Canada

- **Growth is expected to accelerate over the next two years owing to firmer domestic activity, expanding fiscal stimulus, and increasing foreign demand.**
- **For the first time in years, housing and auto sales are expected, however, to provide a mild drag on growth.**

CANADA CONSOLIDATES GAINS IN 2017

Canadian economic performance appears to have been mixed in the second half of 2016, but activity looks set to strengthen during 2017. Underlying output growth averaged around 1.5% y/y during 2016 amid weakness in exports and business investment. Growth is expected to accelerate beyond the economy's 1.5% potential to around 2% during 2017–18 (Chart 1), supported by steady consumer demand, stabilizing investment, strengthening US domestic purchases of Canadian exports in the context of a weaker Canadian dollar (CAD), firmer oil prices, and fiscal stimulus, including increased Canadian infrastructure spending. Some moderation in major housing markets is, however, likely to provide a slight drag on growth.

STEADY CONSUMERS

Consumers remain relatively upbeat despite a mixed employment and tax picture for households: consumer confidence returned to its long-run average in December (Chart 2), though some survey data indicate major purchase plans have softened somewhat in recent months. New vehicle sales, for instance, are likely to come down after four consecutive record years, following recent price hikes. Domestic wage and income gains were held back throughout most of 2016 given the largely part-time nature of job creation. While there was a strong increase in full-time hiring at the end of the year, Canada's aggregate employment-to-population ratio is still around 2 percentage points below its pre-recession peak (Chart 3) and long-term unemployment remains high (Chart 4).

Apart from Quebec's elimination of its health contribution as of 2017, Canadian households are unlikely to witness material tax relief through 2018 as a range of levies are set to be raised. As of January 2017, Alberta and Ontario will join British Columbia and Quebec with broad frameworks for pricing carbon, followed by at least four other provinces a year later. The impact of carbon pricing will be softened for low-income households by credits offered by a number of provinces, which add to the 2016 enhancements to targeted federal and provincial benefits, notably Ottawa's and Alberta's respective increased child benefits.

Overall, we expect real consumer spending will grow in line with underlying real income growth of around 1.5–2% annually during 2017–18. The boost to household purchasing power and discretionary spending from the Canada Child Benefit should be partially offset by higher food and energy inflation, municipal fee increases, and higher mortgage costs. Record indebtedness amid rising interest rates shall likely limit the capacity of households to ramp up spending notably, and should prompt a more cautious approach to further debt accumulation.

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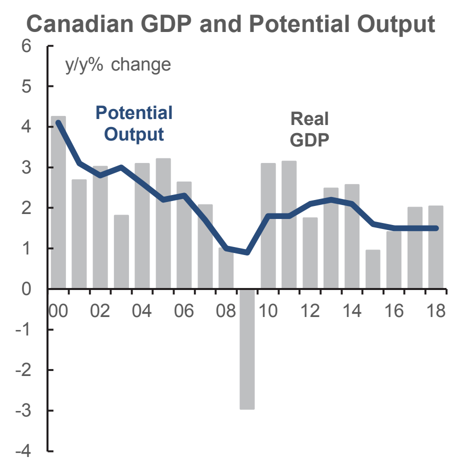
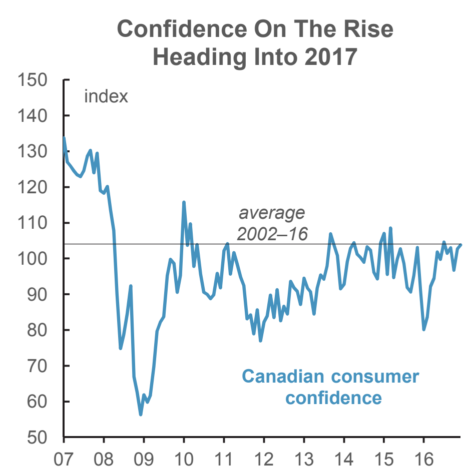
Chart 1



Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

Chart 2



Sources: Scotiabank Economics, Conference Board Of Canada.

HOUSING: LESS HOT

Although residential investment continues to account for a near-record share of Canadian economic activity (Chart 5), a less torrid housing market in Toronto and Vancouver, combined with a calmer situation in the rest of the country and a modest decline in housing starts, should bring residential investment down slightly during 2017. National home sales are forecast to decline about 5% in 2017 given the significant erosion in affordability in several of Canada's large urban centres, and the impact of both the latest tightening in mortgage insurance rules and the additional transfer tax on foreign real estate investors in Metro Vancouver.

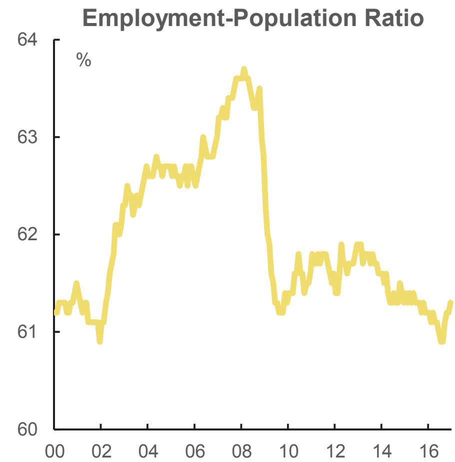
Home prices are, however, expected to continue rising, albeit at a slower pace, owing to historically tight resale supply. While national home sales rose 6% last year to a new annual record, the number of newly listed homes fell 4%. More than half of local markets in Canada, primarily located in Ontario and BC, are still considered to be in sellers' territory.

The recent uptick in fixed mortgage rates and the potential for a pullback in foreign buying add downside risk to the housing outlook. Even so, several factors, including a wave of millennials ageing into their prime first-time homebuyer years, increasing immigration, strengthening job growth, and our expectation that any further interest rate increases will proceed slowly, remain supportive of longer-term housing demand. After contributing an average of 0.2 percentage points to annual GDP growth since 2010, real residential investment is forecast to provide a modest drag on growth during 2017–18. This in turn will have knock-on effects on a range of industries, including manufacturing, retail and wholesale trade, and financial and professional services.

INVESTMENT STABILIZES

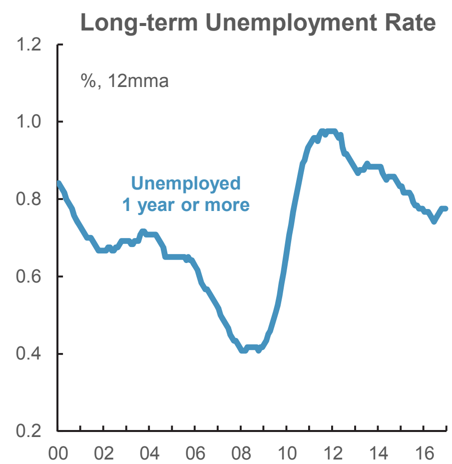
Economy-wide industrial utilization rates are near their long-term average, and capacity constraints in a number of industries, including several export-intensive sectors, should prompt a modest investment recovery through 2018 (Chart 6). Even so, we expect this firming in investment to be gradual: businesses remain relatively cautious in their

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Table 1 — Quarterly Canadian Forecasts

	2016				2017				2018			
	Q1	Q2	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic												
Real GDP (q/q, ann. % change)	2.7	-1.3	3.5	2.5	1.8	2.2	2.0	2.0	2.0	1.9	1.9	1.9
Real GDP (y/y, % change)	1.3	1.1	1.3	1.8	1.6	2.5	2.1	2.0	2.0	2.0	1.9	1.9
Consumer Prices (y/y, % change)	1.5	1.6	1.2	1.3	1.9	1.9	2.3	2.2	2.0	2.0	2.1	2.1
CPIX (y/y % change)	2.0	2.1	1.9	1.7	1.7	1.7	1.8	1.8	1.9	1.9	1.9	1.9
Financial												
Canadian Dollar (USDCAD)	1.30	1.29	1.31	1.34	1.38	1.40	1.38	1.36	1.36	1.34	1.32	1.30
Canadian Dollar (CADUSD)	0.77	0.77	0.76	0.74	0.72	0.71	0.72	0.74	0.74	0.75	0.76	0.77
Bank of Canada Overnight Rate (%)	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
3-month T-bill (%)	0.45	0.49	0.53	0.46	0.50	0.50	0.50	0.50	0.60	0.80	0.90	1.10
2-year Canada (%)	0.54	0.52	0.52	0.75	0.75	0.85	0.95	1.05	1.20	1.35	1.45	1.60
5-year Canada (%)	0.68	0.57	0.62	1.11	1.15	1.25	1.30	1.40	1.50	1.65	1.80	1.90
10-year Canada (%)	1.23	1.06	1.00	1.72	1.75	1.80	1.85	1.90	1.95	2.10	2.20	2.35
30-year Canada (%)	2.00	1.72	1.66	2.31	2.35	2.30	2.35	2.45	2.55	2.65	2.75	2.80

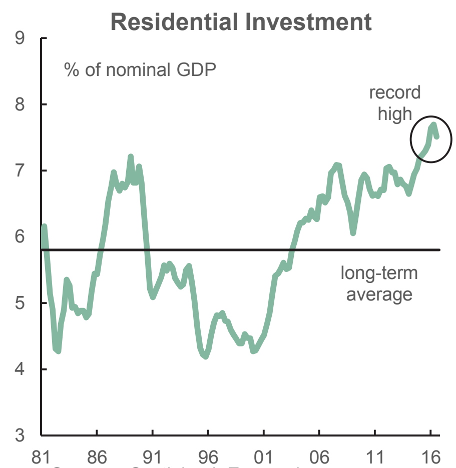
expansion plans due to ongoing global economic uncertainty, weak profit growth, the introduction of country-wide carbon pricing in Canada, rising protectionist sentiment in the US, and the increasing cost of capital goods imports with a weaker loonie.

Investment growth in the resource sector will likely be flat or mildly positive. Oil and gas capital expenditures are only just showing signs of bottoming after the steep cutbacks during 2014 and 2015. Firmer oil prices, which we expect to average around USD 58/bbl in 2017 should help to support energy investment. In mining, soft pricing and excess capacity will, however, continue to weigh on the investment outlook. The forestry sector faces a potentially complicated year with the strong likelihood of yet another protracted dispute with US industry groups before a new agreement on softwood lumber trade is reached.

NON-ENERGY EXPORTS BEGIN TO TURN A CORNER

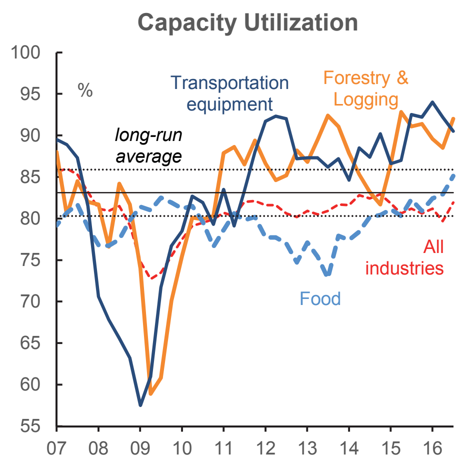
The lagged effects of a weaker Canadian dollar, resilient US consumer demand, and firming business confidence in the US may now be starting to show up in Canada's non-energy export numbers. The largest non-resource segments of Canada's export portfolio have advanced considerably in 2016, with autos and parts (+12% ytd), consumer goods (+7%) and forest products (+4%) leading the way. Service exports, which currently account for a near-record 17% of overall export receipts (Chart 7), are expected to continue to grow at around 5%, led by rising business and personal tourism inflows attracted by a weaker CAD. Transportation and commercial services exports also continue to post steady gains of around 4% per year as household wealth increases, more families require additional educational and financial services, and businesses ramp up their online presence and technological capabilities.

Chart 5



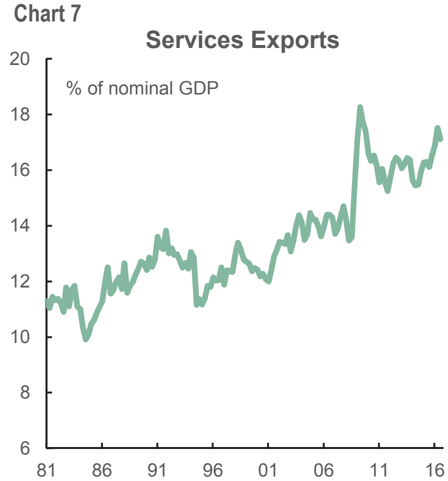
Sources: Scotiabank Economics, Statistics Canada.

Chart 6



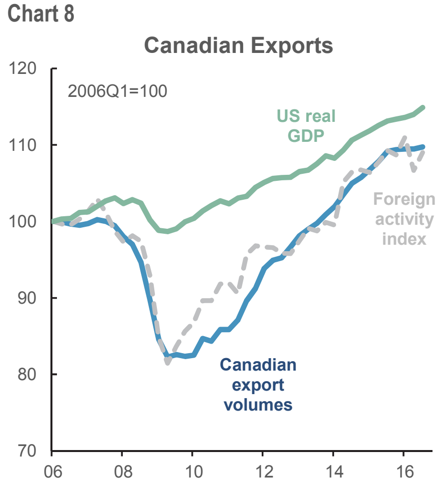
Sources: Scotiabank Economics, Statistics Canada.

Chart 7



Sources: Scotiabank Economics, Statistics Canada.

Chart 8



Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

Canadian exports tend to track global demand closely (Chart 8), and the moderation in world growth in recent years has slowed Canadian export expansion. Canadian export growth has also been held back by a lack of spare capacity in export-intensive sectors, such as forestry and logging, transportation equipment, and food (Chart 6 again). Expectations for stronger global growth in 2017, led by the United States, some firming in Canadian investment, and higher energy prices should together support further modest export recovery.

It is still too early to factor in any major changes to Canada-US trade policy under the new US administration. The potential for an escalation in cross-border trade disputes, however, remains a notable downside risk to our forecast for exports and overall Canadian growth.

FISCAL STIMULUS SUPPORTS GROWTH

The public sector's solid contribution to Canada's real GDP growth in 2015 and 2016 is expected to rise from 0.4 percentage points to half a percentage point in 2017 before pulling back to 0.3 percentage points in 2018. This represents a substantial departure from the deficit reduction measures enacted during 2011–

14, which made fiscal policy mildly contractionary. Ottawa's infrastructure plan, *Investing in Canada*, and other pre-existing programmes, are expected to double federal investment spending from 2016 to CAD 17.5bn by fiscal 2018–19. Any potential investment under the proposed Strategic Infrastructure Bank would add to these figures. Given the size and breadth of the planned infrastructure projects, allocated funding may not be fully deployed by 2018 when Phase 2 of *Investing in Canada* begins.

The provinces, territories, and municipalities are expected to match federal funding as required, while also continuing to invest in their own priority areas. In aggregate, projected growth in the operating expenditures of the junior governments over the next two years is expected to fall below anticipated population and inflation increases, and make no contribution to GDP growth.

Table 2 — Canada

	2000–15	2016e	2017f	2018f
		(annual % change)		
Real GDP	2.2	1.4	2.0	2.0
Consumer Spending	2.9	2.2	2.0	1.7
Residential Investment	3.8	2.3	-1.8	-0.8
Business Investment	2.7	-6.8	0.0	2.9
Government	2.2	1.8	2.1	1.5
Exports	1.3	1.0	2.3	4.0
Imports	3.1	-0.8	1.3	3.0
Nominal GDP	4.4	2.1	4.3	4.0
GDP Deflator	2.2	0.7	2.3	2.0
Consumer Price Index (CPI)	2.0	1.4	2.1	2.0
Core CPI (CPIX)	1.8	1.9	1.7	1.9
Pre-Tax Corporate Profits	3.9	-5.0	9.0	4.0
Employment	1.4	0.7	1.1	0.8
Unemployment Rate (%)	7.1	7.0	6.9	6.8
Current Account Balance (CAD bn)	-13.9	-69.3	-55.0	-43.0
Merchandise Trade Balance (CAD bn)	28.2	-31.1	-17.5	-8.5
Federal Budget Balance (FY, CAD bn)	-2.9	-1.0	-27.0	-32.0
per cent of GDP	-0.2	0.0	-1.3	-1.5
Housing Starts (000s)	199	198	190	185
Motor Vehicle Sales (000s)	1,639	1,949	1,940	1,925
Industrial Production	0.5	-0.7	2.0	1.6
WTI Oil (USD/bbl)	64	43	58	61
Nymex Natural Gas (USD/mmbtu)	5.09	2.55	3.25	3.15

KEY RISKS TILT TO THE POSITIVE

The key risks to Canada's outlook are mixed, but tilt toward the positive in the context of a stronger global economy. On the upside, higher-than-projected oil prices could boost growth and produce knock-on positive effects through several sectors. Similarly, an even stronger pick-up in US business activity and investment would produce a faster export turnaround. Canadian housing markets could perform more strongly than projected as Canadian growth picks up and real estate prices remain attractive to foreign buyers. On the downside, the risks are more diverse, but not necessarily more profound. Higher mortgage rates (see pp. 14–16 here) and tighter lending standards could dent housing-sector activity and squeeze already indebted Canadian households, with knock-on effects for the entire Canadian economy. Meanwhile, US corporate tax cuts and a more pro-growth regulatory policy agenda south of the border could further erode the relative competitiveness of Canadian business. US trade policy remains a significant unknown, but the Canadian government is engaging proactively to limit any possible damage.

The Provinces

THE VARIANCE IN REGIONAL GROWTH NARROWS

- **As recoveries gain traction in 2017–18 in Alberta and Saskatchewan—two major oil-producing economies—and industrial restructuring continues across all regions, rising infrastructure outlays will offer an offset to uneven business investment gains and some easing in housing activity.**
- **The Provinces' stepped-up capital investment in response to federal initiatives steepens the challenge of restraining their net debt burdens.**

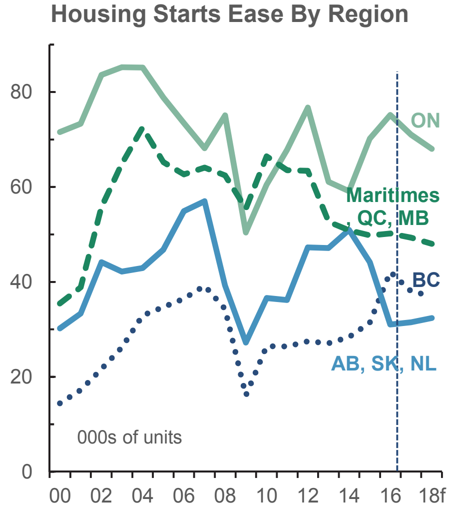
Although regional adjustments to low commodity prices are well under way, their impact lingers. The more favourable interprovincial migration trends witnessed over the past year by most net oil-consuming provinces are expected to persist through at least 2017, expanding their available labour pools and limiting wage increases. With oil & gas investment recovering but still historically subdued, the 2017 rise in non-residential construction costs across Canada is expected to be relatively restrained.

Alberta's and Saskatchewan's forecast turnaround to positive growth in 2017, following a 5½% contraction in their combined real GDP during 2015–16, reflects higher oil production and a gradual pick-up in energy investment, particularly on conventional projects. Encouraging is the anticipated 2017 combination of WTI oil prices averaging USD58/barrel and a Canadian dollar softer than 75¢(US). Also supportive is the possibility of the Keystone and Trans Mountain pipelines now proceeding. Yet in the wake of major cost-cutting efforts, petroleum producers are expected to be cautious on re-hiring and other initiatives. With non-energy investment still correcting, Alberta's total business investment is expected to edge lower in 2017, even with Fort McMurray's reconstruction. Over the next two years, projected softness in potash prices is forecast to dampen Saskatchewan's recovery, while Newfoundland and Labrador's output and employment will be eroded as work progresses on a couple of major resource projects.

Growth in the high-flying BC and Ontario economies is forecast to moderate this year. BC is weathering a significant slowdown in its housing sector (Chart 9), dampening related service activity and consumption into 2018. For the forest products sector in BC and other regions, the risk of adverse trade developments persists until a *Softwood Lumber Agreement* is signed. In Ontario, housing starts are expected to soften, and motor vehicle production to stabilize, albeit at high levels; but as in BC, momentum in financial and business services should help to sustain growth. In the Maritime provinces, Quebec, and Manitoba, after their soft landing in housing starts since 2012, a modest upturn leaves residential construction not far above recent lows. Thus, the projected robust upswing this year and next in transit, water treatment, road and social infrastructure across Canada is forecast to underpin growth.

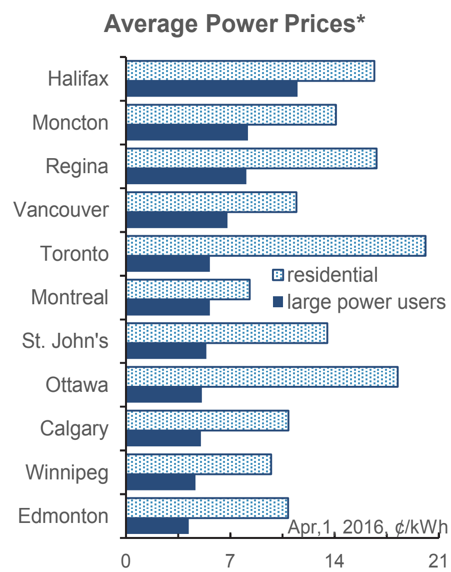
Over the next two years, businesses and discretionary household income will be impacted by adjustments and hikes to a range of provincial and municipal levies. In part this reflects broad carbon-pricing frameworks, introduced in Ontario and Alberta in 2017 and in at least four other provinces in 2018, with further hikes in the minimum carbon price phased in through 2022. The existing regional variance in residential and industrial power prices (Chart 10) underlines the upcoming struggle among regions to remain cost competitive.

Chart 9



Sources: Scotiabank Economics, CMHC.

Chart 10



*Including taxes. Sources: Scotiabank Economics, Hydro-Québec.

THE FISCAL OUTLOOK

The Provinces' mid-year updates for fiscal 2016-17 (FY17) indicate an aggregate deficit close to $17 billion, $1 billion narrower than the *Budget* estimates, but $4.3 billion wider than FY16. The aggregate shortfall, however, masks the combined FY17 deficit of less than $3.5 billion (0.2% of GDP) across the seven net oil-consuming Provinces. In FY18, the deficit for these seven Provinces is expected to narrow to less than $1 billion as five of the Provinces target black ink. For the Provinces achieving or approaching balanced books, increased flexibility should facilitate participation in Ottawa's ambitious infrastructure and environmental plans.

As interest rates creep higher over the next two years, the Provinces, post-recession, have substantially lengthened the maturity of their debt. Risks remain, including retirement benefit obligations, renewable power expenses and the costs inherent in constructing or refurbishing major power generating or transmission capacity. A further challenge is preserving provincial competitiveness when global excess capacity persists in many industries. Potentially complicating this challenge is Trump's commitment to reduce the burden of government by cutting taxes and trimming environmental and other regulations.

Table 3 — The Provinces annual % change, except where noted

	CA	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Real GDP											
2000–15	2.2	2.5	1.8	1.4	1.2	1.7	2.0	2.4	2.1	3.1	2.7
2016e	1.4	0.3	1.3	1.3	0.5	1.6	2.6	2.1	-0.5	-2.7	3.1
2017f	2.0	-1.2	1.2	1.3	0.6	1.7	2.3	2.0	1.7	2.1	2.3
2018f	2.0	-0.9	1.3	1.2	0.6	1.6	2.3	1.9	2.0	2.4	2.3
Nominal GDP											
2000–15	4.4	5.7	4.3	3.3	3.3	3.6	3.8	4.5	6.0	6.5	4.5
2016e	2.1	-1.8	2.4	2.5	1.5	2.8	4.2	3.2	-2.8	-4.6	4.8
2017f	4.3	2.5	2.7	2.8	2.0	3.4	4.3	3.6	5.1	6.1	4.3
2018f	4.0	2.1	2.7	2.7	1.9	3.3	4.1	3.5	4.6	5.4	4.1
Employment											
2000–15	1.4	1.0	1.2	0.7	0.5	1.3	1.3	1.0	1.3	2.5	1.2
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017f	1.1	-1.3	0.4	0.3	0.3	1.0	1.3	0.6	0.2	0.5	1.5
2018f	0.8	-0.9	0.3	0.3	0.2	0.7	1.1	0.5	0.4	0.8	1.2
Unemployment Rate (%)											
2000–15	7.1	14.3	11.2	8.9	9.6	8.1	7.2	5.1	4.9	4.9	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017f	6.9	13.6	10.5	8.1	9.4	6.9	6.4	5.9	6.2	7.9	5.9
2018f	6.8	13.7	10.4	8.0	9.2	6.8	6.3	5.9	6.1	7.6	5.9
Housing Starts (units, 000s)											
2000–15	199	2.7	0.8	4.3	3.6	44	71	5.1	5.2	35	28
2016	198	1.4	0.6	3.8	1.8	39	75	5.3	4.8	25	42
2017f	190	1.5	0.5	3.6	1.8	38	71	5.4	5.0	25	38
2018f	185	1.4	0.5	3.4	1.7	37	68	5.4	5.0	26	37
Motor Vehicle Sales (units, 000s)											
2000–15	1,639	28	6	48	37	410	624	47	45	216	178
2016e	1,949	34	8	55	43	465	802	56	51	220	215
2017f	1,940	32	7	54	42	463	796	56	52	223	215
2018f	1,925	30	6	54	42	459	788	55	53	226	212
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–15	-2,917	59	-39	-31	-146	-953	-5,216	-84	425	1,746	291
2016	-987	-2,207	-13	-11	-261	2,191	-5,029	-846	-675	-6,442	730
2017f*	-27,000	-1,584	-8	12	-332	0	-4,324	-1,004	-1,044	-10,811	2,242
2018f*	-32,000	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

* FY17: Provinces' estimates, SK excluding pension accrual adjustment; history: MB:FY04–FY15 and AB:FY05–FY15.