Economics

ECONOMIC INSIGHTS

February 16, 2023

More room at the inn? Rethinking Canada's medium-term upside

by **Avery Shenfeld** avery.shenfeld@cibc.com and **Andrew Grantham** andrew.grantham@cibc.com

We're still in the early days of 2023, but it's not too soon to be thinking about what lies beyond this year. After all, investor views on year-end levels for both bond yields and equities are tied to what's in store for '24.

With monetary policy on high alert, the upside for the economy will be dictated by how much room there is for real GDP to advance while still getting inflation sustainably back to 2%. In that regard, we've been doing some rethinking on that question for Canada, and finding reasons to be more optimistic. Simply put, while Canada faces a stall in growth later this year as a result of past interest rate hikes, several factors suggest that there's more elbow room for non-inflationary growth than we previously estimated.

We've raised 2023 growth in the US and Canada to allow for a positive Q1 real GDP pace (Tables 1 and 2), as seems likely given strong job gains in January. But instead of that cutting into 2024's non-inflationary pace, particularly for Canada, we now see a bit more room for growth that year as well. That will be key to allowing central banks to ease up on rates next year, and for the Bank of Canada helping them stay on hold in 2023, even as we've added a quarter point hike for the Fed in May (Tables 3 and 4).

Is the supply shock now permanent?

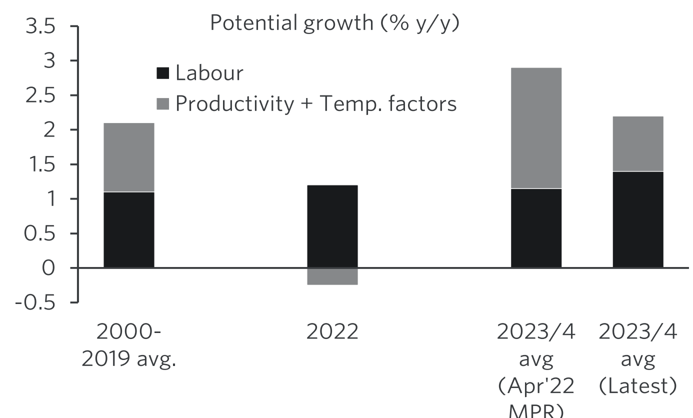
Prior to the pandemic, the Bank of Canada relied on the output gap, the actual level of real GDP relative to its non-inflationary ceiling, to assess whether the economy was prone to accelerating or decelerating inflation, and used its forecast for "potential growth" to estimate how fast that non-inflationary ceiling for GDP would expand. But in late 2021, the GDP-based output gap remained negative, even as labour markets tightened and inflation accelerated.

Reaching full employment, while seeing real GDP well below the pre-pandemic trend, implied a significant dent to productivity. The Bank therefore added a loosely-described hit to "supply" from factors pertaining to the pandemic period to argue that, including that supply haircut, worth 1.8% of GDP, the economy was in fact approaching excess demand.

These supply headwinds were originally expected to dissipate by the end of 2022. That hope was evident in the Bank's April 2022 Monetary Policy Report, in which the economy's potential growth, including the alleviation in these supply issues, showed a big surge over 2023-24 as productivity rebounded from the 2022 weakness (Chart 1). But subsequent MPRs undid that, with the economy's non-inflationary ceiling now including no better productivity growth than the pre-pandemic trend. Has the Bank now made a temporary haircut to output per hour a permanent feature of Canada's economy?

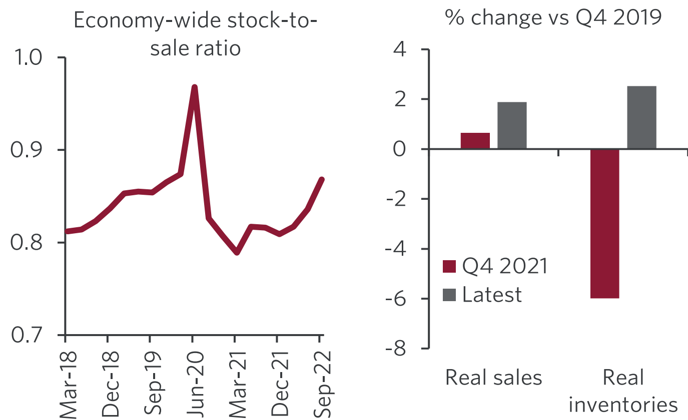
If so, that seems contrary to the Bank's original description of what was driving it, and recent developments in the economy. The supply haircut was originally ascribed to two sources: 1., production and shipping bottlenecks that were elevating costs or delaying needed parts and materials; and 2., labour market

Chart 1: Bank of Canada no longer expecting a catch-up in potential growth



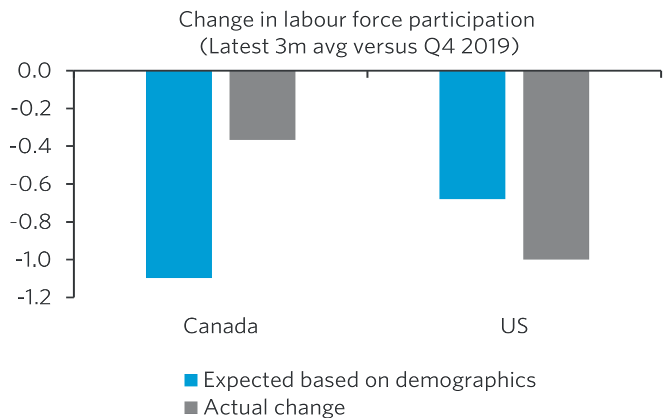
Source: Bank of Canada, CIBC

Chart 2: Stock-to-sales ratio improves (L), due to a pick up in inventories (R)



Source: Statistics Canada, CIBC

Chart 3: Canada's participation rate has fallen less than demographic trends would suggest



Source: Statistics Canada, BLS, CIBC

mismatches between workers still available and jobs that were open, contributing to a rise in long-term unemployment. The latter included the surge in sectors booming due to consumption shifts caused by the pandemic, but a surplus of labour skilled in sectors that were still struggling.

Both of these factors would appear to be healing to some extent. On the supply chain front, the auto sector would still appear to be unable to fully ramp up, but elsewhere, inventory rebuilding suggests that major shortages are behind us. The inventory to sales ratio has recovered (Chart 2, left), and not because of weakness in sales. Inventory volumes have made an impressive recovery (Chart 2, right). Shipping costs have fallen from earlier peaks, construction material price declines, including a steep drop in lumber, point to better availability, and so on.

Looking ahead, China's reopening should improve the flow of goods from that key exporter. A slowing in the global economy over the balance of the year should also help ease shortages of materials and supplies, particularly with demand shifting from goods to services.

As for labour markets, while January showed some improvement in the elevated levels of absenteeism that are cutting into output per employee, this remains an issue relative to pre-pandemic norms. But sector mismatches should be less of an issue given that activity has rebalanced in the direction of a more conventional mix of goods and services activities. We no longer need to train pilots and flight attendants to work at an e-commerce vendor, as they are back in demand by airlines.

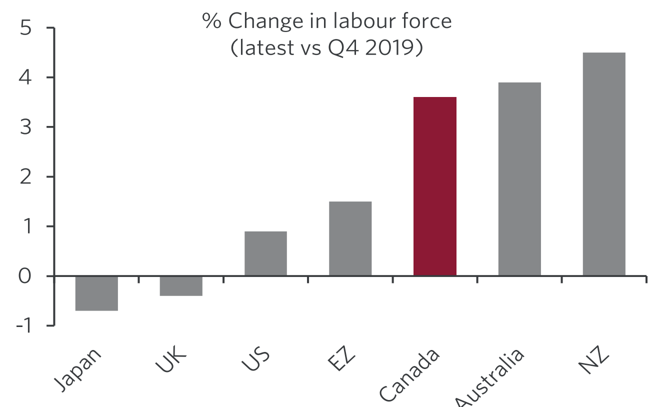
Having employees who have skills that are better matched to where hiring is taking place should improve output per hour, and we don't have Canadians stuck in long-term unemployment or sitting on the sidelines because their sector isn't hiring. Long-term unemployment, a factor cited by the Bank of Canada as a barrier to supply in October 2021, has now dropped to pre-pandemic levels.

Adding more workers

What is more true now than in late 2021 is that to generate growth, we'll need to add to the working-age population. The unemployment rate is near multi-decade lows. And labour force participation is also already running hot, once you take demographics into account. The participation rate is lower today than it was prior to the pandemic in both the US and Canada. But in Canada, all of that reflects population aging, which is not the case stateside. North of the border, the drop in participation would have been much steeper had each demographic group merely maintained its participation rate (blue bars on Chart 3). Instead, we've seen increases in participation in most cohorts.

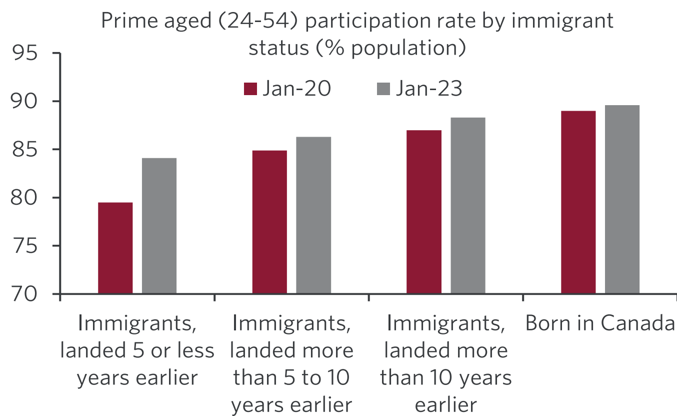
Fortunately, Canada stands head and shoulders ahead of the US and much of the developed world in terms of population growth, owing to brisk immigration. Coupled with the increase in age-adjusted participation, that's seen Canada outpace others in labour force growth since 2019 (Chart 4). Immigration

Chart 4: Canada near the top of the pack in labour force growth



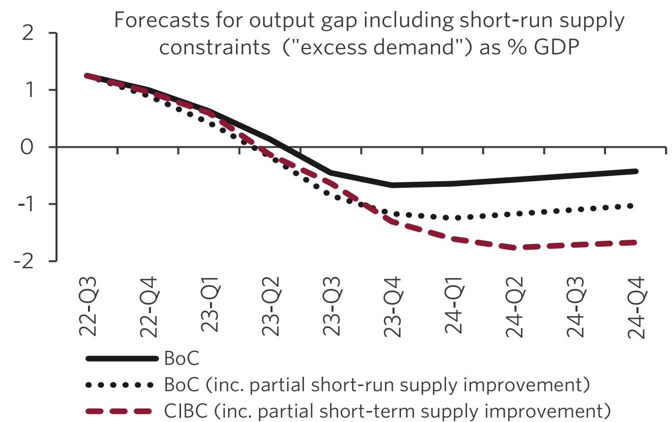
Source: OECD, Statistics Canada, BLS, CIBC

Chart 5: Participation has improved dramatically among new immigrants



Source: Statistics Canada, CIBC

Chart 6: Further supply improvements would open up a lot of slack by 2024



Source: Bank of Canada, CIBC

is expected to remain robust, with Ottawa targeting a climb to half a million immigrants annually.

Increasingly, and in part due to the practice of targeting those with needed skills, immigrants are able to tap into jobs in this country. Labour force participation still trails those born here, but particularly for those within 5 years of arrival, the gap to the native born population has narrowed in the last three years (Chart 5). The unemployment rate of those new immigrants is also much lower and closer to that which prevails for the Canadian-born population.

Huge implications for disinflationary slack

Putting this all together, should labour force growth continue to be fueled by immigration, and productivity recover as supply chain hurdles diminish, the Bank of Canada would now be seriously understating the room for non-inflationary growth both this year and in the future. It shows some room in its forecast, as weak growth over the four quarters of 2023 turns the economy from having excess demand of about 1% of GDP at the end of last year into a position in which its non-inflationary supply exceeds demand by about 0.5% of GDP at its widest.

But should even half of the current "supply" headwinds dissipate, potential GDP would be accelerating, implying that about twice that amount of slack would open up (Chart 6). Even more slack would be opened up if we adopt CIBC's somewhat weaker growth trajectory. That wider slack would, in turn, put greater downward pressure on CPI than we previously had allowed for in our prior forecasts, which didn't capture this additional room for potential growth to improve as supply issues diminished.

How will we know that the supply headwinds are in fact lightening up, and creating added room for non-inflationary growth? Essentially, we should see it in the reversal of the phenomenon that led the Bank of Canada to identify the "supply" shock to non-inflationary growth in 2021. We should see stronger growth in GDP than employment as we get more output per hour, and lighter pressure on inflation relative to what such real GDP growth might typically entail. So we'll know it when we see it, but some of the preconditions, including supply chains that are starting to function better, are out there already.

That extra room for non-inflationary growth over the medium term is key to our view that while the Bank of Canada will cling to at least its current 4.5% overnight rate this year, it will find itself with ample room to ease policy and accelerate growth in 2024. Much of the benefit from that greater elbow room might not show up until 2025, when the lagged impact of an easing next year would materialize. But it's something that Canada can look forward to as we run through what's likely to be a sluggish 2023.

Table 1: Canada forecast detail (real % change, SAAR, unless otherwise noted)

Variable	22Q3A	22Q4F	23Q1F	23Q2F	23Q3F	23Q4F	2022F	2023F	2024F
Real GDP Growth (AR)	2.9	1.2	0.9	-0.6	0.4	-0.2	3.6	0.9	1.1
Real Final Domestic Demand (AR)	-0.6	1.6	1.3	-0.3	0.1	1.2	2.8	0.7	1.6
Household Consumption (AR)	-1.0	2.1	1.3	-1.3	-0.6	0.8	4.8	0.9	1.0
All Items CPI Inflation (Y/Y)	7.2	6.7	5.5	3.1	2.9	2.8	6.8	3.5	2.1
Unemployment Rate (%)	5.1	5.1	5.0	5.4	5.6	5.8	5.3	5.5	5.6

Table 2: US forecast detail (real % change, SAAR, unless otherwise noted)

Variable	22Q3A	22Q4A	23Q1F	23Q2F	23Q3F	23Q4F	2022A	2023F	2024F
Real GDP Growth (AR)	3.2	2.9	1.7	-0.4	0.3	-0.2	2.1	1.3	1.0
Real Final Sales (AR)	4.5	1.4	2.1	-0.1	1.0	-0.4	1.4	1.5	1.0
All Items CPI Inflation (Y/Y)	8.3	7.1	5.8	3.8	3.0	2.6	8.0	3.8	2.2
Core CPI Inflation (Y/Y)	6.3	6.0	5.4	4.6	3.4	2.4	6.2	3.9	2.2
Unemployment Rate (%)	3.6	3.6	3.5	3.8	4.2	4.3	3.6	3.9	4.1

Table 3: Canadian interest rates (end of period)

Variable	2023 15-Feb	2023 Mar	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
Overnight target rate	4.50	4.50	4.50	4.50	4.50	4.00	3.50	3.25	3.00
98-Day Treasury Bills	4.52	4.45	4.35	4.25	4.00	3.50	3.25	2.90	2.60
2-Year Government Bond	4.12	4.25	4.25	3.90	3.50	3.10	2.75	2.40	2.30
10-Year Government Bond	3.13	3.40	3.55	3.30	3.20	2.90	2.80	2.65	2.50
30-Year Government Bond	3.12	3.45	3.60	3.50	3.35	3.00	2.90	2.85	2.75
Canada - US T-Bill Spread	-0.25	-0.50	-0.75	-0.85	-0.95	-1.00	-0.65	-0.70	-0.70
Canada - US 10-Year Bond Spread	-0.60	-0.50	-0.45	-0.50	-0.50	-0.60	-0.60	-0.70	-0.50
Canada Yield Curve (10-year — 2-year)	-0.98	-0.85	-0.70	-0.60	-0.30	-0.20	0.05	0.25	0.20

Table 4: US Interest rates (end of period)

Variable	2023 15-Feb	2023 Mar	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
Federal funds rate	4.625	4.875	5.125	5.125	5.125	4.625	4.125	3.875	3.625
91-Day Treasury Bills	4.76	4.95	5.10	5.10	4.95	4.50	3.90	3.60	3.30
2-Year Government Note	4.58	4.65	4.80	4.40	4.00	3.90	3.40	3.20	2.80
10-Year Government Note	3.73	3.90	4.00	3.80	3.70	3.50	3.40	3.35	3.00
30-Year Government Bond	3.76	4.00	4.25	4.10	3.90	4.05	3.90	3.70	3.60
US Yield curve (10-year — 2-year)	-0.86	-0.75	-0.80	-0.60	-0.30	-0.40	0.00	0.15	0.20

Table 5: Foreign exchange rates

Exchange rate	2023 15-Feb	2023 Mar	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
CAD-USD	0.75	0.75	0.76	0.76	0.76	0.76	0.77	0.78	0.78
USD-CAD	1.33	1.34	1.32	1.32	1.31	1.31	1.30	1.29	1.28
USD-JPY	132	130	125	123	121	120	118	116	115
EUR-USD	1.08	1.07	1.10	1.11	1.13	1.14	1.15	1.15	1.16
GBP-USD	1.22	1.21	1.24	1.24	1.26	1.27	1.28	1.28	1.30
AUD-USD	0.70	0.68	0.69	0.70	0.71	0.72	0.74	0.75	0.76
USD-CNY	6.81	6.85	6.85	6.81	6.79	6.75	6.73	6.71	6.69
USD-BRL	5.15	5.20	5.05	5.20	5.40	5.20	5.20	5.40	5.00
USD-MXN	18.5	20.0	21.0	20.5	19.8	20.0	20.5	21.5	21.0

Contacts:

Avery Shenfeld
416 594-7356
avery.shenfeld@cibc.com

Benjamin Tal
416 956-3698
benjamin.tal@cibc.com

Andrew Grantham
416 956-3219
andrew.grantham@cibc.com

Karyne Charbonneau
613 552-1341
karyne.charbonneau@cibc.com

Katherine Judge
416 956-6527
katherine.judge@cibc.com

FICC Strategy
Ian Pollick
416 594-7057
ian.pollick@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com

CIBC World Markets Inc., CIBC World Markets Corp., CIBC World Markets Plc., CIBC Australia Limited and certain other corporate banking and capital markets activities of Canadian Imperial Bank of Commerce operate under the brand name CIBC Capital Markets.

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice. This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2023 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.

The CIBC logo and "CIBC Capital Markets" are trademarks of CIBC, used under license.