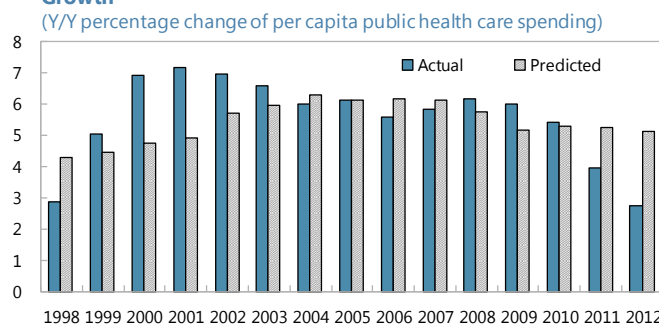
**Econometric analysis suggests that cyclical factors and budgetary restraints can only partly explain the slowdown in health spending, suggesting that structural changes may also be at play.** We

estimated a panel data model of health care spending through a regression specification including a series of macroeconomic and demographic variables (real per capita GDP growth, real per capita federal cash transfers, real per capita provincial

government debt service, and population below 65 and above 65 years old) for the 10 Canadian provinces over the 1987–2012 period. The model uses fixed-provinces effects, as well as a set of dummy variables to control for changes in federal health transfer programs. We then use the estimated coefficients to see whether the model can predict the sharp decline over the post crisis period. The results indicate that only part of the decline in health care spending in 2011–12 can be explained by the macroeconomic and demographic

determinants (Chart). At the provincial level, the model over-predicts health care spending growth especially in British Columbia, Ontario and Québec, the provinces that have been most active on trying to introduce structural reforms in funding and delivering health care costs.

**Canada: Actual vs. Predicted Real Per Capita Health Spending Growth**  
(Y/Y percentage change of per capita public health care spending)



Sources: Statistics Canada; Canadian Institute for Health Information; and IMF staff calculations.

<sup>1</sup> Several papers have looked at the factors driving the post-crisis slowdown of healthcare spending, in particular in the United States. Among others, Chandra, Amitabh, Jonathan Holmes, and Jonathan Skinner, "Is This Time Different? The Slowdown in Healthcare Spending," Brookings Panel on Economic Activity, September 2013, and the IMF, October 2013 *Fiscal Monitor* and IMF Country Report No. 13/236.

those efforts it is important to publish long-term fiscal sustainability analysis at both provincial and general government levels. The announced establishment in Ontario of a Financial Accountability Office (FAO) is a promising step in that direction.<sup>6</sup>

**18. The mission also discussed the merit for changes in the fiscal framework at both federal and provincial levels once the return to a balanced budget is completed.** The federal authorities have recently announced the intention to introduce a rule requiring balancing the federal budget "during normal economic times," with a clear timetable for returning to a balanced position if falling into deficit. Staff welcomed the plan, as introducing a formal rule could strengthen the fiscal framework after the deficit is eliminated and when the desire for fiscal discipline is likely to wane. While the authorities said that the details of the rule still need to be

<sup>6</sup> The FAO will be responsible for producing an annual report and providing independent analysis about the state of the province's finances, including the budget, and trends in the provincial and national economies.

worked out, staff emphasized that the rule would need to be simple, transparent, and supportive of macroeconomic stability by avoiding pro-cyclical fiscal stances. Following up on last year's recommendation, staff also re-stated the importance of adopting fiscal frameworks that going forward would allow saving the revenue windfall gains from high commodity prices and minimize the fiscal and macroeconomic volatility associated with commodity price fluctuations. The introduction of a new fiscal framework in Alberta in 2013 appears to go in this direction.<sup>7</sup> The authorities noted that the recommendation would be appropriate for energy-abundant provincial jurisdictions, but staff noted there could be room for similar changes at the federal level, given the projected growing importance of the resource sector in the Canadian economy, and, therefore the federal budget.

## D. Policies for the Housing Sector: What Role for Government-Backed Mortgage Insurance?

**19. While the moderation of housing activity since its post-crisis peak suggests no need for additional macro-prudential measures at the current juncture, it is important to remain vigilant.** The macro-prudential measures introduced over the past few years have been effective in moderating the pace of household debt accumulation and cooling off the housing market. Staff and the authorities concurred that the pickup in home sales and housing starts since the summer of 2013 is likely to be a transitory phenomenon, the result of demand brought forward at the expense of future months as more borrowers have finalized their mortgages on fears that rates would continue to increase further. Nonetheless, there was broad consensus that should house price and mortgage credit growth re-accelerate on a more widespread and sustained basis, additional measures may be needed. In staff's view, possible options could include higher down-payment requirements for first-time buyers and lower caps on debt-service-to-income ratios.

**20. The mission discussed the merit of rethinking the role of government-backed mortgage insurance over the long term.** The current system of pervasive government-backed mortgage insurance (Box 3) has its advantages, particularly as it gives the government a macro-prudential tool that can be used to stabilize the housing sector and the financial system more broadly, as shown during the recent crisis; and because it provides cheap funding to small mortgage lenders, potentially boosting competition in the mortgage market.

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<sup>7</sup>In March 2013, Alberta introduced a new fiscal framework, based on three different plans: (i) a "saving plan", whereby a share of the revenues from non-renewable resource will be saved every year into a Contingency Account up to a maximum amount, with any excess revenue diverted into the Alberta Heritage Savings Trust Fund or other provincial endowments; (ii) an "operating plan", consisting of operating revenues and expenses, that can only run a deficit if there is money into the Contingency Account; and (iii) a "capital plan", largely funded through borrowing and with limits to annual debt-servicing costs, linked to the size of operational revenues, that will finance infrastructure projects.

### Box 3. Mortgage Insurance in Canada

**Federally-regulated lenders in Canada are required to purchase insurance for mortgage loans with LTV ratios above 80 percent.** Mortgages with LTV ratios of 80 percent or below ("low LTV loans") may also be insured. Mortgage lenders that insure low LTV loans typically do so for securitization purposes, as these loans are packaged and sold as mortgage backed securities (MBS), to access low-cost funding for new loans.

**Mortgage insurance is provided by the Canada Mortgage and Housing Corporation (CMHC) and two private companies.** CMHC, which has a market share of about 75 percent, is a federal government-owned corporation. The two private mortgage insurers, Genworth and Canada Guaranty, have a combined market share of about 25 percent. Private mortgage insurers and CMHC's commercial activities are supervised by the Office of the Superintendent of Financial Institutions (OSFI), but OSFI does not have corrective powers over the CMHC.

**The federal government guarantees 100 percent of CMHC's insured loans and 90 percent of the original value of those insured by private companies.** To address risks associated with the provision of these guarantees, the federal government sets underwriting standards for insured mortgages and for participating mortgage insurers ("sandbox rules"). Insured mortgage loans have lower risk weights in banks' balance sheets than uninsured loans, with CMHC-insured mortgages having a capital risk weight of zero. Overall, government-backed mortgage insurance covers around two-thirds of all mortgage loans in Canada (about 40 percent of GDP). The total value of CMHC's mortgage insurance is currently limited by legislation to a maximum of Can\$600 billion (about one-third of GDP), a limit which has been raised four times since 2004 (from below 20 percent of GDP). The limit for private insurers is Can\$300 billion.

**The federal government also provides guarantees to Mortgage Backed Securities (MBS) backed by insured mortgages.** CMHC provides a guarantee of principal and interest payments on the National Housing Act (NHA) MBS, introduced in 1986. Hence, investors in NHA MBS benefit from a two-layer government-backed guarantee, first against the risk that the borrower may default on the underlying mortgages, and second against default by the issuer of the securities. NHA MBS investors however, remain subject to prepayment risk, since their cash flows are reduced if borrowers make full or partial prepayments on their mortgages. Starting from 2001, financial institutions may sell NHA MBS to the Canada Housing Trust, a special-purpose trust created by CMHC, which funds itself by issuing Canadian Mortgage Bonds (CMB). The CMB program enhances the NHA MBS program because CMBs are structured to eliminate prepayment risk for the investors.

**CMHC's securitization programs account for about one-third of total outstanding residential mortgages in Canada, up from about 10 percent in early 2000s.** An important reason for the growth of the CMHC's securitization programs, especially CMBs, is that they provide a low-cost term funding vehicle to mortgage lenders, especially small non-bank lenders. Issuance grew strongly during the global financial crisis, as the federal government purchased NHA MBS from financial institutions through the Insured Mortgage Purchase Program, which ended in 2010, to provide an additional source of liquidity.

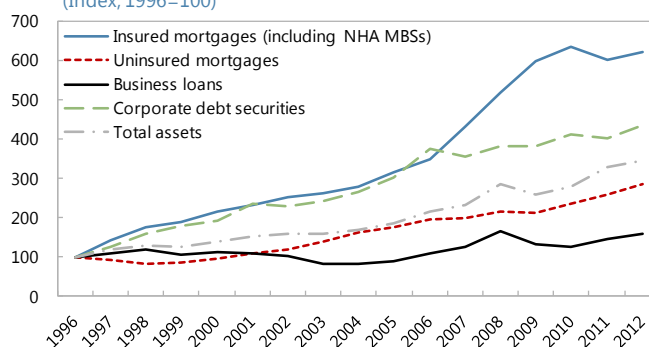
**A number of measures have been introduced since 2011 to limit government's exposure to mortgage insurance and strengthen the oversight of CMHC.** These measures include (i) withdrawing government-backed insurance on lines of credit secured by houses (HELOCs) and refinanced mortgages; (ii) formalizing the rules for the government-backed mortgage insurance and other existing arrangements with private mortgage insurers, and increasing insurance-in-force limit for private mortgage insurers; (iii) prohibiting banks from issuing covered bonds backed by government-insured mortgages; (iv) setting quantitative limits on new issuance of NHA MBS and CMBs; (v) requiring CMHC to pay the federal government a risk fee on new insurance premiums written and a charge of 10 basis points on new portfolio insurance starting January 2014; and (vi) announcing plans to prohibit the use of government-backed insured mortgages in non-CMHC securitization programs and gradually limit the insurance of low LTV mortgages to those that will be used in CMHC securitization program. Moreover, CMHC oversight has been strengthened in 2012, including by mandating OSFI to conduct examinations of CMHC's insurance and securitization businesses.

But it also presents risks, as stressed in the companion 2013 Financial System Stability Assessment (FSSA).<sup>8</sup> First, underpriced mortgage insurance may encourage excessive risky loans and expose the taxpayers to housing sector risks. Second, it may result in an inefficient allocation of resources, with banks leaning toward risk-free mortgages at the expense of loans towards more productive uses of capital, especially loans to small-and-medium-size enterprises. Mortgages and consumer loans secured by real estate, the single largest exposure of Canadian banks, grew at a faster pace than any other bank asset since the mid-1990s (Chart) and are relatively high compared to other countries (Chart).

**21. Staff suggested that the transition to a different regime would need to be gradual.**

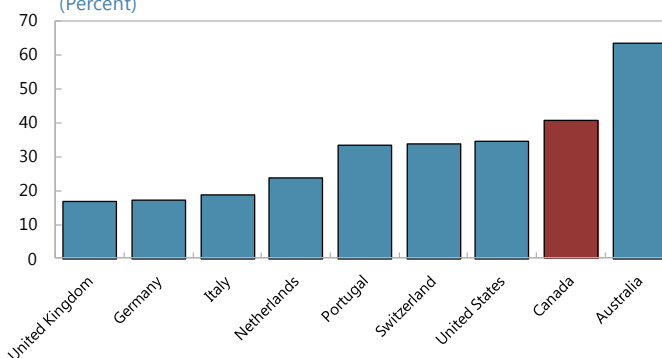
The authorities noted that reviewing the government's exposure to the sector is on their long-term agenda. Staff argued that any structural change to mortgage insurance should be made gradually over time, to avoid any unintended consequences on financial stability, and welcomed the measures announced in 2013 to reduce the use of government-backed insurance for mortgages with low loan-to-value (LTV) ratios and private securitization programs (Box 3). Staff also recommended extending the scope of the Office of the Superintendent of Financial Institutions (OSFI) oversight of the federally-owned Canada Mortgage and Housing Corporation (CMHC), for example, by giving OSFI the authority to impose greater capital or liquidity positions or prohibit the writing of new business, as this would level the playing field with private mortgage insurers.

**Evolution of Canadian Banks' Balance Sheet**  
(Index, 1996=100)



Source: OSFI

**Residential Mortgage Loans to Total Loans, 2012**  
(Percent)



Source: IMF, Financial Soundness Indicators (FSI) database.

## E. Financial Sector: Outlook, Risks, and Policies

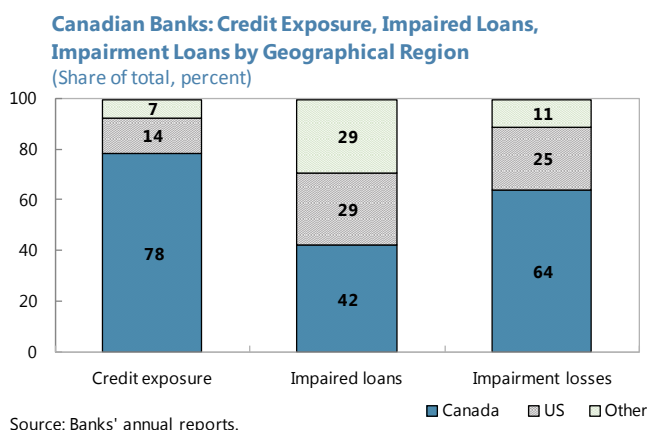
**22. Canada's banking system is well capitalized, profitable, and has low nonperforming loans** (Figure 5). Canadian banks reported record profits in 2013, as greater income from fees and wealth management and costs compression have more than offset narrower interest rate margins from the slower growth in household loans. Tier 1 capital levels have remained high at about 12 percent while leverage increased somewhat from 2012, and nonperforming loans are

<sup>8</sup> See, Canada: *Financial System Stability Assessment*, IMF Country Report No. 14/16.



only 0.6 percent of total loans. Stress tests performed as part of the recent FSAP mission showed that Canadian largest banks are resilient to credit, liquidity, and contagion shocks from a tail-risk scenario that is more severe than any recession experienced in Canada over at least the last 35 years. Staff argued that risks remain from the continuation of a low interest rate environment and a further decline in household loan growth, especially if

this were to induce Canadian banks to expand more aggressively abroad, noting that foreign operations account for a higher share of loan losses than of overall credit exposure (Chart). The authorities indicated that the expansion abroad could in principle help Canadian banks diversify risks, but also that they would need to monitor potential changes in banks' risk appetite, including through on-site visits. The authorities argued that they are increasing their monitoring of Canadian banks' exposures in tax haven countries and risks associated with money laundering, including by planning a cross-sectoral review of a few banks in this area.



**23. The pressure on pension funds and life insurance companies eased somewhat in 2013.** Higher long-term rates, strong equity markets, higher contributions as well as cuts in benefits in some cases have led to an improvement in the solvency of Canadian defined benefit pension funds relative to 2012. Financial results of life insurance firms have also improved in 2013, due to a pickup in income from wealth-management and insurance sales, particularly outside Canada. Many pension funds have continued to use liability-driven investment strategies to better match the assets and liabilities in their balance sheet. To the extent these strategies involve leverage, they may increase returns but at the costs of exposing pension funds to other risks, including counterparty and liquidity risks. The authorities claimed that the solvency position of Canadian pension plans improved significantly in 2013 due to strong equity returns, rising long-term interest rates and sponsors' contributions to meet the minimum solvency funding requirements for their deficits. Still, the authorities indicated they continue monitoring for signs of excessive risk taking, also with reference to life insurance firms given the potential financial incentives to invest in alternative, non-fixed income, assets to meet target rates of return in a low interest rate environment.

**24. Staff welcomed the progress in the financial reform agenda since the last Article IV consultation:**

- *Basel standards.* Basel III regulation on capital standards was introduced in January 2013, while the regulation on Liquidity Coverage Ratios is expected to be implemented in 2015. The authorities expressed their intention to proceed swiftly with the implementation of Basel III

regulations on Net Stable Funding Ratios and Leverage Ratios once they are finalized over the course of 2014.

- *Domestic Systemically Important Banks (DSIBs)*. The six largest banks were designated as DSIBs by OSFI in 2013, and will therefore be subject to higher capital requirements, enhanced supervision, and additional disclosure requirements.<sup>9</sup> One provincially regulated financial institution, Desjardins, was also designated as provincial systemically important institution by the Autorité des Marchés Financiers (AMF). The authorities noted that third generation resolution plans for the DSIBs were expected to be completed by the end of 2013 and the fourth generations of recovery plans are expected to be submitted in 2014. They said they are developing a new “bail-in” regime for DSIBs.
- *OTC derivatives market*. Staff welcomed the decision to strengthen the oversight of the OTC derivatives market by designating LCH Clearnet’s SwapClear, the largest global central clearing counterparty for interest rate derivatives market, as systemically important to the Canadian financial system, given that interest rate derivatives represent three-fourths of the notional outstanding of Canada’s OTC market.<sup>10</sup> Moreover, in 2013 the largest provincial securities regulators have announced plans to harmonize the rules for trade repositories and the requirements for derivatives data reporting. This will enhance transparency in the OTC derivatives market, and help detect possible systemic risks and market abuse.
- *Repo market*. Staff welcomed recent progress in expanding the functions of the central clearing counterparty (CCP) for the Canadian repo market, a core funding market in Canada and a source of funds for financial institutions. The authorities said that they expect to work closely with industry to make further progress on reforms in this area throughout 2014 and beyond, initially by broadening the participation in the repo CCP to include other significant players in the Canadian repo market, like pension funds and insurance companies. Additional future reforms could also include the ability to clear general-repo transactions in which any government security can serve as collateral.
- *Credit rating agencies*. Further progress has been made in reducing the reliance on external credit ratings agencies, in line with FSB principles, as the Bank of Canada established in 2013 a credit rating assessment group to evaluate the credit risks of sovereign assets that the Bank manages on behalf of the government. The authorities indicated that they are currently assigning ratings to investment exposures of the government’s FX reserves to sovereigns and that they intend to apply these for purposes of determining eligibility and investment limits in

<sup>9</sup> DSIBs are expected to meet a 1 percent common equity surcharge by no later than January 1, 2016.

<sup>10</sup> As a result, Bank of Canada will share the oversight of LCH Clearnet’s SwapClear with the Bank of England (SwapClear’s lead regulator) and other national regulators (like the Federal Reserve Bank of New York) under a multilateral arrangement for oversight cooperation. While national legislation gives Bank of Canada powers to collect information, conduct audits and issue directives to LCH in order to preserve domestic financial stability, the multilateral arrangement should facilitate consultation, cooperation and information-sharing between national regulators.



2014. The Bank is also reviewing the role external credit ratings play in its collateral policy and assessing possible options for reducing mechanistic reliance on such ratings.

**25. Staff welcomed the agreement between the Ministers of Finance of British Columbia, Ontario and Canada to establish a cooperative capital markets regulatory system.** The system will have a federal statute that will address criminal matters, systemic risks in capital markets and national data collection, while member provinces will adopt a uniform act which will cover all the areas that the existing provincial securities statutes address. Staff welcomed the initiative, which is consistent with recommendations in previous years' staff reports, as it is expected to reduce compliance costs and facilitate coordination across jurisdictions and regulatory authorities, as well as to enhance systemic risk monitoring and enforcement, especially if all provinces participated. The authorities agreed that the new system would be more effective if all provinces joined the cooperative system, and acknowledged that even if the federal government could in principle take measures to ensure system-wide financial stability, it would prefer taking those measures related to capital markets within a cooperative system.

**26. The mission and authorities discussed the scope for further strengthening Canada's financial system along the lines of the 2013 FSAP Update recommendations (Box 4).** In particular:

- Staff argued for more clarity around the legal independence of OSFI, and suggested that there are areas (including on the acquisition and ownership of banks, related-party transactions and large exposures) where reporting and notification obligations for banks could be made more formal, to ensure that OSFI has timely and complete information and the ability to exercise its prudential powers when necessary. The authorities argued that the current delineation of prudential responsibilities is appropriate in providing the finance minister, who is ultimately accountable for financial stability, with a decision-taking responsibility on transactions which may raise fundamental policy issues, and that the current risk-based approach to supervision is more effective than rules-based approaches.
- Staff emphasized that financial stability would be strengthened if all large Canadian depository institutions, whether provincially or federally regulated, were subject to the same level of supervision and regulation and tested against tail risks in a regular, common stress testing exercise. The authorities noted that there is already adequate informal cooperation between federal and provincial authorities, and that introducing more formal coordination might undermine the incentives for provincial regulators to oversee, supervise, and provide backstop to provincially regulated financial institutions.
- Staff also argued that providing a formal mandate for macro-prudential policy to a single entity would strengthen transparency and accountability, and reinforce Canada's ability to identify and respond to future crises. The authorities maintained that the current system has served Canada well and that systemic risks are effectively analyzed within the current informal decentralized framework. They agreed with staff, however, that systemic risk

assessment would be strengthened if additional data (on shadow banking system, securities markets, and a number of provincially regulated financial institutions) were obtained.

#### Box 4. Canada: 2013 FSAP Update—Key Recommendations

##### Data

- Expand financial sector data collection and dissemination with a view to enhancing coverage, regularity, and availability of time-series to facilitate analysis.

##### Housing Finance

- Reduce the government's exposure to mortgage insurance gradually.

##### Stress Testing

- Augment OSFI's top-down stress testing framework for banks with risk-sensitive concepts of key credit risk input parameters and econometric, model-based approaches using longer time series.
- Include major regulated entities at federal and provincial level in a regular, common stress testing exercise which would involve a degree of collaboration between relevant federal and provincial authorities.

##### Financial Sector Oversight

- Equip OSFI with powers to make its own enforceable rules by administrative means, supplementing the use of guidelines and government regulations; amend legislation on statutory decisions to give OSFI sole decision-making authority on prudential criteria.
- Replace certain informal and ad hoc reporting requirements by federally regulated financial institutions with more formal requirements.
- Adopt a transparent and consistent regulatory regime for group-wide insurance supervision; give OSFI the authority to take supervisory measures at the level of the holding company.
- Address shortcomings in risk identification and enforcement in securities regulation.
- Enhance supervisory cooperation among federal and provincial supervisors and subject all systemically significant financial institutions to intensive supervision.

##### Safety Nets and Crisis Preparedness

- Provide a clear mandate to an entity (i) to monitor systemic risk to facilitate macro-prudential oversight, and (ii) to carry out system-wide crisis preparedness.
- Increase the ex-ante funding of CDIC and enhance its data collection and analysis of depositor profiles.

## STAFF APPRAISAL

**27. The Canadian economy strengthened in 2013 after a subdued performance in 2012, but growth has remained modest as both exports and business investment continued to disappoint.** Growth has averaged 2.2 percent in the first three quarters of 2013, but this to a large extent reflect the unwinding of the temporary disruptions in exports and energy

productions in the second half of 2012. Private consumption growth has remained robust, thanks to an increase in household wealth and still easy financial conditions, but business investment made no contribution to growth, and the volume of non-energy exports remained well below the levels reached after earlier recessions, owing to weak external demand and increased competitiveness challenges.

**28. Monetary policy remained appropriately accommodative, while fiscal consolidation imposed a modest drag on growth.** The greater degree of economic slack contributed to weaken inflationary pressures and the Bank of Canada kept the policy rate at 1 percent, the same level since September 2010. The federal government's fiscal deficit declined at a faster-than-expected pace in 2012–13, but the impact on growth was partly offset by less restraint at other levels of government, with a number of provinces delaying the return to a balanced budget. Thanks to the macro-prudential measures adopted in the past, construction activity and house price growth converged to more sustainable trends. Household credit growth also continued to slow, but the household debt-to-income ratio reached a new high in mid-2013.

**29. Staff expects growth to accelerate to 2¼ percent in 2014, from an estimated 1¾ percent in 2013.** The projected pickup in the U.S. recovery is expected to boost Canadian exports. As final demand and capacity utilization increase, business investment is expected to strengthen, particularly spending on machinery and equipment. Investment in the energy sector is also projected to expand, with greater reliance on rail transportation and additional pipeline and refining capacity expected to reduce the volatility of the price of Canadian heavy oil. Over time, the combined additional contribution to growth from net exports and business investment will more than offset the anticipated weakening in the contribution from household consumption and residential investment, as households gradually reduce their debt burden, construction activity moderates to levels consistent with demographic trends, and house price growth slows further. Fiscal policy will remain a modest headwind, subtracting about ¼ percentage points of GDP growth per year over the next three years. The gradual absorption of the existing economic slack is expected to drive inflation back to 2 percent by end-2015, with the policy interest rate projected to increase starting in early 2015.

**30. The risks around this baseline scenario are predominantly on the downside.** A faster-than-expected increase in long-term rates in the context of exit from QE could negatively affect the U.S. recovery and hence demand for Canadian exports. Protracted weakness in the euro-area economic recovery and lower-than-anticipated growth in emerging markets would also hurt the prospects for Canada's exports, including through lower commodity prices. Elevated house prices and household leverage could amplify the growth impact of these external shocks, potentially triggering a less friendly unwinding of domestic imbalances and further weakening of household spending. At the same time, a stronger pickup of the US economy and better performance of Canada's housing sector poses upside risks to the growth outlook, although the latter would also increase risks of a sharper correction of domestic imbalances down the road. On the domestic front, the long period of low productivity growth and strong Canadian dollar may have left a

deeper dent in Canada's exports potential (especially in the traditional manufacturing base), limiting the economy's ability to benefit from the projected strengthening in external demand.

**31. The energy sector is a source of both upside and downside risks to the outlook.** Our baseline scenario incorporates continued growth in the exports of crude oil over the medium term, under the assumptions that capacity constraints will be relieved through the construction of new pipelines and U.S. demand will remain robust (with Canada gaining market share in the U.S. oil market). A more rapid growth in U.S. production of unconventional energy and/or delays in the expansion of transportation capacity would limit the demand for Canadian energy, put downward pressure on Canadian energy prices, and adversely affect exports and investment. At the same time, faster progress in solving the infrastructure bottlenecks would allow increasing Canadian energy producers' access to international (non U.S.) markets and Canadian eastern provinces, boost production, and raise the price of Canadian energy. Maintaining an open regime for inward FDI in the energy sector and addressing potential skills shortages in resource-rich provinces would also increase the upside potential from the energy sector.

**32. Monetary policy should remain accommodative until there are firmer signs that growth is picking up above potential, with a sustainable transition from household spending to exports and business investment.** Given the greater output gap, the low inflation rate, well-anchored inflation expectations, and downside risks around the pickup in growth in 2014, staff's view is that policymakers can afford to wait before starting to raise policy rates towards more normal levels. The slowing trends in construction activity, house prices, and household credit, together with the projected increase in long-term rates as the Fed gradually exits from QE, also give the Bank of Canada more room to wait before raising policy rates. Additional macro-prudential measures remain the first line of defense against a renewed acceleration in housing imbalances, although the authorities would likely need to consider bringing forward the tightening cycle if this acceleration were to happen in the context of stronger growth. At the same time, the high level of household debt and elevated house prices would limit the room for conventional monetary policy easing if growth were to disappoint.

**33. Fiscal adjustment plans should strike the right balance between supporting growth and rebuilding the fiscal space.** At the federal level, continued progress in fiscal consolidation is appropriate to rebuild the room for fiscal maneuver used during the crisis, but there is room to delay the adjustment needed to return to a balanced budget in 2015 if there is no meaningful pickup in economic growth. At the provincial level, consolidation plans are facing increasing challenges on the backdrop of disappointing economic growth, and some provinces may need to consider additional measures, especially on the revenue side, to return to a balanced budget.

**34. Addressing long-term fiscal challenges remains an important priority.** Canada has a relatively low net public debt-to-GDP ratio compared to most other advanced economies. Still, it is not immune to long-term spending pressures, mainly coming from population aging and continued growth in per capita health care costs. While important steps have been taken recently at the provincial level to limit health care spending growth, it is important to ensure that the recent moderation is maintained into the future and the savings are obtained through efficiency

gains in addition to budgetary restrictions. Establishing independent budget offices at the provincial level (as in the case of Ontario's Financial Accountability Office) and having them publish long-term fiscal sustainability analysis would help raise public awareness of the challenges ahead, and build consensus around the needed policy measures. The mission welcomed the recently announced intention by the federal government to introduce a rule requiring balancing the budget in normal economic times, as this would allow locking in recent progress in deficit reduction, but it would be important to design it in a way that avoids imposing a pro-cyclical bias to fiscal policy. Federal and especially energy-abundant provincial jurisdictions should also consider changing their fiscal frameworks to better manage the volatility associated with commodity prices and save the revenue windfall. In this regard, Alberta's recently legislated fiscal framework is a step in the right direction.

**35. Over the long run, the need for extensive government backed mortgage insurance should be re-examined.** The current system has its advantages, including as a macro-prudential tool. However, it exposes the fiscal budget to financial system risks and might distort the allocation of resources in favor of mortgages and away from more productive uses of capital. Against this background, the government's recent initiatives to impose limits on government-backed mortgage insurance have been appropriate. Looking ahead, further measures should be considered to encourage appropriate risk retention by the private sector and increase the market share of private mortgage insurers. Importantly, any structural change should be made gradually over time to avoid any unintended consequence on financial stability.

**36. While Canada's financial sector is healthy, it is essential to remain vigilant against the potential risks from the prolonged period of low interest rates.** Canada's banking system is characterized by elevated capitalization, strong profitability, and high quality of assets. Stress tests conducted as part of the recent IMF FSAP mission demonstrate the resilience of major Canadian banks and insurance companies to credit, liquidity, and contagion risks arising from a severe stress scenario. Pension funds and life insurance companies appear to have coped well with a prolonged period of low interest rates, although their increased reliance on non-traditional investment strategies continues to deserve close scrutiny from regulators. Continued expansion abroad of both Canadian banks and life insurance companies, while contributing to diversification, also calls for enhanced monitoring.

**37. Staff welcomes the progress made by the authorities on the international financial reform agenda over the past year.** Basel III capital standards were introduced in 2013 and the authorities plan to introduce Basel III liquidity standards in 2015. The six largest federally regulated deposit-taking financial institutions have been designated as systemically important by OSFI and one provincially regulated institution has been designated as provincially systemically important by AMF and will be therefore subject to higher capital standard requirements, in addition to enhanced disclosure, supervisory and recovery and resolution planning requirements. Significant progress has been made towards strengthening the resilience of the repo market by expanding the functions of the central counterparty established in 2012. To enhance the safety and soundness of OTC derivatives market, the largest global central counterparty for the OTC

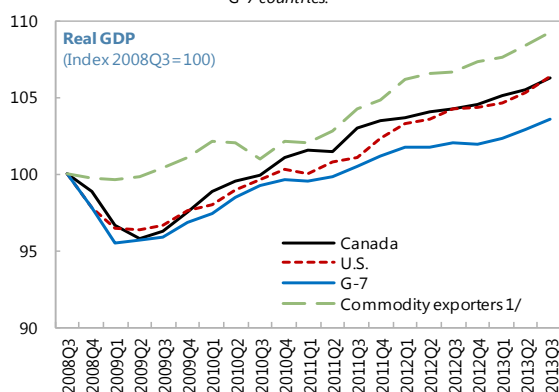
interest rate derivatives market was designated for oversight because of its systemic importance to the Canadian financial system. The recent agreement among two major provinces and the federal government to establish a cooperative capital markets regulator could prove a useful step in further harmonizing securities market regulation and oversight nationally.

**38. There are a few areas where the resilience of Canadian financial sector could be strengthened further.** Canada's compliance with international standards for regulation and supervision of banks and insurers is strong. Still, staff called for more clarity around the legal independence of OSFI and for assigning stronger prudential responsibilities to this regulator. The mission also saw room for stronger coordination across federal and provincial authorities in both the supervision and stress-testing of large depository institutions, whether provincially or federally regulated. It also suggested that a clear mandate could be given to an entity to carry out macro-prudential oversight, with participation broad enough to allow a complete view of systemic risks across all financial institutions and markets, and with powers to collect the data required for the analysis of systemic risks.

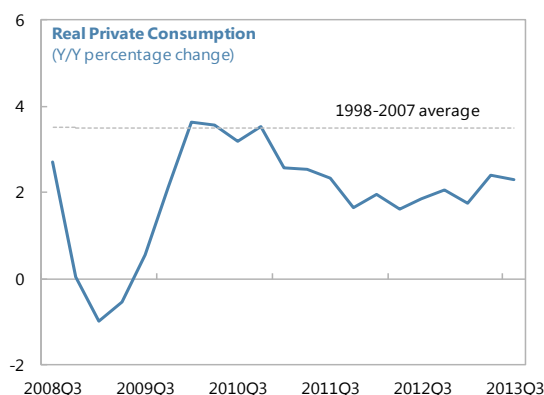
**39. It is recommended that the next Article IV consultation take place on the standard 12-month cycle.**

**Figure 1. Growth Has Accelerated But Remains Unbalanced**

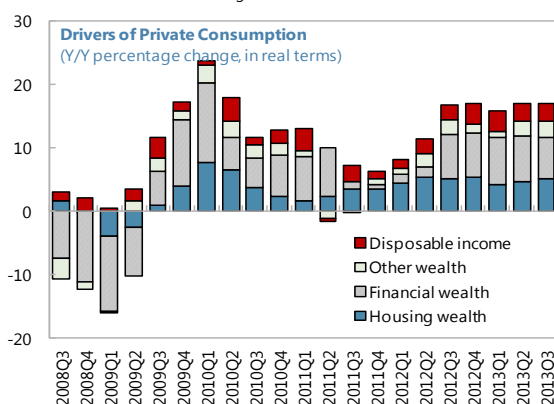
Canada's post-2008 recovery has been the strongest among G-7 countries.



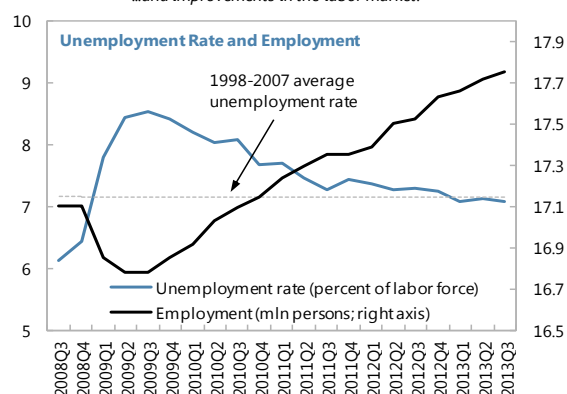
Private consumption growth has rebounded...



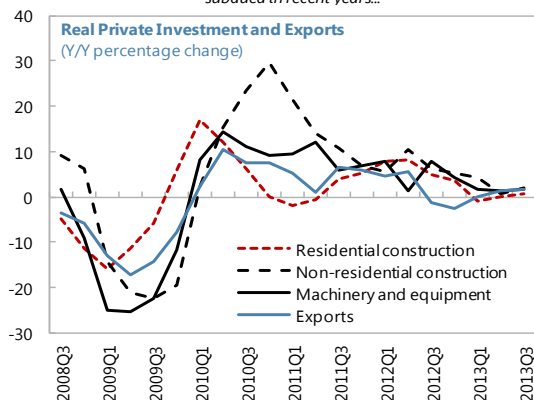
...thanks to continued growth in household wealth and income...



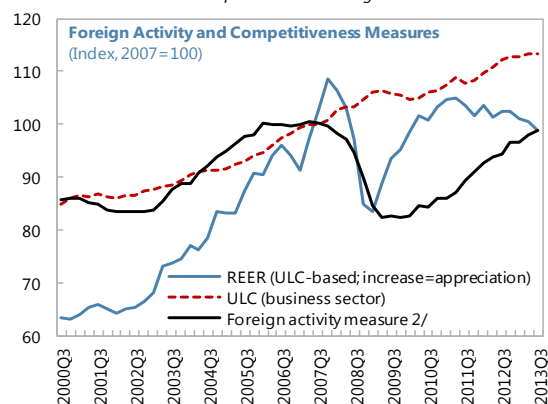
...and improvements in the labor market.



Private investment and export growth, however, remained subdued in recent years...



...reflecting slower recovery in external demand and competitiveness challenges.



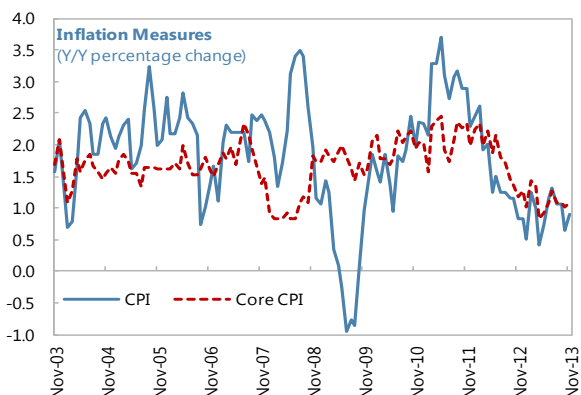
Sources: Statistics Canada; Haver Analytics; Bank of Canada; and IMF staff estimates.

1/ Includes Australia, New Zealand, and Norway.

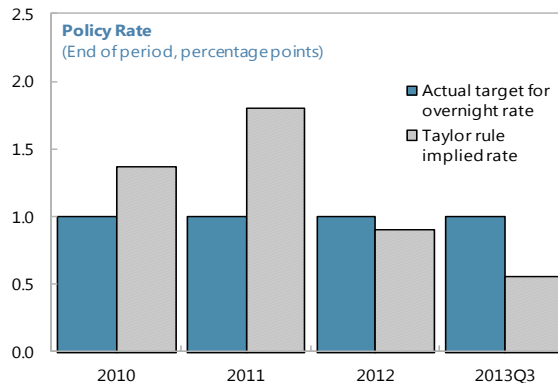
2/ The Bank of Canada's foreign activity measure captures the composition of foreign demand for Canadian exports by including components of U.S. private final domestic demand and economic activity in Canada's other trading partners.

**Figure 2. Monetary Conditions Remain Accommodative**

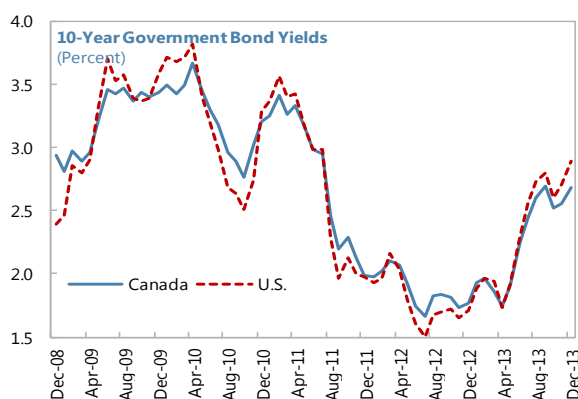
Headline and core inflation has been low, with recent weakness reflecting in part special factors (low food and domestic regulated prices).



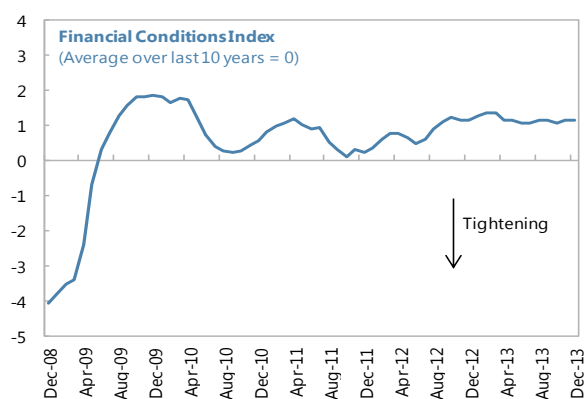
Given low inflation and remaining slack, the current monetary policy stance is broadly appropriate.



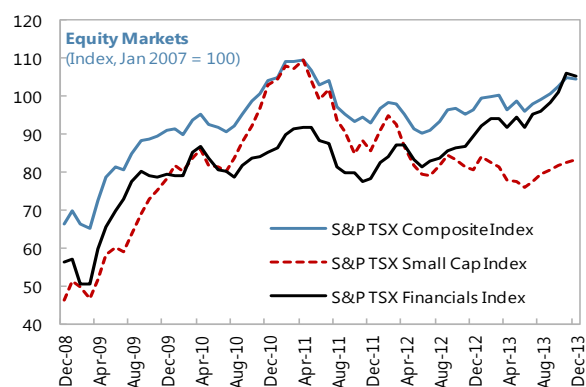
Long-term interest rates have increased since end-May, in line with U.S. rates.



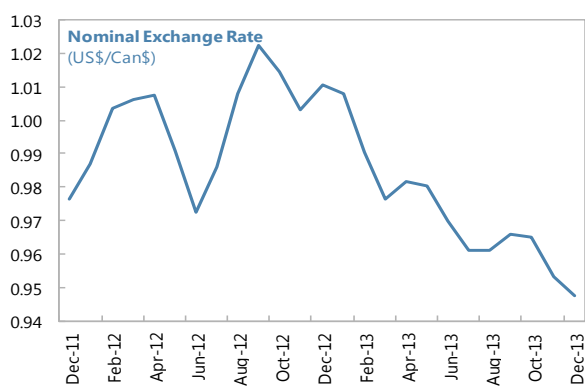
Still, overall financial conditions remain largely unchanged and very accommodative...



...as the stock market rebounded since the beginning of 2012...

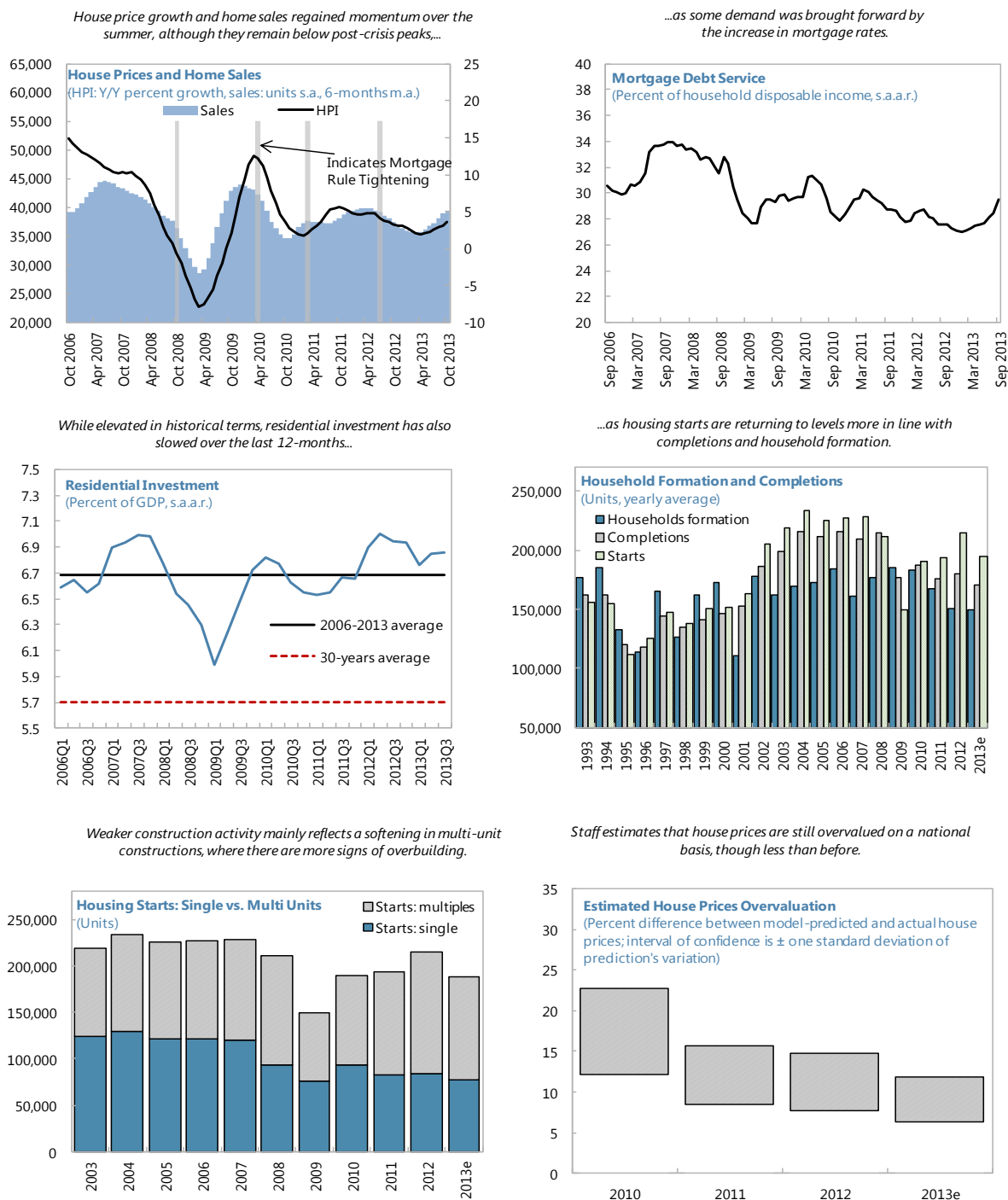


...and the exchange rate has depreciated.



Sources: Haver Analytics; Bloomberg; and IMF staff estimates.

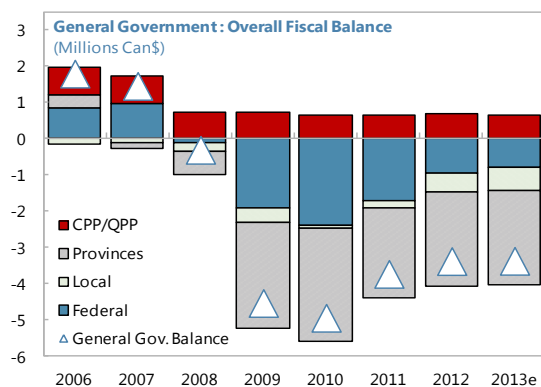


**Figure 3. A Cooling Housing Sector**

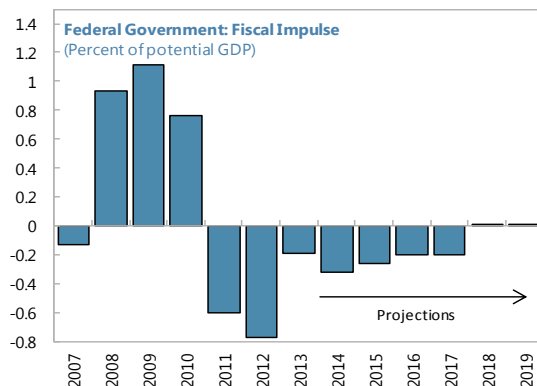
Sources: CREA; CMHC; Department of Finance Canada; Haver Analytics; Statistics Canada; and IMF staff calculations.

**Figure 4. Fiscal Consolidation is Underway**

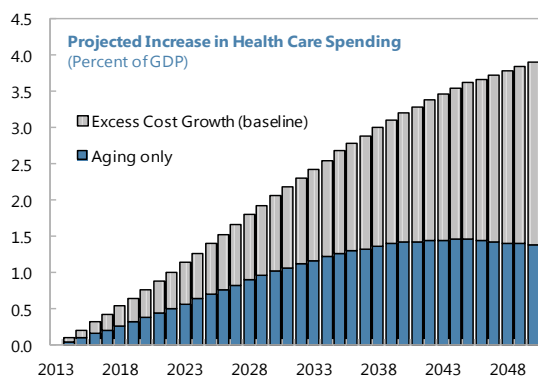
*Fiscal consolidation is proceeding for the federal government but has stalled for provincial and local governments...*



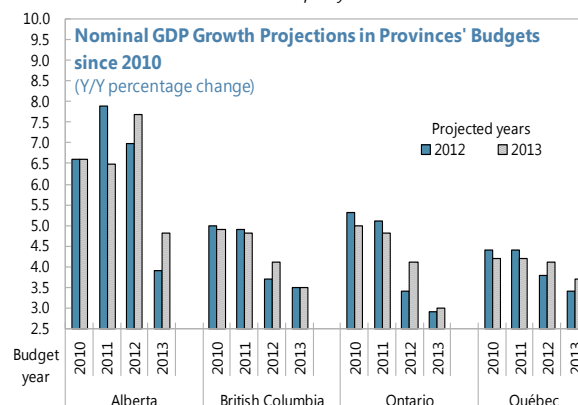
*Going forward, we expect fiscal consolidation to continue at the federal level, but at a slow pace.*



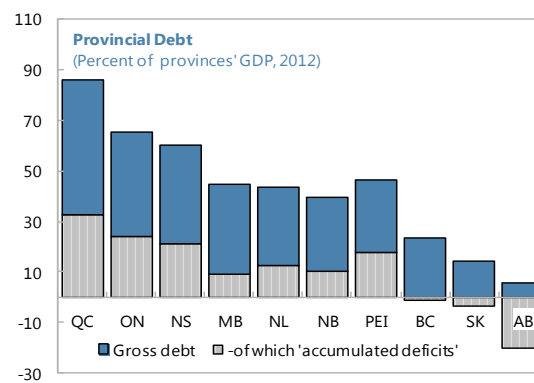
*...yet they all face long-term challenges from population aging, mainly associated with rising health care costs.*



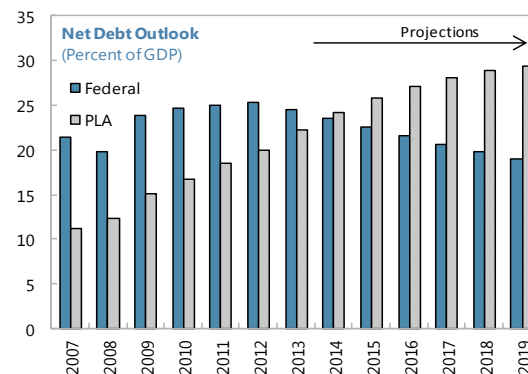
*...as provincial growth projections have been revised down significantly over the past years.*



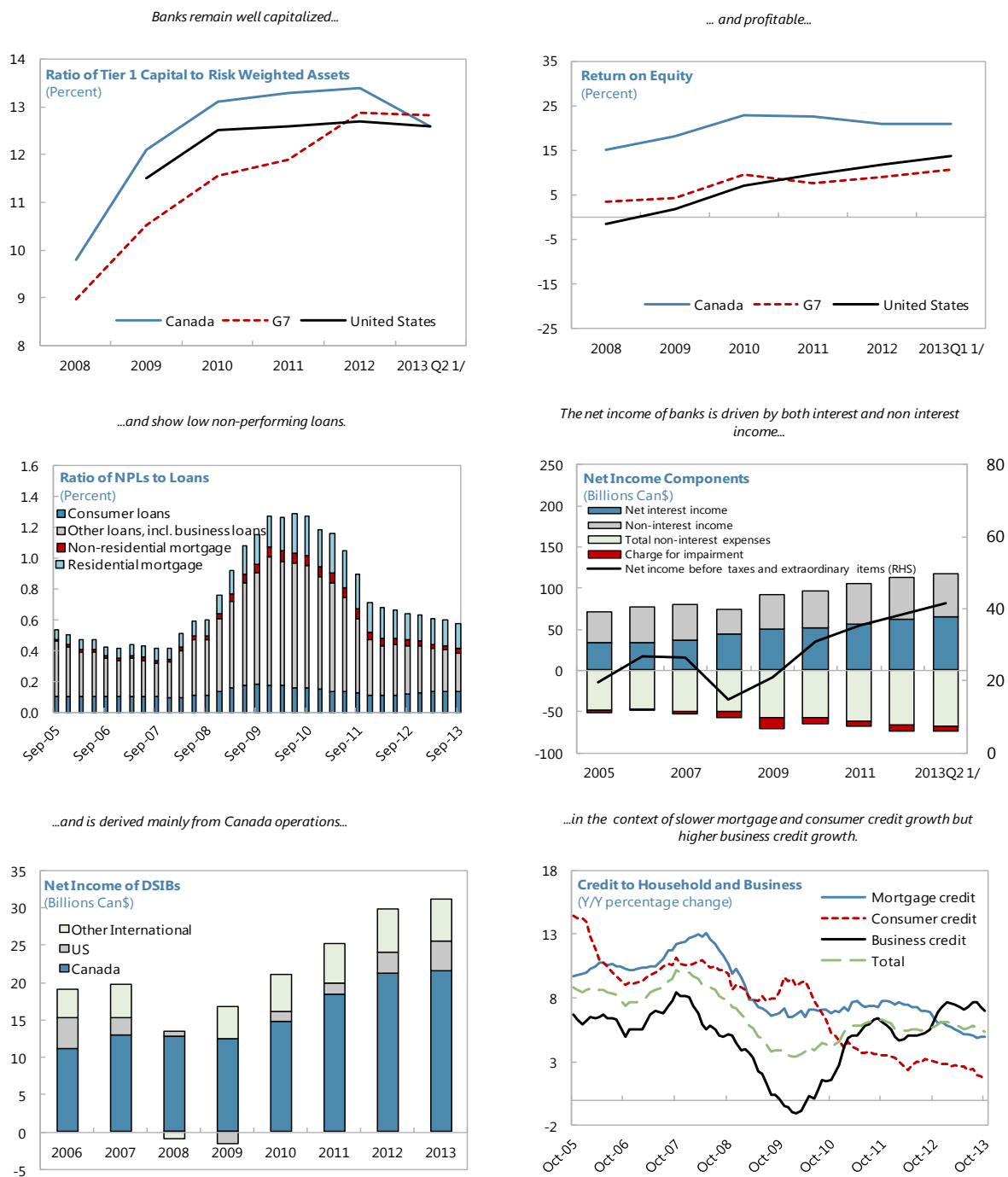
*Provinces start from very different debt-to GDP ratios...*



*As a result, net debt is projected to grow at the provincial and local levels, driving the increase in the general government debt dynamics.*



Sources: Budget documents; Statistics Canada; Institut de la Statistique Québec; and IMF staff calculations.

**Figure 5. The Financial Sector Remains Resilient**

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

**Table 1. Canada: Risk Assessment Matrix 1/**

Source of Risks	Likelihood	Expected Impact
Sharper increase in long-term interest rates related to QE exit	Medium	<p><b>Medium/High</b></p> <p>The main risk is from a faster-than-expected increase in U.S. long-term rates, as markets overreact to the exit from QE, which could hinder the expected pick-up in the U.S. recovery. Even if this were to happen in the context of stronger U.S. economic growth, the net impact on Canadian output would be negative if the increase in U.S. interest rates were to lead to a sharp and persistent increase in mortgage rates in Canada as well as a faster decline in house prices than currently in our baseline scenario (see Annex I for details).</p>
Protracted period of slower growth in Europe	High	<p><b>Low/Medium</b></p> <p>This could impact Canada mainly through indirect trade channels, although domestic demand would also be affected through negative confidence effects and tighter financial conditions. In a scenario where European GDP falls by about 3½ percent below baseline after 5 years of slow growth, with higher debt accumulation forcing more fiscal consolidation and higher cost of capital, output in Canada would fall by about 0.4 percent after 5 years, mainly because of a smaller contribution from net exports (see Annex I).</p>
Protracted period of slower growth in emerging economies	Medium	<p><b>Medium</b></p> <p>This shock would affect Canada through a negative effect on the terms of trade (as commodity prices would fall), as well as through a decline of external demand, although the weakening of the Canadian dollar would soften the impact. Staff simulations show that a 10 percent two-year decline of investment in major emerging market economies (that leads to a fall in global GDP by about 2 percent, and a decline in energy prices of about 10 percent per year over the two-year horizon) would subtract about 0.35 percent from Canada's output on average over two years (see Annex I).</p>
Sustained decline in commodity prices	Medium	<p><b>High</b></p> <p>A sustained decline in energy prices would substantially impact Canada through reducing production and investment in the energy sector, and via the negative terms of trade shock. An intensification of hydraulic fracturing activity in the U.S. energy sector and delays in pipeline projects may also pose downside risks to Canada. Staff simulations show that in a scenario where infrastructure constraints persist and crude oil production growth slows (to below 2 percent per year over 2014–2020, compared to 3 percent growth in staff's baseline scenario), Canada's real GDP would be 2 percent lower in the long run (see Selected Issues paper).</p>
<p>1/ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non mutually exclusive risks may interact and materialize jointly.</p>		

**Table 2. Canada: Medium-Term Scenario 2011–2019***(Percentage change, unless otherwise indicated)*

			Projections						
	2011	2012	2013	2014	2015	2016	2017	2018	2019
National Accounts in constant prices									
Real GDP	2.5	1.7	1.7	2.2	2.4	2.4	2.2	2.1	2.1
Q4/Q4	2.4	1.0	2.2	2.3	2.4	2.3	2.2	2.1	2.1
Net exports 1/	-0.4	-0.5	0.1	0.2	0.3	0.3	0.2	0.2	0.2
Final domestic demand	2.4	2.3	1.5	2.1	2.1	2.1	2.1	2.0	1.8
Private consumption	2.3	1.9	2.2	2.1	2.1	2.1	2.0	2.0	2.0
Public consumption	0.8	1.1	0.6	1.1	1.2	1.3	1.4	1.4	1.3
Private fixed domestic investment	7.0	5.1	0.8	2.9	3.2	2.9	2.7	2.3	1.9
Private investment 2/	19.1	19.9	19.7	19.8	19.8	20.0	20.1	20.2	20.2
Public investment	-7.0	0.5	1.0	1.8	2.1	2.2	2.3	2.3	2.2
Change in inventories 1/	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Nominal GDP	5.8	3.4	3.2	4.1	4.3	4.4	4.4	4.3	4.3
Employment and inflation									
Unemployment rate 3/	7.5	7.3	7.0	6.9	6.8	6.8	6.7	6.6	6.6
Employment	1.5	1.2	1.3	1.2	1.0	1.0	1.0	1.0	1.0
CPI inflation	2.9	1.5	1.0	1.5	1.9	2.0	2.0	2.0	2.0
Core CPI inflation (y/y)	1.7	1.7	1.3	1.7	2.0	2.0	2.0	2.0	2.0
GDP deflator	3.2	1.7	1.5	1.9	1.9	2.0	2.1	2.1	2.1
Potential output growth	1.8	2.0	1.8	1.9	2.0	2.0	2.0	2.1	2.1
Output gap 4/	-1.1	-1.4	-1.4	-1.1	-0.7	-0.3	-0.1	0.0	0.0
Indicators of fiscal policies									
	(Percent of GDP)								
Federal fiscal balance	-1.7	-1.0	-0.8	-0.4	-0.1	0.2	0.4	0.4	0.4
General government fiscal balance 5/	-3.7	-3.4	-3.1	-2.6	-2.0	-1.6	-1.1	-0.9	-0.6
General government gross debt	83.5	88.1	89.2	87.4	86.5	85.3	84.0	82.8	81.7
General government net debt	32.4	36.7	38.6	39.7	40.1	39.9	39.4	38.6	37.6
Three-month treasury bill 3/	0.9	1.0	1.0	1.1	1.2	2.0	3.0	3.9	4.1
Ten-year government bond yield 3/	2.8	1.9	2.3	3.0	3.4	4.0	4.8	5.3	5.4
External indicators									
Current account balance 2/	-2.8	-3.4	-3.3	-3.2	-2.9	-2.6	-2.6	-2.5	-2.4
Merchandise trade balance 2/	0.0	-0.7	-0.5	-0.3	-0.1	0.1	0.2	0.3	0.6
Export volume	5.0	2.1	1.5	3.9	5.5	5.3	5.1	4.9	4.9
Import volume	5.9	3.3	1.9	3.7	4.5	4.5	4.4	4.2	4.2
Terms of trade	3.4	-0.9	0.3	0.4	-0.1	-0.3	-0.2	0.1	0.4
Real effective exchange rate	1.4	0.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Saving and investment									
	(Percent of GDP)								
Gross national saving	21.1	21.2	21.1	21.3	21.6	22.0	22.1	22.3	22.3
General government	0.7	1.1	1.2	1.6	1.9	2.2	2.5	2.6	2.7
Private	20.3	20.2	19.9	19.7	19.6	19.8	19.6	19.7	19.6
Gross domestic investment	23.8	24.7	24.4	24.4	24.5	24.6	24.7	24.8	24.8
Personal savings 6/	4.4	5.0	5.7	5.9	6.0	6.0	6.0	6.1	6.1

Sources: Haver Analytics; and IMF staff estimates.

1/ Contribution to growth.

2/ Percent of GDP.

3/ Percent.

4/ Percent of potential GDP.

5/ Includes the balances of the Canada Pension Plan and Quebec Pension Plan.

6/ Percent of disposable income.

**Table 3. Canada: General Government Fiscal Indicators, 2011–2019 1/***(Percent of GDP, unless otherwise indicated)*

	2011	2012	Projections						
			2013	2014	2015	2016	2017	2018	2019
<b>Federal Government</b>									
Revenue	14.0	13.9	13.9	13.9	14.1	14.3	14.4	14.4	14.4
Income taxes	8.7	8.7	8.6	8.6	8.7	8.8	8.9	8.9	8.9
Expenditures	15.6	14.9	14.6	14.3	14.2	14.1	14.0	14.0	14.0
Program spending	13.9	13.6	13.5	13.0	12.9	12.7	12.6	12.5	12.4
Transfers	5.0	5.0	4.9	4.9	4.9	4.9	4.9	4.9	5.0
Interest payments	1.6	1.5	1.4	1.3	1.3	1.3	1.2	1.1	1.0
Budgetary balance	-1.7	-1.0	-0.8	-0.4	-0.1	0.2	0.4	0.4	0.4
Cyclically-adjusted balance 2/	-1.5	-0.7	-0.6	-0.2	0.0	0.2	0.4	0.4	0.4
<b>Provincial and Local Governments</b>									
Revenue	25.5	24.7	24.8	24.9	25.0	25.0	25.1	25.2	25.3
Income taxes	5.5	5.7	5.7	5.8	5.9	6.0	6.0	6.1	6.2
Expenditures	28.2	27.9	27.8	27.7	27.6	27.4	27.3	27.1	27.0
Interest payments	1.9	1.9	2.0	2.0	2.0	2.0	2.1	2.1	2.1
Budgetary balance	-2.7	-3.1	-3.0	-2.8	-2.6	-2.4	-2.2	-1.9	-1.7
Cyclically-adjusted balance 2/	-2.4	-2.7	-2.6	-2.5	-2.4	-2.3	-2.1	-1.9	-1.6
<b>Canada/Quebec Pension Plans</b>									
Revenue	3.2	3.3	3.3	3.3	3.4	3.4	3.4	3.5	3.5
Total spending	2.5	2.6	2.7	2.7	2.7	2.8	2.8	2.8	2.9
Budgetary balance	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6
<b>Consolidated General Government 3/</b>									
Revenue	42.1	41.5	41.5	41.7	41.9	42.2	42.4	42.5	42.7
Expenditure	45.8	44.8	44.6	44.2	44.0	43.8	43.5	43.4	43.3
Overall balance	-3.7	-3.4	-3.1	-2.6	-2.0	-1.6	-1.1	-0.9	-0.6
Primary balance	-3.3	-2.8	-2.7	-2.2	-1.6	-1.1	-0.8	-0.6	-0.4
Cyclically-adjusted balance 2/	-3.2	-2.8	-2.5	-2.1	-1.7	-1.4	-1.1	-0.9	-0.6
Net public debt	32.4	36.7	38.6	39.7	40.1	39.9	39.4	38.6	37.6
Gross public debt	83.5	88.1	89.2	87.4	86.5	85.3	84.0	82.8	81.7
<b>Memorandum Items</b>									
Real GDP growth (percentage change)	2.5	1.7	1.7	2.2	2.4	2.4	2.2	2.1	2.1
Nominal GDP growth (percentage change)	5.8	3.4	3.2	4.1	4.3	4.4	4.4	4.3	4.3
Three-month treasury bill (percent)	0.9	1.0	1.0	1.1	1.2	2.0	3.0	3.9	4.1
Ten-year government bond (percent)	2.8	1.9	2.3	3.0	3.4	4.0	4.8	5.3	5.4

Sources: Department of Finance Canada Budget; Department of Finance Canada Fiscal Update; Haver Analytics; OECD; and IMF staff estimates.

1/ National Accounts basis.

2/ Percent of potential GDP.

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

**Table 4. Canada: Balance of Payments, 2008–2019***(Percent of GDP, unless otherwise indicated)*

	2010	2011	2012	Projections						
	2013	2014	2015	2016	2017	2018	2019			
<b>Current Account</b>										
Current Account Balance	-3.5	-2.8	-3.4	-3.3	-3.2	-2.9	-2.6	-2.6	-2.5	-2.4
Merchandise Trade Balance	-0.6	0.0	-0.7	-0.5	-0.3	-0.1	0.1	0.2	0.3	0.6
Exports, goods	24.3	26.0	25.4	25.4	25.5	25.5	25.6	25.9	26.2	26.5
Export Volume Growth (percentage change)	8.4	5.0	2.1	1.5	3.9	5.5	5.3	5.1	4.9	4.9
Imports, goods	24.9	25.9	26.1	25.9	25.7	25.6	25.6	25.7	25.9	25.9
Import Volume Growth (percentage change)	14.0	5.9	3.3	1.9	3.7	4.5	4.5	4.4	4.2	4.2
Services Balance	-1.3	-1.3	-1.3	-1.3	-1.1	-1.0	-0.9	-0.8	-0.7	-0.6
Investment Income Balance	-1.3	-1.2	-1.1	-1.3	-1.5	-1.5	-1.4	-1.7	-1.8	-2.1
<b>Capital and Financial Accounts</b>										
Direct Investment, net	-0.4	-0.7	-0.7	-0.6	-0.6	-0.5	-0.4	-0.2	0.0	0.0
Portfolio Investment, net	6.0	4.6	2.6	3.2	3.3	3.3	3.0	2.8	2.6	2.5
Other Investment, net 1/	-1.9	-0.3	1.6	0.7	0.5	0.1	-0.1	0.0	0.0	0.0
Capital Account Balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
International Reserves	-0.2	-0.5	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Statistical Discrepancy	0.1	-0.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Memorandum Items</b>										
Terms of Trade (percent change)	5.0	3.4	-0.9	0.3	0.4	-0.1	-0.3	-0.2	0.1	0.4
Net International Investment Position 2/	-16.8	-15.5	-16.6	...	...	...	...	...	...	...
Assets	131.3	125.0	131.5	...	...	...	...	...	...	...
FDI	59.4	52.6	54.2	...	...	...	...	...	...	...
Portfolio	44.5	43.1	47.5	...	...	...	...	...	...	...
Other	24.0	25.5	26.0	...	...	...	...	...	...	...
Reserves	3.4	3.8	3.7	...	...	...	...	...	...	...
Liabilities	148.1	140.4	148.1	...	...	...	...	...	...	...
FDI	59.9	52.2	54.3	...	...	...	...	...	...	...
Portfolio	65.9	65.7	69.5	...	...	...	...	...	...	...
Other	22.3	22.6	24.3	...	...	...	...	...	...	...
Gross External Debt	68.9	72.4	77.0	...	...	...	...	...	...	...
Real Effective Exchange Rate 3/	9.3	1.4	0.0	...	...	...	...	...	...	...

Sources: Haver Analytics; and IMF staff calculations.

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

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

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



**Table 5. Canada: Financial Soundness Indicators, 2008–2012***(Percentage change, unless otherwise indicated)*

	2008	2009	2010	2011	2012
<b>Total Assets</b>					
Total Assets 1/	2,958	2,806	3,023	3,433	3,845
Percent of GDP	179.7	179.3	181.6	194.8	211.6
<b>Capital Adequacy</b> (percent)					
Total Capital Ratio	12.2	14.7	15.6	15.9	16.1
Tier 1 Ratio	9.8	12.1	13.1	13.3	13.4
Core tier 1 Ratio					
Capital to Assets	3.5	4.5	4.7	5.1	5.1
<b>Credit Risk</b>					
NPLs Net of Provisions to Capital	7.9	11.2	10.4	6.1	5.9
NPLs to Gross Loans	0.8	1.3	1.2	0.8	0.6
Provisions (Individual) to NPL	30.6	26.8	25.2	29.7	22.4
Sectoral Distribution of Loans					
Residents	75.0	77.4	74.9	76.7	74.3
Nonresidents	25.0	22.6	25.1	23.3	25.7
<b>Profitability</b>					
Return on Assets	0.5	0.7	1.1	1.1	1.1
Return on Equity	15.0	18.2	22.9	22.5	20.8
Interest Margin on Gross Income	54.7	46.4	48.6	49.3	51.9
Trading Income to Gross Income	-8.6	8.7	6.9	4.2	5.3
Non-interest Expenses to Gross Income	77.7	73.4	65.3	63.8	63.4
<b>Liquidity</b>					
Liquid Assets to Total Assets	12.9	15.6	15.7	15.5	12.4
Liquid Assets to Short-Term Liabilities	41.1	55.3	52.0	58.1	56.3
Consumer Deposits to Loans	112.2	114.2	114.1	113.5	96.6
<b>FX and Derivative Risk</b>					
FX Loans to Total Loans	29.2	25.9	27.5	27.0	26.0
FX Liabilities to Total Liabilities	44.2	38.2	36.2	39.1	41.1

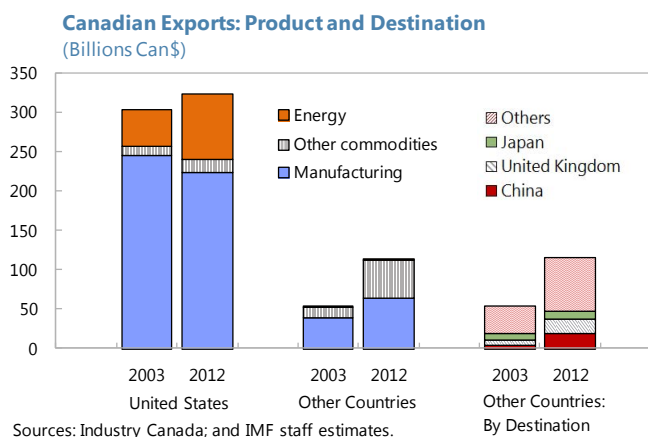
Sources: OSFI; Bank of Canada; and IMF staff calculations.

1/ Billions of Canadian dollars.

## Annex I. Canada's Trade and Financial Linkages and Risk Scenarios

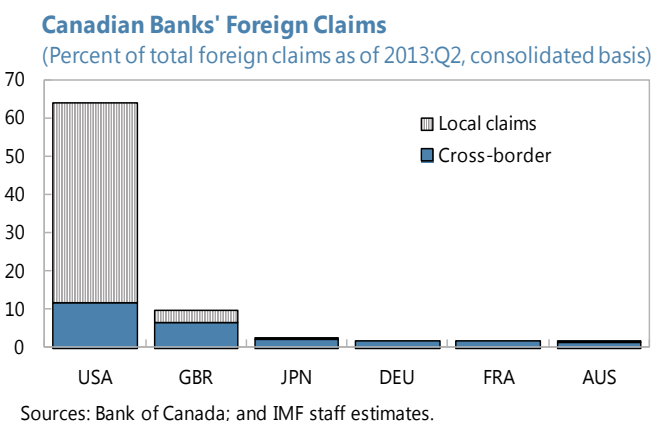
### *Inward Spillovers: Trade Channels*

**1. Canada's trade remains tightly linked to the United States but trade spillovers from emerging markets have become more important.** Canada's merchandise exports remain predominantly directed to the United States, although the U.S. share of Canadian exports has steadily declined from about 85 percent in 2003 to 75 percent in 2012. In terms of the product mix, manufacturing as a whole still accounts for about two-thirds of Canada's merchandise exports in 2012, but energy has taken over automotive as Canada's largest export sector. Canada's export growth remains highly synchronized with the U.S. business cycle, especially with U.S. business investment (which significantly uses imported manufacturing goods). Staff estimates that a one percentage point increase in U.S. business investment growth is associated with  $\frac{1}{2}$  percentage point increase in Canada's real exports of goods and services growth after one year. Canada also became more exposed to emerging markets, mainly through their substantial impact on commodity prices. As stated in the 2012 Article IV Consultation Staff Report (IMF Country Report No. 13/40), Canada is particularly exposed to fluctuations in China's fixed asset investment given its high commodity-intensity: a one-percentage point decline in China's fixed asset investment growth could reduce Canada's export growth by up to  $\frac{1}{4}$  percentage point.



### *Inward Spillovers: Financial Channels*

**2. Canada's financial linkages with the United States are also particularly strong.** As of 2013:Q2, Canadian banks' consolidated claims on non-residents were about 65 percent of GDP, of which two-thirds were on the United States (Chart), up from about one-half in 2010. Most consists of local claims by U.S. subsidiaries of Canadian banks, reflecting Canadian banks' active expansion in the U.S. since 2005, including through acquisitions of U.S. financial institutions. Canada's liabilities to foreign banks are relatively small (about 20 percent of GDP)



compared to other advanced economies, with U.S. banks holding about 30 percent of total foreign claims, closely followed by U.K. banks.

**3. Canadian corporations and banks have increasingly raised debt abroad, particularly in the United States.** From 2007 to 2012, the foreign ownership share of Canada's overall stock of debt securities has increased sharply (IMF 2013 *Spillover Report*). Canadian banks have also increasingly tapped the U.S. wholesale funding market: the Canadian banks' share of U.S. prime money market funds has almost doubled from 6.5 percent of their total assets in August 2011 to 11 percent in April 2013. The three largest Canadian life insurance companies also have significant foreign operations, with the U.S. market nearly matching the Canadian market in terms of gross insurance liabilities.

### **Risk Scenarios**

**4. Model-based simulations suggest that tighter-than-expected financial conditions in the United States are unlikely to affect Canada negatively if they occur in the context of stronger U.S. economic recovery.** The 2013 *Spillover Report* presented three scenarios in which the Fed tightens monetary policy earlier and faster than in our baseline. In the first two scenarios this happens in response to higher-than-expected growth, and long-term rates either remain anchored (that is, they rise in line with standard expectations theory) or increase by a further 100 basis points (bps) for a year following a term premium shock, with interest rates rising in other countries in line with historical correlations. In both cases, the net impact on Canada's output is positive, as the trade gains from higher exports to the United States and currency depreciations with respect to the U.S. dollar more than compensate the negative impact of tighter financial conditions on private domestic demand. In the third scenario, however, the monetary policy tightening occurs despite a lack of growth momentum in the United States, and the net impact on Canadian output is negative.<sup>1</sup>

**5. But elevated household leverage and overvalued house prices are a source of vulnerability.** The models used in the 2013 *Spillover Report* do not have any role for house prices and household leverage, and therefore may underestimate the impact of the shocks on Canada. To control for this, we tweak the IMF's Global Integrated Monetary and Fiscal (GIMF) model and G35-S model so that they include a house price and debt service shocks. Specifically, we consider the following scenarios:

- *A financial tightening in the U.S. with a 10 percent annual decline of house prices in Canada.* In this scenario, U.S. private domestic demand accelerates at a

Output Elasticity	Output Gain/Loss in 2014 (Percentage point deviation from baseline, min - max)		
	House Price Decline (Percent)		
	5 - 8	8.5 - 11.5	12 - 15
Low	0.2 / 0.5	0.0 / 0.4	-0.2 / 0.3
Medium	0.0 / 0.4	-0.3 / 0.1	-0.6 / 0.1
High	-0.2 / 0.3	-0.6 / -0.1	-1.0 / -0.4

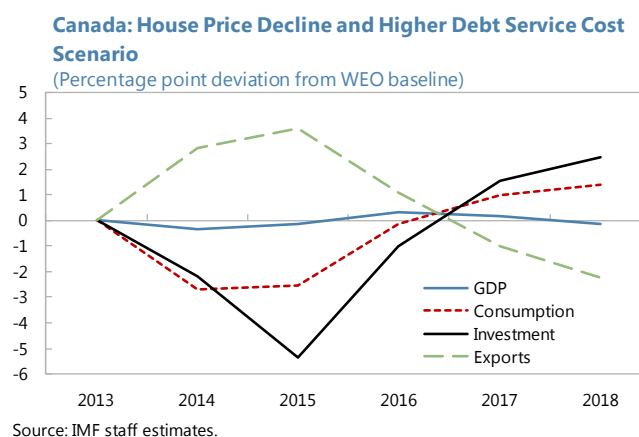
Source: IMF staff estimates.

<sup>1</sup> This may happen out of concern for rising financial risks, because the excess supply in the U.S. turns out to be lower than previously thought (as explored in the April 2013 WEO with GIMF simulations), or simply because of policy mistakes.

faster-than-expected pace and U.S. long-term interest rate increase, peaking at about 150 basis points above baseline in 2014:Q4. Canadian long-term interest rates increase as well, peaking at 75 basis points above baseline in 2014:Q3. Tighter financial conditions are assumed to lead to a 10 percent decline of Canadian house prices over one year. Assuming that the output elasticity to a 1 percent decline in house prices is 0.12 (as in Igan and Loungani, 2012, IMF WP/12/217), the simulation results from the G35-S model indicate that the negative financial shock and positive trade shock broadly offset each other, and Canada's output remains largely unchanged in 2014. Greater response of house prices to tighter financial conditions and/or greater output sensitivity to the decline of house prices would tilt the balance toward a net negative impact on Canada (Table).

- *A financial tightening in the U.S. with a debt-service shock and house price decline in Canada.*

This scenario is similar to the previous one, but adds a debt service shock to Canadian households within the *GIMF* model setup. Following the more rapid acceleration of U.S. domestic demand, U.S. nominal market interest rate begins to increase in 2014 and peaks at about 300 basis points above baseline in 2016. As growth accelerates, monetary policy is tightened in Canada, and the market interest rate increases by about 100 bps above baseline in 2015 and 2016. Higher market rates affect mortgage debt service (interest payments), which is estimated to increase from about 14 percent of household disposable income to over 17 percent.<sup>2</sup> As in the previous scenario we assume again a 10 percent fall in house prices in 2014. The higher interest payment and the decline in house prices force household to increase saving and lower private consumption, while the increase in the cost of capital hurts investment growth. Despite exports benefiting from the stronger external demand and lower Canadian dollar, Canadian output would be slightly lower in 2014 and 2015 (by about ⅓ and ½ percent, respectively) (Chart).



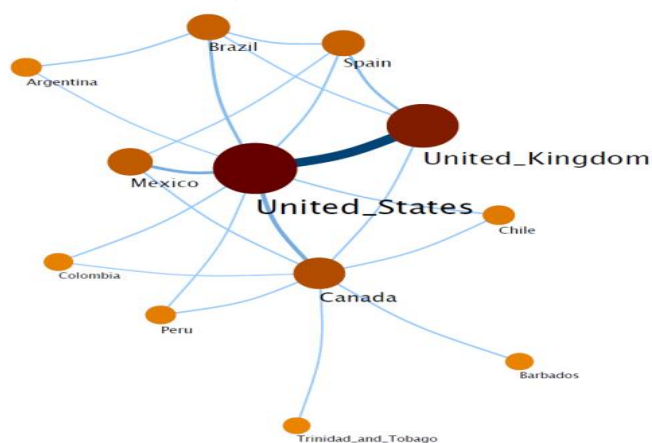
## 6. Hard landing in emerging markets or prolonged slow growth in the euro area could also adversely affect Canada. We considered two scenarios:

<sup>2</sup> These estimates are based on staff's calculations of the average Canadian household's monthly mortgage service payments, based on a five-year mortgage at an interest rate of 4 percent. Thus, a 100 basis point increase in interest rates would raise the debt service burden by about 3¼ percent of disposable income. Assuming no new borrowing, households would need a commensurate cut in private consumption. Assuming that about one-third of mortgages are rolled over each year, the reduction in private consumption-to-GDP ratio takes place gradually, reaching 2 percentage points in 2016.

- *A significant but temporary slowdown in emerging markets resulting from weaker investment coupled with capital outflows.* In this scenario, private investment demand in the BRICS economies falls 10 percent in one year. Furthermore, all emerging markets experience capital outflows, resulting in long-term interest rate increases of 200 basis points in China and India, and 400 basis points in Brazil, Russia, and South Africa, while equity prices fall 40 percent in all of these countries. These shocks are transmitted to Canada mainly through the indirect trade channel, as global GDP falls about 2 percent per year over a two year horizon, and the terms of trade channels, as energy commodity prices decrease by 10 percent after one year. Under this scenario, Canada's GDP falls by about 0.35 percent on average over a two year period, although the contribution to output from net exports remains close to the baseline as the exchange rate depreciation partly offsets the negative impact of lower external demand.
- *A gradual but persistent deterioration in euro area growth.* In this scenario, investment in the euro area falls 3 percent below the baseline in the first year and an additional 5 percent in the following year, as a result of the debt overhang on firms' balance sheets. The impact on output from lower investment is compounded by the knock-on effects to private consumption, as employment declines. Higher debt-to-GDP ratios in the euro area lead to further increases in sovereign and corporate spreads (25 bps and 12.5 bps on average across the euro area, respectively, each year for 5 years), additional fiscal tightening, and credit contraction. Risk premia rise in advanced economies by one-tenth of the increase in the average euro area, with emerging market risk premium rising by one-quarter. At the end of the 5-year period, GDP is about 3½ percent below baseline for Europe, 1¼ percent for the world, and 0.4 percent in Canada, mainly because of the indirect trade channel, as the smaller contribution from net exports accounts for two-thirds of the decline.

### Outward Spillovers

**7. Outward spillovers to the Caribbean could be substantial given Canadian banks' dominant presence in the region.** A network analysis (Ohnsorge, 2013) based on the BIS banking statistics, indicates that while Canada's banking system has significant cross-border linkages to eight partner countries, it is unlikely to generate broad outward spillovers given that most of these countries are not strongly interconnected among themselves (Chart). But Canadian banks are a potential source of significant spillovers for a number of Caribbean countries, where they have a dominant market position (Chart). For example, Canadian



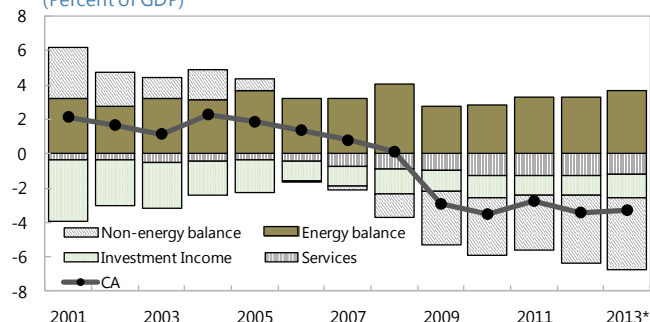
banks account for about 60 percent of the ECCU's banking system assets. Changes in Canada's economic conditions can also affect Caribbean islands through tourism, as Canada is the second most important source country of tourism flows to the region, after the United States.

## Annex II. External Stability Assessment

### 1. Canada's current account deficit has remained broadly stable in 2013.

After posting surpluses in the 2000s (averaging about 1¾ percent of GDP), Canada's current account balance fell to -3 percent of GDP in 2009 and has remained close to that level since then (Chart). The deterioration is almost entirely accounted for by the non-energy trade balance, which has gyrated from a surplus of about 2½ percent of GDP in 2000 to a deficit of about 3 percent in the third quarter of 2013. As also noted in the staff report, the Great Recession only exacerbated the long-term decline in Canada's merchandise trade balance, with energy trade surplus only partly offsetting the deterioration in the non-energy trade balance since early 2000s (Chart). While exports of crude oil have grown at a fast and increasing pace in volume terms over the last decade, infrastructure constraints (e.g., limited pipeline and refinery capacity) have limited the potential contribution to the trade balance, mainly as the excess supply has translated into lower prices for Canada's heavy oil. As a result, the spread between the price of the Western Canadian Select (WCS), Canada's main heavy crude oil blend for exports, and the price of the West Texas Intermediate (WTI) more than doubled in the last 5 years. Market access limitations have cost Canada an estimated ½ percent of GDP or about 2 percent of exports revenues per year.

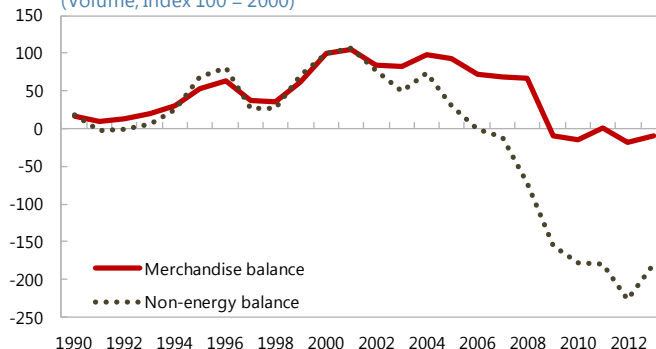
Canada: Current Account Balance  
(Percent of GDP)



Sources: Haver Analytics; and IMF staff estimates.

Note: Figures for 2013 are averages of actual for 2013:Q1-Q3 and projected

Canada: Merchandise and Non-energy Trade Balance  
(Volume, Index 100 = 2000)

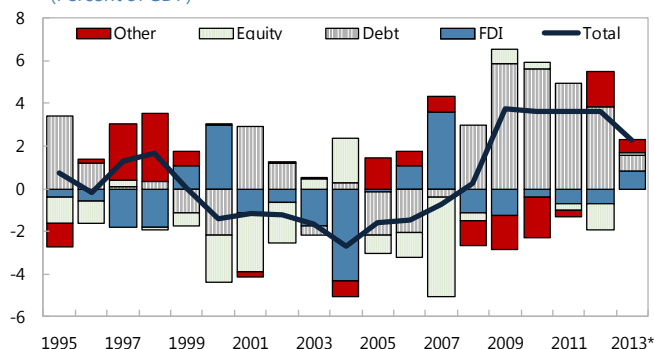


Sources: Haver Analytics; and IMF staff estimates.

### 2. Canada's current account deficits continued to be largely financed by foreign purchases of Canadian debt securities.

Over 2009–13, average annual net portfolio inflows (debt and equity) amounted to 4 percent of GDP, against net outflows of 2 percent of GDP in 2000–07 (Chart). Net FDI and other investment inflows have remained mostly negative since 2008. Recent portfolio inflows have been concentrated in debt securities, which

Canada: Net Capital Inflows  
(Percent of GDP)



Sources: Haver Analytics; and IMF staff calculations.



enjoyed strong global demand mainly owing to Canada's relatively healthy corporate and government balance sheet positions. As the U.S. tapering talk picked up steam in 2013, inflows into the Canadian debt markets have moderated, both on a gross and net basis. Canada's net external liabilities stood at about 3½ percent of GDP as of end-September 2013, mainly reflecting an increase in the net equity position, while the net debt position has changed little since end-2012. Canada's gross external debt of 77 percent of GDP as of end-2012 is relatively low compared to other advanced economies and is a modest vulnerability.

**3. Staff estimates suggest that the current account is weaker, and the real exchange rate is stronger than implied by medium-term fundamentals.** Results from the IMF's External Balance Assessment (EBA), based on data available as of November 2013, indicate that Canada's medium-term current account (CA) should be between -1 and 0 percent of GDP, while the real effective exchange rate (REER) should be between 5 and 15 percent below the average level over the period between January and October 2013. In particular:<sup>1</sup>

- EBA regression-based estimates suggest that the CA "norm"—the current account consistent with medium-term economic fundamentals and appropriate domestic and foreign policies—is a *surplus* of 0.2 percent of GDP. Importantly, most of the difference between the current (cyclically-adjusted) CA balance and the CA norm derives from the fact that the EBA CA regression can only partially replicate the actual dynamics of Canada's CA. Only a very small portion of the gap is explained by differences in policies in Canada and other countries from "appropriate" levels.
- The EBA external stability approach finds that a current account *deficit* of 0.9 percent of GDP would be enough to stabilize the ratio of Canada's net foreign asset to GDP over the medium term.
- Based on staff's estimated relationship between the current account and the real effective exchange rate (REER) for Canada, the two EBA estimates above suggest that Canada's REER should fall between 5 and 15 percent. EBA regressions-based estimates suggest that the size of the REER overvaluation is about 10 percent.

**4. A few factors can explain the CA gap for Canada.** First, the EBA may overestimate the CA norm for Canada as the adjustment for the business cycle is done using Canada's output gap relative to the world (GDP-weighted average) output gap, while a more relevant measure for Canada is the gap relative to the United States. As the latter is currently larger, the regression may be underestimating Canada's CA improvement as the U.S. output returns to potential. Second, the oil trade balance and the terms of trade variables are both likely to be biased upward for Canada, as the EBA uses the WEO global oil prices rather than the lower market price for Canadian oil. To the extent the difference is due to infrastructure bottlenecks, adding transportation capacity over the medium term should help closing the CA gap. Finally, while the CA regression captures safe-haven

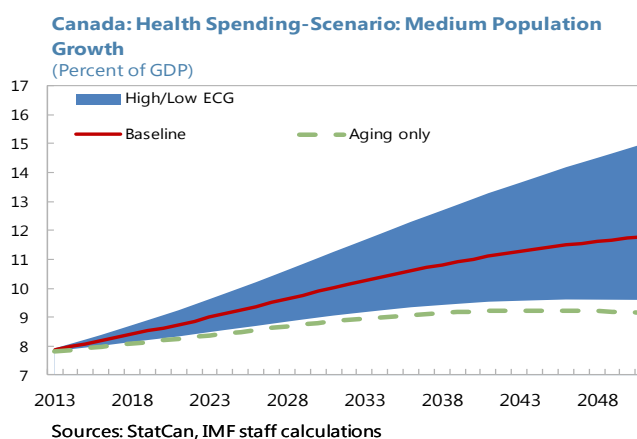
<sup>1</sup> See the 2013 External Sector Report for a discussion of EBA methodologies.

capital inflows using the country's currency share in the total stock of world reserves, a large part of recent purchases of Canadian assets have come from the United States, and thus implied a relatively small change in the Canadian dollar share in world reserves. To the extent that recent capital inflows to Canada were a temporary reflection of a high interest rate differential with the United States, a reduction of capital inflows over the next few years should also help close the CA gap, by lowering upward pressures on the Canadian exchange rate.

## Annex III. Long-Term Fiscal Sustainability

**1. This Annex presents an update of staff assessment of the long-term sustainability of Canada's public finances at the general government level.**<sup>1</sup> Projections over the medium term (2013–18) are based on macroeconomic and fiscal projections contained in Tables 3 and 4, respectively. Projections for 2019–50 are derived as follows:

- **Revenues** are expected to remain constant as a share of GDP, that is, to grow at the same pace as nominal potential GDP (about 4 percent annually).
- **Federal transfers to provinces** follow the current growth rate set up by the federal government, i.e. Canadian Health Transfers and Equalization Transfers grow at the 3-year moving average of nominal GDP growth; the Canada Social Transfer at a 3 percent annual nominal growth; and other transfers at nominal GDP growth. Overall, transfers from the federal to provincial governments are projected to slightly moderate as a share of GDP, from 4.2 percent of GDP in 2012 to about 4 percent by 2030.
- **Health care spending** projections are based on staff's calculations and IMF (2013).<sup>2</sup> These projections are obtained assuming that the current structure of health care spending per age group is constant over the forecasting horizon (CIHI, 2011). Each age group is then assumed to grow based on the "medium-growth" scenario provided by Statistics Canada. In this scenario, Canada's elderly population will increase rapidly over the next 20 years, with the old-age dependency ratio projected to increase from 20 percent in 2010 to around 40 percent by 2050. Finally, health spending per each age group is assumed to grow in real terms at an annual rate that is 0.65 percentage points in excess of productivity growth (1.1 percent), in line with the average health care Excess Cost Growth (ECG) over the last three decades (1980–2012). Based on these assumptions, health spending is projected to grow from 7.5 percent of GDP in 2012 to almost 12 percent by 2050, with population aging and ECG expected to contribute equally to the increase until 2030, while ECG is the main driver of growth thereafter. However, this scenario fails to take into account the significant slowdown of health care spending over the last few years discussed in Box 2. On



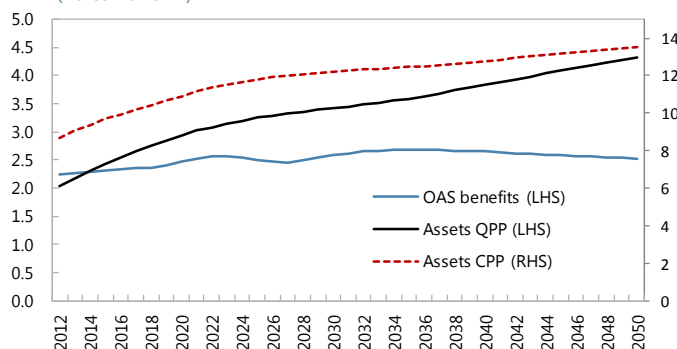
<sup>1</sup> General government includes the federal, provincial, territorial, and local governments, the Canada Pension Plan (CPP) and the Québec Pension Plan (QPP).

<sup>2</sup> IMF Fiscal Monitor October 2013, Appendix I.

average over the last 5 years (and excluding the year of the recession, 2009) health care ECG has been 0.12 percentage points, reflecting a combination of budgetary restrictions and efficiency gains. If the same ECG was maintained over the whole forecasting period, health care spending would grow to 9.5 percent of GDP by 2050. By contrast, an acceleration of the ECG to the high levels recorded in the 2000s before the recession (the high growth scenario with ECG at 1.27 percentage points) would bring health care spending to 15 percent of GDP in 2050.

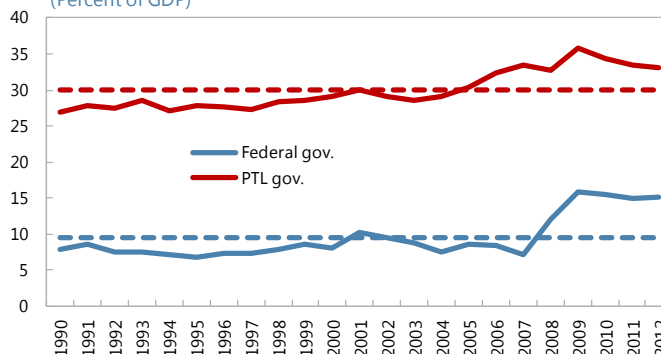
- Pension expenditures** are based on the latest actuarial reports of the Offices of the Chief Actuary for the CPP (2013) and QPP (2011). For the CPP, they show that the legislated contribution rate of 9.9 percent is sufficient to fund future outlays, while for the QPP contribution rates would need to increase 1.12 percentage points to ensure long-term funding. In our projections we assume the increase is implemented, and so both CPP and QPP balances are kept constant over the projection horizon. Elderly benefits are projected based on the assumption that benefit payments are indexed to inflation only and reflecting the legislated increase in age eligibility. Spending on Old-Age Security benefits is expected to increase from 2¼ percent of GDP in 2013 to 2.7 percent of GDP by 2030, and to stabilize around 2.5 percent by 2050, owing to the increase in old-age dependency ratio.
- Spending on education** is projected to decrease slightly, in line with population projections, from 5.4 percent of GDP in 2012 to 5.2 percent by 2030.
- Other spending programs** are assumed to remain constant as a share of GDP over the forecasting horizon.

**Canada: Pensions Projections**  
(Percent of GDP)



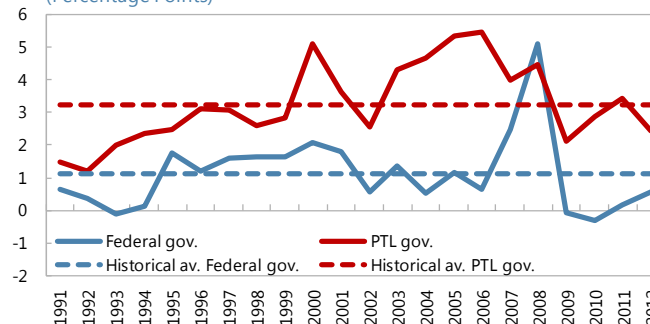
Sources: OSFI, QPP, Haver, IMF staff calculations

**Canada: Government's Financial Assets**  
(Percent of GDP)



Sources: StatCan NBS, IMF staff calculations

**Canada: Governments Effective Return on Financial Assets and Debt Costs Differentials**  
(Percentage Points)



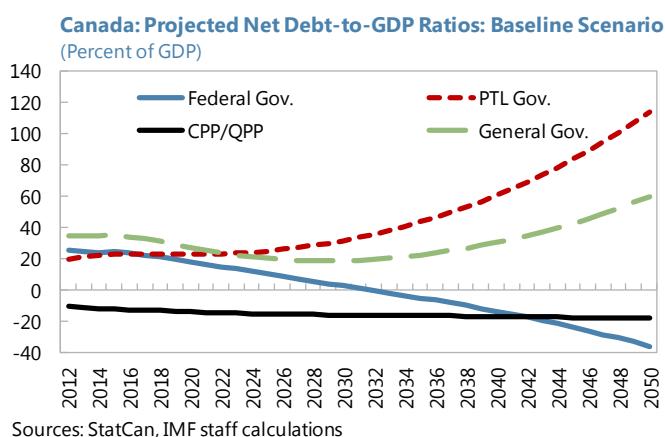
Sources: StatCan NBS, IMF staff calculations

- **Financial assets** are set to gradually return to their long-term trends after 2018 (about 30 percent of GDP for provincial, territorial, and local governments, and 10 percent for the federal government). We also assume the effective return on financial assets and debt service costs to gradually return to historical averages (Chart).

**2. Based on these assumptions, the general government's net-debt-to GDP ratio will reach 60 percent of GDP by 2050, driven by a deterioration of the provincial fiscal position.** In our baseline scenario, the general government net debt-to-GDP ratio is expected to decline slightly from 2017 before starting to move upward by end-2020s. The overall fiscal position is the result of very different dynamics at the federal and provincial level:

- At the federal level, the net debt-to-GDP ratio is expected to trend downward by end-2013 and turn into a net asset position from mid-2030s.

- At the provincial level, the increase in health care expenditure causes a deterioration of the primary fiscal balance from the mid-2020s. The net debt-to-GDP ratio is expected to reach 30 percent by 2030 and 115 percent by 2050, from about 20 percent currently.



**3. Even if provinces were able to contain health care ECG going forward, their debt position would still remain unsustainable.** In a scenario in which ECG is kept at 0.12 percentage points for the whole forecasting period, provinces' net debt would still increase rapidly as a share of GDP, reaching about 65 percent by 2050.

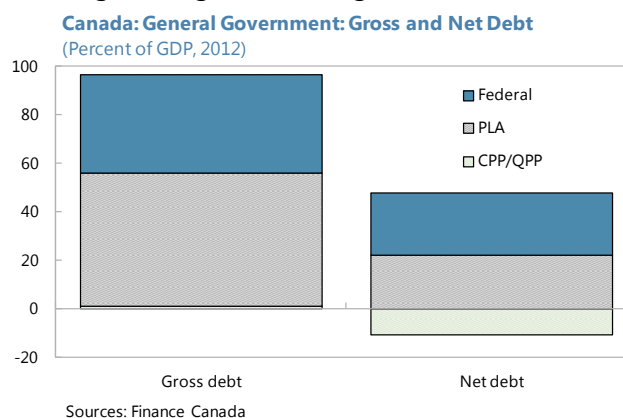
**4. Further efforts would thus be needed to put the provincial debt-to-GDP ratio on a sustainable path.** Staff estimates that if provinces were able to reach a primary balance of 0.5 percent of GDP by 2020 and keep it thereafter, their net debt-to-GDP ratio would return to current levels by 2030. This is consistent with overall annual spending growing at 3½ percent on average over the 2014–2020 period, and at potential GDP afterwards, compared to 4 percent and 4¾ percent respectively, in the baseline scenario.

## Annex IV. Public Debt Sustainability Analysis<sup>1</sup>

Canada's general government gross debt is expected to peak at 89 percent of GDP in 2013 and to decline thereafter under staff's baseline scenario. Government financial assets are sizeable in Canada and represent about 50 percent of GDP, which put the net debt-to-GDP ratio close to 40 percent as of 2013. Gross financing needs are relatively large, but are expected to be below 20 percent of GDP by 2015. The general government debt position is relatively resilient to a series of macro and fiscal shocks in the medium term.

### Stress Tests

- Baseline scenario.** In staff baseline scenario, the general government gross debt-to-GDP ratio will peak at 89 percent in 2013, before declining to 85 percent in 2018. Canada's effective interest rate is expected to reach a historical low at 4 percent in 2013 and then rise towards its historical average of 6 percent by 2018. Net debt stands currently at 38½ percent of GDP and is expected to reach 40 percent by 2015 before declining thereafter.
- Primary balance shock.** A scenario involving a deterioration of the structural primary balance of about 1 percent of GDP over the next two years has the gross debt-to-GDP ratio rising to 89½ percent by 2015 and gradually returning to baseline by 2018. The risk premium on sovereigns is assumed to increase by 25 bps for each 1 percent of GDP slippage, with little effects on the debt path.
- Growth shock.** A lower real output growth by 1 standard deviation for 2 years starting in 2014 would have a significant impact on the level of gross debt, which will reach 93 percent of GDP in 2015. The deterioration in the primary balance would be minor given current consolidation plans, and the debt-to-GDP ratio would remain on a downward path over the projection period.
- Interest rate shock.** An increase in sovereign risk premia by 200 bps for two years would raise the government's interest bill by about 0.5 percent by 2015 (about 96 percent of outstanding marketable debt is in fixed coupon bonds). Higher borrowing costs would slow the decrease in the debt-to-GDP ratio, which ends up 2 percentage points higher than in the baseline in 2018, at around 85 percent.
- Exchange rate shock.** If the exchange rate depreciates by about 15 percent (the upper limit of its estimated overvaluation range, see Annex II) the fiscal impact is minimal—almost 90 percent



<sup>1</sup> The new framework for public debt sustainability analysis for market-access countries is described in <http://www.imf.org/external/np/pp/eng/2013/050913.pdf>.

of Canada's outstanding marketable debt instruments are in Canadian dollar, and both federal and sub-national governments usually hedge their FX exposures.

- **Combined macro-fiscal shock.** In a scenario with all the above shocks combined, the gross debt-to-GDP ratio rises to about 95 percent of GDP by 2015 but is back on a downward—though slower—trend by the end of the forecasting horizon. Gross financing needs fall below the 20 percent benchmark by 2017 only, but are down to 17 percent of GDP in 2018.
- **Commodity price shock.** Lower than expected commodity prices, by 7 percent on average over the forecasting horizon would increase the gross debt to 95 percent of GDP in 2015.<sup>2</sup> The ratio would then stabilize at this level over the forecast horizon.

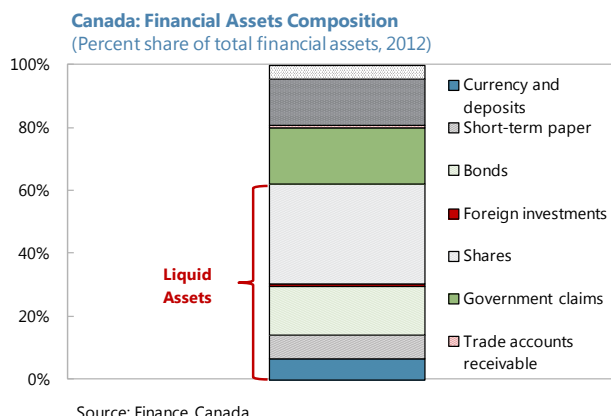
**The sizable general government liquid financial assets represent a mitigating factor for**

**Canada's high gross debt and financing needs.** In all the above scenarios, Canada's gross debt rises above 85 percent of GDP and the gross financing needs go above 25 percent of GDP in at least one of the following years (see the heat map below). However, general

government's financial assets represent more than 50 percent of GDP, half of which is liquid and highly-liquid assets (deposits, short-term papers, and bonds, Chart).

About  $\frac{2}{3}$  of these liquid assets is held by provinces and municipalities, while federal government's assets consist largely of equity and loans to federal commercial Crown corporations. These assets are expected to decline significantly over the

next two years as the large loan (about 3 percent of GDP) from the federal government to the federal government-owned Canada Mortgage and Housing Corporation under the Insured Mortgage Purchasing Program will be fully repaid.



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

<sup>2</sup> This scenario is based and benchmarked on the 2012 Federal budget revisions.



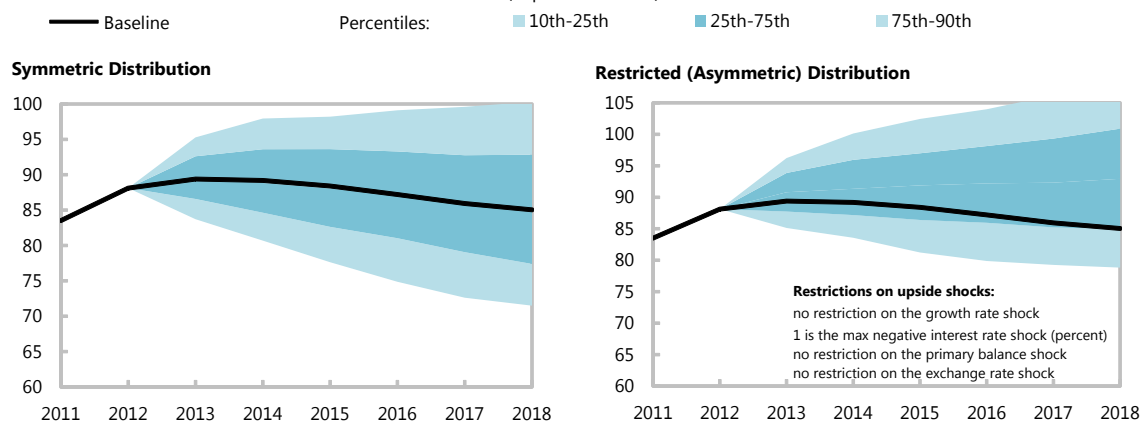
## Canada Public DSA Risk Assessment

## Heat Map

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

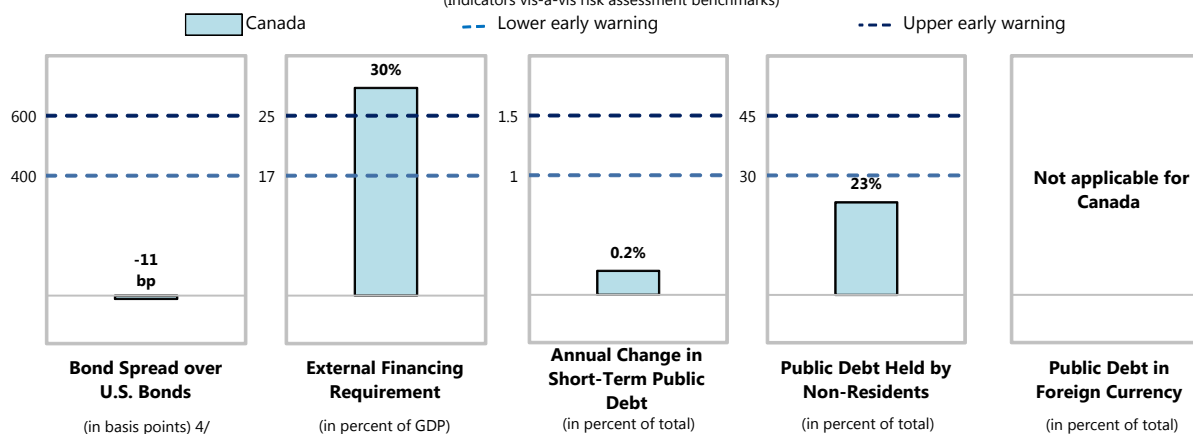
## Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



## Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

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

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

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

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

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

Lower and upper risk-assessment benchmarks are:

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

4/ An average over the last 3 months, 14-Sep-13 through 13-Dec-13.

## Canada Public DSA - Realism of Baseline Assumptions

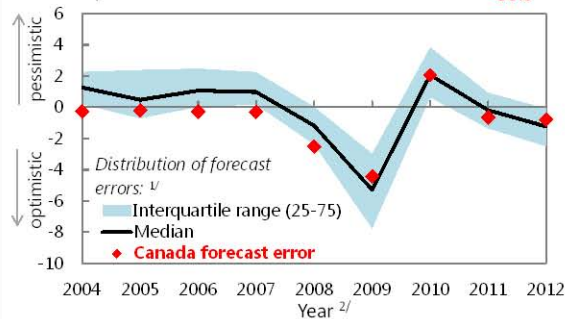
### Forecast Track Record, versus surveillance countries

#### Real GDP Growth

(in percent, actual-projection)

Canada median forecast error, 2004-2012:  
Has a percentile rank of:

**-0.29**  
**30%**

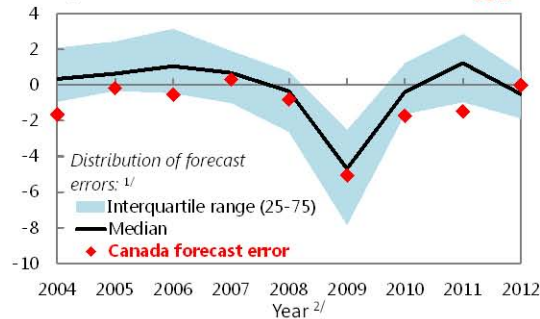


#### Primary Balance

(in percent of GDP, actual-projection)

Canada median forecast error, 2004-2012:  
Has a percentile rank of:

**-0.80**  
**31%**

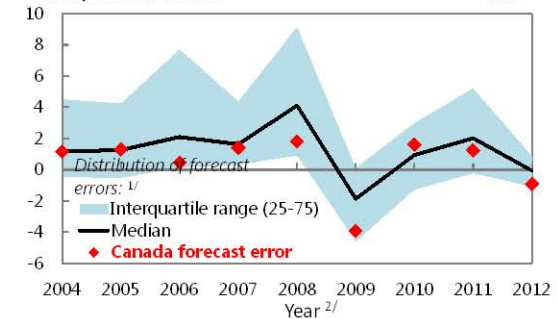


#### Inflation (Deflator)

(in percent, actual-projection)

Canada median forecast error, 2004-2012:  
Has a percentile rank of:

**1.25**  
**48%**

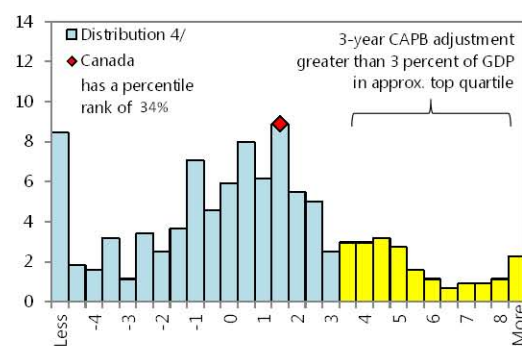


### Assessing the Realism of Projected Fiscal Adjustment

#### 3-Year Adjustment in Cyclically-Adjusted

#### Primary Balance (CAPB)

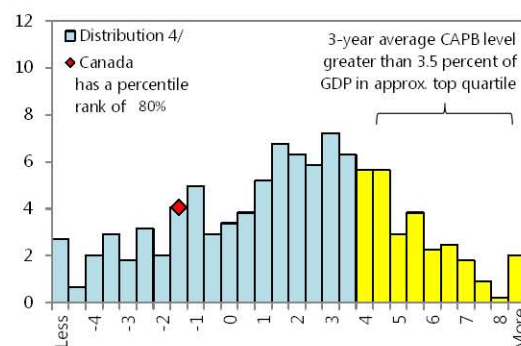
(Percent of GDP)



#### 3-Year Average Level of Cyclically-Adjusted Primary

#### Balance (CAPB)

(Percent of GDP)

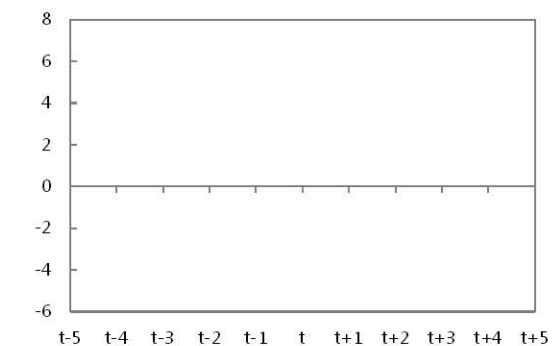


### Boom-Bust Analysis 3/

#### Real GDP growth

(in percent)

Canada



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Canada.

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

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

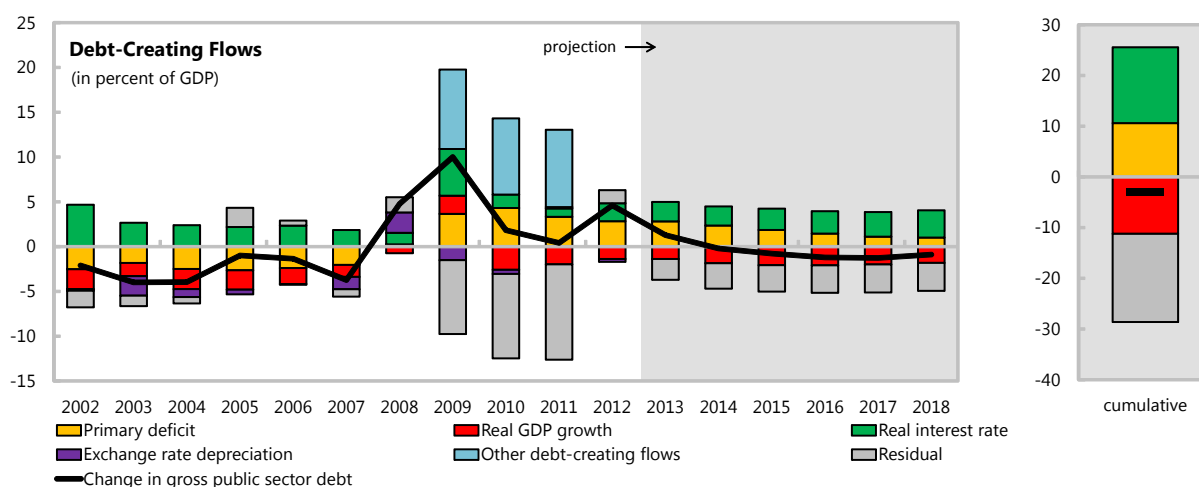
(in percent of GDP unless otherwise indicated)

### Debt, Economic and Market Indicators <sup>1/</sup>

	Actual			Projections						As of December 13, 2013		
	2002-2010 <sup>2/</sup>	2011	2012	2013	2014	2015	2016	2017	2018			
Nominal gross public debt	74.9	83.5	88.1	89.4	89.2	88.4	87.2	85.9	85.0	Sovereign Spreads		
Public gross financing needs	n.a.	22.9	23.3	21.2	20.8	19.5	17.2	15.6	14.8	Spread (bp) <sup>3/</sup>		
Net public debt		53.3	57.7	59.2	61.0	61.3	60.8	60.3	60.1	CDS (bp)		
Real GDP growth (in percent)	1.9	2.5	1.7	1.6	2.2	2.4	2.5	2.4	2.2	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.4	3.2	1.7	1.3	1.7	1.8	2.0	2.1	2.1	Moody's	Aaa	Aaa
Nominal GDP growth (in percent)	4.4	5.8	3.4	2.9	3.9	4.3	4.5	4.6	4.3	S&P's	AAA	AAA
Effective interest rate (in percent) <sup>4/</sup>	6.1	4.5	4.2	3.9	4.2	4.7	5.0	5.5	5.8	Fitch	AAA	AAA

### Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2002-2010	2011	2012	2013	2014	2015	2016	2017	2018		
Change in gross public sector debt	0.1	0.41	4.59	1.3	-0.2	-0.8	-1.2	-1.3	-0.9	-3.1	
Identified debt-creating flows	2.0	11.05	3.14	3.6	2.6	2.2	1.9	1.9	2.2	14.3	
Primary deficit	-0.6	3.3	2.8	2.8	2.4	1.9	1.5	1.1	1.0	10.6	
Primary (noninterest) revenue and grants	36.4	34.9	34.9	34.8	35.0	35.2	35.3	35.4	35.3	211.0	
Primary (noninterest) expenditure	35.8	38.3	37.8	37.6	37.3	37.0	36.8	36.5	36.4	221.6	
Automatic debt dynamics <sup>5/</sup>	0.7	-0.9	0.3	0.8	0.3	0.3	0.4	0.8	1.2	3.7	
Interest rate/growth differential <sup>6/</sup>	1.3	-1.1	0.6	0.8	0.3	0.3	0.4	0.8	1.2	3.7	
Of which: real interest rate	2.7	0.9	2.0	2.2	2.1	2.4	2.5	2.7	3.0	15.0	
Of which: real GDP growth	-1.4	-2.0	-1.4	-1.4	-1.9	-2.1	-2.1	-2.0	-1.8	-11.2	
Exchange rate depreciation <sup>7/</sup>	-0.5	0.1	-0.3	...	...	...	...	...	...	...	
Other identified debt-creating flows	1.9	8.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes <sup>8/</sup>	-2.0	-10.6	1.5	-2.3	-2.8	-2.9	-3.1	-3.1	-3.1	-17.4	



Source: IMF staff.

<sup>1/</sup> Public sector is defined as general government.

<sup>2/</sup> Based on available data.

<sup>3/</sup> Bond Spread over U.S. Bonds.

<sup>4/</sup> Defined as interest payments divided by debt stock at the end of previous year.

<sup>5/</sup> Derived as  $[(r - p(1+g) - g + ae(1+r))/(1+g+p+gp)]$  times previous period debt ratio, with  $r$  = interest rate;  $p$  = growth rate of GDP deflator;  $g$  = real GDP growth rate;

$a$  = share of foreign-currency denominated debt; and  $e$  = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

<sup>6/</sup> The real interest rate contribution is derived from the denominator in footnote 4 as  $r - p(1+g)$  and the real growth contribution as  $-g$ .

<sup>7/</sup> The exchange rate contribution is derived from the numerator in footnote 2/ as  $ae(1+r)$ .

<sup>8/</sup> Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

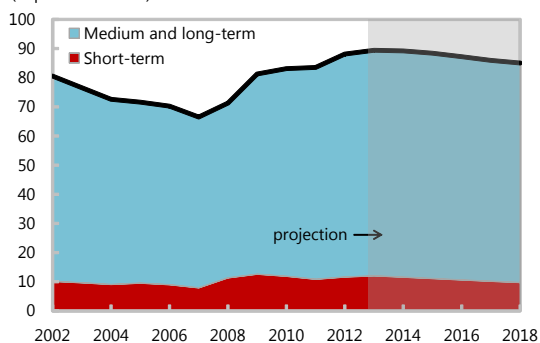
<sup>9/</sup> Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

## Canada Public DSA - Composition of Public Debt and Alternative Scenarios

### Composition of Public Debt

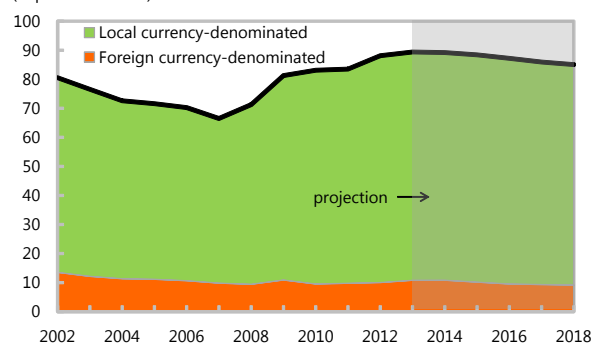
#### By Maturity

(in percent of GDP)



#### By Currency

(in percent of GDP)



### Alternative Scenarios

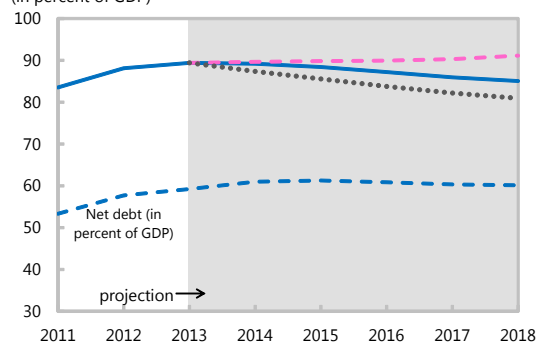
— Baseline

..... Historical

--- Constant Primary Balance

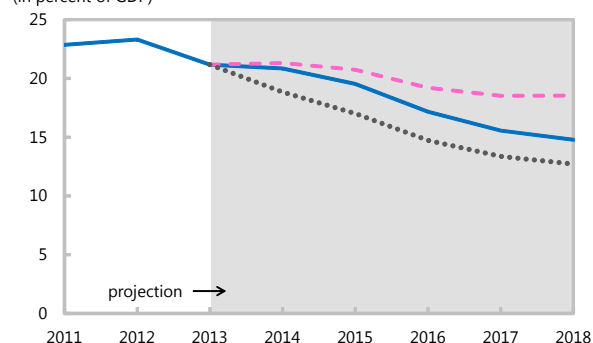
#### Gross Nominal Public Debt

(in percent of GDP)



#### Public Gross Financing Needs

(in percent of GDP)



### Underlying Assumptions

(in percent)

#### Baseline Scenario

	2013	2014	2015	2016	2017	2018
Real GDP growth	1.6	2.2	2.4	2.5	2.4	2.2
Inflation	1.3	1.7	1.8	2.0	2.1	2.1
Primary Balance	-2.8	-2.4	-1.9	-1.5	-1.1	-1.0
Effective interest rate	3.9	4.2	4.7	5.0	5.5	5.8

#### Constant Primary Balance Scenario

	2013	2014	2015	2016	2017	2018
Real GDP growth	1.6	2.2	2.4	2.5	2.4	2.2
Inflation	1.3	1.7	1.8	2.0	2.1	2.1
Primary Balance	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8
Effective interest rate	3.9	4.2	4.7	5.0	5.4	5.6

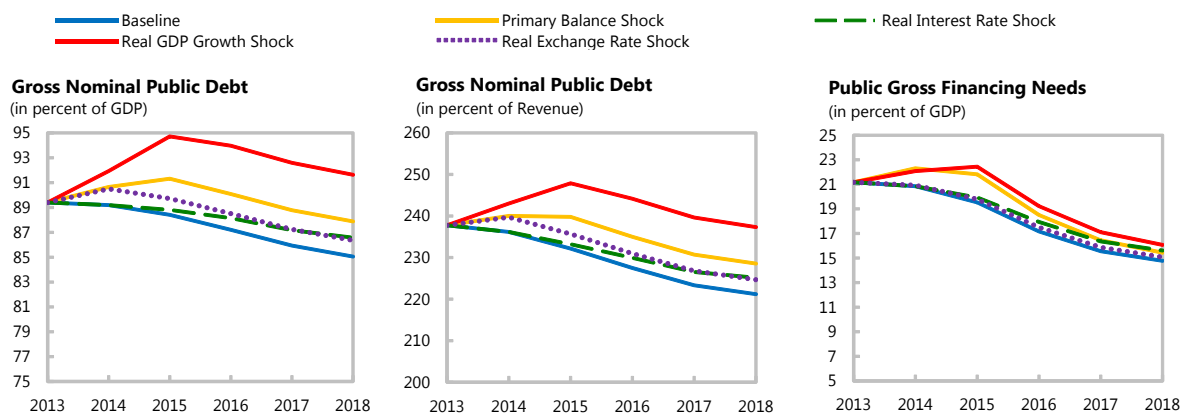
#### Historical Scenario

	2013	2014	2015	2016	2017	2018
Real GDP growth	1.6	1.9	1.9	1.9	1.9	1.9
Inflation	1.3	1.7	1.8	2.0	2.1	2.1
Primary Balance	-2.8	-0.3	-0.3	-0.3	-0.3	-0.3
Effective interest rate	3.9	4.2	4.8	5.2	5.7	6.1

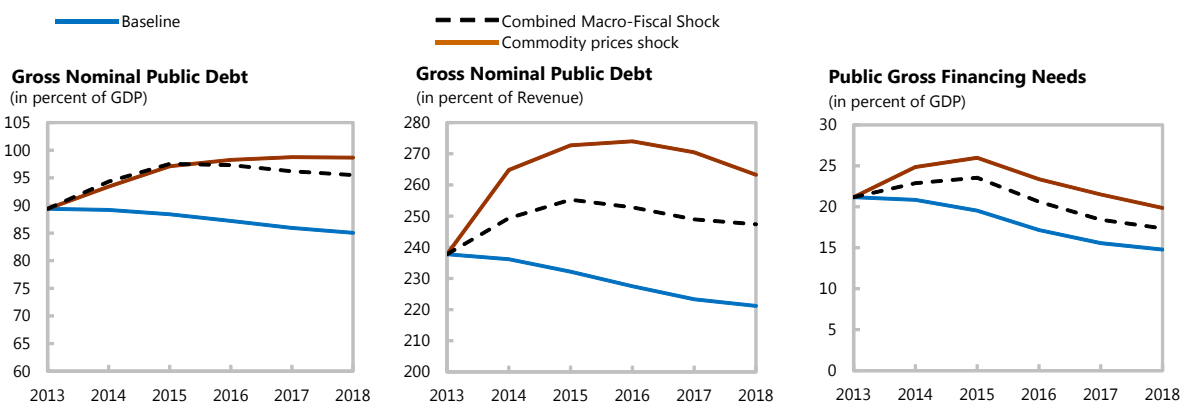
Source: IMF staff.

## Canada Public DSA - Stress Tests

## Macro-Fiscal Stress Tests



## Additional Stress Tests

Underlying Assumptions  
(in percent)

Primary Balance Shock							Real GDP Growth Shock						
	2013	2014	2015	2016	2017	2018		2013	2014	2015	2016	2017	2018
Real GDP growth	1.6	2.2	2.4	2.5	2.4	2.2	Real GDP growth	1.6	0.4	0.7	2.0	2.4	2.2
Inflation	1.3	1.7	1.8	2.0	2.1	2.1	Inflation	1.3	1.3	1.4	1.9	2.1	2.1
Primary balance	-2.8	-3.8	-3.3	-1.5	-1.1	-1.0	Primary balance	-2.8	-3.2	-3.5	-1.5	-1.1	-1.0
Effective interest rate	3.9	4.2	4.7	5.0	5.4	5.7	Effective interest rate	3.9	4.2	4.7	5.1	5.4	5.8
Real Interest Rate Shock							Real Exchange Rate Shock						
	2013	2014	2015	2016	2017	2018		2013	2014	2015	2016	2017	2018
Real GDP growth	1.6	2.2	2.4	2.5	2.4	2.2	Real GDP growth	1.6	2.2	2.4	2.5	2.4	2.2
Inflation	1.3	1.7	1.8	2.0	2.1	2.1	Inflation	1.3	2.2	1.8	2.0	2.1	2.1
Primary balance	-2.8	-2.4	-1.9	-1.5	-1.1	-1.0	Primary balance	-2.8	-2.4	-1.9	-1.5	-1.1	-1.0
Effective interest rate	3.9	4.2	5.1	5.6	5.8	6.1	Effective interest rate	3.9	4.3	4.7	5.0	5.4	5.8
Combined Shock							Commodity prices shock						
	2013	2014	2015	2016	2017	2018		2013	2014	2015	2016	2017	2018
Real GDP growth	1.6	0.4	0.7	2.0	2.4	2.2	Real GDP growth	1.6	1.9	1.9	2.4	2.4	2.2
Inflation	1.3	1.3	1.4	1.9	2.1	2.1	Inflation	1.3	1.7	1.8	2.0	2.1	2.1
Primary balance	-2.8	-3.8	-3.5	-1.5	-1.1	-1.0	Primary balance	-2.8	-6.3	-6.0	-4.0	-3.1	-2.0
Effective interest rate	3.9	4.3	5.1	5.6	5.7	6.0	Effective interest rate	3.9	4.2	4.5	4.8	5.1	5.4

Source: IMF staff.



# CANADA

## STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 15, 2014

Prepared By

The Western Hemisphere Department  
(in consultation with other departments)

### CONTENTS

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STATISTICAL ISSUES	<a href="#">6</a>

## FUND RELATIONS

(As of November 30, 2013)

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

<b>General Resources Account:</b>	<b>SDR Million</b>	<b>Percent of Quota</b>
Quota	6,369.20	100.00
Fund holdings of currency	4,319.45	67.82
Reserve Tranche Position	2,049.76	32.18
Lending to the Fund		
New Arrangements to Borrow	948.46	

<b>SDR Department:</b>	<b>SDR Million</b>	<b>Percent of Allocation</b>
Net cumulative allocation	5,988.08	100.00
Holdings	5,633.06	94.07

**Outstanding Purchases and Loans:** None.

**Latest Financial Arrangements:** None.

**Projected Obligations to Fund:**

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

	2013	2014	Forthcoming 2015	2016	2017
Principal					
Charges/Interest		0.39	0.39	0.39	0.39
Total		0.39	0.39	0.39	0.39

**Implementation of HIPC Initiative:** Not Applicable.

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

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

**Exchange Rate Arrangements:** The authorities maintain a "free floating" exchange rate regime. The exchange rate regime is free from exchange restrictions and multiple currency practices. The Canadian authorities do not maintain margins with respect to exchange transactions. However, the authorities may intervene to maintain orderly conditions in the exchange market. There are

no taxes or subsidies on purchases or sales of foreign exchange. Canada has accepted the obligations of Article VIII, Sections 2, 3, and 4 (a), and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions. Canada maintains exchange restrictions for security reasons, based on UN Security Council Resolutions, that have been notified to the Fund for approval (most recently in June 2013) under the procedures set forth in Executive Board Decision No. 144-(52/51).

**Last Article IV Consultation:** The Staff Report for the 2012 consultation with Canada was considered by the Executive Board on February 11, 2013 (IMF Country Report No. 13/40). Canada is on a 12-month consultation cycle.

The 2013 Article IV discussions were conducted in Toronto, Calgary, and Ottawa from November 12–26, 2013, by Roberto Cardarelli (head), Lusine Lusinyan, Julien Reynaud (all WHD), Ivo Krznar (MCM), and Minsuk Kim (SPR). Messrs. Alejandro Werner and Gian Maria Milesi-Ferretti (both WHD) and Simon Gray (MCM) joined the mission for the concluding meetings with Minister of Finance Flaherty and Bank of Canada Governor Poloz in Ottawa on November 26. Mr. Antoine Brunelle-Cote (Senior Advisor) attended the meetings, and Mr. Thomas Hockin (Executive Director) participated in some of the meetings. A press conference was held on November 27 in Toronto. Outreach activities included discussions with private sector and trade union representatives and think tanks.

### **FSSA Participation and ROSC Assessments**

***Canada–Financial System Stability Assessment–  
Volume II: Report on Observance of Standards in  
the Financial System***

[www.imf.org](http://www.imf.org)  
June 30, 2000

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

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



created association of securities regulators, the Canadian Securities Administrators. Although there remain multiple regulators at the provincial level, a Senate commission was created to develop specific recommendations on further harmonization and streamlining of securities regulation.

***Canada: Report on the Observance of Standards  
and Codes—Fiscal Transparency Module***

IMF Country Report  
No. 02/51, 03/12/02

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

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

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

***Canada: Report on the Observance of Standards  
and Codes—Data Module***

IMF Country Report  
No. 03/328, 10/23/03

**Summary:** Canada’s macroeconomic statistics are comprehensive, timely, and accurate and thus adequate to conduct effective surveillance of economic and financial policies. Official institutions responsible for the compilation and dissemination of the macroeconomic datasets are supported by adequate legal and institutional frameworks. These frameworks protect confidentiality and ensure that statistical work is conducted within a quality assurance program and with sufficient resources. Integrity is ensured by the professionalism of the staff, transparency in statistical policies and practices, and the provision of ethical guidelines for staff. Compilers generally follow internationally accepted guidelines in the production of the macroeconomic statistics, which is well-

supported by excellent efforts to develop source data that facilitate a high degree of accuracy and reliability. Statistics are generally relevant, well documented, available with good frequency on a timely basis, and readily accessible to users, who trust them as objective.

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

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

***Canada: Report on the Observance of Standards and Codes—FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism***

IMF Country Report  
No. 08/372, 12/11/08

**Summary:** Canada underwent a detailed FATF evaluation of its anti-money laundering and combating the financing of terrorism (AML/CFT) framework in 2007. Shortcomings were identified with respect to the scope of customer due diligence, AML/CFT supervision, and the Canadian financial intelligence unit. Since then, a number of steps have been taken to strengthen the framework in these three areas, resulting in significant improvements.

***Canada: Financial System Stability Assessment-Update***

IMF Country Report  
No. 08/59, 02/13/08

**Summary:** The FSSA update concluded that Canada's financial system is mature, sophisticated, and well-managed. Financial stability was underpinned by sound macroeconomic policies and strong prudential regulation and supervision, and well-designed deposit insurance and arrangements for crisis management and failure resolution. The banking system appeared sound, with stress tests showing that the major banks could withstand sizeable shocks, although they did face some challenges related to the global financial turmoil that started in mid-2007. Also, there were some concerns

about bank attempts to build on their secure domestic position, to enter highly competitive foreign markets or complex activities. The update reiterated the advantages of moving towards a single securities regulator, including the streamlining of policy development, reductions in compliance costs, and improved enforcement. However, it also recognized the significant improvements to the regulatory system from the creation of the Canadian Securities Administrators (CSA), and the implementation of the passport system.

**Canada: Financial System Stability Assessment-  
Update**

IMF Country Report  
No. 14/XX, 01/29/14

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

**Technical Assistance:** Not Applicable.

**Resident Representative:** Not Applicable.

## STATISTICAL ISSUES

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

**Real Sector.** Statistics Canada provides timely and adequate data in monthly, quarterly, and annual frequency thereby facilitating the analyses of economic developments and policy assessments within

a quantitative macroeconomic framework. In May 2001, Statistics Canada effected a smooth transition from Laspeyres methodology for estimating real expenditure-based GDP to Fisher index formulae, which enabled more accurate comparison between Canada and other G-7 countries. In October 2012, Statistics Canada started aligning the Canadian System of National Accounts (CSNA) with the SNA2008 international standard. The changes introduced in the CSNA2012 included, among others, capitalization of research and development, move to replacement cost-based valuation of consumption of fixed capital, and valuing equity more consistently at market price. Reflecting resource constraints and data availability, the SNA2008 is planned to be implemented in a staggered way. Additional changes are planned with the 2014 release of the CSNA, which however for the most part will not have a significant impact on GDP and represent the development of new accounts, improved integration between the CSNA and Government Finance Statistics, additional detail, and presentational changes that better align with international standards (see, [Statistics Canada](#)).

**Fiscal Sector.** Statistics Canada provides quarterly data (a Statement of Government Operations along with a Balance Sheet) on the general government and its subsectors following the *Government Finance Statistics Manual 2001 (GFSM 2001)* recommendations. In addition, the Department of Finance Canada provides monthly and annual data on the federal government's budget (according to the national presentation) and tax policies. The provided data enable adequate assessment of the impact of fiscal policy measures on Canada's economic performance.

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

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

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

## CANADA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of Publication <sup>6</sup>	Memo Items:	
						Data Quality – Methodological soundness <sup>7</sup>	Data Quality – Accuracy and reliability <sup>8</sup>
Exchange Rates	Same day	Same day	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	Dec 25, 2013	Jan 3, 2014	W	W	W		
Reserve/Base Money	Dec 25, 2013	Jan 3, 2014	W	W	W	LO, O, LO, LO	O, O, O, O, O
Broad Money	Dec 25, 2013	Jan 3, 2014	M	M	M		
Central Bank Balance Sheet	Dec 25, 2013	Jan 3, 2014	W	W	W		
Consolidated Balance Sheet of the Banking System	Nov 2013	Dec 23, 2013	M	M	M		
Interest Rates <sup>2</sup>	Same day	Same day	D	D	D		
Consumer Price Index	Nov 2013	Dec 20, 2013	M	M	M	O, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	2013 Q3	Dec 2013	Q	Q	Q	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	23/12/13	Oct 2013	M	M	M		
External Current Account Balance	2013 Q3	Nov 28, 2013	Q	Q	Q	O, O, LO, O	O, O, O, O, O
Exports and Imports of Goods and Services	Nov 2013	Jan 7, 2013	M	M	M		
GDP/GNP	2013 Q3	Nov 29, 2013	Q	Q	Q	O, O, O, LO	O, O, O, O, O
Gross External Debt	2013 Q3	Dec 11, 2013	Q	Q	Q		
International Investment Position <sup>5</sup>	2013 Q3	Dec 11, 2013	Q	Q	Q		

<sup>1</sup> Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

<sup>2</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Includes external gross financial asset and liability positions vis-à-vis nonresidents.

<sup>6</sup> Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

<sup>7</sup> Reflects the assessment provided in the data ROSC published on October 23, 2003 and based on the findings of the mission that took place during January 22-February 5, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), not observed (NO); and not available (NA).

<sup>8</sup> Same as footnote 8, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

## Statement by the IMF Staff Representative on Canada

January 29, 2014

1. **This note reports on information that has become available since the staff report (SM/14/19) was issued and does not alter the thrust of the staff appraisal.**
2. **Recent economic indicators suggest that economic activity is picking up somewhat.** Canadian manufacturing sales increased for the third month in a row in November 2013, at a faster pace than market expectations, with motor vehicle sales reaching the highest level (in nominal terms) since November 2007. The Bank of Canada's Winter Business Outlook Survey suggests that the export and investment outlook is gradually improving, although weak demand and domestic uncertainty continue to limit sales expectations and expansion plans. As a result, business investment is expected to focus on shorter-term projects and upgrading of existing capacity. For the labor market, the year ended on a weaker note, as unemployment rate increased to 7.2 percent in December, after holding steady at 6.9 percent in September–November. However, monthly labor statistics have been volatile, and job creation trended up on a quarterly basis in 2013:Q4. Staff continues to expect unemployment rate to average about 6.9 percent in 2014.
3. **Activity in the Canadian housing sector continued to moderate, in line with staff projections.** Home sales fell in December (-1.8 percent, m/m), the third consecutive monthly decline, and stood at close to 2012 levels on an annual basis. The number of newly listed homes fell 4.3 percent (m/m) in December, and year-end listings were somewhat below the 2012 figures. House prices rose 4.3 percent (y/y) in December, led by increases in Calgary and Greater Toronto area. Construction activity continued to moderate, with housing starts declining to around 188,000 units in 2013, down from 215,000 in 2012. The steady growth in the number of completed and unabsorbed units in 2013 (reaching 212,000 units, up from 190,000 units in 2012) suggest the excess supply of housing should put downward pressures on house prices in the coming years.
4. **On January 22, as widely expected, the Bank of Canada left the overnight rate unchanged at 1 percent, emphasizing the downside risks to inflation.** While lowering the projected path of inflation in 2014 (from 1½ percent forecasted in October to 1¼ percent), the Bank still expects total and core inflation measures to remain below the 2 percent target until 2015:Q4 (similar to staff's projections). Noting the improved growth in 2013:H2, the Bank revised up its 2013 growth forecast for Canada (to 1.8 percent from 1.6 percent in October forecast) but stressed the lack of signs of rebalancing towards exports and investment. Backed by a stronger outlook for the U.S. recovery, the Bank revised up its projection of Canada's growth in 2014 (to 2.5 percent from 2.3 percent), driven by a higher contribution from net exports. Markets appear to have interpreted the monetary policy statement as moderately more dovish, and the Canadian dollar and bond yields weakened in the wake of the release. Analysts continue to expect interest rates to remain on hold until 2015, with some expecting the tightening cycle to begin in as late as the second half of 2015.

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INTERNATIONAL MONETARY FUND



Press Release No. 14/39  
FOR IMMEDIATE RELEASE  
February 3, 2014

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

### **IMF Executive Board Concludes 2013 Article IV Consultation with Canada**

On January 29, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Canada.<sup>1</sup>

The Canadian economy strengthened in 2013 after a subdued performance in 2012, but the underlying growth has remained modest. The composition of growth does not yet point to the much needed rebalancing from household consumption and residential construction towards exports and business investment. In particular, despite the depreciating exchange rate, non-energy exports remained well below the levels reached after earlier recessions. These low export levels reflect not only the slower recovery in external demand but also increased challenges to competitiveness. Thanks to rising household wealth and still easy financial conditions, private consumption growth remained robust, but the household debt-to-income ratio reached a new historical high in the second half of 2013. The housing market has cooled, owing in part to macro-prudential measures adopted in the past, but house prices remain overvalued, although with important regional differences.

Economic growth is expected to accelerate to 2¼ percent in 2014, up from an estimated 1¾ percent in 2013. Canada's export growth should benefit from the projected pick-up in U.S. growth in 2014, boosting business investment. Over time, a higher contribution to growth from net exports and business investment is expected to more than offset the slowdown in private consumption and residential investment. There are, however, still significant downside risks to the outlook, from an overshooting of long-term interest rates following the Fed's exit from quantitative easing that would hinder the pick-up in economic activity in the United States, protracted weakness in the euro area growth, and lower-than-expected growth in emerging markets which could also lower commodity prices. Elevated household leverage and house prices, while a risk per se, could amplify the growth impact of adverse external shocks. The energy sector could be a source of both downside and upside risks, largely depending on progress in addressing infrastructure bottlenecks. A faster acceleration of the U.S. economy and

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<sup>1</sup> 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. An explanation of any qualifiers used in the summing up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.



further strength in Canada's housing market pose upside risks to our forecast, although the latter would imply more risks down the road.

Fiscal consolidation continued, with the general government overall deficit expected to improve by about  $\frac{1}{4}$  percentage points of GDP in 2013 to 3.1 percent of GDP. The federal government fiscal deficit declined at a faster-than-expected pace on the back of stronger spending restraint, and is expected to reach its balanced budget target in 2015. In contrast, a number of provinces delayed the return to a balanced budget, and the aggregate fiscal stance at the provincial level remained broadly unchanged in 2013.

As the output gap widened and inflation remained subdued, the Bank of Canada kept its policy rate at 1 percent, the same level since September 2010, and gave more emphasis to the risks associated with low inflation. Reacting to the perceived shift in Bank of Canada's policy stance, markets postponed the expected timing of the first increase in the policy rate.

Canada's banking sector remains well capitalized and has low levels of nonperforming loans. Stress tests suggest that major financial institutions (banks and insurance companies) would continue to be resilient to a severe stress scenario, although risks remain from the continuation of a low interest rate environment. The regulatory and supervisory framework is strong, and is complemented by a credible federal system of safety nets, although there is no single body with an explicit mandate to take a comprehensive view of systemic risks or to undertake crisis preparedness. Improving cooperation between federal and provincial authorities would further reinforce system wide oversight arrangements. Steps have been taken towards a more coordinated regulation of securities markets, and the progress on the international financial reform agenda continued.

### **Executive Board Assessment**

Executive Directors commended the authorities for their continued sound macroeconomic and financial sector management. Directors noted that, after a subdued performance in 2012, the Canadian economy strengthened in 2013, but the expected rebalancing from household consumption and residential construction towards exports and business investment has not materialized.

Directors welcomed the improved short-term growth outlook, but noted that the balance of risks remains tilted to the downside and important vulnerabilities, including elevated household leverage, remain. Directors agreed that policies should continue to sustain economic activity until the transition to more balanced growth gains firmer momentum, while assuring the continued gradual unwinding of domestic imbalances. Directors considered that raising productivity growth and broadening market access to Canada's energy resources are key to boost growth potential.

Directors viewed the current accommodative monetary policy stance as appropriate in light of low inflation, well-anchored inflation expectations, the negative output gap, and looming downside risks. The existence of domestic imbalances, however, reduces the room for lowering the policy rate despite the recent moderation in the housing sector and household borrowing. In

case of a renewed acceleration in housing imbalances, Directors saw additional macro-prudential measures as the first line of defense.

Directors stressed that fiscal policy should strike the right balance between supporting growth and rebuilding fiscal buffers. If significant downside risks to growth materialize, the federal government has room to slow its planned return to a balanced budget. Provinces with a weak fiscal position might need to consider additional measures to ensure their deficit reduction timetable is met.

Directors underscored the importance of addressing long-term fiscal sustainability challenges at the general government level. They welcomed recent steps taken at the provincial level to limit health care spending growth and stressed the need to maintain those savings into the future, including through efficiency gains. Directors agreed that publishing long-term fiscal sustainability analysis at both provincial and general government levels would help raise the public awareness of the challenges ahead and build consensus around the needed policies.

Directors concurred that there is scope for re-examining the role of government-backed mortgage insurance over the long term. While acknowledging the advantages of the current system, Directors welcomed the authorities' recent initiatives to impose limits on government-backed mortgage insurance and noted that further measures should be considered to encourage appropriate risk retention by the private sector and a more efficient allocation of resources.

Directors commended Canada's strong financial regulatory and supervisory framework. They supported recent steps towards a more coordinated regulation of provincial securities markets and continued progress on the international financial reform agenda. They also welcomed the strong results from the stress tests conducted for major Canadian financial institutions in the context of the 2013 update of the Financial Sector Assessment Program. Directors agreed that further strengthening Canada's financial system would require improving its macro-prudential oversight and system-wide crisis preparedness, fostering more cooperation between federal and provincial authorities, and strengthening prudential responsibilities of the federal financial sector regulator.

## Canada: Selected Economic Indicators

(Percentage change, unless otherwise indicated)

	2010	2011	2012	2013 Proj.	2014 Proj.
<b>National accounts in constant prices</b>					
Real GDP	3.4	2.5	1.7	1.7	2.2
Q4/Q4	3.6	2.4	1.0	2.2	2.3
Net exports 1/	-2.0	-0.4	-0.5	0.1	0.2
Final domestic demand	5.0	2.4	2.3	1.5	2.1
Private consumption	3.4	2.3	1.9	2.2	2.1
Public consumption	2.7	0.8	1.1	0.6	1.1
Private fixed domestic investment	11.6	7.0	5.1	0.8	2.9
Private investment 2/	18.6	19.1	19.9	19.7	19.8
Public investment	10.5	-7.0	0.5	1.0	1.8
Change in inventories 1/	0.2	0.5	0.0	0.0	0.0
Nominal GDP	6.1	5.8	3.4	3.2	4.1
<b>Employment and inflation</b>					
Unemployment rate 3/	8.0	7.5	7.3	7.0	6.9
CPI inflation	1.8	2.9	1.5	1.0	1.5
GDP deflator	2.6	3.2	1.7	1.5	1.9
<b>Exchange rate</b>					
U.S. dollar / Canadian dollar	0.97	1.01	1.00	0.97	n.a.
Percentage change	11.0	4.1	-1.0	-2.9	n.a.
Nominal effective exchange rate	9.8	2.0	0.9	n.a.	n.a.
Real effective exchange rate	9.3	1.4	0.0	n.a.	n.a.
<b>Indicators of fiscal policies</b>					
	(Percent of GDP)				
Federal fiscal balance	-2.4	-1.7	-1.0	-0.8	-0.4
Provincial fiscal balance	-3.2	-2.7	-3.1	-3.0	-2.8
General government fiscal balance 4/	-4.9	-3.7	-3.4	-3.1	-2.6
Three-month treasury bill 3/	0.6	0.9	1.0	1.0	1.1
Ten-year government bond yield 3/	3.2	2.8	1.9	2.3	3.0
<b>External indicators</b>					
Current account balance 2/	-3.5	-2.8	-3.4	-3.3	-3.2
Merchandise trade balance 2/	-0.6	0.0	-0.7	-0.5	-0.3
Export volume	8.4	5.0	2.1	1.5	3.9
Import volume	14.0	5.9	3.3	1.9	3.7
Terms of trade	5.0	3.4	-0.9	0.3	0.4
<b>Saving and investment</b>					
	(Percent of GDP)				
Gross national savings	19.8	21.1	21.2	21.1	21.3
General government	0.0	0.7	1.1	1.2	1.6
Private	19.8	20.3	20.2	19.9	19.7
Gross domestic investment	23.3	23.8	24.7	24.4	24.4

Sources: Haver Analytics; and IMF staff estimates.

1/ Contribution to growth.

2/ Percent of GDP.

3/ Percent.

4/ Includes the balances of the Canada Pension Plan and Quebec Pension Plan.