THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE — SEPTEMBER 1996

KEY MESSAGES

- In the second quarter, real GDP rose by 1.3% for the second consecutive quarter.
- Growth returned to being export-led. As a result, the real trade balance rose to its highest level since 1985, yielding the first quarterly current account surplus since 1984.
- The recovery in production would have been stronger but for business working down the excess inventories that had accumulated during 1995. Lower inventories now will help set the stage for growth in the second half of the year to be more in line with underlying demand growth.
- Employment surged in August, bringing total net job creation in July and August to over 100,000.
- Short-term interest rates have fallen about 60 basis points since the end of June alone, bringing the cumulative decline since January 1995 to over 425 basis points. Canadian rates have continued to drop relative to those in the United States, with the negative spread between Canadian and U.S. yields on 3-month Treasury bills at about 125 basis points. Indeed, Canadian rates are now below comparable U.S. rates up to 5-year maturities.

SUMMARY[1]

The demand for Canadian goods has been gathering strength since the second half of last year (Chart 1) and, fuelled by strong growth in exports, continued to do so in the second quarter. Since imports declined with domestic demand, the trade balance rose sharply, producing Canada's first current account surplus since 1984.

However, as has been the case since the second half of 1995, this stronger demand has yet to translate into strong production growth, as business has slowed inventory investment. In the second quarter, inventories actually shrank substantially.

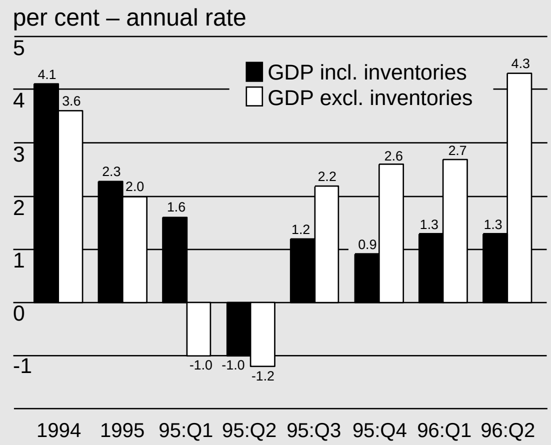
Further, final domestic demand – spending by households, business and government on goods and services and capital formation – was largely unchanged in the quarter, with a sharp jump in residential investment largely offset by falling business investment in plant and equipment.

Domestic inflation and cost pressures remained subdued, with unit labour costs rising moderately in the second quarter. Low inflation, fiscal restraint at federal, provincial and local levels and an improved current account balance have permitted interest rates to fall sharply from levels early last year.

External trade boosts growth

External trade was the engine of growth in the second quarter, as it has been for most of the recovery. Real exports increased due to stronger growth in the United States and the ongoing recoveries in Japan and the European G-7 countries and Canada's excellent

Chart 1
Growth in GDP including and excluding inventory investment



[1] Unless otherwise noted, data and per cent changes are quoted at annual rates. The cut off date for data in this document is September 6, 1996.

competitiveness. Also, part of the increase can be attributed to a rebound from the impact in the first quarter of strike activity in the United States on Canada's automotive production.

At the same time, real imports weakened due to a sharp inventory liquidation and little change in final domestic demand. As a result, the real trade balance improved by $7.9 billion to its highest level since 1985.

Sharp inventory decumulation

Economic activity was slowed significantly in the second quarter by a substantial inventory disinvestment. This reaction by producers to an inventory build-up during 1995 returned the economy-wide inventory-to-sales ratio to a level more in line with its downward trend.

Main economic indicators
(per cent changes at annual rates or per cent levels, unless otherwise indicated)

	1994	1995	1995: Q4	1996: Q1	1996: Q2	Most recent	
Real gross domestic product	4.1	2.3	0.9	1.3	1.3	–	
GDP excluding inventories	3.6	2.0	2.6	2.7	4.3	–	
Final domestic demand	2.6	0.6	1.2	5.2	-0.3	–	
Government expenditure	-0.8	-0.3	0.4	-0.9	-0.1	–	
Consumer expenditure	2.9	1.4	0.0	5.1	0.2	–	
Residential investment	1.8	-15.1	-7.2	22.4	27.4	–	
Business fixed investment	7.6	5.2	10.4	10.2	-10.3	–	
Non-residential construction	6.1	-5.6	-10.4	-2.3	-3.4	–	
Machinery and equipment	8.4	10.9	20.7	15.7	-13.0	–	
Business inventory change[1]	0.5	0.3	-1.6	-1.4	-2.9	–	
Trade balance[1]	0.9	1.2	1.1	-2.4	5.2	–	
Exports	14.7	12.0	12.3	-1.6	6.5	–	
Imports	11.5	8.7	9.5	4.1	-5.6	–	
Current account balance (nominal)	-22.2	-11.2	-1.3	-6.5	4.6	–	
(percentage of GDP)	-3.0	-1.4	-0.2	-0.8	0.6	–	
Real personal disposable income	0.7	1.1	2.5	2.1	-1.9	–	
Profits before taxes	34.4	13.1	-15.3	-21.4	-5.5	–	
Costs and prices (%, y/y)							
GDP price deflator	0.7	1.5	1.8	1.0	0.9	–	
Consumer price index	0.2	2.1	2.1	1.4	1.4	1.2	July 96
CPI – excluding food and energy	0.1	2.2	2.3	1.6	1.4	1.4	July 96
Unit labour costs	-1.3	0.8	2.1	1.8	1.3	–	
Wage settlements (total)	0.3	0.9	0.7	0.5	0.7	0.5	June 96
Labour market							
Unemployment rate	10.4	9.5	9.4	9.5	9.6	9.8	July 96
Employment growth (%, a.r.)	2.1	1.6	1.1	2.7	0.7	1.7	July 96
Financial markets (average)							
Exchange rates (average)	73.24	72.88	73.75	73.04	73.29	72.85	Sept. 6, 96
Prime interest rate	6.88	8.65	7.75	7.00	6.50	5.75	Sept. 6, 96

[1] Annualized change expressed as a percentage of GDP in the previous period.

Sources: Statistics Canada, the Bank of Canada and Human Resources Development Canada.

Chart 2
Personal savings rate

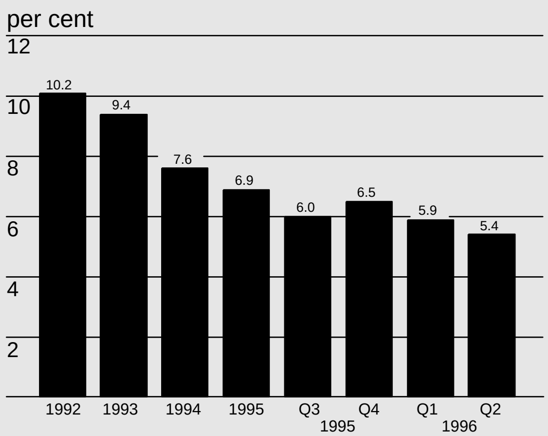
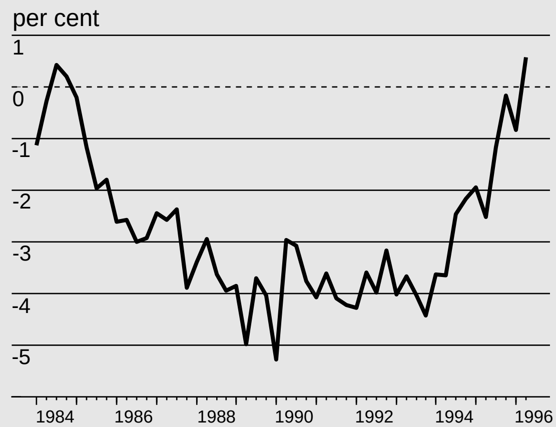


Chart 3
The current account balance as a share of GDP



Household spending largely unchanged

Real consumer spending increased modestly in the quarter after rising sharply in the first quarter. This weakness was due to falling real disposable income, a reflection of slow labour income growth, lower investment income, lower federal payments related to the *Western Grain Transportation Act* subsidy buy-outs, and higher tax payments.

With personal disposable income rising more modestly than spending, the personal savings rate fell from 5.9% in the first quarter to 5.4% in the second, its lowest level since 1970 (Chart 2).

Residential investment has responded to the downward trend in interest rates, rising 27.4% in the quarter, the second consecutive gain.

Business investment falls

Business non-residential investment fell 10.3% in the quarter. Machinery and equipment investment, which had been one of the few sources of domestic demand strength, registered an uncharacteristic sharp drop while non-residential construction continued to weaken, as it has for some time.

Current account surplus

The current account went from a deficit of $6.5 billion in the first quarter to a surplus of $4.6 billion in the second, the first surplus since 1984 (Chart 3). The sharp rise in the nominal merchandise trade surplus played a major role. Further, a record level of spending by non-residents in Canada helped to sharply reduce the travel deficit. Finally, the deficit in investment income flows fell about $2 billion, reflecting lower corporate profits and the downward trend in interest rates.

Prices, costs and profitability

Domestic cost performance remained good. Unit labour costs rose a modest 1.3% in the quarter after having fallen marginally in the first, leaving them 1.3% above their level from a year earlier.

GDP inflation (the broadest measure of inflation for Canadian-produced goods and services) continued to be moderate. The implicit price index for GDP rose 1.9% at an annual rate in the second quarter, but was only 0.9% above its level of a year earlier.

With slow growth limiting price increases, corporate profits fell yet again, dropping 13.5% below their level in early 1995. Declines were concentrated in the non-financial sector, where nearly half of the industries saw reductions. Decreases were particularly notable in the wood and paper industries, especially in pulp and paper. The profit share of GDP fell to 7.2%, still well above its trough of 4.8% set at the end of 1991 but still well below its long-run average from 1960 to 1994 of 9.9%.

Employment surges

The pace of job creation has rebounded sharply after job losses in May and June, when producers were reducing inventories. Employment rose by 82,000 in August, bringing the July/August total gain to just over 100,000. This followed a net loss of 68,000 jobs in May and June. 202,000 net new jobs have been created in the nine months since November, with the private sector accounting for the entire gain and more. Indeed, from the end of 1993 to the first quarter of 1996, the growth rate of employment has kept pace with that of the United States and exceeded those of each of the European G-7 countries and Japan.

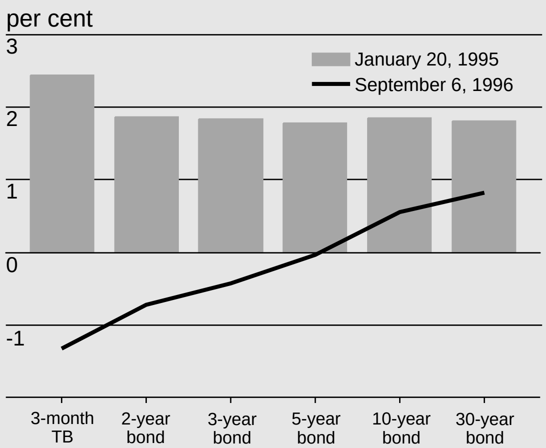
While employment growth has been strong, the labour force has continued to grow along with the population. As a result, the unemployment rate, at 9.4% in August, is the same as it was in November 1995.

Third quarter indicators

The outlook to date for real GDP growth in the third quarter is positive. Recent surveys suggest the inventory correction may be close to complete, which should allow production to grow at a pace more in line with underlying demand growth. The employment surge in August is consistent with stronger production growth. Other indicators are also encouraging.

Home resales and motor vehicle production both rose sharply in July to levels well above their second-quarter averages. Housing starts in that month also exceeded their second-quarter averages. Finally, increased motor vehicle sales in August left average monthly sales to date in the third quarter above that in the second.

Chart 4
Canada-U.S. interest rate spreads



Interest rates decline further

Since early 1995, fiscal restraint, an improving current account, slow growth and low inflation have allowed interest rates to decline, an easing which has continued through recent months. Short-term interest rates have fallen about 60 basis points since the end of June alone, bringing the cumulative decline since January 1995 to over 425 basis points. This drop has brought the negative spread between Canadian and U.S. yields on 3-month Treasury bills to about 125 basis points (Chart 4). Negative spreads have emerged on bonds with maturities up to five years.

While long rates have backed up since early 1996, they have done so more in the United States than in Canada. As a result, long rates are now down almost 220 basis points since early 1995. The spread with U.S. 10-year bonds has narrowed to less than 60 basis points, over a full percentage point less than a year earlier.

The Canadian dollar has traded in a fairly narrow range of 72 to 74 cents U.S. since January despite the emergence of negative interest-rate spreads up to 5-year maturities.

On September 6, the 3-month Treasury bill rate was 4.00% and the closing value of the Canadian dollar was 72.85 cents U.S.

The main source of data used in this publication is Statistics Canada. Subscription inquiries should be directed to the Distribution Centre (613) 995-2855. For other inquiries about this publication, contact Jeremy Rudin (613) 992-2370.
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