

THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE

MARCH 1997

KEY MESSAGES

- Real GDP grew 2.9% in the fourth quarter of 1996, a pace slightly below that in the third but much healthier than in 1995 and the first half of 1996. Growth was 1.5% for 1996 as a whole.
- Stronger Canadian demand was the source of strength in the fourth quarter. Final domestic demand grew at its strongest pace since the third quarter of 1987, as previous declines in interest rates fuelled significant gains in interest-sensitive expenditures. In particular, consumer spending picked up, especially on durables, while residential and non-residential investment posted strong gains. A large increase in inventory investment also added to demand for the second consecutive quarter.
- Overall, growth was held back by external trade. Imports rose with Canadian demand, especially in import-sensitive categories such as machinery and equipment. Exports fell sharply due to a weakening in foreign demand in the quarter and the disruption in Canadian motor vehicle supply by the GM strike in October. With imports rising and exports falling, the real trade balance fell \$12 billion to its lowest level since the first quarter of 1994. This pushed the current account back into a small deficit.
- Domestic cost and price pressures remained subdued.
- With employment growth continuing to lag output growth, the unemployment rate remains relatively unchanged.
- Interest rates remain well below their levels of early 1995. The cumulative drop is over 5 percentage points for short rates and 3 percentage points for long rates. The negative spreads that developed between Canadian and comparable U.S. rates of up to 10-year maturities appear to be more entrenched. The spread on 3-month Treasury bills continues to be more than 2 percentage points.

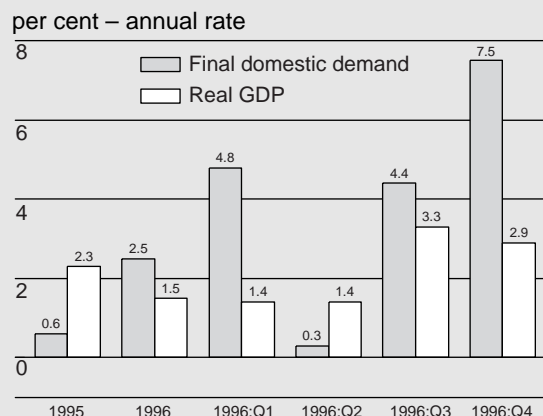
SUMMARY¹

Demand by Canadian consumers and business has gathered steam (Chart 1). Final domestic demand – spending by households, business and government on goods and services and capital formation – rose a sharp 7.5% in the fourth quarter, energized by previous declines in interest rates. Personal spending picked up, particularly on housing and interest-sensitive durables such as motor vehicles. Business non-residential investment rose significantly while a second consecutive large jump in investment in business inventories added to Canadian demand. However, external trade held back overall growth.

Domestic inflation and cost pressures remained subdued, with unit labour costs in the fourth quarter only modestly above the level of a year earlier.

¹ Unless otherwise noted, data and per cent changes are quoted at annual rates. The cut off date for data in this document is March 7, 1997.

Chart 1
Growth in final domestic demand
and real GDP



Low inflation and fiscal restraint at federal and provincial levels have allowed the sharp drop in interest rates since early 1995 to be maintained.

Household spending picks up

Real consumer expenditure in the quarter responded strongly to lower interest rates, greater wealth and a firming in consumer confidence. Spending growth was strongest in the interest-sensitive durables category.

Spending on new motor vehicles increased at its fastest pace in more than five years.

This pick-up occurred despite continued sluggishness in real personal disposable income growth. The strongest growth in labour income (6.6%) since the second quarter of 1989 was partly offset by a decline in measured personal investment income (due partly to lower interest rates), a fall in farm income (due to declines in agricultural prices), lower EI payments and

Main economic indicators

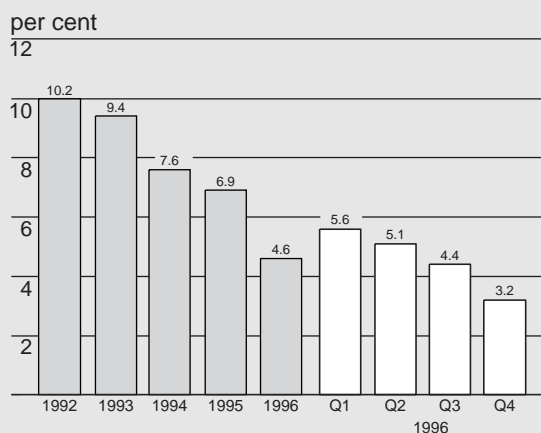
(per cent changes at annual rates or per cent levels, unless otherwise indicated)

	1995	1996	1996: Q2	1996: Q3	1996: Q4	Most recent
Real gross domestic product	2.3	1.5	1.4	3.3	2.9	—
GDP excluding inventories	2.0	2.3	3.9	0.6	0.3	—
Final domestic demand	0.6	2.5	0.3	4.4	7.5	—
Government expenditure	-0.3	-1.9	-1.8	-4.2	-0.7	—
Consumer expenditure	1.4	2.4	0.6	2.0	5.6	—
Residential investment	-15.1	11.5	35.2	19.6	22.9	—
Business fixed investment	5.2	6.6	-7.3	25.1	23.4	—
Non-residential construction	-5.6	-3.2	-0.1	0.0	5.8	—
Machinery and equipment	10.9	11.0	-10.1	36.8	30.7	—
Business inventory change ¹	0.3	-0.8	-2.4	2.7	2.6	—
Trade balance ¹	1.2	-0.2	4.5	-3.7	-7.5	—
Exports	12.0	4.5	8.4	8.6	-10.1	—
Imports	8.7	5.1	-2.2	18.8	7.4	—
Current account balance (nominal)	-11.2	-1.7	4.3	1.2	-6.8	—
(percentage of GDP)	-1.4	-0.2	0.5	0.1	-0.8	—
Real personal disposable income	1.1	-0.2	-1.8	-1.4	0.8	—
Profits before taxes	13.1	0.2	2.0	50.6	19.3	—
Costs and prices (% , y/y)						
GDP price deflator	1.5	1.3	1.0	1.1	1.6	—
Consumer price index	2.1	1.6	1.4	1.4	2.0	2.2 Jan 97
CPI – excluding food and energy	2.2	1.5	1.4	1.3	1.5	1.8 Jan 97
Unit labour costs	0.8	1.3	1.5	0.8	1.1	—
Wage settlements (total)	0.8	0.9	0.7	1.2	1.5	0.7 Dec 96
Labour market						
Unemployment rate	9.5	9.7	9.6	9.8	9.9	9.7 Feb 97
Employment growth (% , a.r.)	1.6	1.3	0.6	0.6	1.4	-1.6 Feb 97
Financial markets (average)						
Exchange rates (average)	72.88	73.34	73.29	72.99	74.06	73.28 Mar 6, 97
Prime interest rate	8.65	6.06	6.50	5.92	4.83	4.75 Mar 6, 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.

Chart 2
Personal savings rate



increased taxes. With spending rising faster than disposable income, the personal savings rate fell to 3.2%, its lowest level since 1961 (Chart 2). The personal savings rate for 1996 as a whole was 4.6%.

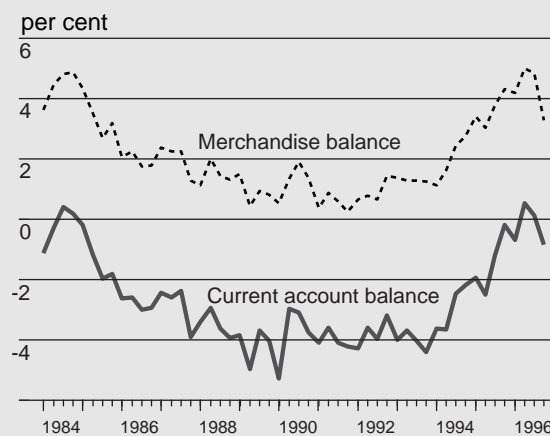
This lower savings rate has resulted from the positive impacts on spending of lower interest rates, increased wealth – including that from capital gains on equity and bond holdings that are not captured in the income and expenditure accounts – and firming consumer confidence.

Investment growth remains strong

Business non-residential investment jumped more than 20% for the second consecutive quarter. Machinery and equipment investment, which has generally been a source of strength in recent quarters, soared more than 30% after having risen nearly 37% in the third quarter. Non-residential construction rose by about 6%, led by gains in engineering works rather than commercial buildings.

Residential investment continued to respond to lower interest rates, rising nearly 23%, the fourth consecutive large quarterly gain. The gain in the fourth quarter came mostly from a strong gain in home resales, as investment in new construction fell somewhat.

Chart 3
The current account balance as a share of GDP



Inventory investment adds to growth

Another source of strength in domestic demand was a second consecutive large increase in investment in inventories. This followed a previous run-down in inventories. However, given the strong increase in demand, the economy-wide inventory-to-sales ratio is still near its lowest point ever.

Imports grow while exports weaken

The volume of imports continued to grow strongly, as domestic demand for import-intensive items like machinery and equipment was strong.

Real exports fell sharply, noticeably moderating overall economic growth in the quarter. Motor vehicle sales weakened in the United States and that, along with the GM strike, lowered Canadian exports of automotive products. Overseas demand for Canadian products also moderated in the quarter, notably in Japan.

With imports rising and exports falling, the real trade balance on goods worsened by \$14 billion to its lowest level since the second quarter of 1989.

Current account returns to small deficit

The current account moved to a small deficit in the fourth quarter from a small surplus in the third because of the deterioration in the goods trade balance (Chart 3). The deficits in services and investment income (including retained earnings) narrowed in the fourth quarter. Within services, the deficits in commercial services and travel both improved noticeably, with spending by non-residents on travel in Canada reaching a record level. The deficit in investment income improved by \$1.7 billion due in large part to a sharp rebound in interest received by Canadians from non-residents following unusually low receipts in the previous quarter.

For 1996 as a whole, the current account deficit was the smallest since 1984, both in dollar terms and as a percentage of GDP.

Prices, costs and profitability

Underlying domestic cost pressures continued to be modest. Unit labour costs in the fourth quarter were only 1.1% above their level of a year earlier.

GDP inflation (the broadest inflation measure for Canadian products) was 2.5% in the fourth quarter using the implicit price deflator, but prices were only 1.6% above their level of a year earlier. However, the increase in the chain measure of GDP inflation (Statistics Canada's preferred measure) fell to 1.2% in the fourth quarter from 1.5% in the third.

Corporate profits surged nearly another 20% after having soared over 50% in the third quarter. Gains were concentrated in the financial sector, notably at chartered banks and insurance companies. Despite these gains, the share of corporate profits in GDP (8.6%) is only about equal to its level in early 1995.

Employment lags output growth

Output has grown faster than employment in recent quarters. Real output in the fourth quarter was 2.3% higher than in the same quarter of 1995 while employment was up only 1.3%. With average

employment in the first two months of the year only slightly above the average in the fourth quarter following the loss of 19,000 jobs in February, slow employment growth has apparently continued into the first quarter.

Overall, a total of 116,000 net new jobs have been created since June 1996. With the relatively steady rate of participation in the labour market, these employment gains have brought the unemployment rate down to 9.7% in February from 10% in June.

First quarter indicators

The outlook for the first quarter is for continued growth. Business confidence remains well above its average over the last two decades according to the Conference Board of Canada. And Statistics Canada's survey of private and public investment intentions suggests non-residential investment in 1997 will increase at its fastest rate since 1994, with non-residential construction expected to reverse its declines in 1995 and 1996. Housing starts, home resales and motor vehicle production all appear to be growing strongly in the quarter.

Interest rates remain low

Fiscal restraint, the general improvement in the current account, low inflation and output below potential have allowed interest rates to decline since early 1995. Short-term interest rates have fallen over 5 percentage points while long rates have come down over 3 percentage points.

The negative spreads between Canadian and U.S. yields on bonds with maturities up to 10 years appear to have become more firmly entrenched. On 3-month Treasury bills, the negative spread remains greater than 2 percentage points.

The Canadian dollar has returned to a trading range of 72 to 74 cents U.S., a range it has been in for most of the last year, despite the emergence of these large negative interest rate spreads.

