

THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE

DECEMBER 1996

KEY MESSAGES

- In the third quarter, real GDP grew 3.3%, the fastest pace since the fourth quarter of 1994.
- This reflected stronger demand by Canadian business plus continued strong foreign demand. Notably, a sharp rebound in machinery and equipment investment and a second consecutive robust gain in residential investment resulted in solid growth in final domestic demand. Unlike the second quarter, this growing demand was met out of increased production rather than a reduction in inventories.
- Part of the increased demand was satisfied by imports, pushing import growth well above that of exports and reducing the real trade surplus. However, higher export prices helped support the second quarterly current account surplus in a row, the first surpluses since 1984.
- Domestic cost pressures continued to be moderate, with a decline in unit labour costs in the third quarter relative to the second leaving them only 0.7% above their level of a year earlier.
- Indicators for fourth quarter growth are generally positive to date.
- Interest rates have fallen over a percentage point since early September, bringing the cumulative decline since January 1995 to over 5 percentage points for short rates and 3 percentage points for long rates. Also, Canadian rates have dropped relative to those in the United States, with the negative spread between Canadian and U.S. yields on 3-month Treasury bills at about 2 percentage points. Indeed, Canadian rates have been below comparable U.S. rates up to, at times, 10-year maturities for the first time since 1985.

SUMMARY¹

The demand for Canadian goods has been gathering strength since the second half of last year. In the third quarter, this finally translated into stronger production growth, as business stopped running down inventories (Chart 1).

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, December 9, 1996.

Final domestic demand – spending by households, business and government on goods and services and capital formation – rose sharply in the quarter, as machinery and equipment investment soared and residential investment registered another strong gain. However, consumer spending growth continued to be sluggish while government spending fell sharply.

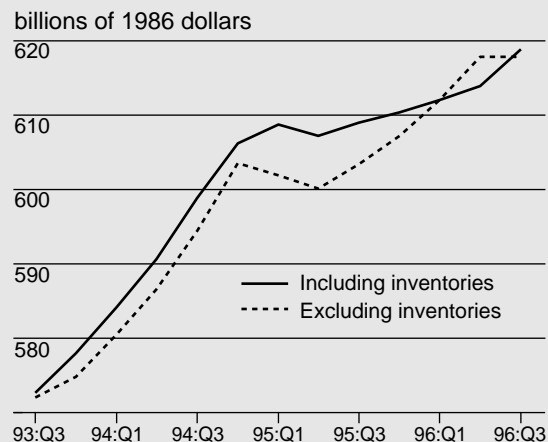
Domestic inflation and cost pressures remained subdued, with unit labour costs falling in the third quarter. Low inflation, fiscal restraint at federal and provincial levels and another current account surplus allowed interest rates to continue their sharp declines.

Inventory investment stops falling

An important factor in strengthening domestic demand was the largest positive swing in inventory investment since 1991. This swing was not a surprise given the sharp run-down in inventories in the second quarter. However, it was increased farm inventories due to a strong grain harvest that modestly boosted the overall stock. The stock of business non-farm inventories fell slightly, albeit by nowhere near as much as in the second quarter.

With sales growth exceeding that of inventories, the economy-wide inventory-to-sales ratio fell for a fourth consecutive quarter to near its lowest point ever and in

Chart 1
GDP including and excluding
inventory investment



line with its long-standing downward trend. This should allow production to grow with underlying demand in the future.

Business investment soars

Final domestic demand growth registered a sharp pick-up to 3.8% (Chart 2), led by business non-residential investment, which jumped 23.5% in the quarter. Machinery and equipment investment, which has generally been a source of strength in recent

quarters, soared nearly 33% after a temporary dip in the second quarter. Non-residential construction rose by about 3%, following a marginal decline in the second quarter, as oil and gas drilling resumed after being delayed by adverse weather in the second quarter.

Residential investment also continued to respond to lower interest rates, rising nearly 17% in the quarter, building on the 26% surge in the second quarter.

Main economic indicators

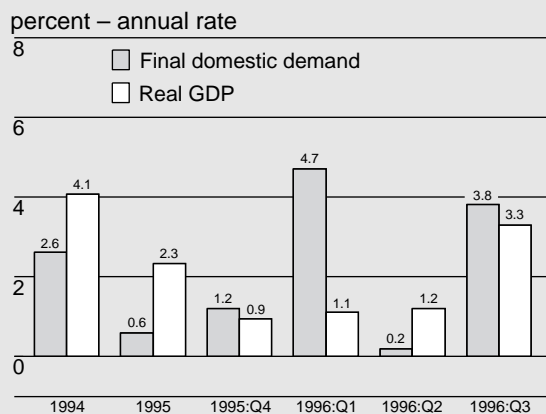
(per cent changes at annual rates or per cent levels, unless otherwise indicated)

	1994	1995	1996: Q1	1996: Q2	1996: Q3	Most recent	
Real gross domestic product	4.1	2.3	1.1	1.2	3.3	—	
GDP excluding inventories	3.6	2.0	3.2	3.9	0.0	—	
Final domestic demand	2.6	0.6	4.7	0.2	3.8	—	
Government expenditure	-0.8	-0.3	-1.9	-1.6	-3.6	—	
Consumer expenditure	2.9	1.4	5.1	0.7	1.3	—	
Residential investment	1.8	-15.1	22.7	26.3	16.9	—	
Business fixed investment	7.6	5.2	8.5	-6.6	23.5	—	
Non-residential construction	6.1	-5.6	4.9	-0.2	3.1	—	
Machinery and equipment	8.4	10.9	10.0	-9.2	32.8	—	
Business inventory change ¹	0.5	0.3	-2.0	-2.6	3.3	—	
Trade balance ¹	0.9	1.2	-1.8	4.7	-3.5	—	
Exports	14.7	12.0	-1.7	9.7	8.5	—	
Imports	11.5	8.7	2.5	-1.5	18.2	—	
Current account balance (nominal)	-22.2	-11.2	-6.7	4.4	2.2	—	
(percentage of GDP)	-3.0	-1.4	-0.9	0.6	0.3	—	
Real personal disposable income	0.7	1.1	0.6	-1.4	0.8	—	
Profits before taxes	34.4	13.1	-10.6	-0.6	51.9	—	
Costs and prices (% , y/y)							
GDP price deflator	0.7	1.5	1.2	1.1	1.3	—	
Consumer price index	0.2	2.1	1.4	1.4	1.4	1.8	Oct. 96
CPI – excluding food and energy	0.1	2.2	1.6	1.4	1.3	1.3	Oct. 96
Unit labour costs	-1.3	0.8	1.8	1.5	0.7	—	
Wage settlements (total)	0.3	0.8	0.5	0.7	1.2	1.6	Sept. 96
Labour market							
Unemployment rate	10.4	9.5	9.5	9.6	9.7	10.0	Oct. 96
Employment growth (% , a.r.)	2.1	1.6	2.7	0.7	0.5	3.7	Oct. 96
Financial markets (average)							
Exchange rates (average)	73.24	72.88	73.04	73.29	72.99	73.78	Dec. 9, 96
Prime interest rate	6.88	8.65	7.00	6.50	5.92	4.75	Dec. 9, 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
Growth in final domestic demand and real GDP



Household spending growth still sluggish

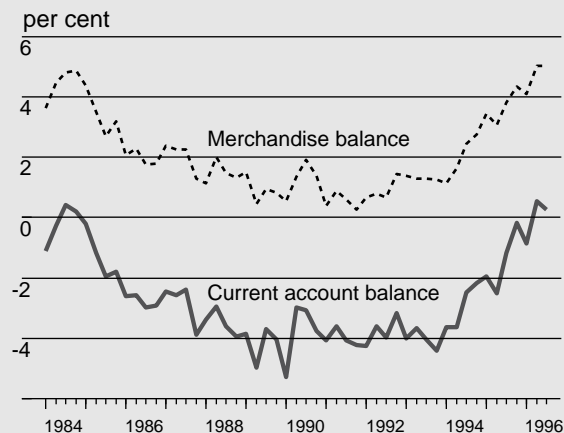
Real consumer spending increased modestly again in the quarter. Gains were more or less limited to services and non-automotive durables. This sluggishness was largely due to even more modest growth in real personal disposable income. Slow labour income growth due to slow employment and real wage gains in the quarter continued to weigh on household spending.

With spending rising faster than disposable income, the personal savings rate has fallen from 5.6% in the first quarter to 5.2% in the second and 5.1% in the third, its lowest level since 1970. However, one reason that the savings rate is low is that inflation is low. During inflationary periods, the higher investment income (from higher nominal interest rates) tends to be saved to preserve the real value of capital. Thus, the highest personal savings rates were seen during the years of double-digit inflation.

Exports remain strong but imports surge

Export growth eased to a still robust 8.5% in the third quarter, driven by continued but slowing growth in the United States, ongoing recoveries in Canada's overseas major export markets, and Canada's excellent competitive position.

Chart 3
The current account balance as a share of GDP



The volume of imports was up sharply (18.2%) in the third quarter. A major factor was a sharp rise in imports of machinery and equipment that accompanied increased domestic investment. Another likely factor was that the inventory decline in the second quarter depressed imports at that time. Overall, the real trade surplus (goods and services combined) declined by \$5.5 billion, with the reduction concentrated in the merchandise trade balance.

Current account remains in surplus

The current account surplus was halved from \$4.4 billion in the second quarter to \$2.2 billion in the third (i.e. from 0.6% of nominal GDP to 0.3% of GDP (Chart 3)). But the decline in the real merchandise trade surplus was not the main factor in this development.

The nominal merchandise surplus actually rose modestly to another record high in the third quarter, as the prices of Canada's merchandise exports rose faster than the prices of Canada's merchandise imports.

The lower current account surplus was due, in part, to an increase in the services deficit of about \$1 billion, largely reflecting a deterioration in the travel account, as receipts fell while Canadian spending outside of Canada rose. Also, with the balances for interest, dividends and retained earnings all worsening, the deficit in investment income increased by over \$1 billion.

Prices, costs and profitability

Underlying domestic cost pressures continued to be moderate. Unit labour costs fell about 1% in the third quarter after having risen in the second, leaving them only 0.7% above their level from a year earlier.

GDP inflation (the broadest inflation measure for Canadian-made products) reached its fastest rate – 2.8% – since the third quarter of 1992. But this largely reflected the surge in export prices. The implicit price index for GDP was only 1.3% above its level of a year earlier.

With these price *increases* and cost *decreases*, corporate profits surged by over 50%. Gains were concentrated in the non-financial sector, notably in the wood and paper industries. The profit share of GDP rose to 8.2%, well above its trough of 4.8% at the end of 1991 but still well below its longer-run average of about 10%.

Employment gains

The pace of job creation has improved since the middle of the year. After job losses in May and June, when producers were sharply reducing inventories, and despite losses in September, the cumulative gain from June to November was over 100,000 net new jobs.

While employment growth generally has been strong, the labour force has grown faster than the population, as the participation rate has picked up somewhat in recent months. As a result, the unemployment rate, at 10.0% in November, is the same as it was in June.

Recent indicators

The outlook to date for growth in the fourth quarter is positive. Interest rates have declined further since the end of the third quarter. Business confidence remains well above its average level over the last two decades according to the Conference Board. The solid employment gain in October, coupled with the very modest gain in November, is consistent with further production growth. Other indicators are also encouraging. Home resales and motor vehicle sales both appear to be growing strongly and housing starts in November rose to their highest level in two years, more than offsetting a drop in October.

Interest rates decline further

Since early 1995, fiscal restraint by the federal and provincial governments, the improved current account, slow growth and low inflation have allowed interest rates to decline. Short-term interest rates have fallen more than a percentage point since early September, bringing their cumulative decline since January 1995 to over 5 percentage points. This has brought about a rather large negative spread between Canadian and U.S. yields on 3-month Treasury bills (Chart 4).

Long rates also have fallen about a percentage point since early September and are now down over 3 percentage points since early 1995. Indeed, negative spreads with U.S. rates have emerged, at times, on bonds with maturities up to 10 years for the first time since 1985.

Despite the emergence of large negative interest-rate spreads, the Canadian dollar strengthened to over 75 cents U.S. in early November. Since then, however, the dollar has returned to its trading range for most of 1996 – 72 to 74 cents U.S.

Chart 4
Canada-U.S.
interest rate spreads

