OXFORD ECONOMICS

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Country Economic Forecast | Canada

Recession on the horizon

- **Canada's economy looks headed for a moderate recession. Rapid monetary policy tightening, a deepening housing correction, falling real incomes, and looming recessions in the US, UK, and eurozone will likely push Canada into a downturn this fall. Accordingly, our GDP growth forecast has been revised down 0.3ppts to 2.9% in 2022 and cut a sharp 2.1ppts to -1.1% in 2023.**
- **The economy is already losing steam. GDP edged up just 0.1% q/q in June and early indications are the economy contracted 0.1% m/m in July, providing a very weak kick-off for H2. The labour market is slowing, too. Some 39,700 (-0.2%) jobs were lost in August – the third straight monthly decline – and the unemployment rate jumped 0.5ppts to 5.4%. We now expect mounting layoffs will lift the unemployment rate to a peak of 8.2% in early 2024.**
- **After a surprise 100bps hike in July, the Bank of Canada delivered a 75bps hike in September, bringing the policy rate to 3.25% – just above the BoC's neutral range but well into restrictive territory in our view. The Bank also clearly intends to press forward with further tightening to rein in inflation. We anticipate another 50bps hike in October before evidence of a weakening economy, loosening labour markets, and easing inflation finally prompt the Bank to pause.**
- **Inflation likely peaked at 8.1% in June, and we expect a marked easing in 2023 as energy and house prices fall, supply stress continues to gradually lessen, aggregate demand weakens, and labour market slack builds. Nevertheless, stickier core inflation will likely see headline inflation average 3.3% in 2023, up 1ppt from last month, and not return to 2% until early-2024.**
- **The correction in Canada's housing market has been swift, but we now expect an even deeper price decline. We now forecast prices will fall 30% peak-to-trough by Q3 2023.**

Table 1: Canada forecast overview

(Annual percentage changes unless specified)	2020	2021	2022	2023	2024	2025
GDP	-5.2	4.5	2.9	-1.1	2.8	3.7
Private consumption	-6.1	4.9	5.0	-0.9	2.4	4.0
Fixed investment	-2.8	7.1	-0.2	-3.9	3.0	5.8
Government consumption	0.0	5.8	1.2	-2.1	-0.2	0.8
Exports of goods and services	-9.7	1.4	3.9	5.2	3.5	3.5
Imports of goods and services	-10.8	7.7	7.7	-0.3	0.8	3.5
Industrial production	-8.1	4.3	3.7	-0.5	3.8	3.8
Consumer prices	0.7	3.4	6.7	3.3	2.0	2.3
Unemployment rate (%)	9.6	7.4	5.4	7.5	8.0	7.1
Current a/c balance (% of GDP)	-1.8	0.0	1.2	2.2	1.2	0.1
Government balance (% of GDP)	-10.7	-4.7	-1.9	-2.9	-3.1	-2.6
Cen. bank policy rate (%, EOP)	0.25	0.25	3.75	3.25	2.00	2.00
10yr govt. bond yield (%, EOP)	0.67	1.42	3.55	3.09	2.85	2.85
Exchange Rate (Per US$)	1.27	1.27	1.32	1.32	1.26	1.21
Exchange Rate (Yen per Can $)	81.32	90.71	108.10	94.25	86.84	86.48

Source: Oxford Economics/ Haver Analytics

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Forecast overview

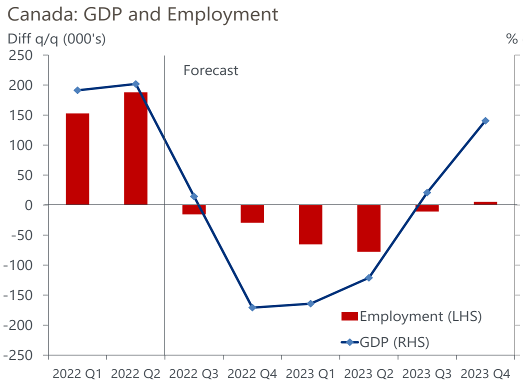
Recent developments

The Canadian economy expanded 0.8% q/q in Q2 2022, in line with our expectations and matching the Q1 advance. The reopening of the economy and release of pent-up demand boosted household spending on services and semi-durable goods in Q2, supporting a solid 2.3% q/q rise in overall consumer spending. Inventories rose sharply and were the largest contributor to growth (+1.5ppts), as firms replenished both farm and non-farm stocks.

As anticipated, residential investment was a huge drag on the economy in Q2 (-7.8% q/q), as the correction in home prices cut resales and renovation activity. Net trade also shaved growth, as imports (+6.9% q/q) grew faster than exports (+2.6% q/q). Despite the solid quarterly advance, the economy ended Q2 with weakening momentum. GDP edged up just 0.1% m/m in June and StatCan's advance estimate for a 0.1% decline in July presents a weak kick-off for H2.

The latest labour market data also signalled a slowing economy. Canada lost 39,700 (-0.2%) jobs in August which helped drive the joblessness rate up 0.5ppts to 5.4%. The third consecutive monthly job loss leaves employment down 114,000 (-0.6%) from May 2022.

Chart 1: We now forecast a recession lasting three quarters, beginning in Q4 2022



Source: Oxford Economics/Haver Analytics

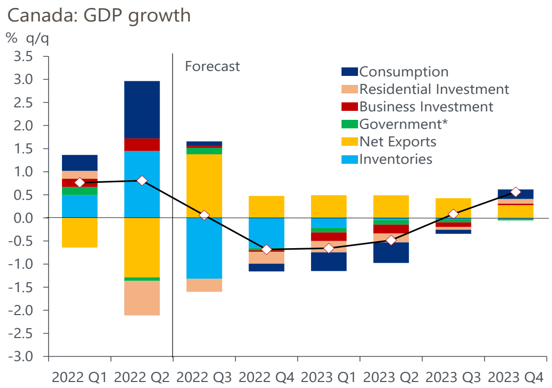
Short-term outlook

With economic momentum already decelerating, we now expect GDP growth will slow to a measly 0.1% q/q pace in Q3 and may even turn negative. While we see continued but very weak growth in consumption and business investment, residential investment is expected to represent another sizeable drag in Q3 due to the ongoing correction in house prices and activity. Moreover, a repeat of the massive build-up of inventories in Q2 is not likely. So, even if firms add to stocks, inventories will likely prove a drag on growth in Q3.

Earlier this summer, we highlighted the elevated risk of recession in Canada, pointing out that aggressive rate hikes by the Bank of Canada represented the biggest risk to the economy. Since then, the BoC has delivered consecutive oversized rate hikes, bringing the policy rate to a 14-year high of 3.25%. This will raise debt-service costs for households sharply and deepen the housing correction already underway. Higher debt-service costs, negative wealth effects from falling house prices, declining real incomes, and deteriorating confidence will cause households to pull back on spending while expected recessions in the US, UK and Eurozone will weaken external demand.

Together, we expect these factors will push the Canadian economy into recession in Q4. The downturn will likely last three quarters, with GDP expected to fall 1.8% peak-to-trough by Q2 2023. This would be similar in duration but shallower than the typical Canadian recession of the past 50 years, where GDP on average fell 2.5% peak-to-trough. While we can't rule out the recession worsening and turning into a financial crisis, we view that as a very low probability event.

Chart 2: Housing and consumption expected to be hit hard in the downturn



Source: Oxford Economics/ Haver Analytics

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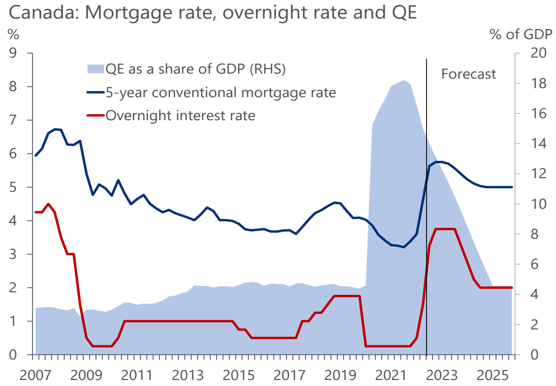
Key drivers of our short-term forecast

Higher rates will weigh on households. The BoC has already raised the overnight rate 300bps this year, and we expect a 50bps hike in October. The Bank will then likely pause to reassess the outlook amid signs of a slowing economy, rising labour market slack, and falling inflation. Such aggressive monetary policy tightening will raise debt service costs for households sharply and aggravate Canada's underlying household debt imbalances. We now expect household spending will fall 0.9% y/y in 2023 after a 5% rise in 2022, with interest-sensitive durable goods spending expected to contract 3.7% in 2023 following a 1.8% drop in 2022.

Chart 3: BoC expected to deliver final 50bps rate hike of this tightening cycle in October

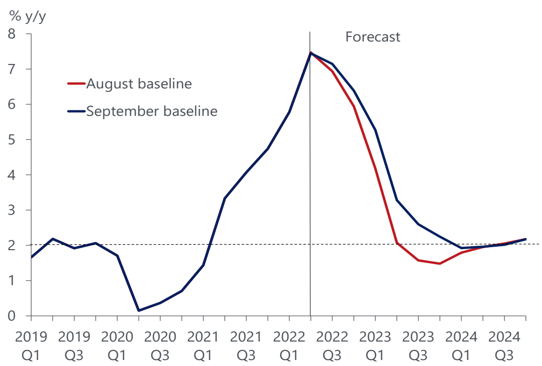


Source: Oxford Economics/ Haver Analytics

Inflation to fall, but core will be stickier. Headline CPI inflation fell to 7.6% y/y in July after reaching a four-decade high 8.1% in June, largely driven by lower gasoline prices. We expect inflation will continue to ease through the remainder of this year and through 2023 due to falling global energy and commodity prices, lower house prices, gradually improving supply chains, and weaker aggregate demand due to mounting job losses and lower incomes.

However, we now think core inflation will prove slightly stickier than forecast last month. This will hold headline CPI inflation higher next year, and likely keep the Bank of Canada from easing rates until late 2023. We now forecast inflation will slow from 6.7% in 2022 to 3.3% in 2023, up 0.2ppts and 1ppt from last month, respectively. On a quarterly basis, inflation is forecast to fall from 7.5% y/y in Q2 2022 to 2.3% y/y by the end of 2023 and further to 2% y/y by early 2024. While risks to inflation remain tilted to the upside largely due to the prevailing geopolitical tensions and tight labour markets, we don't think it's likely that higher inflation becomes entrenched and results in a wage-price spiral.

Chart 4: We have raised our inflation forecast but still expect a marked easing in 2023

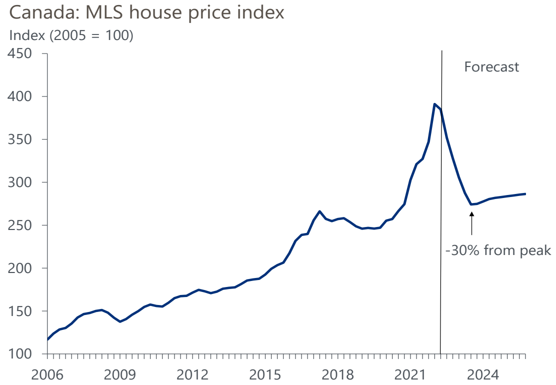


Source: Oxford Economics/Haver Analytics

Unemployment rate to hit 8.2% by early 2024. We now forecast a decline in employment and a higher unemployment rate as the economy contracts. Employment is forecast to fall around 200,000 (-1%) between Q2 2022 and Q3 2023, which will lift the unemployment rate from 5% in Q3 2022 to a peak of 8.2% in Q1 2024.

A faster and deeper house price correction. We also now foresee a faster and deeper house price correction – a key catalyst of the recession – with prices declining 30% peak-to-trough by mid-2023. Still, affordability will likely worsen further in the very near term, as higher mortgage rates weigh on household borrowing capacity.

Chart 5: House prices to fall 30% by mid-2023



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 24th out of 164 countries.

Canada's economy performed well in H1 2022, but we now expect the combined effects of aggressive interest rate hikes by the Bank of Canada, the ongoing and deepening housing correction, high inflation, falling real incomes, and weakening external demand will push the economy into recession starting in Q4 2022.

We forecast GDP growth will weaken from 4.6% in 2021 to 2.9% in 2022 and -1.1% in 2023. Overall, we now view risks to our baseline forecast as roughly balanced, but a deeper, more prolonged recession or financial crisis cannot be entirely ruled out.

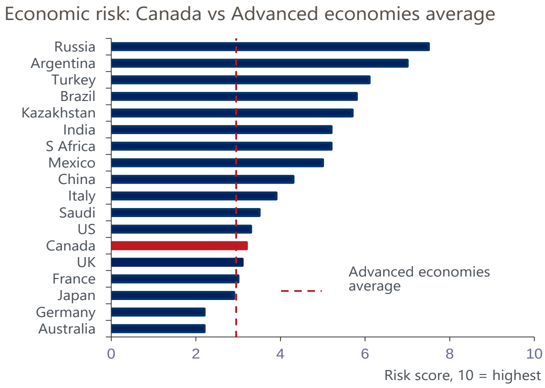
Market demand: 4/10

The market demand risk score remains moderate at 4 but is still higher than the advanced economy average of 3.4.

Domestic demand is expected to contract in the near term, as higher interest rates limit the ability of highly leveraged households to spend, housing contracts further, and businesses pull back on investment amid reduced demand, weaker profits, elevated uncertainty, and higher borrowing costs.

Accordingly, Canada's imports are forecast to decline 0.3% y/y in 2023, which helps buffer the impact of lower domestic demand during the recession. Importantly, the outlook could deteriorate further if inflation remains higher for longer, the Bank of Canada hikes interest rates even more than assumed or if the war in Ukraine devolves into a more prolonged conflict.

Chart 6: Canada's risk score is low at 3.2



Source: Oxford Economics

Market cost: 3/10

The market cost risk score is 3, roughly in line with the advanced economy average of 2.7.

Canada's headline inflation rate fell to 7.6% in July from a peak of 8.1% in June as gasoline prices fell sharply. We expect inflation will continue to fall in 2023 and return to the Bank of Canada's 2% target in early-2024. Over the medium term, steady increases in the carbon levy are expected to hold inflation above the central bank's 2% target, averaging 2.2% between 2024-2030.

Table 2: Economic Risk Index

	Sep 2022 (Scores from 1 to 10 with 10 = highest risk)	Score change from March	Rank out of 164 (1= lowest)
Overall	3.2	0.0	24
Market demand	4.0	0.0	27
Market cost	3.0	0.0	13
Exchange rate	2.7	0.0	35
Sovereign credit	3.2	-0.3	18
Trade credit	3.0	0.0	12

Source: Oxford Economics/ Haver Analytics

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Exchange rate: 2.7/10

Exchange rate risk is 2.5, slightly higher than the advanced economy average of 2.3. Canada's score reflects the country's solid political and regulatory framework. Although the Canadian dollar is exposed to movements in global oil prices, the relationship has diminished in recent years.

The Canadian dollar is expected to depreciate slightly through the remainder of this year and in 2023 as the economy experiences a deeper recession than the US and the Federal Reserve raises interest rates by more 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: 3.2/10

After downgrading Canada in 2020, Fitch affirmed its AA+ rating in June 2022, 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 3.2, in line with the 3.3 average score for advanced economies.

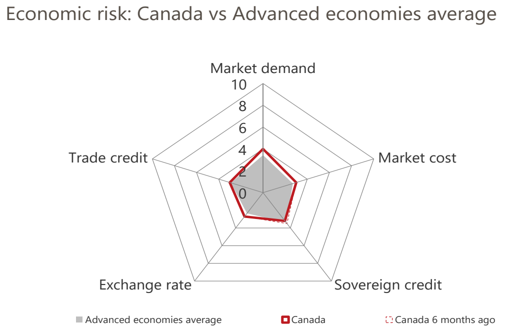
Canada's prudent policymaking, robust regulatory framework, manageable federal debt burden, and reasonably solid longer-term economic prospects make it a very safe place to invest from a sovereign risk perspective. However, the score is pushed higher by the large increase in private-sector debt since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

We don't expect the recession will trigger a sharp rise in private sector defaults or financial crisis, but this low-probability event can't be entirely ruled out.

Trade credit: 3/10

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	●	Canada is now forecast to experience a moderate recession starting in Q4 2022
CPI inflation	●	Inflation likely peaked at 7.5% in Q2 but will slow to 2% by early-2024
Current account balance	●	Positive current account balance now expected through 2025
Government balance	●	Deficits expected to shrink as pandemic measures end, but remain large
Government debt	●	Gov't debt to ease to about 112% of GDP in 2022 from 117% in 2021
External debt	●	External debt to rise to 121% of GDP in 2023 from 117% in 2022

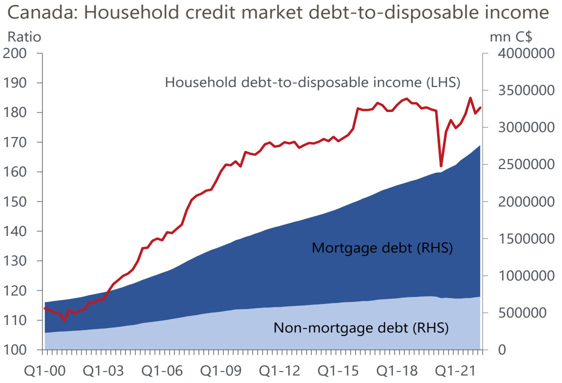
Source: Oxford Economics/ Haver Analytics

What to watch out for

High household indebtedness. Historically high debt makes Canadian households acutely vulnerable to a loss of jobs and income or a sharp rise in interest rates, a key driver of the expected downturn.

Excessively high house prices. We now forecast a 30% fall in home prices by mid-2023, however risks of a larger crash and financial crisis remain.

Chart 9: Canada's household debt-to-disposable income ratio is elevated



Source: Oxford Economics/Haver Analytics

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

Coronavirus pandemic. The pandemic has faded in recent months, but the potential for dangerous new variants to emerge this fall and winter continues to present downside risk to the outlook.

US growth. We now expect the [US economy will enter a mild recession] in H1 2023.

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

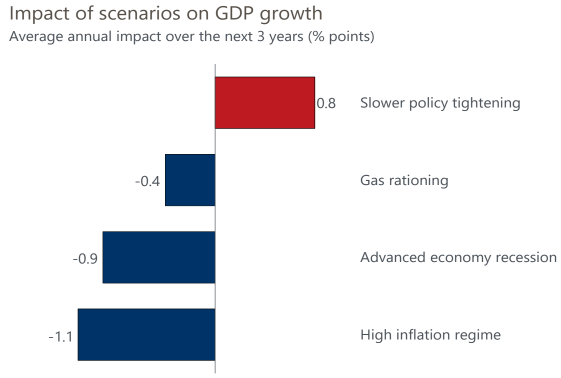
Oil and gas sector. High energy prices should increase profits and incomes in regions that are heavily dependent on oil and gas production. However, longer-term capital investments appear unlikely to pick up unless higher prices are sustained and regulatory hurdles are removed.

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

Exposure to key global risks

High inflation regime. In this scenario, central bank credibility is threatened by the ongoing period of elevated inflation. Despite the rapid central bank tightening already underway, long-term inflation expectations become de-anchored from central bank targets. Financial markets are rocked. Globally, monetary policy tightens more rapidly, accompanied by marked rises in government bond yields and sharp falls in equity prices. As a result, Canada's GDP contracts 2.1% in 2023 and the recovery in 2024 is weaker, with GDP rebounding a modest 0.5% vs. the 2.8% recovery in our baseline.

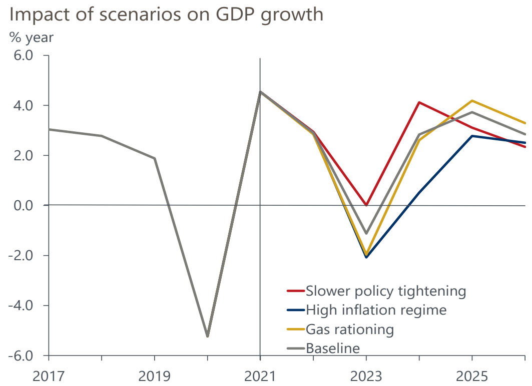
Chart 10: High inflation regime would have largest drag on growth of our scenarios



Source: Oxford Economics

Slower policy tightening. In this upside scenario, earlier rises in producer prices partially unwind amid easing supply-chain pressures and less-than-expected commodity market disruption. Inflationary pressures fade more rapidly than assumed in our baseline forecast, prompting a slowing of monetary policy tightening. In the US, rate cuts are brought forward. Canada's GDP sees no growth in 2023, +1.1ppt from our baseline. In 2024, GDP rises 4.1%, 1.3ppts faster than our baseline.

Chart 11: Risks to our baseline are now more balanced



Source: Oxford Economics

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Long-term prospects

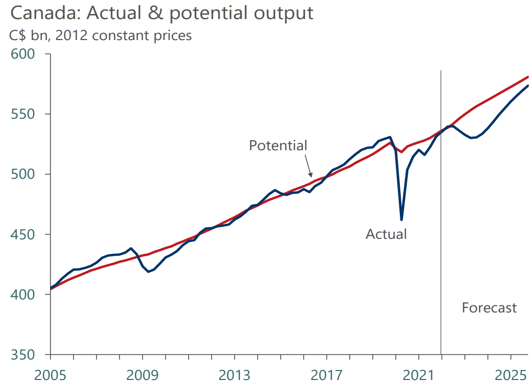
Canada has relatively easy access to the US. However, we expect sluggish investment in both the energy and non-energy sectors to improve only gradually. We forecast the capital stock to expand 1.5% pa over the next decade, weaker than the 2.1% pa expansion in 2010-2020.

The contribution of labour to potential output growth is also expected to remain modest in the next decade. However, StatCan's new population projections expect Canada's population will rise to just over 50 million by 2050, about 1.3 million (+2.7%) higher than their prior projection – primarily due to higher immigration. Accordingly, we now expect growth in equilibrium employment to rise to 1.3% pa over the next decade, up from 0.9% in 2010-2020. Still, Canada's long-run economic growth will be limited by its ageing population, which also underpins a forecast decline in the overall labour force participation rate.

We expect total factor productivity (TFP) growth to contribute an average 0.6ppts to potential growth over the next decade, an 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.

Chart 12: Canada's potential growth to average 1.9% this decade



Source: Oxford Economics/ Haver Analytics

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	1.3
Capital Stock	2.1	1.5
Total Factor Productivity	0.4	0.6
*ln(Potential GDP)=0.65*ln(Employment at NAIRU) +0.35*ln(Capital Stock)+ln(Total Factor Productivity)		

Source: Oxford Economics/ Haver Analytics

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	2.6	2.2
Consumption	2.3	0.7	3.1	2.6
Investment	1.5	-0.4	2.3	2.9
Government consumption	0.6	1.8	1.1	1.1
Exports of goods and services	4.0	-0.3	3.5	1.8
Imports of goods and services	2.9	-0.7	3.8	2.3
Unemployment (%)	7.2	6.9	7.1	6.1
Consumer prices, average	1.7	1.6	3.5	2.2
Current a/c balance (% of GDP)	-3.0	-2.4	0.9	-0.8
Exchange rate (Trade-Weighted Index)	96.2	83.7	86.6	88.5
Government balance (% of GDP)	-0.8	-1.8	-3.0	-1.5
Short-term Interest Rates (%)	1.1	1.3	2.3	2.2
Long-term Interest Rates (%)	2.1	1.5	2.7	2.9
Working population	1.1	1.3	1.4	1.3
Labour supply	0.8	0.8	1.6	1.0
Participation ratio	66.2	65.2	65.0	64.0
Labour productivity	1.1	0.4	0.4	1.0

Source: Oxford Economics/ Haver Analytics

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 King, 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.

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