

OFFICE OF
THE PARLIAMENTARY BUDGET OFFICER



BUREAU DU
DIRECTEUR PARLEMENTAIRE DU BUDGET

Economic and Fiscal Outlook Update

Ottawa, Canada
October 29, 2012
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 data received up to October 17, 2012.

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Economic Context¹

The global economic outlook has deteriorated since PBO's April 2012 Economic and Fiscal Outlook² (EFO) (Slide 1). The recent International Monetary Fund (IMF) *World Economic Outlook* indicates that fiscal consolidation and a still-weak financial system are pulling down growth in advanced economies while previously strong growth in major emerging-market economies has also decreased. Further, IMF staff suggest that uncertainty surrounding policymakers' ability to control the euro crisis and to avoid the "fiscal cliff" (i.e., automatic tax increases and spending reductions) in the U.S. is weighing on growth in advanced as well as in emerging market and developing economies. IMF staff expect global economic activity to strengthen only gradually and judge that downside risks to their outlook have increased and are "considerable".

Reflecting additional fiscal consolidation in the U.S., PBO has revised down its outlook for U.S. real gross domestic product (GDP) growth in 2013 from 2.2 to 1.8 per cent. Consistent with continued household balance sheet repair, persistently high unemployment and fiscal consolidation, PBO projects that the U.S. economy will remain well below its potential for an extended period of time (Slide 2). Based on the Bank of Canada's index, commodity prices have been weaker than PBO projected in its April EFO. This weakness, combined with a more sluggish global recovery, has prompted PBO to revise down its outlook for commodity prices (Slide 3). That said, PBO's commodity price outlook remains well above levels implied by oil and natural gas futures prices, which the Bank of Canada uses to prepare its forecast.

These developments have led PBO to revise down the outlook for the Canadian economy relative to its April EFO.³ As a result, the level of nominal GDP is now projected to be \$22 billion lower annually, on average, due to downward revisions to both real GDP and the GDP deflator (Slide 4). Reflecting better-than-expected labour market performance in the second and third quarters of 2012 and revisions to its estimates of potential GDP, PBO has revised down its outlook for the unemployment rate (Slide 5). PBO has also revised down its projection of long-term interest rates in line with lower expected long-term rates on U.S. government bonds. As a result, PBO is now projecting lower tax revenues, which are offset by lower spending on Employment Insurance (EI) benefits and public debt charges, resulting in projected budgetary balances that are in line with the April EFO.

PBO Economic Outlook

Real GDP in Canada grew at 1.8 per cent in the first half of 2012 – only marginally lower than the 1.9 per cent PBO projected in its April EFO. PBO projects that the Canadian economy will expand by 1.6 per cent in the second half of 2012, leaving real GDP 1.9 per cent below its level of potential GDP in the fourth quarter (Slide 6) and resulting in annual growth of 1.9 per cent in 2012. Combined with the expected weakness in the global economy and commodity prices, government spending reductions and restraint will act as an additional drag on economic growth and job creation going

¹ All rates are expressed at annual rates unless otherwise noted. The "Government" refers to Government of Canada.

² Available at: http://www.pbo-dpb.gc.ca/files/files/Publications/EFO_April_2012.pdf.

³ The GDP data presented in this report are based on the Canadian System of National Accounts 97 (CSNA97). On October 1, 2012 Statistics Canada released historical data (back to 1981) based on its new system CSNA12. PBO is in the process of incorporating the new system of accounts into its projection models.

forward. As a result, PBO projects Canadian real GDP to grow by 1.5 and 2.0 per cent in 2013 and 2014, respectively.⁴ The weakness in near-term growth pushes the economy further below its potential (Slide 7) resulting in an 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, real GDP growth is projected to average 2.7 per cent over the 2015 to 2017 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 reductions and restraint, which amount to \$48.2 billion over 2012-13 to 2016-17 – all else equal – real GDP would be approximately 1 per cent higher annually, on average, over 2014 to 2016 than projected (Slide 8). Further, the level of employment – across the entire economy – in 2016 would be 0.7 per cent (approximately 125,000 jobs) higher than projected.

Risks to the Private Sector Economic Outlook

Since the release of PBO's April EFO, private sector forecasters have revised down their outlook for real GDP growth in 2012 and 2013, bringing it more into line with PBO's April EFO projection (Slide 9). Compared to the average of private sector forecasts published in September, 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 \$22 billion annually, on average, than the projection based on an average of private sector forecasts.⁵ PBO judges that the balance of risks to the private sector outlook for nominal GDP is tilted to the downside, likely reflecting larger impacts from government spending reductions and a more sluggish U.S. recovery, 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 10).

⁴ PBO's economic outlook also reflects the impacts of the reduction in the maximum increase in the EI premium rate and other Budget 2012 measures that would affect real GDP and job creation. See PBO's May 2012 follow-up report to the Standing Committee of Finance (available at: http://www.pbo-dpb.gc.ca/files/files/Publications/EFO_April_2012_follow-up.pdf) for additional detail.

⁵ The private sector outlook for nominal GDP based on the average of private sector forecasts of real GDP growth and GDP inflation published in September is lower than the Budget 2012 fiscal-planning assumption for nominal GDP, which adjusted downward the March private sector outlook by \$20 billion annually over the period 2012 to 2016.

PBO Fiscal Outlook

As the pace of the economic 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 \$1.83 (per \$100 of insurable earnings) in 2012 to \$2.08 in 2017, that are required to eliminate the cumulative deficit in the EI Operating Account. PBO projects the Government's program expenses to grow at 2.2 per cent annually, on average, from 2012-13 to 2017-18 (Slide 12). Based on the outlook presented in Budget 2012, the Government's direct program expenses are assumed to remain essentially frozen for 6 years, growing at 0.2 per cent annually, on average, which is well below the historical average of 4.3 per cent (Slide 13). PBO projects public debt charges to increase from \$31.1 billion in 2012-13 to \$36.3 billion in 2017-18 as interest rates rise from current levels.

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 \$18.1 billion (1.0 per cent of GDP) in 2012-13 to a surplus of \$13.8 billion (0.6 per cent of GDP) in 2017-18 (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 60 per cent, 70 per cent and 75 per cent in 2015-16, 2016-17 and 2017-18, respectively (Slide 15).

The projected improvement in the budgetary balance over the period 2012-13 to 2017-18 primarily reflects an improvement in the Government's structural balance. PBO estimates that the Government's structural balance will improve from a deficit of \$9.3 billion in 2012-13 to a surplus of \$14.0 billion in 2017-18 (Slide 16). Relative to potential income, this represents an increase of 1.1 percentage points in the structural balance from -0.5 per cent in 2012-13 to 0.6 per cent in 2017-18 (Slide 17). The projected improvement in the Government's structural balance (relative to potential income) is primarily due to the Government's planned spending reductions and restraint over the medium term.

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's 2012 Fiscal Sustainability Report⁶ (FSR) provided an assessment of the sustainability of the Government's fiscal structure, as well as that of the provincial-territorial-local government and public pension plan sectors, over the long term (Slide 18). In the 2012 FSR, PBO concluded that the Government's fiscal structure was sustainable over the long term given recent policy changes: the reduction in growth in the Canada Health Transfer (CHT) beyond 2016-17; reductions in direct program expenses; and, the increase in the age of eligibility for the Old Age Security (OAS) program (Slide 19). PBO estimated that the Government would have sufficient fiscal room – amounting to 1.4 per cent of GDP – to reduce taxes, increase spending on programs or some combination of both while maintaining fiscal sustainability.

⁶ Available at: http://www.pbo-dpb.gc.ca/files/files/FSR_2012.pdf.

Improving Budget Transparency and Accountability

PBO is pleased to note that Finance Canada is now publishing its estimates⁷ of the Government's structural, or cyclically-adjusted, budget balance on a Public Accounts basis in its annual *Fiscal Reference Tables*. Consistent with PBO's estimates, Finance Canada's estimates now indicate a relatively small but growing structural deficit over the period 2008-09 to 2011-12 (Slide 20).

PBO is also pleased to note that Finance Canada has recently published a report⁸ on Canada's ageing population. Finance Canada's report on population ageing confirms PBO's analyses of the federal fiscal structure presented in its September 2011 Fiscal Sustainability Report⁹, its January 2012 assessment of the CHT renewal¹⁰ and its September 2012 Fiscal Sustainability Report. That is, prior to the Government's December 2011 change to the CHT the federal fiscal structure was not sustainable, as federal debt relative to GDP was projected to rise unchecked over the long term. As PBO noted in its January 2012 assessment, as a result of the reduction in the growth rate of the CHT, the federal fiscal structure was rendered sustainable. Further, PBO's January 2012 assessment did not incorporate the Government's program spending reductions and restraint or the increase in the age of eligibility for the OAS program.

To improve budget transparency and accountability, PBO continues to strongly encourage Finance Canada to publish:

- Its historical estimates and medium-term projections (i.e., five years ahead) of the economy's potential GDP (income), as well as the methodology and assumptions used;
- Its medium-term projections of the Government's structural, or cyclically-adjusted, budget balance, as well as the methodology and assumptions used;
- The assumptions, projections and methods used to translate the private sector economic forecasts into Finance Canada's fiscal projections; and,
- The fiscal sustainability analyses of the provincial-territorial government sector that it prepared.¹¹

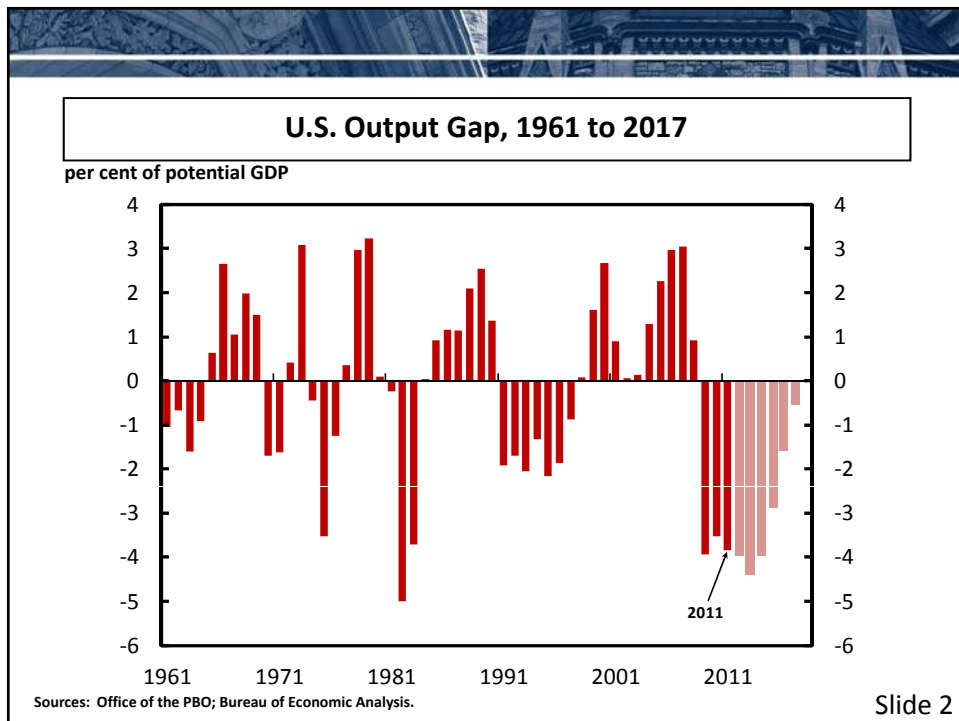
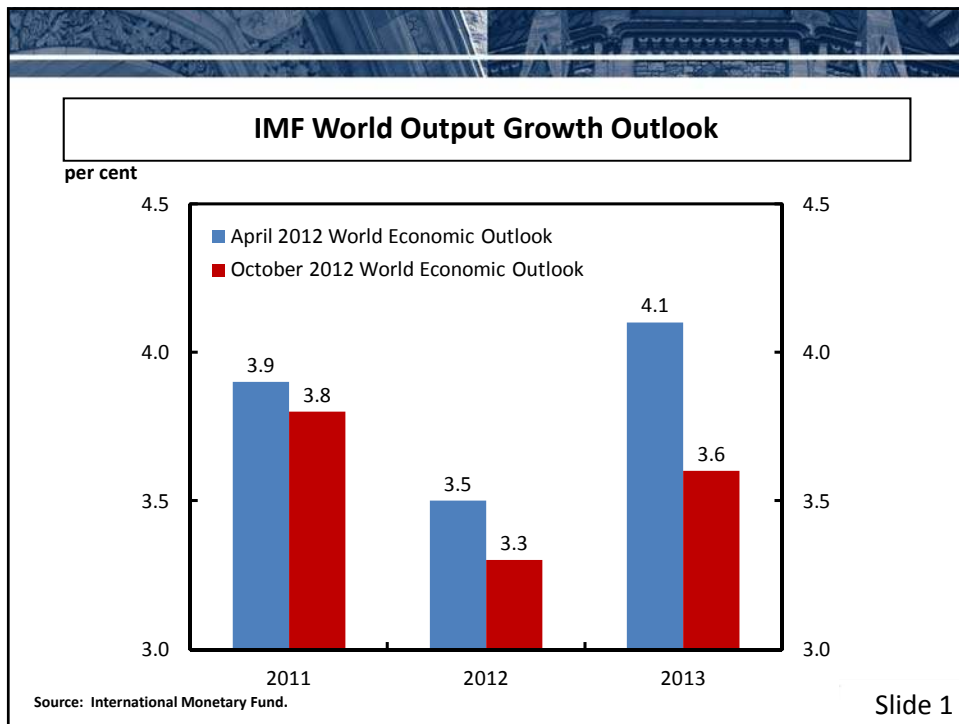
⁷ Available at: <http://www.fin.gc.ca/frt-trf/2012/frt-trf-1203-eng.asp#tbl17>.

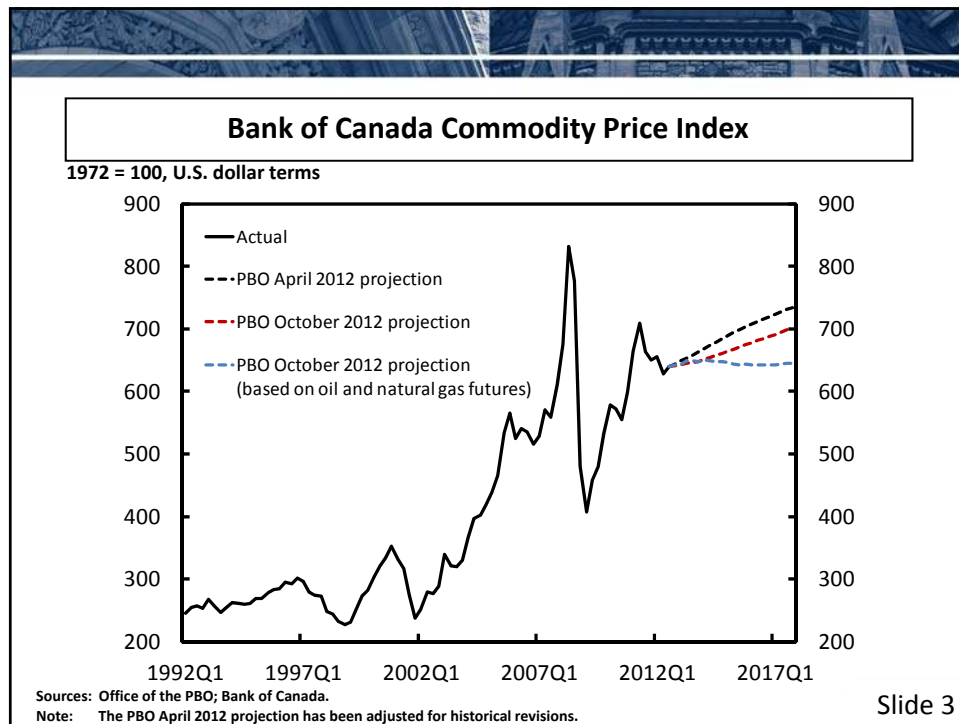
⁸ Available at: <http://www.fin.gc.ca/pub/eficap-rebvpc/eficap-rebvpc-eng.pdf>.

⁹ Available at: http://www.pbo-dpb.gc.ca/files/files/Publications/FSR_2011.pdf.

¹⁰ Available at: http://www.pbo-dpb.gc.ca/files/files/Publications/Renewing_CHT.pdf.

¹¹ The Auditor General's recent report on Finance Canada's long-term fiscal sustainability analyses (available at: http://www.oag-bvg.gc.ca/internet/docs/parl_oag_201210_07_e.pdf) noted, on page 17, that Finance Canada prepared "45- and 55-year long-term fiscal projections for all provinces and territories combined [...]".





Slide 3

PBO Economic Outlook – April and October 2012

	2012	2013	2014	2015	2016	2017
Real GDP growth (%)						
April 2012 projection	1.9	1.6	2.2	2.9	3.2	2.6
October 2012 projection	1.9	1.5	2.0	2.9	3.0	2.3
GDP inflation (%)						
April 2012 projection	1.7	1.8	1.9	1.9	2.0	2.0
October 2012 projection	1.1	1.5	1.8	1.9	2.0	2.0
Nominal GDP growth (%)						
April 2012 projection	3.6	3.4	4.1	4.9	5.2	4.7
October 2012 projection	3.0	2.9	3.8	4.9	5.1	4.3
Nominal GDP level (\$ billions)						
April 2012 projection	1,780	1,841	1,917	2,011	2,116	2,215
October 2012 projection	1,773	1,825	1,895	1,987	2,089	2,179
U.S real GDP growth						
April 2012 projection	2.1	2.2	2.7	3.3	3.6	3.5
October 2012 projection	2.2	1.8	2.7	3.5	3.6	3.4

Source: Office of the PBO.

Slide 4

PBO Economic Outlook – April and October 2012

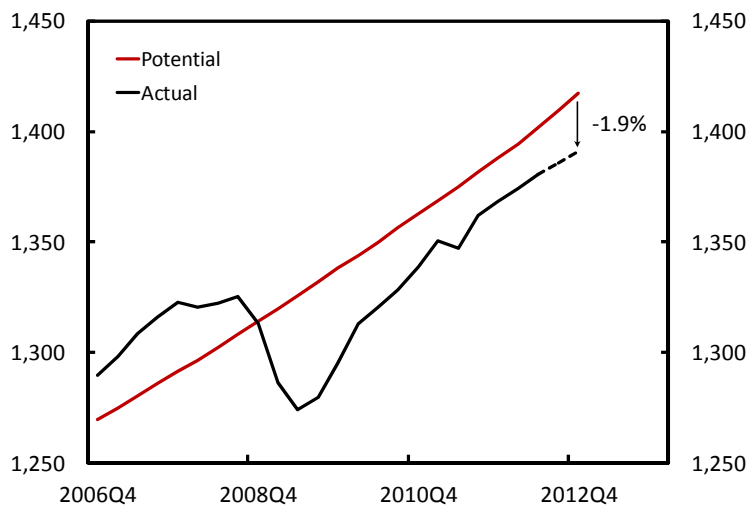
	2012	2013	2014	2015	2016	2017
3-month treasury bill rate (%)						
April 2012 projection	0.9	1.0	1.0	1.8	2.8	3.8
October 2012 projection	1.0	1.0	1.0	1.4	2.8	4.0
10-year government bond rate (%)						
April 2012 projection	2.7	3.8	4.3	4.6	4.9	5.2
October 2012 projection	1.9	2.2	2.8	3.6	4.4	5.2
Consumer Price Index inflation (%)						
April 2012 projection	2.0	1.7	1.8	1.9	2.0	2.0
October 2012 projection	1.6	1.6	1.8	1.9	2.0	2.0
Unemployment rate (%)						
April 2012 projection	7.7	7.9	7.9	7.5	7.0	6.6
October 2012 projection	7.4	7.6	7.6	7.3	6.8	6.5
Exchange rate (US cents/C\$)						
April 2012 projection	100.2	99.3	98.8	99.1	100.2	101.0
October 2012 projection	100.1	102.0	102.5	102.8	102.9	103.0

Source: Office of the PBO.

Slide 5

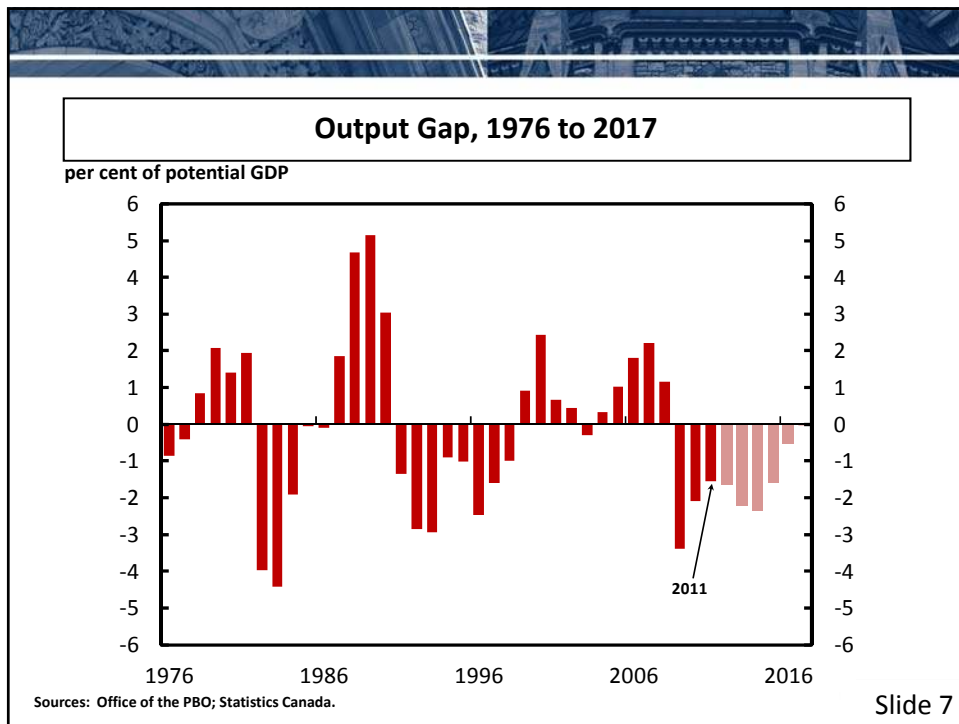
Real and Potential GDP

billions of chained (2002) dollars

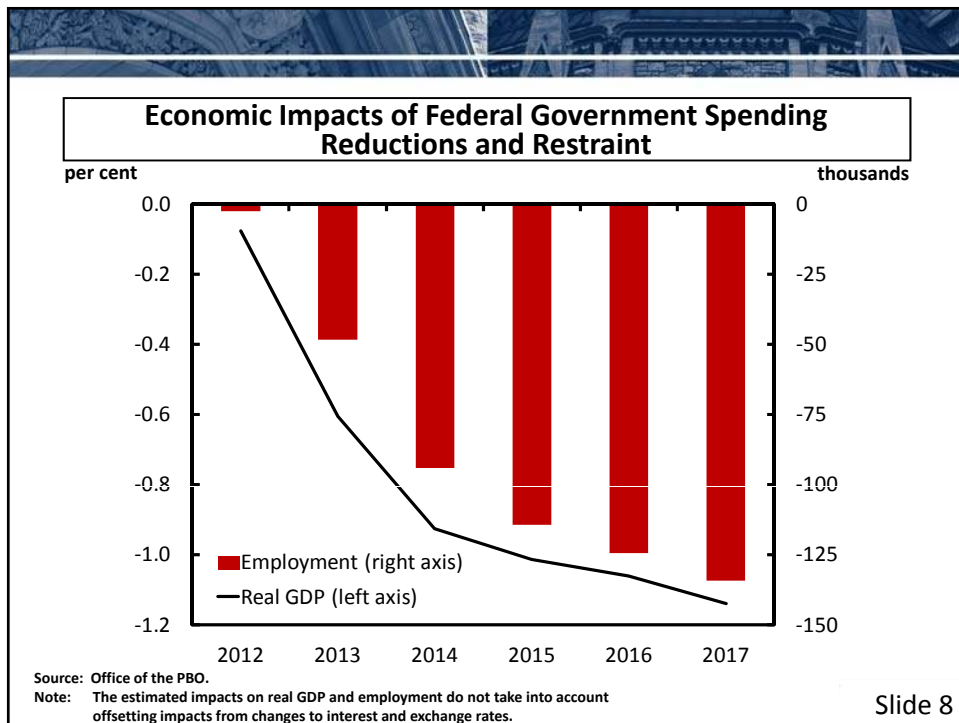


Sources: Office of the PBO; Statistics Canada.

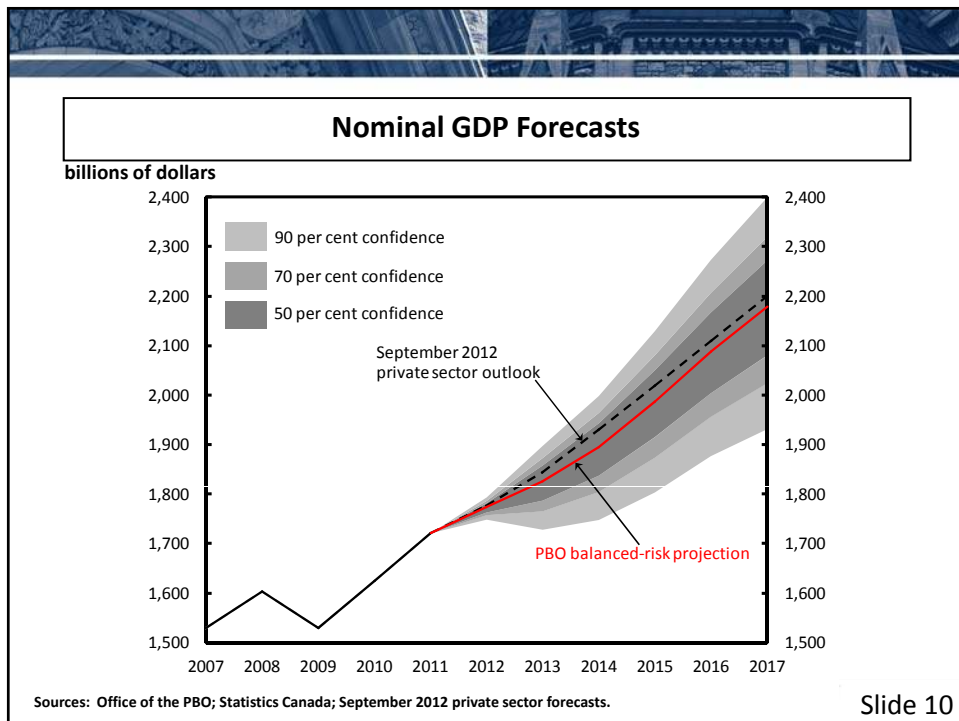
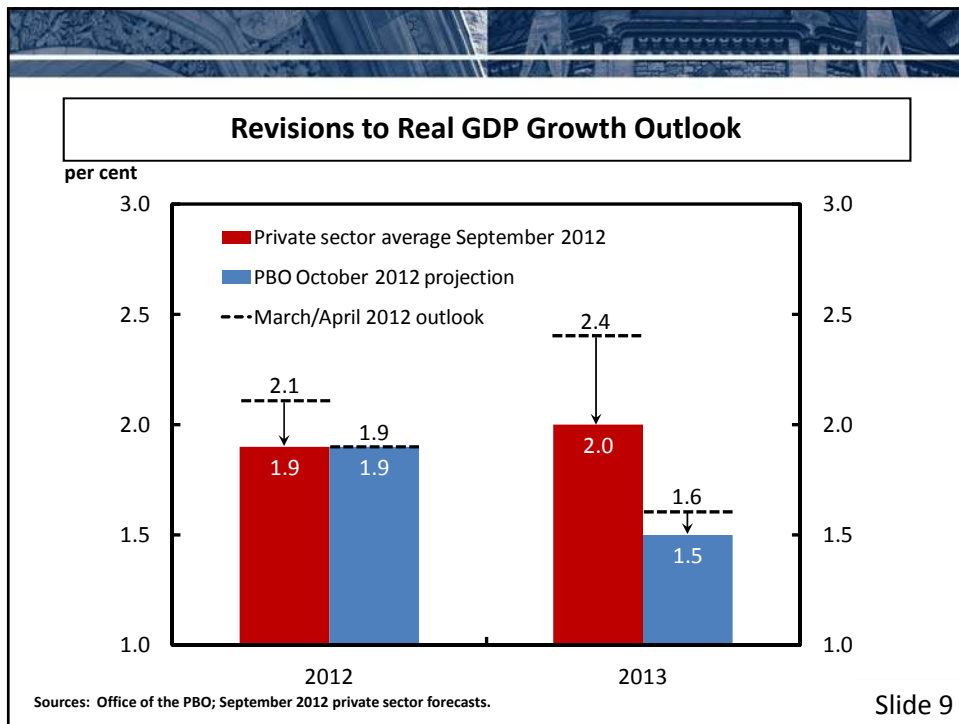
Slide 6



Slide 7



Slide 8



PBO Outlook for Budgetary Revenues

billions of dollars

	2012- 2013	2013- 2014	2014- 2015	2015- 2016	2016- 2017	2017- 2018
Income taxes						
Personal income tax	127.9	134.7	141.6	150.1	158.7	166.6
Corporate income tax	28.8	28.9	31.0	33.7	36.5	38.6
Non-resident income tax	5.8	6.1	6.4	7.0	7.5	8.0
Total income tax	162.4	169.8	179.0	190.8	202.7	213.1
Excise taxes/duties						
Goods and Services Tax	30.3	31.4	32.6	34.1	35.7	37.1
Custom import duties	4.0	4.2	4.4	4.6	4.8	5.0
Other excise taxes/duties	10.9	10.9	11.0	10.9	10.7	10.7
Total excise taxes/duties	45.2	46.5	47.9	49.6	51.2	52.9
El premium revenues	20.1	21.6	23.0	24.8	26.7	27.1
Other revenues	29.3	29.7	29.4	30.7	32.2	31.5
Total budgetary revenues	257.0	267.5	279.3	295.9	312.8	324.6

Source: Office of the PBO.

Slide 11

PBO Outlook for Expenses

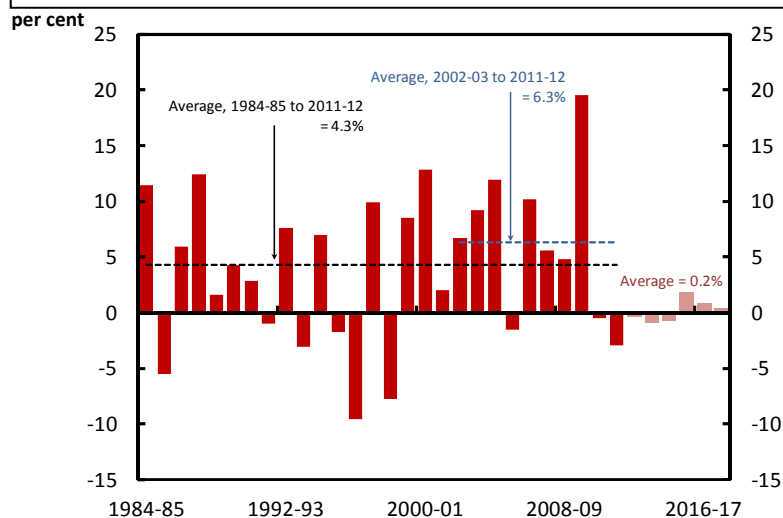
billions of dollars

	2012- 2013	2013- 2014	2014- 2015	2015- 2016	2016- 2017	2017- 2018
Major transfers to persons						
Elderly benefits	40.2	42.4	44.7	47.2	49.7	52.4
Employment Insurance benefits	18.6	20.8	21.0	21.1	20.9	21.1
Children's benefits	13.2	13.5	13.8	14.0	14.1	14.3
Total	72.0	76.7	79.5	82.2	84.7	87.8
Major transfers to OLG	57.2	59.2	61.7	64.2	67.1	69.9
Direct program expenses						
Transfer payments	32.8	31.9	30.7	30.1	30.2	29.8
Capital amortization	5.3	5.5	5.8	6.0	6.1	6.2
Other operating expenses	23.2	23.2	23.4	24.4	24.4	24.4
Operating expenses subject to freeze	53.6	53.3	53.3	54.8	55.6	56.4
Total	114.9	113.9	113.2	115.3	116.3	116.8
Public debt charges	31.1	31.2	29.7	31.0	33.9	36.3
Total expenses	275.2	281.0	284.1	292.7	302.0	310.9

Source: Office of the PBO.

Slide 12

Growth in Direct Program Expenses, 1984-85 to 2017-18



Sources: Office of the PBO; Finance Canada.

Slide 13

PBO Fiscal Projection – Summary

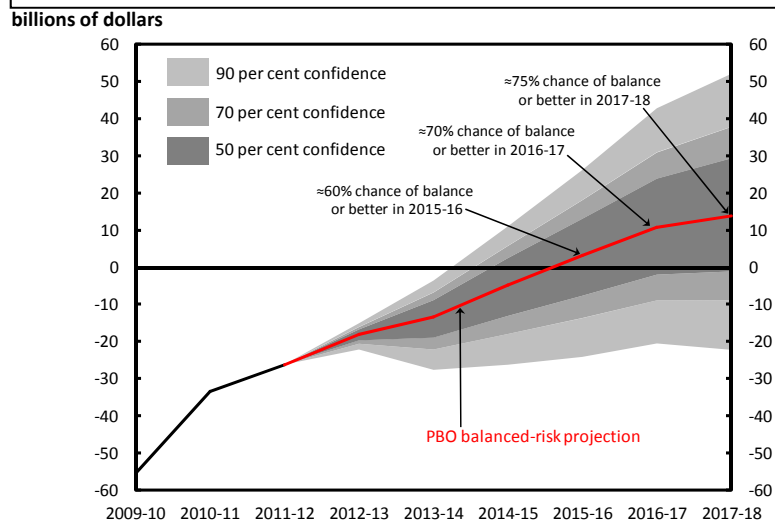
billions of dollars

	2012- 2013	2013- 2014	2014- 2015	2015- 2016	2016- 2017	2017- 2018
Budgetary revenues	257.0	267.5	279.3	295.9	312.8	324.6
Program expenses	244.1	249.8	254.4	261.7	268.2	274.6
Public debt charges	31.1	31.2	29.7	31.0	33.9	36.3
Total expenses	275.2	281.0	284.1	292.7	302.0	310.9
Budgetary balance	-18.1	-13.5	-4.7	3.2	10.8	13.8
Federal debt	600.3	613.8	618.5	615.3	604.5	590.7
Per cent of GDP						
Budgetary revenues	14.5	14.7	14.7	14.9	15.0	14.9
Program expenses	13.8	13.7	13.4	13.2	12.8	12.6
Public debt charges	1.8	1.7	1.6	1.6	1.6	1.7
Budgetary balance	-1.0	-0.7	-0.2	0.2	0.5	0.6
Federal debt	33.9	33.6	32.6	31.0	28.9	27.1

Source: Office of the PBO.

Slide 14

Budgetary Balance Outcomes Given Economic Uncertainty



Sources: Office of the PBO; Finance Canada.

Slide 15

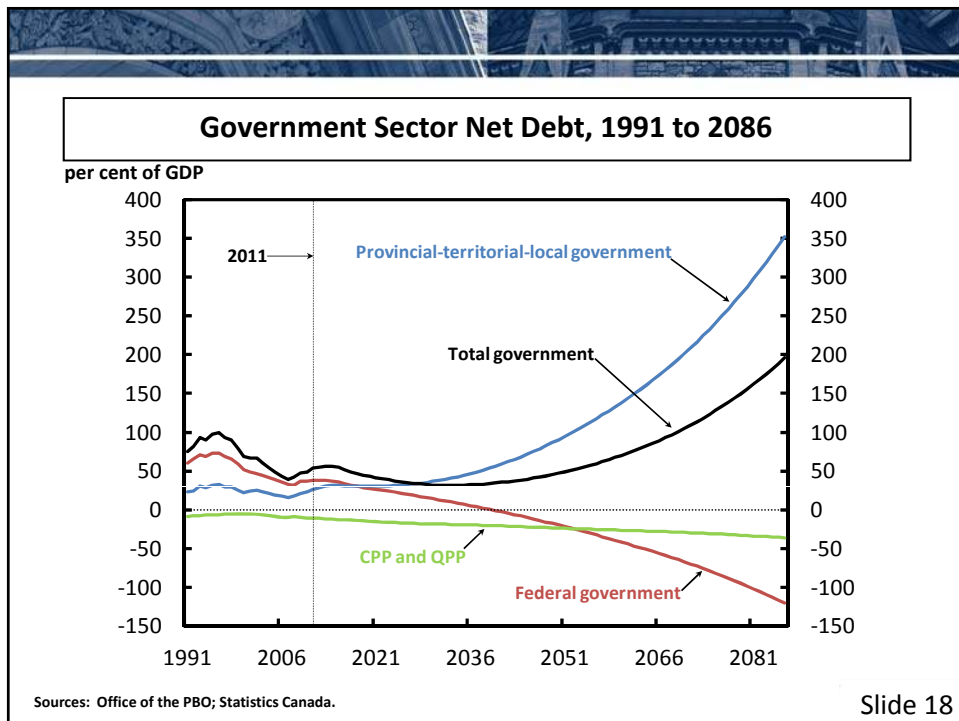
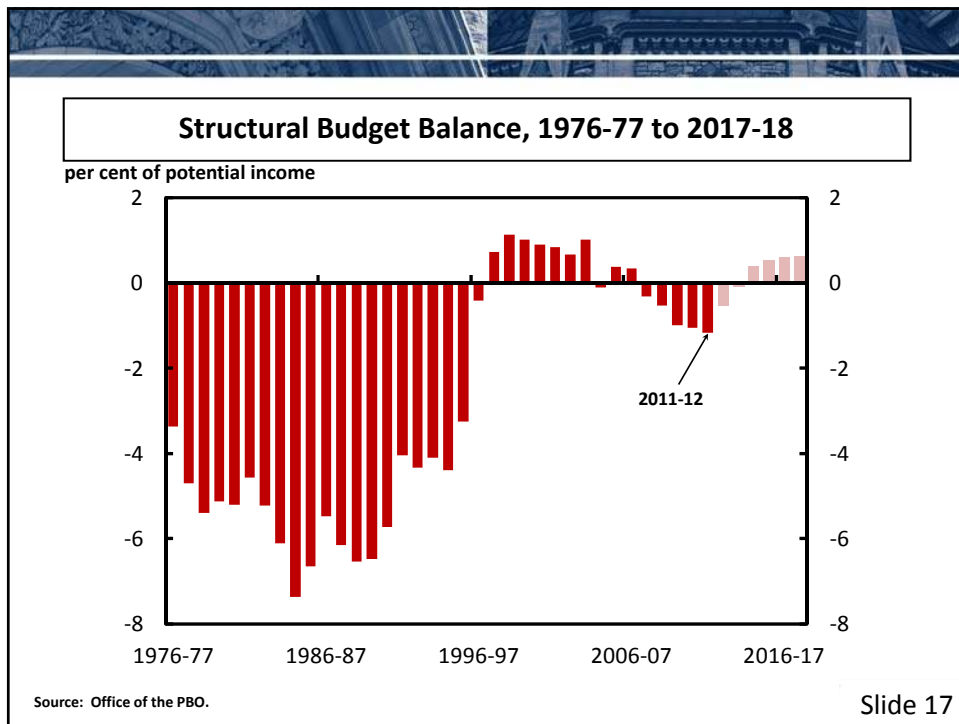
Structural and Cyclical Budget Balance Estimates

billions of dollars

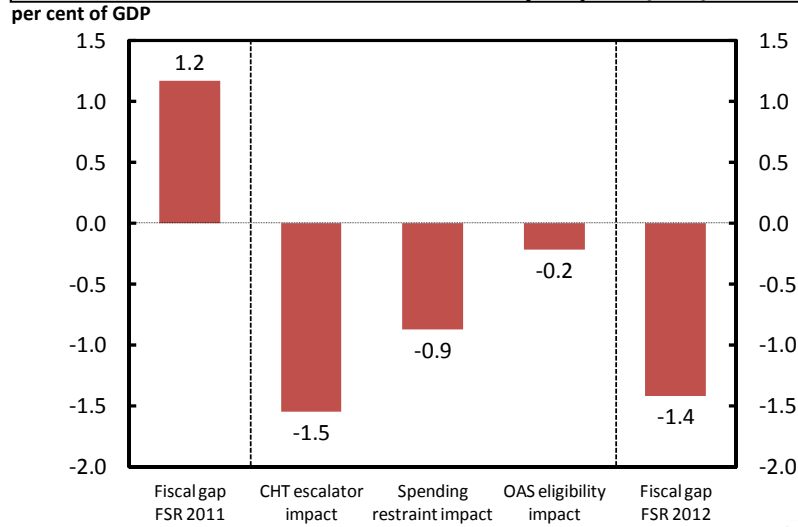
	2012-2013	2013-2014	2014-2015	2015-2016	2016-2017	2017-2018
Budgetary balance	-18.1	-13.5	-4.7	3.2	10.8	13.8
Structural balance	-9.3	-1.2	7.7	10.8	13.1	14.0
Cyclical balance	-8.9	-12.3	-12.5	-7.6	-2.3	-0.2

Source: Office of the PBO.

Slide 16



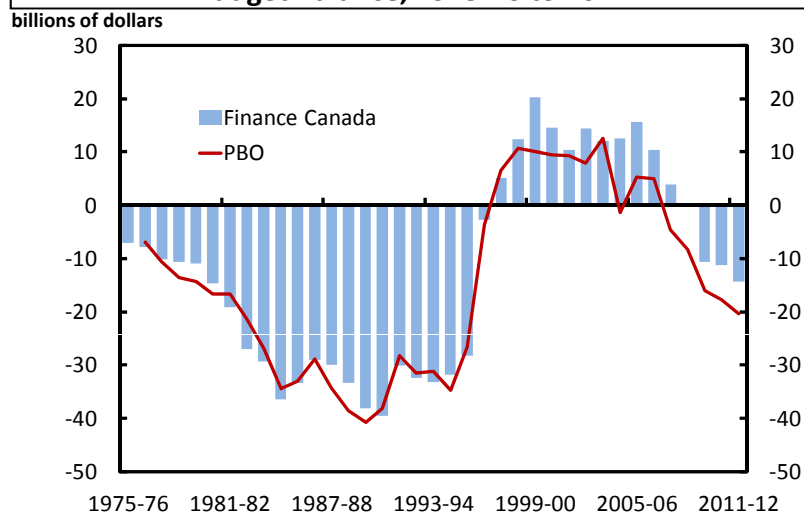
Impacts of Key Policy Changes on the Federal Fiscal Gap since the 2011 Fiscal Sustainability Report (FSR)



Source: Office of the PBO.

Slide 19

PBO and Finance Canada Estimates of the Federal Structural Budget Balance, 1975-76 to 2011-12



Sources: Office of the PBO; Finance Canada.

Slide 20