OFFICE OF
THE PARLIAMENTARY BUDGET OFFICER

BUREAU DU
DIRECTEUR PARLEMENTAIRE DU BUDGET

Economic and Fiscal Outlook Update

Ottawa, Canada
October 28, 2013
www.pbo-dpb.gc.ca

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 responds to the September 29, 2011 Standing Committee of Finance motion that "[c]onsistent with the Parliamentary Budget Office[r] (PBO) mandate to provide independent analysis about the state of Canada's finances and trends in the national economy [...] that the PBO provide an 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 report presents PBO's updated Economic and Fiscal Outlook (EFO) based on economic data received up to October 4, 2013 and the *Annual Financial Report of the Government of Canada* for 2012–13 released on October 22, 2013.

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* Any errors or omissions are the responsibility of the authors. Please contact Mostafa Askari (email: mostafa.askari@parl.gc.ca) for further information.

The global economic outlook is weaker than at the time of the April 2013 Economic and Fiscal Outlook (EFO)[1] (Slide 1). According to the International Monetary Fund (IMF)[2], much of the pickup in growth over the next several years will be driven by advanced economies, as growth in emerging market economies remains strong but cools from the stimulus-driven surge in activity that followed the Great Recession. However, the IMF emphasises that risks to the outlook remain on the downside, and include the reestablishment of normal monetary policy conditions (particularly in the United States), unfinished financial sector reforms in the euro area, impaired monetary policy transmission and corporate debt overhang in some euro area economies, high government debt and related fiscal and financial risks in many other advanced economies, including Japan and the United States, and the reemergence of geopolitical risks in recent months.

Despite consistent improvement in U.S. economic fundamentals, particularly in the U.S. housing market, PBO has revised down its outlook for U.S. real gross domestic product (GDP) growth in 2013 from 2.0 to 1.6 per cent due to downward revisions to U.S. real GDP in the second half of 2012 and first half of 2013, and continued fiscal consolidation at the federal and state levels, exacerbated by the recent U.S. federal government shutdown. PBO assumes the impact of the federal government shutdown will be consistent with the impact of the 1995 U.S. government shutdown estimated by the Congressional Budget Office. After 2013, the projection remains largely unchanged from the April 2013 EFO projection.

Based on the Bank of Canada's commodity price index, commodity prices have been moderately stronger than PBO projected in its April 2013 EFO. However, futures prices for crude oil suggest a modest but persistent decline from current prices (Slide 2). This is due, in part, to the expected increased supply of oil as the proliferation of enhanced recovery technologies supports a large increase in oil production in the U.S. and elsewhere while also increasing the viability of some existing conventional formations. Taking into account the weakness in futures prices and applying the method for projecting the Bank of Canada index outlined in Annex A of the April 2013 EFO, PBO assumes the Bank of Canada energy commodity price index will decline by an average of 0.4 per cent each quarter from the fourth quarter of 2013 to the fourth quarter of 2018. If PBO were to use futures prices exclusively, the Bank of Canada energy commodity price index would decline by an average of 1.0 per cent each quarter from fourth quarter of 2013 to the fourth quarter of 2018 and the level of nominal GDP in 2018 would be approximately $18 billion lower than is currently projected. Included in this projection is the discount on Western Canadian Select (WCS) heavy crude oil from West Texas Intermediate (WTI) light sweet crude oil, which is expected to diminish from the recent quarterly peak of US$31.96 per barrel to US$20.15 per barrel over the medium term.

PBO Economic Outlook

These developments have led PBO to revise down the outlook for the Canadian economy relative to its April 2013 EFO. As a result, the level of nominal GDP is now projected to be over $20 billion lower annually, on average, from 2013 to 2017, due to downward revisions to both real GDP and the GDP deflator (Slide 3). Further, PBO has revised up its projection of long-term interest rates due to the announced tapering of asset purchases by the U.S. Federal Reserve (Slide 4). Combined with the weaker outlook for commodity prices, this has put downward pressure on PBO's projection of the U.S.-Canada exchange rate.

Real GDP in Canada grew at 1.8 per cent in the first half of 2013 – slightly higher than the 1.6 per cent PBO projected in its April 2013 EFO. Real GDP is projected to increase by 2.3 per cent in the third quarter of 2013, in part due to the recovery following the June 2013 floods in Alberta, which leaves real GDP 1.6 per cent below its potential level (Slide 5). PBO projects that the Canadian economy will expand by 2.0 per cent in the second

[1] http://www.pbo-dpb.gc.ca/files/files/EFO_April_2013.pdf.
[2] http://www.imf.org/external/pubs/ft/weo/2013/02/pdf/text.pdf.

half of 2013, resulting in annual growth of 1.6 per cent in 2013. Combined with the expected weakness in the global economy and commodity prices, continued government net spending reductions and restraint will act as an additional drag on economic growth and job creation going forward. As a result, PBO projects Canadian real GDP to grow by 2.0 and 2.6 per cent in 2014 and 2015, respectively.[3] The weakness in near-term growth pushes the economy further below its potential (Slide 6) resulting in a modest increase in the unemployment rate. With inflationary pressures well contained and Consumer Price Index (CPI) inflation remaining below its 2 per cent target, PBO expects the Bank of Canada to maintain its policy interest rate at 1 per cent through the first quarter of 2015. As the economic recovery firmly takes hold and the level of real GDP returns to its potential level, real GDP growth is projected to average 2.0 per cent over the 2016 to 2018 period.

Based on Finance Canada's estimated "multipliers" (i.e., the dollar impact on real GDP of a permanent one-dollar change in spending), PBO estimates that in the absence of the Government's planned spending and revenue measures outlined in Economic Action Plan (EAP) 2013, which amount to a $10.8 billion contraction over 2013-14 to 2017-18 – all else equal – real GDP would be approximately 0.1 per cent higher annually, on average, over 2013 to 2018 than projected (Slide 7).[4] Further, the level of employment – across the entire economy – in 2016 would be approximately 13,000 jobs higher than projected. These impacts are complemented by the changes in the Employment Insurance (EI) premium rate announced on September 9, 2013, which is projected to increase the level of real GDP and employment modestly through 2015, although this will be subsequently offset by declines in the level of real GDP and employment thereafter.

Risks to the Private Sector Economic Outlook

In contrast to the PBO real GDP growth projection for 2013, which has changed only modestly since April 2012, the private-sector average forecast has been revised down dramatically over this same period but has been in line with the PBO projection since April 2013 (Slide 8). Compared to the average of private sector forecasts in September 2013, PBO is projecting slower real GDP growth and lower GDP inflation in 2013 and 2014. As a result, PBO's outlook for nominal GDP – the broadest measure of the Government's tax base – is lower, by $25 billion annually, on average, than the projection based on an average of private sector forecasts. PBO judges that the balance of risks to the average private sector forecast for nominal GDP is tilted to the downside, reflecting both weaker real GDP growth and GDP inflation. This likely reflects larger negative impacts from savings measures and revisions to spending levels since EAP 2012, as well as differences in views on commodity prices and their impacts on real GDP growth and GDP inflation. To illustrate the uncertainty and balance of risks to the private sector projection of nominal GDP, PBO constructs a fan chart based on the historical forecast performance of the average forecasts from Finance Canada's survey of private sector economists (Slide 9).

[3] PBO's economic outlook reflects the impacts measures in Economic Action Plan 2013 and the changes in the EI premium rate announced in September 2013.

[4] EAP 2013 indicates the sources underlying revisions to direct program spending levels, which amount to a reduction of $9.1 billion over 2013-14 to 2017-18. Given the uncertainty surrounding the potential economic impacts of some of these sources, PBO has assumed that half of the reduction in spending levels ($4.55 billion) would not flow through to the economy.

PBO Fiscal Outlook

PBO expects budgetary revenues to be lower over the outlook than projected in the April 2013 EFO due primarily to weaker nominal GDP and lower EI premium rates (Slide 10). The projection for most individual revenue categories is lower than in April 2013, most notably for personal income taxes and EI revenues. The exception is corporate income taxes, which were particularly resilient in 2012-13 and are expected to continue to be higher than projected in the April 2013 EFO. EI revenues are substantially lower relative to the April 2013 EFO projection in each year of the outlook for two reasons: (1) the Government's recent policy announcement freezing premium rates in 2014 and imposing a maximum rate in 2015,[5] and (2) a lower beneficiaries-to-unemployed ratio projection which improves the EI operating account balance and allows lower premium rates to be set in years 2016 to 2019.

On September 9, 2013, the Government announced it will set the EI premium rate at 1.88 per cent of insurable earnings in 2014 and no higher than 1.88 per cent in 2015 and 2016.[6] PBO projects that in 2015 the maximum premium rate of 1.88 per cent will apply and that in 2016 the rate will be set at the EI account forecast break-even rate of 1.74 per cent, which balances revenues and expenses in 2016 and eliminates the EI account deficit accumulated since 2008 (Slide 11). From 2017 onward, the premium rate will be set such that revenues and expenses balance over a 7-year rolling forecast, which PBO projects will allow a rate decrease to 1.61 per cent in 2017 and over the remainder of the outlook.

Relative to the premium rates which would have been set in the absence of a rate freeze, PBO projects that the new rate policy will result in lower premiums over the next two years, but a higher rate in 2016 than would have been set otherwise. Without the rate freeze, the cumulative EI account deficit would have been eliminated in 2015 and the premium rate in 2016 could have been reduced even further than 1.74 per cent to 1.63 per cent. PBO estimates the new policy will reduce revenues by $0.6 billion in 2014 and by $0.1 billion in 2015, and that in 2016 revenues will be $1.5 billion higher than before the announcement. The revenue impact of the policy change beyond 2016 is small.

Budgetary expenses are roughly unchanged since the April 2013 EFO with the exception of EI benefits and public debt charges (Slide 12). Lower EI benefits are driven by a lower expected number of regular EI beneficiaries to unemployed persons (the B/U ratio) than projected in PBO's April 2013 EFO (Box 1). Higher public debt charges are a result of higher interest bearing debt accumulated from higher budgetary deficits and lower surpluses (projected effective interest rates have not changed significantly). PBO uses the Government's EAP 2013 outlook for direct program expenses to 2017-18[7] and has not incorporated the commitment to freeze the overall federal operating budget announced in the 2013 Speech From the Throne. Direct program expenses in PBO's outlook grow at an average annual rate of only 0.7 per cent from 2013-14 to 2018-19, well below the average historical growth of 4.3 per cent.

Overall, PBO expects total expenses to grow more slowly than nominal GDP, at 2.9 per cent annually from 2013-14 to 2018-19, due to slow growth in EI expenses as the economy and labour market improve as well as the planned direct program expenses restraint.

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[5] PBO projects the Government's announced maximum EI rate for 2016 will not apply.
[6] http://www.fin.gc.ca/n13/13-114-eng.asp.
[7] For 2018-19, PBO assumes direct program expenses grow at the same rate as in 2017-18.

Box 1: Recent trends in the B/U ratio.

The B/U ratio is the number of regular EI beneficiaries in the reference week of the Employment Insurance Coverage Survey divided by total unemployed persons. It summarizes the accessibility of regular EI benefits and is used in PBO's projection of EI expenses and in the Chief Actuary's calculation of the forecast break-even rate.

A declining B/U ratio was observed over 2011 and 2012 and was assumed to be the result of increasing durations of unemployment leading to exhaustion of benefits. In the April 2013 EFO, PBO had assumed a rapid recovery in the B/U ratio as the labour market recovered and returned to historical durations of unemployment. Instead of the expected recovery of the B/U ratio, a further decline has been observed in the first half of 2013. PBO's updated projection of the B/U ratio uses the ratio forecast by the Chief Actuary for 2014, increasing gradually thereafter to reach its 10-year pre-recession average when the output gap closes in 2016 (Slide 13).

If the B/U ratio continues to remain low, or declines further, expenses will be reduced and the budgetary balance will be improved over the short term; however, an improved projection of the EI operating account would result in a higher premium reduction when the system moves to the 7-year balancing rate, which would negatively affect revenues in 2016 and beyond.

Budgetary balance. Under current policy and PBO's economic outlook, PBO projects the budget will return to surplus in 2015-16 and will remain in surplus thereafter (Table 1; Slide 14). Although PBO projects the Government's 2015-16 deficit elimination target will be achieved, projected surpluses are significantly lower than in the April 2013 EFO. Using PBO's assessment of the balance of risks to the private sector economic outlook, PBO estimates that the likelihood of realizing a budgetary balance or better is approximately 50 per cent in 2015-16, 55 per cent in 2016-17, and 60 per cent in 2018-19 (Slide 15).

Table 1: Budgetary balance outlook ($ billions)

	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
Budgetary balance	-18.9	-14.7	-5.6	0.2	1.7	2.4	5.1

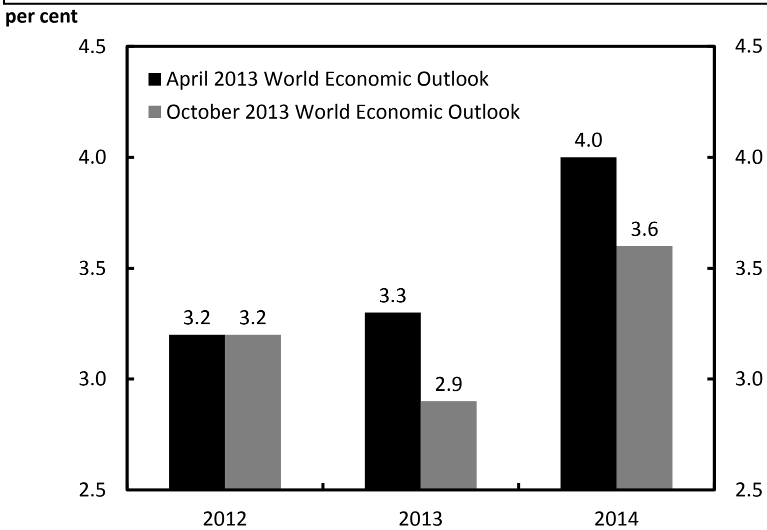
Structural balance. PBO estimates that the Government's structural balance will improve from a deficit of $8.0 billion in 2012-13 to a surplus of $0.9 billion in 2016-17 (Slide 16). Relative to potential income, this represents an increase from -0.4 per cent in 2012-13 to 0.0 per cent in 2016-17 (Slide 17). However, the downward revision to the economic outlook, partly offset by the change in the EI program, results in a small structural deficit of $0.5 billion in 2017-18. In 2018-19, the structural budget balance will return to a surplus of $2.1 billion.

Despite the lower outlook for the budgetary balance, if the Government runs a balanced budget beyond fiscal-year 2018-19 a deficit target of 25 per cent of GDP would be achieved through GDP growth alone under PBO's economic growth assumptions. Because budgetary surpluses are expected toward the end of the medium term and would continue under current policy, the Government is likely to have additional fiscal room to achieve the target if fiscal outcomes follow expectations.

Fiscal Sustainability

Although PBO projects the Government's structural balance to improve from a deficit to a surplus position over the medium term, assessing whether a government's fiscal structure is sustainable requires looking over a longer horizon to take into account the economic and fiscal implications of population ageing. PBO provided such an assessment for the federal government, provincial-territorial-local-aboriginal governments (PTLA), as well as the Canada and Quebec Pension Plans (CPP and QPP), in Fiscal Sustainability Report 2013 (FSR 2013) (Slides 18 and 19). In FSR 2013, PBO concludes that the federal government's fiscal structure is sustainable and that the Government has fiscal room of 1.3 per cent of GDP (or $24.8 billion) in 2013, achieved largely through spending restraint and changes to the Canada Health Transfer escalator (Slide 20). This means that if the federal government permanently reduces taxes, increases program spending, or a combination of both by an amount equivalent to 1.3 per cent of GDP in 2013 and allows the cost of those measures to grow with nominal GDP over the next 75 years, the net debt to GDP ratio will return to its 2012 level by 2087. PBO also estimates that the CPP and QPP are sustainable. In contrast, the fiscal structure of the PTLA sector is currently unsustainable with a fiscal gap of 1.9 per cent of GDP. This means that in order to stabilize the ratio of net debt to GDP at its 2012 level, the PTLA sector has to reduce spending, raise tax revenues or a combination of both by an amount equal to 1.9 per cent of GDP.

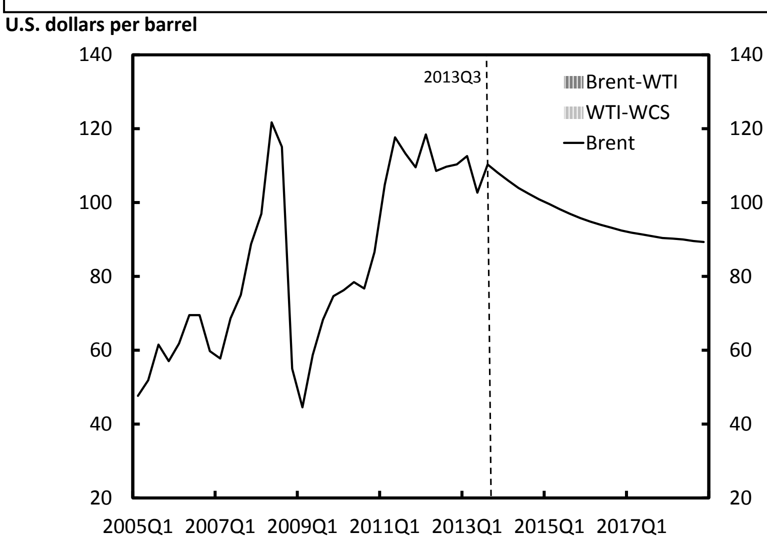
IMF World Output Growth Outlook



Source: International Monetary Fund.

Slide 1

Crude Oil Historic and Futures Prices



Sources: Office of the Parliamentary Budget Officer; CME Group; Baytex Energy Corp.
Note: WTI refers to West Texas Intermediate and WCS refers to Western Canadian Select.

Slide 2

PBO Economic Outlook – April and October 2013

	2013	2014	2015	2016	2017	2018
Real GDP growth (%)						
April 2013 projection	1.5	1.9	2.7	3.0	2.2	
October 2013 projection	**1.6**	**2.0**	**2.6**	**2.6**	**1.9**	**1.5**
GDP inflation (%)						
April 2013 projection	1.7	1.8	1.9	2.0	2.0	
October 2013 projection	**1.3**	**1.4**	**1.5**	**1.9**	**2.0**	**2.0**
Nominal GDP growth (%)						
April 2013 projection	3.2	3.7	4.7	5.1	4.3	
October 2013 projection	**2.9**	**3.4**	**4.2**	**4.6**	**4.0**	**3.5**
Nominal GDP level ($ billions)						
April 2013 projection	1,876	1,946	2,037	2,140	2,232	
October 2013 projection	**1,873**	**1,937**	**2,017**	**2,110**	**2,193**	**2,270**
U.S real GDP growth						
April 2013 projection	2.0	2.8	3.5	3.6	3.4	
October 2013 projection	**1.6**	**2.7**	**3.4**	**3.6**	**3.3**	**2.6**

Source: Office of the Parliamentary Budget Officer.

Slide 3

PBO Economic Outlook – April and October 2013

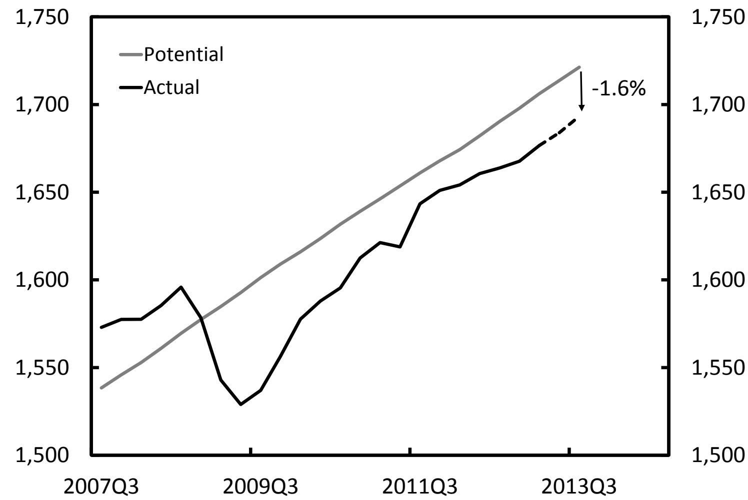
	2013	2014	2015	2016	2017	2018
3-month treasury bill rate (%)						
April 2013 projection	1.0	1.0	1.4	2.8	4.0	
October 2013 projection	**1.0**	**1.0**	**1.4**	**2.8**	**4.0**	**4.2**
10-year government bond rate (%)						
April 2013 projection	2.1	2.8	3.6	4.4	5.2	
October 2013 projection	**2.3**	**3.2**	**3.8**	**4.5**	**5.2**	**5.3**
Consumer Price Index inflation (%)						
April 2013 projection	1.4	1.8	1.9	2.0	2.0	
October 2013 projection	**1.0**	**1.7**	**1.9**	**2.0**	**2.0**	**2.0**
Unemployment rate (%)						
April 2013 projection	7.3	7.4	7.1	6.6	6.3	
October 2013 projection	**7.2**	**7.3**	**7.0**	**6.5**	**6.3**	**6.1**
Exchange rate (US cents/C$)						
April 2013 projection	100.0	101.0	101.5	101.7	101.7	
October 2013 projection	**97.3**	**96.5**	**96.6**	**96.0**	**95.6**	**94.6**

Source: Office of the Parliamentary Budget Officer.

Slide 4

Real and Potential GDP

billions of chained (2007) dollars

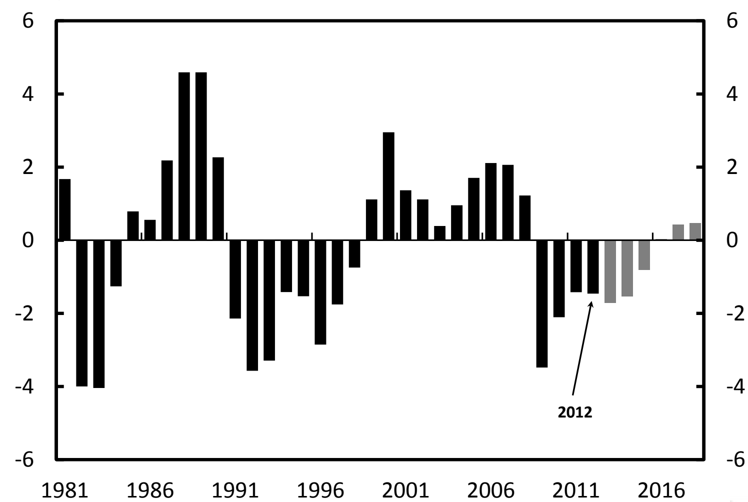


Sources: Office of the Parliamentary Budget Officer; Statistics Canada.

Slide 5

Output Gap, 1981 to 2018

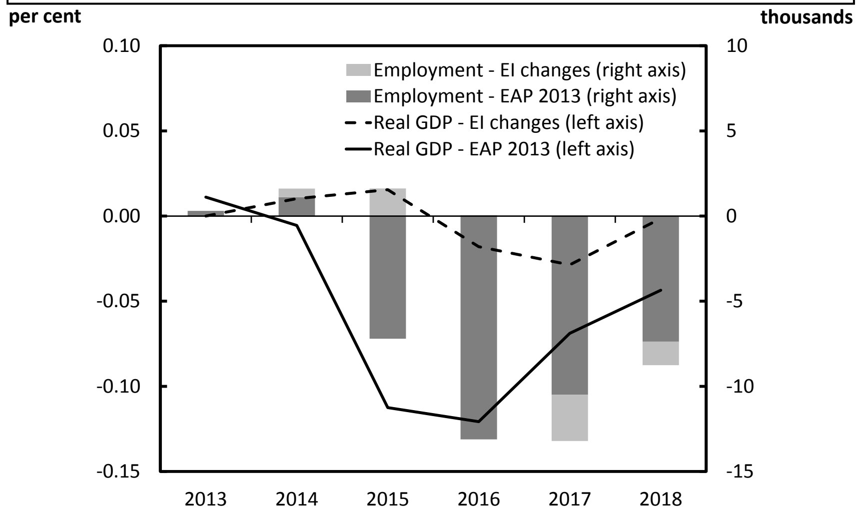
per cent of potential GDP



Sources: Office of the Parliamentary Budget Officer; Statistics Canada.

Slide 6

Economic Impacts of EAP 2013 and Announced EI Changes

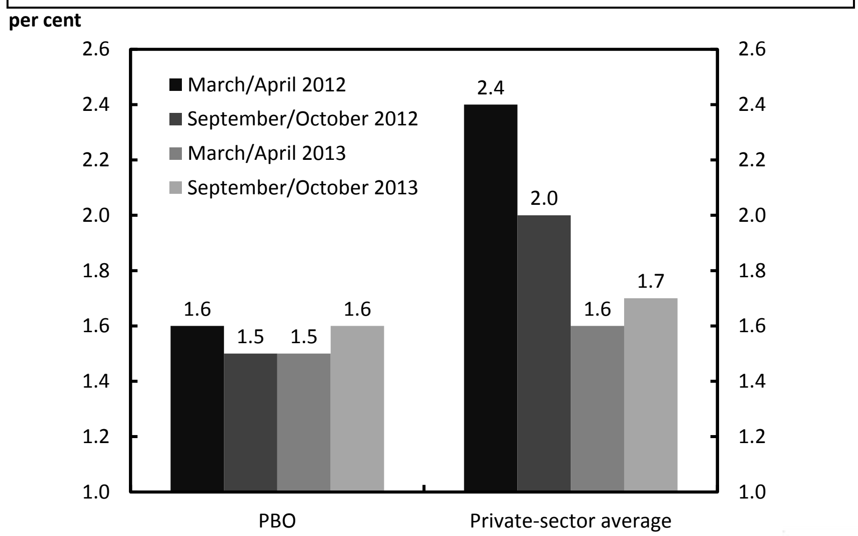


Source: Office of the Parliamentary Budget Officer.

Note: The estimated impacts on real GDP and employment do not take into account offsetting impacts from changes to interest and exchange rates.

Slide 7

Revisions to 2013 Real GDP Growth Outlook

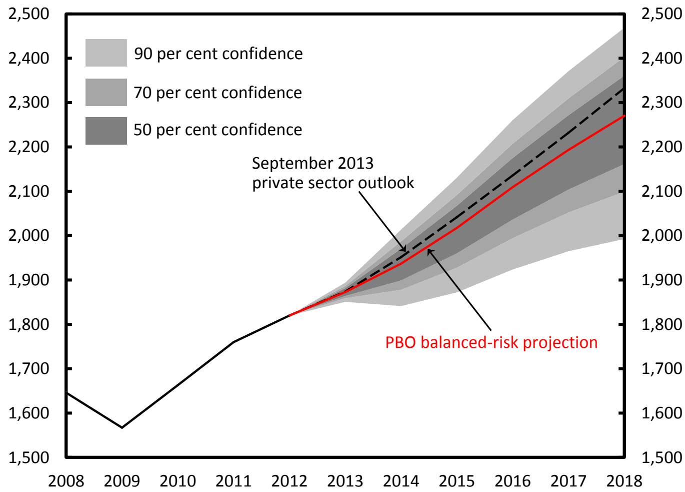


Sources: Office of the Parliamentary Budget Officer; private sector forecasts.

Slide 8

Nominal GDP Forecasts

billions of dollars



Sources: Office of the Parliamentary Budget Officer; Statistics Canada; September 2013 private sector forecasts.

PBO Outlook for Budgetary Revenues

billions of dollars

	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
Income taxes							
Personal income tax	125.7	132.6	141.5	149.4	157.1	164.0	170.4
Corporate income tax	35.0	34.2	34.2	37.2	40.2	43.1	45.1
Non-resident income tax	5.1	5.5	5.9	6.4	6.8	7.1	7.4
Total income tax	165.8	172.3	181.7	193.0	204.1	214.2	222.8
Excise taxes/duties							
Goods and Services Tax	28.8	30.9	32.3	33.6	35.0	36.2	36.5
Custom import duties	4.0	4.1	4.5	4.9	5.1	5.3	5.3
Other excise taxes/duties	10.8	10.9	10.7	10.6	10.5	10.5	10.4
Total excise taxes/duties	43.6	45.9	47.5	49.1	50.6	52.0	52.3
EI premium revenues	20.4	21.3	22.2	22.6	21.6	21.0	21.4
Other revenues	26.9	27.7	28.6	29.9	31.2	32.5	33.6
Total budgetary revenues	**256.6**	**267.2**	**280.0**	**294.5**	**307.5**	**319.6**	**330.2**

Source: Office of the Parliamentary Budget Officer.

EI premium rate projections

projected premium rate (per $100 of insurable earnings)

	2012	2013	2014	2015	2016	2017	2018
April 2013 EFO	1.83	1.88	1.93	1.98	2.03	1.62	--
October 2013 EFOU							
Before rate freeze	1.83	1.88	1.93	1.89	1.63	1.62	1.61
Maximum premium rate 1.88	1.83	1.88	1.88	1.88	1.74	1.61	1.61

Source: Office of the Parliamentary Budget Officer.

PBO Outlook for Expenses

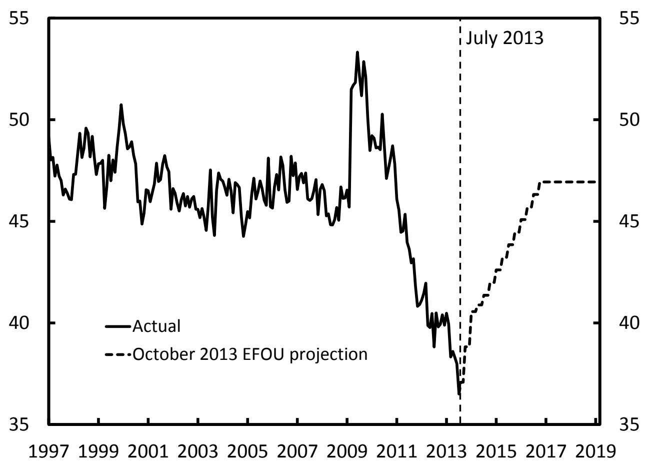
billions of dollars

	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
Major transfers to persons							
Elderly benefits	40.3	41.8	44.0	46.5	49.1	51.8	52.5
Employment Insurance benefits	17.1	17.2	18.2	18.9	19.4	19.7	20.0
Children's benefits	13.0	13.1	13.3	13.5	13.7	13.9	14.1
Total	70.3	72.1	75.6	78.9	82.2	85.4	86.7
Major transfers to OLG	58.4	60.5	62.7	65.3	68.2	70.7	73.5
Direct program expenses	117.7	119.8	117.3	118.3	120.0	122.0	124.1
Public debt charges	29.2	29.6	30.0	31.8	35.4	39.0	40.8
Total expenses	**275.6**	**281.9**	**285.6**	**294.3**	**305.8**	**317.2**	**325.1**

Source: Office of the Parliamentary Budget Officer.

B/U ratio, January 1997 to March 2019

number of regular EI beneficiaries to unemployed persons



Source: Office of the Parliamentary Budget Officer.

Slide 13

PBO Fiscal Projection – Summary

billions of dollars

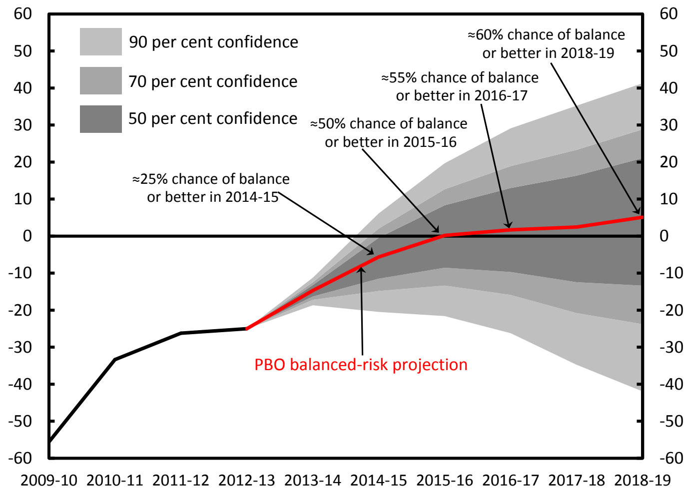
	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
Budgetary revenues	256.6	267.2	280.0	294.5	307.5	319.6	330.2
Program expenses	246.4	252.4	255.6	262.5	270.4	278.1	284.2
Public debt charges	29.2	29.6	30.0	31.8	35.4	39.0	40.8
Total expenses	275.6	281.9	285.6	294.3	305.8	317.2	325.1
Budgetary balance	-18.9	-14.7	-5.6	0.2	1.7	2.4	5.1
Federal debt	602.4	617.2	622.8	622.6	620.9	618.5	613.4
Per cent of GDP							
Budgetary revenues	14.1	14.3	14.5	14.6	14.6	14.6	14.5
Program expenses	13.5	13.5	13.2	13.0	12.8	12.7	12.5
Public debt charges	1.6	1.6	1.6	1.6	1.7	1.8	1.8
Budgetary balance	-1.0	-0.8	-0.3	0.0	0.1	0.1	0.2
Federal debt	33.1	33.0	32.2	30.9	29.4	28.2	27.0

Source: Office of the Parliamentary Budget Officer.

Slide 14

Budgetary Balance Outcomes Given Economic Uncertainty

billions of dollars



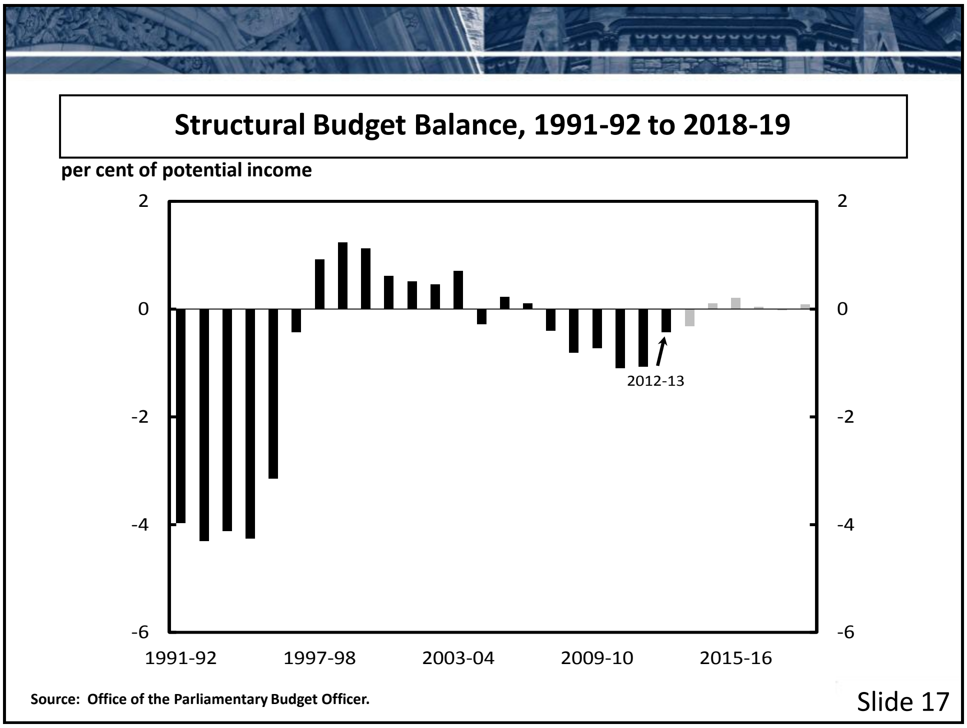
Sources: Office of the Parliamentary Budget Officer; Finance Canada.

Structural and Cyclical Budget Balance Estimates

billions of dollars

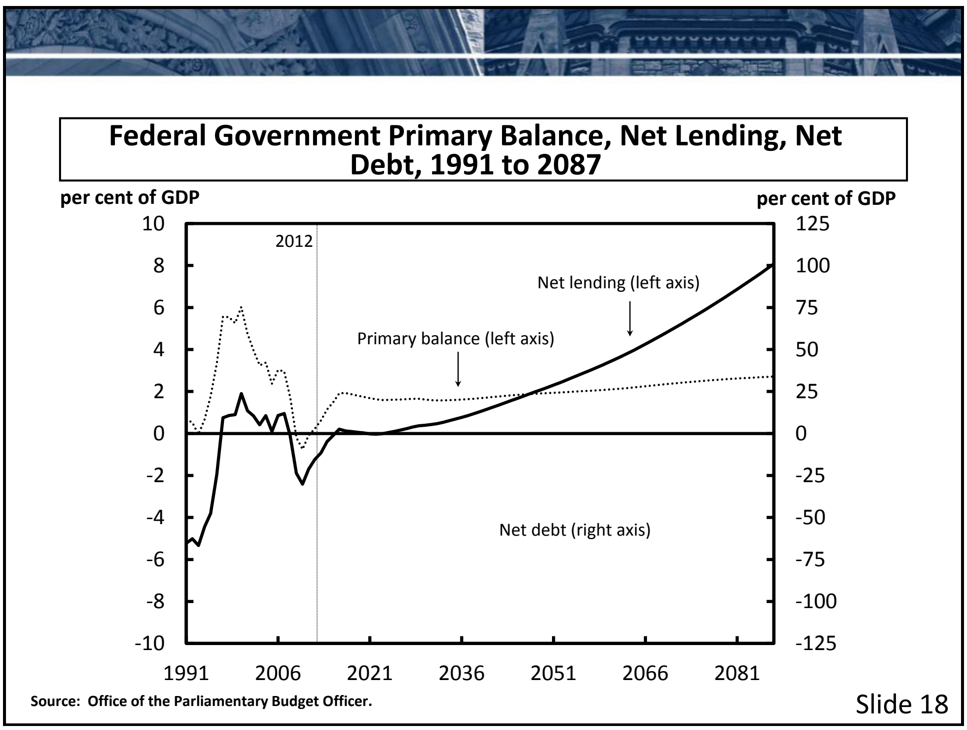
	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018	2018-2019
Budgetary balance	-14.7	-5.6	0.2	1.7	2.4	5.1
Structural balance	-6.0	2.1	4.2	0.9	-0.5	2.1
Cyclical balance	-8.7	-7.8	-4.1	0.8	2.9	3.0

Source: Office of the Parliamentary Budget Officer.



Source: Office of the Parliamentary Budget Officer.

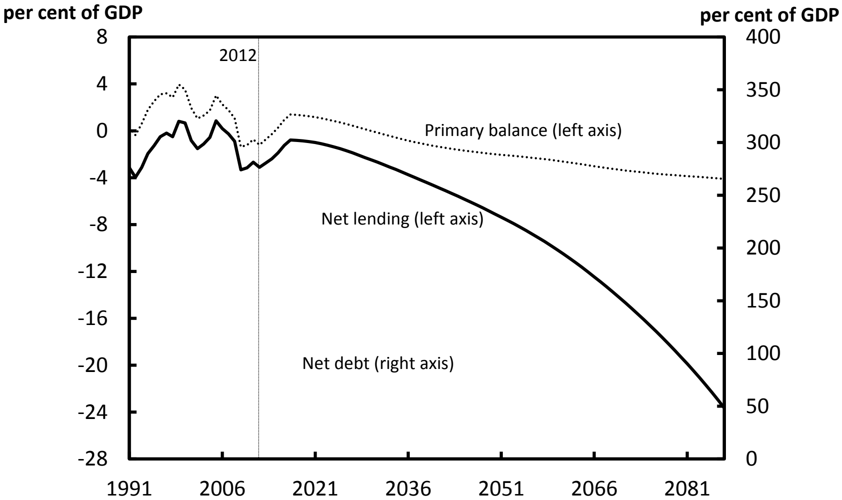
Slide 17



Source: Office of the Parliamentary Budget Officer.

Slide 18

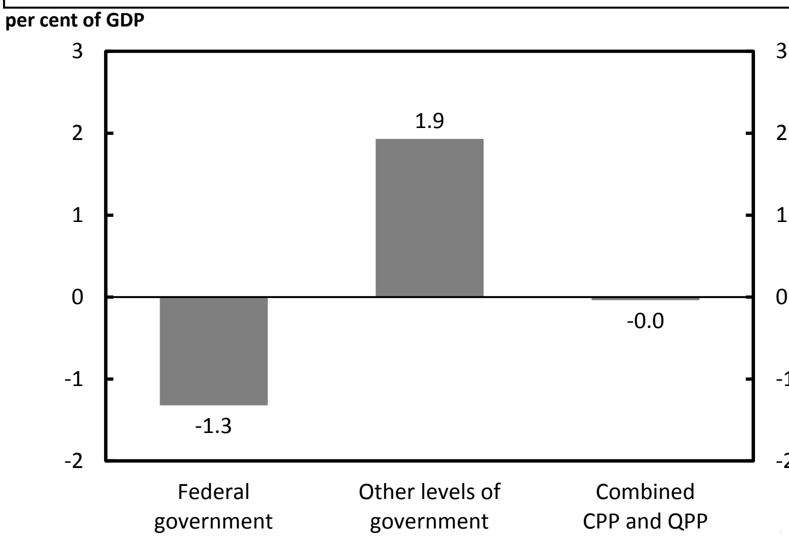
Other Levels of Government Primary Balance and Net Debt, 1991 to 2087



Source: Office of the Parliamentary Budget Officer.

Slide 19

Fiscal Gaps



Source: Office of the Parliamentary Budget Officer.

Slide 20