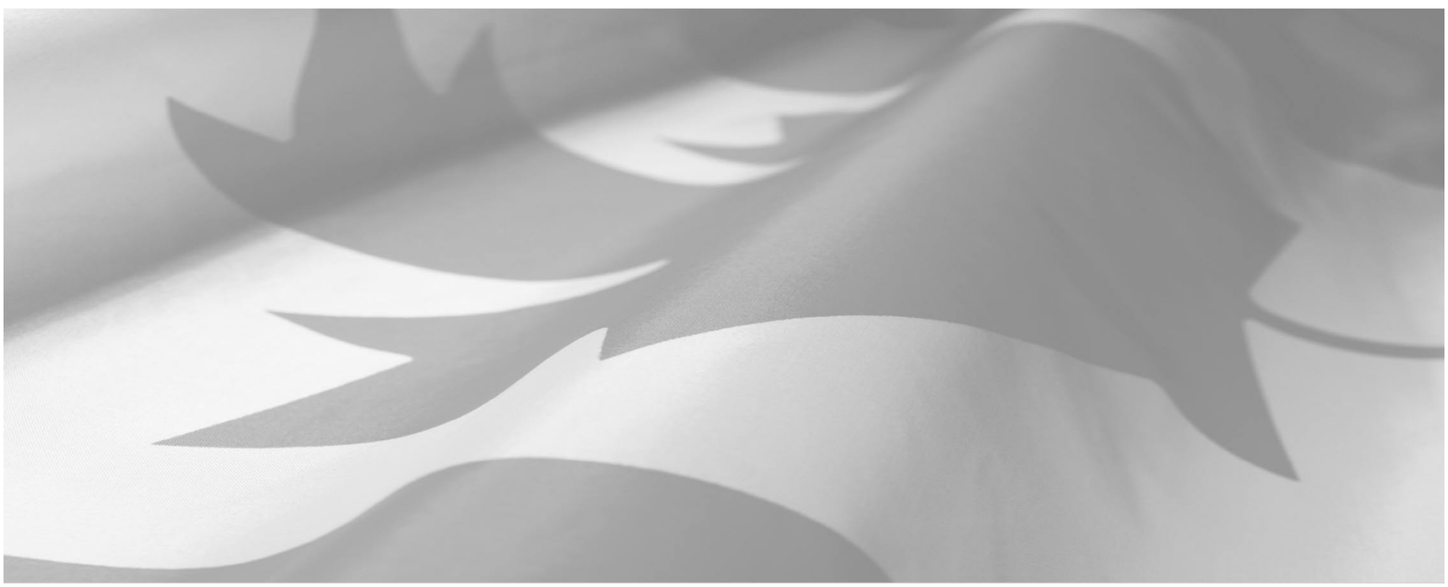
May 17, 2001

ECONOMIC UPDATE



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Presentation

by the
Honourable Paul Martin, P.C., M.P.

to the
House of Commons
Standing Committee on Finance

May 17, 2001
CHECK AGAINST DELIVERY

Introduction

Thank you, Mr. Chairman, and let me thank the committee for this opportunity to appear before you today.

In the months leading up to today's Update, I have had the opportunity to participate in extensive discussions on the global economy with the G-7 and G-20 finance ministers, the International Monetary Fund and the World Bank; on the North American economy with members of the business community from both sides of the border; and on our economy with a group of key Canadian economists.

Most importantly, since January, I have travelled to every region of the country, meeting with Canadians, participating in informal consultations, town hall meetings and locally based roundtables. In one community after another, the participants were kind enough to share their ideas, their insights, their hopes and concerns, and I want to thank all of those who took the time to do so.

Sometimes, in analyzing data, it is easy to get caught up in the language of economists and statisticians, but we must never forget that while economic activity is reported in numbers, it is experienced in the lives of Canadian families. After all, the "the economy" is not some abstract concept – "out there," "somewhere," "some time." It is the fabric of everyday life; it is the plans people make, the confidence they have and the activities they enjoy.

So it is certainly understandable that when Canadians speak about the economy it is not in the language of rates and ratios. They speak of affording a home, buying groceries or planning their children's education. They talk about their wish for a secure retirement and a health care system that's there when they need it. They also speak of the need to direct the economic strength of our nation to improving the lives of our people. They tell us that economic growth must be aimed at a higher purpose. And that is why a balanced approach is as important as a balanced budget.

Most Canadians I met expressed their confidence in the overall direction of our economy but, naturally, they were concerned about how the current slowdown, which started in the U.S., will affect them and their families. Today I want to speak to those concerns. Specifically, I want to update Canadians on how the global changes that have taken place since last October's Statement have affected our nation's finances and our economic prospects, and to outline the measures we are taking to support growth.

International Economic Situation

Let me begin with the broader international picture.

For an open economy like Canada's, with more than 40 per cent of our gross domestic product (GDP) generated by exports, what happens outside our borders has a direct impact on what happens inside.

At its meetings last month, the International Monetary Fund said that short-term prospects for global growth have weakened and, as a result, projections for growth were lowered from 4.2 per cent to 3.2 per cent for this year. In Europe the pace of economic activity has slowed and is below potential. In Japan, the world's second largest economy, low consumer confidence and fundamental problems in the financial system continue to prevent a sustained recovery.

United States' Economic Situation

In the United States – the economy that affects us most – the slowdown has turned out to be steeper than expected. The U.S. economy started last year growing at an annual rate of 5 per cent, but by the final quarter it was growing at just 1 per cent.

While preliminary estimates for the first quarter of this year show some improvement, the near-term outlook remains unclear. Indeed, the most recent labour force statistics, which showed a decline in U.S. employment, point to this uncertainty. Private sector economists are now projecting that growth in the U.S. will average 2 per cent in 2001. This reflects the widely held view that significantly lower interest rates will pave the way for renewed growth this year. We hope that proves to be the case. But we remain cautious and are taking nothing for granted.

Current State of the Canadian Economy

Clearly, the Canadian economy is feeling the effects of the weaker U.S. economy. Growth here in the final quarter of last year was considerably less than in the preceding quarter, primarily reflecting much slower activity in the automobile industry and in the information and communications technology sector. Both industries, which depend heavily on exports, have faced falling demand from the U.S. In response, both have had to cut back production to deal with excess inventories. These actions, in turn, have had their effect on the Canadian economy, postponing investment decisions and reducing near-term growth.

At the same time, however, there have been a number of encouraging developments which have helped to offset this weakness.

First, other export-oriented Canadian industries, such as aerospace and energy, have continued to grow at a strong pace. Service industries and construction – particularly the housing sector – which are domestically oriented, have also continued their solid performance. This strength in services, aerospace, energy and construction is important because together they produce more than 75 per cent of Canada's total economic output.

Second, Canada's external balance has improved substantially – from a deficit of $28 billion in 1993 to a surplus of $19 billion in 2000. This, in turn, has resulted in a sharp decline in our foreign indebtedness – from 44 per cent of GDP in 1993 to 23 per cent last year, its lowest level since the early 1950s. This decline in foreign indebtedness is significant. Reducing the amount of money that we pay to international creditors gives us greater flexibility to manage our own affairs and keep interest rates low. This is all the more welcome in today's uncertain global environment.

Third, and most importantly, employment continues to grow and Canadians are beginning to see their disposable income rise again. This, combined with large tax cuts and lower interest rates, is supporting solid consumer spending this year.

Mr. Chairman, given the mixed signals on the health of the economy, it is not surprising that there are differing perceptions about its present state. What is important is to put these differing opinions into context. In summary, what is clear is that all of the available facts and figures show that, albeit at a slower pace than last year, the longest Canadian economic expansion since the 1960s – some 22 quarters of growth – is continuing.

Since taking office in 1993 we have consistently budgeted on a rolling two-year basis. Given the uncertainty inherent in long-term projections, this approach has served us well in the past and will do so again in the future. As part of this approach, the Department of Finance surveys some 19 private sector forecasters to obtain their best estimates of the economic outlook. Based on that survey, we then meet with the chief economists of Canada's major chartered banks and four leading forecasting firms to make doubly sure that the average of private sector forecasts is a reasonable basis upon which to plan. This approach ensures that the assumptions we use are realistic and credible.

In preparation for this Update, we have again conducted this process. Mr. Chairman, looking ahead to the next two years, the economists have projected that while the deceleration in economic growth is sharper than previously anticipated, the economy will continue to expand. Where there is less agreement is on the extent of that growth. Indeed, the forecasts for 2001 range from a high of 2.8 per cent to a low of 1.6 per cent, with an average of 2.4 per cent. For next year, 2002, the economists expect a rebound, with forecasts ranging from growth of 2.5 per cent to 4 per cent, with an average of 3.4 per cent.

The question is: What do these forecasts mean for the finances of the nation? Specifically, what do they mean for our projections of balanced budgets? For the tax cuts promised in Budget 2000 and in the October Statement? For the Health Accord reached with the provinces and territories last year?

Let me begin by reminding you of the situation at the time of the October Statement and what we had projected for each of the next two years.

In October, after funding our tax cuts and expenditures such as the Health Accord, we projected a total surplus of $8.3 billion for 2001-2002. This was made up of $4.3 billion in unallocated surplus – to cover priorities such as those outlined in the Red Book – the $3-billion Contingency Reserve and $1 billion in economic prudence.

Based on the revised average of the private sector forecasts of 2.4-per-cent growth in 2001, offset by lower interest rates and the ongoing impact of higher-than-expected revenues last year, the budgetary balance will decline by $1.1 billion. This leaves a surplus for the current fiscal year of $7.2 billion for prudence, to cover our $3-billion Contingency Reserve and to deal with policy measures, of which $600 million has been committed to date.

For 2002-2003 we projected a total surplus of $7.6 billion. This was made up of $2.6 billion in unallocated surplus, the $3-billion Contingency Reserve and $2 billion in economic prudence. Using the revised average of the private sector forecasts of 3.4-per-cent growth for 2002, and again taking into account similar offsets, the budgetary balance will decline by $300 million. This leaves a surplus for 2002-2003 of $7.3 billion for prudence, the Contingency Reserve and policy measures, of which $400 million has been committed.

Mr. Chairman, let me go one step further. The aforementioned numbers are derived from the average of the total range of private sector forecasts. Let me now use the average of the most pessimistic of the private sector forecasts. Even here – 1.8-per-cent growth in 2001 and 2.9-per-cent growth in 2002 – the net impact would result in an adjusted budgetary surplus of $6.2 billion this year and $5.1 billion next year. In other words, Mr. Chairman, despite the economic slowdown, and even assuming the more pessimistic average private sector forecast, the Health Accord is protected; the $100 billion in tax cuts is protected. And we will not fall back into deficit. This is the payoff for the prudent approach we have adopted from the beginning.

In the past some have suggested that we were being overly cautious. However, we have never assumed that the business cycle had been abolished. We have always believed that it is better to prepare for rain, even in the sunniest of forecasts. Now that clouds have appeared, Canada has not been caught unprepared.

Mr. Chairman, that being said, while our fiscal situation allows us to ride out the current economic slowdown, we are very conscious of the reality that many Canadians are feeling its effects. It is of little comfort to them to hear that the Government is doing fine. They need to know that we have acted – and continue to act – in ways that will benefit them.

Actions Supporting the Canadian Economy

In the February 2000 budget and the October Statement, we outlined a number of actions which are part of our ongoing strategy to protect Canadians, a strategy to invest in the social fabric of our country, reduce taxes and pay down debt. These actions are not only the kind of initiatives that will contribute to the long-term strength of our economy – they also provide stimulus in the short term when we need it now, by putting more money into the hands of Canadians, by spurring business, sparking investment and creating jobs.

First and foremost, there are tax cuts – the largest in Canadian history.

Last October we reduced the tax on capital gains and increased the investment amount for tax-free rollovers. In January we took a second step in creating a new Canadian advantage for investment and job creation. We cut corporate income tax rates by one percentage point, and further cuts – two points in each of the next three years – will bring corporate rates below levels in the U.S. Because these corporate tax cuts are being fully legislated, businesses can – and should – factor them into their investment plans starting immediately.

In terms of personal income taxes, our actions have been even more dramatic. In January of this year we reduced taxes at all income levels – 21 per cent on average – putting more money into the hands of Canadians, especially moderate-income families with children. As well, the earlier reintroduction of indexation increased personal credits and tax brackets so that taxpayers will be forever protected from inflation. And finally, in July a further $900-million stimulus will come with the increase in the Canada Child Tax Benefit, bringing significant help to families with children.

What do all of these tax measures mean for Canadians?

A typical two-earner family of four with a combined income of $60,000 will see its federal taxes drop by $1,000 this year – an 18-per-cent tax cut. A single parent with one child and $25,000 in income is receiving an additional $800 this year, for a total benefit of $2,500. Mr. Chairman, this year alone these tax measures will provide the Canadian economy with $17 billion in added stimulus.

Furthermore, in addition to the tax reductions, which are largely focused on middle- and low-income earners, a number of strategic investments are being made in areas that are also of great importance to Canadians – areas like health care, education and innovation.

As mentioned earlier, last September the federal, provincial and territorial governments signed a five-year Health Accord, to which the Canadian government contributed $21.1 billion. This included $2.2 billion for early childhood development, which will help to ensure that our children get the best possible start in life, arriving at school ready to learn and equipped to succeed. This year, as a result of the Accord, the Canadian government will provide an additional $2.8 billion to the provinces and territories for health, education and children. In addition, $1 billion has just been provided to the provinces and territories to purchase medical equipment, along with $500 million for investments in health information technology and $200 million per year for each of the next four years for the Health Transition Fund, which supports innovation in primary health care reform.

A further $800 million in equalization payments will flow this year as a result of the lifting of the ceiling for 1999-2000. This is in addition to the recently announced $1-billion increase in equalization payments for 2000-2001.

Mr. Chairman, in Budget 2000, we announced a five-year program consisting of $2 billion for infrastructure, particularly in the area of the environment, and $600 million for highways. Because this funding will be provided on a cost-shared basis, it will leverage more than $6 billion for infrastructure and $1.2 billion for highways. These investments will benefit communities right across Canada. Agreements on the infrastructure portion have now been reached with all of the provinces and two of the three territories. As a result, we expect more than $1 billion in new capital investment this year alone.

One of the most consistent threads that has run through our policies in recent years has been a recognition that innovation is key both to the strength of our economy and to the quality of our lives. Budget 2000 and the October Statement built on that imperative, making large, long-term investments in the knowledge infrastructure of our country – our universities and research institutes. Thus, this year alone $500 million will be injected into the economy through the Canada Foundation for Innovation, Genome Canada and the Atlantic Investment Partnership.

Mr. Chairman, taken together, all of the expenditure initiatives announced in Budget 2000 and the October Statement amount to almost $7 billion in stimulus for the Canadian economy this fiscal year. When combined with the $17 billion in tax measures, the total impact this year alone will be close to $24 billion – this is one of the most, if not the most, stimulative packages introduced into its economy by any government of a major industrialized country this year.

Finally and very significantly, reinforcing these fiscal actions have been the steps taken by the Bank of Canada to lower interest rates. The Bank Rate has fallen by a full percentage point in the last four months alone, providing real relief to Canadian families. One-year mortgage rates, for example, have fallen significantly since last December. This means it is easier for young couples to buy that first home or for families to trade up to a larger one. It means cars and other major items are less expensive to finance and it means lower borrowing costs for those wanting to start or expand their businesses.

Mr. Chairman, so far I have talked about the state of the economy, the impact the current slowdown is having on our finances and some of the measures we are taking to stimulate growth. Looking ahead to the longer term and to the underlying fundamentals of our economy, let me now address two other issues.

First, the anchor of a low interest rate policy is the establishment of a low-inflation regime. The Bank of Canada and the federal government have achieved success in this respect through three-year agreements on inflation targets. The existing agreement is due to expire this year. To maintain low inflation, lower interest rates and continued growth, I am pleased to announce today that we have agreed with the Bank of Canada not only to extend the current agreement on inflation targets, but to do so for five years. That means our target range for inflation will remain between 1 per cent and 3 per cent. Maintaining these targets will allow markets and investors to plan with confidence, knowing that Canada will remain a low-inflation environment.

Second, in terms of the national debt, Canada has reduced its federal debt-to-GDP ratio from a peak of 71 per cent in 1995-1996 to below 53 per cent at the end of last year. In recent years no country has reduced this ratio as much as Canada. Furthermore, in absolute terms, we have paid down the federal debt at an unparalleled pace. When times are slow, the rate of debt reduction will naturally slow, but when times are good – as they were last year – we should take advantage of that fact to reduce the burden on future generations.

In the October Statement, the Government committed to paying down at least $10 billion of debt. Because our revenues were higher than expected, I am pleased to announce today that we will do better than that. We now expect to pay down at least $15 billion of debt for the year just ended. This means that we will have retired more than $33 billion of debt in the last four years – $27 billion in the last two years alone – saving Canadians close to $2 billion a year in interest payments – money that can be used for other priorities such as health care and education, year in and year out.

Conclusion

Mr. Chairman, let me just say in closing, that the global economy is slowing is clear. Our job is to enable Canadians to ride through the downturns and to take advantage of the upturns. Therefore, we will continue to report to Canadians on the trends. And let there be no doubt, we will remain vigilant.

However, there are those who say that to counter the slowdown now we should cut taxes more or that we should spend more. In other words, that we should take the chance of going back into deficit. Well, that we will not do. We will not put at risk all that Canadians have worked so hard to achieve over the past few years. Rather, we will maintain the approach that has seen us through the peso crisis of 1994 and the Asian crisis of 1997, and which will see us through the current slowdown.

Looking ahead, our long-term plan means we will continue to cut taxes, it means we will continue to cut debt and it means we will continue to control spending. But as well, it means we will never forget that in the knowledge economy, the real engine of growth is the human mind, and that how we equip our people today – to learn, to invent, to create – will determine this nation's ability to produce jobs, to generate growth, raise living standards and provide opportunity tomorrow. For this reason, we must continue to invest in education and innovation. We must overcome the shortage of skilled workers across the economy and help those who have difficulty with the transition, never forgetting that the society we build is just as important as the economy we create.

That is why, Mr. Chairman, when challenges come, we must keep our eyes fixed on the purposes we have set and remind ourselves not only of what we have already done but, above all, of what we can do together.

Annex 1

Recent Economic Developments and Outlook[1]

[1] Incorporates data available up to May 11, 2001.

Highlights

- *The Canadian economy enjoyed a strong economic performance over the past four years: gross domestic product (GDP) growth averaged 4¼ per cent, over 1.5 million jobs were created, the unemployment rate fell significantly to 6.8 per cent in 2000, productivity growth improved, and real per capita personal disposable income rose 2.9 per cent last year.*

- *In late 2000, however, the global outlook began to weaken, led by a sharp slowdown in growth in the United States.*

- *The U.S. manufacturing sector has been hit hardest, particularly in the automotive sector and in information and communications technologies industries. As confidence and equity markets declined, U.S. growth forecasts for 2001 have been revised down from 3.5 per cent in September 2000 to 2 per cent in May 2001.*

- *As a result of Canada's strong economic links with the U.S., especially in the manufacturing sectors of the two countries, the slowdown in the U.S. has spilled over into Canada – in particular into the manufacturing industries most affected in the United States.*

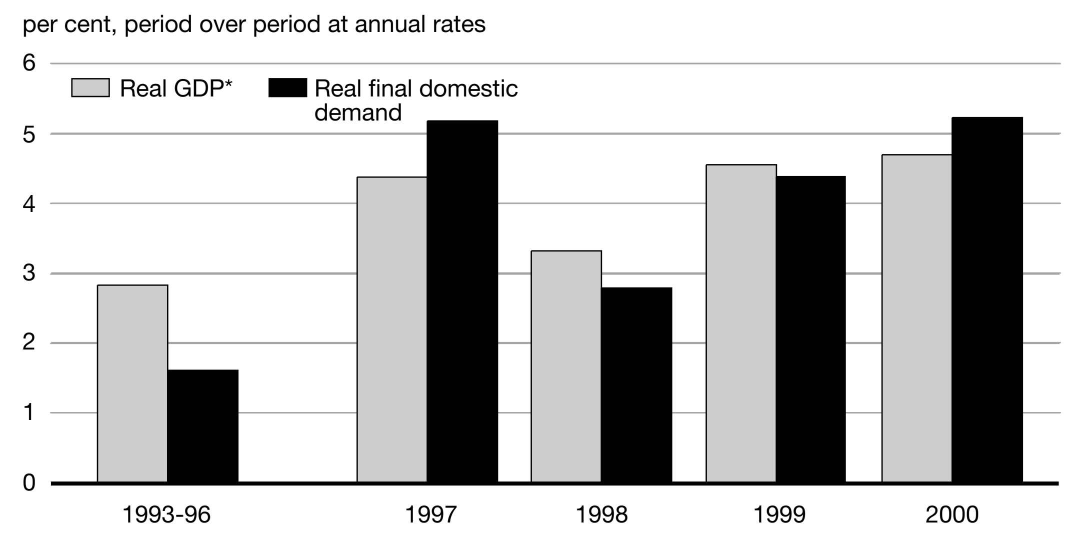
- *However, other sectors of the Canadian economy – such as service, energy, construction and aerospace industries – are continuing to grow solidly.*

- *In addition, tax cuts at all levels of government will contribute to growth both this year and next, while declines in interest rates will continue to encourage business investment, housing demand and consumer spending.*

- *Overall, private sector forecasters have lowered their expectations for 2001 growth in Canada from 3.5 per cent at the time of the October 2000* Economic Statement and Budget Update *to 2.4 per cent in the March 2001 private sector survey. Expected growth in 2002 is now 3.4 per cent, up slightly from the October Statement.*

The Canadian economy has grown strongly in recent years

Real GDP and Final Domestic Demand Growth

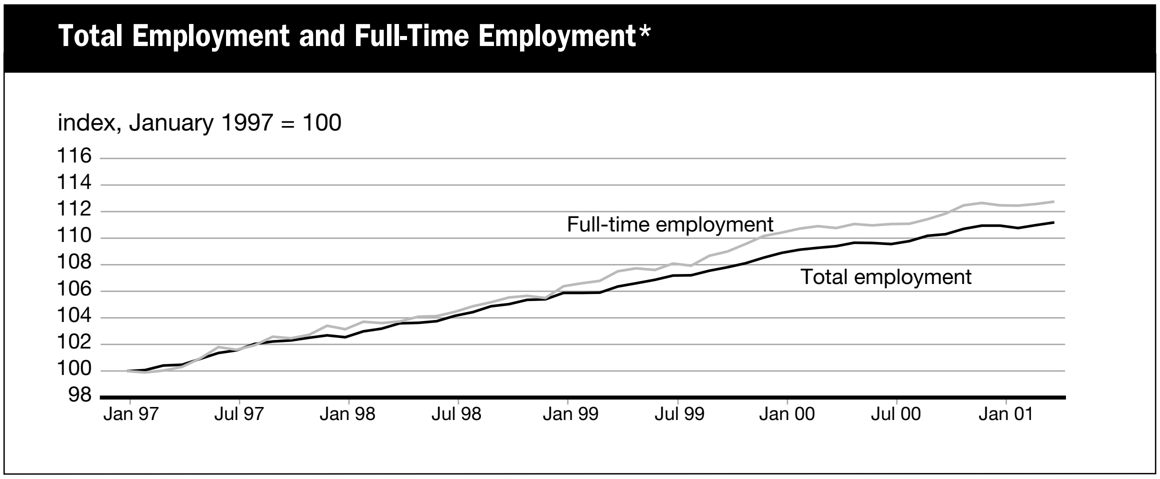


* These numbers could change due to methodological revisions by Statistics Canada that will be incorporated in the May 31 National Income and Expenditure Accounts release (see page 44 for details).

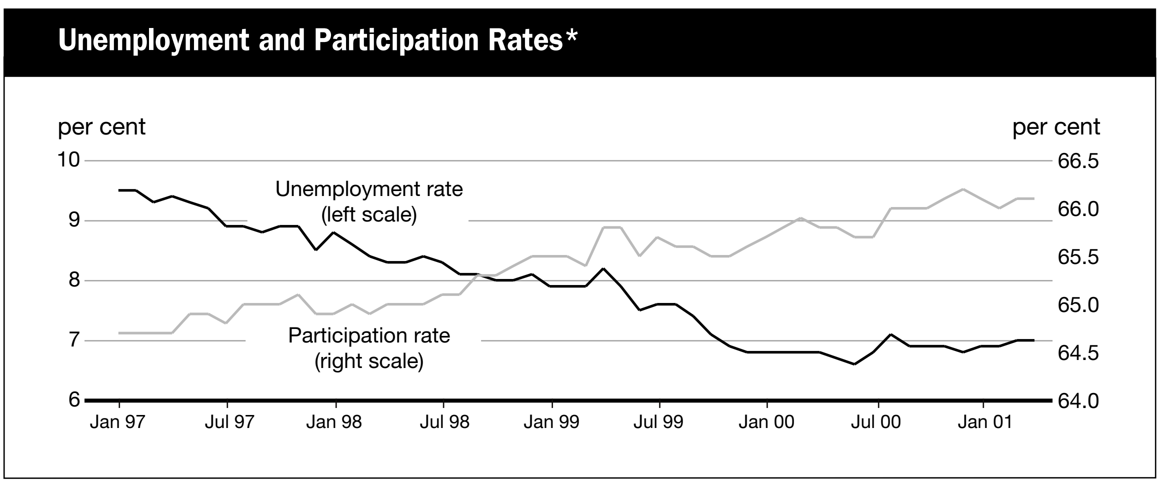
- Since the Canadian economic turnaround began in earnest in 1996, Canada has enjoyed strong real GDP growth averaging 4¼ per cent compared with just 2.8 per cent over the previous four years. Indeed, in the fourth quarter of 2000, real GDP advanced for the 22nd consecutive quarter.

- Since 1996 growth has been well balanced between robust foreign demand – particularly from the United States – and a strong expansion of domestic demand.

Strong labour market performance since 1996



* Incorporates data to April 2001.

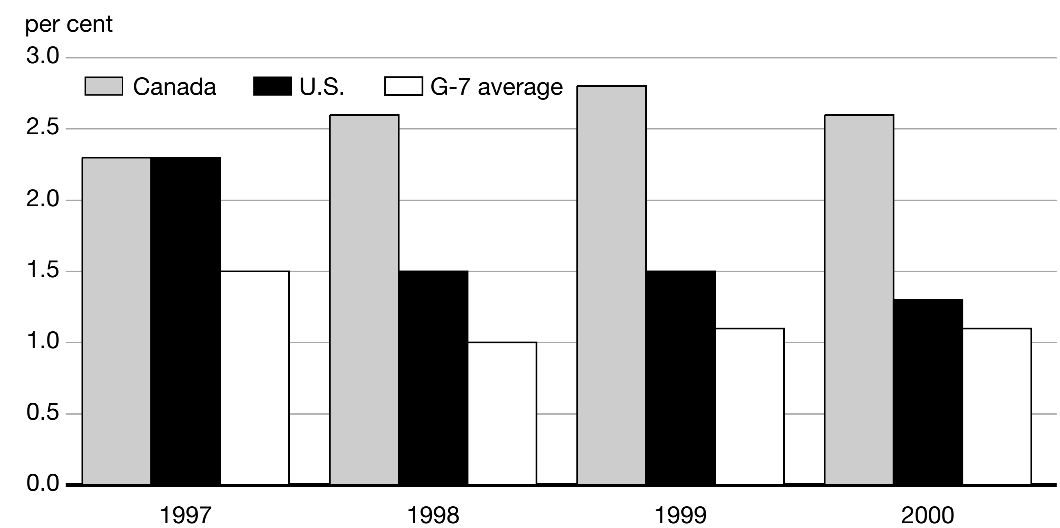


* Incorporates data to April 2001.

- Since the end of 1996 sustained demand growth has generated a marked improvement in labour market conditions.
- Over this period the Canadian economy has generated over 1.5 million jobs, virtually all of which have been full-time. In the last 12 months alone 240,000 new jobs have been created.
- The unemployment rate has dropped sharply from 9.5 per cent at the beginning of 1997 to an average of 6.8 per cent in 2000.
- Improved employment prospects prompted a resurgence in labour market participation, which rose to its highest level in nine years at the end of 2000.
- After a pause in January and February of 2001, employment growth resumed in March and April, with a total of 55,000 jobs created.

Canada has led the Group of Seven (G-7) in employment growth for four consecutive years

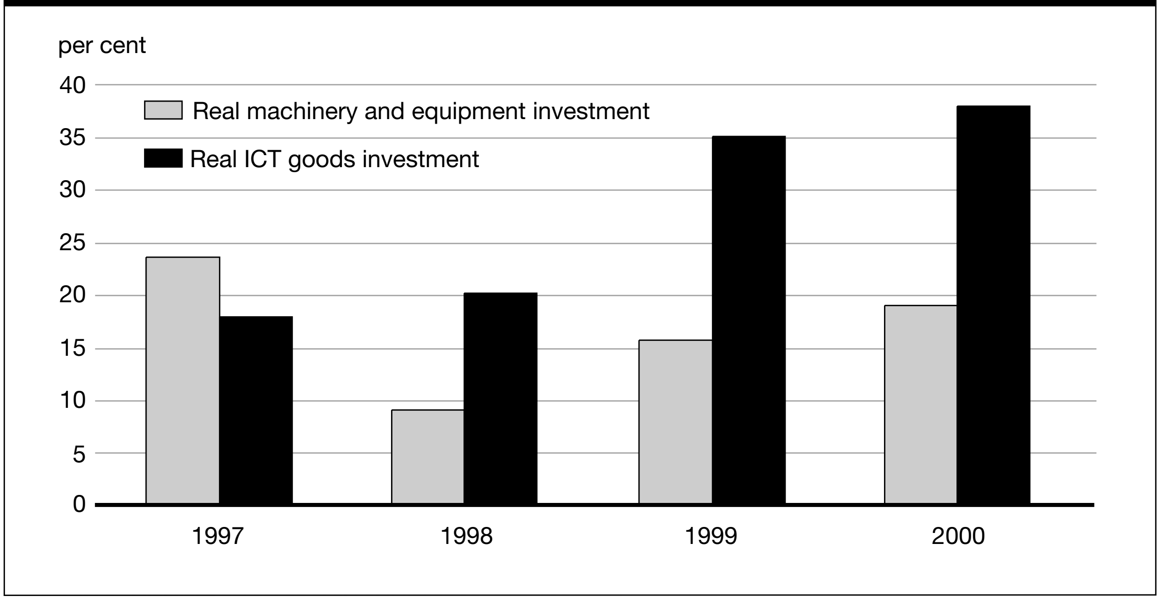
Employment Growth: Canada vs. G-7



- Since 1996 Canada had the best job creation rate of any G-7 country.
- Over that period employment growth in Canada was more than double the G-7 average and over 1.5 times the rate of employment growth in the United States.

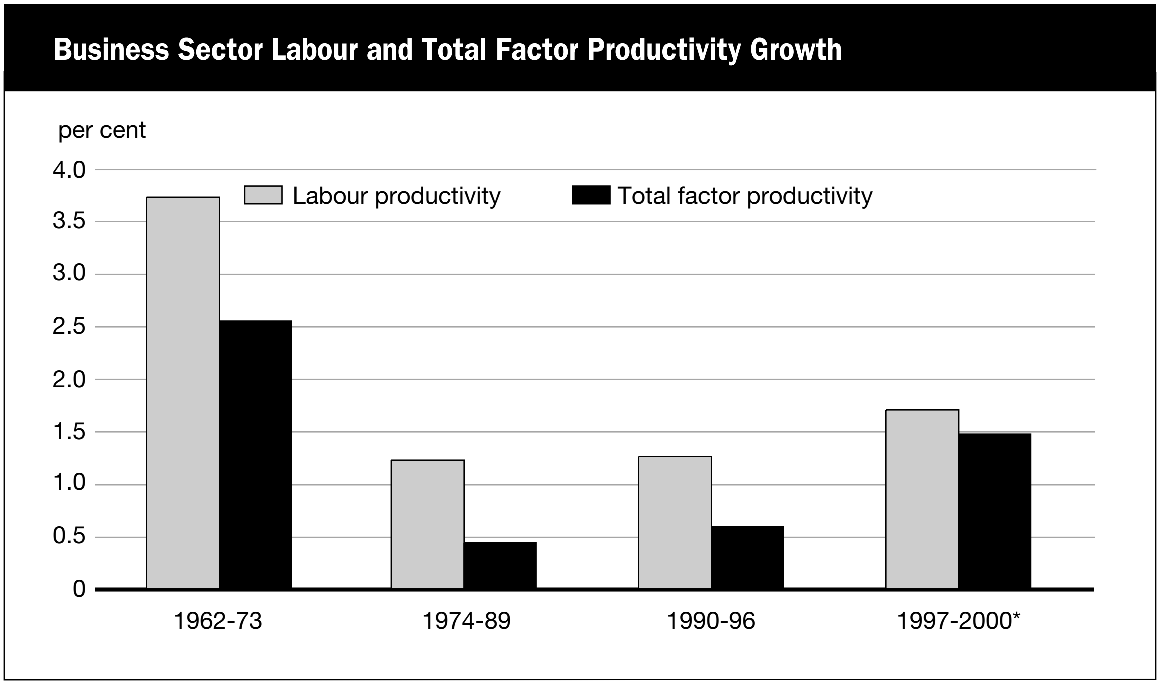
Growth has been boosted by surging business investment in information and communications technology (ICT) goods

Business Investment in Machinery and Equipment and ICT Goods Growth



- Since 1996 a significant force behind Canada's strong economic performance has been business investment in ICT goods.
- Over this period business investment in these areas has averaged growth of 27.4 per cent, over four times the rate of growth of all other business investment and over six times the rate of growth of the overall economy.

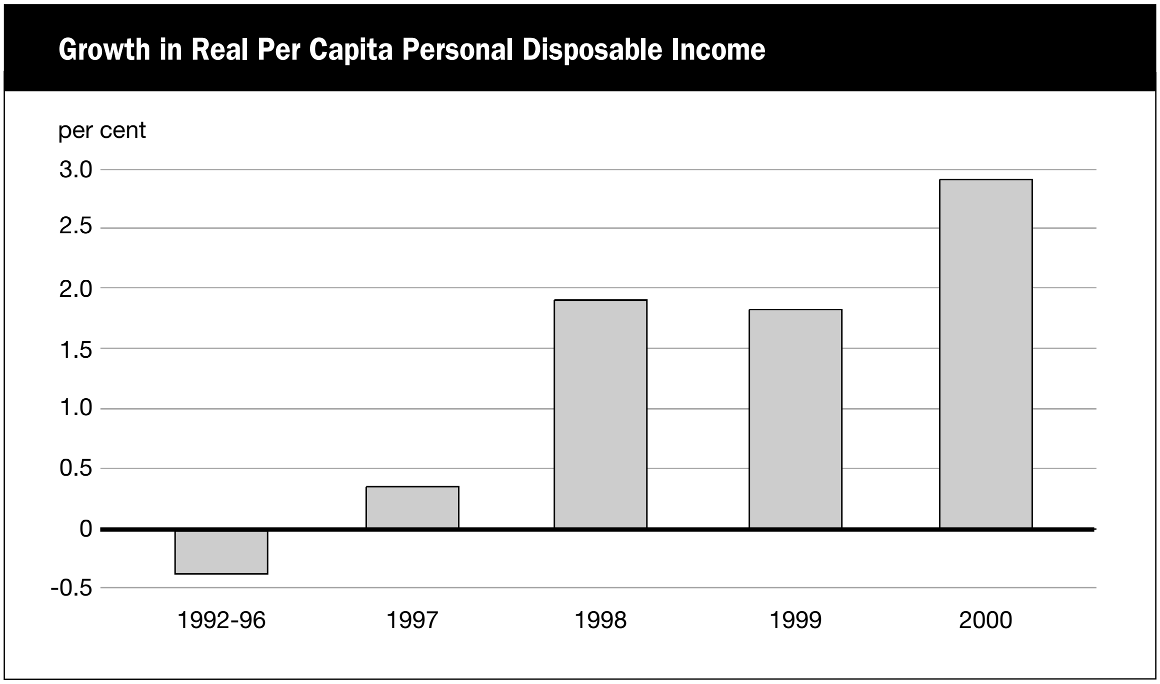
Our productivity performance is beginning to improve



* 1997-99 for total factor productivity.

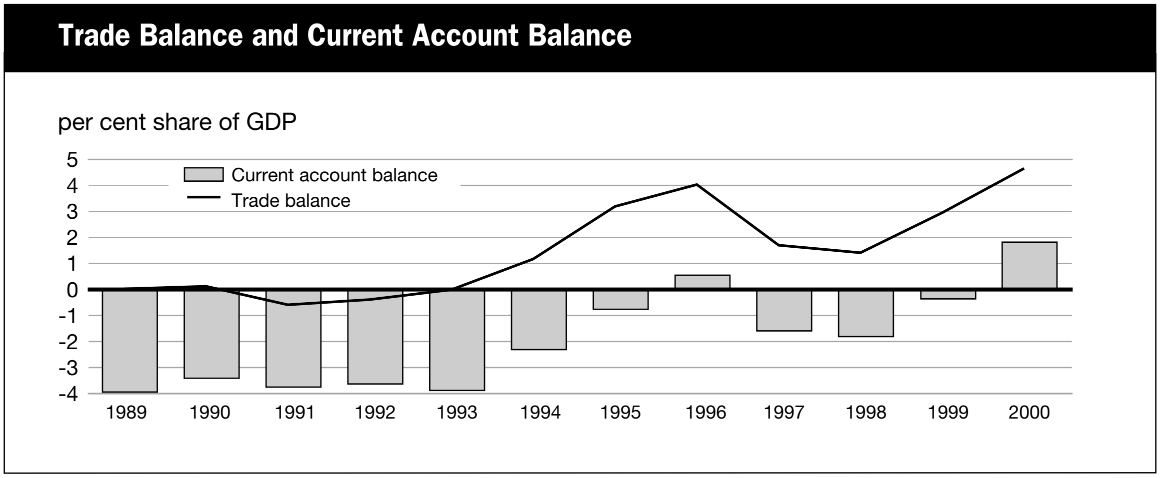
- Strong growth in business investment is translating into a noticeable improvement in our productivity performance.
- Since 1996 growth in business sector labour productivity (output per hour) has begun to increase, advancing to 1.7 per cent annually compared to 1.2 per cent annually over the previous two decades.
- Total factor productivity growth, which accounts for the productivity of both labour and capital, has improved even more over the past four years, growing by 1.5 per cent annually compared with 0.4 per cent annually over the previous two decades.

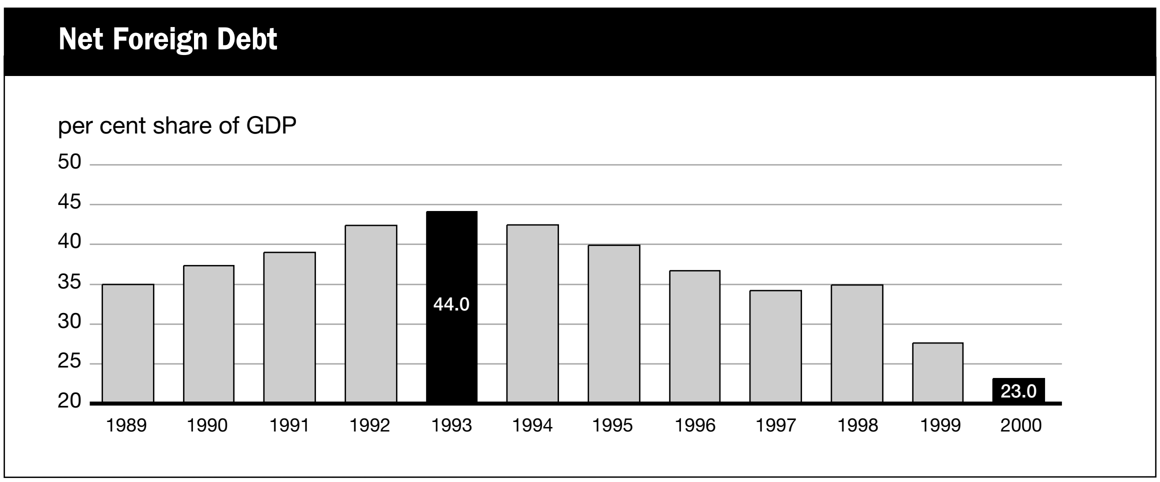
Improved employment and productivity growth are leading to higher real incomes



- Strong employment growth, combined with the recent pickup in our productivity performance, has led to improved growth in real per capita personal disposable income – an important indicator of living standards.
- From 1992 to 1996 weak employment and productivity growth caused real per capita personal disposable income to fall by an average of 0.4 per cent per year.
- Since 1996 strong growth in employment and improved productivity growth have meant that real per capita personal disposable income growth has averaged 1.7 per cent.
- In 2000 real per capita personal disposable income enjoyed its strongest annual growth since the late 1980s, rising 2.9 per cent.

Canada's trade, current account and international investment positions are much improved

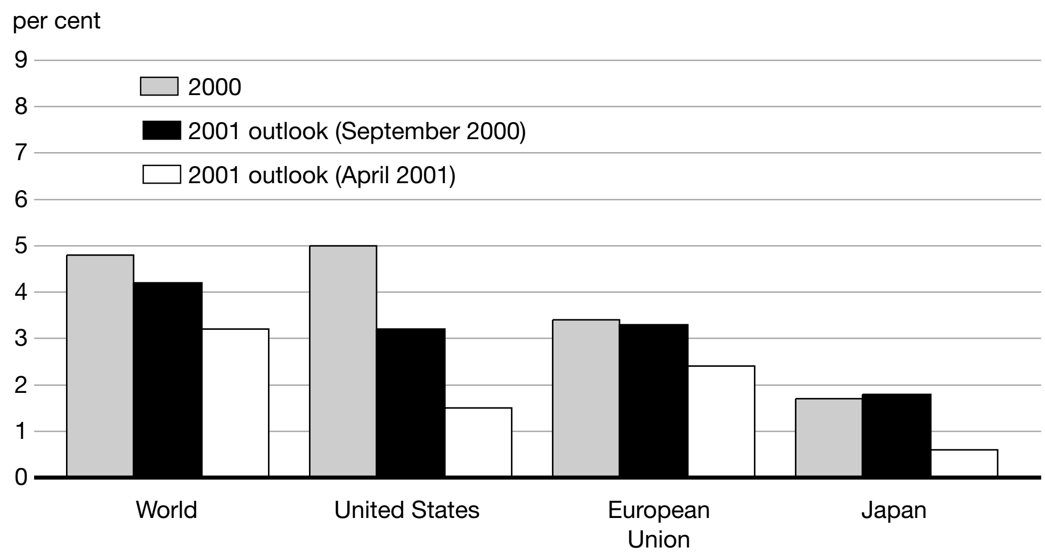




- Strong growth in exports, particularly to the United States, has meant that Canada now enjoys its most favourable trade balance and current account balance on record. In 2000 our current account balance rose to a record $18.9 billion surplus (or 1.8 per cent of GDP) – a sharp contrast to the record high current account deficit of close to $28 billion (or 3.9 per cent of GDP) in 1993.
- The elimination of our current account deficit has pushed Canada's net foreign debt as a share of GDP down to its lowest level since the 1950s. Since 1993 Canada's net debt to foreigners has dropped from 44 per cent of GDP to just 23 per cent in 2000.
- This benefits us by reducing our net investment income flows to foreigners and lowering our exposure to global financial market shocks.

Recently the global economic environment has weakened ...

Real GDP Growth



Source: International Monetary Fund, *World Economic Outlook*, September 2000 and April 2001.

- The outlook for global economic growth this year has weakened, from 4.2 per cent at the time of the October 2000 *Economic Statement and Budget Update* to 3.2 per cent by April 2001, led by a deceleration in economic activity in the United States. While forecasters expect this slowdown to be relatively short-lived, downside risks to global growth have clearly increased.

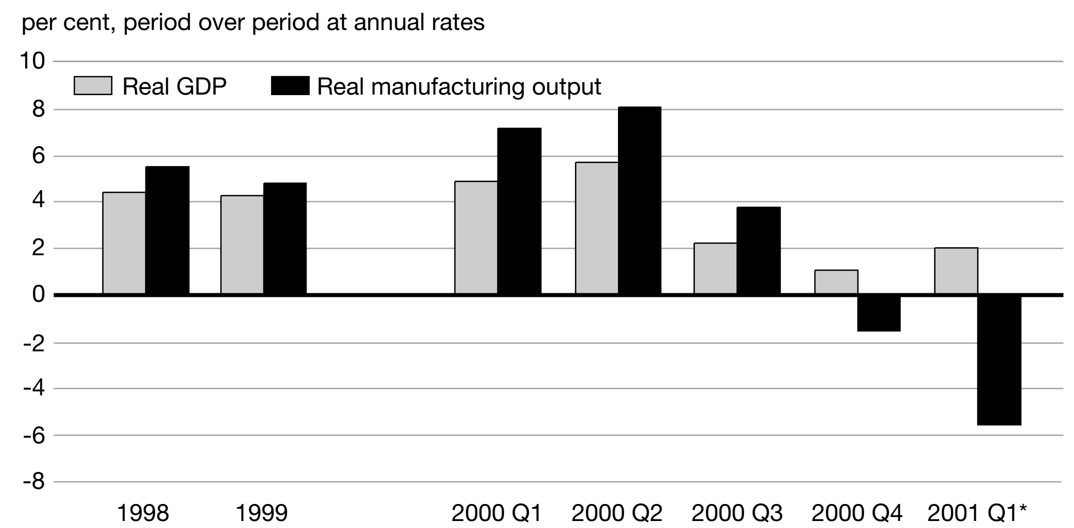
- While the European Union is expected to record a better performance than the United States this year, growth for the European Union is expected to slow to a below-potential pace as well, providing no offset to the impact of slower U.S. growth on the global economy.

- Ongoing structural problems in the Japanese financial system continue to pose a barrier to economic recovery in that country. And, with weaker global demand conditions, growth in the Japanese economy is expected to remain very weak in 2001.

- Slower growth in advanced economies is expected to contribute to weaker growth prospects for developing economies in Asia and Latin America.

... led by a sharp slowdown in the U.S. economy

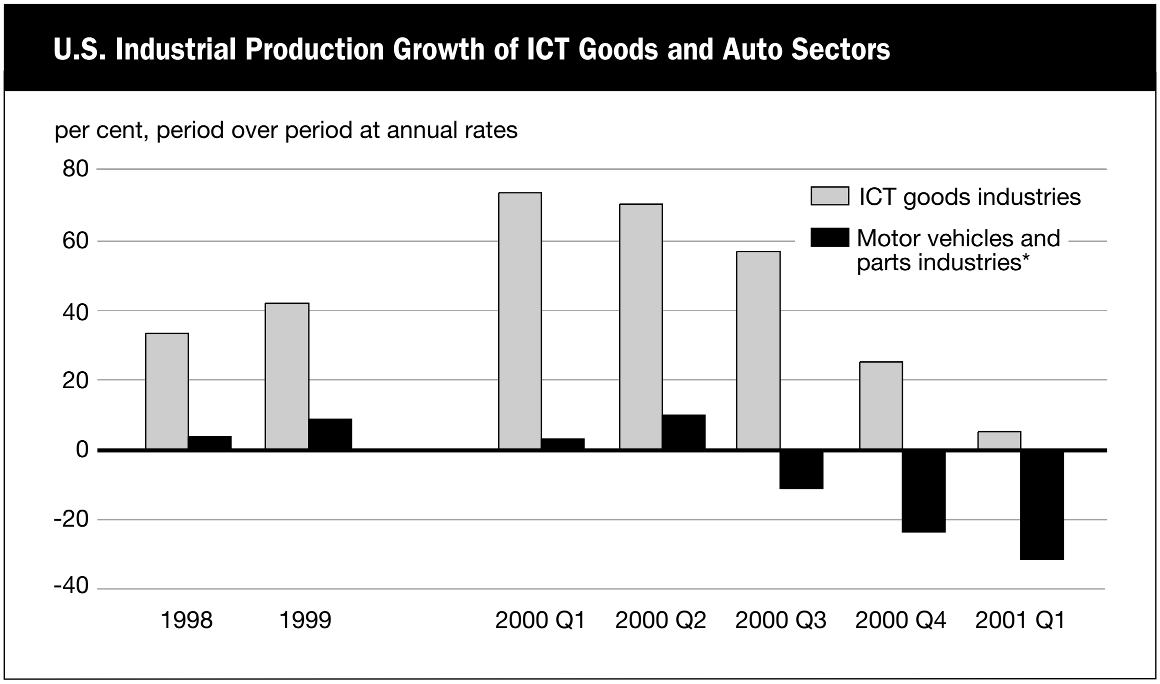
U.S. Real GDP and Manufacturing Output Growth



* Advance estimate for real GDP growth.

- While weakening global demand has obvious implications for the outlook for the Canadian economy, what is most significant is the performance of our most important trading partner, the United States.
- In the second half of 2000, a sharp slowdown in demand for U.S. manufactured goods led to a buildup in manufacturing inventories.
- In response, U.S. manufacturers pared output growth by half in the third quarter of 2000, and reduced output in the fourth quarter of 2000 and first quarter of 2001.
- As a result, overall U.S. economic growth slowed from an average of 5.2 per cent in the first half of 2000 to an average of 1.6 per cent over the final two quarters of the year, before recovering modestly to 2.0 per cent in the first quarter of 2001.

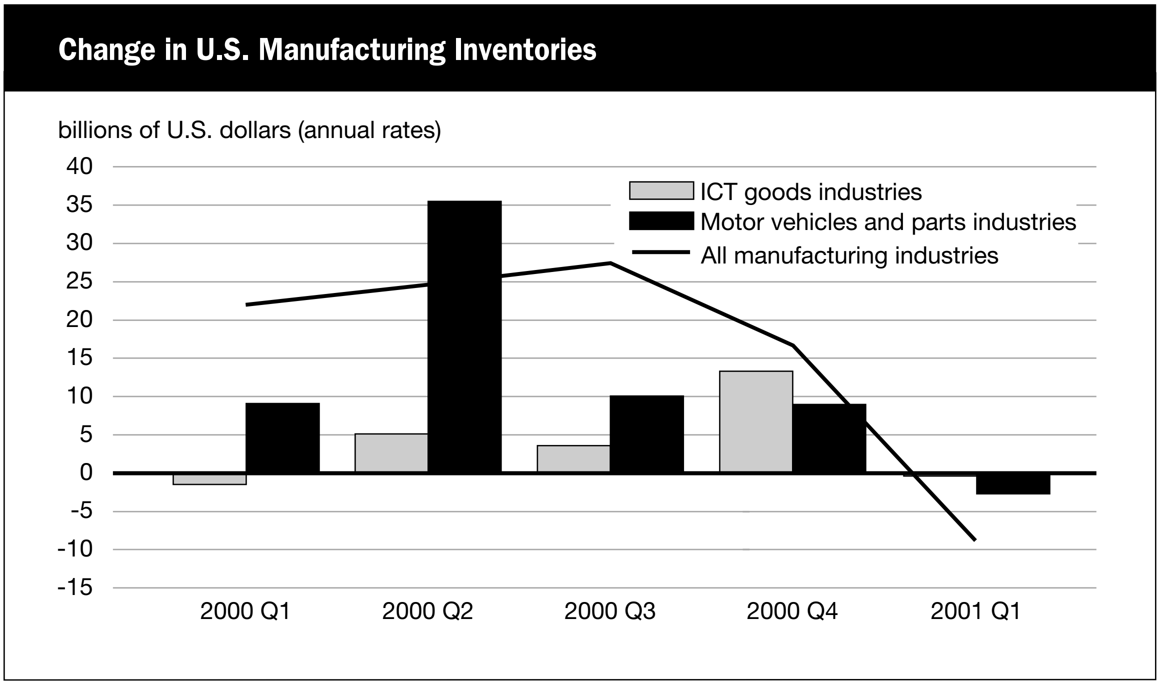
Much of the weakness has been focused in the information and communications technologies and automotive industries



* Includes wholesale and retail components.

- Within the U.S. manufacturing sector, the sharpest declines were seen in the automotive and ICT goods industries.
- Following a period of very robust growth, sales of new motor vehicles began to ease in the U.S. in early 2000. However, intense competition for market share within the sector led manufacturers to extend incentive programs and sustain high levels of production, despite falling demand. As a result, inventory levels began to rise and production had to be curtailed sharply beginning in the second half of 2000.
- Output of the ICT goods industries grew a very strong 66.8 per cent on average over the first three quarters of 2000, fuelled by rapid growth in business investment in high technology. These industries account for 8.5 per cent of U.S. industrial output, compared with 5.7 per cent for the motor vehicles and parts industry.
- However, as business confidence was shaken by volatility in equity markets, demand fell sharply in the following two quarters. As a result, output growth of the ICT goods industries fell to 25.2 per cent in the final quarter of 2000, and declined further to 5.1 per cent in the first quarter of 2001 – declines which contributed significantly to the overall slowdown in U.S. economic growth.

U.S. manufacturing inventory correction underway

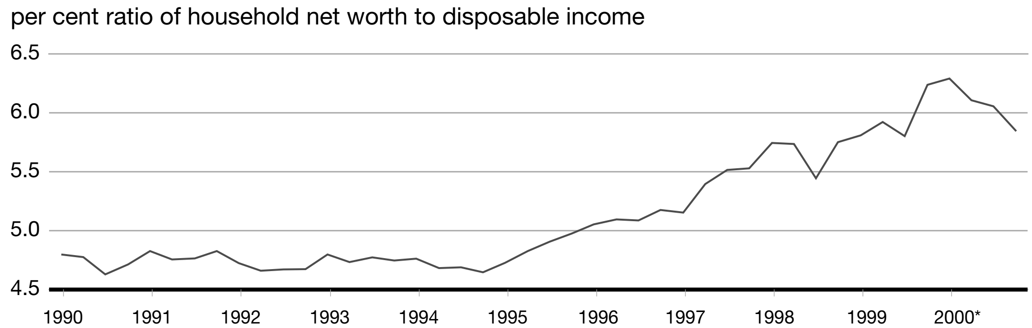


- The delayed response by automotive manufacturers to the slowdown in demand for new vehicles in the United States left a considerable buildup in inventories in mid-2000, which led to large declines in production. Declining inventories this year have removed much of this overhang in the automotive sector.

- Inventory accumulation in the ICT goods industries also increased in late 2000, reflecting a carry-over from the very strong output growth in previous quarters and expectations that the downturn in demand would be relatively short-lived. Some correction is also apparent in those industries thus far in 2001.

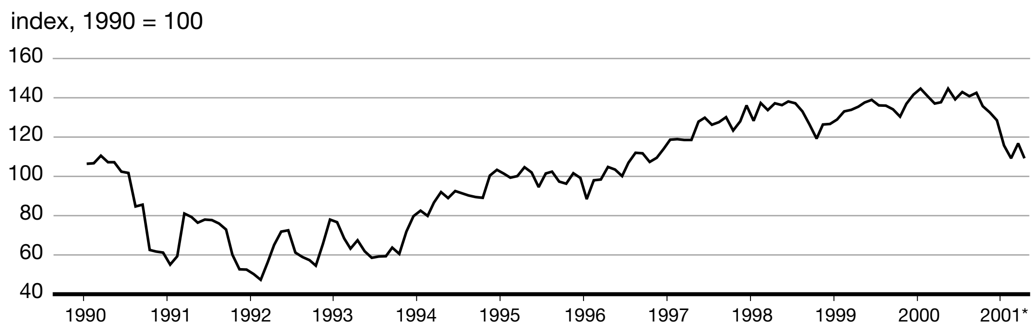
The U.S. slowdown has affected household wealth and confidence

U.S. Household Net Worth to Disposable Income



* Last data point: 2000 Q4.

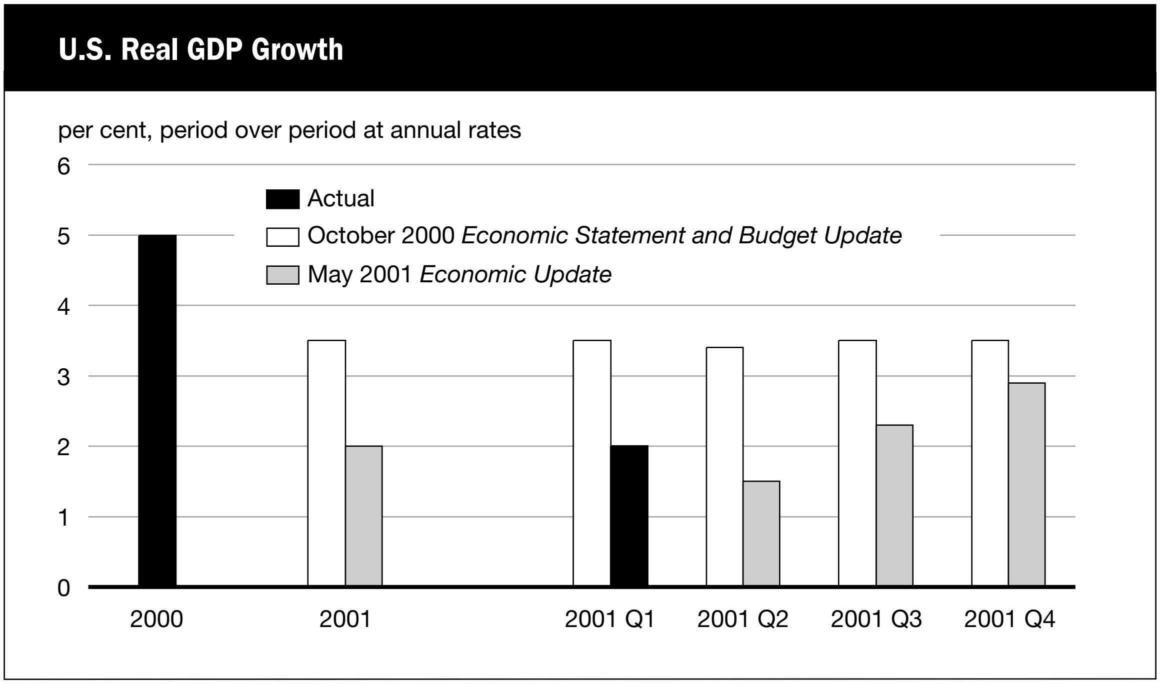
U.S. Conference Board Consumer Confidence Index



* Last data point: April 2001.

- The rapid run-up in equity prices from the mid-1990s through early 2000 was partly reversed by the "dot.com" correction, creating large-scale volatility in equity markets and reducing stock valuations within the ICT sector. As uncertainty rose through the course of the year, equity prices in other sectors were increasingly affected, and by early 2001 most sectors had witnessed declines in stock market prices from their levels at the beginning of 2000.
- Declines in market valuation have meant that the ratio of U.S. household net worth to personal disposable income declined in 2000 for the first time since 1994. It should be noted, however, that the decline in 2000 only partly unwound the very strong gains enjoyed over the previous five years. For example, in the fourth quarter of 2000, the ratio of net worth to disposable income was close to its average level in 1999, and remained over 20 per cent above its level in 1995.
- Nevertheless, growing uncertainty over future economic conditions and declines in stock market wealth have translated into a sharp decline in consumer confidence in the United States in late 2000 and into early 2001. There is a risk that this could be exacerbated by recent employment weakness (employment fell by 223,000 in April).

Forecasters have lowered their growth outlook for the U.S.



Source: *Blue Chip Economic Indicators,* September 2000 and May 2001.

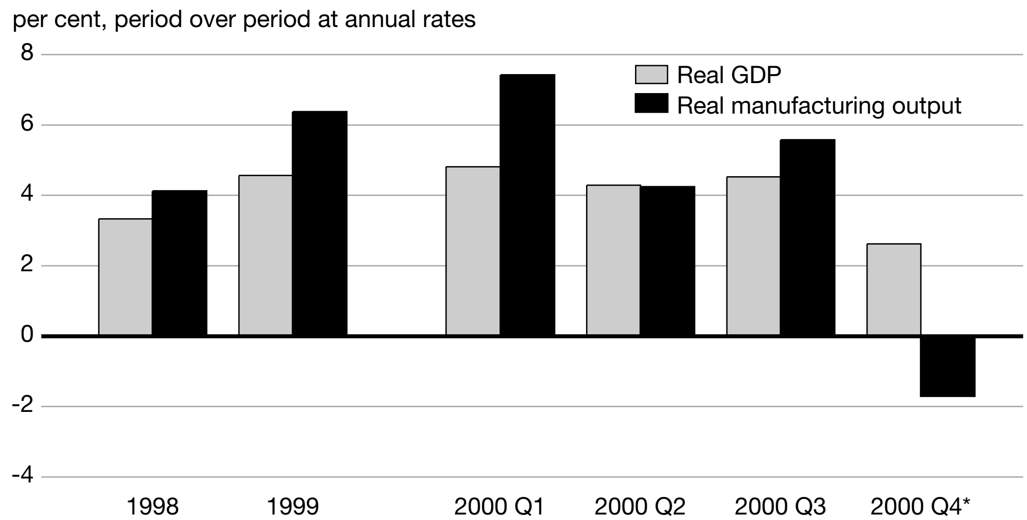
- At the time of the October 2000 *Economic Statement and Budget Update*, private sector economists believed that growth in the U.S. would slow from 5.0 per cent in 2000 to 3.5 per cent in 2001 – a more sustainable, yet still robust, pace.

- However, the recent declines in U.S. manufacturing output and consumer and business confidence have led private sector forecasters to reduce their expectations of U.S. growth for 2001.

- By May 2001 the average private sector forecast for real U.S. GDP growth had fallen to 2.0 per cent, with weakness concentrated in the first half of the year. However, forecasters expect growth to pick up to close to 3 per cent by the final quarter of 2001.

The Canadian economy has been affected, mostly in manufacturing

Growth in Real GDP and Manufacturing Output

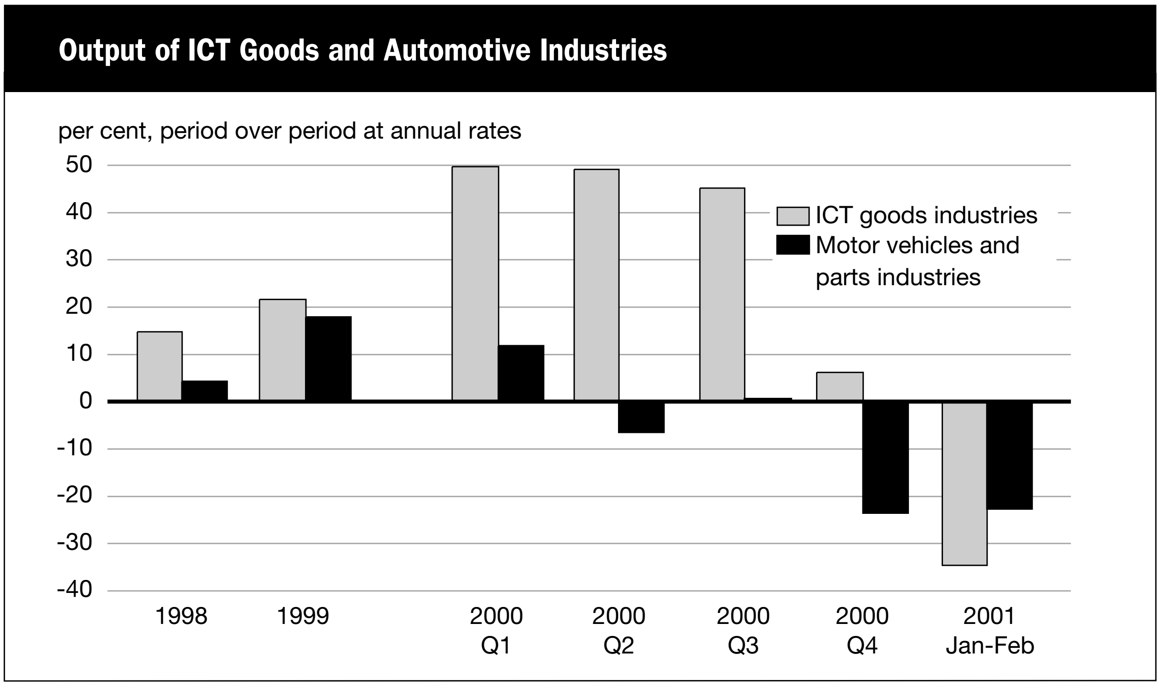


* Real GDP for 2001 Q1 will not be available until May 31.

- Given Canada's strong trade links with the U.S. and the close ties between the manufacturing sectors of the two economies, the slowdown in the United States has spilled over into Canada.

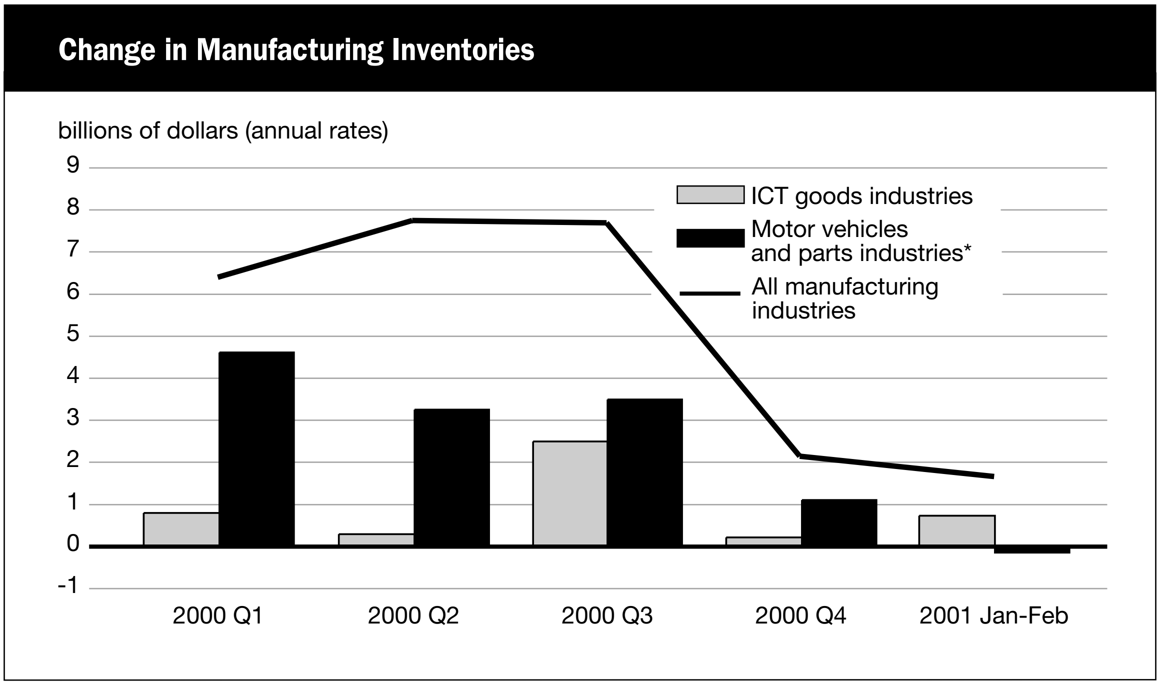
- After averaging 4.5 per cent in the first three quarters of 2000, real GDP growth in Canada slowed to 2.6 per cent in the fourth quarter of the year, led by a 1.7-per-cent contraction in real manufacturing output.

Most export-oriented manufacturing industries in Canada are experiencing weaker demand



- As has been the case in the United States, the output of automotive industries as well as the ICT sector has been hit hardest – not surprisingly, as the majority of Canadian ICT and automotive output is destined for U.S. markets.
- Although these two sectors together accounted for only 5 per cent of total output and 25 per cent of manufacturing output, they were responsible for one-fifth of total output growth in the first three quarters of 2000.
- The strong international linkages in these industries imply that slower demand from the U.S. for these commodities has impacted not only on manufacturing output, but on trade between Canada and the U.S. as well.

Inventory accumulation has slowed dramatically

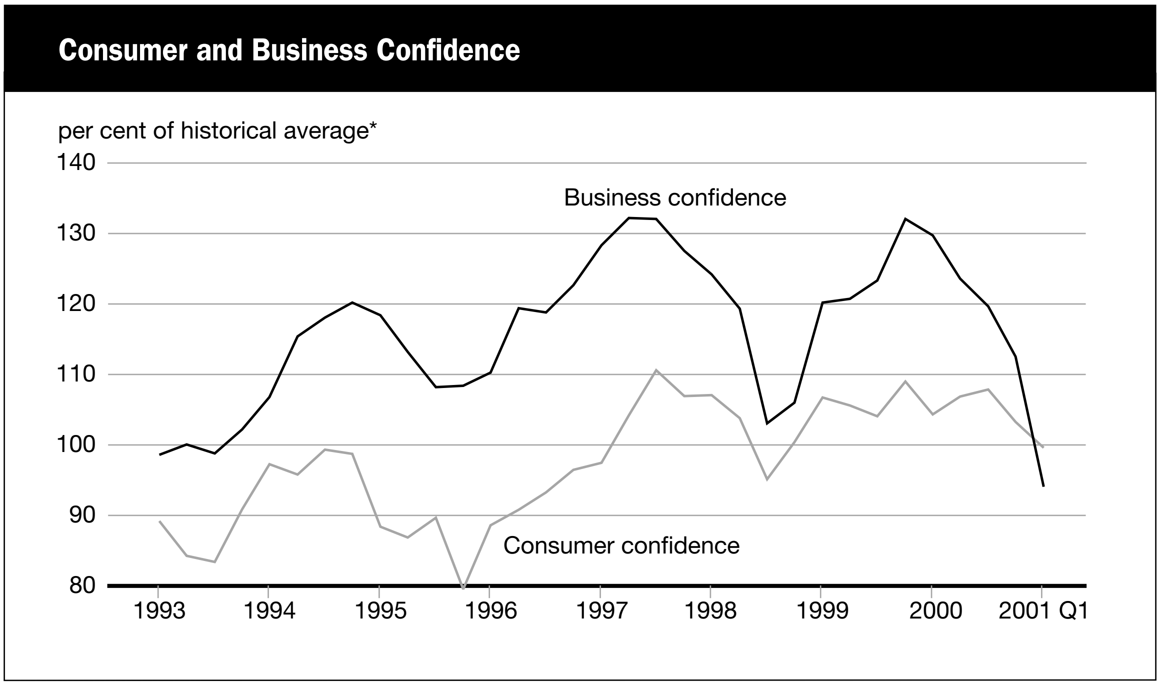


* Includes wholesale and retail components.

- Slowing demand from the United States also contributed to a rise in inventories in Canada. In response, Canadian manufacturers have sharply reduced the pace of inventory accumulation at the end of 2000 and in early 2001, particularly in the automotive and ICT industries.

- This suggests that the realignment between output and demand growth required for a subsequent output growth recovery is underway.

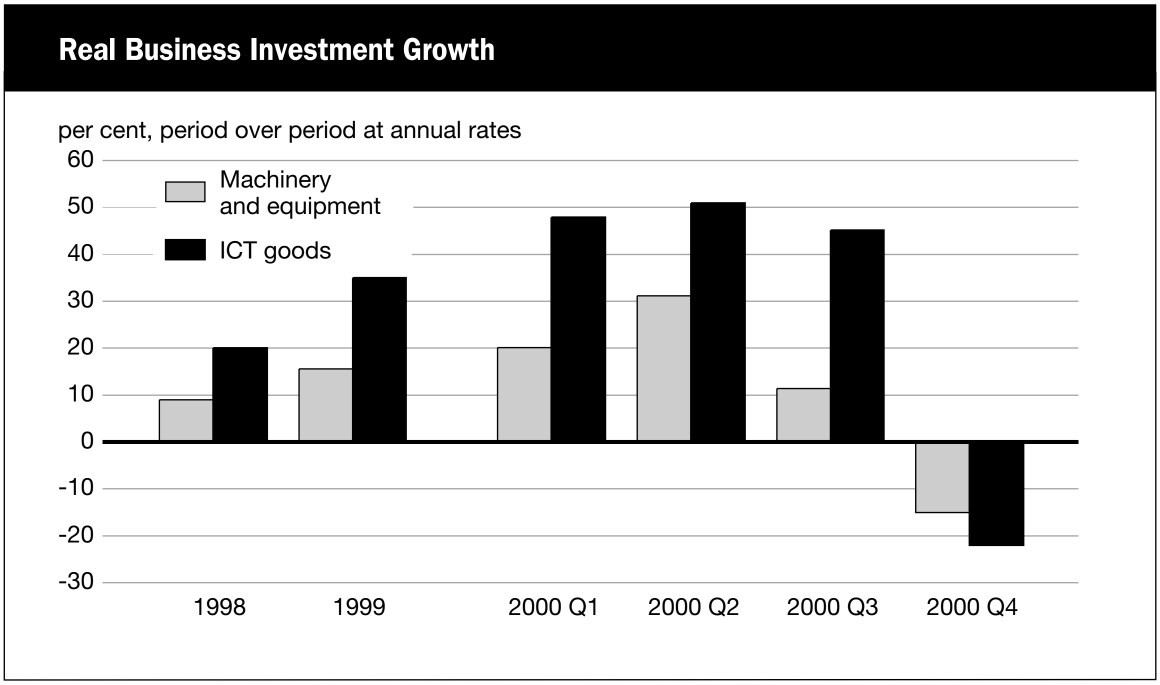
Both consumer and business confidence have declined



* Consumer confidence: 1972 Q1 to 2001 Q1. Business confidence: 1977 Q1 to 2001 Q1.
Source: The Conference Board of Canada.

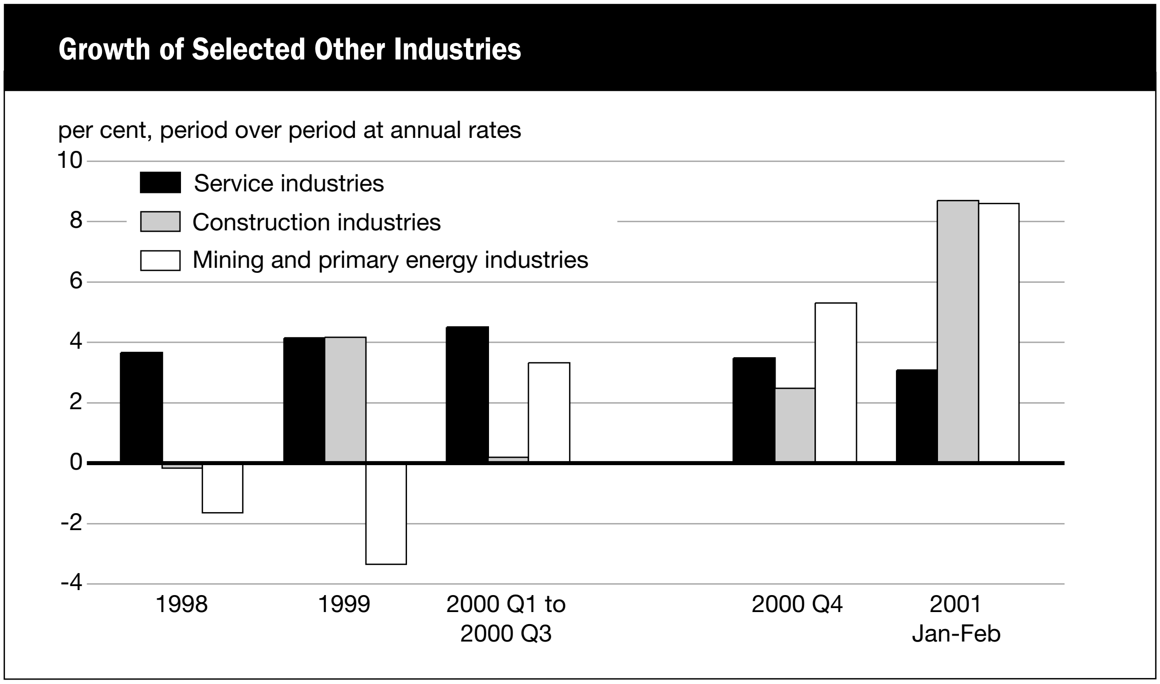
- Rising uncertainty over demand conditions in our largest trading partner, in combination with volatility in financial markets, has impacted on measures of confidence in Canada.
- This has been particularly evident in business confidence, which has declined sharply since early 2000 in tandem with declines in equity markets. For example, the Conference Board of Canada's Index of Business Confidence has declined 27.5 per cent since the first quarter of 2000. As well, Statistics Canada's Quarterly Business Conditions Survey showed a sharp decline in confidence in manufacturing industries in its January 2001 survey, which was followed by a partial rebound in the April survey.
- However, the declines in these measures of business confidence largely reflect the impact of weaker foreign demand faced by larger manufacturing firms. This was illustrated by a recently released survey by the Canadian Federation of Independent Business, which revealed that small and medium-sized businesses – which are much more dependent on domestic demand conditions – remain confident over their future prospects.
- While consumer confidence has also fallen modestly in recent quarters, it remains close to its historical average and above levels seen during the Mexican peso crisis of 1994 and the Asian crisis of 1997.
- This has been demonstrated by the resilience of consumer spending and housing demand thus far in 2001.

Uncertainty has led to slower business investment in Canada



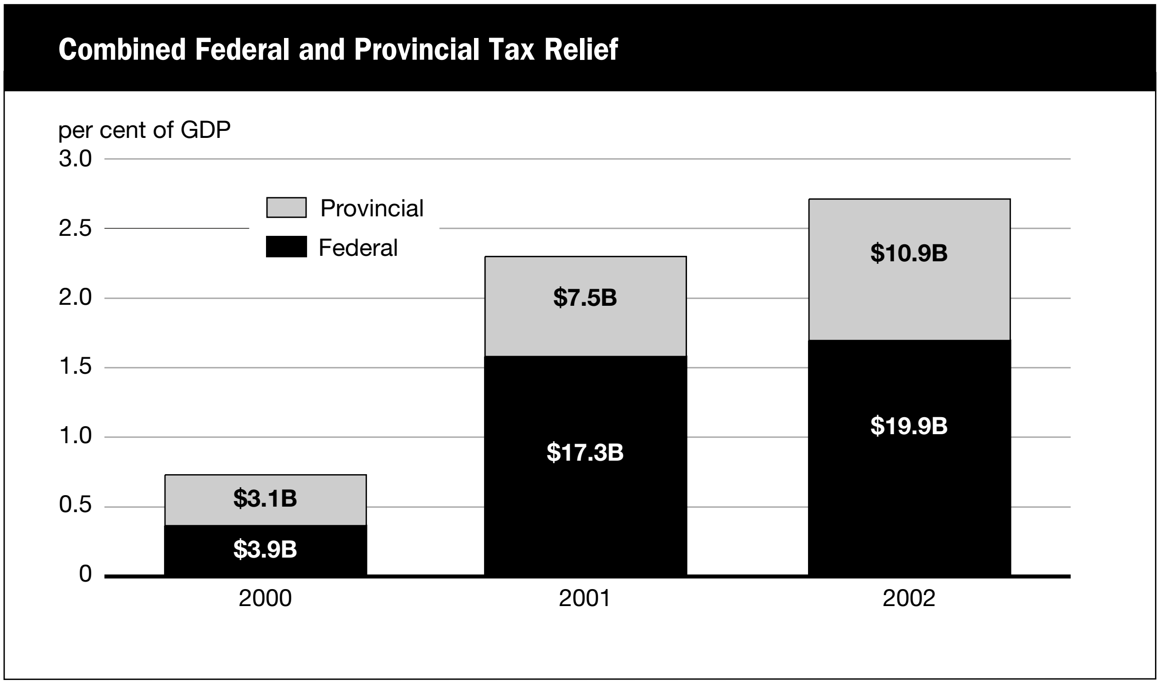
- The declines in business confidence and concerns about slower U.S. demand led firms to curb investment spending in the fourth quarter of 2000.
- In particular, firms cut back on investment in ICT goods – which had grown an astounding 48.0 per cent on average over the previous three quarters.
- This sharp turnaround in high-technology business investment was a substantial contributor to the slowdown in final domestic demand in the final quarter of 2000. And, as a substantial share of these capital goods are imported, this was also reflected in a sharp decline in imports in the quarter.

Positive factors: Growth in other sectors has accelerated



- While it is clear that the slowdown in the U.S. has spilled over into Canada, it is important to note that there are several factors which place Canada in good stead to weather the current economic slowdown.
- Much of the slowdown in Canada has been concentrated in several manufacturing industries, with other sectors experiencing stronger growth in recent quarters.
- Industries such as aerospace and energy have continued to benefit from strong demand for their products, growing by 10.1 per cent and 8.6 per cent respectively thus far in 2001. As well, the continued strength of residential investment has translated into stronger growth in the construction industries (8.7 per cent thus far in 2001).
- Most importantly, growth in service industry output – representing close to two-thirds of total economic activity in Canada – has been very solid. While it has moderated slightly recently, growth remains robust, averaging 3¼ per cent in the final quarter of 2000 and thus far in 2001.

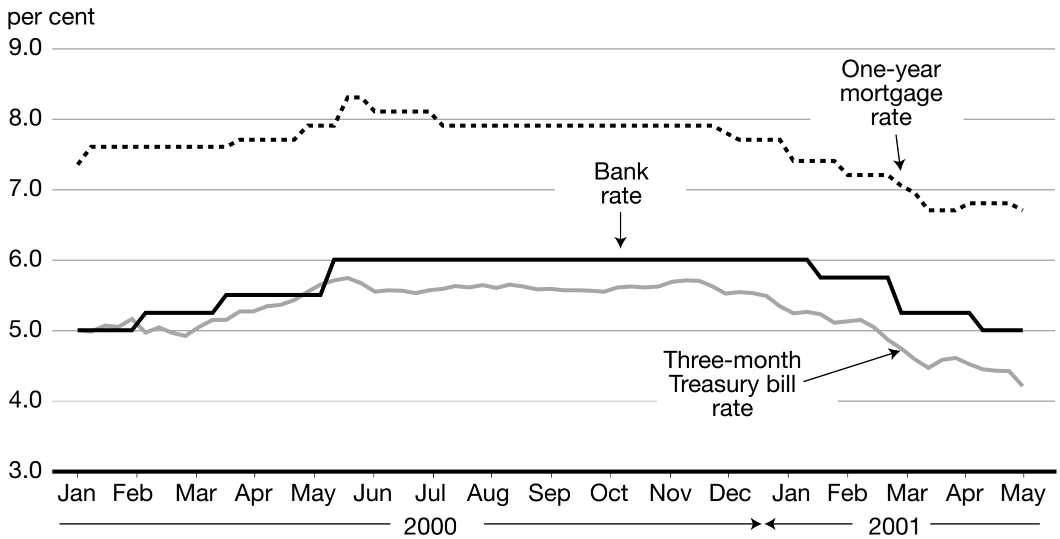
Positive factors: Federal and provincial tax cuts will support economic growth



- Large tax cuts were introduced in the February 2000 budget and the October 2000 *Economic Statement and Budget Update*.
- These federal tax cuts amount to $3.9 billion in 2000, growing rapidly to $17.3 billion in 2001 and $19.9 billion by 2002.
- At the same time, some provinces have also announced tax cuts, amounting to a further $3.1 billion in 2000, $7.5 billion in 2001 and $10.9 billion in 2002.
- Together, tax cuts at all levels of government amount to 0.7 per cent of GDP in 2000, 2.3 per cent of GDP in 2001 and 2.7 per cent of GDP in 2002. This represents a large fiscal stimulus to the economy, especially in 2001.

Positive factors: Declining interest rates

Bank Rate, One-Year Mortgage Rate and Three-Month Treasury Bill Rate*

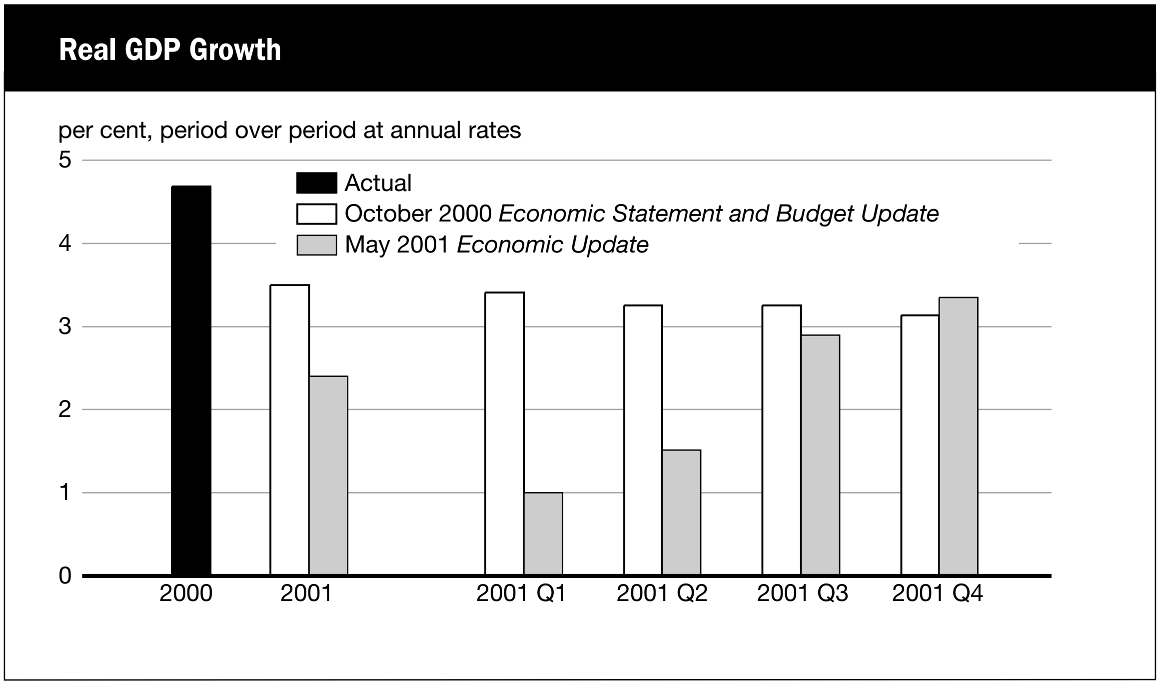


* Incorporates data to May 9, 2001.

- Low and stable inflation has allowed the Bank of Canada to respond to the economic slowdown by reducing the Bank Rate by a full percentage point since the beginning of January. Lower interest rates will provide support to business investment, housing markets and consumer durable expenditure.

- For instance, one-year mortgage interest rates have declined by one percentage point since the end of 2000, which means that a homeowner with a typical one-year mortgage of $100,000 will save about $700 annually.

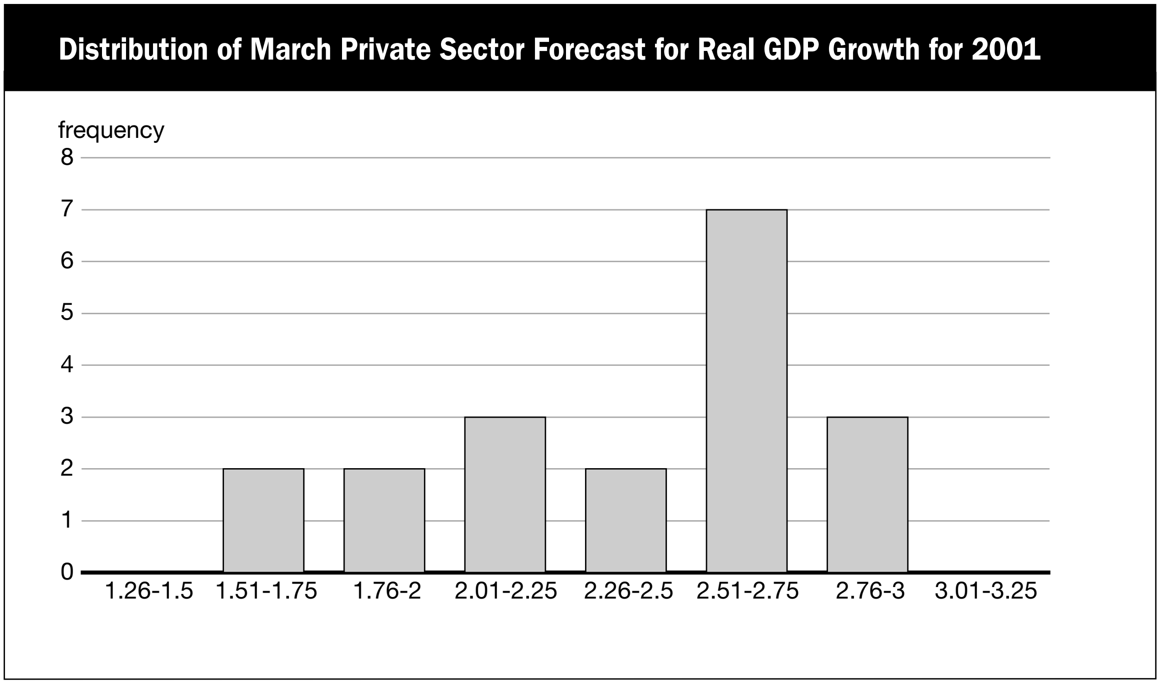
Forecasters have lowered expectations of Canada's GDP growth for 2001



Sources: September 2000 and March 2001 Department of Finance surveys of private sector forecasters.

- Private sector forecasters have lowered their expectations for growth in the Canadian economy in 2001, from 3.5 per cent at the time of the October *Economic Statement and Budget Update* to 2.4 per cent in the most recent survey conducted in March 2001.
- The survey suggests that most private sector forecasters expect the slowdown to be concentrated in the first half of 2001, with growth returning to approximately 3 per cent by year-end and rising to 3.4 per cent in 2002.
- Consumer price index (CPI) inflation is expected to decline modestly this year and next, falling to 2.4 per cent on average in 2001 and 2.0 per cent in 2002, in line with expectations at the time of the October Statement.
- Expectations of lower output growth have been accompanied by private sector forecasts of lower short-term interest rates. At the time of the March survey, private sector forecasters expected short-term rates to remain near current levels in both 2001 and 2002, compared with forecasts of 5.8 per cent and 5.5 per cent, respectively, at the time of the October Statement.

Real GDP growth forecast distribution



Source: March 2001 Department of Finance survey of 19 private sector forecasters.

- The survey also revealed a wide range of forecasts for this year, which underscores the uncertainty in the current economic environment.
- This reflects the increased downside risk to the outlook, in particular if the U.S. recovery is slowed by a retrenchment in consumer spending caused by signs of weakening in the U.S. job market and wealth losses associated with declines in equity prices. In that context, the April U.S. employment decline of 223,000 and accompanying increase in the unemployment rate from 4.3 per cent to 4.5 per cent is a cause for concern.
- The lowest 20 per cent of private sector forecasts averaged real GDP growth of 1.8 per cent for 2001.

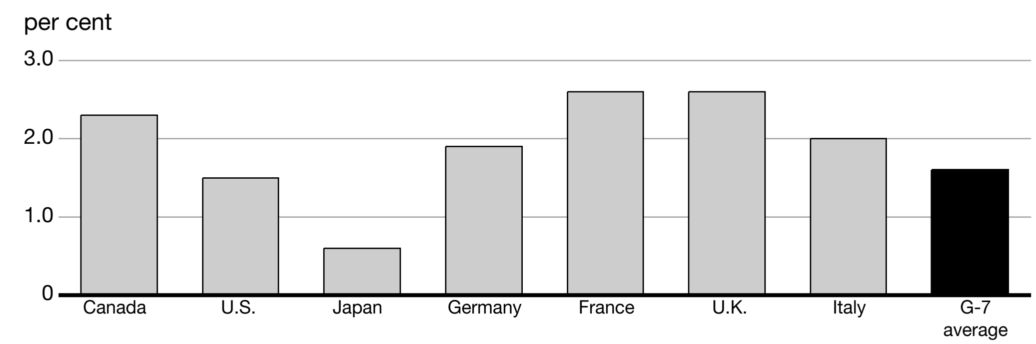
Evolution of the average of private sector forecasts for Canada

	2001	2002
	(per cent)	
Real GDP growth		
October 2000 *Economic Statement and Budget Update*	3.5	3.0
May 2001 *Economic Update*	2.4	3.4
GDP inflation		
October 2000 *Economic Statement and Budget Update*	2.0	1.5
May 2001 *Economic Update*	1.8	1.7
Nominal GDP growth		
October 2000 *Economic Statement and Budget Update*	5.5	4.6
May 2001 *Economic Update*	4.2	5.1
Employment growth		
October 2000 *Economic Statement and Budget Update*	1.8	1.6
May 2001 *Economic Update*	1.3	1.6
Unemployment rate		
October 2000 *Economic Statement and Budget Update*	6.6	6.5
May 2001 *Economic Update*	7.1	6.9
CPI inflation		
October 2000 *Economic Statement and Budget Update*	2.4	2.0
May 2001 *Economic Update*	2.4	2.0
3-month Treasury bill rate		
October 2000 *Economic Statement and Budget Update*	5.8	5.5
May 2001 *Economic Update*	4.6	4.7
10-year government bond yield		
October 2000 *Economic Statement and Budget Update*	5.9	5.8
May 2001 *Economic Update*	5.3	5.6

Sources: September 2000 and March 2001 Department of Finance surveys of private sector forecasters.

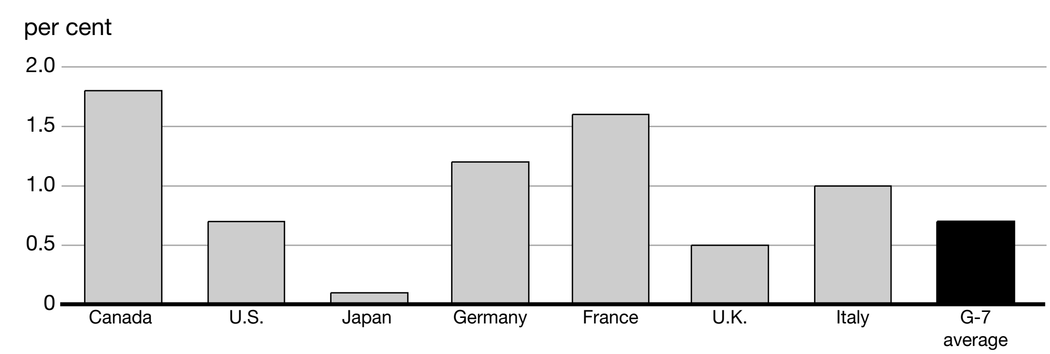
Canada still expected to be above the G-7 average in output growth and lead the G-7 in employment growth in 2001

International Monetary Fund (IMF) Forecast for G-7 Real GDP Growth in 2001



Source: IMF, *World Economic Outlook*, April 2001.

IMF Forecast for G-7 Employment Growth in 2001



Source: IMF, *World Economic Outlook*, April 2001.

- While major international organizations recognize the negative impact of a slowing U.S. economy on Canadian growth, they continue to be positive about Canada's prospects for real GDP and employment growth.

- In its April forecast the IMF expects Canada to outperform the U.S. in terms of real GDP growth, and to be above the average for the G-7, in 2001. Canada is also expected to continue to lead the G-7 countries in employment growth in 2001.

Upcoming Changes in the Measurement of Real GDP

■ Statistics Canada will revise its measures of real economic growth with the release of the first-quarter National Income and Expenditure Accounts on May 31. Three changes will occur: the movement to the chain Fisher measure of GDP, the inclusion of software as investment, and a regular historical revision incorporating updated benchmark data.

■ The most significant change is the adoption of the chain Fisher index as the official measure of real expenditure-based GDP.

■ Real GDP is currently measured using 1992 prices. With the new chain Fisher index formula, real GDP growth will be measured each quarter using weights based on prices from the current and previous quarters.

■ The reason for this change is twofold: it produces the most accurate measure of quarter-to-quarter growth in real GDP and its components, and the change brings the Canadian measure in line with the U.S. quarterly National Income and Product Accounts, which also use the chain Fisher formula to measure real GDP.

■ In practice, the new measure of real GDP growth will generally be lower than the current measure, particularly in recent years. Growth in 2000, for example, will be restated from 4.7 per cent under the current measure to 4.1 per cent (before historical revision and inclusion of software) under the chain Fisher measure, largely reflecting the lower weight in overall growth of information and communications technology goods in the chain Fisher measure.

■ This impact will be particularly noticeable in the fourth quarter of 2000, when real GDP growth under the chain Fisher measure will be 1.4 percentage points lower than under the current measure.

■ As growth for 2001 depends on the level of fourth-quarter GDP in 2000, this implies that the measured annual real GDP growth rate for 2001 may also be modestly lower than currently projected by the private sector economists. However, as this impact is purely statistical in nature, it does not affect the underlying outlook for economic growth during the year.

■ It is important to note that the chain Fisher measure only affects real variables. This means that the change in methodology will have no impact on nominal GDP, which is the primary determinant of government revenues. As a result, the switch to the new measure will not have implications for the fiscal situation.

■ With the May 31 release, Statistics Canada will also change its treatment of business and government investment in computer software. As a result, more software will be considered as investment, which may partially offset the impact of lower chain Fisher growth in some years. Preliminary data suggest that this change will add modestly to real GDP growth in 1999, but will have little impact on real GDP growth in 2000.

Annex 2

Impact of Economic Developments on Canada's Fiscal Prospects

Highlights

- *A budgetary surplus of at least $15 billion is expected for 2000-01, all of which will be used to reduce the national debt. As a result, the debt reduction in 2000-01 will be at least $5 billion more than that committed by the Government in the October 2000* Economic Statement and Budget Update*.*
- *This surplus in 2000-01 will be the largest since Confederation and the fourth consecutive annual surplus, following surpluses of $3.5 billion in 1997-98, $2.9 billion in 1998-99 and $12.3 billion in 1999-2000.*
- *As a result, net public debt will have declined by at least $33.7 billion over the last four fiscal years, to stand at no higher than $549.5 billion. The reduction in debt results in interest savings of about $2 billion for each and every year.*
- *The debt reduction, coupled with the growth in the economy, has lowered the net debt-to-GDP ratio to below 53 per cent in 2000-01, a drop of over 18 percentage points from its peak of 71.2 per cent in 1995-96.*
- *The current economic uncertainty underscores the importance of the Government's prudent approach to budget planning. This includes making budget decisions on a two-year rolling basis and the inclusion in the budget plans of economic prudence and the Contingency Reserve.*
- *Standard fiscal sensitivity analysis indicates that the changes in the private sector economic forecasts for 2001 and 2002 can be accommodated within the prudence and remaining balance established in the October 2000* Economic Statement and Budget Update*.*

Table 1
Possible Fiscal Outcome for 2000-01

	($ billions)
October 2000 *Economic Statement and Budget Update*	
Budgetary surplus	11.9
Less: impact of policy decisions since October Statement	
Canada Foundation for Innovation	0.8
Defence	0.6
Agricultural assistance	0.5
Genome Canada	0.1
Other	0.1
Total	2.1
Plus: impact of economic developments	5.2
Net change	3.1
Potential budgetary surplus outcome	15.0

- In the October 2000 *Economic Statement and Budget Update*, a budgetary surplus of $11.9 billion was projected, after accounting for the cost of the Agreements on Health Renewal and Early Childhood Development and other initiatives announced in the Statement. Of this amount, the Government committed to paying down at least $10 billion of debt in 2000-01, leaving a remaining balance of $1.9 billion.

- Since the October Statement, a number of new initiatives have been announced. These include an additional $750 million in funding to the Canada Foundation for Innovation, $624 million to defence, $500 million for agricultural assistance, $140 million to Genome Canada, $34.5 million in incremental funding for merchant marines and $15 million to compensate potato farmers in Prince Edward Island. The fiscal impact of these measures exhausted the remaining balance.

- Based on the monthly results to date, budgetary revenues will be higher than estimated, largely because the tax base and tax yield for 2000 turned out to be higher than estimated at the time of the October Statement, while program spending (excluding the impact of the above policy initiatives) and public debt charges are expected to be somewhat lower. The net impact is expected to increase the budgetary surplus by at least $5 billion.

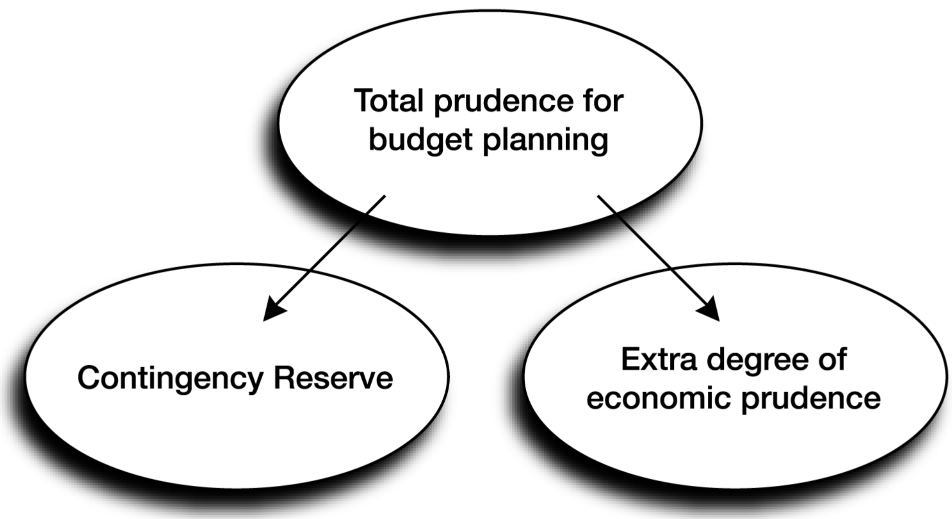
- Some of the better-than-expected outcomes for revenues and public debt charges in 2000-01 can be expected to carry forward into 2001-02 and 2002-03. Although the exact amount will not be known until final audited results are available, it could amount to at least $1 billion in 2001-02 and $750 million in 2002-03. This will provide some offset to the impact of the revised economic outlook on the budgetary balance.

- The fiscal results for the period April 2000 to March 2001 are consistent with the expected surplus for the year as a whole of at least $15 billion (see *The Fiscal Monitor* for March 2001).

Prudence in budget planning

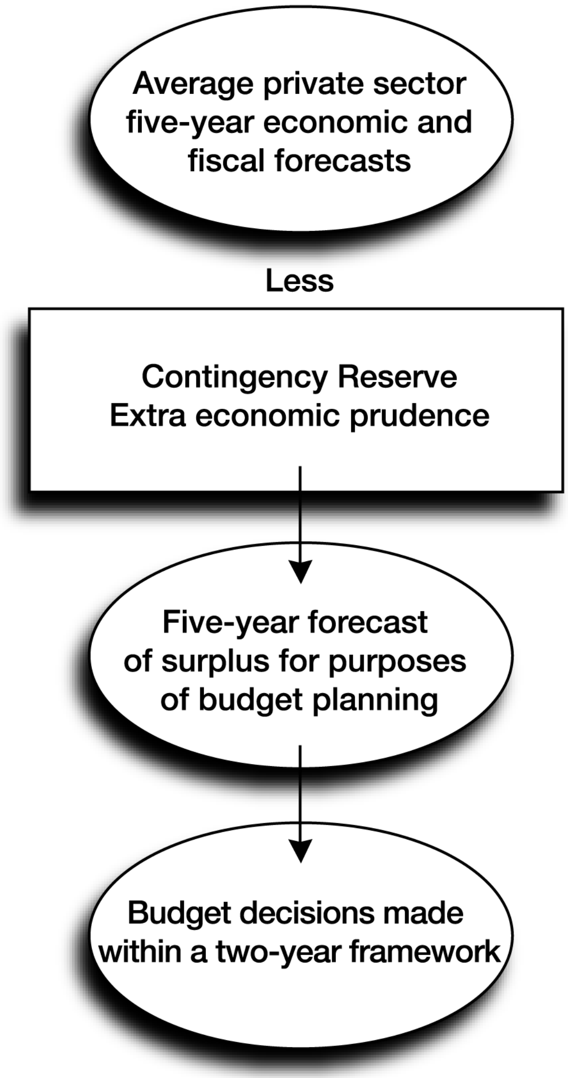
- Since 1993 the Government has followed a prudent approach to budget planning involving a number of important steps.
- The first step relates to the use of private sector economic forecasts for budget-planning purposes.
  - The Department of Finance conducts surveys of private sector economic forecasters. In total, about 20 forecasters are surveyed on a regular basis.
  - Each fall the Department of Finance conducts extensive consultations with an economic advisory group, which includes the chief economists of Canada's major chartered banks and four leading economic forecasting firms. A key purpose of these consultations is to assess the risks associated with using the average of private sector economic forecasts for budget-planning purposes.
- The second step relates to the use of these economic assumptions to develop status quo fiscal projections.
  - Each fall the four major private sector economic forecasting firms develop detailed fiscal projections for each of the next five years, based on tax and spending policies in place at that time, using the average of the private sector economic forecasts.
- The third step involves including prudence in these fiscal projections for budget-planning purposes.
  - An annual amount of $3 billion is set aside in a Contingency Reserve. The Contingency Reserve is included primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed fiscal forecasts and unpredictable events. The Contingency Reserve also provides a backup against adverse errors in the economic forecast. It is not a source of funding for new policy initiatives. If not needed, it will be used to pay down the public debt.
  - An extra degree of economic prudence is included to provide further assurance against falling back into deficit. The amount is based on an assessment by the private sector economic advisory group of the risks associated with using the average of the private sector economic forecasts. Prior to the 2000 budget this prudence was embedded in the revenue and spending projections, with the result that the exact dollar amount was not explicitly identified, which made it difficult to judge the credibility of the key components of the fiscal projections. For transparency purposes, it has been shown separately since then.

Prudence in budget planning (cont'd)



- Finally, in the October 2000 *Economic Statement and Budget Update*, the Government announced that each fall, it would assess the economic circumstances and determine whether a greater amount of debt paydown is warranted for that year.
- It is the view of the private sector economic advisory group that for the purposes of public debate on policy options in the run-up to the annual budget, a five-year time horizon is appropriate. However, it is also the view of the private sector economic advisory group that great caution is warranted in the use of long-term projections as a basis for budget decisions. Therefore, budget decisions continue to be made on a rolling two-year horizon.
- The May 2001 *Economic Update* is an update of the economic forecasts for 2001 and 2002 and their implications for the 2001-02 and 2002-03 budgetary surpluses. To help prepare this Update, the Department of Finance met with the private sector economic advisory group in May 2001.
- This fall, as part of the regular budget preparation cycle for the next budget, the four private sector economic forecasting firms will again be asked to present five-year status quo fiscal projections based on the average private sector economic forecasts available at that time.

Summary: framework for fall update and budget



- In summary, for the purposes of public debate and for budget-planning purposes, the Government will:
  - present in the fall of each year, the average private sector five-year projections of the fiscal surplus, which are based on a common set of economic assumptions;
  - include a $3-billion Contingency Reserve which, if not needed, will be applied to reducing the debt; and
  - include an extra degree of prudence, which will be shown explicitly.
- However, budget decisions are made within a rolling two-year planning horizon, reflecting the difficulties in forecasting economic events over a longer period.
- This approach to budget planning has allowed the Government to better its stated fiscal targets each and every year.

Table 2
Prudence in Budget Planning: October 2000 *Economic Statement and Budget Update*

	2001-02	2002-03
	($ billions)	
October 2000 Statement budgetary surplus (after including costs of initiatives)	8.3	7.6
Prudence		
Contingency Reserve	3.0	3.0
Economic prudence	1.0	2.0
Total	4.0	5.0
Remaining balance	4.3	2.6

- The October 2000 *Economic Statement and Budget Update* forecast a budgetary surplus of $8.3 billion in 2001-02 and $7.6 billion in 2002-03. This was after accounting for the costs of the tax cuts and spending initiatives announced in the October 2000 *Economic Statement and Budget Update*.

- In the October 2000 Statement, the Government committed to balanced budgets or better in both 2001-02 and 2002-03.

- To ensure that these targets would be met, economic prudence was set at $1 billion in 2001-02 and $2 billion in 2002-03, while the Contingency Reserve was set at $3 billion for each year. Thus, the total prudence included in the October 2000 Statement was $4 billion in 2001-02 and $5 billion in 2002-03.

- Taking the projected budgetary surplus and subtracting the prudence, there was a remaining balance of $4.3 billion in 2001-02 and $2.6 billion in 2002-03.

- It was noted in the October 2000 Statement that these remaining balances could be directed to further debt reduction, increased prudence, further tax cuts or increased spending in priority areas.

Table 3
Policy Initiatives Since the October 2000 *Economic Statement and Budget Update*

	2001-02	2002-03
	($ millions)	
Spending initiatives		
Tobacco Control Strategy	70	95
Cultural initiatives	122	189
CBC	60	
Canadian Television Production Fund	100	
Support for Olympic bids/Toronto waterfront	132	125
Government On-Line	120	
Amateur sports	10	10
Organized crime	30	30
Environmental initiatives	79	41
Health commissioner	12	3
Revitalizing Canada's capital	21	58
Total	755	552
Less: Tobacco tax increase	200	200
Net fiscal impact	555	352

Note: Numbers may not add due to rounding.

- Since the October 2000 *Economic Statement and Budget Update*, the Government has announced funding for a number of initiatives. These include the Tobacco Control Strategy, major investments in Canadian culture, support for Olympic bids and amateur sports, incremental funding for Government On-Line, new funding to fight organized crime, investments in a number of environmental initiatives, and funding to launch the Commission on the Future of Health Care in Canada and to revitalize Canada's capital. The total cost of these initiatives amounts to $755 million in 2001-02 and $552 million in 2002-03.

- Offsetting part of this fiscal cost is the increase in tobacco taxes as of April 6, 2001, which is expected to increase federal excise taxes and duties by $200 million per year.

- As a result, the net impact of the policy initiatives announced since the October 2000 *Economic Statement and Budget Update* amounts to $555 million in 2001-02 and $352 million in 2002-03.

Table 4
Sensitivity of Fiscal Outlook to Economic Shocks

	Year 1	Year 2
	($ billions)	
Estimated change in fiscal position from:		
1-per-cent decrease in real GDP growth		
Revenue decrease	1.8	1.9
Expenditure increase	0.5	0.7
Deterioration in budgetary balance	2.4	2.6
1-per-cent decline in inflation		
Revenue decrease	1.9	1.8
Expenditure decrease	0.5	0.5
Deterioration in budgetary balance	1.4	1.3
100-basis-point decrease in interest rates		
Revenue decrease	0.4	0.5
Expenditure decrease	1.1	1.9
Improvement in budgetary balance	0.8	1.4

Note: Numbers may not add due to rounding.

- An indication of the impact of the change in economic assumptions since the October 2000 *Economic Statement and Budget Update* can be derived using standard estimates of the sensitivity of the budgetary balance to changes in key economic variables, such as real gross domestic product (GDP) growth, inflation and interest rates.

- A decrease in the growth of real GDP (through equal reductions in employment and productivity) would lead to lower federal government revenues through a contraction in various tax bases, and an increase in spending, primarily due to higher employment insurance benefits. Using the standard sensitivity analysis, a 1-per-cent decrease in real GDP for one year would lower the budgetary balance by $2.4 billion in the first year and by $2.6 billion in the second year.

- A 1-per-cent reduction in the growth in nominal GDP resulting solely from a one-year decline in the rate of inflation would lower the budgetary balance by $1.4 billion in the first year and $1.3 billion in year two. Most of the impact would be on budgetary revenues, as wages and profits would be lower as well as the price of goods and services subject to sales and excise taxes. The impact on expenditures would be largely reflected in those programs that are indexed to inflation, such as elderly benefit payments.

- A sustained 100-basis-point decline in all interest rates would improve the budgetary balance by $0.8 billion in the first year, rising to $1.4 billion in year two. This improvement comes solely from the reduction in public debt charges, which reduces overall budgetary expenditures. Expenditures would fall by $1.1 billion in the first year and by $1.9 billion in year two, as longer-term debt matures and is refinanced at the lower rates. Dampening this impact are somewhat lower interest earnings on the Government's interest-bearing assets, which are recorded as part of non-tax revenues.

Table 5
Changes in Economic Assumptions Since October 2000 Statement
Private Sector Average

	2001	2002
	(per cent, unless otherwise indicated)	
Real GDP growth		
October 2000 *Economic Statement and Budget Update*	3.5	3.0
May 2001 *Economic Update*	2.4	3.4
Difference (percentage points)	-1.1	0.4
GDP price		
October 2000 *Economic Statement and Budget Update*	2.0	1.5
May 2001 *Economic Update*	1.8	1.7
Difference (percentage points)	-0.2	0.2
90-day interest rate		
October 2000 *Economic Statement and Budget Update*	5.8	5.5
May 2001 *Economic Update*	4.6	4.7
Difference (percentage points)	-1.2	-0.8
10-year Government of Canada bond rate		
October 2000 *Economic Statement and Budget Update*	5.9	5.8
May 2001 *Economic Update*	5.3	5.6
Difference (percentage points)	-0.6	-0.2

- As shown in Annex 1, private sector forecasters have lowered their economic growth expectations for 2001 by 1.1 percentage points, but raised their outlook for 2002. The GDP price outlook is somewhat lower for 2001 but correspondingly higher for 2002. Short-term interest rates have been revised down by 120 basis in 2001 and 80 basis points in 2002, while long-term rates are 60 and 20 basis points lower, respectively.

Table 6
Impact of Changes in Economic Assumptions on Budgetary Surplus
Private Sector Average

	2001-02	2002-03
	($ billions)	
Impact from changes in:		
Real output	-2.6	-1.9
GDP price	-0.3	0.0
Interest rates	0.8	0.8
Net impact	-2.1	-1.1

- The revised outlook for real GDP growth reduces the budgetary balance by $2.6 billion in 2001-02 and $1.9 billion in 2002-03. Similarly, the revised outlook for inflation lowers the budgetary balance by an additional $0.3 billion in 2001-02. However, the lower outlook for interest rates improves the budgetary balance by $0.8 billion in 2001-02 and $0.8 in 2002-03.

- The net impact, therefore, lowers the budgetary surplus established in the October 2000 *Economic Statement and Budget Update* by $2.1 billion in 2001-02 and $1.1 billion in 2002-03.

Table 7
Changes in Economic Assumptions Since October 2000 Statement
Lower Growth Scenario*

	2001	2002
	(per cent, unless otherwise indicated)	
Real GDP growth		
October 2000 *Economic Statement and Budget Update*	3.5	3.0
May 2001 *Economic Update*	1.8	2.9
Difference (percentage points)	-1.7	-0.1
GDP price		
October 2000 *Economic Statement and Budget Update*	2.0	1.5
May 2001 *Economic Update*	2.0	1.4
Difference (percentage points)	0.0	-0.1
90-day interest rate		
October 2000 *Economic Statement and Budget Update*	5.8	5.5
May 2001 *Economic Update*	4.4	4.2
Difference (percentage points)	-1.4	-1.3
10-year Government of Canada bond rate		
October 2000 *Economic Statement and Budget Update*	5.9	5.8
May 2001 *Economic Update*	5.2	5.2
Difference (percentage points)	-0.7	-0.6

* Average of four forecasters with the weakest economic growth forecast for 2001.

- As noted in Annex 1, the current survey of private sector economists reveals a wide range of economic forecasts for 2001, which underscores the uncertainty over the current economic environment and its potential fiscal impact.

- An alternative economic scenario was derived by taking the average of the four economic forecasters with the weakest outlook for economic growth for 2001 and assessing its potential impact on the budgetary balance.

- In this lower real GDP growth scenario, real output growth of only 1.8 per cent is assumed for 2001, with a rebound to 2.9 per cent in 2002. In the October 2000 *Economic Statement and Budget Update*, real growth of 3.5 per cent was expected for 2001 and 3.0 per cent for 2002. Inflation is assumed to be virtually unchanged from that assumed in the October 2000 *Economic Statement and Budget Update*. Short-term interest rates are 140 basis points lower in 2001 and 130 basis points lower in 2002 than those assumed in the October 2000 *Economic Statement and Budget Update*, while long-term rates are 70 basis points lower in 2001 and 60 basis points lower in 2002.

Table 8
Impact of Changes in Economic Assumptions on Budgetary Surplus
Lower Growth Scenario

	2001-02	2002-03
	($ billions)	
Impact from changes in:		
Real output	-4.0	-4.7
GDP price	0.0	-0.1
Interest rates	0.9	1.6
Net impact	-3.1	-3.3

Note: Numbers may not add due to rounding.

- The lower outlook for real GDP growth in both 2001 and 2002 reduces the budgetary balance by $4.0 billion in 2001-02 and $4.7 billion in 2002-03. Part of this deterioration is offset by the lower outlook for interest rates – $0.9 billion in 2001-02 and $1.6 in 2002-03.
- The net impact is to reduce the budgetary surplus by $3.1 billion in 2001-02 and $3.3 billion in 2002-03.

Table 9
Change in Budgetary Surplus: Summary

	2001-02	2002-03
	($ billions)	
October 2000 *Economic Statement and Budget Update:* budgetary surplus	8.3	7.6
Carry-forward from better-than-expected 2000-01 outcome	1.0	0.8
Impact of changes in economic assumptions: private sector average	-2.1	-1.1
Adjusted budgetary balance	7.2	7.3
Memorandum item 1		
Adjusted budgetary surplus under lower economic growth scenario	6.2	5.1
Memorandum item 2		
Policy initiatives since October Statement	0.6	0.4

- In summary, the budgetary surplus, after subtracting the fiscal cost of the tax reductions and other policy initiatives announced up to and including those in the October 2000 *Economic Statement and Budget Update*, was $8.3 billion in 2001-02 and $7.6 billion in 2002-03.

- Some of the better-than-expected outcome for 2000-01 is expected to carry forward into 2001-02 and 2002-03, improving the budgetary surplus projections for those years by $1 billion and $750 million, respectively.

- The net fiscal costs of the changes in the private sector economic outlook are estimated to reduce the budgetary surplus by $2.1 billion in 2001-02 and $1.1 billion in 2002-03.

- The net effect of these changes is to reduce the budgetary surplus by $1.1 billion to $7.2 billion in 2001-02 and by $0.3 billion to $7.3 billion in 2002-03.

- Under the lower economic growth scenario, the net impact is to reduce the budgetary surplus by $2.1 billion to $6.2 billion in 2001-02 and by $2.5 billion in 2002-03 to $5.1 billion.

- These adjusted budgetary surpluses are for economic prudence, the Contingency Reserve and to fund policy measures.

- The net cost of new policy initiatives announced since the October 2000 *Economic Statement and Budget Update* is $0.6 billion for 2001-02 and $0.4 billion for 2002-03.

- As a result, under either scenario, the fiscal impact of the changes in the economic forecasts as well as the cost of the new initiatives since the October 2000 *Economic Statement and Budget Update* can be accommodated within the budgetary surpluses set out in the October 2000 *Economic Statement and Budget Update*, without putting at risk the balanced budget targets for 2001-02 and 2002-03.