Canada

- **As both US and global growth continue to pick up, Canadian growth remains set to slow gradually over the next two years from its peak in 2017, but remain supported by domestic and US fiscal stimulus. With economic activity still growing above potential, inflation is expected to head north of the Bank of Canada's 2% target in 2018 and prompt further increases in the Bank's overnight rate target.**
- **Risks to the near-term outlook appear mixed as the chances for a deal on renewing NAFTA may be improving at same time as the US-China trade conflict threatens to undermine global growth. Over the medium-term, however, Canada's business prospects could be somewhat complicated by US tax reform and policy developments in Canada.**

SLOWING, BUT STILL STEADY

Coming into 2018, Canadian growth has slowed from 2017's hot pace and inflation has gradually picked up as anticipated in our previous *Global Outlook.* Canadian macroeconomic aggregates are closely tracking the forecasts generated by the *Scotiabank Global Macroeconomic Model* (SGMM) that we introduced last year and discussed in our *Long-Term Outlook*. The SGMM's performance so far buttresses our view that Canadian growth should continue to decline through 2018 and 2019 toward our 1.6% estimate of potential as households begin to pull back from spending in response to tighter credit conditions.

Informed by our model, we project real GDP growth to keep coming down from 3.0% in 2017 to 2.2% in 2018, down from our previous projection of 2.4%, and 2.1% in 2019, up from 1.9% in our previous forecasts—owing to our current view that spillovers from US fiscal stimulus will take a bit longer than previously programmed to materialize in Canada's economy through increased export demand (tables 1, 2, and 3). Growth also receives a boost in 2019 from higher oil prices.

Our revised growth projections also reflect two cross-cutting and largely offsetting sets of influences: Canadian economic activity does receive positive spillovers from US fiscal stimulus, but this is counter-balanced by our presumption that investment is dampened by uncertainty stemming from the still-pending status of NAFTA, escalating US-China trade rhetoric, and adjustment to the recent additional tightening of mortgage lending standards in Canada. Remove these caveats and our macro model implies growth rates about 30 bps higher in 2018 and 10 bps higher in 2019, respectively (table 2).

Although Canadian growth is decelerating, a closed output gap and excess demand still imply a pick-up in inflation over the next two years to just above the Bank of Canada's 2% target (chart 1). The *US & Canadian Monetary Policy & Capital Markets* report translates our macro outlook into an expected rate path for the Bank of Canada. We continue to look for slowing, but still above-potential, growth to be met with two more increases in the Bank's target for the overnight rate later this year—although somewhat more back-loaded than previously projected—and three more increases in 2019.

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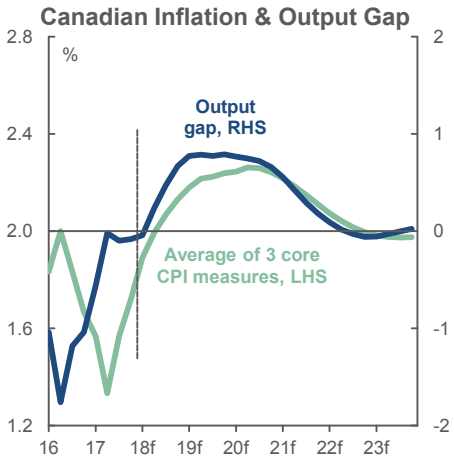
Chart 1



Sources: Scotiabank Economics.

CONSUMERS REMAIN THE MAINSTAY OF CANADIAN GROWTH

Consumers continue to make an outsized contribution to Canada's overall economic performance. A confluence of highly favourable factors—a still-strong employment market, rising wages, increased government transfers, increasing wealth, low borrowing costs, and a growing population—drove up household expenditures last year by the strongest pace since 2010; positive, albeit more moderate, momentum continues into 2018 (table 3). The surge in spending has been led to this point by big-ticket durable goods, a testament to consumer confidence—but this sentiment is beginning to be pared back by higher prices and tighter macroprudential measures.

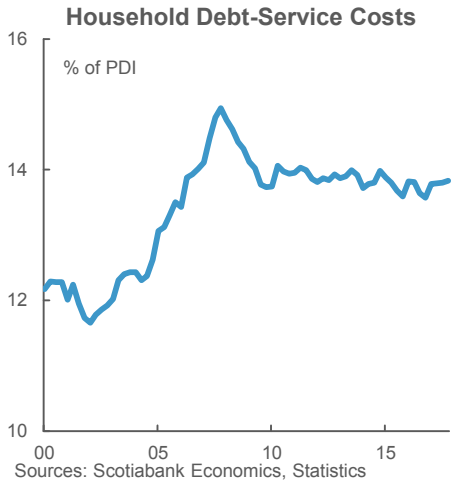
The fundamental drivers supporting strong household spending remain in place. Last year saw the strongest pace of hiring in a decade, with the vast majority of the new positions in full-time roles. The unemployment rate has dropped to a 43-year low of 5.8% —equivalent to 4.8% using the same methodology that is standard in the United States where the unemployment rate is 4.1%. The prime-age (i.e., 25–54 years old) employment-to-population ratio now sits at 82.5%: down slightly from its all-time high of 82.7% in December, 2017.

While forward-looking surveys of hiring intentions remain upbeat, some slowing in job growth seems inevitable during the remainder of 2018. Growing labour shortages are being reported across sectors and regions, as the number of job vacancies has surged 15% over a year ago. The pool of available workers to be tapped to fill these openings appears increasingly limited or mismatched with employer needs given that the participation rate of Canadians aged 15 to 64 is already near record highs.

Accelerating wage gains should sustain healthy income growth even in the face of more muted hiring. Average hourly earnings growth has more than doubled over the past year to 3% year-over-year amid the tightening in labour markets and minimum wage increases in a number of provinces. Further legislated minimum wage increases this year and in 2019 in nine of ten provinces are expected to take wage growth to 4% in 2018 and keep it around 3% in 2019. Combined with employment gains, overall earnings growth for Canada as a whole is set to exceed 5% in 2018.

A buoyant tourism sector also is fueling higher outlays, including on accommodation and food services, recreation and entertainment, and transportation. Inflation-adjusted tourism spending in Canada rose 4% last year, reflecting increased expenditures by

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

Table 1

Quarterly Canadian Forecasts	2017		2018				2019			
	Q3	Q4	Q1e	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	1.5	1.7	1.8	2.6	2.4	2.4	2.2	1.9	1.6	1.6
Real GDP (y/y % change)	3.0	2.9	2.4	1.9	2.1	2.3	2.4	2.2	2.0	1.8
Consumer prices (y/y % change)	1.4	1.8	2.0	2.2	2.3	2.3	2.3	2.3	2.3	2.3
Avg. of new core CPIs (y/y % change)	1.5	1.7	1.9	2.0	2.1	2.1	2.2	2.2	2.2	2.2
Financial										
Canadian Dollar (USDCAD)	1.25	1.26	1.29	1.27	1.26	1.25	1.25	1.22	1.22	1.25
Canadian Dollar (CADUSD)	0.80	0.80	0.78	0.79	0.79	0.80	0.80	0.82	0.82	0.80
Bank of Canada Overnight Rate (%)	1.00	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.50
3-month T-bill (%)	1.00	1.06	1.15	1.25	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada (%)	1.52	1.69	1.78	1.90	2.10	2.30	2.40	2.50	2.55	2.60
5-year Canada (%)	1.75	1.87	1.97	2.10	2.25	2.45	2.55	2.60	2.65	2.70
10-year Canada (%)	2.10	2.05	2.09	2.25	2.40	2.50	2.60	2.65	2.70	2.75
30-year Canada (%)	2.48	2.27	2.23	2.40	2.60	2.70	2.80	2.85	2.90	2.95

Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

Canadians staying at home as well as by international visitors to Canada. While the tourism boost from last year's Canada 150 celebrations has wound down, stricter requirements on travel into the US, improved Canadian visa facilitation, and increased air capacity from key Canadian tourism markets, including China, India, and Mexico, are together expected to sustain a rising number of international arrivals in 2018 and 2019. Meanwhile, a relatively soft Canadian dollar limits short cross-border shopping trips by Canadians to the United States.

Table 2

Real GDP growth: impact of policy developments

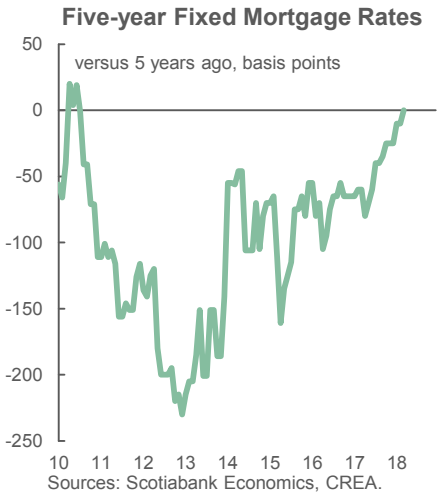
	2018f	2019f
Model-based projections based on fundamentals	**2.5**	**2.2**
Less: adjustments for policy developments	**-0.3**	**-0.1**
B-20 mortgage rules	-0.1	0.0
NAFTA uncertainty	-0.1	0.0
Global protectionism	-0.1	-0.1
Current baseline	**2.2**	**2.1**

Source: Scotiabank Economics.

We continue to forecast relatively healthy consumer trends, but it is unlikely that the recent pace of spending can be sustained. The largest initial boost to income and spending from enhanced child-benefit payments provided during 2016–17 has faded and further assistance to low-income households is less comprehensive. Wealth effects also are expected to be weaker in light of the softening in house prices in some markets and lacklustre equity returns thus far in 2018.

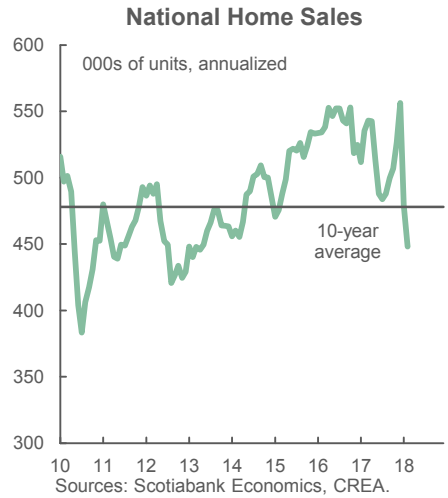
Higher borrowing costs also are likely to dent consumer purchases. Household debt-servicing costs as a share of disposable income are edging higher, a trend that is set to continue as the Bank of Canada moves to normalize interest rates. Over most of the past decade, increased borrowing has been offset by falling interest rates, leaving overall debt financing burdens relatively flat (chart 2). For the first time since 2010, five-year fixed mortgages are set to roll over at higher rates than at origination (chart 3).

Chart 3



At the margin, sales of big-ticket items that are more likely to be financed on credit, including motor vehicles, furniture, and major household appliances, are expected to soften first. Accelerating price increases for new cars and light trucks have reduced new-vehicle affordability to its lowest level of the past decade and will likely also weigh somewhat on new sales. Many households have started to shift to the used-vehicle market, with sales of pre-owned models jumping an estimated 10% y/y in 2017, outpacing gains in new vehicle purchases. Full-year 2018 new motor vehicle sales are forecast to moderate to 2 mn units, putting an end to a string of five consecutive annual sales records, but still keeping overall volumes at extremely high levels.

Chart 4



Canadian households appear to be taking initial steps toward deleveraging. Consumer and mortgage credit growth has decelerated in recent months near to 5.5% y/y, near a two-year low. The ratio of household credit-market debt to disposable income inched down to 170.4% in Q4 from a record high of 170.5% in Q3, and likely edged lower in Q1 in the wake of a sharp slowdown in home sales. Recalculated on the same terms as US numbers, the Canadian ratio currently sits at 156.4%, below the US peak of 168.4% recorded in 2007. Consumer confidence surveys are signalling increased caution toward major purchases. Overall, real consumer spending growth is projected to slow from a seven-year high of 3.5% in 2017 to 2.6% this year and 2.0% in 2019, bringing it closer in line with underlying income trends.

NEW MORTGAGE RULES AND HIGHER RATES COOL HOUSING DEMAND

The new, tougher, B-20 stress-test rules that took effect on January 1st sparked a larger-than-expected fall-off in home sales in early-2018 after buyers rushed to close deals

before the end of 2017 (chart 4). The current pullback has been sharpest in the Greater Vancouver (see our recent report on BC housing) and Greater Toronto areas, which are disproportionately affected by the new rules compared with other regions owing to their high home prices and relatively large share of uninsured mortgages. Buyers, some of which are now able to qualify only for smaller mortgages than they previously considered, continue to shift their preferences toward more affordable housing options, including condominiums and townhomes.

Heading into Q2, a partial recovery is likely as buyers and sellers adjust to the new guidelines. Housing demand fundamentals, including low unemployment, strengthening wage gains, ageing Millennials, and strong immigration rates, remain supportive. While affordability is increasingly strained in the Greater Vancouver and Toronto-Hamilton areas, it remains healthy in much of the rest of the country.

Even so, the combination of the new stress tests, BC's recently announced housing tax measures, and higher interest rates is expected to lead to some moderation in Canadian home sales this year. National home sales are forecast to decline by 5–10% in 2018 before stabilizing in 2019 at what remain historically high levels. Annual increases in nationwide home prices, measured by the benchmark composite MLS Home Price Index (HPI), are expected to moderate from 14% to around 3% in 2018, with the majority of local markets in balanced territory.

Housing starts are projected to slow from 220,000 units in 2017 to 208,000 in 2018 and 196,000 units in 2019, in line with underlying demographic demand and some boost from affordable housing initiatives. While the overall temperature of the housing market has cooled, builder confidence remains underpinned by rising new home prices, still strong pre-construction sales, and a declining inventory of completed and unsold units. There is little evidence of over-supply in the vast majority of major markets in Canada.

NON-RESIDENTIAL CONSTRUCTION STRENGTHENING

Private non-residential construction spending is set to stage a gradual recovery during 2018–19 after two years of contraction during 2016–17. Strengthening industrial activity and rising capacity utilization rates are prompting some businesses to increase spending on new facilities, notwithstanding uncertainty created by the ongoing renegotiation of NAFTA. Industrial construction intentions are trending close to their highest level in five years.

Commercial building construction volumes are also turning higher. Tight central office market conditions persist in Toronto and Vancouver, which is spurring additional development activity, while Calgary and Edmonton are showing signs of stabilization after years of high vacancy rates. Demand remains strong across the country for new warehouse and distribution facilities amid the continuing rise in e-commerce.

HIGH-TECH LEADS MANUFACTURING OUTPERFORMANCE

While the Canadian economy has moderated in recent months, the manufacturing sector has held up better, with growth advancing by 3.2% y/y in January, ahead of economy-wide growth which slowed to 2.7% y/y. However, nearly half of all manufacturing industry groups also decelerated at the start of the year by at least as much as the overall economy. The high-tech sector is a notable exception, with output growth accelerating to 13.9% y/y in January, its best performance since the opening months of 2004. Ordering activity for Canadian high-tech products also remains robust, which is leading to an expanding order backlog that has increased 8% overall as inventories have come down since late-2016.

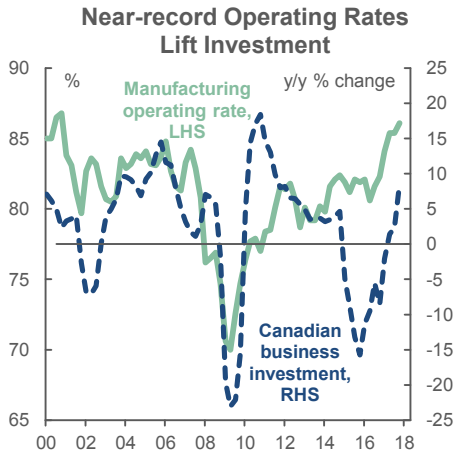
Table 3

Canada	2000–16	2016	2017	2018f	2019f
	(annual % change, unless noted)				
Real GDP	2.1	1.4	3.0	2.2	2.1
Consumer spending	2.9	2.3	3.4	2.6	2.0
Residential investment	3.7	3.4	3.0	1.2	0.4
Business investment	2.2	-8.8	2.5	4.1	2.5
Government	2.2	2.7	2.5	2.4	1.5
Exports	1.3	1.0	1.0	1.6	3.6
Imports	2.9	-1.0	3.6	3.0	2.5
Nominal GDP	4.2	2.0	5.3	4.5	4.5
GDP Deflator	2.1	0.6	2.3	2.2	2.4
Consumer price index (CPI)	1.9	1.4	1.6	2.2	2.3
CPI ex. food & energy	1.6	1.9	1.6	2.0	2.2
Pre-tax corporate profits	3.6	-1.9	20.2	6.0	1.0
Employment	1.3	0.7	1.9	1.3	1.0
Unemployment rate (%)	7.1	7.0	6.3	5.8	5.7
Current account balance (CAD bn)	-17.1	-65.4	-63.9	-58.6	-47.6
Merchandise trade balance (CAD bn)	25.1	-25.9	-23.9	-23.8	-16.0
Federal budget balance* (FY, CAD bn)	-2.8	-1.0	-17.8	-19.4	-15.1
percent of GDP	-0.2	0.0	-0.9	-0.9	-0.7
Housing starts (000s)	199	198	220	208	196
Motor vehicle sales (000s)	1,657	1,949	2,041	2,000	1,950
Industrial production	0.6	0.1	5.1	2.2	1.0
WTI oil (USD/bbl)	63	43	51	65	68
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.80	2.85

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg. * Canada ex risk adjustment of $1.5bn & $3.0bn for FY18 & FY19.

Canadian mineral processing and machinery manufacturing also continue to post robust gains, buoyed by ongoing growth in global business investment. Data from the OECD indicate that capital expenditures among the advanced OECD economies grew by 4% y/y in Q4-2017, the largest expansion since early 2014. In fact, capital expenditure has accounted for one-third of the growth in overall economic activity among industrialized nations over the past year; on average, capital expenditure usually contributes only about a fifth of total growth across the OECD. Preliminary industry data on global equipment sales point to ongoing momentum, led by a 40% y/y increase in Asia for February 2018.

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

NEAR-RECORD CAPACITY UTILIZATION POINTS TO INCREASED INVESTMENT

Monthly data for Canada also point to accelerating domestic machinery demand, driven by near-record industrial operating rates and strengthening business confidence. The advance in machinery orders is broadly-based, but is strongest for metalworking machinery, as well as construction and mining equipment. Industrial operating rates in Canada have jumped by 4.6 percentage points over the past year to 86%, one of the largest year-over-year increases on record (chart 5). The current rate is well above the 80.5% average operating rate of the last decade, which appears to reflect both high demand for Canadian industry's products and some reticence to invest in new capacity in export-intensive sectors that are dependent on NAFTA for trade with the US.

Outside of the auto sector, the order backlog at Canadian factories continued to deepen by 10% y/y in January 2018 even after the solid 4% annual production gains recorded in 2017; however, expansion in the order backlog has moderated from the more than 20% annualized rate recorded in the first half of 2017. Ongoing robust interest in Canadian-made machinery, owing to rising orders from the US market, as well as increased demand for chemicals and plastics, accounts for nearly half of the jump in the non-automotive order backlog over the past year—even though those sectors account for less than a quarter of total Canadian manufacturing activity.

Recent surveys of investment intentions remain mixed. In the Bank of Canada's Q1-2018 *Business Outlook Survey*, released on 9 April, 44% of firms expect to increase spending on machinery and equipment over the next twelve months, down modestly from 48% the previous quarter and well above the low of 26% in Q4-2015. In contrast, Statistics Canada's latest more broadly-based and detailed *Capital Expenditure Survey* details a fourth consecutive annual decline in Canadian business investment intentions on the way into 2018.

Actual investment data look stronger: tight capacity and ongoing gains in new orders prompted domestic businesses to boost capital expenditures by 8.6% y/y in Q4-2017. If uncertainty around NAFTA eases, we expect Canadian business investment to pick up further and lift full-year 2018 capital spending to its fastest growth in six years, led by export-intensive sectors in central Canada that have been running hot for a couple years.

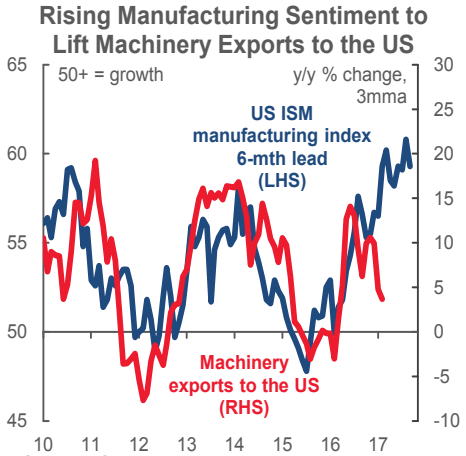
BUOYANT SPENDING TURNS FISCAL POLICY PRO-CYCLICAL

Across all levels of government, the already robust contributions of current and capital expenditures to Canada's real GDP are now expected to edge up to a combined 0.5 percentage points in 2018 (i.e., nearly a quarter of total economy-wide growth of 2.2%) and 0.3 percentage points in 2019. The extra boost stems from growth in provincial spending plans, particularly in Ontario's and Quebec's pro-cyclical pre-election budgets: we assume that some of the current governments' new spending will proceed even if power changes hands in the coming provincial votes. The upswing in provincial outlays that we have incorporated in our forecasts would be even higher were it not for (i) our usual caution that ambitious infrastructure agendas are unlikely to be fully implemented on their scheduled timeline; (ii) Alberta's decision to scale back its capital outlays by almost 30% during fiscal 2018–19; and, (iii) continued wage restraint and public service attrition in a couple of provinces.

This year's federal budget outlined new initiatives and incremental additional spending on existing initiatives that will more than reverse: (i) the reduction in expenditures in Ottawa's Fall Update; and (ii) the bottom-line improvements brought about by stronger GDP growth. This additional spending also shifts the composition of federal outlays from previous plans: for example, during fiscal 2018–19, planned infrastructure investment of CAD 1.9 bn is re-profiled to future years to allow current funds to be repurposed to support research & development and to provide incentives to increase female labour-force participation. Federal efforts to, amongst other things, explore the creation of a national pharmacare program are likely to shift overall provincial structural expenditures to a higher path over the next decade.

The challenges posed to Canadian competitiveness by the recent reform of US personal and corporate income taxes have so far elicited only limited responses from Canada's federal and provincial governments. A couple of provinces are engaged in streamlining regulatory burdens, particularly on environmental assessments, but we anticipate that further efforts to reinforce Canada's relative strengths will likely be required.

Chart 6



Sources: Scotiabank Economics, ISM, Statistics Canada.

EXPORT BOOST COMING FROM US STIMULUS, BUT TAKE-AWAY CAPACITY LIMITS OIL SHIPMENTS

Export growth was muted in Q4-2017 and is tracking weakly in Q1-2018 following an auto plant's closure for retooling in late-2017. Nevertheless, overall export growth is projected to accelerate from 1.0% in 2017 to 1.6% in 2018 (table 3). Canadian machinery manufacturing should particularly benefit from the increases in US business investment needed to relieve rapidly-rising capacity pressures in the US industrial sector, where some measures of confidence remain near their highest points since 2011 (chart 6). Labour market strength and rising household incomes in the US should also provide a boost to Canadian exports of consumer goods. Economic strength is not limited to the US, however: accelerating growth in Europe, Latin America, and India, with still-solid growth in China, should lift demand for Canadian industrial and consumer goods.

In 2017, exports of energy products rose by 10.7% y/y in volume terms, their fastest annual pace of growth since data have been available; however, this high growth rate has been primarily due to the sector's bounce-back from the 2016 Alberta wildfires. We anticipate slower volume growth over the coming 18–24 months. While output is growing, bottlenecks in the transportation of crude due to tight pipeline capacity (see our report *here*) have decreased the price received by producers and have prompted a widening in the price discount on western Canadian oil compared with the West Texas Intermediate (WTI) benchmark. While exports by rail may ease some of western Canada's take-away constraints, crude exports are pushing rail capacity in Canada to its limits and, in turn, displacing exports of other products: canola and wheat exports saw steep month-on-month declines in February owing to inadequate availability of railcars and engine sets.

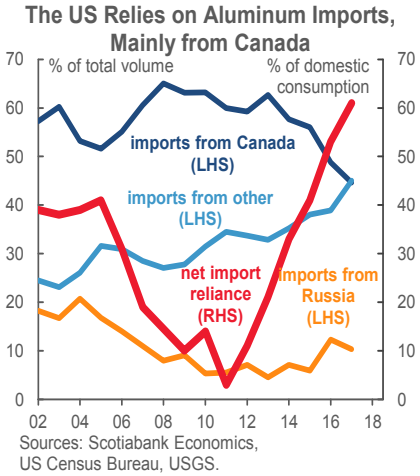
NAFTA RISK MAY BE RECEDING, BUT IT'S NOT OVER 'TIL IT'S OVER

The US administration appears newly eager to conclude an agreement-in-principle on a renegotiated and modernized NAFTA, with the possibility that a preliminary deal may be announced in the coming weeks or months. The recent rush appears to be driven in part by the US Trade Representative's (USTR) desire to show progress on NAFTA with Canada and Mexico ahead of the 1 May deadline to extend their exemptions from US steel and aluminum tariffs. The new urgency on NAFTA may also stem from a USTR desire to focus on the escalating trade conflict with China. An announcement of an agreement-in-principle on NAFTA would likely require some additional flexibility from the three parties that builds on recent progress on revising the auto-sector's rules of origin. The very modest revisions to the US-Korea Free Trade Agreement (KORUS) that were deemed a victory by the White House at end-March imply, however, that the bar for US Presidential satisfaction on a revised NAFTA may now be lower than previously supposed.

The threat that US tariffs on Canadian (and Mexican) steel and aluminum will be imposed if a NAFTA deal is not reached by end-April is only a modest stick to force closure on the talks. Canada alone provides about 16% of US steel imports and around 45% of US aluminium imports (chart 7): the US would find it somewhere between difficult and impossible to generate domestic

replacements for these imports in the short- to medium-term, if ever. As a result, the US would likely have to maintain imports of Canadian steel and aluminum with relatively modest changes, which implies that the burden of any tariffs imposed would fall mainly on US industry and consumers.

Chart 7



Sources: Scotiabank Economics, US Census Bureau, USGS.

When an agreement-in-principle is announced, a great deal of work will remain to conclude the negotiations and subject the final agreement to ratification in all three countries. For instance, US Congressional processes would require at least 195 days to proceed to a ratification vote on a modest set of revisions to the pact; more significant changes could require at least 285 days before a vote is called. In either case, the Congressional clock starts only once a final agreement—not an agreement-in-principle—has been concluded amongst the three countries' negotiators.

Canada and Mexico will need to use their newly-found leverage in the NAFTA talks with great judiciousness. Uncertainties about NAFTA will likely hang over Canadian business activity at least until a preliminary agreement is announced. But this uncertainty will not be fully eliminated until a final NAFTA text is agreed and ratified—and ratification will almost certainly stretch into 2019 despite the current urgency coming from the US Trade Representative to proceed more quickly. As the future of NAFTA becomes clearer, the Canadian real GDP growth rate could be raised by 10 bps in 2018 (table 2).

NEAR-TERM RISKS ABATING, LONG-TERM RISKS INTENSIFYING

Since our last quarterly *Global Outlook*, immediate risks to the Canadian economy have remained mixed. For the moment, very preliminary data imply that Canada's tight labour markets appear to be absorbing recent minimum wage increases, while these boosts to income are likely helping to improve household finances by shifting the low end of the wage distribution. At the same time, pressure in parts of the country's hottest housing markets has begun to recede, while increases in household indebtedness have started to level off as Canadians adjust to tighter mortgage standards and reassess their appetite for consumer debt.

The US tone on NAFTA has also turned more constructive, with the recent push for a quick conclusion to the talks representing a positive for Canada as it likely implies a respite from the chilling effect of NAFTA-related uncertainties and a relatively minimalist set of revisions to the pact. Pro-cyclical fiscal stimulus in both the US and Canada provides additional support to growth—but at the potential cost of more aggressive action by the countries' respective central banks, which is the typical catalyst to the end of very prolonged expansions. The rapidly-developing trade skirmish between the US and China could undo the synchronization of global growth just as it has taken hold.

Canada's medium-term prospects have, in contrast, dimmed somewhat. Canada's open economy is heavily dependent on trade, and tit-for-tat tariffs between the US and China, even if quickly unwound as such measures have been in the past, could slow Canadian growth more rapidly than we already anticipate. Scotiabank Economics' *Recession Probability Model* implies that the current low probability of a recession in Canada rises materially by 2021 when spillovers to Canada from the present US fiscal stimulus will have waned.

US policy reforms have eliminated Canada's corporate tax advantages compared with the US, while the federal and provincial governments have introduced a set of long-term policy shifts pointed towards greater environmental sustainability and social inclusion—including higher minimum wages, tighter rules on pay equity, carbon pricing, and more extensive project approval processes—that together could make Canada a relatively more complicated place to invest and do business compared with the US. Canada's attractiveness as a destination for foreign direct investment appears to have waned since 2015, nearly halving from CAD 58 bn in 2015 to CAD 31 bn in 2017. Weaker inward investment into energy and mining has accounted for a large share of the drop as volatile oil prices, combined with uncertainty about the sector's regulatory environment and take-away infrastructure, appear to have dented investor confidence in undertaking projects that require heavy front-end capital outlays. Inflows into the manufacturing sector also significantly slowed throughout 2016 and most of 2017, possibly on trade concerns, though they picked up late last year.

Competitiveness is more than sum of low tax rates and policy permissiveness, but Canada will likely need to do more in the years ahead to accentuate the full sweep of features that make it an attractive place to invest and work.

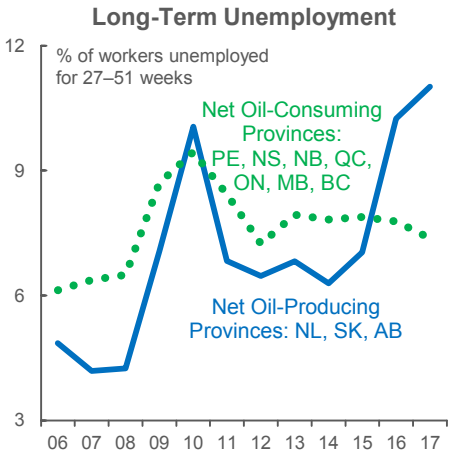
The Provinces

- **Alberta and British Columbia are expected to retain growth leadership through 2019. All provinces are forecast to post gains this year and next, though only two avoid the slower trend anticipated after the 2017 surge.**
- **For a second year, the Provinces project an aggregate deficit for fiscal 2017–18 (FY18) less than CAD 10 bn (0.4% of GDP). Spring *Budgets* forecast a combined deficit of up to CAD 17 bn for FY19, pending election outcomes this year in Ontario, New Brunswick and Quebec.**

SUSTAINING EXPANSION

For Canada's three major oil-producing provinces, a significant assist is anticipated from the steep gains forecast for WTI and Brent oil prices this year and the more moderate advance for Western Canadian Select prices for bitumen. This assumes, however, that at least two of the three major oil pipeline projects—the Line 3 refurbishment and either the Trans Mountain Expansion or Keystone XL—proceed as planned. Combined, the other seven provinces enter 2018 expanding faster than their underlying trend rates, with capacity constraints emerging. In these provinces, the share of longer-term unemployed has slid to levels not seen since 2012 (chart 1), and the fraction of part-time workers seeking full-time jobs in 2017 fell to a post-recession low.

Chart 1

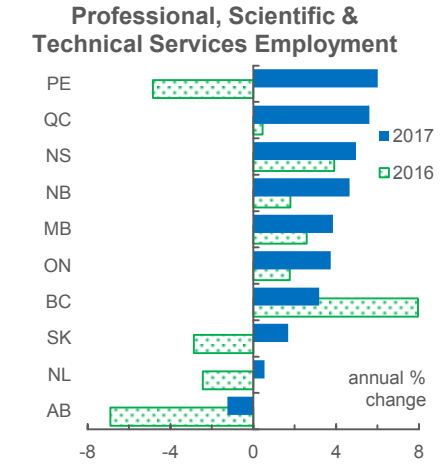


Sources: Scotiabank Economics, Statistics Canada.

Job creation across the seven oil-consuming provinces is expected to ease over the next two years from the robust 2017 pace. As growth moderates, it will take time to absorb the jump in full-time positions that approached or exceeded 2.0% in six provinces last year. Wage increases, as measured in several surveys, appear to be picking up in higher-growth areas reflecting skills shortages in some instances. In Central Canada, unemployment rates are at historic lows. The 2015–16 setback in Alberta's and Saskatchewan's wages that dampened national averages into early 2017 is reversing. The upward trend in minimum wages has steepened, reflecting double-digit increases in the four largest provinces since the end of 2016, and annual indexation in a number of other provinces providing gradual steady increases. Also boosting household incomes are job gains in high-wage industries such as professional, scientific & technical services, where weekly wages were 38% above the all-industry average in 2017, and employment rose in nine provinces (chart 2).

Core consumer price inflation in recent months has picked up in PEI, Nova Scotia, Manitoba and BC, and with the exception of Manitoba, services are a frequent source of higher prices. In coming quarters in regions witnessing above-trend growth, rising inflation is expected to diminish the real purchasing power of higher wages. On a sector-specific basis, unexpectedly strong housing starts last year plus elevated infrastructure investment are bolstering apartment construction costs apart from land prices (chart 3).

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

A gentle cooling characterizes our consumption and housing outlooks for most provinces given new mortgage restrictions, moderating job creation, debt burdens and rising interest rates. For the first time on record, six of the net oil-consuming provinces reported 2017 retail sales growth over 6%, a surge that is likely unsustainable. Motor vehicle unit sales are forecast to drop in seven provinces both this year and next (table 1) while less buoyant housing market activity is expected to constrain spending on other durables. Upbeat statistics for 2017, such as increased international visitors in seven provinces, affirm the rising trend in tourism receipts. Further gains should be

supported by the Canadian dollar averaging roughly 80¢(US) and multiple regional tourism investments, either completed or under way.

Housing affordability issues are expected to persist in and around British Columbia's largest cities and in Ontario's Greater Golden Horseshoe. More balanced housing markets, however, are anticipated for most other regions, with affordable ownership options and rental vacancy rates typically at or above the 3.0% threshold indicating supply matching demand. In Nova Scotia, an upswing in multi-units has accounted for 55% of housing starts over the last three years, transforming the Halifax skyline and leaving sufficient inventory to drop provincial starts back below 4,000 units annually through 2019. In Quebec City, average residential transaction prices have been virtually flat since 2013, but Montreal witnessed a 5.5% jump in house prices in 2017, mirroring the CMA's strong job creation and the Province's significant personal tax relief. Inventories of completed and unsold housing units, built up since the 2014 commodity price correction, remain elevated in Calgary, Edmonton and Saskatoon, and to a lesser extent in Regina. This inventory is expected to forestall new residential construction and limit price gains, even as housing demand firms.

The projected recovery in business investment this year will be concentrated among the oil-consuming provinces and in machinery & equipment (M&E). Statistics Canada's capital investment intentions survey indicated a 4.2% rebound in nominal M&E purchases for the net oil-consuming provinces (chart 4). This may well understate the eventual increase given reported capacity constraints, particularly in Central Canada and British Columbia, and the anticipated market opportunities. The expected upswing in M&E investment in the oil-consuming provinces is corroborated by the late 2017 spike in industrial machinery imports, and the surge last year in domestic machinery orders and shipments.

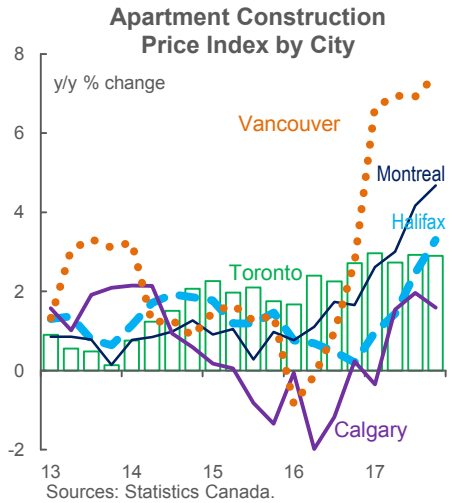
Business investment activity across the three oil-producing provinces, after three years of substantial declines, is unlikely to begin regaining lost ground until 2019–20. While their M&E purchases are expected to stabilize over the next year and western Canada's conventional oil & gas exploration remains buoyant, new oil sands construction is more limited after recent major capacity additions and the completion of Hebron, Newfoundland and Labrador's fourth offshore oil field. Apart from the oil & gas sector, non-residential construction is expected to advance this year in areas such as commercial development, pipelines, and utilities.

As in 2017, net exports in 2018 are expected to support the three oil-producing provinces' expansion. Their imports will be constrained by their subdued business investment plans as their oil production continues to climb, albeit with some easing from last year's gains. For non-energy exports, BC should continue to benefit from its strong Asian ties (chart 5) and the Comprehensive Economic and Trade Agreement with the EU offers opportunity for all regions. In Ontario, net exports are posing a drag on growth. As the province's domestic spending strength pushes Ontario's imports higher, the forecast 7½% decline in motor vehicles assembled will detract from the anticipated gains in areas such as machinery.

POTENTIAL DIVERGENCE IN PROVINCIAL FISCAL PATHS

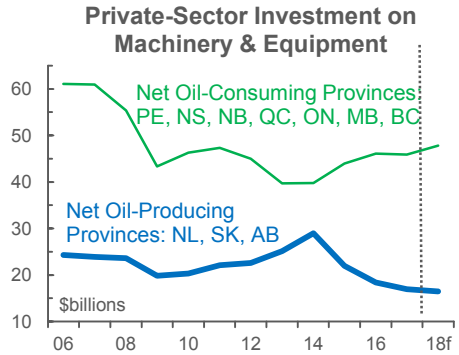
The Provinces' wider FY19 aggregate deficit is primarily due to BC's and Quebec's more modest surpluses and Ontario's CAD 6.7 bn deficit, though upcoming Central Canada elections could alter the forecast (chart 6). Deficit reduction by the three oil-

Chart 3



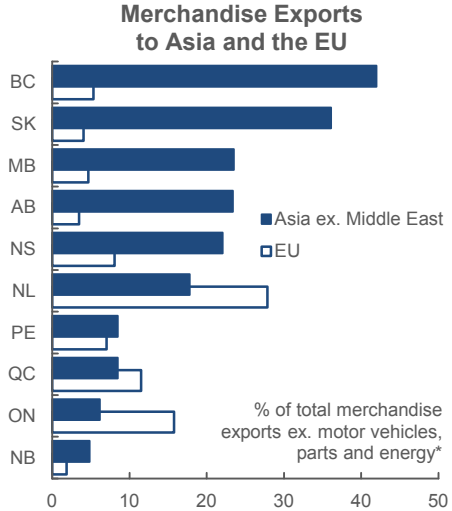
Sources: Statistics Canada.

Chart 4



Sources: Statistics Canada, *Capital & Repair Expenditures Survey*.

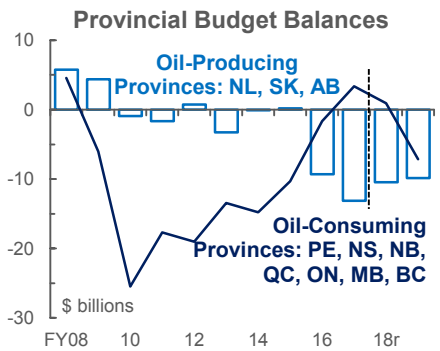
Chart 5



* Oil & gas, power and motor vehicles & parts exports largely destined for the US market.
Sources: Scotiabank Economics, Industry Canada.

producing Provinces continues, with a forecast CAD 3 bn (-25%) improvement since FY17. New *Budget* priorities this year include: raising child care availability and affordability; expanding lower-price rental housing supply; reinforcing immigrant attraction and retention efforts; and broadening innovation, in addition to each region's participation in Ottawa's selected superclusters on oceans, AI, advanced manufacturing, protein industries and digital technology. Challenges include the rising amortization and interest charges resulting from several consecutive years of stepped-up infrastructure investment and employee remuneration demands after lengthy restraint.

Chart 6



Source: *Budget* documents.

Table 1

The Provinces											(annual % change except where noted)
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000–16	2.1	2.5	1.7	1.3	1.2	1.7	2.0	2.3	2.0	2.7	2.8
2016	1.4	1.9	2.3	0.8	1.2	1.4	2.6	2.2	-0.5	-3.7	3.5
2017e	3.0	-1.5	2.2	1.6	1.4	2.8	2.9	2.3	1.9	4.3	3.5
2018f	2.2	0.5	1.8	1.4	1.0	2.1	2.1	2.0	1.8	2.5	2.6
2019f	2.1	1.2	1.6	1.0	0.7	1.9	2.0	1.8	2.0	2.3	2.4
Nominal GDP											
2000–16	4.2	5.6	4.2	3.4	3.3	3.6	3.8	4.4	5.3	5.9	4.5
2016	2.0	2.6	4.0	2.8	3.6	2.7	4.3	2.3	-4.0	-4.9	4.8
2017e	5.3	3.1	4.0	3.2	3.0	4.2	5.1	4.0	4.8	7.6	5.6
2018f	4.5	3.6	3.6	3.1	2.7	4.0	4.5	3.9	3.8	5.3	4.8
2019f	4.5	4.5	3.6	2.9	2.4	4.1	4.4	3.6	4.3	5.3	4.8
Employment											
2000–16	1.3	0.8	1.0	0.6	0.4	1.3	1.3	0.9	1.1	2.3	1.4
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017	1.9	-3.7	3.1	0.6	0.4	2.2	1.8	1.7	-0.2	1.0	3.7
2018f	1.3	-0.8	1.5	0.5	0.3	1.5	1.5	0.6	0.4	1.5	1.6
2019f	1.0	-0.5	0.8	0.2	0.1	0.8	1.0	0.6	0.6	1.1	1.2
Unemployment Rate (%)											
2000–16	7.1	14.3	11.2	8.8	9.6	8.0	7.1	5.1	5.0	5.1	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
2017	6.3	14.8	9.8	8.4	8.1	6.1	6.0	5.4	6.3	7.8	5.1
2018f	5.8	14.9	9.9	8.2	8.0	5.5	5.5	5.3	5.8	7.0	4.8
2019f	5.7	15.0	10.0	8.0	8.0	5.4	5.4	5.2	5.7	6.9	4.8
Housing Starts (units, 000s)											
2000–16	199	2.6	0.7	4.3	3.5	44	71	5.1	5.2	34	28
2016	198	1.4	0.6	3.8	1.8	39	75	5.3	4.8	25	42
2017	220	1.4	0.9	4.0	2.3	46	79	7.5	4.9	29	44
2018f	208	1.3	0.9	3.8	2.1	42	77	6.3	5.0	28	42
2019f	196	1.3	0.8	3.8	2.1	38	71	6.3	5.0	30	38
Motor Vehicle Sales (units, 000s)											
2000–16	1,657	29	6	48	38	413	635	47	45	216	180
2016	1,949	33	9	54	44	458	807	55	51	220	218
2017	2,041	33	9	59	42	453	847	62	56	245	235
2018f	2,000	32	8	58	40	445	821	61	56	248	231
2019f	1,950	30	8	56	39	434	791	60	56	250	226
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–16*	-2,803	-93	-38	-30	-153	-768	-5,115	-142	307	1,064	319
2016	-987	-2,206	-13	-13	-261	2,191	-3,515	-839	-1,520	-6,442	811
2017	-17,770	-1,148	-1	150	-119	2,361	-991	-764	-1,218	-10,784	2,737
2018f**	-19,400	-812	1	134	-115	850	642	-726	-595	-9,066	151
2019f	-15,100	-683	1	29	-189	0	-6,704	-521	-365	-8,802	219

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents. * MB:FY04–FY16; AB:FY05–FY16. ** Federal & Provinces' FY18 & FY19: Budget documents. Federal FY19: ex risk adjustment of $3.0bn.