

# THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE

MARCH 1996

## KEY MESSAGES

- External trade continued to be the major source of growth in the fourth quarter of 1995, helping push the current account deficit down to its lowest level as a share of GDP in a decade. Final domestic demand, however, remained weak, with the result that real GDP increased only 0.8% in the fourth quarter and 2.2% for the year as a whole.
- Until recently, Canadian interest rates had been falling noticeably, virtually eliminating the spread in short-term rates with the U.S. However, in response to much stronger than expected job growth in the U.S. in February, U.S. rates jumped in early March, pulling Canadian rates with them. Nevertheless, interest rates remain well below their levels of a year ago.
- Recent strong gains in employment suggest that growth is strengthening in early 1996.

## SUMMARY<sup>1</sup>

Output growth was weak for the fourth consecutive quarter, with external trade continuing to be the primary source of growth. Domestic demand remained weak (Chart 1), as a sharp rise in machinery and equipment investment was largely offset by declines in most other major categories of domestic demand. Also, a decline in inventory investment again slowed economic activity.

<sup>1</sup> Unless otherwise noted, data and per cent changes are quoted at annual rates. The cut off date for data reported in this document is noon, March 11, 1996.

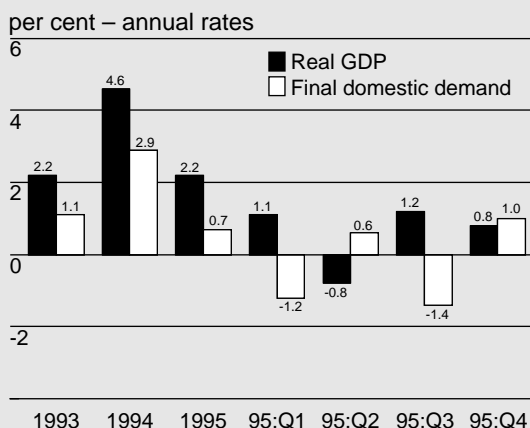
Domestic cost pressures remained subdued, whether measured by wage settlements, growth in average wages, or unit labour costs. This, combined with the weak state of the economy and declines in export prices, reduced growth in the GDP deflator (the broadest measure of inflation for Canadian-made products) from nearly 3% in the second quarter to 0.6% in the fourth.

The weak economy and waning inflation pressures have permitted a substantial easing in monetary conditions, with interest rates down sharply since early 1995.

## Household spending falls slightly

Real consumer spending decreased 0.4% in the fourth quarter. Purchases of durable goods, such as automotive products and furniture, and semi-durables fell noticeably, as consumer confidence fell to its lowest level outside of actual recessions. This was partially offset by modest spending growth on non-durable goods and services.

Chart 1  
Real GDP and final domestic demand



The drop in consumer spending, combined with a modest gain in disposable income, resulted in the personal savings rate rebounding to 7.0% in the fourth quarter from 6.5% in the third, when it was at its lowest level in the last 24 years.

In the quarter, residential investment registered its sixth consecutive decline despite a modest rebound in new-home construction. Home resales and alterations and improvements both dropped

sharply. This can be largely attributed to weak consumer confidence and the continuation of high real mortgage rates, as house prices have been declining.

### Smaller inventory accumulation again

Economic activity was slowed for the second consecutive quarter by a decline in the rate of inventory accumulation from the unsustainably

#### Main economic indicators

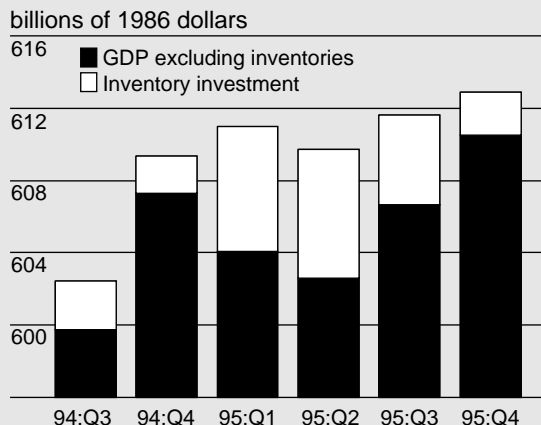
(per cent changes at annual rates or per cent levels, unless otherwise indicated)

	1994	1995	1995: Q2	1995: Q3	1995: Q4	Most recent	
Real gross domestic product	4.6	2.2	-0.8	1.2	0.8	—	
GDP excluding inventories	4.3	1.8	-1.0	2.7	2.6	—	
Final domestic demand	2.9	0.7	0.6	-1.4	1.0	—	
Government expenditure	-0.8	-0.4	-2.3	-4.4	-0.3	—	
Consumer expenditure	3.0	1.4	1.2	2.4	-0.4	—	
Residential investment	3.0	-13.8	-15.7	-7.7	-6.5	—	
Business fixed investment	9.4	5.2	9.2	-10.1	12.0	—	
Non-residential construction	5.2	-4.5	-20.7	-6.2	-7.0	—	
Machinery and equipment	11.6	10.1	26.2	-11.7	21.1	—	
Business inventory change <sup>1</sup>	0.3	0.4	0.2	-1.4	-1.7	—	
Trade balance <sup>1</sup>	1.1	1.0	-2.2	4.0	1.5	—	
Exports	14.2	11.8	-11.1	12.8	13.9	—	
Imports	10.5	9.0	-6.0	2.5	10.1	—	
Current account balance (nominal)	-22.3	-13.1	-18.9	-10.3	-5.1	—	
(percentage of GDP)	-3.0	-1.7	-2.4	-1.3	-0.6	—	
Real personal disposable income	1.1	1.2	-1.3	-1.8	1.5	—	
Profits before taxes	36.1	14.8	-7.5	3.0	-2.5	—	
Costs and prices (% y/y)							
GDP price deflator	0.6	1.8	1.8	1.9	1.9	—	
Consumer price index	0.2	2.1	2.7	2.4	2.1	1.6	Jan 96
CPI – excluding food and energy	0.1	2.2	2.5	2.7	2.3	1.7	Jan 96
Unit labour costs	-1.5	0.7	0.3	1.1	1.6	—	
Wage settlements (total)	0.3	0.9	1.1	0.9	0.7	0.6	Dec 95
Labour market							
Unemployment rate	10.4	9.5	9.5	9.5	9.4	9.6	Feb 96
Employment growth (% a.r.)	2.1	1.6	0.5	0.6	1.1	3.9	Feb 96
Financial markets (average)							
Exchange rates (average)	73.24	72.88	72.93	73.77	73.75	73.09	Mar 8/96
Prime interest rate	6.88	8.65	9.25	8.08	7.75	7.00	Mar 8/96

<sup>1</sup> Annualized change expressed as a percentage of GDP in the previous period.

Sources: Statistics Canada and the Bank of Canada.

**Chart 2**  
**Real GDP: Including & excluding inventory investment**



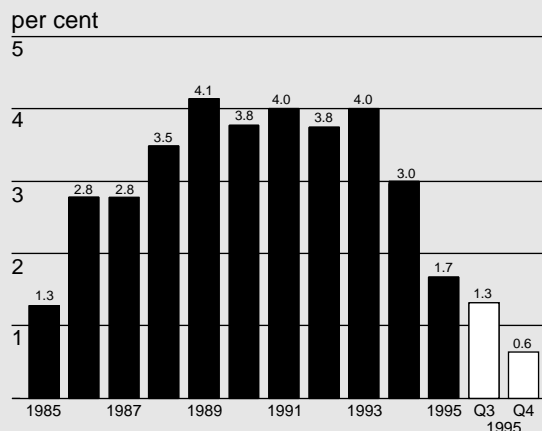
high levels earlier in the year (Chart 2). After significant increases at the beginning of 1995, this stabilized the economy-wide inventory-to-sales ratio at a level slightly above its 1994 average, when it was at a record low.

### Business investment rises

In the fourth quarter, business investment returned to the pattern evident throughout much of 1995, with healthy growth in machinery and equipment investment and significant declines in non-residential construction. For the year as a whole, machinery and equipment investment was up about 10% with the strength most evident in office equipment. Non-residential construction was a source of weakness throughout 1995, declining 4.5% for the year as a whole. The weakness was largely in engineering projects (bridges, roads, etc.).

The preliminary 1996 Private and Public Investments Intentions Survey suggests this pattern of business investment will continue in 1996, with nominal machinery and equipment investment rising slightly and non-residential construction declining substantially.

**Chart 3**  
**Current account deficit as a share of GDP**



### Current account improves sharply again

A stronger increase in exports than imports, despite slower growth in the U.S., raised the real trade surplus substantially again in the fourth quarter. This reflected the significant improvement in Canada's cost competitiveness in recent years.

With import prices falling more than export prices, the merchandise and overall nominal trade balances both rose to record levels in the quarter and for 1995 as a whole. This gain largely accounted for a halving of the current account deficit from \$10.3 billion in the third quarter to \$5.1 billion in the fourth (Chart 3). As a share of nominal GDP, the current account deficit stood at 0.6%, its lowest point in over 10 years.

### Prices, costs and profitability

Domestic cost performance remained good. Average wage settlements in the fourth quarter were 0.7%. Unit labour costs rose modestly for the fourth consecutive quarter, but remained below their 1992 level.

As well, weak economic demand and a compositional shift toward goods and services with slower price increases reduced growth in the GDP deflator (the broadest measure of inflation for

Canadian-made products) to 0.6% at annual rates in the fourth quarter from 1.9% in the third. In particular, export prices actually fell about 1% at an annual rate.

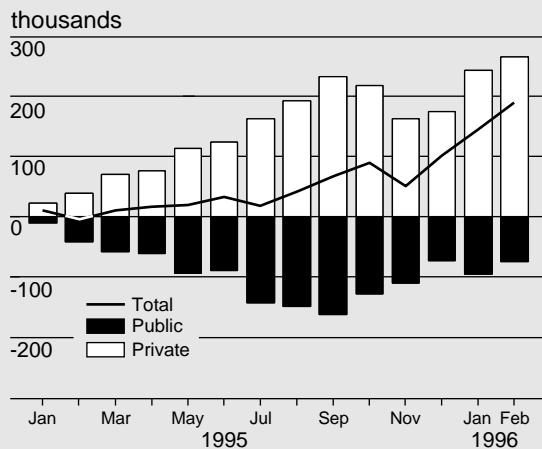
With production costs rising slightly faster than prices, corporate profits declined modestly in the fourth quarter. Nonetheless, profits increased nearly 15% for 1995 as a whole, raising their share of GDP to 8.4%, its highest level since 1989, but leaving it well below the 9.9% average from 1960 to 1994.

### Employment growth picks up

In the last three months, 137,000 net new jobs have been created. This followed a 12-month period in which only 39,000 new jobs were created. The gain since November has been mostly in the private sector, where over 100,000 new jobs were created. This recent gain continues a longer-term trend where the private sector has been the engine of job growth, but with much of the gain offset by declines in public-sector employment.

Despite the stronger employment growth in the last three months, the unemployment rate has been relatively stable at 9.6%. This reflected a pick-up in labour-force participation in response to better job opportunities.

Chart 4  
Cumulative employment change  
since December 1994



### First quarter indicators

The first quarter outlook is generally positive. The recent job gains have left the average level of employment in January and February 0.6% (quarterly rate) above the fourth quarter level. In January, house resales jumped sharply and department store sales, despite a decline in the month, remained above their fourth quarter average. Further, average sales of motor vehicles in January and February were above their fourth-quarter average. On the other hand, despite an increase of 13% in February, average housing starts in January and February were about 7% below their fourth quarter average.

### Interest rates decline

The monetary easing that began early last year halted in early March, at least temporarily, when the U.S. reported an unexpectedly large increase in employment. With that, interest rates in the U.S., especially long rates, jumped, resulting in similar increases in Canada. However, Canadian rates remained well below earlier peaks, as continuing economic weakness, low inflation, and fiscal restraint by all levels of government have put downward pressure on rates, especially short rates. Since March 1995, short rates are down over 300 basis points, with over half of that since the October referendum in Quebec. This narrowed the spread between short rates in Canada and the U.S. from about 250 in March 1995 to, at times, below 10 basis points. Spreads had not been this low in nearly a year and a half.

Long rates have fallen less than short rates, down about 190 basis points from their 1995 peaks. The recent increases, however, have left them high relative to inflation and still well above those in the U.S.

Since early October, the value of the Canadian dollar has weakened from above 75 cents U.S. to just above 73 cents U.S., partly a reflection of the narrowing spread in short-term interest rates between Canada and the U.S.

On March 8, the 3-month Treasury bill rate was 5.21% and the closing value of the Canadian dollar was 73.09 cents U.S.

