

# THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE

JUNE 1997

## KEY MESSAGES

- Real GDP rose 3.4% in the first quarter of 1997, continuing the healthy pace set in the second half of 1996.
- Final domestic demand again grew strongly, as previous declines in interest rates continued to fuel economic activity. Interest-sensitive spending on plant and equipment, housing investment and consumer durables was especially robust.
- Real exports rebounded strongly from a drop in the previous quarter, reflecting both strong demand growth in the United States and a production rebound at Canadian GM plants after the strike in October.
- Economic growth was healthy in spite of a considerable slowdown in inventory investment as well as continued government restraint.
- From March through May, employment registered its strongest three-month gain since early 1989.
- 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 are now more entrenched. The spread on 3-month Treasury bills remains near 2 percentage points.

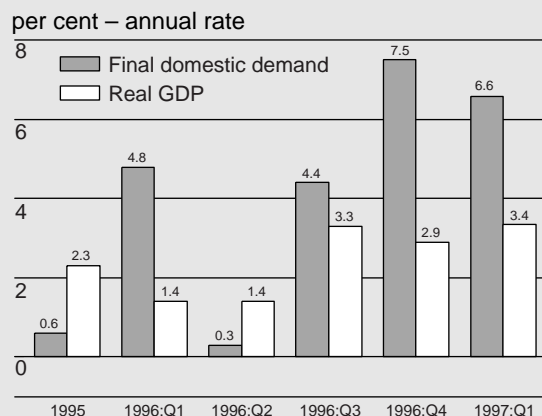
## SUMMARY<sup>1</sup>

Final domestic demand – spending by households, business and government on goods and services and capital formation – rose 6.6% in the first quarter of 1997 (Chart 1), sparked by lower interest rates. Final domestic demand has risen at a 4.7% annual rate since the end of 1995. Interest-sensitive spending on housing, furniture and appliances and motor vehicles all strengthened in the quarter. Business non-residential investment surged over 20% for the third consecutive quarter.

Foreign demand also increased noticeably, as exports rebounded from a drop in the previous quarter. However, sharply weaker inventory investment by business restrained overall growth (Chart 1).

Domestic inflation and cost pressures remained subdued, with unit labour costs in the first quarter only modestly above their year-ago level.

Chart 1  
Growth in final domestic demand and real GDP



<sup>1</sup> Unless otherwise noted, data and per cent changes are quoted at annual rates. The cut off date for data in this document is noon, June 6, 1997.

## Solid household spending growth

Real consumer expenditure in the quarter again responded to lower interest rates, increasing wealth and firming consumer confidence. Growth was strongest in the interest-sensitive categories. Spending on new motor vehicles rose sharply while spending on furniture and appliances surged 12.4%, aided by increased housing activity.

The pickup in spending occurred despite the lack of growth in nominal personal disposable income. Higher earned income was offset by declines in measured personal investment income (due partly to lower interest rates), transfers from government (due partly to the end in the previous quarter of the federal payments tied to the elimination of the *Western Grain Transportation Act* subsidy) and by increased tax revenues. The personal savings rate fell to 1.7%, its

### Main economic indicators

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

	1995	1996	1996: Q3	1996: Q4	1997: Q1	Most recent
Real gross domestic product	2.3	1.5	3.3	2.9	3.4	—
GDP excluding inventories	2.0	2.3	0.6	0.3	5.8	—
Final domestic demand	0.6	2.5	4.4	7.5	6.6	—
Government expenditure	-0.3	-1.9	-4.2	-0.7	-0.2	—
Consumer expenditure	1.4	2.4	2.0	5.6	5.2	—
Residential investment	-15.1	11.5	19.6	22.9	12.4	—
Business fixed investment	5.2	6.6	25.1	23.4	20.5	—
Non-residential construction	-5.6	-3.2	0.0	5.8	6.9	—
Machinery and equipment	10.9	11.0	36.8	30.7	25.7	—
Business inventory change <sup>1</sup>	0.3	-0.8	2.7	2.6	-2.2	—
Trade balance <sup>1</sup>	1.2	-0.2	-3.7	-7.5	-0.6	—
Exports	12.0	4.5	8.6	-10.1	23.2	—
Imports	8.7	5.1	18.8	7.4	23.8	—
Current account balance (nominal)	-7.4	3.8	6.3	-2.2	-4.9	—
(percentage of GDP)	-1.0	0.5	0.8	-0.3	-0.6	—
Real personal disposable income	1.1	-0.2	-1.4	0.8	-1.5	—
Profits before taxes	13.1	0.2	50.6	19.3	16.9	—
<b>Costs and Prices (% , y/y)</b>						
GDP price deflator	1.5	1.3	1.1	1.6	2.0	—
Consumer price index	2.1	1.6	1.4	2.0	2.1	1.7 Apr-97
CPI – excluding food and energy	2.2	1.5	1.3	1.5	1.7	1.8 Apr-97
Unit labour costs	0.8	1.3	0.8	1.1	0.8	—
Wage settlements (total)	0.9	0.9	1.2	1.6	1.5	1.6 Mar-97
<b>Labour market</b>						
Unemployment rate	9.5	9.7	9.8	9.9	9.6	9.5 May-97
Employment growth (% , a.r.)	1.6	1.3	0.6	1.4	1.1	5.5 May-97
<b>Financial markets (average)</b>						
Exchange rates (average)	72.88	73.34	72.99	74.06	73.61	72.61 June 5-97
Prime interest rate	8.65	6.06	5.92	4.83	4.75	4.75 June 5-97

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

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

lowest level in the post-Second World War period but near rates in the early 1960s when inflation and interest rates were similar to current levels.

Another factor underlying the low savings rate is that the national accounts underestimate 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 net personal wealth that continues to grow and to drive consumer spending.

### Investment growth remains strong

Business non-residential investment jumped more than 20% for the third consecutive quarter. Within that category, machinery and equipment investment soared more than 25% for the third consecutive time. Non-residential construction rose about 7% after increasing nearly 6% in the previous quarter.

Residential investment continued to respond to lower interest rates as well, rising 12.4%, the fifth consecutive large quarterly gain. This was mainly in new residential construction, as housing starts rose significantly. Alterations and improvements also grew noticeably. However, overall growth in residential activity was restrained by a sharp drop in transfer costs (real estate commissions), as home resales fell off their record levels of late 1996.

### Inventories restrain growth

Inventory accumulation by business was only about a third of its level in the previous quarter, thereby acting to restrain output growth. With sales rising noticeably, the economy-wide inventory-to-sales ratio fell to its lowest recorded level, suggesting demand increases in the near term are more likely to translate directly into production gains.

### Exports rebound but imports grow faster

Foreign demand for Canadian products rose sharply, as real exports rebounded strongly from their fourth-quarter decline. Much of this was in automotive products, where exports rose as U.S. motor vehicle sales increased significantly and Canadian production rebounded from the GM strike in October 1996.

But import volumes continued to grow strongly along with domestic demand for import-intensive items like machinery and equipment and motor vehicles. With import growth actually exceeding that of exports, the real trade deficit on goods and services worsened by about \$1 billion.

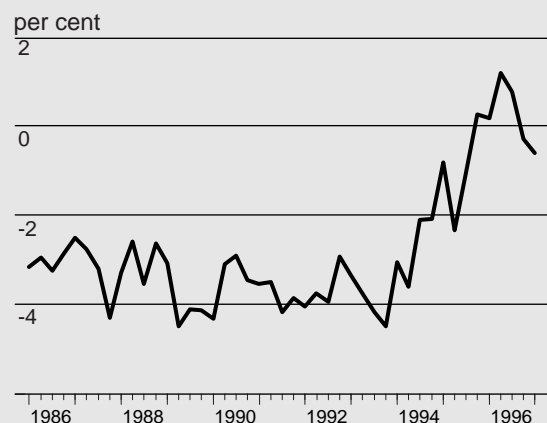
### Current account posts small deficit

The current account deficit increased to \$4.9 billion or 0.6% of nominal GDP from a deficit of \$2.2 billion in the last quarter of 1996 (Chart 2). These deficits followed four consecutive quarterly surpluses (and a surplus for 1996 as a whole, the first annual surplus since 1982). The main reason for the deterioration in the first quarter was a \$2.9 billion decline in the net investment income balance, driven by the profitability of foreign-owned firms on their Canadian operations. But that increased outflow was partly offset by smaller net interest payments, attributable to both lower interest rates and reduced borrowing from abroad.

### Prices, costs and profitability

With the economy still operating below potential output, underlying price and cost pressures remain quite low. The implicit price index for GDP (Canada's broadest inflation measure) rose 1.5% in the first quarter, following a rise of 2.5% in the fourth. This brought the four-quarter increase to 2.0%.

Chart 2  
Current account balance  
as a share of GDP



Unit labour costs declined 0.6% in the quarter, after rising 3.6% in the fourth. On a year-over-year basis, unit labour costs were up 0.8% in the first quarter.

Corporate profits surged another 17% in the quarter, for a fourth consecutive increase. Gains in the quarter were concentrated in the automotive sector, spearheaded by strong domestic demand and rebounding exports. The share of corporate profits in GDP rose to 8.8% – the highest level since mid-1989 but below the shares in the 1980s.

### Employment perks up

The benefits of low interest rates are finally spilling over into the labour market. With 61,000 net new jobs created in May, employment in that month was 156,000 more than in February, the largest three-month gain since 1989 (Chart 3). These new jobs were mostly full time and in the private sector.

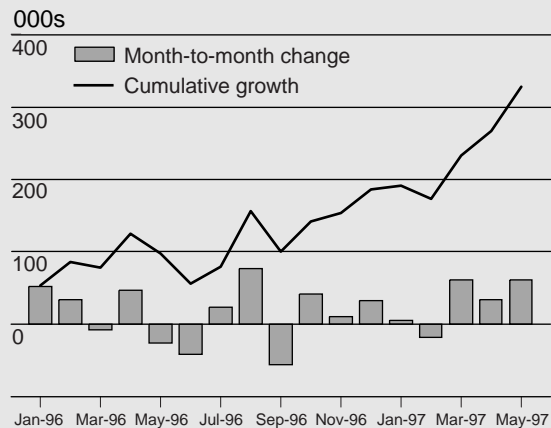
With job creation picking up in recent months, so too has participation in the labour market. As a result, the 9.5% unemployment rate in May was only modestly below the rate in February.

### Second quarter indicators

Available indicators for the second quarter are mixed but positive on balance. The most important indicator, employment growth, is strongly positive. Average employment in April and May was about 3% above the first-quarter monthly average. Motor vehicle production and department store sales in April were also above their first-quarter monthly averages.

On the negative side, available data show both house resales and housing starts to date in the second quarter have slipped below their first-quarter averages.

**Chart 3**  
**Employment growth**  
**in 1996 and 1997**



### Interest rates remain low

Fiscal restraint, by both the federal and provincial governments, a near balance in the current account, low inflation and output below potential have helped to keep Canadian interest rates low. Since early 1995, short rates have fallen over 5 percentage points while long rates are down more than 3 percentage points. Indeed, since late 1996, short rates have been at levels last seen some 35 years ago.

The negative spreads between Canadian and U.S. yields on bonds with maturities up to 10 years are now quite firmly entrenched and 30-year bond yields have moved close to parity as well. On 3-month Treasury bills, the negative spread remains near 2 percentage points.

The Canadian dollar, despite brief periods of volatility, continues to trade in the 72 to 74 cents U.S. range seen for most of the last two years, despite these large negative interest-rate spreads.