January 15, 2018

Canada

- **Growth is expected to remain at or above potential well into 2019. Combined with tight labour markets and rising wages, which should dampen some of the Bank of Canada Governor's concerns about the Canadian economy, inflation is projected to move toward the Bank's 2% target by 2019 and prompt three policy rate increases in 2018 and three more in 2019.**
- **The year ahead is likely to be filled with volatile, and sometimes difficult, headlines on trade, but we expect NAFTA's key elements to remain in place through a 'shadow' period of uncertainty and agreement to be reached eventually on a renegotiated and modernized pact.**

GOLDILOCKS' PORRIDGE STARTS TO COOL

After running hot through the first half of 2017, Canada's economic momentum appeared to flag slightly in the second half of 2017, which led us to mark down our growth estimate for the year as a whole to a still impressive—and G-7 leading—2.9% real GDP expansion. Canadian growth should continue to decelerate gradually in line with its underlying trend through 2018 and 2019 as policy measures, including tighter mortgage qualification standards and higher interest rates, start to blunt spending by already heavily-indebted households. We project real GDP growth to cool to 2.3% in 2018 and further to 1.7% in 2019 (chart 1 and table 2), converging near our estimate of Canada's potential GDP growth rate of 1.6%.

While growth is expected to slow, the prospect of three successive years of expansions at or above potential implies that inflation should accelerate mildly over the next two years and reach the Bank of Canada's 2% target during 2019. Increases in provincial minimum wages will play only a very marginal role in pushing up prices as a closed output gap, low unemployment, rebounds in the oil-producing regions of the country, and catch-up in deferred market-wage increases should provide an organic boost to prices after years in which inflation has seemed unable to gain ground. As explained in the *US & Canadian Monetary Policy & Capital Markets* report, we expect the Bank of Canada to respond with three policy-rate increases in 2018 and three more in 2019 despite concerns about trade, real estate, household indebtedness, the labour market, and cybersecurity.

CONSUMERS STILL IN THE DRIVER'S SEAT: THEIR TAILWINDS HAVEN'T YET FADED

Canada's strong economic performance owes much to its spendthrift consumers. Real consumer spending increased almost 4% in 2017, the strongest annual advance since the immediate post-recession recovery in 2010. Auto makers tallied a fifth consecutive record year with sales exceeding two million vehicles for the first time.

A booming job market is fueling confidence and spending. The strongest pace of employment growth in a decade and a half has pushed the unemployment rate to

CONTACTS

Brett House, VP & Deputy Chief Economist
416.863.7463
Scotiabank Economics
brett.house@scotiabank.com

Carlos Gomes
416.866.4735
Scotiabank Economics
carlos.gomes@scotiabank.com

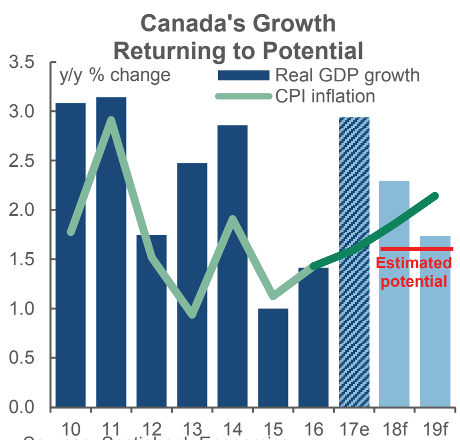
Juan Manuel Herrera
416.866.6781
Scotiabank Economics
juanmanuel.herrera@scotiabank.com

Adrienne Warren
416.866.4315
Scotiabank Economics
adrienne.warren@scotiabank.com

Mary Webb
416.866.4202
Scotiabank Economics
mary.webb@scotiabank.com

Marc Desormeaux
416.866.4733
Scotiabank Economics
marc.desormeaux@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

5.7%, its lowest level in 43 years. Canada's prime-age employment-to-population ratio is at a record high of 82.7%. Almost all of the net new jobs added over the past year have been full-time positions (chart 2) and the January Bank of Canada Business Outlook Survey (BOS) notes that firms' hiring and wage intentions remain strong versus post-2008 norms.

The fundamental drivers of household spending remain favourable. Wage growth has picked up to nearly 3% y/y amid the tightening in labour market conditions. A further acceleration is anticipated in 2018, reinforced by legislated minimum wage increases (including annual inflation indexation) in nine provinces (chart 3). The Bank of Canada staff estimate the minimum wage increases will lift national real wages by 0.7% by 2019 without having a meaningful impact on either Canada-wide growth, inflation, or employment.

Wealth gains from rising home and equity prices have further bolstered household purchasing power. Household net worth increased by CAD 387 bn in the past year. Assuming a wealth effect of 4 cents on the dollar, this may have added upwards of one and a half percentage points to the annual increase in consumer spending.

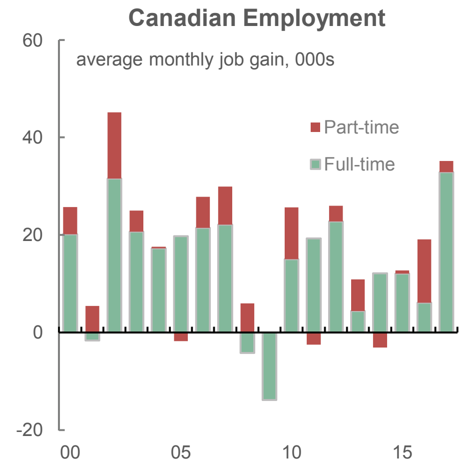
Solid population growth is boosting demand for goods and services. Fuelled by the highest nominal level of immigration in over a century, Canada's population has risen 1.3% in the past year, the fastest pace since the early 1990s and almost double the 0.7% increase in the US. Ottawa's announced increase in annual immigration targets, from 300,000 in 2017 to 340,000 by 2020, will take the immigration rate from eight to nine per one thousand of the Canadian population. Given the demographic tilt of newcomers under Canada's immigration point system, this should support solid household formation over the medium-term.

A surge in domestic and international tourism is underpinning travel-related service industries, including accommodation and food, transportation, and arts and recreation. Inflation-adjusted tourism expenditures increased 5% year-over-year through the first three quarters of 2017. The number of international visitors to Canada last year was on track to exceed 30 mn, its highest since 2006.

The tourism outlook remains positive, even as the fillip from last year's Canada 150 celebrations fades. A competitive Canadian dollar continues to attract international visitors to Canada, while at the same time limiting cross-border shopping by Canadians. Overseas visits to Canada are expected to reach a fifth consecutive annual record this year, benefiting from improved visa facilitation and increased airline capacity from a number of key markets, including Mexico, China, and India. Domestic travel intentions through early 2018 also remain elevated, on par with last year.

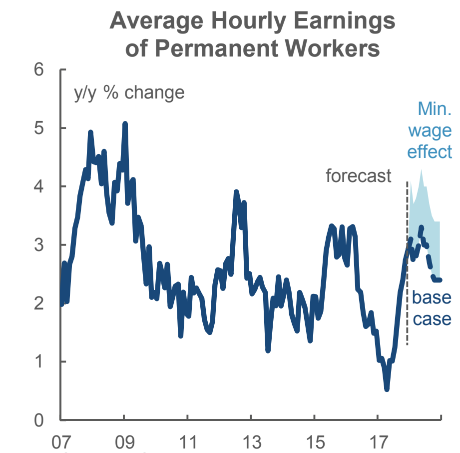
Even so, Canadian households are unlikely to maintain the torrid pace of spending of the past year. Families will receive some modest additional support as indexation of the Canada Child Benefit (CCB) begins in mid-2018, but the overall boost to growth from the CCB is set to fade. While hiring intentions remain firm, growing labour shortages may constrain the ability of employers to match available workers to job openings. Statistics Canada reported 468,000 job vacancies as of Q3 2017, a 15% increase from a year-earlier (chart 4). Rising vacancies were prevalent across industrial sectors and regions, with the largest increase in BC, Ontario, and Quebec. Job vacancies also are on the rise in Alberta, though the provincial vacancy rate remains slightly below the national average.

Chart 2



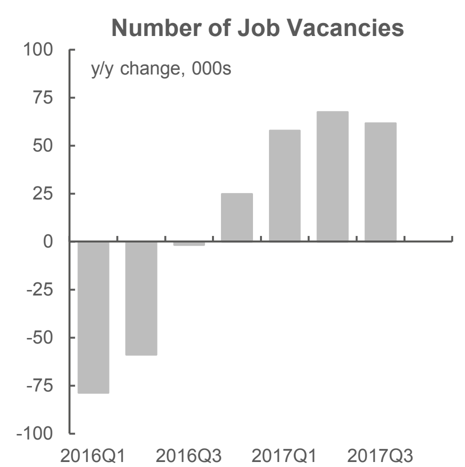
Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Meanwhile, higher interest rates are expected to divert some discretionary spending toward debt servicing. Households on balance have a more limited savings cushion to finance purchases in excess of current income. While the pace of credit accumulation is relatively stable at 5.6% y/y, much of the recent boom in consumption has come at the expense of drawing down the savings rate below 3% for the first time since 2007.

A SOFT LANDING FOR CANADA'S HOUSING MARKET

Canada's housing market is displaying remarkable resilience despite its unprecedented late-cycle stage. National home sales rebounded strongly in the final months of 2017, though overall activity remains below its early-year peak. The pickup has been most pronounced in the Greater Golden Horseshoe as market sentiment adjusts to Ontario's April 2017 introduction of its Fair Housing Plan. It is also likely that some buyers brought forward their home purchases ahead of tighter mortgage qualifying rules that came into effect January 1st.

The combination of the new mortgage rules and higher interest rates is expected to lead to some moderation in national sales activity this year. The Bank of Canada estimates that about 10% of borrowers would be impacted by the new stress tests, including about 12% in Vancouver, Toronto, and surrounding areas. The overall impact on sales, however, is likely to be smaller, as some potential buyers may choose to purchase lower-priced homes, while others may be able to extend their amortization periods, make a larger down payment, or opt for a lower variable mortgage rate in order to extend their buying power. Some borrowers may turn to credit unions or private lenders not subject to the OSFI mortgage guidelines.

Housing demand fundamentals, including low unemployment, strengthening wage gains, aging millennials, and increased immigration, remain supportive. While affordability has become increasingly strained in the Greater Vancouver and Toronto-Hamilton Areas, it remains healthy in much of the rest of the country. National average price growth is forecast to remain positive, albeit more subdued in the low single digits, with the majority of local markets in balanced territory.

Moderately higher interest rates should be manageable for most borrowers. Roughly 70% of outstanding mortgages are fixed rate, with the five-year term being the most popular, and are thus impacted only gradually. Five-year terms rolling over in the coming year are likely to do so at rates only moderately higher than at origination, though a larger rate increase is likely for renewals at shorter-term durations. At the same time, borrowers may have higher incomes to manage increased payments as well as increased home equity that can be tapped.

Table 1

Quarterly Canadian Forecasts	2017		2018				2019			
	Q3	Q4e	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Economic										
Real GDP (q/q ann. % change)	1.7	2.0	2.6	2.2	1.9	1.9	1.6	1.6	1.5	1.5
Real GDP (y/y % change)	3.0	2.9	2.7	2.2	2.2	2.2	1.9	1.8	1.7	1.6
Consumer prices (y/y % change)	1.4	1.8	1.8	1.9	1.9	1.9	2.1	2.1	2.2	2.2
Avg. of new core CPIs (y/y % change)	1.5	1.7	1.7	1.8	1.9	1.9	2.0	2.0	2.0	2.0
Financial										
Canadian Dollar (USDCAD)	1.25	1.26	1.28	1.27	1.26	1.25	1.25	1.22	1.22	1.25
Canadian Dollar (CADUSD)	0.80	0.80	0.78	0.79	0.79	0.80	0.80	0.82	0.82	0.80
Bank of Canada Overnight Rate (%)	1.00	1.00	1.25	1.50	1.50	1.75	2.00	2.25	2.25	2.50
3-month T-bill (%)	1.00	1.06	1.30	1.55	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada (%)	1.52	1.69	1.90	2.05	2.20	2.30	2.40	2.50	2.55	2.65
5-year Canada (%)	1.75	1.87	2.05	2.15	2.30	2.45	2.55	2.60	2.65	2.75
10-year Canada (%)	2.10	2.05	2.20	2.30	2.45	2.60	2.65	2.70	2.75	2.85
30-year Canada (%)	2.48	2.27	2.35	2.50	2.75	2.90	3.00	3.10	3.15	3.10

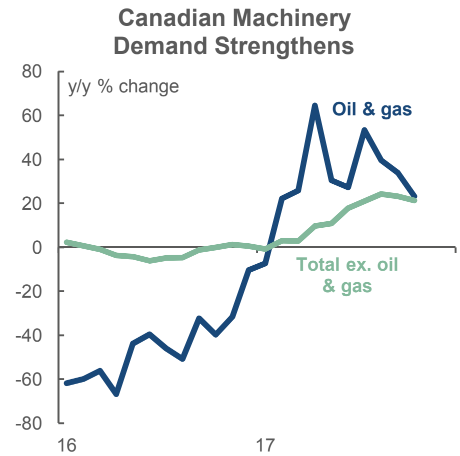
Sources: Scotiabank Economics, Statistics Canada, Bloomberg.

INVESTMENT IN MACHINERY DRIVES ORDER BACKLOG HIGHER

Industrial activity continues to expand at a faster pace than the more stable service sector, led by gains of nearly 20% y/y through October in both mining and machinery. This trend reflects a global upturn in business investment, which lifted capital expenditure growth among the advanced OECD economies to more than 3% y/y in the third quarter of 2017. This represents a sharp improvement from the decelerating trend that was in place during most of 2016, and is the best performance in more than three years.

A pickup in industrial activity and orders has lifted the production backlog at Canadian factories, outside of the auto sector, to record highs. A surge in demand for Canadian-made machinery accounts for much of the increase in the manufacturing backlog. The machinery sector has accounted for nearly 60% of the surge in the value of unfilled orders in Canada over the past year—roughly ten times its 6% share of overall Canadian manufacturing activity. Much of the surge in demand for Canadian machinery is coming from outside of Canada, as the sector exports more than 90% of its output, compared to only 54% for other manufacturers.

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

Machinery demand has also picked up within Canada, reversing the declining trend that was in place from early 2015 through a year ago (chart 5). Rising operating rates and elevated business and consumer confidence, as well as a strengthening backlog are overwhelming the uncertainty created by the negotiations on the North American Free Trade Agreement (NAFTA), and prompting businesses to begin to open their purse strings. The rebound in machinery demand is strongest in Alberta, but has also picked up in other provinces. For example, machinery demand in Ontario, which accounts for nearly half of the Canadian total, jumped 9% y/y through October, and likely climbed to an annual record in 2017, buoyed by a double-digit increase in corporate profits and the highest manufacturing operating rates since 2000.

CANADIAN GOVERNMENTS: STILL SPENDING

Current and capital expenditures across all three levels of government are expected to add 0.4 percentage points to real GDP growth during 2018, before easing to a 0.2 percentage point contribution in 2019. Assisted by Phase 1 of the federal infrastructure program, execution of numerous projects across all regions is picking up, with social and green infrastructure initiatives such as social housing, daycare spaces, community facilities, and wastewater management, in addition to transportation and public-transit outlays, proceeding. Other new federal spending adjustments, owing to their complexity, will likely continue to face delays, with significant ongoing spillovers to future years.

The federal government's fiscal 2016–17 deficit came in at a narrower-than-expected CAD 17.8 bn, owing mainly to the reprofiling of previously-planned expenditure. Ottawa's efforts to sustain gradual improvements from this benchmark are being eased by the stronger-than-expected output and employment growth during calendar 2017 and related federal revenue adjustments. Compared with the government's projections this past October in its *Fall Economic Statement 2017*, which projected a widening in

Table 2

Canada	2000–16	2016	2017e	2018f	2019f
	(annual % change, unless noted)				
Real GDP	2.1	1.4	2.9	2.3	1.7
Consumer spending	2.9	2.3	3.6	2.8	1.9
Residential investment	3.7	3.4	2.6	-0.8	-0.9
Business investment	2.2	-8.8	1.5	3.6	2.6
Government	2.2	2.7	2.1	1.8	1.0
Exports	1.3	1.0	1.0	2.3	3.2
Imports	2.9	-1.0	3.3	2.4	2.7
Nominal GDP	4.2	2.0	5.1	4.3	4.0
GDP Deflator	2.1	0.6	2.1	2.0	2.3
Consumer price index (CPI)	1.9	1.4	1.6	1.9	2.1
CPI ex. food & energy	1.6	1.9	1.6	1.8	2.0
Pre-tax corporate profits	3.6	-1.9	20.0	5.0	1.0
Employment	1.3	0.7	1.9	1.5	0.8
Unemployment rate (%)	7.1	7.0	6.3	5.9	5.9
Current account balance (CAD bn)	-17.1	-65.4	-66.8	-66.4	-60.1
Merchandise trade balance (CAD bn)	25.1	-25.9	-24.7	-27.4	-24.2
Federal budget balance* (FY, CAD bn)	-2.8	-1.0	-17.8	-16.8	-14.8
percent of GDP	-0.2	0.0	-0.9	-0.8	-0.7
Housing starts (000s)	199	198	220	206	196
Motor vehicle sales (000s)	1,657	1,949	2,038	2,000	1,950
Industrial production	0.6	0.1	5.2	2.0	1.1
WTI oil (USD/bbl)	63	43	51	57	60
Nymex natural gas (USD/mmbtu)	4.94	2.55	3.02	2.95	2.95

Sources: Scotiabank Economics, Statistics Canada, CMHC, Bloomberg. * Canada ex risk adjustment of $1.5bn & $3.0bn for FY18 & FY19.

the deficit during fiscal 2017–18, we now expect this fiscal year's shortfall to narrow to CAD 16.8 bn (assuming the CAD 1.5 bn risk adjustment is not required) and to keep contracting in fiscal 2018–19 to less than CAD 15 bn, an improvement of almost CAD 10 bn from last spring's *Budget* estimate if the CAD 3 bn risk provisioning is not invoked. Enhancing federal fiscal flexibility are the rising revenues anticipated from the recent policy changes on the taxation of corporate passive investment income. Achieving our projected federal deficits would edge Ottawa's accumulated deficit below 30% of GDP by March 2019 for the first time since March 2009.

The Provinces are evenly divided between those that are set to maintain balanced books from fiscal 2017–18 onward and those that are still working to eliminate their remaining budget shortfalls in the years ahead. In general, the Provinces have less forward fiscal flexibility than their federal counterparts owing to three key issues: first, all ten governments face their usual spending pressures in health, education, social services, and senior care; second, they may feel compelled to raise matching funds for federal initiatives in, amongst other things, infrastructure, the environment, and indigenous services; and third, new priorities, such as efforts to dampen power price increases, have arisen.

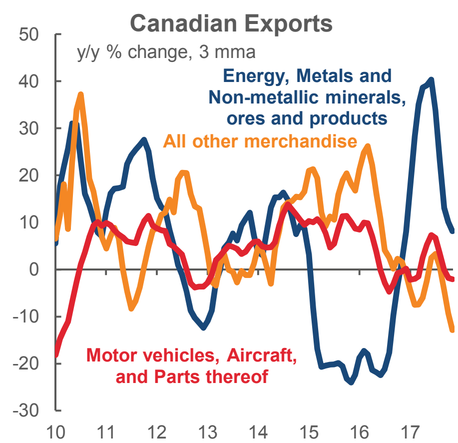
The recent US tax reform erodes almost entirely Canada's sizeable prior advantage in corporate taxation, in terms of both the combined federal and provincial/state statutory rates and the marginal effective tax rate on new capital investment. Tax rates aren't, however, the only consideration in business decisions: the federal and provincial governments could act to enhance competitiveness with tax-policy adjustments, regulatory reforms, and other measures, all of which could be engineered to be revenue-neutral for government.

IMPROVING GLOBAL ECONOMIC CONFIDENCE TO LIFT CANADIAN MANUFACTURING EXPORTS

In 2017, Canadian merchandise exports expanded at around 5% y/y, but showed trends that contrasted sharply between each half of the year. Until June, monthly goods exports averaged double-digit growth, led by an increase in energy products exports that averaged slightly over 60% growth year-on-year, which compensated for declines in several industrial product exports. During the second half of the year, softer, but still strong, commodities exports were unable to compensate fully for retreats concentrated in other sectors, namely motor vehicles, aircraft, and their respective parts (chart 6). Yet, industrial machinery exports are set to get a boost from increased global demand for manufactured goods, with world industrial production growing at its fastest pace in more than three years.

Industrial capacity pressures in the US, alongside tax reforms that make capital equipment investments more advantageous, should lead to increased demand for Canadian industrial goods in 2018. Motor vehicles exports south of the border are also set to rebound as US auto dealer inventories dwindle, personal consumption remains strong, and pickup truck production ramps up in Oshawa. The fly in the Canadian export ointment continues to be uncertainty surrounding NAFTA and the imposition of countervailing duties by the US on certain Canadian products such as airplanes, softwood lumber, and some paper products.

Chart 6



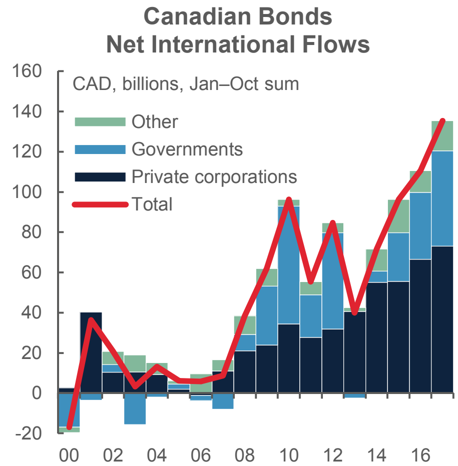
Sources: Scotiabank Economics, Statistics Canada.

Nevertheless, the Bank of Canada BOS puts Canadian firms' investment intentions near post-2008 highs and we expect Canadian goods exports to expand by around 0.9% y/y in 2018 in dollar terms, below the projected 1.3% y/y growth in imports. During the second half of 2018, merchandise export growth should slightly exceed import growth and carry into 2019. On a quarterly basis, the country's merchandise trade deficit is expected to narrow from its 2017 high of CAD 36 bn to the low CAD 20 bn range by end-2019. Together with narrowing in the services and non-merchandise trade balances, Canada's current account deficit is projected to fall from an estimated 3.1% of GDP in 2017 to 3.0% of GDP and 2.6% of GDP in 2018 and 2019, respectively.

CAPITAL INFLOWS TO DEBT MARKETS STEP UP

Last year saw large capital flows from international investors into Canadian securities, with the 12-month total net flow from October 2016 to 2017 amounting to close to 5.5% of Canadian GDP, up from 4.9% in the previous year. On a year-to-date basis, government bond acquisitions by foreigners grew 43% y/y versus 10% y/y for corporate bonds (chart 7). While net foreign purchases of debt securities are more than double those of equities, the latter saw a massive 67% y/y increase in the year to October owing to record-breaking investment in Canadian shares in February 2017 related to cross-border mergers and acquisitions activity, which is unlikely to be repeated this year. Overall, Canada's gross external debt (public and private) has stabilized at around 110% of GDP since late-2015, after a steep rise in banks' external funding which climbed from 24% of GDP in 2013 to as high as 46% of GDP in 2016. Since its Q4-2016 peak, the ratio of banks' gross external debt to Canadian GDP has fallen to 41% in Q3-2017 as foreign deposit growth has levelled off while banks' debt in the form of long-term instruments has remained on a nearly constant climb.

Chart 7



Sources: Scotiabank Economics, Statistics Canada.

RISKS: INSOMNIA SHOULD BE WANING

Over the last few months, Bank of Canada Governor Poloz has articulated five major concerns for the Canadian outlook: trade relations with the US under NAFTA, stretched home real-estate valuations, household indebtedness, the labour market, and cybersecurity. While all five issues are important considerations for policy makers, we don't expect developments on any of these fronts to meaningfully derail the outlook we've sketched for the Canadian economy. As we detailed in several reports on our NAFTA microsite (*www.scotiabank.com/nafta*), it is likely that the tone of our trade talks with the US and Mexico will intensify over the coming months, that agreement on a renegotiated and modernized NAFTA may not be reached by the current end-March deadline, and that the NAFTA discussions may enter a 'shadow' period during the remainder of 2018 during which the agreement remains in effect, but its future seems uncertain. A series of key US dates (box 1) may prompt efforts by the White House to increase pressure on Canada and Mexico, including through threats to withdraw from NAFTA. Investors, businesses, and households should look through these tensions: the incentives remain aligned for eventual agreement on a revised NAFTA, but we may not see a consensus on how this will look until 2019. As detailed above, recent jobs data imply that labour markets are running hot enough to prompt wage increases that should ease worries about debt levels and housing affordability, while immigration and capital inflows are set to sustain real-estate markets. Canadian government and business are responding to cybersecurity threats, and we do not see macroeconomic implications from these threats at this stage.

Additional areas of uncertainty could arise around the introduction of Canada's carbon-pricing regime, long-term erosion in our corporate tax competitiveness as a result of US fiscal reform, and increasing labour-market rigidity following the introduction of a host of provincial measures that go well beyond increases in minimum wages. These are, however, longer-term issues that could affect Canada's performance over the next five to 10 years, rather than crimp the outlook for 2018 and 2019.

Box 1. KEY NAFTA-RELEVANT US RISK DATES DURING 2018

While NAFTA talks are tentatively set to conclude by end-March 2018, it is likely that they could be extended into next year: Mexico's presidential elections in July and the US Congressional midterm elections in November could both inhibit meaningful progress from Q2 to Q4 2018. Intensified rhetoric and more pointed negotiating tactics are likely to surface around the following dates, which could set off difficult headlines, but should not meaningfully change our expectation that NAFTA's key provisions will remain in place.

- **January 23–28.** Sixth round of NAFTA negotiations in Montréal, Canada.
- **January 25.** US International Trade Commission's final voting phase on antidumping and countervailing duty investigations into 100- to 150-seat aircraft from Canada.
- **January 30.** US President's State of the Union Address to Congress. The President is likely to highlight his protectionist agenda and raise concerns about the country's largest trading partners: Canada, China and Mexico. Immigration policy regarding Mexico may also figure in the speech.
- **January 31.** Self-imposed deadline by Senate Majority Leader on immigration reform.
- **Mid-February.** Seventh round of negotiations in Mexico.
- **March 5.** Deferred Action for Childhood Arrivals (DACA) permits begin expiring in the US.
- **Mid-March**. Eighth round of negotiations in Washington, DC
- **End-March.** Tentative deadline for conclusion of NAFTA negotiations and deadline for any request to Congress to extend the 2015 Trade Promotion Authority (TPA) and/or to submit to Congress any proposed changes to NAFTA, both of which require a 90-day notice period ahead of the existing TPA's expiry at end-June.
- **Early-April.** If the US were to invoke NAFTA's Article 2205 withdrawal clause at this point, its six-month notice period would conclude around the time of the US Congressional midterm elections in November.
- **May 23.** US Department of Commerce to make final determination on countervailing duties on uncoated groundwood paper from Canada.
- **End-June 2018.** The 2015 TPA expires. TPA must be extended or renegotiated in order to present changes to NAFTA to Congress subject to only an up-down vote without amendments.
- **By end-June.** Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) expected to be ratified by six of the 11 member countries, thereby bringing it into force for those countries.
- **July 1.** Mexican presidential, congressional and state elections.
- **November 6.** US midterm elections along with some State elections.

The Provinces

BUILDING ON SLOWER GROWTH

- **Positive real GDP growth, albeit slowing, is forecast for all provinces in 2018 and 2019 for the first time since 2010–11. Alberta and British Columbia will lead the pack.**

- **With operating deficits curtailed, the Provinces' net new borrowing will be increasingly dominated by capital investment (chart 1).**

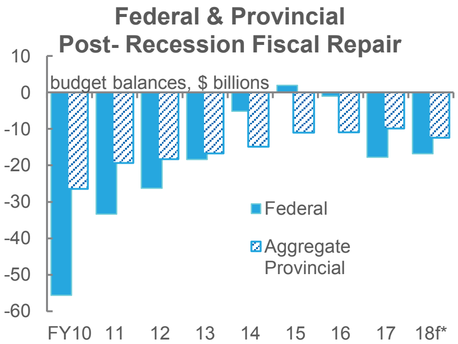
Growth leadership for 2018–19 remains with British Columbia and Alberta, though their expansion is expected to decelerate sharply by 2019 (table 1). The other provinces emerge from a surprisingly buoyant 2017 with varied growth engines that should sustain some momentum—from rising Halifax Shipyard activity to robust orders for buses in Manitoba and overseas demand for the Prairies' pulse crops.

Entering 2018, Alberta is estimated to have recouped just over half of its two-year 7.2% real GDP decline during 2015–16 and Saskatchewan has regained all of its 1.5% two-year fall-off. Anchoring these recoveries was an unexpectedly large rebound in energy sector investment, concentrated in supporting infrastructure and conventional oil & gas. The Line 3 oil pipeline replacement is proceeding but, overall, more muted energy-related investment gains are now anticipated as conventional capital outlays climb more slowly and oil sands investment stabilizes before commencing a careful upturn. Similarly, last year's export gains (chart 4), based on solid oil production increases of 9.0% for Alberta and 3½% for Saskatchewan and Newfoundland and Labrador, will be dampened in 2018–19 with the completion of the major oil sands projects started before the oil price correction. Newfoundland and Labrador's positive but weak growth this year and next reflects output ramping up at its fourth offshore oil field and the West White Rose offshore development, as work winds down on the Muskrat Falls hydroelectricity project. In all three net oil-producing provinces, the pent-up demand aiding 2017 consumer spending and the replacement purchases for the Fort McMurray rebuild are now expected to wane.

The extended mining sector recovery is expected to leave more balanced regional population growth intact for the rest of the decade. The net outflow of Alberta's and Saskatchewan's residents to other provinces that exceeded 23,000 in 2016 is receding, but a return to substantial net worker inflows is not anticipated through 2019, preserving other provinces' work forces. For international immigration, the broadening provincial distribution since 2000 lays the framework for all provinces to more fully benefit from the planned national immigration increase to 340,000 by 2020 from 300,000 annually in 2016–17 and a 262,000 average for 2012–15 (chart 2).

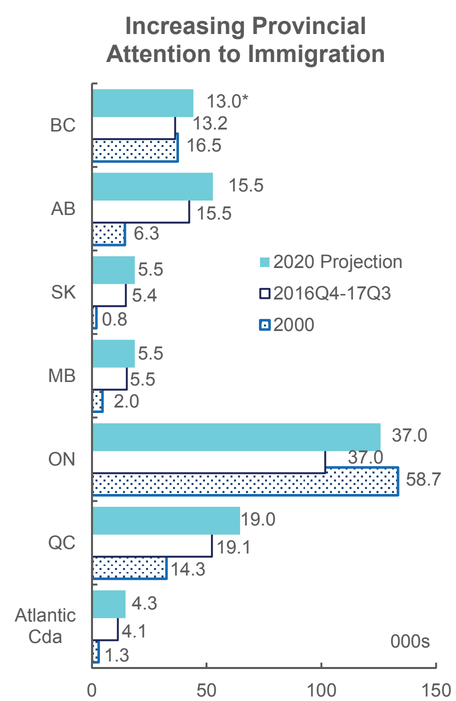
Alongside higher immigration, employment growth in 2017 across the net oil-consuming provinces matched or exceeded prior post-recession highs, a positive development for both housing demand and consumption. Yet the factors previously expected to spur increasing household caution over the next two years are still in place. Rising interest rates, regulatory tightening, a diminishing impact from higher federal child benefits and a late cycle consumer with an extended balance sheet are still hurdles. The late-2017 job creation surge is expected to cool as 2018 proceeds

Chart 1



* FY18: provincial *Budgets*; federal: Scotiabank Economics. Sources: Scotiabank Economics, Finance Canada, provincial *Budget* documents.

Chart 2



* Per cent of national immigration. Sources: Statistics Canada, Scotiabank Economics.

and ease further in most provinces in 2019. Some offset to slower job gains is expected from wages trending upward (chart 3) through the forecast period, a shift reinforced by minimum wage hikes, particularly in Ontario and Alberta, this year and next. Labour market tightness in high-growth areas will add to wage pressures, though rising inflation is expected to partially dampen real purchasing power. Further growth, though more gradual, is forecast for tourists' spending, supported by the ongoing renewal and expansion of tourism facilities across the provinces.

The strong fundamentals underpinning housing demand in the high-priced Toronto and Vancouver markets is spilling over to adjacent centres—Victoria, Abbotsford and Kelowna in BC and in Ontario, Hamilton and Oshawa among others. In these nearby housing markets, decreased inventories, very low rental vacancy rates and rising prices and rents are limiting choice and reducing affordability. In Manitoba, Quebec and the Atlantic provinces, a moderate pick-up in housing demand is occurring in their major cities, in part due to the uptick in local economic growth. These centres, however, have the benefit of more ample housing supply to cushion the impact on their housing affordability.

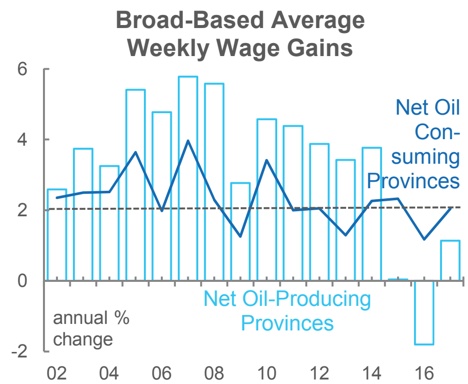
Rising exports across multiple non-energy industries (chart 4) are spurring investment that in turn is elevating demand for products such as fabricated metals and machinery and a range of support services. Most provinces are expected to benefit from strengthening US demand for consumer products, including motor vehicles, and industrial goods. Provincial mining sector prospects, apart from oil & natural gas, are mixed. The further price increases forecast for industrial base metals are encouraging and new capacity is opening in industries such as gold mining, but excess global supply is still projected for key minerals such as potash and uranium through 2019.

In the shadow of NAFTA negotiations, with the outline of an agreement unlikely by this March, the impact of existing and potential US trade actions varies. For softwood lumber, strong US demand stemming from rising residential construction has mitigated the overall impact of substantive countervailing and anti-dumping duties. Greater damage could result from the recently announced levies on Canadian newsprint because of the weaker market conditions for this product. Major aerospace activity is affected by US trade actions, but significant gains among smaller players in areas such as parts, overhaul and maintenance are reported in several provinces. In Ontario, after a strike and line closure last fall, a 9¾% jump of in motor vehicles assembled is expected from Q42017 to Q12018, but the sector, including pick-up trucks, is still subject to ongoing NAFTA discussions on "rules of origin".

A range of business services and services exports, from finance to scientific & technical inputs, should continue to accelerate regional employment and income growth. Technology's expanding role is well documented by the job surge of nearly 19% from 2006 to 2016 in computer & information systems (C&I) occupations, an increase that was more than double the total employment gain. In addition to C&I job creation in southern BC and Ontario's tech corridor stretching from Ottawa to Kitchener-Waterloo, significant concentrations exist in smaller centres such as Quebec City, Halifax and Fredericton (chart 5).

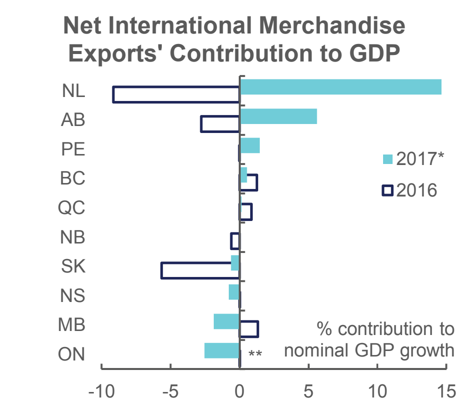
Inflation was relatively modest in a number of provinces through most of 2017 but started to quicken late last year, even in Quebec where the price response to stronger growth has been slow. High-growth areas already are seeing some price pressures, with y/y increases in Vancouver's non-residential construction price index topping 5%.

Chart 3



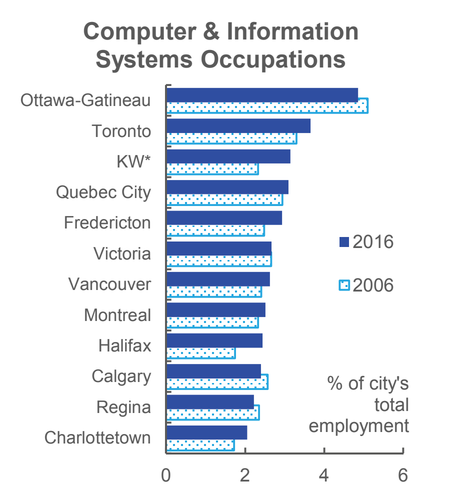
Sources: Scotiabank Economics, Statistics Canada, *Survey of Employment, Payrolls & Hours*.

Chart 4



* January. - November. ** Ontario, 2016: 0. Source: Statistics Canada.

Chart 5



* Kitchener-Cambridge-Waterloo. Source: Statistics Canada.

OLD AND NEW PROVINCIAL FISCAL CHALLENGES

With our forecast of 2017 real GDP growth for every Province surpassing their *Budget* assumptions last spring, some quite positive bottom line revisions were anticipated in their mid-year updates for fiscal 2017–18 (FY18). Their reports, however, indicated disappointing personal income tax revenues as households' tax planning in 2015 in advance of the federal top bracket rate hike in 2016 eroded the projected income base. Even with solid corporate and sales tax results, and the outlook for improving resource receipts despite possible weakness in bitumen prices, staying on track or improving upon fiscal plans this fiscal year and next is likely to require some difficult trade-offs for a number of Provinces.

To trim provincial net debt burdens run up relative to pre-recession levels for all but three Provinces, elevated capital spending to leverage available federal funding remains a hurdle. The Provinces and their municipalities also must accommodate the operating and maintenance expense of the new infrastructure. As they balance competing demands, a key provincial advantage given our forecast of higher interest rates is their post-recession success in lengthening the term of their debt when coupon rates were low.

Table 1

The Provinces	(annual % change except where noted)										
Real GDP	**CA**	**NL**	**PE**	**NS**	**NB**	**QC**	**ON**	**MB**	**SK**	**AB**	**BC**
2000–16	2.1	2.5	1.7	1.3	1.2	1.7	2.0	2.3	2.0	2.7	2.8
2016	1.4	1.9	2.3	0.8	1.2	1.4	2.6	2.2	-0.5	-3.7	3.5
2017e	2.9	-1.5	1.8	1.6	1.4	2.7	2.9	2.3	1.9	4.2	3.5
2018f	2.3	0.1	1.5	1.1	1.1	2.0	2.3	2.0	2.1	2.5	2.5
2019f	1.7	0.7	1.1	0.8	0.5	1.5	1.8	1.5	1.7	1.9	1.8
Nominal GDP											
2000–16	4.2	5.6	4.2	3.4	3.3	3.6	3.8	4.4	5.3	5.9	4.5
2016	2.0	2.6	4.0	2.8	3.6	2.7	4.3	2.3	-4.0	-4.9	4.8
2017e	5.1	2.6	3.6	3.2	3.0	3.8	5.0	4.0	4.9	7.6	5.6
2018f	4.3	3.0	3.2	2.8	2.7	3.6	4.5	3.7	4.1	4.9	4.6
2019f	4.0	4.0	2.9	2.6	2.2	3.3	4.0	3.3	4.2	5.0	4.0
Employment											
2000–16	1.3	0.8	1.0	0.6	0.4	1.3	1.3	0.9	1.1	2.3	1.4
2016	0.7	-1.5	-2.3	-0.4	-0.1	0.9	1.1	-0.4	-0.9	-1.6	3.2
2017	1.9	-3.7	3.1	0.6	0.4	2.2	1.8	1.7	-0.2	1.0	3.7
2018f	1.5	-0.8	0.6	0.4	0.3	1.5	1.6	0.8	0.5	1.5	1.7
2019f	0.8	-0.4	0.4	0.2	0.1	0.7	1.0	0.5	0.6	1.0	1.1
Unemployment Rate (%)											
2000–16	7.1	14.3	11.2	8.8	9.6	8.0	7.1	5.1	5.0	5.1	6.6
2016	7.0	13.4	10.7	8.3	9.5	7.1	6.5	6.1	6.3	8.1	6.0
2017	6.3	14.8	9.8	8.4	8.1	6.1	6.0	5.4	6.3	7.8	5.1
2018f	5.9	14.9	9.7	8.1	7.9	5.6	5.6	5.3	6.0	7.3	4.9
2019f	5.9	15.0	9.6	8.0	7.8	5.6	5.6	5.2	5.9	7.2	4.8
Housing Starts (units, 000s)											
2000–16	199	2.6	0.7	4.3	3.5	44	71	5.1	5.2	34	28
2016	198	1.4	0.6	3.8	1.8	39	75	5.3	4.8	25	42
2017e	220	1.4	0.9	4.0	2.3	46	79	7.5	4.9	29	44
2018f	206	1.3	0.9	3.8	2.1	41	75	6.5	5.0	29	41
2019f	196	1.4	0.8	3.8	2.1	38	71	6.2	4.9	30	38
Motor Vehicle Sales (units, 000s)											
2000–16	1,657	29	6	48	38	413	635	47	45	216	180
2016	1,949	33	9	54	44	458	807	55	51	220	218
2017e	2,030	34	8	58	42	450	845	60	55	248	230
2018f	2,000	32	8	57	41	444	825	59	56	251	227
2019f	1,950	30	7	56	40	433	795	58	56	253	222
Budget Balances, Fiscal Year Ending March 31 (CAD mn)											
2000–16*	-2,803	-93	-38	-30	-153	-821	-5,115	-142	360	1,064	319
2016	-987	-2,206	-13	-13	-261	2,191	-3,515	-839	-675	-6,442	811
2017	-17,770	-1,148	-1	150	-119	2,361	-991	-764	-1,354	-10,784	2,737
2018f**	-16,800	-778	1	132	-135	0	0	-840	-679	-10,064	190
2019f	-14,800	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Sources: Scotiabank Economics, Statistics Canada, CMHC, Budget documents. * MB:FY04–FY16; AB:FY05–FY16; SK:FY15–FY18f: ex. accrual adjustment for pension expense.
** Provinces' FY18: Budget documents. Federal FY18-FY19: Scotiabank Economics forecast ex risk adjustment of $1.5bn and $3.0bn for FY18 & FY19, respectively.