Economic Outlook 2023

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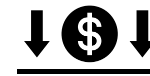
2023 At a glance

The great consumer squeeze will remain an essential theme for the economic outlook, with a premise that household finances are being squeezed by both:



1. The erosion in purchasing power coming from the high inflation rate, with prices rising faster than wages.
2. Fast-rising interest rates, leading to a rapid increase in the cost of households to service their record level of debt.

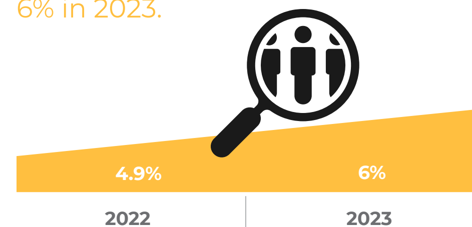
Canada

Growth in Canada slowed to a crawl in the second half of 2022 and we expect the economy to go through a mild recession in the first half of 2023, as fast-rising interest rates start to impact the broader economy.

While consumer-related sectors will underperform, we don't expect business investment and exports to be robust enough to prevent a recession. This is because many businesses have faced some severe capacity pressures over the past year, either through supply chain issues or labour shortages, and have expressed a desire to expand their production capacity.

We expect that weaker growth will lead to some underperformance in the labour market. However, we do not expect a big wave of job layoffs at this point, as many employers who have faced labour shortages over the past year may be reluctant to reduce their workforce.

A sharp reduction in hiring and some modest job losses should lead to a gradual rise in the unemployment rate from the current record low of 4.9% to mid-6% in 2023.



Probability of a recession

While consumer-related sectors will underperform, we don't expect business investment and exports to be strong enough to prevent a recession.

50%

The latest Bank of Canada (BoC) Business Outlook Survey shows that investment intentions are moderating and that overall business sentiment has deteriorated in the recent quarter, with a majority of businesses expecting a recession in 2023.

Inflation

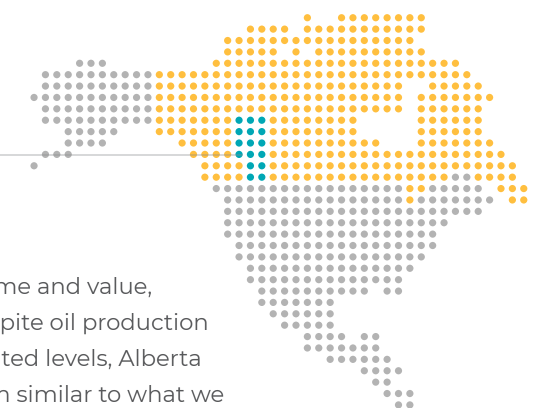
The inflation experienced in 2022 was a global phenomenon, and Canada is not the only country fighting a sharp rise in consumer prices. Developments in recent months suggest that inflationary pressures are easing, however, the question remains as to how sticky inflation will be.

Recession

To fight inflation, central banks will continue to work to create slack in the economy or push the unemployment rate above NAIRU (non-accelerating inflation unemployment rate) to reduce inflationary pressures. As a result, a recession and a rising unemployment rate are likely the "necessary evils" to bring inflation back to target. Recent economic data suggests that the global economy is not yet contracting but growth has stalled.

Housing

The first casualty from the sharp rise in interest rates has been the housing market, where the level of activity has declined sharply since winter 2022. This is mainly due to the fact that low interest rates were the main source of affordability in many markets.



Alberta

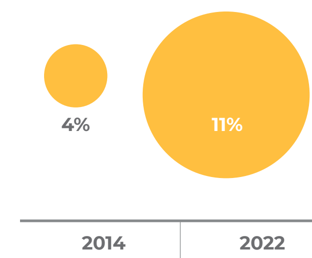
Oil production in Alberta, both in volume and value, is reaching record levels. However, despite oil production and revenues climbing to unprecedented levels, Alberta is not experiencing an economic boom similar to what we saw in the mid-2010s and the 2000s because the nature of the oil industry has changed, likely forever, and its impact on the economy has weakened.

Where's the Boom: Oil + Gas

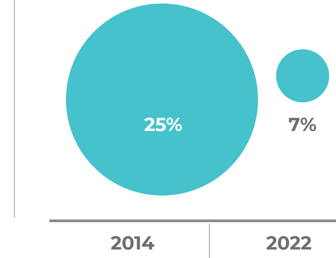
The lack of boom directly results from a much smaller share of oil revenues staying in the province.

Despite being a smaller positive than in previous booms, rising oil revenues remain a tailwind on the economy. Hence, it will support growth, income and the labour market, leading to stronger economic performance than in the rest of the country.

Sharesharesholder returns



Proportion of reinvestment



Only about a quarter of shareholders are Canadian, meaning that most of the revenues being returned to shareholders are leaving the country.

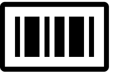
Outlook 2023

The pandemic brought a variety of unprecedented economic stories, from rising disposable income when the unemployment rate increased at its fastest pace in modern history to a worldwide disruption to the global supply chain and the global transportation industry. The period also saw wild swings in the prices of key commodities, especially food and energy, only to be exacerbated by the invasion of Ukraine by Russia. Moreover, the world witnessed unprecedented economic policy support at the height of the pandemic in the form of substantial fiscal spending, near-zero interest rates and quantitative easing, all in an effort to stimulate the economy.

One of the consequences of these disruptions has been a global rise in inflation, reaching levels well above the central bank's target not seen in more than three decades. This has led to one of the fastest monetary tightening cycles since the 1990s, pushing interest rates to levels similar to the global financial crisis. In Canada, inflation has reached its highest level since the early 1980s, leading the BoC to increase its policy rate by 350 basis points (bp) since the beginning of the year.

With all these economic shocks, there are concerns about the impact these changes will have on the global outlook and the Canadian economy.

What is going on with inflation?



Inflation experienced in 2022 is a global phenomenon, and Canada is not the only country fighting a sharp rise in consumer prices. Looking at OECD countries, the inflation rate is currently above 10%; this is more than double last year's rate. Fig 1 illustrates the inflation rate in a subset of countries.

Recent developments suggest that inflationary pressures from commodity prices, global chain disruptions and transportation costs are easing and could moderate inflation in the coming months. However, the question remains as to how sticky inflation will be.

Commodity prices

The sharp rise in commodity prices, especially energy and food, exacerbated by Russia's invasion of Ukraine, has been a significant contributor to the jump in inflation this year. For example, Western Texas Intermediate (WTI) oil prices reached about $120 a barrel following the invasion and European natural gas prices reached record levels over the summer.

However, what matters for inflation is not the level of prices but the changes compared to the same period the year prior. On that measure, oil prices rose steeply – by about 65% on average – in the first half of 2022 and by about 75% in the second half of 2021 (Fig 2). This was one of the fastest, most persistent increases in oil prices over the past four decades. Considering recent reductions and stabilization in prices, we could see an easing in inflationary pressures from energy prices in 2023. The year-over-year change in energy prices has decelerated sharply in recent months. As such, if oil prices remain unchanged at current levels, energy prices could be lower than the year prior by March 2023, meaning that they become a drag on headline inflation in many countries.

A similar moderation is also being observed in other commodity prices. As such, we note that the price of industrial commodities is currently lower than a year ago, while agricultural commodity prices are still above where they were last year. This suggests that some of the inflationary pressures due to commodity prices are easing, albeit still positive.

In the case of food prices, we also need to account for the delay of about 12 months in the pass-through from higher commodity prices to the food component of the Canadian Consumer Price Index (CPI) (Fig 3).

Fig 1: Global inflation rates

Source: Bloomberg, OECD

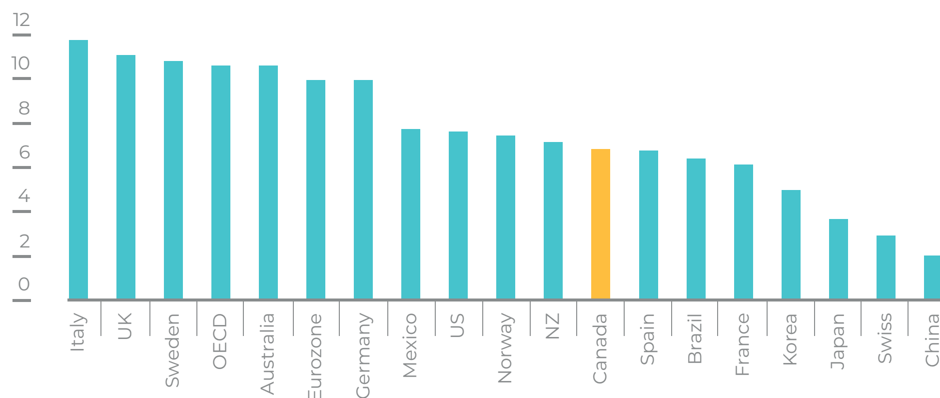


Fig 2: World Commodity (% y-o-y)

Source: Bloomberg

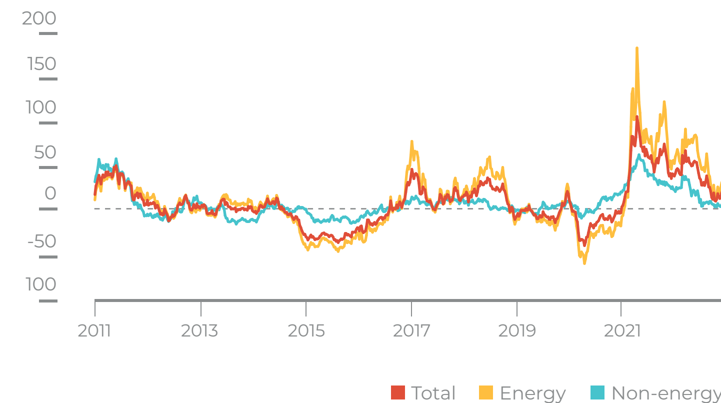
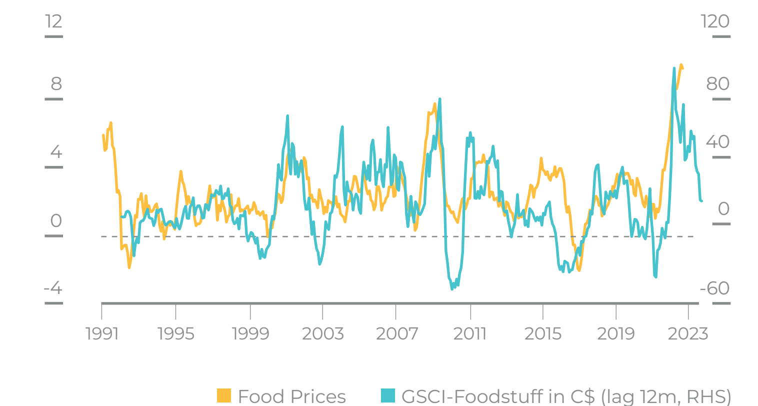
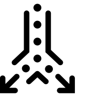


Fig 3: World food commodity prices vs CPI food component

Source: Bloomberg, Statistics Canada, Alberta Central



Transportation costs and supply-chain disruptions have shown signs of normalization in recent months.



Supply chain and transportation bottlenecks and labour shortages easing

The global supply chain continues to be disrupted, leading to production delays and shortages of some goods and services. In addition, labour shortages remain intense in many sectors globally and nationally, constraining businesses' production capacity. This continues to put upside pressures on prices and wages as firms compete for limited inputs and workers.

Transportation costs and supply-chain disruptions have shown signs of normalization in recent months. For example, the Federal Reserve of New York's global supply pressure index has improved since the beginning of the year, but tensions remain. Similarly, container shipping costs, especially between China and the US, have declined rapidly recently but remain higher than they were pre-pandemic.

We believe supply constraints will continue to ease as producers manage to catch up on orders and a slowing global economy reduces demand. However, there is a risk that the resolution of global chain disruptions could be more deflationary than expected. This could be the case if the global economic demand slowdown is more meaningful than expected, due to the sharp global tightening in monetary policy, at a time when producers are ramping up supply. This could create a period of oversupply in some areas and could put downward pressures on prices.

Inflation is broad and likely to be sticky

While some improvements in the global supply chain could ease some of the inflationary pressures, inflation is expected to remain sticky because of various factors:

- The shock from energy prices has been enormous and likely had a non-linear impact on other prices. What we mean is that the increase is too significant to be absorbed by businesses' profit margins, requiring a greater pass-through to consumers and leading to broad price increases. As such, the initial spillover from higher energy costs has been on transportation costs, affecting the prices of goods and utilities. However, given the size of the energy shock, the services sector also has to pass the increased energy cost to their customers since energy is also an important cost for the industry (heating, cooling, lighting). As a result, many countries, including Canada, have seen broadening inflationary pressures as evidenced by elevated core inflation.
- Inflation expectations have increased as inflation reached levels not seen in decades and remains stubbornly high. It will take a period of inflation closer to the target to bring expectations back down. This stickiness in inflation from higher expectations will likely require a considerable amount of slack in the economy to bring inflation down if left unchecked and increasing.
- The rise in wage growth, due to higher inflation expectations and workers demanding compensation for declining purchasing power, could also lead to more persistence in inflation. This is because higher wages increase the operating costs of firms, which subsequently increase prices to keep profit margins unchanged.

Fig 4: Global supply pressure index (%)

Source: Federal Reserve of New York

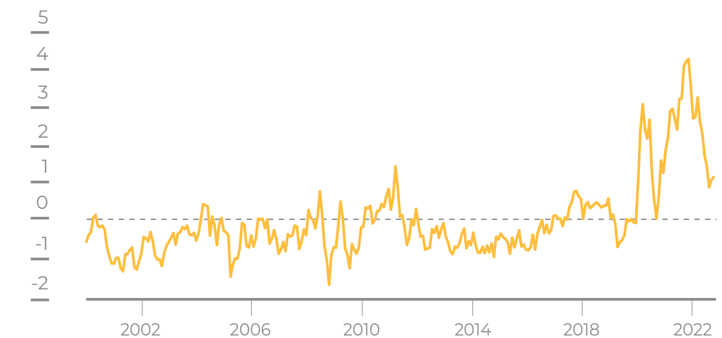
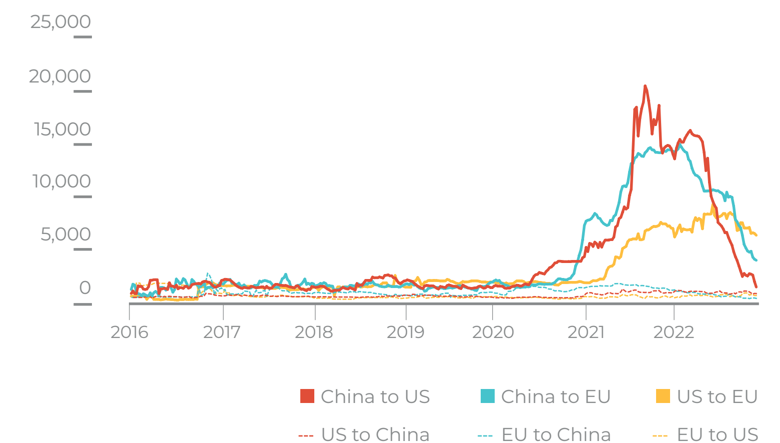


Fig 5: Shipping cost (USD per 40ft container)

Source: Bloomberg



> Inflation in Canada has been affected by many global factors: a surge in commodity prices, global supply chain disruptions and higher transportation costs.

Canadian context

Inflation in Canada remains close to 7% and reached 8.1% earlier this year, its highest level since the 1980s. Moreover, inflation is broad, with about 75% of CPI components increasing at more than 3% y-o-y and two-thirds of components growing at more than 5%. The BoC's measures of core inflation and inflation excluding food and energy have been above 5% for some months.

Inflation in Canada has been affected by many global factors: a surge in commodity prices, global supply chain disruptions and higher transportation costs. In addition, a strong rebound in global demand, as economic activity normalized post-pandemic restriction, supported by policy support (government programs and low interest rates) led to higher income and savings.

However, there are also some Canada-specific sources of inflation. As such, the shelter component has been responsible for almost a quarter of the increase in inflation over the past year. In large part, this reflects a sharp rise in ownership costs, partly due to rising house prices and, more recently, rising rents. As a result, this segment of CPI may prove stickier than others.

Inflation expectations have also increased in Canada, with businesses and consumers expecting inflation to remain elevated for the next two years. However, longer-term inflation expectations have remained broadly unchanged, suggesting that agents do not doubt the BoC's resolve to bring inflation back to its target.

Wage growth has increased in recent months but remains well-below inflation, suggesting a continued decline in purchasing power. However, recent business surveys indicate that businesses do not expect a further rise in wage growth. Similarly, the latest Survey of Canadian Consumers by the BoC suggests households' wage expectations remain contained.

Outlook for inflation

With the contribution from energy prices expected to diminish, if energy prices do not spike again, we expect headline inflation to continue to moderate, especially at the start of 2023. The deceleration in inflation could be relatively fast starting in March, as the y-o-y change in energy prices could turn negative. Nevertheless, despite an expected sharp decline, headline inflation will likely remain between 3.5% and 4% for most of the second half of 2023, well above the BoC's target.

Looking at core inflation, the current dynamics in the underlying measures of inflation suggest that it may have peaked. As such, the 3-month annualized rate of changes in most broad components of CPI has been below the y-o-y change for a couple of months. This suggests that core inflation is no longer accelerating and could have peaked or is close to peaking. Nevertheless, core inflation is expected to remain above 5% until almost mid-2023. After which, it is expected to decelerate to reach 3.3% at the end of 2023.

The risk to this forecast is that inflation could be more persistent and stickier than expected, especially if inflation expectations continue to rise.

Fig 6: Broad inflationary pressures (%)

Source: Statistics Canada, Alberta Central calculations

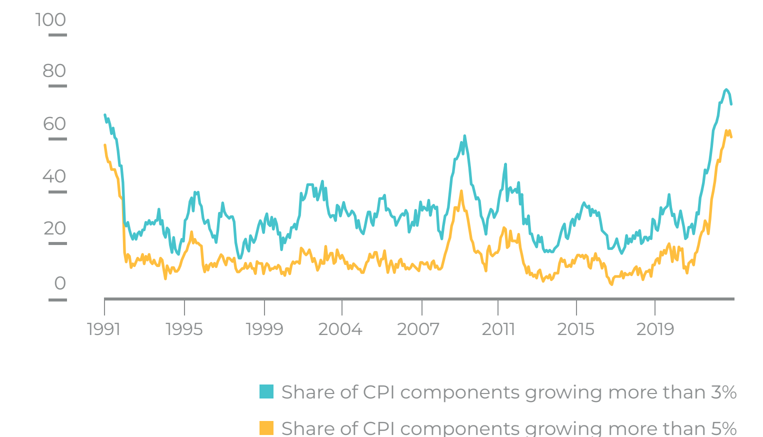
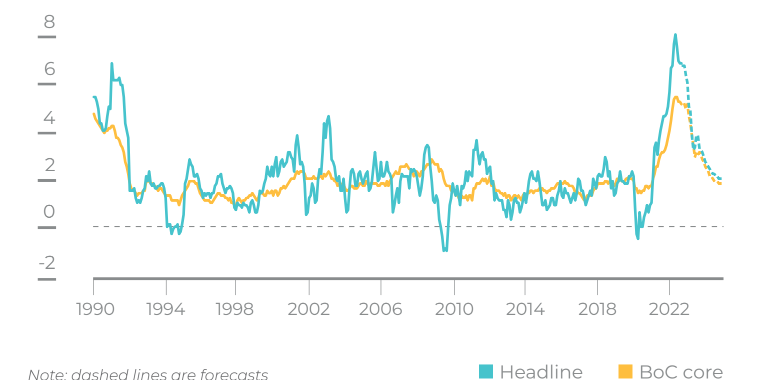


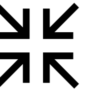
Fig 7: Headline and core inflation (%)

Source: Statistics Canada, Alberta Central forecasts



Note: dashed lines are forecasts

Fast tightening of monetary policy



Most central banks started 2022 with interest rates close to zero and even in negative territory (in the case of the European Central Bank). To fight inflation, these central banks must bring monetary policy into restrictive territory. In economic terms, they need to raise interest rates beyond the neutral rate (or the rate of interest rates that prevails when an economy's output is at its potential level and inflation is at the central bank targets). This level is unobservable, making it difficult to estimate with precision, leading to uncertainty. In the current environment, central banks face the difficult challenge of balancing the risks of doing too little and risking inflation becoming persistently high or doing too much, leading to a deep recession and high unemployment.

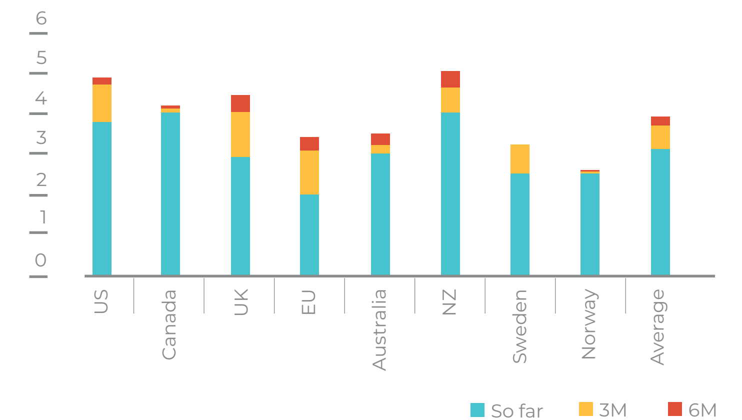
So far this year, most central banks in the world, including the Federal Reserve, the European Central Bank, the BoC, the Bank of England, and the Reserve Bank of Australia, have increased their policy rate aggressively. Since the start of the tightening cycle, these central banks have increased interest rates by more than 360bp on average and are expected to have increased them by a total of 420bp by mid-2023.

In addition, central banks are not only increasing interest rates to fight inflation, but also conducting quantitative tightening; i.e. reducing their holdings of government bonds, thereby draining the liquidity that was injected into the economy when rates hit the lower bound. The withdrawal of this liquidity will likely impact the longer-end of the yield curve and equity markets, increasing financing costs for businesses, and will substitute for some policy rate hikes. In recent months, these central banks have reduced their balance sheets by almost $1800bn, which remains modest as it represents about 7% of their combined balance sheets.

In Canada, the BoC has increased its policy rate by 400bp this year, from 0.25% to 4.25%. This is the sharpest rise in the official rate since the early 1990s. However, with a starting point close to zero and after a decade of very low interest rates, the current cycle is very different. In addition, the BoC has shrunk the size of its balance sheet by about $165bn, a reduction of almost 30% in the size of its balance sheet, mainly by not reinvesting the proceeds from maturing government bonds it holds.

Fig 8: Rate expectations: amount of hikes (%)

Source: Bloomberg



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Relevancy for credit unions:

The shock from energy prices has been enormous and is likely to have a non-linear impact on other prices. This means that the increase is too significant to be absorbed by profit margins and broad price increases will be required. When coupled with the rise in wage growth, inflation is expected to persist. As a result, a considerable amount of slack in the economy will be required to bring inflation down.

In Canada, the BoC has increased its policy rate by 400bp this year, from 0.25% to 4.25%. This is the sharpest rise in the official rate since the early 1990s.

Outlook for monetary policy

The BoC has recently signaled that the pace of rate hikes could slow. As such, recent estimates from the BoC put the neutral rate at between 2% and 3%, meaning that the current policy rate is well into restrictive territory, suggesting that the policy rate is likely approaching its terminal rate or the rate at which the BoC will stop hiking rates.

The BoC hiked its policy rate by 50bp at the December meeting to 4.25% and will likely increase it by 25bp to 4.50% at the January meeting. However, whether it will hike again beyond that point depends on whether inflation is stabilizing or peaking. Based on our projection of inflation decelerating in early 2023, we expect the central bank to keep rates unchanged for the first half of 2023.

In addition to raising its policy rate, the BoC is also conducting quantitative tightening by not reinvesting the proceeds from maturing government bonds it holds. About $90bn worth of bond holding will mature in 2023. This represents about a quarter of the bonds held by the BoC and about 6% of all Government of Canada bonds outstanding. Such a withdrawal of liquidity will have an impact on financial markets and will likely act as a substitute for interest rates hikes.

With a likely recession and inflation expected to slow in the first half of 2023, we think that there is a possibility that the BoC could make some fine-tuning to its monetary policy in the second half of the year, likely cutting by 25bp at the October meeting. However, any cuts would be heavily dependent on the inflation dynamic. If inflation proves to be stickier than expected, the BoC is likely to keep rates unchanged, despite an economic contraction.

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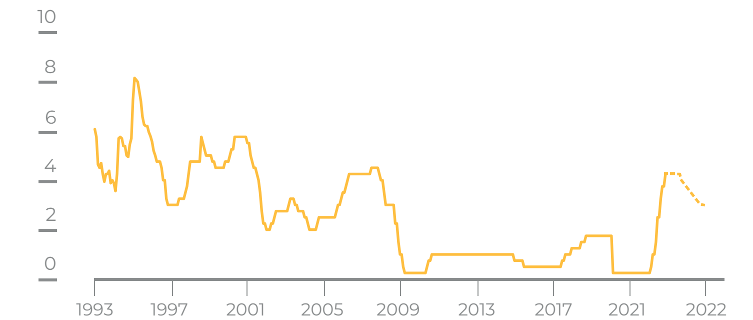
Relevancy for credit unions:

Global monetary tightening and in Canada, through higher interest rates and a reduction in central banks balance sheets, are expected to reduce the availability of credit, both in terms of prices and quantity.

Higher rates will impact credit unions' margins and the demand for loans. It will also affect liquidity as higher interest rates entice more depositors to switch from demand deposits to term deposits.

Fig 9: BoC policy rate (%)

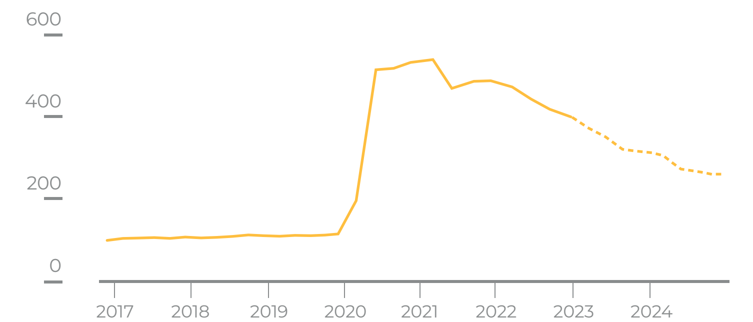
Source: Bank of Canada, Alberta Central forecasts



Note: the dotted line is forecast

Fig 10: BoC balance sheet ($bn)

Source: Bank of Canada, Alberta Central forecasts



Note: the dotted line is forecast

A recession may be a necessary evil to bring inflation down

Additional insights::
Supply-induced inflation: mind the differences

There is a lot of uncertainty about the impact of a quick monetary tightening cycle on the global economy. However, as we have repeatedly argued over the past year, see *Supply-induced inflation: mind the differences*, central banks need to create slack in the economy or push the unemployment rate above NAIRU (Non-accelerating inflation unemployment rate) to reduce inflationary pressures. As a result, a recession and a rising unemployment rate are likely the necessary evil to bring inflation back to target.

Recent economic data suggests that the global economy is not yet contracting but growth has stalled. As such, the Purchasing Managers Indexes - a measure that provides insight on some of the emerging trends in manufacturing – has been declining recently in most countries. This suggests a deceleration or stalling growth; in some cases, growth is contracting. However, global trade measures suggest that export volumes, as measured by the CPB (Netherlands Bureau for Economic Policy Analysis), have remained resilient and continue to increase at a pace of about 4% y-o-y.

Nevertheless, there continue to be many downside risks to global growth. In Europe, the sharp rise in energy prices, the ensuing energy crisis and the sharp rise in inflation will most likely push the region into a recession, especially as the European Centre Bank (ECB) continues to increase its policy rate after years of negative rates. The question in Europe is not whether there will be a recession but how bad will the recession be?

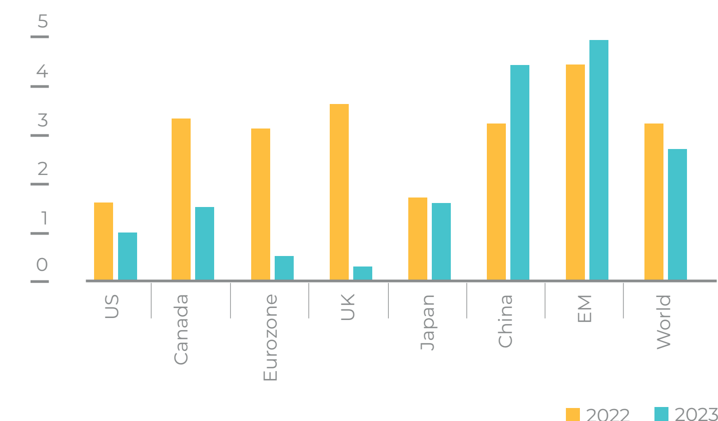
In the US, growth rebounded in the third quarter after two consecutive quarters of contractions, owing to a decline in net exports (Q1) and inventories (Q2). So far, domestic demand remains resilient. However, with the Federal Reserve continuing to hike its policy rate and signaling more to come, there are increasing expectations that the country will fall into a recession in the coming quarters. However, the labour market remains strong so far and does not suggest a sharp downturn is imminent.

On the flip side, the end of the COVID zero policy in China and the reopening of the economy and the introduction of measures to spur growth could be a tailwind on the global economy and push commodity prices higher.

How weak the global economy is may hinge on how much the misery index, calculated by adding the inflation rate and the unemployment rate, will rise this year. The index, developed by economist Arthur Okun, provides a simple measure of the economic pain faced by households. If it rises too much, it may lead to further economic underperformance as households restrain their spending further.

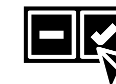
Fig 11: IMF growth forecast 2002 vs 2023 (%)

Source: International Monetary Fund



A recession is more likely than not in Canada

Additional insights:
Where's the boom? How the impact of oil on Alberta may have permanently weakened



As mentioned previously, the Canadian economy needs to operate with some slack or excess supply to bring inflation down. This means that there needs to be a period of growth below potential growth, estimated at between 1.4% and 3.3% for 2023, by the BoC. This will lead to a rise in the unemployment rate and a negative output gap.

The formula below shows a simple inflation model, where the inflation level depends on inflation expectations and the amount of slack in the economy.

$$\pi = \pi^e + GAP$$

The negative output gap and the higher unemployment rate will push inflation lower. In addition, they will also influence inflation expectations, as consumers and businesses believe in the success of the central bank's campaign against inflation.

However, considering the rapid rise in interest rates and debt-related vulnerabilities in the Canadian economy, it is very likely that Canada will experience a recession in 2023.

Some analysts and policymakers have suggested that improvement in the terms of trade coming from higher energy prices could help mitigate some of the downside risks. However, as we have shown in *Where's the boom? How the impact of oil on Alberta may have permanently weakened*, the terms-of-trade improvement from higher oil prices is not as positive as it looks on the surface. This is because a greater share of oil revenues is leaving the country and a smaller share is being reinvested in their operations.

This situation has some implications for the Canadian economy:

- More of the oil revenues being returned to foreign shareholders leads to less appreciation in the Canadian dollar than otherwise would be the case. This results in marginally higher costs for imported goods and services, leading to higher inflation, all else equal.
- It leads to lower national income than would otherwise have been the case. Hence, it will lead to weaker income growth and a bigger loss in purchasing power than historical patterns suggest.

Overall, the smaller positive terms-of-trade from higher energy prices will provide less of a buffer from a recession than some may expect.

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Relevancy for credit unions:

Oil revenues leaving the province as they are returned to foreign shareholders, has resulted in a lower national and provincial income and weaker economic growth for Canada and Alberta, a trend that is expected to persist despite historical patterns. The upside will be that the expected "bust" following the so-called "boom" in Alberta will be lessened.

Housing is the first casualty

Additional insights:

Rising interest rates to erode housing affordability, but could benefit Alberta

House prices will have to decline further to restore affordability, except in the Prairies

The first casualty from the sharp rise in interest rates has been the housing market, where the level of activity has declined sharply since February 2022. This shouldn't be surprising. As we have shown in *Rising interest rates to make many Canadian cities unaffordable* and low interest rates were the main source of affordability in many markets, especially in Toronto.

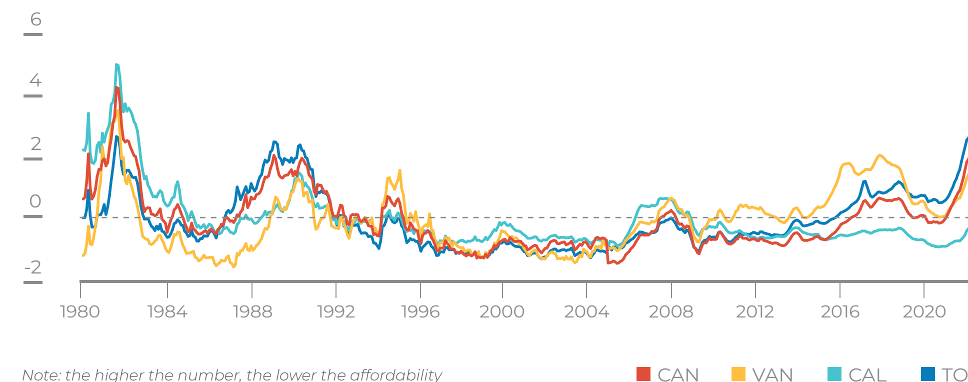
With prices reaching records in most markets in 2022, the increase in mortgage rates has led to a sharp rise in interest payments and a significant deterioration in affordability. For example, on a benchmark house price of $1.27 million in Toronto, the 400bp increase in interest leads to a $40,600 per year increase in interest payments. In Vancouver, it is an increase of $39,500, $22,300 in Ottawa, $17,000 in Montreal, $18,200 in Calgary, and $10,300 in Edmonton. House prices will have to decline further to restore affordability, except in the Prairies (see *House prices will have to decline further to restore affordability, except in the Prairies.*). Fig 12 shows the Z-score of the average mortgage payment relative
to the average income for a subset of Canadian cities. It shows that affordability has declined significantly in recent months and is at its lowest in many markets since the early 1990s.

As a result of a sharp drop in affordability, demand has declined sharply, largely explaining the fall in housing activity. Improving affordability, many housing markets are seeing price declines since peaking earlier this year: 12% in Toronto, 9% in Vancouver, 7% in Ottawa. Generally, the more robust house price increases have been since the pandemic, the bigger the decline in house prices. In Calgary, house prices have yet to peak, even though they have been relatively stable in recent months. This results from less post-pandemic excess and greater affordability, requiring less price adjustment.

The price declines shouldn't come as a surprise considering the massive drop in affordability due to rising interest rates. We believe further reductions are likely. We estimate that to restore affordability to where it sat on average between 2009 and 2019, house prices in Toronto would need to decline by 44%, 41% in Ottawa, 39% in Montreal and 22% in Vancouver. In Calgary and Edmonton, house prices would need to decrease by 18% and 9%, respectively. However, there is an important caveat for Alberta's metropolitan cities. Affordability was below its long-term average between 2009 and 2019, meaning that house prices were undervalued during that period. As a result, the calculation overestimates the size of the needed correction. Suppose we assume that affordability returns to its long-term average (1980 to today). In that case, prices in Calgary only have to decline by 5% and 1% in Edmonton, suggesting little need for a correction in these cities.

Fig 12: Affordability measures (Z-score) (%)

Source: Alberta Central Calculations



Note: the higher the number, the lower the affordability

The great consumer squeeze

Additional insights:

The great consumer squeeze

The great consumer squeeze will remain an essential theme for the economic outlook, see *The Great Consumer Squeeze* for details.

The premise is that households finances are being squeezed by both:

- The erosion in purchasing power coming from the high inflation rate, with prices rising faster than wages.
- Fast-rising interest rates are leading to a rapid increase in the cost of households to service their record level of debt.

The result is that a greater proportion of household income needs to be directed toward essential purchases (e.g., food, housing costs, etc.) and debt-service, leaving less money available for other uses, reducing discretionary spending.

The fact that households have accumulated a vast amount of savings during the pandemic, which we estimate at $320bn with $137bn currently held in demand deposit, could help mitigate some of the impacts on consumption. However, this will depend on whether households use their savings to increase or maintain their spending level or continue to save the money as a precaution against a potential adverse shock, like a recession.

We have already seen a significant decline in consumer confidence since April. The Bloomberg/Nanos measure is close to its lowest level on record if we exclude the early days of the pandemic. But, so far, the decline in confidence has not yet affected spending intentions, according to the latest BoC Canadian Survey of Consumer Expectations. Similarly, retail sales volumes are holding up so far and appear to have stalled, rather than declined, meaningfully.

Fig 13. Real income ($tr)

Source: Statistics Canada, Alberta Central

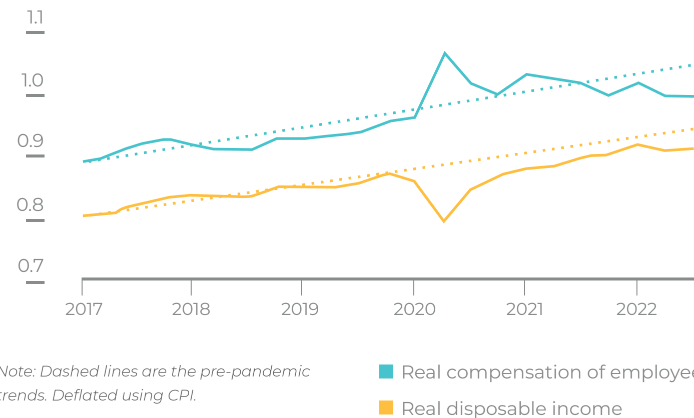


Fig 14. Impact of BoC's hikes on the debt-service ratio (%)

Source: Statistics Canada, Alberta Central forecasts

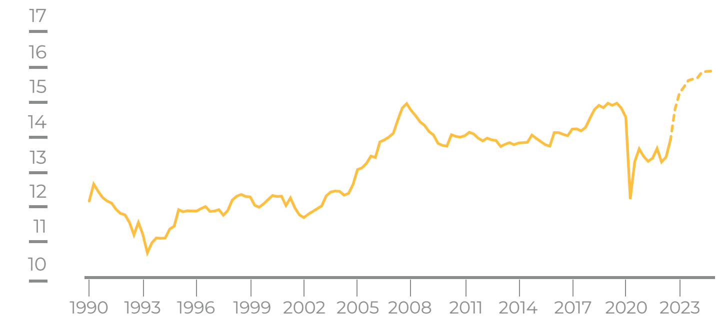
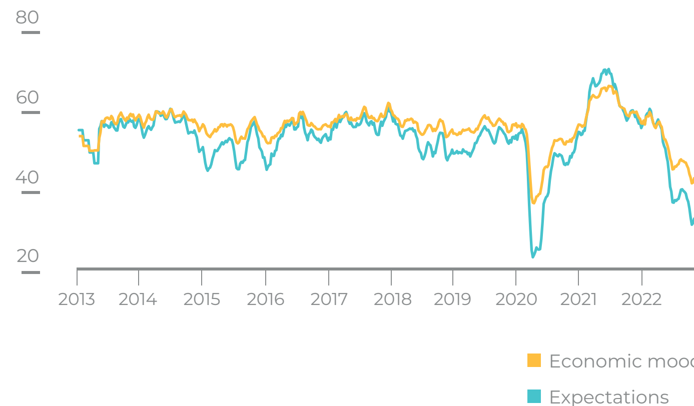


Fig 15. Drop in consumer sentiment (%)

Source: Bloomberg/Nanos



Outlook for growth

Growth in Canada has slowed to a crawl in the second half of 2022 and we expect the economy to go through a mild recession in the first half of 2023, as fast-rising interest rates start to impact the broader economy. The drag on growth will come mainly from a contraction in consumer spending as households reduce discretionary spending. In addition, a continued correction in the housing market will lead to a decline in residential investment.

While consumer-related sectors will underperform, we don't expect business investments and exports to support growth, thereby preventing a recession. On the exports side, the global economy is expected to slow meaningfully next year, with the IMF forecasting global growth to decelerate to 2.7% in 2023 from 3.2% in 2022. Moreover, growth expectations of the US, Canada's main trading partner, are also weak, with growth expected at 0.3% in 2023, according to economists surveyed by Bloomberg. In addition, those surveyed also put the likelihood of the US economy experiencing a recession at 65% in 2023.

On business investment, many businesses have faced some severe capacity pressures over the past year, either through supply chain issues or labour shortages, and have expressed a desire to expand their production capacity. The latest BoC's *Business Outlook Survey* shows that investment intentions remain high. However, overall business sentiment has deteriorated in the recent quarter and a majority of businesses view the probability of a recession is above 50%. Such expectations could hold back firms from increasing investment. Moreover, rising borrowing costs could make some investments less attractive. As such, while we do not expect a decline in business investment, it is unlikely to be a major contributor to growth in 2023.

We expect that weaker growth will lead to some underperformance in the labour market. However, we do not expect a big wave of job layoffs at this point, as many employers who have faced labour shortages over the past year may be reluctant to reduce their workforce. Nevertheless, a sharp reduction in hiring and some modest job losses should lead to a gradual rise in the unemployment rate from the current record low of 4.9% to mid-6% in 2023. As mentioned before and highlighted in a recent speech by BoC's Governor Macklem, a rising unemployment rate is necessary to bring inflation down.

Risks to the outlook

The risks around the outlook are clearly tilted to the downside. On the upside, the economy could be more resilient to the higher interest rates, as consumers remain keen on using their savings accumulated during the pandemic and the labour market could hold better than expected.

On the downside, the high level of household debt is a significant source of vulnerability for the Canadian economy. While higher interest rates will increase the cost of servicing and carrying the debt, households are likely to remain solvent as long as their income does not suffer. However, many households likely require two incomes to make obligated payments on their debt. As a result, there is a significant risk of insolvencies if household income drops because of job losses. Hence, a sharp deterioration of the labour market could be the Achilles heel of the Canadian economy, as layoffs would lead to further weakness in consumer spending and rising defaults, negatively impacting the financial sector and the housing market.

With this in mind, such a situation could potentially lead to a challenging position for the BoC, as it would face a trade-off between fighting inflation and preventing financial instability and a deeper and longer recession.

Even if the downside risks do not materialize, there is a lot of uncertainty as to what the recovery will look like in the second half of 2023 and in 2024. With consumer spending likely to remain constrained for some time, there is a possibility that the recovery could be very slow, especially if inflation remains sticky, preventing the BoC from cutting rates and stimulating the economy.

Alberta: Where's the boom?

Additional insights:
Where's the boom? How the impact of oil on Alberta may have permanently weakened

Oil production in Alberta, both in volume and value, is reaching record levels. However, despite oil production and revenues climbing to unprecedented levels, Alberta is not experiencing an economic boom similar to what we saw in the mid-2010s and the 2000s. As we showed in the report *Where's the boom? How the impact of oil on Alberta may have permanently weakened*, this is because the nature of the oil industry has changed, likely forever, and its impact on the economy has weakened.

The lack of boom directly results from a much smaller share of oil revenues staying in the province. Oil producers returned about 11% of their revenues (about $25bn) to shareholders in dividends and share buybacks over the past year. This compares to about 4% of revenues ($4.5bn) in 2014. Moreover, only about a quarter of those shareholders are Canadian, meaning that most of the revenues being returned to shareholders are leaving the country. In addition, oil producers reinvested a smaller share of revenues into their operations (about 7% of their revenues, $15bn over the past year). In 2014, this proportion was about 25% of revenues ($28bn).

The type of investment is also evolving, thereby changing the economic spillover of oil and gas investment on the broader economy. Energy transition and a reduction in global greenhouse gas emissions are leading to a likely peak in oil demand around 2030, according to many research institutes, including the International Energy Agency. In addition, the war in Ukraine and the resulting energy crisis and high prices could be a catalyst for a faster transition away from fossil fuels. This situation means that Alberta's oil producers no longer need to invest as much as before in new production capacity with high upfront costs and a very long lifespan. Historically the investments in new production projects, especially oil sands, have significant economic spillovers to other industries, especially construction and manufacturing, and labour market. With less investment in new production capacity, the tailwinds to the broader economy from investment in oil and gas are weaker.

In 2022, oil producers focused their capital expenditures on improving their efficiencies in terms of lower costs and greenhouse gas emissions per barrel. These types of investments have a smaller economic multiplier, hence less support for growth. Moreover, it is changing the composition of the labour market. As such, we note that the level of employment in the mining, oil and gas sector is about 30k below its 2014 level. It is 30k lower for the construction sector and 20k for manufacturing, while overall employment is 130k higher than in 2014.

This new reality has some important consequences for the economic outlook: 1) growth is now less sensitive to changes in oil prices, 2) weaker income growth, as economic growth is weaker and a greater share of revenues are not staying in the province, and 3) the lack of boom may also mean a small bust when oil prices drop, leading to reduced economic volatility.

Fig 16. Alberta's oil production value (C$bn)
Source: Alberta Energy Regulator, Alberta Central

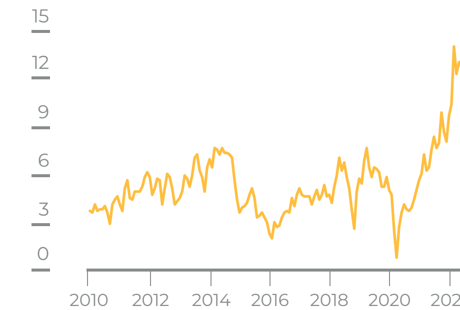


Fig 17. Alberta's oil production volume (bn m3)
Source: Alberta Energy Regulator, Alberta Central

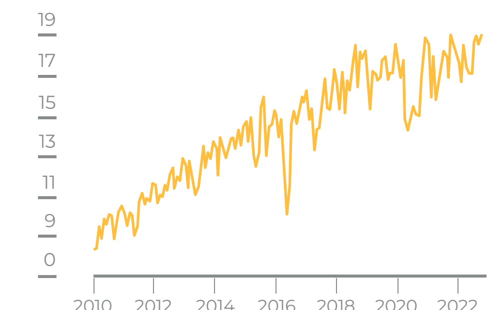


Fig 18. Capital returned to shareholders (4q sum)
Source: Bloomberg, Alberta Central

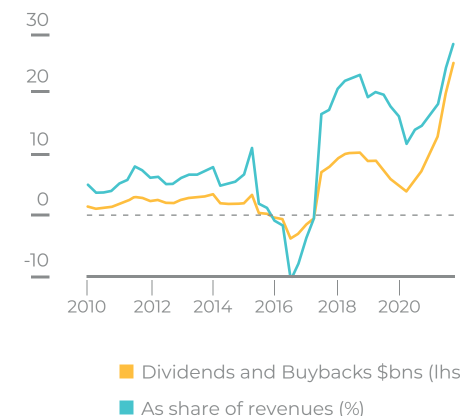
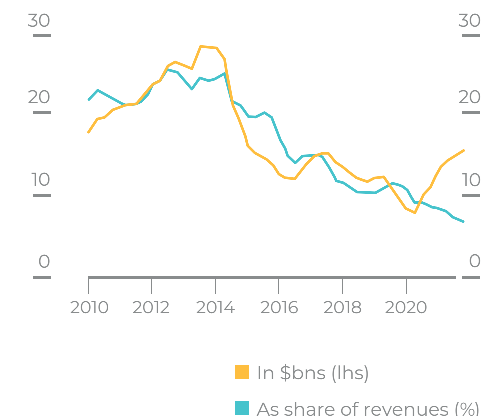


Fig 19. Oil producers' capex (4q sum)
Source: Bloomberg, Alberta Central



Alberta more resilient than the rest of the country

Despite being a smaller positive than in previous booms, rising oil revenues remain a tailwind on the economy. Hence, it will support growth, income and the labour market, leading to stronger economic performance than in the rest of the country. Although it may not prevent a recession in Alberta, it will mean that any contraction in economic activity is likely to be smaller in the province than elsewhere in the country.

Similarly, the province's housing market is likely to be more resilient to higher interest rates. Several reasons explain the expected outperformance of the province's housing market:

- There are no signs of overvaluation, with the housing market not having accumulated the same amount of froth as elsewhere in the country, especially compared to Toronto.
- Affordability remains high despite higher interest rates, with mortgage payments on the average house in the main cities relative to income remaining within the historical range.
- Alberta has positive migration flows, with almost 22k people moving from other provinces over the past year, keeping demand for housing robust.
- A more resilient economy will also provide support to the housing market.

One potential risk for Alberta is that households in the province are some of the most indebted in the country, with debt-to-disposable income at 190%. This could make Albertans more sensitive to the impact of higher interest rates. However, we note that a greater share of their debt is non-mortgage debt and linked to loans for cars, ATVs, RVs and other non-mortgage items, which are usually at fixed rates, hence not impacted by the rise in interest rates.

Outlook for Alberta

We expect the Alberta economy to have grown by 4.8% in 2022, after a rise of 4.8% in 2021. In 2023, we expect a relatively sharp slowdown to 1.6%, as higher interest rates and weaker global and national growth act as a drag on the province. We expect the province to see a rise in unemployment to about 6.3% as growth underperforms.

With the provincial growth data being annual, it will be difficult to confirm whether the province will experience a recession in 2023. However, as mentioned previously, if the economy contracts next year, it will be less than nationally.

Think+

Relevancy for credit unions:

The non-recourse nature of mortgage loans in Alberta is always a concern in economic downturn. However, a less overvalued housing market and the likely economic out performance of the province relative to the rest of the country reduces this risk.

Risks to the outlook

The risks around the outlook are clearly tilted to the downside. On the upside, the economy could be more resilient to the higher interest rates, as consumers remain keen on using their savings accumulated during the pandemic and the labour market could hold better than expected.

On the downside, the high level of household debt is a significant source of vulnerability for the Canadian economy. While higher interest rates will increase the cost of servicing and carrying the debt, households are likely to remain solvent as long as their income does not suffer. However, many households likely require two incomes to make their obligated payments on their debt. As a result, there is a significant risk of insolvencies if household income drops because of job losses. A sharp deterioration of the labour market could be the Achilles heel of the Canadian economy, as layoffs would lead to further weakness in consumer spending and rising defaults, negatively impacting the financial sector and the housing market.

With this in mind, such a situation could potentially lead to a challenging position for the BoC, as it would face a trade-off between fighting inflation and preventing financial instability and a deeper and longer recession.

Even if the downside risks do not materialize, there is a lot of uncertainty as to what the recovery will look like in the second half of 2023 and in 2024. With consumer spending likely to remain constrained for some time, there is a possibility that the recovery could be very slow, especially if inflation remains sticky, preventing the BoC from cutting rates and stimulating the economy.

Think+

Relevancy for credit unions:

Close monitoring of the economic environment will be essential in 2023 to detect any deterioration in the quality of the lending book and a rise in insolvencies. Credit unions will need to be ready and proactive to take the appropriate steps to prevent losses.

Fig 20. Forecast details – Canada

	2022				2023				2021	2022	2023	2024
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	Q4				
Nominal GDP	15.8	17.2	-2.7	0.4	0.2	1.5	2.6	3.6	13.6	11.3	1.6	3.8
Real GDP	**2.8**	**3.2**	**2.9**	**0.5**	**-1.0**	**-0.4**	**0.5**	**1.5**	**5.0**	**3.5**	**0.5**	**1.7**
Personal consumption	2.3	9.5	-1.0	0.8	-1.0	-0.5	0.0	1.5	5.1	4.7	0.3	1.6
Non residential fixed invest	7.7	17.0	4.3	6.3	2.5	2.5	4.1	4.7	4.3	10.5	4.6	4.4
Residential fixed invest	8.8	-31.5	-15.4	-10.0	-10.0	-5.0	0.0	1.3	14.9	-10.7	-9.6	0.6
Government expenditures	0.7	-1.8	3.7	1.5	1.5	1.0	1.0	1.0	5.3	1.4	1.4	1.0
Exports	-7.6	8.1	8.6	2.5	1.2	1.2	1.7	2.2	1.4	2.6	2.9	2.8
Imports	0.2	29.5	-1.5	2.2	1.5	1.5	2.2	2.7	7.8	8.3	2.9	2.6
Contributions to GDP:												
Domestic final sales	2.8	2.2	-0.6	0.6	-0.7	-0.2	0.7	1.7	5.9	3.2	-0.3	1.2
Inventories	2.6	6.9	0.2	-0.2	-0.1	-0.1	0.0	0.0	1.0	2.1	0.8	0.4
Net trade	-2.6	-5.8	3.3	0.1	-0.1	-0.1	-0.2	-0.2	-1.9	-1.8	-0.1	0.0
Unemployment rate	**5.8**	**5.1**	**5.2**	**5.1**	**5.4**	**5.8**	**6.1**	**6.3**	**7.4**	**5.3**	**5.9**	**6.2**
Employment, 000	153	188	-66	151	2	-3	15	33	867	699	142	240
Personal income (y-o-y)	10.2	10.3	8.7	6.7	2.2	0.6	0.2	1.5	8.5	9.0	1.1	4.3
Disposable income (y-o-y)	4.4	4.5	4.9	6.4	2.1	1.6	1.4	2.0	4.1	5.1	1.8	4.1
Net corps. operating surplus (y-o-y)	7.0	21.2	16.3	5.7	-0.9	-11.7	-3.3	-0.8	35.8	12.4	-4.4	6.1
Current Account balance	0.9	2.6	-11.1	-8.3	-9.8	-9.6	-10.2	-10.4	-1.7	-4.0	-10.0	-10.3
% of GDP	0.1	0.4	-1.6	-1.2	-1.4	-1.4	-1.4	-1.4	-0.3	-0.6	-1.4	-1.4
Consumer prices	**5.8**	**7.5**	**7.2**	**6.7**	**5.8**	**3.9**	**3.7**	**3.4**	**3.4**	**6.8**	**4.2**	**2.7**
Core CPI	4.9	6.0	6.0	5.7	5.0	3.8	3.3	3.3	2.8	5.6	3.9	2.6
Housing starts (000)	244.2	270.5	281.8	252.2	230.2	219.9	218.9	219.4	276.8	262.2	222.1	219.4
Housing sales (y-o-y)	-12.3	-23.8	-29.0	-37.5	-37.9	-21.2	-7.9	-2.8	31.7	-25.6	-17.4	0.9
House price index (y-o-y)	29.3	19.8	7.2	-6.0	-20.7	-21.9	-14.3	-7.9	23.2	12.0	-16.6	-0.3
Overnight target rate	**0.50**	**1.50**	**3.25**	**4.25**	**4.50**	**4.50**	**4.50**	**4.25**	**0.25**	**4.25**	**4.25**	**3.50**
BoC's assets ($bn)	486.9	455.9	431.9	413.4	385.2	362.4	328.8	323.5	499.4	413.4	385.2	362.4
3-month T-Bill	0.60	2.08	3.58	4.23	4.05	3.90	3.70	3.55	0.16	4.23	3.55	3.05
2-year government bond	2.27	3.10	3.79	4.06	4.09	3.94	3.78	3.69	0.95	4.06	3.69	3.10
5-year government bond	2.42	3.17	3.24	3.37	3.40	3.40	3.30	3.20	1.30	3.37	3.20	3.20
10-year government bond	2.40	3.23	3.16	3.30	3.30	3.30	3.25	3.25	1.42	3.30	3.25	3.25
USD/CAD	1.25	1.29	1.37	1.35	1.35	1.33	1.30	1.28	1.27	1.35	1.28	1.28
WTI (USD)	94.7	108.4	89.2	82.4	79.0	79.0	77.0	77.0	68.2	93.7	78.0	75.0
WCS (USD)	83.0	92.0	68.0	53.7	62.0	64.0	64.0	66.0	54.9	74.2	64.0	64.5
WTI-WCS	11.7	16.4	21.3	28.8	17.0	15.0	13.0	11.0	13.3	19.5	14.0	10.5

Note: shaded areas are forecast. Source: Alberta Central

Fig 21. Forecast details – Alberta

	2020	2021	2022	2023	2024
Nominal GDP	-15.7	26.2	11.2	-3.4	5.9
Real GDP	**-8.0**	**4.8**	**4.3**	**1.6**	**2.8**
Personal consumption	-6.3	4.4	4.5	0.2	2.1
Non residential fixed invest	-20.6	3.3	12.0	7.2	5.0
Residential fixed invest	-3.2	21.5	7.2	0.0	1.5
Government expenditures	0.9	0.7	0.8	0.8	0.8
Exports	-5.3	3.7	4.2	2.5	3.9
Imports	-7.6	4.0	5.8	2.7	3.0
Unemployment rate	**11.6**	**8.6**	**5.8**	**6.1**	**6.0**
Employment, 000	-147.9	110.0	112.4	31.7	55.8
Personal income (y-o-y)	1.9	2.9	5.1	1.0	3.8
Disposable income (y-o-y)	3.9	1.3	4.5	1.8	3.7
Net corps. operating surplus (y-o-y)	-60.3	284.9	16.0	0.6	18.4
Consumer prices	**1.1**	**3.2**	**6.5**	**4.2**	**2.7**
Core CPI	1.2	1.3	4.7	4.1	2.6
Housing starts (000)	24.1	32.1	38.4	40.8	40.0
Housing sales (y-o-y)	3.5	66.2	-0.7	-18.9	2.3
House price index (y-o-y)	1.3	8.5	4.7	-2.1	1.1
Population growth (y-o-y)	1.3	0.7	1.8	1.9	1.6
Oil prices (WTI, $)	38.6	68.2	93.7	78.0	75.0
Oil price spread (WTI-WCS)	12.0	13.3	19.5	14.0	10.5
Overnight target rate	0.25	0.25	4.25	4.25	3.50
3-month T-Bill	0.06	0.16	4.23	3.55	3.05
2-year government bond	0.20	0.95	4.06	3.69	3.10
5-year government bond	0.41	1.30	3.37	3.20	3.20
10-year government bond	0.67	1.42	3.30	3.25	3.25
USD/CAD	1.27	1.27	1.35	1.28	1.28

Note: shaded areas are forecast. Source: Alberta Central

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