Market View
Economics and Strategy

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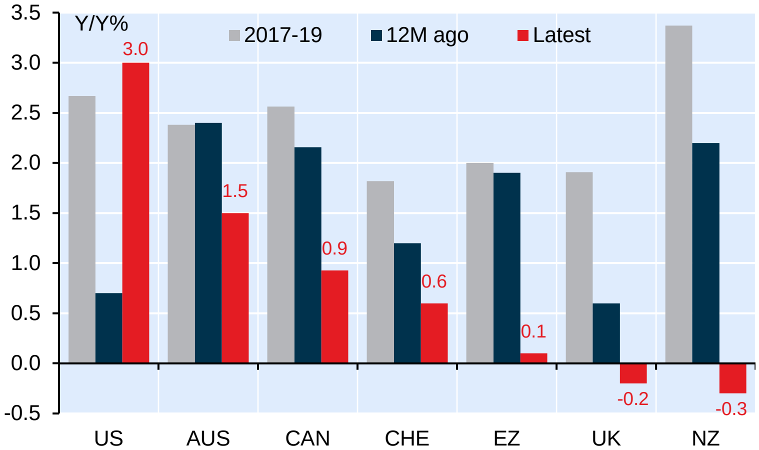
# How does Canada's economy stack up globally? Not great.

By Taylor Schleich

The most important development for Canadian monetary policy this year has been softer-than-expected inflation. In the United States, it's been the opposite as re-accelerating prices have been the dominant driver of the ongoing interest rate reassessment. Diverging Canada-U.S. data isn't a new story this cycle—GDP growth has been on two different planes for some time—but it is a new development when it comes to price pressures. That's prompted debate over what the Bank of Canada should do in this environment. 'Conventional wisdom' says that the BoC is constrained by the Fed. Where Powell goes, Macklem can't stray too far. Empirically, it's true that Canadian and U.S. interest rates are strongly correlated but that's at least partially because the two economies are so strongly correlated, Canada shipping three quarters of its exports southbound. But, at least for now, the economic and inflation correlation *has* broken down.

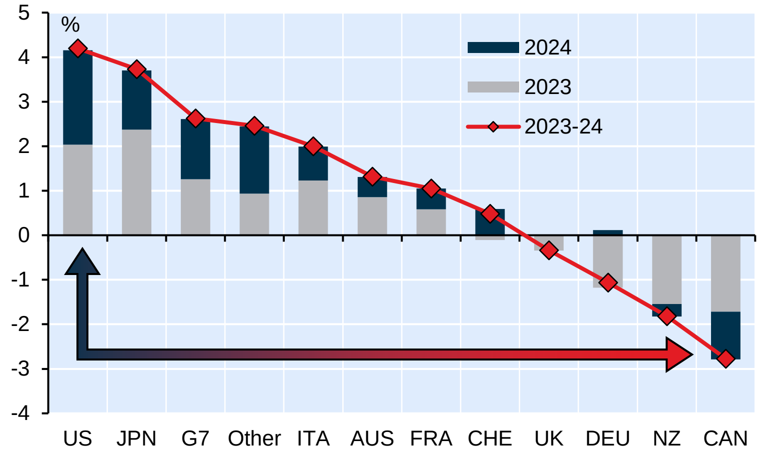
From a growth perspective, Canada more closely resembles Europe than the United States. Across the pond, the ECB is all but assured to begin the process of lowering rates in June. Should the Bank of Canada follow soon after? We'd argue yes. While currency implications and the fear of imported inflation may come into play at some point, there's plenty of capacity to cut before that becomes a binding constraint in our opinion. As this *Market View* illustrates, Canadian data is consistent with dialing back monetary policy restriction. The impact of earlier rate increases is as or more evident in Canada than in the economies of its peers.

**Chart 1: Canadian growth slower but still relatively solid...**
*Year-over-year real GDP growth by country/country group (quarterly data)*




*Source: NBF, Bloomberg | Note: 12M ago = release for the same quarter as latest, 1Y ago.*

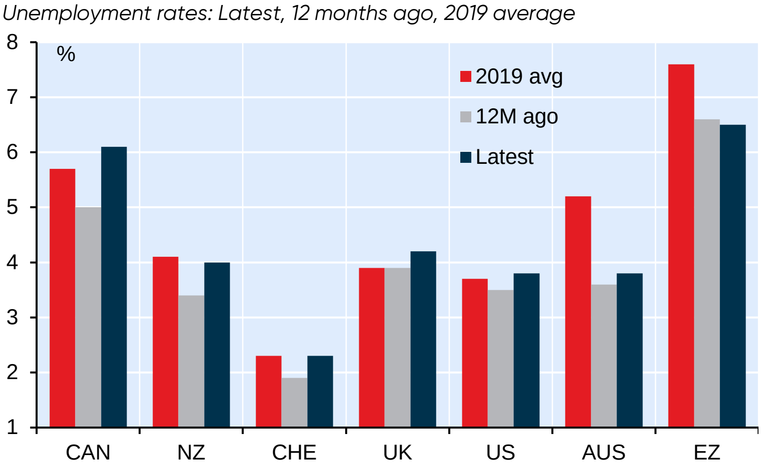
**Chart 2: ...until you account for population growth**
*Real, per capita GDP growth by country/country group: 2023-2024*




*Source: NBF, IMF | Note: Other refers to advanced non-G7, Euro area countries*

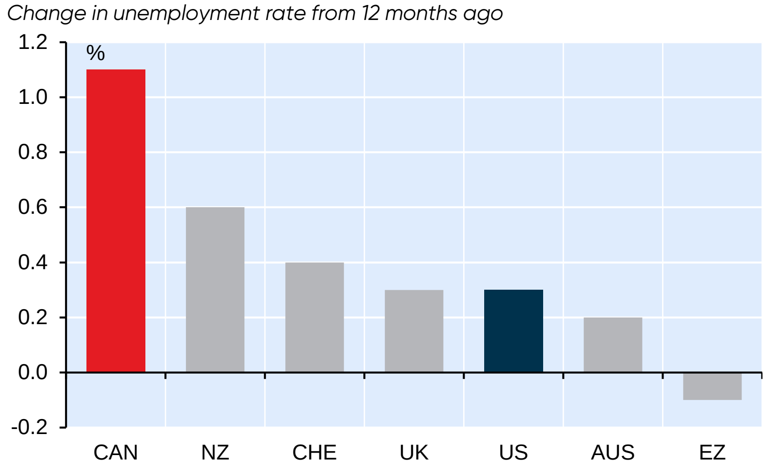
All the BoC's peer central banks are seeing their economies operate at below pre-COVID growth rates, except for the U.S. which continues to expand at an above-potential clip. An expansion of roughly 1% Y/Y puts Canada in the top half of the countries/country groups we've sampled above but that misses an important piece of the puzzle. Population growth here far outpaces all other jurisdictions, rendering per capita growth comparisons much less encouraging. Canada ranks 38th out of 41 advanced economies on projected real per capita GDP growth over 2023 and 2024. Versus the U.S., Canada's growth by this measure lags by a staggering 7%-pts.

**Chart 3: Canada's jobless rate is up vs. last year and 2019...**
*Unemployment rates: Latest, 12 months ago, 2019 average*




*Source: NBF, Bloomberg*

**Chart 4: ...and has risen by more than key peers**
*Change in unemployment rate from 12 months ago*

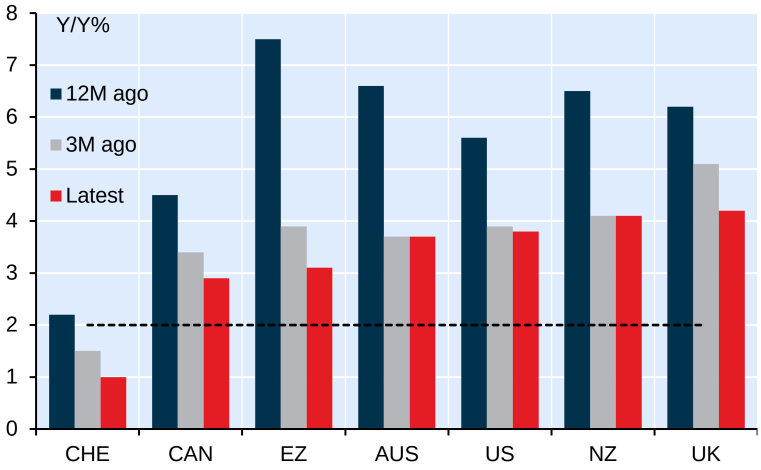



*Source: NBF, Bloomberg*

Most jurisdictions have seen labour market conditions soften of late as tighter monetary policy restricts demand. Nowhere is that more apparent than Canada where the unemployment rate has risen by over 1%-pt, more than any country in the sample above. Moreover, the Canadian jobless rate is one of just a few that are above pre-pandemic levels and no others have surpassed their 2019 average by more. Admittedly, we wouldn't call the labour market loose... but it is looser than key peers.

### Chart 5: Canada has made more progress on core inflation…

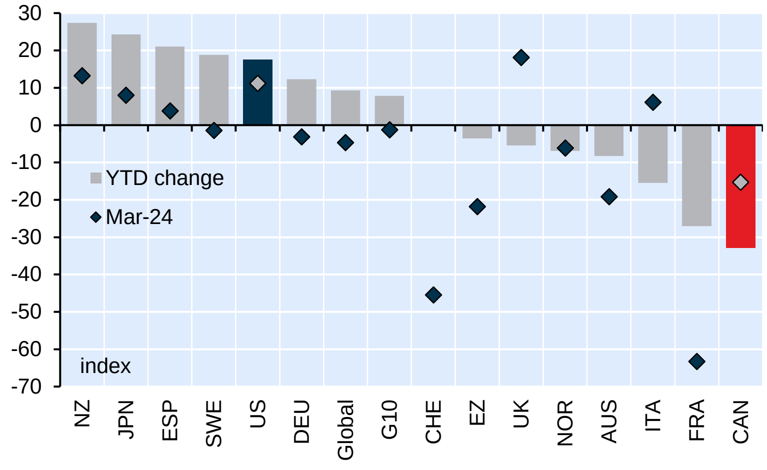
*Core CPI inflation (ex-food and energy): Latest, 3M ago, 12M ago*




*Source: NBF, Bloomberg | Note: Concepts may differ slightly (e.g., excl. alcohol, tobacco)*

### Chart 6: …thanks to a series of big-time inflation misses

*YTD change and level of Citi inflation surprise index*

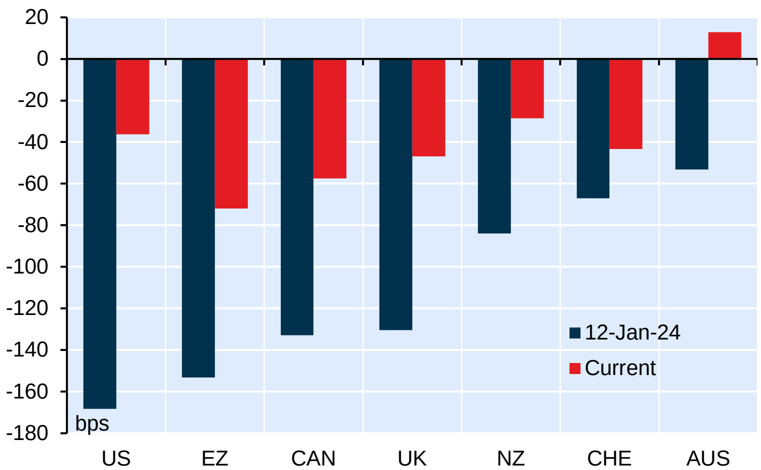



*Source: NBF, Bloomberg*

Core inflation is cooler in Canada than most other economies and, unlike in the U.S. for example, disinflation has continued over recent months. To be fair, this wasn't expected but Canada has enjoyed a series of major downside inflation surprises in 2024. The YTD decline in Citi's inflation surprise index has been larger than all other advanced economies that are tracked. South of the border, it's been the opposite phenomenon. Softer-than-expected U.S. inflation is a relic of 2023.

### Chart 7: Rate expectations recast everywhere

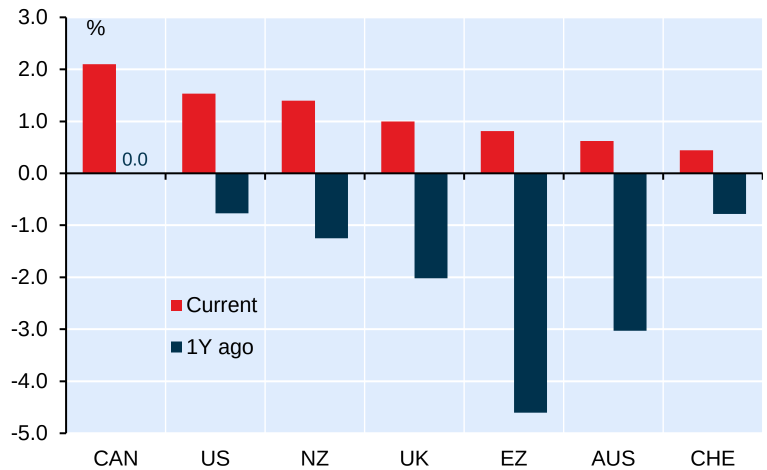
*OIS-implied policy rate change by end of 2024*




*Source: NBF, Bloomberg | Note: 12-Jan was day after U.S. Dec. CPI report. Data per Bloomberg's WIRP page (proj. rate at last meeting of year). AUS data based on futures.*

### Chart 8: The BoC still maintains the highest real policy rate

*Real policy rate by country/country group: Current vs. 1-year ago*




*Source: NBF, Bloomberg | Note: Real policy rate = nominal rate - Y/Y inflation ex-F&E*

The release of December's U.S. CPI report led to peak euphoria for rate expectations as the OIS market briefly priced nearly 175 basis points of Fed rate cuts in 2024. Other markets (including Canada's) projected less, but still significant easing. Since then, inflation data in the U.S. has been decidedly less encouraging which has helped drive a global interest rate reassessment. The relative shift in rate expectations has been consistent with relative changes in economic/inflation data but the total amount of easing that's expected isn't drastically different across jurisdictions (e.g., 37 bps of easing priced in the U.S., vs 56 bps in Canada). This assessment holds up if you consider end of 2024 *or* end of 2025 rates. We'd argue that we probably *should* see more divergence when comparing the BoC and Fed, for example. Certainly, real policy rates are more restrictive in Canada than elsewhere, and they have been for some time. On 'fundamentals' then, faster and more material cuts in Canada are likely appropriate. But are there other considerations that might prevent this from playing out (i.e., the currency)? The short answer is yes and no. While the BoC is unlike to completely decouple from the Fed, policy rate differentials aren't a binding constraint right now… this is a topic we'll be exploring more in a future note.

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