The Economy in Brief

DEPARTMENT OF FINANCE SEPTEMBER 2006

Overview

- In the second quarter of 2006 real gross domestic product (GDP) grew 2.0%, following a 3.6% gain in the first quarter.
- Real final domestic demand climbed 4.0%, led by consumer spending and business non-residential investment. However, net exports subtracted from growth, as real exports dipped 1.2%, the second consecutive decline, while imports jumped 9.4%.
- The current account surplus dropped $15.9 billion from $32.7 billion in the first quarter. At 1.2% of nominal GDP, this was the 28th consecutive quarterly surplus.
- Employment grew 3.1%, even more sharply than the 1.6% pace in the first quarter. However, the unemployment rate edged up from 6.4% in July to 6.5 % in August.

Real GDP increases 2.0%

Real GDP rose 2.0% in the second quarter of 2006, as final domestic demand continued to grow at a solid pace, but external trade subtracted from growth (Chart 1).

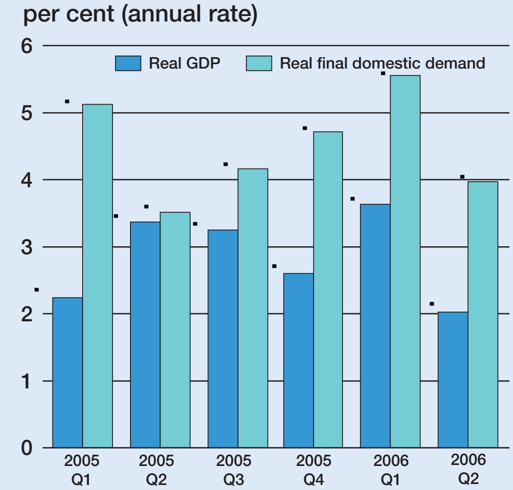
Consumer spending remains healthy

Real consumer expenditure grew 4.2% in the second quarter following an increase of 5.1% in the first (Chart 2). Spending on durables, semi-durables, non-durables and services all rose. However, growth of spending on furniture and appliances slowed with a weaker housing market and sales of motor vehicles declined after a jump in the first quarter.

Personal income dipped in the second quarter after a 12.0% jump in the first, despite a solid rise in wages and salaries and stronger employment growth than in the previous quarter. In the first quarter, a large payment to an employer-sponsored

Note: Unless otherwise noted, data and per cent changes are quoted at annual rates. The cut-off date for data is noon, September 13, 2006.

Chart 1
Growth in real GDP and real final domestic demand



Main economic indicators
(per cent change at annual rates unless otherwise indicated)

	2004	2005	2005:Q4	2006:Q1	2006:Q2	Most recent	
Real gross domestic product	3.3	2.9	2.6	3.6	2.0		–
Final domestic demand	4.2	4.3	4.7	5.5	4.0		–
Government expenditure							–
Goods and services	3.0	2.7	4.4	2.6	4.7		–
Gross fixed capital	3.3	6.8	13.4	5.4	3.7		–
Consumer expenditure	3.3	3.9	3.6	5.1	4.2		–
Residential investment	7.8	3.2	0.0	12.7	-5.2		–
Business fixed investment	9.1	9.4	11.4	8.5	7.3		–
Non-residential construction	7.4	7.9	12.0	8.2	5.5		–
Machinery and equipment	10.3	10.5	10.8	8.8	8.8		–
Business inventory investment ($ billion)	9.7	15.5	14.9	11.1	16.5		–
Exports	5.2	2.1	6.4	-3.8	-1.2		–
Imports	8.2	7.1	12.7	-1.9	9.4		–
Current account balance							
(nominal $ billion)	27.6	31.8	52.1	32.7	16.8		–
(percentage of GDP)	2.1	2.3	3.7	2.3	1.2		–
Nominal personal income	5.0	5.0	4.8	12.0	-1.5		–
Nominal personal disposable income	4.7	4.2	4.3	14.9	-2.4		–
Real personal disposable income	3.2	2.5	3.7	13.2	-4.1		–
Profits before taxes	18.3	10.6	23.6	-14.1	1.7		–
Costs and prices (%, y/y)							
GDP price deflator	3.0	3.2	4.1	3.7	2.8		–
Consumer Price Index (CPI)	1.9	2.2	2.3	2.4	2.6	2.4	July-2006
Core CPI[1]	1.6	1.6	1.6	1.7	1.8	2.0	July-2006
Unit labour costs	1.4	2.3	3.2	3.7	2.7		
Wage settlements (total)	1.8	2.3	1.7	2.2	2.7	2.5	Jun-2006
Labour market							
Unemployment rate (%)	7.2	6.8	6.5	6.4	6.2	6.5	Aug-2006
Employment growth	1.8	1.4	2.4	1.6	3.1	-1.2	Aug-2006
Financial markets (average)							
Exchange rate (U.S. cents)	77.0	82.6	85.2	86.6	89.1	89.33	12-Sep-06
Prime interest rate (%)	4.0	4.4	4.8	5.3	5.9	6.00	12-Sep-06

Note: Real values are in chained 1997 dollars.

[1] Core inflation excludes eight of the components of the CPI basket that display the greatest volatility, as well as the effect of changes in indirect taxes on the remaining components.

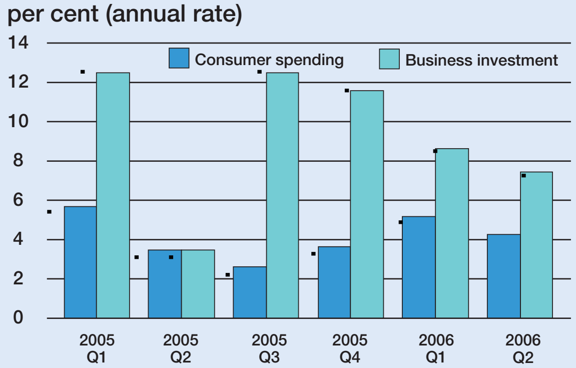
Sources: Statistics Canada, the Bank of Canada and Human Resources and Social Development Canada.

pension plan led to a large one-time increase in supplementary labour income, and three temporary programs swelled government transfers to persons. Returns to normal in these categories produced the second-quarter dip in personal income. Real personal disposable income therefore declined 4.1% in the second quarter after 15 consecutive increases. Per capita real personal disposable income fell 5.0%, but stood more than 21% above its recent trough in the second quarter of 1996. The personal savings rate was 1.0%, down from 3.0% in the first quarter.

Residential investment decreases

Residential investment decreased 5.2% in the second quarter following a 12.7% gain in the previous quarter. This first decline since the beginning of 2005 saw new construction activity drop 8.2% despite housing starts remaining above their average level in 2005. Warmer than usual weather had boosted starts in the first quarter to their highest level since 1987. House resales also fell, reducing agents' commissions and ownership transfer costs. Renovations increased 2.9%.

Chart 2
Growth in consumer spending and business non-residential investment



Business fixed investment climbs

Supported by healthy profitability, above average capacity utilization, and lower import prices due to the appreciating dollar, business spending on plant and equipment registered a 14th consecutive increase in the second quarter, up 7.3% (Chart 2). Non-residential construction grew 5.5% on the strength of a surge in engineering projects. Higher energy prices have boosted investment in oil and gas extraction. However, spending on building construction, such as office towers and shopping malls, weakened slightly.

Investment in machinery and equipment increased 8.8% for the second consecutive quarter. It climbed across the board with the exception of transportation equipment. Growth in spending on telecommunications equipment and computers was robust.

Business inventories build

Businesses added $16.5 billion to inventories, up from the $11.1-billion accumulation in the first quarter. Wholesale and manufacturing inventories increased, consistent with sagging foreign demand and a surge in imports. Retail inventories also increased, consistent with weaker motor vehicle sales. The overall inventory-to-sales ratio, however, remained low.

Exports dip again

Real exports decreased 1.2% in the quarter, the second consecutive decline (Chart 3). Exports of machinery and equipment, motor vehicles and forest products fell sharply. Weaker U.S. residential investment and business investment in machinery and equipment, in particular spending on motor vehicles, negatively affected Canada's exports in the quarter. However, energy exports jumped 25.2% and exports of services increased 6.3%.

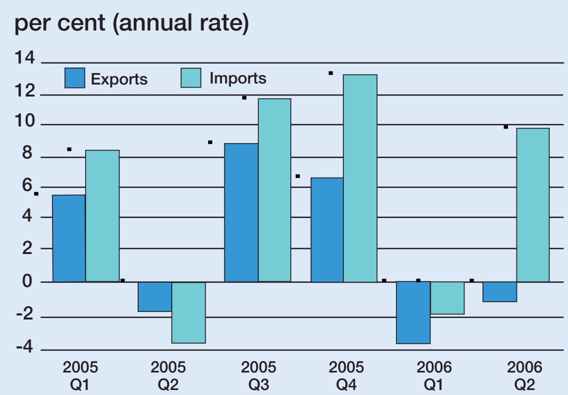
Imports increase

Real imports increased 9.4% after a 1.9% dip in the first quarter. This was the 11th gain since the end of 2002, when the Canadian dollar began to appreciate. A sharp rebound in energy imports dominated, but all major categories rose except agricultural and fish products. Machinery and equipment and consumer goods responded to increased business and household spending. Imports of services rose 10.2%.

Current account surplus shrinks

In the second quarter, the terms of trade fell as export prices declined more than import prices. The export price drop largely resulted from lower prices for commodity exports. Meanwhile, the price of energy imports rose. As a result, the nominal trade surplus dropped by $16.4 billion. The investment income deficit also worsened as profits Canadians earned on direct investments abroad weakened. The current account surplus shrank to $16.8 billion or 1.2% of GDP in the quarter.

Chart 3
Growth in real exports and real imports



Healthy corporate profits continue

In the second quarter corporate profits edged up 1.7%, maintaining their 13.7% share of nominal GDP, well above the historical average of 10.2% (Chart 4). Higher metal prices boosted mining profits while retailers' profits benefited from continued growth in household spending. However, manufacturing profits slid with exports and chartered banks' profits dipped.

Consumer price inflation remains subdued

The GDP deflator, a comprehensive measure of prices, decreased 1.1% in the second quarter, reflecting the special pension contribution in the first quarter and lower energy prices in the second quarter.

Year-over-year consumer price inflation fell to 2.4% in July from 2.5% in June and 2.8% in May, owing in part to a cut to the goods and services tax. At 2.0% in July, core CPI inflation, which excludes the eight most volatile items and the effect of changes in indirect taxes, remained in the middle of the 1%–3% inflation target.

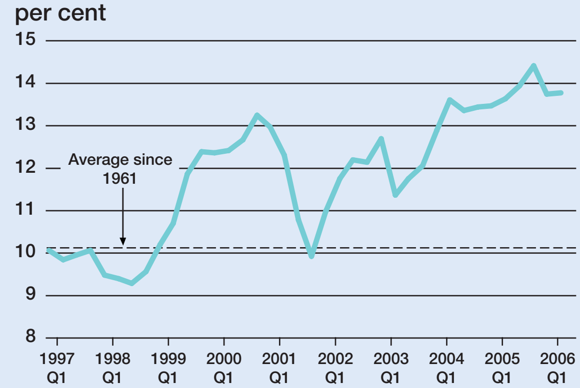
Low unemployment rate edges higher

Aided by a surge in May, employment grew a robust 3.1% in the second quarter, double the first-quarter pace. Following the May spike, employment eased in the following three months, with a loss of 26,100 jobs. As a result, since the end of 2005 the Canadian economy has created a healthy 194,100 net new jobs, all of them full-time. The participation rate stood at 67.2% in August, down from 67.3% in July.

After dropping to 6.1% in May and June, the lowest rate in over 30 years, the unemployment rate has edged higher. In August, it sat at 6.5%, up from 6.4% in July.

Hourly labour productivity decreased 1.0% in the second quarter, the first decline in two years. Productivity sat 1.2% higher than a year earlier. Affected by the special pension payment in the first quarter, labour costs per unit of output fell in the second quarter to sit 2.7% higher than a year earlier.

Chart 4
Profits before taxes as a share of nominal GDP



Bank of Canada holds policy rate steady

On September 6, the Bank of Canada held its key policy rate—the target for the overnight rate—unchanged at 4.25% for the second consecutive announcement after seven one-quarter-percentage-point increases over nine months. Expecting the Canadian economy to operate at about its production potential, the Bank stated the current level of the target rate "is judged at this time to be consistent with achieving the inflation target over the medium term." On August 8, the U.S. Federal Reserve held its policy rate unchanged at 5.25% after 17 increases that began in June 2004. U.S. rates at all maturities exceed those in Canada.

The Canadian dollar climbed to close at a 28-year high of 91.05 U.S. cents on June 12, as commodity prices remained high. It has since eased and closed at 89.33 U.S. cents on September 12.

The main source of data used in this publication is Statistics Canada. Subscription inquiries should be directed to the Department of Finance Distribution Centre at 613-995-2855. For other inquiries about this publication, contact Steven James at 613-992-4321.
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