ECONOMIC VIEWPOINT

Back to the Future: What It Would Take to Get a 1990s-Style Recession in Canada

By Randall Bartlett, Senior Director of Canadian Economics, and Lorenzo Tessier-Moreau, Principal Economist

KEY TAKEAWAYS

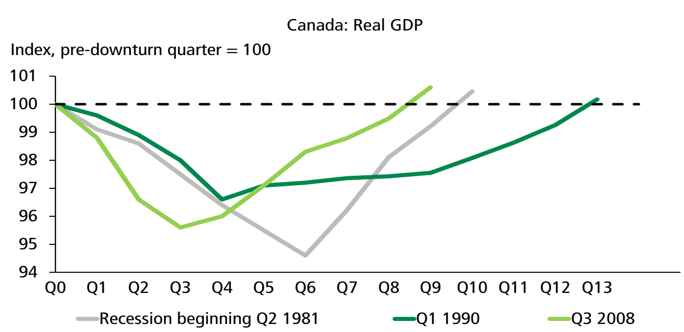
- **Our baseline forecast is for a mild recession in Canada in the first half of 2023.** We continue to view this as the most likely scenario (50% chance of occurring). In 2023, annual real GDP growth is expected to be flat while real household consumption should advance by 1.6%.
- **Risks to the baseline forecast are tilted to the downside.** If households dig in by slashing consumption and keeping the savings rate elevated, real GDP growth could contract like it did in the early 1990s. In this downside scenario (as much as a 30% chance of occurring), we could see real GDP fall by 1.5% in 2023 and real household consumption decline by 1.1%.
- **Materially lower consumption will have knock-on effects on the labour market.** In the downside scenario, employment shrinks by 0.3% in 2023 (vs. a 0.3% advance in our baseline scenario). As a consequence, the unemployment rate rises to 7.0% in 2023 (vs. 6.5% in our baseline). With employment and household income falling, other real GDP expenditure categories such as residential investment would also move lower relative to our baseline forecast.
- **We expect this would prompt the Bank of Canada to reverse course sooner than in our baseline scenario.** Indeed, we anticipate the Bank could begin cutting interest rates as early as the second quarter of 2023 if the downside scenario comes to fruition. The overnight rate could reach 3.00% by the end of 2023 vs. 3.50% in our baseline projection.

For most people, the 1990s are probably best remembered for the music. But for Canadian homeowners of that era, the protracted recession in the early part of the decade continues to stir strong emotions. Characterized by high inflation and interest rates along with the bursting of the late-1980s housing bubble, it draws a lot of comparisons with our current economic circumstances. It's therefore no surprise that we get questions about the possibility of a 1990s-style recession in Canada. In this note, we'll explore that outcome and the channels through which a downside scenario could develop.

A Blast from the Past

So what did the 1990s recession look like? It was deep, long and hit households particularly hard. From a real GDP perspective, it took over three years for output to return to its Q1 1990 pre-recession peak (Graph 1). At the same time, the savings rate held steady as households dug in for the long

GRAPH 1
The 1990s economic downturn was deep and very long



Sources: Statistics Canada and Desjardins Economic Studies haul. Consequently, the 1990s recession saw the most dramatic decline in real household consumption of any Canadian recession since World War II. Average home prices in Canada remained broadly unchanged for the entire decade, as subdued existing home sales and falling new listings kept Canadian housing consistently flirting with a seller's market.

The Fear of the '90s Is Alive in Canada

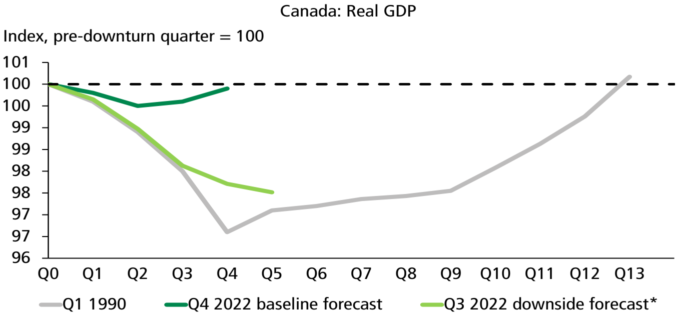
Fast forward to today, and many of these same fears are alive and well. What if Canadian households retrench so that the savings rate remains elevated and unchanged this year and next? This scenario would result in a dramatic downward revision to our real GDP growth forecast next year on plunging real household consumption (Table 1 and Graph 2). As employment falls on the back of the economic contraction, the unemployment rate would likely rise considerably, prompting wage growth to slow. And as core CPI inflation moves lower on a sharply slowing economy, the Bank of Canada would probably cut interest rates sooner rather than later. In fact, in this scenario the Bank of Canada could even start cutting rates in the first half of 2023.

Table 1: Desjardins baseline forecast vs. downside scenario

%, y/y (unless otherwise indicated)	Scenario			
	October 2022 EFO		Downside scenario	
	2022	2023	2022	2023
Savings rate (%)	6.4%	3.7%	6.5%	6.5%
Real consumption growth	5.3%	1.6%	5.1%	-1.1%
Real GDP growth	3.2%	0.0%	3.1%	-1.5%
Employment growth	3.5%	0.3%	3.5%	-0.3%
Unemployment rate (%)	5.4%	6.5%	5.4%	7.0%
Core CPI inflation	5.0%	3.4%	4.9%	3.2%
Policy rate (%, eop)	4.00%	3.50%	4.00%	3.00%

Sources: Statistics Canada, Bank of Canada and Desjardins Economic Studies

GRAPH 2
Our downside scenario points to a deep and prolonged downturn

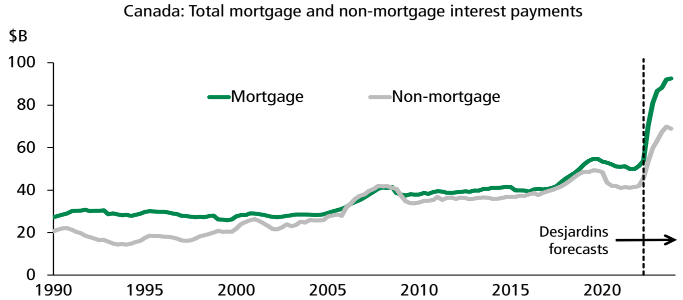


*The recession in the downside scenario starts a quarter earlier than in the baseline forecast.
Sources: Statistics Canada and Desjardins Economic Studies

Down on the Upside

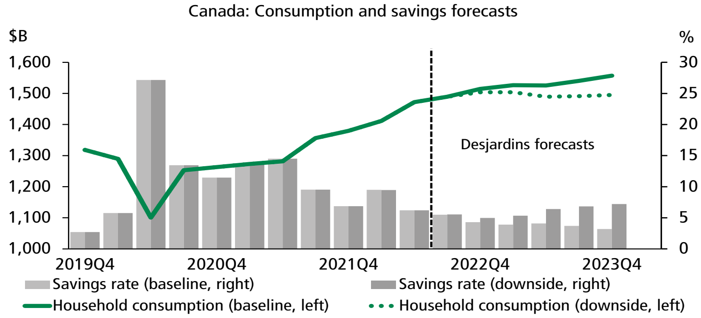
This downside scenario stands in contrast to the baseline forecast published in our [October 2022 Economic and Financial Outlook](#) (EFO). Indeed, it makes our relatively bearish baseline scenario look almost optimistic. The primary differentiator between the baseline and downside forecasts is how consumers respond to higher mortgage interest costs (Graph 3). In the baseline scenario, they largely reduce savings to adjust to higher borrowing costs. This pushes the household savings rate lower, ultimately to roughly the 20-year pre-COVID average by the end of 2023 (Graph 4). In contrast, nearly half of the higher mortgage interest cost comes out of consumption in the downside scenario.

GRAPH 3
Interest payments on debt* are about to take a bite out of disposable income



*Forecasts assume debt obligations are met at the effective interest rate
Sources: Statistics Canada and Desjardins Economic Studies

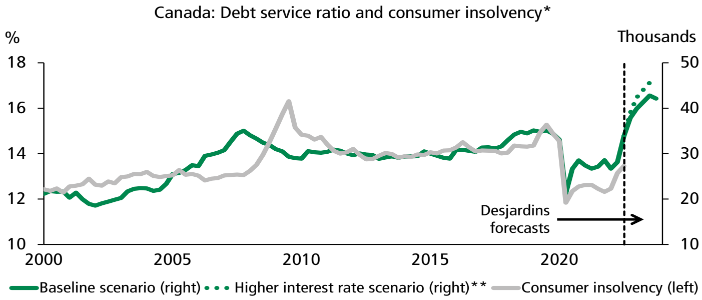
GRAPH 4
Savings and consumption decisions will be key drivers of the outlook



Sources: Statistics Canada and Desjardins Economic Studies

But this is only one of the possible catalysts that could push the Canadian economy into a more severe recession. More aggressive interest rate hikes by the Bank of Canada could squeeze mortgage holders enough to not just reduce spending, but also increase insolvencies if the unemployment rate spikes (Graph 5). New listings would likely rise if this were to happen, pushing the sales-to-new-listings ratio lower. This could lead to a prolonged 1990s-style seller's market and recession. A policy mistake by the Federal Reserve could have similar implications for Canada, driving up longer-term borrowing costs at home while weakening the prospects for Canadian exports. But what if Canadians instead take on more debt to keep up their consumption? This could mean a less severe downturn in the short run, possibly prompting a stronger response from the Bank of Canada and leading to even more insolvencies and pain in the future. Needless to say, the risks to our baseline forecast are tilted very much to the downside.

GRAPH 5
More rate hikes would lead to a higher debt service ratio and possibly more consumer insolvency



*Seasonally adjusted by Desjardins Economic Studies. **Based on overnight rate reaching 5.0%.
Sources: Statistics Canada, Office of the Superintendent of Bankruptcy and Desjardins Economic Studies

Bottom Line

Whether from consumers slashing spending or central banks hitting the brakes too hard, risks to the outlook abound. Canadians would therefore be wise to keep the downside scenario in mind. That said, we don't think it's the most likely outcome. Canadian households are still sitting on excess savings built up during the pandemic despite the erosion of their purchasing power from high inflation and rising interest rates. This should help to soften the blow of higher mortgage interest costs. Further, a very tight labour market and elevated immigration targets should help to keep a floor on home prices. As such, we think the chance of a downside scenario materializing is around 30% vs. 50% for our baseline scenario (and 20% for an upside scenario). But keep your flannel shirts and ripped jeans at the ready just in case the '90s come back in style.