

Canadian Downturn: How Deep Is Our Valley?

Douglas Porter, CFA, Deputy Chief Economist

The fact that Canada and the global economy are mired in recession ceased to be a debate late last year, but the depth and duration of the downturn are still very much in question. Over the space of the past month, it has become painfully clear that: 1) the global economic downturn accelerated dramatically around the turn of the year, with global trade plunging, and 2) the Canadian economy has been fully taken along for the ride. The recent wave of downbeat economic data washing over Canada has been striking not just in terms of the speed of the decline, but also its breadth across sectors and all regions of the country. The downturn first began in earnest in exports to the rest of the world, but domestic spending is now braking forcefully as well, with the upcoming GDP release for Q4 likely to reveal a hefty drop in consumer spending, housing and business investment.

Our latest Canadian forecast (which will be fine-tuned after the Q4 results) now expects this downturn to climb into the same league as those of the early 1980s and 1990s (*Chart 1*). GDP is expected to drop by nearly 3% from the peak to the trough, with the downturn lasting roughly a year. While neither the length of the recession, nor the drop in GDP is currently projected to be quite as bad as the two previous serious downturns, there has been a nasty pattern of deep downward revisions to the forecast since the credit crunch kicked into overdrive.

For example, the consensus forecast for 2009 GDP growth in Canada has dropped by 0.5 percentage points on average during each of the past six months, and has yet to stop falling (*Chart 2*). In fact, the consensus taken in early February of a 1.1% drop in GDP this year, while close to the Bank of Canada's January call of -1.2%, already looks ripe for a further serious downward revision (we are now looking at a 2.2% decline). Even our call could very easily be exceeded to the downside. After an ugly performance in Q1 (when we see GDP dropping at a 5.7% annual rate), which is already almost baked in the cake, we see only modest further declines in GDP thereafter, which could easily prove optimistic based on the ongoing trauma in global growth.

CHART 1
REMEMBRANCE OF THINGS PAST

Canada (y/y % chng)

Real GDP

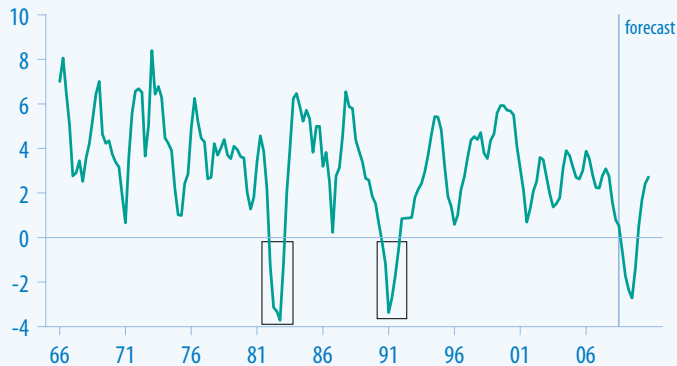
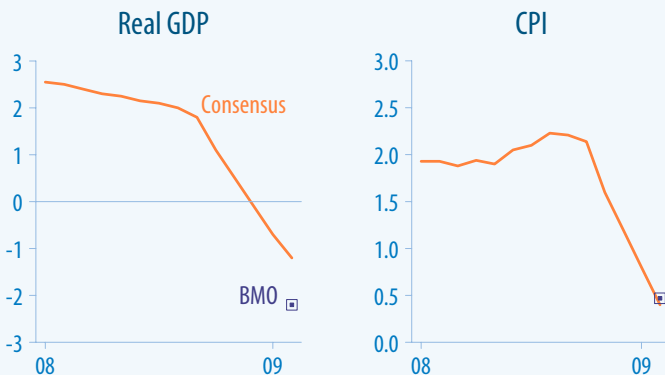


CHART 2
CONSENSUS SENSES A CHANGE

Forecasts – Canada (2009: y/y % chng)



Source: Consensus Economics, BMO

TABLE 1
COMPARING RECESSIONS

Canada

	Peak-to-Trough					
	Real GDP (% decline)	Employment (% decline)	Unemployment Rate (ppt rise)	Housing Starts* (% decline)	Auto Sales* (% decline)	Industrial Production (% decline)
1981-82	-4.9	-5.4	6.0	-54.0	-29.8	-13.5
1990-92	-3.4	-3.5	4.8	-51.5	-21.2	-8.3
Current: To-Date	-1.3 **	-1.2	1.4	-31.0	-16.2	-7.2
Projection	-2.9	-3.1	3.2	-34.4	-23.3	-12.2

* (from peak 3-month period to trough 3-month period)

** (latest monthly data)

CHART 3
UNCOMFORTABLE ECHO

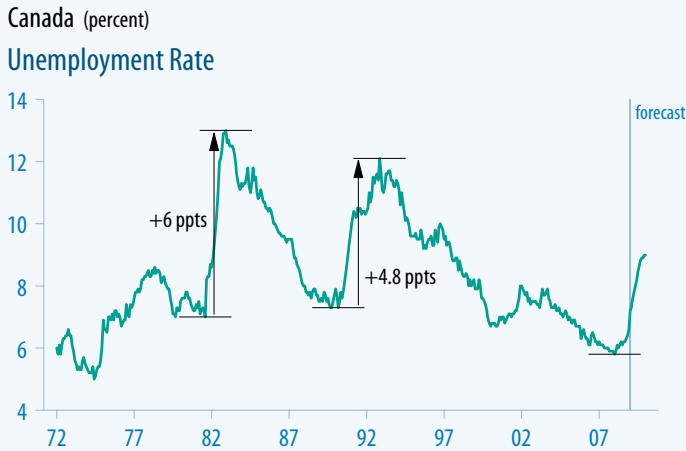


CHART 4
GLOBAL DOWNTURN

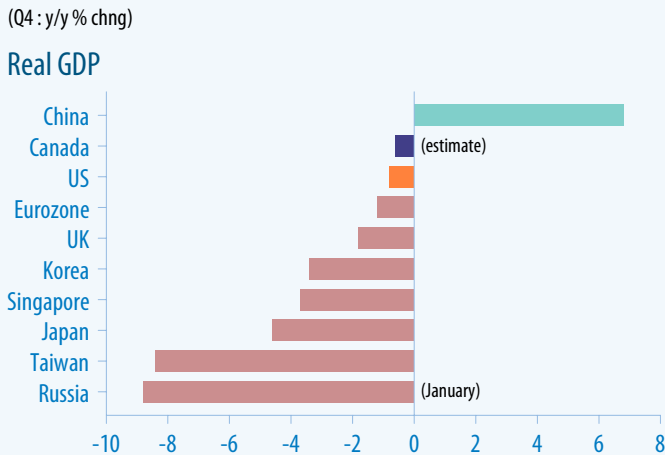
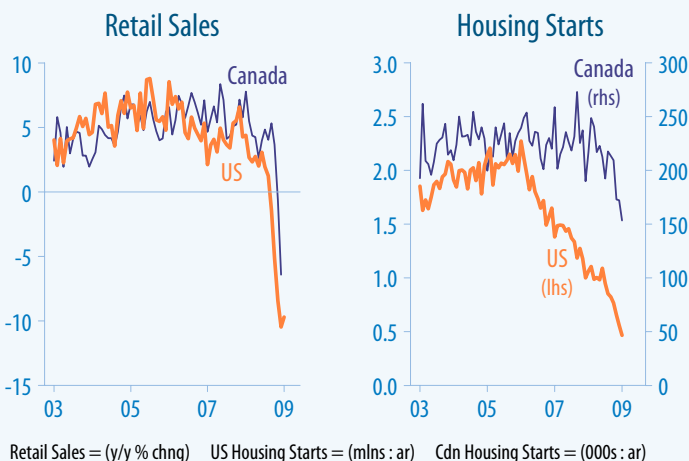


CHART 5
FOLLOWING THE LAGGARD



Comparing our forecast to past recessions shows that we expect the hit to most indicators to be a bit lighter this cycle (*Table 1*). However, the past two major recessions could give a taste of what's to come. Note that the unemployment rate, for example, climbed by 6- and 4.8-percentage points in the past two recessions from its pre-recession low to the peak (*Chart 3*). Both times it rose from around a low of 7% to above 12% (hitting a modern day high of 13% at the end of 1982). Matching even the smaller increase seen in the early 1990s would take joblessness this time around into double-digits from the 5.8% low hit just over a year ago.

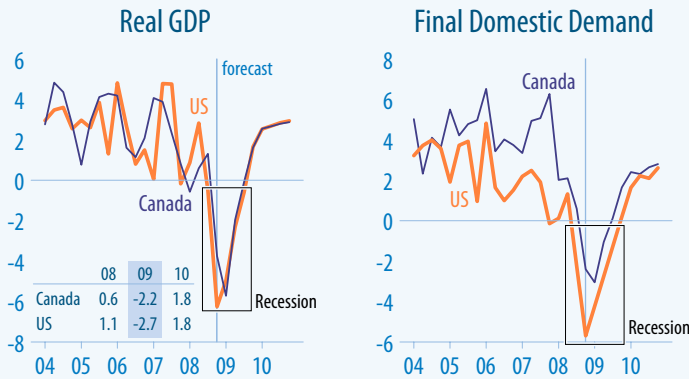
So, why should we believe that this recession will not be quite as bad as the two earlier downturns? First, interest rates were cut early and often in this cycle, and are much, much lower than in the past two downturns. (Overnight rates were still well into double-digit terrain at an advanced stage of both.) Second, stimulative fiscal policy is kicking in relatively early in this downturn. Third, corporate balance sheets were in much healthier shape heading into the recession than in the past two cycles. Fourth, the 20% depreciation of the Canadian dollar over the past year will offer some relief for industry.

Unfortunately, there are nevertheless serious downside risks to the forecast, which suggest this cycle could be just as bad (if not worse). Those factors include: 1) the U.S. and global downturn is shaping up to be as serious as any other in the post-war period; 2) the collapse in commodity prices—down more than 50% since mid-2008—is still being felt (B.C. and Alberta are now being especially hard hit), and 3) the heavy auto intensity of the Canadian economy makes it particularly vulnerable to the harrowing drop in U.S. sales this year.

Our latest call also suggests that there will be very little difference between the Canadian and U.S. GDP outlook. In fact, the U.S. has actually managed to see one of the smallest output declines in the past year among the major economies, which are all now reeling in unison (*Chart 4*). We now expect global GDP to contract 0.5% this year, light years from the string of 5% growth rates seen in the middle part of the decade. The very weak global backdrop is clearly bad news for Canadian exporters, but also

CHART 6
STILL SOME DIFFERENCE... BENEATH THE SURFACE

(q/q % chng : ar)



Final Domestic Demand = Real GDP less net exports and inventories

suggests that it will be difficult for commodity markets to stage a quick turnaround with so much slack built into the global economy.

But beyond falling exports, Canadian domestic demand is also weakening markedly after a very strong run. The housing sector is now in full-fledged retreat, with home sales down almost 40% from a year ago, prices weakening, and housing starts poised to drop by a quarter this year. Consumer spending is also taking a big step back, with retail sales now following the U.S. lead with an unnerving degree of tightness (*Chart 5*). Finally, even employment—a former ace in the hole for Canada—has dropped at nearly the same rapid pace as in the U.S. over the past three months (-1.2% versus -1.3%).

Bottom Line: Our current view remains that the Canadian recession will be somewhat milder than the past two major downturns and its U.S. counterpart, but the distinction—especially with the U.S.—is becoming too close for comfort (*Chart 6*). Even so, we continue to maintain the view that a recovery will indeed take hold by the end of the year, despite the recent wave of downbeat economic releases, assuming the U.S. can stabilize its banking system.

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