Canadian Economic Forecast: Canada's Economy Is Flying High but Growth Will Ultimately Migrate South

Institute of Fiscal Studies and Democracy
at the University of Ottawa

Randall Bartlett, Chief Economist, and Dominique Lapointe, Senior Analyst

This report was prepared under the supervision of Kevin Page, President & CEO of the Institute of Fiscal Studies and Democracy (IFSD).

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115 Séraphin-Marion Room 107

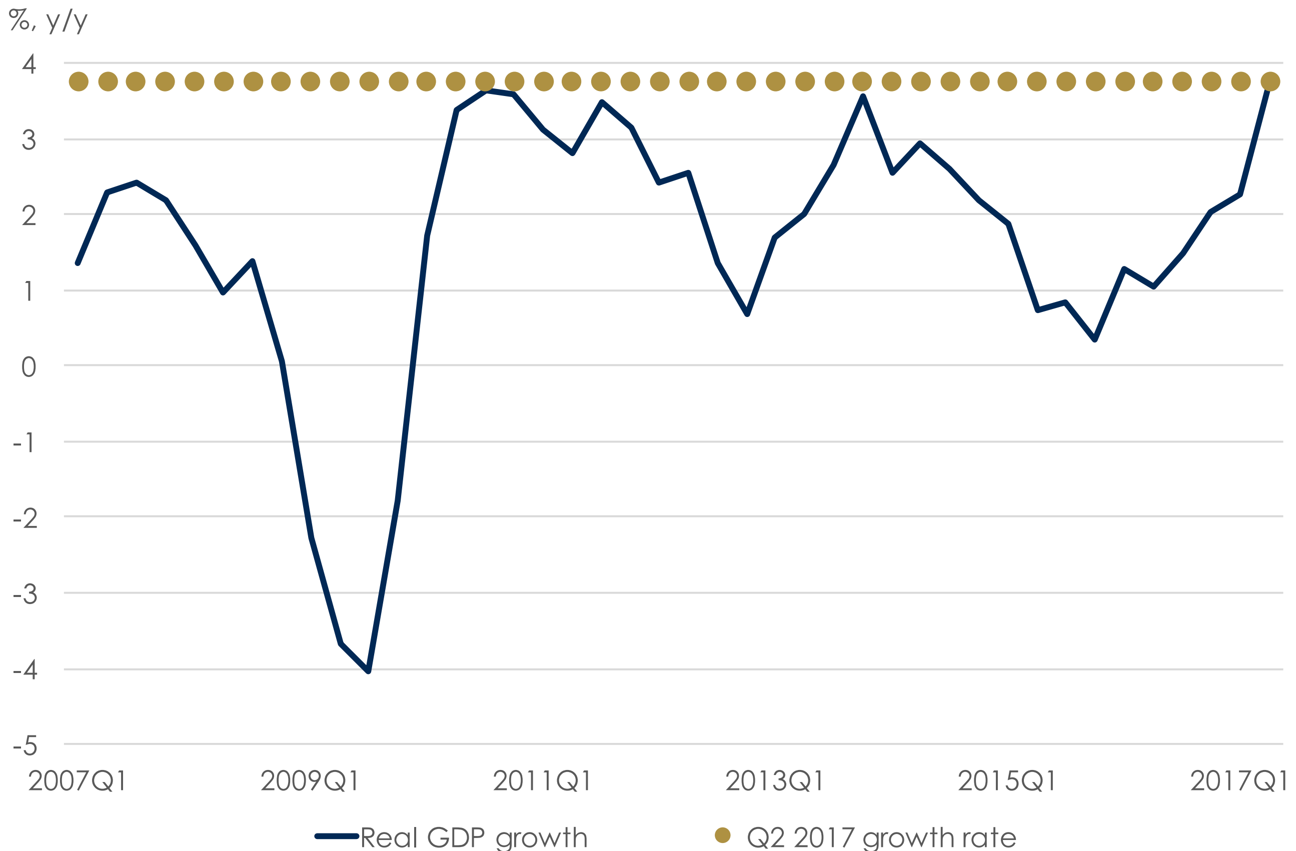
Ottawa ON K1N 6N5

613-562-5800 x 5628

Ifsd.ca | info@ifsd.ca

The Canadian economy is firing on all cylinders. After hitting growth rates in the range of roughly 2.5% to 3.5% annualized in the last half of 2016 and Q1 2017, the second quarter of the year blew the doors off with an above-expectations outturn of 4.5%. This is the strongest quarterly advance in real GDP since Q3 2011, when the global economy rebounded from the trade disruptions that resulted from the earthquake and tsunami in Japan. Indeed, on a year-over-year basis, real GDP growth posted its strongest advance in Q2 2017 of any quarter in the past decade (Chart 1).

Chart 1: Canadian Real GDP Growth



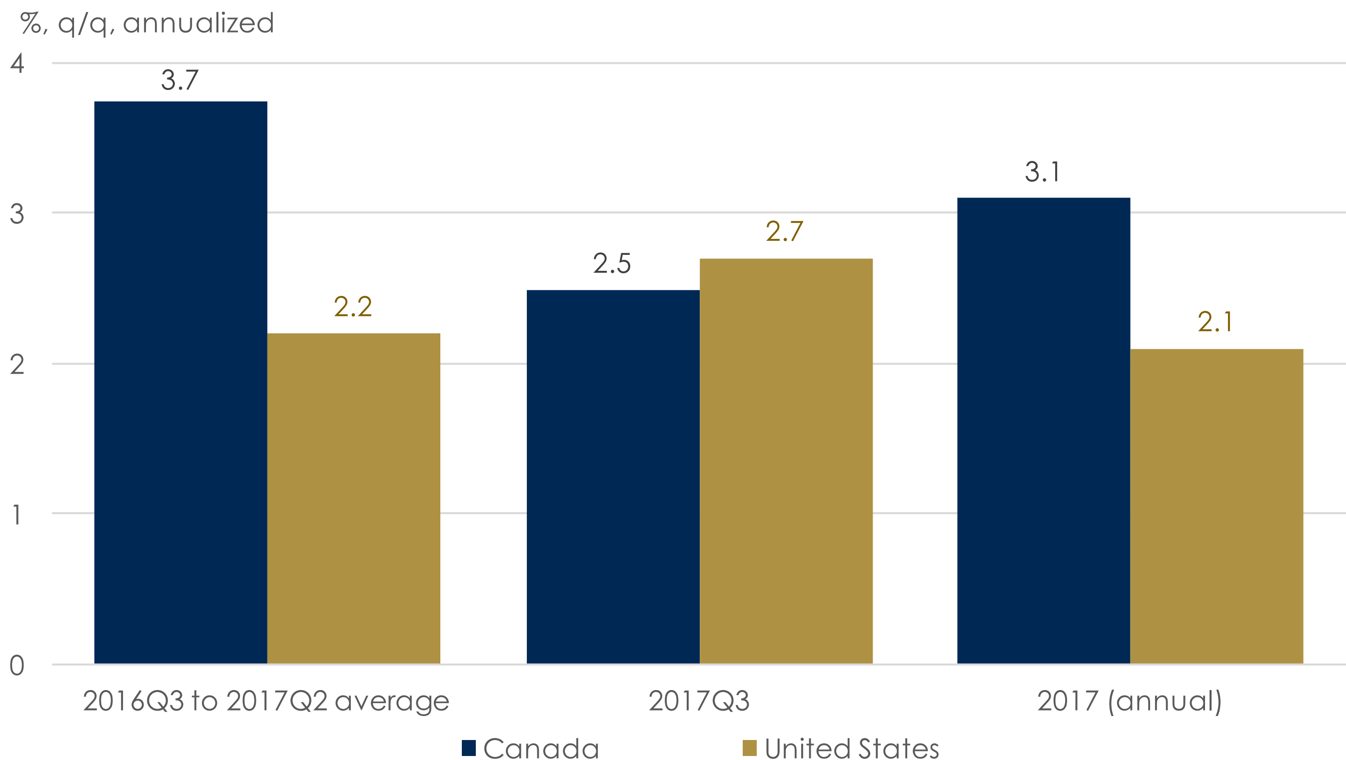
Sources: Statistics Canada, Institute of Fiscal Studies and Democracy.

Even better than just strong headline GDP number was that the growth in Q2 2017 was broad based. Consumers were hitting the malls while businesses were feeling optimistic enough about future demand to invest at a pace not seen for some time. Trade also stepped up to the plate, with very strong export growth topping a nearly equally robust advance in imports. However, the tide does appear to have turned in residential investment. This can almost entirely be chalked up to the introduction of regulatory measures by the Province of Ontario to cool the housing market in and around the Greater Toronto Area (GTA), which seem to have had their intended effect.

Despite the weakness in residential investment, solid growth is expected to continue, at least in the near term. For instance, @NowcastCanada has estimated that real GDP will post an advance of 2.5% annualized in Q3 2017 (Chart 2). When combined with the solid growth numbers already posted this year and last, real GDP is expected to move ahead 3.1% in 2017 as a whole. That will mark the strongest annual growth in real GDP since 2011. As a comparison, growth in the United States

has been much more lackluster. Indeed, the good ol' US of A is expected to see real GDP move ahead by a modest 2.1% in 2017—a paltry print when compared to its neighbour to the north.

Chart 2: Real GDP Growth in Canada and in the US

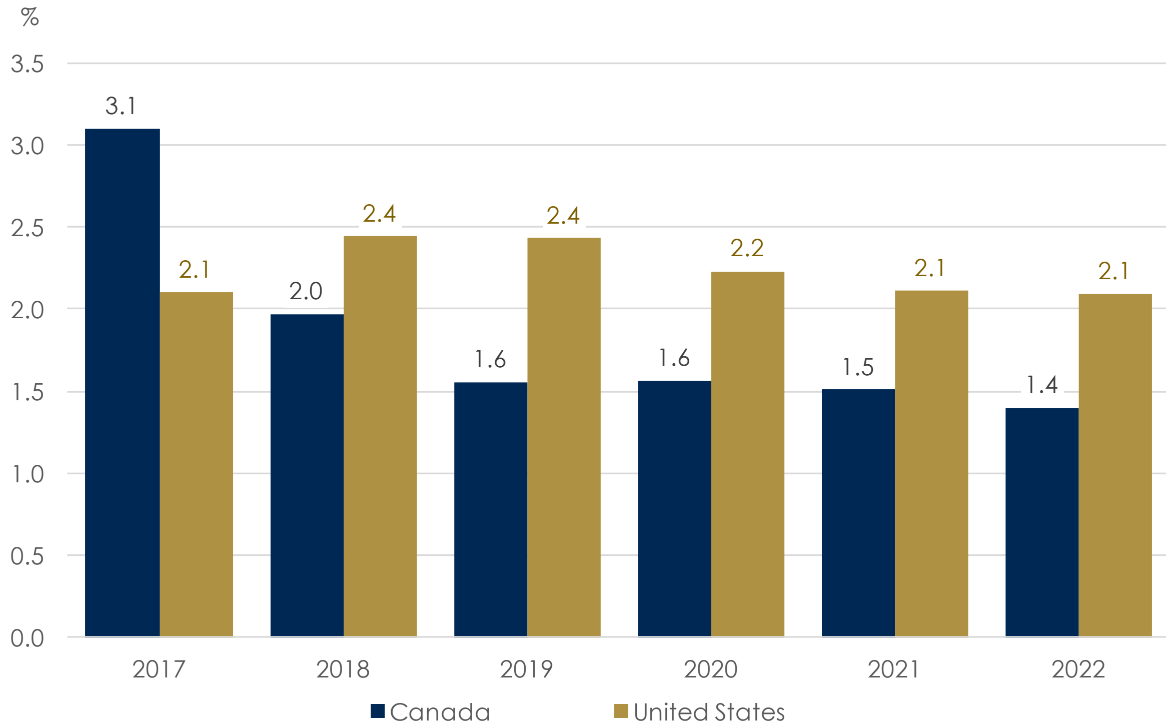


Sources: Bureau of Economic Analysis, Statistics Canada, U.S. Federal Reserve, @NowcastCanada, Institute of Fiscal Studies and Democracy.
Notes: The 2017Q3 real GDP growth value for Canada is from @NowcastCanada as of Sept. 6, 2017. The US value for 2017Q3 is the average of nowcasts from the Federal Reserve Banks of Atlanta and New York as of Sept. 2, 2017.

But, all good things must come to an end, as they say. And, nowhere will this be more true than in the context of the Canadian economy. Indeed, real GDP growth is forecast to slow from its torrid pace of 3.1% in 2017 to a much more modest 1.9% in 2018, and to cool further through 2022 (Chart 3). In contrast, the growth of the U.S. economy is expected to pull ahead in 2018, hitting 2.4%, and will remain ahead of Canada for the rest of the 5-year forecast.

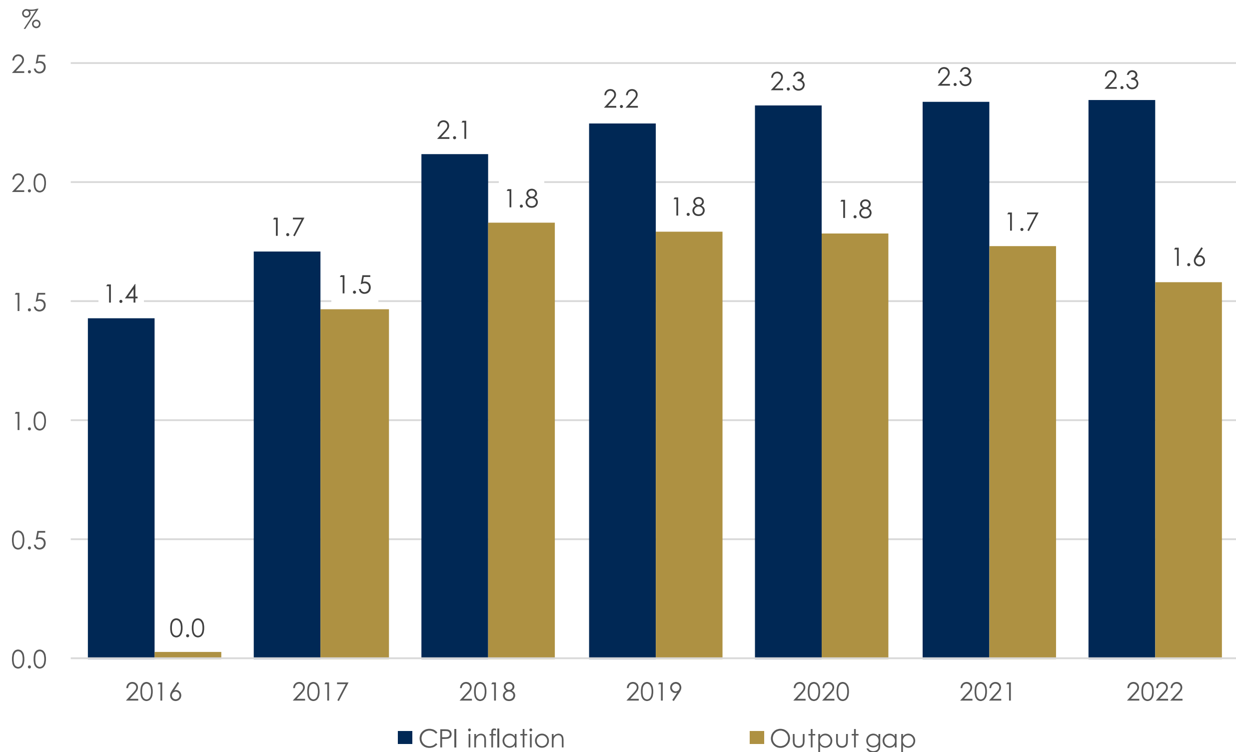
There are a few reasons for this anticipated change of fortune. The first is that the Canadian economy is operating well above its trend level of output, which is an unsustainable position to be in over the long-term (Chart 4). This is because, as economic strength makes its way into the labour market, as we have already seen in recent quarters, wages and inflation start to rise. And, while wages and inflation seem to have become temporarily disconnected for output and hiring in recent years, it is really just a matter of time as the labour market continues to tighten.

Chart 3: Canada and US Real GDP Growth



Sources: Bureau of Economic Analysis, Statistics Canada, Institute of Fiscal Studies and Democracy.
Notes: US and Canadian real GDP is available to 2017Q2. The sources of 2017Q3 values are in Chart 1.

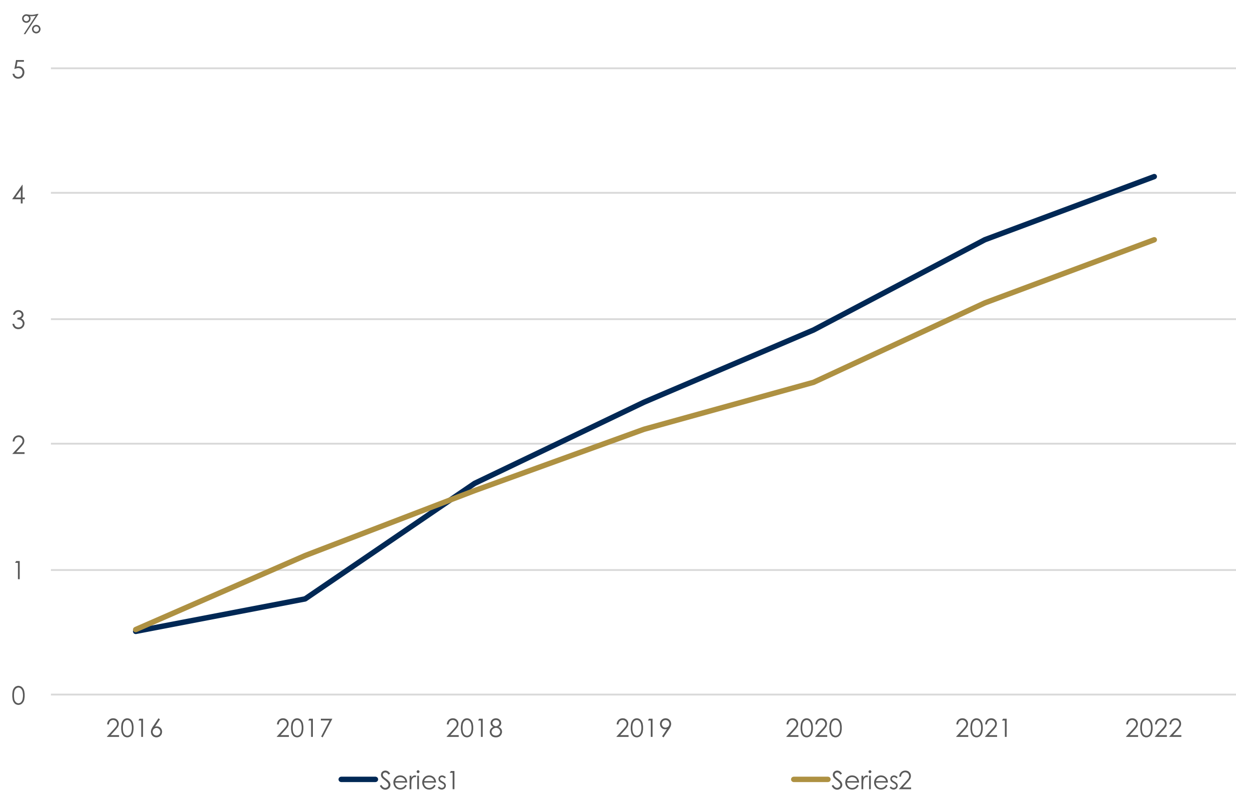
Chart 4: Canadian CPI Inflation and Output Gap



Sources: Statistics Canada, Institute of Fiscal Studies and Democracy.
Note: The output gap is expressed as a percent of potential GDP while CPI inflation is year-over-year growth.

Concern over this relationship has already drawn the attention of central banks. Indeed, given the strength of the economic performance north of the 49th, the Bank of Canada pulled the trigger on its first interest hike since September 2010 in July of this year, and did so again in September. And, given the heat of the Canadian economy and forward-looking nature of monetary policy, the hikes aren't likely to end soon. This, along with the cooling of Toronto's housing market, should have a dampening effect on the Canadian economy. In contrast, the U.S. Federal Reserve has taken a temporary hiatus from increasing interest rates in order to start the process of normalizing its balance sheet. As a result, barring any radical shift in the Fed's orientation at the end of Janet Yellen's term in February 2018, the monetary policy interest rate in Canada (the overnight rate) is expected to catch up to, and ultimately surpass, the federal funds rate (Chart 5).

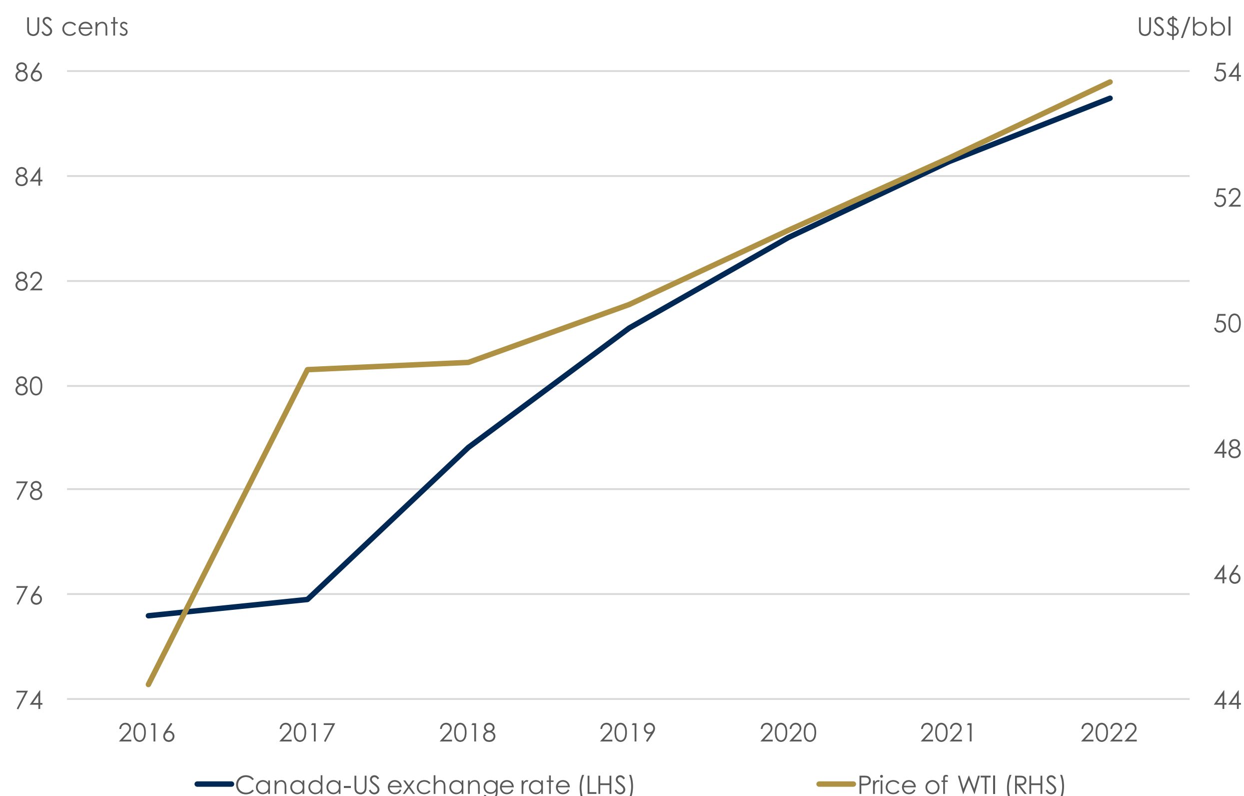
Chart 5: Canada and US Monetary Policy Rates



Sources: Bank of Canada, US Federal Reserve, Institute of Fiscal Studies and Democracy.

Besides the evolving spread between U.S. and Canadian interest rates, another anticipated contributor to the cooling of the Canadian economy is softer net exports thanks to the high-flying loonie (Chart 6). Thanks to Hurricane Harvey, the spot and futures price of West Texas Intermediate (WTI)—the North American light sweet crude benchmark—has moved higher, and the Canadian dollar along with it. Indeed, the Canadian dollar recently hit its strongest value against the greenback since mid-2015. And, while higher oil prices tend to have a positive impact on the Canadian economy, the impact has been felt more strongly through the dollar than via the price received by Canadian producers. This is demonstrated by the widening spread between the price of WTI and the Canadian heavy crude benchmark, Western Canada Select (WCS). As such, while Harvey may put wind beneath the wings of the loonie, it doesn't look to be doing the same to Canadian crude prices.

Chart 6: Canada-US Exchange Rate and Oil Price

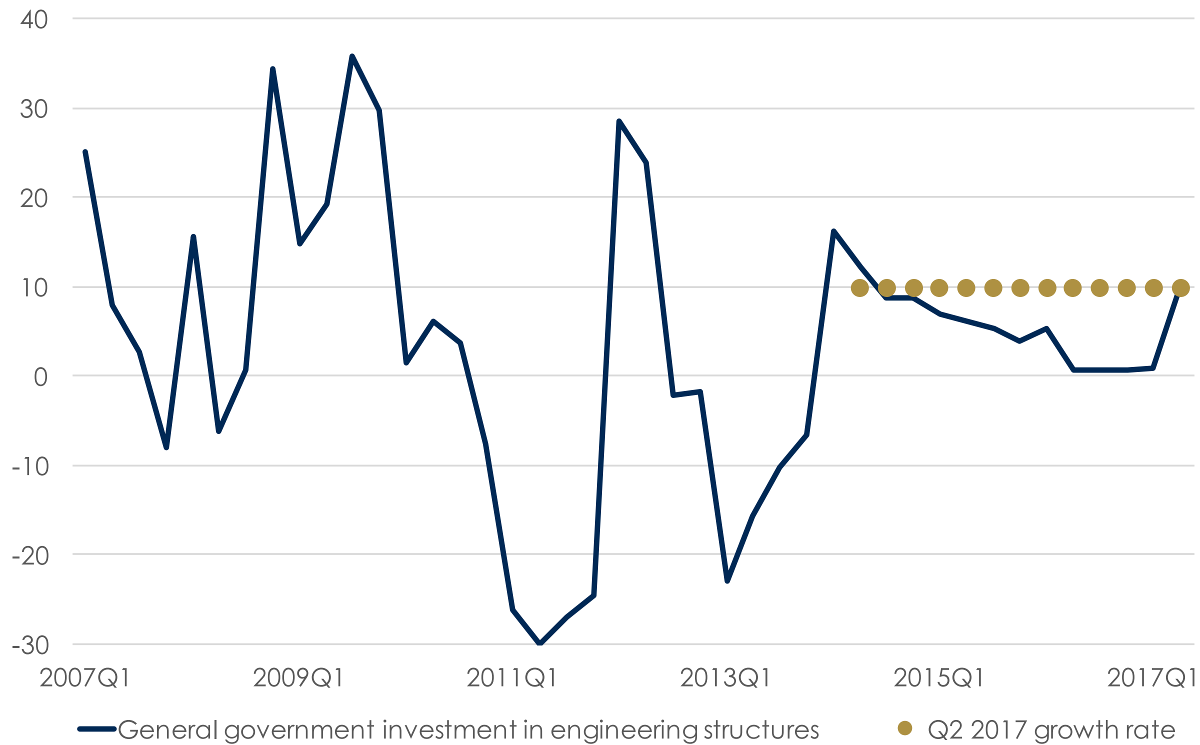


Sources: Bank of Canada, CME Group, Haver Analytics, Institute of Fiscal Studies and Democracy.

But, while interest rates, the Canadian dollar, and residential investment are all expected to be headwinds to growth in the coming quarters, there are some factors that should support growth going forward. One is of course the U.S. economy, which is expected to perform well relative to Canada and recent history starting in 2018. This should lead to a positive contribution to growth from trade despite a stronger loonie. Of course, all of this is contingent on the North American Free Trade Agreement (NAFTA) negotiations not going completely off the rails.

The other positive contributor to growth is the long-awaited federal infrastructure program. Announced in Budget 2016, the federal government and Bank of Canada wrongly expected it to pour quickly into the Canadian economy. This incorrect assumption ultimately led to repeated downward revisions to growth forecasts on the part of the Bank because, as history has shown time and again, infrastructure investment takes time to make its way into measureable changes in output. However, the good news is that it finally has, with Q2 2017 showing the strongest advance in government investment in engineering structures (i.e. roads) since Q2 2014 (Chart 7). Looking more closely at the monthly GDP by industry, much of the advance in construction activity in Q2 2017 was in repair construction, which fits well with the federal government's infrastructure plan. Going forward, an elevated contribution from infrastructure investment is expected to continue. Unfortunately, it has arrived at a time when the Canadian economy is near its potential, so the outcome is ultimately likely to be more smoke (inflation) than fire (real economic activity).

Chart 7: Real Government Investment in Infrastructure



Sources: Statistics Canada, Institute of Fiscal Studies and Democracy.

The Take Away

The Canadian economy has shown exceptional outperformance in recent quarters and, while growth is expected to slow in the coming years relative to 2017, it is likely to remain solid. The U.S. economy is also expected to perform well barring any adverse impacts from unexpected policy changes. As long as the current U.S. administration doesn't derail its economy, or that of Canada, the process of monetary policy normalization should also continue in the coming years in both countries. Indeed, in the Canadian case, the recent economic outperformance and infrastructure investment about to land on the scene mean interest rates are likely to rise faster in the Great White North than stateside. In essence, it looks as though the new normal when it comes to the economy is rapidly reverting to the old normal.

Table A. U.S. Economic Outlook, 2017 to 2022	2017	2018	2019	2020	2021	2022
		per cent, unless otherwise indicated				
Nominal GDP level (billions of dollars)	17,067	17,485	17,910	18,310	18,696	19,087
Nominal GDP growth	3.9	4.3	4.3	4.2	4.1	4.1
Real GDP growth	2.1	2.4	2.4	2.2	2.1	2.1
GDP inflation	1.8	1.8	1.9	1.9	1.9	1.9
Total CPI inflation	2.1	2.1	2.2	2.4	2.4	2.4
Core CPI inflation	1.9	2.0	2.2	2.3	2.4	2.4
Unemployment rate	4.5	4.6	4.6	4.6	4.7	4.7
Employment growth	1.2	0.5	0.6	0.6	0.6	0.6
Federal funds rate	1.1	1.6	2.1	2.5	3.1	3.6
Yield on:						
3-month Treasury bill	0.9	1.4	1.9	2.3	2.8	3.3
6-month Treasury bill	1.1	1.6	2.0	2.4	2.9	3.4
1-Year Treasury bond	1.2	1.6	2.1	2.4	2.9	3.4
2-Year Treasury bond	1.4	1.8	2.2	2.5	3.1	3.5
3-Year Treasury bond	1.6	2.0	2.4	2.7	3.3	3.7
5-Year Treasury bond	1.9	2.3	2.7	3.0	3.5	3.9
7-Year Treasury bond	2.2	2.5	2.9	3.2	3.6	4.0
10-Year Treasury bond	2.4	2.6	3.0	3.3	3.7	4.1
20-Year Treasury bond	2.7	2.9	3.2	3.5	3.9	4.2
30-Year Treasury bond	3.0	3.1	3.4	3.6	4.0	4.3
WTI crude oil price ($US per barrel)	49.3	49.4	50.3	51.5	52.6	53.8
HH natural gas price ($US per mmbtu)	3.1	3.1	3.0	3.1	3.1	3.2

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, U.S. Census Bureau, U.S. Federal Reserve, CME Group, Haver Analytics, Institute of Fiscal Studies and Democracy.
Notes: All values are annual averages. Energy prices are derived from futures contracts two years from the most recent month of data, and increase by 2.3% annually thereafter.

Table B. Canada Economic Outlook, 2017 to 2022	2017	2018	2019	2020	2021	2022
	per cent, unless otherwise indicated					
Nominal GDP level (billions of dollars)	2,144	2,236	2,324	2,418	2,513	2,610
Nominal GDP growth	5.7	4.3	4.0	4.0	4.0	3.8
Real GDP growth	3.1	2.0	1.6	1.6	1.5	1.4
GDP inflation	2.6	2.3	2.4	2.4	2.4	2.4
Total CPI inflation	1.7	2.1	2.2	2.3	2.3	2.3
Average of core inflation measures	1.6	1.9	2.1	2.3	2.4	2.4
CPI-trim	1.7	2.0	2.2	2.4	2.4	2.5
CPI-median	1.7	2.0	2.2	2.4	2.4	2.5
CPI-common	1.4	1.7	1.9	2.1	2.2	2.3
Unemployment rate	6.5	6.5	6.6	6.6	6.6	6.7
Employment growth	1.6	0.6	0.5	0.5	0.5	0.4
BOC overnight rate	0.8	1.7	2.3	2.9	3.6	4.1
Yield on:						
3-month Treasury bill	0.8	1.6	2.3	2.8	3.5	4.0
6-month Treasury bill	0.8	1.6	2.3	2.8	3.5	4.0
1-Year GOC bond	1.0	1.7	2.4	2.9	3.6	4.1
2-Year GOC bond	1.1	1.8	2.4	2.9	3.6	4.1
3-Year GOC bond	1.2	1.8	2.4	2.9	3.6	4.2
5-Year GOC bond	1.4	1.9	2.5	2.9	3.6	4.2
7-Year GOC bond	1.5	2.1	2.5	3.0	3.6	4.2
10-Year GOC bond	1.8	2.2	2.6	3.0	3.6	4.2
30-Year GOC bond	2.3	2.5	2.9	3.2	3.7	4.2
WTI crude oil price ($US per barrel)	49.3	49.4	50.3	51.5	52.6	53.8
HH natural gas price ($US per mmbtu)	3.1	3.1	3.0	3.1	3.1	3.2
Exchange rate ($US/$CN)	75.9	78.8	81.1	82.8	84.3	85.5

Sources: Statistics Canada, Bank of Canada, CME Group, Haver Analytics, Institute of Fiscal Studies and Democracy.
Notes: All values are annual averages. Energy prices are derived from futures contracts two years from the most recent month of data, and increase by 2.3% annually thereafter.