Monetary Policy Report

January 2024

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 with a press release followed by a press conference, 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. 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).

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

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ISSN 1201-8783 (Print)
ISSN 1490-1234 (Online)
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BANK OF CANADA
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Monetary Policy Report

January 2024

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Overview

The global economy is slowing but has been more robust than anticipated in the October Report, in large part due to the surprising strength of the US economy. Growth is expected to moderate further in 2024. Inflation is coming down in most major economies and is expected to continue to decline gradually toward central banks' targets.

In Canada, consumer price index (CPI) inflation is still too high but is easing gradually. Recent data reinforce that monetary policy is working to moderate spending and relieve price pressures across a wider range of goods and services. However, shelter price inflation is high and is expected to put upward pressure on inflation for some time.

Economic growth stalled in Canada in the middle of 2023. Given this weakness, supply has caught up with demand, and the economy now looks to be in modest excess supply. Labour market conditions have also eased, with more indicators signalling an improved balance between labour supply and demand. However, wage growth is still around 4% to 5%.

In 2024, economic activity is forecast to remain weak in the first quarter and then to pick up gradually, with annual growth in gross domestic product (GDP) just under 1%. Past interest rate increases will continue to constrain household spending and business investment, while weak foreign demand will slow export growth. Spending by governments contributes materially to growth through 2024. GDP growth is projected to rise to about 2½% in 2025.

Inflation is projected to stay around 3% through the first half of 2024. As excess supply in the economy weighs on prices, inflation is forecast to ease to 2½% in the second half of 2024 and to return to target in 2025.

While the economy is evolving largely as projected in the October Report, considerable uncertainty remains. Overall, the risks to the outlook for inflation appear balanced. Given that inflation is still above 3% and underlying inflation is proving persistent, the Bank of Canada remains concerned that upside risks could materialize and cause inflation to remain above the target for longer than expected.

Global economy

Inflation is easing across most economies and across a widening range of goods and services. With slowing growth, inflation rates in most advanced economies are expected to come down slowly and reach central bank targets in 2025. The pace of disinflation is gradual because prices for services—including shelter—are still increasing at an elevated rate in many economies.

Global growth slowed in 2023 but has been stronger than anticipated at this time last year, partly because of unexpected strength in the US economy. US consumption has been strong, supported by resilient employment growth and households continuing to spend savings they accumulated during the COVID-19 pandemic. Since the October Report, the outlook for the US economy has been revised up again (**Box 1**).

Nevertheless, global growth is expected to slow further in 2024 (**Table 1**).[1] In the United States, this is due to a slowdown in consumption as households continue to adjust to past increases in interest rates and have less pandemic-era savings. Ongoing structural and policy challenges should restrain activity in China. Modest economic growth is expected in the euro area. Global growth strengthens in 2025 as the impacts of past monetary tightening fade and financial conditions ease.

Table 1: Projection for global economic growth

	Share of real global GDP* (%)	Projected growth† (%)			
		2022	2023	2024	2025
United States	16	1.9 (1.9)	2.5 (2.2)	1.7 (0.8)	1.2 (1.2)
Euro area	12	3.4 (3.4)	0.4 (0.5)	0.5 (0.7)	1.6 (1.5)
Japan	4	0.9 (1.0)	2.0 (2.0)	0.7 (0.8)	1.1 (0.9)
China	18	3.0 (3.0)	5.2 (5.1)	4.5 (4.5)	4.5 (4.4)
Oil-importing EMEs‡	34	4.5 (4.5)	3.7 (3.6)	3.1 (3.0)	3.6 (3.4)
Rest of the world§	16	3.5 (3.5)	1.2 (1.7)	1.5 (1.4)	1.5 (1.3)
World	100	3.4 (3.4)	3.0 (2.9)	2.5 (2.3)	2.7 (2.6)

* Shares of gross domestic product (GDP) are based on International Monetary Fund (IMF) estimates of the purchasing-power-parity valuation of country GDPs for 2022 from the IMF's October 2023 *World Economic Outlook*. The individual shares may not add up to 100 due to rounding.

† Numbers in parentheses are projections used in the previous 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

1 The global projection was completed before the release of fourth-quarter activity data for China.

Box 1

Changes to the economic projection since the October Report

Global outlook

The outlook for global growth is somewhat stronger over the projection compared with the October Report.

- Growth in the United States has been revised up for 2023 and 2024. Projected annual growth for 2024 is now approximately 1 percentage point higher. The upward revision reflects a combination of eased financial conditions and higher-than-expected government expenditures.
- Overall, the level of global gross domestic product (GDP) is expected to be almost ½% higher at the end of the projection.

Canadian outlook

The Canadian economy has evolved largely as projected in the October Report.

- Growth in GDP in the third quarter of 2023 was somewhat below expectations.[1] Notably, there was weakness in the consumption of goods and services that are sensitive to interest rates.
- The outlook for GDP growth is broadly unchanged in 2024 and 2025. **Table 2** and **Table 3** show the revisions to the forecast.

The outlook for consumer price index inflation has been revised down by 0.2 percentage points, on average, through the end of 2024 and is unchanged in 2025. The revision mainly reflects the impacts of lower gasoline prices that result from a lower assumption about oil prices over the projection.

1 Historical revisions to previous years have left the level of Canadian GDP roughly 0.8% higher by the end of the second quarter of 2023. The assessment of the output gap is largely unchanged for the third quarter of 2023 due to a small upward revision to potential output and weaker-than-expected GDP growth.

Lower inflation

Inflation is easing across a growing range of goods and services around the world (**Chart 1** and **Chart 2**). Inflation in prices for core goods continues to decline in the United States and the euro area. This is due to past improvements in supply chains and the shift in spending away from goods toward services. Past increases in policy rates are also playing an important role. The decrease in inflation has been most apparent in durable goods, the demand for which tends to be more sensitive to changes in interest rates.

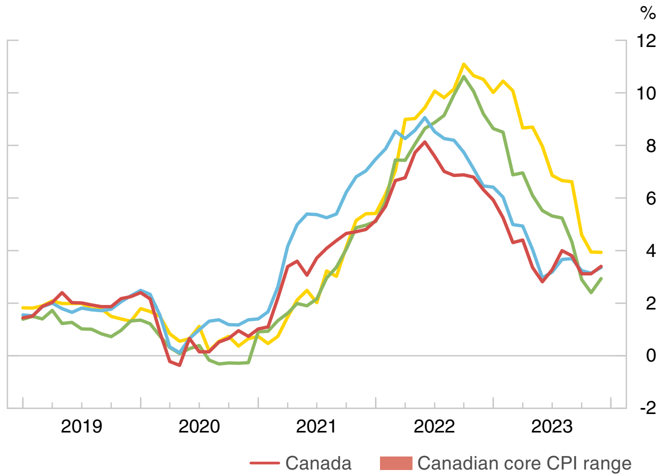
Further declines in inflation in core goods prices are expected in the United States and the euro area as demand weakens. Goods price inflation in the euro area also slows due to fading cost pressures from past energy disruptions and less pressure on import prices—partly reflecting falling producer prices in China. However, further disruptions to trade through the Red Sea could reverse some of the downward pressure on inflation that has come from improvements in supply chains.

Inflation in prices for core services, including shelter, remains elevated but has also been falling gradually. This decline is expected to continue in 2024. In the United States, inflation in prices for core services excluding shelter is expected to moderate as monetary policy constrains demand and labour market conditions ease. Wage growth is expected to slow while productivity growth remains solid. Shelter price inflation is projected to ease from an elevated rate due to the delayed effect from slower growth in rental prices for new tenants.

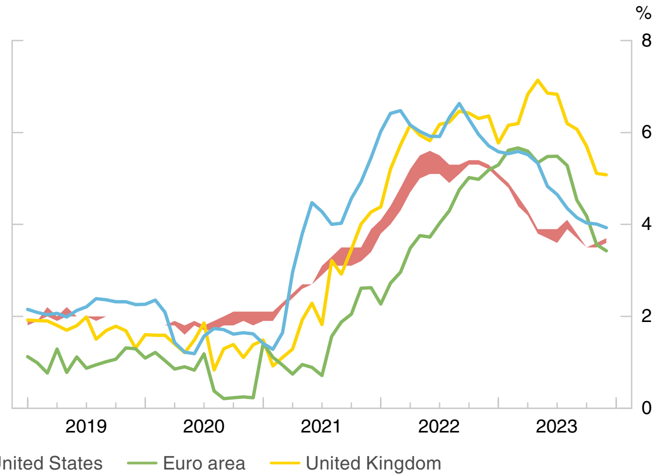
Chart 1: Inflation has been slowing

Year-over-year percentage change, monthly data

a. Total inflation



b. Core inflation



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

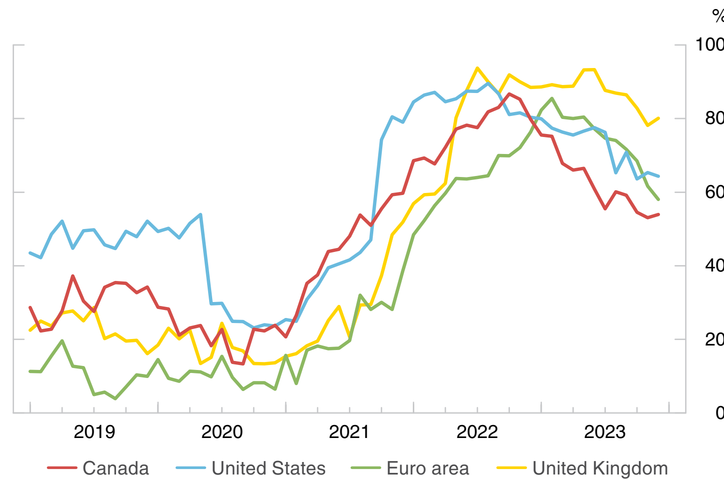
Note: The rate of inflation is calculated based on the Harmonised Index of Consumer Prices for the euro area and the consumer price index (CPI) for all other countries. Core inflation is a range of CPI-trim and CPI-median for Canada and CPI excluding food and energy for the other countries.

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

Last observation: December 2023

Chart 2: The share of CPI components with high inflation has fallen

Weighted share of CPI components with year-over-year inflation above 3%, monthly data



Canada — United States — Euro area — United Kingdom

Note: Calculations use the components of the Harmonised Index of Consumer Prices for the euro area and the consumer price index (CPI) for all other countries and their respective index weights.

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

Last observation: December 2023

In the euro area, inflation in services prices is receding, as pent-up demand from the pandemic has faded and monetary policy weighs on demand. Nevertheless, some cost pressures linger as wage growth remains elevated despite slow productivity growth.

The recent fall in energy prices is also projected to generate some ongoing downward pressure on headline inflation in the coming months. Overall, inflation returns sustainably to target in the United States and the euro area in 2025.

Easier financial conditions

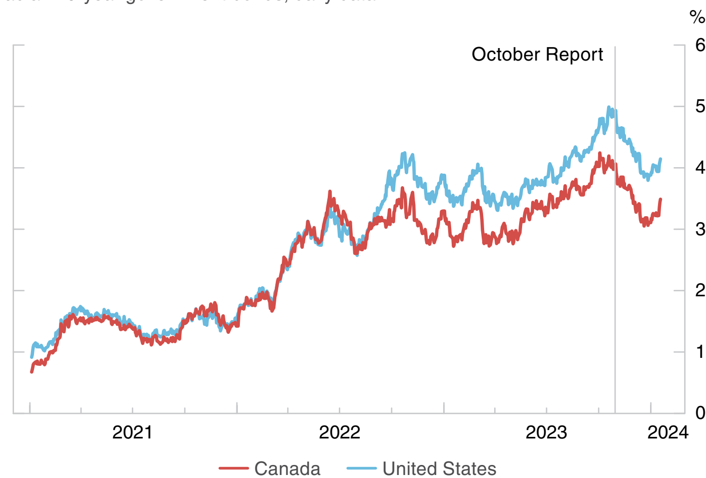
The sharp tightening in financial conditions experienced before the October Report has dissipated, led by declines in yields on long-term government bonds. Two main factors have contributed to these declines. First, the term premium is estimated to have fallen, as markets perceive fewer risks to the outlook for growth and inflation. Second, real yields have decreased as markets have also revised down their expectations for policy rates. As a result of these factors, nominal yields on 10-year US government bonds have fallen by around 75 basis points (bps) since the October Report (**Chart 3**). This has contributed to declines in corporate borrowing rates and the interest rates on household mortgages.

Credit conditions have also shown signs of easing. Issuance of US corporate bonds has been robust, and credit spreads have narrowed. Moreover, US equity prices have rebounded strongly.

The Canadian dollar has remained close to the level observed at the time of the October Report (**Chart 4**).

Chart 3: Yields on North American long-term bonds have come down since the October Report

US and Canadian 10-year government bonds, daily data

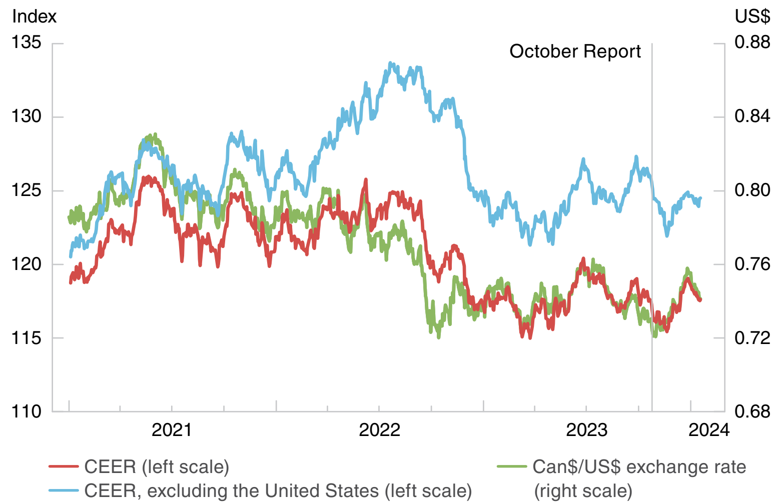


Source: Bloomberg Finance L.P.

Last observation: January 18, 2024

Chart 4: The Canadian dollar has remained close to the level observed at the time of the October Report

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: January 18, 2024

Slowing global economy

Economic growth in the United States is expected to slow in 2024. Growth in consumer spending moderates in the near term as spending of accumulated savings no longer offsets the effects of past increases in borrowing costs. Moreover, banks have become less willing to lend money to consumers, and labour income growth is projected to slow. Softening consumer demand and still-elevated corporate borrowing rates are also projected to weaken US business investment. Moreover, government spending is not expected to support growth in 2024 to the extent that it did in 2023.

Private domestic demand leads a modest pickup in quarterly growth in the United States starting in late 2024 as the impacts of past monetary tightening fade and financial conditions ease.

China's economy is expected to grow between 4% and 5% over the projection horizon. Ongoing issues in the property sector as well as policy uncertainty and weak consumer confidence continue to restrain activity.

Growth in the euro area remains modest. Past interest rate increases are acting as a drag on demand. In addition, foreign demand is subdued, and factors such as the strength of the euro and comparatively high energy costs have eroded competitiveness and are hampering growth. Growth is projected to pick up gradually over 2024 and 2025 as the effects of energy shortages fade and monetary policy becomes less restrictive.

Lower oil prices

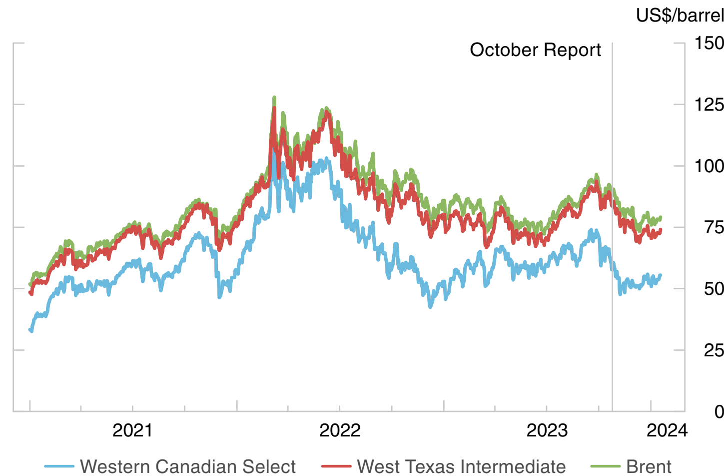
The price of Brent oil is close to US$80, considerably lower than the assumption of US$90 in the October Report (**Chart 5** and **Box 2**). The decline reflects a combination of better-than-expected conditions for supply and weaker-than-anticipated demand for oil.

The risk premium in oil prices has declined, reflecting the market's assessment that the war in Israel and Gaza is less likely to have a negative impact on global oil supply. Moreover, oil production in countries that are not members of the Organization of the Petroleum Exporting Countries has expanded faster than anticipated in recent months, led by the United States, Brazil and Guyana. Global demand for oil has moderated more than expected due to the slowdown in global manufacturing activity and an easing in demand growth for transportation fuels.

The Bank of Canada's Commodity Price Index excluding energy has been flat since the October Report, with strengthening lumber prices offset by weakness in other commodities.

Chart 5: In oil markets, increased supply and recent weakness in demand have caused prices to decline

Daily data



Sources: Kalibrate Canada Inc., NYMEX and Intercontinental Exchange via Haver Analytics
Last observation: January 18, 2024

Box 2

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:

- Over the projection horizon, the per-barrel prices for oil 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 $10 lower than in the October Report.
- By convention, the Bank does not forecast the exchange rate in the *Monetary Policy Report*. The Canadian dollar is assumed to remain at 74 cents US over the projection horizon, close to its recent average and unchanged from the assumption in the October Report.
- Potential output in Canada is expected to increase by about 2% on average over 2023 to 2025.[1]
- The latest estimate for population growth in 2023 is close to 3%. Population growth is projected to average just below 2% in 2024 and 2025.[2]
- Growth in real gross domestic product is estimated to be close to zero in the fourth quarter of 2023. As a result, the Bank estimates that the output gap is between -0.25% and -1.25% in the fourth quarter, which is 0.5 percentage points lower than the estimate for the third quarter of 2023.
- The projection incorporates information from all provincial and federal budgets available at the time of writing.
- The nominal neutral interest rate in Canada is estimated to be in the range of 2% to 3%. The economic projection assumes that the neutral rate is at the midpoint of this range. 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.

1 As per the usual practice, potential output and the nominal neutral interest rate will be reassessed in April 2024.

2 These population estimates are for people aged 15 years and older. The 2023 population growth estimate is based on a combination of data from Statistics Canada's Labour Force Survey and quarterly population estimates. The projection over 2024 and 2025 is based on a combination of the high-growth (HG) and medium-growth (M1) population scenarios from Statistics Canada.

Canadian economy

CPI inflation continued to ease, reaching 3.3% in the fourth quarter of 2023. Since the October Report, data have provided further evidence that monetary policy is working as expected to slow growth and eliminate excess demand pressures on inflation. However, inflation remains too high, with persistent strength in shelter and food price inflation.

Economic growth is anticipated to remain close to zero through the first quarter of 2024. It is then expected to pick up gradually as the effects of past interest rate increases on growth begin to fade and the recent easing in financial conditions supports demand. Inflation is expected to remain close to 3% over the first half of 2024 before easing gradually and returning to the 2% target in 2025.

Despite significant progress since the summer of 2022, considerable uncertainty remains about the pace of future decreases in inflation. While the slowdown in the economy is anticipated to reduce inflationary pressures, other forces could keep inflation above the target for longer than expected.

Stalled economic activity

Economic growth is estimated to have stalled since the middle of 2023 (**Table 2**, **Table 3** and **Chart 6**). Past interest rate increases continue to weigh on household spending and business investment, and slowing foreign demand has restrained exports. Temporary factors, such as the Quebec public sector strikes, also impact growth in the near term. In the first quarter of 2024, growth is expected to remain close to zero.

Consumption per capita has declined and will likely continue to contract in the near term. It has been particularly weak for goods and services that are sensitive to interest rates, such as furniture, restaurants and accommodations (**Chart 7**). Some of this weakness has been offset by the recovery in travel spending and by strength in motor vehicle sales due to increased product availability. Housing resale activity has also been weak, and house prices fell in the fourth quarter. However, new construction activity has picked up, responding to increased demand from strong population growth.

Table 2: Contributions to average annual real GDP growth

Percentage points*†

	2022	2023	2024	2025
Consumption	2.7 (2.5)	1.2 (1.3)	0.3 (0.4)	0.9 (0.9)
Housing	-1.2 (-1.1)	-0.9 (-1.1)	0.4 (0.2)	0.5 (0.7)
Government	0.8 (0.5)	0.5 (0.3)	0.6 (0.6)	0.5 (0.5)
Business fixed investment	0.5 (0.7)	0.1 (0.2)	-0.1 (0.0)	0.3 (0.5)
Subtotal: final domestic demand	2.8 (2.6)	0.9 (0.7)	1.2 (1.2)	2.2 (2.6)
Exports	1.0 (0.9)	1.6 (1.6)	0.3 (0.3)	1.3 (0.8)
Imports	-2.4 (-2.4)	-0.3 (0.4)	-0.1 (-0.6)	-0.9 (-0.8)
Inventories	2.4 (2.3)	-1.2 (-1.5)	-0.6 (0.0)	-0.2 (-0.1)
GDP	3.8 (3.4)	1.0 (1.2)	0.8 (0.9)	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)	1.0–3.2 (1.0–3.2)
Real gross domestic income (GDI)	5.3 (5.1)	-1.0 (-1.7)	0.3 (0.7)	1.4 (2.3)
CPI inflation	6.8 (6.8)	3.9 (3.9)	2.8 (3.0)	2.2 (2.2)

* Numbers in parentheses are from the projection in the previous 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*

	2023			2024		2022	2023	2024	2025
	Q2	Q3	Q4	Q1		Q4	Q4	Q4	Q4
CPI inflation (year-over-year percentage change)	3.6 (3.6)	3.7 (3.7)	3.3 (3.3)	3.2		6.7 (6.7)	3.3 (3.3)	2.4 (2.5)	2.1 (2.1)
Real GDP (year-over-year percentage change)	1.2 (1.1)	0.5 (0.7)	0.7 (1.0)	0.2		2.2 (2.1)	0.7 (1.0)	1.6 (1.3)	2.7 (3.0)
Real GDP (quarter-over-quarter percentage change at annual rates)†	1.4 (-0.2)	-1.1 (0.8)	0.0 (0.8)	0.5					

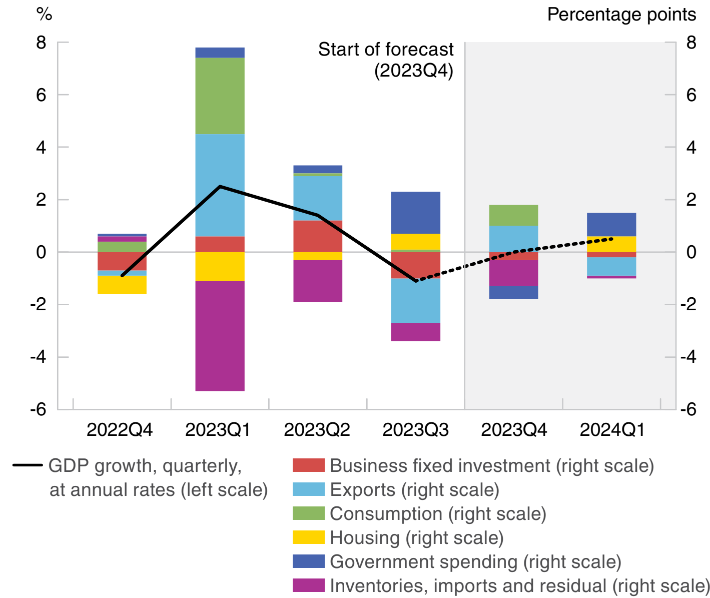
* Details on the key inputs to the base-case projection are provided in **Box 2**. Numbers in parentheses are from the projection in the previous Report.

† Over the projection horizon, 2023Q4 and 2024Q1 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 such, they can differ from the growth rates of annual averages shown in **Table 2**.

Sources: Statistics Canada and Bank of Canada calculations and projections

Chart 6: Real GDP growth has stalled

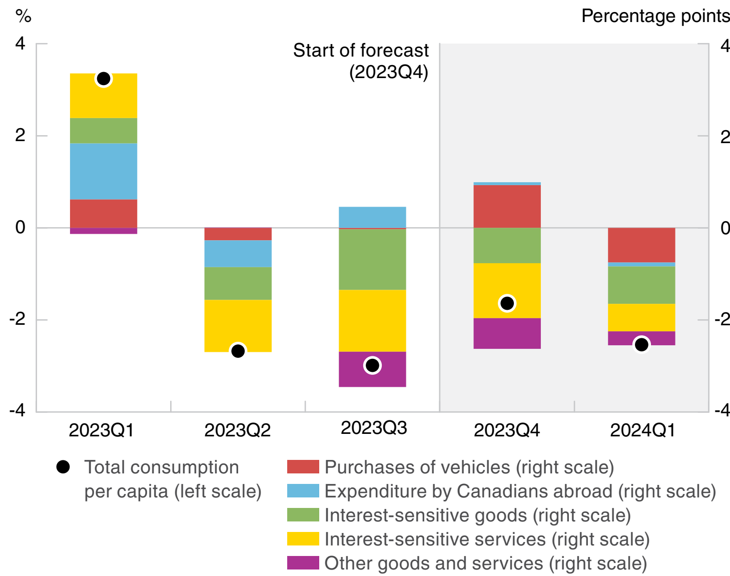
Contribution to real GDP growth, quarterly data



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

Chart 7: Growth of consumption per capita has been negative

Contribution to real consumption growth per capita (aged 15 and over), quarterly data



Note: For more information about what is included in the consumption categories, see T. Chernis and C. Luu, "Disaggregating Household Sensitivity to Monetary Policy by Expenditure Category," Bank of Canada Staff Analytical Note No. 2018-32 (October 2018).

Sources: Statistics Canada and Bank of Canada calculations

Last data plotted: 2024Q1

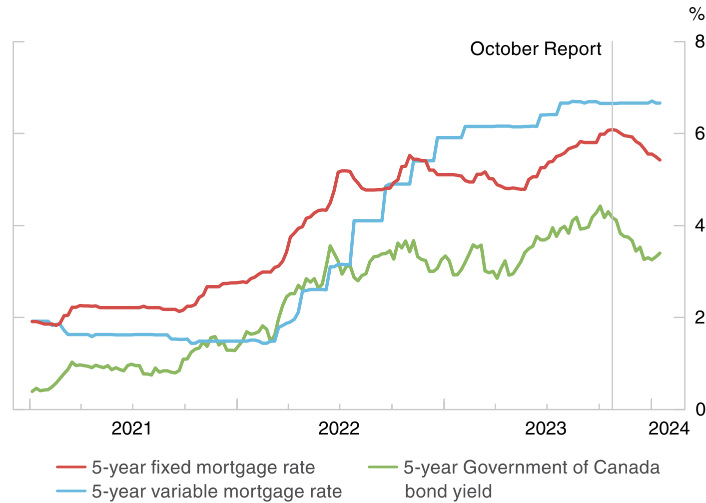
Easing financial conditions

Financial conditions have eased for Canadian households and businesses since the October Report, even though policy interest rates remain elevated. Long-term government bond yields have fallen. Bank funding costs have also gone down, and financial institutions have subsequently lowered their interest rates for mortgages. For example, five-year fixed mortgage rates have fallen by about 65 basis points since mid-October 2023 (**Chart 8**). Equity prices have risen, and corporate credit spreads have also narrowed.

However, elevated borrowing costs have weighed on household and business credit growth over the past year (**Chart 9**). The Senior Loan Officer Survey for the third quarter of 2023 also reported an overall tightening in business lending conditions. Measures of household financial stress have continued to edge up in recent months. Delinquency rates are rising. Those for mortgages remain low compared with pre-pandemic levels, while those for other debt products are the same or have increased.

Chart 8: Canadian financial conditions have eased since October

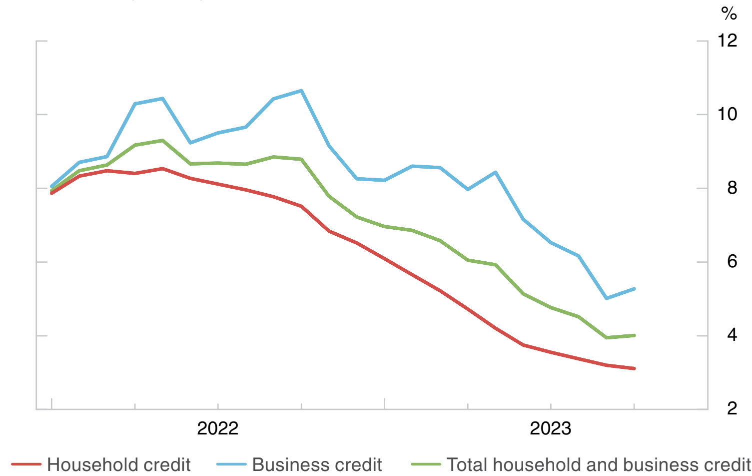
Weekly data



Sources: Banks' regulatory filings, Lender Spotlight and Bank of Canada calculations
Last observation: January 16, 2024

Chart 9: Household and business credit growth have slowed over the past year

Year-over-year percentage change, monthly data



Source: Statistics Canada

Last observation: October 2023

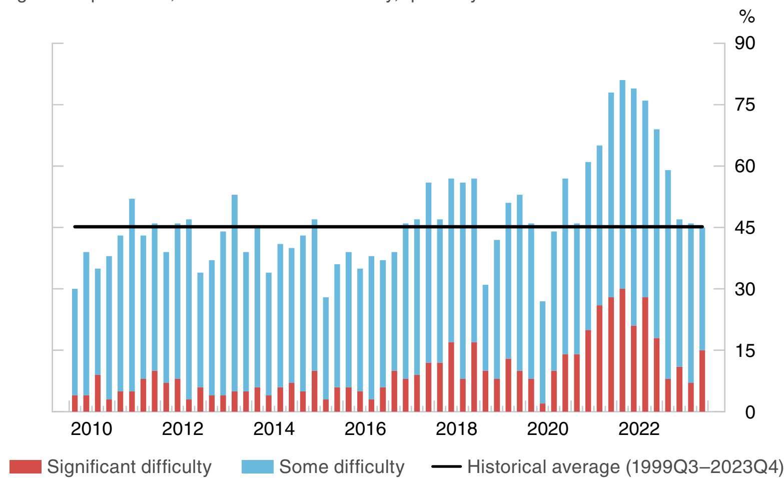
Economy in modest excess supply

Demand growth has stalled since the middle of 2023 amid rising supply, and the economy is judged to have moved into modest excess supply.

The output gap is estimated to have fallen to between -0.25% and -1.25% in the fourth quarter of 2023. This is broadly in line with evidence from the Bank's Business Outlook Survey that businesses are in a better position than they were a year ago to deal with an unexpected increase in demand (**Chart 10**).

Chart 10: Capacity pressures have eased

Percentage of respondents, Business Outlook Survey, quarterly data



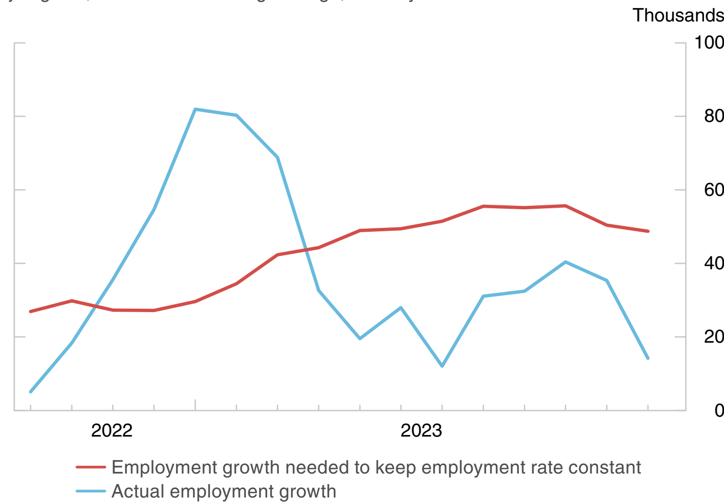
Note: Percentage of respondents to the Business Outlook Survey reporting some or significant difficulty meeting an unexpected increase in demand or sales.

Source: Bank of Canada

Last observation: 2023Q4

Chart 11: Employment growth has been below population growth

Net monthly job gains, three-month moving average, monthly data



Note: *Employment growth needed to keep employment rate constant* is calculated by multiplying the net monthly change in the size of the working-age population in the Labour Force Survey by the previous month's employment rate.

Sources: Statistics Canada and Bank of Canada calculations

Last observation: December 2023

Labour market conditions have eased further. The job vacancy rate has declined to near pre-pandemic levels, and job creation has been slower than the pace implied by population growth (**Chart 11**). The unemployment rate has risen modestly to 5.8% from 5.5% last summer. Respondents to the Bank's business surveys reported that labour shortages have declined and are close to their historical averages. In contrast, wage growth is still elevated at around 4% to 5%. Overall, the evidence suggests that labour supply and demand are better balanced.

Inflationary pressures easing but still elevated

CPI inflation declined from 8.1% in June 2022 to 3.4% in December 2023. The initial decreases were largely due to falling energy prices and improvements in global supply chains. Evidence continues to mount that the slowing economy is leading to lower price pressures across a broad range of goods and services.

Despite this progress, CPI inflation is still too high. Shelter service price inflation remains elevated at close to 7% due to rising mortgage interest costs and strong growth in rent (**Box 3**).[2] Food price inflation has declined from its peak but is still around 5%. Inflation in services excluding shelter has fallen significantly. However, the decline is far less pronounced when each month's most volatile prices are removed. This suggests that underlying pressures on services prices could persist.

2 Shelter services excludes utilities other than water. This differs slightly from Statistics Canada's definition of shelter, which includes those utilities.

Box 3

CPI inflation and the evolution of shelter costs

In Canada, consumer price index (CPI) inflation began to climb in the spring of 2021 and reached 5.7% by February 2022. The pickup included a strong increase in shelter services price inflation.[1] This was driven by a 14% rise in components related to house prices. Increases in house prices reflected the strong demand for housing, partly resulting from low mortgage rates.[2]

In response to rising inflation, the Bank of Canada began to rapidly increase the policy interest rate in March 2022. Over time, these increases have helped reduce inflation across a wide range of goods and services.

An important exception is inflation in shelter services prices, which remains elevated around 7%. While this is similar to its rate in early 2022, important changes have occurred within its key components:

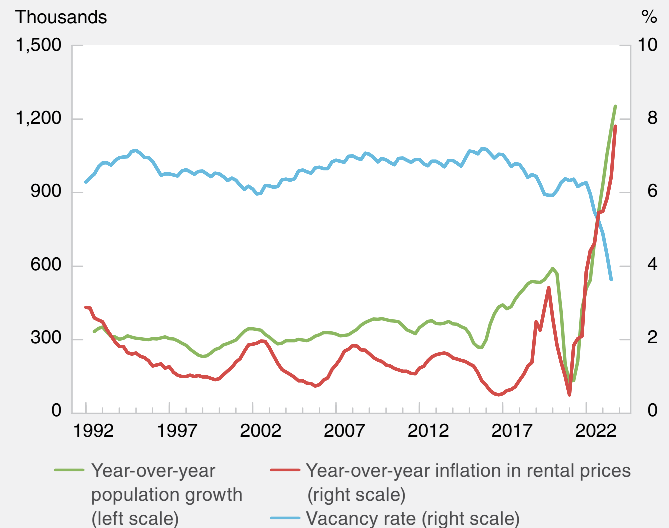
- Inflation in components related to house prices has since turned slightly negative because rising interest rates have reduced demand for owned housing.
- Mortgage interest costs and rental price inflation have risen sharply and are currently around 29% and 8%, respectively. These components are now the main drivers of inflation in prices for shelter services.[3]
- For all other components, inflation rose to 5% in December 2023 from 3% in February 2022.

The decline in overall shelter price inflation has been smaller than it was during other monetary policy tightening cycles. Several factors can explain this outcome:

- Mortgage interest costs are boosting inflation to a greater extent than in previous episodes of monetary policy tightening. This reflects the combined effect of a long period of historically low interest rates and a very rapid increase in policy rates through 2022 and 2023.

Chart 3-A: Strong population growth is supporting inflation in rental prices

Quarterly and monthly data



Note: The vacancy rate measure uses estimates of the total housing stock and the total number of Canadian households to calculate the share of housing that is currently unoccupied or vacant.

Sources: Statistics Canada and Bank of Canada calculations

Last observations: vacancy rate, 2023Q3; others, 2023Q4

- Several long-standing structural constraints have held back growth in housing supply. For example, home builders point to zoning restrictions, lengthy permitting processes and a shortage of construction workers.
- A larger increase in newcomers than in the past is adding pressure to the structural supply constraint in housing. This has helped to push the overall housing vacancy rate to record lows, which has underpinned house prices and led to higher rents (**Chart 3-A**).

Many of the forces supporting elevated shelter services price inflation are expected to persist:

- Inflation in mortgage interest costs will remain elevated as more households renew their mortgages at rates that are higher than when they purchased their home or when they last renewed their mortgage.

(continued...)

1 Shelter services excludes utilities other than water. This differs slightly from Statistics Canada's definition of shelter, which includes those utilities.

2 Components related to house prices include homeowners' replacement costs and other owned-accommodation expenses.

3 Increases in interest rates support rental price inflation by reducing the affordability of housing, which keeps households in the rental market for longer. Interest rate increases also lead to higher debt costs for property owners, which can be passed on to tenants.

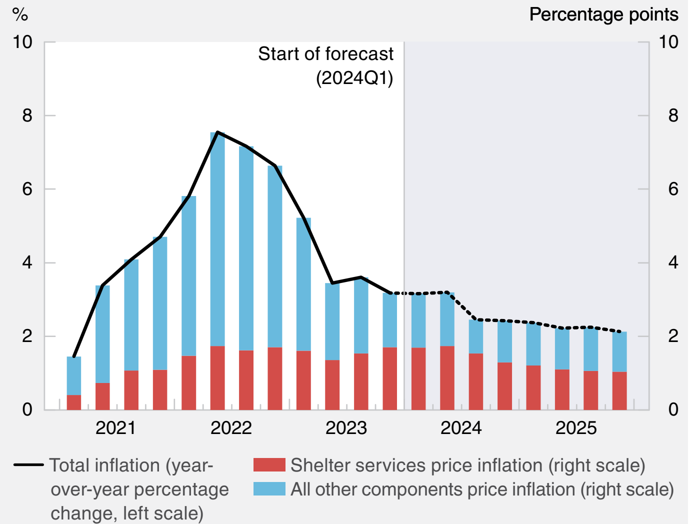
Box 3 (*continued*)

- Persistent structural supply challenges and strong underlying demand from population growth will likely continue to put pressure on house and rental prices. While recent government actions should help moderate some of these constraints, the imbalances are expected to be resolved only gradually.

Over the next few years, shelter services price inflation is expected to decline modestly (**Chart 3-B**) and act as a material headwind against the return of inflation to the 2% target.

Chart 3-B: Shelter services price inflation is expected to add persistent upward pressure on inflation

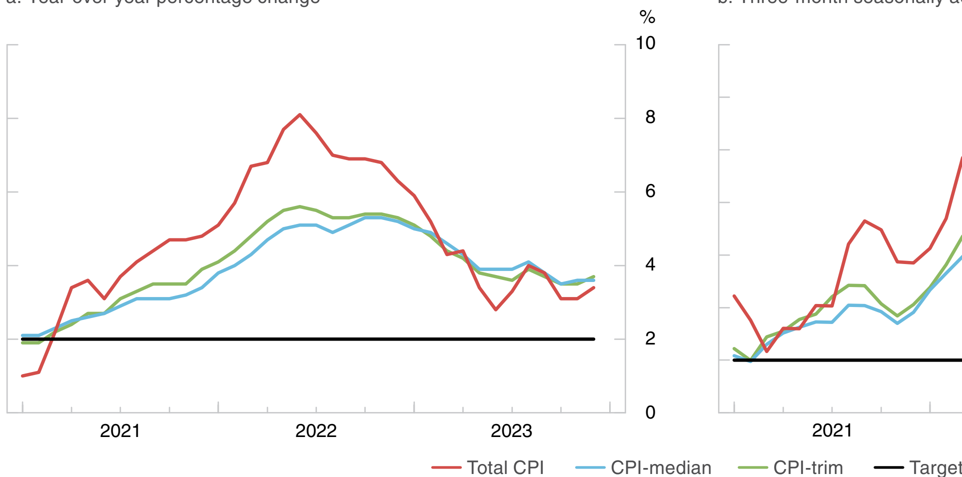
Contribution to CPI inflation, quarterly data

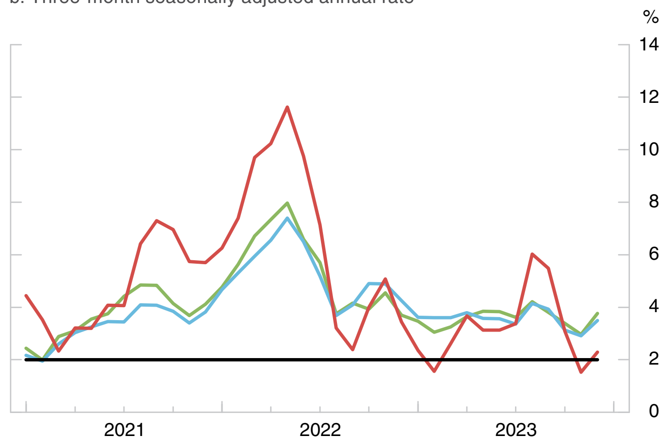


Source: Bank of Canada calculations, estimates and projections
Last data plotted: 2025Q4

Chart 12: Core inflation remains elevated and is easing only gradually

Measures of total and core inflation, monthly data



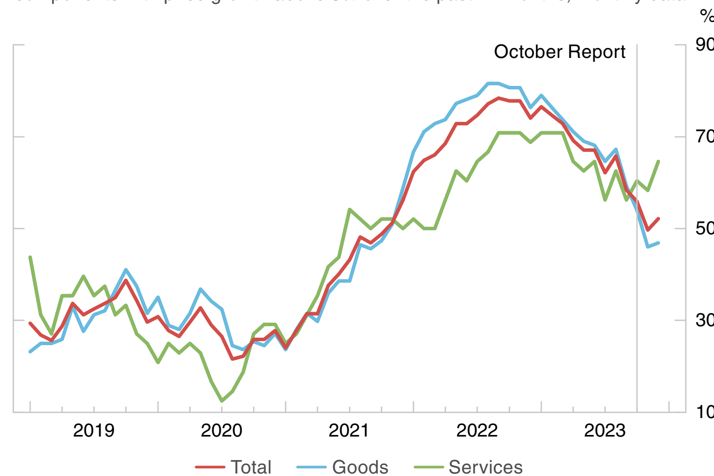


Note: More information about the CPI measures the Bank of Canada uses can be found on the Bank's website.
Sources: Statistics Canada and Bank of Canada calculations
Last observation: December 2023

Core inflation has remained elevated in the range of 3½% to 4% on a year-over-year basis (**Chart 12**). The three-month rates are also in this range. Alternative measures of core inflation have shown mixed results since the October Report. While CPIX has eased to about 2½%, CPI excluding food and energy has ticked up to around 3½%.

Chart 13: The proportion of CPI components with price growth above 3% has declined over the past year

Share of CPI components with price growth above 3% over the past 12 months, monthly data



Sources: Statistics Canada and Bank of Canada calculations
Last observation: December 2023

The share of CPI components growing above 3% has declined since the October Report, but the decrease was entirely in the prices of goods (**Chart 13**). In contrast, the share of services components growing above 3% has increased recently.

Inflation expectations and wage growth remain elevated

As inflation eases toward the 2% target, inflation expectations are anticipated to decline, businesses' pricing behaviour to normalize further and wage growth to moderate. While progress has been made, it is uneven across these inflation indicators.

Businesses are returning toward their pre-pandemic pricing behaviours. The share of businesses expecting to increase their prices more often than normal has declined over the last four quarters, as has the share of businesses that anticipate posting larger-than-normal price increases (**Chart 14**).

Near-term inflation expectations of businesses and households have also come down, but only very modestly (**Chart 15**). Results from the Business Outlook Survey for the fourth quarter of 2023 indicate that businesses' inflation expectations for the next two years have eased, but still average between 3% and 3½%.[3] Consumers' near-term inflation expectations have not declined significantly.[4] In addition, the distribution of inflation expectations remains wider than it was before the pandemic. This suggests elevated uncertainty about the path of inflation over the next few years. Long-term expectations remain consistent with the 2% target.

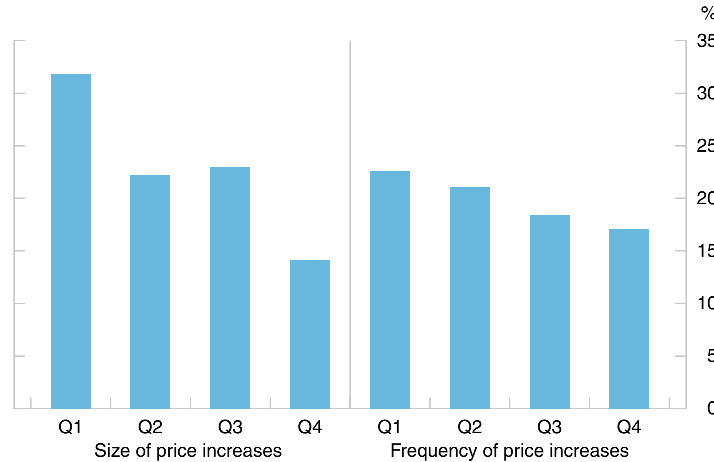
3 The Business Outlook Survey for the fourth quarter of 2023 was conducted from November 14 to December 1, 2023. The October CPI data were released on November 21, 2023.

4 The Canadian Survey of Consumer Expectations for the fourth quarter of 2023 was conducted from November 1 to 17, 2023. The latest available CPI data during the survey period was for the month of September 2023.

Wage growth remains around the 4% to 5% range, which is high relative to productivity growth (**Chart 16**). If wages continue to grow at this pace and productivity growth remains weak, inflationary pressures could increase (**Box 4**).

Chart 14: Firms' pricing behaviour is normalizing

Balance of opinion in 2023, quarterly data



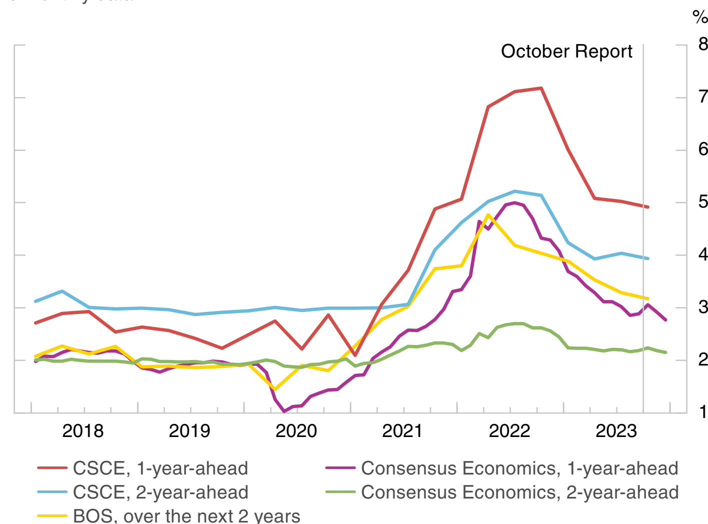
Note: The balance of opinion for *Size of price increases* is the percentage of firms responding to the Business Leaders' Pulse that are experiencing or expecting larger-than-normal price increases minus the percentage that are experiencing or expecting smaller-than-normal price increases. The balance of opinion for *Frequency of price increases* is the percentage of firms responding to the Business Leaders' Pulse that are experiencing or expecting more-frequent-than-normal price increases minus the percentage that are experiencing or expecting less-frequent-than-normal price increases. Firms without regular pricing frequency were excluded.

Source: Bank of Canada

Last observation: 2023Q4

Chart 15: Near-term inflation expectations have improved very little over the past few quarters

Quarterly and monthly data



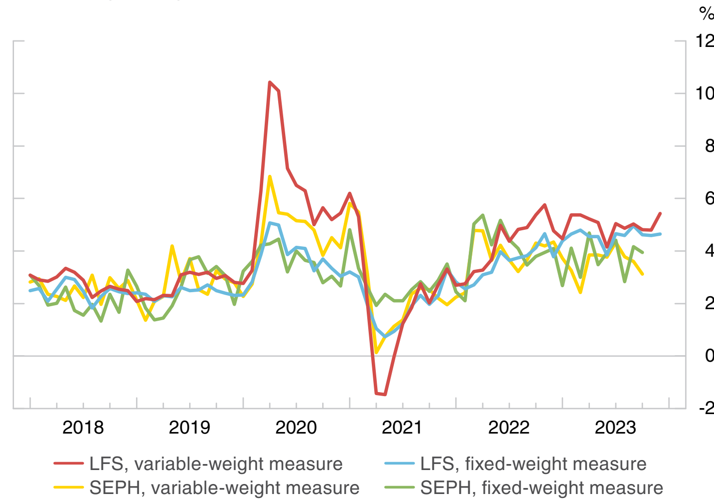
Note: CSCE is the Canadian Survey of Consumer Expectations; BOS is the Business Outlook Survey. Consensus Economics' forecasts for the next year (based on monthly data) and the next two years (based on a combination of monthly and quarterly data releases) are transformed into fixed-horizon forecasts by the weighted average of fixed-date forecasts. *1-year-ahead* refers to inflation expectations for the next 12 months. *2-year-ahead* refers to inflation expectations for the period 13 to 24 months from now.

Sources: Consensus Economics, Bank of Canada and Bank of Canada calculations

Last observations: Consensus Economics, December 2023; CSCE and BOS, 2023Q4

Chart 16: Measures of wage growth remain around 4% to 5%

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: LFS, December 2023; SEPH, October 2023

Box 4

Real wages and productivity

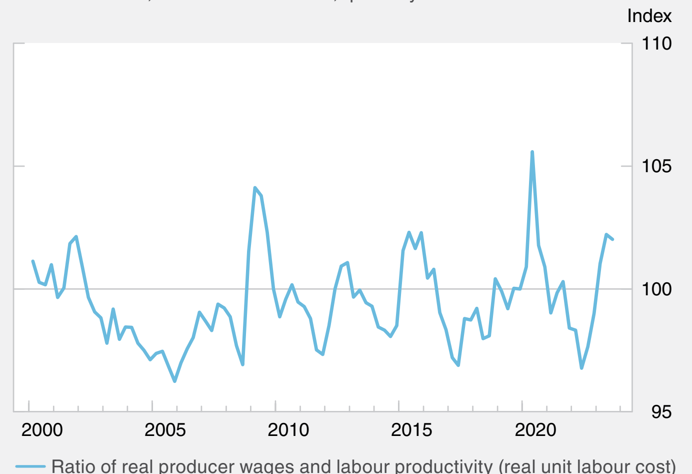
Changes in wages and labour productivity can provide insight into the evolution of inflationary pressures in the Canadian economy. Although the individual experiences of households have varied dramatically over the past few years, this box focuses on developments at an aggregate level.

Both inflation and nominal wages have experienced large swings since the start of the COVID-19 pandemic. In 2020, inflation fell to under 1%. It then picked up and averaged roughly 5% at an annual rate between the first quarter of 2021 and the third quarter of 2023. Nominal wages (compensation per hour worked in the business sector) were also volatile but on average grew just over 2% between the first quarter of 2021 and the third quarter of 2023.[1] The most recent data show that real consumer wages—earnings per hour after adjusting for CPI inflation—stand roughly 3% above the levels recorded in the fourth quarter of 2019.[2]

(*continued…*)

Chart 4-A: Ratio of real producer wages to labour productivity is above pre-pandemic levels

Business sector, index: 2019Q4 = 100, quarterly data



Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2023Q3

1 In 2020 and 2021, nominal wages were affected by compositional effects—particularly the unequal impacts of the pandemic on low-wage workers. Nominal compensation per hour is methodologically consistent with the labour productivity data, which is not the case for other wage data.

2 If instead the deflator for household final consumption or the deflator for GDP were used to determine real wages, the result would be 5.5% or 0.5%, respectively.

Box 4 (*continued*)

When evaluating their costs, businesses look at wages adjusted by output prices—in this case by using the price level of gross domestic product (GDP) as a proxy—rather than by the CPI.[3] This is known as the real producer wage. As of the third quarter of 2023, the ratio between real producer wages and productivity had risen above its pre-pandemic level, pushing up unit labour costs (**Chart 4-A**).[4] This development is broad-based across business sectors, and real producer wages are now growing faster than productivity in 13 of 16 industries (**Chart 4-B**).

Chart 4-B: Real producer wage growth exceeded labour productivity growth in most business sectors in 2023

Average growth between 2023Q1 to 2023Q3

Note: NAICS is the North American Industry Classification System. Industries shown include, from left to right: utilities; construction; wholesale trade; agriculture, forestry, fishing and hunting; finance and insurance, and holding companies; manufacturing; professional, scientific and technical services; other business services; administrative and support, waste management and remediation services; real estate and rental and leasing; retail trade; accommodation and food services; mining, quarrying, and oil and gas extraction; transportation and warehousing; information and cultural industries; arts, entertainment and recreation.

Sources: Statistics Canada and Bank of Canada calculations

Wages, productivity and the outlook for inflation

Labour market conditions appear to be easing. Job vacancies are nearing their pre-pandemic levels, and evidence from Bank surveys suggests that businesses expect wage growth to ease over 2024.

Even if real wages rise faster than productivity for a short period, inflation may not increase. For instance, higher wage costs could be absorbed by businesses' profit margins or be offset by declining non-labour costs, such as energy or imported inputs. If the period of weak productivity growth relative to real wages continues for an extended period, businesses may pass on the additional costs, adding to inflationary pressures.

3 The CPI is a measure of households' cost of living. It includes many imported final consumer goods that do not factor into calculating businesses' profitability.

4 The choice of deflator does not change the finding presented here. Using either the price level of GDP, the CPI or the price level of final consumption results in a ratio that is at or above its pre-pandemic level.

Slow demand growth and rising supply

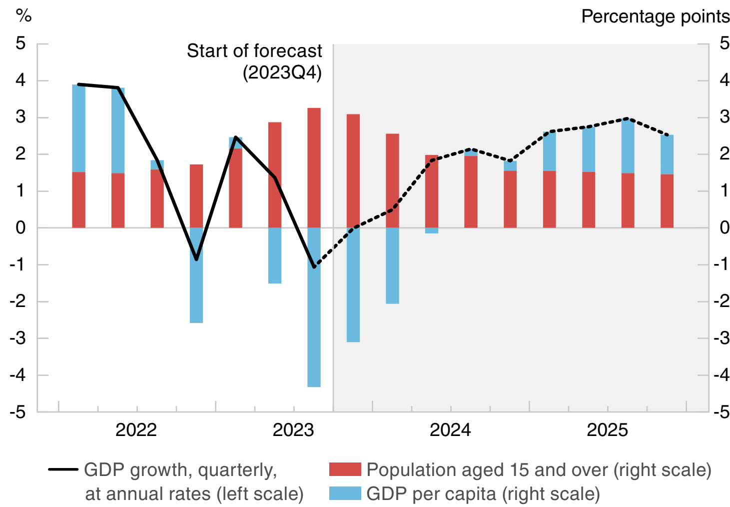
Economic growth is expected to be modest in 2024, largely unchanged from the October Report. The effects of past interest rate increases continue to restrain consumption and business investment. In addition, soft foreign demand will weigh on exports through the rest of the year. Spending by governments contributes materially to growth through 2024. While strong population growth props up overall economic activity, GDP per capita is expected to continue declining over the near term.

With demand continuing to grow more slowly than potential output, excess supply in the economy is projected to increase through the first half of 2024.

Growth is expected to pick up around the middle of 2024, rising to about 2½% in 2025 (**Chart 17**). Household spending strengthens as the dampening effects of monetary policy tightening on growth fade, financial conditions ease and confidence improves. Exports and business investment are supported by the recovery in foreign demand.

Chart 17: GDP growth per capita is expected to be subdued in 2024

Contribution to real GDP growth, quarterly data



Note: Data for the population aged 15 and over are from the Labour Force Survey.

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

Weak household spending growth

Growth in consumption is expected to remain weak until the end of 2024. While consumption is supported by strong population growth, on a per capita basis it is projected to continue declining through 2024. This is partly due to slow growth in labour income as the labour market eases further. In addition, consumer spending is held back by high debt-servicing costs and weak consumer confidence. Responses to the Canadian Survey of Consumer Expectations for the fourth quarter of 2023 indicate that households are cutting back on their spending and delaying purchases. Spending on most major purchases remains muted, especially for durable goods, which are more likely to be purchased on credit.

In 2025, consumer spending is expected to recover as income growth improves and the drag from high debt-servicing costs gradually declines. This decline is the net result of two opposing factors:

- For some time, households are expected to face higher interest rate payments when renewing their mortgages. The impact of the increases are anticipated to become smaller as mortgage rates gradually ease.
- However, some variable-rate mortgage holders with fixed payments will need to reset their amortization schedules and their required payments to catch up on their principal payments.

Residential investment is expected to pick up in early 2024. The boost to new construction comes from strong population growth, the recent easing in financial conditions and the waning effects of past increases in interest rates. Resale activity is projected to increase from its current low levels. House price growth is expected to be moderate over the projection horizon.

Soft business investment and export growth

Business investment is expected to remain weak through the first half of 2024, held back by slow demand and still-elevated borrowing costs. It is anticipated to pick up in the second half of 2024 with the diminishing impact of past interest rate increases as well as easing financial conditions and improving demand.

Export growth is expected to remain modest over the near term due to soft foreign demand for non-commodity exports. Plant shutdowns and retooling in the auto sector will also likely continue to affect motor vehicle exports through most of 2024. Nevertheless, overall, exports are anticipated to increase in the second half of the year—foreign demand will likely improve, and capacity for energy transportation will increase following the completion of the Trans Mountain Expansion project.

Growth in imports will likely remain muted through the first half of 2024. It is expected to pick up in the second half of 2024 and 2025 due to strengthening domestic demand.

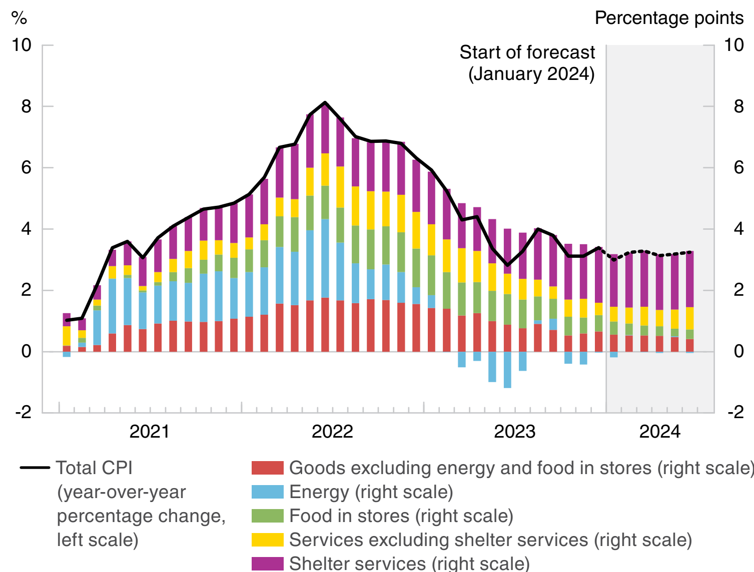
Inflation eases gradually

CPI inflation is expected to remain close to 3% over the first half of 2024. Elevated shelter price inflation and food price inflation are contributing to keep the level of inflation high (**Chart 18**).

Some components of inflation are expected to ease. For example, inflation in prices for goods excluding food and energy is projected to slow as excess supply deepens and inflation expectations decline. Food price inflation also slows because of lower global prices for agricultural products. More broadly, slowing growth in input costs is expected to lead to lower inflation for many other goods, including non-durables. Most businesses interviewed in the Business Outlook Survey expect input price growth to ease over the next 12 months.

Chart 18: CPI inflation is expected to remain close to 3% over the near term

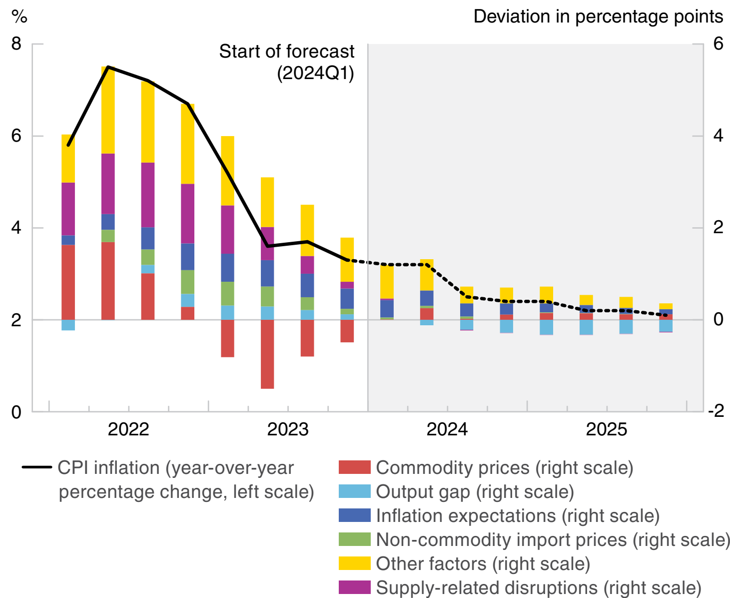
Contribution to CPI inflation, monthly data



Sources: Statistics Canada and Bank of Canada calculations, estimates and projections
Last data plotted: June 2024

Chart 19: CPI inflation is forecast to return to target in 2025

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



Note: *Non-commodity import prices* includes the impact of the Can$/US$ exchange rate. *Other factors* could include 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. 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*. Numbers may not add to total due to rounding.

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

In contrast, inflation in prices for services excluding shelter is anticipated to pick up modestly over the near term, largely due to less downward pressure from telecommunications prices.

As projected in the October Report, inflation is expected to decline to around 2½% in the second half of 2024 and then return to the target in 2025 (**Chart 19**). Over the projection horizon, ongoing excess supply in the economy continues to weigh on prices, and corporate pricing behaviour and inflation expectations gradually return to normal. Wage growth is expected to slow, falling closer in line with inflation and modest productivity growth.

Shelter price inflation remains elevated for some time. Growth in mortgage interest costs remains high as households continue to face higher rates at renewal and new mortgages are issued at rates above the average of the existing stock. Nevertheless, inflation in mortgage interest costs slows gradually as financial conditions ease and the impact of additional households renewing and taking on new mortgages decreases. Rental price inflation is supported by strong demand for housing and tight supply (**Box 3**). However, rental price inflation is also expected to moderate due to a slowdown in population growth and an expected increase in new housing construction. House prices are expected to contribute only modestly to overall shelter price inflation.

Risks to the inflation outlook

The Bank considers the outlook in the base-case scenario to be the most likely outcome for inflation. The Bank sees both upside and downside risks to this outlook. With inflation still above 3% and not expected to return to the 2% target for more than a year, the Bank remains particularly concerned about the upside risks.

Main upside risks

There are two broad types of upside risk: inflation could stall materially above 2%, or new developments could lead to renewed inflationary pressures.

Progress toward the inflation target could stall

First, inflation expectations have come down only very modestly over the past few quarters. If households and businesses continue to expect inflation to stay elevated, this could impede the pace at which price and wage growth moderate.

Second, wages have been increasing at a fast pace relative to productivity growth. On average, consumers' real wages are higher than they were in 2019. Productivity growth is effectively stalled and wages are still rising robustly. Because of this, the Bank remains concerned that cost pressures could add to inflation.

Third, house prices could also rise more than anticipated. This would increase inflation by raising shelter costs. While the base case includes a modest increase in house prices, this forecast is subject to a high degree of uncertainty. This risk could materialize if easing financial conditions lead to stronger-than-expected demand for housing while supply remains constrained.

New developments could fuel renewed inflation

The conflict in Israel and Gaza and attacks on ships in the Red Sea are affecting seaborne trade in the region and could push oil prices and shipping costs higher. So far, global disruptions from these developments have been contained. But if the conflict were to spread further, oil prices could rise sharply and the prices for traded goods could also increase significantly.

Main downside risks

As in the October Report, the main downside risk to inflation is a slowdown in the Canadian economy that is more pronounced than expected. Slowing could occur through two main channels.

First, monetary policy could have a greater impact than in the base case. Many Canadians are facing upcoming mortgage renewals and record-high levels of household debt. They could become more cautious and cut back consumption spending more than projected. This could also lead to a larger-than-expected slowdown in business investment and hiring.

Second, global activity could be weaker than in the base case. This risk could materialize if central banks in the United States or the euro area need to keep monetary policy tighter than expected to bring inflation back to target. In China, high debt levels of local governments and challenges in the property sector could further limit growth. This could lead to weaker global demand, which may reduce prices for commodities and tradable goods.

Canadian economic growth and inflation would both be pulled down if these risks were to materialize.