Monetary Policy Report

July 2023

Canada's inflation-control strategy

Inflation targeting and the economy

- The objective of Canada's monetary policy is to promote the economic and financial well-being of Canadians. Canada's experience with inflation targeting since 1991 has shown that the best way that monetary policy can achieve this goal is by maintaining a low and stable inflation environment. Doing so fosters confidence in the value of money and contributes to sustained economic growth, a strong and inclusive labour market and improved living standards.
- In 2021, the Government of Canada and the Bank of Canada renewed the flexible inflation-targeting strategy of the monetary policy framework for a further five-year period, ending December 31, 2026.[1]
- The inflation target was renewed at the 2% midpoint of the 1%–3% control range, with inflation measured as the 12-month rate of change in the consumer price index (CPI).
- The Government and the Bank agreed that the best contribution monetary policy can make to the economic and financial well-being of Canadians is to continue to focus on price stability. The Government and the Bank also agreed that monetary policy should continue to support maximum sustainable employment, recognizing that maximum sustainable employment is not directly measurable and is determined largely by non-monetary factors that can change through time.
- Further, the Government and the Bank agreed that because well-anchored inflation expectations are critical to achieving both price stability and maximum sustainable employment, the primary objective of monetary policy is to maintain low, stable inflation over time.

Inflation targeting is *symmetric* and *flexible*

- Canada's inflation-targeting approach is *symmetric*, which means the Bank is equally concerned about inflation rising above or falling below the 2% target.
- Canada's inflation-targeting approach is also *flexible*. Typically, the Bank seeks to return inflation to target over a horizon of six to eight quarters. However, the most appropriate horizon for returning inflation to target will vary depending on the nature and persistence of the shocks buffeting the economy.
- The 2021 agreement with the Government specifies that the 2% inflation target remains the cornerstone of the framework.
- The agreement further notes that the Bank will continue to use the flexibility of the 1%–3% control range to actively seek the maximum sustainable level of employment, when conditions warrant. The Bank will also continue to leverage the flexibility inherent in the framework to help address the challenges of structurally low interest rates by using a broad set of policy tools. The Bank will use this flexibility only to an extent that is consistent with keeping medium-term inflation expectations well anchored at 2%.

Monetary policy tools

- Because monetary policy actions take time to work their way through the economy and have their full effect on inflation, monetary policy must be forward-looking.
- The Bank normally carries out monetary policy through changes in the target for the overnight rate of interest (the policy rate). The Bank also has a range of monetary policy tools it can use when the policy rate is at very low levels. These tools consist of guidance on the future evolution of the policy rate, large-scale asset purchases (quantitative easing and credit easing), funding for credit measures, and negative policy rates. The potential use and sequencing of these tools would depend on the economic and financial market context.
- All of the Bank's monetary policy tools affect total demand for Canadian goods and services through their influence on market interest rates, domestic asset prices and the exchange rate. The balance between this demand and the economy's production capacity is, over time, the main factor that determines inflation pressures in the economy.

Communications

- Consistent with its commitment to clear, transparent communications, the Bank regularly reports its perspectives on the economy and inflation. Policy decisions are typically announced on eight pre-set days during the year, and full updates to the Bank's outlook are published four times each year in the *Monetary Policy Report*.
- The Bank is committed to explaining when it is using the flexibility of the inflation-targeting strategy.
- Given the uncertainty about the maximum sustainable level of employment, the Bank will consider a broad range of labour market indicators.[2] The Bank will also systematically report to Canadians on how labour market outcomes have factored into its policy decisions.

Monitoring inflation

- In the short run, the prices of certain CPI components can be particularly volatile and can cause sizable fluctuations in CPI inflation.
- In setting monetary policy, the Bank seeks to look through such transitory movements in CPI inflation and focuses on "core" inflation measures that better reflect the underlying trend of inflation. In this sense, these measures act as an operational guide to help the Bank achieve the CPI inflation target. They are not a replacement for CPI inflation.
- The Bank's two preferred measures of core inflation are CPI-trim, which excludes CPI components whose rates of change in a given month are the most extreme, and CPI-median, which corresponds to the price change located at the 50th percentile (in terms of basket weight) of the distribution of price changes.

1 For more details, see *Joint Statement of the Government of Canada and the Bank of Canada on the Renewal of the Monetary Policy Framework* (December 13, 2021); *Monetary Policy Framework Renewal—December 2021;* and T. Macklem, "Our Monetary Policy Framework: Continuity, Clarity and Commitment" (speech to the Empire Club of Canada, Toronto, December 15, 2021).

2 See, for example, the range of indicators that the Bank is using to track the recovery of the labour market from the effects of the COVID-19 pandemic.

The *Monetary Policy Report* is available on the Bank of Canada's website at bankofcanada.ca.

For further information, contact:

Public Information
Communications Department
Bank of Canada
234 Wellington Street
Ottawa, Ontario K1A 0G9

Telephone: 613-782-8111;
1-800-303-1282 (toll-free in North America)
Email: info@bankofcanada.ca Website: bankofcanada.ca

ISSN 1201-8783 (Print)
ISSN 1490-1234 (Online)
© Bank of Canada 2023

BANK OF CANADA
BANQUE DU CANADA

Monetary Policy Report

July 2023

This is a report of the Governing Council of the Bank of Canada:
Tiff Macklem, Carolyn Rogers, Paul Beaudry, Toni Gravelle, Sharon Kozicki and Nicolas Vincent

Contents

Overview 1

Global economy 2

Tighter financial conditions 3

Box 1: Key inputs to the projection 4

Persistent inflation 4

Buoyant but slowing US economy 6

Weak growth in the euro area 6

Slow growth in China after surge 6

Lower oil prices 7

Canadian economy 8

Persistent inflationary pressures 9

Surprisingly strong demand 11

Tight labour market with some signs of easing 12

Slowing demand growth and rising supply 14

Box 2: Revised outlook for inflation and economic activity 15

Box 3: Household financial health 18

Inflation at target in 2025 20

Risks to the inflation outlook 23

Main upside risks 23

Main downside risks 24

Overview

Inflation continues to fall globally, but core inflation in major economies remains elevated. In response, several central banks have raised—or signalled they will raise—their policy rates further.

Global economic growth in the first half of 2023 was stronger than had been expected at the beginning of the year, with surprisingly robust US consumption growth. Growth in global demand should moderate over the next year due to monetary policy tightening and a slowdown in China.

In Canada, inflation has continued to come down. Consumer price index (CPI) inflation was 3.4% in May. This represents significant progress toward price stability over the past year as inflation has steadily dropped from a high of 8.1% last summer.

However, the downward momentum in inflation is slowing, largely because demand in Canada continues to outpace supply. Household spending has been robust, supported by strong demand for labour, population growth and accumulated household savings. Housing resales and house prices have picked up. At the same time, business investment is softening. Labour market conditions remain tight but appear to be easing.

Growth in gross domestic product (GDP) is projected to slow, averaging about 1% in the second half of this year and the first half of next year. This implies GDP growth of 1.8% in 2023 and 1.2% in 2024. As the cumulative interest rate increases work their way through the economy, they will weigh on household spending and business investment. Weak foreign demand is also expected to slow export growth. GDP growth is projected to gradually pick up starting in the second half of 2024, reaching 2.4% in 2025.

Inflation is now projected to remain around 3% over the next year. As excess demand dissipates and labour market conditions ease, inflation gradually returns to the 2% target in the middle of 2025. This is about two quarters later than forecast in the January and April reports.

A considerable amount of uncertainty surrounds the forecast, particularly into 2024 and 2025. Three-month rates of core inflation have stayed in the 3½% to 4% range for some time. While near-term inflation expectations are easing, they remain high. And excess demand has been more persistent than expected. All this suggests increased risk that the progress toward price stability could stall.

Global economy

Inflation continues to fall in most regions, but core inflation—especially for services—is proving to be stubborn. Tight labour markets, robust consumer demand and elevated inflation expectations are generating persistent inflationary pressures in many economies. In response, several major central banks have raised their policy rates further or signalled more increases are likely.

Global economic growth has been stronger than expected. This is especially the case in the United States, Canada's largest trading partner. US consumer spending has been surprisingly strong because households continued to draw down savings accumulated during the pandemic, and a tight labour market has supported incomes. US business investment has also been unexpectedly robust. In contrast, economic growth in the euro area has been weak, largely as expected.

Over the next year, global economic growth is projected to slow as monetary policy further restricts demand. In the United States, fiscal policy restraint and reduced spending from pandemic-related savings also weigh on demand growth. At the same time, the pace of economic activity in China is expected to slow as the boost from the lifting of pandemic restrictions wanes and growth of external demand moderates. Global growth is projected to pick up modestly in the second half of 2024 before strengthening in 2025, as the effects of higher interest rates on economic growth dissipate (**Table 1**).

Inflation is projected to ease as demand growth slows. Lower goods price inflation leads this decline, while services price inflation adjusts more gradually. By the end of 2025, inflation is projected to approach central bank targets. However, the speed of this decline remains uncertain.

Table 1: Projection for global economic growth

	Share of real global GDP* (%)	Projected growth† (%)			
		2022	2023	2024	2025
United States	16	2.1 (2.1)	1.8 (1.3)	0.6 (0.4)	1.4 (1.8)
Euro area	12	3.5 (3.5)	0.3 (0.7)	1.0 (0.5)	1.5 (1.5)
Japan	4	1.0 (1.0)	1.3 (0.9)	0.9 (1.2)	1.2 (1.3)
China	19	3.0 (3.0)	5.5 (5.7)	4.7 (4.7)	4.3 (4.2)
Oil-importing EMEs‡	33	4.3 (4.4)	3.6 (3.0)	3.0 (2.7)	3.6 (3.6)
Rest of the world§	17	3.5 (3.3)	1.4 (1.3)	1.4 (1.2)	1.7 (1.7)
World	100	3.4 (3.4)	2.8 (2.6)	2.4 (2.1)	2.7 (2.8)

* Shares of gross domestic product (GDP) are based on International Monetary Fund (IMF) estimates of the purchasing-power-parity valuation of country GDPs for 2021 from the IMF's October 2022 *World Economic Outlook*. The individual shares may not add up to 100 due to rounding.

† Numbers in parentheses are projections used in the April Report.

‡ The oil-importing emerging-market economies (EMEs) grouping excludes China. It is composed of large EMEs from Asia, Latin America, the Middle East, Europe and Africa (such as India, Brazil and South Africa) as well as newly industrialized economies (such as South Korea).

§ "Rest of the world" is a grouping of other economies not included in the first five regions. It is composed of oil-exporting EMEs (such as Russia, Nigeria and Saudi Arabia) and other advanced economies (such as Canada, the United Kingdom and Australia).

Sources: National sources via Haver Analytics and Bank of Canada calculations and projections

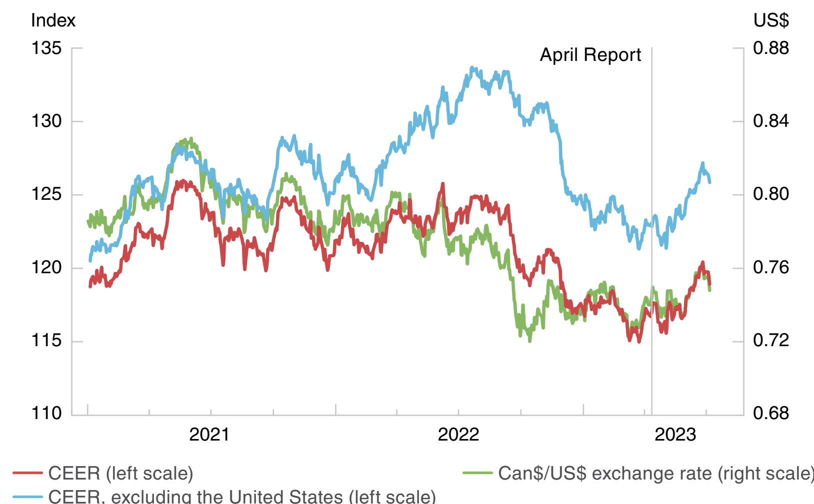
Financial conditions tightened modestly

Global financial conditions are now modestly tighter than they were at the start of the year. Yields on government bonds across advanced economies have risen as central banks have increased policy rates and markets have priced in a more prolonged tightening. Equity returns have risen, mostly driven by a small number of technology stocks.

The value of the Canadian dollar is little changed against its US counterpart, but it has appreciated against a broader basket of currencies (**Chart 1** and **Box 1**).

Chart 1: The Canadian dollar is little changed against its US counterpart

Canadian exchange rates, daily data



Note: CEER is the Canadian Effective Exchange Rate index—a weighted average of bilateral exchange rates for the Canadian dollar against the currencies of Canada's major trading partners.

Sources: Bloomberg Finance L.P. and Bank of Canada calculations

Last observation: July 6, 2023

Box 1

Key inputs to the projection

The Bank of Canada's projection is conditional on several key inputs and assumptions about their future path. The Bank regularly reviews these assumptions and adjusts the economic projection accordingly. The key inputs to the Bank's projection are as follows:

- Oil prices are lower than in the April Report. Over the projection horizon, the per-barrel prices in US dollars are assumed to be $80 for Brent, $75 for West Texas Intermediate and $60 for Western Canadian Select. These prices are all $5 lower than in the April Report.
- By convention, the Bank does not forecast the exchange rate in the *Monetary Policy Report*. The Canadian dollar is assumed to remain at 75 cents US over the projection horizon, close to its recent average and roughly unchanged relative to the April Report.
- Potential output growth in Canada is expected to increase from 1.4% in 2022 to about 2% per year over the projection horizon.
- Real gross domestic product (GDP) is estimated to have grown at about 1.5% in the second quarter of 2023, below potential output growth. As a result, the Bank estimates that the output gap is between 0% and 1% in the second quarter. This is slightly less excess demand than estimated for the first quarter.[1]
- The projection incorporates information from all provincial and federal budgets available at the time of writing. Government spending is growing by about 2% per year, contributing 0.5 percentage points on average to GDP growth over the projection horizon.
- The nominal neutral interest rate in Canada is estimated to be in the range of 2% to 3%.[2] The economic projection assumes that the neutral rate is at the midpoint of this range.

1 The estimate for the output gap for the first quarter of 2023 is 0.25% to 1.25%, unchanged from the estimate in the April Report.

2 The nominal neutral interest rate is defined as the real neutral rate plus 2% for inflation. The real neutral rate is the rate consistent with both output remaining sustainably at its potential and inflation remaining at target on an ongoing basis. It is a medium- to long-term equilibrium concept. For more details, see J. Champagne, C. Hajzler, D. Matveev, H. Melinchuk, A. Poulin-Moore, G. K. Ozhan, Y. Park and T. Taskin, "Potential output and the neutral rate in Canada: 2023 assessment," Bank of Canada Staff Analytical Note No. 2023-6 (May 2023); and S. Ahmed, A. Avshalumov, T. Chaar, E. Ekanayake, H. Lao, L. Poirier, J. Rolland-Mills, A. Toktamyssov and L. Xiang, "Assessing global potential output growth and the US neutral rate: April 2023," Bank of Canada Staff Analytical Note No. 2023-5 (May 2023).

Persistent inflation

Inflation has been declining due to falling energy prices, easing supply constraints and tighter monetary policy. However, core inflation is not yet on a firm downward trend (**Chart 2**). In many countries, high core inflation reflects persistently strong inflation in core services prices.

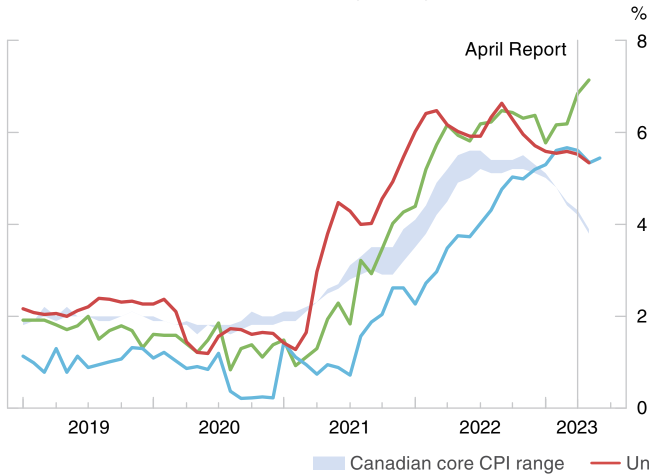
Over the projection horizon, inflation is expected to ease toward central bank targets in response to tighter monetary conditions and the resulting slowdown in demand growth. This pace of adjustment reflects the sluggish response of prices for services. Strong demand for services (**Chart 3**, panel a), tight labour markets and elevated expectations for near-term inflation are all keeping services price inflation stubbornly high.

In contrast, inflation in core goods prices is expected to come down faster. Demand for manufactured goods is relatively soft (**Chart 3**, panel b), energy prices have declined, and supply chain challenges have been dissipating.

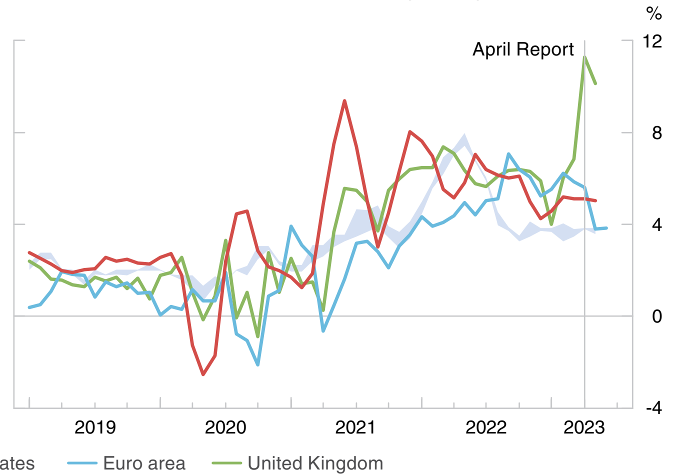
Chart 2: Core inflation remains high in many economies

Monthly data

a. Core inflation, year-over-year percentage change



b. Core inflation, 3-month annualized percentage change



Canadian core CPI range — United States — Euro area — United Kingdom

Note: The rate of inflation is calculated based on the Harmonised Index of Consumer Prices for the euro area and the consumer price index (CPI) for all other countries. The Canadian core CPI is a range of CPI-trim and CPI-median. Data are seasonally adjusted except for the euro area, United States and United Kingdom in panel a. For panel b, Bank of Canada staff calculated the seasonal adjustment of the United Kingdom series.

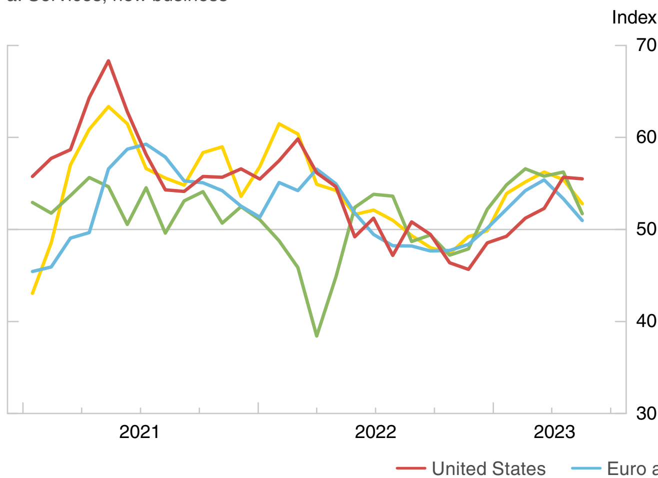
Sources: Statistics Canada, US Bureau of Economic Analysis, Eurostat and Office for National Statistics (United Kingdom) via Haver Analytics and Bank of Canada calculations

Last observations: euro area, June 2023; others, May 2023

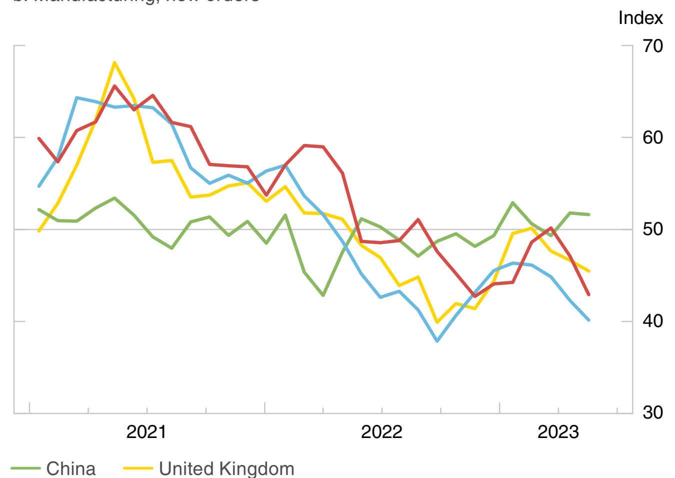
Chart 3: Demand is elevated for services but weak for goods

Purchasing Managers' Index, monthly data

a. Services, new business



b. Manufacturing, new orders



— United States — Euro area — China — United Kingdom

Note: The Purchasing Managers' Index (PMI) is a diffusion index of business conditions. A reading above (below) 50 indicates an improvement (a deterioration) in overall business conditions compared with the previous month. For China, the PMI is based on the Caixin index.

Source: S&P Global via Haver Analytics

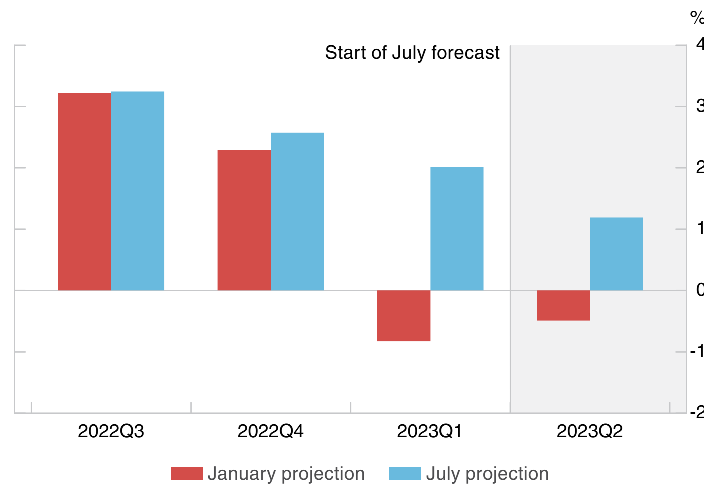
Last observation: June 2023

Buoyant but slowing US economy

Despite the surprising strength of US consumption and investment spending during the first half of 2023, economic growth in the United States is slowing (**Chart 4**). Growth is projected to stall in the first half of 2024 due to restrictive monetary conditions, tighter fiscal policy and less support from accumulated savings. As spending wanes, unemployment starts to rise and wage growth eases. Slowing US economic activity and the rebalancing in consumption away from goods toward services are projected to weaken demand for imports, including from Canada. In the second half of 2024 and in 2025, US economic growth increases as the impact of tightening of monetary policy fades.

Chart 4: US output growth is slowing but has been stronger than expected

US real GDP growth, quarterly, at annual rates



Sources: US Bureau of Economic Analysis and Bank of Canada calculations and projections
Last data plotted: 2023Q2

Weak growth in the euro area

Economic growth in the euro area effectively stalled over the first half of the year. Weak consumer sentiment, declining purchasing power and the tightening of monetary policy are weighing on domestic demand. The manufacturing sector is contracting as foreign demand for goods is slowing. At the same time, activity in the services sector has been robust as households continue to catch up on services they missed out on during the pandemic.

Economic growth is projected to remain weak through mid-2024 as monetary policy continues to dampen demand and bring inflation back toward the European Central Bank's target. Growth then strengthens in 2025.

Slow growth in China after surge

After surging earlier in the year, China's growth is slowing. The rebound in activity in the services sector that followed the lifting of COVID-19 restrictions resulted in a more rapid pickup in growth than had been expected earlier this year. But the rebound is now fading faster than previously projected. Slowing

global growth is weighing on exports, especially of manufactured goods, and domestic confidence is low. Additionally, the property sector remains weakened by past overbuilding.

In the projection, policy easing is assumed to provide some support to the economy through 2024. Growth slows in 2025 due to a shrinking workforce and slowing business investment.

Lower oil prices

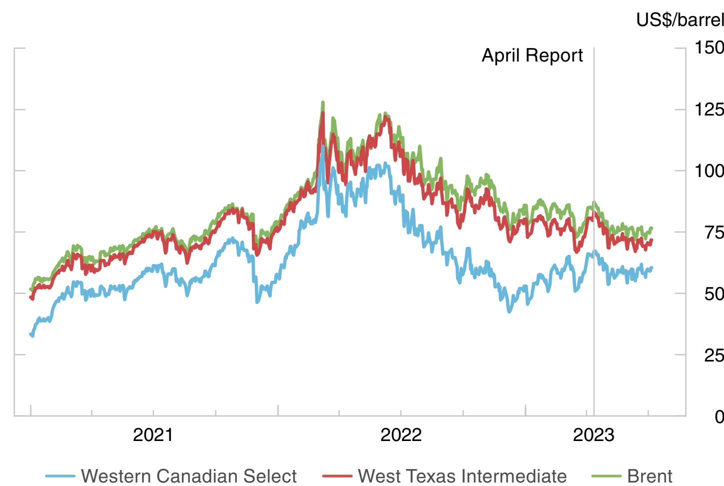
Oil prices have declined further over the past three months, with the price of Brent oil generally around US$75 per barrel (**Chart 5**). The fall in oil prices largely reflects market concerns that weakness in future global industrial activity will restrain demand.

However, oil prices would likely rise if demand evolved in line with the Bank of Canada's projection for global growth and oil supply did not keep up. To better balance these risks, the Bank assumes Brent oil prices to be US$80 per barrel over the projection.

Natural gas prices have been relatively stable for several months compared with the volatility in 2022. Base metal prices have fallen, mostly in response to weak activity in China's housing market and industrial sector. Other non-energy commodity prices are roughly unchanged.

Chart 5: Oil prices have declined recently

Daily data



Sources: Kalibrate Canada Inc., NYMEX and Intercontinental Exchange via Haver Analytics
Last observation: July 6, 2023

Canadian economy

Considerable progress has been made in the Bank's efforts to return inflation back to the 2% target. Inflation fell from a peak of 8.1% last summer to 3.4% in May 2023.

Economic activity—especially household spending—has proven surprisingly strong, supported by tight labour markets, rapid population growth and the high level of accumulated household savings.[1] Consumption growth in the first quarter of 2023, at 5.8%, was stronger than expected. This strength was observed both in goods that are sensitive to interest rates and in services. Housing resales and house prices also picked up earlier than anticipated. At the same time, the labour market remained tight, having eased only mildly since the beginning of the year.

Economic growth is projected to moderate to an average of about 1% through the second half of 2023 and the first half of 2024 (**Table 2** and **Table 3**). This slowdown results from the effects of higher interest rates on household spending and business investment as well as the fading of some temporary factors. Weak foreign demand also restrains export growth. In the second half of 2024, GDP growth is expected to pick up as the effect of higher interest rates on economic growth dissipates. Foreign demand also strengthens, boosting exports.

Going forward, further easing of inflation will likely take longer than expected in previous reports, with inflation projected to remain near 3% for the next year. Greater excess demand and more stubborn core inflation are sustaining underlying price pressures. Tight monetary policy weighs on demand growth, and the economy is projected to enter into mild excess supply in the beginning of 2024. Inflation should then ease, reaching the 2% target in the middle of 2025. The return of inflation to target is expected to occur two quarters later than previously projected.

1 In this Report, the Bank compares its most recent outlook with that from the January 2023 Report. This longer time frame provides a better perspective on the accumulated evidence of how the economy and inflation have evolved. The projections from the April Report are provided in **Table 2** and **Table 3**.

Table 2: Contributions to average annual real GDP growth
Percentage points*†

	2022	2023	2024	2025
Consumption	2.5 (2.6)	1.5 (1.1)	0.7 (0.5)	1.1 (1.2)
Housing	-1.1 (-1.1)	-0.8 (-0.8)	0.5 (0.4)	0.6 (0.4)
Government	0.5 (0.5)	0.5 (0.6)	0.6 (0.5)	0.4 (0.5)
Business fixed investment	0.7 (0.7)	0.0 (0.1)	0.1 (0.0)	0.4 (0.5)
Subtotal: final domestic demand	2.6 (2.6)	1.2 (1.0)	1.9 (1.4)	2.5 (2.6)
Exports	0.9 (0.9)	1.6 (1.4)	0.0 (0.3)	0.7 (1.0)
Imports	-2.4 (-2.3)	0.4 (0.2)	-0.7 (-0.5)	-0.7 (-0.8)
Inventories	2.3 (2.2)	-1.4 (-1.2)	0.0 (0.1)	-0.1 (-0.3)
GDP	3.4 (3.4)	1.8 (1.4)	1.2 (1.3)	2.4 (2.5)
Memo items (percentage change):				
Range for potential output	0.5–2.0 (0.5–2.0)	1.4–3.2 (1.4–3.2)	1.0–3.2 (1.0–3.2)	1.2–2.8 (1.2–2.8)
Real gross domestic income (GDI)	5.1 (5.1)	-1.2 (-0.2)	1.0 (0.5)	2.1 (1.9)
CPI inflation	6.8 (6.8)	3.7 (3.5)	2.5 (2.3)	2.1 (2.1)

* Numbers in parentheses are projections used in the April Report.
† Numbers may not add to total due to rounding.
Sources: Statistics Canada and Bank of Canada calculations and projections

Table 3: Summary of the quarterly projection for Canada*

	2022	2023				2022	2023	2024	2025
	Q4	Q1	Q2	Q3		Q4	Q4	Q4	Q4
CPI inflation (year-over-year percentage change)	6.7 (6.7)	5.2 (5.2)	3.6 (3.3)	3.3		6.7 (6.7)	2.9 (2.5)	2.2 (2.1)	2.1 (2.0)
Real GDP (year-over-year percentage change)	2.1 (2.1)	2.2 (2.0)	1.7 (1.4)	1.5		2.1 (2.1)	1.8 (1.1)	1.5 (1.9)	2.5 (2.6)
Real GDP (quarter-over-quarter percentage change at annual rates)†	-0.1 (0.0)	3.1 (2.3)	1.5 (1.0)	1.5					

* Details on the key inputs to the base-case projection are provided in **Box 1**. Numbers in parentheses are from the projection in the April report.
† Over the projection horizon, 2023Q2 and 2023Q3 are the only quarters for which some information about real GDP growth was available at the time the projection was conducted. For longer horizons, fourth-quarter-over-fourth-quarter percentage changes are presented. They show the Bank's projected growth rates of CPI and real GDP within a given year. As a result, they can differ from the growth rates of annual averages shown in **Table 2**.
Sources: Statistics Canada and Bank of Canada calculations and projections

Persistent inflationary pressures

CPI inflation in Canada has declined from 8.1% in June 2022 to 3.4% in May. Inflation has been easing with lower energy prices, improvements in global supply chains and the effects of higher interest rates moving through the economy. In recent months, rising refinery margins have mitigated some of the impact of lower oil prices on inflation. Because energy prices in particular can cause significant volatility in inflation, gauging underlying inflationary pressures by examining measures of core inflation is useful.

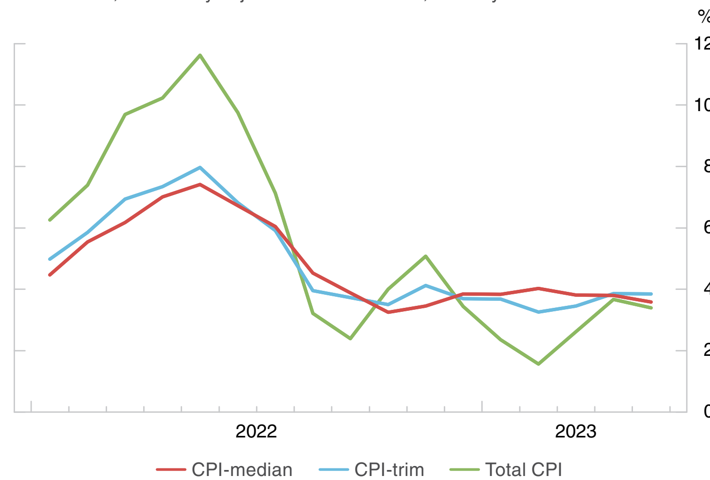
Core inflation continues to edge down, but that is due largely to base-year effects as the large price increases from last spring drop from the year-over-year calculations. In contrast, three-month rates of core inflation have stalled in the range of 3½% to 4% since September 2022 (**Chart 6**), which is almost 1 percentage point above the Bank's expectations in January.

Other three-month rates of inflation show a similar pattern, with little to no progress since the summer of 2022 (**Chart 7**).

The stubbornness of core inflation in Canada suggests that inflation may be more persistent than originally thought. A similar pattern exists in other economies.

Chart 6: Downward momentum in core inflation has stalled

3-month rates of inflation, seasonally adjusted at annual rates, monthly data

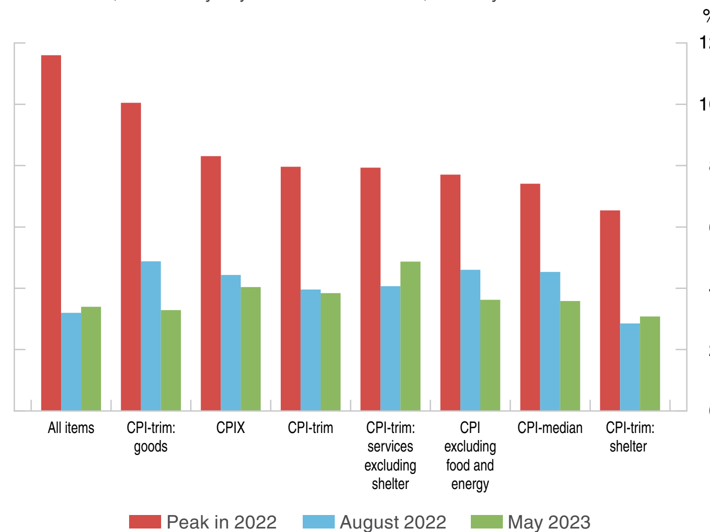


Sources: Statistics Canada and Bank of Canada calculations

Last observation: May 2023

Chart 7: Disinflation for many CPI aggregates shows little progress since August 2022

3-month rates of inflation, seasonally adjusted at annual rates, monthly data



Note: For background on various CPI measures, see the Bank's website. "CPI-trim: goods," "CPI-trim: services excluding shelter" and "CPI-trim: shelter" categorize the price changes that contribute to CPI-trim each month.

Sources: Statistics Canada and Bank of Canada calculations

Last observation: May 2023

Surprisingly strong demand

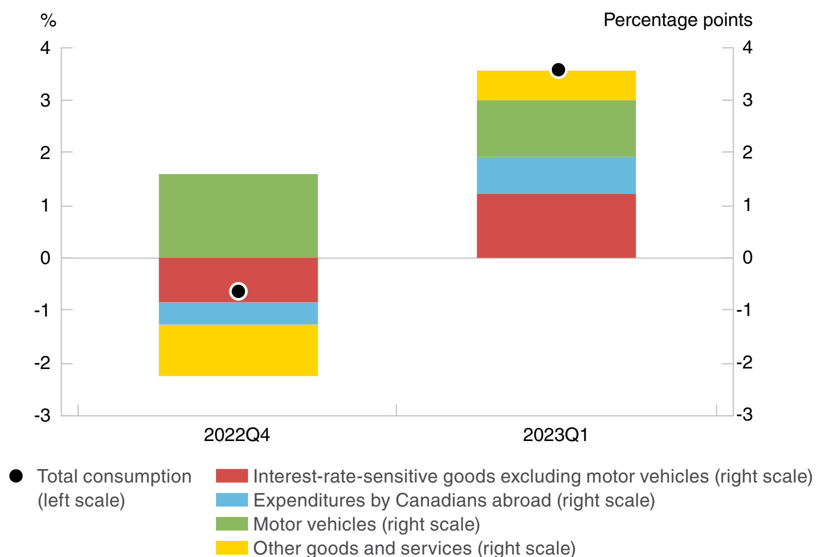
Economic activity was robust in the first quarter of 2023, and growth over the first half of the year will likely surpass expectations at the time of the January Report. An increase in the population due to strong inflows of newcomers to Canada supported this growth.[2]

Consumption spending per capita across a broad range of goods and services surged unexpectedly in the first quarter. Spending on interest-rate-sensitive goods such as furniture, clothing and recreational equipment was surprisingly strong (**Chart 8**). Based on recent retail sales data, strength in goods consumption seems to have continued. In addition, spending on services has been robust, continuing to recover from the impact of the COVID-19 pandemic.

Homebuyers have started returning to the resale market (**Chart 9**, panel a). In an environment of lagging supply, house prices increased in May for the second consecutive month (**Chart 9**, panel b). Increases in both resales and prices have been widespread across the country and stronger than anticipated in January.

Chart 8: Spending on goods and services was robust in the first quarter of 2023

Contribution to real consumption growth per capita (aged 15 and over), seasonally adjusted at annual rates, quarterly data



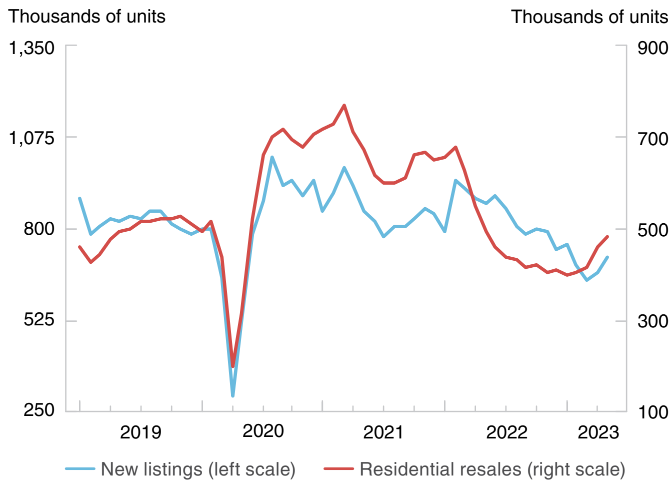
Sources: Statistics Canada and Bank of Canada calculations and estimates
Last observation: 2023Q1

2 Newcomers to Canada include recent arrivals of both permanent and non-permanent residents.

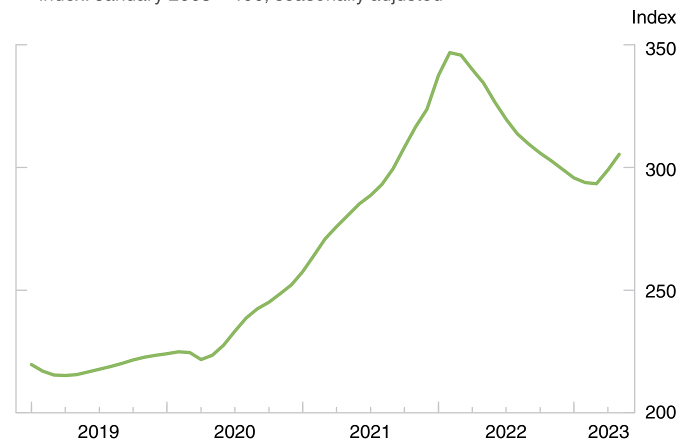
Chart 9: Housing resale activity and prices have picked up in recent months

Monthly data

a. Residential resales and new listings, annualized, seasonally adjusted



b. Resale prices, Multiple Listing Service® Home Price Index, index: January 2005 = 100, seasonally adjusted



Sources: Canadian Real Estate Association and Bank of Canada calculations
Last observation: May 2023

The unexpected strength of household spending over the first half of 2023 appears to reflect several factors—some of which are temporary, while others could be persistent:

- a tight labour market
- population growth resulting from increased arrivals of newcomers to Canada
- accumulated household savings
- pent-up demand for services
- fiscal measures in recent federal and provincial budgets

Disentangling the effects from these factors is difficult. In the projection, the Bank tries to balance the risks around the outlook for household spending, but risks remain.

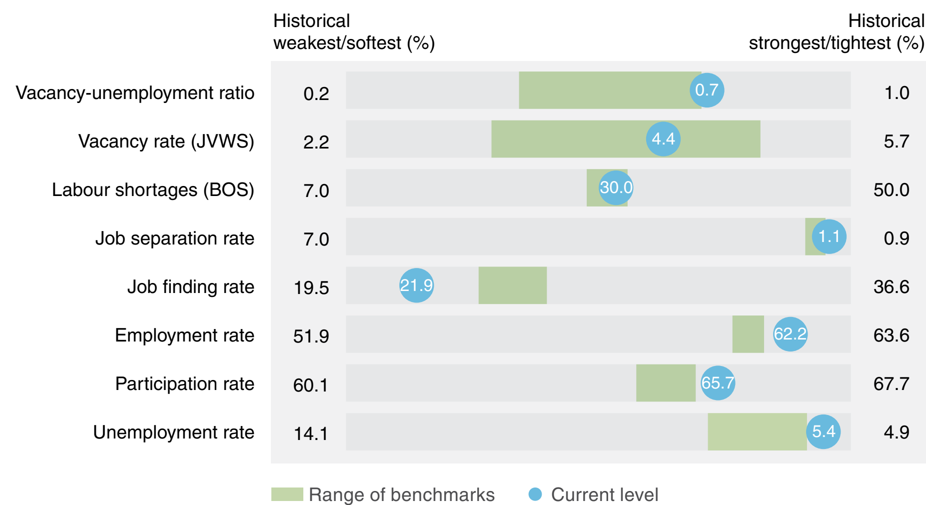
An unexpected increase in exports, partly related to stronger-than-expected foreign demand, also supported economic activity and the labour market in the first half of 2023. As well, improvements in supply chains boosted shipments of motor vehicles abroad.

Tight labour market with some signs of easing

With strong overall demand, the labour market remains tight. A broad range of indicators suggest that it is still above maximum sustainable employment (**Chart 10**). Labour demand remains strong, and job gains have been robust, with about 290,000 net new jobs created in the first six months of 2023. Many new entrants to the labour market have been hired quickly. The unemployment rate has edged up but remains low by historical standards. Wage growth has been in a range of about 4% to 5% (**Chart 11**).

Chart 10: The labour market remains tight

Selected labour market measures compared with their historical strongest/tightest and historical weakest/softest



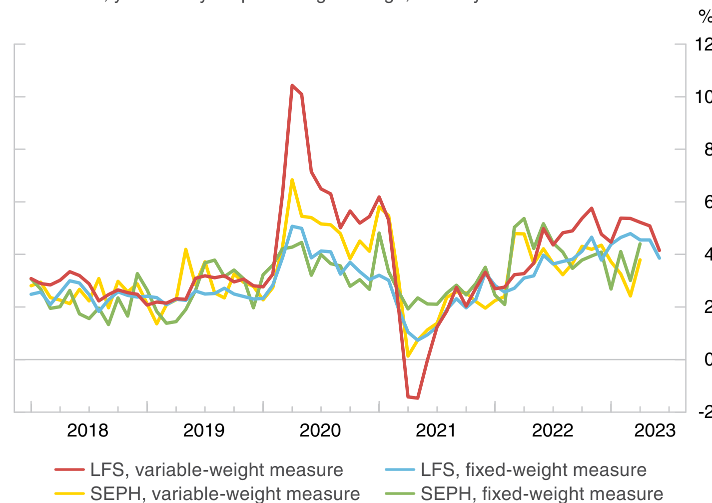
Note: BOS is the Business Outlook Survey, JVWS is the Job Vacancy and Wage Survey, and LFS is the Labour Force Survey. The vacancy-unemployment ratio is based on data from the JVWS and LFS and is expressed as a ratio and not in percent. Data for all other series are from the LFS unless otherwise noted. For details on the benchmarks included, see E. Ens, K. See and C. Luu, "Benchmarks for assessing labour market health: 2023 update," Bank of Canada Staff Analytical Note No. 2023-7 (May 2023).

Sources: Statistics Canada, Bank of Canada and Bank of Canada calculations

Last observations: BOS, 2023Q2; JVWS, April 2023; LFS, June 2023

Chart 11: Most measures of wage growth have been in the 4% to 5% range

Wage growth measures, year-over-year percentage change, monthly data



Note: LFS is the Labour Force Survey; SEPH is the Survey of Employment, Payrolls and Hours. The LFS fixed-weight measure is constructed using 2019 employment weights.

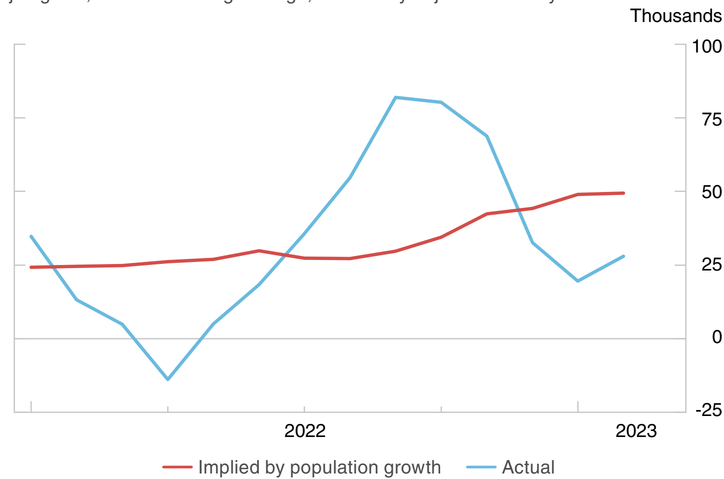
Sources: Statistics Canada and Bank of Canada calculations

Last observations: SEPH, April 2023; LFS, June 2023

At the same time, tighter monetary policy appears to be moderating the demand for labour. Job vacancies have declined since the January Report, and net job creation has been below the pace implied by population growth in recent months (**Chart 12**). As well, respondents to the Business Outlook Survey for the second quarter of 2023 noted that finding the workers they need has become easier. Firms attribute this to less competition for labour and improved labour supply.

Chart 12: Employment growth has fallen below the pace implied by surging population growth

Net monthly job gains, 3-month moving average, seasonally adjusted monthly data



Note: Employment growth implied by population growth is calculated by multiplying the net monthly change in the Labour Force Survey working-age population by the previous month's employment rate.

Sources: Statistics Canada and Bank of Canada calculations

Last observation: June 2023

Slowing demand growth and rising supply

Economic growth in Canada is expected to moderate over the next year. Higher interest rates have raised debt-service costs and lowered the amount of money households and firms have available to spend on goods and services. Higher rates have raised the cost of new borrowing and slowed household credit growth. This has weighed on purchases of big-ticket items such as homes, motor vehicles and other consumer durables. When demand slows, production ultimately catches up. Both demand for labour and wage growth then ease, reinforcing the slowdown in overall demand.

Exports are projected to decline as the impacts of higher rates abroad, particularly in the United States, weigh on the demand for imports from Canada. Moreover, the effect of some of the factors temporarily supporting export growth—such as the recovery of motor vehicle production with the resolution of supply chain issues—is anticipated to fade.

Real GDP growth is estimated to have slowed in the second quarter of 2023 to 1.5% and is projected to moderate to an average of about 1% through the second half of 2023 and the first half of 2024. This is below population growth, which is expected to grow 1.9% on average over this period (**Chart 13** and **Table 3**). Declines in real GDP per capita largely reflect per capita reductions in consumption and weak business investment.

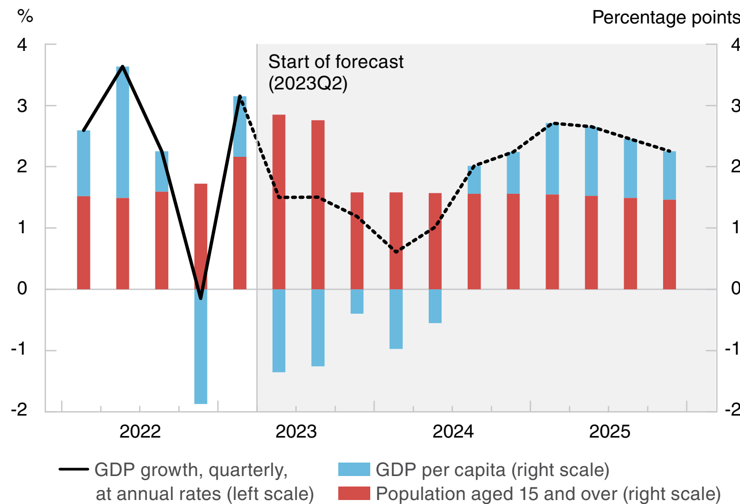
Economic activity is projected to pick up in the second half of 2024 as the effects of monetary policy tightening on growth fade (**Table 2**). GDP growth is expected to rise from 1.2% in 2024 to 2.4% in 2025.

Potential output growth is assumed to average about 2% over the projection horizon, reflecting solid growth in trend labour input and a pickup in trend labour productivity growth. The labour force is projected to expand robustly due to strong immigration and an ongoing influx of temporary residents, which more than offset the effects of an aging population.

While the Bank continues to expect a period of mild excess supply, this will take longer to materialize than previously anticipated. Excess demand is now projected to continue throughout 2023 (**Box 2**).

Chart 13: After showing strength in the first quarter of 2023, economic growth is expected to slow and remain muted until mid-2024

Contribution to real GDP growth, quarterly data



Sources: Statistics Canada and Bank of Canada calculations, estimates and projections

Box 2

Revised outlook for inflation and economic activity

This box focuses on the revisions to the outlook for inflation and economic activity since the January Report.[1]

Since the January Report, the outlook for inflation has been revised up. Consumer price index (CPI) inflation is forecast to be higher by as much as 0.4 percentage points in the first half of 2024 (**Chart 2-A**). As well, inflation is now expected to return to 2% in the middle of 2025, two quarters later than projected in January and April. Core inflation is also projected to be higher—by as much as 0.5 percentage points in the first quarter of 2024.

The upward revision to the inflation outlook is due to:

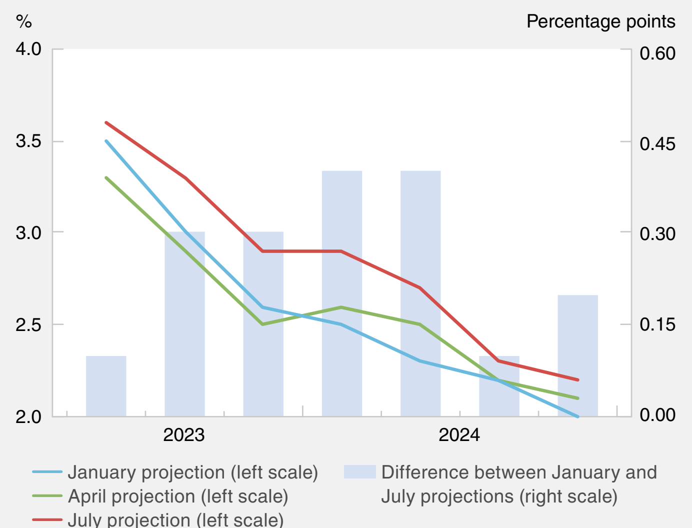
- more persistent excess demand
- higher-than-expected house prices
- higher-than-expected prices for tradable goods

(continued…)

1 In this Report, the Bank compares its most recent outlook with that from the January 2023 Report. This longer time frame provides a better perspective on the accumulated evidence of how the economy and inflation have evolved. The projections from the April Report are also provided in the charts within this box.

Chart 2-A: The outlook for CPI inflation is higher than in January

Year-over-year percentage change, quarterly data



Sources: Statistics Canada and Bank of Canada calculations and projections
Last data plotted: 2024Q4

Box 2 (*continued*)

Excess demand

The forecast for excess demand through 2023 has been revised up by almost 1 percentage point since the January Report (**Chart 2-B**). The rebalancing of supply and demand is now expected to happen in early 2024, three quarters later than previously anticipated.

In particular, the outlook for consumption has been revised up. A stronger outlook for house prices compared with January is increasing household net worth and is expected to boost consumer spending. Other factors contributing to the upward revision to the consumption outlook include:

- the tighter-than-expected labour market
- greater pent-up demand for services
- fiscal measures in recent federal and provincial budgets

House prices

The faster-than-expected pickup in housing resales, combined with a lack of supply, has pushed house prices higher than anticipated in January (**Chart 2-C**). The previously unforeseen strength in house prices is likely to persist and boost inflation by as much as 0.3 percentage points by the end of 2023, compared with the January outlook.

Tradable goods prices

Inflation for goods excluding food and energy has continued to fall, although more gradually than expected at the time of the January Report. This has occurred at a time when growth in input costs is moderating and supply chain disruptions have been resolving more quickly than anticipated at the start of the year.

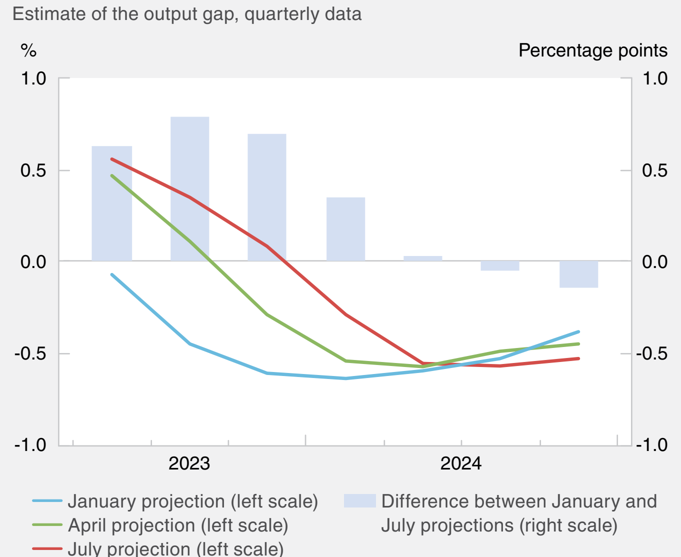
Some possible explanations behind the stronger-than-expected goods price inflation include:

- slower normalization of pricing behaviour by firms abroad. Strong global demand may have motivated businesses to pass through ongoing cost reductions more slowly than anticipated, partly explaining higher-than-expected import prices in 2023.
- weaker growth in labour productivity in the goods sector due to deglobalization and de-risking of supply chains.

Although goods price inflation (excluding food and energy) is expected to ease further, it remains temporarily higher than in January. In contrast, services price inflation has been in line with the January forecast. Inflation in services, excluding shelter, is expected to slow further over the projection horizon.

Chart 2-B: Compared with the January projection, excess demand is expected to persist for three additional quarters

Estimate of the output gap, quarterly data

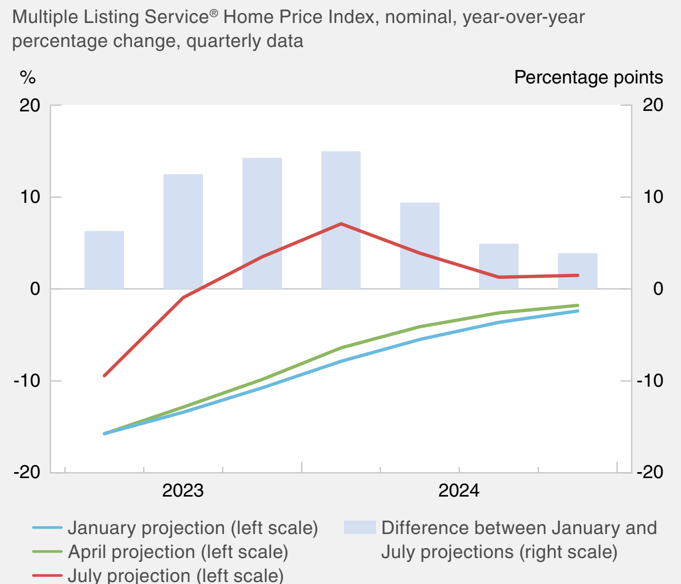


Source: Bank of Canada calculations, estimates and projections

Last data plotted: 2024Q4

Chart 2-C: Growth in house prices is much stronger than expected in January

Multiple Listing Service® Home Price Index, nominal, year-over-year percentage change, quarterly data



Sources: Canadian Real Estate Association and Bank of Canada calculations and projections

Last data plotted: 2024Q4

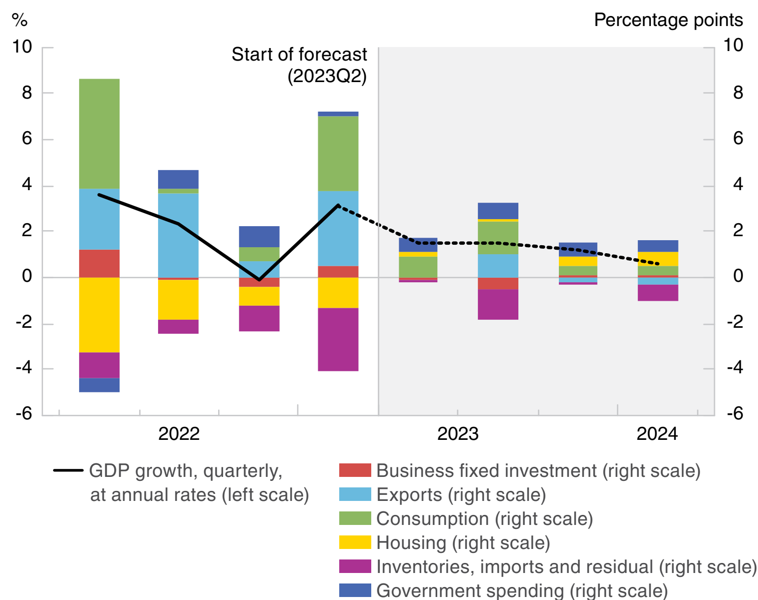
Household spending growth to moderate

Growth in consumption spending is projected to slow over the next year as demand for interest-rate-sensitive goods and services weakens and more households renew their mortgage at higher rates (**Chart 14** and **Box 3**). Income growth also slows as the labour market comes into balance, weighing on consumption spending growth.

After contracting for one year, spending on residential investment is expected to grow again, supported by strong inflows of newcomers to Canada. In recent months, house prices have moved up. This strength is projected to continue over the coming months before annual price growth slows to a range of 2% to 3%, roughly in line with the expectations of respondents to the Canadian Survey of Consumer Expectations for the second quarter of 2023.

Chart 14: Economic activity is expected to moderate as consumption and export growth weaken

Contribution to real GDP growth, quarterly data



Sources: Statistics Canada and Bank of Canada calculations, estimates and projections

Box 3

Household financial health

Debt-service costs are rising as elevated interest rates work their way through the economy, leading households to cut back on their discretionary spending. The current high level of household debt amplifies this impact, but the extent of the increase in debt-service costs differs across segments of the population. This box takes a deeper look at the impact of higher interest rates using microeconomic indicators of households' financial positions.

These indicators show that the financial positions of many households remain healthy, due in part to strong labour markets and the buildup of large liquid savings since the beginning of the COVID-19 pandemic. For these households, higher interest rates are unlikely to lead to severe financial stress or have disproportionately large effects on their spending.

There is, however, a smaller portion of households who are experiencing considerable financial stress. While most indicators of household financial stress remain below pre-pandemic levels, there are signs that some households are relying more on credit card debt, and some have fallen behind on their payments. These households are likely to cut their spending by disproportionately more than others.

It's also important to note that the full effect of rate increases has yet to be felt by some borrowers. Over time, as borrowers renew mortgages and other loans with fixed rates and payment schedules, more households will face higher debt-service costs.

Household financial stress

While delinquency rates have been rising, most continue to be below pre-pandemic levels (see Indicators of financial vulnerabilities and **Chart 3-A**). In particular, the delinquency rates on mortgage loans are near all-time lows. This is true even for variable-rate mortgage holders with variable payments, who have felt the largest impact of elevated interest rates so far.

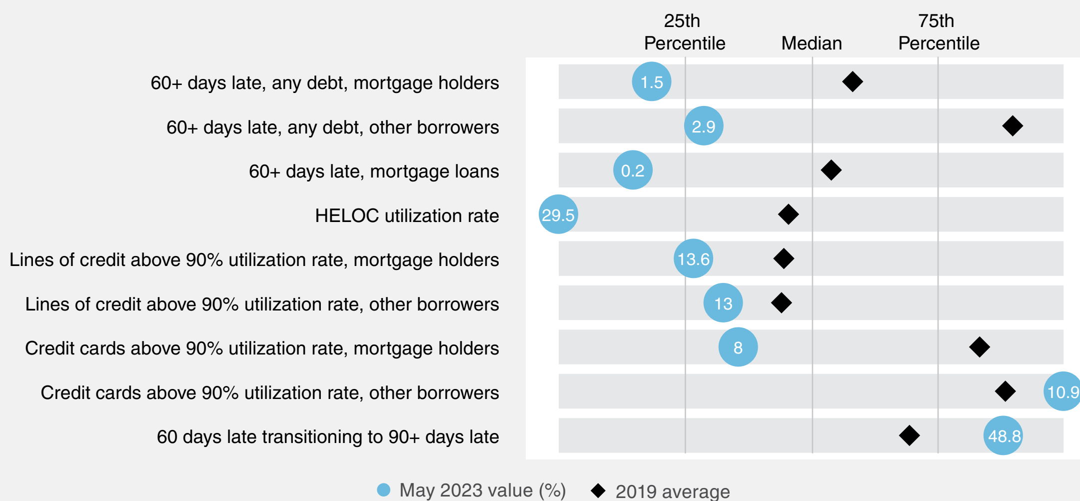
Other measures of financial stress have also remained close to historical lows, including utilization rates for home equity lines of credit (HELOCs) as well as the share of HELOCs and line of credit accounts with a utilization rate above 90%.[1]

Credit data show that borrowers are using their credit cards more extensively than they have in the past. The share of credit card accounts reaching their credit limit is

(*continued…*)

Chart 3-A: Household financial stress remains limited

Indicators of borrowers' stress levels compared with history, seasonally adjusted



Note: HELOC is home equity line of credit, and "HELOC utilization rate" is the percentage of a HELOC's available credit limit that is being used. The indicator for the HELOC utilization rate is the share of the overall credit limit for HELOCs used by borrowers. Indicators of a utilization rate above 90% are the share of accounts falling into those categories. "60+ days late" show the shares of borrowers falling into those categories. Data available from TransUnion go back to 2015. To protect the privacy of Canadians, TransUnion did not provide any personal information to the Bank. The TransUnion dataset was anonymized, meaning it does not include information that identifies individual Canadians, such as names, social insurance numbers or addresses.

Sources: TransUnion and Bank of Canada calculations

Last observation: May 2023

1 Credit utilization rate is defined as the percentage of a loan's available credit limit that is currently being used.

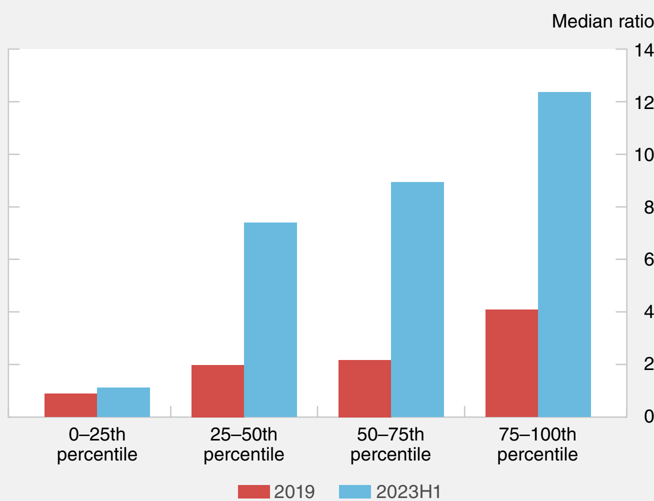
Box 3 (*continued*)

at a historical high for non-mortgage holders, although it remains below the median for mortgage holders.

In addition, although overall delinquency rates on loans remain relatively low, the share of borrowers moving from 60 to 90+ days late on any credit product has risen and is now close to a historical high. This suggests that borrowers who are already behind on their payments are increasingly likely to see a further deterioration in their financial situation, suggesting that financial stress—while not broad-based—is significant for some segments of the population.

Chart 3-B: Estimated household liquidity buffers have increased significantly for most households

Median ratio of liquid assets to monthly expenditures, by income group



Note: Data are split by income groups (for post-tax income, including transfers) for 2019 and the first half of 2023.

Source: Bank of Canada calculations

Last observation: 2023H1

To date, approximately one-third of mortgage holders have been directly affected by higher rates. As this share increases over the coming quarters, more households will face higher debt-service costs. Mortgage holders with variable-rate fixed payments could be particularly exposed. As these borrowers renew their mortgage and return to their original amortization schedule, they could face large increases in payments.

Strong labour markets and large financial buffers

Large financial buffers that accumulated during the pandemic, combined with the strength of the labour market, are supporting borrowers facing higher debt-service costs. Simulations from the new version of the Bank of Canada's Household Risk Assessment Model show liquid savings have increased significantly for three-quarters of households (**Chart 3-B**).[2] The Bank's Canadian Survey of Consumer Expectations for the second quarter of 2023 finds that mortgage holders—including those renewing within the next 12 months—are confident they will be able to make higher payments.

The financial health of Canadian households may change as economic circumstances evolve. The Bank will be watching closely the indicators of financial stress.

2 The new version of the Household Risk Assessment Model builds on the original by explicitly modelling household consumption, savings and mortgage repayment decisions. For information on the original model, see B. Peterson and T. Roberts, "Household Risk Assessment Model," Bank of Canada Technical Report No. 106 (September 2016).

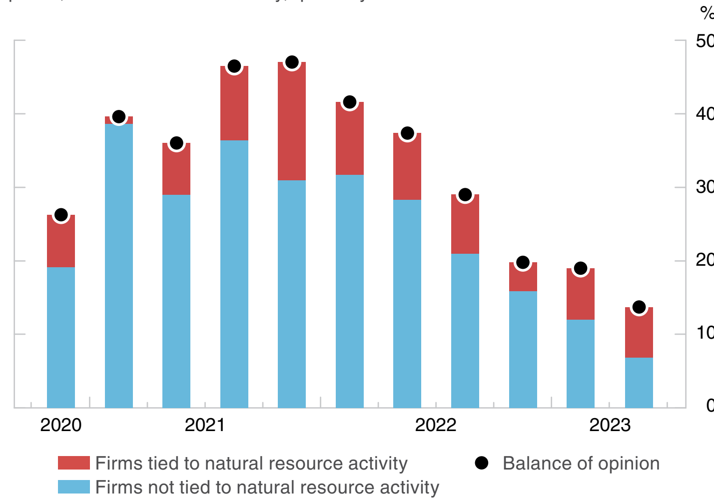
Soft business investment and declining export growth

Business investment growth is expected to be soft through to the middle of 2024, dampened by weak demand for Canadian exports, high financing costs and the winding down of large infrastructure projects (**Chart 15**). Businesses cite elevated borrowing costs, tight credit conditions and the prospect of slowing economic activity as key factors holding back investment.

After a strong start to 2023, non-commodity exports are expected to decline through 2024 as foreign demand weakens. In contrast, commodity exports are projected to grow modestly, supported by supply improvements, including the completion of the Trans Mountain Expansion project in 2024.

Chart 15: Investment intentions are weak for firms not tied to natural resource activity

Balance of opinion, Business Outlook Survey, quarterly data



Note: Balance of opinion is the percentage of respondents to the Business Outlook Survey that expect their investment spending to be higher over the next 12 months than over the past 12 months minus the percentage that expect it to be lower.

Source: Bank of Canada

Last observation: 2023Q2

Inflation at target in 2025

CPI inflation declined to 3.4% in May and is expected to remain near 3% for about a year. The first stage of this decline in inflation—from about 8% in June 2022 to its current rate—occurred rapidly, reflecting large declines in oil prices, lower inflation in other goods prices and base-year effects as large past increases in these prices fall out. The drop in inflation for goods excluding food and energy resulted from slowing growth in global demand, improving supply chains and a decline in the costs of some imported goods. These factors are expected to continue to contribute to weaker inflation over the projection horizon, but their impact is shrinking (**Chart 16**).

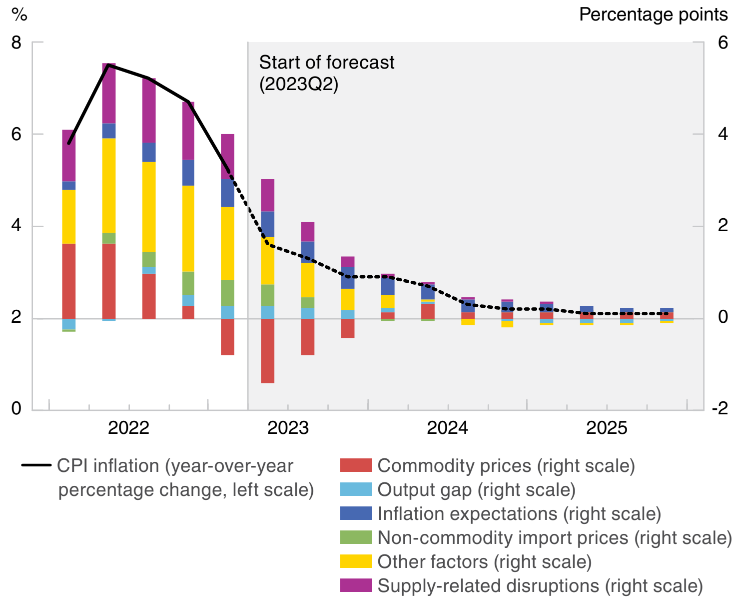
Looking ahead, the next stage in the decline of inflation toward target is expected to take longer and is more uncertain. This is partly due to elevated services inflation, which can adjust sluggishly, and uncertainty about expected inflation.

Slowing domestic demand is central to the anticipated decline in inflationary pressures. At the beginning of last year, strong excess demand in the context of rising costs made it easier for firms to fully pass cost increases onto prices. However, as the economy rebalances and the excess demand dissipates, not only will direct inflationary pressures from strong demand ease, but the ability of firms to pass along cost increases will also diminish.

Results from the Bank's Business Leaders' Pulse survey indicate that firms continue to expect larger-than-normal price increases and more-frequent-than-normal price changes (**Chart 17**). The frequency of price changes, in particular, is greater when high inflation and demand are strong. However, firms' responses are indicating that price-setting behaviour will continue to normalize.

Chart 16: CPI inflation is forecast to return to target in the middle of 2025

Contribution to the deviation of year-over-year inflation from 2%, quarterly data

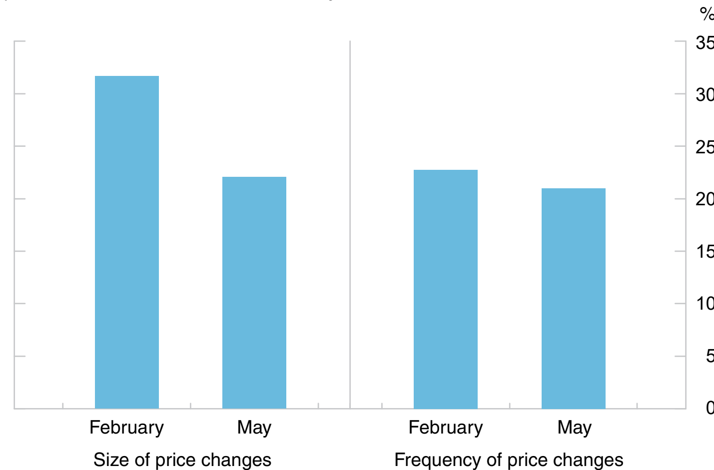


Note: Other factors could be underestimated demand pressures, such as from large imbalances in the housing market, or previously unobserved factors, such as greater pass-through from oil or import prices and atypical pricing behaviour by firms. Non-commodity import prices include the impact of the Can$/US$ exchange rate. Numbers may not add to total due to rounding. The impact of the carbon price on year-over-year inflation is roughly 0.1 percentage point over the projection horizon and is included in commodity prices.

Sources: Statistics Canada and Bank of Canada calculations, estimates and projections

Chart 17: Firms have not yet returned to their normal pricing behaviour

Balance of opinion, Business Leaders' Pulse, monthly data



Note: Size of price changes—Balance of opinion is the percentage of firms responding to the Business Leaders' Pulse that expect larger-than-normal price increases minus the percentage that expect smaller-than-normal price increases over the next 12 months. Frequency of price changes—Balance of opinion is the percentage of firms responding to the Business Leaders' Pulse that expect more-frequent-than-normal price increases minus the percentage that expect less-frequent-than-normal price increases over the next 12 months. Firms without regular pricing frequency were excluded.

Source: Bank of Canada

Last observation: May 2023

Firms responding to the Bank's Business Outlook Survey for the second quarter of 2023 indicated that supply chains and labour shortages are becoming less pressing issues. Meanwhile, firms are increasingly concerned about slowing demand. In the face of strong wage gains, businesses are looking for opportunities to become more efficient and lower their costs.

Inflation is expected to return to 2% in the middle of 2025, although the timing is uncertain given the gradual movement of inflation toward the target in the outlook. The delayed return to target largely reflects the greater persistence of excess demand in 2023, the upward revision to house prices and, to a lesser extent, higher-than-expected imported goods prices (**Box 2**).

Near-term survey-based inflation expectations remain elevated. In the base case, inflation expectations are assumed to return to the 2% target relatively quickly and with a mild slowdown in the economy. This soft landing occurs because inflation expectations are assumed to be well anchored to the inflation target as they have been for many years. However, with inflation above target for more than two years and with it projected to remain close to 3% for an additional year, it is possible that inflation expectations will remain higher for longer. If that were to occur, inflationary pressures would be more persistent.

Risks to the inflation outlook

The outlook in the base-case scenario is the most likely outcome for inflation, and the Bank sees both upside and downside risks to this outlook. On the upside, high inflation, if left unchecked, could be more persistent than expected. As well, household spending could be stronger than projected, which would create more excess demand and increase inflationary pressures. On the downside, goods price inflation may be weaker than anticipated as global cost pressures dissipate. In addition, the global economy could face a more marked slowdown than in the base-case projection, leading to downward pressures on demand for Canadian exports and on prices for commodities and tradable goods.

In assessing the risks, with inflation above target for two years and expected to stay close to 3% for an additional year, the Bank is concerned that progress toward price stability could stall and that inflation could rise again if there are positive surprises.

Main upside risks

Inflation expectations could be more stubborn

Since reaching its peak of 8.1% in June 2022, CPI inflation has been trending downward. In the base-case outlook, inflation remains close to 3% until the middle of 2024 and then continues to slow, reaching the 2% target in the middle of 2025.

Over the projection, inflation expectations are assumed to be well anchored to the inflation target. As a result, expectations return to target relatively quickly, as they typically have for the last 25 years. Firmly anchored inflation expectations limit the knock-on inflationary effects shocks can have, including those from the relative price shocks (i.e., higher prices for energy and tradable goods) that played an important role in the rise in inflation. As a result, when the shocks dissipate, a relatively modest amount of excess supply is needed to bring inflation back to target.

However, with inflation above target for more than two years and with it projected to remain close to 3% over an additional year, firms and households could expect inflation to return to target more gradually.

This possibility could already be reflected in the evolution of some key nominal measures. In Canada, three-month rates of core inflation have been stuck in the range of 3½% to 4% since September 2022. At the same time, wages have been growing at around 4% to 5% for about a year, despite the weakness in productivity growth.

If firm and household inflation expectations remain elevated for longer, actual inflation would also be more persistent. This would make a timely return of inflation to target more challenging, and the output losses larger.

Household spending could be stronger

Another upside risk is that the outlook for household spending could be stronger than expected, leading to greater inflationary pressures. Since the beginning of the pandemic, many Canadians have accumulated a considerable amount of savings. For example, households' bank deposits have increased by more than $330 billion, and they are still growing. The projection assumes that households are treating these savings as wealth. The tendency to consume from this wealth, especially for high-income households, is relatively low. However, Canadian households could spend more aggressively from their accumulated savings, as US households have done.

Main downside risks

Past increases in prices of intermediate and final goods could reverse

Core goods price inflation has fallen significantly since the middle of 2022. It is expected to continue to ease over the projection. There is a risk, however, that the inflation of many goods prices may fall more sharply than assumed in the projection. Several input costs, including for energy and transportation, have fallen, and supply chain disruptions have been dissipating. Over time, prices may reflect these cost reversals more prominently than they have to date.

Global activity could be weaker

A severe global slowdown is another key downside risk to inflation. Advanced economies continue to tighten monetary policy, and global activity could slow by more than expected. Weaker global demand could lead to softer prices for commodities and tradable goods. It is also possible that higher policy rates could interact with long-standing global financial vulnerabilities, such as elevated levels of debt, to significantly slow global growth further.

Canadian economic growth and inflation would be dragged down if these risks materialized.