Executive Summary

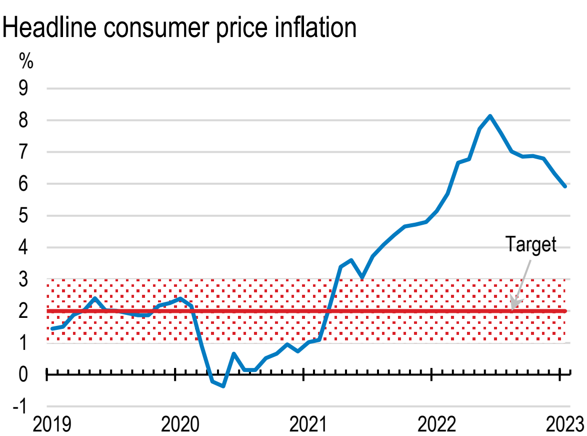
Growth and inflation are declining

Canada's economy recovered from the COVID-19 pandemic, but inflation has since surged. Charting a path towards lower inflation without sharp disruption to economic activity and employment is challenging given the uncertainties and risks.

By the beginning of 2022 Canada's economic output was above pre-pandemic levels. The rate of unemployment subsequently hit record lows, contributing to wage and price pressures, with headline consumer price inflation well above 3% (the upper bound of the Bank of Canada's target range). The impact of Russia's war of aggression against Ukraine on global food and energy prices further fuelled inflation, which peaked at 8.1% in June 2022 (Figure 1).

Energy independence and limited direct ties to hard-hit economies have shielded Canada from some of the effects of the war. Canada has actively supported Ukraine, including through sanctions on Russia, an emergency immigration stream, military support and loans.

Figure 1. Inflation far exceeds the target



Source: OECD (2022), Main Economic Indicators (database).

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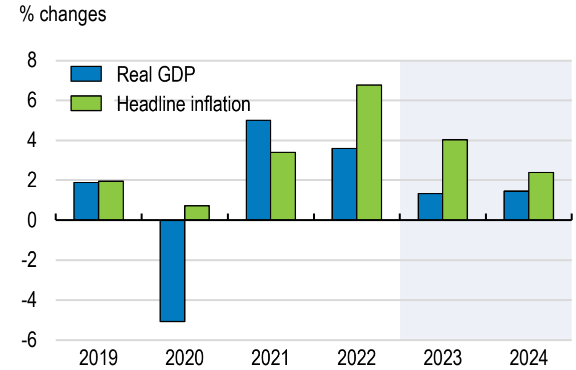
The Bank of Canada has been tightening monetary policy since spring 2022. This has tempered demand and helped keep long-term inflation expectations anchored. Inflation has started easing and OECD projections envisage it reaching target by the end of 2024. Annual output growth of 1.3% is expected in 2023 and 1.5% in 2024 (Figure 2).

Figure 2. Activity and inflation will slow further



Note: Shaded area indicates projections.
Source: OECD Economic Outlook 112 (database), updated.

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Table 1. Growth has moderated

Annual growth rates, unless specified	2021	2022	2023	2024
Gross domestic product	5.0	3.6	1.3	1.5
Private consumption	5.0	4.7	1.3	1.5
Government consumption	6.4	1.4	1.1	0.7
Fixed capital formation	7.4	-0.8	-1.0	1.5
Exports	1.4	2.5	2.5	1.9
Imports	7.8	7.7	1.4	1.4
Unemployment rate, %	7.4	5.3	5.3	5.7
Consumer price index	3.4	6.8	4.0	2.4
Fiscal balance, % GDP	-4.4	-0.6	-0.1	0.1
Current account balance, % GDP	-0.3	-0.6	-1.5	-1.5
Policy rate (end of period)	0.3	4.3	4.5	3.8

Note: Provisional economic forecast by the OECD in February 2023.
Source: OECD Economic Outlook 112 and OECD calculations.

Risks are elevated. As an open economy, Canada's main risk is a rapid slowing in global demand**.** Canada is also exposed to heightened volatility in commodity and financial markets from Russia's war against Ukraine. Domestically, uncertainty in how consumer spending will evolve remains elevated. Higher interest rates, softening home values, and uncertainty in the employment outlook point to households becoming more cautious. Rising interest rates exacerbate macro-financial risks given high household debt. However, financial-stress indicators generally remain low. Like elsewhere, there is growing concern about volatility and reduced liquidity in fixed-income markets.

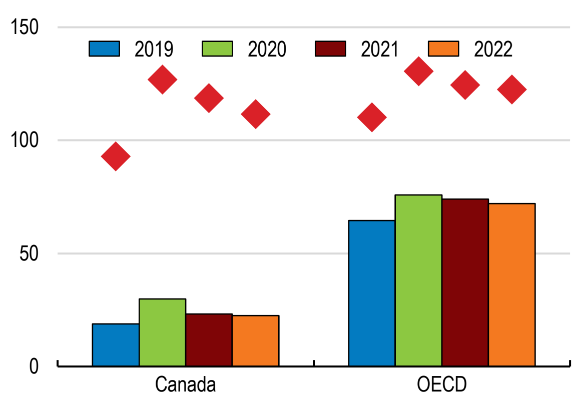
Rebuilding fiscal buffers

Canada's fiscal balances are expected to improve further. However, continued rapid improvements over the longer run will be more challenging given large multi-year spending pressures.

Fiscal deficits are shrinking. For 2022, the unwinding of COVID-19 support, recovery in revenues from the lifting of lockdowns and other constraints, plus revenue boosts from higher commodity prices, have helped reduce deficits. This is despite new spending, including temporary support for Canadian households in the face of rising living costs and investments to further the green transition. A general government deficit of 1.7% of GDP is expected for 2022, after 11.4% in 2020. Public debt still stands above the pre-pandemic level (Figure 3), but is expected to decline rapidly. Canada fares better than most countries in this regard.

Figure 3. Public debt reduction is underway

Public debt, % of GDP



Note: Data for 2022 are estimates. The bars show net debt, the diamonds gross debt.
Source: OECD Economic Outlook 112 (database).

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Tax reforms and improved public spending efficiency could boost growth potential and sustainably lower the fiscal deficit. Recent budgets have included savings through public spending efficiency gains that remain to be detailed. Recent large commodity price increases raise questions about the adequacy of taxation of windfall gains and how related public revenues are spent, particularly in the provinces. Long-term reform should aim to reduce economic distortions from the tax system, including through less reliance on taxes on income and more use of indirect taxes.

Strengthening the environment for business

Canada's productivity and investment growth has weakened relative to the United States and other leading OECD economies. Lowering internal trade barriers and better competition policy would help improve performance.

Inter-provincial non-tariff trade barriers are high. Canada is unusual in the degree to which differences in technical standards and regulations across sub-national jurisdictions hamper flows of goods and services. The barriers extend across many activities, including the dairy sector and legal and accounting services. Similarly, non-recognition of certain qualifications between provinces reduces the efficiency of Canadian labour markets and limits mobility.

There is scope to improve competitiveness. Foreign ownership restrictions remain a feature in some sectors. In addition, competition law must change to handle challenges related to Big Tech. These include barriers to entry linked to data access, abusive and exclusionary practices, and lock-in of consumers and businesses to service providers.

Money laundering remains an issue. Canada is strengthening its capacity to counter financial crimes, including through better corporate transparency measures. Russia's war against Ukraine has also increased attention on Russia-linked money laundering.

Better supporting the vulnerable

Cost-of-living increases are eroding real incomes. Successful implementation is key for a new national childcare reform. Deep disadvantage among Indigenous peoples needs to continue to be addressed.

Temporary measures are providing cost-of-living relief, but challenges remain in affordable housing. Some provincial measures are not targeted to the most vulnerable groups. A new set of federal measures helping with house purchase for low-income households, and boosting the supply of affordable housing, is being rolled out.

Implementation of the childcare reform will be challenging. The reduction in childcare costs and increases in the number of childcare places will take time to achieve given the substantial investment required. Also, monitoring the reform will be complex due to the large number of childcare suppliers across sub-national jurisdictions. Successful implementation would strengthen labour force participation, particularly among women, and boost living standards.

Significant socio-economic gaps between Indigenous peoples and non-Indigenous Canadians remain. Government policy continues to expand efforts to advance reconciliation, close gaps, and improve the living standards of Indigenous peoples. There is a need to continue supporting self-determination through transfer of powers to community governments and co-developing policy.

Transitioning to net zero emissions

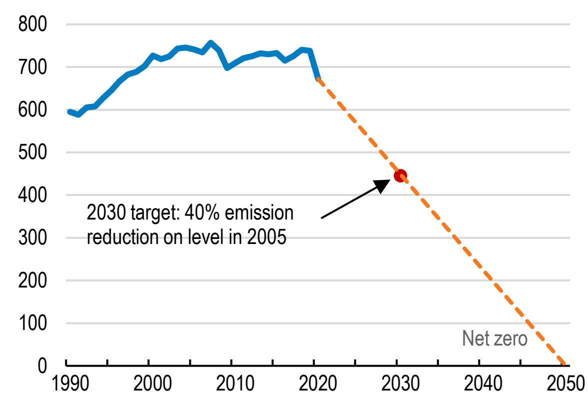
A new climate plan with a revised 2030 target is in place to accelerate Canada's transition to net zero by 2050 (Figure 4). Achieving net zero requires deep energy savings and replacement of fossil fuels with clean energy. Residual emissions will need to be trapped and stored or offset with sequestration elsewhere.

Emissions pricing has a central place in the national emissions reduction plan. In 2023, strengthened minimum national stringency criteria take effect. These criteria include an increasing carbon price trajectory to CAD 170 per tonne of carbon dioxide equivalent emissions in 2030. Further tightening of stringency criteria, beyond that achieved in the latest update, would help harmonise and strengthen abatement incentives across federal, provincial and territorial carbon pricing schemes.

While much of Canada's electricity comes from hydropower, more could be done to decarbonise power. Provinces will need more wind and solar energy to meet new demands on grids. Some provinces sell electricity at low regulated prices, which reduces returns to renewable-energy investment and discourages energy efficiency. Reforms to pool power and transition to market-based pricing could lower the cost of the green energy transition.

Figure 4. Net zero is a long way off

Total greenhouse gas emissions, Mt CO_2 eq.



Source: Environment and Climate Change Canada.

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Oil and gas extraction contributes one quarter of Canada's emissions. Together with technology support measures, the federal government aims to strengthen pricing signals for greener production. This should be done within current carbon pricing systems.

Road transport is a major source of emissions. Beyond measures to encourage electric vehicle take-up and reduce emissions from conventional vehicles, a policy focus is needed on reducing car dependency. Road user charging and fewer barriers to housing supply in cities could support the appeal and accessibility of public transport.

Canada uses large amounts of energy to heat buildings. Hitting emissions reduction targets will require, along with market-based incentives, fast adoption of tough energy standards for new buildings and rapid retrofitting of existing ones. Better information on buildings' energy performance would improve incentives to upgrade energy-intensive homes and other buildings.

Reducing climate change impacts is important. Average temperatures across Canada increased by 1.9 degrees Celsius from 1948 to 2021. This is double the global average rate of warming. Canadian communities face increased risk of damage from flooding, melting permafrost and heatwaves in the years ahead.

MAIN FINDINGS	KEY RECOMMENDATIONS
Ensuring macroeconomic stability	
High inflation is widespread and reflects the cost of energy, food and housing. With capacity strained in a tight domestic labour market, there is risk of a destabilising wage-price spiral.	Continue to shrink the central bank's balance sheet and stand ready to raise the policy rate further as warranted to bring inflation sustainably back to target.
Interest rate rises are increasing financial stress on some households, many of which have high debt. Concern around the liquidity of fixed-income asset markets has grown.	Maintain a close watch on housing debt and on fixed-income markets. If necessary, take further steps to relieve household financial stress.
The fiscal deficit has declined rapidly. Continued improvement would help rebuild fiscal buffers. Some windfall gains from high commodity prices are being spent while fiscal buffers for future shocks are thin.	Ensure that fiscal policy continues to work in the same direction as monetary policy by tempering excess demand. Maintain a credible medium-term plan for lowering federal government debt. This should include the detailing of spending efficiency plans. Rechannel strong resource revenues towards reducing public debt and/or towards stabilisation funds.
Lifting productivity growth	
Canada's productivity growth and investment continues to underperform relative to leading OECD countries. Internal barriers to trade have large economic costs and limit the efficiency and scope of labour markets. Competition in some sectors is hampered by limits on foreign ownership and board membership of Canadian companies. Canada has lagged in adjusting competition laws to a more digital world. Russia's war against Ukraine has increased attention to Russia-linked money laundering and sanctions evasion.	Accelerate reduction in internal barriers to trade, including through widening the scope and powers of the Canadian Free Trade Agreement. Evaluate, with a view to removing, foreign ownership restrictions in network sectors. Strengthen instruments in competition law and regulation that prevent the emergence of anti-competitive behaviour around large digital enterprises ("ex ante" regulation). Ramp up efforts to shut down channels for money laundering, including by following through on the proposed establishment of a new beneficial ownership registry by the federal government.
Ensuring support for the most vulnerable and improving childcare	
Federal and provincial governments have brought in a wide range of temporary measures to help households cope with rising living costs. Some provincial measures are not well targeted.	Better target provincial temporary support to households most in need of relief on living costs.
The major initiative underway to lower the cost of childcare and increase the number of childcare spaces will mitigate cost-of-living pressures and support female employment and gender equality.	Monitor and, where necessary, support the provinces' and territories' delivery of lower cost childcare and the creation of additional childcare spaces.
Significant socio-economic gaps between Indigenous people and the rest of Canada's population remain. Large multi-year investments are underway to advance reconciliation.	Support self-determination among Indigenous peoples through further transfer of powers to communities, including through capacity building in Indigenous governments, and co-developing policy.
Ensuring an efficient transition to net zero emissions	
Planned higher prices levied on a larger share of emissions are needed to achieve Canada's ambitious climate targets.	Follow through with planned carbon price increases and annual tightening of emissions benchmarks in federal and provincial baseline-and-credit schemes. Expand emissions pricing to cover additional industries and types of greenhouse gases.
Increased electricity trade could aid transitions to market-based pricing and lower costs of storing intermittent energy. Limited interties impede inter-provincial trade. Policies to moderate peak demand will be important to minimise generation capacity needed to accommodate new power demand.	Plan for long-run transitions to market-based electricity pricing at the provincial level, aided by pooling production with other provinces and federal infrastructure investment to support intertie development. Introduce time-of-use electricity pricing as a default option for residential customers in provincial electricity markets, supported by smart meters.
Carbon costs facing oil sands producers are too low to achieve federal greenhouse gas emission targets. Overlapping credit schemes, grants and tax support for carbon capture utilisation and storage risk over rewarding carbon capture investments as technologies improve.	Focus on strengthening price signals for decarbonisation of oil and gas extraction using existing federal and provincial carbon pricing systems. Continue support for carbon capture and storage investments while consolidating subsidies, as planned, when technology improvements permit.
Policies to reduce car use and support active transport and public transport would have benefits beyond emission reduction.	Provinces should increase use of road user charging and pare back constraints on new supply of housing in urban areas to improve the viability of efficient and accessible public transport.
National model energy codes for buildings continue to tighten. But slow provincial adoption of the codes risks large retrofitting costs later on.	Encourage fast provincial adoption of the latest energy code with federal support for capacity building.
Retrofitting schemes can accelerate building energy improvements but risk disproportionately benefiting well-off households.	Expand and re-target retrofitting grants towards middle and lower-income households.
Canada's climate is changing already. Flooding is the most common and costly natural disaster in Canada, with high-risk properties often uninsured and buyers unaware of their flood risk.	Improve flood maps and communication of flood risks while integrating climate-related risks in land-use planning. Consider introducing measures to support the availability and take-up of affordable flood insurance.

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