Economics

ECONOMIC INSIGHTS

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The economic “gift” that keeps on giving

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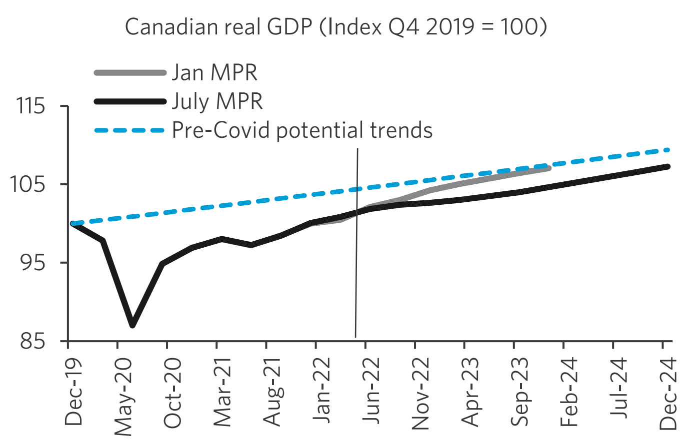
Markets and policy makers were clearly caught off guard by this year’s inflation spike. Simply put, the scale of the CPI upsurge has dwarfed what would have been expected in the face of what’s actually only a modest overheating in demand. Some of that relates to the war in Ukraine and its impact on commodity prices. But a close look at the factors behind the upsurge suggests that a lot of the blame rests on the fact that Covid-19 is the “gift” that keeps on giving as a disruption to the smooth functioning of economies, including Canada’s.

The result is that to get inflation under control, policymakers seem forced to accept a less-than-impressive track for real economic output. In the space of only a half a year, the Bank of Canada went from expecting to reattain the pre-Covid trend in real GDP by the end of 2023, to seeing the economy still well shy of that benchmark as far out as their forecast runs (Chart 1). It now sees supply disruptions persisting “beyond the forecast horizon”. With that horizon extended to the end of 2024, that is more than a year later than its prior assessment.

Chart 1: Bank of Canada now expects economic path to remain well below pre-Covid trend



Source: Bank of Canada, Statistics Canada, CIBC

Similarly, our own forecast for Canadian real GDP growth has inflation coming down, and staying down, only because growth slows to well below what used to be considered its non-inflationary potential (Table 1, page 5), and we expect that to remain the case through 2024. So even if a recession is avoided, we’re in for a protracted period of sub-par growth, which shows up in our projections for the US as well (Table 2, page 5).

Demand recovers, supply still held back

In Canada, as in the US and Europe, both consumers and public health authorities have seemingly put the pandemic behind them in terms of voluntary or mandated restraints on activity. As a result, demand for goods and services has been much less affected this year.

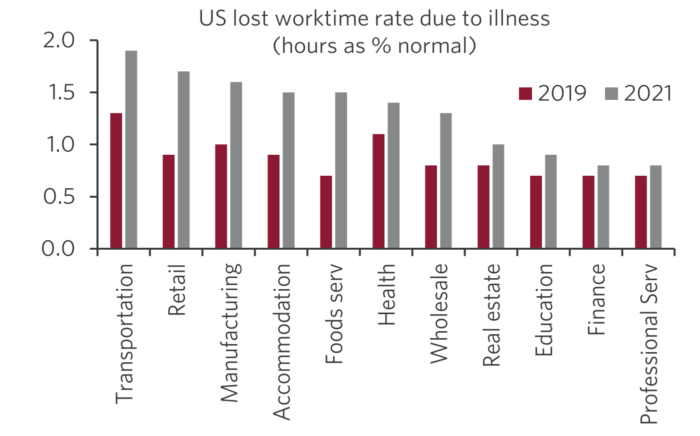
But Covid isn’t fading away as a supply constraint, or as a health issue. Variants that spread more rapidly have meant that present trends suggest that more Canadians will have died from Covid in 2022 than in the prior year, even with a much smaller share of cases proving to be fatal. Long-Covid is still a risk for those who are vaccinated, and there are countries where vaccine counts remain woefully low.

How is all of this linked to the fact that a temporary hit to the Canadian economy’s non-inflationary supply ceiling is now assumed to last at least through 2024? The Bank of Canada ascribes three reasons for its new and more pessimistic take: 1. longer-lasting supply chain disruptions, 2. a greater difficulty in matching those looking for work with available positions, and 3. weaker growth in capital spending. Covid-19 continues to contribute in no small measure to each of these factors impeding the economy’s non-inflationary capacity.

Chart 2: Omicron-related shutdowns had a bigger impact on Chinese exports than initial lockdown

Source: CPB, CIBC

Chart 4: US data shows consumer-facing services sectors are disproportionally hit by rise in illness-related absenteeism



Source: BLS, CIBC

Workers off the job abroad and in Canada

On the supply chain front, while the war in Ukraine gets part of the blame, so too do the continued disruptions to global activity. The most evident hit has been in China, where authorities continued to impose severe lockdowns this year, perhaps fearing that the vaccines they deployed will be less effective than those in greater use elsewhere. The result is that China's exports experienced a larger dip during this year's Omicron wave than what we saw during its early 2020 lockdown (Chart 2).

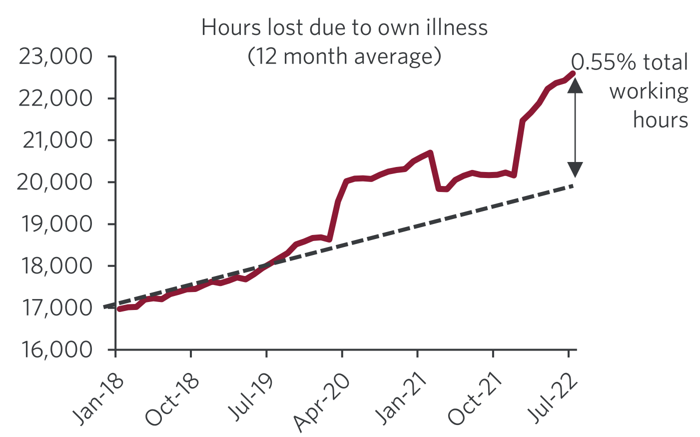
But elsewhere, it's not lockdowns, but employee illness that is impacting business output. Flights are cancelled when crew members call in sick, hospitals cut back services because staff members are ill, and live entertainment shows are postponed for the same reason. In Canada, the Omicron variant has been associated with a significant upturn in total hours worked lost due to illness this year (Chart 3).

US data show limited impacts where work can be done from home (finance, professional services), suggesting that many are able to continue to work during mild Covid-19 cases, but a much sharper rise in absenteeism from pre-pandemic norms in sectors requiring an on-site presence (Chart 4).

Long-Covid can actually see some forced to entirely step away from the labour market. While that's on the rise again in Canada, thus far the numbers are quite small, representing only an added 0.2% of the workforce versus the pre-pandemic norm (Chart 5).

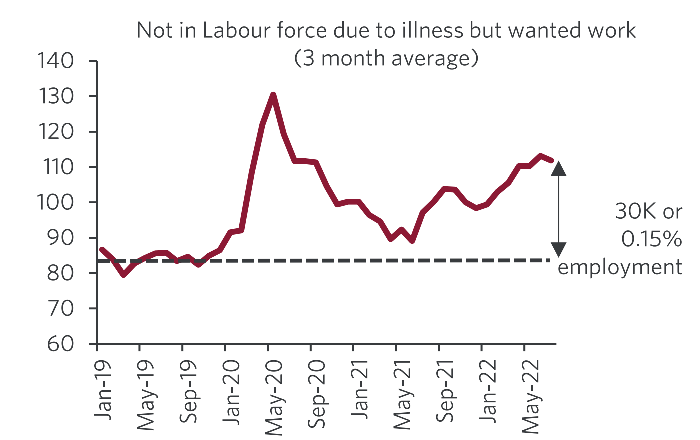
But the UK presents a precautionary tale of what could happen if the pandemic stretches on, and Canada fails to take steps to control the peaks of future waves, thereby adding to the toll of those with Long-Covid. UK Covid-19 cases have generally been higher than in Canada through the pandemic given much lighter public health restrictions, and letting the coronavirus run more freely has left what looks to be a lasting dent in the workforce from Long-Covid. Fully 0.6% of the population there are now

Chart 3: Lost working hours due to illness have risen further above their pre-pandemic trend



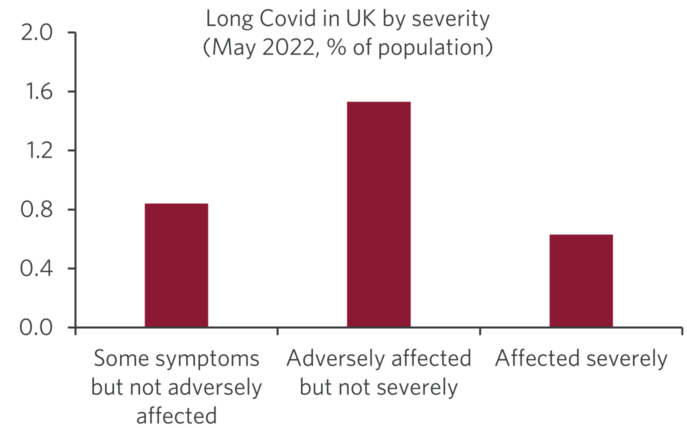
Source: Statistics Canada, CIBC

Chart 5: No steep rise in people dropping out of the Canadian labour force due to illness yet



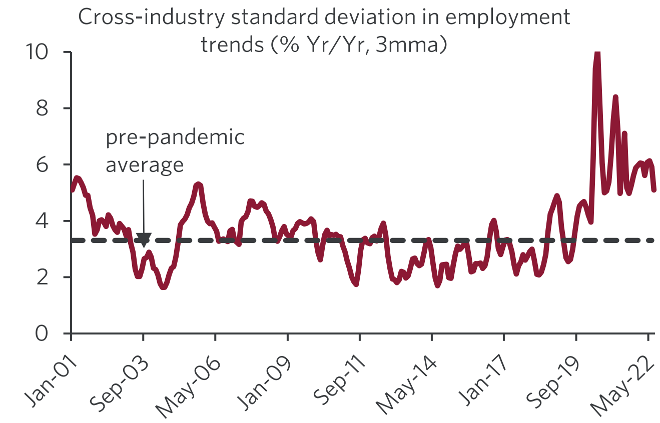
Source: Statistics Canada, CIBC

Chart 6: Just over 0.6% of UK population is severely affected by Long-Covid issues



Source: ONS, IFS, CIBC

Chart 7: Volatility in employment trends across sectors has remained well above pre-pandemic norms



Source: Statistics Canada, CIBC

"severely affected" by Long-Covid according to a recent study (Chart 6).

Beyond the hit to working hours and consumer goods supplies, Covid also impacts another of the factors that the BoC cites for weaker trend growth: sluggish capital spending. That could relate in part to the degree of uncertainty that waves of Covid-19 pose for the outlook ahead. Moreover, the same Covid-related supply chain issues that are impeding the production of consumer goods are also cutting into capital equipment supplies. The result is less productive capacity in sectors where equipment is on back order, or where Covid uncertainties have forstalled investment.

Labour market mismatching should improve

In both Canada and the US, central banks and economists have cited the mismatch between job availability and hiring as a reason why labour markets might be even tighter than the unemployment rate alone would suggest. That has shown up in more job vacancies at a given jobless rate than in prior cycles, and in Canada a weaker "job finding rate", with fewer of those not working able to match up with one of those jobs than would normally be the case with so many positions sitting open. That results in either greater pressure on wages, as employers get desperate to fill the vacancies, or a cap on output. We can't use all the tables at the restaurant, or have more flights, because we can't get the waiters or baggage handlers.

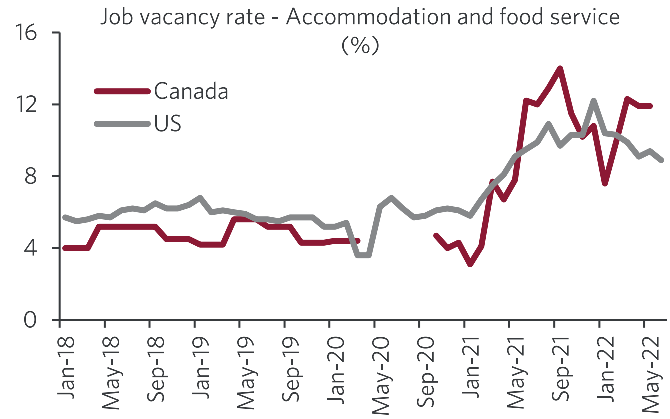
Again, we see the unusual nature of the Covid-19 recession and subsequent recovery as a factor behind where we sit today. But in this case, we're less pessimistic about how long this will persist.

Every recession and recovery features an initial period of job losses, and then a subsequent bout of net hiring. But what's been so atypical in the Covid-19 case is the degree to which some sectors were initially hit by unprecedented job declines (while others still had net hiring), then saw long employment droughts, but now are trying to rehire in huge numbers. That extreme cross-sector variance has never been seen before (Chart 7). A typical recession doesn't see air travel drop by 90%, and doesn't see live theatres close outright. A typical recovery doesn't see the sudden opening we're experiencing in these same sectors.

That extreme variance in employment and economic activity is why occupations that aren't particularly skill-based (baggage handlers, restaurant waiters, etc.) have seen persistent job vacancies this year. Those who held such jobs in early 2020 had two years to move on; unlike after a typical two- or three-quarter recession, they weren't working in a related position in the prior year, so these businesses need fresh faces, and they're all hiring at the same time. So a snapshot taken today will indeed see many vacancies, and yet not many rushing to fill them.

Our sense it that the industry mix of economic activity is already migrating towards a more normal degree of volatility, and that time will help the adjustment to a more active service sector in terms of filling low-skill positions. That is already evident in declining job vacancies in accommodation & food services, particularly in the US which got an earlier start to that sector's reopening (Chart 8). We'll also be shedding jobs in some high-skill sectors where rate hikes are ending the boom, for example, in construction. Both effects should see the job-filling rate improve, and the relationship between job vacancies and the unemployment rate normalize.

Chart 8: Job vacancies in accommodation and food services rose the most, but are starting to decline



Source: Statistics Canada, BLS, CIBC

Consequences for markets and policy makers

An improvement in labour market matching would still leave us feeling the impact of further Covid waves on supply chains and absenteeism. What are the consequences of that for markets and economic policy?

While the markets are pricing in rate hikes for the balance of this year, they've flirted with projecting a quick turn toward outright cuts, a reason why the spread between overnight and two-year or 10-year rates reached such narrow levels. If potential (i.e. non-inflationary) GDP is still handicapped by Covid-19 into 2024, those projected rate cuts could prove premature.

There might be room for a modest rate trimming in 2024, but only because that could be needed to keep growth in the 1.0-1.5% range. Room for steeper cuts would only be there if we open up a lot of slack with a recession in 2022 or 2023. As a result, our forecast has overnight rates holding at restrictive levels through 2023, although by the end of that year the bond market could again be pricing in modest rate cuts in 2024 (Tables 3 and 4, page 6).

Is there anything that policymakers can do to reduce the Covid-related economic albatross? Of course, getting more vaccines and boosters into arms worldwide is still job one, as is research to improve their efficacy against a broader range of variants.

But a policy that has been undertaken with the idea that it would improve the economy — dropping mask mandates and vaccine requirements — may actually be working to prolong some of Covid's economic costs. Yes, demand may have been enhanced by eliminating these measures. Some were precluded from activities by not being vaccinated, while today's much-reduced mask use has given others the (somewhat misleading) impression that crowded indoor activities were fully safe again.

While helping on the demand side, diminished public health restraints, particularly during surges in case counts, are cutting into the economy's supply capabilities. Their absence is likely elevating the peak levels for Covid cases, and thereby increasing the costs of worker absenteeism, and perhaps, as we've seen in the UK, risking longer term labour market damage due to Long Covid. So while lockdowns should be behind us, consideration should be given to mask wearing during future waves as well as improvements in indoor air quality and a further push in global vaccination. If Covid sticks around, such steps will help ensure that its hit to economic supply is less onerous.

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

Variable	22Q1A	22Q2F	22Q3F	22Q4F	23Q1F	23Q2F	23Q3F	24Q4F	2021A	2022F	2023F
Real GDP Growth (AR)	3.1	4.2	1.2	0.8	1.4	1.2	1.8	1.5	4.5	3.4	1.5
Real Final Domestic Demand (AR)	4.8	4.1	1.4	0.9	0.7	0.5	1.5	1.4	5.6	3.8	1.1
Household Consumption (AR)	3.4	7.2	2.7	0.6	0.9	0.6	1.7	1.1	5.0	5.2	1.5
All Items CPI Inflation (Y/Y)	5.8	7.5	7.5	6.8	5.1	1.9	1.3	1.4	3.4	6.9	2.4
Unemployment Rate (%)	5.8	5.1	5.0	5.3	5.5	5.4	5.3	5.3	7.4	5.3	5.3

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

Variable	22Q1A	22Q2A	22Q3F	22Q4F	23Q1F	23Q2F	23Q3F	24Q4F	2021A	2022F	2023F
Real GDP Growth (AR)	-1.6	-0.9	2.4	1.3	1.1	1.0	1.2	1.2	5.7	1.8	1.2
Real Final Sales (AR)	-1.2	1.1	0.3	1.1	1.8	2.0	1.8	1.6	5.3	0.8	1.4
All Items CPI Inflation (Y/Y)	8.0	8.6	8.6	7.2	5.1	2.7	1.6	1.7	4.7	8.1	2.7
Core CPI Inflation (Y/Y)	6.3	6.0	6.4	5.4	3.9	2.8	1.8	2.0	3.6	6.0	2.6
Unemployment Rate (%)	3.8	3.6	3.6	3.8	3.9	3.9	3.9	3.9	5.4	3.7	3.9

Table 3: Canadian interest rates (end of period)

Variable	2022 5-Aug	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Overnight target rate	2.50	3.25	3.25	3.25	3.25	3.25	3.25
98-Day Treasury Bills	2.67	3.30	3.15	3.00	3.00	2.85	2.60
2-Year Government Bond	3.24	3.15	3.10	3.10	2.85	2.80	2.65
10-Year Government Bond	2.77	3.00	2.90	2.80	2.65	2.60	2.50
30-Year Government Bond	2.84	3.10	3.00	2.90	2.85	2.75	2.55
Canada - US T-Bill Spread	0.19	0.50	-0.23	-0.38	0.20	0.15	0.10
Canada - US 10-Year Bond Spread	-0.07	-0.20	-0.15	-0.15	-0.15	-0.05	0.20
Canada Yield Curve (10-year — 2-year)	-0.47	-0.15	-0.20	-0.30	-0.20	-0.20	-0.15

Table 4: US Interest rates (end of period)

Variable	2022 5-Aug	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
Federal funds rate	2.375	2.875	3.375	3.375	3.375	3.375	3.375
91-Day Treasury Bills	2.48	2.80	3.38	3.38	2.80	2.70	2.50
2-Year Government Note	3.22	3.25	3.15	3.00	2.85	2.75	2.55
10-Year Government Note	2.84	3.20	3.05	2.95	2.80	2.65	2.30
30-Year Government Bond	3.10	3.35	3.40	3.10	3.00	2.80	2.60
US Yield curve (10-year — 2-year)	-0.38	-0.05	-0.10	-0.05	-0.05	-0.10	-0.25

Table 5: Foreign exchange rates

Exchange rate	2022 5-Aug	2022 Sep	2022 Dec	2023 Mar	2023 Jun	2023 Sep	2023 Dec
CAD-USD	0.77	0.78	0.76	0.75	0.75	0.76	0.76
USD-CAD	1.29	1.29	1.31	1.33	1.33	1.31	1.31
USD-JPY	135	135	132	127	126	125	122
EUR-USD	1.02	0.99	1.00	1.03	1.05	1.07	1.08
GBP-USD	1.21	1.16	1.17	1.20	1.21	1.23	1.23
AUD-USD	0.69	0.68	0.67	0.68	0.69	0.70	0.71
USD-CNY	6.76	6.70	6.60	6.65	6.60	6.55	6.55
USD-BRL	5.19	6.00	5.70	5.90	5.70	5.50	5.30
USD-MXN	20.4	21.0	21.5	21.0	21.5	21.3	21.5

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