OXFORD ECONOMICS

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Country Economic Forecast | Canada

Sharp growth slowdown in 2023, faster rate hikes ahead

- **Canada's economy successfully weathered the Omicron wave in Q1, but slower growth is on the horizon. An increasingly hawkish Bank of Canada, inflation at a four-decades high, fallout from the war in Ukraine, and a correction in house prices are all expected to contribute to a sharp slowdown in economic growth next year. We forecast GDP will rise 4.1% in 2022 before growth decelerates to 2.2% in 2023, unchanged from last month.**
- **We've nudged up our inflation forecast, but still expect it to begin falling in H2 2022. After peaking at 6.8% y/y in Q2, we forecast CPI inflation will ease to just over 5% by year end and average 6% in 2022 overall (up 0.1ppt from last month). In 2023, falling energy and commodity prices, gradually improving supply chains, tighter monetary policy, and weaker aggregate demand will pull inflation down to 2.7% on average, up 0.1ppt from last month.**
- **The job market was less buoyant in April, as the bounce from the reopening of the economy faded. Employment rose just 15,300 (+0.1% m/m) following a cumulative gain of 409,100 in the prior two months. Despite much slower job growth, the unemployment rate slid 0.1ppt to 5.2%, an all-time low. Favourable job prospects and higher wages should start to draw more workers into the labour force, pushing up the unemployment rate to 6% by early 2023.**
- **High inflation and tight labour markets will likely prompt the Bank of Canada to hike rates another 50bp at its next meeting in early June. We then expect the Bank to raise rates 25bp in July, before pausing at 1.75% to reassess the impact of tighter monetary policy on the economy. However, risks to our interest rate forecasts are tilted to the upside.**
- **We predict a 24% correction in house prices will start later this year as record unaffordability, rising rates, and new government policies cause the market to cool markedly.**

Table 1: Canada forecast overview

(Annual percentage changes unless specified)						
	2020	2021	2022	2023	2024	2025
GDP	-5.2	4.6	4.1	2.2	1.8	2.3
Private consumption	-6.1	5.1	5.9	2.8	2.2	2.3
Fixed investment	-2.8	7.2	2.0	1.1	1.6	3.0
Government consumption	0.0	4.9	0.8	-1.2	0.0	0.8
Exports of goods and services	-9.7	1.4	6.0	6.4	3.4	2.5
Imports of goods and services	-10.8	7.4	6.2	4.8	1.5	1.9
Industrial production	-8.1	4.2	4.9	3.6	2.3	2.2
Consumer prices	0.7	3.4	6.0	2.7	2.2	2.3
Unemployment rate (%)	9.6	7.4	5.7	6.0	6.0	6.0
Current a/c balance (% of GDP)	-1.8	0.1	0.6	0.1	-0.6	-1.0
Government balance (% of GDP)	-10.7	-4.4	-1.6	-1.4	-1.4	-1.3
Cen. bank policy rate (%, EOP)	0.25	0.25	1.75	2.00	2.00	2.00
10yr govt. bond yield (%, EOP)	0.67	1.42	3.15	3.05	2.86	2.85
Exchange Rate (Per US$)	1.27	1.27	1.30	1.30	1.25	1.19
Exchange Rate (Yen per Can $)	81.32	90.71	94.42	87.64	87.29	87.63

Source: Oxford Economics

Tony Stillo - Director of Canada Economics - tstillo@oxfordeconomics.com

Forecast overview

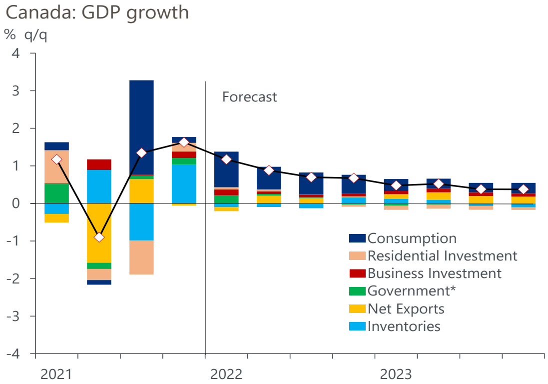
Recent developments

Recent data have confirmed the economy's strong performance in Q1, despite Omicron and much tighter public health restrictions. GDP rose 1.1% m/m in February as the widespread easing of restrictions supported a 0.9% m/m rise in services output, while goods-producing industries recorded an even stronger 1.5% m/m advance.

This was well above Statistics Canada's preliminary estimate for a 0.8% m/m rise. Moreover, StatCan's flash estimate is for a 0.5% advance in March GDP, which would imply solid 1.4% q/q GDP growth in Q1. We see some downside to this, and think the economy grew at a slightly weaker 1.2% q/q pace in Q1.

The 2022 federal budget proposes C$35bn in new stimulus over the next five years. This is much less than the C$53bn fiscal expansion pledged by the Liberals in the 2021 election. We estimate the 2022 budget package lifts GDP growth 0.4ppts this year and raises consumer prices 0.2ppts by 2023 – moderately less than the Liberals' larger election platform we had factored in previously, which would have boosted growth 0.6ppts in 2022 and prices 0.3ppts by 2023.

Chart 1: GDP expected to grow 1.2% q/q in Q1



Source: Oxford Economics

Short-term outlook

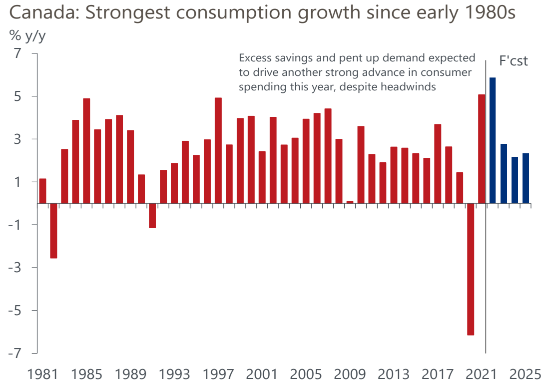
After rising in early April, Covid cases have fallen in recent weeks and hospitalizations have started to edge lower again. The most recent wave didn't elicit a retightening of public health restrictions, which bodes well for the economic outlook in Q2.

Although pandemic risks continue to linger, there has been a clear shift towards a "living with Covid" approach to the virus, which likely means large economic disruptions will be avoided again in subsequent waves. We expect another solid 0.9% q/q advance in Q2 GDP.

However, the Canadian economy faces several headwinds that are likely to hit growth in H2 and through 2023. Canada has few direct ties with Russia and Ukraine, but there will be spill-over effects from the war via weaker external demand. Further strain on supply chains and negative confidence effects will constrain the recovery in business investment this year. Moreover, China's 'zero-Covid' policy is exacerbating supply chain issues.

Canadian households are already feeling the pinch of higher energy prices on their real disposable income, which will weigh on consumer outlays in the near term. Also, sooner-than-expected rate hikes by the Bank of Canada this year mean consumers will soon feel the sting of rising debt service costs. However, we think the nearly $245bn (9.4% of GDP) in excess savings built up by households during the pandemic, along with significant pent-up demand, will continue to support strong consumer spending growth of 5.9% in 2022. But considerable downside risks to the consumer spending outlook remain – notably Canada's extremely elevated level of household debt and the potential for a larger-than-expected negative wealth effect from our forecast decline in house prices later this year.

Chart 2: Consumer spending forecast to rise 5.9% in 2022 before slowing to 2.8% in 2023



Source: Oxford Economics/Haver Analytics

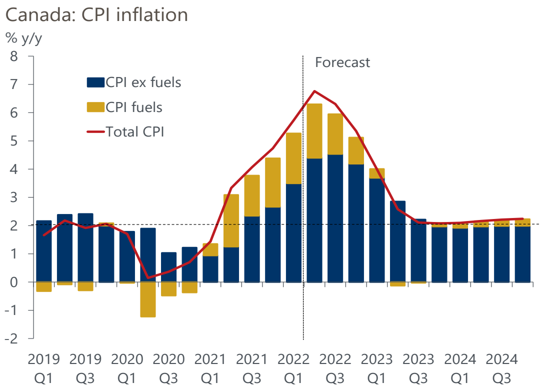
Tony Stillo - tstillo@oxfordeconomics.com

Key drivers of our short-term forecast

Elevated inflation. We now expect inflation to peak at 6.8% in Q2 2022 before slowing to 2.1% by mid-2023. We've nudged up our forecast by 0.1ppt to 6% on average in 2022. However, the combined effects of gradually improving supply chains, falling global energy and commodity prices, rate hikes by the Bank of Canada and weaker aggregate demand are expected to reduce inflation sharply next year.

We forecast inflation will fall from 6.8% in Q2 2022 to 2.1% y/y in Q3 2023, slightly above the Bank of Canada's 2% target. For the rest of the decade, steady increases in the federal carbon levy will see inflation average 2.2% from 2024-2030, well within the Bank's 1%-3% target range.

Chart 3: Inflation forecast to slow to just above the Bank of Canada's 2% target by mid-2023



Source: Oxford Economics/Haver Analytics

Labour market remains quite tight. Although job growth slowed to a measly 15,300 (+0.1% m/m) pace in April, all indications are the labour market is tight, illustrated by the unemployment rate edging down to an all-time low of 5.2%.

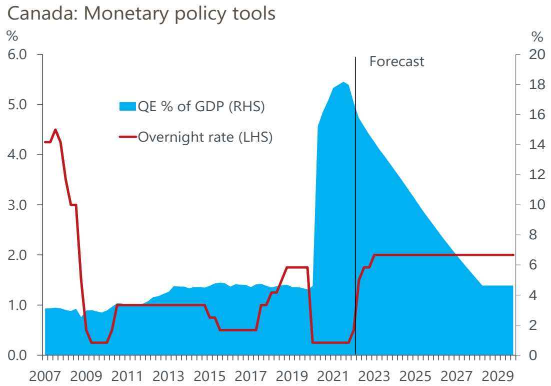
We expect job growth will continue at a modest pace in the near term. Favourable labour market conditions and rising wages will likely draw more workers into the labour force, helping to lift the unemployment rate to 6% by early 2023.

Further rate hikes ahead. With inflation elevated and labour markets tight, the Bank of Canada looks set to tighten monetary policy further. We expect the Bank will hike the overnight interest rate another 50bps at its next meeting on June 1 and follow that up with a 25bp hike in July. However, the Bank will then need to pause to reassess the outlook, particularly the impact of recent rate hikes on households and the housing market, before lifting the policy rate to 2% in early 2023.

We continue to believe the Bank will be cautious as it raises rates to avoid aggravating Canada's underlying household debt and house price vulnerabilities. We expect more details from the Bank on these issues in its annual financial system review, due later this month.

Aggressive rate hikes by the Bank of Canada raise the risk of a much sharper slowdown in the economy in 2023 and 2024. Nevertheless, there are upside risks to our interest rate outlook. The Bank raised its estimate of the neutral rate 25bps to between 2%-3% in its April projection, and we will also be reassessing our 2% neutral rate assumption.

Chart 4: We now expect the Bank will hike rates another 50bps at its June meeting



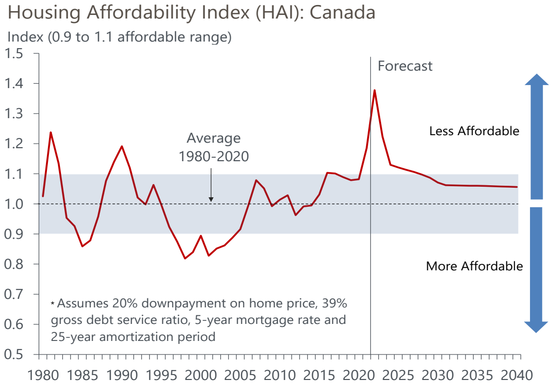
Source: Oxford Economics/ Haver Analytics

House price correction to start by autumn. We continue to believe the combination of rising mortgage rates, record unaffordability, and new government policies designed to curb demand and boost supply will trigger a housing market correction beginning later this year.

After cresting in late summer 50% above their pre-pandemic level, we forecast home prices will decline 24% by mid-2024. Lower house prices will likely have a modest negative effect on consumption, but we don't expect it will result in a recession or undue stress on the financial system. However, should the price boom continue unabated, risks grow of a larger crash with dire economic consequences.

Tony Stillo - tstillo@oxfordeconomics.com

Chart 5: House prices forecast to fall 24% by mid-2024, return to affordable range by 2028



Source: Oxford Economics/Haver Analytics

Economic risk

Economic risk evaluation

Overall risk for Canada: 3.2/10*

Canada's overall economic risk score is low at 3.2, ranking it 26th out of 164 countries.

We expect strong economic growth this year, but headwinds from the war in Ukraine, elevated commodity, and energy prices, falling house prices and a hawkish Bank of Canada are likely to weigh on growth in 2023 and 2024. We forecast GDP growth will slow from 4.6% in 2021 to 4.1% in 2022, 2.2% in 2023 and 1.8% in 2024.

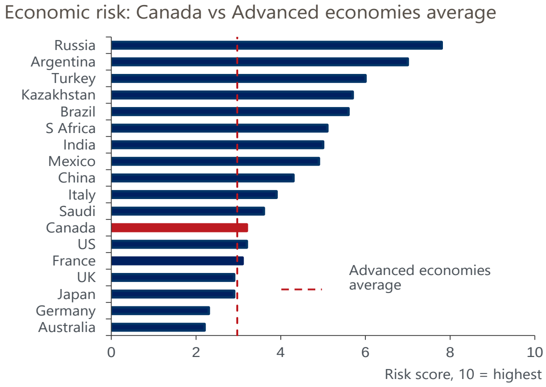
Market demand: 4.0/10

The market demand risk score remains moderate at 4.0 but is still higher than the advanced economy average of 3.4.

Domestic demand was hit hard by the pandemic, but the economy was more resilient than expected amid tighter restrictions and the Omicron wave in early 2022. Furthermore, new global headwinds and increased uncertainty from the war in Ukraine have raised downside risks and will weigh on growth in the near term.

There are other downside risks to the domestic demand outlook. A sustained pandemic would hurt Canada's growth prospects, particularly in less vaccinated, more resource-dependent provinces. On the investment front, a sharp drop in oil prices or a persistent shock to the global economy would weigh on capital expenditure.

Chart 6: Canada has a low risk score



Source: Oxford Economics

Market cost: 3.0/10

The market cost risk score is 3.0, roughly in line with the advanced economy average of 2.7.

Inflation rose to a four-decade high of 6.7% in March, but we think the near-term rise will prove temporary, with inflation forecast to ease to 2.7% in 2023. But risks are tilted to the upside. Over the medium term, excess demand pressures and planned increases in the carbon levy are expected to hold inflation above the Bank of Canada's 2% target, averaging 2.2% between 2024-2030.

Table 2: Economic Risk Index

	May 2022 (Scores from 1 to 10 with 10 = highest risk)	Score change from November	Rank out of 164 (1= lowest)
Overall	3.2	-0.1	26
Market demand	4.0	0.0	27
Market cost	3.0	0.0	13
Exchange rate	2.7	0.1	39
Sovereign credit	3.4	-0.3	22
Trade credit	3.0	0.0	12

Source: Oxford Economics

Exchange rate: 2.7/10

Exchange rate risk is 2.7, in line with the advanced economy average of 2.4. Canada's score reflects the country's solid political and regulatory framework, although it is exposed to changes in global oil prices.

The Canadian dollar is expected to depreciate slightly this year and next as the US Federal Reserve raises interest rates more aggressively than the Bank of Canada. Over the medium term, the Canadian dollar is forecast to strengthen, reflecting a gradual rise in domestic interest rates as economic growth steadies and commodity prices rise.

Sovereign credit: 3.4/10

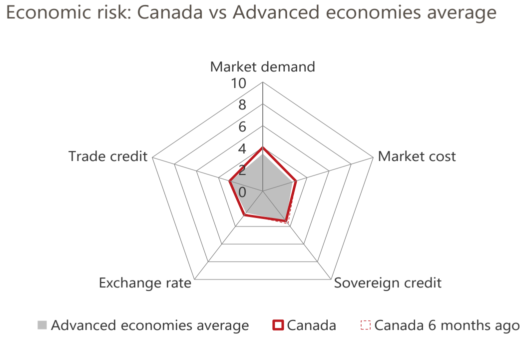
After downgrading its rating in 2020, Fitch affirmed Canada's AA+ status in June 2021, continuing to attach a "stable" outlook to the country's long-term creditworthiness. We also believe Canada is very creditworthy. Our sovereign credit risk model assigns Canada a risk score of 3.4, in line with the 3.4 average score for advanced economies.

Canada's prudent policymaking, robust regulatory framework, manageable federal debt burden, and reasonably solid longer-term economic prospects make it a very safe place to invest from a sovereign risk perspective. However, the score is pushed higher by the large increase in private sector debt since the global financial crisis and the mix of a current account deficit and net FDI outflows.

Trade credit: 3.0/10

Canada's trade credit risk, a measure of private sector repayment risk, is broadly in line with the advanced economy average of 2.9. Overall, we expect Canada to maintain its trajectory of prudent policymaking into the medium term, keeping the risks to Canadian businesses relatively low. After depreciating slightly later this year, we expect the Canadian dollar to slowly appreciate over the medium term.

Chart 7: Canada's risk score is roughly in line with the advanced economy average



Source: Oxford Economics

* Risk scores are from 1 to 10, with 10 representing the highest risk. For our full country risk service, see http://www.risk-evaluator.com/. Sovereign credit risk comes from our sovereign risk tool and foreign exchange risk comes from our FX tool. Find out more.

Risk warnings

Chart 8: Inflation is the biggest near-term risk

Risk warnings		
GDP growth		After a resilient Q1, growth is likely to slow as headwinds mount
CPI inflation		Inflation to peak at 6.8% in Q2, slow to 2.7% on average in 2023
Current account balance		Modest positive balance expected in 2022 before turning negative in H2 2023
Government balance		Deficits expected to shrink as pandemic measures end, but remain large
Government debt		Gov't debt to ease to about 108% of GDP in 2022 from 118% in 2021
External debt		External debt to remain above 115% of GDP in the near term

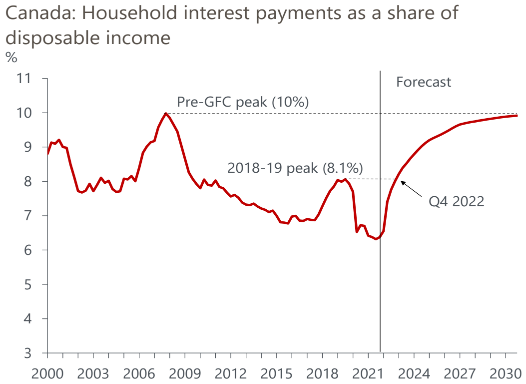
Source: Oxford Economics

What to watch out for

Coronavirus pandemic. The Omicron wave has faded, and most regions have eased restrictions or dropped them entirely. But the potential for dangerous new variants to emerge continues to present downside risk to the outlook.

US growth. Our US growth outlook has been revised lower and recession risks have increased. Weaker US growth would also likely mean a weaker Canadian economy.

Chart 9: Household interest payments set to increase as rates rise



Source: Oxford Economics/Haver Analytics

High household indebtedness. Historically high debt makes Canadian households acutely vulnerable to a loss of jobs and income or sharp rise in interest rates, which could endanger the recovery.

Excessively high house prices. We now see a 24% fall in home prices by mid-2024 as the most likely scenario, however risks of a larger crash and financial crisis remain.

Pick-up in business investment. Sustained, strong private investment is needed to add capacity and support exports.

Oil and gas sector. The recent surge in energy prices should increase profits and incomes in regions that are heavily dependent on oil and gas production. However, longer-term capital investments appear unlikely to pick up unless the recent price surge is sustained.

Financial sector stability. Canada's banking system remains largely stable and well-fortified, although the real estate sector and high household debt are key risks.

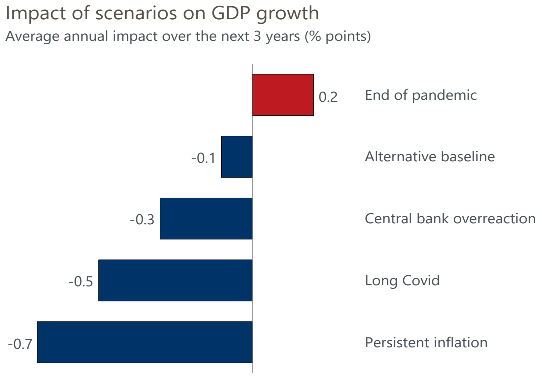
Higher interest rates. Sharply higher rates could choke Canada's economic growth, especially since the economy is more interest-sensitive due to high household debt.

Exposure to key global risks

Alternative baseline. In this plausible downside scenario, the fighting in Ukraine lasts well into 2023, the West imposes further sanctions, and Russia retaliates by restricting gas supplies.

Canada's GDP growth is unchanged at 4.1% in 2022, but growth slows further to 1.9% in 2023 compared with 2.2% in our current baseline.

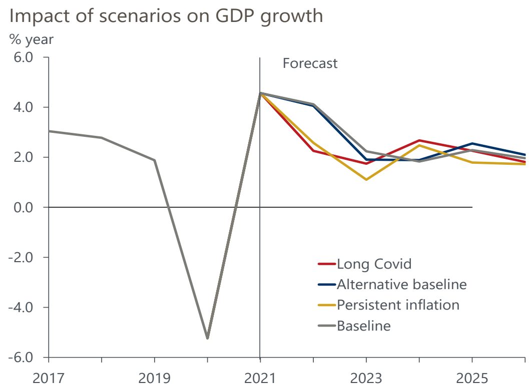
Chart 10: Persistent inflation scenario would be the most damaging to Canada's economy



Source: Oxford Economics

Persistent inflation. In this scenario, inflationary pressures prove more persistent than anticipated in our baseline forecast. Supply-chain disruptions continue to weigh on the global economy throughout 2022 and the early part of 2023. Consumer price inflation also remains elevated further ahead, against a backdrop of higher commodity prices and inflation expectations and a disappointing recovery in labour market participation. The pace of the global recovery is subdued as higher inflation squeezes real incomes, while weaker financial markets exacerbate the hit to demand. Canada's GDP grows just 2.6% in 2022, 1.5ppts slower than our baseline, and 1.1% in 2023, 1.1ppts below our current forecast.

Chart 11: Risks are skewed to the downside



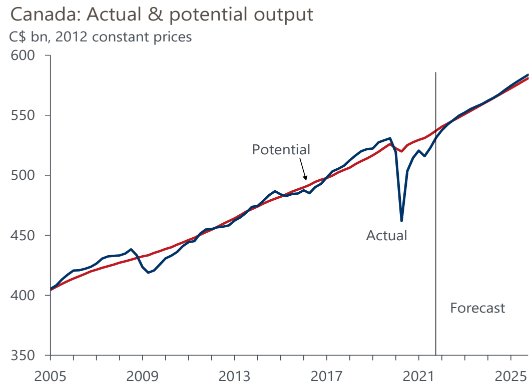
Source: Oxford Economics

Long-term prospects

Canada has relatively easy access to the US. However, we expect sluggish investment in both the energy and non-energy sectors to improve only gradually. We forecast the capital stock to expand 1.6% pa over the next decade, weaker than the 2.1% pa expansion in 2010-2020.

The contribution of labour to potential output growth is also expected to remain modest. We expect growth in equilibrium employment to rise to 1% pa over the next decade, up from 0.9% in 2010-2020. This reflects the ageing population, which also underpins a forecast decline in the overall participation rate. We expect total factor productivity (TFP) growth to contribute 0.7ppts to potential growth over the next decade, a material improvement on the 0.4ppts contribution to growth in 2010-2020. As a result, we expect potential GDP growth to average 1.9% pa over the next 10 years.

In the longer term, we expect the impact of a warming climate to contribute positively to GDP growth in Canada. Without a significantly expanded mitigation effort, the world is on course to warm by about 2°C above pre-industrial levels by 2050. We estimate this will increase Canada's potential output by just over 6% by 2050.



Source: Oxford Economics

Table 3: Potential GDP and its components

Average Percentage Growth		
	2011-2020	2021-2030
Potential GDP*	1.7	1.9
Employment at NAIRU	0.9	1.0
Capital Stock	2.1	1.6
Total Factor Productivity	0.4	0.7
*ln(Potential GDP)=0.65*ln(Employment at NAIRU) +0.35*ln(Capital Stock)+ln(Total Factor Productivity)		

Source: Oxford Economics

Table 4: Long-term forecast for Canada

(Average annual percentage change unless otherwise stated)				
	2011-2015	2016-2020	2021-2025	2026-2030
GDP	2.1	0.6	3.0	1.8
Consumption	2.3	0.7	3.6	2.1
Investment	1.5	-0.4	2.9	2.1
Government consumption	0.6	1.8	1.1	1.1
Exports of goods and services	4.0	-0.3	3.9	1.3
Imports of goods and services	2.9	-0.7	4.4	1.6
Unemployment (%)	7.2	6.9	6.2	6.0
Consumer prices, average	1.7	1.6	3.3	2.2
Current a/c balance (% of GDP)	-3.0	-2.4	-0.2	-1.2
Exchange rate (Trade-Weighted Index)	96.2	83.7	86.5	88.0
Government balance (% of GDP)	-0.8	-1.8	-2.0	-0.6
Short-term Interest Rates (%)	1.1	1.3	1.7	2.2
Long-term Interest Rates (%)	2.1	1.5	2.6	2.9
Working population	1.1	1.3	1.2	1.1
Labour supply	0.8	0.8	1.4	0.6
Participation ratio	66.2	65.2	65.2	63.7
Labour productivity	1.1	0.4	0.8	1.2

Source: Oxford Economics

Background

Economic development

Canada is a market economy, where most decisions are taken by private individuals and firms. However, while the economy is much freer in this respect than many other developed economies, there is more government regulation than in the US. The economy is diversified, although huge deposits of oil sands give Canada the third-largest reserves of oil in the world and have increased the importance of the country's energy sector in recent years. However, the price of oil must remain quite high to make such production economically viable. Although commodities and manufacturing account for relatively small shares of total output and employment, they make up more than half of Canada's exports.

Structure of the economy

Canada has a reputation as a resource-based economy, but that is misleading. While it is certainly rich in resources, from energy commodities to lumber and minerals, the economy is largely services-based. About two-thirds of the nation's output originates in the services sector and nearly three-quarters of workers are employed there. Key service sub-sectors include retail trade, business services (financial services, real estate, and communications), education, and health services. The main manufacturing industry is motor vehicles and parts, which is centred in the province of Ontario. The manufacturing sector is responsible for less than 10% of total employment, while agriculture accounts for less than 2%.

Balance of payments and structure of trade

Trade is a very important sector of the economy – both imports and exports represent more than a third of GDP. About 75% of exports go to the US and more than 60% of imports originate there, so economic conditions in the US can be critically important for Canada. Services are an increasingly important part of Canada's trade with foreign countries, stressing its competitive advantage as a knowledge-based economy with a highly skilled workforce.

Policy

The Bank of Canada, the country's central bank, first implemented the policy of inflation targeting in 1991. The current target is to keep inflation at 2%, with a range of 1% to 3%, over the medium term. The Bank of Canada's Governing Council meets eight times a year with the goal of achieving this objective. The primary policy tool to achieve this objective is the target the central bank sets for the overnight interest rate – the rate financial institutions charge each other for overnight loans. The central bank's mandate is reviewed every five years in conjunction with the federal government.

The government in power – with the prime minister at the helm – has control over the federal budget. Importantly, Canada's federal constitution allows the provincial governments to pursue their own fiscal policies independently from the policy set by the federal government in Ottawa. This allows the federal and provincial governments to pursue fiscal policies pertinent to the desires of their constituencies.

Politics

Canada is a parliamentary democracy and constitutional monarchy. Parliament comprises three distinct parts: the Queen, the Senate, and the House of Commons. The House of Commons, containing 338 sitting members, is the main seat of parliamentary power and can propose, debate, and vote on bills before they become law. Only the House of Commons can propose changes to fiscal policy. Federal elections are conducted every four years. Canada has many political parties, although the two main parties are the Conservative Party and the Liberal Party. The Liberals retained a minority government in the 2021 federal election.