ECONOMIC VIEWPOINT

Recession Risks Revisited:

What's a Recession and Is Canada Headed for One?

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Highlights

- Following quarterly declines in Canadian real GDP in 2023, it came as little surprise that we received plenty of questions from members and clients on the risks of a recession.
- First and foremost, what is a recession? It is a "pronounced, persistent, and pervasive decline in aggregate economic activity." (CD Howe Institute, 2017) What it isn't is just two consecutive quarterly declines in real GDP— known colloquially as a "technical recession." There are examples when two quarters of negative real GDP growth were found to not be recessions as they were highly concentrated in a few sectors. Also, a recession in the US does not imply a recession in Canada. In fact, far from it.
- Is Canada in a recession now? As of the end of the third quarter of 2023, Canada was likely not yet in a recession. The data were particularly revision-prone last year, with a drop in Q2 2023 real GDP having been re-estimated to a respectable move higher. We think a positive revision of similar magnitude could occur in Q3. And while the monthly data have been mixed in the second half of last year, Q4 real GDP growth is tracking a modest positive print. That said, the trend has been toward a general softening in economic indicators, with monthly real GDP showing broad-based weakness and the ongoing decline in real GDP per capita accelerating in recent months.
- Is Canada likely to experience a recession in 2024? We think so, probably starting in the first half of the year. Canadian households are highly leveraged, particularly when it comes to housing. Residential investment also makes up a disproportionate share of economic activity in Canada. As such, the Canadian economy is particularly interest rate sensitive. And as monetary policy is known to act with long and variable lags, there is more pain to come even as rate cuts likely begin around the middle of the year. Hence, consumption should be weak this year as well.

Soon after central banks began aggressively hiking interest rates in early 2022, we published a report outlining what defines a recession in the United States and Canada. At the time, the US had just experienced a contraction in quarterly real GDP and was on track for a second. While we won't repeat that extensive analysis here, we will briefly discuss the criteria that define a recession in Canada, whether Canada is currently in a recession, and why we believe the Canadian economy is likely to experience a recession in early 2024.

What Is a Recession?

In the US, the official arbiter of recession dates is the National Bureau of Economic Research's (NBER) Business Cycle Dating Committee. We don't have a similar body in Canada. However, the CD Howe Institute's Business Cycle Council (the Council) has stepped in to unofficially but competently fill this role.

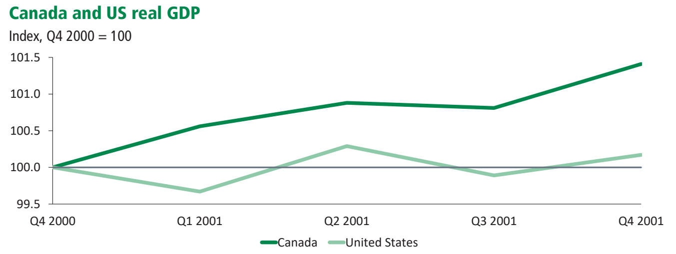
Much like the NBER, the Council looks to a wide range of economic indicators to determine if a downturn qualifies as a recession. Broadly speaking, what the Council is looking for is a "pronounced, persistent, and pervasive decline in aggregate economic activity." (CD Howe Institute, 2017) All three of these criteria must be met for an economic downturn to be considered a recession. The recession that accompanied the Global Financial Crisis (GFC) in 2008–09 qualified. So did the deep recession resulting from public-health-mandated lockdowns in the early days of the COVID-19 pandemic. The recessions in the early 1980s and 1990s did too.

However, most mainstream commentary tends to focus only on the first two criteria of the recession definition. In fact, recessions are often even more narrowly identified as two consecutive quarters of negative real GDP growth. This has come to be dubbed a "technical recession" in popular culture—a term that makes most economists cringe. That's because it fails to capture how widespread weakness is in an economy and is therefore insufficient on its own to satisfy the definition of a recession.

There are examples of times when two consecutive quarterly declines in real GDP were not considered a recession. Take for instance the US in the first half of 2022. The NBER hasn't ruled this downturn a recession. That's likely because it reflected in part a drawdown in inventories from unprecedented levels built up during the pandemic as opposed to widespread weakness. That period also saw consecutive quarterly advances in real GDP by industry and surging job creation. Closer to home we have the example of the sharp drop in oil prices in 2014, which precipitated two consecutive quarters of falling real GDP in Canada in the first half of 2015. This decline was highly concentrated in the energy sector, with a drag from investment in non-residential structures outweighing broad-based gains in the rest of the economy and labour market (graph 1). As such, the CD Howe Institute determined that this was not a recession.

Another common misconception is that a recession in the US also means a recession in Canada. For example, the NBER concluded that the US economy experienced a recession in 2001 despite avoiding two consecutive quarterly declines in real GDP. That was due to the broad-based nature of the economic weakness (NBER, 2003). In contrast, the Council determined that there was no corresponding recession in Canada (graph 2).

Graph 2
Canada's Economy Outperformed the US in 2001, Avoiding Recession



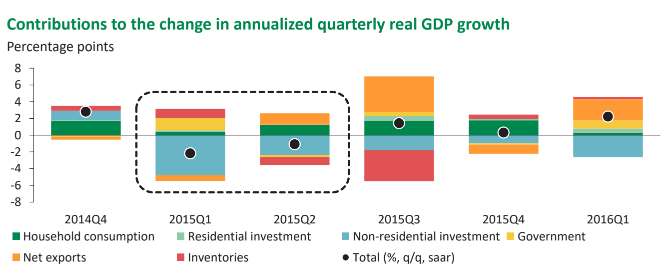
Statistics Canada, Bureau of Economic Analysis and Desjardins Economic Studies

Is Canada in a Recession Now?

As of the end of the third quarter of 2023, Canada was likely not yet in a recession. Despite an annualized drop in real GDP by expenditure of 1.1% in Q3, the modest 0.2% decline in the previous quarter was revised away (it was re-estimated to be a 1.4% increase) (graph 3). And according to our analysis, a similar upside revision is also possible for Q3 when the final data for 2023 are released. Indeed, revision risk is part of the reason recession-dating bodies wait until well after a downturn has ended before weighing in with an official proclamation. They also subsequently revisit their decisions.

On a by-industry basis, real GDP was not quite flat in the third quarter. Having peaked in May 2023, monthly real GDP by industry has yet to recover from declines in June and July. And this recent weakness was quite broad-based. To measure the pervasiveness of a decline in aggregate economic activity, we use a diffusion index, where "a score above 50 indicates more expanding than contracting industries and a score below 50 the opposite." (CD Howe Institute, 2017) This index points to more than half of the main industries in real GDP having shrunk in every month since May 2023 (graph 4 on page 3). This pattern is more typical of a recession than not. Indeed, the last time such persistent weakness was observed was during the recession that accompanied the GFC in 2008–09.

Graph 1
Canada's 2015 Economic Downturn Was Highly Concentrated



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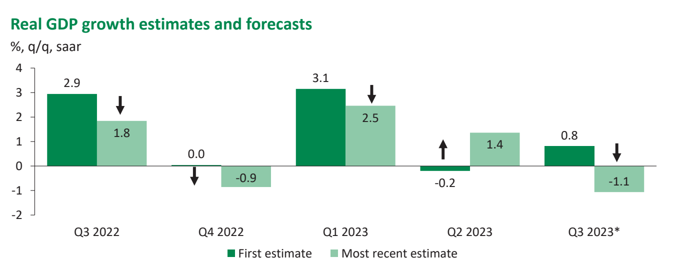
Graph 3
Recent Revisions to Real GDP Growth Have Been Substantial



*The Bank of Canada's forecast from the October 2023 Monetary Policy Report was used in place of the first estimate.
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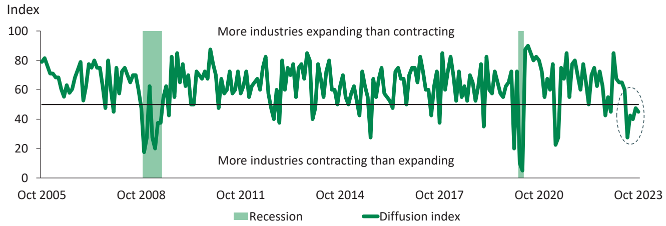
Graph 4
Economic Weakness Has Been Broad-Based in Canada Recently

Monthly real GDP growth diffusion index



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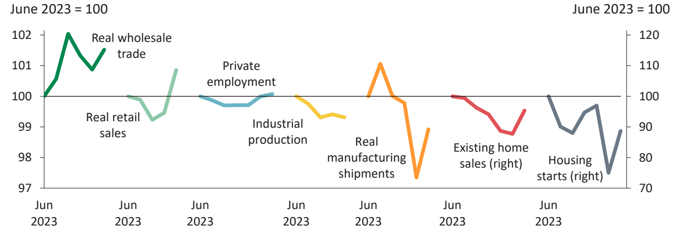
Graph 6
Economic Indicators Have Been Mixed but Trending Lower since Q2

Monthly Canadian economic indicators



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This broad-based weakness comes despite the highest pace of population growth since the 1950s. On a per capita basis, economic activity has been much weaker than even the moribund headline number would suggest (graph 5). It has declined every month since May but has been trending lower since September 2022. And starting in April 2023, month-over-month gains in population have outpaced monthly hiring, leading to a gradual climb in the unemployment rate, albeit to a still-low level relative to history.

Other recent monthly economic indicators have been more mixed but have also generally weakened (graph 6). Existing home sales declined in almost every month since June on renewed rate hikes, while the unexpected strength in housing starts in 2023 has waned more recently. Real manufacturing shipments peaked in January 2023 and have been on a trend decline since. In contrast, real wholesale trade excluding food and fuel performed well in the second half of the year. Retail trade volumes have also showed renewed signs of life in recent months. Employment has advanced in every month since July 2023 as well. Taken together, real GDP in Canada is tracking a modest advance in the final quarter of the year, suggesting the drop in Q3 may not be the start of a recession in Canada. That said, it must be emphasized that the expansion we are currently tracking is quite weak, and there is still a lot of data to come pertaining to the fourth quarter. So it's possible that the tracking could deteriorate further, leaving the door open to a second consecutive broad-based quarterly decline in real GDP.

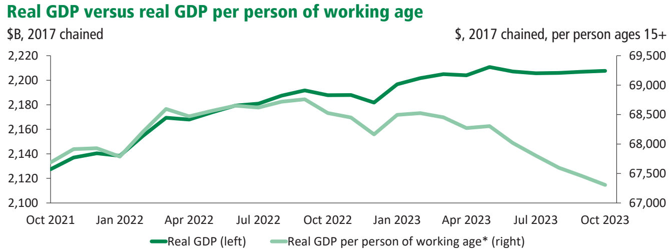
Meanwhile, Quebec posted its second consecutive quarterly decline in real GDP in the third quarter. The weakness was largely attributable to substantial drags from inventories and net trade, whereas domestic demand rebounded in the province in Q3. That said, the broader picture has been weak, with either real GDP or domestic demand close to flat on a year-over-year basis. And monthly real GDP by industry contracted in four of the five months starting in April 2023, underperforming the mediocre performance at the national level (graph 7). Looking to the final quarter of 2023, while September real GDP increased sharply and put Q4 on a more solid footing, the public sector strike that began in November is likely to tip growth into negative territory for a third consecutive quarter. Altogether, the information we have on hand suggests that a recession might have started during 2023 in Quebec, even though it remains a very close call.

Is Canada Likely to Experience a Recession in 2024?

Even if we ultimately determine that Canada as a whole was not in recession in 2023, we think it will be soon. As we published in our most recent Economic and Financial Outlook, we expect the Canadian economy to experience a recession in the first half of 2024. While short and shallow, the economic downturn is likely to be broad-based, weighed down by consumption, investment

Graph 5
Canada's Real GDP per Capita Accelerated Its Slide in 2023

Real GDP versus real GDP per person of working age



* Uses population ages 15 and over from the Labour Force Survey
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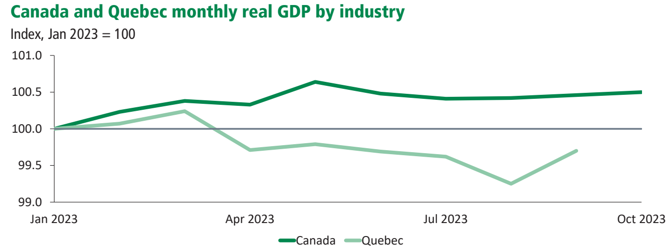
Graph 7
Quebec's Economy Has Underperformed the Rest of Canada

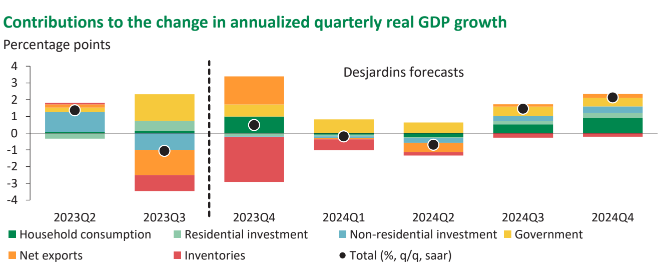
Canada and Quebec monthly real GDP by industry



Statistics Canada, Institut de la Statistique du Quebec and Desjardins Economic Studies and trade (graph 8). Still-high interest rates will play a central role, squeezing households' budgets and forcing them to reduce spending to meet mortgage payments. The unemployment rate is expected to move higher as well, continuing to rise even as growth rebounds on rate cuts in the second half of the year.

Some will note that we have been projecting a recession for a while. A few things have surprised us since we first made the call in mid-2022. The first is surging population growth, which we expect to start to wane in 2024 (see our recent note on the outlook for Canada's population). The second is the unanticipated strength of consumer durables, which typically lag only residential investment in their sensitivity to interest rates (Bank of Canada, 2018). That reflected both pent-up demand for autos coming out of the pandemic and purchases by newcomers to Canada—tailwinds that are quickly fading. Finally, as Milton Friedman famously said, monetary policy works with long and variable lags. Having not yet felt the full impact of the rate hikes in 2022 and 2023, the Canadian economy will increasingly be weighed down by them (graph 9). Even if to a lesser extent, this dynamic should play out in the US as well, thus reducing demand for Canadian exports. Together, these factors suggest to us that a mild recession is likely in the near term. And along with the trend decline in inflation, this should prompt rate cuts, likely starting this spring in Canada.

Graph 8
We Expect Broad-Based Economic Weakness to Lead to a Recession



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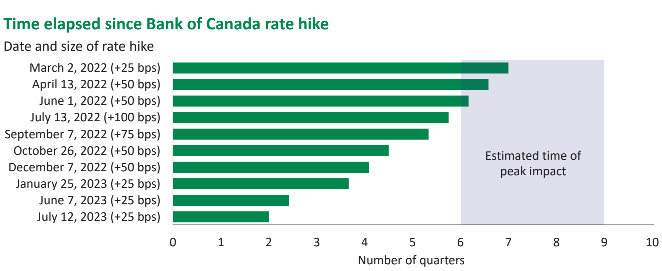
Graph 9
Past Rate Hikes Have Not Yet Been Fully Felt in the Economy



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Conclusion

When it comes to quick judgments about whether a recession is happening, it's always best to take them with a grain of salt. The term "technical recession" is unhelpful, as it tends to sow confusion, particularly in a cycle as atypical as the current one. That doesn't mean that going through two consecutive quarters of contraction should be bluntly dismissed either, as it is indeed often correlated with recessions. Think of it as no more than a helpful starting point for determining if an economic slowdown constitutes a recession. Our assessment is that, while economic indicators don't allow us to conclude decisively that Canada was in recession in Q3 2023, they are still pointing to a broad-based weakening in the economy. We are of the view that this trend will continue, pushing the Canadian economy into recession starting in the first half of 2024.

But just like it used to take a while for NHL officials to review whether the puck had crossed the line on a contested goal, don't expect the recession arbiters to render their verdict anytime soon. This is not the pandemic where things were screaming obvious, but rather a very complex and highly unusual set of dynamics, playing out in a context of exceptional uncertainty. Confidently making a judgment will warrant very careful consideration.

Our hope is that the daily quibbling about a recession is seen for what it is, which is a mostly futile debate among purists. The Canadian economy is in a rebalancing process that still has further to run, and this really should be the takeaway. We don't see reasons to be overly pessimistic about what is happening. In fact, the reasons behind our assessment of a short and shallow recession still largely hold. There remain structural labour shortages, housing shortages continue to prevent a major erosion of real estate wealth, and consumer savings are elevated. If things get ugly, the Bank of Canada has plenty of room to respond. But neither would it be responsible to pretend that the worst for the economy was left behind us in 2023.