

THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE

MARCH 1998

KEY MESSAGES

- In the fourth quarter of 1997, real GDP grew 3.0% at an annual rate. While somewhat off the pace of the previous three quarters, this sixth consecutive solid gain left output up 4.2% from a year earlier. For 1997 as a whole, real GDP grew 3.8%, up sharply from 1.2% in 1996.
- Real exports continued to grow strongly, reflecting strong foreign demand. Further, Canadian households sharply boosted their demand for durable goods, notably motor vehicles, new houses and renovations, as the low interest rate environment continued to encourage "big ticket" purchases.
- However, other components of domestic demand fell, slowing overall growth. Consumer spending excluding durables declined, as did business investment in plant and equipment.
- Slower growth in domestic demand was mirrored in slower real import growth. But with import prices rising faster than export prices, the overall nominal trade surplus declined.
- Nonetheless, the current account deficit narrowed, as an improvement in the investment income deficit more than offset the weakening in the nominal trade surplus.
- A gain of 82,000 jobs in February brought the number of net new jobs created since the end of 1996 to 453,000. The entire gain, both in February and since the end of 1996, was in the private sector and full time. The unemployment rate in February was 8.6%, the lowest since September 1990.

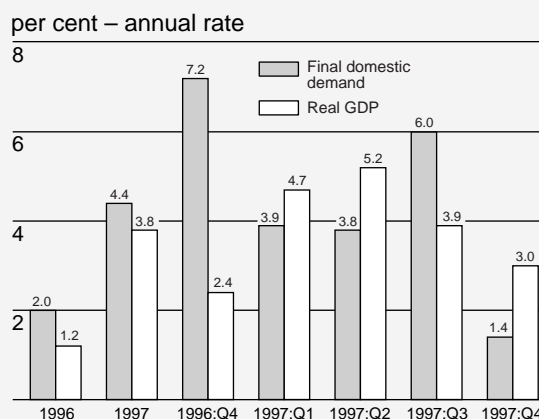
SUMMARY¹

Strong foreign demand boosted output in the fourth quarter. However, growth in final domestic demand – spending by households, businesses and government on goods, services and capital formation – moderated to 1.4% from 6.0% in the third quarter (Chart 1). Much of the domestic gain was in interest-sensitive expenditures by households. Business investment in plant and equipment fell in the quarter after five consecutive quarters of strong growth.

Domestic cost and inflation pressures remained very subdued according to all national accounts measures. Indeed, unit labour costs fell throughout 1997.

¹ Unless otherwise noted, data and per cent changes are quoted at annual rates. The cut-off date for data in this document is noon, March 13, 1998.

Chart 1
Growth in real final domestic demand and real GDP



Consumer spending growth slows

Real consumer expenditure growth slowed to 2.3% after four quarters of very strong growth. Spending on durable goods did jump 21.5%, with an especially large gain for motor vehicles, as manufacturers offered buyer incentives. But consumer expenditures on other types of goods actually fell, with unseasonably mild weather sharply reducing the need for energy consumption.

The spending slowdown occurred despite real personal disposable income rising 1.4% after having fallen 1.6% in the third quarter. Unincorporated business and net farm income jumped, and investment income grew after six consecutive declines. But smaller employment gains and work stoppages by Canadian postal workers and educators in Ontario slowed labour income growth.

Main economic indicators

(per cent change at annual rates unless otherwise indicated)

| | 1996 | 1997 | 1997Q2 | 1997Q3 | 1997Q4 | Most Recent |
|--|-------|-------|--------|--------|--------|-----------------|
| Real gross domestic product | 1.2 | 3.8 | 5.2 | 3.9 | 3.0 | — |
| GDP excluding inventories | 2.1 | 3.1 | 1.9 | 3.4 | 3.2 | — |
| Final domestic demand | 2.0 | 4.4 | 3.8 | 6.0 | 1.4 | — |
| Government expenditure | -1.5 | -0.6 | -0.2 | 1.6 | -0.8 | — |
| Consumer expenditure | 2.4 | 3.9 | 4.6 | 5.5 | 2.3 | — |
| Residential investment | 10.9 | 13.1 | 10.9 | -1.3 | 8.7 | — |
| Business fixed investment | 4.2 | 14.5 | 4.6 | 23.0 | -2.0 | — |
| Non-residential construction | 4.3 | 9.1 | 7.0 | 10.7 | -3.1 | — |
| Machinery and equipment | 4.2 | 18.7 | 3.0 | 32.3 | -1.3 | — |
| Business inventory change ¹ | -0.9 | 0.7 | 3.2 | 0.6 | -0.2 | — |
| Trade balance ¹ | 0.3 | -1.4 | -1.0 | -3.4 | 0.8 | — |
| Exports | 5.7 | 8.6 | 3.3 | 12.2 | 8.3 | — |
| Imports | 5.2 | 13.4 | 6.4 | 23.8 | 6.0 | — |
| Current account balance (nominal \$billion) | 3.7 | -17.0 | -12.9 | -26.5 | -24.9 | — |
| (percentage of GDP) | 0.4 | -2.0 | -1.5 | -3.1 | -2.9 | — |
| Real personal disposable income | -0.1 | -0.7 | 1.0 | -1.6 | 1.4 | — |
| Profits before taxes | -3.4 | 17.3 | -12.2 | 32.9 | 22.3 | — |
| Costs and prices (% , y/y) | | | | | | |
| GDP price deflator | 1.4 | 0.5 | 0.6 | 0.4 | -0.3 | — |
| Consumer Price Index | 1.6 | 1.6 | 1.6 | 1.7 | 1.0 | 1.1 Jan-98 |
| CPI – excluding food and energy | 1.4 | 1.6 | 1.8 | 1.5 | 1.1 | 1.2 Jan-98 |
| Unit labour costs | 1.3 | 0.0 | 0.0 | 0.2 | -0.9 | — |
| Wage settlements (total) | 1.0 | 1.6 | 1.8 | 1.4 | 1.6 | — |
| Labour market | | | | | | |
| Unemployment rate (%) | 9.7 | 9.2 | 9.4 | 9.0 | 8.9 | 8.6 Feb-98 |
| Employment growth | 1.3 | 1.9 | 3.5 | 3.3 | 1.8 | 7.2 Feb-98 |
| Financial markets (average) | | | | | | |
| Exchange rate (cents U.S.) | 73.34 | 72.24 | 72.14 | 72.21 | 70.99 | 70.90 Mar 12-98 |
| Prime interest rate (%) | 6.06 | 4.96 | 4.75 | 4.75 | 5.58 | 6.50 Mar 12-98 |

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

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

Chart 2
The personal savings rate



Over the four quarters of 1997, nominal personal spending rose 5.5% but personal disposable income rose only 0.9%. As a result, the personal savings rate fell to 0.6%, its lowest recorded level (Chart 2).

However, this low savings rate partly reflects the fact that the national accounts income measure does not include some wealth increases such as capital gains on equity and bond holdings. This is relevant because such wealth rose during 1997, helping support spending.

Business investment slips

Business investment in plant and equipment slipped 2.0% in the fourth quarter after five consecutive strong gains.

Machinery and equipment investment dipped 1.3% after soaring over 30% in the third quarter, leaving it still 12.4% above its level of a year earlier. Investment in non-residential structures fell 3.1% because of a sharp drop in engineering projects as Hibernia was completed. But investment in non-residential buildings continued to rise sharply, increasing another 11.4%.

Residential investment rose 8.7% following a drop in the third quarter. New housing construction rose despite housing starts in the quarter being basically unchanged, as activity spilt over from the third

quarter. Alterations and improvements also grew strongly but lower house resales reduced real estate commissions.

Inventory growth continues

Total business inventory accumulation eased slightly but remained quite high. Indeed, real non-farm business inventories have increased some \$26.4 billion over the last three quarters. However, rising sales have kept the economy-wide inventory-to-sales ratio near its all-time low. With Statistics Canada's January *Quarterly Survey of Business Conditions* showing most manufacturers feeling inventory levels are not excessive, this suggests further demand increases in the near term are likely to translate directly into production gains.

Exports outjump imports

Strong foreign demand for Canadian products boosted real exports 8.3%, to a level 11.9% higher than a year earlier. With Canadian domestic demand lagging, import growth fell short of export growth and the real trade surplus rose \$1.7 billion (1992 dollars).

Subdued price and cost increases propel profits upward

With the economy still operating below potential, underlying price and cost pressures remained very subdued in the fourth quarter. Aided by solid gains in productivity, unit labour costs fell for the fourth consecutive quarter to a level 0.9% lower than a year earlier.

Meanwhile, the implicit price index for GDP was 0.3% below its level of a year earlier after a 0.4% increase in the quarter. This year-over-year decline in the GDP deflator was largely due to weakening export prices during most of 1997, a reflection of softening commodity prices.

Pre-tax corporate profits surged 22.3% in the fourth quarter, the fifth large quarterly gain in the last year-and-a-half. This raised the share of corporate profits in GDP to 9.8% – the highest level in nearly nine years. The gains were most notable in the petroleum, natural gas, transportation and telecommunications sectors.

Current account posts smaller deficit

The current account deficit narrowed \$1.6 billion to \$24.9 billion, or 2.9% of nominal GDP. This reflected a \$5.1 billion improvement in the investment income balance. This more than countered a deterioration in the nominal trade surplus caused by falling terms of trade. Weakening commodity prices restrained the growth in the average price of exports in the quarter while the average price of imports rose, partly reflecting the decline in the value of the Canadian dollar.

Employment situation is positive

The solid fundamentals of the Canadian economy are reflected in the labour market. With a gain of 82,000 in February, the number of net new jobs created since the end of 1996 has risen to 453,000. All were full time and in the private sector (Chart 3). The unemployment rate, at 8.6% in February, was the same as in December 1997 and the lowest rate since September 1990.

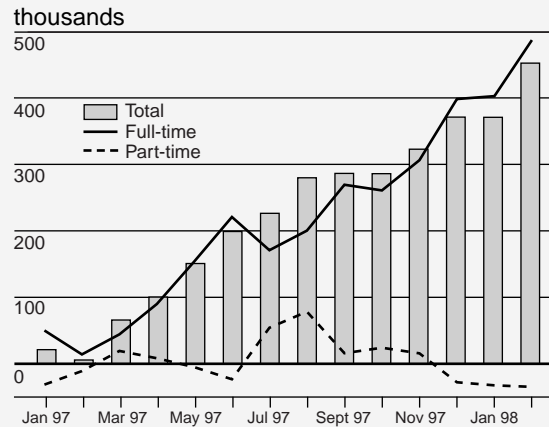
Interest rates rise but remain low

Canadian short-term interest rates have risen more than 1½ percentage points since the end of September, an increase coinciding with a decline in the value of the Canadian dollar to an all-time low of 68.10 cents U.S. on January 29. This partly reflected uncertainty in world financial markets given developments in Asia in the fourth quarter. But rates remain low by historical standards, reflecting fiscal restraint by federal and provincial governments, low inflation and continuing slack in the economy. Short-term rates are over 3½ percentage points lower than in early 1995 while long rates continue to be more than 4 percentage points lower.

On 3-month Treasury bills, the negative spread between Canadian and U.S. rates has narrowed but remains more than ½ percentage point. And interest rate spreads with U.S. rates remain negative across the entire maturity spectrum.

Recently, the dollar has recovered and has been trading near 71 cents U.S.

Chart 3
Cumulative employment growth since 1996



First quarter indicators

Available indicators to date for the first quarter are scarce and distorted because of the January ice storm in Ontario, Quebec and the Maritime provinces.

But employment data show continued strong growth. Even if March employment were unchanged from that in February, employment growth in the first quarter would be 0.7% (quarterly rate).

Another positive development, for 1998 as a whole, is that the *Private and Public Investment Intentions Survey* released in February suggests that private-sector investment will record a fifth consecutive year of healthy growth in 1998, though the rate of growth is projected to slow substantially from last year's very rapid pace.

