

Canadian High Commission



Haut Commissariat du Canada

Macdonald House
1 Grosvenor Square
LONDON W1X 0AB

June 1, 1988

Dear Charles

Further to our telephone conversation, I am enclosing some material on the Canadian economy for use in preparing Mrs Thatcher's speech to Parliament on June 22. We will also chase up Derek Burney in case he has any other material that may be helpful.

Yours very truly


R Roy McMurtry
High Commissioner

Mr Charles Powell
Private Secretary to the
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Prime Minister's Office
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LONDON SW1A 2AA

The Economy in Brief

A Quarterly Publication of the Department of Finance

March 1988

Highlights of the Fourth Quarter

- Real gross domestic product (GDP) rose at an annual rate of 6.3% in the fourth quarter. Final domestic demand expanded by over 7%, outpacing real GDP for the sixth consecutive quarter. For 1987 as a whole, real output grew by 3.9% - substantially faster than was anticipated by most forecasters last year.
- Business non-residential investment spending in real terms was the most buoyant component of final domestic demand during the quarter, increasing by 30%. For the year, business investment rose 9.2% and is expected to grow even more rapidly in 1988, according to the Private and Public Investment Intentions (PPI) Survey just released.
- Consumer price inflation slowed throughout the second half of 1987. Inflation in the fourth quarter was lower in Canada than in the United States. Labour cost increases remained moderate in 1987.
- Employment surged 4.2%, or by 486,000 jobs, in 1987 and the unemployment rate declined 1.6 percentage points during the year to 8.1%. Another 95,000 jobs were created in January and February and the unemployment rate fell to 7.8%.
- The Canadian dollar has gained steadily against the U.S. dollar over the last year, reaching above U.S. \$0.79 in February. On a trade-weighted basis, the dollar has also appreciated, although less so. By early March, the dollar had moved above U.S. \$0.795.

Summary

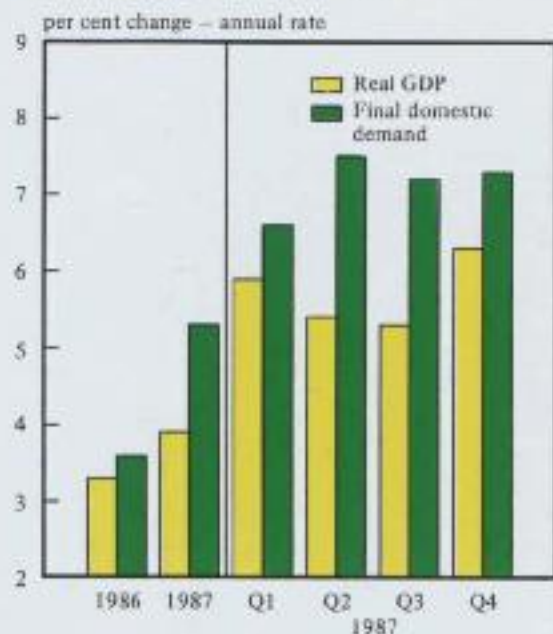
The Canadian economy performed very well in 1987. Growth in real output (GDP) was 6.3% at annual rates in the fourth quarter, bringing real GDP to a level 5.7% higher than a year earlier. On average for the year, real GDP expanded by 3.9%. The strength in 1987 was clearly reflected in labour markets as employment posted another sharp increase. The unemployment rate dropped from 9.7% at the beginning of 1987 to 8.1% by year-end.

The strength of the Canadian economy in 1987 was domestically based, and this trend continued in the fourth quarter (Chart 1). Neither consumption nor investment showed any evidence of a negative effect from the October stock market decline. Consumer spending was up sharply in the fourth quarter, and real business non-residential investment soared 30%.

Over the last four quarters, real business investment has risen 19%. According to the March 1988 PPI survey by Statistics Canada, business investment spending in real terms is expected to register a double-digit increase on average in 1988.

Chart 1

Real Gross Domestic Product and Final Domestic Demand



Canada

Chart 2
Nominal Business Non-Residential Investment Intentions (March PPI)

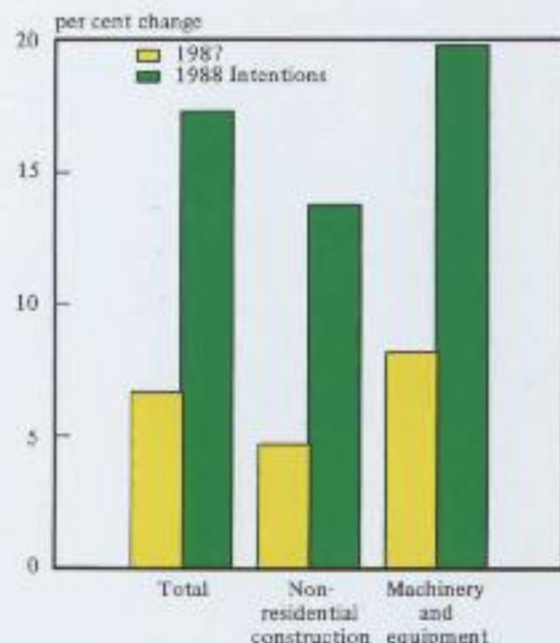
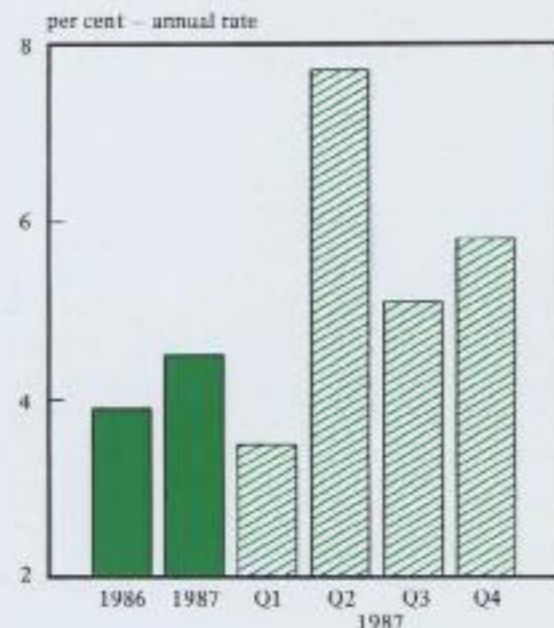


Chart 3
Change in Real Consumer Expenditure



Residential investment decreased during the quarter as housing starts were down from the very strong pace of the previous two quarters. A significant part of the previous pent-up demand that has driven housing starts to record levels has now been satisfied in some parts of the country.

The continued strength of final domestic demand, particularly business investment spending, was reflected in a significant decrease in the merchandise trade surplus as growth in imports outstripped strongly increasing exports. While a strong terms of trade improvement dampened the impact on the current account, the current account deficit, nevertheless, increased to a record level in the fourth quarter.

Business non-farm inventory investment increased \$4.5 billion in the final quarter of last year, but the inventory-to-sales ratio remained at its trend level. Farm inventory investment, on the other hand, fell \$0.7 billion to \$0.5 billion.

In 1987, consumer prices increased 4.4%, a rate of growth only slightly higher than in the previous three years. After rising sharply to 4.8% in June, consumer price increases moderated throughout the second half of last year to 4.1% in January of 1988. Moderate labour cost increases, slower energy and food price increases and the strength of the Canadian dollar all served to contain and lessen inflationary pressures.

Robust Business Investment

Business non-residential investment spending in real terms continued to rise at double-digit rates in the fourth quarter, with both non-residential construction and machinery and equipment investment climbing 30%. The current rapid growth in investment is being fueled by a sharp turnaround in corporate profits. Indeed, the share of profits in total GDP rose to its highest level since before the recession. Investment growth is expected to increase in 1988, according to the March PPI Survey by Statistics Canada (Chart 2). Nominal investment expenditures are expected to grow 17.3% in 1988, after a 6.7% increase in 1987, with a strong pick-up in growth in both the resource and non-resource sectors. The broadening of investment growth among sectors and regions is expected to continue in 1988. Indeed, for the first time since 1981, all major sectors and regions are expected to increase nominal investment spending in 1988.

Consumption Remains Strong

Real consumer expenditure growth continued to contribute very strongly to growth in final domestic demand during the fourth quarter, dispelling fears that the stock market decline would lead to a severe retrenchment of spending (Chart 3). Durable goods spending growth slowed somewhat from an over 10% increase in the previous quarter, but there was a strong pick-up in non-durable goods spending. Nevertheless, growth of personal disposable income exceeded consumer expenditure growth for the first time in four quarters, leading to a rise in the personal savings rate to 8.9% in the fourth quarter from 8.5% in the previous quarter.

Deterioration of the Current Account

The substantial increase in final domestic demand in 1987, particularly the boom in business investment spending, resulted in a further deterioration of the current account balance. The merchandise trade surplus in real terms decreased \$1.5 billion to \$17.2 billion as a result of very strong growth of imports of finished products, especially motor vehicles, and machinery and equipment. However, Canada's terms of trade improved by 2% during the year, the first yearly increase since 1982. Even though the rise in the terms of trade dampened the effect of the lower trade volume, the current account deficit still averaged \$9.6 billion, slightly larger than in 1986. While the trade balance with the United States worsened in 1987, the deficits with the European Economic Community and Japan improved markedly.

Dollar Strengthens

The Canadian dollar appreciated against the U.S. dollar throughout 1987, closing the year at U.S. \$0.77, a gain of 4 1/2 cents U.S. The dollar rose a further 2 cents in January and February, bringing the Canadian dollar to over U.S. \$0.79 and, by early March, the dollar was consistently above U.S. \$0.795. This strong increase in the dollar reflects increased confidence in Canada's economic prospects as well as attractive yields on investment. Since the beginning of 1987, the Canadian dollar has appreciated 8.8% against the U.S. dollar and 5.2% against a trade-weighted (G-10) currency basket (Chart 4).

Main Economic Indicators

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

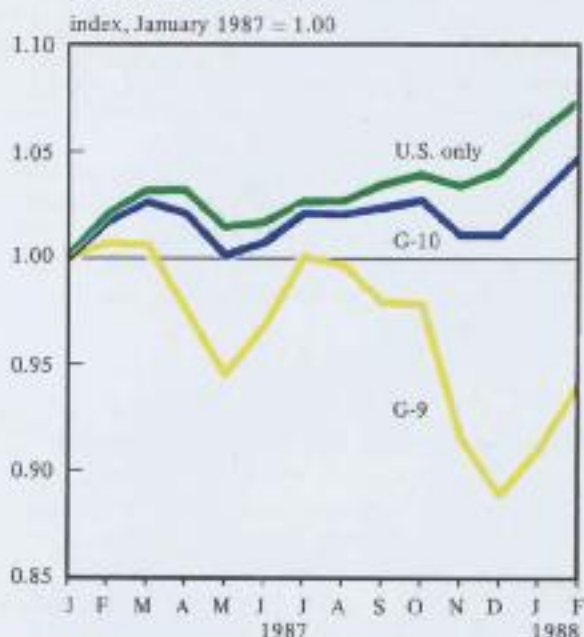
	1986		1987		1987			
	1986	1987	Q3	Q4	Q1	Q2	Q3	Q4
Real gross domestic product	3.3	3.9	0.4	0.0	5.9	5.4	5.3	6.3
Final domestic demand	3.6	5.3	4.7	1.4	6.6	7.5	7.2	7.3
Consumption	3.9	4.5	7.1	0.3	3.5	7.7	5.1	5.8
Residential construction	14.9	14.9	13.6	12.3	23.1	17.9	15.6	-4.5
Business fixed investment	2.2	9.2	-3.1	3.3	13.8	10.7	22.0	30.0
Non-residential construction	-8.2	1.6	-22.0	-1.2	10.5	9.4	12.8	30.4
Machinery and equipment	11.5	14.8	13.2	6.5	16.0	11.6	28.3	29.7
Business inventory investment (\$b, a.r.)	3.6	1.9	3.1	1.3	1.1	0.2	1.1	5.0
Non-farm (\$b, a.r.)	1.7	1.8	0.9	0.1	0.8	-0.0	1.0	5.5
Trade balance (\$b, a.r.)	16.6	13.6	16.2	16.4	17.2	16.1	13.1	8.0
Current account balance (\$b, current, a.r.)	-9.3	-9.6	-8.4	-11.7	-6.4	-7.8	-10.3	-14.0
Incomes								
Real personal disposable income	1.1	2.1	-4.1	2.7	3.3	3.0	1.5	8.1
Profits before taxes	-4.8	25.3	5.9	38.0	26.7	35.8	20.2	22.7
Costs and prices (% Y/Y)								
GDP price deflator	3.0	4.6	2.5	3.2	4.2	4.8	4.7	4.6
Consumer price index	4.1	4.4	4.2	4.3	4.0	4.6	4.6	4.2
CPI - energy	-7.1	2.6	-9.7	-13.0	-9.8	4.1	8.1	9.9
CPI - excluding food and energy	5.3	4.6	5.4	5.6	5.1	4.4	4.4	4.3
Unit labour costs	3.0	2.8	2.3	3.7	3.1	3.4	2.8	1.7
Labour market								
Unemployment rate	9.6	8.9	9.6	9.5	9.6	9.1	8.7	8.2
Employment	2.9	2.8	-0.3	2.2	3.3	4.5	2.9	4.9
Financial developments								
Exchange rate - closing (U.S. cents)	72.44	76.96	72.07	72.44	76.60	75.08	76.26	76.96
Prime interest rate (end of period)	9.75	9.75	9.75	9.75	8.75	9.50	10.00	9.75

Sources: Statistics Canada and the Bank of Canada.

The Economy in Brief

Chart 4

Canadian Dollar Exchange Rate Against the U.S. and Overseas Currencies



Inflation Continues to Decline

The consumer price index (CPI) advanced 4.1% on a year-over-year basis in January, down slightly from 4.2% in December and well below the 1987 peak of 4.8% posted in June. For the year as a whole, CPI inflation averaged 4.4%. Unit labour cost increases remained moderate throughout 1987, in part as a result of healthy (1.1%) productivity gains. Year-over-year increases in unit labour costs have fallen sharply in the past three quarters to a three-year low of 1.7%. Increased costs of raw materials, especially non-ferrous metals and wood, put some upward pressures on producer prices during the year. At the same time, the appreciation of the Canadian dollar against the U.S. dollar has contained inflationary pressures.

Further Decline in the Unemployment Rate

Employment increased by a substantial 486,000 jobs in 1987, the best year of job creation

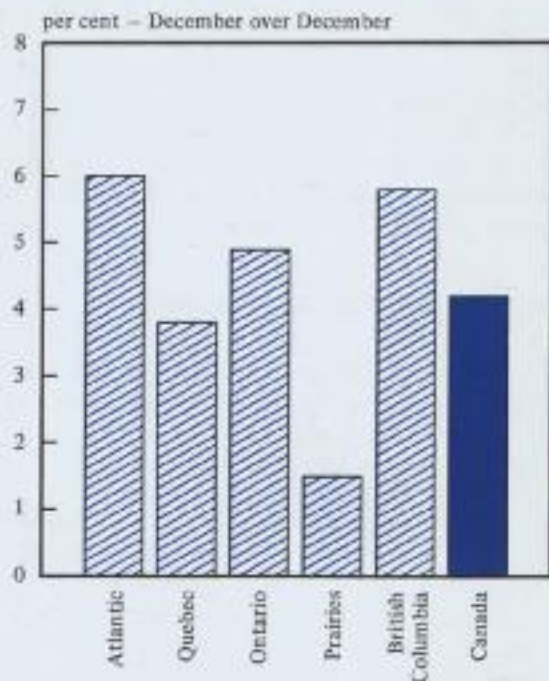
in the 1980s. In spite of a marked increase in labour force growth during the year – the participation rate reached record levels – the unemployment rate dropped 1.6 percentage points over the year to 8.1% in December. Employment gains in 1987 were spread more evenly among industries and regions compared to 1986, with the largest increases in British Columbia and the Atlantic region (Chart 5). In the first two months of 1988, an additional 95,000 jobs were created and the unemployment rate fell to 7.8% in February.

Stock Prices Firming

In the four months following the stock market downturn, stock prices have firmed in both Canada and the United States. The firming of stock prices reflects lower interest rates, renewed institutional purchases and dwindling concerns in the market about a possible recession.

Chart 5

Employment Growth in 1987



This publication summarizes the *Quarterly Economic Review* available from the Canadian Government Publishing Centre, Supply and Services Canada, Ottawa, K1A 0S9 (819-997-2560) at an annual subscription rate of \$20.00. The main source of data used in this publication is Statistics Canada. For inquiries on information in this publication, contact M. Kennedy (613-996-0336). Cet imprimé est également offert en français.



The Fiscal Monitor

A Publication of the Department of Finance

March 1988

Highlights of Financial Results for April - December 1987

- In the first nine months of fiscal year 1987-88, the federal deficit, at \$17.7 billion, was \$2.9 billion lower than in the corresponding period in 1986-87.
- Accompanying the strong economic performance in 1987, particularly the robust advances in employment and profits, revenues increased by 10.5 per cent on a year-over-year basis.
- Total spending was up 4.4 per cent on a year-over-year basis, with program spending increasing 4.3 per cent and public debt charges increasing 4.8 per cent.
- The increase in program spending continued to be influenced by large increases in spending under various agricultural assistance programs, particularly the Special Canadian Grains Program and the Western Grain Stabilization Program.

Summary

In the first nine months of fiscal year 1987-88 (April to December), the budgetary deficit was \$17.7 billion, down \$2.9 billion from the level registered in the first three quarters of 1986-87. This year-over-year improvement in the deficit reflects the strength in the Canadian economy in 1987, which has resulted in increased budgetary revenues and has continued to moderate the growth in budgetary expenditures. As well, the deficit, on a year-over-year basis, continued to be influenced by the timing of various receipts and payments, especially in the areas of public debt charges and major transfer payments, and the ongoing impacts of actions taken to control expenditures.

Non-budgetary transactions, in the first three quarters of 1987-88, provided the government with a net source of funds amounting to \$1.3 billion, compared to \$2.9 billion in the same period of 1986-1987. Financial requirements, excluding foreign exchange transactions, were \$16.4 billion, down \$1.3 billion on a year-over-year basis. Foreign exchange transactions gave rise to a net source of funds amounting to \$0.5 billion in the first nine months of 1987-88, whereas in the comparable period in 1986-87 there was a net

requirement of \$0.6 billion. Thus, total financial requirements, including foreign exchange requirements, stood at \$15.9 billion, down \$2.3 billion from the level recorded in the same period of 1986-87.

**Federal Deficit
1986-87 and 1987-88
Year to Date**

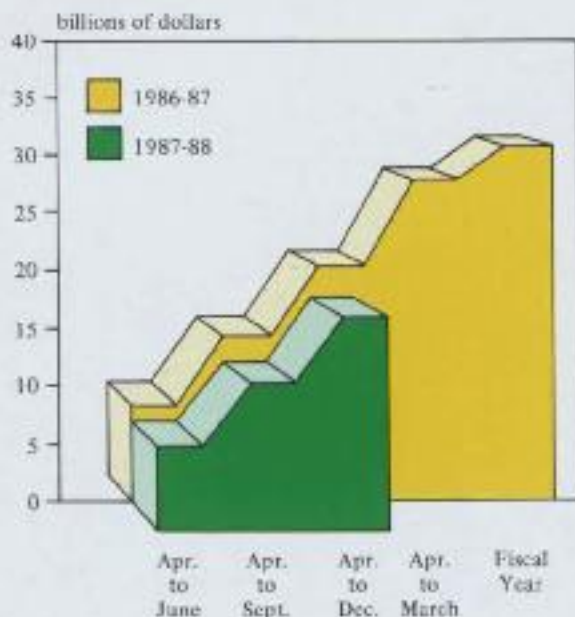


Table 1

Summary Statement of Transactions

	April to December		Per cent change
	1986-87	1987-88	
	(millions of dollars)		
A. Budgetary transactions			
1. Revenues	62,095	68,641	10.5
2. Expenditures	82,677	86,309	4.4
3. Deficit	-20,582	-17,668	-14.2
B. Non-budgetary transactions			
4. Loans, investments and advances	630	174	
5. Specified purpose accounts	4,945	5,577	
6. Other transactions	-2,667	-4,494	
7. Net source (+) or requirement (-)	2,908	1,257	
C. Financial requirements (excluding foreign exchange transactions)	-17,674	-16,411	
D. Foreign exchange transactions: net source (+) or requirement (-)	-553	471	
E. Total financial requirements	-18,227	-15,940	
F. Unmatured debt transactions	16,994	14,466	
G. Cash balance at end of period	3,511	3,145	

Table 2

Budgetary Revenues and Expenditures

	April to December		Per cent change
	1986-87	1987-88	
	(millions of dollars)		
A. Budgetary revenues			
1. Personal income tax	28,121	31,917	13.5
2. Corporate income tax	5,837	6,921	18.6
3. Unemployment insurance contributions	7,190	7,623	6.0
4. Sales and excise taxes/duties	15,743	16,744	6.4
5. Other revenues	5,204	5,436	4.5
6. Total budgetary revenues	62,095	68,641	10.5
B. Budgetary expenditures			
1. Statutory programs			
- Old age security benefits	10,047	10,680	6.3
- Unemployment insurance benefits	7,339	7,190	-2.0
- Established Programs Financing*	6,708	6,560	-2.2
- Fiscal transfers	4,736	5,265	11.2
- Canada Assistance Plan	3,044	3,269	7.4
- Family allowances	1,895	1,916	1.1
- Other	4,156	5,031	21.1
- Total statutory programs	37,925	39,911	5.2
2. Non-statutory programs			
- Defence	6,555	6,606	0.8
- Other	17,780	18,403	3.5
- Total non-statutory programs	24,335	25,009	2.8
3. Total program expenditures	62,260	64,920	4.3
4. Public debt charges	20,417	21,389	4.8
5. Total budgetary expenditures	82,677	86,309	4.4

* Cash portion only. Including the tax portion, total entitlements are expected to grow by 5 per cent.

Budgetary Revenues

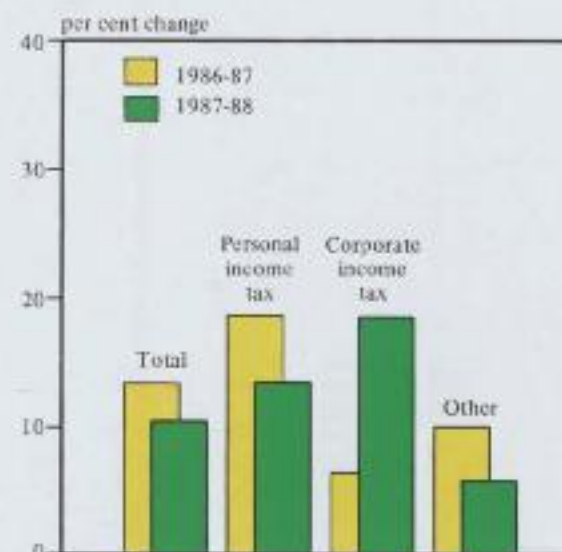
Strong advances in personal and corporate income tax receipts, along with the inclusion of the proceeds from the sale of Teleglobe Canada, underlie the growth in budgetary revenues during the first nine months of 1987-88. The robust year-over-year increases in personal and corporate income tax collections reflect, in large measure, the strength in economic activity in 1987, particularly the significantly higher levels of employment and corporate profits. The year-over-year growth in personal income tax collections was also affected by the first prepayment of a portion of the refundable child tax credit in November 1986, which had dampened collections in 1986-87. Significantly higher employment levels, coupled with an increase in maximum insurable earnings, underlie the strength in unemployment insurance contributions.

Sales and excise tax receipts were up 6.4 per cent over the same period in 1986-87. The impact of strong growth in consumer and business expenditures on sales and excise tax collections was dampened, to a certain extent, by a number of discretionary actions. These actions included the final round of tariff rate reductions as specified under the 1979 Multilateral Trade Negotiations Agreement, the reductions in the quarterly indexation factor on the sales tax rate for gasoline and diesel fuel as well as the elimination of the Petroleum and Gas Revenue Tax, effective October 1986. The sale of Teleglobe Canada accounts for all of the year-over-year increase in the other revenue component, as the other elements within this component recorded a decline.

Budgetary revenues collected over the April to December period are consistent with the February 1988 budget projection for the fiscal year as a whole. Differences in growth rates between the current year-to-date results and those for the year as a whole largely relate to timing considerations. For example, the April to December increase in personal income tax collections is somewhat less than that projected in the February 1988 budget for the fiscal year as a whole. This difference is due to the impact of accelerating the receipt of personal income tax deductions at source from large employers in the final quarter of 1987-88, which is expected to result in a one-time increase in revenues of \$1.2 billion. This acceleration of source

Budgetary Revenues: 1986-87 and 1987-88

April to December Year-Over-Year Growth



deductions impacts on large employers only and has no effect on an individual's personal income tax liability.

Budgetary Expenditures

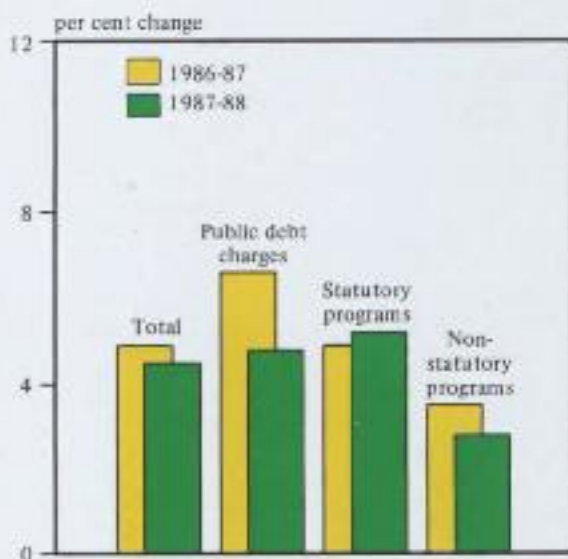
On a year-over-year basis, budgetary expenditures increased by 4.4 per cent over the first nine months of fiscal year 1987-88. Public debt charges increased by 4.8 per cent while program spending was up by 4.3 per cent, or \$2.7 billion. Of the increase in program expenditures, nearly \$1.6 billion was due to higher expenditures under the various agricultural assistance programs.

Statutory programs are largely demand-driven, or formula-funded, with changes reflecting developments in economic activity and the underlying population bases. This component of government spending, which accounts for about two-thirds of total program spending, increased by 5.2 per cent in the first nine months of 1987-88 compared to the same period in 1986-87. The increase in old age security payments was due to increases in both the eligible population base and in the level of benefits, which are indexed to quarterly changes in the consumer price index. The impact on the equalization formula of strong increases in overall provincial revenues accounted for most of the increase in fiscal transfer payments. Final payments to farmers under the Western Grain

The Fiscal Monitor

Budgetary Expenditures: 1986-87 and 1987-88

April to December Year-Over-Year Growth



Stabilization Act with respect to the 1986 crop year and increased payments to railways under the Western Grain Transportation Act account for the large advance in the "other" statutory program spending category. Unemployment insurance benefit payments were below those recorded in the previous fiscal year, reflecting the lower levels of unemployment. Although the total federal contribution to provinces under Established Programs Financing arrangements is up by about 5 per cent, direct cash payments to provinces declined on a year-over-year basis, as the impact of strong growth in income tax revenues resulted in higher transfers through the tax system.

The payment to farmers in the first quarter of 1987-88 under the Special Canadian Grains Program accounted for virtually all of the increase in non-statutory program spending in the first nine months of 1987-88. Spending on the remaining components of this category remained restrained largely due to the phasing-out of the Petroleum Incentive Program and the actions that the government has undertaken to control direct operating costs.

Timing considerations account for the difference in growth rates between the year-to-date increase in budgetary expenditures and that projected for the fiscal year as a whole, as set out in the February 1988 budget. Payments of \$1.1 billion under the second Special Canadian Grains Program were announced in December 1987, of which \$800 million is to be paid in the final quarter of 1987-88. In addition, as announced in the February 1988 budget, approximately \$250 million of expenditures originally targeted for 1988-89 will be brought forward into 1987-88. Higher interest rates in the last half of 1987 will continue to exert upward pressure on public debt charges. Payments under various native programs and foreign aid are also expected to pick up in the last quarter of the fiscal year.

Financial Requirements

Non-budgetary transactions in the first nine months of 1987-88 resulted in a net source of funds amounting to \$1.3 billion, compared to \$2.9 billion in the comparable period of 1986-87. This lower source of funds was due to a number of factors, including lower loan repayments by the Farm Credit Corporation and the impact of lower interest rates on the interest and unmaturing debt accounts.

On a year-over-year basis, financial requirements, excluding foreign exchange transactions, declined by \$1.3 billion to \$16.4 billion during the first nine months of 1987-88, as the improvement in the budgetary deficit of \$2.9 billion more than offset the reduction in net funds from non-budgetary transactions. Foreign exchange transactions provided a net source of funds of \$0.5 billion, compared to a net requirement of \$0.6 billion in the first nine months of 1986-87. As a result, total financial requirements in the first nine months of 1987-88 stood at \$15.9 billion, down \$2.3 billion from that reported during the comparable period in fiscal year 1986-87. This was financed by net borrowing, primarily in the form of Canada Savings Bonds and other marketable bonds, of \$14.5 billion and a \$1.5 billion drawdown in cash balances.

The information in this Monitor is based on preliminary financial statements for the month ending December 31, 1987. For further information contact: L.A. Langlois 996-7397 or P. DeVries 996-7380. Cet imprimé est également offert en français.

