ECONOMIC VIEWPOINT

A Recession Seems Likely in Canada and Other Countries

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HIGHLIGHTS

- After more than two years of the COVID-19 pandemic, sustained high inflation has forced many central banks to aggressively hike interest rates. But bringing inflation to heel won't be easy. Today's inflationary pressures stem in part from factors that are beyond central banks' control.
- **As inflation is high and having widespread effects, we now believe a soft landing is increasingly unlikely.** Canada's economy, like so many others, seems to be entering a slight downturn that should reach its nadir in early 2023. **In our opinion, this decline is a necessary evil and will help offset some of the imbalances that are feeding inflation.** A gradual reduction in current supply chain constraints and other issues on the production side will also help to calm inflation.
- **The Bank of Canada (BoC) is facing an increasingly delicate situation.** Continued monetary tightening is necessary to fight inflation, but this will be to the detriment of the economic expansion.
- **The Canadian overnight rate is expected to reach at least 3.25% this fall.** The main drag on growth will be the real estate market, which we expect to keep retrenching. But we also expect household spending and business investment to slow throughout the second half of this year, ultimately leading to a slight contraction in real GDP in early 2023.
- **Recession risks are global.** In the United States, chances of an official recession next year are high. Getting the tightening just right will be difficult for the Fed, and households have seen their savings buffer diminish. Across the Atlantic, Europe is vulnerable to the fallout from the war in Ukraine, particularly the sanctions and Russia's retaliation. The European Central Bank (ECB) has also begun aggressively tightening its monetary policy. China's GDP shrank in the second quarter, and its strict zero-COVID policy is limiting its ability to recover.
- **There are a number of risks to our baseline scenario for Canada.** In terms of downside risks, a deeper recession could materialize, especially if more aggressive monetary tightening proves necessary to rein in inflation or the United States enters a severe recession. In terms of upside risks, Canadian households are still building excess savings, which will help them weather financial pressures. Public finances have improved recently as well. As a result, governments are in a good position to soften the blow and lay the foundations for a recovery. **This could be a good opportunity to make judicious public investments to increase productivity and resiliency in the medium term.**

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Global Growth Is Slowing Quickly

The global economy is being hit by several economic shocks. Chief among them is the pandemic, which is still creating massive disruptions. Even though most economies have now learned to live with the virus, China's zero-COVID policy continues to be a drag on its economy and global supply chains. Meanwhile the war in Ukraine and its consequences underscore the fact that risks to commodity prices remain skewed to the upside. And due in part to pandemic-era stimulus measures, such as generous household transfers, labour markets are extraordinarily tight in many countries and wages are increasing more rapidly. Inflation expectations have also increased, albeit in different proportions depending on the time horizon analyzed. This could make inflation more persistent.

Decades-high inflation has prompted many central banks to tighten monetary policy aggressively. They're doing so by rapidly raising interest rates and, in some cases, by shrinking their balance sheets. The expected negative impact on demand has significantly raised the risk of recession in many countries. The energy crisis resulting from Russia's invasion of Ukraine has left **Europe** particularly vulnerable just as the ECB made its first interest rate hike in over a decade. **China**'s economy contracted in the second quarter of this year thanks to COVID-related lockdowns and is likely to see a shallower rebound than in 2020, contributing to slower overall global growth this year. In the **United States**, real GDP growth contracted for the second consecutive quarter in 2022. And while the US did avoid an official recession in the first half of the year,[1] the Fed's aggressive rate hikes suggest the risk of a true recession, with job losses, is elevated in 2023 (table 1).

TABLE 1
Economic outlook overview

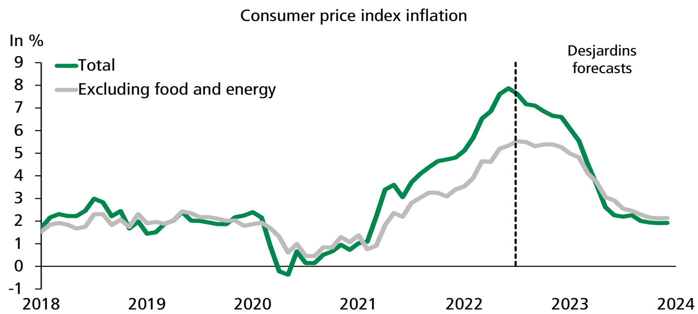
IN %	ACTUAL 2021	PROJECTIONS 2022	PROJECTIONS 2023
United States			
Real GDP growth	5.7	1.6	0.4
CPI inflation	4.7	8.0	3.7
Unemployment rate	5.4	3.6	4.5
Federal funds rate*	0.25	3.50	3.25
10-year Treasury yield*	1.52	2.85	2.70
Canada			
Real GDP growth	4.5	3.4	0.3
CPI inflation	3.4	6.9	3.0
Unemployment rate	7.5	5.3	6.2
Existing home sales	20.7	-24.0	-21.0
Average home price	21.3	1.0	-11.5
Overnight rate*	0.25	3.25	2.75
10-year Treasury yield*	1.42	2.90	2.35
Quebec			
Real GDP growth	5.6	3.7	0.5
CPI inflation	3.8	6.8	3.1
Unemployment rate	6.1	4.4	5.2
Existing home sales	-2.4	-16.6	-16.8
Average home price	18.9	7.5	-11.6
Ontario			
Real GDP growth	4.3	3.2	0.1
CPI inflation	3.5	6.9	3.0
Unemployment rate	8.0	5.6	6.8
Existing home sales	18.6	-33.5	-23.1
Average home price	25.6	3.9	-14.0

CPI: Consumer price index; * End of period.
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Statistics Canada, Canadian Real Estate Association and Desjardins, Economic Studies

Canadians Should Expect a Mild Recession in 2023

The Canadian economy is not immune to these global trends. Both total inflation and core inflation are at levels not seen in decades (graph 1). As elsewhere, energy and goods inflation are high in Canada. Services prices aren't far behind, with wages rising and Canadians rushing back to consume services unavailable during the lockdowns. This has propelled both total and core CPI inflation to decades-high levels (graph 1). Accelerating wage growth is also raising concerns that elevated inflation expectations are becoming entrenched.

GRAPH 1
High inflation remains a central focus of Canadians and policymakers

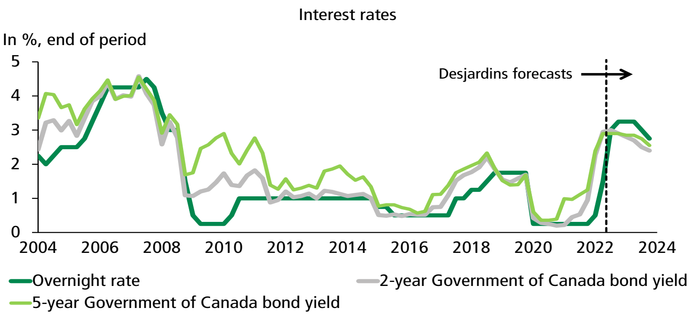


Sources: Statistics Canada and Desjardins, Economic Studies

These factors have prompted the BoC to raise interest rates aggressively. Most recently, the BoC delivered a 100 basis point interest rate hike—the largest since 1998 and larger than any other increase by a major central bank this cycle. As a result, the BoC's policy rate has gone from 0.25% in February 2022 to 2.50% today—the highest level since September 2008. And the BoC has made clear that it doesn't intend to stop there. We're of the view that the BoC is likely to end this hiking cycle with the overnight rate at least to 3.25% by the end of 2022 (graph 2 on page 3). At the same time, long-term bond yields may have already hit their peak in anticipation of future interest rate reductions before the end of 2023.

[1] For more details, see: *Recessions: We Don't Always Know Them When We See Them*, Desjardins, Economic Studies, *Economic Viewpoint*, July 12, 2022, 5 p.

GRAPH 2
The Bank of Canada is hiking forcefully to bring down inflation

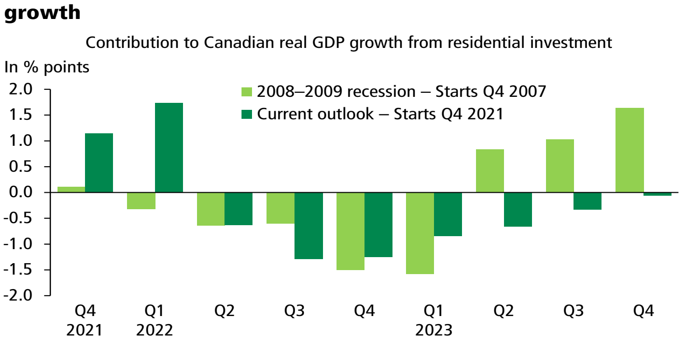


Sources: Bank of Canada and Desjardins, Economic Studies

Aggressive monetary policy tightening has had clear and immediate consequences on the housing market. Existing home sales have fallen by 31% nationally since reaching their peak in February 2022. The average existing home price has fallen by 17% over the same period. We expect the housing market to continue to cool for several more quarters, which should pull down residential investment through the end of 2023. This will act as the main drag on the Canadian outlook (graph 3).

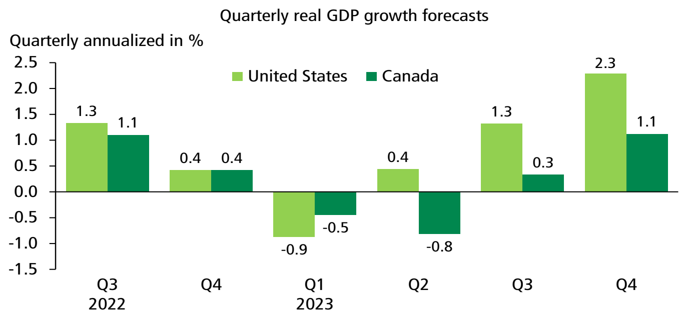
We now expect the Canadian economy to tip into a mild recession in the first half of 2023 (graph 4). The weak growth that we anticipate in the United States will also have impacts on this side of the border. Consequently, the job market will weaken materially. This is likely to push up the unemployment rate as employment gains fall short of the increase in the labour force. A slowdown in economic activity should help to cool domestic inflation and wage growth, prompting the BoC to reverse course in the second half of 2023 (table 1 on page 2).

GRAPH 3
Residential investment will be a substantial drag on real GDP growth



Sources: Statistics Canada and Desjardins, Economic Studies

GRAPH 4
Canadian real GDP growth is expected to be negative in H1 2023



Source: Desjardins, Economic Studies

Overview of the Risks to Our New Baseline Scenario

Our forecasts remain subject to considerable uncertainty. Downside or upside risks could cause the reality to diverge significantly from the predicted trajectory.

Among the downside risks, inflation may prove to be more persistent than we currently anticipate. This could happen if commodity prices spike again, if new supply chain disruptions emerge (for example, due to geopolitical events) or if governments fuel inflation by distributing too much money to households. These shocks could drive inflation expectations and create a wage-price spiral.

Monetary policy measures could also be tighter than expected. If inflation sticks around, central banks could be compelled to act more forcefully. There's also a chance that central banks will overtighten, since it's unclear exactly how supply and demand are affecting inflation now and how they will in the future.

We will also have to closely monitor the state of the US economy. Our current baseline scenario calls for only a slowdown south of the border, but it wouldn't take much to trigger a recession. Canada being a small and open economy that is sensitive to foreign demand, its outlook would be worse if such a scenario occurred.

In terms of upside risks, the overall picture could turn out to be less bleak if the labour market proved more resilient. The job market is starting from a position of strength, with record high labour shortages. The high profit margins that many businesses are enjoying suggest that they can weather the storm while retaining their best workers for when the economy turns around. In these conditions, the unemployment rate could rise less than predicted.

Moreover, Canadian household savings could act as a stronger buffer. Even taking inflation into account, Canadian households have more savings overall than they did before the pandemic. Together with an enhanced and broadened employment insurance program, this could result in fewer households struggling financially.

Lastly, a confirmed recession and weaker inflation will justify an increase in public spending. Some measures could be reintroduced to help employers retain employees, facilitating the recovery of the labour market. Budgets have improved dramatically since 2020, giving the federal and provincial governments plenty of leeway to implement fiscal stimulus measures. Ideally, these measures would be laser focused on increasing productivity, improving the housing supply and accelerating the energy transition. This would lay the foundations for a new economic cycle that is more equitable and sustainable.

Short-Term Economic Pain for Long-Term Gain

In the end, the perfect scenario is one of a “soft landing,” where inflation returns to the BoC’s 2% target without leading to a recession. While it’s not entirely impossible, this scenario seems less and less realistic compared to one in which we see a mild recession.

Failure to respond to high inflation would be even more detrimental for economic growth in the long term. Inflation hurts everyone, but particularly the most vulnerable. It destroys purchasing power, and many Canadians don’t see their income keep up with their expenses. Inflation also adds uncertainty to financial markets and discourages investment.

A recession in 2023 might not be good news, but it should help stave off an even more painful outcome. It is also likely to lay the groundwork for stronger growth in 2024, accompanied by lower and more stable inflation.