October 14, 1998

The Economic and Fiscal Update

strong economy and secure society

Department of Finance Canada
Ministère des Finances Canada

For additional copies of
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Distribution Centre
Department of Finance
300 Laurier Avenue West
Ottawa K1A 0G5

Telephone: (613) 995-2855
Facsimile: (613) 996-0518

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

to the
House of Commons
Standing Committee on Finance

October 14, 1998
CHECK AGAINST DELIVERY

Mr. Chairman,

Let me thank you and the members of this committee for the opportunity to be here today.

Our country will begin a new century – a new millennium – in little more than 400 days. The decisions we make now – the path we choose to follow – will in no small way determine Canada's economic strength and confidence as we enter that new era.

Global Economic Developments

Last week, a series of important international meetings were held in Washington. The G-7 – finance ministers and central bank governors of the United States, Japan, Germany, the United Kingdom, France, Italy and Canada – met, followed by meetings of the International Monetary Fund (IMF) and the World Bank. These were significant discussions. And the reason is clear.

The international economy has entered a period of turmoil not seen for a very long time – and it is far from easy to predict how long the uncertainty and volatility will last.

Comparatively, Canada, while not immune to the economic volatility beyond our borders, is well positioned to weather the storm. Consider what is happening elsewhere.

Much of the globe is now in recession. The IMF's estimate for overall world economic growth this year is now down to 2.0 per cent from 3.1 per cent only a few months ago.

Japan, the world's second largest economy, is in recession.

Korea, Malaysia, Indonesia and Thailand – once known as the Asian Tigers – are in difficulty. Their economies are predicted to shrink, on average, by over 9 per cent this year.

Major economies in Latin America – including those of Mexico, Brazil and Venezuela – have been badly shaken by world capital markets.

Worrisome political and economic chaos has gripped Russia, with the system of government itself showing signs of very serious stress.

People everywhere have been disconcerted as stock markets around the world have tumbled from their recent highs.

Many parts of the world are suffering as a result of the inability to borrow the money they need to grow, a drying up of resources that is bringing whole economies to a virtual halt.

The prices of world commodities – natural resources – have fallen by nearly 30 per cent since their peak at the end of 1996. In real terms, they are now close to their lowest level since the early 1970s.

Millions upon millions of people in the developing world are being thrown into poverty – and families throughout the developed world wonder if their well-being and security are now at serious risk.

These facts and others fill the headlines. But they also illustrate serious fault lines – fault lines that must be fixed.

Until recently we've seen – and benefited from – several years of significant economic expansion around the world.

Now we are seeing globalization's other face.

In an unprecedented fashion, negative developments in far-off corners of the world are having immediate repercussions everywhere. Very clearly, the global economy has entered uncharted waters.

This might well be the first real test of the stability and sustainability of globalization.

Let there be no doubt. Open markets and economic growth have brought previously unheard of prosperity to literally hundreds of millions of people around the globe. And that successful quest for a higher standard of living can, and will, resume once the current challenges are met.

The instability that we are now seeing in so many countries was inevitable at some point.

Faulty domestic financial systems, inadequate oversight and regulation, political rigidity, structural economic flaws, distorted competition and cronyism – these and other faults could be papered over, but not forever.

The foundation was weak and eventually bound to crack – and now it has.

The global challenge is to repair the damage, to build a durable foundation – to take the measures necessary to ensure that the world economy can restore and maintain sustained growth.

The pursuit of protectionism is no answer. Indeed, it would be a grave error. Markets must remain open. In order to move on to the next stage of growth, our challenge is to mend and reinforce the fabric of the global economy, not to abandon it.

As we speak, the challenges domestically for many economies are profound – and they are profound as well for the international community and its institutions.

The discussions we held in Washington focused on these clearly difficult, complex and very significant issues – and they marked an important first step in building the new foundation we now need.

We agreed that the Bretton Woods institutions, which have served the global economy well for over 50 years, are now in need of renovation. We reached a consensus that the time for diagnosis is over. Meaningful solutions have been advanced. Job one is now to implement them.

Canada has put forward a six-point plan to deal with the international situation. Our initiatives were well received by the global community in Washington last week and many of our specific suggestions will form the building blocks of the new financial architecture.

All of us, G-7 and emerging markets alike, agreed on the absolute necessity of creating and maintaining domestic policy environments conducive to steady, non-inflationary growth.

We made progress in Washington, but not nearly enough. More must be done and we must act quickly because, in the end, this is about protecting people. Ultimately, they are the ones who will suffer if strong and resolute action is not taken.

Mr. Chairman, no country, no matter how large, can prevent or control the kind of worldwide economic turbulence we are experiencing today. And no economy – no matter how strong – can shield itself fully from its consequences.

This is especially true for Canada, a country that always has, and always will, depend on trade for so many of its jobs and so much of its prosperity.

The global economy will come through this difficult period, as it has before. Canada is particularly well placed, with our public finances restored to health.

But let us make no mistake. It is likely to be a year of heavy weather ahead. The winds of financial turmoil will continue to blow, and Canada is going to feel the effects – even if we are well prepared, and even if we are only at the edge of the storm.

Our Challenge and Our Plan

In the face of these forces, we have spoken about what our responsibilities are internationally. The question now arises as to what our responsibilities are here at home. Our view is crystal clear.

It is to act in the short term but to always look to the long term.

It is to continue to put in place the kind of robust policy framework that can cushion the impact of global shocks – and, at the same time, sustain and strengthen the social safety net on which all Canadians rely.

It is to do what we must to weather the tempest around us and to strengthen the economy to face future storms that will inevitably arise.

That is what our balanced approach is all about – an approach we knew when we came into office was long overdue.

We understood, then, that the economic and fiscal problems facing the country were not superficial; they were structural.

And we realized that there were many interrelated problems to address, that a simple solution focused on a single problem alone would not work. That tinkering would not do; that deep reform was required.

For that reason, we put in place a long-term plan.

Its goal? To provide Canadians with what had been absent for too long: the architecture of a modern, productive economy, one of growth and jobs.

In short, to forge a new alliance between the strength of our economy and the security of our society.

The steps to reach that goal were clear.

First, we knew we had to get interest rates down – because they were standing in the way of growth and the creation of jobs. And to get interest rates down, we knew we had to restore sound financial management and move decisively towards a balanced budget.

Second, we knew we had to reduce our debt-to-GDP ratio – because interest payments on the debt were chewing up precious resources the country needed to build and secure the future. And we recognized that this meant not only getting the debt down, but improving the productivity of the economy – getting growth up.

Third, we recognized that spending cuts would be necessary in the short term, and that these would be difficult. But we knew as well that, once our financial health was restored, focused investment in the key social and economic priorities of Canadians would be essential if we were to reach our overarching goal – a Canada of opportunity, one where all our citizens could be confident of their future, able to enhance their own prospects and those of their families.

Finally, we also knew that taxes had to be brought down – because Canadians simply deserved to keep more of the income they earn through their own hard work.

Through all of this, Mr. Chairman, we knew that the nature of government itself had to change. Not only its budget, but its focus. Not simply its size, but its direction.

That the days of trying to be everything to everyone at any cost were over.

That the need to have clear priorities, to realize where government could make a difference – and where it could not – was essential.

That the pursuit of frugality had to become a defining feature of everything that we do – that partnership in today's modern economy was not a sign of weakness, but of strength.

That approach – one we have been pursuing for five years – has worked. As the Prime Minister has said, it will not be abandoned. Indeed, it will be bolstered.

Let me emphasize that we have not been doing any of this because it satisfies some textbook definition of good economic fundamentals.

We are doing this because it speaks to the fundamentals that really count for Canadians.

A higher standard of living – for the many, not the few. And a higher quality of life – in communities from coast to coast to coast in this country.

Putting Our Performance and Our Prospects in Perspective

Now, Mr. Chairman, when we were talking about our plan and our prescription several years ago, it was proposition. But today, we are well beyond that. Today, we can talk about proof, about performance.

Consider the progress the country has made.

Five years ago, the federal deficit stood at $42 billion and rising.

We said we would bring it down steadily each and every year. And we did – not only meeting, but beating every target we set.

Last February, we said we would balance the budget in the 1997-98 fiscal year that was then coming to an end.

And we have.

Indeed, as outlined in the *Annual Financial Report* being released today, we have done better than that.

I am pleased to announce that, for the first time in more than a generation, the Government of Canada recorded a surplus – $3.5 billion.

That money has been applied directly to the debt.

This marks the first time in 28 years that Canada has actually paid down the debt.

This is a historic milestone.

And it is an achievement that belongs not to government but to Canadians themselves.

Let me emphasize a further point as well. The accounting method we in Canada use to calculate our balance sheet is considered among the most rigorous in the world, for it includes all the liabilities government incurs in any given year. This is the measure on which I have just reported.

Most other major industrial economies use another measure – financial requirements – which includes only the borrowings that government makes in the financial market.

According to this measure, Canada has in fact recorded a financial surplus for two years in a row – the only G-7 country to do so.

This has allowed us to lower the amount of debt we owe to financial markets. As such, we paid down $9.6 billion of market debt last fiscal year. And we will likely be able to report a significant further paydown at the end of the current fiscal year as well.

Mr. Chairman, this speaks to progress at the federal level. However, the provinces have made very significant progress as well. In 1992-93, the federal and provincial governments, taken together, recorded a $66 billion deficit. That has now been entirely erased.

Beyond financial progress, consider as well the economic progress the country has made over the past four years. This, too, serves as an essential starting point for our future course of action, for the choices we must make in this period of economic uncertainty.

In the fall of 1993, the unemployment rate was 11.4 per cent. Today, while still too high, it is at 8.3 per cent, its lowest point in eight years, a track record of improvement exceeded only by the U.K. among the G-7 nations. Over 1.3 million jobs have been created during this period – 636,000 since the beginning of last year.

Interest rates have been brought down substantially. The spread between Canadian and U.S. rates is significantly less than it was only three years ago.

As importantly, interest rates on long-term government bonds – which have a key influence on mortgage rates and on what business pays on the money they borrow to invest, thereby creating jobs – are at their lowest level in three decades.

Inflation is under firm control and will remain so. Indeed, Canada now enjoys a solid reputation as a low inflation country.

Now, as we have said, no one is immune from the developments in Asia, Russia and elsewhere. Clearly, they are having an impact on our economic prospects, as they are on those of others.

For instance, through to the end of the first quarter of this year, the economy enjoyed seven quarters of robust growth, averaging 3.7 per cent. However, over the past few months, performance has been disappointing.

Our exports to Asia are down sharply – by more than 30 per cent in the first seven months of 1998, compared to the same period one year ago, although this has been offset by strong growth in our trade with the United States. Economic growth has slowed in many parts of the country. Western Canada, in particular British Columbia, is being hit hard.

As a result, private sector forecasts for overall Canadian growth are down for this year and next.

And the fact is our currency has been under pressure.

But consider not only where our currency would be, but where the country might be today if we had not acted five years ago.

Consider what the impact on Canada of today's global uncertainty would be if we were still running massive deficits, if our reliance on foreign lenders was still increasing, if our interest rates were sky high and rising.

We would be talking about more painful cuts, not new investments.

We would be talking about how large the debt would grow, not about bringing it down.

And we would not be talking about cutting taxes.

No one should downplay the danger posed by the current global environment. But the fact remains: despite recent developments, the major international institutions – the IMF and the Organization for Economic Co-operation and Development, the OECD – expect Canada's economic and employment growth this year to be among the best of the major industrial nations.

And we will, as we said in February, balance the budget this year, and we will balance the budget next year.

And let us be very clear on the issue of our currency.

Yes, these have been troublesome times for the Canadian dollar.

But it is the structural problems that were allowed to fester over a period of 25 years that have caused its long-term decline – problems that Canadians have gone a long way to address.

The markets have an image of the Canada of yesterday, not the Canada of today. The perception is wrong. The filter is false. Consider the following:

- For two decades, Canadian inflation was generally above U.S. inflation; for the last five years, it has been consistently lower.
- Throughout the 1970s, 1980s and early 1990s, government deficits were much larger in Canada than the U.S.; Canada now has a surplus.
- Our debt-to-GDP ratio was rising for more than 20 years; now it is falling.
- For many years, Canadian productivity growth lagged behind that in the U.S.; last year, it was much higher in Canada – 2.8 per cent here versus 1.7 per cent there.
- In 1980, exports of resource-based commodities accounted for 60 per cent of total exports; today, the share is down to 35 per cent.
- Exports of machinery, equipment and automotive products have accounted for a larger share of our exports than have commodities every year since 1992.
- The high-tech sector in Canada has posted a level of growth in jobs and output throughout this decade that is twice the rate of the rest of the economy.

Mr. Chairman, this reality is Canada: more diversified, more sophisticated and anchored in a much sounder financial footing than it has been for decades.

The Road Forward: Our Balanced Approach

That being said, we still have a long way to go.

Let me elaborate on how we will meet the challenges still before us.

Reducing the Debt Burden

Despite the headway we have made in balancing the books, it is clear that a quarter century of deficits has left us with a debt burden that is still far too high.

The best measure of this burden is to look at the debt in relation to the size of the economy that supports it. This is the debt-to-GDP ratio – what we owe in relation to what we produce. The lower the ratio, the more manageable the debt.

For 20 years, that ratio was rising relentlessly. However, in 1996-97, as a result of a growing economy and the restraint measures we introduced, it fell meaningfully for the very first time.

Last year, it fell even further – by 3.3 percentage points, from 71.1 per cent to 67.8 per cent.

This represents the largest single year improvement since 1956-57.

It also represents the first consecutive back-to-back reduction in the debt-to-GDP ratio since the early 1970s.

However, we still have a long way to go. Our debt-to-GDP ratio is the second highest in the G-7. Too much of every tax dollar goes to pay interest on the debt rather than to purposes that are productive – for the country and for Canadians.

Looking ahead, our commitment is to keep the debt-to-GDP ratio falling permanently.

The Debt Repayment Plan we put in place in the last budget will ensure that happens.

First, we will, as we always have, present two-year fiscal plans based on prudent economic assumptions. This year, the budget will be balanced. And we will balance the budget next year. This will mean three consecutive years of budgets that are balanced or better.

We will not forego the gains we have made. Our commitment to continued financial progress is rock solid.

Second, we will build into our plans, as before, a buffer, a $3 billion Contingency Reserve.

And third, if the Contingency Reserve is not needed, it will go directly to paying down the debt.

Based on a realistic assumption of between 3.5- and 4-per-cent average nominal income growth and budgets that are in balance, in five years, the debt-to-GDP ratio would be down to around 55 per cent.

This would represent real progress. But we cannot stop there, and we won't.

The fact is, the federal government has a responsibility to all Canadians to continue to make progress on reducing its debt burden.

Let me give you one example. The interest rates the federal government pays on its debt determine, in large measure, the interest rates provinces pay on theirs.

As our financial recovery continues, they will benefit. Were we to stall or fall back, they would pay the price too.

Moreover, the federal debt-to-GDP ratio stood at 68 per cent last year – the provincial debt burden stood at only 26 per cent.

Last year, we paid 27 cents out of every revenue dollar for interest on the debt. The provinces paid only 13 cents.

The provinces may want to take this into account in making demands on the federal purse.

Investing in the Highest Priorities of Canadians

Mr. Chairman, let me now turn to the second element of our balanced plan – investment in the highest priorities of Canadians.

It is critical to restate the fundamental point that the role of government does not begin and end with taking care of the books. Its purpose is to respond to the needs of its people.

Its role must be to help Canadians adjust to change and prepare for the future.

There are crucial needs that market forces, if left alone, will simply not meet.

Government has a clear responsibility to act – for example, on protecting the environment, on advancing research and development, in fostering the creation of jobs, and in helping to lead the fight against child poverty.

We can never lose sight of the fact that a strong economy and a secure society are not separate, distinct ends. A strong economy is necessary to support a secure society. But so, too, a secure society provides strength to the economy.

It gives Canadians the confidence they need to reach as high as their talents and ambitions can take them.

A secure society widens the mainstream. It expands opportunity. It allows each individual to act upon and realize their own potential.

Clearly, health care is at the top of the list for Canadians in every region of the country.

It is at the core of how we define ourselves as a national community – one of fairness and compassion.

That is why, as the Prime Minister has said, “the government will invest more of our resources in the years ahead to reinforce our public health care system”.

The principles contained in the *Canada Health Act* – of access to care based on need, not income – are, for most Canadians, not simply sections of a piece of legislation. They virtually constitute a charter of rights.

Yet today, Canadians are profoundly concerned that their health system is declining. That quality care will not be there when they or their loved ones need it. That the worst may, in fact, lie down the road. This concern must be addressed. Let me tell you, no one can take on the challenges of the new economy while preoccupied with the availability of basic health care. No parent of an ill child. And no child of an ageing parent.

We welcome the assurances of Canada’s premiers that any additional federal funding provided to the provinces for health care will indeed be used for that purpose.

We share strongly their desire – and the desire of all Canadians – to have confidence restored in the health care system, and we want to work in partnership with the provinces to secure that confidence.

Reducing Taxes

Let me turn now to the third part of our plan – reducing taxes for Canadians.

With the budget in balance, Canadians have a right – and we have a responsibility – to ensure that more money is left in their pockets. This is one key to raising the standard of living and increasing disposable incomes for all Canadian families.

When the deficit reduction challenge had yet to be fully met, we were not able to move forward with broad tax relief. We simply could not afford it.

However, as a result of our better-than-expected financial progress, we were able to provide targeted tax relief where the need was greatest – for students, for charities, for persons with disabilities, and for the children of working parents with low incomes.

Then, last February, for the first time, with budget balance secure, we were able to not only offer even more significant targeted tax assistance, but to also move on to broader tax measures, focused, as a matter of fairness, on low- and middle-income Canadians. These were only first steps, but they were important – affecting 90 per cent of all taxpayers. In total, the tax measures in our last budget will provide $7 billion of relief over three years.

We said in the last budget that we would build upon these measures as we can, and that we would do so in a measured and responsible way. That is what we will do.

Limited Resources and Responsible Choices

Mr. Chairman, at this point, it is essential that we step back and consider the economic context in which we must make our policy choices in the coming months.

In a very short time, the world has become an inhospitable place – one of great danger and considerable risk.

We are in a situation that calls for great care and caution.

We must be realistic about the resources at our disposal.

Today, some seem to believe we have mountains of money to spend. We don't.

They seem to feel we are now in a position where we don't have to continue to make hard choices. We do.

Look at what has happened to the average forecast of economic growth by private sector experts since only the beginning of this year.

In January, they were estimating nominal income growth of 4.7 per cent for 1998. That has now been revised downward to 3 per cent.

And for 1999, they were projecting 4.9-per-cent nominal income growth. That, too, is down significantly – to 3.5 per cent.

What do these revisions mean for the size of the dividend as projected by the private sector?

The answer is they would knock over $5 billion out of government revenues in 1999-2000.

Only a few months ago, these forecasters were estimating a 1999-2000 surplus, before any new budget actions, of around $10 billion. The recent downward revisions would lower their estimates to around $5 billion – or $2 billion once the $3 billion Contingency Reserve is subtracted.

Mr. Chairman, at the time of our last budget, many criticized us for being too prudent, too cautious.

Well, in the face of today's global turmoil, I doubt if there are many people who would still subscribe to that notion.

The dramatic downward revision in private sector forecasts illustrates more clearly than anything why this government must stick to its careful approach to budget planning, why we simply cannot afford the risks associated with changing planning assumptions so drastically, month by month.

This is not academic, some arcane point from economic theory.

Consider the result if we had followed the advice of some not long ago to take $9 billion to $10 billion worth of tax action – action they claimed we could afford. We would now be heading for a substantial deficit.

Further, while we have noted that the downward revision to economic forecasts could lower the private sector estimate of the dividend to $2 billion – when the $3 billion Contingency Reserve is taken out – with all the uncertainty that exists worldwide, it may well be that further downward revisions will occur.

In any event, it is clear the dividend in the next two years will be modest, much less than would be required to provide sufficient funding for the size of initiatives – on taxes and spending – that many are calling for. And clearly, careful choice in allocating that dividend will be required.

Now, some, of course, would throw caution to the wind, saying, well, maybe we will have the money. Maybe the dividend will be larger than we think. That it's worth the risk to cross our fingers, and pray that things will turn out that way. In other words, it's time now, acceptable now, to set aside the careful and cautious approach we have been following.

Well in my opinion, that is the financial equivalent of reckless driving – you may not have an accident but, if you do, you not only hurt yourself, you can sideswipe a lot of innocent people.

The very reason we have met our targets, the very reason we are now able to say that, despite the global economic crisis, we are still on track not only to balance the books but to have a dividend – all of this is anchored in the caution we have applied from the very beginning.

Those who propose that we can comfortably contemplate putting aside caution – especially now – are either shooting from the hip or suggesting that we should shoot ourselves in the foot.

Mr. Chairman, let me give you an example of what I mean.

Despite recent events, some are saying we should implement a major personal income tax cut, for example, of an average of $600 annually per taxpayer.

That would cost about $9.0 billion per year.

Some are demanding that employment insurance premiums be reduced to the so-called 'break-even' level.

That could cost more than $6 billion per year.

The provinces are asking, despite the rise in tax points, that cash transfers be increased.

Their proposal would cost about $6 billion per year.

And still others are saying we should mount a larger attack on the debt.

That could cost, for example, another $3 billion per year.

Now, add all that up.

The total bill is $24 billion – each and every year. And that is a long way from a complete inventory of the demands that are being made.

We have pointed to the downward revision in private sector forecasts and the impact slower economic growth is likely to have on our revenues and therefore available financial resources.

Adopting all the proposals we have just outlined would very clearly put the country back into a situation of serious, chronic deficits.

Not only that. Apart from debt reduction, adopting any one of these proposals in their entirety would put us in financial difficulty.

That, quite simply, is the very worst thing we could do.

Safeguarding our financial health at home is the *sine qua non* of riding out the global storm we are now in.

Turbulence abroad mandates vigilance here at home.

Make no mistake. We will do what we can. But we will only do what we can afford.

It is in this context that the discussion on the reduction of employment insurance premiums must be engaged. As we noted earlier, many are demanding the premiums be brought down dramatically. This flows from the procedure that has been in place for some time to set premium rates.

Under this procedure, the Employment Insurance Commission is mandated to set the rate so that premiums paid in will balance the costs of benefits paid out over the course of an economic cycle. In order to monitor the status of this program, there is a notional Employment Insurance Account that records revenues and expenses each year and shows the cumulative balance between them over time.

Mr. Chairman, what has caused a great deal of misunderstanding is that, while there is a notional Employment Insurance Account, it is an accounting mechanism only. Since 1986 – at the insistence of the then-Auditor General – the Employment Insurance Program has been fully integrated into the overall finances of the federal government.

In other words, as a result of decisions taken by those who came before us, EI premiums paid are entered in the country's books just like any other source of revenue – as are benefits paid out, just like with any other program. Even prior to 1986 – indeed from its inception in 1940 – the EI Program was specifically designed in such a way so that no actual funds enter into a special account.

Some are saying we are breaking new ground in continuing to have EI premiums cover more than the cost of the EI Program itself. We are not. This is not new. Far from it.

Throughout the history of the EI Program, the cumulative balance between premiums and expenditures has swung between deficit and surplus. In fact, there has been a deficit at the end of 10 of the last 17 years, and the government assumed responsibility for it. In years of deficit in the EI Account, the government covered the excess of costs over premiums – and, as a result, the government's overall deficit was pushed up. On the other hand, in years of surplus in the EI Account, the government's overall fiscal balance improved as a result.

It is true that the surplus is much larger now than ever before; however, it is important to note that other political parties have either explicitly or implicitly advocated over the past five years – that the resources generated by the EI Program be part of our successful effort to balance the nation's books.

Therefore, Mr. Chairman, what is the fundamental issue before us? Every year since we have taken office, we have reduced EI premiums. Employees and employers are saving $2.6 billion alone this year as a result. However, some say that it is now time to bring the EI premium rate down even more sharply.

Where the rubber hits the road is that this could cost more than $6 billion annually and could drive the country back into deficit.

Moreover, with such a large reduction, clearly there would be no room for personal income tax cuts. No possibility of any needed investment in health care or anything else.

The issue isn't simply how much do we cut EI premiums, it's do we ignore the turmoil enveloping the world economy? It's do we abandon the balanced approach that has served the country so well over the last five years?

It is at this point that the debate is truly joined. It is here that some very straight talk is required.

Let there be no doubt. We wish we could reduce EI premiums significantly. We wish we could bring personal income taxes down dramatically. We wish we could devote large-scale new resources to health. We wish we could invest significantly more in the environment, in job creation, in research and development, and in addressing child poverty.

We wish we could do all of that – and more. But we can't. We simply don't have the money now.

The world economy is going through a period of major difficulty and disruption.

As a government, we have many responsibilities, but today there is one that is most immediate. And that is to use every means at our disposal to protect this nation and its people from the global troubles that surround us.

This, we will do.

The challenge today is not to concoct some wish list as if money was no object and as if the world were a tranquil place.

The challenge we face is to take the limited resources that we have and make responsible choices in a world of great turmoil.

Therefore, there can only be very limited action, if any, in bringing down the EI rate for 1999, because we are determined to protect the finances of the nation, continue to foster jobs and growth and, as resources permit, invest in medicare and the reduction of personal income taxes for Canadians.

Mr. Chairman, we have stated today what our priorities and our choices are. Others, of course, will have different views. And this committee is a very important forum for the debate that is now underway.

When people make the case for a drastic, immediate EI rate cut, ask them if we should put the financial health of the nation at risk at a time of worldwide economic turmoil.

Ask them if they place less importance on investment in health, or on reducing personal income taxes for Canadians.

When people ask for additional spending, ask them where we are to get the money. And when others say that the way to pay for a large reduction in taxes is to slash spending, ask them to tell you specifically what they would cut – when, in relation to the size of the economy, government spending on programs today is already at its lowest level since demobilization after World War II.

Conclusion

Mr. Chairman, today we have outlined our plan for the future. Although many of the measures of which we have spoken relate to the short term, they are also very much part of a longer-term agenda which must be the focus of all our efforts going forward. The goal of that effort is to raise the standard of living and the quality of life for all Canadians. And the only way to get there is to continue, year after year, to put in place the foundation for a stronger, more productive economy.

Despite the problems of the day, we must never again allow short-term preoccupations to blind us to the long-term needs of the nation. The fact is, that's what governments have done all too often, neglecting the need for a consistent, long-term economic strategy – and it is Canadians who paid the price.

Employment policies were adopted that actually discouraged people from working. Intrusive regulation and micromanagement of the economy became a growth industry. In good years, there were big deficits. In bad years, there were bigger deficits. Through it all, trying to square a circle that could ultimately not be squared, governments adopted rosy economic outlooks – almost always wrong.

Governments focused on fine tuning economic performance to smooth out bumps in the road. What they didn't do was look far enough ahead to see that the road was in fact a dead end.

The result? Soaring taxes. Double digit deficits. Triple digit debt.

Our plan has been dedicated to addressing each of those root causes one by one.

Progress has been made. Is it significant? Clearly, yes. Is it good enough? Clearly, no.

We must press on – and press on we will.

Mr. Chairman, we began today's discussion by addressing the economic turmoil that is gripping much of the globe – and whose consequences are today reaching our shores.

We have made it clear that, while concern is warranted, Canada is well positioned – something it would not have been possible to say only four years ago.

But it must also be understood, much as all of us would wish it otherwise, that today's period of difficulty and uncertainty is neither the first, nor the last, our country will face. As globalization widens and deepens – as it surely will – other disruptions will occur. That is simply a fact of life.

However, this does not mean our only response can be a fatalistic shrug. Indeed, it means the opposite.

Let me quote from our February budget, brought down at a time when the clouds were only beginning to gather on the horizon:

"Globalization and technological change are a reality. They are not a religion. They are a fact. They are not a faith.

We commit a very serious mistake if we ever come to believe that the global economy abroad means there is no role, no responsibility on the part of government to provide opportunity and security at home.…"

Mr. Chairman, what does that mean for the future?

As the Prime Minister has said, first, it means continued sound financial management. And second, it means responsible and focused economic and social investment. Both of which will work together, reinforcing each other, to build a strong economy and a secure society – one that will provide a higher standard of living and quality of life for all.

In short, it means exercising the kind of economic leadership that will help shield us when times are bad – and propel us forward when times are good. That is our purpose and our course.

There can be no doubt that recent economic developments are indeed disturbing.

After spending years of effort and sacrifice cleaning up the mess inherited from the past, Canadians are now confronted with new challenges, ones this time not of our own making, but originating beyond our shores.

We face a choice, a test.

Do we look to the long-term needs of the nation or do we pull back, seeking refuge in quick fixes, in desperate measures, in short cuts to nowhere?

Do we stick to, and strengthen, our balanced plan of sound fiscal management, of responsible tax policy, of careful and focused investment? Or do we fall prey to the temptation to tilt, to take undue risks with the financial health of our country?

Mr. Chairman, today we have provided our answers to those questions.

The plan we have pursued, and the principles which underpin it, have served our country well.

Ours is not a plan only for good times.

It is a plan not to be implemented – or judged – on the basis of one budget, one year – or one mandate. It is a plan of solid and sure steps, each building on the last, of careful construction of the new framework for the new economy of the new century.

Canada is no longer the high deficit, high inflation, commodity-dependent, low productivity country of the past – but is in fact becoming a leader, a country that can set our own standards of excellence because we have already met the standards others have set.

The most important debate in this country is no longer only that between left and right.

It is between those who believe we should settle for second best – and those who know our country has the potential to be the very best.

It is between those who believe our future will be but a pale imitation of the past – and those who see our story as one whose greatest chapters have yet to be written.

It is between those who believe the role of government is to simply stand aside and do nothing – and those who know that today, more than ever, government has a responsibility to stand with, to stand alongside Canadians.

We believe in a strong and secure Canada. Canadians are building that country today.

Make no mistake. While the winds may buffet us, they will not drive us off course. We will succeed.

Annexes

1

Canada’s Economic Developments and Prospects

Highlights

"The international economy has entered a period of turmoil not seen for a very long time."

"… no one is immune from the developments in Asia, Russia and elsewhere."

"As a result, private sector forecasts for overall Canadian growth are down for this year and next."

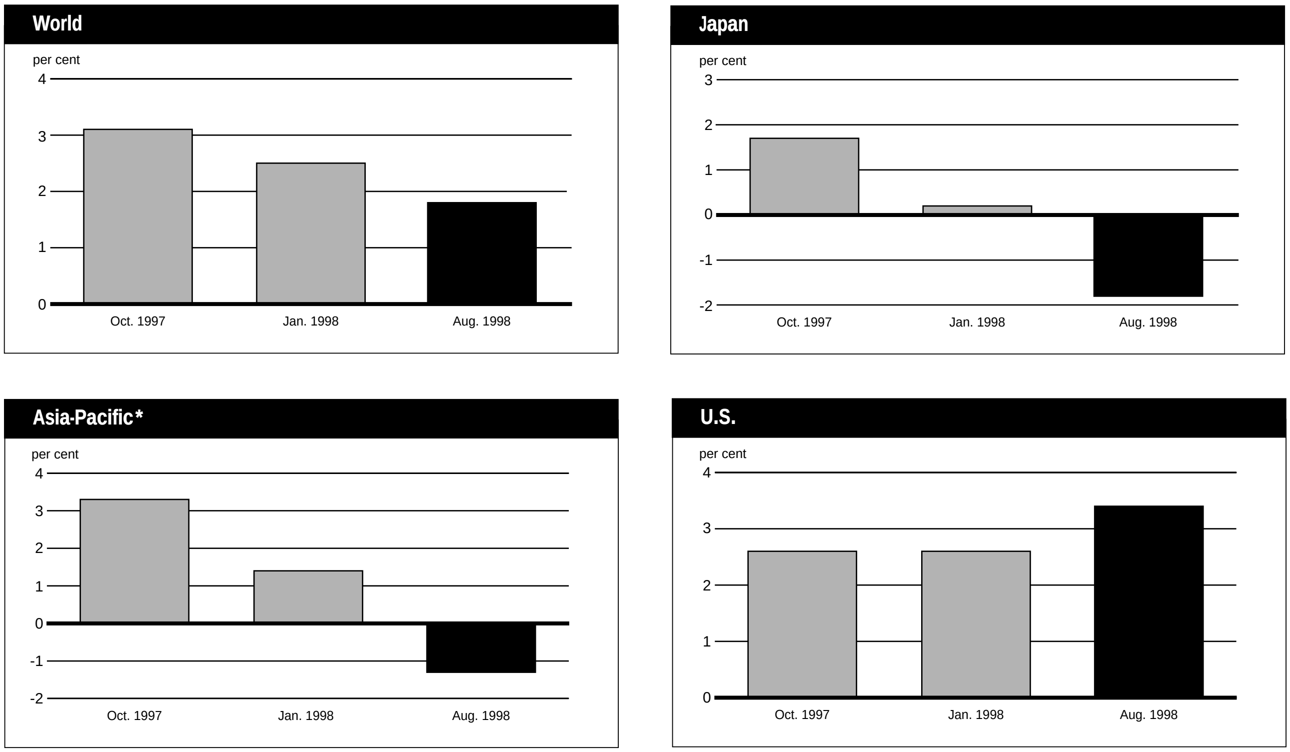
"… despite recent developments, the major international institutions … expect Canada's economic and employment growth this year to be among the best of the major industrial nations."

The Honourable Paul Martin
Minister of Finance

- *The outlook for world economic growth in 1998 has been revised down steadily over the past year, owing mainly to the financial crisis in Asia.*
- *This crisis and the accompanying weakness in global commodity prices have adversely affected Canada's trade sector, particularly in British Columbia. Better-than-expected economic performance in the U.S. in late 1997 and early 1998 has partly offset this weakness.*
- *Weak commodity prices have negatively affected Canada's terms of trade and have dampened gross domestic product (GDP) inflation, as well as nominal income, which is an important determinant of the government's revenue base.*
- *Real output growth has also moderated recently, although some of this moderation reflects the impact of strikes and other temporary factors.*
- *Canada's success in eliminating the deficit and in keeping inflation low has helped keep interest rates at historically low levels despite recent increases.*
- *As a result of world economic and financial turbulence, private sector forecasters expect the expansion to slow substantially in 1998 and 1999.*
- *Nevertheless, the International Monetary Fund (IMF) still expects Canada to compare favourably to the rest of the Group of Seven (G-7) countries in real GDP growth in 1998 and 1999 and to be far in the lead in job creation.*

Forecasts for world growth have been marked down since the budget.

Real GDP growth forecast for 1998



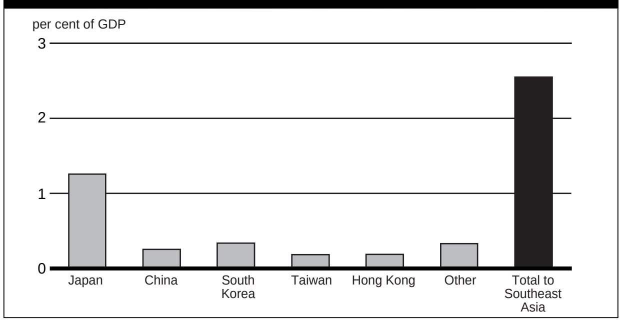
*Japan, China, Hong Kong, Indonesia, Malaysia, New Zealand, Australia, Singapore, South Korea, Taiwan, Pakistan, Philippines, Sri Lanka, Vietnam and Thailand.

Source: Consensus Economics.

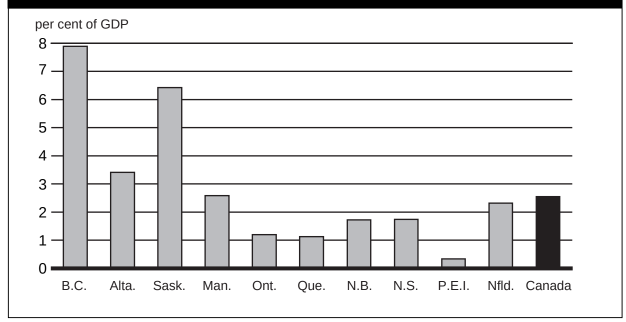
- As a result of the financial crisis in many Asian economies and the recession underway in Japan, the outlook for world economic growth in 1998 has been revised down steadily over the past year.
  - The economic and political crisis in Russia and the possible contagion effect on Latin American countries represent an additional source of risk to the global outlook.
- The impact on Canada of the situation in Asia has been partly offset, however, by a better-than-expected economic performance in the U.S. in late 1997 and early 1998. This has led forecasters to revise up their U.S. growth projections for 1998 as a whole.

Developments in Asia have had a negative impact on Canada's trade performance.

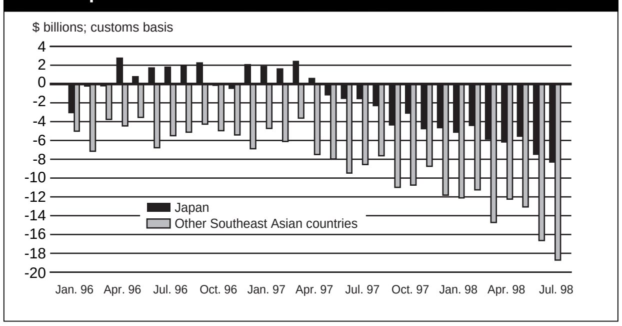
Exports to Southeast Asia in 1997



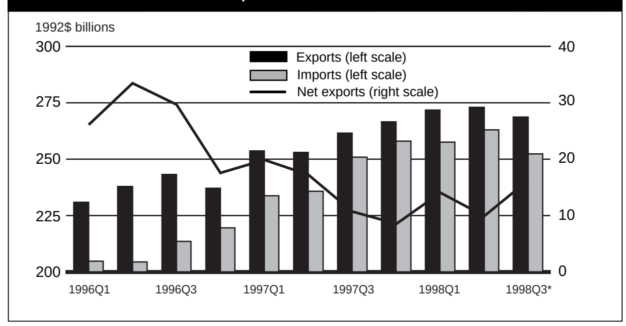
Exports to Southeast Asia in 1997 by province



Net exports to Southeast Asia



Real merchandise trade, all countries

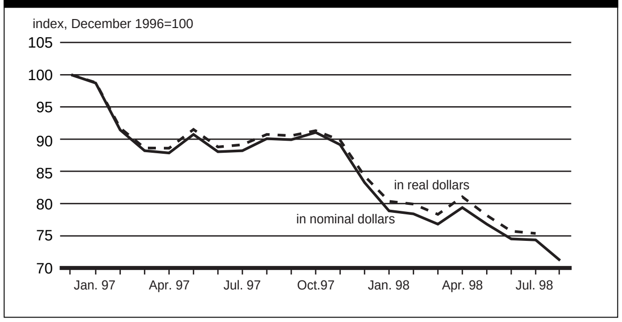


*Based on July data.

- Canada's trade with Asia has been adversely affected by weaker activity in Asia and the steep depreciation of many Asian currencies.
- Canada's western provinces, especially British Columbia, have been the hardest hit as they rely heavily on trade with Asia.
- That said, exports to Southeast Asia – which includes many of the Asian countries involved in the crisis – account for only about 2½ per cent of Canada's GDP; half of this is accounted for by Japan. In comparison, exports to the U.S. amount to nearly 30 per cent of Canada's GDP.
- Given the high concentration of Canada's foreign trade with the U.S., our trade and economic performance has been somewhat insulated from the adverse effects of the "Asian flu", at least in real (i.e. inflation-adjusted) terms.
  - Indeed, total real net exports have improved so far in 1998 – despite the onset of the Asian crisis – partly as a result of continued strong growth in the U.S. which has supported exports to that country.

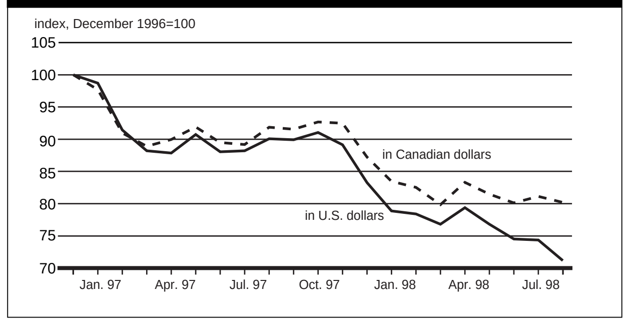
Commodity prices have also been adversely affected.

Commodity prices



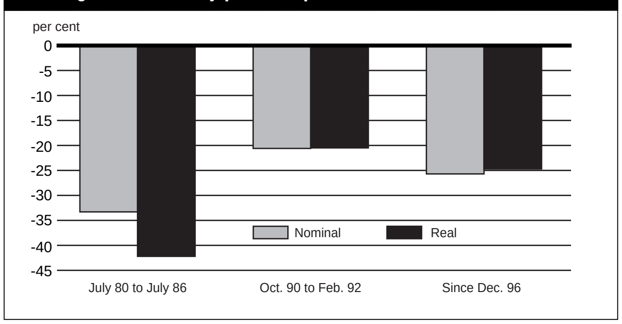
Source: Department of Finance Commodity Price Index, in U.S. dollars.

Commodity prices in Canadian and U.S. dollars



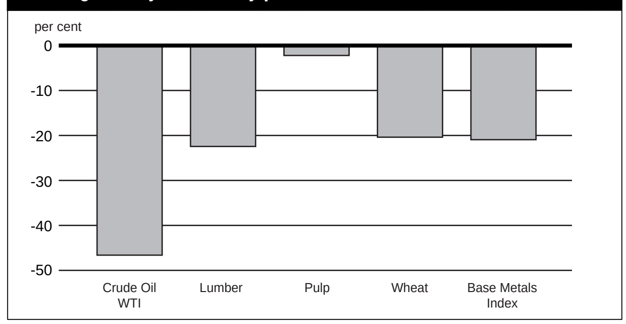
Source: Department of Finance Commodity Price Index.

Change in commodity prices in previous downturns



Source: Department of Finance Commodity Price Index, in U.S. dollars.

Change in key commodity prices since December 1996

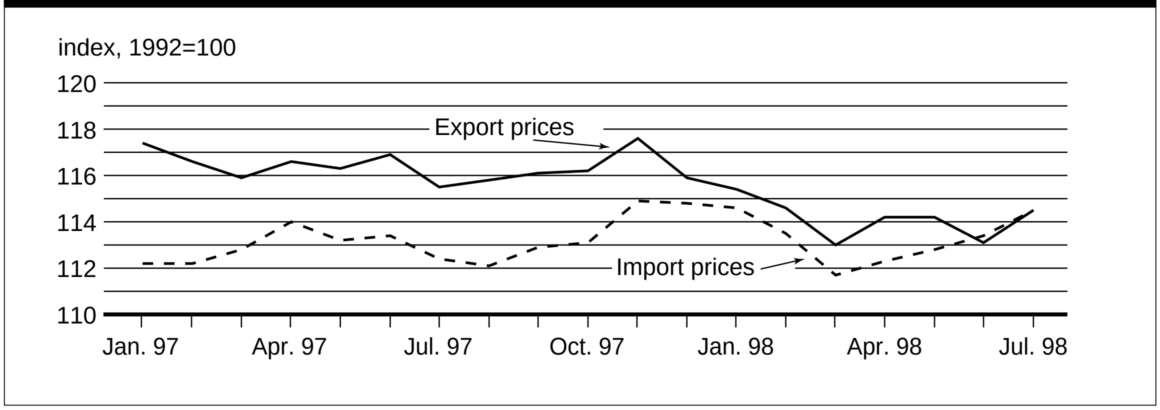


Source: U.S. Commodity Research Bureau and Walden's Fiber & Board Report, in U.S. dollars.

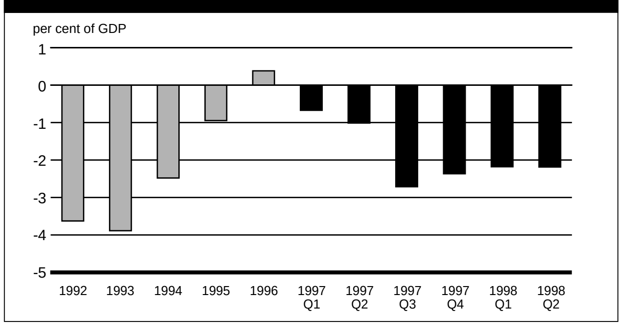
- The build-up of large excess supplies of commodities, due in part to the turmoil in Asian economies, has put downward pressure on world commodity prices since late 1996.
- The U.S. dollar prices of resource-based commodities produced by Canada have fallen about 28 per cent since their peak in December 1996.
- However, the depreciating Canadian dollar has helped to buffer the impact of lower commodity prices on commodity producers' Canadian dollar cash flow. As a result, in Canadian dollars, commodity prices haven fallen by less (about 20 per cent) since December 1996.
- In both nominal and real terms, the current decline in commodity prices is similar to the one experienced in the early 1990s, but much less severe than the decline in the first half of the 1980s.
  - However, the current downturn is more widespread with prices for crude oil, lumber, wheat and base metals all experiencing sharp declines. Moreover, commodity prices have dropped more quickly than in previous major downturns.

Lower commodity prices have translated into lower export prices.

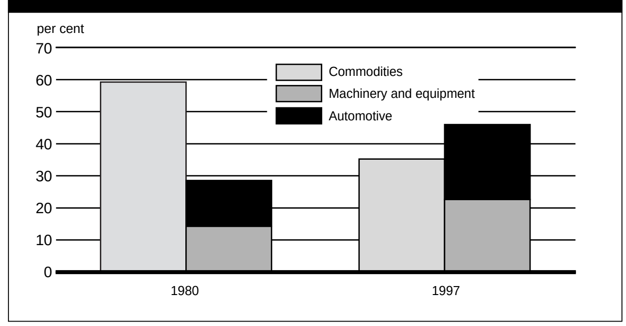
Export and import prices



Current account balance



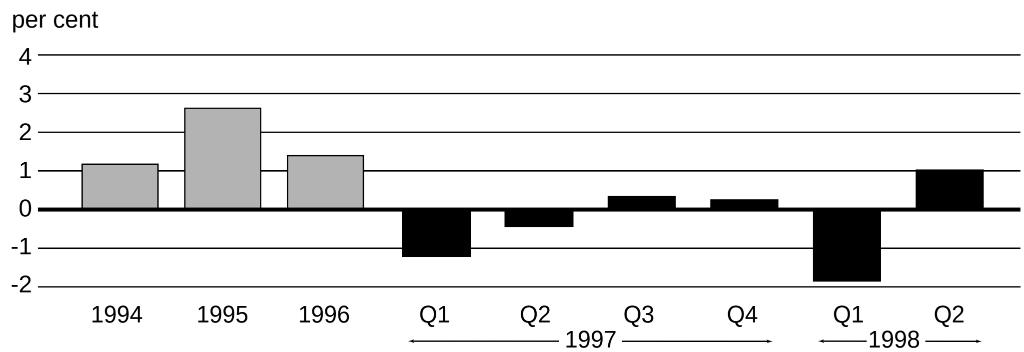
Shares of selected products in Canada's merchandise exports



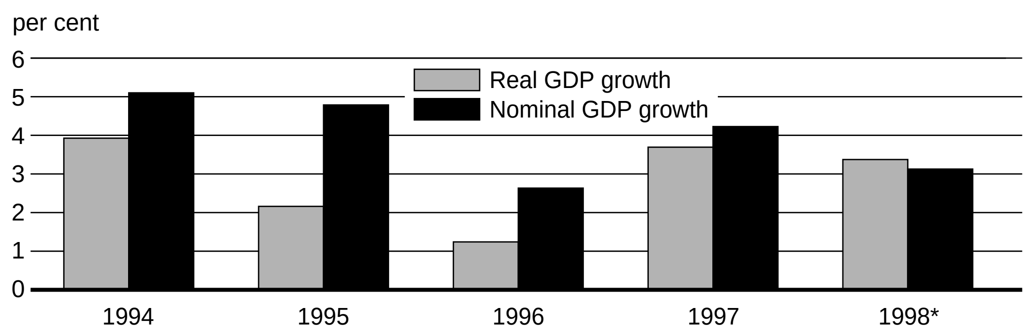
- The large decline in commodity prices has led to a decline in the price of Canada's exports relative to the price of our imports – a deterioration in the terms of trade. This has contributed to a rise in the current account deficit. Nevertheless, as a share of GDP, the current account deficit remains much smaller than in the early 1990s.
  - Less favourable prices of exports relative to imports have the potential to dampen growth in incomes and profits, particularly in the commodities-producing sector.
- While resource-based commodities are still important to the Canadian trade sector, they are much less so than in the past. The share of commodities in Canada's merchandise exports declined from nearly 60 per cent in 1980 to 35 per cent in 1997, while the share of machinery and equipment and automotive exports increased from about 28 per cent to more than 45 per cent over the same period.

The overall price of production and nominal GDP growth are also lower.

GDP inflation



Real and nominal GDP growth

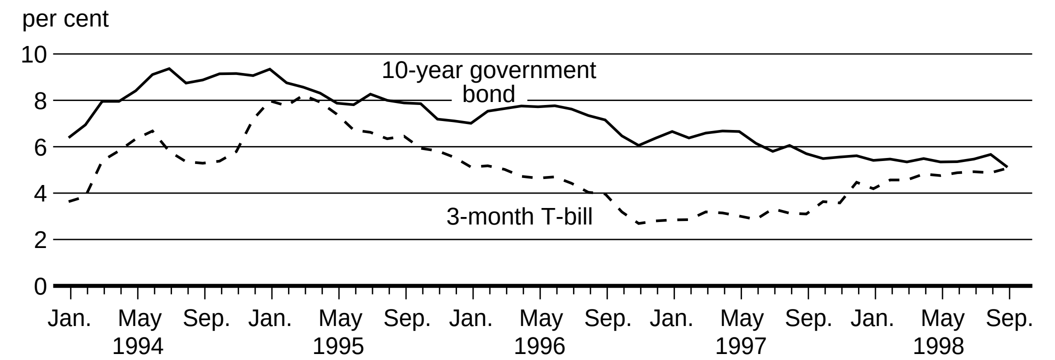


* Growth of real GDP in 1998 is the year-over-year growth for the first two quarters of 1998.

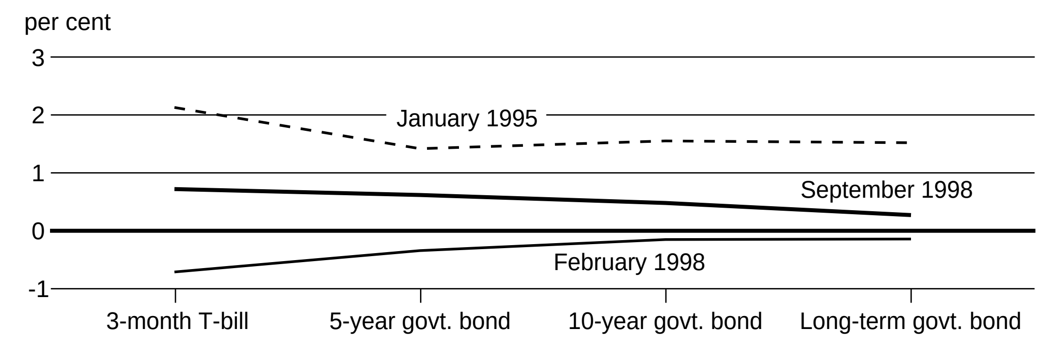
- Less favourable prices of exports have put downward pressure on the aggregate price of Canada's production. For the first time in 35 years, the quarterly growth rate in the aggregate price for Canada's production (GDP inflation) was negative in three of the last six quarters. Moreover, by the second quarter of 1998, this price was 0.5 per cent below its level at the end of 1996.
- Real economic activity expanded at a healthy pace through 1997, with real GDP rising by 3.7 per cent – the second strongest performance seen in the 1990s. But with the slowing growth in the aggregate price of production through 1997, nominal GDP did not increase much more than real GDP in 1997.
- Nominal GDP growth is likely to slow substantially in 1998 compared to 1997, owing to slower growth in both real GDP and GDP price deflator.
  - Nominal GDP growth provides a good approximation for growth in the government's tax base, and thus growth in revenue collections.

But interest rates remain low by historical standards.

Canadian interest rates



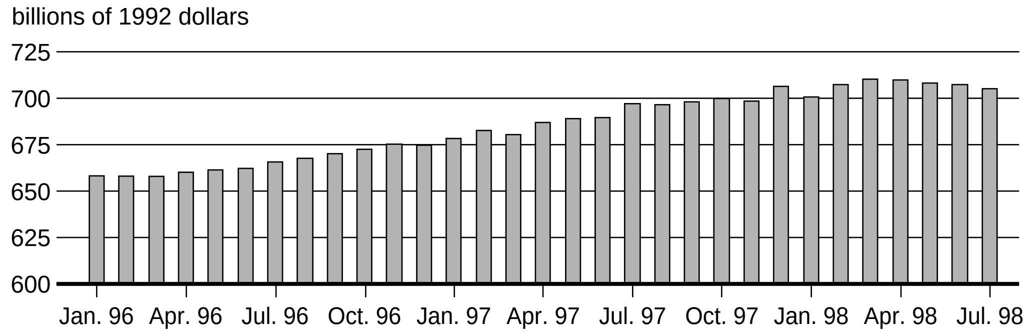
Canada-U.S. spreads along the yield curve



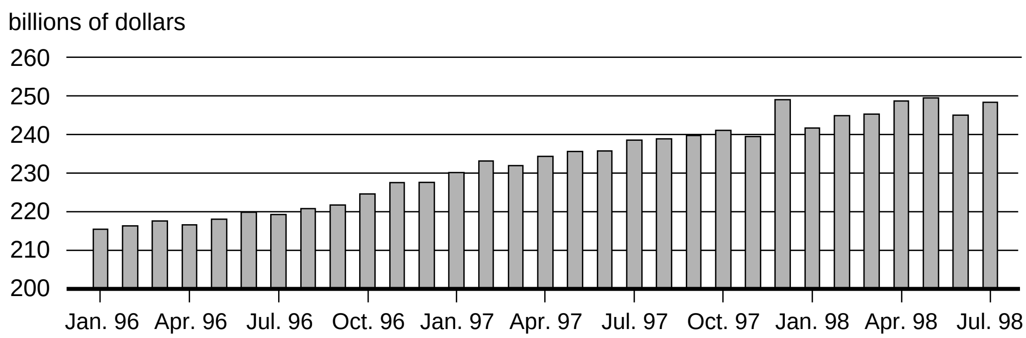
- The implementation of sound economic and fiscal policies over the last four years has helped to reduce interest rates.
- Despite recent increases, interest rates are still much lower than their peak levels reached early in 1995.
  - In particular, at less than 5 per cent at the end of September, both short- and long-term interest rates remain nearly half their average levels over the last two decades.
  - Although Canadian interest rates have moved slightly above U.S. rates, spreads remain well below where they were in 1995 and below historical averages.

Lower interest rates will help support domestic demand.

Real GDP



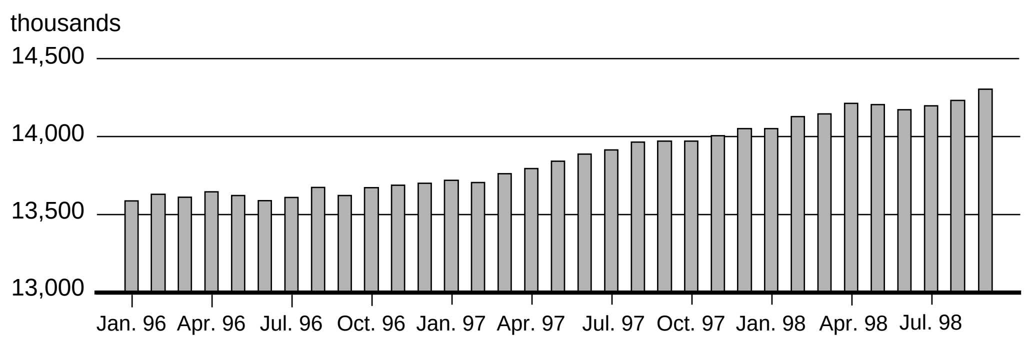
Retail sales



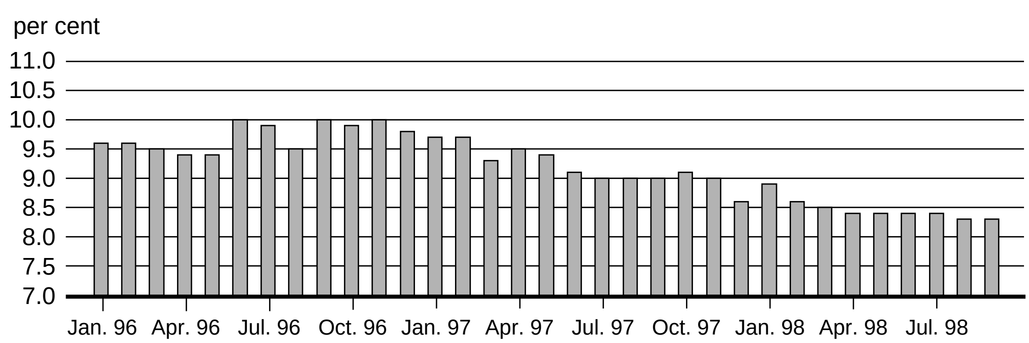
- The Canadian economy expanded at a strong pace through 1997 and into the first quarter of 1998. But B.C. has been hard hit since late 1997 by developments in Asia and in commodities markets.
- Growth moderated to 1.8 per cent (annual rate) in the second quarter and showed some softness at the beginning of the third quarter. However, strikes and other temporary factors have distorted recent data, thereby complicating the assessment of the underlying trend of growth in recent months.
  - For example, the General Motors (GM) strike in the U.S. caused most Canadian GM operations to cease due to parts shortages, forcing many domestic GM suppliers to reduce output as well. The fall in automobile industry output in June and July reduced real GDP growth by 0.3 percentage point in the second quarter and by 0.6 percentage point so far in the third quarter. However, with the end of the strike early in the third quarter, much of this lost activity is likely to be recovered over the rest of the year.
- Nevertheless, a solid rise in retail sales in July augurs well for continued growth in domestic demand in the third quarter.

Job creation has been solid.

Employment

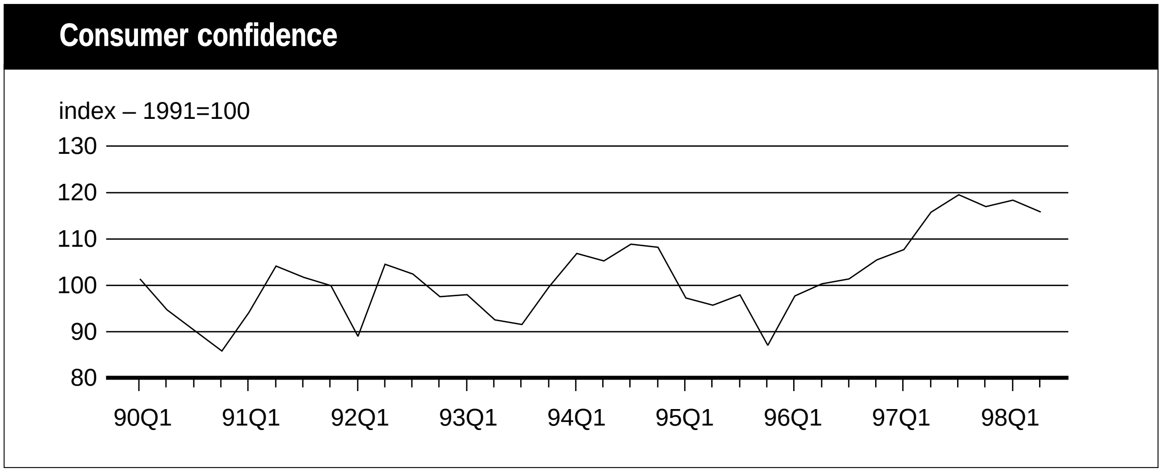


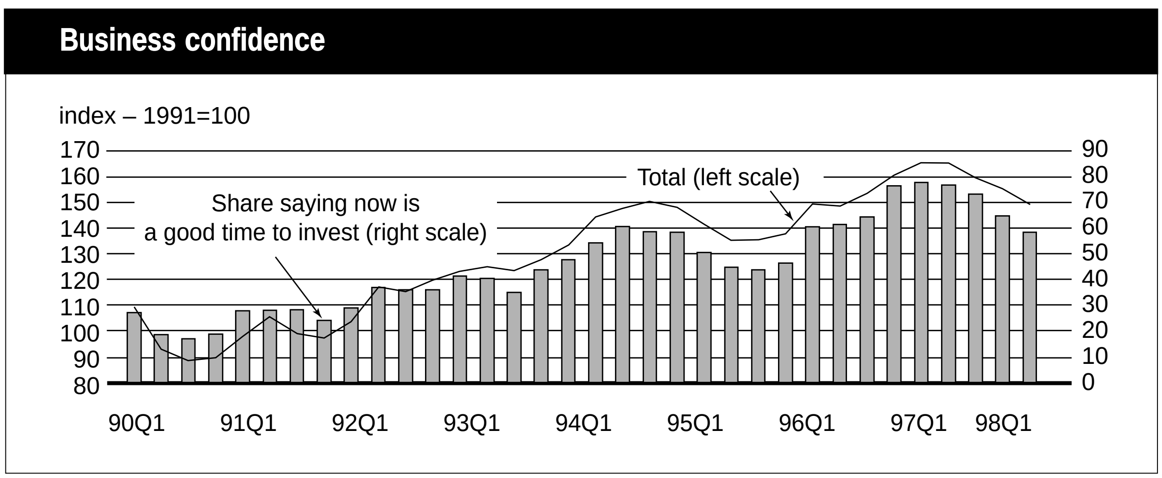
Unemployment rate



- Overall labour market conditions have been healthy – 264,000 jobs have been created over the first nine months of this year, bringing the total number of jobs created to 636,000 since the end of 1996 and to over 1.3 million since the fall of 1993.
- This solid employment growth has driven down the unemployment rate from nearly 10 per cent at the end of 1996 to 8.3 per cent in September 1998 – its lowest level in eight years.

Solid confidence boosted domestic demand.

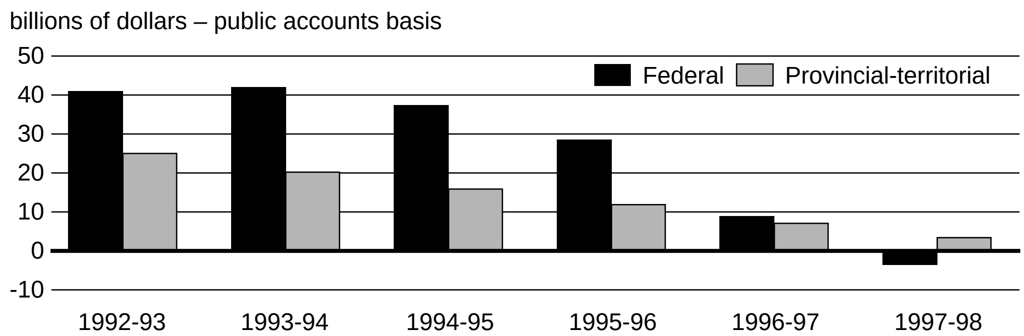




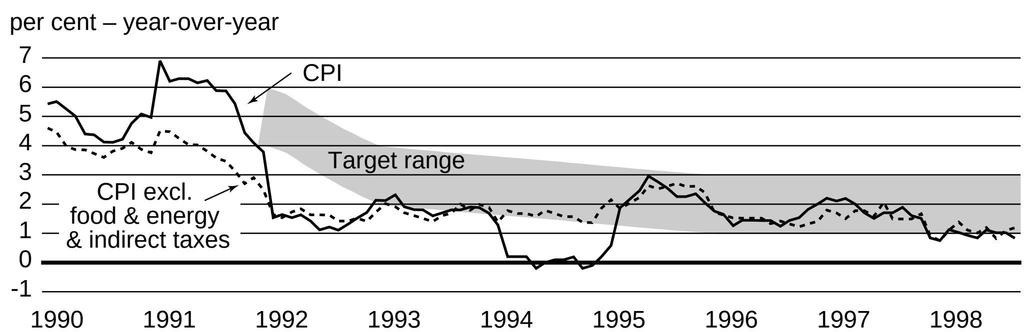
- High levels of consumer and business confidence fuelled the momentum in domestic demand that gathered strength over the last year-and-a-half.
  - Solid consumer confidence boosted strong growth in household spending.
  - Record levels of business confidence contributed to a surge in investment in 1997.
- The turbulence and uncertainty associated with the Asian crisis has shaken both consumer and business confidence from their historically high levels. However, confidence remains above levels witnessed at the beginning of the decade.
- Moreover, solid employment and income growth are favourable to continued growth in consumer spending, while allowing a recovery of the savings rate from the unprecedented negative level witnessed during the second quarter of 1998.

Canada's policy environment remains supportive of growth.

Federal and provincial–territorial deficits

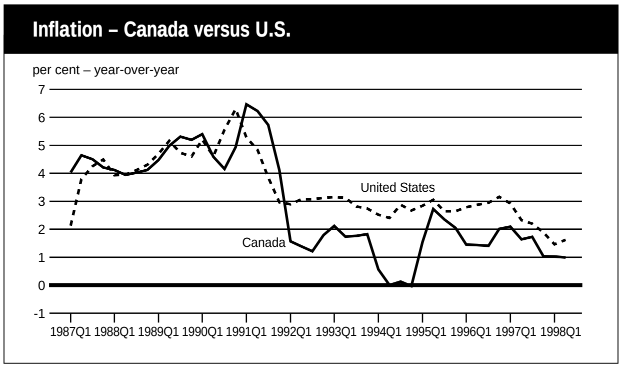


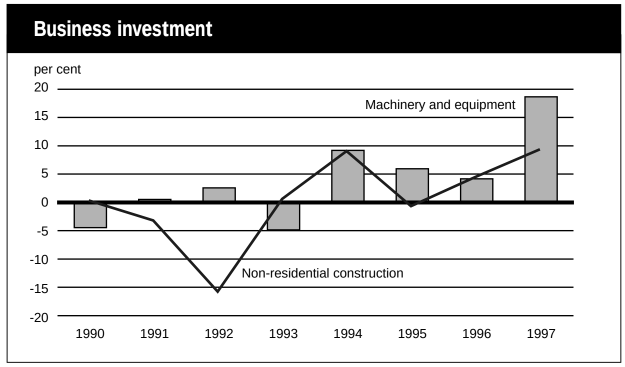
CPI inflation

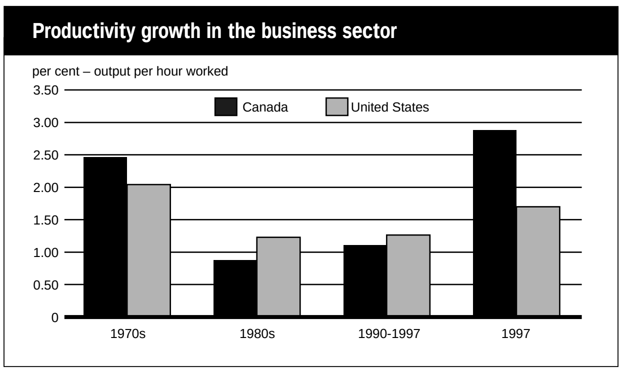


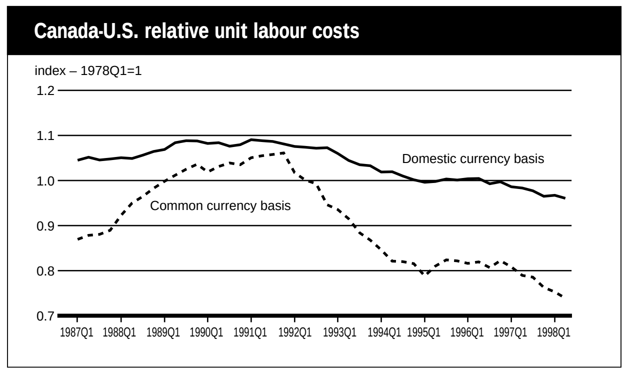
- Although there are still challenges ahead, Canada has made great strides toward establishing a policy environment supportive of sustained growth in the years to come.
- With the federal balance in surplus, and six provincial and territorial governments balanced or in surplus, Canada has made remarkable progress in restoring fiscal health. Indeed, a small surplus was recorded for the total government sector in 1997-98.
- Indeed, Canada's general financial balances have improved from the second worst among the G-7 countries (after Italy) in 1992 to the best in 1997, and are projected to lead all G-7 countries in 1998 and 1999 according to the Organization for Economic Co-operation and Development (OECD) *Economic Outlook*.
- Canada's commitment to low inflation has been amply demonstrated with inflation averaging less than 2 per cent over the last six years. The extension, in February 1998, of the 1- to-3-per-cent inflation target bands through 2001 further solidified this commitment.

Canada's policies have also increased competitiveness.









- Canada's success in maintaining low inflation is directly helping our competitiveness by containing costs.
- A low inflation environment and our success at eliminating the deficit has also led to improved confidence which, in turn, translated into strong investment growth in 1997.
- This is helping Canada to begin to close some of the productivity growth gap that emerged during the 1980s when Canada was hit harder than the U.S. by the general productivity slowdown seen in most industrial countries.
- During the 1990s, Canadian labour productivity growth lagged somewhat behind U.S. gains, in part due to a relatively slower average pace of real GDP growth. In 1997, as growth strengthened, Canadian labour productivity increased by 2.9 per cent. This marked the strongest annual gain in more than a decade and considerably outstripped U.S. productivity growth.
- Stronger productivity growth and moderate wage growth are translating into a decline in Canadian unit labour costs relative to the U.S. in both domestic and common currency terms.

Private sector forecasts for 1998 and 1999[1].

Expansion expected to continue but at a much slower pace than in 1997.

- The September consensus of private sector forecasters is that real GDP growth will be 2.9 per cent in 1998, down from the 3.5-per-cent pace expected in January. In 1999, growth is expected to slow to 2.2 per cent, down from January's expectation of 2.9 per cent.
- GDP inflation is also expected to be significantly lower in 1998 and 1999 than previously forecast. As a result, both the growth and level of nominal GDP are expected to be much lower in these years.

Interest rates are expected to remain low in 1998 and 1999.

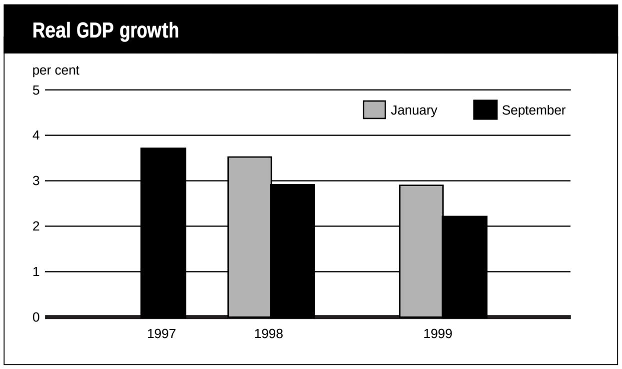
- Private sector forecasters expect the 3-month Treasury bill rate to average 5.0 per cent in 1998 and 5.2 per cent in 1999.
- The yield on Canadian 10-year government bonds is expected to average 5.4 per cent in both 1998 and 1999, down from 6.1 per cent in 1997.

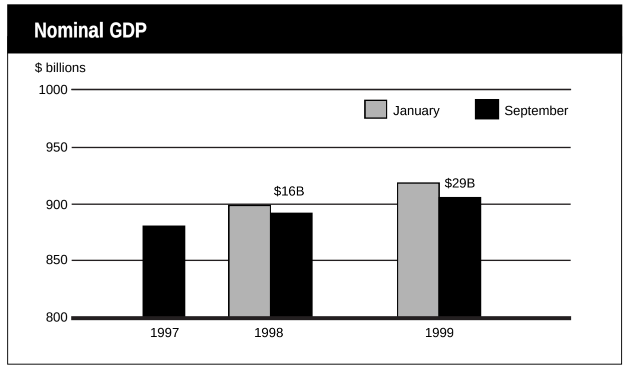
Evolution of private sector forecasts survey results

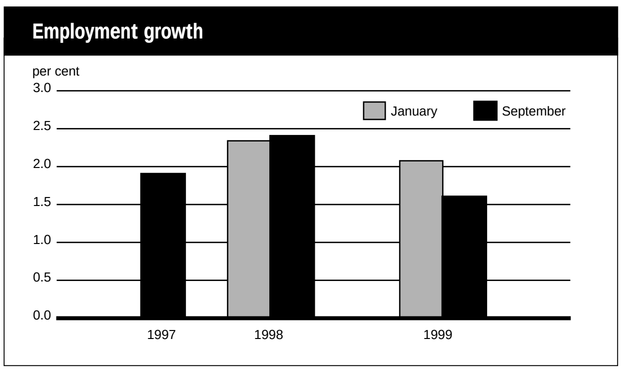
	1997	1998	1999
Real GDP growth (%)			
January 1998	3.8	3.5	2.9
September 1998	3.7	2.9	2.2
GDP inflation (%)			
January 1998	0.7	1.2	2.0
September 1998	0.5	0.1	1.3
Nominal GDP growth (%)			
January 1998	4.5	4.7	4.9
September 1998	4.2	3.0	3.5
Nominal GDP ($ billions)			
January 1998	857	897	941
September 1998	855	881	912
CPI inflation (%)			
January 1998	1.7	1.5	1.7
September 1998	1.6	1.2	1.6
Unemployment rate (%)			
January 1998	9.2	8.5	8.2
September 1998	9.2	8.4	8.3
Employment growth (%)			
January 1998	1.9	2.3	2.1
September 1998	1.9	2.4	1.6
3-month T-bill rate (%)			
January 1998	3.3	4.6	4.6
September 1998	3.3	5.0	5.2
10-year govt. bond rate (%)			
January 1998	6.2	5.9	6.0
September 1998	6.1	5.4	5.4

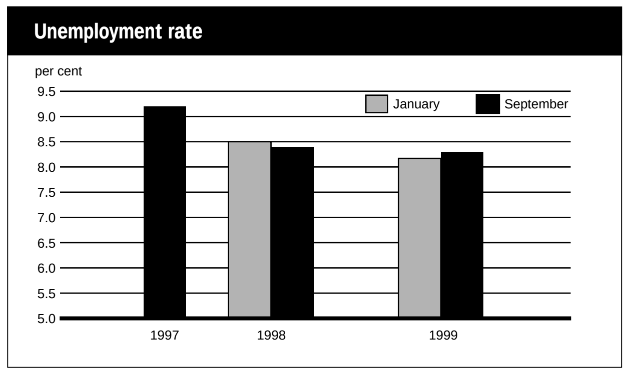
[1] Based on a survey of 24 private sector forecasters of which 20 responded to the September survey.

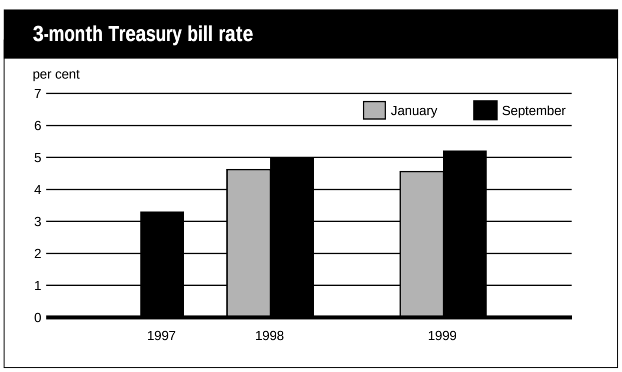
Private sector forecasts for 1998 and 1999.

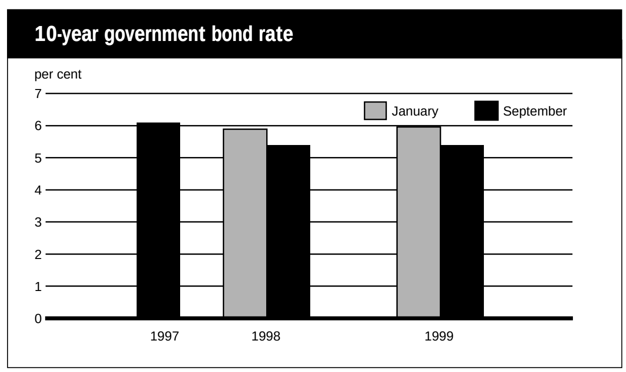






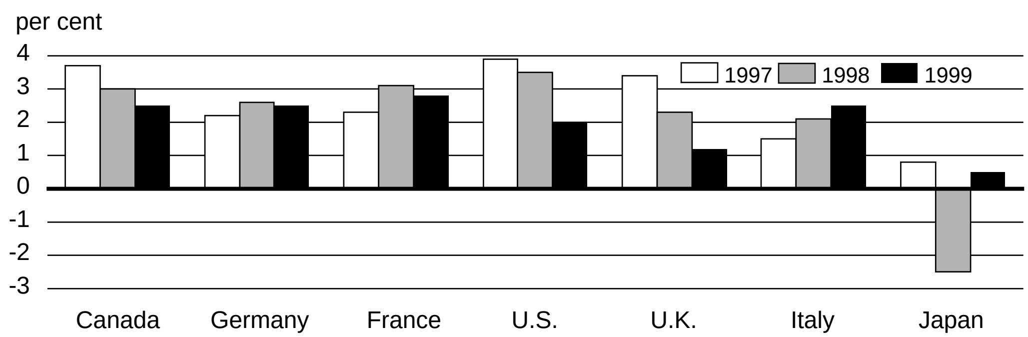




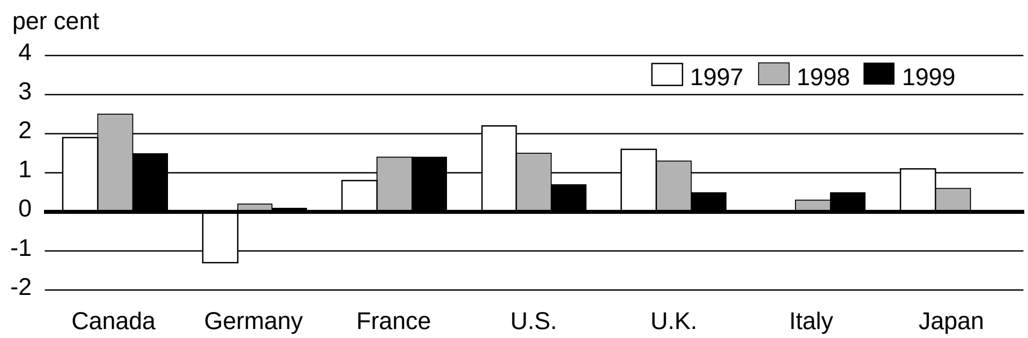


Canada is still expected to be near the top of the G-7 in growth in 1998 and 1999 and to lead in job creation.

IMF forecasts for Canadian real GDP growth for 1998 and 1999



IMF forecasts for Canadian employment growth for 1998 and 1999



Source: IMF *World Economic Outlook*, September 1998.

- Major international organizations remain very positive about Canada's prospects for real GDP and employment growth.
  - For example, in its September forecast, the IMF still expects that Canada's real GDP growth will compare favourably with the other G-7 countries in both 1998 and 1999.
  - And the IMF expects Canada to be well ahead of the other G-7 countries in employment growth in 1998 and 1999.

2

Canada’s Historic Fiscal Progress

Highlights

"Five years ago, the federal deficit stood at $42 billion and rising. We said we would bring it down steadily each and every year. And we did – not only meeting, but beating every target we set."

"I am pleased to announce that, for the first time in more than a generation, the Government of Canada recorded a surplus – $3.5 billion … This is a historic milestone. And it is an achievement that belongs not to government but to Canadians themselves."

"… Canada has in fact recorded a financial surplus for two years in a row – the only G-7 country to do so."

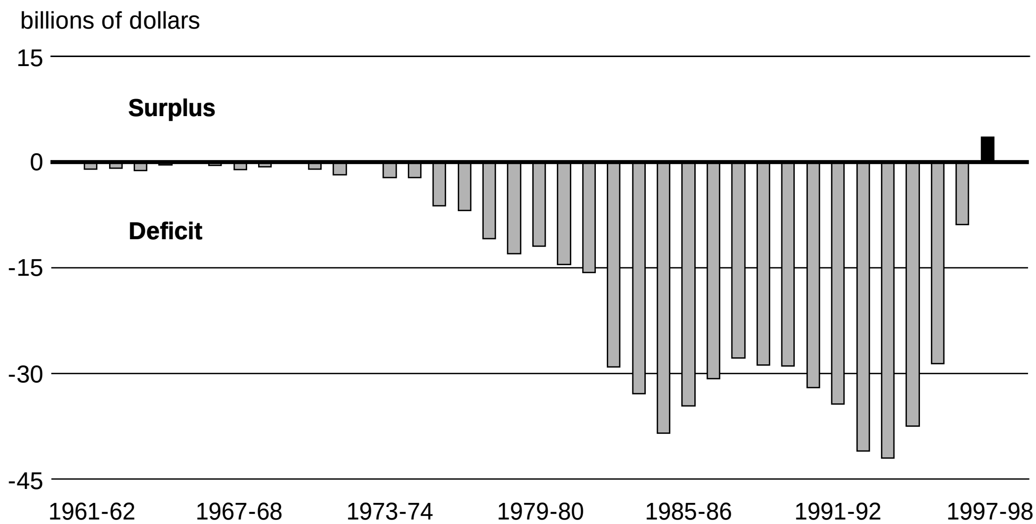
"… We paid down $9.6 billion of market debt last fiscal year. And we will likely be able to report a significant further paydown at the end of the current fiscal year as well."

The Honourable Paul Martin
Minister of Finance

- *The federal government recorded a budgetary surplus of $3.5 billion in 1997-98 – the first since 1969-70.*
- *Since 1993-94, the federal budget has swung from a budgetary deficit of $42 billion to a budgetary surplus of $3.5 billion – a $45.5 billion improvement in just four years.*
- *The fiscal turnaround primarily reflects discretionary actions to reduce and reform program spending and the positive impact of a growing economy on budgetary revenues.*
- *In 1997-98, total program spending as a percentage of the economy (GDP) stood at 12.7 per cent, a decline of 3.9 percentage points since 1993-94. This is the lowest ratio since 1949-50.*
- *The budgetary surplus means that the net public debt fell from $583.2 billion in 1996-97 to $579.7 billion in 1997-98 – the first decline in the absolute level of the net public debt since 1969-70.*
- *The debt-to-GDP ratio is now on a permanent downward track. It fell 3.3 percentage points to 67.8 per cent in 1997-98 – the largest single year decline since 1956-57.*
- *The 1997-98 fiscal year marked the second consecutive year that the government had a financial surplus – the difference between cash coming in to the government and cash going out – the first back-to-back financial surpluses since 1965-66.*
- *The government retired $9.6 billion of market debt in 1997-98.*
- *Fiscal progress at the federal level has been complemented by progress at the provincial level. The aggregate federal-provincial budgetary balance has swung from a record deficit of $66 billion in 1992-93 to a small surplus in 1997-98.*

The federal government went into surplus in 1997-98 – the first time since 1969-70.

Federal budgetary balance
(public accounts basis)



- The federal government recorded a budgetary surplus of $3.5 billion in 1997-98 – the first since 1969-70. This is a sharp improvement from 1993-94 when there was a budgetary deficit of $42 billion.
- The improvement in the federal budgetary balance is the most dramatic turnaround in federal government finances since the Second World War demobilization.
- The budgetary surplus means that the absolute level of the net public debt fell by a corresponding amount in 1997-98.

The 1997-98 surplus reflects a strong economy and continued fiscal restraint.

Financial highlights
(public accounts basis)

	1996-97	1997-98	Change
		billions of dollars	
Budgetary revenues	140.9	153.2	12.3
Program spending	104.8	108.8	3.9
Public debt charges	45.0	40.9	-4.0
Budgetary balance	-8.9	3.5	12.4

Numbers may not add due to rounding.

- The federal budgetary balance moved from a deficit of $8.9 billion in 1996-97 to a surplus of $3.5 billion in 1997-98, an improvement of $12.4 billion.
- A rebound in economic growth, accompanied by strong employment gains, a drop in the unemployment rate to its lowest level in eight years, robust corporate profit growth and higher consumer spending, increased revenues by $12.3 billion.
- Although program spending was up $3.9 billion, more than all of the increase was due to one-time factors totalling $5.5 billion: the Canada Millennium Scholarship Foundation ($2.5 billion); a change in accounting for assistance to international financial institutions ($1.8 billion); compensation for hepatitis C victims ($0.8 billion); and the aboriginal healing strategy ($0.35 billion). Net of these one-time adjustments, program spending would have declined $1.5 billion due to the impact of restraint measures introduced in the 1995 and 1996 budgets.
- The decline in public debt charges was due to a lower average effective interest rate on interest-bearing debt, an absolute decline in the stock of interest-bearing debt, and a change in accounting for interest costs related to public sector pension plans, as recommended by the Public Sector Accounting and Auditing Board and the Auditor General.

The outcome for 1997-98 was better than anticipated in the 1998 budget.

1997-98 outcome and 1998 budget projection
(public accounts basis)

	Outcome	1998 budget estimate	Change
		billions of dollars	
Budgetary revenues	153.2	147.5	5.7
Program spending	108.8	106.0	2.8
Public debt charges	40.9	41.5	-0.6
Budgetary balance	3.5	0.0	3.5

Numbers may not add due to rounding.

- The 1997-98 outcome bettered the 1998 balanced budget estimate by $3.5 billion.
- Most of the better outcome was due to stronger-than-expected revenues ($5.7 billion greater than estimated in the budget), primarily reflecting strong personal and corporate income tax receipts at the end of 1997-98 and adjustments relating to previous fiscal years.
- Public debt charges were $0.6 billion lower.
- The better-than-estimated revenue growth and lower public debt charges were offset somewhat by higher program spending ($2.8 billion greater than estimated in the budget), attributable to higher-than-expected end-of-year accounting adjustments for liabilities incurred during the year.

Fiscal progress since 1993-94 has been due to a growing economy and a reduction in program spending.

Sources of changes in the federal budgetary balance
(public accounts basis)

	1993-94 to 1997-98
	billions of dollars
Factors reducing the federal deficit	
Higher revenues due to economic growth	31.2
Reduction in program spending	16.8
One-time revenue adjustments	3.7
Revenue-raising measures	2.3
Subtotal	54.0
Factors increasing the federal deficit	
Cost of one-time expenditure initiatives	5.5
Increase in debt charges	2.9
Subtotal	8.4
Net improvement in the federal budgetary balance	45.5

Numbers may not add due to rounding.

- The federal budget balance has improved from a deficit of $42 billion in 1993-94 to a surplus of $3.5 billion in 1997-98 – *a $45.5 billion turnaround in just four years*.
- Budgetary revenues increased $37.2 billion. Of this amount, about $31 billion is attributable to economic developments (about 90 per cent of this amount was due to the growth in the economy while about 10 per cent is due to the interaction between the tax system and rising incomes). One-time factors, which depressed revenues in 1993-94 but increased revenues in 1997-98, accounted for about $3.7 billion. Net revenue-raising measures introduced since 1993 (primarily aimed at removing and reducing tax preferences, increasing fairness and ensuring taxpayers pay the taxes they owe when they are due) accounted for an additional $2.3 billion.
- Program spending declined $11.3 billion. This reflects a decline in ongoing program spending of $16.8 billion, partly offset by $5.5 billion of one-time spending initiatives/accounting changes in 1997-98.
- Partially offsetting these positive developments were somewhat higher public debt charges, due to a higher stock of interest-bearing debt.

Fiscal progress since 1993-94: an alternative measure.

Changes relative to growth in economy
(public accounts basis)

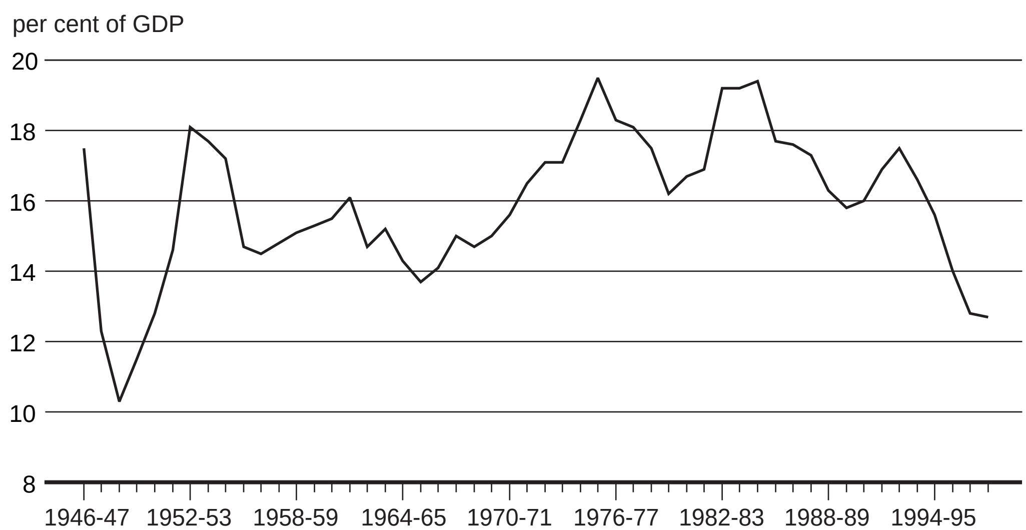
	1993-94	1997-98	Change	Contribution
		per cent of GDP		(%)
Budgetary revenues	16.0	17.9	1.9	30.8
Program spending	16.6	12.7	3.9	61.9
Public debt charges	5.2	4.8	0.5	7.3
Budgetary balance	-5.8	0.4	6.2	100.0

Numbers may not add due to rounding.

- The contribution of revenue increases and expenditure reductions to the improvement in the budgetary balance is best illustrated by looking at the evolution of budgetary revenues, program spending, public debt charges and the resulting budgetary balance as a share of the economy.
- Since 1993-94, the budgetary balance swung from a deficit of 5.8 per cent of gross domestic product (GDP) to a surplus of 0.4 per cent of GDP, an improvement of 6.2 percentage points.
- Less than one-third of the improvement in the budgetary balance was due to an increase in the revenue yield (revenues as a share of GDP). This reflects the impact of one-time factors which depressed revenues in 1993-94 but increased them in 1997-98, revenue-raising measures introduced since 1993, the interaction of the tax system with rising incomes, and the exclusion from nominal GDP of certain components of income subject to taxation (for example, capital gains and income from pension plans).
- Over 60 per cent of the improvement in the budgetary balance was due to the fall in program spending as a share of GDP. This primarily reflects the impact of the discretionary actions taken since 1993, including the expenditure reduction actions taken in the 1995 and 1996 budgets as a result of the Program Review.
- Public debt charges, as a percentage of GDP, declined slightly as a result of a decline in the average effective rate on the government's interest-bearing debt, a slowing in the rate of growth in interest-bearing debt, and a change in accounting for interest costs related to public sector pension plans.

Program spending continues to decline as a share of GDP.

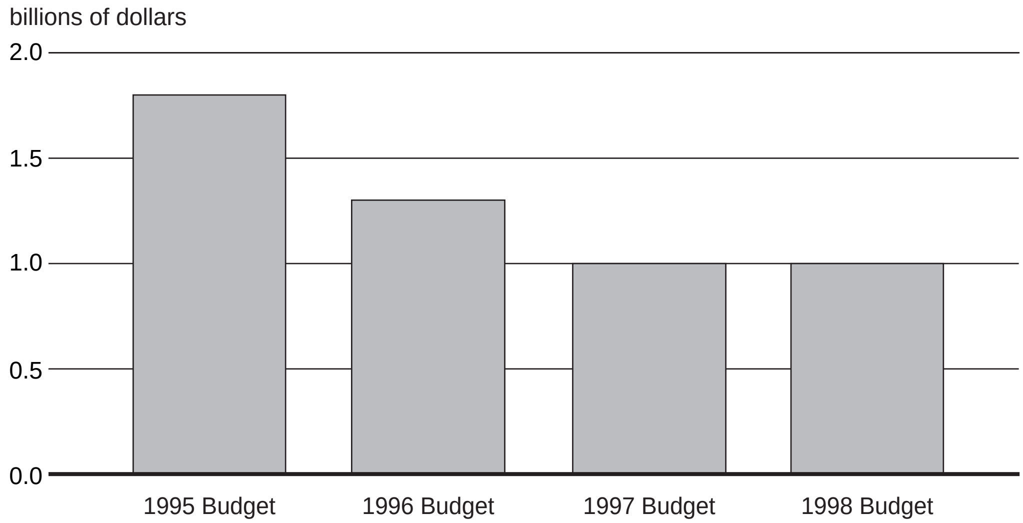
Federal program spending to GDP
(public accounts basis)



- The reforms to program spending undertaken since 1993-94, coupled with strong economic growth, reduced program spending as a percentage of GDP to 12.7 per cent – its lowest ratio since 1949-50 when it was 11.5 per cent.
- Since 1993-94, the ratio has declined 3.9 percentage points. This decline was primarily the result of a fundamental review of all federal government programs, beginning with the 1994 budget and followed up in the 1995 and 1996 budgets. This review was conducted in two parts: most components of direct program spending (total program spending less major transfers to persons and other levels of government) were subject to the Program Review exercises, while major transfers to other levels of government and employment insurance benefits were reviewed separately, to ensure that they would be sustainable over the long term.

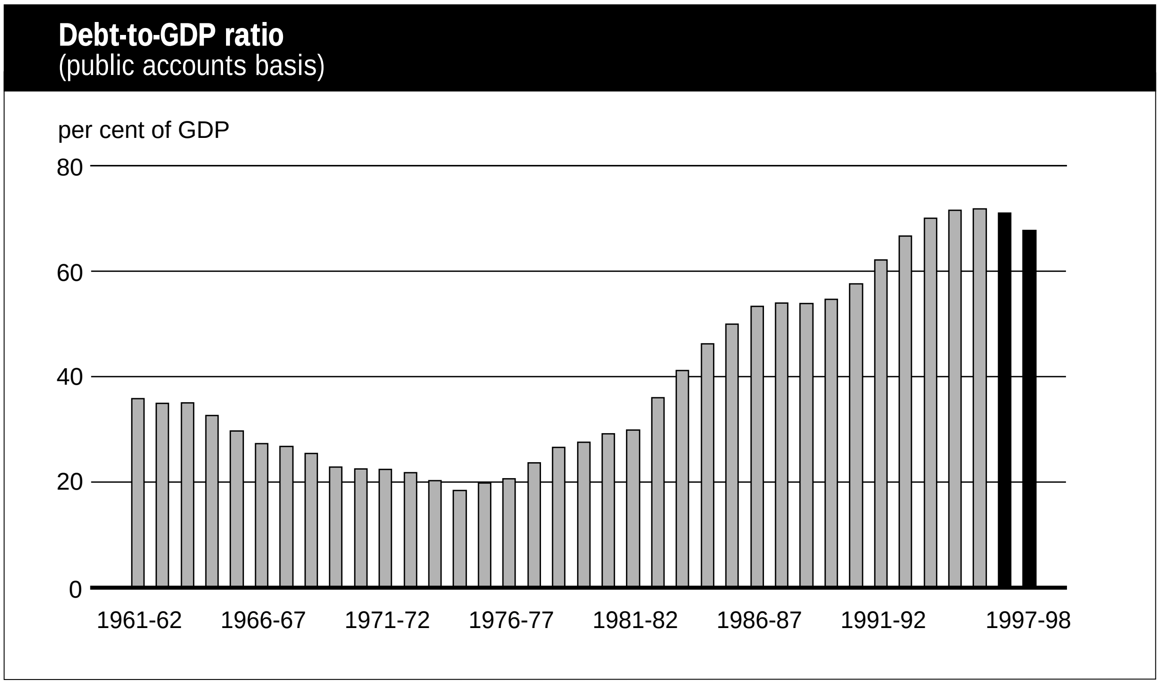
The sensitivity of debt charges to interest rate changes has been reduced.

Sensitivity of public debt charges to 100-basis-point increase in all interest rates: first year impact
(public accounts basis)



- With the high stock of interest-bearing debt, public debt charges represent the largest component of total federal expenditures. It is important, therefore, that the government's debt operations be managed to raise stable low-cost funding and to protect against unexpected changes in interest rates.
- The government has restructured the debt stock to ensure that it is less sensitive to changes in interest rates.
- It has achieved this by increasing the fixed rate share of the government's gross debt to 65 per cent in 1997-98 from 53 per cent in 1993-94.
- As a result, the impact of a 100-basis-point increase in interest rates on the budget balance in the first year of the increase is now about $800 million lower today than at the time of the 1995 budget (i.e. $1 billion compared to $1.8 billion).

The debt-to-GDP ratio is on a permanent downward track.



- With the budget in surplus in 1997-98, the net stock of federal government debt declined.
- However, the best indicator of the burden of debt on the economy is the debt-to-GDP ratio.
- In 1997-98, the debt-to-GDP ratio fell to 67.8 per cent from 71.1 per cent in 1996-97 – a 3.3-percentage-point decline.
- This is the largest single year decline in the debt-to-GDP ratio since 1956-57.
- The debt-to-GDP ratio has declined for two consecutive years – a total of 4.1 percentage points from its peak of 71.9 per cent in 1995-96 – the first back-to-back declines in the debt ratio in over 20 years.
- Through its Debt Repayment Plan, the government is committed to ensuring that the debt-to-GDP ratio continues on a permanent downward track.

There was a financial surplus of $12.7 billion in 1997-98.

Budgetary balance and financial requirements / surplus
(public accounts basis)

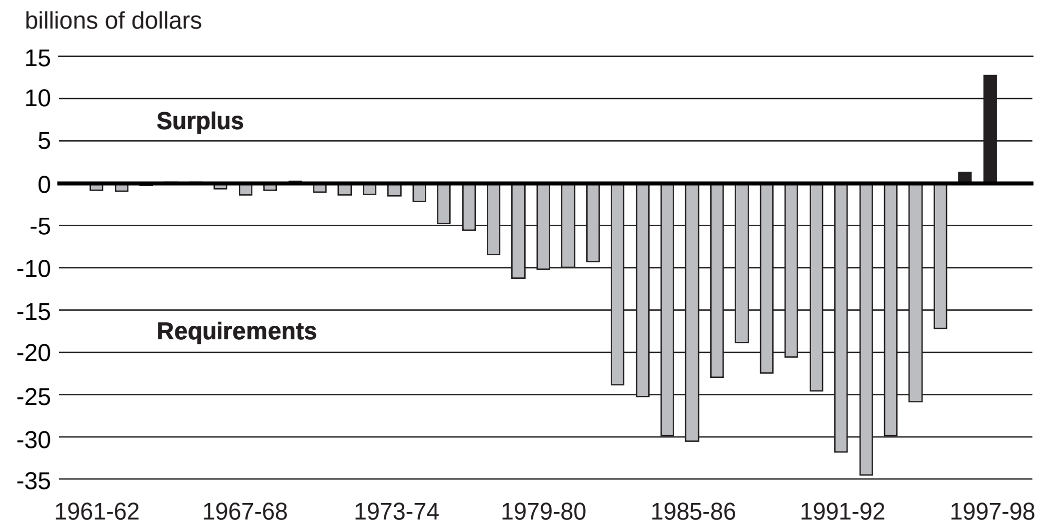
	1996-97	1997-98
	billions of dollars	
Budgetary balance: surplus(+) / deficit (-)	-8.9	3.5
Non-budgetary transactions		
Public sector pension and other accounts	6.9	3.8
Loans, investments and advances	0.3	2.0
Other transactions	3.0	3.4
Total	10.2	9.3
Financial requirements/surplus (excluding foreign exchange transactions)	1.3	12.7

Numbers may not add due to rounding.

- The budgetary deficit/surplus – the budgetary balance – is but one measure of the government's financial position. It is the most comprehensive measure as it includes liabilities incurred by the government regardless of when the actual cash payment is made.
- However, another important measure of the government's financial position is financial requirements/surplus which measure the difference between cash coming in to the government and cash payments made for programs and public debt charges. Thus, financial requirements/surplus do not include liabilities incurred by the government during the year for which there is no cash payment made.
- The adjustments required to convert the budgetary balance to financial requirements/surplus are included in non-budgetary transactions. The largest adjustment relates to the pension accounts for the government's employees which report the net flow of funds into these accounts. Other non-budgetary categories include the government's net investments in loans, investments and advances (primarily to its enterprise Crown corporations and sovereign governments). Other transactions primarily include the adjustments to convert the accrual figures included in the budgetary balance to a cash basis.
- With a budgetary surplus of $3.5 billion and a net source of funds of $9.3 billion from non-budgetary transactions, the financial surplus, excluding foreign exchange transactions, amounted to $12.7 billion in 1997-98, up from a surplus of $1.3 billion in 1996-97.

There has been a financial surplus for two consecutive years.

Financial requirements / surplus (excluding foreign exchange transactions)
(public accounts basis)



- The financial surplus, excluding foreign exchange transactions, of $12.7 billion in 1997-98 marks the second consecutive year in which a surplus was recorded and the first consecutive financial surpluses since 1965-66. This is a dramatic improvement since 1992-93 when financial requirements amounted to $34.5 billion.
- The financial balance is broadly comparable to the measures of the budgetary balance used by other major industrialized countries, including the United States. On this basis, Canada and the United States are the only Group of Seven (G-7) countries in surplus positions in 1997-98 (measured in terms of their respective fiscal years).

Market debt declined $9.6 billion.

Federal government financial assets and liabilities
(public accounts basis)

	1996-97	1997-98	Change
		billions of dollars	
Interest-bearing debt			
Market debt	476.9	467.3	-9.6
Public sector pensions/other accounts	123.7	127.5	3.8
Total	600.6	594.8	-5.8
Current liabilities and allowances	40.1	43.7	3.6
Financial assets[1]	-57.5	-58.8	-1.4
Net public debt	583.2	579.7	-3.5

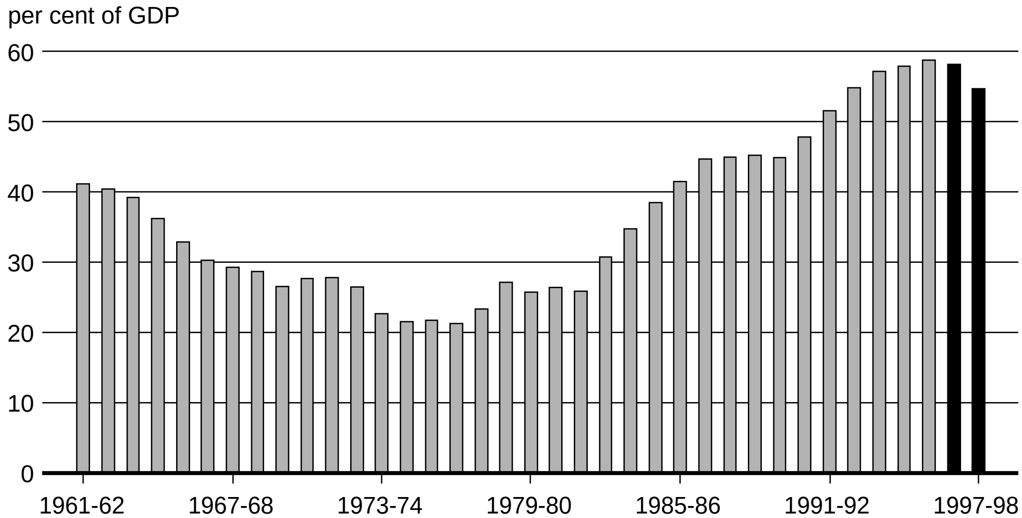
Numbers may not add due to rounding.

[1]Financial assets are shown as a negative entry because they reduce the net debt.

- Net public debt of $579.7 billion in 1997-98 consisted of interest-bearing debt ($594.8 billion), current liabilities and allowances ($43.7 billion) – primarily accounts payable – and financial assets ($-58.8 billion), consisting of cash, accounts receivable, assets in the foreign exchange account, investments in Crown corporations and loans to other governments.
- Interest-bearing debt consists of market debt and the government's liabilities to the federal employees' pension plans and other accounts. The former refers to debt issued on credit markets in the form of Government of Canada bonds, Canada Savings Bonds and Treasury bills. In 1997-98, market debt declined by $9.6 billion while the liabilities to the public sector pensions and other accounts increased by $3.8 billion.
- The government's liabilities to the public sector pensions and other accounts will continue to increase over time. However, with a commitment to balanced budgets in 1998-99 and in 1999-2000, net public debt will remain constant while the stock of market debt will continue to decline.

Market debt declined as a share of GDP for a second consecutive year.

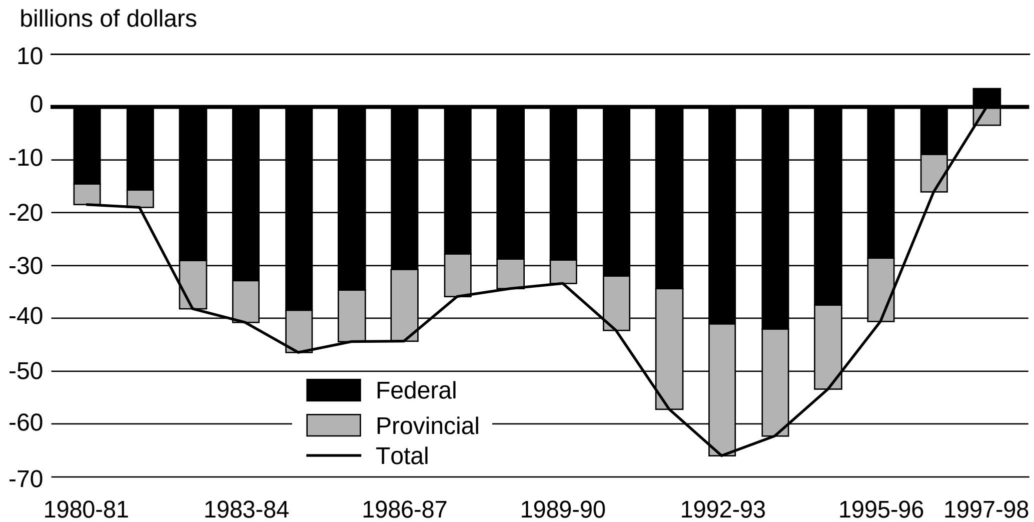
Market debt
(public accounts basis)



- Market debt as a percentage of GDP fell from 58.1 per cent in 1996-97 to 54.6 per cent in 1997-98 – a decline of 3.5 percentage points.
- The decline in market debt-to-GDP in 1997-98 was the largest since 1973-74 when it fell 3.8 percentage points.
- Since 1995-96, market debt as a share of GDP has fallen 4.2 percentage points – the first back-to-back decline since 1973-74.

The aggregate federal-provincial budget is now in a surplus.

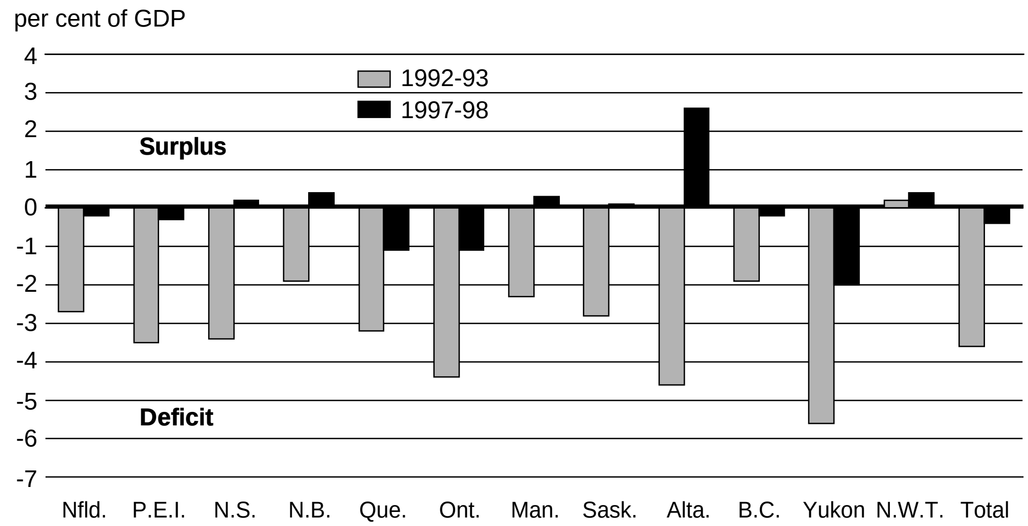
Total federal and provincial deficit / surplus
(public accounts basis)



- Fiscal progress at the federal level has been complemented by progress at the provincial level.
- From its peak of $25 billion in 1992-93, the provincial-territorial deficit declined to $3.4 billion in 1997-98.
- The aggregate provincial-territorial budget is projected to be in balance by 2000-01.
- The total government sector budgetary balance has swung from a deficit of $66 billion in 1992-93 to a small surplus of $0.1 billion in 1997-98.

Half of the provinces and territories realized balanced budgets.

Provincial-territorial budgetary balances
(public accounts basis)

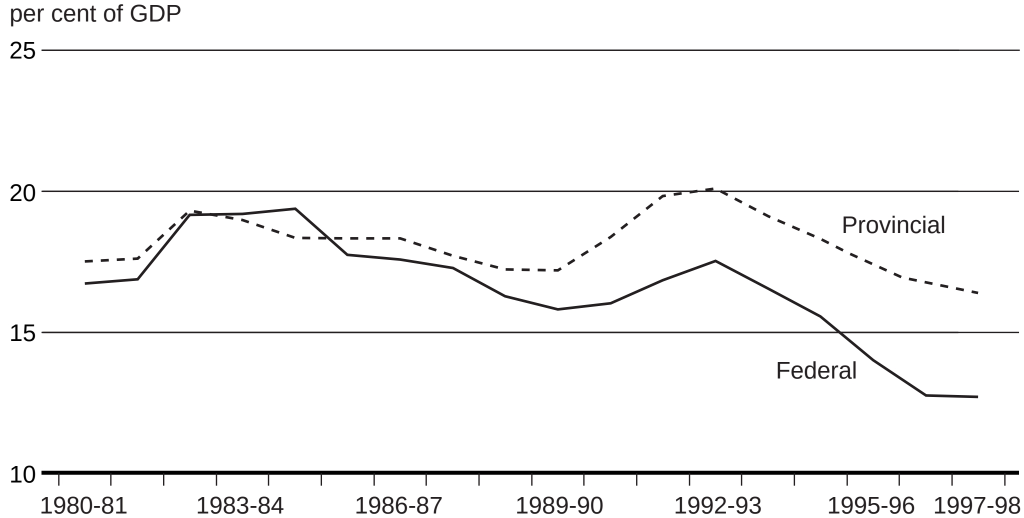


Source: Department of Finance, Canada.

- Five provinces and one territory realized a balanced budget or surplus last year.
- This represents a substantial improvement from 1992-93 when all but one of the 12 provincial-territorial budgets were in deficit.

Provincial program spending has been declining as a share of the economy.

Federal and provincial program spending
(public accounts basis)



- As has been the case at the federal level, deficit reduction at the provincial-territorial level has been achieved primarily through spending reductions.
- From 1992-93 to 1997-98, provincial-territorial program spending has declined by 3.7 percentage points to 16.4 per cent of GDP.
- This compares to a decline of 4.8 percentage points at the federal level.

3

The Challenge of Reducing Canada’s Debt Burden

Highlights

"… it is clear that a quarter century of deficits has left us with a debt burden that is still far too high."

"Too much of every tax dollar goes to pay interest on the debt rather than to purposes that are productive – for the country and for Canadians."

"… our commitment is to keep the debt-to-GDP ratio falling permanently. The Debt Repayment Plan we put in place in the last budget will ensure that happens."

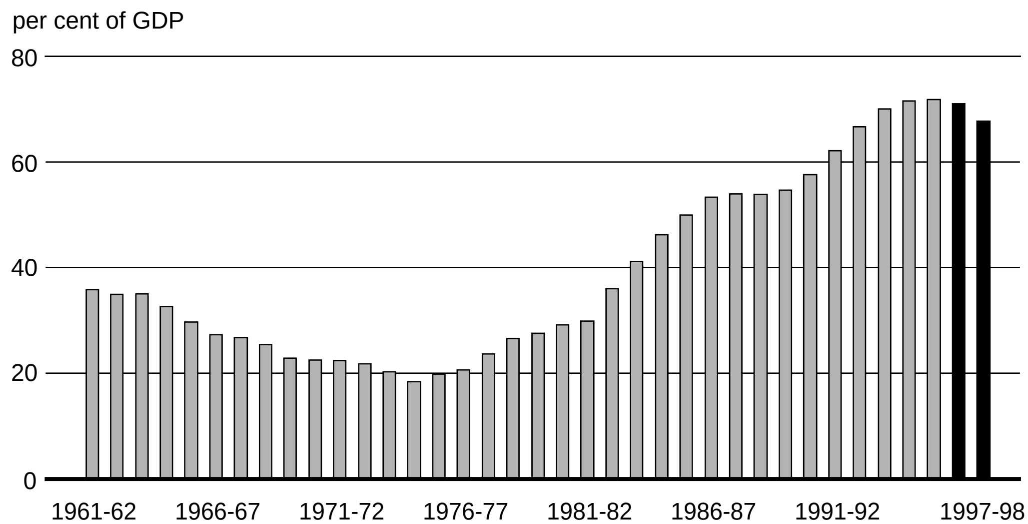
"Our commitment to continued financial progress is rock solid."

The Honourable Paul Martin
Minister of Finance

- *The absolute level of the net public debt declined in 1997-98 – the first decline since 1969-70.*
- *The debt in relation to the level of income generated in the economy – the debt-to-GDP ratio – declined in both 1996-97 and 1997-98 – the first back-to-back declines since the early 1970s.*
- *The federal debt-to-GDP ratio, while declining, is still high in relation to historical experience and the debt-to-GDP ratios of provincial governments.*
- *The portion of every federal revenue dollar consumed by public debt charges in 1997-98 was down to 27 cents from a peak in 1995-96 of 36 cents.*
- *Even at 27 cents, the share of each federal revenue dollar consumed by public debt charges is still high compared to the 13 cents for provincial government revenues.*
- *Recent improvements in Canada's international debt standing must continue in order to maintain and enhance Canada's attractiveness as a location for investment.*
- *Reducing the debt burden now is critical to ensuring that future generations are not left an unduly high tax burden.*
- *The Debt Repayment Plan will ensure that, at a minimum, with the budget in balance, the debt-to-GDP ratio will continue to fall steadily.*

The federal debt-to-GDP ratio is declining but is still high by historical standards.

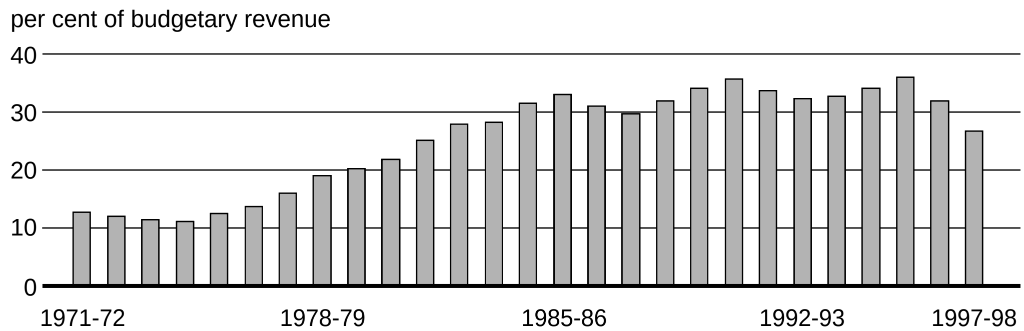
Net public debt-to-GDP ratio
(public accounts basis)



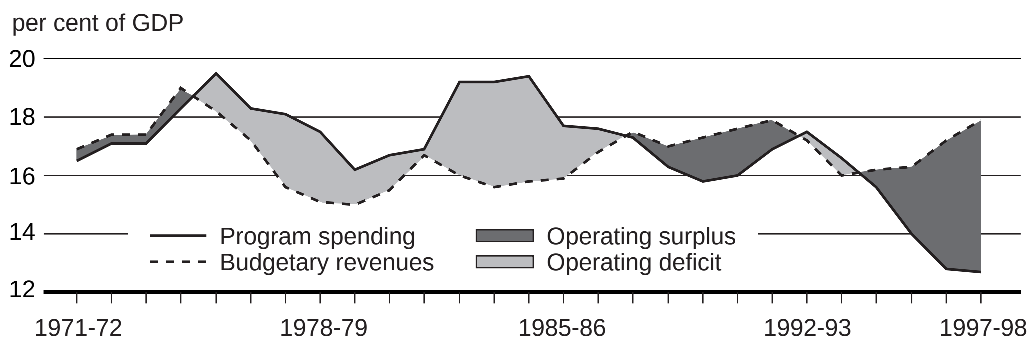
- The net public debt is the accumulation of budgetary deficits and surpluses since Confederation.
- The most appropriate indicator of the burden of the debt is not the absolute level of the debt but its level in relation to total income generated in the economy – the debt-to-GDP ratio. Just as households with higher incomes can support larger mortgages, countries with higher levels of output and incomes can support a larger level of debt.
- The burden of debt remains extremely high by historical Canadian standards – it has only fallen back to where it was prior to 1993-94.

The cost of servicing the debt requires operating surpluses.

Debt servicing costs as a share of revenues
(public accounts basis)



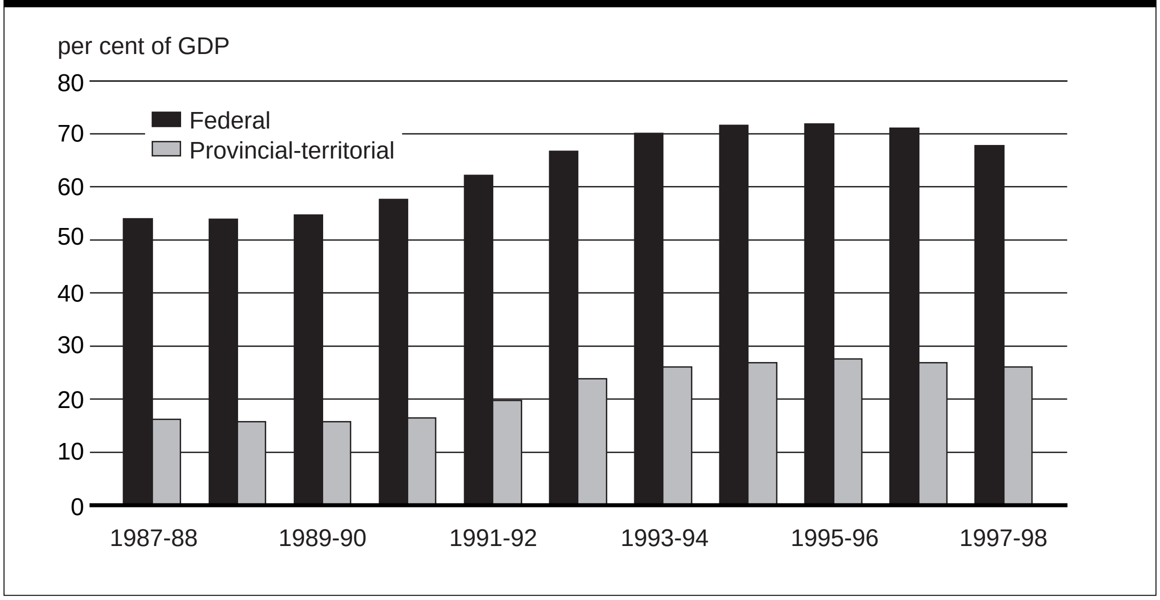
Operating balance
(public accounts basis)



- Another indicator of the burden of debt is the portion of each revenue dollar that must go to paying interest on the debt and the implications this has for the operating balance – revenues less program spending.
- The ratio of debt charges to total revenues has begun to decline as the deficit has been eliminated. In 1997-98, 27 cents of every dollar of revenue went to servicing the debt, down from a peak in 1995-96 of almost 36 cents. Of this decline, 1.8 cents was attributable to the accounting change for interest costs related to public sector pension plans.
- But the cost of servicing this debt remains high. And this means that, just to keep the budget in balance, the government must run large operating surpluses – in other words, revenues must exceed program expenditures by a wide margin. Therefore, the cost of servicing the debt reduces the monies available that could otherwise be used to reduce taxes and fund priority programs.

The federal debt ratio has been more than twice as high as the total provincial government ratio.

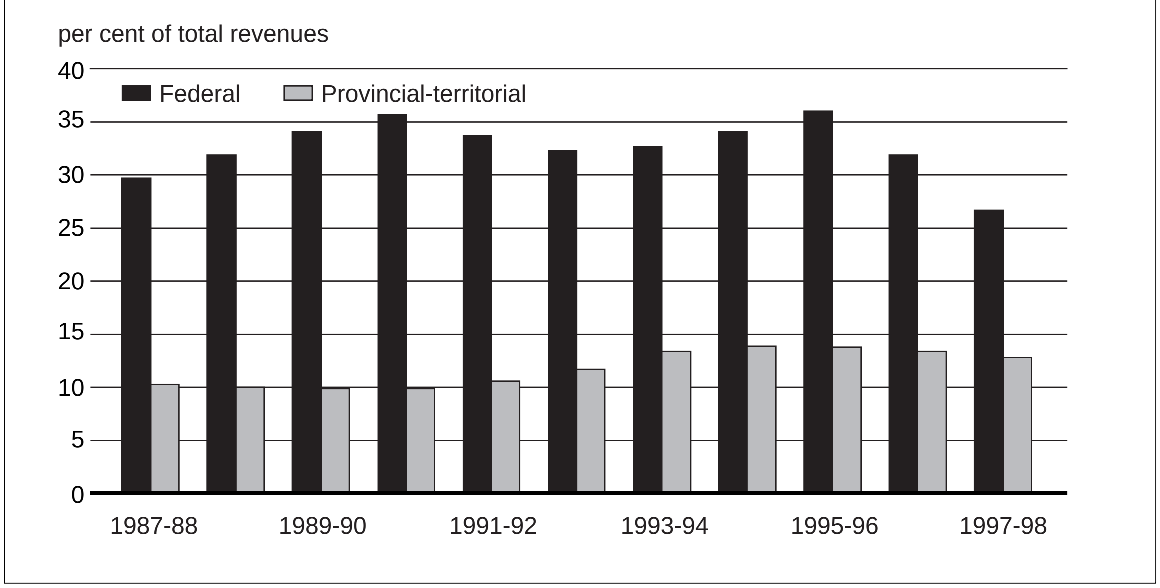
Federal and provincial-territorial net debt
(public accounts basis)



- Relative to the size of the economy, the federal debt has been more than twice as high as provincial-territorial debt ratios throughout the past decade.
- In 1997-98, the federal debt ratio was 67.8 per cent of GDP compared to 26.1 per cent for the provinces and territories.

Debt charges as a per cent of revenues are higher at the federal level.

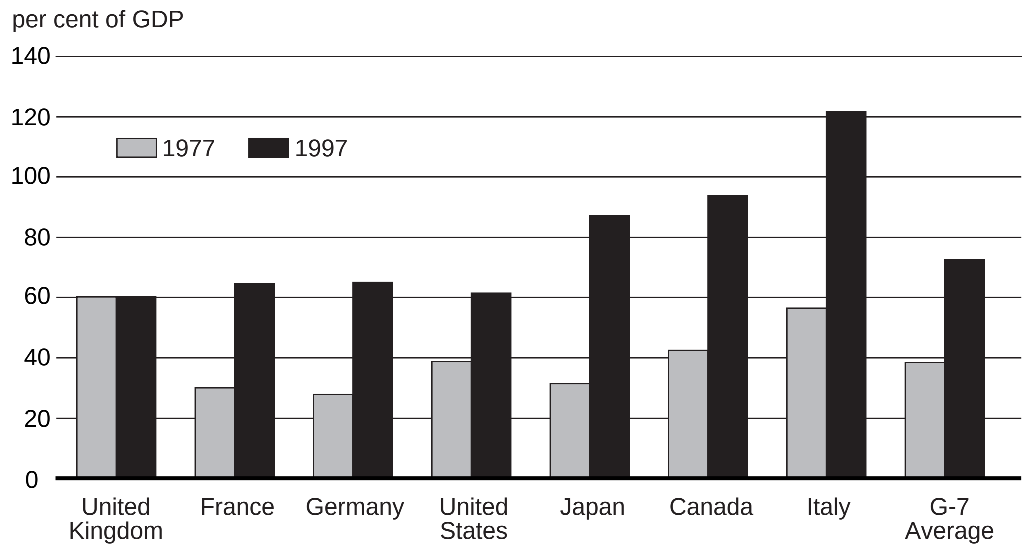
Federal and provincial-territorial debt charges
(public accounts basis)



- The higher federal debt ratio means that debt charges take up far more federal revenue than at the provincial-territorial level.
- In 1997-98, debt charges consumed 13 cents of every dollar in revenue raised by provincial-territorial governments compared to about 27 cents at the federal level.

Canada's public debt is high by international standards.

Total government gross debt
(national accounts basis)

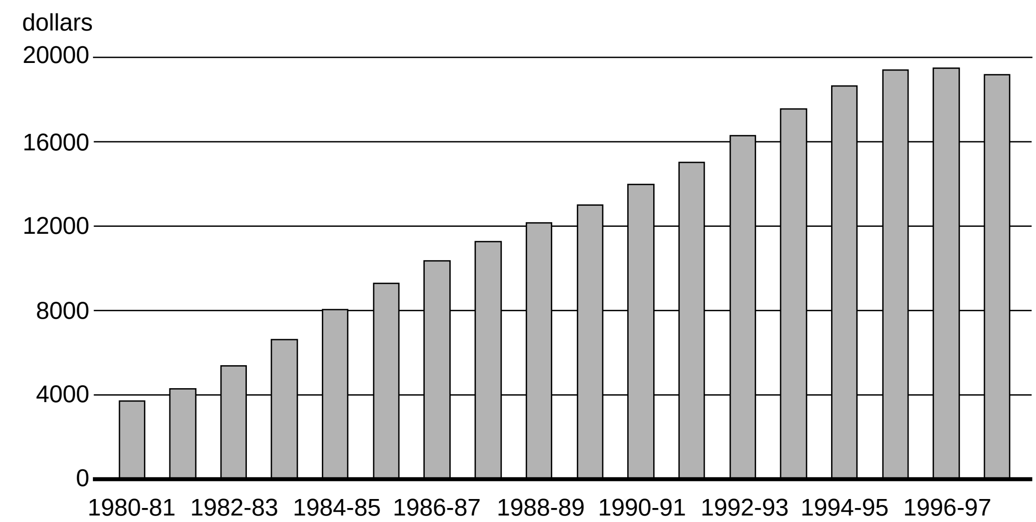


Source: OECD *Economic Outlook* No. 63 (June 1998).

- The deterioration in Canada's total government (federal, provincial and local governments, and the balances in the Canada and Quebec Pension Plans) debt-to-GDP ratio, which started in the mid-1970s, was a feature common to most other Group of Seven (G-7) countries.
- However, in Canada's case, the deterioration was among the most pronounced.
- Between 1977 and 1997, growth in the total government debt in Canada resulted in the second highest gross debt-to-GDP ratio of the G-7 countries (to ensure comparability across countries, this chart uses national accounts data).
- Improving Canada's international debt standing is critical to maintaining Canada's attractiveness as a location for investment.

Reducing the debt burden is also a matter of fairness towards future generations.

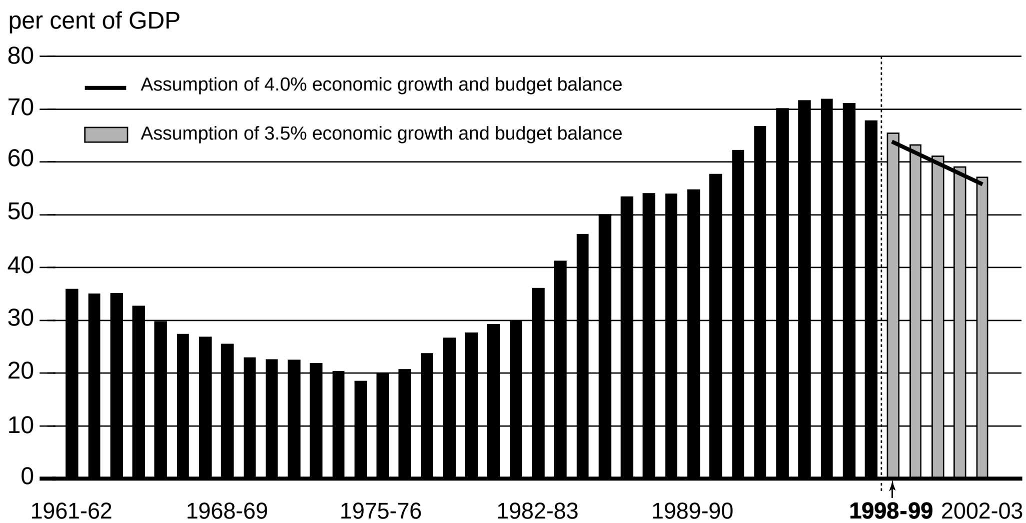
Net debt per capita



- Reducing the debt-to-GDP ratio will ensure that the legacy left to future generations is one of sound economic and social policies, not one of high debt and high taxes.
- Much of the current debt is related to the past consumption of goods and services rather than spending on investments in the economy.
- The debt-to-GDP ratio must be reduced while the generations that benefited the most from its run-up are still in the labour force. This is a matter of fairness.

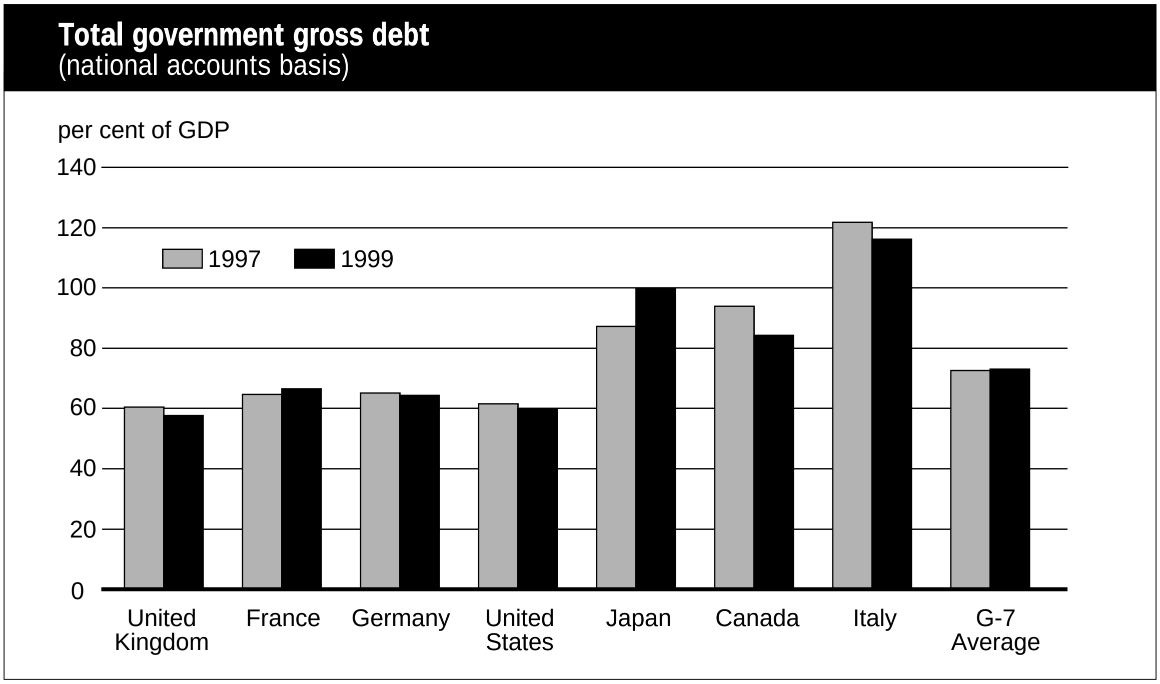
The Debt Repayment Plan, combined with sustained economic growth, will ensure a continuing decline in the debt-to-GDP ratio.

Debt-to-GDP ratio
(public accounts basis)



- The Debt Repayment Plan consists of: two-year fiscal plans based on prudent economic assumptions, a commitment to balanced budgets, a $3 billion Contingency Reserve, and a commitment to use the Contingency Reserve to pay down the debt if it is not needed.
- The key to reducing the debt-to-GDP ratio is sustained long-term economic growth and – at a minimum – ensuring that the budget remains in balance.
- Assuming economic growth (nominal GDP growth) averages 4 per cent annually and an annual budget balance (in other words, holding the net debt at its current level), by 2002-03, the debt-to-GDP ratio would fall to about 55 per cent. If nominal economic growth averaged 3.5 per cent, the debt ratio would fall to 57 per cent by 2002-03. Thereafter, the debt-to-GDP ratio would decline by about 2 percentage points each year.
- If, year by year, the Contingency Reserve is not required and hence goes to paying down the debt, then the respective debt ratios would be about 1.5 percentage points lower by 2002-03.

The debt burden will also decline in relation to other G-7 countries.



Source: OECD Economic Outlook No. 63 (June 1998).

- The Debt Repayment Plan will also ensure that the debt-to-GDP ratio in Canada will continue to decline faster than in other countries.
- According to Organization for Economic Co-operation and Development (OECD) projections, which are based on existing government programs and policies, Canada's gross debt-to-GDP ratio on a national accounts basis will decline by over 9 percentage points between 1997 and 1999, the largest decline of any of the G-7 countries.

4

Strengthening Productivity and Improving the Living Standards of Canadians

Highlights

"The goal of that effort is to raise the standard of living and the quality of life for all Canadians."

"And the only way to get there is to continue, year after year, to put in place the foundation for a stronger, more productive economy."

"… we put in place a long-term plan. Its goal? To provide Canadians with what had been absent for too long: the architecture of a modern, productive economy, one of growth and jobs."

The Honourable Paul Martin
Minister of Finance

- *The central objective of economic policy is to enhance the well-being of people through higher living standards.*
- *The best measure of the living standards is real gross domestic product (GDP) per capita.*
- *Growth in real GDP per capita has slowed markedly in Canada in recent decades.*
- *The government's economic strategy is aimed at reversing this trend, thereby improving living standards.*
- *Deficit elimination, low inflation, trade liberalization, reforms of transfer programs and employment insurance (EI), and government support for skills development, education and new technologies, are designed to increase the rate of productivity growth and boost employment.*

Measuring living standards.

$$\frac{\text{Real GDP}}{\text{Population}} = \frac{\text{Real GDP}}{\text{Employment}} \times \frac{\text{Employment}}{\text{Population}}$$

The most commonly used measure of living standards is real (inflation-adjusted) gross domestic product divided by the size of the population.

- Real GDP is a measure of all goods and services produced in the country in a year.
- Equivalently, real GDP measures the amount of income generated in Canada during a year, including wages and salaries, business profits and earnings from self-employment.

Real GDP per capita is the product of two key variables:

- the average value of goods and services produced by each person working (the productivity level); and
- the proportion of the population that is working (the employment rate).

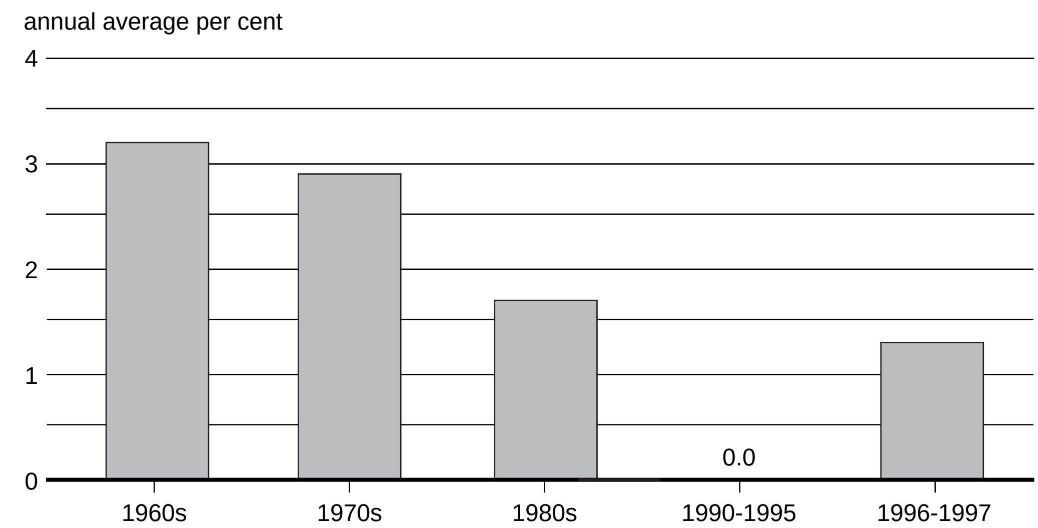
The higher the productivity level of each worker and the larger the share of the population that is working, the higher real GDP per capita will be, everything else equal.

Thus, living standards can be improved:

- by increasing average labour productivity; and
- by increasing the employment rate.

Growth in real GDP per capita has slowed in recent decades.

Growth in real GDP per capita



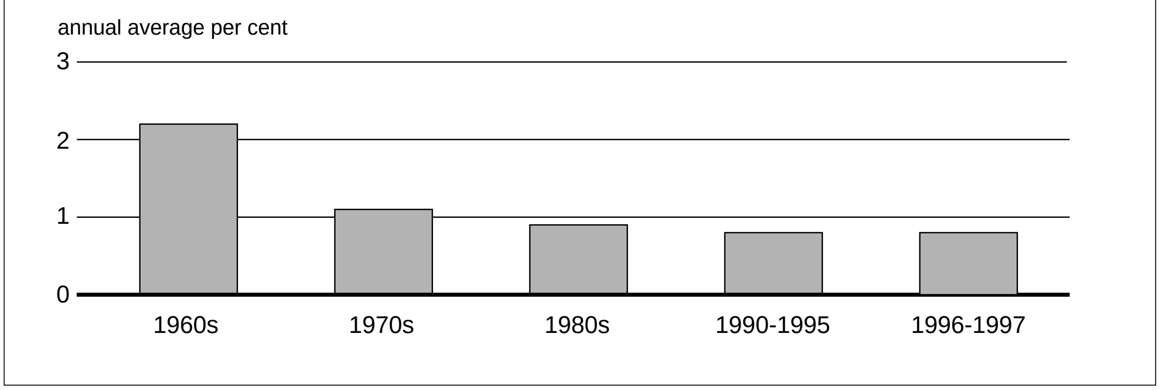
Source: Statistics Canada.

What has happened to real GDP per capita in Canada over the last few decades?

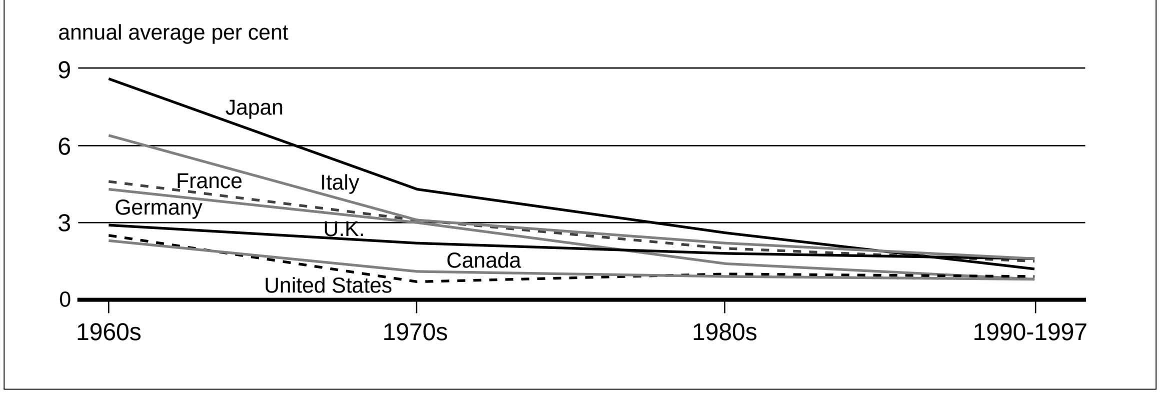
- In the 1960s and 1970s, real output per capita grew rapidly.
- However, growth in real GDP per capita has slowed noticeably since the end of the 1970s.
- In the first half of the 1990s, real GDP per capita failed to grow at all, although there has been some improvement in the last two years.

The growth of labour productivity has slowed in Canada and throughout the industrialized world.

Growth of labour productivity in Canada



Growth of labour productivity in G-7 countries

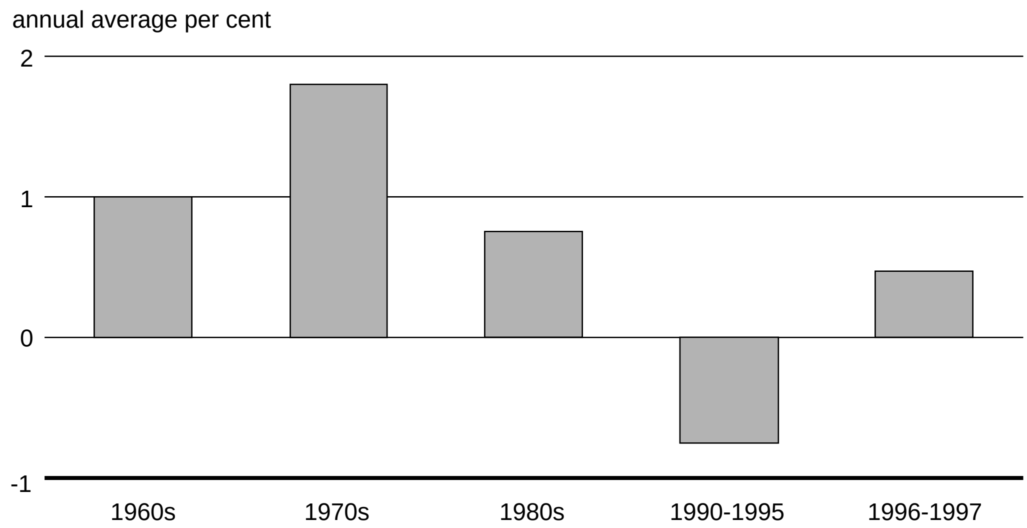


Sources: Statistics Canada, OECD.

- Labour productivity growth in Canada has slowed from over 2 per cent per year in the 1960s to less than 1 per cent in both the 1980s and so far this decade.
- Canada was not alone in experiencing a slowdown in the growth of labour productivity. Every major industrialized country has experienced a similar or even greater slowing of productivity growth. Nonetheless, throughout the 1980s and most of the 1990s, Canada has recorded the lowest rate of productivity growth among the Group of Seven (G-7) countries.

The employment rate fell over the first half of the 1990s but has recently begun to rise again.

Change in the employment rate

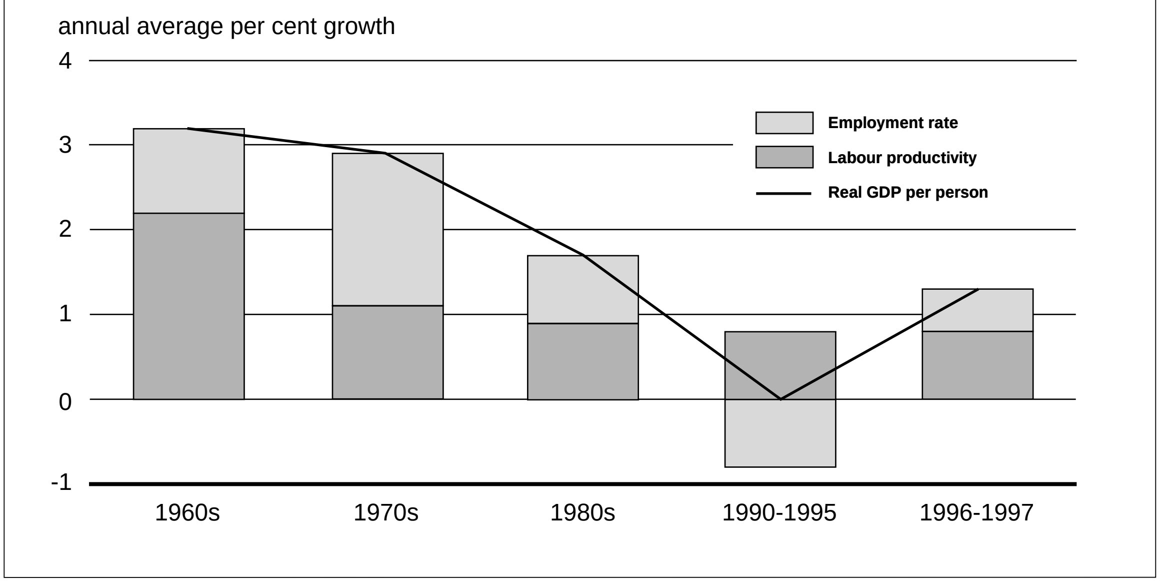


Source: Statistics Canada.

- The employment rate is sensitive to structural factors such as the age structure of the population, the average length of schooling and the customary retirement age. It is also subject to the business cycle, falling when the economy is weak and rising when it is strong.
- During the 1960s, 1970s and into the 1980s, large numbers of young baby boomers were entering the workforce. As well, more women were taking jobs. Both trends pushed up the employment rate, boosting growth in real GDP per capita.
- In the 1990s, however, there are fewer young people coming into the workforce, the female employment rate is no longer rising rapidly, youth have been staying in school longer, and there has been a rising trend towards early retirement. In addition, the labour market has been generally weak. These factors have all worked to depress the employment rate which fell over the first half of the decade.
- As the economy has strengthened over the last few years, rising employment has led to a pickup in the employment rate. This is expected to continue over the next several years, and the employment rate is expected to rise modestly in the next decade.
- However, the bulk of the baby boom will retire in the next 25 years which could push the employment rate down substantially, starting from about 2005 and accelerating from about 2010.
- With the impending retirement of the baby boom, the employment rate cannot be expected to rise to support growth in real GDP per capita. This means that higher productivity growth is essential to ensure higher living standards for Canadians.

Combining productivity growth and the employment rate.

Explaining growth of real GDP per capita



Source: Statistics Canada.

Together, the pattern of slowing labour productivity growth and fluctuations in the employment rate explain the slowing of growth of real GDP per capita since the 1960s.

- In the 1960s, with both rapid productivity growth and a rising employment rate, real GDP per capita grew rapidly.
- In the 1970s, slowing productivity growth was partially masked by a sharp increase in the employment rate so that real GDP per capita continued to rise rapidly.
- However, in the 1980s, productivity growth slipped somewhat further and growth in the employment rate was significantly reduced. As a result, real GDP per capita grew only about half as fast as in the earlier decades.
- In the first half of the 1990s, continued modest productivity growth was negated by a fall-off in the employment rate and, as a result, real GDP per capita stagnated.
- In the last few years, a pickup in the employment rate and continued modest productivity growth have led to renewed growth in real GDP per capita.
- Productivity growth and employment levels are influenced by a wide range of policies. No single policy initiative can, by itself, dramatically speed the growth in Canadians' living standards. What is required is action in a broad range of areas.
- The payoff from a concerted strategy of supporting productivity growth and employment will be a better standard of living for all Canadians.

Government policies to promote higher living standards.

Policy area	Channels	Accomplishments
Fiscal and monetary policy	A stable macroeconomic environment with low inflation brings lower interest rates and boosts confidence, encouraging investment which enhances productivity growth and boosts employment	Federal deficit eliminated Debt-to-GDP ratio on a clear downward path Substantial fiscal progress at the provincial government level Low inflation record of 1990s
Tax policy	Taxes can affect the allocation of resources and alter the incentives to work, save and invest	Beginning of general tax relief National Child Benefit System to support working parents HST to reduce compliance costs
Support for education and skills development	Gets more people into the workforce, boosting the employment rate. Helps people get higher productivity, higher wage jobs	Canadian Opportunities Strategy Canada Millennium Scholarships Canada Study Grants and tax relief for interest on student loans Canada Education Savings Grants Increased education and tuition tax credits SchoolNet to give young students Internet access Increased funding for youth at risk who lack basic education and job skills
Support for R&D	Provides the innovation needed to improve production processes, boosting productivity	Canada Foundation for Innovation Technology Partnerships Canada Tax support for R&D Networks of Centres of Excellence
Social and labour market policies	Influences work incentives Can facilitate workforce participation by removing barriers	EI reform
Trade policy	Increases competition and allows countries to specialize in products they are good at making, boosting productivity and competitiveness	NAFTA Leading player in WTO Ongoing efforts to ensure the free flow of goods and services within Canada
Letting the market work	Regulation and subsidies can dampen market signals and distort the allocation of resources, inhibiting productivity growth Privatization can enhance competition and boost productivity	Reduced business and transportation subsidies Partial or full privatization of Air Canada, Petro Canada, Canadair, De Havilland Canada and CN

5

Building a Strong Foundation for the Canadian Dollar

Highlights

"But it is the structural problems that were allowed to fester over a period of 25 years that have caused its [the Canadian dollar's] long-term decline."

"The markets have an image of the Canada of yesterday, not the Canada of today."

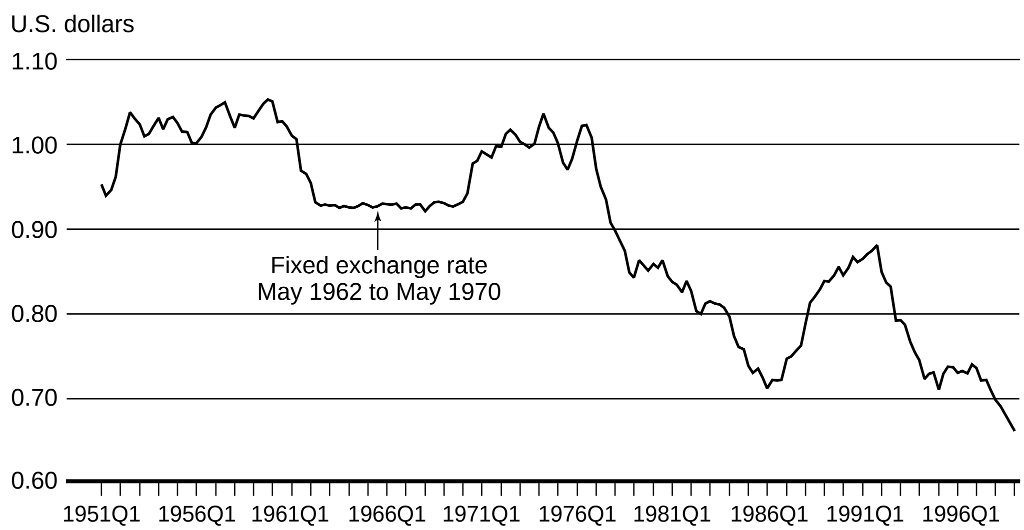
"This reality is Canada: more diversified, more sophisticated and anchored in a much sounder financial footing than it has been for decades."

The Honourable Paul Martin
Minister of Finance

- *Economic and policy developments both in Canada and in our trading partners influence the external value of the Canadian dollar.*
- *The weakness in the dollar over the past year, punctuated by a series of record lows against the U.S. dollar in August, reflects external developments: sharp declines in world commodity prices and the international financial market volatility stemming from the financial crises in Asia and Russia that boosted the U.S. dollar relative to all currencies.*
- *In contrast with the U.S. and other Group of Seven (G-7) countries, Canada is a net exporter of commodities. When commodity prices fall, our net exports fall and so does the value of the Canadian dollar.*
- *But foreign exchange markets may have overlooked the changes in the Canadian economy.*
- *Canada's dependence on commodity-based exports has steadily declined from 60 per cent less than 20 years ago to 35 per cent.*
- *And action has been taken to deal with the problems that contributed to the weakening of the dollar in the past such as poor inflation performance in the 1970s and 1980s, chronic government deficits and growing public debt.*

The historical evolution of the dollar.

The Canadian dollar: 1951Q1 to 1998Q3



Source: Bank of Canada.

- From the 1950s to the mid-1970s, which includes the period from May 1962 to May 1970 when the exchange rate was pegged, the Canadian dollar was relatively stable and remained close to parity with the U.S. dollar.
- From the mid-1970s to the mid-1980s, the dollar steadily drifted downward from just under $1.04 U.S. in June 1976 to a then-record low of 69.13 U.S. cents in February 1986. This downward trend reflected a number of factors: falling real commodity prices; deteriorating fiscal positions in Canada; and increasing inflation in Canada relative to the U.S.
- From the low in 1986, the dollar temporarily appreciated to over 89 U.S. cents in November 1991. This appreciation was due to Canadian interest rates rising sharply above U.S. rates to reduce inflation and rising commodity prices.
- As the interest rate differential narrowed and the U.S. economy recovered more rapidly than the Canadian economy, the dollar drifted back down. By April 1994, the dollar had moved down to the 72-U.S.-cent range.
- From early 1994 to late 1997, the dollar was relatively stable, trading in the 71- to 75-U.S.-cent range.
- Over the summer, as the Asian and Russian financial crises deepened, the dollar moved down through a series of new lows to a record closing low of 63.31 U.S. cents on August 27, before rebounding in September.

Factors influencing the Canadian dollar.

Long-term structural factors

- Terms of trade (commodity prices)
- Canada's economic performance and policies relative to trading partners

In general, these factors exert a strong influence on the longer-term trend movements in the exchange rate.

Some of these factors are beyond Canada's control, such as movements in our terms of trade (driven principally by swings in commodity prices) and economic performance and policies in our major trading partners.

Canadian economic and financial performance is an important factor influencing the exchange rate. This includes inflation, unit labour cost growth, government deficits, public debt and the current account balance.

Short-term factors

- Interest rates
- Investor confidence (domestic policy, political developments and uncertainty)
- Safe-haven effects (international market volatility)

The short-term macroeconomic policy stance in Canada can exert a strong influence on the Canadian dollar. The exchange rate, for example, is affected by changes in the short-term interest rate differential with the U.S.

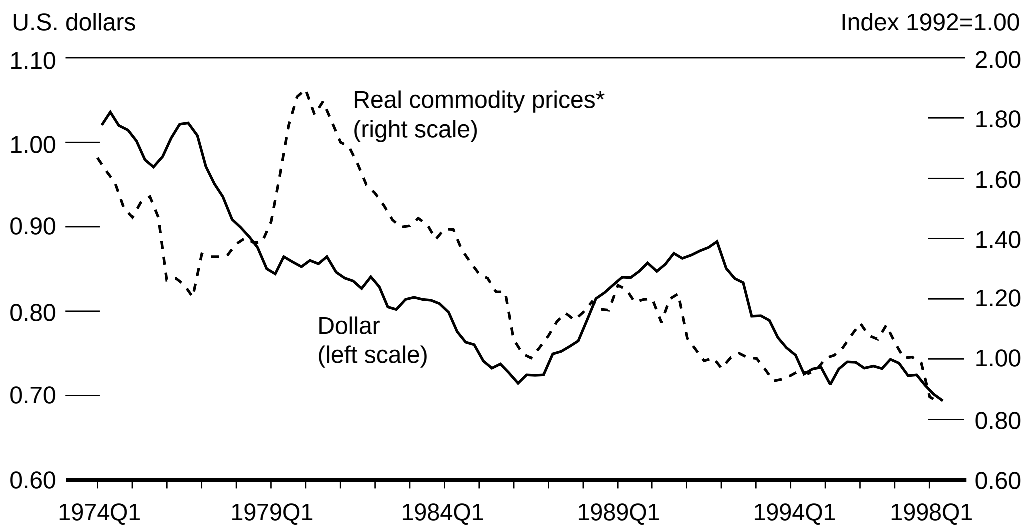
A tightening of Canadian monetary conditions that raises Canadian interest rates relative to those in the U.S. tends to cause the dollar to rise. As well, expectations of changes in the policy stance can also bring about immediate changes in the exchange rate.

Confidence and safe-haven effects can also be important factors for the exchange rate. Investor sentiment towards a country's currency can swing in response to both domestic and international economic and policy developments and political uncertainty.

For example, the U.S. dollar typically strengthens during periods of financial market turbulence as it has with the Asian and Russian financial crises.

Real commodity prices are a key factor in the evolution of the dollar.

Relationship between dollar and commodity prices

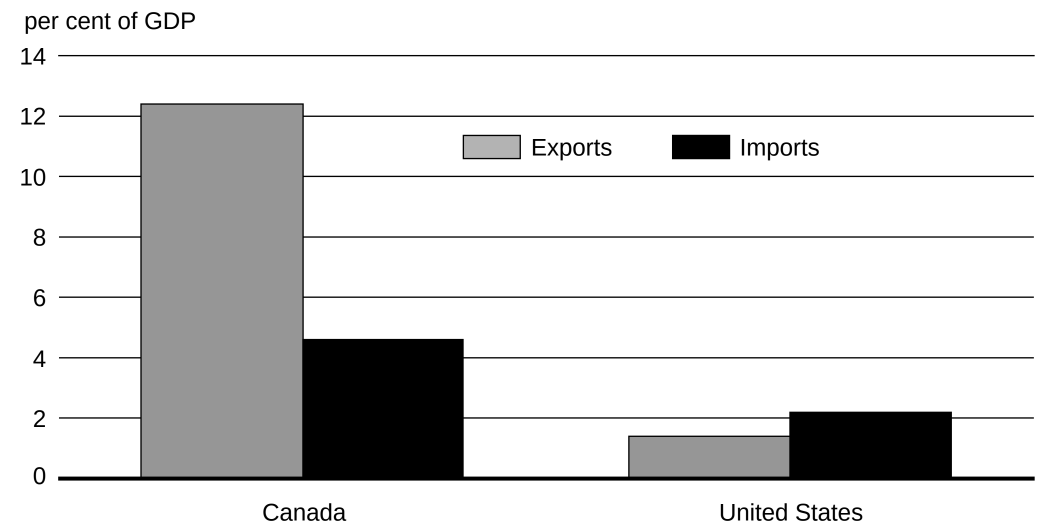


Sources: Department of Finance and Bank of Canada.
*U.S. dollar Commodity Price Index deflated by U.S. GDP deflator.

- The trend decline in the exchange rate from the 1970s to mid-1980s is partly explained by a corresponding decline in the real price of commodities.
- The recent depreciation of the Canadian dollar largely reflects the impact on Canadian exports and export earnings of falling world commodity prices, compounded by international financial market turbulence due to developments in Asia and, more recently, Russia.
- The magnitude of the recent commodity price decline is striking. Commodity prices have fallen about 28 per cent since their peak at the end of 1996. Real commodity prices have drifted down since the early 1970s. In real terms, they are now close to their lowest level since the early 1970s.

Canada is an important net exporter of commodities.

Commodity-based exports and imports: 1997

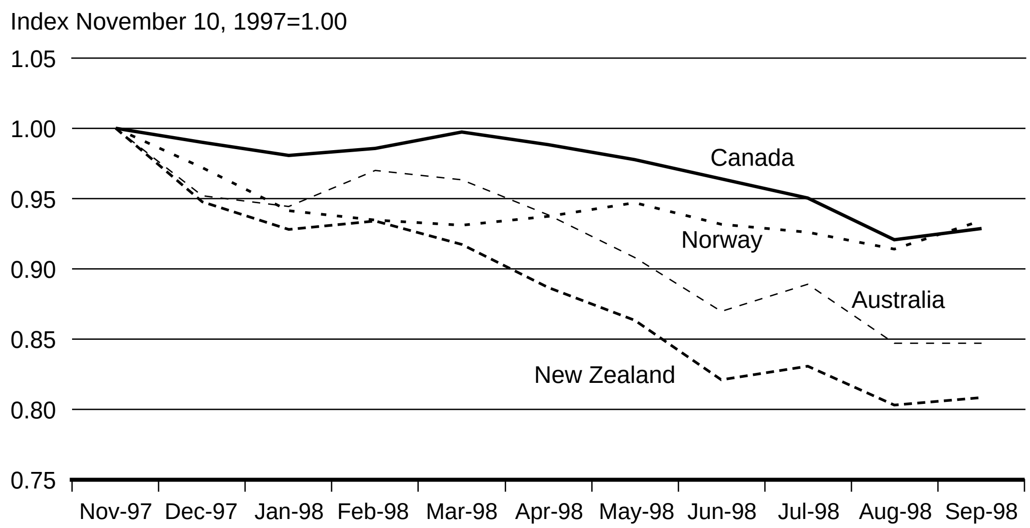


Source: Statistics Canada and U.S. Bureau of Census.

- Canada is an important net exporter of commodity-based products to the rest of the world. In 1997, Canada had a net surplus on commodity trade of about 7 per cent of gross domestic product (GDP) or $62 billion.
- Accordingly, movements in commodity prices have a significant impact on the Canadian economy. In general, when commodity prices rise, so too does our trade balance. And when commodity prices fall, our net exports fall as well. Because the exchange rate adjusts to equilibrate trade and capital flows in a flexible exchange rate system, this implies that rising commodity prices are associated with an appreciation of the dollar and vice versa.
- In contrast, the United States and the other G-7 countries are net importers of commodity-based products. For example, in 1997, the United States had a deficit on commodity trade equivalent to about 0.8 per cent of GDP or $66 billion.
- As a result, their currencies tend to strengthen when commodity prices decline as the decline in the value of their exports is more than offset by the lower costs of their imports.

Currencies of other commodity exporters have depreciated.

Recent currency movements relative to the U.S. dollar

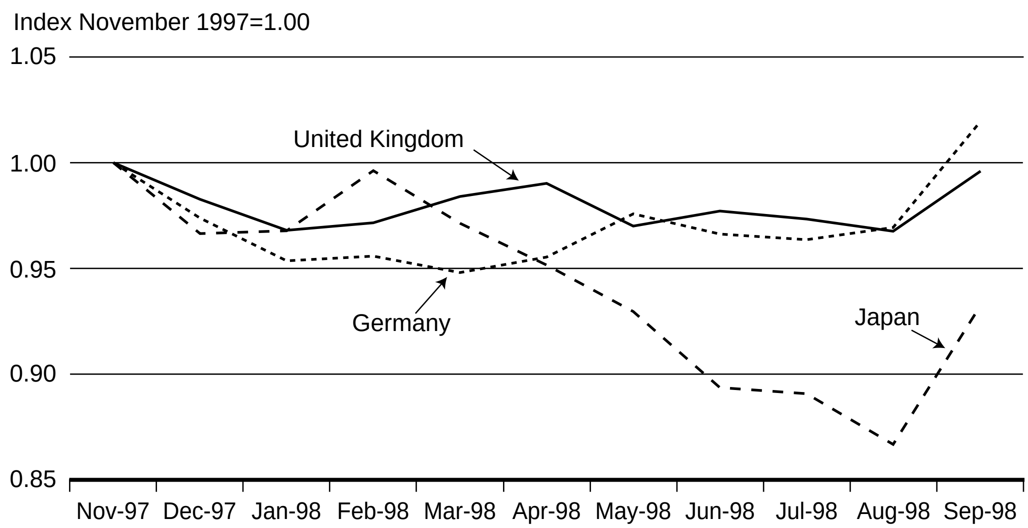


Source: Federal Reserve Board.

- The currencies of countries that are net exporters of commodity-based products have depreciated relative to the U.S. dollar.
- The currencies of Australia and New Zealand – which are both highly dependent on commodity exports and Asian demand for their exports – have lost considerably more value than has the Canadian dollar. From last November to the end of September, these countries' currencies have declined more than 15 per cent against the U.S. dollar. Over the same period, the Canadian dollar dropped about 7 per cent.
- Similarly, the Norwegian krone has declined sharply against the U.S. dollar. This has occurred despite the Norwegian central bank raising key interest rates seven times so far in 1998, for a cumulative increase of 450 basis points – 300 basis points in August alone.

The American dollar has been strong against other G-7 currencies.

Recent currency movements relative to the U.S. dollar

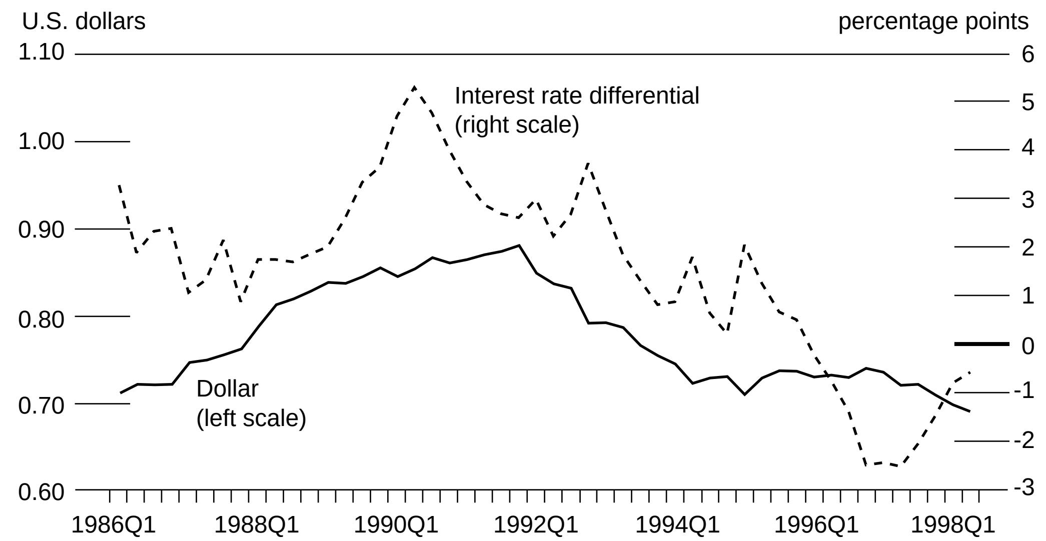


Source: Federal Reserve Board.

- The currencies of the European economies, which are net importers of commodities, have been comparatively stable relative to the U.S. dollar.
- But even these countries saw their currencies decline.
- The Asian financial and economic crisis and, more recently, the developments in Russia have led investors to seek “safe havens” in U.S.-dollar-denominated assets.
- Until very recently, this has tended to boost the U.S. dollar relative to all currencies, including European currencies.

The dollar is also affected by interest rates in the short term.

The dollar and Canada-U.S. short-term interest rate differentials



Source: Bank of Canada.

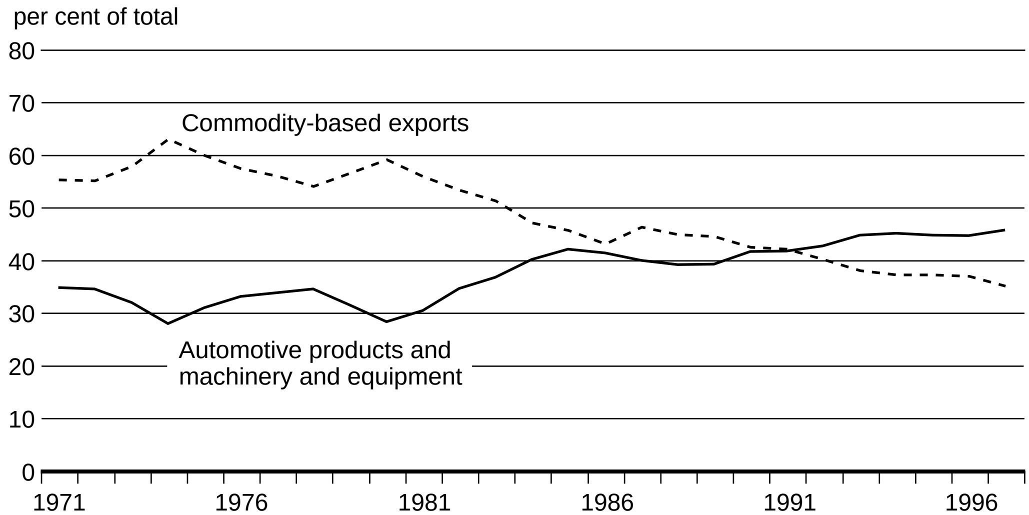
- However, commodity prices are not the whole story; other factors also affect the exchange rate. On a number of occasions, the dollar has moved in the opposite direction to commodity prices for an extended period of time, especially in the 1970s and early 1980s.
- The short-term policy stance and interest rate differentials have also been an important influence on the dollar during certain periods. They are readily apparent in the movements in the dollar in the late 1980s and early 1990s.
- The dollar appreciated significantly in the late 1980s and early 1990s following very steep increases in Canadian interest rates, which took them to 5 percentage points above U.S. rates. Rising commodity prices also contributed to the dollar's strength at that time.
- In contrast, by late 1996, when it was clear that the government's commitment to reverse the steady erosion of our public finances was paying off, Canadian interest rates were well below comparable U.S. rates while the appreciation of the dollar had abated.

The Canadian economic and policy environment that undermined the dollar in the past has changed for the better.

- While commodity prices have played a role in the decline in the external value of the Canadian dollar over the past 20 years or so, our economy has evolved and our reliance on commodity-based exports has declined significantly.
- Other structural factors that undermined the dollar in the past have been turned around.
- From the mid-1970s to late 1980s, higher rates of growth of prices and production costs in Canada than in the United States put downward pressure on the dollar.
- The run-up in government deficits and debt in Canada that began in the early 1970s undermined investor confidence and weakened the dollar.
- In addition, government deficits contributed to the widening of the current account deficit, adding to the downward pressure on the dollar.
- These long-term structural factors have been turned around: Canada has become a low inflation country; the government deficit has been eliminated; and the debt-to-GDP ratio is on a clear downward track.
- This combination of economic and policy achievements provides a strong foundation for the dollar.
- Indeed, 18 months ago, most analysts saw these achievements underpinning a strengthening of the dollar in the months and years ahead.
- These underlying strengths remain.

The diversification of the Canadian economy is ongoing.

Canadian exports of commodities and machinery, equipment and automobiles

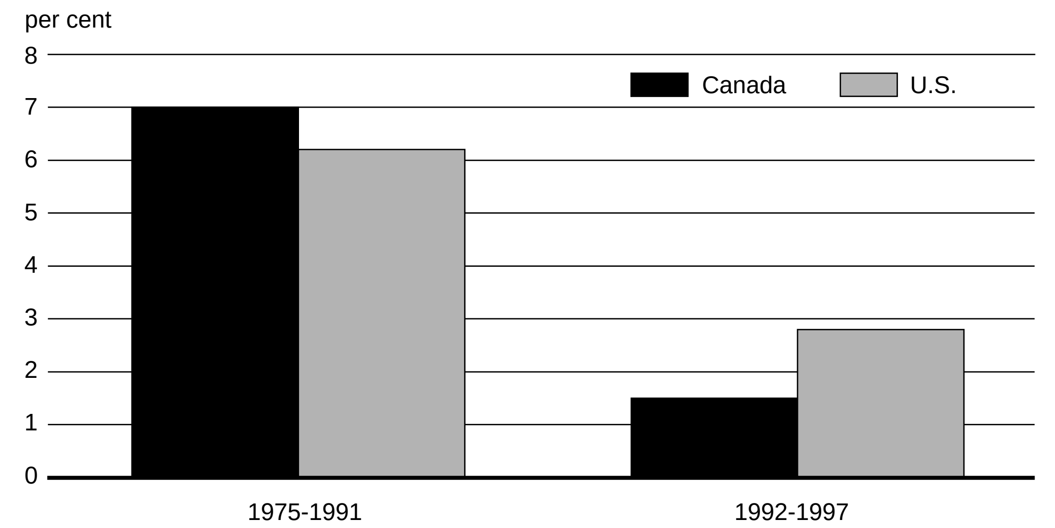


Source: Statistics Canada.

- The ongoing diversification of the Canadian economy is reflected in the declining share of commodity exports and the rising share of manufactured product exports.
- The share of commodity exports in Canada's exports has declined from about 60 per cent in 1980 to about 35 per cent in 1997.
- Automotive products and machinery and equipment each account for about one-quarter of Canada's merchandise exports. Since 1992, exports of these manufactured products have exceeded exports of commodities.
- In the 1990s, the high-tech sector in Canada has posted output and job growth that was double the rate in the rest of the economy.
- Canada's declining reliance on commodity-based exports is sometimes overlooked. This is consistent with a recent OECD study which found that the Canadian dollar was undervalued by a wide margin.

Canada is a low inflation country.

Average annual CPI inflation in Canada and the U.S.

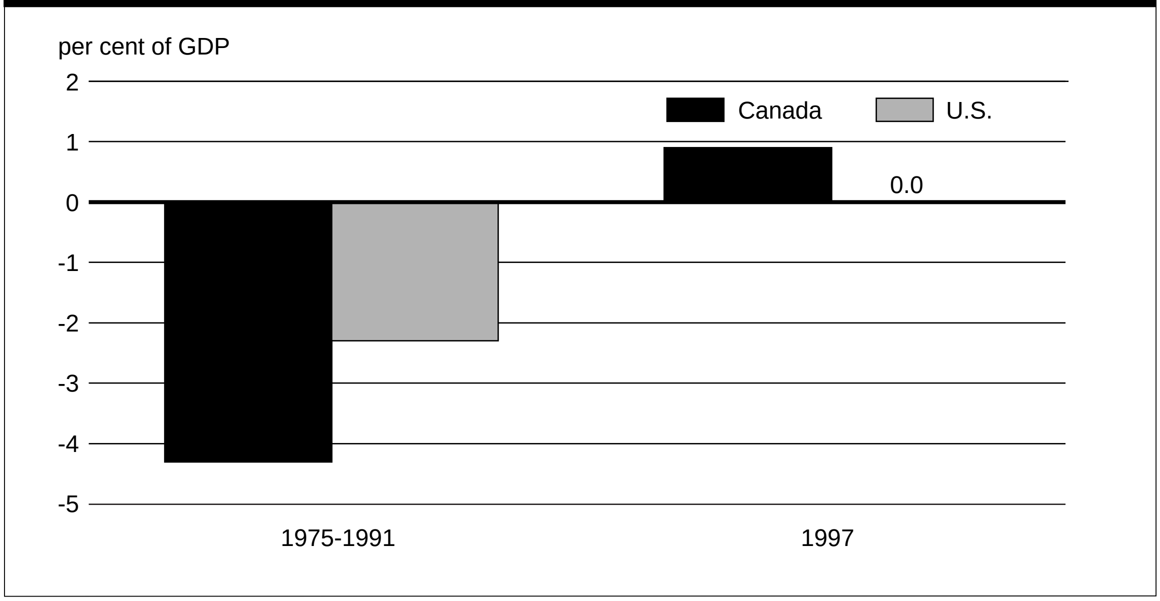


Sources: Statistics Canada and U.S. Bureau of Labour Statistics.

- For years, Canadian inflation was generally above U.S. inflation; for the last five years, it is consistently below U.S. inflation.
- From 1975 to 1991, Canada's annual inflation rate exceeded the U.S. rate by almost 1 percentage point on average.
- The more rapid growth in prices and costs in Canada eroded Canada's competitiveness and weakened the dollar.
- Since 1992, price and cost inflation in Canada has been well below that in the U.S.
- Further, Canada has had the second lowest inflation rate among the G-7 countries over this period.
- Canada's strong inflation performance has made a significant contribution to Canada's international competitiveness.

The federal government's deficit has been eliminated and the total government sector has moved into surplus.

Total government budget balances in Canada and the U.S. – annual averages

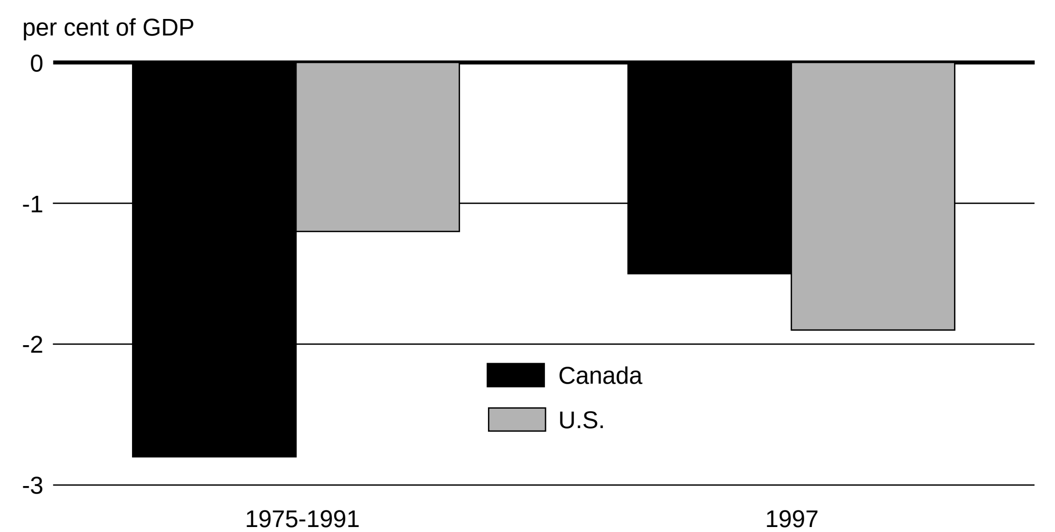


Sources: Statistics Canada and OECD.

- In the 1970s and 1980s, government deficits were much larger in Canada than the U.S. Last year, while the overall government sector in the U.S. just managed to balance its books, we were already in surplus on a national accounts basis.
- The federal government deficits of the 1970s, 1980s and early 1990s were reflected in rising public debt.
- That debt is now being paid down.

Fiscal surpluses will lessen Canada's reliance on foreign savings.

Current account balances in Canada and the U.S. – annual averages



Sources: Statistics Canada and U.S. Bureau of Economic Analysis.

- Canada's government deficits in the 1970s and 1980s increased Canada's reliance on foreign savings, widening the current account deficit.
- Canada's current account deficit was, on average, more than twice as large as that in the U.S. from the mid-1970s to early 1990s.
- These deficits, in turn, contributed to a weaker Canadian dollar.
- The swing to surplus in the government sector's financial situation will contribute to reducing Canada's reliance on foreign savings.

6

Canada's Economic Performance in the G-7

Highlights

"In the fall of 1993, the unemployment rate was 11.4 per cent. Today, while still too high, it is at 8.3 per cent, its lowest level in eight years, a track record of improvement exceeded only by the U.K. among the G-7 nations."

"Inflation is under firm control and will remain so. Indeed, Canada now enjoys a solid reputation as a low inflation country."

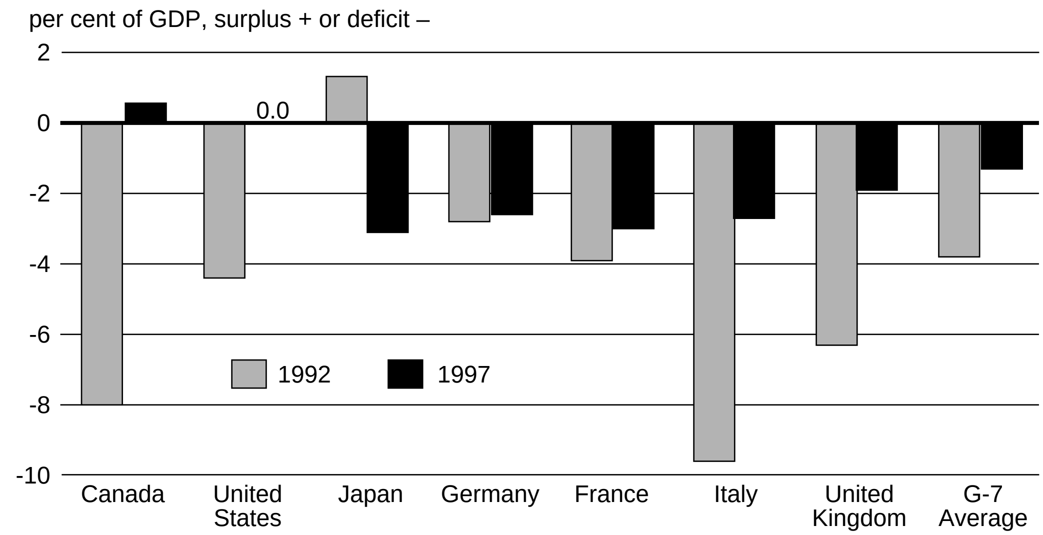
"… the major international institutions – the IMF and the Organization for Economic Co-operation and Development, the OECD – expect Canada's economic and employment growth this year to be among the best of the major industrial nations."

The Honourable Paul Martin
Minister of Finance

- *Canada's fiscal and economic performance compares very favourably with that of other Group of Seven (G-7) countries since the early 1990s.*
- *Canada has taken the necessary measures to put its fiscal house in order. As a result, in 1997, Canada was the only country in the G-7 to post a surplus.*
- *Canada has gained an international reputation as a low inflation country.*
- *Canada is the most trade-oriented country in the G-7.*
- *As a result of sound economic policies, Canada's economic performance is now among the best in the G-7.*
- *Employment growth in Canada averaged 1.7 per cent over the 1993-1997 period, the second highest in the G-7.*
- *Moreover, the International Monetary Fund (IMF) expects Canada's employment growth to average 2 per cent in 1998 and 1999, the best performance in the G-7.*
- *Key challenges for Canada are to improve productivity growth and reduce its reliance on foreign savings.*

Canada has made the strongest fiscal improvement in the G-7.

Total government financial balances
(national accounts basis)

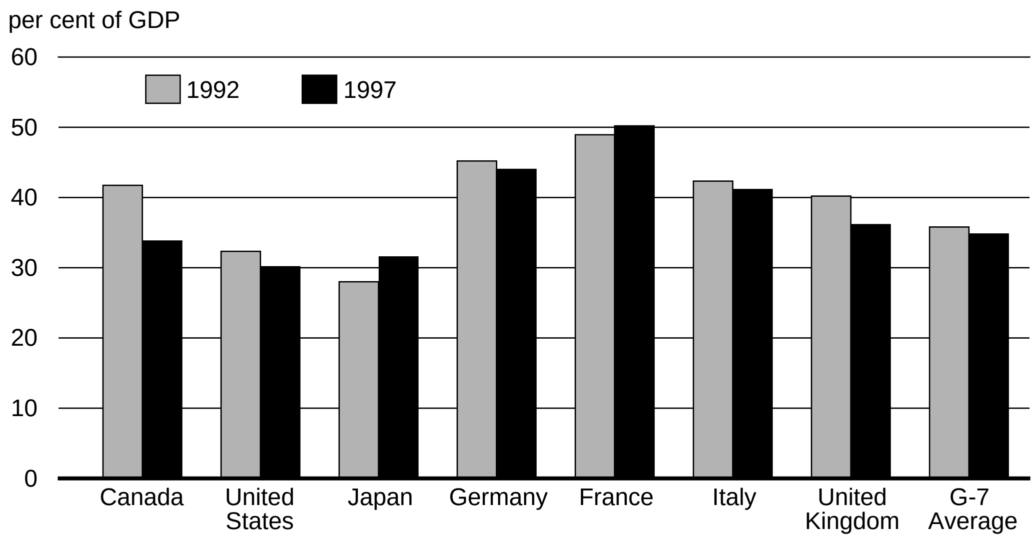


Source: OECD Economic Outlook, June 1998.

- Unco-ordinated macroeconomic policies in the late 1980s and early 1990s led to a substantial deterioration in Canada's public finances.
- In 1992, Canada had the second highest deficit as a per cent of gross domestic product (GDP) in the G-7.
- However, Canada responded to the fiscal challenge and took the necessary measures to put its fiscal house in order. As a result, in 1997, Canada was the only country in the G-7 that posted a surplus.
- The federal government has been paying down market debt since early 1997.
- In 1997-98, for the first time since 1969-70, the federal government reduced the absolute level of its debt.
- Indeed, Canada has made the strongest fiscal improvement in the G-7.

Canada has recorded the largest reduction in program spending in the G-7.

Total government program spending
(national accounts basis)

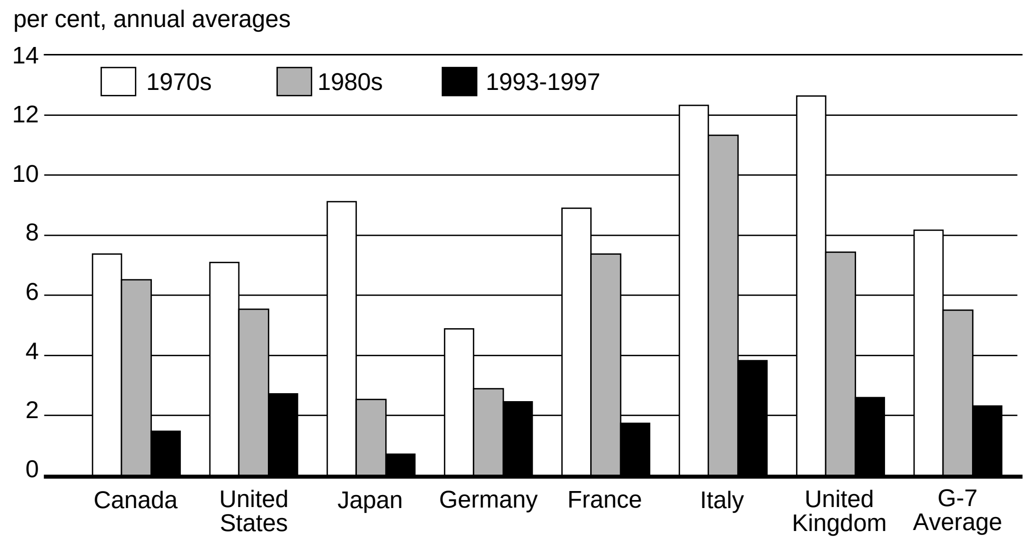


Source: OECD *Economic Outlook*, June 1998.

- Sharp reductions in program spending were the major factor underlying Canada's fiscal improvement.
- In fact, Canada's program spending has fallen much faster than in other G-7 countries.
- Between 1992 and 1997, Canada's total government program spending was reduced from 41.7 per cent to 33.8 per cent of GDP, a reduction of about 8 percentage points. Over the same period, program spending in the G-7 countries declined by only 1 percentage point on average, from 35.8 per cent to 34.8 per cent of GDP.
- As a result, Canada's program spending in relation to the size of its economy is now lower than the G-7 average.

Canada has gained an international reputation as a low inflation country.

CPI inflation

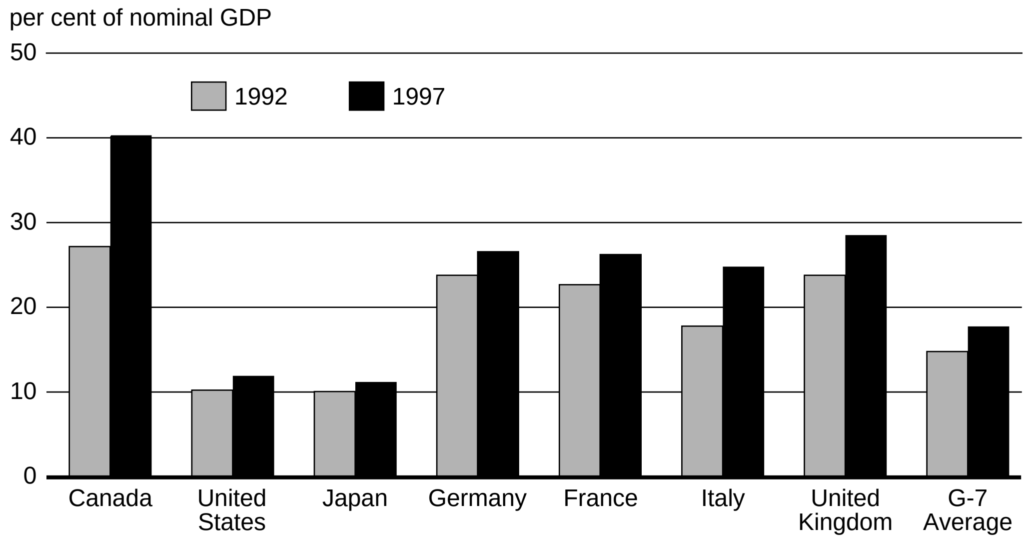


Sources: OECD *Economic Outlook*, June 1998; *International Financial Statistics Yearbook*, 1997.

- There has been much success in lowering inflation in all the G-7 countries. In fact, inflation in most countries has fallen to levels not seen in decades.
- In that favourable international context, Canada's inflation averaged less than 2 per cent over the past few years, the second lowest in the G-7. This is substantially lower than its inflation in the 1970s and 1980s which was above that in the U.S.

Canada is the most trade-oriented country in the G-7.

Exports of goods and services

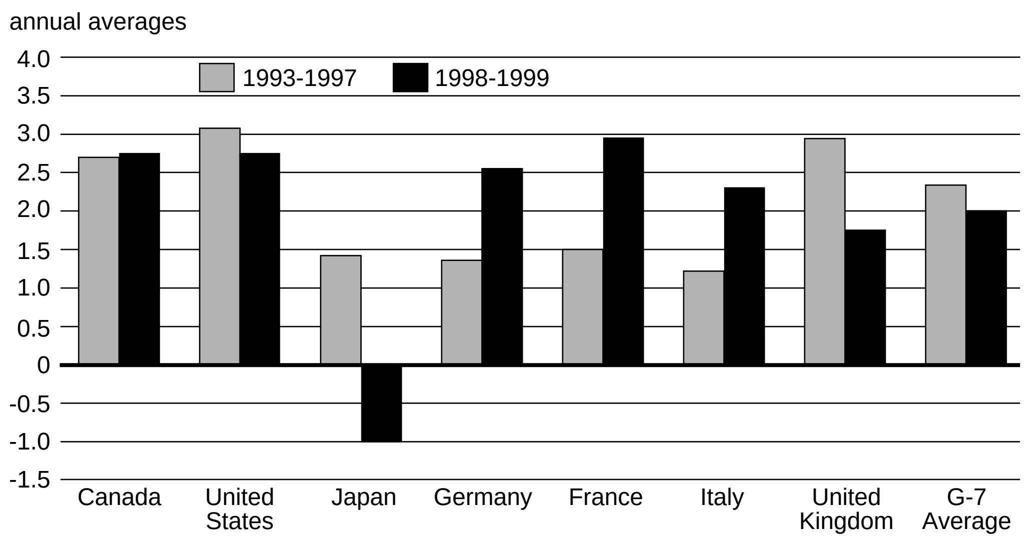


Source: OECD *Economic Outlook*, June 1998.

- Trade constitutes a significant portion of economic activity in Canada. That portion has been growing rapidly over the past few years owing to the success of recent trade initiatives and the successful completion of multilateral trade negotiations.
- The share of exports in total economic activity has recently risen in all the G-7 countries with Canada posting the largest increase, from 27 per cent in 1992 to just over 40 per cent in 1997.
- Canada's exports as a share of GDP are now more than twice as high as the G-7 average.

Sound economic policies have made Canada a top performer in the G-7 in terms of economic growth.

Real GDP growth

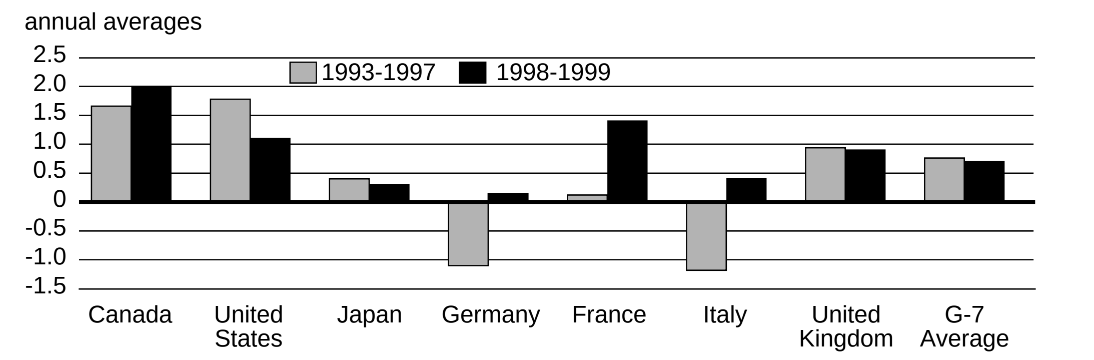


Source: IMF *World Economic Outlook*, October 1998.

- Canada's economic growth has picked up over the past few years from its poor performance in the early 1990s.
- Real GDP growth averaged 2.7 per cent over the 1993-1997 period, bettered only marginally by the U.S. and the U.K.
- Moreover, Canada's growth performance is expected to remain favourable. The IMF projects Canada's growth to average 2.8 per cent in 1998 and 1999, among the top performances in the G-7.

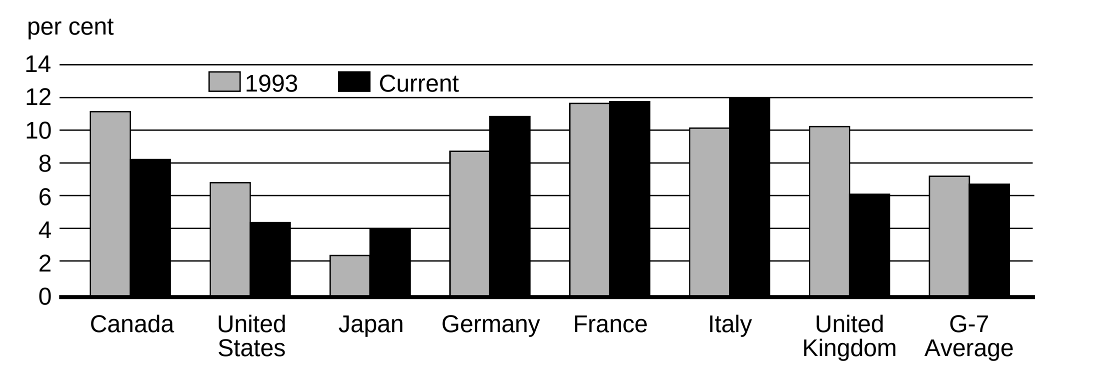
Canada's job creation is among the best in the G-7.

Employment growth



Source: IMF *World Economic Outlook*, October 1998.

Unemployment rate

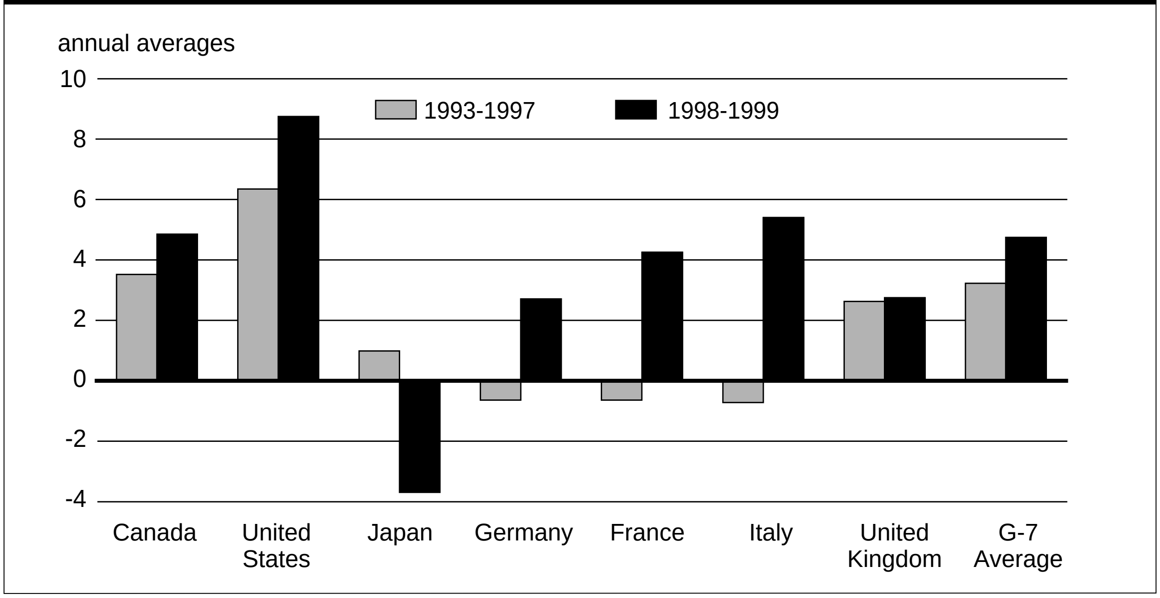


Source: DRI

- Improving economic activity is boosting employment growth and reducing the unemployment rate. Canada has been a top performer in the G-7 in this regard.
- Employment growth in Canada averaged 1.7 per cent over the 1993-1997 period, the second highest in the G-7 after the United States. Moreover, the IMF expects Canada's employment growth to average 2 per cent in 1998 and 1999, the best performance in the G-7.
- While the unemployment rate still remains too high in Canada, it has declined significantly in recent years – at 8.3 per cent in August, the unemployment rate is at its lowest level in eight years. Indeed, Canada's unemployment rate has fallen by nearly 3 percentage points since 1993, the second largest decline in the G-7 after the United Kingdom.

Canada has posted the second highest investment growth in the G-7.

Growth in real fixed investment

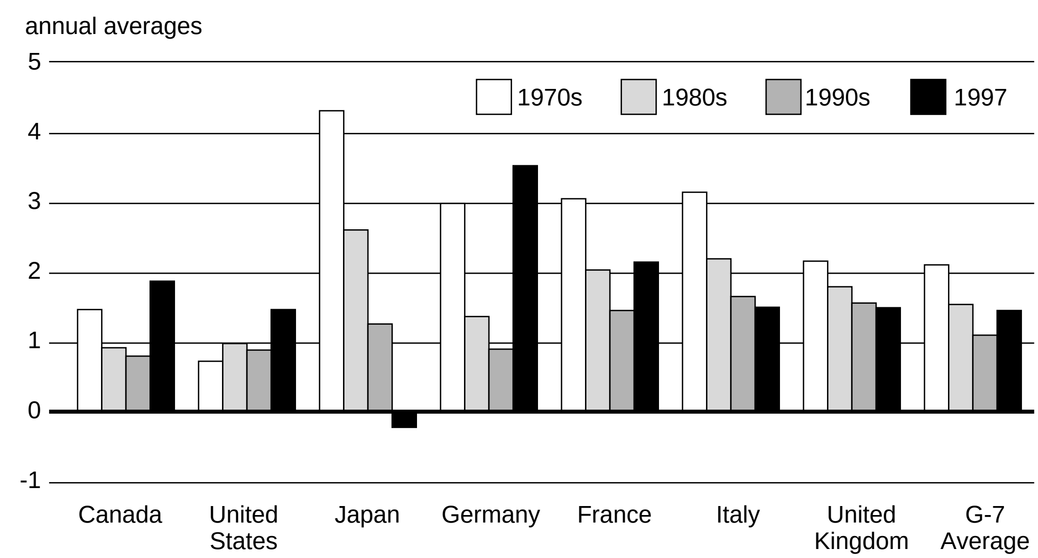


Source: IMF *World Economic Outlook*, October 1998.

- Sound economic policies have contributed to strong growth in investment, a key factor in enhancing productivity growth.
- Canada has posted the second highest growth in business investment in the G-7 since 1993.
- Moreover, the IMF expects average growth in Canada's fixed investment to rise further in 1998 and 1999, and to post one of the best growth performances in the G-7.

A key challenge for Canada is to improve its productivity growth.

Total economy productivity growth

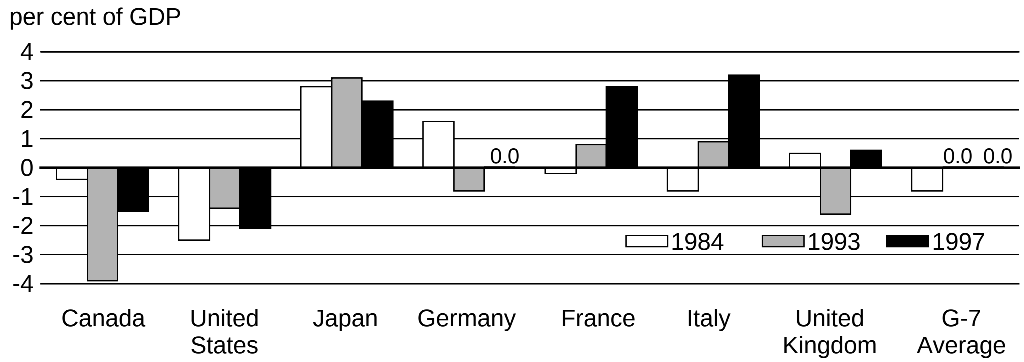


Source: OECD *Economic Outlook,* June 1998.

- Canada, like other G-7 countries, has experienced a slowdown in productivity growth over the past three decades.
- Canada had the worst performance in the G-7 in the 1980s and early 1990s.
- Canada's productivity growth in 1997 was the best in more than a decade and better than the G-7 average. However, it is too early to say whether we have entered an era of higher productivity growth.
- To continue this performance, in addition to addressing macroeconomic imbalances, policy initiatives have been implemented aimed at improving productivity. These initiatives include increased support to R&D, technology diffusion, education and training.

Another challenge for Canada is to reduce its reliance on foreign savings further.

Current account



Source: OECD *Economic Outlook*, June 1998.
Note: 1997 data for Canada is the new revised data from Statistics Canada.

- Canada has traditionally had a current account deficit and thus has needed to rely on foreign capital.
- In the 1950s and 1960s, the current account deficit was associated with the need to finance strong domestic investment. But in the 1980s and early 1990s, the current account deficit was driven by the need to finance chronic fiscal deficits.
- The substantial improvement in Canada's fiscal position underpinned a significant improvement in the current account, which moved from a deficit of 3.9 per cent of GDP in 1993 to a deficit of 1.5 per cent in 1997.
- This means that Canada now borrows less from the rest of the world to finance its current account deficit.
- A challenge for Canada is to reduce its reliance on foreign savings further. This underscores the need for a continued prudent fiscal policy that helps to increase national savings and encourage private savings.

7

Key Facts on Tax and EI Premium Rate Reductions

Recent Federal Action to Lower EI Premiums and Personal Income Tax

- The federal government has already acted to leave more money in the pockets of Canadians in two areas: lower EI premiums and reductions in personal income tax.
- EI premium rates have declined significantly since 1994. The resulting cumulative reduction in EI revenues since 1994 is about $5 billion ($2.6 billion in 1998 alone).
- Some details of specific actions since 1994 are:
  - EI premiums were prevented from rising to $3.30 per $100 of insurable earnings in 1994;
  - EI premiums have been reduced each year since 1994 from $3.07 to the current level of $2.70 in 1998;
  - the New Hires Program announced in November 1996 provides relief to small firms that create jobs in 1997 and 1998. The total relief provided will be $465 million over the two years;
  - an EI premium holiday was announced in the February 1998 budget to provide relief for all firms for the new hiring of young Canadians for 1999 and 2000. The total relief will be $200 million over the two years; and
  - the maximum insurable earnings (MIE), the base for the calculation of maximum EI premiums, was lowered from $43,940 to $39,000 in 1996 and then frozen at that level. This provided relief of $1.8 billion over three years.
- The process of providing broad personal income tax relief was begun in the 1998 budget with $4 billion of general income tax cuts over three years. The total value of tax relief provided in the 1998 budget, including broad and targeted tax cuts, was $7 billion over three years.
- General tax relief to individuals was provided through:
  - a supplementary amount of income that can be earned on a tax-free basis of up to $500 for low-income individuals and $1,000 for low-income families; and
  - the elimination of the general 3-per-cent surtax for taxpayers with incomes up to about $50,000 and a reduction in the surtax for individuals with incomes between $50,000 and $65,000.

The Fiscal Cost of Tax and Premium Rate Reductions

- The following table provides a comprehensive list of rules of thumb for the fiscal cost of all key tax and premium rates.
- The one key message that emerges from this table is that any significant action in reducing personal income tax levels is very costly. For example:
  - a $100 tax reduction for all taxpayers would cost about $1.5 billion annually;
  - a 1-percentage-point reduction in the three tax rates of 17, 26 and 29 per cent would cost upwards of $3.7 billion annually; and
  - it would cost $1.1 billion annually to reduce the 26-per-cent rate facing middle-income Canadians by 1 percentage point.
- The cost of reducing EI premiums is also large:
  - a 5-cent reduction in the premium rate (7-cent reduction in employer premiums) would cost $350 million; and
  - reducing the premium rate to the break-even level could cost more than $6 billion annually.
- Given these costs, any action to leave more money in the pockets of Canadians would necessarily be modest in any single budget. However, the size of such relief should build up in the future as more fiscal resources become available, allowing the cumulative impact of such relief to grow over time.

Fiscal costs of tax and premium rate reductions: full-year impact estimates for 1999

	Cost of change
	($ million)
Personal Income Tax	
$100 tax reduction for all taxpayers[1]	1,450
$100 increase in amounts used to established selected credits	
Basic personal amount	250
Married/equivalent-to-married amount	40
Federal surtaxes	
Reduction by 1 percentage point of the general 3% surtax[2]	350
Reduction by 1 percentage point of high-income 5% surtax[3]	130
Reduction in marginal tax rates (per percentage point)[4]	
Lowest rate (17%)	2,060
Middle rate (26%)	1,100
High rate (29%)	570
1 percentage point reduction in each rate	3,730
$100 increase in base benefit under Canada Child Tax Benefit[5]	600
$100 increase in GST credit for a family of four[6]	505
Restoring indexation of tax parameters[7]:	
Total impact:	
Year 1	840
Year 2	1,690
Year 3	2,550
Year 4	3,410
Components	
Personal credits and tax brackets:	
Year 1	610
Year 2	1,215
Year 3	1,825
Year 4	2,435
Canada Child Tax Benefit (CCTB):	
Year 1	160
Year 2	325
Year 3	495
Year 4	665
Goods and services tax credit (GSTC):	
Year 1	80
Year 2	160
Year 3	245
Year 4	330
Employment Insurance Premiums	
5-cent reduction in employee rate/7-cent change in employer rate (combined change)	
Employee 5-cent reduction[8]	145
Employer 7-cent reduction[8]	205
Total	350

Fiscal costs of tax and premium rate reductions: full-year impact estimates for 1999 *(cont'd)*

	Cost of change
	($ million)
Business Income Tax	
1-percentage-point reduction in rates:	
All rates	780
Selected rates	
General rate (excl. M&P and small business income)	375
M&P rate	220
Small business rate	185
1-percentage-point change in the 4% surtax[9]	145
0.025-percentage-point change in the large corporations tax[10]	170
Sales Tax	
1-percentage-point change in GST[11]	3,000
1-cent-per-litre change in motor and aviation fuels	620
1-per-cent change in excise duties on:	
Spirits	5
Beer	5
Wine	1
Tobacco	20

[1] Non-refundable.

[2] The general 3% surtax was eliminated for all taxpayers earning less than $50,000 and reduced for those with incomes between $50,000 and $65,000 in the 1998 budget. The cost refers to the remainder of the surtax.

[3] Currently applies on basic federal tax in excess of $12,500 on an income level of about $65,000.

[4] 17% rate applicable to taxable incomes up to $29,590; 26% rate applicable to taxable incomes from $29,591 to $59,180; 29% rate applicable to taxable incomes from $59,181 and up.

[5] Current credit value of base Canada Child Tax Benefit (CCTB) is $1,020.

[6] Current credit value of goods and services tax credit (GSTC) depends on family type:
- $199 for the filer and spouse or equivalent-to-spouse; and
- $105 for each child.

[7] Estimates assume 1.5% annual inflation. Impacts are cumulative.

[8] Employers pay 1.4 times employee premium.

[9] On basic 28% federal corporate tax.

[10] Current rate of 0.225%.

[11] No change to GSTC.