



OFFICE OF THE  
PARLIAMENTARY BUDGET OFFICER



BUREAU DU  
DIRECTEUR PARLEMENTAIRE DU BUDGET

## **PBO Economic and Fiscal Outlook**

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Ottawa, Canada

November 1, 2011

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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 seeks to fulfill the September 29, 2011 Standing Committee of Finance motion that "[c]onsistent with the Parliamentary Budget Officer (PBO) mandate ... the PBO provide a Economic and Fiscal Outlook to the Committee the fourth week of October and April of every calendar year and be available to appear before the Committee to discuss its findings shortly thereafter." The following presents PBO's economic and fiscal outlook based on data received up to October 12, 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.

## **Economic Context**

The global economic outlook has deteriorated since PBO's June 2011 Economic and Fiscal Outlook (EFO). The weaker outlook for global growth is primarily the result of growing concerns related to sovereign debt in the Euro zone and has led to a significant reduction in commodity prices (Slide 1). At the same time, a number of economic indicators released since May have been weaker than expected including U.S. real GDP growth in the first and second quarters of the year, as well as downward revisions to previous quarters which showed that the U.S. recession was larger, and the rebound weaker, than previously estimated (Slide 2). Long-term interest rates in the U.S. have also decreased considerably in recent months reflecting expectations of short-term rates remaining low for longer, as well as a flight to quality.

Taken together, these developments have led PBO to revise down the outlook for the Canadian economy relative to its June 2011 EFO. The level of nominal GDP is now projected to be approximately \$49 billion lower annually, on average, over the projection horizon due to downward revisions to both real GDP and the GDP deflator (Slide 3). PBO has also revised up its projection of the unemployment rate and revised down its projection for short- and long-term interest rates consistent with the weaker economic outlook (Slide 4). As a result, PBO is now projecting lower tax revenues, which are partially offset by lower public debt charges, resulting in larger budgetary deficits relative to its June 2011 EFO.

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

In Canada, the National Income and Expenditure Accounts released on May 31 showed that the economy contracted by 0.4 per cent at an annual rate in the second quarter of 2011, due to weak external demand and one-time factors. PBO projects that the Canadian economy will expand by 1.8 per cent at an annual rate in the second half of 2011 (leaving real GDP 2.5 per cent below its productive capacity (Slide 5)), resulting in annual growth of 2.2 per cent in 2011. Given the expected weakness in the global economy and commodity prices, PBO projects Canadian real GDP to grow by 1.5 and 2.1 per cent in 2012 and 2013, respectively. The weakness in near-term growth pushes the economy further below its productive capacity resulting in an increase in the unemployment rate. As the economic recovery takes hold, real GDP growth is projected to average 2.8 per cent over the 2014 to 2016 period. As a result, PBO expects the Bank of Canada to maintain the overnight rate target at 1 per cent through the third quarter of 2013 before gradually raising rates over the remainder of the projection.

PBO projects slower real GDP growth in the near term than currently envisioned by private sector forecasters based on Finance Canada's September 2011 survey (Slide 6). PBO is also projecting a lower level of nominal GDP, the broadest measure of the Government's tax base, relative to private sector forecasters over the entire projection horizon primarily due to a weaker outlook for GDP inflation (Slides 7 and 8). PBO judges that the balance of risks to the private sector outlook for nominal GDP is tilted to the downside reflecting a more sluggish near-term U.S. recovery (real GDP growth of 1.6 versus 2.0 per cent in 2012), a larger impact from the recent decline in commodity prices (GDP inflation of 1.1 versus 2.0 per cent in 2012), and the high level of Canadian household

indebtedness which will likely restrain growth by a larger amount in the near term than appears to be factored in by private sector forecasters (Slide 9). To illustrate the uncertainty and balance of risks to the average private sector forecast of nominal GDP, PBO constructs a fan chart based on the historical forecast performance of Finance Canada's survey of private sector forecasters (Slide 10).

## **PBO Fiscal Outlook**

PBO's updated fiscal projection incorporates measures contained in the Government's June 2011 budget. As the pace of the recovery gains momentum, budgetary revenues (Slide 11) are projected to outpace growth in nominal GDP. This reflects a cyclical rebound in revenues as well as increases in Employment Insurance (EI) premium rates, from \$1.78 (per \$100 of insurable earnings) in 2011 to \$2.28 in 2016, that are required to balance the EI account over time. 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 2.8 per cent annually, on average, from 2011-12 to 2016-17 (Slide 12). Over the same period, direct program expenditure is assumed to grow modestly at 1.6 per cent annually, on average, which is significantly slower growth than observed over the 5 years preceding the downturn but stronger than the average growth experienced in the second half of the 1990s (Slide 13). PBO projects public debt charges to increase from \$30.9 billion in 2010-11 to \$40.7 billion in 2016-17 as budgetary deficits add to the stock of interest-bearing debt and interest rates rise from current levels. Relative to the June 2011 EFO, PBO is projecting significantly lower public debt charges despite higher projected levels of interest-bearing debt resulting from downward revisions to short- and long-term interest rates.

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 \$33.4 billion (2.1 per cent of GDP) in 2010-11 to a deficit of \$7.3 billion (0.3 per cent of GDP) in 2016-17 (Slide 14). Given PBO's assessment of the balance of risks to the private sector economic outlook, PBO estimates that the likelihood of realizing budgetary balance or better is approximately 10 per cent, 25 per cent and 40 per cent in 2014-15, 2015-16 and 2016-17, respectively (Slide 15).

The projected reduction in the budgetary deficit over the period 2011-12 to 2016-17 primarily reflects an improvement in the Government's structural balance. PBO estimates that the Government's structural deficit will decline from \$25 billion in 2011-12 to \$1.6 billion in 2016-17 (Slide 16). Relative to potential income, this represents a decline of 1.3 percentage points in the structural deficit from 1.4 to 0.1 per cent in 2016-17 (Slide 17). The decline in the structural deficit (relative to potential income) stems largely from PBO's assumed modest growth in direct program expenditure over the medium term. Relative to the June 2011 EFO, PBO's estimate of the Government's structural deficit in 2015-16 is \$4.6 billion smaller. This revision primarily reflects a reduction in spending on public debt charges, operating expenses and Equalization payments. Structural revenues have also been revised upward to incorporate Budget 2011 measures to close corporate and personal tax loopholes and a higher EI premium rate in 2016.

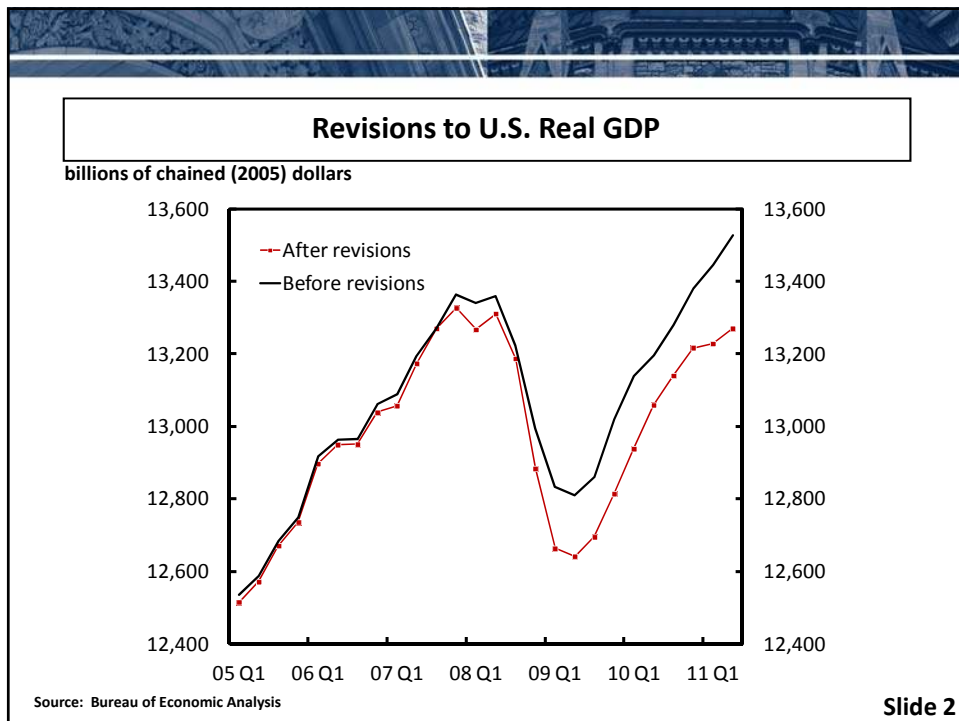
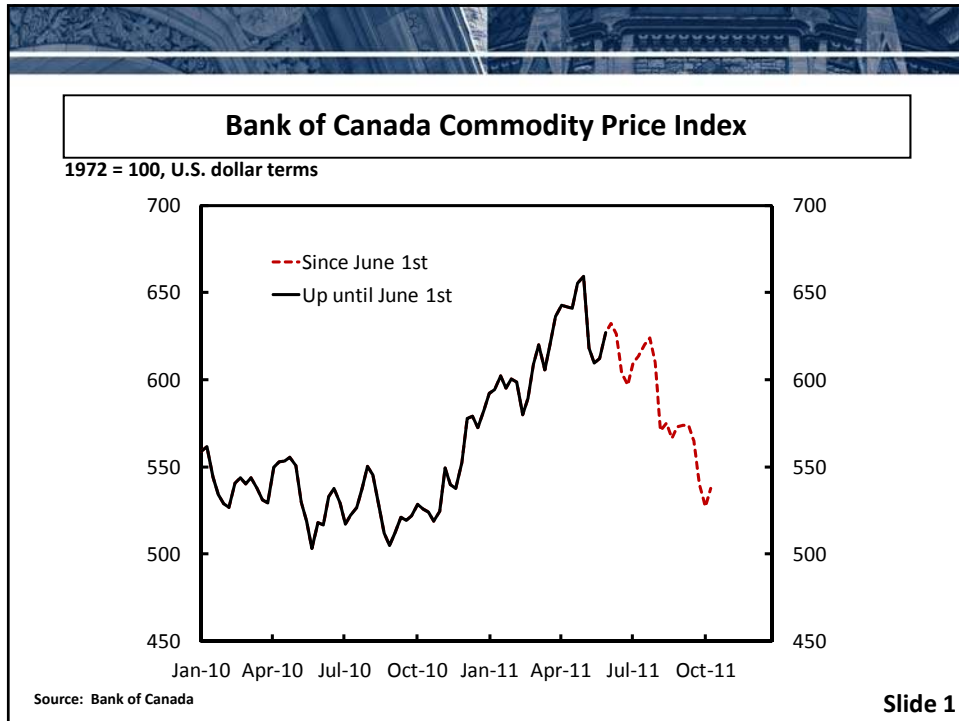
Although PBO estimates that the Government's structural deficit will essentially be eliminated by the end of the projection horizon, assessing whether a government's fiscal structure is sustainable requires looking beyond projections of budgetary deficits and debt over a medium-term horizon to take into account the economic and fiscal implications of population ageing (Slide 18).

### **Fiscal Sustainability**

PBO's 2011 Fiscal Sustainability Report provided an assessment of the sustainability of the current federal and provincial-territorial fiscal structure over the long term and concluded that this structure is not sustainable (Slide 19). In its baseline projection, PBO estimated that restoring sustainability to federal and provincial-territorial government finances would require permanent policy actions to improve the operating balance – either by raising taxes, reducing program spending, or some combination of both – amounting to 2.7 per cent of GDP (1.5 per cent of GDP at the provincial-territorial level and 1.2 per cent of GDP at the federal level) to ultimately stabilize the net debt-to-GDP ratio at its current level of 58 per cent of GDP (Slide 20).

To put the required amount of fiscal action into historical context, it is helpful to compare these amounts to movements in the estimated structural operating balance over history (Slide 21). Although the consolidated federal and provincial-territorial government structural operating balance improved by 6.2 percentage points of GDP from 1994-95 to 1997-98 (which is well in excess of the estimated 2.7 per cent of GDP in required fiscal actions), this improvement was reversed over the decade that followed.

It is important to note, however, that the fiscal actions required to achieve sustainability do not need to be taken immediately. Implementing the necessary measures may be delayed until the economy has fully recovered without unduly increasing the overall amount of required fiscal action. PBO estimates that delaying fiscal actions until the economy has fully recovered would only increase the amount of required adjustment moderately from 2.7 to 3.0 per cent of GDP. However, a significant delay in implementing fiscal actions substantially increases the required amount of corrective measures. For example, delaying fiscal actions by 10, 20 and 30 years would increase the amount of corrective measures to 3.4, 4.4 and 5.8 per cent of GDP, respectively.



### PBO Economic Outlook – May and October 2011

	2011	2012	2013	2014	2015	2016
<b>Real GDP growth (%)</b>						
PBO May 2011 projection	2.9	2.2	2.3	2.5	2.9	2.9
PBO October 2011 projection	2.2	1.5	2.1	2.5	2.8	3.0
<b>GDP inflation (%)</b>						
PBO May 2011 projection	3.3	1.9	2.0	2.0	2.0	2.0
PBO October 2011 projection	2.6	1.1	1.8	2.0	2.2	2.2
<b>Nominal GDP growth (%)</b>						
PBO May 2011 projection	6.2	4.2	4.3	4.5	5.0	4.9
PBO October 2011 projection	4.8	2.6	4.0	4.5	5.0	5.3
<b>Nominal GDP level (\$ billions)</b>						
PBO May 2011 projection	1,723	1,795	1,872	1,957	2,054	2,155
PBO October 2011 projection	1,703	1,747	1,817	1,899	1,995	2,100

Source: Office of the PBO

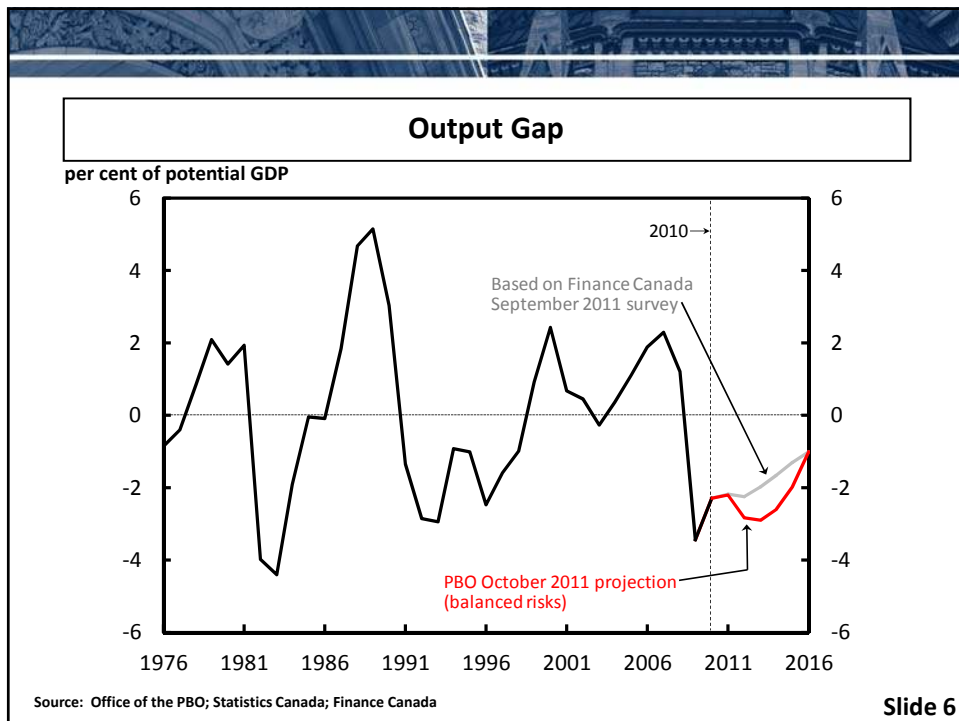
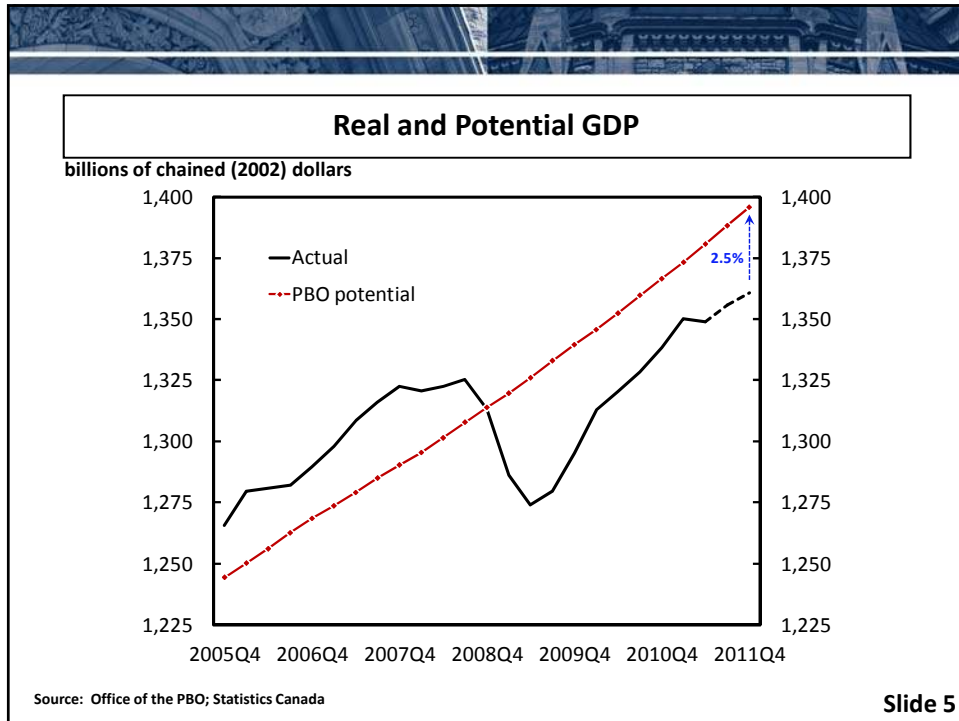
Slide 3

### PBO Economic Outlook – May and October 2011

	2011	2012	2013	2014	2015	2016
<b>3-month treasury bill rate (%)</b>						
PBO May 2011 projection	1.2	1.8	2.5	3.5	4.0	4.3
PBO October 2011 projection	1.0	1.0	1.0	1.8	2.8	3.8
<b>10-year government bond rate (%)</b>						
PBO May 2011 projection	3.4	3.8	4.2	4.6	5.0	5.3
PBO October 2011 projection	2.9	3.1	3.8	4.5	5.0	5.3
<b>Unemployment rate (%)</b>						
PBO May 2011 projection	7.8	7.8	7.7	7.5	7.1	6.7
PBO October 2011 projection	7.4	8.0	8.0	7.8	7.5	7.0
<b>Exchange rate (US cents/C\$)</b>						
PBO May 2011 projection	102.2	102.0	102.0	102.0	102.0	102.0
PBO October 2011 projection	101.0	96.0	96.3	96.8	98.2	99.8
<b>U.S real GDP growth</b>						
PBO May 2011 projection	2.4	2.6	2.8	2.9	3.0	2.8
PBO October 2011 projection	1.5	1.6	2.3	2.6	3.1	3.5

Source: Office of the PBO

Slide 4





## Finance Canada and PBO Economic Outlooks

	2011	2012	2013	2014	2015	2016
<b>Real GDP growth (%)</b>						
Finance Canada September 2011 survey	2.2	2.1	2.5	2.5	2.5	2.3
PBO October 2011 projection	2.2	1.5	2.1	2.5	2.8	3.0
<b>GDP inflation (%)</b>						
Finance Canada September 2011 survey	3.0	2.0	2.0	2.0	2.0	2.0
PBO October 2011 projection	2.6	1.1	1.8	2.0	2.2	2.2
<b>Nominal GDP growth (%)</b>						
Finance Canada September 2011 survey	5.3	4.1	4.5	4.5	4.5	4.3
PBO October 2011 projection	4.8	2.6	4.0	4.5	5.0	5.3
<b>Nominal GDP level (\$ billions)</b>						
Finance Canada September 2011 survey	1,711	1,781	1,861	1,945	2,032	2,120
PBO October 2011 projection	1,703	1,747	1,817	1,899	1,995	2,100

Source: Office of the PBO; Finance Canada

Slide 7

## Finance Canada and PBO Economic Outlooks

	2011	2012	2013	2014	2015	2016
<b>3-month treasury bill rate (%)</b>						
Finance Canada September 2011 survey	0.9	1.2	2.0	2.9	3.5	3.7
PBO October 2011 projection	1.0	1.0	1.0	1.8	2.8	3.8
<b>10-year government bond rate (%)</b>						
Finance Canada September 2011 survey	2.8	2.7	3.2	3.9	4.5	4.5
PBO October 2011 projection	2.9	3.1	3.8	4.5	5.0	5.3
<b>Unemployment rate (%)</b>						
Finance Canada September 2011 survey	7.5	7.2	7.0	6.8	6.6	6.4
PBO October 2011 projection	7.4	8.0	8.0	7.8	7.5	7.0
<b>Exchange rate (US cents/C\$)</b>						
Finance Canada September 2011 survey	101.2	102.1	102.1	98.8	97.9	98.0
PBO October 2011 projection	101.0	96.0	96.3	96.8	98.2	99.8
<b>U.S real GDP growth</b>						
Finance Canada September 2011 survey	1.6	2.0	2.4	2.9	2.9	2.8
PBO October 2011 projection	1.5	1.6	2.3	2.6	3.1	3.5

Source: Office of the PBO; Finance Canada

Slide 8

## 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 Euro zone

### Commodity prices

- larger negative impact on Canadian income from the recent fall in commodity prices
- lower nominal GDP due to the impact of the negative terms of trade shock on GDP inflation

### Domestic

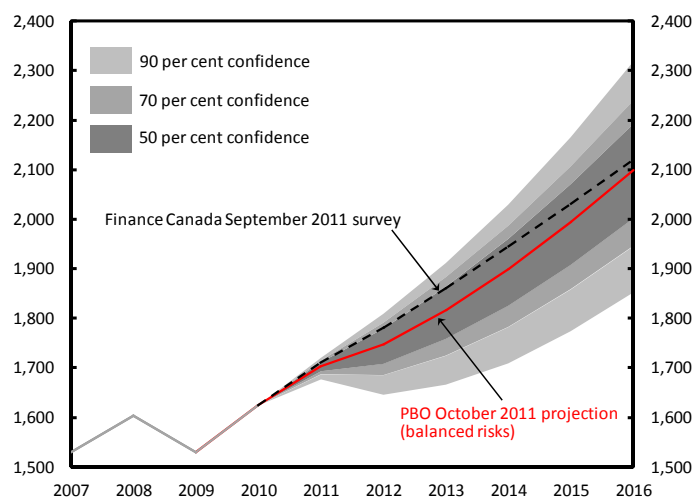
- high level of household debt further restraining consumer spending and residential investment

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

Slide 9

## Nominal GDP Forecasts

billions of dollars



Source: Office of the PBO; Statistics Canada; Finance Canada

Slide 10

## PBO Revenue Projection

billions of dollars

	2011- 2012	2012- 2013	2013- 2014	2014- 2015	2015- 2016	2016- 2017
Income taxes						
Personal income tax	119.6	127.1	134.5	142.2	150.9	159.7
Corporate income tax	27.7	26.5	28.2	29.9	32.3	35.3
Non-resident income tax	5.4	5.7	6.1	6.4	7.0	7.5
Total income tax	152.8	159.3	168.8	178.4	190.1	202.5
Excise taxes/duties						
Goods and Services Tax	29.0	30.1	31.3	32.7	34.2	35.9
Custom import duties	3.8	4.0	4.2	4.4	4.7	4.9
Other excise taxes/duties	11.0	10.9	10.9	10.8	10.8	10.8
Total excise taxes/duties	43.8	45.1	46.4	47.9	49.7	51.6
El premium revenues	19.0	20.8	22.9	25.3	27.9	30.0
Other revenues	27.7	29.0	29.7	29.6	30.9	32.5
<b>Total budgetary revenues</b>	<b>243.3</b>	<b>254.2</b>	<b>267.9</b>	<b>281.2</b>	<b>298.6</b>	<b>316.6</b>

Source: Office of the PBO

Slide 11

## PBO Expenditure Projection

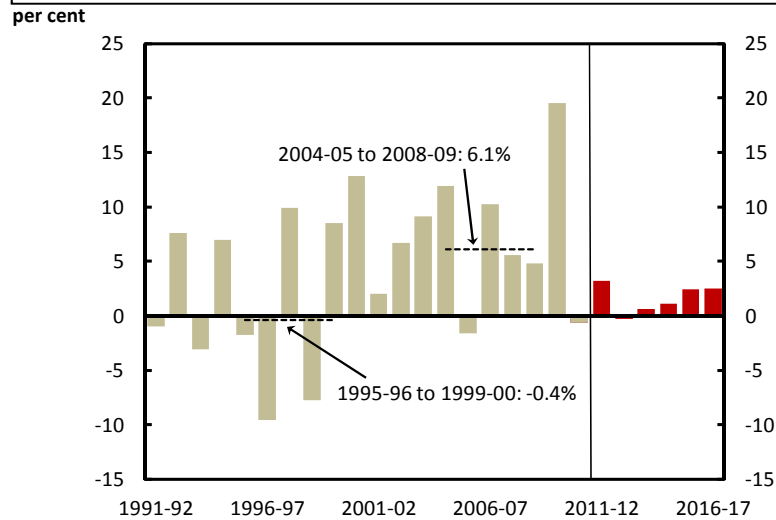
billions of dollars

	2011- 2012	2012- 2013	2013- 2014	2014- 2015	2015- 2016	2016- 2017
Major transfers to persons						
Elderly benefits	37.5	39.8	42.0	44.3	46.8	49.3
Employment Insurance benefits	18.6	20.7	21.4	21.7	21.9	21.8
Children's benefits	13.1	13.5	13.7	13.8	13.9	13.9
Total	69.2	74.0	77.1	79.9	82.6	85.1
Major transfers to OLG	57.5	56.8	59.4	61.8	64.7	67.8
Direct program expenses						
Transfer payments	37.3	34.0	31.8	30.6	30.6	30.6
Capital amortization	4.7	5.0	5.2	5.4	5.6	5.8
Other operating expenses	23.5	24.4	25.3	25.8	26.7	27.6
Operating expenses subject to freeze	56.8	58.6	60.4	62.3	64.3	66.3
Total	122.3	122.0	122.7	124.1	127.2	130.3
Public debt charges	31.6	31.8	32.9	34.2	37.4	40.7
<b>Total expenses</b>	<b>280.6</b>	<b>284.7</b>	<b>292.1</b>	<b>299.9</b>	<b>311.8</b>	<b>323.9</b>

Source: Office of the PBO

Slide 12

### Growth in Direct Program Expenditure



Source: Office of the PBO; Finance Canada

Slide 13

### PBO Fiscal Projection – Summary

billions of dollars

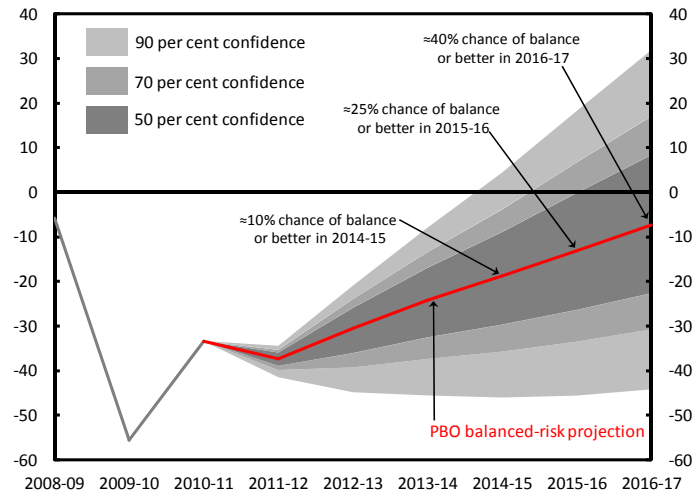
	2011- 2012	2012- 2013	2013- 2014	2014- 2015	2015- 2016	2016- 2017
<b>Budgetary revenues</b>	243.3	254.2	267.9	281.2	298.6	316.6
Program expenses	249.0	252.9	259.2	265.7	274.4	283.2
Public debt charges	31.6	31.8	32.9	34.2	37.4	40.7
<b>Total expenses</b>	280.6	284.7	292.1	299.9	311.8	323.9
<b>Budgetary balance</b>	-37.3	-30.5	-24.2	-18.7	-13.1	-7.3
Federal debt	587.6	618.1	642.3	661.0	674.1	681.4
<b>Per cent of GDP</b>						
Budgetary revenues	14.3	14.5	14.7	14.8	15.0	15.1
Program expenses	14.6	14.5	14.3	14.0	13.8	13.5
Public debt charges	1.9	1.8	1.8	1.8	1.9	1.9
Budgetary balance	-2.2	-1.7	-1.3	-1.0	-0.7	-0.3
Federal debt	34.5	35.4	35.4	34.8	33.8	32.5

Source: Office of the PBO

Slide 14

## Budgetary Balance Outcomes Given Economic Uncertainty

billions of dollars



Source: Office of the PBO

Slide 15

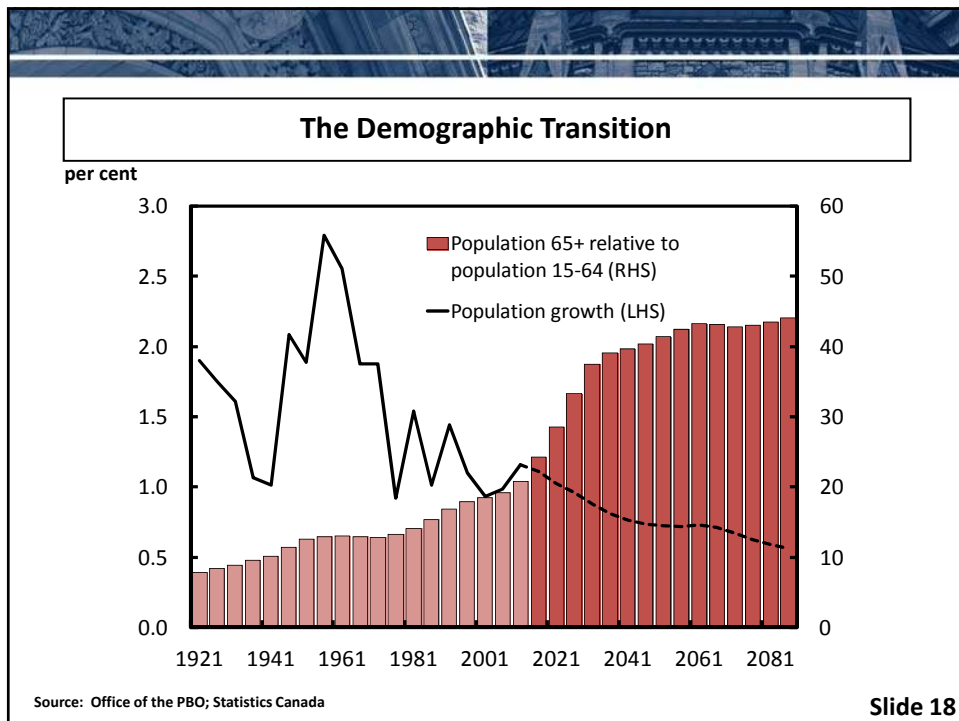
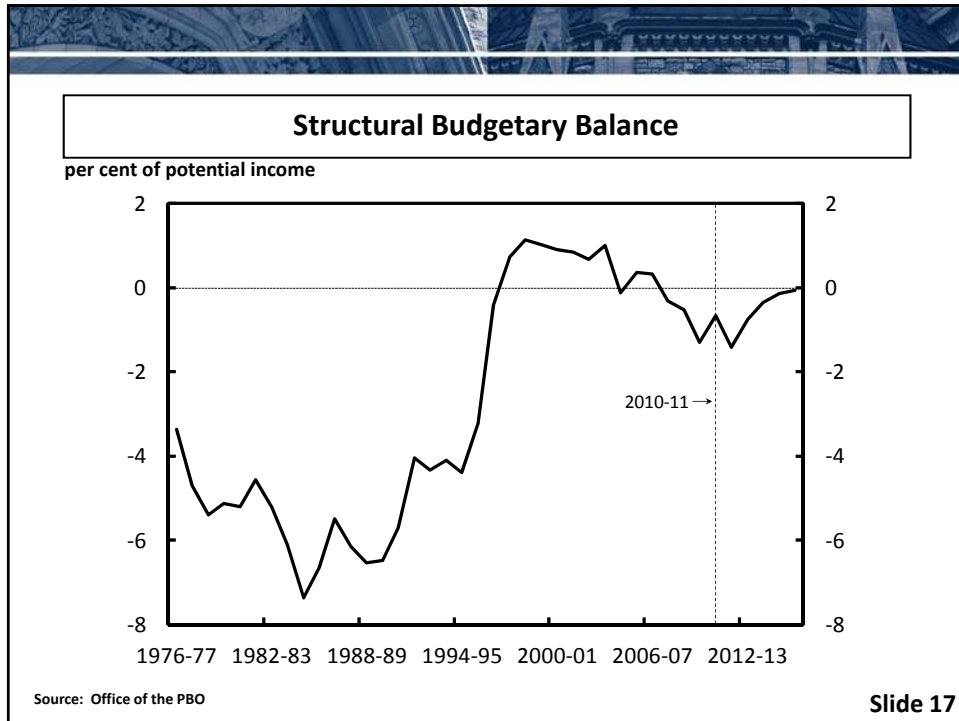
## Structural and Cyclical Budget Balance Estimates

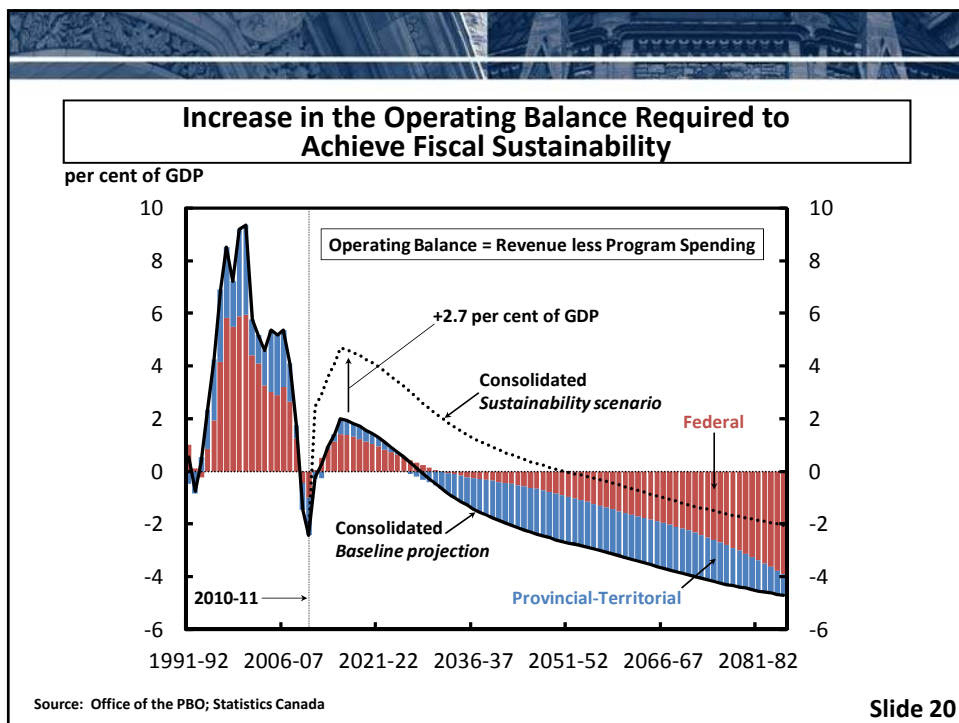
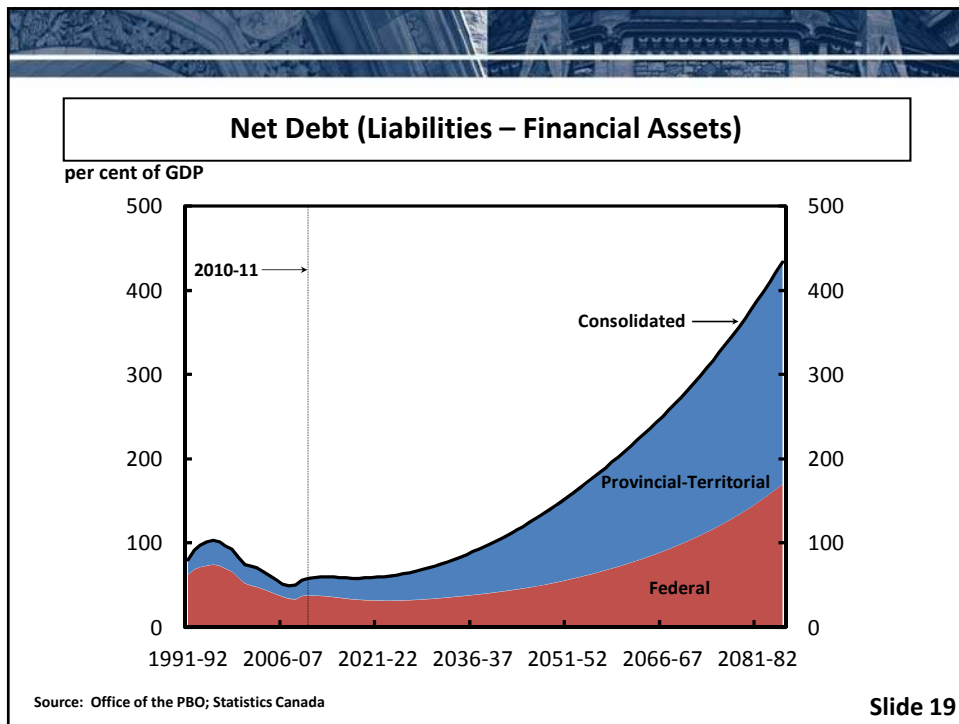
billions of dollars

	2011-2012	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017
Budgetary balance	-37.3	-30.5	-24.2	-18.7	-13.1	-7.3
Structural balance	-25.0	-14.1	-6.9	-2.9	-1.3	-1.6
Cyclical balance	-12.3	-16.4	-17.3	-15.9	-11.9	-5.7

Source: Office of the PBO

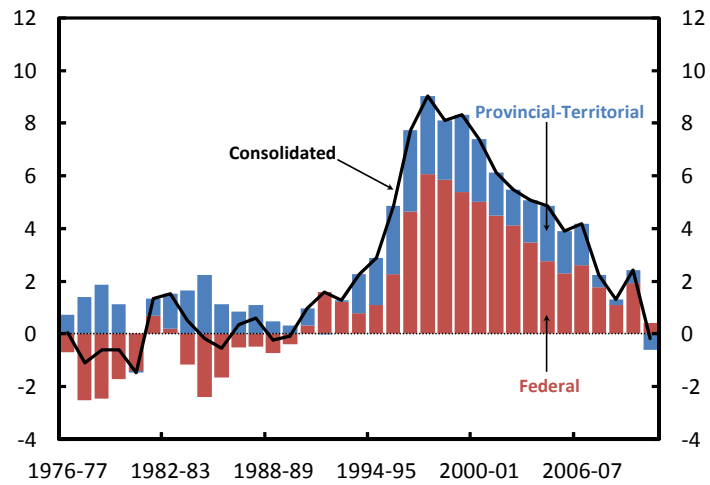
Slide 16





## Structural Operating Balance

per cent of potential income



Source: Office of the PBO

Slide 21