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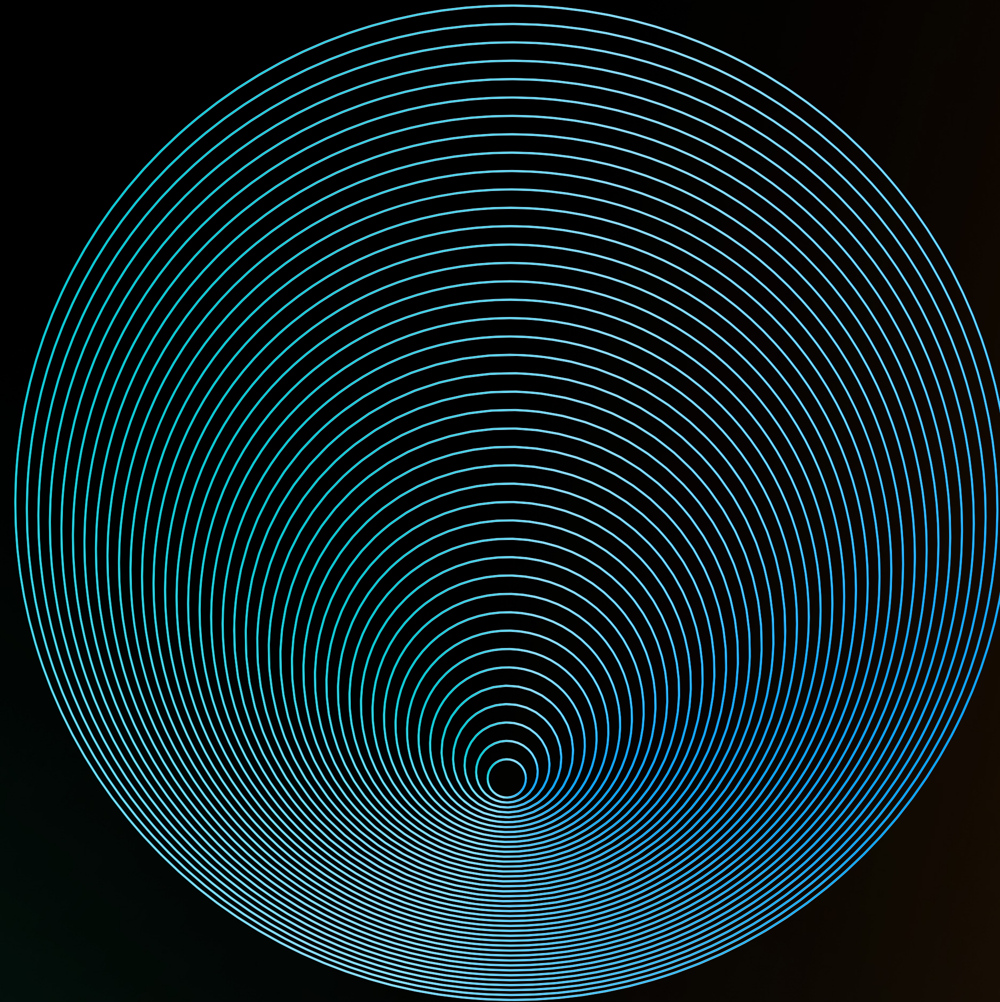


Rising interest rates and inflation to slow growth

Economic outlook | June 2022

Foreword by Chief Economist Craig Alexander

Canada's economic outlook continues to experience rapid change. In two years, we've gone from the deepest recession since the Great Depression to an overheating economy with broad-based labour shortages. Now, it seems, we're back to renewed recession worries.

These fears are being fuelled by rapid monetary tightening around much of the world to rein in inflation. Add in rising interest rates, and life seems more unaffordable than ever. That belief has many households worried about their future financial prospects, triggering a negative impact on consumer confidence. Businesses are then reacting to the potential of reduced demand from the household sector with caution around their investment and expansion plans. This narrative is just as true in Canada as in the United States, implying that the fallout of inflation and US Federal Reserve interest rate hikes will slow US economic growth and demand for Canadian exports. All of these factors have created an environment of heightened uncertainty, introducing new elements of risk into the outlook.

We believe high inflation and rising rates will take some of the wind out of the sails of the economic recovery. Household spending and residential investment will be the most adversely affected. Despite these factors, we don't expect Canada to fall back into recession. We anticipate a sharp slowdown in growth beginning next year and lasting into 2024 as the economy reacts to this new higher-interest rate environment. This is reflected in the more conservative growth expectations for the next two years relative to our spring forecast. Overall, we expect real GDP to grow by 3.3% this year before slowing to a pace of just 1.7% next year and 1.5% in 2024.

So, let's spend a moment on the case for resilience. First, on the household front, Canadians amassed more than $300 billion in savings during the pandemic, helping to cushion the rising cost of living and allowing wallets to remain open. Household wealth also surged during the pandemic. Wealth gains are expected to remain intact, even allowing for a correction in equity markets and residential real estate prices. Most importantly, labour markets are expected to remain tight during the coming economic slowdown. Unemployment will remain low as more baby boomers enter retirement. This will keep jobs plentiful for working-age Canadians and support solid wage growth—a key factor for consumer sentiment. Finally, the tightening of monetary policy will raise debt service costs but will also cool the rate of increase in the cost of living—a good thing for consumers.

Foreword cont'd

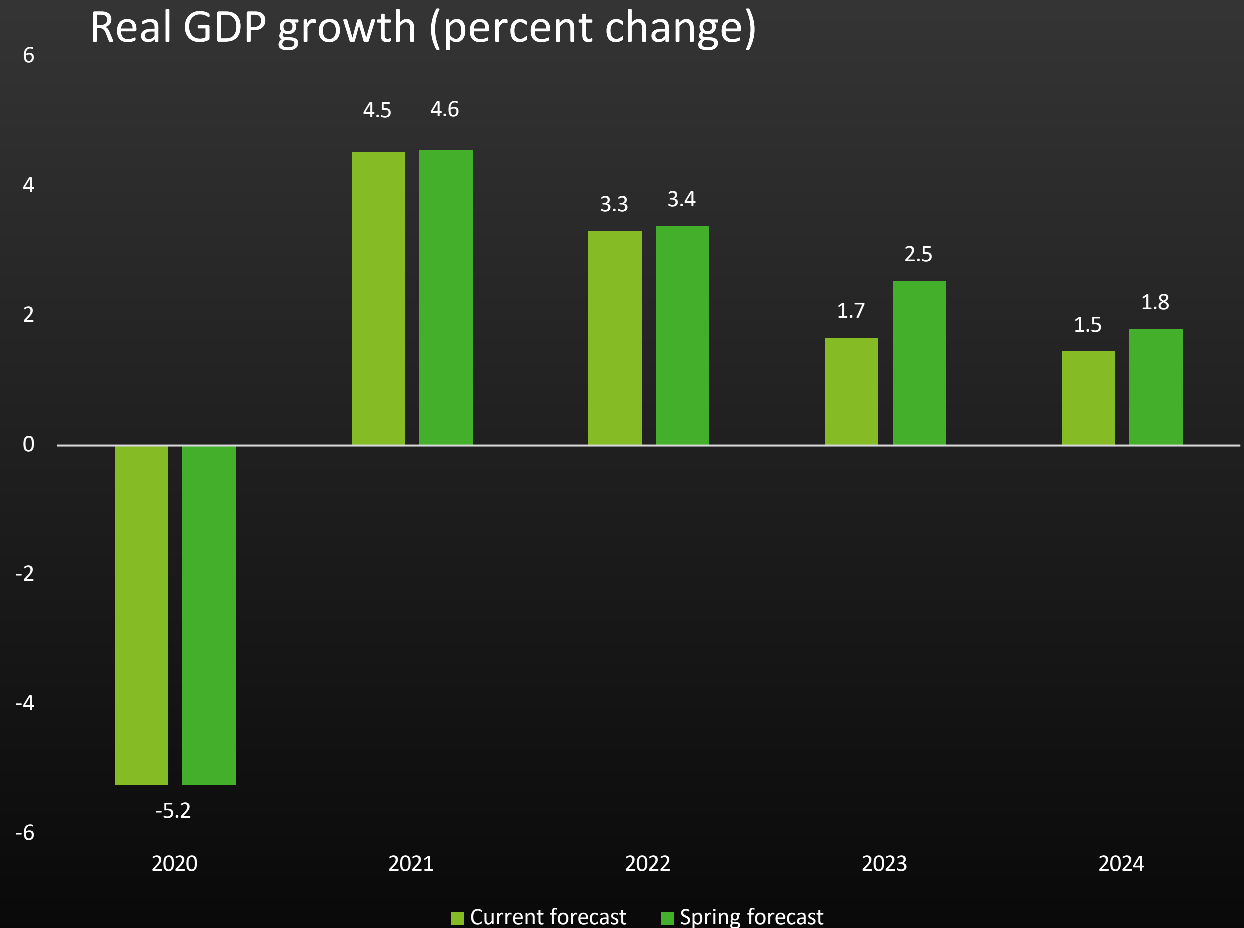
To some, this prediction that a recession will be avoided may seem optimistic.

On the business front, the coming economic slowdown and the rising cost of capital (due to higher interest rates) will weaken investment. But the labour.shortages and the higher cost of workers should incentivize some additional investment as firms look to substitute capital in place of labour. Environmental, social, and governance- related investments have also gained importance in recent years and could buck the cyclical weakening of capital outlays. High commodity prices are advantageous to the resource sector which should boost investment. Meanwhile, the massive digital investments companies made during the pandemic have likely only resulted in a small portion of their productivity gains which should feed through to business bottom lines.

Many government commitments made during the pandemic—such as infrastructure investments and expanded social and environmental programs—are still in the pipeline. The value of these investments and expenditures is considerable.

The main point is everything is not as dire as the headlines make out. High inflation and rapidly rising interest rates could trigger a recession, but it doesn't have to end that way. Based on our assumption that the Bank of Canada raises the overnight rate to 3%, gradually cooling inflation (with the Federal Reserve tightening an equivalent degree and having a similar outcome), our economic models suggest a significant slowdown. But a recession scenario only becomes likley if inflation fails to moderate as expected and/or the central banks hike by more than projected, a recession scenario becomes likely.

Lastly, it's important to remember that recessions can be psychological events. The self-fulfilling prophecy occurs when everyone expects a recession and acts as if one will occur.



Fiscal and monetary policy

Monetary and fiscal policy are tightening after providing a staggering amount of economic support during the pandemic. On the fiscal side, the federal government's most recent budget contained more belt-tightening than was anticipated and acknowledged the need to reduce its deficit. Strong nominal GDP growth and high commodity prices have improved the fiscal picture of some provinces. However, the provinces have a long way to go to reduce their collective deficit. As a result, we expect to see real government spending on goods and services decline this year and next. Public investment spending will also drop next year, as some of the stimulus funding winds down.

The monetary side of policymaking is getting more attention. Inflation in much of the developed world is growing at a pace not seen in decades. Here in Canada, inflation reached 7.7% in May; in the United States it increased by a stunning 8.6% in May. Even more concerning than the high headline numbers is that price pressures have become broad-based, pushing inflation expectations up and building fears that it will become ingrained. Our forecast calls for a slow deceleration of price pressures, with inflation peaking near its current rate of just below 8 per cent in the third quarter of this year before it steadily decreases. However, it will not reach the Bank of Canada's 2% target before at least 2025.

In response to high inflation, the Bank of Canada lifted its target for the overnight rate by 125 basis points in the first half of 2022. Further tightening is expected this year, with another 50-basis point hike in July followed by additional 25-point hikes at its September, October, and December announcements. A final hike in early 2023 would bring the overnight rate to 3%, where it's expected to stabilize. With higher inflation in the United States, the Federal Reserve is currently adopting a more aggressive tightening pace. After lifting rates by 25 basis points in March, it delivered a 50-point hike in May, followed by a 75-basis point increase in June. With the aggressive tightening expected to continue, the federal funds rate would reach 3% by the end of this year. This heightened pace of rate hikes will put downward pressure on the Canadian dollar, resulting in the loonie depreciating to USD 77 cents during 2023 before gradually beginning to recoup some lost value, moving back toward its purchasing-power parity level over the longer term.

Households

High inflation and rising interest rates will have the most impact on the household sector. Consumer spending and residential investment helped lift the economy out of recession, but the tide is turning for these key growth drivers.

Inflation is far outpacing wage growth, triggering a decline in real wages. At the same time, we're starting to feel the impact on debt-servicing costs. These are rising as payments tied to variable-rate loans increase and those with fixed-rate mortgages begin renewing at higher rates. This will accelerate as more variable-rate mortgages require payment adjustments (not all automatically adjust with each interest rate increase), and fixed mortgages continue to roll over and renew at higher rates. Further, job growth is expected to slow as tight labour markets will necessitate a deceleration in employment gains. The decline in real wage growth, higher debt-servicing costs, and a slowdown in job creation all mean that household disposable income growth will take a hit. As a result, we can no longer rely on households to support the economic recovery to the same extent as in recent years.

There will be an even larger impact on residential investment than consumer spending on goods and services. Not only is the decline in disposable income a factor, but the run-up in housing prices over the last couple of years has been dramatic, drastically reducing affordability. At the same time, higher prices for several commodities required for new construction, such as lumber and electrical wires, are making new housing expensive to build. The combination of rising costs and reduced incomes will hit housing activity hard. We already saw a pullback during April and May in resale market activity. We expect to see housing starts follow suit in the second half of this year. The Bank of Canada's move to a neutral level of borrowing costs will weigh on the residential market for years. Renovations, resale, and new housing investment will all decline. We expect total real residential investment to fall by 0.4% this year and by an average of 3.6% a year over 2023-24.

Spending on goods and services will be less affected A strong demand for services after the pandemic lockdowns will offset weakness on the goods side. Consumer spending on transportion, accommodation, food and beverage, information, culture, and recreation services are likely to experience growth. Durable goods spending will be muted as outlays on furniture and appliances decline. Real consumer spending is expected to grow by 3.2% next year, after posting a gain of 5.3% this year, before decelerating to a 1.9% pace in 2024.

Business

The recession hit business investment hard. After dropping by a staggering 55% in the spring of 2020, non-residential investment is still 3.7% below its pre-pandemic level by the first quarter of 2022. Growth will continue this year thanks to an anticipated rebound in energy investment. This will increase non-residential business investment by 9.8% this year and 5.7% in 2023. However, labour shortages and rising production costs due to higher energy and other input prices are weighing on business sentiment and investment plans in other areas of the economy.

The outlook for oil investment has improved for the next two years due to surging oil demand following the easing of travel restrictions and rapidly rising oil prices due to the war in Ukraine. The EU and US ban on Russian oil imports is also increasing demand for Canadian energy. However, Canadian energy producers remain hesitant to invest in major new capacity due to the uncertainly over oil prices and government policy direction. The long-term investment outlook for Canada's oil and gas sector is also dampened as businesses are shifting their investment away from conventional oil to clean energy and technologies.

Investment in machinery and equipment has been strong and has now fully recovered thanks mainly to the strength in industrial machinery and equipment and computer investments. However, investment in transportation-related categories is still significantly below pre-pandemic levels. Not surprising, given,COVID-19-related travel restrictions. As these continue to ease and the supply chain disruptions unwind worldwide, we expect investment in transportation categories to rebound starting this summer, boosting the outlook of machinery and equipment over the next two years.

We saw a significant reduction in trade exports during the first quarter of 2022. But high commodity prices will aid recovery in export activity this year and into the next. High energy prices will boost oil exports, while more semi-conductor chips will also help boost the trade of motor vehicles and parts. Increased imports of consumer goods (clothing and footwear) and motor vehicles will drive merchandise import growth. Trade in the service industry—especially —will support strong import growth as the industry recovers from pandemic losses. Overall, expect real exports to increase by 2.2% this year and 5.2% in 2023, while imports increase by 5% and 4.7%, respectively. With imports growing faster than exports in 2022, trade will subtract from growth. The outlook for next year is better, with faster export growth helping to support economic growth as the household sector cools.

Outlook by province

Following severe economic declines in 2020, Canadian provinces have been recovering at different paces, depending on how they fared during the global crisis. In 2021, just five provinces recouped their losses. Most of these provinces had relatively lower COVID-19 case counts and less-strict public measures, like most Atlantic provinces and British Columbia. Despite a high case count and long-lasting public health measures, Quebec also recouped its pandemic losses last year. We expect economic activity in the provinces experiencing a delayed recovery (mainly Ontario and the Prairies) to come back strong over the next two years following the lifting of restrictions and a rebound in the mining sector.

However, soaring inflation, rising interest rates, and labour constraints are weighing heavily on the overall provincial economic outlook. Ontario’s future, for instance, will be hampered by rising interest rates as it had the highest provincial debt-service ratio (measuring interest payments as a share of disposable income) in 2020.

Economic growth will be relatively subdued in Atlantic Canada over the near term since their post-pandemic recoveries are complete. Instead, we will see slowing population growth and reduced purchasing power eat into economic gains. This will leave the region experiencing below-average growth this year. Next year we'll see growth accelerate in Newfoundland and Labrador thanks to the recently approved Bay du Nord oil project.

Real GDP growth by province, percent change

	2020	2021	2022	2023
Newfoundland and Labrador	-5.3	1.2	1.2	1.9
Prince Edward Island	-1.8	6.6	3.3	1.3
Nova Scotia	-2.5	5.8	3.0	1.5
New Brunswick	-3.1	5.3	2.0	1.2
Quebec	-5.4	5.6	2.9	1.3
Ontario	-5.0	4.6	3.5	1.5
Manitoba	-4.5	1.2	2.8	2.6
Saskatchewan	-5.1	-0.3	3.6	4.3
Alberta	-8.0	5.1	5.0	1.6
British Columbia	-3.4	6.2	3.5	1.7

Outlook by province cont'd

In the near term, Quebec will benefit from strong growth in public sector spending, but high inflation will eat into consumer purchasing power. That, combined with slower population growth, will squeeze household spending and investment. Another factor weighing on growth is the tight labour market conditions. Quebec is experiencing the second-highest rate of job vacancies after British Columbia. Overall, real GDP in the province is expected to increase by 2.9% this year before softening to 1.3% next year.

Ontario’s economic reopening was relatively slow compared to other provinces', meaning real GDP in the province did not fully recover last year. We expect that Ontario’s real GDP will advance by 3.5% in 2022 and 1.5% in 2023, driven by the strength in the province’s manufacturing industry. As global supply disruptions start to unwind post-pandemic, we anticipate a rebound in motor-vehicle and parts-manufacturing activities, boosting the province’s economic outlook.

Severe drought conditions affected growth in Manitoba and Saskatchewan last year, hammering the agricultural industry. Saskatchewan is the only province that experienced two consecutive years of declining GDP growth. Near-term, we expect Saskatchewan to do much better, supported by China’s recent lift of the three-year ban on Canadian canola and rising demand for Saskatchewan’s potash after the Russian-Ukrainian war threatened the global potash supply. Real GDP growth in the province over the next two years will top the leaderboard with an average annual gain of 4%. In Manitoba, growth will be steadier, with an average gain of 2.7% a year over the next two years.

The dual challenge of COVID-19 and a sharp collapse in oil prices and demand hit Alberta's economy hard in 2020. After recording an 8% decline in real GDP in 2020, the economy grew 5.1% in 2021, with nearly all sectors rebounding. As energy prices soar, we expect the province's energy-fuelled economic recovery to continue this year with 5% growth before slowing to 1.6% in 2023. British Columbia's near-term economic outlook is mixed. Growth has been strong enough that the province is now running into capacity constraints. In March 2022, the provincial job vacancy rate hit 7.3%, by far the highest among all provinces. While the outlook remains promising for some of British Columbia’s key sectors, growth is anticipated to slow to 3.5% this year and 1.7% in 2023.

Final thoughts

The economic outlook continues to be subject to an unusual amount of risk and uncertainty—the war in Ukraine, the possibility of a COVID-19 resurgence, and aggressive monetary tightening against a backdrop of elevated debt levels are all elevating risk levels.

The most significant change since our last outlook is the entrenchment of inflation and the reaction speed of central bankers seeking to contain it. This is a big change for the economy. The last time we saw interest rates this high was before the financial crisis of 2008-09. Back then, debt levels were much lower. We haven't experienced a bout of inflation this high since the inflation targeting regime was adopted in 1991. This is not only a challenging set of circumstances for businesses and households but also policymakers as they attempt to orchestrate a soft landing while slowing price growth.

In our baseline forecast, we expect policymakers will be able to slow inflation. That also means much weaker growth ahead. The record-low interest rates enjoyed over the last decade and a half have ended. There will be some short-term pain for interest-rate-sensitive sectors like housing and consumer durables. Rebalancing away from an economy driven by housing and consumer-spending debt will ultimately pay dividends in the form of better productivity growth and a reduction in financial vulnerabilities.

We acknowledge the recession risks. At the time of writing, we put the odds of a slowdown at 60% versus a recession at 40%. If inflation proves harder to tame or interest rates climb more than anticipated, it won't take much to trigger a contraction. Central banks fell behind the inflation curve and are playing catch-up. They'll try to engineer a soft landing, but the conduct of monetary policy is far from an exact science.

Nevertheless, with all this negativity, it's worth remembering some positives. Economic modelling suggests that a pronounced slowdown is the most likely scenario, and that's what businesses and governments should plan for. However, recession scenario planning is a prudent move, even if only as a contingency plan.

Key economic indicators

	2022				2023				21 actual	22 forecasted	23 forecasted
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Real economic activity											
Gross domestic product	3.1	2.7	2.1	1.8	1.3	1.7	1.5	1.4	4.5	3.3	1.7
Consumption expenditure	2.9	2.7	1.7	1.7	2.0	1.9	1.7	1.6	5.1	3.6	1.9
• Durable goods	10.8	-0.5	-0.2	0.7	1.3	1.4	1.2	1.1	7.3	1.9	0.9
• Services	3.0	8.7	7.6	5.9	4.7	3.4	2.9	2.4	5.0	8.2	4.9
Residential investment	18.1	-1.6	-4.5	-6.1	-4.3	-3.1	-2.8	-2.7	15.3	-0.4	-4.0
Non-residential fixed investment	9.0	12.9	11.8	7.7	3.4	4.6	2.5	1.2	2.3	9.8	5.7
• Non-residential structures	12.0	14.3	11.3	8.0	3.1	3.9	1.1	0.2	-0.3	11.3	5.3
• Machinery & equipment	3.8	10.7	12.7	7.4	3.8	5.7	4.9	2.9	6.6	7.3	6.4
Government consumption & investment	2.3	-3.5	-5.3	-4.2	-2.3	-0.7	0.3	0.8	5.6	-0.1	-2.3
Exports of goods & services	-9.4	7.4	7.3	6.3	4.9	4.3	3.6	3.4	1.4	2.2	5.2
Imports of goods & services	-2.8	8.5	7.2	4.7	4.6	3.8	3.1	2.9	7.7	5.0	4.7
Prices											
Consumer price index (y/y)	5.8	6.8	7.0	6.6	5.5	4.1	3.2	2.8	4.6	6.6	2.8
Implicit GDP price index (y/y)	8.8	9.2	10.4	8.8	5.7	3.0	0.8	0.7	8.9	8.8	0.7
Labour market											
Employment	3.2	4.3	0.1	1.4	1.5	1.4	1.3	1.2	4.8	3.9	1.4
Unemployment rate (%)	5.8	5.1	5.4	5.4	5.4	5.4	5.4	5.4	7.4	5.4	5.4

Note: Unless otherwise noted, all figures are expressed as annualized % changes.
Sources: Statistics Canada, Bank of Canada. Forecast by Deloitte Economic Advisory, as of **June 15, 2022**.

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Financial market indicators

	2022				2023				21 actual	22 forecasted	23 forecasted
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Interest rates (%)											
Overnight rate target	0.33	1.17	2.08	2.58	2.83	3.00	3.00	3.00	0.25	2.58	3.00
3-month T-bill	0.39	1.35	2.11	2.59	2.81	2.97	2.96	2.96	0.10	2.59	2.96
1-year GoC note	1.22	2.40	2.82	3.13	3.25	3.37	3.33	3.32	0.63	3.13	3.32
2-year GoC note	1.49	2.65	3.02	3.27	3.35	3.42	3.38	3.35	0.92	3.27	3.35
5-year GoC note	1.76	2.75	3.13	3.37	3.49	3.58	3.58	3.58	1.34	3.37	3.58
10-year GoC bond	1.92	2.90	3.23	3.46	3.58	3.68	3.70	3.72	1.58	3.46	3.72
Yield curve spread (pp)											
3-month vs. 10-year	1.53	1.55	1.12	0.86	0.77	0.71	0.74	0.76	1.48	0.86	0.76
2-year vs. 10-year	0.43	0.25	0.21	0.19	0.23	0.26	0.32	0.37	0.66	0.19	0.37
Foreign exchange											
USD/CAD ($C)	1.27	1.28	1.29	1.29	1.29	1.30	1.30	1.30	1.26	1.29	1.30
CAD/USD (US cents)	0.79	0.78	0.78	0.77	0.77	0.77	0.77	0.77	0.79	0.77	0.77

Sources: Statistics Canada, Bank of Canada. Forecast by Deloitte Economic Advisory, as of June 15, 2022.

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