Global Insight (Canada), One Financial Place, 1 Adelaide St. East
Suite 2505, P.O. Box 179, Toronto, Ontario, M5C 2V9 Canada
Tel: 416 360 9995 Fax: 416 360 0088 www.globalinsight.com

Economic Forecast and Fiscal Plan
July 2005 Update

Prepared for:

Standing Committee on Finance
House of Commons

Prepared by:

Global Insight (Canada) Ltd.
Canadian Macroeconomic Services
Suite 2505, Adelaide Street East
Toronto, Ontario, Canada
M5C 2V9

July 15, 2005

Contacts

Main Contact

Dale Orr
Managing Director
Canadian Macroeconomic Services
Suite 2505
1 Adelaide Street East
Toronto, ON M5C 2V9
Tel: 416 682-7301
Fax: 416 360-0088
E-mail: dale.orr@globalinsight.com

Wojciech Szadurski
Senior Economist
Canadian Macroeconomic Services
Suite 2505
1 Adelaide Street East
Toronto, ON M5C 2V9
Tel: 416 682-7315
Fax: 416 360-0088
E-mail: wojciech.szadurski@globalinsight.com

Executive Summary

The House of Commons Standing Committee on Finance asked Global Insight to provide an update of the economic and fiscal forecast in July 2005. This report updates Global Insight's forecast of March 2005, which in turn updated the forecasts of Budget 2005. In this July update Global Insight has used its June 2005 economic forecast for Canada. The fiscal forecast relies upon information on new government initiatives contained in the May 13 report from Finance Canada, monthly fiscal numbers available in the *Fiscal Monitor*, and any other economic and fiscal information available to early July.

The single most important indicator in the economic forecast is the level of nominal GDP (NGDP), which is often referred to as the "general tax base." Statistics Canada has now revised NGDP for 2004 slightly downwards. Global Insight's forecast for nominal GDP for 2005 remains slightly below the forecast of Budget 2005. In March Global Insight's forecast of nominal GDP for 2006 was considerably weaker than that of Budget 2005, and we leave our March forecast virtually unchanged in this update.

Turning to real GDP growth (GDP), Statistics Canada has now recorded GDP growth for 2004 at 2.9%, slightly above the forecast of Budget 2005 (2.7%) as well as Global Insight's March forecast (2.8%). Global Insight continues to forecast real GDP growth for 2005, 2006 and 2007 at the same pace as we did in March. This pace is however, slightly weaker than that of Budget 2005. Global Insight forecasts little change from our March forecast for most of the other economic indicators. Labor markets are a slight exception, where we now see a lower unemployment rate this year as well as next. As well, relative to our March forecast, we now expect interest rates to be a bit stronger at the short end in 2006 and 2007 but weaker at the long end this year.

With the reporting of March 2005 fiscal results in the May Fiscal Monitor, (FM) we now have "preliminary actuals" for the 2004/05 fiscal year. Year end adjustments are now being incorporated and final audited results will be available in the Fiscal Reference Tables, expected in early October, 2005. The "preliminary actuals" from the May 2005 FM, along with consideration of the adjustments which were made last year, as well as other information on fiscal policy actions to July 2005, are very informative in Global Insight's July update of the fiscal forecast. The May Fiscal Monitor results reported revenues for fiscal 2004/05 virtually on the forecast of Budget 2005 as well as Global Insight's March forecast. (FM = $197 billion, Budget 2005 = $196 billion, GI Mar. 2005 = $197 billion) In this July update, anticipating positive year end adjustments, we have raised our revenue forecast for 2004/05 just slightly to the $199 billion level. For 2005/06 Global Insight now forecasts revenues slightly higher than we (or Budget 2005) did in March, but our forecast for revenues in 2006/07 remains similar.

Turning to program spending, the May FM reported a "preliminary actual" for program spending for 2004/05 at $153 billion relative to the Budget 2005 plan of $158 billion. In March Global Insight forecast spending for 2004/05 would be $157 billion. In this July update we stick close to this forecast, anticipating significant upward year end

adjustments to the FM number. For 2005/06, Budget 2005 planned for $161 billion, but recent initiatives have raised that to the $163 billion level. Similarly for 2006/07, recent initiatives have raised the plan by several billion from the $170 billion level. Our July forecast for debt charges for each year is similar to that of our March forecast. The Global Insight forecast is just slightly below that of Budget 2005 for 2004/05, but moves to about $1.0 billion lower for this year and next.

As in the budget, we allocated $3.0 billion to the contingency reserve in every year, which, if unclaimed by fiscal emergencies, is used to pay down the debt. As well, we allocated $1.0 billion and $2.0 billion in 2005/06 and 2006/07 respectively, to economic prudence.

In this July update the planning surplus—after allocation to reserves- is now forecast at $4.2 billion for 2004/05, $1.1 billion for 2005/06 and -$0.6 billion for 2006/07. This is a slightly higher surplus for 2004/05 than forecast by Global Insight in March ($4.2 billion vs. $2.7 billion). For 2005/6 we now also forecast a slightly higher planning surplus ($1.1 billion vs. $0.2 billion) but a slightly lower planning surplus for 2006/07 (-$0.6 billion vs. $0.7 billion). This compares to the forecast of Budget 2005 where the planning surplus was forecast at exactly $0.0 for each year. In interpreting these results, they must be considered approximations to the nearest several billion dollars. Also note, these forecasts of the planning surplus include reserves.

This report also includes analysis of a more pessimistic and a more optimistic scenario, based primarily on the risks of a bubble in the US housing market. The scenarios are symmetrical in terms of their probabilities (10%). However, the downside impacts on the economic and fiscal forecast are much more significant than the potential upside impacts.

In the recent May 2005 Fiscal Monitor, reflective of the (perhaps overly) prudent practices of Finance officials, they warn that "it is too early to determine whether the budgetary surplus will be greater than the $3 billion projected for 2004/05 in the budget." This comment from Finance is very revealing, and represents the value to the Finance Committee in seeking fiscal updates from outside sources. In this July update Global Insight forecasts that the (underlying) budgetary surplus for 2004/05 will be $7.2 billion, relative to the $3 billion forecast of Budget 2005, which Finance is still sticking to. Also recall, Global Insight is generally more "prudent" than the other forecasters in this project, who generally have even higher forecasts of the surplus. That being said, the attention should probably be focused more on the forecast of revenue, rather than the surplus itself because late in the fiscal year the government is prone to spending much of the anticipated surplus, "artificially" reducing the final surplus, from a forecasting perspective.

Table of Contents

1. Introduction

The House of Commons Standing Committee on Finance asked Global Insight to provide an update of the economic and fiscal forecast in July, 2005. This report updates Global Insight's economic and fiscal forecast of March 2005, which in turn was compared to the economic and fiscal forecast of Budget 2005 of February. In this July update Global Insight has used its June 2005 economic forecast for Canada. For the fiscal forecast, this July report relies upon information on new government initiatives contained in the May 13 report from Finance Canada, monthly fiscal numbers available in the *Fiscal Monitor*, and any other economic and fiscal information available to early July.

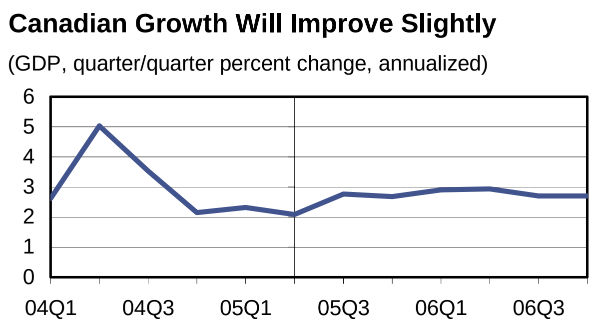
The paper is structured as follows. First we comment on Global Insight's June 2005 economic forecast and compare it with the forecast used in the federal 2005 budget. Changes from Global Insight's March economic outlook are noted. We then compare Global Insight's July fiscal forecast to the fiscal outlook contained in the federal 2005 budget. Changes from the Global Insight fiscal forecast of March are also noted. We finish with a brief discussion of risks to our fiscal outlook.

2. Global Insight's July Economic Forecast

Table 1 replicates the format of the table "Private Sector Forecasts for 2004-2006" from page 62 of *The Budget Plan 2005*. Under every indicator, the first row shows the forecast included in the 2005 budget of February, while the second row displays Global Insight's June 2005 forecast. We have augmented the coverage of the indicators by adding the crude oil price, the Canadian dollar, and the level of Canada's nominal GDP in the addendum portion. We have also augmented the number of years covered by Table 1 from 2004-2006 to 2004-2007.

2.1. Domestic Demand Continues to Support the Economy

Canada's real gross domestic product expanded 2.3% (quarter-on-quarter annualized) in the first quarter, slightly lower than the consensus and Global Insight's forecast of a 2.5% q/q increase. As we anticipated, consumer spending and non-residential business investment grew strongly in the quarter. Government spending and investment also rose smartly. Exports recovered from the decline in the second half of 2004. Imports, however, grew almost twice as fast as did exports. Investment in business inventories slowed after having risen sharply in the previous few quarters. The main surprise in the report was a decline in residential investment, the first since the second quarter of 2000, which reflected a decrease in new construction and a slowing in renovation activity.

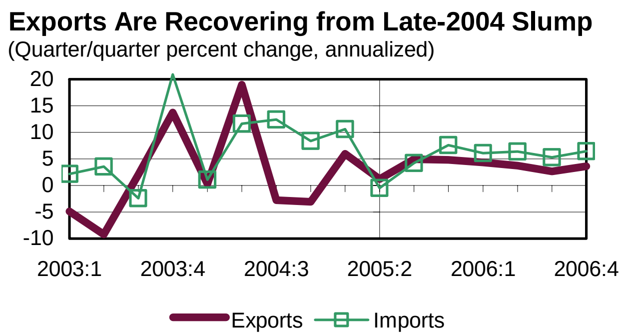


Economic activity fell 0.1% at the end of the first quarter, between February and March, as motor vehicle assemblies and parts manufacturers scaled down production. Although a modest rebound in economic growth can be expected in April, judging from a jump in both employment and hours worked, second-quarter GDP growth is unlikely to be much different from the first-quarter pace.

With the publication of the first-quarter data, Statistics Canada revised income and expenditure numbers back to the first quarter of 2001. Growth in 2004 was revised slightly up from 2.8% to 2.9%. The growth rate in the first quarter of 2004 was revised slightly down; growth rates in the following quarters were revised slightly higher, which provides more forward momentum into 2005.

The first-quarter GDP report is broadly consistent with our current view that the domestic side of the economy is doing the heavy lifting in supporting activity. Consumer spending has benefited from low interest rates and improving balance sheets, thanks to swelling values of real estate and equity assets. Business investment has improved on the coattails of low interest rates, high capacity utilization rates, strong profits, and declines in prices of US-made machinery, equipment and software. Residential construction is the main headwind on the domestic side.

The past appreciation of the Canadian dollar relative to its US counterpart has been increasingly weighing on the external side of the Canadian economy. Fortunately, we are most likely at or near the peak of the negative impact. (The negative impact of net exports on GDP growth in the first quarter was one third that of the fourth quarter.) Recovery in Canadian exports, however, will be limited by a growth slowdown in the United States and most other parts of the world, including China.



Given that the variances from our expectations for all the information noted above, particularly the first-quarter national accounts release, were small and balanced, Global Insight is leaving its forecast for economic growth unchanged at 2.6% for this year and 2.8% for 2006. This stability in the real GDP forecast, coupled with a virtually unchanged forecast of GDP inflation, leaves our forecast for the level of nominal GDP for this year and next just slightly lower. This is important since the level of nominal GDP is, roughly speaking, the general "tax base."

This forecast implies for that for the third consecutive year the US economy will significantly outgrow Canada. In 2003, the United States had a normal year while Canada had a weak one, plagued by SARS, the electricity blackout, and the initial impacts of exchange rate appreciation. In 2004, our 2.9% growth is close to our potential, but the United States had a banner year at 4.4%. Growth there was stimulated by expansionary fiscal and monetary policy and the initial impacts of exchange rate depreciation, while Canada was hobbled by exchange rate appreciation. In 2005, the trade sector—continuing to adjust to the higher dollar and weak labor productivity—will again keep us from reaching our potential pace of growth and matching US growth. Given forecasted labor productivity growth of 1.7%, however, a reasonable pace of job gains will move Canadian GDP growth closer to the US pace over the medium term.

Table 1: Economic Assumptions

	2004	2005	2006	2007
		(per cent)		
Real GDP Growth				
February 2005 Budget	2.7	2.9	3.1	
Global Insight's June 2005 Forecast	2.9	2.6	2.8	2.7
GDP Inflation				
February 2005 Budget	3.3	2.0	1.9	
Global Insight's June 2005 Forecast	3.0	2.1	1.5	1.4
Nominal GDP Growth				
February 2005 Budget	6.1	4.9	5.0	
Global Insight's June 2005 Forecast	6.1	4.8	4.3	4.2
3-month Treasury Bill Rate				
February 2005 Budget	2.2	2.7	3.5	
Global Insight's June 2005 Forecast	2.2	2.5	3.1	3.3
10-year Government Bond Rate				
February 2005 Budget	4.6	4.6	5.1	
Global Insight's June 2005 Forecast	4.6	4.2	4.7	4.9
Unemployment Rate				
February 2005 Budget	7.2	7.2	7.0	
Global Insight's June 2005 Forecast	7.2	6.9	7.0	7.0
Employment Growth				
February 2005 Budget	1.7	1.4	1.5	
Global Insight's June 2005 Forecast	1.8	1.1	1.2	1.3
Addendum:				
U.S. Real GDP Growth				
February 2005 Budget	4.4	3.6	3.4	
Global Insight's June 2005 Forecast	4.4	3.4	2.9	2.9
WTI Crude Oil Price (US$/Barrel)				
February 2005 Budget				
Global Insight's June 2005 Forecast	41.5	49.8	48.4	46.4
Canada-U.S. Exchange Rate (U.S. cents)				
December 2004 Survey of PSF	76.9	83.0	81.7	81.5
Global Insight's June 2005 Forecast	77.0	81.1	85.4	86.4
Canada's Nominal GDP (Billion $)				
February 2005 Budget	1,293	1,356	1,424	
Global Insight's June 2005 Forecast	1,290	1,352	1,411	1,470

PSF--private sector forecasters

2.2. Comparing Global Insight's June 2005 Economic Forecast and that Underlying the February 2005 Budget and Global Insight's March Forecast

The federal budget was prepared and presented (February 23) before the release of the fourth quarter 2004 National Accounts, let alone the first quarter 2005 National Accounts (May 31). In May, the National Accounts were revised back to the first quarter of 2001. The budget's assumption about nominal GDP in 2004 was $3 billion lower than the revised figure of $1,290 billion. While real GDP growth in 2004 was higher than assumed in the budget (2.9% vs. 2.7%), GDP inflation was lower (3.0% vs. 3.3%).

Relative to the economic forecast of budget 2005 Global Insight's June real GDP growth forecast is weaker. GDP inflation is lower in 2006. Nominal GDP is $4 billion lower in 2005 and $13 billion lower in 2006 than assumed in the February budget. Both short- and long-term interest rates are forecasted to be lower in 2005 and 2006. The unemployment rate is lower in 2005 but the same in 2006. Employment growth is lower in both years.

Relative to Global Insight's economic forecast of March 2005, most indicators are very similar. Most importantly, the level of nominal GDP, often referred to as the "general tax base" is forecast virtually unchanged for 2005 and 2006. The rate of increase for real GDP is unchanged. We are now forecasting short term interest rates to be slightly higher in 2006 and long term rates to be slightly lower in 2005. As well, we now expect the unemployment rate to be slightly lower this year as well as next year.

3. Comparison of Global Insight's July Fiscal Forecast with Budget 2005

Budget 2005 provided a five-year fiscal plan, which moved the volume of spending up to exhaust all of the potential room between now and 2009/10, save for the set aside of reserves consistent with prudent budget planning. The fiscal forecast of this July report focuses on the 2004/05 – 2006/07 period, which is the normal "two-year rolling target" typical of previous budgets. In this July report we must continue to consider 2004/05 as a "forecast" even though the fiscal year ended several months ago. While we do have "preliminary actuals" from the May Fiscal Monitor (FM), many and significant year-end adjustments are expected before final audited results are released in the Fiscal Reference tables, expected in early October. The "preliminary actuals" of the May Fiscal Monitor have significant implications for Global Insight's forecast for 2004/05. The fiscal forecast for successive years depends significantly upon our base year forecast for 2004/05. Therefore, we first focus on 2004/05.

3.1. Monitoring the *Fiscal Monitor*

One of the perspectives Global Insight takes to fiscal forecasting, particularly for the "in-year" forecast (currently 2004/05), is to monitor the path of the fiscal indicators as they are reported monthly in the *Fiscal Monitor*. Obviously as we near the end of the fiscal year, the monitoring of the *Fiscal Monitor* becomes more meaningful. This is particularly the case with the May Fiscal Monitor, which, by providing monthly results through March 2005, provides "preliminary actuals" for fiscal 2004/05. It should also be noted that year-end adjustments can result in significant changes from the annual totals reported in the *Fiscal Monitor* of May (reporting results through the end of the fiscal year ending in March). For example, last year revenues were adjusted up by over $4 billion and program spending was adjusted up by almost $3 billion between the May *Fiscal Monitor* and the final results released in October. In the May 2005 FM, referring to the cumulative results covering the months of fiscal 2004/05, the Department of Finance reminds us that "these are not the final results." These results "do not reflect the regular end -of –year accounting adjustments, which incorporate the costs of liabilities incurred during the fiscal year for which no payments were made in 2004/05, and final tax accrual adjustments." As has generally been their bent in recent years, and reflective of the (perhaps overly) prudent practices of Finance officials, they go on to warn that "it is too early to determine whether the budgetary surplus will be greater than the $3 billion projected for 2004/05 in the budget."

This final comment above from Finance is very revealing, and represents the value of the Finance Committee in seeking fiscal updates from outside sources. In our earlier March update Global Insight forecasted that the budgetary surplus for 2004/05 would be $5.7 billion (to be revised upward from there in this July update) relative to the $3 billion forecast of Budget 2005, which Finance is still sticking to. Also recall, Global Insight is generally more "prudent" than the other forecasters in this project, who generally have even higher forecasts of the surplus. That being said, the attention should probably be focused more on the forecast of revenue, rather than the surplus because late in the fiscal year the government is prone to spending much of the anticipated surplus, "artificially" reducing the final surplus, from a forecasting perspective.

Table 2 below (column 1) shows what the May 2005 FM reported for the months April 2004 through March 2005, to provide "preliminary actual" totals for fiscal 2004/05. We then show (column 2) the extent of year end-adjustments that were made between the May 2004 FM and the final audited results for 2003/04. We then present the Budget 2005 (column 3) and Global Insight March 2005 (column 4) fiscal forecasts

Of course there is no necessary relationship between the year-end adjustments which were made last year and those that will be made this year. Last year's adjustments are indicative, and certainly must be taken as an indication that, with the May FM results, we have at best "preliminary actuals" for 2004/05. The table above sets the stage for our updated fiscal forecast for 2004/05. The forecast for 2004/05 is in turn the base for our updated forecast for 2005/06 and 2006/07.

Table 2: Monitoring the *Fiscal Monitor*

2004/05 Fiscal Results for Categories as Reported in	F.M. May 2005 (1)	Yr End Adjustments in 2003/04 (2)	Budget 2005 (3)	GII March 2005 (4)
PIT	88.7	1.8	89.6	91.0
CIT	29.9	1.1	28.4	29.1
GST	31.2	0.0	30.2	30.8
Total Excise and Duties	44.2	0.2	43.4	43.9
EI Premiums	17.2	0.1	17.1	17.0
Total Budgetary Revenues	**196.8**	**4.3**	**195.8**	**197.4**
Elderly Benefits	27.9	0.0	28.0	27.9
E I Benefits	14.7	0.0	15.3	15.0
Total Program Spending	153.0	2.5	158.1	157.0
Debt Charges	34.1	0.2	34.7	34.7
Total Budgetary Expenses	**187.1**	**2.8**	**192.8**	**191.7**
Budgetary Balance	**9.8**	**1.5**	**3.0**	**5.7**

Comments on May Fiscal Monitor "Preliminary Actual" Results for 2004/05

Revenues

The May FM reported a preliminary actual for 2004/05 of $196.8 billion. This was $1.0 billion above the Budget 2005 forecast but $0.6 billion below the Global Insight March forecast. Given that there was an upward adjustment of $4.3 billion to revenues between the May 2004 FM and final audited results, Global Insight certainly maintains its position that final revenues for 2004/05, when reported in October, will likely be above the Budget 2005 total, if not above our March forecast. Given the experience of last year, as well as our understanding of the nature of the year end adjustments, it seems unlikely there would be downward adjustments to revenues. Revenues reported in the May FM were slightly above those of Budget 2005, except for PIT. In the forecasting of PIT, to be discussed later, we particularly lean on the results of our economic modeling.

Program Spending

For Elderly Benefits the preliminary actual of the May FM of $27.9 billion was very close to the forecast of both Budget 2005 as well as the Global Insight March forecast, and last year there were no year-end adjustments to the May FM Elderly benefits. If only everything could be this straightforward! As far as EI Benefits are concerned, the May FM, at $14.7 billion was slightly weaker than the Global Insight March forecast $15.0 billion and considerably weaker than the Budget 2005 forecast ($15.3 billion). Last year there were no year end adjustments, so the Budget 2005 forecast of $15.3 billion does look a bit high. Total Program spending was reported at $153 billion in the May FM. This is far short of the Budget 2005 plan for $158.1 billion as well as the Global Insight March forecast for $157 billion. Last year, year end adjustments were $2.8 billion. As well there was a "new initiative" providing support of $1.1 billion for the agricultural sector and pine beetles given profile in May 2005, which will be booked against 2004/05. Finance reports that this "new initiative" can be accommodated within the Budget 2005 program spending plan for 2004/05. It therefore seems the year-end adjustments to the $153 billion May FM total for program spending will move us well upward toward the Global Insight March forecast of $157 billion.

Debt Charges

The May FM reported $34.1 billion for debt charges for 2004/05. Last year there was a modest upward adjustment to the preliminary actual for debt charges. However, the Budget 2005 forecast, identical to Global Insight's March forecast of $34.7 billion, looks a tad high.

The June Fiscal Monitor, not yet released, will report results for April 2005. These results are not considered to be too informative for fiscal forecasting purposes, being just the first month of the new fiscal year.

While the monitoring of the fiscal monitor was the dominant force in our update for 2004/05, given this new base, our economic modeling becomes the dominant force in the updating process for the successive years.

4. Global Insight's July 2005 Fiscal Forecast

Global Insight used the following methodology for updating the fiscal forecast. The first quarter 2005 National Accounts and the Global Insight March fiscal forecast (in turn relying on Budget 2005) formed the basis for our July fiscal forecast. We used the National Accounts to true up the forecast of fiscal drivers, such as personal income tax (PIT) to personal income (PI) ratio, for the new and revised economic data. The updated fiscal drivers and Global Insight's June economic forecast were used to derive the forecast of federal government revenues and expenditure. Finally, we used the results of the May 2005 *Fiscal Monitor* (preliminary actuals for 2004/05) and the discussion related above, to fine tune the fiscal forecast for 2004/05.

In this section, we first examine the results on a National Accounts basis, resulting from the new Q1 2005 National Accounts data and any other new economic information received since our March update. When examining our economic drivers and the update of our economic forecast we must work on a National Accounts basis since the economic data and our economic model are based on National Accounts data, which includes fiscal data defined and classified on a National Accounts basis. Then, to provide comparability to the budget documents, we must translate this National Accounts data to Public Accounts definitions. Then, we present Global Insight's fiscal forecast for 2004/05, 2005/06, and 2006/07 on a Public Accounts basis and compare it with the February 2005 Budget.

Tables 3 and 4 present Global Insight's updated outlook for revenue and program expenditure, respectively. Table 5 summarizes our fiscal forecast, while table 6 displays the difference between our July fiscal forecast and that from The Budget Plan 2005.

4.1. Results for the Fiscal Year 2004/05 on the National Accounts Basis

The first quarter National Accounts were released on May 31. They provided the results for federal finances on the National Accounts basis. Global Insight has used the updated National Accounts figures to update the assumption for the fiscal drivers over the projection period from those made for the March fiscal update.

❖ Revenue

➢ Total federal revenue came in $2.7 billion below our March projection due to downward revisions for the second, third and fourth quarters of 2004. As a share of nominal GDP, revenue was 0.18 percentage point lower than Global Insight expected in the March update.

➢ The negative surprise in revenue owed mainly to lower corporate income taxes (CIT) (-$2.6 billion) and a lower GST revenue (-$1.0 billion). Important offsets came from a higher personal income tax (PIT) ($0.5 billion) and a higher non-resident tax ($0.4 billion).

➢ As is the case with total revenue, the downward surprise in CIT stemmed from downward revisions in Q2, Q3, and Q4 2004. As a share of corporate profits, CIT was lower by 1.46 percentage point.

➢ The GST revenue was revised down in Q2-Q4 of 2004 and came in lower than anticipated in 2005Q1. As a share of consumer spending, GST revenue was lower by 0.14 percentage points.

➢ The PIT revenue was revised down in 2004Q2 and Q3 but was revised up in Q4 and came in higher than expected in the first quarter of 2005. As a share of personal income, it was slightly lower than Global Insight's March assumptions (-0.03 percentage points).

➢ Non-resident tax revenue was revised upward in 2004Q2-Q4 and came in higher than expected in the first quarter. Relative to nominal GDP, it was 0.03 percentage points higher than assumed.

❖ Expenditure

➢ Current expenditure between 2004Q2 and 2005Q1 was $6.2 billion higher than forecasted in March. This was largely due to the fact that Statistics Canada assumed that the provinces received in the first quarter a larger share of the transfers announced by the federal 2005 budget. Excluding this factor, current expenditure would have been only $1.1 billion higher that forecasted. As a share of nominal GDP, this would imply that the underlying expenditure was 0.11 percentage point higher than expected in 2004/05 on the national accounts basis.

➢ Interest on public debt and business subsidies were also higher than expected in 2004/05, by $0.4 and $0.6 billion, respectively. Interest on public debt was much higher than forecast in 2005Q1 ($1.5 billion), which largely reflected the higher expenditure in the quarter. In contrast, business subsidies were revised higher in 2004Q2-Q4 and came in higher than expected in the first quarter. Relative to nominal GDP they were 0.05 percentage point higher than Global Insight assumed in March.

❖ Other National Accounts Items

➢ Net transfers of capital and capital formation was lower than expected in fiscal 2004/05, by $1.2 and $0.4 billion, respectively. The surprise was consistent through the four quarters of the fiscal year.

❖ National Accounts Federal Balance

➢ On net, the national accounts federal balance for 2004/05 was $9.9 billion lower than forecasted in March. Excluding the $20.7 billion surprise in federal transfers to other levels of government in the first quarter, the balance was $4.7 billion lower, with downward revisions in 2004Q2-Q4.

❖ Adjustments to Drivers

The following adjustments to fiscal drivers were made relative to Global Insight's March assumptions.

➢ PIT/personal income was revised slightly higher in 2005/06, reflecting a steeper pace of increase in this ratio over the previous few quarters.

➢ CIT/corporate profit ratio was lowered by about 0.8 percentage point. This is a conservative adjustment as the ratio was 1.5 percentage point lower than expected in 2004/05.

➢ GST/consumer spending ratio was adjusted lower, in line with the downward adjustment in 2004/05.

4.2. Global Insight's July 2005 Fiscal Forecast

Taking account of all of the information discussed above: particularly the June Global Insight economic forecast, the monitoring of the fiscal monitor, new spending initiatives from the Department of Finance, the examination of our economic drivers and all economic and fiscal information and data to mid July, Global Insight has arrived at the July 2005 fiscal forecast on a Public Accounts basis, which provides direct comparability to budget 2005.

The 2004/05 Fiscal Year

The (underlying) budgetary surplus is expected to have reached $7.2 billion in 2004/05 compared with $3 billion in the 2005 budget plan and $5.7 billion in Global Insight's March update. After allowing for reserves, the remaining planning surplus for 2004/05 is $4.2 billion.

Budgetary revenues are now expected to come in at $198.5 billion, slightly higher than anticipated in the March update ($197.4 billion), up from $195.8 billion forecasted in the budget.

Program expenses are expected to come in at $156.9 billion, close to the March update and down from $158.1 billion forecasted in budget 2005. Based primarily on our monitoring of the fiscal monitor, public debt charges are expected to come in at $34.4 billion. This is a bit lower than the $34.7 billion assumed in both our March update as well as budget 2005.

The 2005/06 Fiscal Year

In 2005/06 the (underlying) budgetary surplus is expected to be slightly smaller than last year, at $5.1 billion compared with $4 billion projected in the budget and $4.2 billion anticipated in our March update.

Budgetary revenues are expected to come in about $2 billion higher than both budgeted and expected in our previous update. This is mainly due to higher PIT and CIT revenue forecasts.

- PIT revenue is higher due to the upward revision in the PIT/personal income ratio
- CIT revenue is higher due to an upward revision to the adjustment factor between national and public accounts. In 2004/05, even though the national accounts show lower CIT, the *Fiscal Monitor* suggests unchanged CIT from our March monitoring, suggesting that the public accounts/national accounts CIT ratio is higher than we assumed in March.

Program expenses, however, are forecasted to be higher than expected in the budget and our March update—$163.2 vs. $161.3 and $161.4 billion, respectively.

- This largely reflects initiatives announced after the 2005 budget, which, on net, raised spending $2.4 billion, and reported in the note from the Department of Finance of May 13, 2005.
- A partial offset comes from lower employment insurance (EI) benefits due to a lower unemployment rate forecasted for this year than expected in both the February 2005 budget and our March update.

Debt charges are expected to be slightly lower than in the budget and our March update, largely due to a lower starting point in 2004/05.

The 2006/07 Fiscal Year

In 2006/07 the underlying budgetary surplus is expected to reach $4.4 billion, compared with $5.0 billion anticipated in the budget and $5.7 billion forecasted in Global Insight's March update.

The surplus is expected to be smaller even though revenue is forecasted to be slightly higher, $210.6 billion compared with $210.1 billion in the budget and $209.5 billion in our March update.

- The upward revision is due to higher CIT revenue as the public accounts/national accounts ratio in CIT revenue was adjusted higher based on 2004/05 data.
- A partial offset came from lower GST revenue due to a downward adjustment of the assumption about the GST/consumer spending ratio.

An upward revision to program expenses overwhelmed the upward adjustment to revenue. Program expenses are expected to reach $171.7 billion compared with $169.5 billion assumed in both the budget and our March update.

- This largely reflects initiatives announced after the 2005 budget, which, on net, raised spending $2.7 billion, as reported in the note from the Department of Finance of May 13, 2005.
- A partial offset comes from lower employment insurance (EI) benefits due to a lower unemployment rate forecasted for 2006 than expected in our March update.

Debt charges are expected to be slightly lower than in the budget due to a lower starting point in 2004/05. They are slightly higher than in our March update due to an upward revision of our short-term interest rate assumption.

Table 3: Global Insight's Revenue Outlook

The Revenue Outlook--Global Insight-- July 2005 -- Public Accounts

	Actual 2003/04	2004/05	2005/06	2006/07
		(billions of dollars)		
Tax Revenue				
Income Tax				
Personal Income Tax	84.9	91.5	96.3	102.4
Corporate Income Tax	27.4	29.1	29.8	29.5
Other Income Tax	3.1	3.6	3.2	3.0
Total Income Tax	115.5	124.1	129.3	135.0
Excise Taxes/Duties				
Goods and Services Tax	28.3	31.0	31.5	32.7
Customs Import Duties	2.9	2.9	3.0	3.1
Energy and Other Taxes/Duties	10.2	10.0	10.0	10.1
Total Excise Taxes/Duties	41.4	43.9	44.5	45.9
Total Tax Revenue	156.8	168.1	173.8	180.9
Employment Insurance Revenue	17.5	17.1	17.1	17.3
Other Revenue	11.8	13.3	11.6	12.4
Total Budgetary Revenue	186.2	198.5	202.4	210.6
Per Cent of GDP				
Personal Income Tax	7.0	7.1	7.1	7.3
Corporate Income Tax	2.3	2.3	2.2	2.1
Other Income Tax	0.3	0.3	0.2	0.2
Goods and Services Tax	2.3	2.4	2.3	2.3
Excise Taxes/Duties (excluding GST)	1.1	1.0	1.0	0.9
Total Tax Revenue	12.9	13.0	12.9	12.8
Employment Insurance Revenue	1.4	1.3	1.3	1.2
Other Revenue	1.0	1.0	0.9	0.9
Total Budgetary Revenue	15.3	15.4	15.0	14.9

Table 4: Global Insight's Program Expenses Outlook

The Program Expenses Outlook--Global Insight--July 2005--Public Accounts

	Actual 2003/04	2004/05	2005/06	2006/07
	(billions of dollars)			
Major Transfers to Persons				
Elderly Benefits	26.9	27.9	29.0	30.1
Employment Insurance Benefits	15.1	14.9	15.2	16.1
Total	42.0	42.8	44.3	46.2
Major Transfers to Other Levels of Government	29.4	39.1	39.1	41.9
Direct Program Expenses	70.0	75.0	79.8	83.7
Total Program Expenses	141.4	156.9	163.2	171.7
Per Cent of GDP				
Major Transfers to Persons				
Elderly Benefits	2.2	2.2	2.1	2.1
Employment Insurance Benefits	1.2	1.2	1.1	1.1
Total	3.5	3.3	3.3	3.3
Major Transfers to Other Levels of Government	2.4	3.0	2.9	3.0
Direct Program Expenses	5.8	5.8	5.9	5.9
Total Program Expenses	11.6	12.2	12.1	12.2

Table 5: Global Insight's Fiscal Projection July 2005

Public Accounts Basis

	Actual 2003/04	2004/05	Projection 2005/06	2006/07
	(billions of dollars)			
Budgetary Transactions				
Budgetary Revenues	186.2	198.5	202.4	210.6
Total Expenses				
Program Expenses	141.4	156.9	163.2	171.7
Public Debt Charges	35.8	34.4	34.2	34.5
Total Expenses	177.1	191.3	197.4	206.2
Budgetary Surplus	9.1	7.2	5.1	4.4
Prudence				
Contingency Reserve		3.0	3.0	3.0
Economic Prudence			1.0	2.0
Total		3.0	4.0	5.0
Planning Surplus	9.1	4.2	1.1	-0.6
Federal Debt				
Assuming Balanced Budget	501.5	501.5	501.5	501.5
Assuming Contingency Reserve Applied to Debt Reduction	501.5	498.5	495.5	492.5
Per cent of GDP				
Budgetary Revenues	15.3	15.4	15.0	14.9
Program Expenses	11.6	12.2	12.1	12.2
Public Debt Charges	2.9	2.7	2.5	2.4
Total Expenses	14.6	14.8	14.6	14.6
Planning Surplus	0.7	0.3	0.1	0.0
Federal Debt				
Assuming Balanced Budget	41.2	38.9	37.1	35.5
Assuming Contingency Reserve Applied to Debt Reduction	41.2	38.6	36.6	34.9

Table 6: Difference between Global Insight's July Fiscal Projection and The Budget Plan 2005

Public Accounts Basis

		Projection	
	2004/05	2005/06	2006/07
	(billions of dollars)		
Budgetary Transactions			
Budgetary Revenues	2.7	2.0	0.5
Total Expenses			
Program Expenses	-1.2	1.9	2.2
Public Debt Charges	-0.3	-0.9	-1.1
Total Expenses	-1.5	1.0	1.1
Budgetary Surplus	4.2	1.1	-0.6
Prudence			
Contingency Reserve	0.0	0.0	0.0
Economic Prudence		0.0	0.0
Total	0.0	0.0	0.0
Planning Surplus	4.2	1.1	-0.6
Federal Debt			
Assuming Balanced Budget	0.0	0.0	0.0
Assuming Contingency Reserve Applied to Debt Reduction	0.0	0.0	0.0
Per cent of GDP			
Budgetary Revenues	0.3	0.2	0.2
Program Expenses	0.0	0.2	0.3
Public Debt Charges	0.0	-0.1	-0.1
Total Expenses	-0.1	0.1	0.2
Planning Surplus	0.3	0.1	0.0
Federal Debt			
Assuming Balanced Budget	0.1	0.1	0.3
Assuming Contingency Reserve Applied to Debt Reduction	0.1	0.1	0.3

5. Risks to Global Insight's July 2005 Fiscal Forecast

Many Canadians are casting worried looks at the US housing market. Even as housing starts south of the border continue to climb higher, evidence has been emerging that in a few regional markets, such as California and Florida, conditions may be ripe for a downward correction. A bout of price deflation in the US housing market would strike not only the residential construction sector but also consumer spending. Depressed US activity would reduce sales of Canadian products in the United States at a time when Canadian exporters have not fully adjusted to the past appreciation of the Canadian dollar.

The housing market bubble is typically burst by a spike in interest rates, as was the case in the late 1980s. The US baseline calls for the fed funds rate to finish this year at 4.0%, up 300 basis points from 1.0% at the start of 2004. The Fed is expected to stay on the sidelines next year. The current tightening cycle is similar to that in the late 1980s, when rates rose 350 basis points between the third quarter of 1986 and the second quarter of 1989. The baseline US forecast does expect a decline in housing starts in 2006 and for house prices to slow down to the pace of CPI inflation. While lower housing starts will depress residential construction, the weaker prices will weigh on households' asset values and thus depress growth in consumer spending. This is why the US baseline forecast expects GDP growth of only 2.9% in 2006. The Canadian baseline forecast calls for GDP growth of 2.8%.

While the risks to our baseline forecast are balanced, there is a small (10%) chance of a sharper-than-expected correction in the US housing market. We can call this scenario pessimistic. It is also possible (10% probability) for the US housing market to remain strong, with sales, construction and prices remaining at high levels. This would be an optimistic scenario.

Pessimistic Scenario (10% probability)

We could get a much bigger correction in the US housing market than assumed in the baseline if the Fed were pushed to raise rates higher. The pessimistic scenario departs in several important ways from the base case. We assume that US productivity growth is weaker than assumed by the Fed. This is motivated by the fact that residential construction, where productivity growth is weaker than in many other sectors of the US economy, has been increasing its share of investment and economic activity. The scenario also assumes a greater loss of confidence in the US dollar than in the base case. The weaker productivity and the greater currency depreciation fan inflationary pressures. In addition, energy costs rise because US-dollar oil prices increase in response to the weaker greenback.

The emergence of price pressures causes the Fed to increase the Fed funds rate more aggressively than in the base case, to 4.5% by the end of this year and to 5.75% by the end of 2006. The bond market also reacts in a negative fashion by raising yields sharply, which results in significantly higher mortgage rates. The higher mortgage rates depress housing starts and prices. Lower housing starts cause layoffs in construction, cutting employment and income. Meanwhile, lower residential real estate values weigh on household assets, which in turn forces consumers to tighten their purse strings.

The Canadian economy is hit hard in the pessimistic scenario. As stateside GDP growth weakens, the demand for Canadian exports falls. The forestry and logging sector, and furniture and household durables manufacturers are particularly affected as the US weakness is concentrated in interest-sensitive consumer spending and residential construction. To make the situation even worse, the downward pressure on the US dollar pushes the loonie sharply higher. Canadian exporters are hit by a double whammy of lower demand and reduced price competitiveness.

The Bank of Canada makes an effort to stimulate the domestic side of the economy by cutting the overnight rate—bottoming out at 1.0% in late 2007. The effort is partly frustrated by higher US interest rates, which pressure Canadian yields higher in 2006. The upward pressure eases in 2007/08 after the Bank of Canada aggressively reduces the short-term interest rate.

The Canadian economy falls into recession in 2006 and 2007 and the unemployment rate surges to 10% by 2008. Export growth grinds to a halt in 2006 and becomes negative in 2007. The Canadian dollar peaks at 93 US cents in 2006, but retraces to just over 85 US cents by 2008 as the Canada-US interest rate spread becomes more negative. The depreciation of the Canadian dollar, lower interest rates, and signs of revival in the US economy put Canada's economy on a recovery path in 2008.

Optimistic Scenario (10% probability)

In the optimistic scenario, we assume that positive supports behind the current housing market boom—employment, mortgage rates, and consumer confidence—become even more positive. In addition, crude oil prices are assumed to be lower than in the baseline. As a result, US GDP growth reaches 4.0% next year and slows to 3.5% by 2008, compared with the baseline scenario of growth staying at 3% during 2006/08. The higher GDP growth comes largely from stronger productivity. The stronger productivity and lower crude oil prices reduce price pressure, allowing the Fed to be less aggressive in raising interest rates. The Fed funds rate finishes this year at 3.50% and rises only to 4.00% by 2008, compared with 4.5% in the baseline. While long-term interest rates are forecasted to rise, the increase by 2008 is approximately 50 basis points less than in the baseline. US housing starts stay at the level of 2.0 million units in 2006 and decline slightly to 1.927 million by 2008. This compares with the level of 1.726 million units in 2008 in the baseline.

The Canadian economy benefits from stronger growth south of the 49th parallel. The benefit comes from higher demand and a weaker Canada-US exchange rate. The Canadian dollar is slightly weaker than in the baseline because the faster US growth attracts investment funds into the United States, providing a generalized support to the greenback.

Canadian GDP growth rises from 2.6% this year to 3.2% in 2006 and 3.6% in 2007. The unemployment rate falls to 6.3% by 2008. The Bank of Canada initially follows the same course as in the baseline but picks up the pace of tightening in 2007. The overnight rate peaks at 4.0% in 2008 compared with 3.25% in the baseline. GDP growth starts to ease in response to higher interest rates, falling to 3.1% in 2008. While the American economy experiences a stronger housing boom in the optimistic scenario, Canadian housing starts fall below the baseline by 2008 due to higher interest rates.

Impacts on Federal Government Finances

Our modeling work suggests that in the pessimistic scenario the federal fiscal balance would be only slightly affected this fiscal year (-$1 to -$2 billion), but that the shortfall from the baseline would jump to at least $10 billion in 2006/07.

In the optimistic scenario, the federal fiscal balance would be little influenced this fiscal year. A small improvement from the baseline of $1 to $2 billion could be expected in 2006/07.