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Interest rate increases start to hit home in Canada

Economic outlook | September 2023

Introduction

One of the biggest surprises over the past year has been the resilience of Canada's economic growth in the face of aggressive monetary tightening. We finally saw some of the negative impact in the second quarter of this year, with real GDP falling by 0.2%. Over the near term, we expect the economy will continue to struggle in the face of high household debt, soaring interest payments, and stubbornly persistent inflation. However, a brighter outlook for growth in the US economy coupled with continuing strong population growth in Canada will provide a much-needed offset and help keep the forthcoming declines in output from being large or broad-based.

Homeowners and policymakers are becoming increasingly concerned about affordability issues. As a share of GDP, Canadian households are the most leveraged across the G7 and, as a result, the 475-basis-point increase in the Bank of Canada's policy rate since spring 2022 is sure to act as a drag on consumer spending. While this impact has been delayed due to many households moving into negative mortgage amortizations and drawing down pandemic-era savings, those compensating factors may have now run their course.

A recent report by MNP Ltd. noted that more than half of Canadians are $200 or less away from not being able to pay their bills at the end of the month as household budgets are being stretched by high interest rates and rising living costs.[1]

Politicians of all stripes are also homing in on the affordability issue. We've seen renewed interest in the housing file from the federal government to try and ease affordability concerns. Further, three premiers chimed in before the latest Bank of Canada interest rate decision, imploring the Bank not to raise it further. After the Bank's pause in September, the federal finance minister issued a statement noting that its decision to hold is a welcome relief to Canadians, a rare foray into monetary policy from the federal government given the importance of central bank independence. At the same time, governments are striving to find a balance between providing targeted supports to those that need it most right now and controlling spending to avoid adding fuel to the inflation fire.

[1] The Canadian Press, "More than half of Canadians $200 away or less from not being able to pay all of their bills," CTV News, July 10, 2023.

Introduction (cont'd)

If individuals and politicians alike are worried about household finances, then there's good reason to be concerned about the impact on the economy. Fortunately, an improved outlook for the trade sector and continued strong population growth are playing important roles in avoiding a deeper recession. Canada's population is set to increase by 2.7% this year. Over the last 60 years, the only time we came close to that type of growth was a 2.2% rise in 1971. With population growth set to be that strong, total consumer spending in inflation-adjusted terms can continue to make gains even if each individual person is consuming less due to budget pressures.

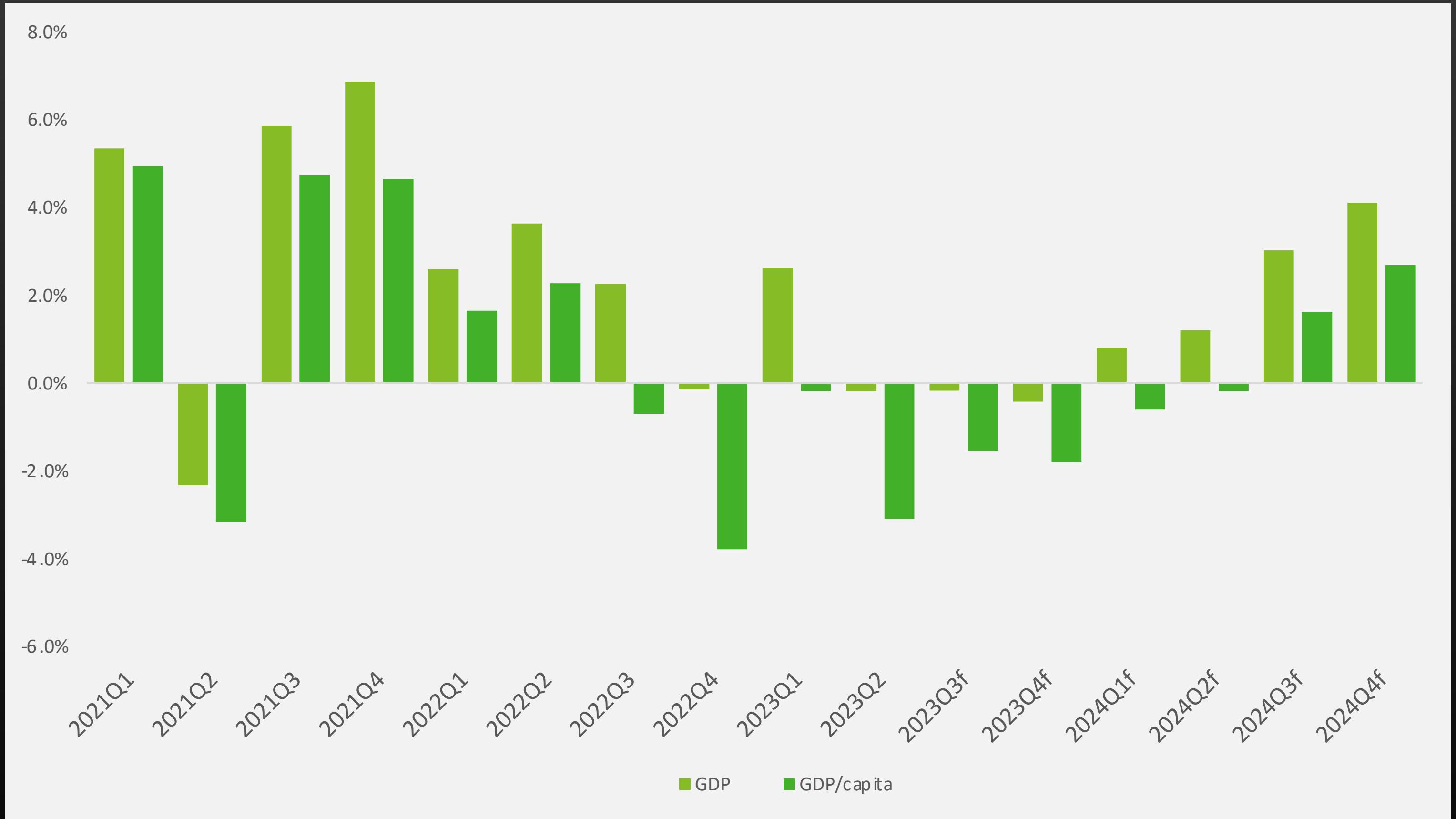
Despite recent strike action at the Port of Vancouver, the outlook for the trade sector is promising given stronger-than-expected growth in the United States. With US consumers and businesses continuing to spend there, the country is no longer expected to experience a recession but rather a mild slowdown, with real GDP expected to grow by 2.4% this year and 1.2% in 2024. This continued growth south of the border bodes well for our trade prospects into next year.

An improved outlook for the trade sector and continued strong population growth are playing important roles in avoiding a deeper recession.

Introduction (cont'd)

With the Canadian economy showing signs of weakness, the Bank of Canada is expected to end its tightening campaign and even begin reversing some of its recent hikes next spring. As monetary policy slowly returns to a neutral level, the economy will begin to recover. Growth is forecast to resume at the beginning of next year as the fear of interest rates moving higher fades. It will take slightly longer for it to feel like we are emerging from the downturn, with GDP per capita not resuming growth until the latter half of 2024. Overall, we expect the Canadian economy to eke out gains of 1% this year and 0.9% next year.

Real GDP growth



Notes: Unless otherwise noted, all figures are expressed as annualized % changes; f = forecast.
Sources: Deloitte, Statistics Canada.

Fiscal and monetary policy

Fiscal and monetary policy

With inflation remaining stubbornly high and interest rates rising aggressively to tame it, what central banks are thinking and where they plan to go next is garnering widespread attention. Since March 2022, the Bank of Canada has lifted its overnight policy rate by a cumulative 475 basis points, reaching its highest level since early 2001. After pausing in September, the question many are asking is, have we finally seen the end of monetary tightening or are further interest rate increases in the cards?

Anyone listening to the Bank of Canada knows the answer depends on inflation. While many across the country are worried that it has over-tightened with its monetary policy campaign, the Bank does not share their concern. It is instead focused on ensuring inflation does not become entrenched above its target and has clearly communicated that more tightening may be necessary to rein in inflation expectations and return price growth to its 2% target.

Inflation has been coming down, although recent reports indicate that progress has been slower than desired. After soaring past 8% last summer, it fell as low as 2.8% in June. Unfortunately for those hoping for a quick return to lower interest rates, inflation since then has been moving in the wrong direction, creeping up to 3.3% in July before jumping to 4% in August.

Much of the recent movements in inflation are attributable to higher mortgage interest costs and gasoline prices. However, August saw core inflation also creep up, a fact that has surely caught the Bank's attention.

Our forecast sees this upward tick in inflation as transitory. With the economy clearly slowing, inflation should follow; however, it will do so at a slow pace, with a return to the 2% target not expected until the middle of 2025. With inflation on track to decelerate next year and economic growth between now and then expected to be non-existent, the Bank should be able to start easing its policy stance beginning next spring. By mid-2025, the overnight rate should be back at its neutral level of 3%. With stronger growth in the United States supporting the strength of its dollar, we've seen downward pressure on the loonie recently. That weakness should be short-lived, with gains expected throughout 2024 and 2025 as the Bank of Canada and the US Fed lower their policy rates and the economic recovery results in less safe-haven demand for US dollars.

Fiscal and monetary policy (cont'd)

Given high debt loads and the need to avoid contributing to inflationary pressures, governments are expected to keep their spending growth modest. While certain priority programs such as health care will continue to see growth, total real government spending on goods and services is expected to increase at an average pace of just 0.5% this year and 1% in 2024. Public sector investment spending will be stronger given growing infrastructure needs, averaging gains of 2% per year over the 2023-24 timeframe. With weak economic growth expected in the near term, the slowdown in spending on goods and services will not be enough to offset softer revenues, pushing the collective provincial and federal government budgetary balances deeper into negative territory. However, as economic growth accelerates next year, government revenue growth will recover, allowing budget deficits to begin shrinking once again.

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Households and businesses

Households

Households are fighting an uphill battle to maintain spending in the face of soaring mortgage interest payments, which were up 64% year over year in the second quarter. When that type of payment increase is combined with persistently high inflation, one would expect to see a sharp pullback in consumer spending. Instead, it has defied gravity lately, continuing to post growth for much longer than expected in the face of economic headwinds. This strong growth has been supported by several factors, including strong population growth, reduced payments on mortgage principals, and robust labour markets. While consumption has thus far held up, signs of slowing are emerging, as consumer spending grew by only 0.2% in the second quarter after eye-popping growth of 4.7% in the first quarter.

With Canada's population growing at record rates, we need to recalibrate our expectations about consumer spending. Adding so many new Canadians each quarter provides a boost to consumption even when economic conditions seem tough. To understand how individual Canadian households are doing, we need to look beyond the headline numbers. On a per-capita basis, real consumption has actually fallen by 1.5% over the past year. That's much closer to what we would expect in light of falling real wages and high interest rates.

On the mortgage front, obligated mortgage payments in the second quarter were down 16.7% relative to last year as cash-strapped households extended their amortizations to avoid substantially higher payments. In the last quarter of 2019, about 45% of household mortgage payments were used to pay down principal balances. By the second quarter of this year, that share had fallen to 35%. By reducing the amount going to principal, households have been able to temper the impact that rising interest rates are having on their near-term budgets, but it's worth noting that this has the potential to increase financial vulnerabilities in the medium and longer terms as debt remains high and options to avoid increased payments dwindle.

As with consumption, we need to recalibrate our expectations for the labour market to account for Canada's new rate of population growth. In a well-publicized piece of analysis, Statistics Canada recently said that the Canadian economy now needs to generate 50,000 new jobs per month to keep up with population growth. By comparison, it calculated that the economy only needed to add 25,000 jobs per month to keep up with population growth as recently as 2017 to 2019.[2]

[2] Statistics Canada, "Labour Force Survey: August 2023," The Daily, September 8, 2023.

Households (cont'd)

This higher neutral rate of job creation, the influx of skilled labour through high immigration levels, and a weakening economy have helped alleviate the intense labour shortages firms experienced in 2022. The job vacancy rate, a key indicator of labour market tightness, continued its slide and now sits at 4.4%—about halfway between its post-pandemic high of 5.9% and its pre-pandemic low of 3.1%. Further, the unemployment rate has ticked up and now sits at 5.5%. With our forecast calling for population growth to outpace job gains in the coming months, we expect to see upward pressure on the unemployment rate, which will hit 5.9% early next year. As unemployment creeps up and the job vacancy rate continues to slide, upward pressure on wages will ease, which in turn will work as a drag on consumer spending.

Taking into account how these factors will affect consumer spending suggests that the household sector will not be a contributor to growth over the rest of this year, with real spending expected to remain essentially flat. With interest rates unlikely to fall until next year, we expect to see continuing weakness in spending on interest-rate-sensitive purchases like vehicles, appliances, and furniture; we expect that services spending will fare a bit better but are nevertheless projecting declines in per-capita consumption for the next three quarters.

But the speed of population growth means that overall volumes will hold steady before beginning to grow again next year. Overall, thanks to the strong start to the year, real consumer spending will grow by 2.0% in 2023 before slowing sharply to a pace of 1.2% in 2024.

While consumer spending has held up in the face of rising interest rates, the same cannot be said for the residential housing market. Between its peak in the first quarter of 2021 and the second quarter of 2023, real residential investment has fallen by almost 30%, driven by declines in ownership transfer costs (which capture transactions in the resale market). High interest rates are expected to continue to take a toll on residential investment in the near term. Home builders are grappling with a dual challenge: reduced demand for pre-construction units and escalating borrowing costs for home construction. Consequently, lower housing starts are expected in 2024. Homeowners are also facing challenges with home renovations due to the high costs of financing, materials, and labour.

Households (cont'd)

The silver lining for next year may lie in the home resale market. Although interest rate hikes in June and July put a pause on the nascent housing market recovery that began in the spring, home sales are anticipated to rebound as interest rates stabilize, helping to offset some of the downturn in the home construction and renovation sectors.

Despite short-term cyclical challenges, Canada's housing market is poised for solid performance over the longer term. Robust population growth in recent years has created significant pent-up demand and, as governments take steps to address housing affordability issues, policy measures and incentives combined with lower interest rates are expected to contribute to a resurgence in new home construction starting in 2025.

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Businesses

High interest rates and economic uncertainties did not deplete Canadian non-residential investment, which experienced a surprising resurgence, thanks to rebounding fortunes in the oil and gas sector. Despite declining from high levels following the Russian invasion of Ukraine, oil prices remain relatively high, prompting an increase in investment. This turnaround is reversing a multi-year decline that began with the 2014 oil price crash and is providing a short-term boost to the economic outlook. However, the optimistic outlook for oil investment is not expected to be sustained in the long run, as the global economy is shifting away from fossil fuels toward clean energy. Relatedly, we are also expecting to see a decline in capital spending on pipelines. In fact, the most significant source of downward pressure on the business investment outlook is pipeline spending. With projects like Coastal GasLink and the Trans Mountain expansion nearing completion and no major projects on the horizon, a substantial contraction in pipeline investment is in store over the next three years.

While the clean energy shift means less investment in pipelines and oil and gas, other Canadian industries are set to benefit. Thanks to the federal government's critical mineral strategy, Canada is positioned to capitalize on the global electric vehicle (EV) revolution. Notable projects—such as the Nemaska Lithium project in Quebec, which is set to supply lithium to Ford for 11 years starting in 2026, and Volkswagen's $7-billion investment in building an EV battery plant in Ontario—are anticipated to boost investment in the manufacturing sector over the medium term.[3] Mining investment outside oil and gas also stands to benefit from the shift to clean energy as companies look to secure access to critical minerals.

[3] Jacob Serebrin, "Ford to buy lithium for electric car batteries from Quebec's Nemaska Lithium," CTV News, May 22, 2023; Kate Dubinsk, "VW CEO says EV battery plant planned for Ontario could become one of the world's largest," CBC, April 21, 2023.

Businesses (cont'd)

The business investment outlook remains muted in the near term. The Bank of Canada's latest *Business Outlook Survey* paints a concerning picture, with business investment sentiment sinking to a three-year low in the second quarter.[4] Rising cost pressures, economic uncertainties, weaking demand, and expectations of slower sales all contribute to this negative sentiment, and will weigh on business investment in the near future.

After making an outsized contribution to economic growth at the start of 2023, the trade sector pulled down overall growth in the Canadian economy in the second quarter, with export growth essentially flat while imports grew. Thanks to strong growth in our main export market (the United States), export growth is forecast to have resumed in the third quarter while import growth will be subdued due to slowing consumer spending and the labour strike at the Port of Vancouver in July.

Looking to 2024, we see export growth slowing, in line with a softened outlook for the United States. After remaining essentially flat in 2023, imports are expected to make a recovery in 2024, buoyed by the likely recovery in investment activity as the Bank of Canada eases its tight monetary policy stance and consumer spending recovers.

One important near-term risk to the trade sector is the potential for disruptions to the North American vehicle supply chain. On September 15, 2023, US auto workers officially began labour strikes at factories owned by General Motors, Ford, and Stellantis. While we're still in the early days, given how highly integrated auto supply chains are between Canada and the United States, we see the potential for further near-term downside risks to auto trade activity beyond the current assumptions in our forecast.

[4] Bank of Canada, *Business Outlook Survey—Second Quarter of 2023*, June 30, 2023.

Provincial outlook

Provincial outlook

Despite a shaky start to the year due to the continued shutdown of the Terra Nova offshore oil vessel, stronger investment is expected to tip **Newfoundland and Labrador**’s economic growth into positive territory this year. Momentum will continue into next year thanks to prospects of a restart for Terra Nova and a favourable outlook for minerals, which will help boost growth to 1.1% in 2024.

The impact of rising interest rates has taken its toll on **Prince Edward Island**'s (PEI) construction sector, with residential investment plummeting since the Bank of Canada began raising interest rates last year. However, the province is benefiting from strong population growth, which outpaced all other provinces in the second quarter of this year. This surge in population has supported spending and employment growth in the province. Overall, this strength will leave PEI tied with Alberta for the strongest growth in the country this year.

While interest rate hikes impact all provinces, household debt is not as elevated in **New Brunswick** as it is in other provinces. Further, the influx of international migration will continue to support consumer spending growth and provide an important offset to higher interest payments. On the downside, growth in manufacturing and fishing is set to slow due to fishing quotas as well as higher energy prices, which are raising costs.

In a theme seen across the Maritime provinces, **Nova Scotia** is benefiting from strong population growth and relatively low levels of household debt, which is supporting spending and investment growth and keeping employment growth positive. However, high interest rates have hindered building efforts across the province this year. Overall, the province is performing better than expected and, thanks to population growth, should see sustained growth this year and next.

Growth in **Ontario**'s economy is likely to follow the national pattern. Given the fact that the province’s households have the second highest debt-to-disposable-income ratio in the country, the Bank’s interest rate hikes will weigh on its economic fortunes this year and into next year as households continue to adjust to a high interest rate environment. Helping to offset this slowdown is the strong gains expected in manufacturing as the motor vehicles and parts sector continues its recovery and an improved outlook for investment as new EV battery plants are constructed. Overall, Ontario’s economy is forecast to grow by 1% this year and 0.9% in 2024.

Provincial outlook (cont’d)

Quebec is expected to experience the weakest growth out of all the provinces this year and next. Activity is being suppressed by mine closures, weak construction activity, and a lack of growth in its manufacturing sector. One outcome of the slowdown is a softening of labour market tightness. The cooling labour market coupled with a rising cost of living is showing signs of impacting consumer spending, with non-essential retail spending softening since the spring.

This year was expected to be a continuation of the rebound that began last year for **Manitoba** and **Saskatchewan**, but dry summer conditions are putting strong economic growth out of reach. The downturn in the agriculture sector will weigh on growth prospects in **Manitoba** as will the impact of monetary tightening. Thankfully, the housing resale market and manufacturing sector have held up well this year, providing support for continued economic growth. However, as US GDP growth slows next year, so too will Manitoba’s manufacturing sector, although a better year for crops in 2024, as expected in our forecast, will offset that and push economic growth higher.

Saskatchewan will also feel the impact of reduced agriculture volumes and that weakness will unfortunately be mirrored in its important potash sector, which is also expected to have a tough year as production was temporarily scaled back due to the strike at the Port of Vancouver. With conditions in the agriculture and potash sectors set to improve next year, real GDP growth will accelerate in 2024.

While oil production in **Alberta** got off to a positive start this year, disruptions caused by wildfires are likely to offset some of these gains. Despite weaker-than-expected growth in oil production this year, we anticipate that headline growth will remain strong as the province continues to be an attractive destination for new migrants. This robust population growth and improved outlook for oil and gas construction is pushing Alberta up in the provincial growth rankings, with real GDP expected to increase by 1.7% this year. The slower growth projected nationally for 2024 won’t be as evident in Alberta, with high oil prices supporting investment and a wave of newcomers fuelling consumer spending.

Provincial outlook (cont'd)

After years of chart-topping economic performance, **British Columbia** is expected to experience more modest GDP growth in the near term. Recent forest fires, the strike at the Port of Vancouver, and interprovincial outmigration are set to lower growth prospects in the province this year. Growth will remain weak into 2024 as highly leveraged households (BC households have the highest debt-to-disposable-income ratio in the country) continue to feel the lagged impacts of past interest rate increases.

Real GDP growth by province (% change)

	2022	2023f	2024f
Newfoundland and Labrador	-1.7	0.6	1.1
Prince Edward Island	2.9	1.7	1.3
Nova Scotia	2.6	1.3	0.9
New Brunswick	1.8	0.8	0.6
Quebec	2.6	0.5	0.4
Ontario	3.6	1.0	0.9
Manitoba	3.9	1.0	1.2
Saskatchewan	5.7	0.8	1.1
Alberta	5.1	1.7	1.6
British Columbia	3.6	1.0	0.8

Note: f = forecast.
Source: Statistics Canada; forecast by Deloitte.

Final thoughts

Final thoughts

The downturn that the country is experiencing is in line with what policymakers at the Bank of Canada are trying to achieve. Indeed, if they can orchestrate a modest slowdown in growth and return inflation to its 2% target without igniting a deep recession, the Bank will be doing exactly what its mandate instructs. Its potential success hinges on the evolution of inflation and what that means for policy rates here and in the United States. If inflation proves too stubborn, the Bank will be forced to raise interest rates further, which will make a deeper downturn very difficult to avoid. Thankfully, our baseline forecast shows that the Bank will be successful and that, after a rough rest of the year, growth should resume in 2024.

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Key economic indicators

	2023				2024				2022	2023f	2024f
	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f			
Real economic activity											
Gross domestic product	2.6	-0.2	-0.2	-0.4	0.8	1.2	3.0	4.1	3.4	1.0	0.9
Household consumption expenditure	4.7	0.2	-0.2	0.0	1.1	2.0	2.7	3.0	4.8	2.0	1.2
• Durable goods	7.5	-2.0	-2.1	-4.5	-1.7	0.0	1.1	1.7	-2.3	2.2	-1.4
• Services	4.7	-0.1	0.5	1.3	2.0	2.6	3.3	3.5	8.6	2.8	1.9
Residential investment	-19.1	-8.2	-6.6	-0.2	3.8	3.2	2.7	4.2	-11.2	-13.7	0.7
Non-residential fixed investment	5.7	10.3	3.4	3.0	2.3	2.9	2.3	2.2	8.0	3.9	3.2
• Non-residential structures	8.8	9.9	3.2	1.4	1.3	2.0	1.5	1.3	8.3	8.1	2.2
• Machinery and equipment	0.3	11.1	3.8	6.0	4.0	4.5	3.7	3.9	7.4	-3.2	4.8
Government consumption & investment	-1.7	2.0	0.5	1.1	0.8	1.1	1.0	1.2	2.0	0.9	1.0
Exports of goods and services	10.2	0.4	4.3	0.3	1.3	0.0	5.6	9.2	2.8	5.4	2.2
Imports of goods and services	0.7	1.9	3.6	3.4	2.3	1.9	2.9	4.0	7.5	-0.1	2.7
Prices											
Consumer price index (y/y)	5.2	3.5	3.2	2.9	3.0	2.8	2.5	2.3	6.6	2.9	2.3
Implicit GDP price index (y/y)	1.3	-1.1	0.8	2.3	2.6	1.8	1.5	0.9	4.1	2.3	0.9
Labour market											
Employment	4.7	1.6	-0.4	0.5	0.6	1.5	1.7	1.7	4.0	2.1	0.9
Unemployment rate (%)	5.0	5.2	5.6	5.8	5.9	5.9	5.8	5.7	5.3	5.4	5.8

Notes: Unless otherwise noted, all figures are expressed as annualized % changes; f = forecast.
Sources: Statistics Canada; Bank of Canada. Forecast by Deloitte Economic Advisory, as of Sept 15, 2023.

Financial market indicators

	2023				2024				2022	2023f	2024f
	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f			
Interest rates (%)											
Overnight rate target	4.42	4.58	5.00	5.00	5.00	4.75	4.67	4.42	3.75	5.00	4.42
3-month T-bill	4.48	4.65	5.01	4.99	4.98	4.72	4.64	4.38	4.20	4.99	4.38
1-year GoC bond	4.44	4.71	5.15	5.18	5.22	4.99	4.95	4.70	4.36	5.18	4.70
2-year GoC bond	3.84	4.12	4.70	4.75	4.59	4.43	4.27	4.10	3.93	4.75	4.10
5-year GoC bond	3.16	3.34	3.95	4.17	4.11	4.05	3.99	3.94	3.32	4.17	3.94
10-year GoC bond	3.03	3.08	3.59	3.85	3.84	3.84	3.84	3.84	3.18	3.85	3.84
Yield curve spread (pp)											
3-month vs. 10-year	-1.45	-1.57	-1.42	-1.14	-1.14	-0.88	-0.80	-0.55	-1.03	-1.14	-0.55
2-year vs. 10-year	-0.81	-1.04	-1.10	-0.90	-0.74	-0.59	-0.43	-0.27	-0.75	-0.90	-0.27
Foreign exchange											
USD/CAD ($C)	1.35	1.34	1.34	1.33	1.33	1.33	1.32	1.30	1.36	1.33	1.30
CAD/USD (US cents)	0.74	0.74	0.74	0.75	0.75	0.75	0.76	0.77	0.74	0.75	0.77

Notes: f = forecast; quarterly values are quarter averages and annual figures reflect period end as measured by Q4.
Sources: Statistics Canada; Bank of Canada. Forecast by Deloitte Economic Advisory, as of Sept 15, 2023.

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With leaders in macroeconomics, microeconomics, policy and regulatory analysis, economic development, and analytics and modelling, Deloitte's Economic Advisory practitioners have the knowledge and experience to tackle some of the most complex and challenging policy and business issues of today.

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