THE ECONOMY IN BRIEF

DEPARTMENT OF FINANCE JANUARY 1998

KEY MESSAGES

- In the third quarter of 1997, real GDP grew a solid 4.1% at an annual rate. While this was off the rapid 5.4% pace set in the previous quarter (revised up from the initial estimate of 4.9%), it represents the fifth consecutive quarter of solid growth, averaging 4.0%.
- Robust domestic demand has been the main source of growth, with much of the strength coming from the positive impact of low interest rates on spending.
- Strong foreign demand raised exports. But as Canadian demand growth outpaced that of our major trading partners, and was especially strong in import-intensive goods, import growth far outpaced export growth. As a result, the trade balance fell sharply and the current account deficit widened.
- In 1997, 363,000 net new jobs were created. All were in the private sector and all were full-time.

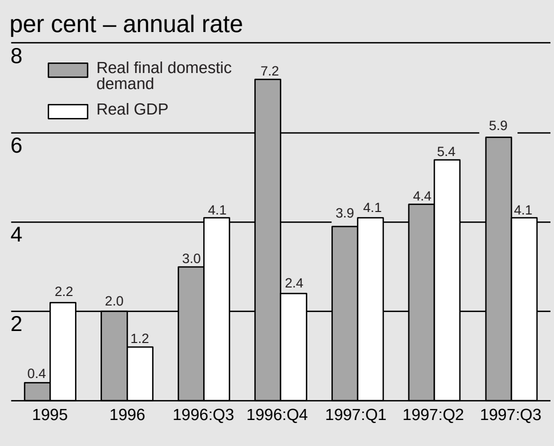
SUMMARY[1]

Strong Canadian demand again boosted growth in the third quarter. Final domestic demand – spending by households, business and government on goods, services and capital formation – rose 5.9% (Chart 1). Much of the strength was in interest-sensitive expenditures, with low interest rates fuelling strong gains in business investment in plant and equipment and consumer spending on durable and semi-durable goods.

But this demand surge was especially strong for import-intensive goods such as machinery and equipment and consumer durables and this leakage moderated the gain in production.

Domestic cost and inflation pressures remained subdued. Unit labour costs and the GDP implicit and chain price indices (the broadest measures of inflation in Canadian products) were all only modestly above their year-earlier levels.

Chart 1
Growth in real final domestic demand and real GDP



1 Unless otherwise noted, data and per cent changes are quoted at annual rates. The cutoff date for data in this document is end of day, January 9, 1998.

Consumer spending growth remains strong

Real consumer expenditure growth once again was robust, with the strongest gains in semi-durables, such as clothing and footwear, and in durables, such as recreational equipment and household furnishings and appliances. Consumers have responded positively to low interest rates, increasing wealth, rising employment and thus increased real disposable income. With solid employment gains boosting wage income, the gain in real personal disposable income in the third quarter was double that in the second quarter and the best since the end of 1995.

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

	1995	1996	1997:Q1	1997:Q2	1997:Q3	Most recent	
Real gross domestic product[1]	2.2	1.2	4.1	5.4	4.1	–	
GDP excluding inventories	1.6	2.1	7.0	2.5	3.6	–	
Final domestic demand	0.4	2.0	3.9	4.4	5.9	–	
Government expenditure	-0.5	-1.5	-1.3	1.1	1.2	–	
Consumer expenditure	1.7	2.4	3.9	4.5	5.3	–	
Residential investment	-14.1	10.9	11.4	10.6	-2.3	–	
Business fixed investment	3.0	4.2	12.7	8.2	24.5	–	
Non-residential structures	-0.7	4.3	7.9	10.8	11.6	–	
Machinery and equipment	5.9	4.2	16.4	6.4	34.4	–	
Business inventory change[2]	0.6	-0.9	-2.8	2.9	0.5	–	
Trade balance[2]	0.9	0.3	2.5	-1.8	-3.0	–	
Exports	9.3	5.7	26.9	2.7	10.1	–	
Imports	6.7	5.2	19.3	8.1	19.9	–	
Current account balance (nominal)	7.6	-3.7	3.3	14.3	23.0	–	
(percentage of GDP)	1.0	-0.4	0.4	1.7	2.7	–	
Real personal disposable income	2.0	-0.1	-3.0	0.8	1.7	–	
Profits before taxes	18.3	-3.4	26.9	6.6	20.2	–	
Costs and Prices (%, y/y)							
GDP implicit price deflator	2.6	1.4	1.5	0.8	0.4	–	
Consumer price index	2.1	1.6	2.1	1.6	1.7	0.9	Nov-97
CPI – excluding food and energy	2.2	1.5	1.7	1.8	1.5	0.9	Nov-97
Unit labour costs	1.2	1.3	0.8	0.1	0.2		
Wage settlements (total)	0.9	0.9	1.3	1.8	1.3	1.7	Oct-97
Labour market							
Unemployment rate	9.5	9.7	9.6	9.4	9.0	8.6	Dec-97
Employment growth (%, a.r.)	1.6	1.3	1.1	3.7	3.3	5.4	Dec-97
Financial markets (average)							
Exchange rates (average)	72.88	73.34	73.61	72.14	72.21	69.92	Jan 9-98
Prime interest rate	8.65	6.06	4.75	4.75	4.75	6.00	Jan 9-98

1 Historical revisions have changed the levels and composition of gross domestic product but left the aggregate growth rate broadly similar.

2 Annualized change expressed as a percentage of GDP in the previous period.

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

Nominal consumer spending rose even faster than disposable income, pushing the personal savings rate down again to 1.5%, its lowest recorded level (Chart 2). However, this low savings rate partly reflects the fact that the National Accounts income measure does not include some wealth increases such as capital gains on equity and bond holdings. This is relevant because such wealth has been growing and boosting spending.

Investment growth strengthens

Business investment in plant and equipment increased 24.5%, the fifth consecutive quarter of strong growth. Low interest rates, rising profits and strong equity markets have improved businesses' ability to invest at the same time as an increased rate of capacity utilization had created a need for new investment. The rate of capacity utilization in non-farm sectors rose to 86.2% in the third quarter, its highest rate since the 86.8% in 1988 and more than four percentage points above its historical average.

Machinery and equipment investment accelerated sharply to 34.4% in the third quarter from 6.4% in the second to reach 23.1% above its level of a year earlier. Especially important was that growth in non-residential structures accelerated to 11.6% to stand 11.5% above its level a year earlier. Investment in such structures, unlike machinery and equipment investment and spending on consumer durables, has little leakage to import. Thus, gains there are more likely to spill over into overall economic growth and job creation.

But residential investment fell 2.3% after six consecutive large quarterly gains. Despite a rise in housing starts in the third quarter, growth in new housing construction fell as the drop in starts in the second quarter led to less construction activity in the third. Growth was also restrained by falling real estate commissions. However, alterations and improvements grew strongly.

Inventory increase boosts growth

Business inventory accumulation increased by almost $1 billion in the third quarter. This contributed to growth but much less than did the larger increase in accumulation in the second quarter. This inventory build-up appears to have been deliberate, as surging sales have reduced the economy-wide inventory-to-sales ratio to an all-time low. That suggests that further demand increases in the near term are likely to translate directly into production gains.

Exports jump but imports soar

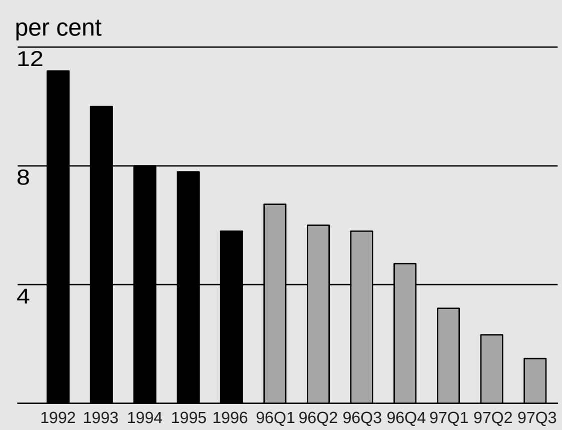
Strong foreign demand for Canadian products sharply boosted exports in the third quarter. But as Canadian demand growth outpaced that of our major trading partners, and was especially strong in import-intensive goods, total import growth far outpaced export growth (19.9% versus 10.1%) and the real trade balance fell sharply by $6 billion (1992 dollars).

Prices, costs and profitability

With the economy still operating below potential, underlying price and cost pressures remain subdued. The conventional implicit price index for GDP fell 0.4% in the third quarter, a third consecutive decline that left it only 0.4% above its level of a year earlier. The chain price index (Statistics Canada's preferred indicator) shows more inflation, but still rose to only 1.1% above the year-earlier level.

Unit labour costs were down 0.4% in the third quarter, after falling 1.0% in the second. On a year-over-year basis, unit labour costs were up only 0.2% in the third quarter, aided by solid gains in productivity.

Chart 2
The personal savings rate



Pre-tax corporate profits increased 20.2% in the third quarter, the fifth consecutive quarterly gain. This raised the share of corporate profits in GDP to 9.6% – the highest level in eight years. The gains were led by rebounding profits in the petroleum and natural gas and automotive sectors. These higher profits have helped business to finance investments in plant and equipment.

Current account posts larger deficit

The current account deficit increased to $23 billion or 2.7% of nominal GDP from a deficit of $14.3 billion in the second quarter. This reflected both the widening of the real trade deficit in goods, a slight deterioration in the terms of trade (as the average price of imports fell less than did the average price of exports) and a worsening in the investment income balance by about $2.7 billion.

Strong employment growth

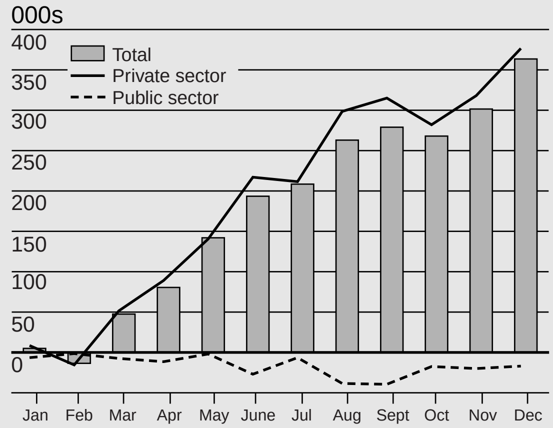
The benefits of low interest rates have spilled into the labour market. During 1997, 363,000 net new jobs were created (Chart 3). These were all in the private sector and all were full-time. The year ended on a strong note, with 111,000 full-time jobs created in December.

The unemployment rate in December was 8.6%, down from 10% in late 1996 and the lowest level since September 1990. And since late 1996, the unemployment rate has fallen in every province.

Fourth quarter indicators

Available indicators to date for the fourth quarter are mixed but generally positive. The most important indicator is employment growth and it shows employment in the fourth quarter was 0.4% (quarterly rate) above that in the third quarter. Current estimates of housing starts, manufacturing shipments, motor vehicle production, and motor vehicle and department store sales, and overall real output all point to continued growth at this time. But house resales and exports appear to be restraining growth.

Chart 3
Cumulative employment growth during 1997



Interest rates rise but remain low

Canadian short-term interest rates have risen about 130 basis points since mid-September, coinciding with downward pressure on the value of the Canadian dollar that partly reflects the uncertainty in world financial markets given developments in Asia. But rates remain low by historical standards because of fiscal restraint by federal and provincial governments, low inflation and continuing slack in the economy. Short and long rates both continue to be around 4 percentage points lower than in early 1995.

On 3-month Treasury bills, the negative spread between Canadian and U.S. rates has narrowed to around 1 percentage point. Negative spreads with U.S. rates still extend, at times, to bonds with 30-year maturities.

Recently, the Canadian dollar has been trading near 70 cents U.S.

The main source of data used in this publication is Statistics Canada. Subscription inquiries should be directed to the Distribution Centre (613) 995-2855. For other inquiries about this publication, contact Jeremy Rudin (613) 992-2370.
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