"It's Complicated": The Macroeconomics of Canada's New Immigration Plans

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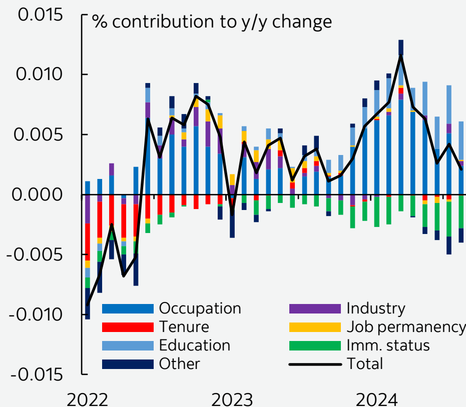
- **Canada threw cold water on its immigration ambitions last week with a plan that would see a modest population contraction over the next two years.**
- **Our immediate reaction questioned the practicalities and probabilities of such a population scenario, leaving us reluctant to substantially change our economic outlook.**
- **With additional time to ponder the implications—and leverage our modeling advantage—we double down on these expectations. We assume that the most likely new baseline scenario would see population growth slow more gradually than stated plans, to 0.9% and 0.5% in 2025 and 2026, respectively, but we cannot discount the possibility of a sharper slowdown. This compares to our pre-announcement forecast for population growth of 1.4% and 0.7% in 2025 and 2026, which incorporated announced measures from earlier this year.**
- **A population deceleration is no doubt a slowdown to headline growth under any scenario. There is broad concurrence here directionally, at least. Our model-driven analysis suggests that for each 1 ppt population shock, just under a half is offset through a combination of productivity and wages gains and a modest temporary fall of the unemployment rate. This means that under the new most likely population assumption, real GDP would grow by 1.9% and 2.0% in 2025 and 2026, compared to our pre-announcement baseline forecast of 2.1% and 2.3%.**
- **Our model generates a net-neutral contraction in supply and demand leaving the output gap broadly unchanged. Nevertheless, our model-driven results suggest additional wage channels could underpin inflationary pressures under more aggressive population attrition scenarios.**
- **A sharper population contraction aligned with government plans could materially drive wage pressures higher, which, in turn, could be sufficiently inflationary to modify our outlook for the interest rate path head—to the beat of 25–50 bps fewer rate cuts over the horizon. On the other hand, our best-guess population path leans towards putting these pressures just as upside risks to our current rate call.**
- **An adjustment to population growth is no doubt in order over the medium term. Population growth in the order of just sub-1% annually likely balances the economic absorptive capacity with the frictions of adjustment as businesses adapt to new realities.**
- **However, immigration plans still lack ambition with crosswalks to unlocking essential business investment. A population adjustment rights Canada's productivity trajectory directionally, but only a stronger business response puts us on the right pitch. There is still a vacuum of ideas.**

Chart 1



Sources: Scotiabank Economics, Bank of Canada.

COURSE CORRECTION

Canada's federal government announced its intention to sharply rein in immigration numbers last week. Their plans would—by their own account—drive a slight contraction in population growth over the next two years (-0.2% annually) before returning to moderate growth by 2027 (0.8%). We earlier probed the probability of such a sharp shock to population growth. We considered a range of implementation scenarios from delivering-against-word to delays in execution. We cautiously concluded that, while stated plans cannot be completely dismissed, a more likely scenario was one of implementation lags and misses that would yield population growth somewhere around 0.9% and 0.5% in 2025 and 2026, respectively.

INSIDE THE BLACK BOX

This note digs deeper into the potential economic implications of these different pathways. We focus on two of our earlier population scenarios (Box 1) and run these scenarios through the Canadian block of Scotiabank's macroeconomic model to better understand the drivers—both headwinds and tailwinds—for growth, inflation, and interest rate paths ahead. We use a shock minus control approach with our pre-announcement base (or control) case reflecting our latest **forecasts**. This largely reflects a soft-landing scenario, namely, inflation durably approaches target, enabling the continued descent in interest rates, and thus unlocking an eventual and progressive rebound in economic activity. (*Note, potential impacts of US election outcomes have not yet been embedded in our baseline given enormous uncertainties*.)

Box 1: Population Scenarios Details

1. Announced plans with delayed effects: The government is largely limited to levers already codified in program changes. Notably, the Temporary Foreign Worker Program (TFWP) through its Labour Market Impact Assessment (LMIA) process drives the curtailment in work visas. The TFWP accounts for 20% of all outstanding temporary permits, with the LMIA stream making up half of that, representing just 10% of the total work permits. Due to administrative barriers and limitations, work visa issuances may only begin to decline in early 2025. Work visa issuance would decrease by 4% in 2025 and another 11% in 2026. This would leave population growth around 0.9% and 0.5% in 2025 and 2026, respectively. This scenario is our "best-guess" baseline population scenario, relative to the pre-announcement baseline scenario of 1.4% and 0.7%.

2. Announced plans: The government introduces and aggressively executes attrition largely in line with stated intentions set out in its new immigration plan. Effectively 70% of current visa holders in the country would either renew, transition to PR or leave the country versus a historic expiration rate of around 30–40%. Population growth would collapse as per the government's stated plans to -0.2% annually over the next two years. We consider this scenario possible, but unlikely.

Table 1: Annual Population Growth Scenarios, %

Scenario	2024	2025	2026
Pre-announcement baseline	2.9	1.4	0.7
Best-guess new baseline	2.9	0.9	0.5
Announced plans	2.9	-0.1	-0.2

Sources: Scotiabank Economics, GoC.

THE SHOCK, AWE, AND OW OF LABOUR CONTRACTIONS

Potential output is weaker than our pre-announcement baseline in both scenarios. The principal channel is obviously via a weaker labour supply, though the relationship is not one-for-one on potential GDP. Recall, potential output is a function of equilibrium hours worked times trend productivity, so a drop in population would provide headwinds to potential output. However, productivity, in the mid-term at least, would likely increase by sheer math. Labour productivity is a function of total factor productivity (TFP) and the capital-to-labour ratio. Assuming no material impact on TFP, capital deepening results automatically from a shrinking labour supply, with capital stock assumed sticky in the near and medium-term. Our model suggests that about a third of the negative effect of the population shock on potential output would be offset by these productivity gains.

Real GDP is also weaker. The population shock dictates weaker demand as there are fewer consumers relative to the pre-announcement baseline. Here again, the impact on GDP is not one-for-one, with a partial offset coming through productivity gains, a modest fall of the unemployment rate and an increase of wages. Just as the rise in the unemployment rate over the past year has partly reflected strong population growth, with labour force growth outpacing job gains, we would now expect weaker population growth to have the opposite effect on the unemployment rate. Tighter labour market conditions, stronger productivity, and weaker labour supply, in turn, would put pressure on wages, increasing incomes and stimulating consumption which would partly offset the negative impact of the population shock on real GDP. A **recent** decomposition of LFS micro wage data by the Bank of Canada demonstrates the dampening effect temporary resident wages have had on overall wage growth since early 2023 (chart 1 on page 1).

The net effect would yield approximately a ~ 0.6 ppt net loss in output for each 1 ppt population shock (table 2). Whereas our pre-announcement baseline forecasts real output of 2.1% and 2.3% in 2025 and 2026, consistent with population growth assumptions at 1.4% and 0.7%, an aggressive population shock (announced plans) would yield growth around 1.6% and 1.7% over this same horizon.

Table 2: Real GDP Growth Outcomes, %

Scenario	2024	2025	2026
Pre-announcement baseline	1.2	2.1	2.3
Best-guess new baseline	1.2	1.9	2.0
Announced plans	1.2	1.6	1.7

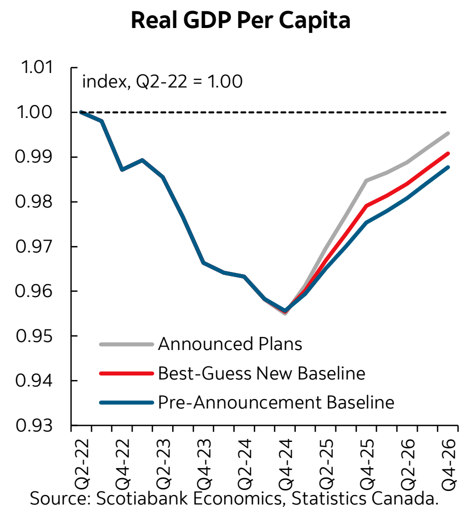
Sources: Scotiabank Economics, Statistics Canada.

However, our best-guess new baseline scenario, which implies a more-likely smaller shock on population, generates real GDP growth around 1.9% and 2.0% in 2025 and 2026, respectively. This is still a material difference, but of a magnitude that could be plausibly overwhelmed by other exogenous drivers (like stronger-than-anticipated US activity, for example, or of course, the outcome of the US elections).

The output gap is expected to remain largely unchanged across all scenarios. The population shock would erode potential GDP broadly commensurate with the labour supply shock and productivity offset. However, a contraction in demand would largely offset the effect on the output gap as supply and demand both adjust at a similar pace due to the expected and gradual nature of the population shock, allowing demand to adjust concurrently[1]. There is some debate out there as to whether consumption contracts faster than supply on the premise that per capita consumption of temporary residents may be lower than that of the rest of the population. This is a valid consideration—even if data are limited—but with about 1.1 mn temporary workers counted in the LFS against 3 mn temporary residents in the country, i.e., two thirds of the temporary population are consumers and not workers, a best-guess is that attrition is not likely one-for-one. That is, the number of lost consumers could reasonably exceed the number of lost workers, with an assumption of lower per capita consumption relative to the rest of the population could leave the overall balance awash.

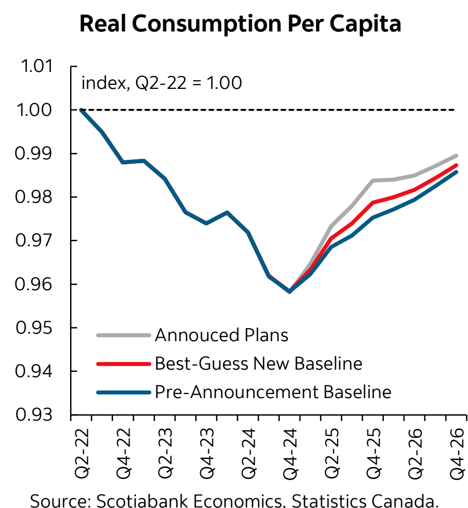
Even though the output gap is expected to remain largely unchanged, wage pressures could reasonably drive modest inflationary pressures. The materiality hinges on the magnitude of the shock. In our pre-announcement baseline, inflation durably hits the Bank of Canada's 2% mid-point by mid 2025. The potential inflationary impact of the new "best-guess" baseline, the gradual population pathway, is relatively modest, pushing that timeline out perhaps a quarter or so. The consequent model-induced impact on the policy rate would also be relatively modest (8 bps and 15 bps higher in 2025 and 2026, respectively, relative to the pre-announcement baseline forecast). Practically, these impacts in isolation would not necessarily change our rate call given they fall within a range of forecasting uncertainties, but would underpin upside risk to inflation—adding to an already-long list that leaves us cautiously guarded.

Chart 2



Source: Scotiabank Economics, Statistics Canada.

Chart 3



Source: Scotiabank Economics, Statistics Canada.

The more aggressive path of population consolidation (announced plans) could reasonably drive a more gradual decline in the overnight rate. The model-run estimate suggests another 20 bps of tightening relative to current policy rate projections in 2025 would be required to offset additional inflationary pressure through wage channels and a 40 bps difference through 2026. Effectively, that could mean taking one to two projected interest cuts off the table over the next eighteen months. Again, we do not yet find this pace of population growth credible, but we do not completely dismiss the risk of a faster-than-expected deceleration that would come with these risks.

PRODUCTIVITY ISN'T EVERYTHING, BUT IN THE LONG RUN, IT IS ALMOST EVERYTHING

Other metrics may pop positively on first glance. Per capita measures—whether GDP or consumption—were already expected to rebound albeit from their recent lows. A combination of an already-anticipated population slowdown, a modest improvement in business investment with lower interest rates, and greater post-settlement labour force integration and market-driven labour reallocation was expected to see a return to growth across these per capita metrics. An even-sharper population slowdown would modestly steepen that recovery (charts 2 and 3) mostly reflecting productivity gains.

The pivot would be welcomed but looks less rosy viewed through a wider lens. The improved tilt from population changes alone would be insufficient to meaningfully narrow productivity gaps and ultimately drive material welfare gains over time. Even with the less-likely announced plans scenario, per-capita measures would remain below their peak in 2022Q2.

[1] Our SGMM model is forward-looking. Economic agents adjust gradually their behaviour today in expectation of the future.

There are some green shoots. Whereas productivity gains and wage improvements universally row in the same direction for output, they compete when it comes to business costs. Under more aggressive population contraction scenarios, productivity gains are increasingly overwhelmed by wage pressures such that the unit labour cost (ULC) gap narrows slower under more sudden contractions in labour supply. In plain language, each worker is producing more, but they are also fetching higher wages in increasingly tighter labour market conditions.

This should *in theory* tilt the relative cost of labour and capital in favour of much needed capital investment to induce greater business investment, but is it enough? Especially to work against countervailing headwinds from uncertainty, be it local or global, economic or geo-political, and incrementally higher financing costs (under the announced population contraction scenario)?

THE RIGHT TARGET, THE WRONG TIMELINES (& THE MISSING BITS)

A population slowdown is likely a necessary, but insufficient step to unlocking greater productivity in Canada. A comprehensive immigration plan would not only double-down on the numbers but also on the economic potential of newcomers. The pace of adjustment would also lean on market forces to absorb some of the potentially deleterious impacts from abrupt dislocations. The government's plans do not put us on this path, but practical considerations likely do. We still lean towards our more moderate "best guess" path for population projections and consequent economic impacts. In a once-again heightened geo-political uncertain environment, we would modestly shave output forecasts but hold the line on inflation and interest rate outlooks.

There is still a critical piece of the policy puzzle missing. Importantly, the immigration plan should be complemented by an equally ambitious strategy to unlock business investment—a shared responsibility across the business community and various levels of government. In the early phases of the pandemic, we had **called** for a time-bound matching grant to kick-start business investment that avoids picking winners. Such debt-financed luxuries are likely (fiscally) long-gone, but if the government is serious about population attrition through a long-run productivity lens, it may need to rethink resource allocation to ensure investment incentives offset the more immediate negatives from population contraction.

This may neither "win the vote" nor "convince the people" but it may be the harsh pill Canadians need to swallow.

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