

Interest rate increases bite,  
leading to deeper recession

Economic outlook | January 2023

# Foreword

Recession talk has ramped up over the past few weeks as the reasons to support the negative turn in sentiment stack up. The Bank of Canada has hiked interest rates by more than we anticipated a few months ago, a trend that is chipping away at household purchasing power. Higher borrowing costs have created a headwind for businesses that want to invest. And aggressive monetary tightening isn't limited to Canada: the European Central Bank and the US Federal Reserve are also embarking on rapid tightening campaigns, which are expected to tip these economies into recession. While a recession has been expected in the eurozone for months, the downgraded outlook for the United States will hit Canada hard, given our trade dependence on our southern neighbours.

Households are being battered by the double whammy of high inflation and rising borrowing costs. Higher interest rates had an almost immediate impact on the resale housing market, as elevated mortgage rates shrank the pool of potential buyers who qualify to borrow. As a result, we've seen household investments in real estate tumble since the second quarter of 2022.

Of course, higher interest rates are also pinching current borrowers. Recent data shows the impact on debt-carrying costs: in the third quarter of last year, interest payments on household debt increased by 16.2%—the largest jump on record. In dollar terms, interest payments increased by \$16.4 billion from the previous quarter. From an economics point of view, because consumption is the largest contributor to our gross domestic product (GDP), that \$16.4 billion being redirected away from spending and saving is creating a notable headwind to growth. Given the increase in interest payments, it's not terribly surprising that real household spending fell in the third quarter. Unfortunately, interest payments are set to continue to increase over the coming year, squeezing household budgets and leading to yet more declines in consumer spending.

In contrast, businesses continued to grow their investment spending in the latter part of 2022. Several factors contributed to this. Business investment is still playing catch-up from the last recession, and very strong growth in corporate profits in the pandemic's aftermath is helping pad capital

# Foreword

expenditure (capex) budgets. Further, labour has become increasingly scarce in Canada, creating an incentive to invest in productivity-enhancing capital to help offset staff shortages. Despite this, business sentiment has been trending downward over the past few months. It's expected to remain subdued as the United States enters a mild recession and domestic consumer spending continues to decline. In addition, business inventories remain at an unsustainably high level, which will create a disincentive to invest in new capacity until the current stockpiles decline. So even though companies are expected to spend more, the gain will be modest because they're also expected to take a cautious approach to investing over the next year.

Our forecast assumes the Bank of Canada's rate-hiking cycle has finished. At its current level of 4.25%, the overnight rate is high enough to be rapidly cooling growth but too high to be sustainable in the longer term. Indeed, our forecast predicts the steady diversion of household income toward interest payments and a US recession will push down Canadian economic growth for

three consecutive quarters, resulting in an overall contraction of 0.9% this year. In response, inflation should decelerate sharply. This will allow the Bank of Canada to begin unwinding some of its restrictive monetary policy before the end of 2023. Rate cuts throughout 2024 will provide stimulus and allow for a modest recovery in activity, with a more robust rebound in store for 2025.

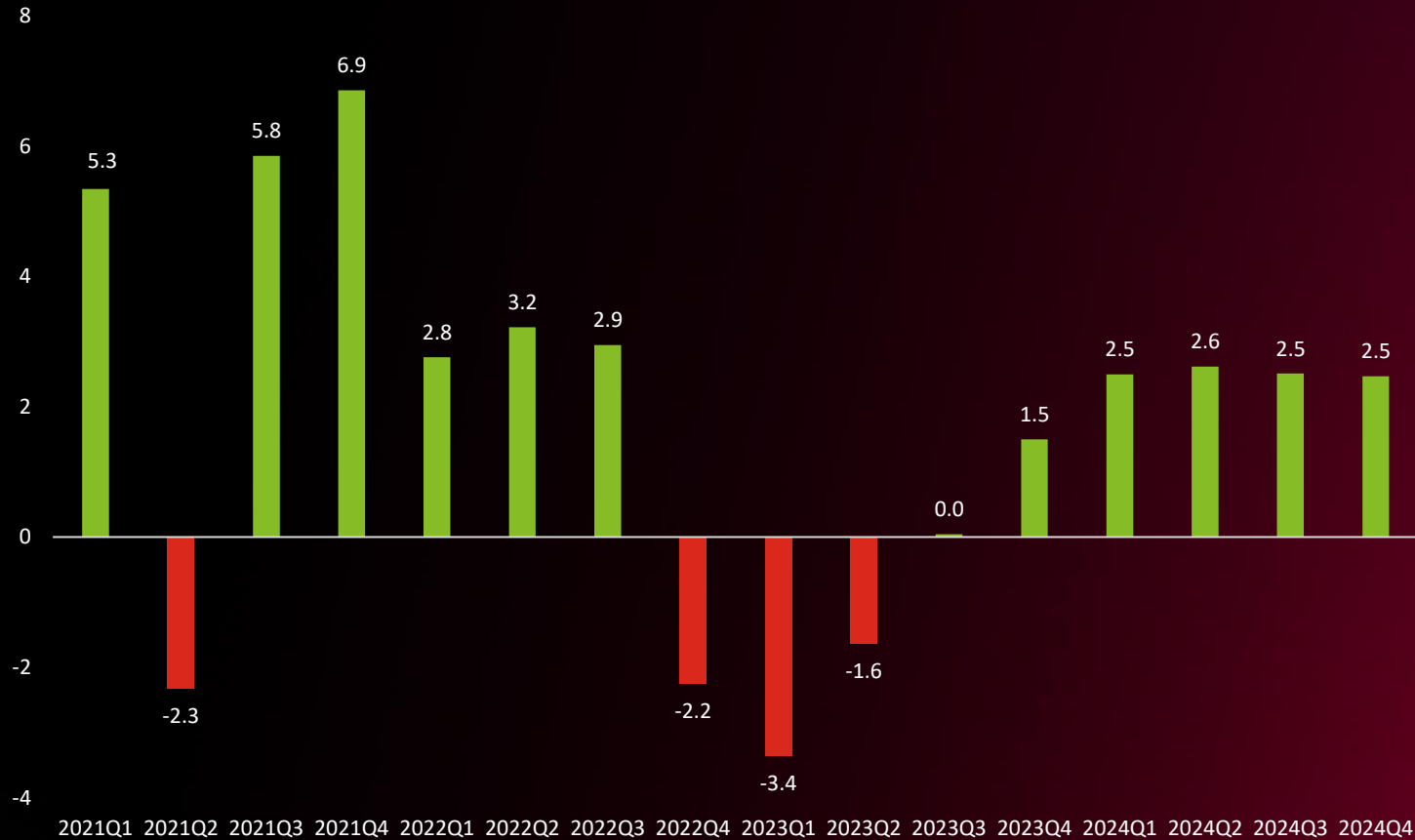
**While all this may sound quite dire, we still expect the recession will be relatively mild and short-lived by historical standards.**

# Fiscal and monetary policy

The dominant economic theme continues to be inflation and the monetary tightening required to cool price growth. The good news is that we are increasingly confident that peak price growth is behind us, with inflation decelerating steadily since hitting 8.1% in June 2022. We expect to see price growth continue to slow, with moderation already evident in gasoline and food prices as well as homeowner replacement costs, in step with sliding housing prices. Inflation remains uncomfortably high, however, which will keep the Bank of Canada vigilant in its fight to return price growth to its target of 1% to 3%.

To push down inflation, the Bank implemented a steady stream of interest rate increases throughout 2022. It announced seven consecutive hikes and the latest, a 50-basis point bump in December, brought the overnight rate to 4.25%. This year-end move was accompanied by a shift in tone, signalling a potential pause in interest rate hikes. We'll know more after the Bank of Canada's January meeting.

Real GDP growth (percent change at annual rates)



Sources: Statistics Canada and Deloitte.

## Fiscal and monetary policy

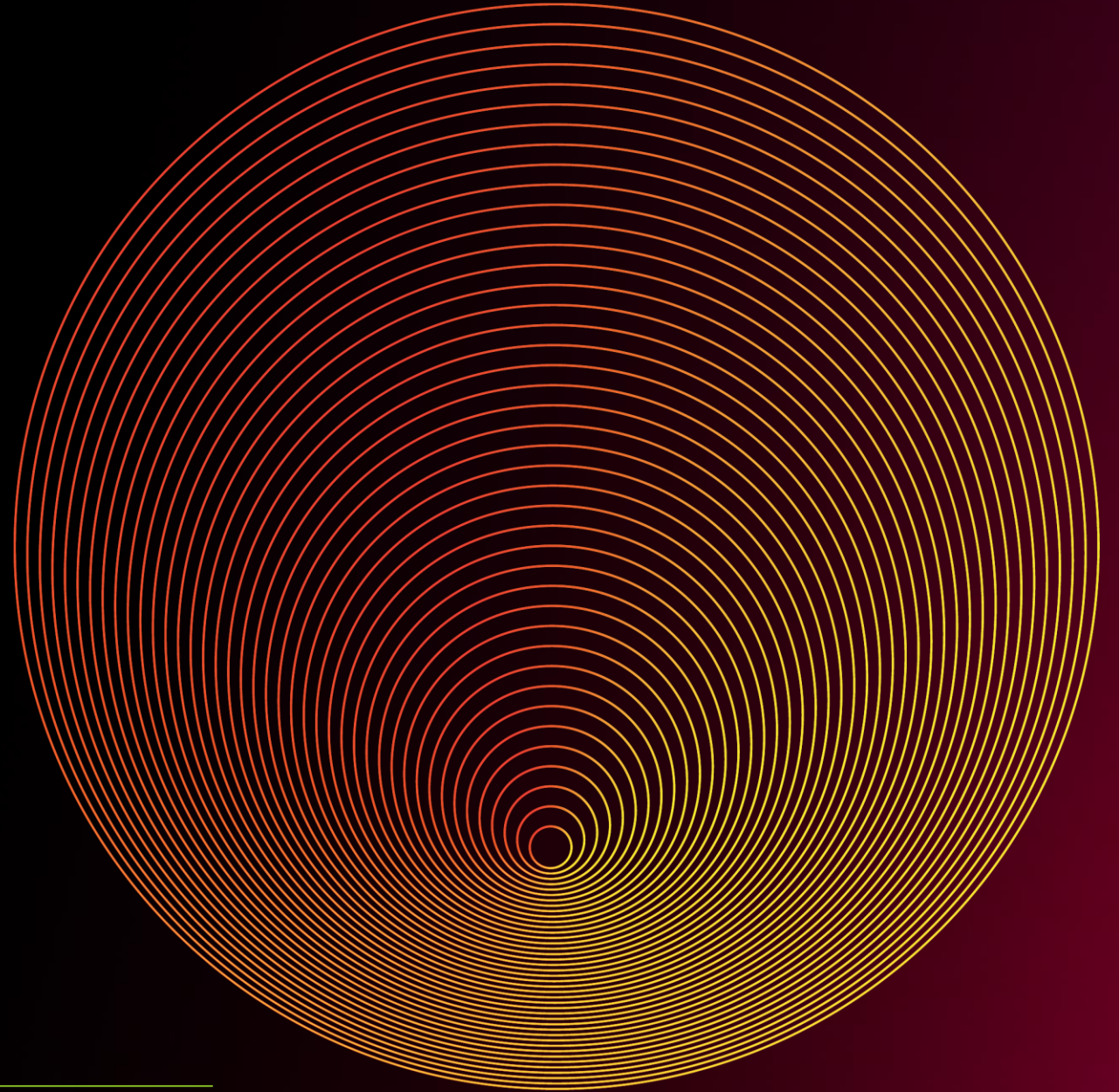
It usually takes between 12 and 18 months for monetary policy changes to take full effect. The impacts of recent hikes were just beginning to materialize in the third quarter of 2022, leaving substantial justification to adopt a more data-dependent approach to future policy moves. Markets are also beginning to price in an easing of monetary policy. The yield curve (as measured by the yield on 10-year bonds minus two-year bonds) turned negative in July 2022 and has become progressively more inverted. By the end of November, the yield on 10-year bonds reached 100 basis points lower than two-year bonds<sup>1</sup>. We have not seen such inversion since before the recession of the early 1990s; however, we don't expect the steep declines in household spending and business investment that we saw back then.

With inflation slowing and the economy entering a recession, the Bank is expected to begin reversing its policy stance by the end of this year. Monetary easing is forecast to continue throughout 2024 as the Bank slowly brings its policy interest rate back down until it reaches the upper bounds of the neutral rate, estimated to be 3%.

We will often see fiscal policy respond in a stimulative way to a budding recession. This time, however, we don't expect to see governments step in with a large-scale relief package despite their better-than-expected fiscal positions. That's because the coming downturn was orchestrated by policy to subdue inflation by realigning demand and supply. Therefore, if fiscal policy were to become overly stimulative, it would trigger the Bank of Canada into offsetting the impact by tightening monetary policy. Some targeted relief measures have already been announced, but the primary trend on the fiscal front remains an unwinding of pandemic-era spending. As such, government spending and investment is expected to decline this year before returning to growth in 2024.

<sup>1</sup> [Bank of Canada, Selected Bond Yields](#), accessed December 2022.

# Households and business



# Households

The 400-basis point increase in the Bank of Canada's policy rate since March 2022 is crushing Canada's housing market. Home sales last October fell 36% from their February peaks, wiping out gains over the past two years with real activity (as measured by ownership transfer costs) down 17.4% from pre-pandemic levels. As demand dries up, prices are also falling, with the average home resale price in October down more than 20% from its February peak.

The housing market outlook is bleak over the next two years, as residential investment is expected to drop another 7.9% this year after falling by 10.6% in 2022. Despite an expected pause in interest rate increases, mortgage rates will remain elevated until the end of 2023, preventing many prospective homebuyers from entering the market and leading to further declines in home ownership transfer costs. Investment in home renovation is expected to drop another 6.5%, following the 4.1% decline in 2022, as resale market activity remains subdued and falling home prices lead to a cautious approach to spending on home upgrades. The good news is that the low levels of activity this year will not last forever—we anticipate the housing market will slowly start to recover in 2024 and 2025 as lower interest rates work to restore market demand.

On top of the plunge in home sales, the expected slowdown in new-home construction is another key contributor to the pessimistic near-term outlook in residential investment. Housing starts ramped up rapidly in the spring and summer of 2022, but such a fast pace is not sustainable when demand cools and home builders face higher costs. As the cyclical downturn hits the new-housing market, starts are expected to decline over the next three years before returning to growth.

While spending on housing was the first area that households cut back on, rising debt-servicing costs and high inflation are causing the pullback in spending to extend to consumer purchases. Consumer spending fell by 0.3% in the third quarter of 2022, and we expect to see declines continue over the first half of this year. These drops will not be broad-based: goods sensitive to interest rates (such as household furnishings and appliances) will get hit the hardest, while discretionary spending on services such as communication, recreation, and culture services, as well as accommodation and food services, will also decline. Meanwhile, other services—including transportation—will continue to enjoy some growth, supported by a drawdown in savings.

# Households

Overall real spending on household goods and services is expected to gain just 0.7% this year, before growth accelerates to a 2.9% pace in 2024.

One of the wild cards in this forecast is what will happen to labour markets. Traditionally, recessions are associated with notable job losses as cautious businesses trim their payrolls to adjust to decelerating demand. This time, however, the situation is such that businesses will need to balance the expected softening in demand against a scarcity of labour. Throughout the 2010s, the majority of labour force growth in Canada was due to people moving to the country. With immigration levels plummeting during the pandemic, we lost a key source of labour supply. The levels are now recovering—but just as a surge of baby boomers retire, resulting in little reprieve for organizations that are struggling to find workers. Indeed, job vacancies remain elevated, especially in lower-paying jobs that have no hybrid work options.

Given these tight labour market conditions, we don't expect employment to decline overall. Employers will likely be reluctant to let go of their workers for fear of not being able to fill those vacant positions once the economy begins to recover next year. To date, we've seen that reluctance show up in strong job data with solid employment growth in October and a decline in unemployment in November. However, it's not good news across the board. Job losses are expected in the industries that are suffering the most in the current conditions: construction, wholesale and retail trade, transportation and warehousing, and information, culture, and recreation, among others.

Despite these isolated losses, we forecast the current labour market will provide important support for the economy that will prevent the downturn from becoming deeper than it would be if employers were more aggressive in cutting their payrolls.



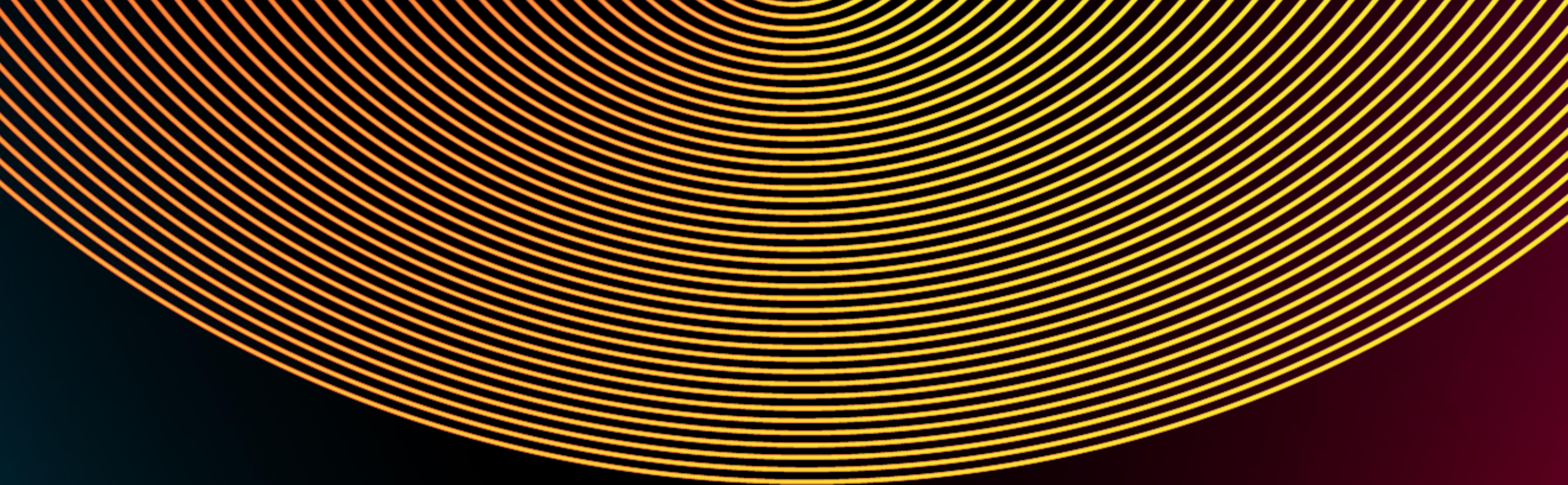
# Business

Perhaps the most significant change from our September 2022 outlook is that we no longer expect the US Federal Reserve (Fed) will be able to orchestrate a soft landing, which means our largest trading partner will slip into recession, albeit a mild one. As in Canada, the US recession will be a policy-induced one. The Fed raised its target for the federal funds rate by 50 basis points at its December meeting but instead of signalling a potential pause, as the Bank of Canada did on this side of the border, members of the Federal Open Market Committee indicated interest rates would need to push higher. While inflation has peaked in the United States it remains well above the Fed's target and above the level Canada is experiencing.

The downgrade to the US outlook has important implications for our trade outlook. For starters, we expect to see Canada's exports fall early this year. After posting strong gains in the second half of 2022, oil exports are forecast to retreat modestly in the coming months as energy demand falls alongside a decline in economic activity. On the other hand, exports of agricultural and fishery products will likely recover, mainly due to wheat and canola as the sector recovers from drought conditions in 2021 and to strong global demand and high product prices because of the war in Ukraine.

On the investment front, businesses are expected to continue to expand the funding they direct toward new capital and machinery thanks to record-breaking corporate profits during the pandemic recovery driven by strong demand and rapidly rising commodity prices. In the second quarter of 2022, corporate profits (measured on a national accounts basis) were more than double their pre-pandemic level. Despite their decline to a more normal level as the economy contracts, that accumulated surplus will allow companies to continue to invest.

While it may seem counterintuitive to do so during a period of economic contraction, investing will allow them to continue to grow despite the challenging labour market conditions. Nevertheless, we have downgraded our outlook for investment spending to account for the economic downturn and the fact that high inventory levels may slow business spending.



# Outlook by province

## Outlook by province

With a deeper recession expected across the country, few provinces will be spared a decline in output this year. Only **Manitoba** and **Saskatchewan** will enjoy positive growth, due to the rebound in their agricultural industries after drought conditions dramatically suppressed output in 2021. These provinces will, nevertheless, be subject to the same downturn in domestic demand that's hitting from coast to coast to coast as Canadians grapple with higher interest rate payments and the impacts of a US recession.

Provinces on the east coast, which have more trade exposure to the European market than the rest of Canada, will feel the pinch of falling demand from Europe, where a deeper recession is expected compared to other areas. Forestry plays a large role in **New Brunswick's** economy, so the province will keenly feel the downturn in the North American housing market. With higher debt payments and inflation pinching household budgets, there will be less money available for discretionary spending, which will negatively affect the tourism-dependent economy of **Prince Edward Island**. Thanks to a surging

housing market, real estate and housing rental and leasing was **Nova Scotia's** largest industry in 2021; as the housing market cools, we'll see output in this sector decline, bringing down economic growth with it. Over in **Newfoundland and Labrador**, increased investment in the mining industry will not be enough to keep the province out of recession, although that support will help mitigate the impact of a slowdown in domestic demand.

The effects of the housing market downturn will be more pronounced in central Canada and British Columbia. **Ontario** and **British Columbia** have by far the most expensive housing markets and, therefore, the highest debt burdens. With interest payments rising, debt-servicing costs will have the biggest impact in these provinces, with most sectors of the economy being affected by the reduction in household purchasing power. Rubbing salt into the wound is the two-year ban on foreign homebuyers and vacant tax increases that will further weigh on the housing outlook in these provinces.

## Outlook by province

Meanwhile, **Quebec** and Ontario are very exposed to conditions in the United States, so the downturn south of the border will negatively affect export prospects. This will bring down growth in both provinces.

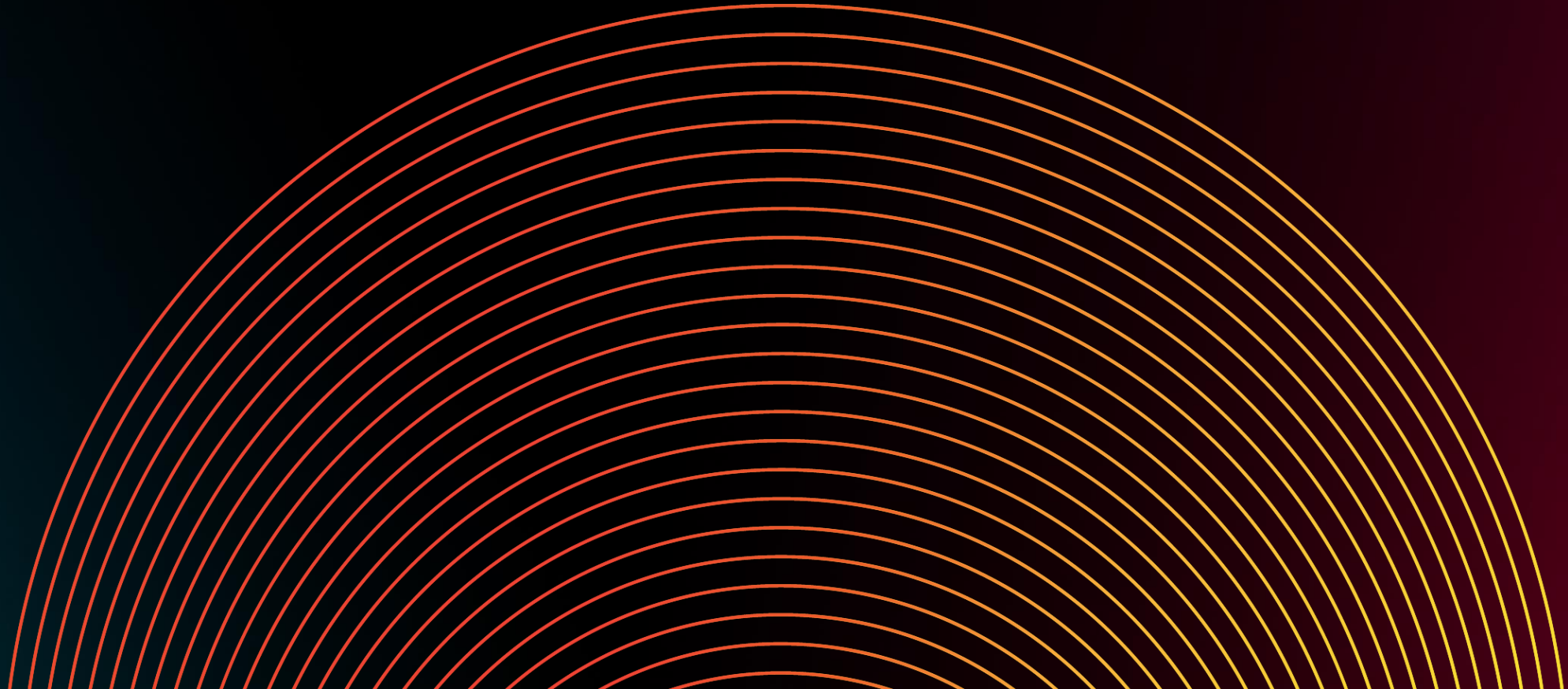
The **Alberta** economy is now expected to enter a recession given its high debt levels (trailing only British Columbia and Ontario) and the reduction in oil demand from the United States. Despite these factors, the downturn in its housing market is expected to be mild relative to other provinces, and strong population growth will help Alberta weather the modest pullback expected in energy demand.

### Real GDP growth by province, percent change

	2021	2022	2023	2024
Newfoundland and Labrador	0.6	2	-0.3	1.4
Prince Edward Island	7.9	4	-1.5	1.4
Nova Scotia	6.2	3.5	-1.1	1.2
New Brunswick	5.8	2.5	-1.5	1.2
Quebec	6	3.6	-1.3	1.3
Ontario	5.1	2.4	-1.3	1.9
Manitoba	1.7	3.4	1.1	2.2
Saskatchewan	-0.7	2.9	1.3	2.1
Alberta	4.9	5.1	-1.1	1.8
British Columbia	6.2	3.8	-1.3	1.8

Sources: Statistics Canada and Deloitte.

# Final thoughts



## Final thoughts

The economic outlook remains clouded by uncertainty. The biggest risk is that the past year's interest rate increases will be more consequential than anticipated, leading to a deeper and more protracted downturn. There's still a risk that policymakers will raise rates higher than we expect, which would also lead to a deeper economic decline, both here and in the United States. One potential upside is that consumers could choose to not cut back on their spending and instead draw down their savings or defer their higher interest payments by extending mortgage amortizations.

In an environment of slowing demand, elevated uncertainty, and tight labour markets, there are a few things that businesses can do to weather the storm:

- They can conduct a scenario analysis that accounts for upside and downside risks to the economic outlook, to assess how revenues and profits could change under different circumstances. Having this information and knowing how to identify when these risks begin to materialize equips them to quickly shift gears and adopt new plans if necessary.
- They can be strategic with their staffing plans. Despite the looming recession, a recent survey reported on by BNN Bloomberg in December showed that half of Canadian workers plan to look for a new job in the first half of 2023, with in-demand professionals looking to leverage tight labour markets to change jobs and boost their earnings. Companies that are facing talent shortages should be seeking to identify and direct any retention measures to top performers.
- They can also be strategic with their investment plans. Organizations will need to carefully consider what resources they'll need when the recovery takes hold and ensure they're ready to respond when demand begins to accelerate.

**This is shaping up to be another rocky year for the Canadian economy. But we're getting rather used to calling on our resilience and acting nimbly to position ourselves to weather the economic storm—the upcoming recession is simply the latest wave.**

# Key economic indicators

	2022				2023				22F	23F	24F
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
<b>Real economic activity</b>											
Gross domestic product	2.8	3.2	2.9	-2.2	-3.4	-1.6	0.0	1.5	3.4	-0.9	1.8
Household consumption expenditure	2.3	9.5	-1.0	-0.1	-0.3	0.0	1.8	2.8	4.7	0.7	2.9
• Durable goods	8.0	-14.4	-8.2	-1.8	-1.8	-1.3	1.5	2.7	-3.3	-2.7	2.8
• Services	1.1	17.8	3.8	0.8	0.7	0.8	2.3	3.1	8.6	2.5	3.3
Residential investment	8.8	-31.5	-15.4	-9.4	-4.1	-2.7	-1.6	0.8	-10.6	-7.9	1.4
Non-residential fixed investment	7.7	17.0	4.3	5.4	3.2	1.3	1.0	1.6	10.5	3.8	1.8
• Non-residential structures	13.3	13.8	11.7	6.3	2.3	0.3	-0.2	0.0	11.8	4.0	0.6
• Machinery & equipment	-1.3	23.1	-7.6	3.9	4.6	3.1	3.1	4.1	8.1	3.4	3.7
Government consumption & investment	0.7	-2.2	3.9	-3.2	-1.4	-0.2	0.2	0.7	1.0	-0.6	0.8
Exports of goods & services	-7.6	8.1	8.6	4.0	-4.6	0.9	2.8	3.6	2.7	1.8	3.7
Imports of goods & services	0.2	29.5	-1.5	0.0	-1.0	0.1	2.2	3.8	8.2	1.7	3.1
<b>Prices</b>											
Consumer price index (y/y)	5.8	7.4	7.1	6.6	5.5	3.5	3.1	2.9	6.7	3.7	2.4
Implicit GDP price index (y/y)	8.8	9.8	6.9	4.4	1.4	-1.5	0.4	1.5	7.4	0.4	1.8
<b>Labour market</b>											
Employment	3.2	3.9	-1.3	1.4	0.0	0.2	0.7	1.3	3.6	0.5	1.6
Unemployment rate (%)	5.8	5.1	5.2	5.2	5.5	5.8	6.0	6.0	5.3	5.8	5.5

Note: Unless otherwise noted, all figures are expressed as annualized % changes.

Sources: Statistics Canada and Bank of Canada. Forecast by Deloitte Economic Advisory, as of **Dec. 13, 2022**.

# Key economic indicators

	2022				2023				22F	23F	24F
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F			
<b>Interest rates (%)</b>											
Overnight rate target	0.33	1.17	2.75	3.92	4.25	4.25	4.25	4.08	2.04	4.21	3.11
3-month T-bill	0.64	1.65	3.22	4.12	4.38	4.31	4.28	4.08	2.41	4.26	3.09
1-year GoC note	1.40	2.58	3.65	4.46	4.68	4.62	4.60	4.41	3.02	4.58	3.45
2-year GoC note	1.71	2.72	3.49	4.13	4.33	4.32	4.33	4.21	3.01	4.30	3.48
5-year GoC note	1.96	2.80	3.14	3.77	4.06	4.16	4.24	4.22	2.92	4.17	3.70
10-year GoC bond	2.08	2.95	2.99	3.55	3.85	3.98	4.10	4.13	2.89	4.01	3.79
<b>Yield curve spread (pp)</b>											
3-month vs. 10-year	1.44	1.30	-0.24	-0.58	-0.53	-0.33	-0.18	0.05	0.48	-0.25	0.69
2-year vs. 10-year	0.37	0.23	-0.50	-0.58	-0.49	-0.34	-0.23	-0.08	-0.12	-0.29	0.30
<b>Foreign exchange</b>											
USD/CAD (\$C)	1.27	1.28	1.31	1.36	1.36	1.34	1.33	1.31	1.30	1.34	1.30
CAD/USD (US cents)	0.79	0.78	0.77	0.74	0.74	0.74	0.75	0.76	0.77	0.75	0.77

Sources: Statistics Canada and Bank of Canada. Forecast by Deloitte Economic Advisory, as of Dec. 13, 2022.



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