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|  | **Canada** | | | | | | | | | | | | | **Overall Assessment** | Annex I. External Balance Assessment |
| **Foreign asset and liability position and trajectory** | **Background**.Canada’s net international investment position (NIIP) rose from 10.3 percent of GDP in 2016 to 18.7 percent of GDP in 2017, reflecting significant valuation gains on external assets. At the same time, gross external debt remained broadly stable at 115 percent of GDP, of which about a third is short-term. The NIIP is projected to decline in the medium term, in line with sustained, albeit narrowing, current account (CA) deficits.  **Assessment**. Canada’s foreign assets have a higher foreign currency component than its liabilities which provides a hedge against currency depreciation. The NIIP level and trajectory are sustainable. | | | | | | | | | | | |  | **Overall Assessment**:  *The external position in 2017 remained moderately weaker than implied by medium-term fundamentals and desirable policies.*  It will take time for the economy to adjust to structural shifts in the allocation of resources, restore lost production capacity, and address productivity underperformance. Recent developments do not suggest a change in the assessment of the external position for 2017*.*  *In the medium term, the external position is expected to strengthen as non-energy exports gradually benefit from improved price competitiveness and investment in services and manufacturing capacity.*  **Potential policy responses**:  Policies to boost Canada’s non-energy exports include measures geared at improving labor productivity; investing in R&D and physical capital; promoting FDI; developing services exports; and diversifying Canada’s export markets. The planned increase in public infrastructure investment should boost competitiveness, and improve the external position over time. A credible medium-term consolidation plan for fiscal policy will also be necessary to support the external rebalancing. Maintaining tight macroprudential policies to ensure financial stability should also support private sector saving. |
| **Current account** | **Background**. The CA deficit narrowed to 2.9 percent of GDP in 2017 (from 3.2 percent of GDP in 2016), driven by an improvement in the energy trade balance. The CA deficit has been largely financed by portfolio inflows, which have more than offset significant direct investment outflows. The overall change in the CA was underpinned by improvements in both public and private savings-investment balances, with both increasing by around 0.1 percent of GDP in 2017.  **Assessment.** The EBA estimates a CA norm of 2.2 percent of GDP, and a cyclically-adjusted CA gap of -4.5 percent of GDP for 2017. This gap has widened significantly compared to last year, partly reflecting EBA methodological changes. The gap also partly reflects CA measurement issues. 1/ Staff also adjusted the CA gap to better reflect the authorities’ demographic projections and current immigration targets, 2/ and a steeper-than-usual discount between Canadian oil prices and international prices. 3/ As such, staff estimate the CA norm to be about 1.8 percent of GDP, with the CA gap between -3.4 and -0.4 percent of GDP. | | | | | | | | | | | |
| CA Assessment 2017 | Actual CA | -2.9 | Cycl. Adj. CA | -2.4 | EBA CA Norm | 2.2 | EBA CA Gap | -4.5 | Staff Adj. | -2.6 | Staff CA Gap | -1.9 |
| **Real exchange rate** | **Background.** The real effective exchange rate (REER) appreciated by around 1.5 percent on an annual average basis between 2016 and 2017. Estimates through [May] 2018 show that the REER has been unchanged relative to the 2017 average.  **Assessment.**  The EBA REER index model points to an overvaluation of 2.2 percent in 2017, while the REER level model points to an undervaluation of around 6 percent. In staff’s view, the REER level model could overstate the extent of undervaluation. 4/ Consistent with the assessed CA gap, staff estimates that the real effective exchange rate is overvalued by about 1 to 13 percent relative to medium-term fundamentals and desirable policies. 5/ | | | | | | | | | | | |
| **Capital and financial accounts:**  **flows and policy measures** | **Background.** The CA deficit in 2017 has been financed by net portfolio inflows (4.9 percent of GDP). Non-resident investors mostly purchased corporate debt securities (59 percent of portfolio net inflows). Foreign acquisition of Canadian equities and government debt securities stood at 10 and 31 percent, respectively. In 2017 foreign direct investment recorded a higher net outflow of 3.3 percent of GDP (2.4 percent of GDP in 2016).  **Assessment**. Canada has a fully open capital account. Vulnerabilities are limited by a credible commitment to a floating exchange rate and, while the government is running fiscal deficits slightly less than 1 percent of GDP in the near term, there is strong and credible commitment to fiscal consolidation over the medium term. | | | | | | | | | | | |
| **FX intervention and reserves level** | **Background.** Canada has a free-floating exchange rate regime, and has not intervened in the foreign exchange market since September 1998 (except for participating in internationally concerted interventions). Canada has limited reserves but its central bank has standing swap arrangements with the U.S. Federal Reserve and four other major central banks (it has not drawn on these swap lines).  **Assessment**.Policies in this area are appropriate to the circumstances of Canada. The authorities are strongly committed to a floating regime which, together with the swap arrangement, reduces the need for reserve holding. | | | | | | | | | | | |
| **Technical Background Notes** | 1/ The statistical treatment of retained earnings on portfolio equity and inflation is estimated to generate a downward bias in the income balance of the current account of the order of 1.7 percent of GDP.  2/ EBA uses UN demographic projections. These differ from the authorities’ projections due to methodological differences. The authorities’ projections suggest slightly higher population growth and a slightly lower CA norm. The authorities’ demographic projections also do not incorporate recent increases in immigration targets, which are assumed to be permanent. Together, these effects are assumed to reduce the EBA estimate of the CA norm by around 0.4 percent.  3/ The price discount between Canadian crude (WCS) and the West Texas benchmark has been $10 per barrel more than its historical average. This amounts to a temporary reduction in oil export prices by around 20 percent and suggests a higher underlying CA position (by around 0.6 percent of GDP).  4/ The approach includes commodity terms of trade rather than oil prices as an explanatory variable, while Canada’s REER has mirrored movements in oil prices much more closely than its commodity terms of trade.  5/ The semi-elasticity of the CA with respect to the REER is estimated at 0.27. | | | | | | | | | | | |  |  |  |

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