

# THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE

SEPTEMBER 1998

## KEY MESSAGES

- In the second quarter of 1998, real GDP growth moderated to an annual rate of 1.8% from 3.4% in the first quarter.
- Final domestic demand growth strengthened sharply to 5.1% in the quarter, especially for import-intensive components like consumer durables and business machinery and equipment.
- The slowing in output growth primarily reflected a sharp slowdown in inventory accumulation plus a further moderation in still strong export growth and a domestic demand shift toward imports. Excluding inventories, real GDP rose 3.7%, only slightly off the first-quarter pace.
- With imports rising faster than exports, the trade surplus declined modestly. But the investment income deficit with non-residents fell, resulting in a small improvement in the overall current account.
- Employment growth was strong during the first four months of 1998 before easing back somewhat in May and June. Growth resumed in July and August despite the negative impact of the strike against General Motors in the United States. The unemployment rate in August was 8.3%.

## SUMMARY<sup>1</sup>

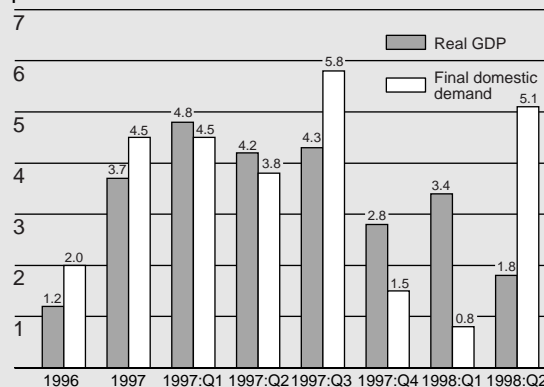
Despite much stronger final domestic demand, overall economic growth slowed in the second quarter (Chart 1). This reflected a sharp slowdown in inventory accumulation, a further modest slowdown in export growth and a shift in spending toward foreign-made products.

Domestic cost and inflation pressures remained subdued.

<sup>1</sup> Unless otherwise noted, data and per cent changes are quoted at annual rates. The cut-off date for data is noon, September 4, 1998.

Chart 1  
Growth in real final domestic demand and real GDP

per cent – annual rate



## Consumers up their spending sharply

Real consumer expenditure growth jumped to 5.5% in the second quarter from 0.6% in the first. Spending shifted toward import-intensive durables, up 24.2% after having dropped 12.4% in the previous quarter. In particular, spending on motor vehicles soared, in part as a response to dealer incentives. Demand for non-durables and services also showed solid gains.

Personal income growth was 2.2% in the second quarter, compared to 6.0% in the first.

Labour income growth moderated sharply to less than half its pace in the first quarter despite similar employment growth in the two quarters. But unlike the first quarter, when full-time jobs more than accounted for the increase, about half of the employment gain in the second quarter came in part-time work. Growth in unincorporated business income was also more or less cut in half. But investment income did

### Main economic indicators

(per cent change at annual rates unless otherwise indicated)

	1996	1997	1997Q4	1998Q1	1998Q2	Most Recent	
<b>Real gross domestic product</b>	1.2	3.7	2.8	3.4	1.8	—	
GDP excluding inventories	2.1	2.9	1.4	3.9	3.7	—	
Final domestic demand	2.0	4.5	1.5	0.8	5.1	—	
Government expenditure	-1.5	-0.7	-1.4	0.7	3.5	—	
Consumer expenditure	2.4	4.1	2.7	0.6	5.5	—	
Residential investment	10.9	13.1	8.7	-0.6	-6.4	—	
Business fixed investment	4.2	14.5	-2.0	2.7	11.5	—	
Non-residential construction	4.3	9.1	-3.1	14.2	7.2	—	
Machinery and equipment	4.2	18.7	-1.3	-4.7	14.6	—	
Business inventory change <sup>1</sup>	-0.9	0.8	1.5	-0.4	-1.8	—	
Trade balance <sup>1</sup>	0.3	-1.6	-0.6	2.3	-0.2	—	
Exports	5.7	8.0	7.3	6.3	5.3	—	
Imports	5.2	13.3	9.2	0.1	6.1	—	
<b>Current account balance</b>							
(BOP basis, nominal \$ billion)	4.5	-12.8	-18.7	-17.1	-16.9	—	
(percentage of GDP)	0.6	-1.5	-2.2	-2.0	-1.9	—	
Real personal disposable income	-0.1	-0.7	0.0	5.5	-2.0	—	
Profits before taxes	-3.4	16.2	14.8	-29.3	-9.1	—	
<b>Costs and prices (% , y/y)</b>							
GDP price deflator	1.4	0.5	-0.3	-0.5	0.0	—	
Consumer Price Index	1.6	1.6	1.0	1.0	1.0	1.0	Jul-98
CPI – excluding food and energy	1.4	1.6	1.1	1.4	1.2	1.3	Jul-98
Unit labour costs	1.3	0.1	-0.7	0.2	0.3	—	
Wage settlements (total)	0.9	1.6	1.7	1.8	1.6	1.3	Jun-98
<b>Labour market</b>							
Unemployment rate (%)	9.7	9.2	8.9	8.6	8.4	8.3	Aug-98
Employment growth	1.3	1.9	1.8	3.0	2.7	3.1	Aug-98
<b>Financial markets (average)</b>							
Exchange rates (cents U.S.)	73.34	72.24	70.99	69.92	69.13	65.00	Sep-3-98
Prime interest rates (%)	6.06	4.96	5.58	6.33	6.50	7.50	Sep-3-98

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

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

Chart 2  
The personal savings rate



jump for a third consecutive quarter. With transfers from government falling modestly and personal income taxes rising noticeably, personal disposable income was largely unchanged in the second quarter.

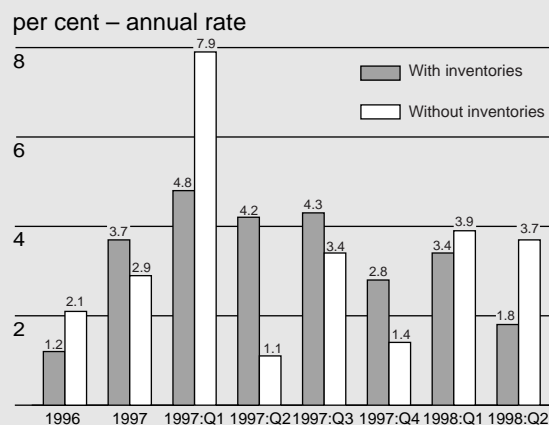
As growth in nominal personal spending exceeded that in nominal disposable income, the personal savings rate fell to -0.7%, its first-ever negative value (Chart 2). This partly reflected measurement issues. The strong gains earned by the personal sector in bond and equity markets up to the second quarter of 1998 represented income to households and likely boosted spending. However such gains are not recorded as income in the national economic and financial accounts since they are not derived from current production. But they do add to the tax liabilities of the personal sector, lowering measured disposable income.

### Strong business investment growth resumes

Business investment in plant and equipment jumped 11.5% in the second quarter. Machinery and equipment investment, notably in motor vehicles, soared 14.6% following drops in the previous two quarters. Much of this equipment was imported.

Investment in non-residential buildings and engineering projects, which is satisfied less by imports and so provides a stronger impetus to

Chart 3  
Real GDP growth with and without inventories



domestic production, grew sharply again but at only about half the pace of the first quarter. The slowdown was in engineering projects, particularly in the oil and gas industry, as declining oil and gas prices reduced the pace of growth of investment in that area. Investment in building construction, however, continued to grow strongly.

Residential investment, another category with high domestic content, fell 6.4%. There was a sharp 20.6% decline in new construction, largely reflecting the negative impact of labour strikes on housing starts in Ontario, and a modest drop in alterations and improvements. Partly offsetting those declines were soaring transfers costs (primarily real estate commissions), the consequence of sharply rising house resales.

### Inventory accumulation sharply lower

Business inventory accumulation dropped from \$10.7 billion in the first quarter to \$6.9 billion in the second, slowing overall growth (Chart 3). This was particularly noticeable for durable goods. Slower growth in overall demand and in inventories left the economy-wide inventory-to-sales ratio up marginally but still near its all-time low and well below levels in the early 1990s.

## Import growth exceeds export growth

Strong foreign demand for Canadian products boosted real exports 5.3% in the second quarter, modestly off the pace in the previous quarter, despite continuing problems in Asia. Stronger domestic demand growth, and the shift in that demand toward consumer durables and business machinery and equipment, boosted imports. As a result, real imports rose 6.1% and the real trade balance fell modestly.

## Current account deficit largely unchanged

The current account deficit fell marginally to \$16.9 billion or 1.9% of nominal GDP. This reflected an improvement in the investment income deficit that offset the deterioration in the trade balance.

## Inflation subdued while profits slump

With the economy operating below potential, underlying price and cost pressures remained subdued in the quarter.

The implicit price index for GDP, despite rising 1.1% in the second quarter, was unchanged from its level a year earlier because of previous declines. Prices have remained at year-ago levels because weakening export prices, a reflection of softening world commodity prices, have offset gains in sectors such as services.

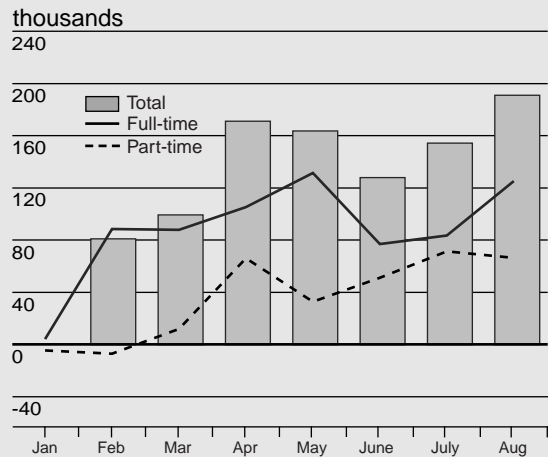
Labour costs per unit of output rose 0.7% relative to their first quarter level, reflecting a decline in labour productivity. But unit labour costs were up only 0.3% from their level of a year earlier.

Pre-tax corporate profits slumped a further 9.1% in the second quarter, to an 8.5% share of nominal GDP. This followed a very sharp 29.3% contraction in the first quarter and reflected the impact on profits of falling commodity prices and slowing economic activity.

## Job creation resumed

Employment jumped by 171,000 during the first four months of 1998 before easing back somewhat in May and June. Job creation

Chart 4  
Cumulative employment growth during 1998



resumed in July and August despite the negative impact of the strike against General Motors in the United States (Chart 4). The unemployment rate was down slightly to 8.3% in August, the lowest rate since mid-1990.

## The Canadian dollar weakens and interest rates move higher

The Canadian dollar closed at an all-time low of 63.31 cents U.S. on August 27. The dollar has been adversely affected by the Asian and then Russian crises, the fall-out on commodity prices and a market preference for assets denominated in U.S. dollars.

The Canadian dollar has since recovered somewhat to trade above 65 cents U.S. following the 1-percentage-point hike in the Bank Rate on August 27.

Short-term interest rates stand more than 2½ percentage points higher than their lowest levels during 1997. Long rates continued to fall until into July before rising modestly, but they remain slightly below their levels at the end of 1997.

With the rise in Canadian interest rates and falls in corresponding U.S. rates, Canadian rates are above U.S. rates across the maturity spectrum for the first time since March 1996.

