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CANADA: RUNNING LOW ON FUEL

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Canada has experienced sluggish economic growth in 2023, owing to rising prices and higher credit costs, which had a direct impact on the investment and consumption channels, despite the benefits of the country's growing population. Furthermore, one cannot expect a significant improvement over the short run.

Canadian households are amongst the most indebted in the world. Admittedly, their level of net wealth contributes to offset this fact, but it still implies an increased vulnerability against the backdrop of monetary tightening and a deteriorating labour market.

The country's fiscal position deteriorated during the Covid-19 crisis but, although some factors point to increased public spending, Canada will continue to benefit from a relatively favourable fiscal position amongst the developed countries, together with a low net debt.

CANADA: POLICY RATE VS. INFLATION

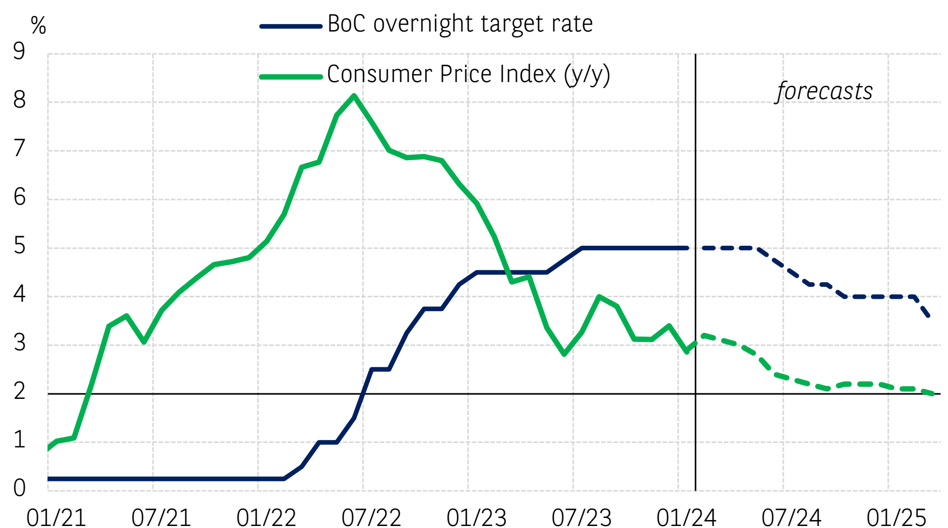

CHART 1 SOURCE: STATISTICS CANADA, BNP PARIBAS

2023 was characterised by sluggish growth (+0,9%), which is set to persist in 2024. However, the gradual easing of financial conditions could prompt a modest recovery, likening to a soft landing. Also, structural issues relating to household indebtedness and the housing market need to be monitored amid rising interest rates. On the other hand, Canada can rely on the soundness of its public finances.

AN IN-BETWEEN PERIOD IN MONETARY POLICY

The Bank of Canada (BoC) has stopped raising its key interest rate, amid tangible signs of a slowdown in economic activity and moderating price increases. The policy rate currently stands at +5.0%, following a cumulative increase of +475 bps between March 2022 and July 2023. This swift and substantial tightening of the monetary policy has taken place against the backdrop of a significant acceleration in inflation, which reached a 40-year high in June 2022 according to the Consumer Price Index (CPI, +8.1% y/y). Recent developments and expectations were more positive with the CPI falling to +3.2% y/y in Q4 2023, prompting the BoC Governor, Tiff Macklem, to formalise the end of the overnight rate hikes[1] while the CPI is expecting to keep decelerating until 2025[23] .

1 *Bank of Canada Holds Key Rate at 5%, Signals It's Done With Hikes*, Bloomberg
2 *Monetary Policy Report*, Bank of Canada, January 2024
3 Bloomberg Consensus

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This leaves the BoC in an intermediate position implying a cautious approach towards the timing of future rate moves. In addition to CPI developments at the aggregate level, the BoC needs to consider the correlation between monetary tightening and factors such as the significant easing of production capacity pressures, which were at their lowest level in Q3 2023 since the Covid-19 outbreak[4]. More generally, the weakening of demand and activity (see below) will play a key role in the decision-making process. Meanwhile, the disinflation path could prove trickier in the final steps towards the 2% target. Indeed, the central bank's preferred key measures of underlying inflation pressures continue to display some rigidity (see chart 2). Furthermore, household inflation expectations remain elevated (4.9% for 1 year, 3.9% for 2 years in Q4 2023[5]) , while corporate wage growth expectations are still above their long-term average. As a result, we expect the monetary easing to be gradual, with the policy rate at or above +4.0% at the end of 2024.

SIGNS OF ECONOMIC SLOWDOWN

Canada's GDP advanced by +0.2% q/q in Q4 2023, avoiding a technical recession after a contraction in Q3 (-0.1% q/q). Indeed, business sentiment has deteriorated significantly and almost continuously since early 2022 but has managed to avoid dipping into negative territory. However, the outlook as measured by the Bank of Canada's survey remains poor, despite a slight late improvement (index at -3.15 following seven quarters of deterioration), which contradicts the idea of a dynamic recovery in the short term.

It should also be noted that the Canadian macroeconomic environment is highly sensitive to developments in the United States. Thus, the buoyancy of the US economy in 2023, illustrated by a +2.5% average annual growth rate as opposed to a widely anticipated recession, has helped to support Canadian activity. However, in contrast to the US, Canada should still experience sluggish growth in 2024, hiding an improvement in the year, helped by the easing of various pressures on demand, while the carryover effect amounts to +0.3%.

Investment has fallen sharply under the impact of rising interest rates. The national accounts report a contraction in private fixed investment over six of the last seven quarters. Nevertheless, it is worth noting the difference in dynamics between the residential and non-residential components of private investment. The latter has proven more resilient before eventually finally contracting in H2 2023. Residential investment had already fallen sharply in 2021 as the post-pandemic momentum dissipated. It shrank again from Q2 2022, for a cumulative 18% decline despite a slight recovery from Q2 2023. Given the expected easing of financial conditions, private investment is likely to constitute de main driver of the slight pick-up in growth expected through 2024.

The negative of the tightening cycle was less pronounced for household consumption than for investment. Consumption benefited first from the resilience of the labour market (the unemployment rate was 5.0% in April 2023, compared with 5.4% before the first-rate hike), and then from the acceleration in the catching up process between wages and inflation (see chart 4). However, 2023 was characterised by this demand item being flat in the national accounts, even though, at the aggregate level, it benefited from the sizeable increase in the country's population. Per capita consumption has therefore fallen by 3.1% in real terms since Q2 2022, while total household consumption has risen by a modest +1.5% over the same period.

4 Business Outlook Survey, Bank of Canada
5 Canada Survey of Consumer Expectations, Bank of Canada, Q4 2023

CANADA: STICKINESS IN UNDERLYING MEASURES OF INFLATION

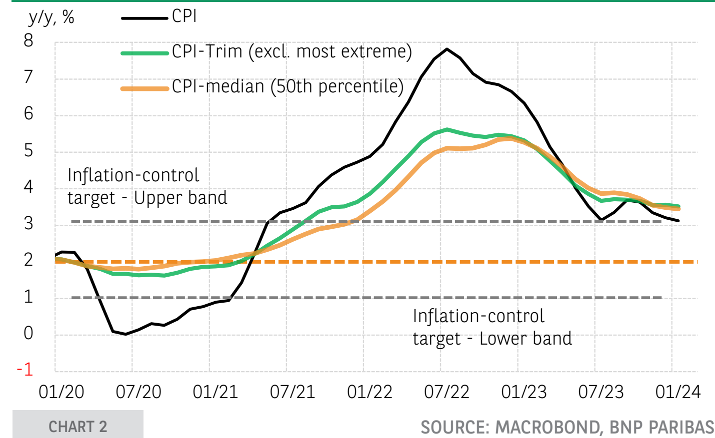

CHART 2 SOURCE: MACROBOND, BNP PARIBAS

CANADA: ECONOMIC GROWTH AND INFLATION

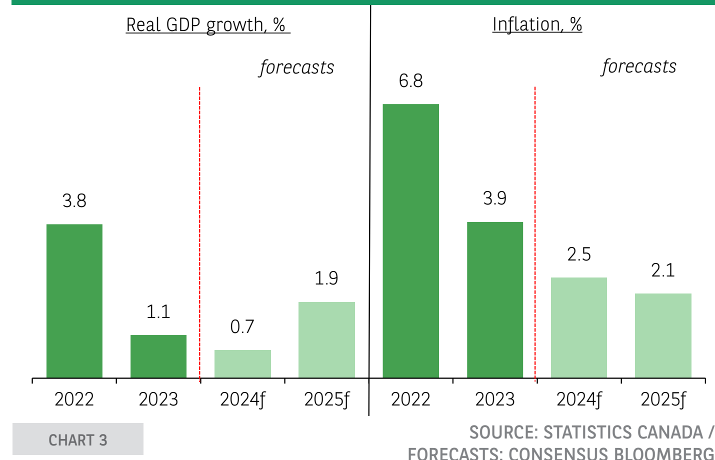

CHART 3 SOURCE: STATISTICS CANADA / FORECASTS: CONSENSUS BLOOMBERG

CANADA: INFLATION AND EARNINGS

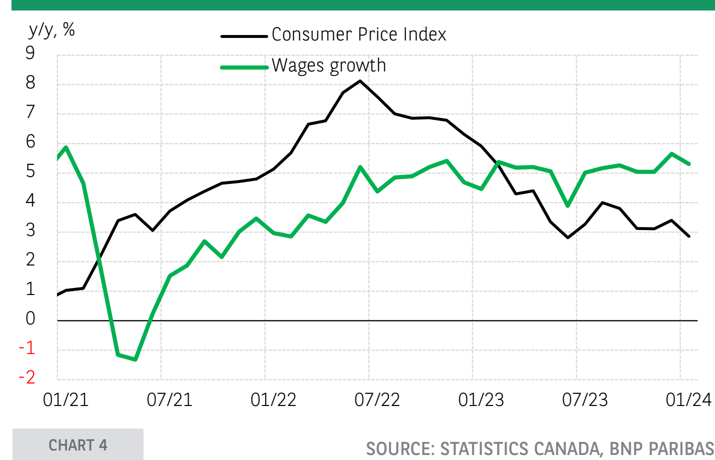

CHART 4 SOURCE: STATISTICS CANADA, BNP PARIBAS

Furthermore, the short-term outlook for households is rather negative. The unemployment rate has picked up in recent months, reaching 5.8% (as of February 2024) with a decrease in the participation rate (65.3%, -0.4pp y/y). Forecasts point to a continuation of this upward trend, with the unemployment rate expected to rise to more than 6.5% in Q4 2024. In addition, if the pause in rate hikes and the slowdown in inflation help to partially reduce the pression exerted on the purchasing power, this will not stop the delayed and cumulative effects of monetary tightening. In this respect, in November 2023 the central bank estimated that 45% of mortgage borrowers had seen an increase in their monthly instalments since the beginning of the rate hikes[6] and expected this process to extend to nearly all of them by the end of 2026 (for a median increase in instalments of +20%).

CAUTION REGARDING STRUCTURAL PROBLEMS RELATED TO HOUSEHOLDS

Canadian households are among the most indebted in the world. Their indebtedness stood at 181.8% of disposable income as of Q3 2023 (compared with an all-time national high of 186.9% a year earlier)[7], despite a decrease related to the slowdown in credit growth (+3.2% y/y in December 2023, down from 10.5% in early 2022)[8] . Some recent developments have further increased the exposure of leveraged Canadians to adverse events. In particular, the use of variable-rate mortgages reached 54.2% of newly originated loans in Q1 2022[9] (before falling to 5.4% since then), inducing an exacerbated sensitivity to monetary policy decisions. Thus, in 2023, households with variable-rate mortgages faced an average increase in repayments of 26.1% or 49.2%, depending on the structure (fixed or variable payments) of their mortgage, compared with February 2022[10] [11] .

In addition, there is an interplay between the issues of household indebtedness has interplay and affordability of real estate. The divergence between the increase in real estate prices and wage growth has induced the emergence and intensification of a structural and critical problem, while at the same time fuelling fears of a potential bubble. This is a major source of tension for the federal government, which is pursuing the goal of improving access to home ownership through a tricky equation, namely playing on supply-side and avoiding a significant decrease in existing home prices that would damage the wealth of homeowners.

Monetary tightening is helping to exacerbate the problem. The +3.9pp rise in mortgage rates since March 2022[12] is exerting negative pressure on demand, which is not offset by the -7.3% fall in prices (according to the Dallas Fed) since the peak at the beginning of 2022. Moreover, the supply-side is also deteriorating, as illustrated by the aforementioned decline in residential investment. This is due to two main factors: the weak outlook linked to the depressed demand and the increase in production costs (credit, construction with +51% between Q4 2020 and Q4 2023 for the latter).

6 The impact of higher interest rates on mortgage payments, Bank of Canada Staff Analytical Note, December 2023
7 Financial indicators of households and non-profit institutions serving households, Statistics Canada
8 Monthly credit aggregates, December 2023, Statistics Canada
9 Indicators of financial vulnerabilities, Bank of Canada
10 Financial System Review, May 2023
11 Prêts hypothécaires à taux variable et à versements fixes : les taux limites sous la coupe, Bank of Canada, November 2022
12 Interest rates charged for new and existing lending by chartered banks, Bank of Canada

CANADA: CONCERNING LEVEL OF HOUSEHOLD DEBT

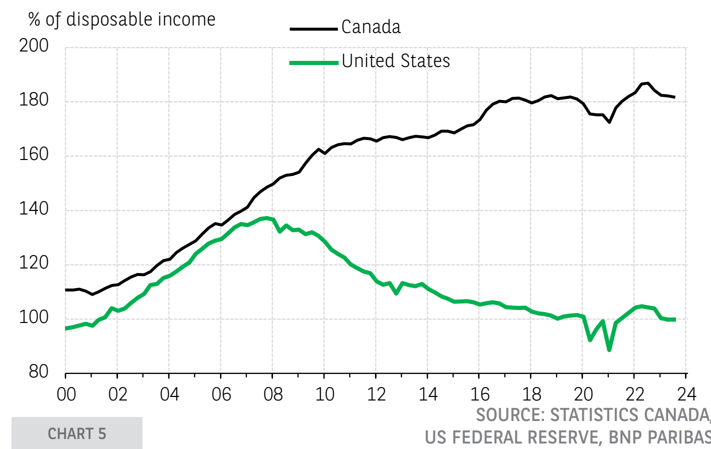

CHART 5

SOURCE: STATISTICS CANADA, US FEDERAL RESERVE, BNP PARIBAS

CANADA: HOUSING AFFORDABILITY ISSUE

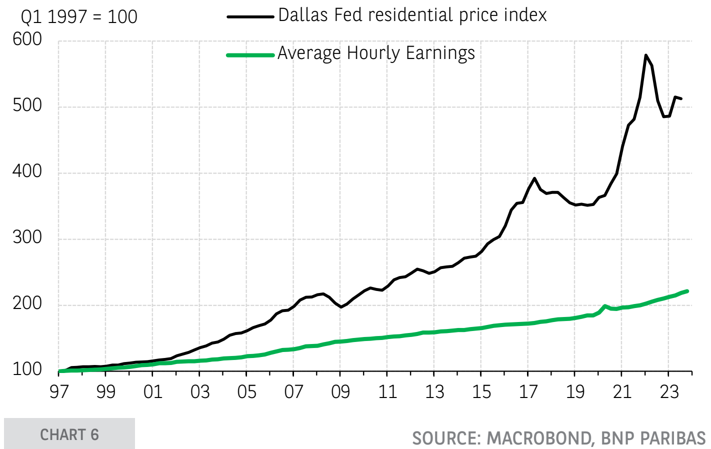

CHART 6

SOURCE: MACROBOND, BNP PARIBAS

CANADA: HOME SALES SIGNIFICANT SLOWDOWN OVER HIGHER RATES

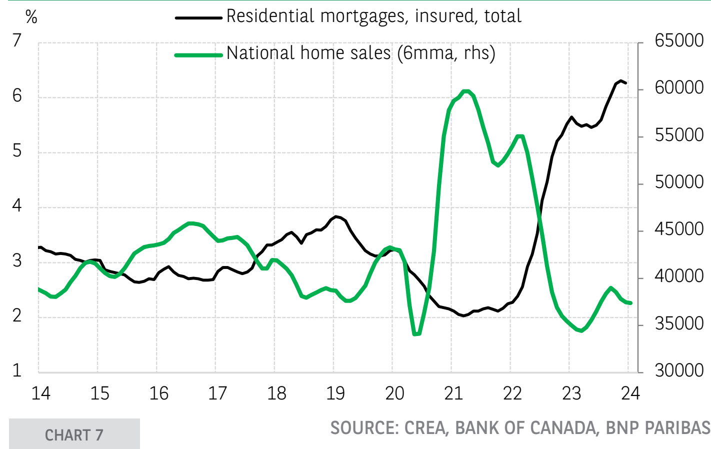

CHART 7

SOURCE: CREA, BANK OF CANADA, BNP PARIBAS

HEALTHY PUBLIC ACCOUNTS

Canada's fiscal position is relatively favourable among developed countries. Admittedly, the public debt ratio increased significantly during the pandemic crisis. According to the IMF, the debt-to-GDP ratio amounted to 90.2% in 2019 and around 106% in 2023, after reaching a new record of 118.9% in 2020. This situation seems to provide Canada with some fiscal leeway in the event of a new adverse shock, as the debt ratio is relatively lower than in other countries. However, it still conceals a degree of vulnerability in a situation in which the debt is being rolled over at a higher nominal rate. This is illustrated by the yield on 10-year Canadian government bonds, which is currently around 3.6%. While their level was below 1.0% in January 2022, they have settled in a range from 2.5% to 4.1% during 2023, which are standards not seen since the beginning of the 2010 decade. During the 2022 - 2023 fiscal year (which begins in April), 57% of Canadian debt will mature in 3 years or less[13] .

Canada's penchant towards fiscal discipline is likely to be challenged over the coming years. Indeed, a number of factors that are not unique to Canada, including the green transition, point to a growing need for public spending. Notably, heightened geopolitical risk may require increased defence expenditures, while the associated budget of 1.3% of GDP is sensibly lower to the NATO (of which Canada is a founding member) requirements. On the domestic front, the growing discontent over housing affordability has led to the creation of the Housing Acceleration Fund and tax exemptions in the construction sector.

Nevertheless, Canada's sovereign rating remains at the highest level for the main agencies, helped by low net debt (liabilities minus assets). According to the IMF, Canada's net debt stood at 14.4% of GDP in 2023, compared to 100% in the United States. The IMF also expects the government debt ratio to gradually decline to 94.7% of GDP by 2028. The government deficit, which is already low (-0.7% in 2023), would also gradually decline at the same time, although the country would not regain the ability to run primary surpluses.

CANADA: PRIMARY AND OVERALL FISCAL BALANCES

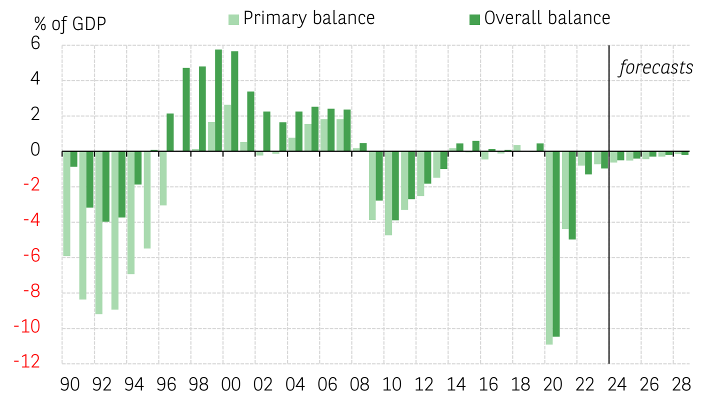

CHART 8 SOURCE: IMF, BNP PARIBAS

CONTRACTIONARY FISCAL STANCE IN CANADA TRANSLATED INTO DEBT TO GDP RATIO

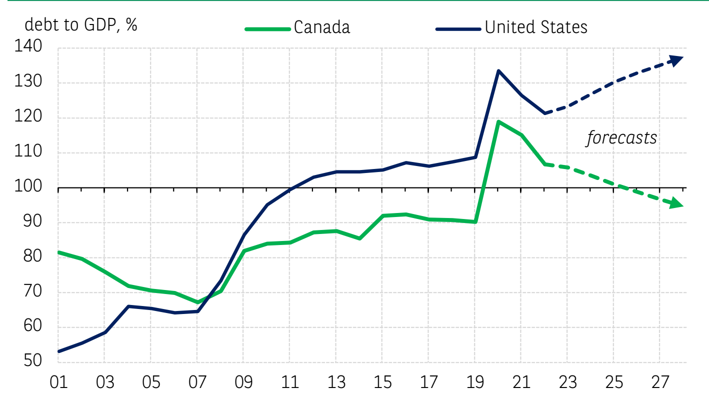

CHART 9 SOURCE: IMF, BNP PARIBAS

13 *Debt Management Report 2022 – 2023*, Government of Canada

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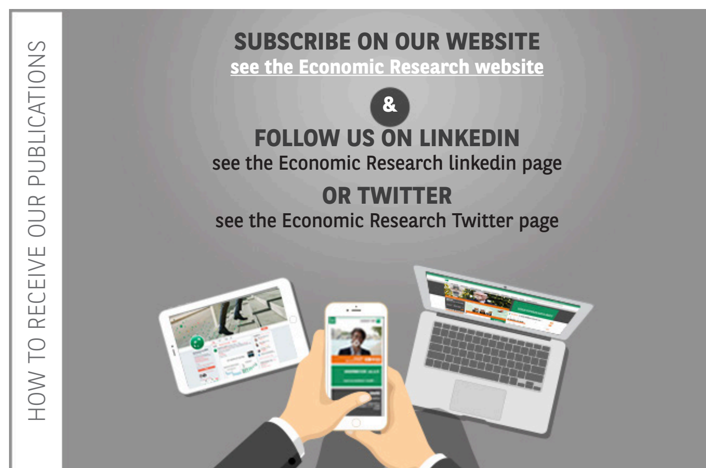

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