



**Opening Statement of Kevin Page, Parliamentary Budget Officer
to the House of Commons Standing Committee on Finance
November 2, 2011**

Good afternoon Mr. Chair, Vice-chairs, and members of the Committee. Thank you for inviting me and my colleagues to speak to you about Canada's economic and fiscal outlook in the context of your consultations leading up to the 2012 Budget. Yesterday, as you know, PBO released a report examining the short- and medium-term outlook. On September 29, 2011, PBO released its 2011 Fiscal Sustainability Report which examines Canada's fiscal structure from a longer-term perspective.

The *Parliament of Canada Act* instructs the Parliamentary Budget Officer to provide independent analysis to the Senate and the House of Commons about the state of the nation's finances and trends in the national economy. The PBO's objective is to provide you with analysis of the planning environment to support your debate about policy priorities and directions and, as members of the House of Commons, your power of the purse role in holding the Government of Canada (Government) to account with respect to the prudent management of public finances.

In an effort to provide you with a rich planning environment, PBO provides you with an independent view on the economic and fiscal outlook in a fully transparent manner. In addition we provide you with analysis to support your work.

- We provide you with analysis of how the economy is projected to perform relative to potential (or trend) output – the size of the so-called output gap.
- We provide you with analysis on the nature of our fiscal balances – what proportion of our federal deficit is cyclical that will go away when our economy returns to its potential level and what proportion is structural.
- We provide analysis on uncertainty – what does the history of private sector economic projections relative to outcomes mean for confidence intervals around projections for nominal GDP and budgetary balances.
- Finally, so we do not lose sight of the long term – we provide you with estimates of the fiscal gap to inform you on the sustainability of current fiscal structures and the size of actions required to stabilize debt relative to the size of the economy in light of ageing demographics and other underlying long-term cost pressures.

In the Budget plan tabled in June 2011, the Government committed to balancing the budget by 2014-15 through reductions in expenses that will be determined and implemented in Budget 2012. The 2012 budget is also a budget that must set up the framework for negotiations with the provinces and territories to be held in 2014 on federal transfers, which represent 30 per cent of federal program spending.

I wish to highlight three challenges in the context of your deliberations on priorities and policy directions leading up to the 2012 budget.

- One, relative to the 2011 Budget planning framework, the outlook is weaker.
- Two, the fiscal outlook over the medium term is highly uncertain.
- Three, the challenges of long-term fiscal sustainability stemming from ageing demographics and other cost pressures are real and need to be recognized and addressed.

The outlook for the Canadian economy has weakened in the eyes of virtually all forecasters reflecting a less optimistic external environment. The negative impacts of deleveraging, fiscal austerity and declining confidence underscored by financial market turbulence are largely behind the softening of growth projections. PBO projects Canadian real GDP to grow by 2.2 and 1.5 per cent in 2011 and 2012 respectively. The weakness in near-term growth pushes the economy further below its productive capacity – a widening of the output gap – resulting in an increase in the unemployment rate. 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.

Underlying the outlook is the assumption that the European sovereign debt crisis will be contained and the US fiscal restructuring will take place in an orderly fashion. PBO is projecting a weaker short-term outlook than the average private sector outlook. PBO judges the balance of risks to the private sector outlook for nominal GDP is tilted to the downside reflecting a more sluggish near-term US 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.

The PBO outlook for the budgetary balance (on a status quo basis) has the deficit falling from \$37.3 billion in 2011-12 (2.2 per cent of GDP) to \$30.5 billion in 2012-13 (1.7 per cent of GDP) and eventually \$7.3 billion in 2016-17 (0.3 per cent of GDP). These magnitudes remain significantly better than the projected outlooks of other G7 countries and are consistent with targets set out by the G20 in Toronto in 2010 for deficit reduction. The progress reflects reduction in both cyclical and structural balances over the medium term. The significant reduction in the structural deficit reflects in part the planned restraint in direct program spending. Over the 2011-12 to 2016-17 period, PBO is assuming that direct program expenditure will grow modestly at 1.6 per cent annually, on average, which is significantly slower than observed over the five years preceding the downturn of 6.1 per cent. Over the longer term, PBO is projecting the structural deficit to rise on a status quo basis due to the impact of aging demographics and other underlying cost pressures.

PBO's 2011 Fiscal Sustainability Report concluded that Canada does not have a fiscal structure at the federal and or provincial-territorial government levels that will stabilize the debt-to-GDP ratio over the long term. We are undergoing a major demographic transition that will slow economic growth; that will slow government revenue growth and put upward pressure on spending. PBO estimates that restoring sustainability would require permanent policy actions to improve the operating balance amounting to 2.7 per cent of GDP (1.5 per cent at the provincial-territorial level and 1.2 per cent at the federal level). While this amount of policy action is significantly less than restraint measures implemented in the 1990s, it will need to be sustained over the long term. These actions do not need to be taken immediately while the economy is operating below its full capacity; however, long delays in taking actions would increase the amount of corrective measures significantly.

The challenges of the planning environment raise important considerations for parliamentarians regarding Canada's fiscal policy directions, targets, credibility and sustainability.

Parliamentarians may wish to debate the policy merits of staying the course fiscal policy reflecting the weaker outlook.

- Projected output losses in Canada relative to potential associated with the ongoing world financial crisis are more severe relative to economic slowdowns in the mid-1990s and early 1980s. The output gap is now projected to close in 2017.
- PBO analysis on balance budget outcomes given economic uncertainty based on accuracy of the average private sector forecast over the past 16 years indicates that the probability of fiscal balance under status quo policy is approximately 10 per cent in 2014-15 and 25 per cent in 2015-16.
- In the context of a relatively large and persistent output gap over the medium term, uncertainty about the fiscal outlook over the medium term and emerging fiscal pressures over the longer term, parliamentarians may wish to debate the pros and cons of further stimulus or restraint measures as well as the achievability, relative merits, and priority trade-offs associated with a fiscal target of budgetary balance in 2014-15.

While many other countries are experiencing market pressure to strengthen their medium-term fiscal plans, parliamentarians may wish to use Canada's better fiscal standing to reinforce the credibility of its medium- and longer-term fiscal plan. A former Deputy Minister of Finance, Scott Clark, has recently written a paper highlighting four criteria for credible fiscal policy. Credible fiscal policy must be realistic, responsible, prudent and transparent.

- According to Mr. Clark, credible fiscal policy should be based on a balanced view of challenges, prospects and risks and not be based on a rosy or unrealistic view. For example, a recent international paper by economist Jeffrey Frankel published by the National Bureau of Economic Research has highlighted the tendency across countries to use overly optimistic forecasts has facilitated complacency and contributed to tax cuts and increases in Government spending. From this perspective, the projections underlying Budget 2011 are no longer realistic. Parliamentarians may wish to consider whether the recently updated average private sector forecast represents a realistic view or they may recommend that the Department of Finance provide an independent economic outlook.
- Responsible fiscal policy means the Government will establish a medium- and longer-term fiscal plan that is sustainable whereby debt will not grow faster than the economy. Parliamentarians may wish to request that the Government, as promised in 2007, provide longer-term fiscal sustainability analysis.
- Prudent fiscal policy means the Government may wish to provision against forecast error and missed fiscal targets due to unforeseen events. Given high levels of uncertainty, parliamentarians may wish to debate the merits of contingency reserves and prudence allowances around the establishment of medium- and long-term fiscal targets.
- Transparent fiscal policy means full disclosure of analysis, information and risks. Parliamentarians may wish to ensure full disclosure of the measures covered by the Strategic and Operating Review to be implemented in Budget 2012, as well as in the annual Reports on Plans and Priorities, with the same level of detail afforded in the 2009 fiscal stimulus plan. Similarly, parliamentarians may wish to request that the Government provide full disclosure of departmental plans associated with Budget 2010 operational restraint measures and the adjustments to the fiscal planning framework associated with the Government's crime agenda.

Thank you for the opportunity to speak to you today. We look forward to your questions.