

# THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE

JUNE 1996

## KEY MESSAGES

- In the first quarter, final domestic demand rose at its strongest pace in over three years, with most major components strengthening. However, because of an unusually large decline in net exports, real GDP increased only modestly, continuing the slow growth which began in early 1995.
- Household spending rose sharply, reflecting employment gains in recent months and significant reductions in interest rates over the last year. Machinery and equipment investment continued to grow strongly and residential investment increased after six consecutive quarterly declines.
- Canadian short-term interest rates have dropped relative to those in the United States and are now below U.S. rates for the first time since 1983. The differential in long-term rates has also narrowed and is a full percentage point lower than in late last October.

## SUMMARY<sup>1</sup>

Final domestic demand rose sharply in the first quarter, unlike in the previous four (Chart 1), with all major components strengthening except for non-residential construction and government spending on goods and services. A rise in inventory investment also contributed to rising GDP. However, overall growth was held back by an unusually large drop in exports, which had been the primary source of growth since the recession. This decline was in part due to temporary factors such as a drawdown of inventories in the United States and a strike in the United States that disrupted Canada's automotive exports. Growth was also modestly inhibited in the quarter by a strike in the Ontario civil service.

<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 7 a.m. June 28, 1996.

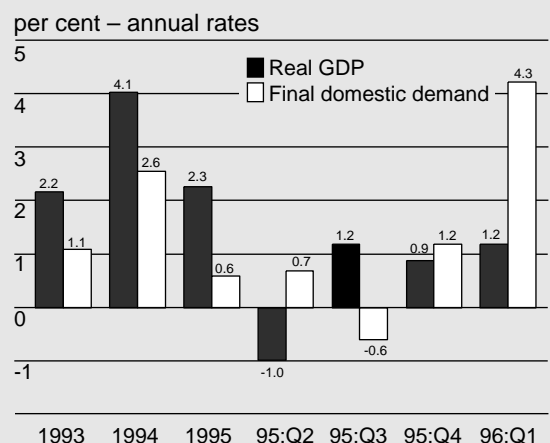
Domestic cost pressures remained subdued, as unit labour costs were more or less unchanged relative to the previous quarter. This, combined with slow GDP growth, resulted in little in the way of inflation pressure.

Low inflation, fiscal restraint at both the federal and provincial levels, reduced current account deficits and slow economic growth have permitted an easing in monetary conditions, with interest rates down sharply from levels early last year.

## Household Spending Rises Firmly

Real consumer spending increased 3.7% in the first quarter, with gains in all broad categories: durables, semi-durables, non-durables and services. A particularly strong gain was recorded in the interest-sensitive automotive category. The increased consumer confidence (as measured by the Conference Board) that accompanies lower interest rates and rising employment contributed to these gains. As disposable income rose along with spending, the personal savings rate fell only slightly to 6.4% in the first quarter from 6.5% in the fourth. However, a large part of the increase in disposable income came from buy-out

Chart 1  
Real GDP and final domestic demand



payments related to the termination of the Western Grain Transportation Act subsidy. About half of the total pay-out expected in 1996 was made in the first quarter.

Residential investment, another interest-sensitive sector, registered a sharp gain of 15.4%. This followed six consecutive quarterly declines. The strength in the quarter was in transfer costs (i.e., real estate commissions), as home resales rebounded strongly,

and in new-home construction, as housing starts increased modestly for the second consecutive quarter.

### Business Investment Rises

Business non-residential investment increased 12.0% in the quarter. This continued the pattern evident since early 1995, with very healthy growth in machinery and equipment investment and a significant decline in non-residential construction.

#### Main economic indicators

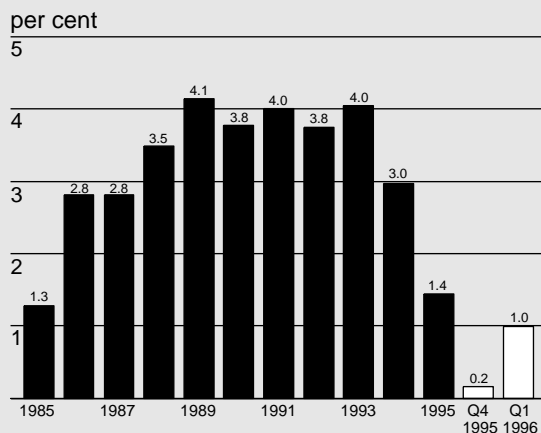
(per cent changes at annual rates or per cent levels, unless otherwise indicated)

	1994	1995	1995: Q3	1995: Q4	1996: Q1	Most recent	
Real gross domestic product	4.1	2.3	1.2	0.9	1.2	—	
GDP excluding inventories	3.6	2.0	2.2	2.6	0.0	—	
Final domestic demand	2.6	0.6	-0.6	1.2	4.3	—	
Government expenditure	-0.8	-0.3	-2.7	0.4	-0.9	—	
Consumer expenditure	2.9	1.4	2.5	0.0	3.7	—	
Residential investment	1.8	-15.1	-7.5	-7.2	15.4	—	
Business fixed investment	7.6	5.2	-7.6	10.4	12.0	—	
Non-residential construction	6.1	-5.6	-4.1	-10.4	-8.4	—	
Machinery and equipment	8.4	10.9	-9.2	20.7	21.3	—	
Business inventory change <sup>1</sup>	0.5	0.3	-1.0	-1.6	1.2	—	
Trade balance <sup>1</sup>	0.9	1.2	2.4	1.1	-3.9	—	
Exports	14.7	12.0	10.7	12.3	-6.1	—	
Imports	11.5	8.7	4.5	9.5	3.1	—	
Current account balance (nominal)	-22.2	-11.2	-9.2	-1.3	-7.8	—	
(percentage of GDP)	-3.0	-1.4	-1.2	-0.2	-1.0	—	
Real personal disposable income	0.7	1.1	-2.8	2.5	2.8	—	
Profits before taxes	34.4	13.1	-8.6	-15.3	-30.7	—	
<b>Costs and prices (% , y/y)</b>							
GDP price deflator	0.7	1.5	1.6	1.8	0.9	—	
Consumer price index	0.2	2.1	2.4	2.1	1.4	1.5	May 96
CPI – excluding food and energy	0.1	2.2	2.7	2.3	1.6	1.5	May 96
Unit labour costs	-1.3	0.8	1.3	2.1	1.8	—	
Wage settlements (total)	0.3	0.9	0.9	0.7	0.5	1.3	Apr 96
<b>Labour market</b>							
Unemployment rate	10.4	9.5	9.5	9.4	9.5	9.4	May 96
Employment growth (% , a.r.)	2.1	1.6	0.6	1.1	2.7	-1.0	May 96
<b>Financial markets (average)</b>							
Exchange rates (average)	73.24	72.88	73.77	73.75	73.04	73.36	27 June 96
Prime interest rate	6.88	8.65	8.08	7.75	7.00	6.50	27 June 96

<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.

**Chart 2**  
**Current account deficit**  
**as a share of GDP**



## A Further Inventory Accumulation

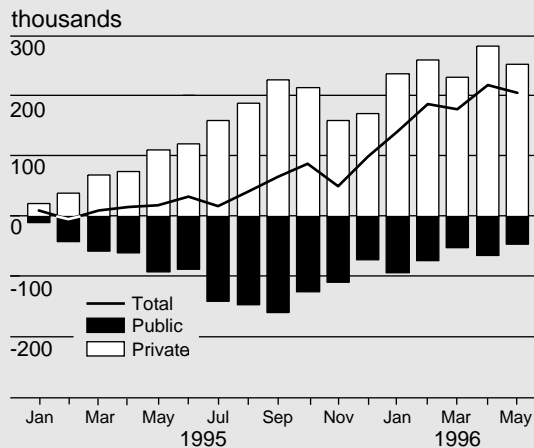
Economic activity was also boosted in the quarter by increased inventory investment. The gain, which was largely in manufacturing and especially in paper products, raised the economy-wide inventory-to-sales ratio to its highest level since mid-1993. But the ratio remains well below the levels of the early 1990s.

## Current Account Deficit Stays Low

External trade had been the engine of growth during most of the recovery, but it exerted a drag on real GDP growth in the first quarter. The real trade balance deteriorated \$6.1 billion, as imports grew with domestic demand but exports fell significantly. Some of the drop in exports can be attributed to a reduction of inventories in the United States and a strike in the United States that disrupted Canada's automotive exports. Exports were also constrained by weak growth in a number of Canada's other major trading partners, notably those in Europe.

The deterioration in the trade balance increased the current account deficit from \$1.3 billion in the fourth quarter to \$7.8 billion in the first. However, relative to GDP, the current account deficit remained near its lowest level in over 10 years (Chart 2).

**Chart 3**  
**Cumulative employment change**  
**since December 1994**



## Prices, Costs and Profitability

Domestic cost performance remained good. After growing between 2% to 3% in the previous three quarters, unit labour costs were virtually unchanged in the first, leaving them 1.8% above their level from a year ago.

GDP inflation (the broadest measure of inflation for Canadian-produced goods and services) continued to be moderate. The implicit price index for GDP actually fell in the first quarter, partly reflecting a compositional swing away from demand components with faster rising prices.

With price increases limited by slow growth, corporate profits declined for the fourth consecutive quarter, taking them 15.0% below year-earlier levels. The declines in the quarter were concentrated in non-financial industries where over two-thirds of corporations saw reductions. The decrease was particularly notable in the wood and paper industries, where prices have been falling. As a result, profit's share of GDP declined to 7.1%, remaining well below its long-run average from 1960 to 1994 of 9.9%. It remained, however, well above its trough of 4.8% set at the end of 1991 thanks to strong growth in 1994 and early 1995.

## Employment Growth Picks Up

The pace of job creation has picked up markedly in recent months. During the first 11 months of 1995, total employment rose by only 50,000. But in the following six months to the end of May 1996, 157,000 net new jobs were created. The private sector has been the engine of job growth for some time (Chart 3). Indeed, from the end of 1993 to the end of 1995, employment increased more in Canada than in all the European G-7 countries and Japan combined.

While employment growth has been strong on average in recent months, the labour force has grown at a similar pace. As a result, the unemployment rate has remained relatively unchanged. In May, it was 9.4%.

## Second Quarter Indicators

The outlook for the second quarter is positive. First, despite a decline in May that partly offset a gain of 40,000 jobs in April, average employment for those two months was 0.3% (quarterly rate) above the first-quarter average. A second positive sign is that real GDP at factor costs rose 0.5% (monthly rate) in April and was 0.4% (quarterly rate) above its first quarter average. Much of that reflected a sharp rebound in

motor vehicle production in April and the end of the civil service strike in Ontario. But motor vehicle production rose again in May, leaving the April/May average nearly 7% (quarterly rate) above that in the first-quarter. Also, in May, housing starts jumped to their highest level since January 1995.

Not all signs, however, are positive. Despite a sharp jump in May, average motor vehicle sales in April and May were below their first-quarter average. Also, surveys of manufacturers reveal growing concern about inventory levels.

## Interest Rates Decline

The monetary easing that began early last year has continued. Low inflation, fiscal restraint at both the federal and provincial levels, more modest current account deficits and slow growth have put downward pressure on interest rates, especially short-term rates. Since their peak in March 1995, short rates are down over 350 basis points. Canadian rates have fallen more than U.S. rates and now are below those in the United States for the first time since 1983. A negative spread of about 50 basis points has developed between Canadian and U.S. yields on 3-month treasury bills (Chart 4). Negative spreads have also emerged on bonds with maturities up to two years.

Long rates have fallen some 200 basis points since early 1995, which is about 100 basis points more than the decline in U.S. rates. U.S. rates have moved back up more than Canadian rates since early March and as a result, the spread with U.S. long rates recently narrowed to less than 100 basis points, a full percentage point less than in late last October. However, Canadian long-rates remain high relative to Canada's low inflation.

The Canadian dollar has traded in a fairly narrow range of 72 to 74 cents U.S. since January despite the emergence of negative interest-rate spreads at the short end.

On June 27, the 3-month treasury bill rate was 4.68% and the closing value of the Canadian dollar was 73.36 cents U.S.

Chart 4  
Canada and U.S. Government  
Bill/Bond Yield Curves (as of June 27)

