

Tight monetary policy to squeeze economic growth

Economic outlook | March 2023

Introduction

It has been a full year since monetary policy began to tighten in Canada and we're now seeing the effects of the cumulative tightening start to spread throughout the economy. The initial impact was felt in housing markets, which spent most of 2022 in free fall. Household interest payments have been climbing steadily and, when combined with decades-high inflation, are cooling consumer spending. Business spending is also showing early signs of stress; in the final quarter of last year, companies slashed their investments on machinery and equipment by over 25% at annualized rates.

Rapid tightening of monetary policy isn't confined to Canada. Developed countries around the world are raising interest rates to quell inflation. The tightening of monetary policy has been particularly aggressive in the United States, which is starting to disrupt growth in certain sectors. One of the more recent casualties of the volatile economic landscape in the United States has been the technology sector, with job losses followed by the sudden collapse on March 10 of a bank that caters to the sector, Silicon Valley Bank (SVB). As its clients had to withdraw deposits to meet their own cash-flow needs, the bank was forced to liquidate assets at a loss due to the impact of rising rates on fixed-income securities. It marked the second-largest bank failure in US history.

The major fear associated with bank failures is financial market contagion, which, as we know from the 2008-09 global financial crisis, can have devastating economic consequences. The initial effects were not limited to SVB as, just two days later, the United States faced its third-largest bank failure when New York-based Signature Bank was seized by government officials. Fortunately, at the time of writing, financial market contagion has not been widespread, notwithstanding the negotiated sale of Credit Suisse in Switzerland to UBS and troubles at the First Republic Bank in San Francisco. However, these events have certainly demonstrated the impact that aggressive monetary tightening can have and renewed uncertainties about the path of economic growth.

With the troubles in the US financial sector, we're likely to see the Federal Reserve (the Fed) take a more gradual approach to tightening than was expected in early March. It's still likely to continue to lift its federal funds rate, albeit at a much slower pace, to signal its determination to return inflation to its target while being mindful of the potential economic fallout stemming from the issues in the sector. Even with rates not moving as high as previously expected, the United States is still likely to experience a mild recession this year because of past rate hikes.

Introduction

Here in Canada, the Bank of Canada appears to be done lifting interest rates, provided inflation continues to cool as expected. By the end of 2023, as more effects from the high interest rate environment show up in the economic growth and inflation data, we expect to see both the Bank and the Fed move to cut interest rates, a process that will continue throughout 2024 as rates move back toward their neutral level.

Against this backdrop of uncertainty, the Government of Canada is expected to release its 2023 budget. This budget is likely to be a balancing act between keeping spending from adding further pressure to inflation and addressing priority areas. Notably, we expect to see affordability measures targeted at lower-income Canadians, additional transfers to provinces to fund health care, and investment incentives for reducing carbon emissions. While higher spending will work to support the economy, these initiatives serve important policy goals and, in the case of the investment incentives, create the conditions to help boost Canada's long-term growth prospects. Provided the spending increases are not dramatic, they should not have a notable effect on inflation.

Several factors are affecting the current outlook for the Canadian economy. The ramifications of elevated uncertainty, the swift rise in borrowing costs, and a downturn south of the border indicate Canada will experience a recession this year.

However, it's not expected to be as deep as anticipated last quarter, thanks in part to the continued resiliency of the labour market, which is supporting incomes. As monetary policy eases throughout the coming year, we'll see better growth prospects in 2024 and 2025. Overall, we forecast real gross domestic product (GDP) to fall by 0.5% this year and then rebound with growth of 2% in 2024.

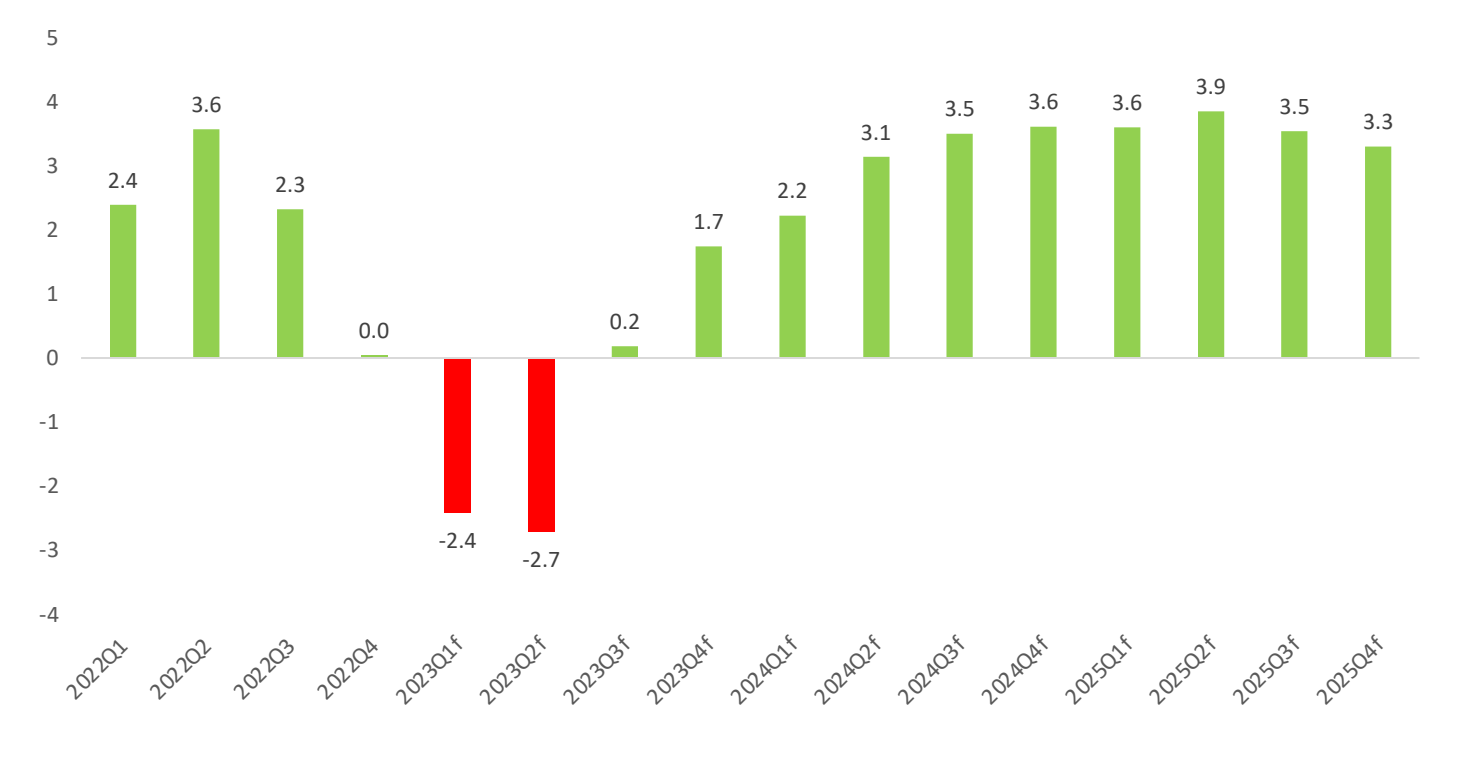
Fiscal and monetary policy

Fiscal and monetary policy

Inflation levels have been coming down in recent months but are still too high for comfort. Inflation clocked in at 6.3% in December 2022 and then decelerated to 5.9% in January—the lowest rate since March of last year. The Bank of Canada has attributed the persistence in inflationary pressures to an economy in excess demand. Simply put, there is too much money in the economy chasing too few goods and services, resulting in upward pressure on prices. After embarking on one of the most aggressive tightening campaigns in its history, moving its overnight rate from 0.25% in early March 2022 to its current level of 4.5% in just 10 months, the Bank has hit pause on rate hikes—contingent on inflation continuing to decelerate.

With a near-term decline in economic output in the cards, our forecast sees inflation cooling throughout the year to reach 3.5% in the second quarter of 2023 and closer to the 2% target rate by the end of 2024. This will allow the Bank to remain on the sidelines for most of this year. As a cooling economy brings down inflation, it will be able to ease its policy stance and start lowering the overnight rate until the rate reaches its neutral level of 3% and is no longer stimulating or suppressing economic growth.

Real GDP growth (percent change at annual rates)



Source: Statistics Canada; forecast by Deloitte

Fiscal and monetary policy

Inflation levels are higher in the United States than in Canada, and the Fed is expected to continue lifting its federal funds rate until it reaches 5.25% in June of this year. However, recent high-profile bank failures have at least temporarily shaken global financial markets and renewed worry about the economy's ability to cope with the rapid pace of monetary tightening. Therefore, the Fed may be more cautious than we are currently expecting.

Nevertheless, with an anticipated widening of the gap between US and Canadian policy rates, the loonie is expected to remain under pressure, falling to an average of about US\$0.726 in the second and third quarter of this year. As the Fed's intention to not push higher than 5.25% gets incorporated into currency markets, the loonie should rally. Further gains in the Canadian dollar are expected throughout 2024 as interest rate cuts from both the Bank of Canada and the US Federal Reserve work to reduce the gap between policy rates in the two countries.

Along with milder weather, spring means it's also budget season in Canada. As governments across the country roll out their spending plans for the year ahead, we expect to see a general trend of improved fiscal fortunes relative to last budget season, enabling provincial and territorial governments to increase spending in priority areas. We've already seen measures to improve affordability. Ontario put in a temporary reduction of its gas tax. Alberta has unrolled its Affordability Action Plan, which calls for direct payments to some

households, energy cost relief, and a slew of other measures. Improving affordability was also a key theme in British Columbia's budget, which saw an additional \$4.5 billion in new spending over three years. While we expect to see additional spending in other jurisdictions to help offset the impacts of high inflation, we don't anticipate a significant ramp-up in spending, given the inflationary effect it would have on an economy already struggling to meet demand.

The federal government is also forecast to be in a better fiscal position than it was when its last budget was tabled. However, we can expect it to be mindful of spending its additional revenues, given the debt it racked up during the pandemic and to avoid overstimulating the economy. That does not mean no new spending at all, but that the spending will be targeted to priority areas: measures to improve affordability for lower-income Canadians (such as the short-term doubling of the GST credit), increased transfers to the provinces and territories for health care, and incentives to increase investment in reducing carbon emissions.

Taking into account the anticipated spending across all levels of government, we expect to see a modest 1% increase in real government spending on goods and services this year. Weaker growth is forecast on the investment front. As noted in the most recent non-residential capital and repair expenditures survey from Statistics Canada, public sector capital spending growth is projected to decelerate to a nominal pace of 2.7% in 2023.¹

¹ Statistics Canada, "[Non-Residential Capital and Repair Expenditures, 2021 \(Revised\), 2022 \(Preliminary\) and 2023 \(Intentions\)](#)," The Daily , February 28, 2023.

Households and business

Households

Consumers continue to bear the brunt of tighter monetary policy. In the final quarter of last year, interest payments on household debt had risen 45% on a year-over-year basis. At the same time, obligated principal payments were down 7%, reflecting the fact that households have been reducing the share of monthly payments for principal balances to get a bit of immediate relief for their other cost-of-living priorities. However, as more households hit their mortgage trigger rates or renew their mortgages at higher rates, interest payments will continue to push higher, putting further pressure on household budgets. Against this backdrop, it's not surprising that consumer confidence is down. The Bank of Canada's latest Survey of Consumer Expectations, released in January, shows that households have reduced their purchases of a broad range of goods and services due to high inflation and interest rates.²

Our forecast assumes that Canadians will continue to pare back their spending over the near term. The declines in the first half of 2023 will be driven by lower spending on interest-rate-sensitive durables, such as motor vehicles and parts, and discretionary semi-durables, like clothing and footwear. Despite the overall decline in consumption, we expect to see service-sector spending continue to grow, although some segments—such as accommodation, food, and beverage services and communication, recreation, and culture services—will see a near-term decline.

Overall, consumer spending is predicted to decline at an annualized rate of 0.1% for the first quarter of 2023 and fall another 0.6% in the second quarter before beginning to recover in the second half of 2023. This will leave consumer spending with 0.9% growth for the year.

As we look to next year, strong population growth, a moderation of inflationary pressures, and interest rate relief will have consumers once again opening their wallets, with real consumer spending set to increase by 2.6%.

While the effect of higher interest rates on consumer spending has been more modest and drawn-out than forecast last quarter, the same cannot be said for the housing market. Activity has plunged in Canada's housing market since the first interest rate increase in March 2022. This February, home sales were down 40% relative to last year. This declining trend is unfortunately expected to continue, at least in the near term. Despite the Bank's recent decision to hold its policy rate steady, elevated interest rates are keeping the cost of borrowing high and thus weighing on many potential homebuyers' and investors' decision to enter the market.

² Bank of Canada, "[Canadian Survey of Consumer Expectations—Fourth Quarter of 2022](#)," January 16, 2023.

Households

With fewer homes trading ownership this year, spending on homeownership transfer costs will remain muted. Weak conditions in the resale market and soft growth in disposable income are expected to limit investments in home renovations, further weighing on residential investment. Market woes are not confined to the resale market. Data for January shows that home builders significantly reduced the number of new homes beginning construction at the start of the year, with housing starts falling to a level not seen since the fall of 2020. Activity picked up in February but with fewer buyers in the market, new home construction is expected to come in lower this year relative to 2022.

The good news on the housing front is that the end of the downturn is in sight.

We expect the housing market to bottom out in the third quarter of this year. With expected rate cuts starting at the end of this year and throughout 2024, the recovery will begin. Over the medium term, the housing market outlook is bright. Strong population gains, thanks to increasing immigration targets, will significantly boost demand and thus support a rebound in housing prices and residential investment.

While there is no doubt that high inflation and interest rates are weighing on the outlook for consumer spending and residential investment, strong labour market conditions continue to provide support to household income growth. Job reports have come in much stronger than expected for the last few months, with a total of 268,000 new jobs created over the November-to-February period. Robust job growth has been enough to offset strong labour force growth and, as a result, the unemployment rate is hovering around 5%. In addition to strong job creation, we have also seen average wage growth accelerate, although wage gains remain below inflation.

We have seen some slack emerging in the labour market through a reduction in job vacancies. In April 2022, the national job vacancy rate was 6% as employers looked to fill over one million vacant positions. By the end of last year, empty positions had fallen to 754,000, representing a vacancy rate of 4.2%. We expect to see vacancies continue to absorb a lot of the labour market impact associated with a slowing economy this year. However, the jobs market will not be completely unscathed by the downturn. Certain industries, such as transportation and warehousing and business, building, and other support services, are expected to experience a decline in employment levels in the short term. This forecast slowdown in job creation, coupled with strong population growth, will help push the unemployment rate up to 5.6% by the start of next year.

Business

Despite a year of record-breaking profitability in 2022, business investment is expected to wane in the near term due to weakening business confidence, higher borrowing costs, and the completion of several large investment projects.

Even with the slowdown in global growth, exports are expected to see a better year in 2023 as the easing of supply chain challenges spurs a recovery in motor vehicle parts and production.

According to Statistics Canada's latest capital expenditures (CAPEX) survey, non-residential investment in construction and machinery and equipment is expected to expand by a nominal 4.3% in 2023, much slower than the double-digit growth seen over the past two years. The main downward contributor to the CAPEX outlook is an almost-50% decline in spending on pipeline transportation as work nears completion on the Coastal GasLink pipeline and Trans Mountain Expansion Project. With no new major projects on the horizon,

we expect investment in pipelines to remain muted over the rest of the decade. On the positive side, we'll see strong investment gains in the mining sector driven by oil and gas and potash. Over the long term, we're optimistic about the outlook in Canada's mineral mining sector, thanks to the federal government's \$3.8 billion Critical Minerals Strategy to increase investment in critical minerals exploration to supply domestic and global production of electric vehicle (EV) batteries. Spending is also expected to accelerate in the manufacturing sector as we boost EV battery production capacity and in utilities as work continues on refurbishing nuclear reactors in Ontario.

While business investment outside the residential sector is expected to grow, we have downgraded our outlook relative to last quarter. The Bank of Canada's Business Outlook Survey for the fourth quarter of 2022 shows that business confidence continues to deteriorate because of softening domestic demand. Of the businesses surveyed, almost 75% reported that interest rate hikes are having a negative impact on their operations, and more than a quarter expect to cut their capital spending (by 20% to 30% or more) from what they originally planned for the coming year.³

³ Bank of Canada, "[Business Outlook Survey—Fourth Quarter of 2022](#)," accessed March 15, 2023.

Business

On the trade front, we've seen exports start the year on very solid footing—total exports increased 5.3% in real terms in January. While motor vehicles and parts have seen one of the slowest export recoveries due to lingering supply challenges, fortunes in this sector have recently turned, with exports up 8.2% in January to \$8.3 billion, the highest level since May 2019. We're also seeing strong growth in agricultural exports as the production of farm products ramped up in the fall of 2022, driving up exports amid a harvest that largely exceeded the previous one and high global demand.

The strong start to the year is, unfortunately, expected to moderate quickly. The United States is forecast to enter a recession beginning in the second quarter of this year, which will act to suppress demand in our largest foreign market. We're already seeing a dramatic drop in wood exports in response to deteriorating conditions in the North American housing market—they were down 25% in the fourth quarter of last year compared to the first quarter of 2022. As conditions sour more broadly in the US economy, we also expect to see energy exports fall due to cyclical factors and structural changes taking place in the country. Even though its economy has fully recovered from the pandemic, consumption of oil is down sharply from its pre-pandemic level and the US government expects it to continue declining this year and into 2024, which will weigh on our all-important energy export sector.⁴

Imports are linked to household consumption and business investment (especially in machinery and equipment). Last year, they surged well beyond what we saw in growth in household spending and in the economy overall. Imports also far outpaced export growth, leading to a substantive drag on economic growth from net trade. Moderation in import volumes is already evident and, as household spending slows and imports related to the LNG Canada facility will not be repeated this year, imports should experience much softer growth in 2023. Overall, we expect to see real imports increase by 1.5% and, with exports forecast to gain 3.5%, we'll see the trade sector make a meaningful contribution to economic growth this year.

⁴ Myles McCormick, "[Fall in petrol use in gas-guzzling US heralds shift for global markets](#)," Financial Times, February 8, 2023



Outlook by province

Outlook by province

With the national downturn in economic growth being driven mainly by households, several provinces are expected to see a decline this year. But not **Manitoba and Saskatchewan**: they're likely to buck the recessionary trend and continue to grow in 2023. Both provinces are still recovering from severe drought conditions in 2021 that hampered activity in their important agriculture industries, but exports were picking up sharply toward the end of last year, a momentum that will help support growth. Saskatchewan will do particularly well—it's expected to lead the country in non-residential investment growth, thanks to the large investment at the Jansen potash mine.

British Columbia will be hard hit by the downturn in its housing market and the drop in key goods-producing sectors, including forestry and non-residential construction, as work begins to wind down on the LNG Canada facility, Coastal GasLink pipeline, and Trans Mountain Expansion Project.

Alberta is expected to see economic activity wane this year due to a sharp drop in oil exports in the last quarter of 2022. The low levels of production heading into 2023 and the recession in the United States will weigh on its energy sector, fuelling a drop in output.

Ontario is set to see a rebound in auto manufacturing activity this year after supply chain challenges suppressed production in 2022. However, with consumers feeling the pinch of high debt loads and high inflation, the gains in manufacturing won't be enough to offset the drop in household spending and investment. The outlook is similar for **Quebec**, where air transportation manufacturing should have a better year. However, labour challenges will stymie growth prospects and a continued migration of residents to other provinces, combined with higher debt payments, will weigh on household spending.

Outlook by province

Out east, we expect mixed performance. In **New Brunswick**, tough conditions in the forestry sector will weigh on output growth there and in manufacturing which is closely tied to performance in the forestry sector. **Nova Scotia** has one of the highest levels of inflation in the country, creating a larger squeeze on household purchasing power. It's also more trade-exposed to the European market than most other provinces—its trade prospects will be subdued in 2023, given expectations for weak growth in the eurozone as the war in Ukraine continues. **Prince Edward Island** will see little change in its economy despite continued strong population growth, given that its tourism sector will be negatively affected by reduced household discretionary spending. Finally, we can expect to see no growth in **Newfoundland and Labrador**—production is forecast to restart at the Terra Nova oil field this spring, but it will only serve to offset weakness on the consumer side.

Real GDP growth by province, percent change

	2021	2022F	2023F	2024F
Newfoundland and Labrador	0.6	1.7	0.0	1.2
Prince Edward Island	7.9	3.8	0.1	1.9
Nova Scotia	6.2	3.7	-0.2	1.7
New Brunswick	5.8	2.6	-1.0	1.6
Quebec	6.0	3.9	-0.5	1.8
Ontario	5.1	3.5	-0.8	2.0
Manitoba	1.7	3.6	1.0	2.3
Saskatchewan	-0.7	4.9	1.8	2.4
Alberta	4.9	4.5	-0.3	2.0
British Columbia	6.2	3.0	-1.0	1.9

Source: Statistics Canada; forecast by Deloitte

Final thoughts



Final thoughts

While recent bank collapses have renewed fears about the global economic outlook, it's no surprise that the rapid rise in interest rates would have consequences; after all, the point of raising interest rates is to slow growth broadly enough that price pressures ease. When you combine high levels of debt with rising interest rates, financial vulnerabilities inevitably emerge. While bank runs were not an expected outcome, for now the fallout on the broader financial system and economy has been limited. Provided we don't see widespread issues in the financial system, the recent troubles in select banks are unlikely to have a substantial effect on the economic forecast. Our overall economic outlook, therefore, continues to call for a mild recession followed by an easing of monetary policy that helps fuel an economic recovery in 2024.

The Deloitte Future of Canada Centre will release an analysis of the 2023 federal budget in the days following the document's release.

Leveraging Deloitte industry and client knowledge and experience, the analysis will offer insights on how the federal government can achieve its spending priorities for the year. Visit the Deloitte [Future of Canada Centre](#) on April 3, 2023, to read the analysis.

Key economic indicators

	2023				2024				22	23F	24F
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Real economic activity											
Gross domestic product	-2.4	-2.7	0.2	1.7	2.2	3.1	3.5	3.6	3.4	-0.5	2.0
Household consumption expenditure	-0.1	-0.6	0.1	2.0	3.2	3.7	3.9	4.3	4.8	0.9	2.6
• Durable goods	-1.1	-3.1	-2.0	0.7	1.4	1.8	2.3	3.2	-2.0	-0.4	0.8
• Services	0.3	0.2	0.7	2.2	3.8	4.4	4.4	4.7	8.6	2.1	3.1
Residential investment	-10.2	-5.7	-2.5	3.8	7.2	7.4	7.2	6.0	-11.1	-10.1	4.5
Non-residential fixed investment	-2.4	1.1	4.0	5.5	1.7	2.2	2.1	1.2	7.8	0.6	2.8
• Non-residential structures	-8.3	-1.5	1.3	2.0	0.1	1.5	1.7	0.3	8.0	1.1	1.0
• Machinery & equipment	-1.3	23.1	-7.6	3.9	4.6	3.1	3.1	4.1	7.6	-0.6	5.7
Government consumption & investment	-0.6	-0.3	0.5	0.9	0.8	1.1	1.3	1.4	2.0	0.8	0.9
Exports of goods & services	8.2	-3.9	1.6	2.6	3.8	3.8	4.5	4.9	2.6	3.5	2.9
Imports of goods & services	9.1	0.2	1.6	4.1	4.4	3.7	3.6	3.8	7.2	1.5	3.4
Prices											
Consumer price index (y/y)	5.5	3.5	3.1	2.8	2.6	2.5	2.3	2.2	6.8	3.7	2.4
Implicit GDP price index (y/y)	1.3	-1.8	-0.2	1.6	2.6	3.2	3.1	2.4	7.3	0.2	2.8
Labour market											
Employment	2.6	0.3	0.5	0.9	1.1	1.5	1.7	1.7	4.0	1.5	1.1
Unemployment rate (%)	5.0	5.2	5.4	5.5	5.6	5.5	5.4	5.2	5.3	5.3	5.4

Note: Unless otherwise noted, all figures are expressed as annualized % changes.

Sources: Statistics Canada and Bank of Canada. Forecast by Deloitte Economic Advisory, as of **March 13, 2023**.

Key economic indicators

	2023				2024				22	23F	24F
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
Interest rates (%)											
Overnight rate target	4.50	4.50	4.50	4.08	3.42	3.00	3.00	3.00	2.00	4.39	3.11
3-month T-bill	4.71	4.64	4.58	4.11	3.44	3.01	3.00	2.98	2.43	4.51	3.11
1-year GoC note	4.92	4.87	4.85	4.41	3.77	3.37	3.37	3.33	3.00	4.76	3.46
2-year GoC note	4.36	4.39	4.41	4.13	3.68	3.37	3.35	3.32	2.96	4.32	3.43
5-year GoC note	3.82	3.98	4.12	3.99	3.69	3.49	3.49	3.50	2.81	3.98	3.54
10-year GoC bond	3.64	3.83	3.99	3.94	3.73	3.59	3.61	3.63	2.80	3.85	3.64
Yield curve spread (pp)											
3-month vs. 10-year	-1.07	-0.81	-0.58	-0.18	0.29	0.57	0.61	0.65	0.37	-0.66	0.53
2-year vs. 10-year	-0.73	-0.56	-0.42	-0.20	0.05	0.21	0.26	0.31	-0.17	-0.48	0.21
Foreign exchange											
USD/CAD (\$C)	1.36	1.38	1.38	1.33	1.26	1.25	1.24	1.24	1.30	1.36	1.25
CAD/USD (US cents)	0.73	0.73	0.73	0.75	0.79	0.80	0.80	0.81	0.77	0.73	0.80

Sources: Statistics Canada and Bank of Canada. Forecast by Deloitte Economic Advisory, as of **March 13, 2023**.

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