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INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with Canada

Approved by Christopher Towe and Anthony Boote

April 14, 2006

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

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

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

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

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

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

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EXECUTIVE SUMMARY

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

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

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

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

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

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

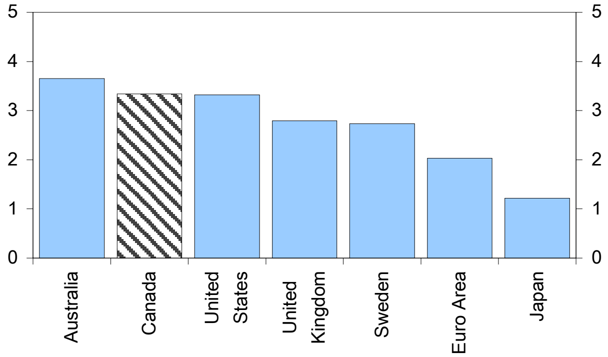
While the financial system appears well placed to support growth, there is still room to furthering its efficiency and resilience. Priorities include providing greater clarity on the regulatory framework governing *bank mergers*, establishing a *national securities regulator*, and better aligning incentives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

I. Introduction

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

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

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

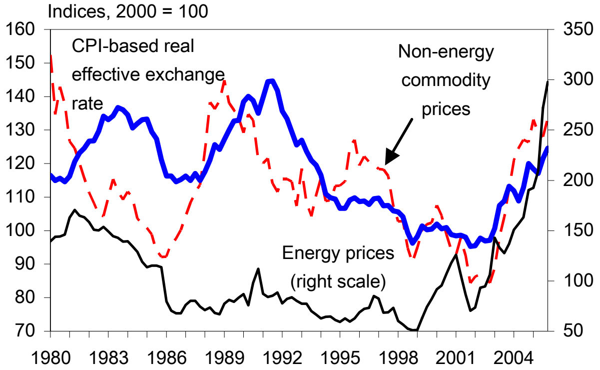


Source: World Economic Outlook.

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

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

Indices, 2000 = 100



Source: Haver Analytics; and IMF Information Notice System.

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

Box 1. Canada as an Energy Exporter[1]

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

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

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

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

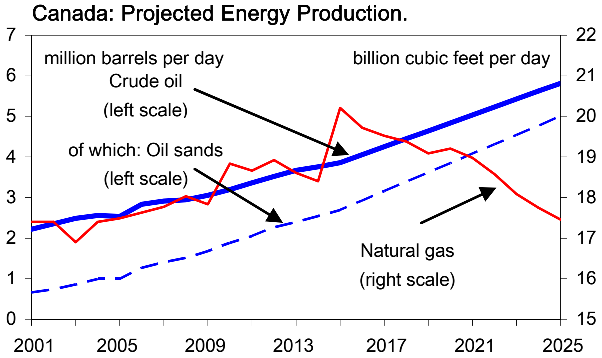
Rising oil production will affect the domestic economy in a number of important ways:

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

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

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

Canada: Projected Energy Production.



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

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

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

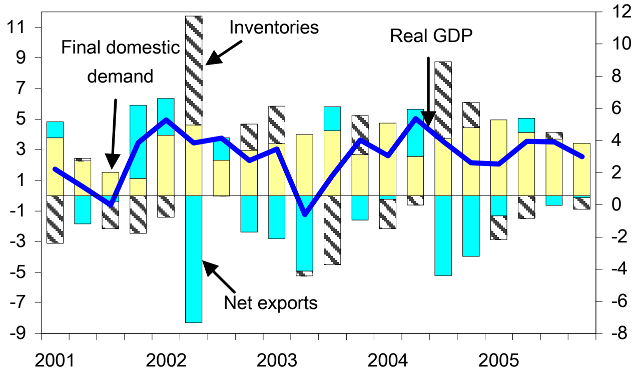
- Following a series of interest rate increases since the fall, the monetary stance has become less accommodative, and while further modest increases in the overnight rate will be required, the Bank of Canada will need to weigh carefully signs that slack has eroded against the drag from currency appreciation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

II. Recent Developments

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

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

Final domestic demand remains robust, while the drag from net exports has declined...
Contribution to growth, quarterly, saar



Source: Haver Analytics.

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

Box 2. Effectiveness and Role of Fund Surveillance

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

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

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

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

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

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

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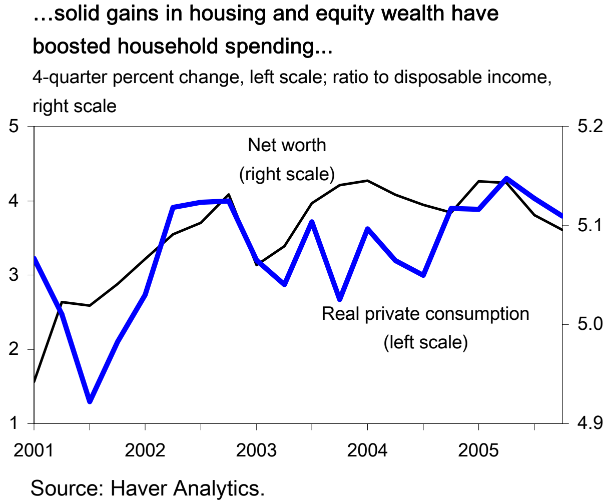
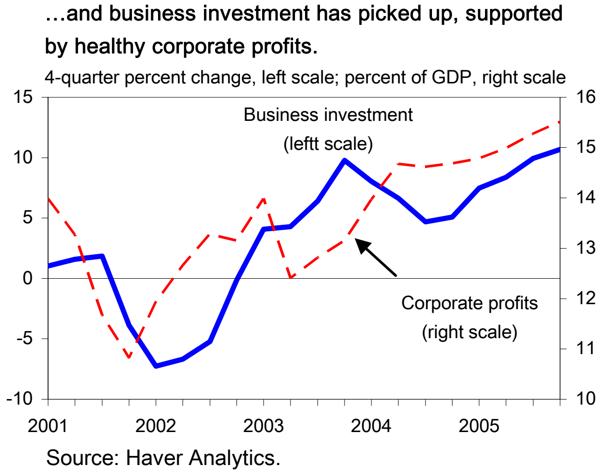
[1] Momani, B., 2005, "Assessing the Utility of and Measuring Learning from Canada's IMF Article IV Consultations," Department of Political Science and History, University of Waterloo.

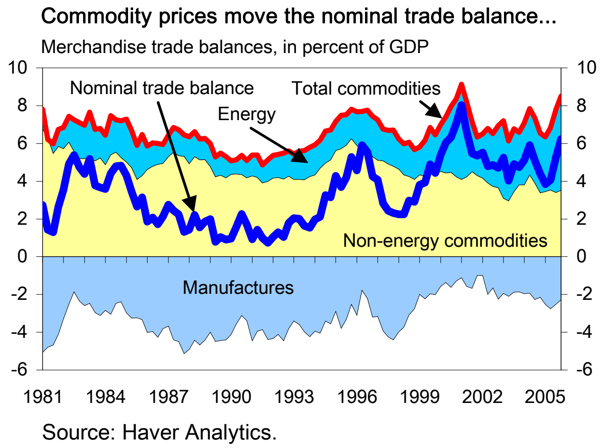
[2] See, for example, Dodge, D., 2006, "The Evolving International Monetary Order and the Need for Evolving IMF," Lecture to the Woodrow Wilson School of Public Affairs, Princeton University.

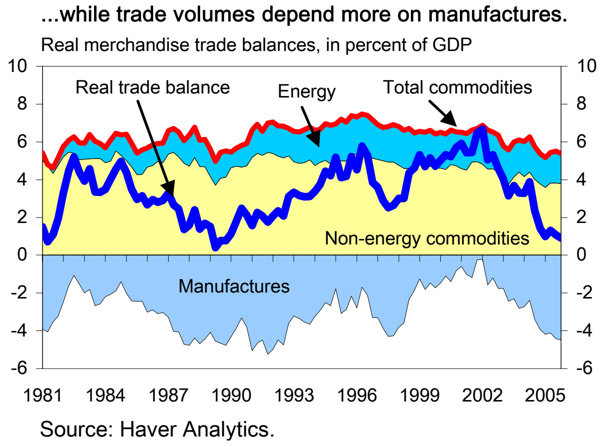




- *The growth of government consumption and investment was more moderate*, reflecting discipline in final spending at both the federal and provincial level.

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



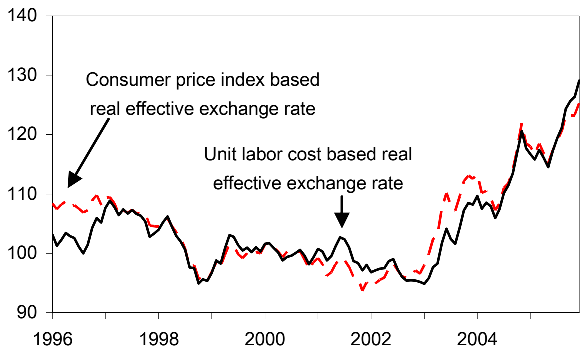


7. ***After a modest retreat in the early months of 2005, the Canadian dollar has resumed its appreciation***. The dollar has gained some 30 percent in real effective terms since early 2003 and has risen to highs not seen since the early 1990s, partly reflecting market responses to growing actual and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

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

The exchange rate has been appreciating...

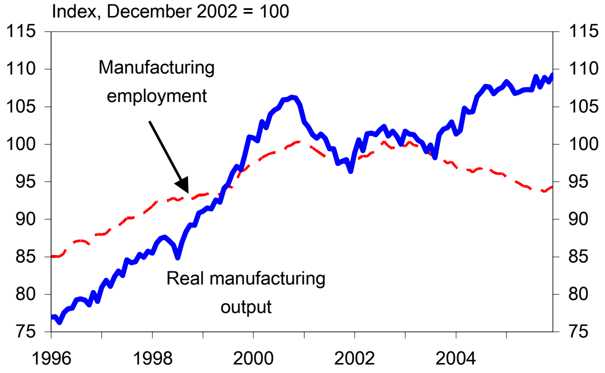
Indices 2000=100. An increase signifies appreciation.



Sources: IFS; and IMF Information Notice System.

...imposing adjustment on the manufacturing sector.

Index, December 2002 = 100

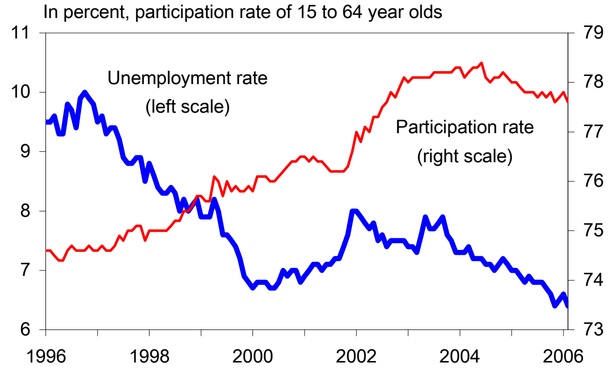


Source: Haver Analytics.

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

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

In percent, participation rate of 15 to 64 year olds



Source: Haver Analytics.

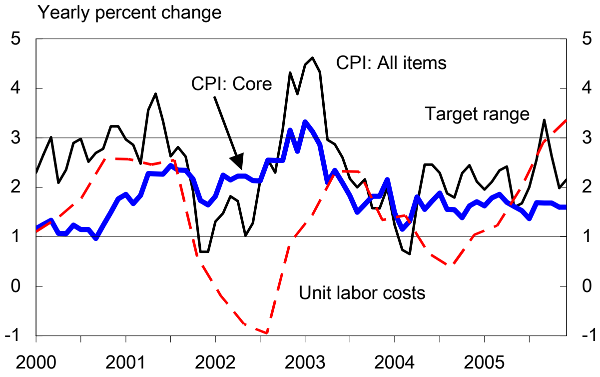
9. ***Nonetheless, inflation remains tame***.[3] As the upward pressure from higher energy prices has dissipated, headline inflation has fallen back to 2.2 percent, close to the center of the Bank of Canada's 1-3 percent target range, while the core measure has stayed below 2 percent since January

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

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

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

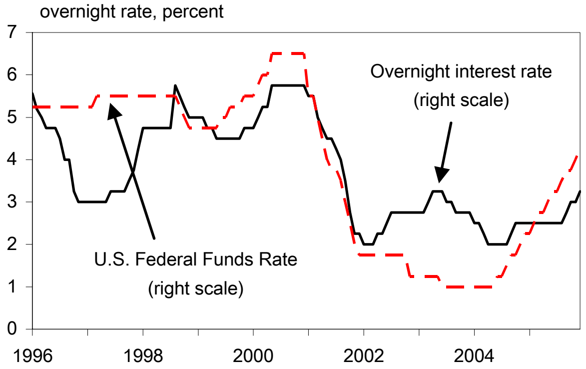
Although unit labor costs have risen recently, core inflation has been stable in the bottom half of the Bank of Canada's target range.



Source: Haver Analytics.

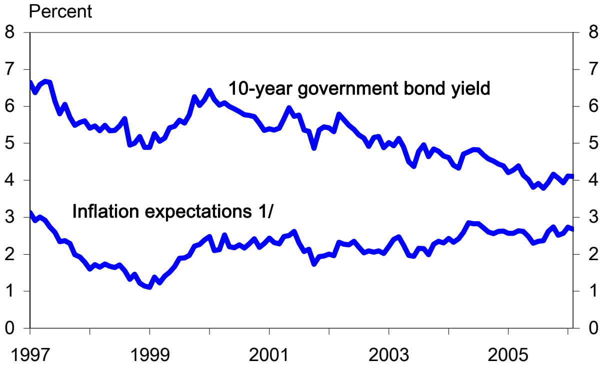
10. ***After pausing for almost a year, the Bank of Canada resumed withdrawing monetary stimulus in the fall of 2005***. Reflecting the assessment that the economy was operating near capacity, the Bank has raised its target for the overnight interest rate to 3¾ percent in five consecutive ¼ percentage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

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



Source: Haver Analytics.

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

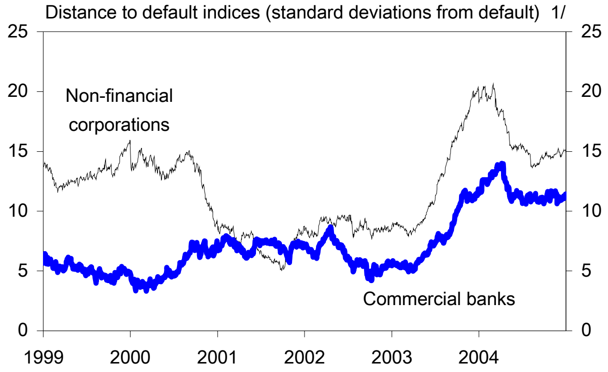


Sources: Bloomberg; and Haver Analytics.

1/ Inflation expectations use bonds maturing in 2021.

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

Bank and corporate finances remain healthy.



Source: IMF staff calculations.

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

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

III. Outlook and Risks

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

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

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

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

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

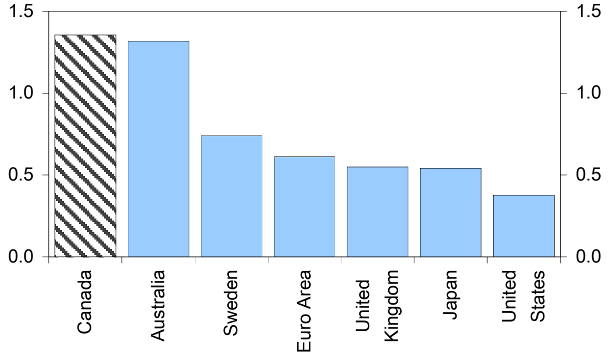
			Projections		2005				2006 (Projections)			
	2004	2005	2006	2007	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP	2.9	2.9	3.1	3.0	2.1	3.6	3.5	2.5	3.2	3.1	3.0	3.0
Net exports (contribution)	-0.9	-1.5	-0.3	0.2	-1.3	0.9	-0.7	-0.2	-0.6	-0.3	0.2	0.2
Total domestic demand	4.0	4.6	3.5	3.0	3.4	2.6	4.5	3.0	4.0	3.6	3.0	2.9
Final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

Sources: Haver Analytics; and Fund staff estimates.

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

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

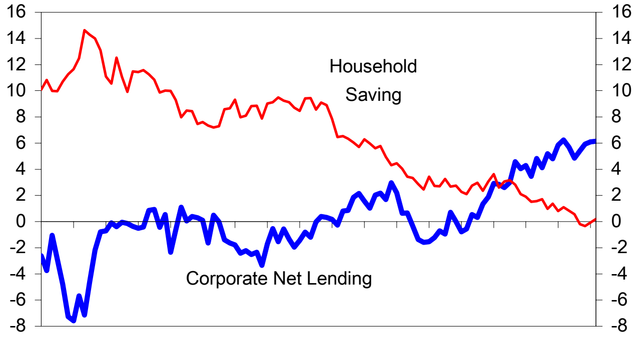
The volatility of Canada's real trade balance illustrates its vulnerability to external shocks.
Standard deviation of change in real trade balance as percent of potential GDP, 1996 - 2005



Source: World Economic Outlook.

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

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



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

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

IV. Monetary Policy and the Exchange Rate

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

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