CANADA

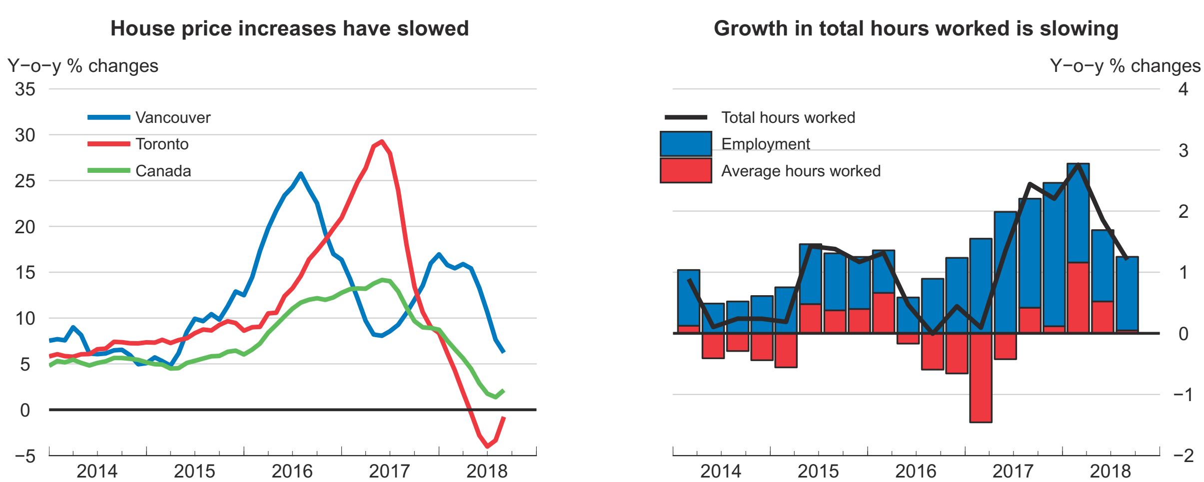
Growth is on course to moderate to slightly below 2% by 2020, with consumption slowing in response to smaller increases in housing wealth, and employment and exports moderating as US growth declines. Unemployment is projected to remain near record lows and inflation to edge up to slightly over 2%.

The Bank of Canada is projected to continue withdrawing monetary stimulus to stabilise inflation around the mid-point of its 1-3% medium-term target band. While fiscal policy is projected to remain neutral, reducing the structural budget deficit would ease the burden on monetary policy and create more room to support the economy in the event of an unexpected downturn. Macro-prudential policies have been tightened and housing markets are stabilising. The government should monitor the effects of recent tightening, especially the prevalence of highly indebted borrowers, and act if it does not decline significantly.

Economic growth remains solid

Economic growth remains strong, even after looking through the rebound from temporary factors (an anticipated adjustment in automobile production and the outage of an oil and gas pipeline) that depressed growth in late 2017. However, its composition is changing. Consumption and residential investment are slowing in response to declining house price gains and rising interest rates. Exports and business investment, in contrast, are strengthening owing to buoyant export markets and growing capacity constraints, respectively. The recently agreed United States-Mexico-Canada Agreement (USMCA) to replace NAFTA reduces uncertainty about access to the US market, which had been weighing on the export and business investment outlook. The legalisation of cannabis in October 2018 has resulted in cannabis activity being included in official economic statistics, increasing the level of real GDP by 0.2 percentage point in 2019; this effect will disappear once GDP is revised to include such activity in earlier periods.

Canada



Source: Teranet and National Bank of Canada, House Price Index; and Statistics Canada.

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Canada: **Demand, output and prices**

	2015	2016	2017	2018	2019	2020
	Current prices CAD billion	Percentage changes, volume (2007 prices)				
GDP at market prices	1 994.9	1.4	3.0	2.1	2.2	1.9
Private consumption	1 146.2	2.3	3.4	2.3	2.3	1.8
Government consumption	417.0	2.2	2.3	2.4	1.4	1.2
Gross fixed capital formation	476.0	-3.0	2.8	3.8	2.5	2.4
Final domestic demand	2 039.2	1.1	3.0	2.6	2.2	1.8
Stockbuilding[1]	5.0	-0.2	0.8	0.0	0.0	0.0
Total domestic demand	2 044.2	0.8	3.8	2.6	2.1	1.8
Exports of goods and services	629.0	1.0	1.1	2.6	3.4	3.4
Imports of goods and services	678.3	-1.0	3.6	4.2	3.2	3.1
Net exports[1]	- 49.3	0.7	-0.9	-0.6	0.0	0.0
Memorandum items						
GDP deflator	_	0.6	2.3	2.0	2.0	2.1
Consumer price index	_	1.4	1.6	2.3	2.1	2.1
Core consumer price index[2]	_	1.9	1.6	1.9	2.0	2.1
Unemployment rate (% of labour force)	_	7.0	6.3	5.9	5.8	5.8
Household saving ratio, net (% of disposable income)	_	3.4	3.7	3.4	3.1	3.2
General government financial balance (% of GDP)	_	-1.1	-1.1	-0.9	-0.5	-0.4
General government gross debt (% of GDP)	_	97.8	93.8	93.0	92.6	92.1
Current account balance (% of GDP)	_	-3.2	-2.9	-3.1	-3.0	-2.9

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.

Source: OECD Economic Outlook 104 database.

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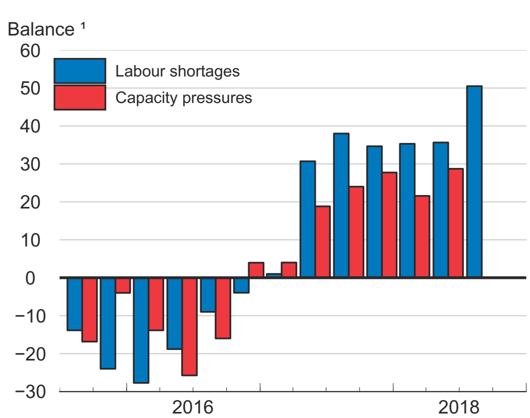
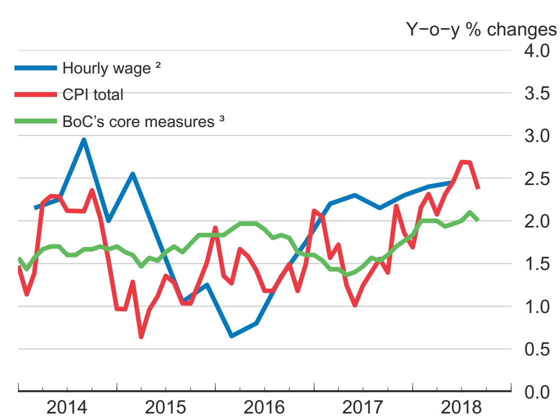
Canada





1. Percentage of firms reporting more intense capacity pressures (or labour shortages) minus the percentage of firms reporting less, compared with 12 months ago.
2. Median of hourly wage growth measures from the Labour Force Survey, National Accounts, Productivity Accounts, and Survey of Employment, Payrolls and Hours.
3. Average of the Bank of Canada's three preferred core inflation measures (CPI-trim, median and common).

Source: Bank of Canada (2018), Business Outlook Survey; Bank of Canada (2018), Monetary Policy Report, July; and Statistics Canada, Tables 18-10-0006-01 and 18-10-0256-01.

StatLink http://dx.doi.org/10.1787/888933876423

Employment growth is slowing and the unemployment rate has fallen to less than 6%, near a 40-year low. Hourly wage growth is rising and will receive a further boost from increases in provincial minimum wages over the next few years. Consumer price inflation has increased to above the midpoint of the Bank's 1-3% annual medium-term target band, boosted by rising energy prices. The average of the Bank's preferred underlying inflation measures has edged up to 2.0%. Inflation expectations remain well anchored, with almost all firms expecting inflation to fall within the target band over the next two years, albeit with most seeing inflation in the upper half of the band.

Macroeconomic policies are becoming less accommodative

Monetary policy stimulus has been withdrawn gradually since mid-2017. With core inflation already at the mid-point of the target band and excess capacity being absorbed, further rate increases will be needed to stabilise the inflation rate close to the midpoint of the band over the medium term. The OECD projects additional official rate increases of 125 basis points by the end of 2020, taking the rate to 2.75%, which falls within the Bank's estimate of the neutral rate (2.5-3.5%). Long-term interest rates will also increase in response to rising global term premia, further tightening financing conditions. Interest rate increases are likely to have a greater impact on the housing market and economic activity than in the past owing to high household indebtedness (around 170% of disposable income, compared with 100% two decades ago).

A series of macro-prudential measures, culminating in the tightening of mortgage underwriting requirements for uninsured mortgages that came into effect in January 2018, have mitigated risks from the recent housing boom. Even so, house prices and household debt are high relative to disposable income, especially in Toronto and Vancouver. Many new mortgage holders, especially in those high-priced markets, have such high loan-to-income ratios that they are vulnerable to falling into arrears in the event of a negative economic shock, such as an increase in mortgage rates (few of which are locked in for more than five years). The government should monitor the effects of recent macro-prudential tightening, especially on the prevalence of highly indebted borrowers, and act if it does not decline significantly. Moreover, co-ordination between federal and provincial regulatory authorities needs to be improved, including by encouraging provincially regulated financial institutions to adhere to federal mortgage underwriting standards.

The fiscal policy stance has been expansionary over the past two years, during which time the underlying primary balance has fallen by an estimated 1.1 percentage points of GDP, but it is estimated to be neutral over the next two years. At this advanced stage of the business cycle, greater budget consolidation would be more appropriate – it would ease the burden on monetary policy and create more fiscal space to support the economy in the event of a downturn.

Growth is projected to ease towards potential

The main contribution to slowing growth is private consumption expenditure, which will weaken in response to slower growth in employment and household wealth and rising interest rates. Business investment should remain robust in the face of capacity constraints. The unemployment rate is projected to edge down to 5.8% in 2020, and wage pressures to rise modestly. With production costs rising, inflation should edge up to just over 2% by late 2020. A major downside risk is greater-than-expected increases in mortgage interest rates, which could impair many households' ability to service their mortgages, lead to a housing market correction and, through lost wealth, lower consumption expenditure. Another is that access to the US market becomes less favourable, even if the USMCA is ratified. On the upside, oil-sector income would be boosted by higher global oil prices and a resolution to regulatory difficulties to increasing oil pipeline capacity.