CANADA

OFFICE OF THE PARLIAMENTARY BUDGET OFFICER
BUREAU DU DIRECTEUR PARLEMENTAIRE DU BUDGET

Economic and Fiscal Outlook

November 2015

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The mandate of the Parliamentary Budget Officer (PBO) is to provide independent analysis to Parliament on the state of the nation's finances, the Government's estimates and trends in the Canadian economy; and, upon request from a committee or parliamentarian, to estimate the financial cost of any proposal for matters over which Parliament has jurisdiction.

This report presents PBO's economic and fiscal outlook. The outlook does not include measures in the new government's platform. PBO will provide an updated outlook including measures proposed by the new government when further details on implementation are released during the new Parliament.

This report was prepared by the staff of the Parliamentary Budget Officer. Scott Cameron, Helen Lao, Chris Matier and Tim Scholz wrote the report. Jason Jacques, Duncan MacDonald, Mark Mahabir and Carleigh Malanik contributed to the analysis. Mostafa Askari provided comments. Patricia Brown and Jocelyne Scrim assisted with the preparation of the report for publication. Please contact pbo-dpb@parl.gc.ca for further information.

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Executive Summary

The economic and fiscal outlook has deteriorated since the Parliamentary Budget Officer's April 2015 report to the House of Commons Standing Committee on Finance.

Although the Canadian economy is expected to rebound from the contraction in the first half of 2015, the recovery is expected to be restrained by weaker global activity and lower commodity prices. Real gross domestic product (GDP) is expected to remain below its potential through 2019.

- PBO projects that real GDP growth will rebound to 2.0 per cent in 2016 and 2.3 per cent in 2017. Growth is then expected to moderate, averaging 1.8 per cent during the period 2018 to 2020, slightly above growth in potential GDP.
- Based on futures prices, PBO projects that West Texas Intermediate (WTI) oil prices will increase gradually to US$59 per barrel by the end of 2020, which is about 10 per cent lower than projected in April.
- The level of nominal GDP is projected to be $20 billion lower each year, on average, between 2015 and 2020 compared with the previous projection made in PBO's April 2015 report.

Economic Outlook

%	2014	2015	2016	2017	2018-2020
Real GDP growth	2.4	1.1	2.0	2.3	1.8
GDP inflation	1.8	-0.4	1.6	2.2	2.1
Nominal GDP (level)	1,975	1,990	2,063	2,157	2,333

Sources: Statistics Canada and Parliamentary Budget Officer.

Note: Figures for 2014 are actual values. Nominal GDP levels are expressed in billions of dollars.

In April, PBO provided its fiscal outlook to the Commons Finance Committee that included measures from Budget 2015. In July, in response to requests from Members of Parliament the Honourable Scott Brison and Mr. Nathan Cullen, PBO used the fiscal sensitivities in Budget 2015 and July's real GDP growth projection from the Bank of Canada to update the fiscal outlook presented in Budget 2015. The updated July budget outlook did not represent PBO's independent economic and fiscal projections.

The fiscal outlook presented in this report is based on PBO's current economic outlook. It incorporates policy measures announced in Budget 2015, as well as policy measures that have obtained parliamentary approval since Budget 2015.

PBO is providing this outlook as an updated independent status quo planning assumption for the start of the 42nd Parliament. The outlook does not include measures in the new government's platform. PBO will provide an updated outlook including measures proposed by the new government when further details on implementation are released during the new legislative session.

PBO projects that in the absence of new policy measures, the budget would be balanced in 2015-16. Over the medium term, PBO projects annual deficits averaging $4.3 billion, or 0.2 per cent of GDP. The deficits after 2015-16 are mainly the result of:

- Surplus in 2015-16 was achieved partly from the sale of General Motors shares, which contributed $2.1 billion to other revenues. This will not be an ongoing source of revenue;
- Baseline Employment Insurance (EI) premium rates are scheduled to be reduced by 20 per cent in 2017.

Despite projected deficits, the federal debt-to-GDP ratio is projected to decline from 31.0 per cent of GDP in 2014-15 to 26.2 per cent of GDP in 2020-21.

Status quo fiscal outlook

$ billions	**2015-2016**	**2016-2017**	**2017-2018**	**2018-2019**	**2019-2020**	**2020-2021**
Revenues	291.6	297.9	307.7	319.7	332.0	345.4
Program expenses	264.0	275.8	283.9	293.0	302.1	312.8
Public debt charges	26.4	25.2	28.5	31.7	34.5	36.8
Total expenses	290.4	301.0	312.4	324.7	336.6	349.6
Budgetary balance	1.2	-3.0	-4.7	-5.0	-4.6	-4.2
Federal debt ratio (% of GDP)	30.8	29.9	28.8	27.9	27.1	26.2

Source: Parliamentary Budget Officer.

Note: The federal debt ratio is expressed as a percentage of nominal GDP.

1. The Economic Outlook

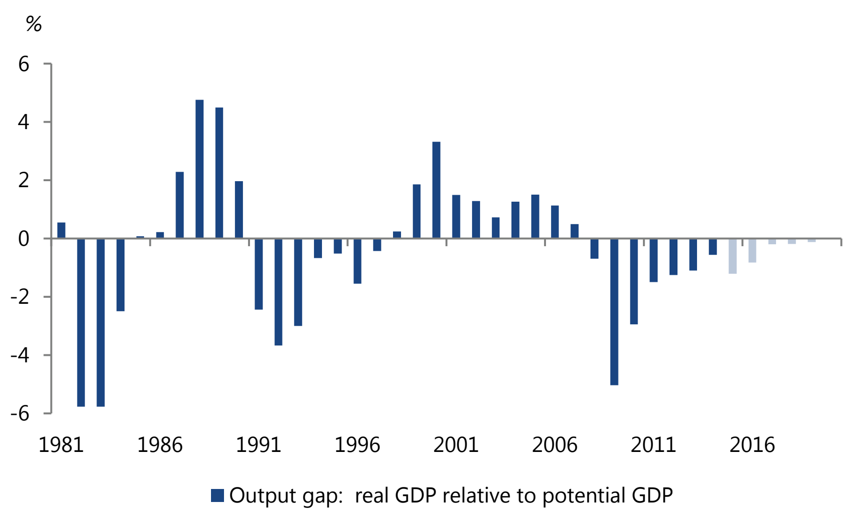
PBO projects that growth in the Canadian economy will slow from 2.4 per cent in 2014 to 1.1 per cent in 2015 mainly as a result of weaker business investment and sluggish export performance.[1] This is a full percentage point lower than the 2.1 per cent annual growth projected in PBO's April report to the Commons Finance Committee.

The downward revision largely reflects the unexpected contraction in real GDP over the first half of 2015. PBO expects real GDP growth to rebound in the second half of the year and through 2016, outpacing growth in potential GDP.

However, the recovery in the Canadian economy is expected to be restrained by weaker global activity and lower commodity prices, with real GDP remaining below its potential through 2019 (Figure 1-1).

Figure 1-1

Output gap: real GDP relative to potential GDP



Sources: Statistics Canada and Parliamentary Budget Officer.

Note: The projection period covers 2015-2020.

1.1. The external environment

In the United States, the economy grew less than expected in the first half of 2015. The economic recovery stalled in the first quarter as real GDP expanded at an annual rate of 0.6 per cent. This setback was caused by temporary factors such as weather and port closures as well as weak non-residential investment in response to lower commodity prices. In the second quarter, the economy rebounded by 3.9 per cent, but this was not sufficient to offset the first-quarter weakness.

Despite weaker activity, the U.S. economy added jobs at an average monthly rate of 213,000 in the first half of 2015; the unemployment rate fell from 5.6 per cent to 5.3 per cent. Wage gains remained modest, with annual growth below 2 per cent during the first half of the year.

Personal consumption expenditure (PCE) inflation fell to 0.2 per cent and core PCE inflation softened to 1.3 per cent in the first half of 2015. Both were well below the Federal Reserve's 2 per cent inflation target.

U.S. economic activity moderated in the third quarter of 2015. The "advance" estimate from the Bureau of Economic Analysis indicates that real GDP grew by 1.5 per cent during the quarter. At the same time, employers increased nonfarm payrolls at an average monthly pace of 167,000. Domestic demand continues to drive growth, supported by accommodative financial conditions and low oil prices.

However, the weak external environment and strong dollar continue to weigh on net exports. In its April outlook, PBO had expected the Federal Reserve to start raising its target rate in September 2015. However, the muted inflationary pressures and uncertain global environment have pushed back the assumed timing and pace of interest rate hikes.

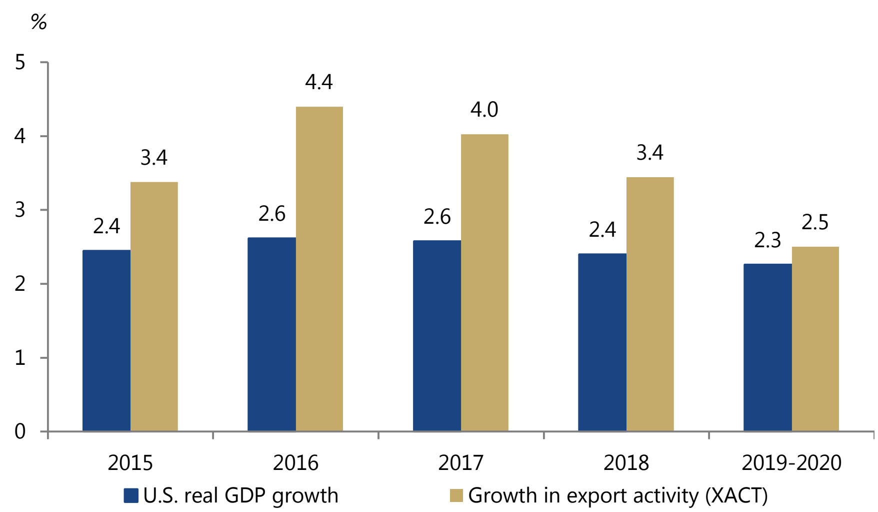
External outlook has weakened

Expectations for slower global growth have dampened the medium-term outlook in the United States. PBO now expects U.S. real GDP to grow at an annual rate of about 2¾ per cent for the next six quarters before gradually settling around 2¼ per cent toward the end of the projection period (Figure 1-2).

Business investment, private consumption and residential construction are expected to drive growth over the projection period as household wealth and incomes improve, the housing stock expands to meet growing demand and businesses replenish their capital stock.

Business investment is high in terms of import content. PBO expects that the components of U.S. GDP that are most relevant for Canadian exporters, as measured by PBO's export activity indicator (XACT), will grow faster than the U.S. economy as a whole throughout the projection period (Figure 1-2).

Figure 1-2 Growth in U.S. real GDP and export activity



Sources: Bureau of Economic Analysis and Parliamentary Budget Officer.

PBO assumes that the Federal Reserve will gradually increase the target federal funds rate beginning in December 2015, a move that will increase broader U.S. market interest rates. The interest rate on U.S. three-month treasury bills is assumed to rise from current levels of close to zero to 3.4 per cent by 2019. However, the pace of increases is assumed to be more gradual compared to April, owing to the uncertain external environment.

PBO expects a smooth normalization in U.S. monetary policy during which trade gains to Canada from a stronger U.S. economy will offset spillovers from higher U.S. long-term interest rates.

The International Monetary Fund (IMF) recently downgraded global growth prospects because of a weaker-than-expected first half of 2015 and ongoing economic vulnerabilities in some emerging market economies. Slowing growth in China and tightening global financial conditions have dampened growth in some emerging market economies, while commodity producers face a challenging adjustment to lower prices.

In advanced economies, growth remains modest and uneven. Gains during the first half of 2015 in the United Kingdom and Japan were less than expected, although the recovery in the euro area is proceeding. The IMF expects global economic activity to strengthen in 2016.

Commodity prices expected to remain soft

Prices of both energy and non-energy commodities have fallen in recent months, pushing the Bank of Canada commodity price index (BCPI) to its lowest level in over a decade (Figure 1-3). The decline in the third quarter was broad based across commodity categories.

Of note, the metals and minerals sub-index declined nearly 17 per cent on a year-over-year basis. In its recent outlook, the IMF noted that both weaker global activity and increased supply capacity have contributed to the recent weakness in energy as well as non-energy prices.

Figure 1-3

Real commodity prices

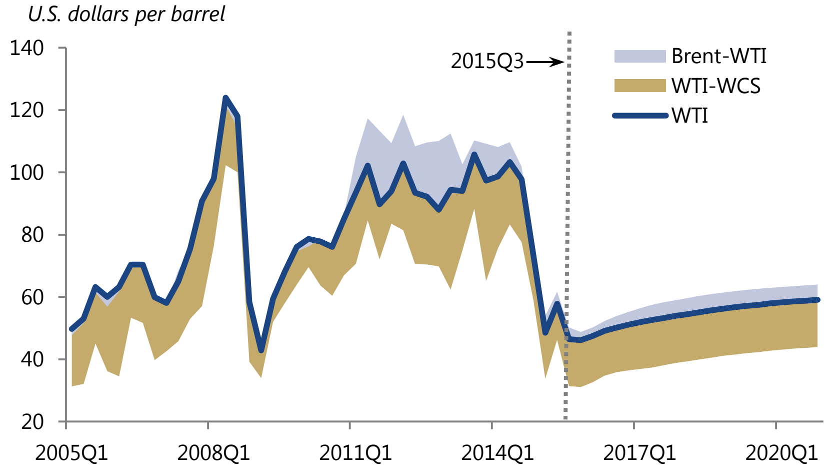
Sources: Bank of Canada and Bureau of Economic Analysis.

Note: Real commodity prices are calculated by deflating the Bank of Canada commodity price index (January 1972=100) by the U.S. GDP price index (2009=1).

After rising to US$58 per barrel for West Texas Intermediate (WTI) in the second quarter of 2015, the price of the U.S. crude oil benchmark fell sharply to US$46 per barrel in the third quarter of 2015. This was significantly lower than the US$54 per barrel projected in PBO's April report.

Based on recent futures prices, PBO projects that WTI oil prices will increase gradually from around US$46 per barrel to US$59 by the end of 2020. This would be about US$7 per barrel (10 per cent) lower than the April projection (Figure 1-4).[2] The weaker outlook for crude oil prices over the medium term likely reflects expectations of weaker global activity.

Figure 1-4 WTI crude oil prices, Brent and WCS differentials



Sources: Baytex Energy Corp.; Bloomberg L.P.; U.S. Energy Information Administration; and Parliamentary Budget Officer.

Note: WTI refers to West Texas Intermediate; WCS refers to Western Canadian Select.

PBO also uses recent futures prices to construct its projections for non-energy commodity components of the BCPI over the near term. The BCPI excluding energy is projected to fall relative to current levels over the next six quarters, mainly the result of weaker metals prices.

Beyond the near term, non-energy commodity prices are assumed to remain stable in real terms. Overall, PBO projects real commodity prices, measured as the BCPI relative to the U.S GDP price index, to increase gradually and only modestly from current levels over the medium term. Compared to PBO's April report, real commodity prices are down by about 14 per cent over the projection horizon.

1.2. Recent developments in the Canadian economy

Real GDP in Canada contracted in the first two quarters of 2015 pushing the economy 1.4 per cent below its potential level (Box 1-1). Business investment declined sharply in response to the weakness in oil prices and non-energy export volumes failed to advance. Real GDP in the first half of 2015 was significantly weaker than anticipated in PBO's April report.

Assessing economic performance

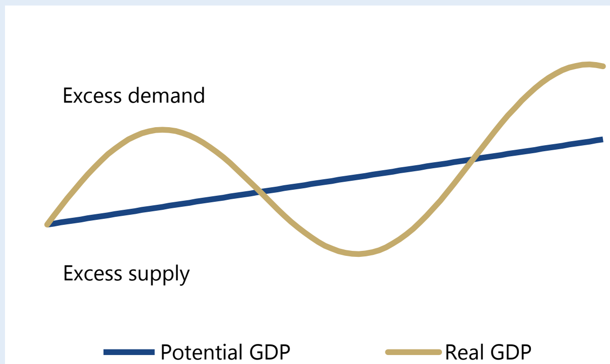
To help parliamentarians assess the overall performance of the Canadian economy PBO provides an estimate of potential GDP.

Box 1-1: Assessing economic performance in "3D"

The contraction in real GDP in Canada in the first two quarters of 2015 generated considerable discussion about defining recessions and economic performance. In PBO's view, the discussion could benefit from a broader assessment of economic performance rather than simply focussing on quarterly declines in real GDP.

PBO's preferred metric for assessing economic performance at a macro level is based on the concept of potential GDP, which is not directly observable but can be estimated (Figure A).†

Figure A: Real GDP and potential GDP



Potential GDP is a measure of the sustainable productive capacity of an economy. As noted by the Congressional Budget Office and Bank of Canada, it is not a technical limit on production: it is the level of output that can be achieved with available resources (labour, capital and technology) without creating inflationary pressures.††

In PBO's view, it is useful to assess overall economic performance along three dimensions:

i. Comparing the <u>level</u> of actual (observed) real GDP to potential, which provides an estimate of excess demand or excess supply in the overall economy;

ii. Comparing <u>growth</u> in real GDP to growth in potential, which gives a sense of how far observed growth is from underlying or "normal" growth, and which indicates whether excess demand/supply is increasing or decreasing; and,

iii. The <u>duration</u> in which the level of real GDP deviates from its potential, which provides an estimate of the length of an economic boom, bust or recovery.

Box 1-1 continued

Moreover, potential GDP—both its level and growth rate—can be influenced by actual economic conditions as well as government policies. Ultimately, an economy's capacity to generate increases in living standards and to support government programs is tied to potential GDP.

Although potential GDP provides a natural benchmark for assessing the overall performance at a macro level, it is important keep in mind that it is an *estimate* and therefore subject to uncertainty.

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† To estimate potential GDP, PBO uses a "production function" approach, similar to that used by Finance Canada and the Organization for Economic Co-operation and Development (OECD). A forthcoming technical report will provide additional detail.

†† See CBO (2001) and Côté (2013).

The decline in business investment was sharper than expected, reflecting a greater sensitivity of businesses to lower oil prices and increased uncertainty than PBO had assumed.

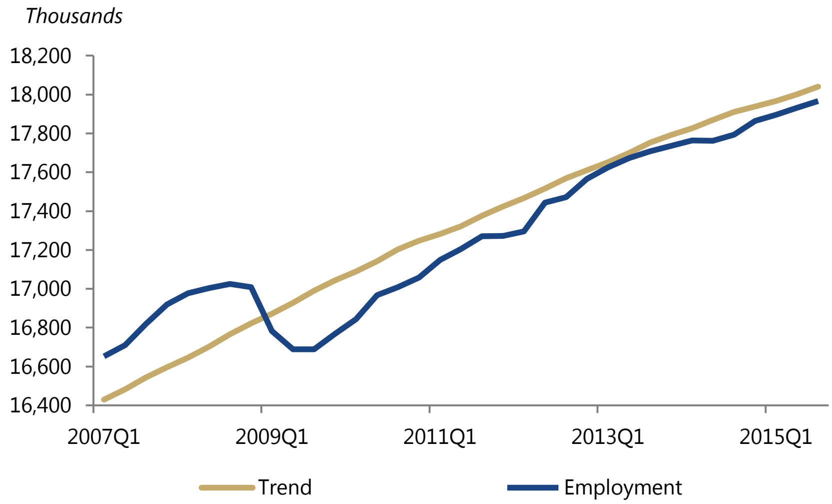
As for the weaker-than-expected performance in non-energy exports, it can only be partly accounted for by the unexpected weakness in global activity. This suggests a slower response to the lower Canadian dollar than PBO anticipated.

Labour market performance solid despite weakness in real GDP

Despite the contraction in real GDP, overall labour market performance has been solid during the first three quarters of 2015. Since the beginning of the year, 127,000 net new jobs have been created, a 0.7 per cent increase, although the level of employment remains about 75,000 jobs below its trend (Figure 1-5).

During the same period, the unemployment rate increased by 0.4 percentage points to 7.1 per cent, largely the result of increased labour force participation. Total hours worked—the broadest measure of the economy's labour input—increased by 1.5 per cent, on average, during the first three quarters. This helped to reduce the labour input gap (i.e., the percentage difference between total hours worked and its trend) from -0.7 per cent in 2014Q4 to -0.2 per cent in 2015Q3.

Figure 1-5 Employment relative to trend



Sources: Statistics Canada and Parliamentary Budget Officer.

Although the labour market at the national level performed reasonably well over this period, this masked a weaker performance in the major oil-producing regions and oil-related industries.

Lower oil prices have also put downward pressure on inflation. Total inflation as measured by the Consumer Price Index (CPI) has fluctuated around the bottom of the Bank of Canada's 1 to 3 per cent target range since the beginning of the year. This reflects year-over-year declines in prices for consumer energy products.

In July, the Bank of Canada lowered the overnight rate target to ½ per cent, noting that additional monetary stimulus was required "to help return the economy to full capacity and inflation sustainably to target".

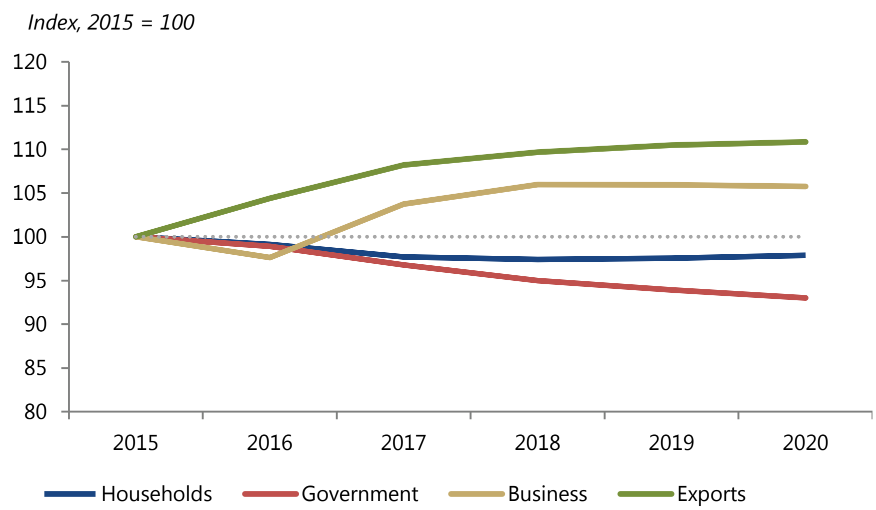
Based on recent monthly indicators, PBO expects real GDP to rebound in the third quarter by 2.5 per cent—well above estimated potential growth of 1.8 per cent. In part, this would reflect a bounce from temporary factors in the previous quarter, such as maintenance shutdowns and production difficulties in non-conventional oil extraction as well as retroactive Universal Child Care Benefit payments. PBO estimates that the Canadian economy was operating 1.3 per cent below potential GDP in the third quarter.

1.3. Canadian economic outlook

Despite the weaker-than-expected performance in business investment and non-energy exports over the first half of 2015, PBO continues to anticipate a rebalancing in the Canadian economy. The composition of real GDP is expected to shift away from consumer spending and housing toward exports and business investment (Figure 1-6).

Figure 1-6

Sector expenditure relative to real GDP



Source: Parliamentary Budget Officer.

Note: The household sector includes household consumption and residential investment; the government sector includes spending and investment; and the business sector includes business investment (non-residential construction, machinery and equipment as well as intellectual property and products).

As noted in PBO's April pre-budget report, the shock to the terms of trade from lower oil prices hinders the rebalancing process as the expected pick-up in business investment is delayed. A summary of the economic outlook is presented in Appendix A.

Economy expected to recover and rebalance

PBO projects that real GDP growth will rebound to 2.0 per cent in 2016 and 2.3 per cent in 2017, then average 1.8 per cent during the period 2018 to 2020 (Table 1-1). Despite the anticipated rebound, real GDP is projected to remain below potential GDP through 2019 as the economy adjusts to the lower terms of trade and sectoral rebalancing progresses.

Table 1-1 Canadian economic outlook

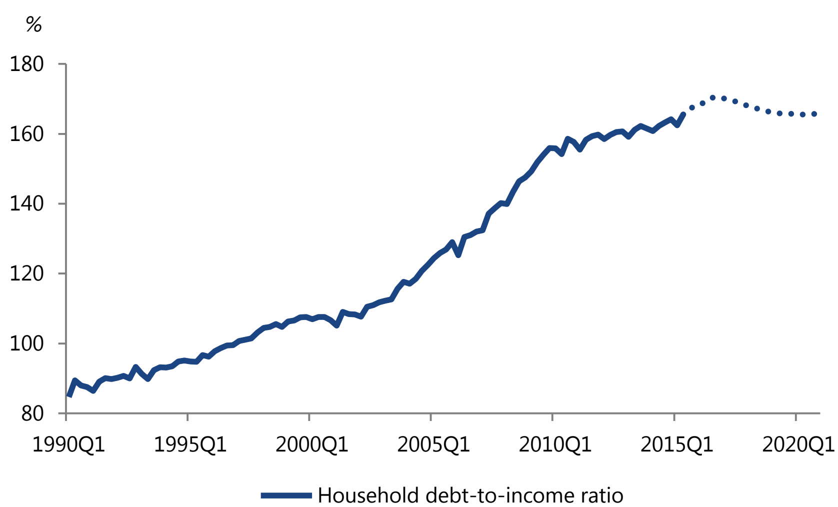
Contributions to real GDP growth	2014	2015	2016	2017	2018-2020
Consumption	1.5	1.1	0.8	0.9	1.2
Housing	0.2	0.2	-0.1	-0.3	0.0
Business investment	0.0	-1.0	0.0	1.1	0.3
Government	-0.1	0.2	0.2	0.0	0.1
Exports	1.7	0.7	2.0	1.9	0.9
Imports	-0.5	0.0	-0.2	-1.6	-0.8
Inventory investment	-0.3	-0.2	-0.7	0.3	0.1
Real GDP growth	2.4	1.1	2.0	2.3	1.8
Additional indicators, %					
GDP inflation	1.8	-0.4	1.6	2.2	2.1
Nominal GDP growth	4.3	0.7	3.7	4.5	4.0
Real GDI growth	2.0	-1.1	1.6	2.5	2.0

Sources: Statistics Canada and Parliamentary Budget Officer.

Note: Contributions to real GDP growth are expressed in percentage points.

PBO projects that growth in consumer spending will moderate from its recent pace. This will occur as households adjust to reduced income and wealth gains (resulting from the deterioration in the terms of trade); then they will ultimately increase their savings rate. Household debt relative to income is projected to increase through 2016, after which it will gradually return close to current levels (Figure 1-7).

Figure 1-7 Household debt relative to disposable income

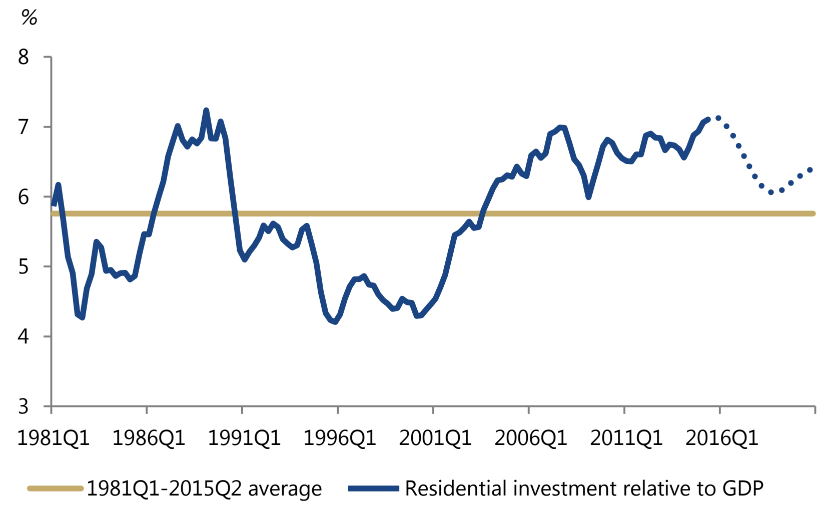


Sources: Statistics Canada and Parliamentary Budget Officer.

Note: The projection period covers 2015Q3-2020Q4.

As growth in household income slows and mortgage rates rise from low levels, gains in real house prices are expected to moderate and residential investment is projected to decline during 2016 to 2018. Despite the projected decline, the share of residential investment in the economy remains above its long-term historical average (Figure 1-8).

Figure 1-8 The share of residential investment in the economy



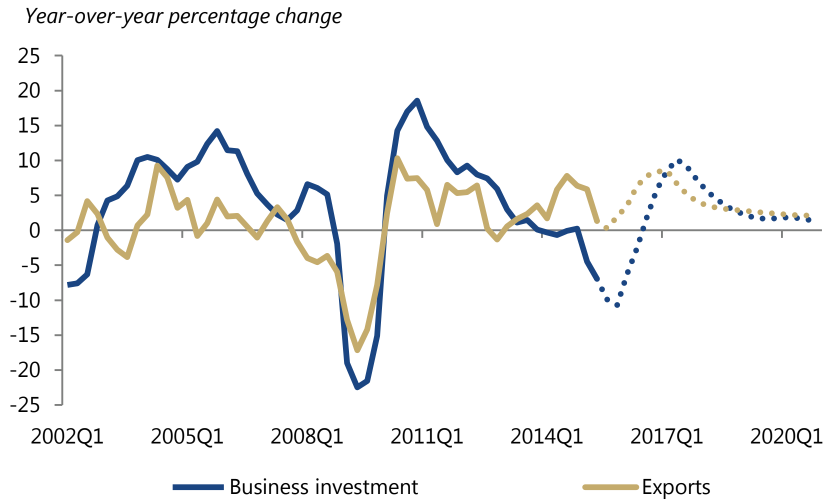
Sources: Statistics Canada and Parliamentary Budget Officer.

Note: The projection period covers 2015Q3-2020Q4.

Business investment is expected to continue to decline over the second half of 2015, then increase only modestly in the first half of 2016 as oil prices remain low (Figure 1-9). At the same time, export growth is expected to surge, fuelled by a favourable composition of U.S. activity and a lower Canadian dollar.

As the recovery in Canada’s export performance takes hold, growth in business investment is expected to accelerate and then remain solid over the medium term. Although the lower Canadian dollar helps to shift spending away from imports towards domestically-produced goods and services, the recovery in investment spending, which itself is relatively high in imported content, supports the growth of imports.

Figure 1-9 Growth in business investment and exports



Sources: Statistics Canada and Parliamentary Budget Officer.

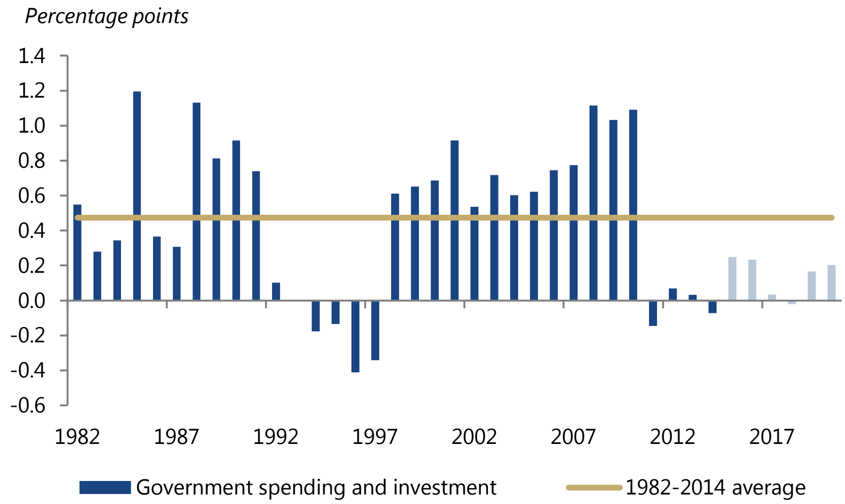
Note: The projection period covers 2015Q3 to 2020Q4.

Inventory investment is expected to subtract from real GDP growth in 2015 and 2016 as firms draw down inventories from elevated levels to meet the surge in demand in 2016. This will bring the ratio of business non-farm inventory stocks to sales closer to historical norms.

Based on federal and provincial budgets, PBO projects that government spending on goods and services, as well as investment, will contribute modestly to real GDP growth in 2015 and 2016.

Beyond 2017, subnational government expenditure is assumed to increase in line with population growth. Federal expenditure is based on Finance Canada's projected operating expenses in Budget 2015. The contribution of government spending and investment to real GDP growth remains significantly below its long-term historical average (Figure 1-10).

Figure 1-10 Contribution to real GDP growth from government

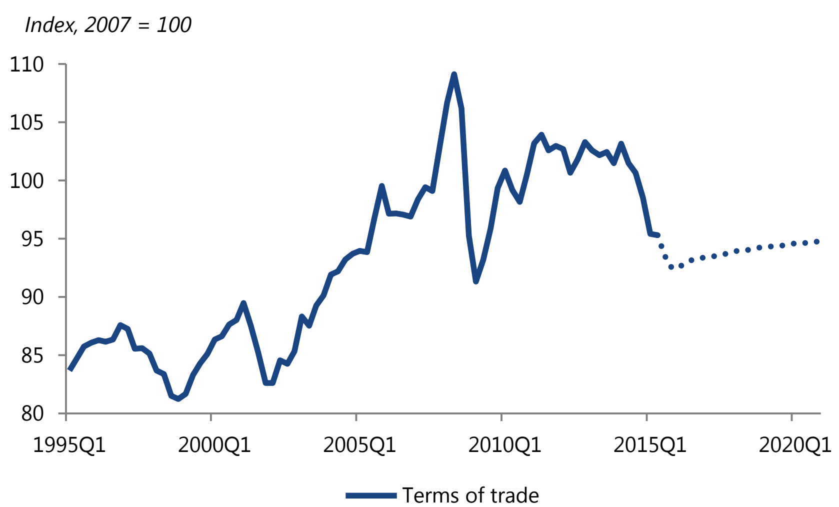


Sources: Statistics Canada and Parliamentary Budget Officer.

Note: The projection period covers 2015-2020.

PBO expects Canada's terms of trade to decline further, falling close to levels last seen during the global financial crisis (Figure 1-11). The decline in the terms of trade results in lower economy-wide prices as measured by the GDP deflator. GDP inflation is projected to be -0.4 per cent in 2015. It is expected to increase to 1.6 per cent in 2016 as commodity price declines moderate, before stabilizing at around 2.1 per cent.

Figure 1-11 Terms of trade



Source: Statistics Canada and Parliamentary Budget Officer.

Note: The projection period covers 2015Q3-2020Q4.

Growth in nominal GDP is expected to fall to 0.7 per cent in 2015, then average 4 per cent a year between 2016 and 2020. Between 2015 and 2020, annual average growth in nominal GDP is expected to be 3.5 per cent.

Reflecting the significant deterioration in the terms of trade, real gross domestic income (GDI) is projected to decline in 2015 by 1.1 per cent. Thereafter, annual growth would average 2 per cent, in line with real GDP growth.

While nominal GDP provides a broad measure of a government's tax base, its composition also matters for the fiscal outlook, given that different incomes and expenditures are taxed at different rates. On the expenditure side of nominal GDP, consumer spending is expected to grow by 3.5 per cent a year on average between 2015 and 2020, while imports are projected to increase 4.1 per cent a year on average.

On the income side of nominal GDP, growth in wage and salary income is projected to average 3.4 per cent annually during the same period. Corporate profits are projected to increase 2.5 per cent a year, on average. At the same time, annual growth in other income, which includes net mixed income and investment income, is projected to average 3.8 per cent.

PBO projects that the Canadian economy will continue to operate below its productive capacity, or potential GDP, through 2019 (Table 1-2). Growth in potential GDP is projected to remain relatively stable at around 1.7 per cent. This would occur as slower growth in trend labour input (total hours worked) is largely offset by faster growth in trend labour productivity.

Table 1-2 Projected growth in potential GDP

%	2014	2015	2016	2017	2018-2020
Potential GDP	1.9	1.8	1.6	1.7	1.7
Trend labour input	0.9	0.8	0.8	0.6	0.4
Trend labour productivity	1.0	1.0	0.9	1.1	1.3
Output gap (level)	-0.6	-1.2	-0.8	-0.2	-0.1
Labour input gap (level)	-0.7	-0.5	-0.7	-0.4	-0.2

Source: Parliamentary Budget Officer.

PBO projects that the unemployment rate will gradually decline from its elevated level as the output gap dissipates over the projection horizon (Table 1-3). The participation rate is expected to continue to decline with the ongoing transition of the baby-boom cohort into retirement.

Employment growth is projected to remain relatively solid through 2017 but lag growth in the working-age population, resulting in a decline in the employment rate. Average weekly hours worked are expected to decrease from above-trend levels and remain below trend while the output gap persists.

Table 1-3 Labour market indicators

%	2014	2015	2016	2017	2018-2020
Unemployment rate	6.9	6.9	6.9	6.6	6.3
Participation rate	66.0	65.8	65.5	65.2	64.4
Employment growth	0.6	0.8	0.6	0.7	0.4
Average hours worked per week	33.9	33.9	33.9	34.0	34.1

Sources: Statistics Canada and Parliamentary Budget Officer.

Note: Figures for 2014 are actual values.

Monetary policy is expected to remain highly accommodative over the projection horizon, which should help facilitate rebalancing in the Canadian economy and the adjustment to the lower terms of trade. PBO expects that the Bank of Canada will gradually increase its policy rate from ½ per cent beginning in the fourth quarter of 2016 (Table 1-4).

Table 1-4 Interest, inflation and exchange rates

%	2014	2015	2016	2017	2018-2020
3-month treasury bill	0.9	0.5	0.5	1.6	2.8
10-year bond rate	2.2	1.6	2.2	3.0	4.2
Exchange rate (cents US)	90.5	78.4	75.4	75.0	74.8
Core inflation	1.8	2.2	2.0	1.9	1.9
Total CPI inflation	1.9	1.2	2.2	2.1	2.0

Sources: Statistics Canada and Parliamentary Budget Officer.

Note: Figures for 2014 are actual values.

PBO expects the Bank of Canada to start raising its policy rate a year after the Federal Reserve's "lift off" and to pursue a more gradual pace of monetary policy normalization. Consequently, short-term interest rates in Canada are expected to remain below U.S. levels from mid-2016 to early 2020. This would put downward pressure on the exchange rate and counter the upward pressure from rising commodity prices.

As a result, the Canadian dollar is expected to remain close to current levels, averaging 75 cents U.S. over 2016-2020. Ten-year Government of Canada benchmark bond rates are expected to move higher, roughly in line with long-term rates in the United States and increases in Canadian short-term rates.

Core inflation is expected to remain close to 2 per cent as the downward pressure from excess capacity is countered by upward pressure from the depreciation of the Canadian dollar. Total CPI inflation is projected to move higher as prices for consumer energy products increase and core inflation remains relatively stable.

1.4. Comparison to April 2015 outlook

Relative to our April report to the Commons Finance Committee, PBO has revised down its projection of nominal GDP by $20 billion annually, on average, over 2015-2020 (Table 1-5). This downward revision results from both lower economy-wide prices and lower real GDP levels. Downward revisions to the outlooks for energy and non-energy commodity prices have pushed the terms of trade and the GDP deflator lower.

Most expenditure categories of real GDP were revised lower, except for subnational government spending and investment, which was revised upward consistent with recent provincial budgets. Both short- and long-term interest rates have been revised down from the April report because of the weaker outlook for the Canadian economy (Appendix A).

Moreover, lower long-term interest rates in Canada also reflect lower U.S. long-term rates. The unemployment rate has been revised up in each year of the projection, while total CPI inflation is little changed from April.

Table 1-5

Comparison to April 2015 outlook

%	2015	2016	2017	2018	2019	2020
Real GDP growth						
April 2015	2.1	2.3	1.8	1.8	1.8	1.7
November 2015	1.1	2.0	2.3	1.8	1.8	1.8
GDP inflation						
April 2015	-0.8	2.5	2.1	2.0	2.1	2.1
November 2015	-0.4	1.6	2.2	2.1	2.1	2.2
Nominal GDP growth						
April 2015	1.3	4.8	4.0	3.9	3.9	3.8
November 2015	0.7	3.7	4.5	4.0	3.9	4.0
Nominal GDP(level)						
April 2015	2,000	2,095	2,179	2,263	2,352	2,442
November 2015	1,990	2,063	2,157	2,243	2,331	2,425

Source: Parliamentary Budget Officer.

Note: Nominal GDP levels are expressed in billions of dollars. April nominal GDP levels have been adjusted for historical revisions.

Comparison to PBO's July report on Budget 2015 outlook

In July, PBO was requested by Members of Parliament the Honourable Scott Brison and Mr. Nathan Cullen to provide an update of the Budget 2015 fiscal outlook based on the Bank of Canada's projection of real GDP growth presented in the July 2015 Monetary Policy Report (MPR), using the Department of Finance's fiscal sensitivities.

The outlook presented in PBO's response was not an update of PBO's April 2015 outlook. Rather, it was an approximation of the Budget 2015 projection as if it had been prepared using the Bank of Canada's real GDP growth projection through 2017, as well as new data for GDP inflation and lower interest rate assumptions. Revisions to interest rate assumptions were required to account for the unexpected reduction to the Bank of Canada's policy interest rate in July.

Compared to the economic outlook on which PBO's July report was based, PBO's November projection is significantly weaker in 2016 and 2017 (Table 1-6). In 2016, nominal GDP is down by $32 billion and in 2017 it is $43 billion lower.

The declines are due two factors: weaker real GDP growth, based on the Bank of Canada's July MPR projection; and, lower GDP inflation, based on the Budget 2015 projection.

Table 1-6 Comparison to PBO's updated Budget 2015 outlook

%	2015	2016	2017
Real GDP growth			
Updated Budget 2015 outlook	1.1	2.3	2.6
November PBO	1.1	2.0	2.3
GDP inflation			
Updated Budget 2015 outlook	-0.1	2.6	2.3
November PBO	-0.4	1.6	2.2
Nominal GDP growth			
Updated Budget 2015 outlook	1.0	5.0	5.0
November PBO	0.7	3.7	4.5
Nominal GDP (level)			
Updated Budget 2015 outlook	1,995	2,095	2,200
November PBO	1,990	2,063	2,157

Sources: Bank of Canada; Finance Canada; Parliamentary Budget Officer.

Note: Nominal GDP levels are expressed in billions of dollars.

Further, the Budget 2015 projection of GDP inflation was based on the assumption that WTI oil prices would average US$67 and US$75 per barrel in 2016 and 2017. These levels are substantially higher than the US$49 and US$53 per barrel, respectively, in PBO's November projection.

1.5. Key risks to the economic outlook

PBO judges that the risks to its economic outlook are roughly balanced.

In terms of downside risks, PBO maintains that the most important risk to its outlook is weaker non-energy export performance. Although the outlook should be highly favourable for Canadian non-energy exports going forward, reduced productive capacity and/or competitiveness issues could result in a weaker-than-expected performance.

In terms of upside risks, PBO believes that the most important risk is stronger residential investment. PBO's outlook incorporates a significant decline in residential investment, consistent with expected movements in its fundamental drivers, such as mortgage rates, house prices and incomes. However, residential investment could continue to surprise on the upside and/or the speed of the adjusment to its fundamentals could be more gradual than expected.

2. Fiscal Outlook

Economic developments since the publication of PBO's April outlook have been significant. PBO is providing this outlook as an updated independent status quo planning assumption for the beginning of the 42nd Parliament. The outlook does not include measures in the new government's platform. PBO will provide an updated fiscal outlook when further details on implementation are released during the new legislative session.

The fiscal outlook is based on PBO's latest economic projection, as well as the 2014-15 Consolidated Financial Statements of the Government of Canada. As of publication, the 2014-15 Public Accounts of Canada have not been released. The outlook has been adjusted for the fiscal impact of policy measures that have obtained parliamentary approval since Budget 2015.

2.1. 2014-15 financial results

The 2014-15 Consolidated Financial Statements and Annual Financial Report were released on 14 September 2015. The financial results showed a budgetary surplus in 2014-15 of $1.9 billion.

Finance Canada forecast a deficit of $2.0 billion in Budget 2015. The following factors contributed to the unexpected surplus:

Balanced budget in 2014-15

Financial results showed a budgetary surplus of $1.9 billion. Budget 2015 forecast a deficit of $2.0 billion while PBO forecast a surplus of $1.8 billion.

- Higher revenues accounted for 75 per cent of the improvement in the budgetary balance relative to Finance Canada's forecast. Personal income tax and corporate income tax revenues were underpredicted by $3.0 billion;
- Direct program expenses, which comprise the spending of federal departments on operations and grant and contribution programs, were lower than expected. This contributed $1.5 billion to the surplus. Part of this lower spending was the result of lapsed funding: federal departments and agencies spending less than their total budgets approved by Parliament. Lapsed spending has come in higher than anticipated and contributed to better-than-expected financial results in each of the last three years;
- Roughly half of the contribution of lower direct program expenses was offset by higher-than-expected elderly benefits, Employment Insurance benefits, and children's benefits.

PBO forecast a surplus of $1.8 billion in the April fiscal outlook presented to the Commons Finance Committee. Although this closely matched the actual surplus of $1.9 billion, there were underlying forecast errors that offset each other:

- Revenues were higher by $3.0 billion than expected, as a result of higher income taxes and other revenues;
- Program expenses were higher by $3.3 billion, mostly because of higher than average year-end spending by federal departments and higher transfers to persons;
- Public debt charges were $0.4 billion lower than expected.

2.2. Fiscal impact of policy measures

Policy changes announced in Budget 2015 were included in PBO's April outlook and the baseline for this projection. The forecast has been adjusted for the following announcements and fiscal impact revisions since the budget:

- PBO has adjusted the forecast of GST revenues to account for the zero-rating of feminine hygiene products announced in May and which took effect 1 July 2015. PBO estimates this measure will cost around $50 million per year;[3]
- PBO has adjusted Employment Insurance revenues to reflect a higher cost of the Small Business Job Credit, which the Chief Actuary has estimated at $318 million in 2015 and $360 million in 2016. Previously PBO had assumed a cost of $275 million in both years, as reported in the 2014 Fall Update of Economic and Fiscal Projections.

PBO has not adjusted the outlook for measures announced in the Liberal party platform during the 42nd Canadian general election.

2.3. Fiscal outlook 2015-16 to 2020-21

PBO's budget outlook is summarized in Table 2-1. Detailed fiscal tables are provided in Appendix B. PBO forecasts a balanced budget in 2015-16 and deficits over the remainder of the outlook.

Table 2-1 Summary of the fiscal outlook

$ billions	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021
Revenues	291.6	297.9	307.7	319.7	332.0	345.4
Program expenses	264.0	275.8	283.9	293.0	302.1	312.8
Public debt charges	26.4	25.2	28.5	31.7	34.5	36.8
Total expenses	290.4	301.0	312.4	324.7	336.6	349.6
Budgetary balance	1.2	-3.0	-4.7	-5.0	-4.6	-4.2
Federal debt ratio (% of GDP)	30.8	29.9	28.8	27.9	27.1	26.2

Source: Parliamentary Budget Officer.

Receipts were stronger than expected in 2014-15 and have been stronger over the first five months of 2015-16. PBO continues to forecast a budgetary surplus in 2015-16. In addition to strong receipts data, the following factors counteract the decline in economic activity and contribute to a surplus in 2015-16:

- The sale of General Motors shares contributes $2.1 billion to other revenues;
- The Budget 2015 spending plan maintains little growth in direct program expenses as a result of the operating budget freeze in place until 2015-16;
- The decline in corporate income taxes as a result of lower oil prices in the energy sector and lower overall economic growth is expected to occur on a lag, with monthly and quarterly instalment payments taking time to adjust to lower profits.

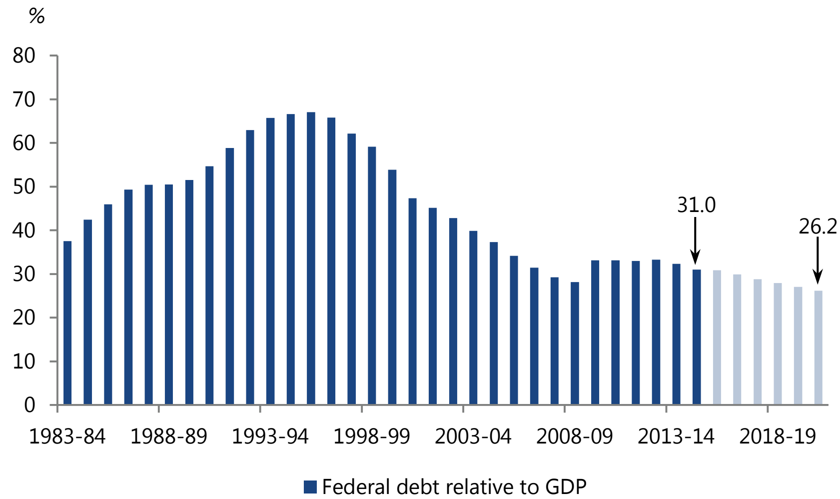
Beyond 2015-16, the outlook forecasts annual deficits averaging $4.3 billion, or 0.2 per cent of GDP. This is mainly the result of the following factors:

- A 20 per cent reduction in EI premium rates in 2017. This is required to eliminate the surplus that will accumulate over 2015 and 2016 as a result of freezing the premium rate above the breakeven rate in those years;
- The Budget 2015 plan to increase direct program expenses annually by 3.0 per cent on average following the operating budget freeze;
- Spending on elderly benefits: These will increase faster than nominal GDP and the growth in overall revenues as a result of population ageing. The current policy to reduce the impact of population ageing by raising the age of eligibility to 67 begins in 2023—beyond the forecast horizon;
- Increasing public debt charges as a result of annual borrowing and higher interest rates as monetary policy normalizes over the outlook.

Despite running deficits, federal debt (accumulated deficit) will fall as a share of GDP from 31.0 per cent in 2014-15 to 26.2 per cent in 2020-21 (Figure 2-1).

Figure 2-1

Outlook for federal debt (accumulated deficit)



Sources: Finance Canada and Parliamentary Budget Officer.

2.4. Comparison to April 2015 outlook

Compared to PBO's April forecast, the outlook for the budgetary balance has been lowered by an average of $2.4 billion a year during 2016-17 to 2019-20 (Table 2-2).

Table 2-2

Comparison to PBO's April outlook for the budgetary balance

$ billions	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021
Budgetary balance						
April 2015	1.1	0.0	-2.6	-2.8	-2.5	na
November 2015	1.2	-3.0	-4.7	-5.0	-4.6	-4.2
Difference	0.1	-3.0	-2.1	-2.2	-2.1	

Source: Parliamentary Budget Officer.

This revision has been mostly the result of lower expected revenues, which have been revised downward by an average of $2.6 billion a year during 2016-17 to 2019-20 (Table 2-3).

Table 2-3 Comparison to PBO's April fiscal outlook

$ billions	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020
Income taxes	3.5	-1.7	-0.9	-1.2	-0.7
Excise taxes/duties	-0.8	-1.1	-1.0	-0.9	-1.0
EI premiums	-0.2	0.8	0.6	0.7	0.6
Other revenues	-0.8	-1.2	-1.1	-1.1	-1.1
Total revenues	1.6	-3.2	-2.4	-2.5	-2.2
Transfers to persons	0.3	0.3	0.3	0.2	0.1
Transfers to governments	0.1	0.2	-0.2	-0.5	-0.5
Direct program expenses	0.0	0.0	0.0	0.0	0.0
Program expenses	0.4	0.5	0.1	-0.3	-0.4
Public debt charges	1.1	-0.7	-0.4	0.0	0.3
Total expenses	1.5	-0.2	-0.3	-0.3	-0.1
Budgetary balance	0.1	-3.0	-2.1	-2.2	-2.1

Source: Parliamentary Budget Officer.

This has been driven by the weaker outlook for nominal GDP. Given the weaker economic outlook, the following factors have contributed to the revision:

- Corporate income taxes are expected to be lower as a result of a lower corporate profits base;
- GST revenues are lower as a result of a weaker outlook for consumer spending and CPI inflation.

Program expenses are roughly unchanged in aggregate. This is the result of several offsetting factors:

- Employment Insurance benefits have increased with higher projected unemployment;
- Transfers to other levels of government are lower among programs tied to the growth of nominal GDP, such as the Canada Health Transfer and fiscal equalization;
- Public debt charges are projected to be higher over the outlook. Although the outlook for interest rates is lower, it is offset by increased borrowing as a result of larger deficits.

Comparison to PBO's July report on Budget 2015 outlook

PBO released a report on 22 July 2015 that, as requested by Members of Parliament the Honourable Scott Brison and Mr. Nathan Cullen, updated the

Budget 2015 outlook using the Bank of Canada's economic forecast at the time. Table 2-4 compares the budgetary balance of that update with PBO's current fiscal outlook.

Table 2-4 **Comparison to PBO's updated Budget 2015 outlook**

$ billions	2015-2016	2016-2017	2017-2018
Budgetary balance			
Updated Budget 2015 outlook	-1.0	0.6	2.2
November PBO	1.2	-3.0	-4.7
Difference	2.2	-3.6	-6.9

Source: Parliamentary Budget Officer.

Compared with the updated Budget 2015 outlook, PBO expects the budgetary balance to be $2.2 billion higher in 2015-16.

PBO's current forecast includes two main revisions that contribute to an improved balance: 1) better-than-expected financial outcomes for 2014-15 which were released subsequent to the report and affected several components of the forecast for 2015-16, and 2) first-quarter financial results for 2015-16 which were higher than predicted by fiscal sensitivies.

The outlook for the budgetary balance in 2016-17 and 2017-18 is $3.6 billion and $6.9 billion lower, respectively. This is a result of the significantly weaker outlook for real GDP, inflation and oil prices in PBO's current economic outlook compared to the Bank of Canada's outlook for real GDP growth in its July 2015 MPR and the Budget 2015 outlook for GDP inflation.

2.5. EI Operating Account and premium rates

PBO's forecast of the EI Operating Account has been updated with the latest information from the 2014-15 Consolidated Financial Statements and the 2016 Actuarial Report on the Employment Insurance Premium Rate.

According to the Chief Actuary, the rate that should have been set for 2016 was 1.56 per cent. It was instead set at 1.88 per cent as part of the government's rate freeze announced in the 2013 Update of Economic and Fiscal Projections.

PBO's latest projection of the rate for the years following the rate freeze is provided in Table 2-5. The forecast rate for 2017 is 1.50 per cent, which is lower than PBO's previous estimate of 1.51 per cent. This is a result of more recent data from the Chief Actuary report and brings PBO's forecast closer to the government's forecast of 1.49 per cent. Had the rate been set at 1.56 per cent in 2016, as recommended by the Chief Actuary, PBO's forecast of the breakeven rate would be 1.53 per cent on average over the remainder of the outlook.

Table 2-5

EI premium rate forecast

%	2016	2017	2018	2019	2020	2021
PBO	1.88	1.50	1.50	1.50	1.50	1.50
Budget 2015	1.88	1.49	1.49	1.49	1.49	na
Forecast breakeven rate	1.56	1.54	1.53	1.53	1.52	1.52

Source: Parliamentary Budget Officer.

Our projection of the EI Operating Account is given in Table 2-6. As a result of the rate freeze in 2015 and 2016, the EI Operating Account is expected to accumulate a surplus of $3.8 billion in 2015-16 and a surplus of $6.3 billion by the end of 2016-17. The account will need to run an annual deficit averaging $1.5 billion from 2017-18 to 2020-21 to eliminate the surplus, as required by the seven-year breakeven framework.

Table 2-6

Forecast of the EI Operating Account

$ billions	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021
EI premium revenues	22.6	23.5	23.7	20.3	21.0	21.1	21.3
Government's contribution as employer	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total revenues	23.0	23.9	24.1	20.7	21.4	21.6	21.7
EI benefits	18.1	18.9	20.0	20.6	21.0	21.2	21.3
Administration expenses	1.7	1.7	1.7	1. 8	1.8	1.8	1.9
Total expenses	19.7	20.5	21.7	22.4	22.9	23.0	23.1
Annual balance	3.2	3.3	2.4	-1.7	-1.4	-1.4	-1.4
Cumulative balance	0.5	3.8	6.3	4.6	3.1	1.7	0.3

Sources: Finance Canada and Parliamentary Budget Officer.

2.6. The structural budgetary balance

The budgetary balance is a result of not only the government's tax and spending policies, but also the economic environment. The *structural* budgetary balance provides an estimate of a government's underlying financial position (Box 2-1).

Box 2-1: The structural budgetary balance

The budgetary balance reflects not only the government's tax and spending policies, but also factors that are largely outside the government's control such as commodity price booms and busts.

The structural budgetary balance provides an estimate of a government's underlying financial position by removing the impacts of temporary factors on revenues and expenditures. It is the budgetary balance that would be observed if the economy and government policy were operating under "normal" conditions.

Using the structural balance as a fiscal anchor for planning purposes can mitigate frequent policy adjustments that can be costly and economically distortive.

For example, assume a budget is balanced during periods of normal economic growth. An economic downturn would lower the tax base and result in a deficit. The revenue shortfall is likely to be temporary and would not require an increase in tax rates, or reductions to spending on programs, to achieve the goal of a balanced budget as the economy recovers. Economic conditions would ultimately improve, restoring the tax base to normal levels.

PBO estimates the structural balance by removing the impacts of the economic cycle and fluctuations in the terms of trade (i.e., export prices relative to import prices), which are driven primarily by shocks to commodity prices. In addition, PBO also removes one-time factors that include irregular fluctuations in revenues such as asset sales, temporary deficits or surpluses in the EI Operating Account, and exceptional expenses such as flood assistance for natural disasters.

Although the structural balance provides an estimate of the government's underlying financial position, it is important to keep in mind that it is unobservable and therefore subject to uncertainty.

PBO estimates that the structural budgetary balance will decline from a surplus of $7.6 billion in 2015-16 to a structural deficit of $3.4 billion in 2020-21 (Table 2-7). The structural surplus declines in 2016-17 as the freeze on the direct program expenses operating budget is lifted. In addition to rising direct program expenses, the structural deficits in 2018-19 and beyond are mainly the result of two factors: elderly benefits that increase faster than overall revenue growth and rising interest rates.

The structural surplus in 2015-16 is higher than estimated in April because of a stronger financial performance in 2014-15 (some of which affects future years under PBO's forecasting methodology). Stronger-than-expected revenues in the first quarter of the 2015-16 financial year were also a factor.

The structural deficit in 2019-20 is higher than estimated in April because of two factors: a deterioration in real potential output as a result of lower investment, and a weaker outlook for terms of trade. Lower potential output and weaker terms of trade combine to reduce the revenue generating capacity of the economy.

Table 2-7 Estimate of the structural budgetary balance

$ billions	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021
Budgetary balance	1.9	1.2	-3.0	-4.7	-5.0	-4.6	-4.2
Structural balance	4.5	7.6	3.0	0.9	-0.5	-2.2	-3.4

Source: Parliamentary Budget Officer.

Appendix A: Economic Outlook

% unless otherwise indicated	2015	2016	2017	2018	2019	2020
Real GDP growth						
April 2015	2.1	2.3	1.8	1.8	1.8	1.7
November 2015	1.1	2.0	2.3	1.8	1.8	1.8
GDP inflation						
April 2015	-0.8	2.5	2.1	2.0	2.1	2.1
November 2015	-0.4	1.6	2.2	2.1	2.1	2.2
Nominal GDP growth						
April 2015	1.3	4.8	4.0	3.9	3.9	3.8
November 2015	0.7	3.7	4.5	4.0	3.9	4.0
Nominal GDP ($ billions)						
April 2015	2,000	2,095	2,179	2,263	2,352	2,442
November 2015	1,990	2,063	2,157	2,243	2,331	2,425
3-month treasury rate						
April 2015	0.7	0.8	1.8	2.6	3.0	3.3
November 2015	0.5	0.5	1.6	2.3	2.7	3.4
10-year government bond rate						
April 2015	1.8	2.6	3.4	4.0	4.4	4.5
November 2015	1.6	2.2	3.0	3.8	4.3	4.5
Exchange rate (US¢/C$)						
April 2015	80.0	80.1	80.0	79.8	79.7	79.7
November 2015	78.4	75.4	75.0	74.9	74.7	74.7
Unemployment rate						
April 2015	6.7	6.6	6.4	6.3	6.2	6.1
November 2015	6.9	6.9	6.6	6.4	6.3	6.2
CPI inflation						
April 2015	1.1	2.3	2.0	2.0	2.0	2.0
November 2015	1.2	2.2	2.1	2.0	2.0	2.0
U.S. real GDP growth						
April 2015	3.0	3.0	2.6	2.3	2.2	2.2
November 2015	2.4	2.6	2.6	2.4	2.3	2.2
WTI oil price ($US)						
April 2015	52.1	58.7	61.7	63.3	64.4	65.5
November 2015	49.7	49.5	53.0	55.4	57.3	58.7

Source: Parliamentary Budget Officer.

Note: April nominal GDP levels have been adjusted for historical revisions.

Appendix B: Detailed Fiscal Outlook

$ billions	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019	2019-2020	2020-2021
Income taxes							
Personal income tax	135.7	141.7	147.5	155.1	162.3	169.8	178.5
Corporate income tax	39.4	37.8	37.3	38.0	38.4	39.7	40.6
Non-resident income tax	6.2	6.3	6.7	6.9	7.2	7.5	7.8
Total income tax	181.4	185.8	191.5	200.0	207.9	217.0	226.9
Excise taxes/duties							
Goods and Services Tax	31.3	32.9	33.9	35.0	36.3	37.7	39.0
Custom import duties	4.6	4.8	4.5	4.8	5.0	5.2	5.4
Other excise taxes/duties	11.3	11.3	11.3	11.3	11.3	11.2	11.4
Total excise taxes/duties	47.2	49.0	49.7	51.1	52.6	54.1	55.8
EI premium revenues	22.6	23.5	23.7	20.3	21.0	21.1	21.3
Other revenues	31.2	33.3	33.0	36.3	38.2	39.8	41.4
Total budgetary revenues	282.3	291.6	297.9	307.7	319.7	332.0	345.4
Major transfers to persons							
Elderly benefits	44.1	45.6	48.2	50.8	53.7	56.7	60.2
Employment Insurance benefits	18.1	18.9	20.0	20.6	21.0	21.2	21.3
Children's benefits	14.3	18.1	18.3	18.6	18.9	19.2	19.5
Total	76.5	82.6	86.4	90.0	93.5	97.0	101.0
Major transfers to other levels of government							
Canada Health Transfer	32.1	34.0	36.1	37.1	38.2	39.8	41.4
Canada Social Transfer	12.6	13.0	13.3	13.7	14.2	14.6	15.0
Fiscal arrangements	15.9	16.5	16.9	17.3	17.7	18.4	19.1
Gas tax fund	2.0	2.0	2.1	2.1	2.1	2.2	2.2
Other	0.5	0.2	0.1	0.1	0.0	0.0	0.0
Total	63.1	65.6	68.5	70.4	72.2	75.0	77.8
Direct program expenses	114.3	115.8	120.8	123.5	127.2	130.1	134.0
Public debt charges	26.6	26.4	25.2	28.5	31.7	34.5	36.8
Total expenses	280.4	290.4	301.0	312.4	324.7	336.6	349.6
Budgetary balance	1.9	1.2	-3.0	-4.7	-5.0	-4.6	-4.2
Federal debt	612.3	613.5	616.5	621.2	626.2	630.8	635.0

Sources: Finance Canada and Parliamentary Budget Officer.

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NOTES

1. This report incorporates data up to and including 30 October 2015 unless otherwise indicated. All rates are reported at annual rates unless otherwise noted.
2. Projected oil prices are based on average futures prices from 12 October to 29 October 2015.
3. A Ways and Means motion was adopted by the House of Commons on 1 June 2015; however, legislation implementing the zero-rating of feminine hygiene products has not yet been introduced. According to the Canada Revenue Agency, retailers can choose whether to charge GST on such products.