



OFFICE OF THE  
PARLIAMENTARY BUDGET OFFICER



BUREAU DU  
DIRECTEUR PARLEMENTAIRE DU BUDGET

## **PBO Economic and Fiscal Outlook**

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[www.parl.gc.ca/pbo-dpb](http://www.parl.gc.ca/pbo-dpb)

The *Parliament of Canada Act* mandates the Parliamentary Budget Officer (PBO) to provide independent analysis to the Senate and House of Commons on the state of the nation's finances, government estimates and trends in the national economy. The following presents PBO's status quo economic and fiscal outlook based on data received up to 26 May 2011.

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\* The authors would like to thank Mostafa Askari for his helpful comments. Any errors or omissions are the responsibility of the authors.

## **Summary**

To enhance PBO's independent analysis on the state of the nation's finances and trends in the national economy and given the downside risks to the average private sector outlook, PBO is providing – for the first time – its own medium-term economic outlook.<sup>1</sup> Previously, PBO had used the average forecasts from Finance Canada's survey of private sector economists to prepare its fiscal projections. PBO's economic outlook incorporates its judgement of the balance of risks and as a result it can be viewed as a 'balanced' projection, which means that higher or lower outcomes are equally likely.

### **PBO Economic Outlook and Risk Assessment**

The world economy continues to recover from the worst global recession since the Second World War. Many advanced economies remain well below their productive capacities and growth continues to be restrained by ongoing balance sheet adjustments. At the same time, global growth is increasingly being driven by emerging market economies. In this context, commodity prices have recovered strongly since early 2009, but still remain well below pre-recession peaks. Recent economic data show that the Canadian economy expanded by 3.9 per cent (annual rate) in the first quarter of 2011. Despite this strong growth, the unemployment rate remains elevated and average weekly hours worked remains below pre-recession levels (Slide 1). PBO continues to estimate that the Canadian economy is operating below its full capacity (Slide 2).

Looking ahead, PBO projects that sluggish U.S. growth combined with the Canadian dollar remaining above parity will subdue near-term growth in the Canadian economy and restrain the decline in the unemployment rate. PBO projects real gross domestic product (GDP) to grow by 2.2 and 2.3 per cent in 2012 and 2013 respectively and average 2.8 per cent over the 2014-2016 period (Slide 3) while the unemployment rate remains above 7 per cent until 2016 (Slide 4). Reflecting the sluggish recovery, PBO projects that the output gap will close gradually, restraining the pace of interest rate hikes by the Bank of Canada.

Relative to PBO's economic projection, the average private sector forecast of real GDP growth presented in the March 2011 budget suggests a more rapid recovery (Slide 5). However, PBO judges that the balance of risks to the private sector outlook continues to be tilted to the downside (Slide 6). First, PBO believes there is downside risk to the average U.S. outlook related to ongoing balance sheet adjustments, persistently high unemployment levels and the impending fiscal consolidation. Second, the recent strength in the Canadian dollar has outpaced the rebound in commodity prices, which likely reflects portfolio shifts and broader-based U.S. dollar depreciation. PBO projects that these factors will persist through the medium term, resulting in a higher exchange rate than private sector economists, on average, anticipate. Third, exceptionally low interest rates have helped fuel the rebound in consumer spending but have also helped push household indebtedness to historic

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<sup>1</sup> The May 2011 PBO economic and fiscal outlook is based on data received up to May 26, 2011 and therefore does not include the recently released March 2011 Fiscal Monitor and the first quarter 2011 National Income and Expenditure Accounts. However, incorporating these data would not significantly impact PBO's overall economic and fiscal outlook.

high. PBO expects that the combination of high household debt and rising interest rates will restrain growth by a larger amount in the near term than appears to be factored in by private sector economists (on average). Lastly, although there are also risks related to sovereign debt issues in Europe, PBO has not explicitly incorporated the balance of these risks into its economic projection. That said, PBO believes that the risks to its economic outlook are roughly balanced.

To illustrate the uncertainty and balance of risks to the average private sector forecasts of real GDP and short-term interest rates, PBO presents fan charts based on their historical forecast performance (Slides 7 and 8).

### **PBO Status Quo Fiscal Outlook**

In contrast to its previous practice of preparing fiscal projections, PBO is now basing its fiscal outlook on its own economic projection. Further, PBO's current fiscal outlook is presented on a status quo basis i.e., excluding new measures announced in the Government's March 2011 budget, which was tabled in the House of Commons but not adopted prior to the dissolution of Parliament on March 26, 2011.

As the economy recovers, PBO projects growth in budgetary revenues to outpace growth in nominal GDP – the broadest measure of the Government's tax base (Slide 9). This reflects a cyclical rebound in revenues as well as increases in Employment Insurance (EI) premium rates that are required to balance the EI program over time. PBO projects EI premium rates to rise by the maximum allowable amount from \$1.73 (per \$100 of insurable earnings) in 2010 to \$2.18 in 2015. However, the impact of this policy action on budgetary revenues is dampened by the legislated reductions in the general corporate income tax rate to 16.5 per cent on January 1, 2011 and to 15 per cent on January 1, 2012.

PBO projects the Government's program expenses to grow at 2 per cent annually, on average, from 2010-11 to 2015-16 (Slide 10). However, projected growth across individual program categories varies significantly. For example, PBO projects elderly benefits to increase by 5.2 per cent annually while transfer payments administered by departments for farm income support, natural resource royalty payments and student financial assistance (which are included in direct program expenses) are projected to decline by 4.4 per cent annually, on average, over the same period. The decline in transfer payments reflects, in part, the unwinding of the Economic Action Plan stimulus measures. PBO projects public debt charges to increase from \$30.9 billion in 2010-11 to \$39.3 billion in 2015-16 as interest rates rise from current levels and budgetary deficits add to the stock of interest-bearing debt. However, the unwinding of the Insured Mortgage Purchase Program (IMPP) partially offsets this increase in the stock of interest-bearing debt.

Since budgetary revenues are increasing at a faster pace than total expenses (program expenses plus public debt charges) the budgetary balance improves steadily over the medium term from a deficit of \$39.5 billion (2.4 per cent of GDP) in 2010-11 to a deficit of \$7.3 billion (0.4 per cent of GDP) in 2015-16 (Slide 11). PBO projects budgetary deficits that are moderately larger, on average, than Finance Canada's projection of the status quo budgetary balance presented in the March 2011 budget. On a cumulative basis, PBO projects budgetary deficits totalling \$128.2 billion over the period 2010-11 to

2015-16, which is significantly higher than the \$93.6 billion projected by Finance Canada over the same period. This discrepancy primarily reflects PBO's higher projected operating expenses.

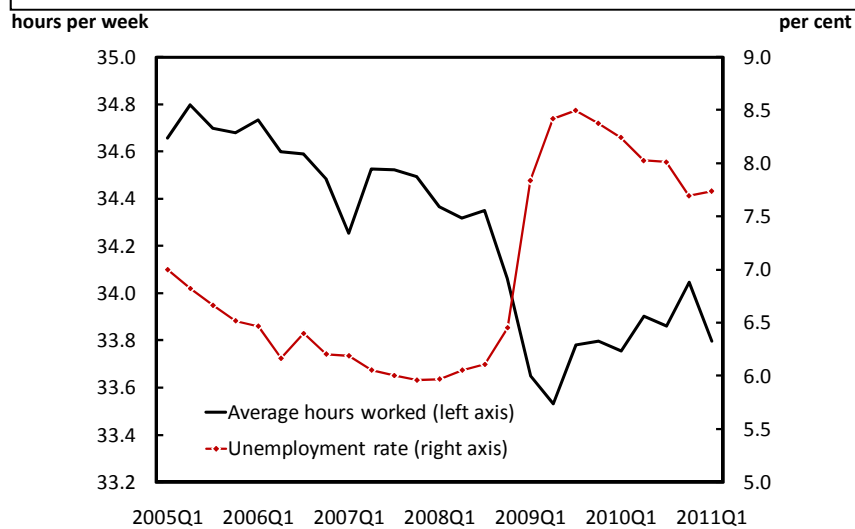
**Status Quo Budgetary Balance Projections**

	<b>2010- 2011</b>	<b>2011- 2012</b>	<b>2012- 2013</b>	<b>2013- 2014</b>	<b>2014- 2015</b>	<b>2015- 2016</b>
	(\$ billions)					
PBO May 2011	-39.5	-26.1	-22.8	-19.3	-13.3	-7.3
Finance Canada March 2011	-40.4	-27.8	-19.0	-9.7	-0.5	3.8

Based on PBO's measure of the economic uncertainty surrounding the private sector forecast, Finance Canada's fiscal sensitivities, and given the balance of risks, PBO estimates that on a status quo basis the likelihood of realizing budgetary balance or better in 2014-15 is approximately 20 per cent and approximately 35 per cent in 2015-16 (Slide 12).

The projected reduction in the budgetary deficit over the medium term largely reflects a cyclical improvement in the economy. PBO estimates that the Government's structural deficit will decline gradually to \$5.9 billion in 2015-16 (Slide 13) or 0.3 per cent of potential income, which is significantly smaller than the structural deficits in the 1980s and early 1990s (Slide 14). PBO's estimate of the structural deficit does not mean that the Government's budget will not return to balance or that its fiscal structure is not sustainable. Rather, it suggests that policy actions to increase revenues and/or reduce spending would be required to ensure that the budget is balanced once the economy returns to its potential. Further, to assess whether a government's fiscal structure is sustainable requires looking beyond projections of budget deficits and debt over a medium-term horizon to take into account the economic and fiscal implications of population ageing. PBO will be providing an update of its assessment of the Government's finances over the long term in its forthcoming Fiscal Sustainability Report.

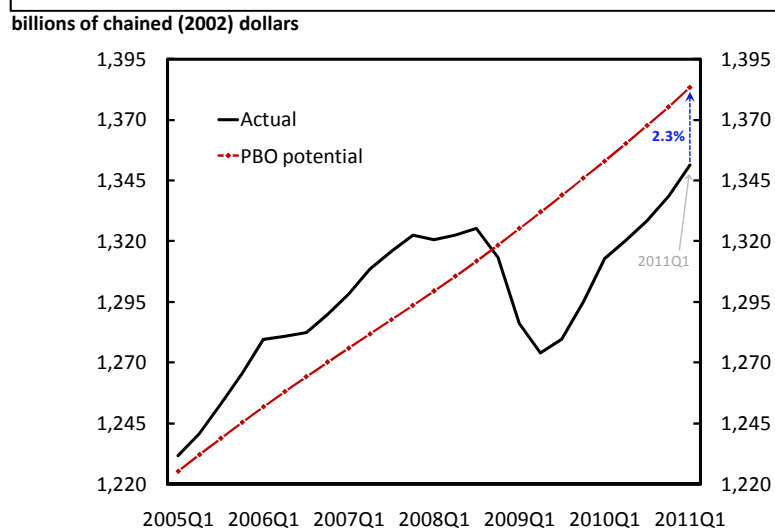
## Unemployment Rate and Average Hours Worked



Source: Office of the PBO; Statistics Canada

Slide 1

## Real and Potential GDP



Source: Office of the PBO; Statistics Canada

Slide 2

## Private Sector and PBO Economic Outlooks

	2011	2012	2013	2014	2015	2016
<b>Real GDP growth (%)</b>						
Finance Canada March 2011 survey	2.9	2.8	2.7	2.5	2.5	2.4
PBO May 2011 projection	2.9	2.2	2.3	2.5	2.9	2.9
<b>GDP inflation (%)</b>						
Finance Canada March 2011 survey	2.8	2.1	2.1	2.0	2.0	2.0
PBO May 2011 projection	3.3	1.9	2.0	2.0	2.0	2.0
<b>Nominal GDP growth (%)</b>						
Finance Canada March 2011 survey	5.8	5.0	4.9	4.5	4.5	4.4
PBO May 2011 projection	6.2	4.2	4.3	4.5	5.0	4.9
<b>Nominal GDP level (\$ billions)</b>						
Finance Canada March 2011 survey	1,716	1,801	1,890	1,975	2,064	2,156
PBO May 2011 projection	1,723	1,795	1,872	1,957	2,054	2,155

Source: Office of the PBO; Finance Canada

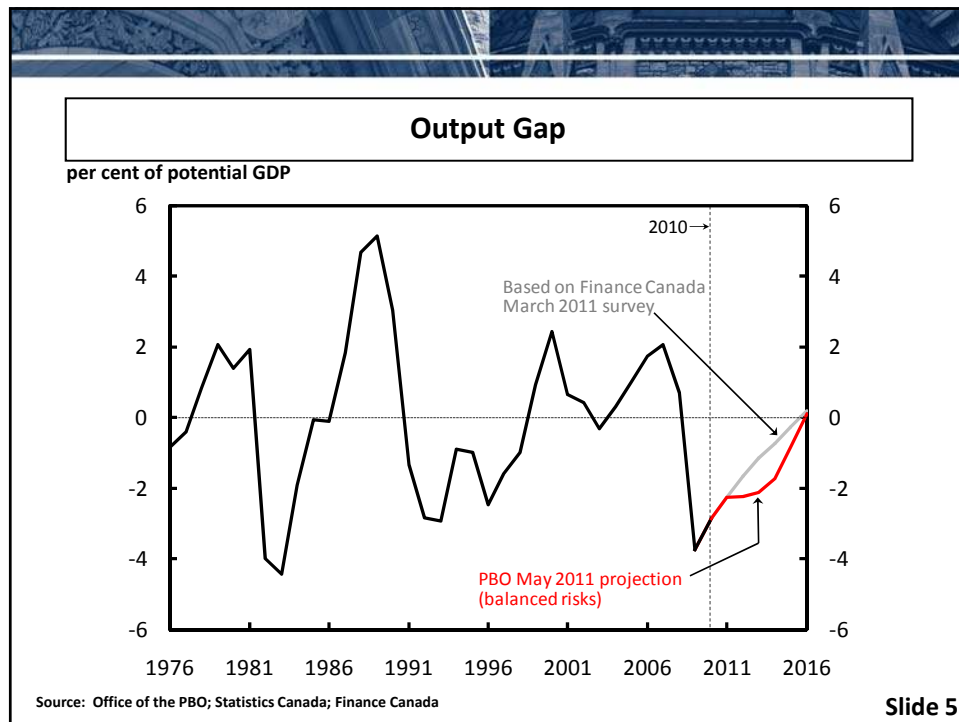
Slide 3

## Private Sector and PBO Economic Outlooks

	2011	2012	2013	2014	2015	2016
<b>3-month treasury bill rate (%)</b>						
Finance Canada March 2011 survey	1.3	2.5	3.4	3.9	4.1	4.1
PBO May 2011 projection	1.2	1.8	2.5	3.5	4.0	4.3
<b>10-year government bond rate (%)</b>						
Finance Canada March 2011 survey	3.5	4.0	4.6	4.8	5.0	5.1
PBO May 2011 projection	3.4	3.8	4.2	4.6	5.0	5.3
<b>Unemployment rate (%)</b>						
Finance Canada March 2011 survey	7.5	7.2	7.0	6.7	6.5	6.4
PBO May 2011 projection	7.8	7.8	7.7	7.5	7.1	6.7
<b>Exchange rate (US cents/C\$)</b>						
Finance Canada March 2011 survey	99.7	98.8	98.1	97.4	96.5	96.2
PBO May 2011 projection	102.2	102.0	102.0	102.0	102.0	102.0
<b>U.S real GDP growth</b>						
Finance Canada March 2011 survey	3.1	3.1	3.2	3.3	3.2	2.7
PBO May 2011 projection	2.4	2.6	2.8	2.9	3.0	2.8

Source: Office of the PBO; Finance Canada

Slide 4



Slide 5

## PBO Assessment of Key Risks to the Private Sector Economic Outlook

### External

- weaker U.S. real GDP growth reflecting balance sheet repair, persistently high unemployment and fiscal consolidation
- sovereign debt concerns in Europe could restrain global growth and put upward pressure on global interest rates

### Currency and commodity prices

- stronger Canadian dollar reflecting higher commodity prices but also portfolio shifts and broader-based U.S. dollar weakness

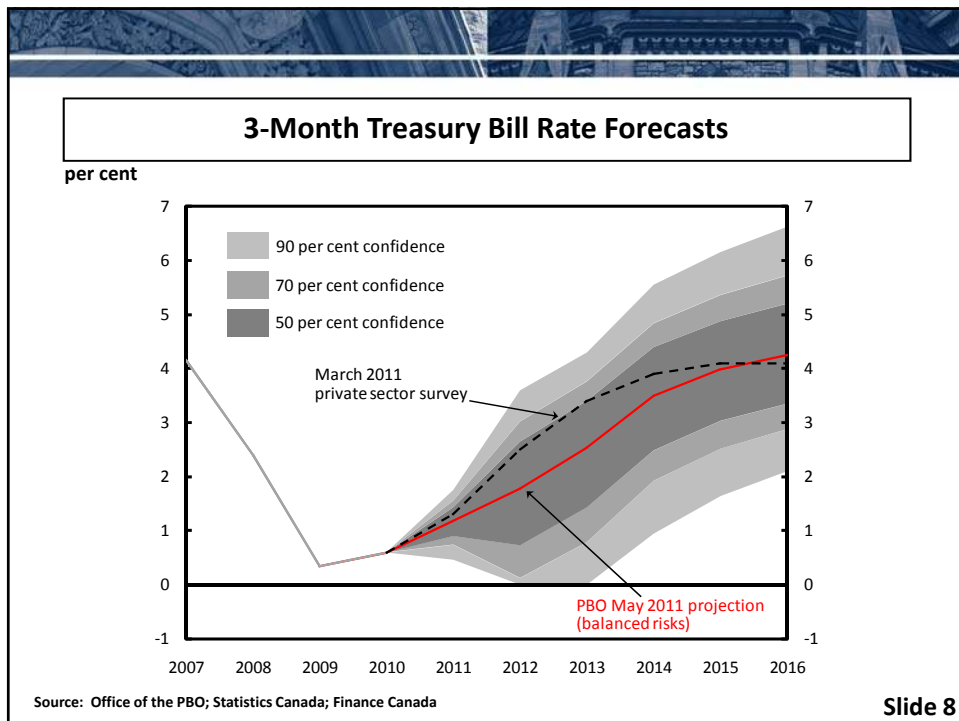
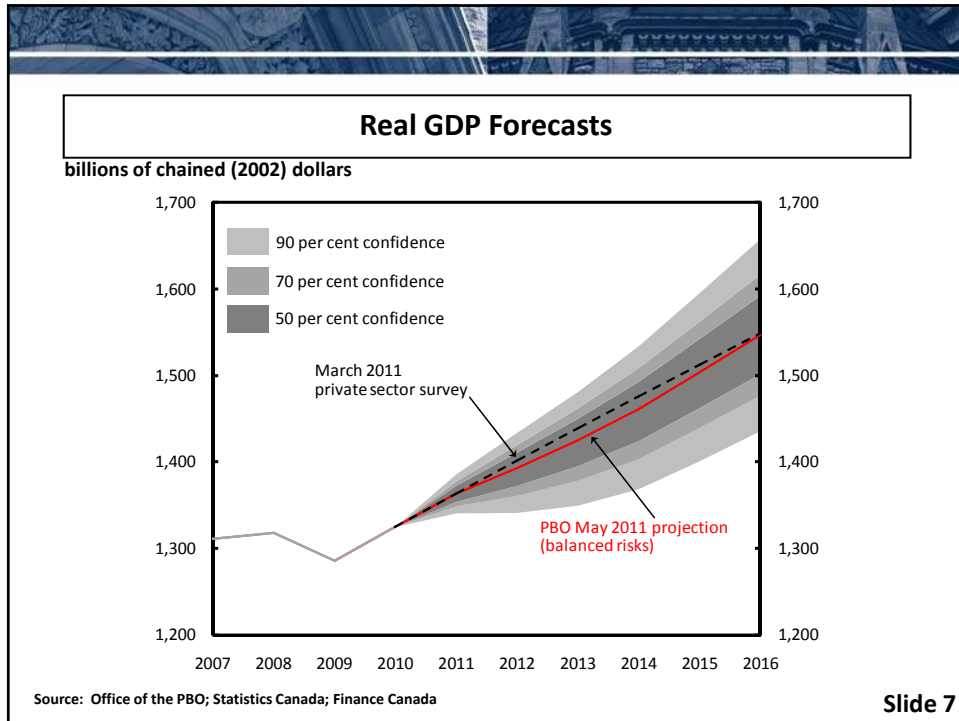
### Domestic

- high level of household debt further restraining consumer spending and residential investment

- Overall downside risk suggests a more sluggish economic recovery
- PBO's projection attempts to adjust for the balance of risks

Slide 6





## PBO Status Quo Revenue Projection

billions of dollars, excluding March 2011 budget measures

	2010- 2011	2011- 2012	2012- 2013	2013- 2014	2014- 2015	2015- 2016
Income taxes						
Personal income tax	113.5	127.6	134.3	141.6	149.7	158.7
Corporate income tax	29.9	28.3	27.5	29.1	30.4	32.0
Non-resident income tax	5.3	6.2	6.4	6.8	7.3	7.7
Total income tax	148.7	162.1	168.2	177.5	187.4	198.4
Excise taxes/duties						
Goods and Services Tax	28.2	29.3	30.7	31.9	33.3	35.0
Custom import duties	3.5	3.7	3.8	4.0	4.1	4.3
Other excise taxes/duties	10.8	10.9	10.9	10.9	10.7	10.8
Total excise taxes/duties	42.5	43.9	45.4	46.8	48.2	50.1
El premium revenues	17.6	19.2	21.2	23.4	25.9	27.9
Other revenues	27.2	28.1	29.3	30.1	29.8	31.0
<b>Total budgetary revenues</b>	<b>236.1</b>	<b>253.3</b>	<b>264.2</b>	<b>277.9</b>	<b>291.3</b>	<b>307.4</b>

Source: Office of the PBO

Slide 9

## PBO Status Quo Expenditure Projection

billions of dollars, excluding March 2011 budget measures

	2010- 2011	2011- 2012	2012- 2013	2013- 2014	2014- 2015	2015- 2016
Major transfers to persons						
Elderly benefits	35.6	37.7	39.9	42.2	44.5	47.0
Employment Insurance benefits	20.2	19.8	20.5	21.1	21.4	21.5
Children's benefits	12.7	13.1	13.5	13.7	13.8	13.9
Total	68.5	70.6	74.0	77.0	79.7	82.4
Major transfers to OLG	53.1	55.4	57.0	59.8	62.3	65.2
Direct program expenses						
Transfer payments	41.3	35.7	33.1	31.8	30.3	30.5
Capital amortization	4.5	4.8	5.0	5.2	5.4	5.5
Other operating expenses	22.1	23.1	24.5	25.5	25.8	26.7
Operating expenses subject to freeze	55.2	57.1	59.0	61.0	63.0	65.1
Total	123.1	120.7	121.6	123.5	124.5	127.8
Public debt charges	30.9	32.8	34.4	37.0	38.0	39.3
<b>Total expenses</b>	<b>275.6</b>	<b>279.4</b>	<b>287.0</b>	<b>297.2</b>	<b>304.5</b>	<b>314.8</b>

Source: Office of the PBO

Slide 10

## PBO Status Quo Fiscal Projection – Summary

billions of dollars, excluding March 2011 budget measures

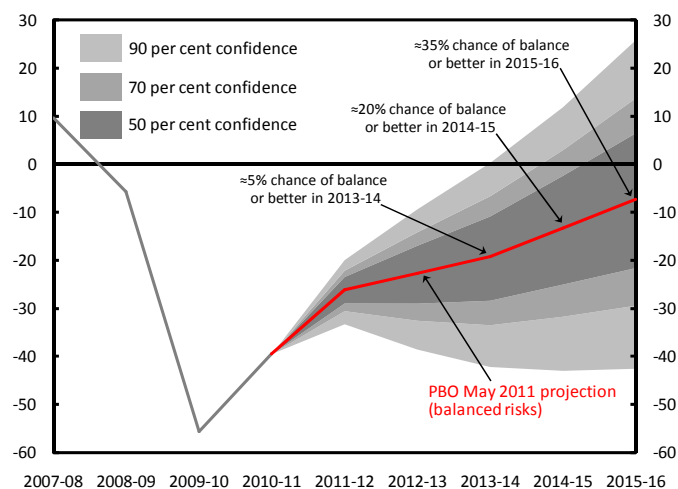
	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016
<b>Budgetary revenues</b>	236.1	253.3	264.2	277.9	291.3	307.4
Program expenses	244.7	246.6	252.5	260.2	266.5	275.4
Public debt charges	30.9	32.8	34.4	37.0	38.0	39.3
<b>Total expenses</b>	275.6	279.4	287.0	297.2	304.5	314.8
<b>Budgetary balance</b>	-39.5	-26.1	-22.8	-19.3	-13.3	-7.3
Federal debt	555.5	581.6	604.3	623.6	636.9	644.2
<b>Per cent of GDP</b>						
Budgetary revenues	14.6	14.7	14.7	14.8	14.9	15.0
Program expenses	15.1	14.3	14.1	13.9	13.6	13.4
Public debt charges	1.9	1.9	1.9	2.0	1.9	1.9
Budgetary balance	-2.4	-1.5	-1.3	-1.0	-0.7	-0.4
Federal debt	34.3	33.8	33.7	33.3	32.5	31.4

Source: Office of the PBO

Slide 11

## Status Quo Budgetary Balance Outcomes Given Economic Uncertainty

billions of dollars



Source: Office of the PBO; Finance Canada

Slide 12

## Structural and Cyclical Balance Estimates

billions of dollars

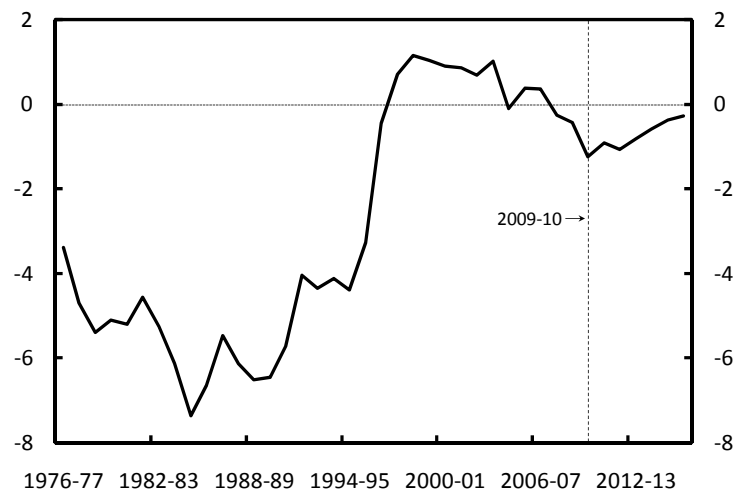
	2009- 2010	2010- 2011	2011- 2012	2012- 2013	2013- 2014	2014- 2015	2015- 2016
Budgetary balance	-55.6	-39.5	-26.1	-22.8	-19.3	-13.3	-7.3
Structural balance	-20.3	-15.5	-18.7	-14.9	-11.3	-7.4	-5.9
Cyclical balance	-35.3	-24.0	-7.3	-7.9	-8.0	-5.9	-1.5

Source: Office of the PBO

Slide 13

## Structural Balance

per cent of potential income



Source: Office of the PBO

Slide 14