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Canada's recession will hit earlier, harder and last longer than expected. The Star talked to economists to find out who is most at risk

Higher interest rates, 'the harsh medicine needed to cool inflation,' are already being felt by businesses and workers.

By Clarrie Feinstein Staff Reporter

Source: Toronto star photo illustration Toronto star photo illustration / Toronto star photo illustration

Alan Liu is in the fight of his life.

The pandemic thrust two brutal years on his once-thriving downtown Thai restaurants. Now, hope for a successful recovery is fading, and like so many small business owners in Toronto, Liu sees nothing but more turmoil ahead.

“We’re still in the throes of an economic comeback from COVID,” Liu said. “But we keep getting hit repeatedly. It’s just one thing after another.”

Savings are all but gone at Liu’s Salad King eateries, and government pandemic loans have ended. Businesses have struggled to prepare. “The conventional wisdom is to have six months of cash savings, but COVID has upended that mechanism. We have no savings left,” Liu said.

There isn’t a dime to spare to help cushion the blow of a major economic downturn.

Yet a downturn is coming, the country’s top economists say: Canada is headed for a recession, and it’s going to hit earlier, harder and last longer than previously forecast.

Most economists agree that a recession is now inevitable, thanks to the Bank of Canada’s decision to hike the overnight rate at a fast and furious pace. But what originally looked like a brief and painless recession is now turning into something to be feared.

Douglas Porter, chief economist and managing director of BMO Financial Group, recently revised his forecast — he now sees a recession coming that's more serious than originally predicted.

He says the next recession, technically defined as two consecutive quarters of negative economic growth, is now forecast to start in the first two quarters of 2023 and will see the Canadian economy depressed for a year and a half.

In times of recession, businesses struggle, wages fall, jobs are lost, assets lose value, and the country's overall economic well-being declines.

"We had so much of a boom in the last couple of years, especially the housing market. Now, we're dealing with the aftermath," Porter said.

Just how bad will that aftermath be, and who will suffer the most?

Past recessions tell us that interest-rate sensitive sectors such as the housing market will be hit hardest, as fewer people buy when interest rates are high, and fewer people sell when home prices plummet. That puts real estate and construction jobs at risk, with fewer clients in the market and home renovations taking a back seat.

But the Canadian economy is also heavily dependent on the U.S., its largest trading partner. The U.S. Federal Reserve is pushing interest rates even more aggressively than Canada, which will likely cause a recession by the end of the year, economists say. Once a recession hits in the U.S., trade with Canada will lessen, hurting manufacturing jobs, according to Claire Fan, an economist with the Royal Bank of Canada.

The upshot is that it's the Canadian workers in manufacturing — who dodged the impact of the pandemic shutdowns — who will likely catch the brunt of next year's downturn, Fan said.

"Historically, manufacturing always takes a hit during a recession because trade with the U.S. lessens."

Pandemic-induced instability

Grey areas mark recessions, with two consecutive quarters of negative GDP growth.

Quarterly change in real gross domestic product, seasonally adjusted at annual rates.

Source: Statistics Canada

Rates hikes: "The harsh medicine needed"

As unpleasant as a recession is, it's becoming increasingly clear that the Bank of Canada sees it as the lesser of two evils.

During the pandemic, interest rates were at extreme lows, making money cheap to borrow. But as prices rose and inflation started creeping in earlier this year, the Bank of Canada quickly began raising interest rates to make the cost of borrowing more expensive, reining in spending in favour of saving.

The Bank is concerned that if inflation were left unchecked, it could get baked into the economy in the form of higher wages, creating the kind of runaway inflation we saw in the 1980s, when rates hit almost 13 per cent. A contraction in the economy was needed, the Bank reasoned, to ensure inflation doesn't become a permanent fixture.

With the current inflation rate at 7.6 per cent, arriving at the bank's target rate of two per cent is difficult to accomplish without a recession, said David Macdonald, senior economist with the Canadian Centre for Policy Alternatives.

The concern, he said, lies in the central bank raising interest rates too high, too fast, resulting in massive collateral damage for the economy, in terms of job loss and diminishing financial assets.

“In the U.S., the language is moving away from a soft landing to a crash landing,” Macdonald said. “Every time we’ve seen big rate hike increases in the past, it’s always ended up in a recession.”

There have been three periods when the Bank of Canada managed to bring down elevated inflation to its target range using rapid interest rate hikes; in 1973, 1980 and 1981 — but each was accompanied by a serious recession, BMO’s Porter said.

Porter forecasts there’s more than a 50 per cent chance North America will enter a recession by the start of next year. He readjusted his forecast from a mild to moderate downturn in part because of the U.S. Federal Reserve’s three-quarter percentage point increase on Sept. 22, accompanied by strong language from chair Jerome Powell, who said the central bank needs to be restrictive for longer to get inflation down to two per cent.

The U.S. Federal Reserve, which needs to be more aggressive in its approach (as the country’s inflation is worse than Canada’s), is predicted to make another one and a half percentage point increase by the start of 2023, pushing the central bank’s rate to a peak of 4.5 per cent to 4.75 per cent.

In response, the Bank of Canada will likely raise its rate from 3.25 per cent to four per cent by the end of year, Porter said. If Canada doesn’t also raise its rate then inflation will continue to soar, making trade with the U.S. more difficult.

“Interest rates are the harsh medicine needed to cool inflation,” he added.

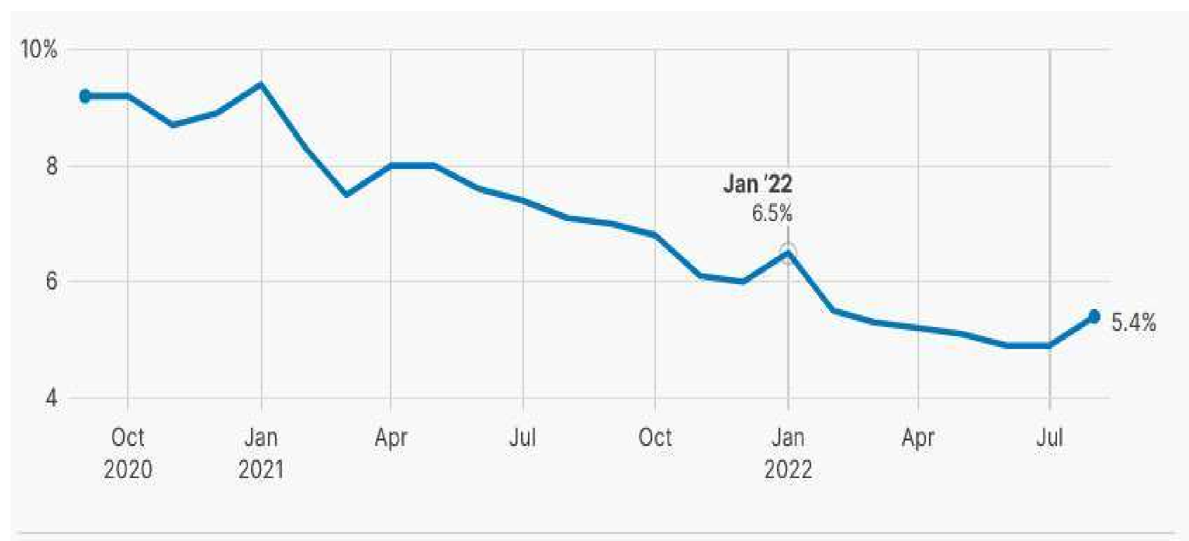
The Bank of Canada’s hike tactic might already be working. In August, inflation dipped to seven per cent from June’s 8.1 per cent. Consumer demand, while elevated compared to 2019 levels, is beginning to level off, said RBC’s Fan.

In August, Canada's economy lost 40,000 jobs, enough to push up the jobless rate by half a percentage point to 5.4 per cent after three consecutive months of more than 100,000 total job losses, according to Statistics Canada.

Signs of weakness

Employment declined in August, with Canada's unemployment rate rising to 5.4 per cent, up for the first time in seven months.

Unemployment rate



Source: Statistics Canada

Fan forecasts that rate will jump to 6.6 per cent by 2023, similar to the unemployment rate during the 2008 financial crash, adding it will be a "bumpy landing" heading into 2023.

Businesses large and small are already feeling the effects.

Toby Sue Carrel, owner of the Riverdale Hive Artists Collective in Toronto, says the one-two punch from inflation and a slowing economy is putting her livelihood at risk.

"I've had sleepless nights thinking about what I need for myself to live and if people will think my classes are too expensive, especially for something that is seen as an extracurricular," she told the Star.

Carrel needs to increase the cost of her pottery classes due to the higher cost of materials combined with increasing rent and utility costs. But the higher prices are a deterrent as consumers tighten their purse strings.

The classes pay for the studio's rent, and Carrel has no savings. What comes in goes out, she said. "It's frightening, I don't know what to do."

Plummeting housing market: "Less work, less spending"

During the 1990 recession, the Canadian housing bubble burst, as home prices peaked in 1989 and bottomed out in 1996. During that period, home prices dropped 40 per cent. The housing crisis at the time made the recession worse by prolonging it, as lower household wealth depressed spending, said Philip Cross, senior fellow at the Macdonald-Laurier Institute and former chief economic analyst at Statistics Canada.

In some ways, we're in a similar situation now. The housing market is on the front lines of the recession, as the sector faces a drastic slowdown in activity and job losses.

The impact of interest rate hikes will be felt in the real estate market for years to come, affecting consumer spending as more of people's income goes to housing, said Macdonald.

Many Canadians bought their homes using a five-year fixed rate mortgage (the most common mortgage type) when interest rates were at historic lows. Renewing their mortgages at higher rates over the next few years will put a big strain on their finances, economists say.

"People will become constrained on what they can spend money on. Buying a new car or doing a renovation will be put off, as well as discretionary spending like travel," Macdonald said. "It will have a cash-flow effect as more people spend money on their carrying debt."

The rate hikes have made homes less affordable for anyone who needs to borrow to buy, as they impact mortgage rates, which have shot up to more than four per cent for five-year variable rate and five per cent for a five-year fixed rate. As a result, home buyers and sellers are continuing to wait on the side-lines to see if prices will drop further.

Sales plunged by more than 44 per cent in Toronto from September 2021 to September 2022, and the average selling price dropped to $1.09 million, down from the February peak of $1.33 million, according to the Toronto Regional Real Estate Board.

The decrease in activity gravely impacts the industry, as jobs losses mount for real estate agents and mortgage brokers. Homeowners will also commit to fewer renovations as the value of their property drops.

"If the value of your property keeps dropping, doing a $20,000 renovation won't add much value to your home," Macdonald said. "There will be less work

for construction workers because of it.” In August, there were 28,000 fewer workers in construction compared to July, according to StatCan.

The average sales price for all home types is down by more than four per cent from last year. But home prices still have much further to fall, said Cross.

“The Canadian housing market is one of the most distorted in the world,” Cross said. Bank economists have forecast house prices to drop by as much as 25 per cent by spring 2023, but 40 to 50 per cent price drops are needed for home prices to return to “normal levels,” he added.

“Housing prices aren’t able to outstrip what people are able to pay forever. Real incomes are the limiting factors for house prices,” Cross said.

Already, more prospective home buyers are choosing to rent, causing Toronto’s current red-hot rental market. People are less interested in investing in property during a recession, especially with talk of job losses and wage freezes.

“As people become more concerned over losing their job, they want to remain flexible and keep their investments liquid, and renting allows for that,” Cross said. “People will be moving around more for work and those graduating school will have to search further afield.”

Timeline of recessions in Canada

- **1929: The Great Crash**

  The Roaring ’20s come crashing down when the stock market collapses, with billions of dollars lost in the process. The economic downturn lasts until the mid-1930s, spurring the Great Depression.

Source: Markets crash, 1929. (THE ASSOCIATED PRESS FILE PHOTO)

- **1937: Economic downturn in the Great Depression**

Another economic collapse in the U.S. knocks back the Canadian economy in 1937. Production of durable goods drops and unemployment rises, impacting the Canadian economy as trade between the two countries lessens. The recession ends in 1938.

- **1947: Post-war transition**

A mild recession hits Canada two years after the Second World War ends. The GDP falls in the third quarter of 1947 and again in the first quarter of 1948.

- **1951: Economic reaction during Korean War**

It's 1950 and inflation in Canada reaches 10 per cent as the Korean War is declared. To keep inflation in check consumers are hit with a 20 per

cent surtax and a 25 per cent tax on durable goods. The recession lasts about seven months in 1951.

Source: THE CANADIAN PRESS FILE PHOTO

- **1953: Defence spending drops**

The Canadian economy slows quickly as defence spending for the Korean War drops drastically and employment falls in the last three quarters of 1953. The first quarter of 1954 also shows a sharp drop in GDP. The recession lasts from July 1953 to July 1954.

- **1957: Industrial production drops**

The GDP falls in three of the four quarters in 1957 as industrial production drops, brought on by an end to the investment boom that occurs after the Korean Armistice in 1953.

- **1959-61: The Coyne Affair**
  Prime Minister John Diefenbaker's office publicly disagrees with Bank of Canada governor James Coyne on how to handle Canada's recession. Government officials urge Coyne to lower interest rates. Instead, the bank's Governor heavily criticizes the government's excessive spending and borrowing, which he says is creating a debt crisis. Tensions come to a head, leading to Coyne's resignation.

James E. Coyne (THE CANADIAN PRESS FILE PHOTO)

- **1974: The '70s recession**
  Soaring economic growth comes to a sudden stop as a financial crisis in the U.S. results in a severe recession south of the border. Canadian exports to the U.S. drastically decline in 1974.
- **1980: Keeping credit in check**
  The U.S. introduces credit controls to curb soaring inflation, triggering a slump in Canada's housing and auto exports. The GDP drops in the first two quarters.
- **1981: Soaring interest rates**
  The economy grows for three quarters at the end of 1980, but interest rates soar above 20 per cent, remaining high until spring 1982.

Unemployment reaches a high of 12 per cent, but the economy begins to recover in 1983.

- **1990: Introducing GST**
  The Canadian economy slows from cutbacks in manufacturing. The GDP drops significantly in the first quarter of 1991, as the combination of the Gulf War and the introduction of the goods and service tax (GST) depresses consumer spending.

- **2008: Global financial crisis**
  The global financial crisis drags down the Canadian economy (although the effect on Canadians is milder than the U.S. and Europe). However, the collapse of oil prices and other Canadian commodity exports leads the country into a recession.

Source: TORONTO STAR FILE PHOTO

Trade with the U.S.: The “spillover effect”

Canada is not the only country facing a recession, the U.S. is heading for one too — and theirs will likely be even worse.

That will hurt us as we’re heavily dependent on trade with the U.S. Seventy-five per cent of Canada’s exports and 62 per cent of imports were with the U.S. in 2021.

Once the U.S. enters a recession, trade volumes will drop drastically, as Americans spend less on imports from its northern neighbour. It will be a blow to the Canadian economy, said RBC’s Fan, with a big impact on certain jobs.

The highest levels of employment in manufacturing in Canada reside in plastic products, motor vehicle parts and metal manufacturing. Domestically and internationally, people will spend less on durable goods such as cars, and semidurable such as appliances, hurting these manufacturing jobs. Lumber, another major Canadian export, will also take a hit.

In addition, the U.S. relies on its global trade partners, especially Europe. But with the continent in the throes of an economic downturn spurred by an energy crisis from Russia’s war in Ukraine, North America’s economy is in a risky situation — and manufacturing jobs will likely be cut as the cost of goods soars.

U.S. reliance on trade with Europe puts Canada in a vulnerable position — if trade slows between the U.S. and Europe, American’s economic prosperity dwindles, having a “spillover effect” in Canada. That means the U.S.’s weakened economy will spend less on exports, limiting trading volumes with Canada.

While central banks around the world hike rates to cool inflation, central banks aren’t the only piece of the recession puzzle. World politics are also at play and out of Canada’s control, said BMO’s Porter.

“We need to see what happens with Russia and Ukraine. That’s a huge variable in the world’s economy,” Porter said.

At Salad King, the cost of rice, which Liu buys from the U.S., has risen to $68 per bag from $40 per bag in recent months. In the summer, it was skyrocketing oil prices that cut into his bottom line. These higher costs of doing business are transferred to customers. Now, a family of four pays on average $100 to dine at Salad King. It used to be $80. Pre-pandemic, a green curry dish cost $11.50. Now it's $15.50.

"Typically in a recession people tend to stop going out to the high-end restaurants. But now, even places like Salad King are becoming more expensive," Liu said.

"There's no relief in sight."