The Economy in Brief

DEPARTMENT OF FINANCE SEPTEMBER 1997

Key Messages

- Real GDP growth accelerated to 4.9% in the second quarter of 1997, its strongest pace since the end of 1994. With four consecutive quarters of solid growth, output is now 3.7% above its year-earlier level.
- Much of the strength was in interest-sensitive expenditures, where previous declines in interest rates are fuelling significant gains, particularly in consumer durables and in residential and non-residential investment.
- Significantly adding to growth was a substantial increase in inventory investment.
- The current account deficit widened as stronger domestic demand increased imports at a faster pace than foreign demand increased exports.
- So far in 1997, over 260,000 net new jobs have been created. All were in the private sector and roughly two-thirds were full-time.
- Interest rates remain well below their levels in early 1995. The negative spread between Canadian and U.S. Treasury bill rates exceeds 2 percentage points and negative spreads have extended to 30-year bonds.

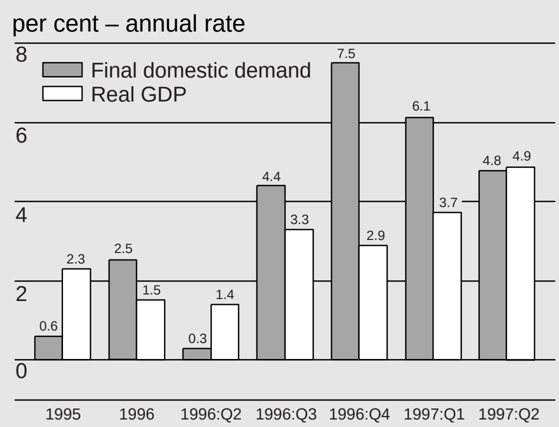
Summary[1]

Final domestic demand – spending by households, business and government on goods and services and capital formation – rose 4.8% in the second quarter of 1997 (Chart 1), propelling real GDP growth to its best gain since 1994. Interest-sensitive spending on housing, automotive products, furniture and appliances and non-residential investment all surged yet again. In the last year, final domestic demand has risen 5.7%.

Also significantly adding to growth in the quarter was an apparently deliberate and sharp increase in inventory investment by business.

Domestic inflation and cost pressures remained subdued. Unit labour costs and the GDP implicit price index (the broadest measure of inflation in Canadian products) were both only modestly above their year-ago levels. The price index actually fell relative to its first-quarter level.

Chart 1
Growth in final domestic demand and real GDP



1 Unless otherwise noted, data and per cent changes are quoted at annual rates. The cutoff date for data in this document is noon, September 5, 1997.

Department of Finance Canada
Ministère des Finances Canada
Canada

Consumer spending growth remains strong

Real consumer expenditure again responded to low interest rates, increasing wealth and firming consumer confidence. Growth was strongest in the interest-sensitive categories. Spending on automotive products surged while that on furniture and appliances also jumped again, fuelled by increased housing activity.

Another factor supporting consumer spending was the sharpest increase in nominal personal disposable income in over two years. Solid employment gains in the quarter boosted earned income. But the even larger rise in nominal consumer spending pushed the personal savings rate down again to 0.9%.

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

	1995	1996	1996: Q4	1997: Q1	1997: Q2	Most recent	
Real gross domestic product	2.3	1.5	2.9	3.7	4.9	–	
GDP excluding inventories	2.0	2.3	0.3	6.7	2.4	–	
Final domestic demand	0.6	2.5	7.5	6.1	4.8	–	
Government expenditure	-0.3	-1.9	-0.7	-1.4	0.5	–	
Consumer expenditure	1.4	2.4	5.6	5.0	4.6	–	
Residential investment	-15.1	11.5	22.9	10.1	10.6	–	
Business fixed investment	5.2	6.6	23.4	20.0	9.5	–	
Non-residential construction	-5.6	-3.2	5.8	6.7	10.4	–	
Machinery and equipment	10.9	11.0	30.7	25.1	9.2	–	
Business inventory change[1]	0.3	-0.8	2.6	-2.8	2.5	–	
Trade balance[1]	1.2	-0.2	-7.5	0.1	-2.7	–	
Exports	12.0	4.5	-10.1	23.6	2.8	–	
Imports	8.7	5.1	7.4	22.3	8.8	–	
Current account balance (nominal)	-7.4	3.8	-2.2	-3.4	-12.7	–	
(percentage of GDP)	-1.0	0.5	-0.3	-0.4	-1.5	–	
Real personal disposable income	1.1	-0.2	0.8	-2.2	1.5	–	
Profits before taxes	13.1	0.2	19.3	25.9	8.4	–	
Costs and Prices (%, y/y)							
GDP price deflator	1.5	1.3	1.6	1.7	0.9	–	
Consumer Price Index	2.1	1.6	2.0	2.1	1.6	1.8	Jul-97
CPI – excluding food and energy	2.2	1.5	1.5	1.7	1.8	1.5	Jul-97
Unit labour costs	0.8	1.3	1.1	0.9	0.5		
Wage settlements (total)	0.9	0.9	1.6	1.5	1.9	1.8	Jun-97
Labour market							
Unemployment rate	9.5	9.7	9.9	9.6	9.4	9.0	Aug-97
Employment growth (%, a.r.)	1.6	1.3	1.4	1.1	3.7	4.8	Aug-97
Financial markets (average)							
Exchange rates (average)	72.88	73.34	74.06	73.61	72.14	72.21	Sep 4-97
Prime interest rate	8.65	6.06	4.83	4.75	4.75	4.75	Sep 4-97

[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.

Another factor underlying the low measured savings rate is that the national accounts underestimate the funds actually available to households. For example, capital gains on equity and bond holdings are not included in income, but they are an important part of personal wealth that continues to grow.

Investment growth continues

Business non-residential investment growth slowed from rates of 20% or more in the previous three quarters but remained impressive at 9.5%.

Especially important was that growth in non-residential construction accelerated to 10.4%, a third consecutive gain. Non-residential construction relies less on imports than spending on consumer durables or machinery and equipment investment, and thus gains there are more likely to spill over into overall economic growth and job creation. Much of the gain was in engineering construction in the oil and gas industry but there was also an increase in building construction. This is consistent with the upward revision to investment intentions in the Private and Public Investment Intentions Survey, which suggests further gains are likely in the second half.

Machinery and equipment investment rose another 9.2%, leaving it 25% higher than a year earlier.

Residential investment continued to respond to low interest rates, recording a sixth consecutive large quarterly gain. Despite a drop in housing starts in the second quarter, growth in housing construction remained strong, reflecting the strong rise in starts in the first quarter. Alterations and improvements also grew noticeably. But overall growth in residential activity was restrained by a drop in transfer costs (real estate commissions), as home resales fell for the second quarter in a row.

Inventory jump boosts growth

Inventory accumulation by business was eight times its level in the previous quarter, boosting output sharply (Chart 2). This appears to have been largely deliberate. With surging sales in the second quarter, the economy-wide inventory-to-sales ratio remained largely unchanged from the low level reached in the first quarter. Indeed, Statistics Canada's July Business Conditions Survey indicated that manufacturers are increasingly concerned about low inventories.

This suggests that further demand increases in the near term are likely to translate directly into production gains.

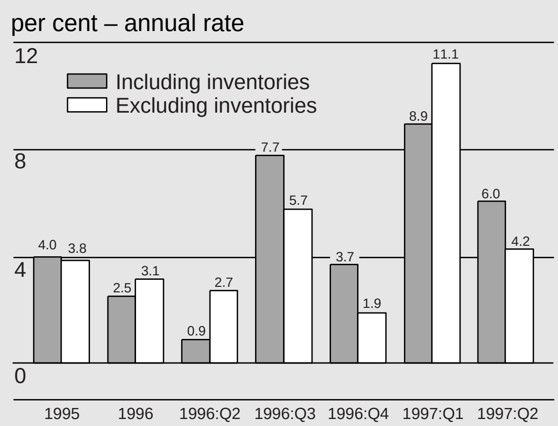
Exports rise modestly but imports jump

Rising foreign demand for Canadian products did boost exports modestly, although assembly problems played a role in restricting exports of automotive products. But import volumes continued to grow robustly, reflecting the strength in domestic demand in import-intensive areas like machinery and equipment investment and motor vehicles. With import growth exceeding that of exports, the real trade deficit on goods and services worsened by $4.3 billion.

Current account posts larger deficit

The current account deficit increased to $12.7 billion or 1.5% of nominal GDP from a deficit of $3.4 billion in the first quarter. This reflected both the widening of the real trade deficit in goods and a deterioration in the terms of trade, as the average price of imports rose while that of exports fell. The decline in the goods balance was partly offset by smaller deficits in services and investment income.

Chart 2
Growth in total demand, including and excluding inventories*



* Total demand equals final domestic demand plus exports plus inventory investment.

Prices, costs and profitability

With the economy still operating below potential, underlying price and cost pressures remain subdued. The implicit and chain price indices for GDP (Canada's broadest inflation measures) actually fell in the quarter, following modest rises in the first. This kept their four-quarter increases to less than 1.0%.

Unit labour costs were unchanged in the second quarter, after dropping in the first. On a year-over-year basis, unit labour costs were up only 0.5%.

Corporate profits jumped for a fifth consecutive quarter, to 9.1% of GDP. Higher profits have been a key source of the funds needed by firms for their increased investments in plant and equipment.

Strong employment growth

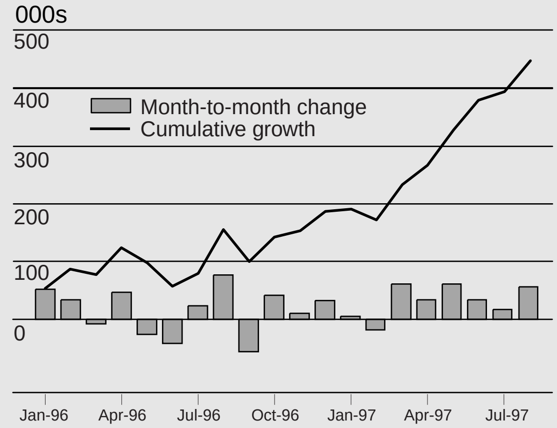
The benefits of low interest rates have spilled into the labour market. So far in 1997, over 260,000 net new jobs have been created. These were all in the private sector and roughly two-thirds were full-time. In addition, youth employment is up 52,000 since May.

With the participation rate in the labour market remaining quite steady, the unemployment rate in August was down to 9.0% from 9.7% in December 1996.

Third-quarter indicators

Available indicators for the third quarter are positive on balance. The most important indicator, employment growth, is strongly positive. With August's strong growth, even no further job gains in September would leave third-quarter employment roughly 3% above that in the second. Also, preliminary estimates show July motor vehicle sales and house resales at levels noticeably above their second-quarter averages. On the down side, despite rising in July, housing starts were below their second-quarter average.

Chart 3
Employment growth in 1996 and 1997



Interest rates remain low

Canadian interest rates remain low because of fiscal restraint by federal and provincial governments, low inflation and continuing slack in the economy. Despite the recent oscillation, short rates continue to be over 5 percentage points lower than in early 1995 while long rates are down more than 3 percentage points. Short rates, on average this year, have been at their lowest since the early 1960s.

On 3-month Treasury bills, the negative spread between Canadian and U.S. rates exceeds 2 percentage points and negative spreads have extended to bonds with 30-year maturities.

In recent months, the Canadian dollar has generally traded between 71½ and 73 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.
Also available on the Internet at http://www.fin.gc.ca/
Cet imprimé est également offert en français.