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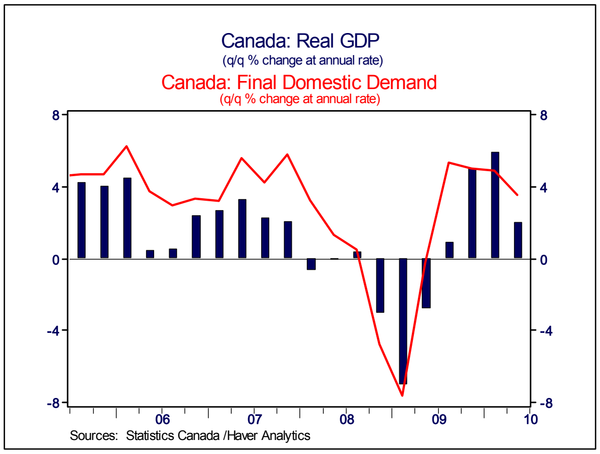
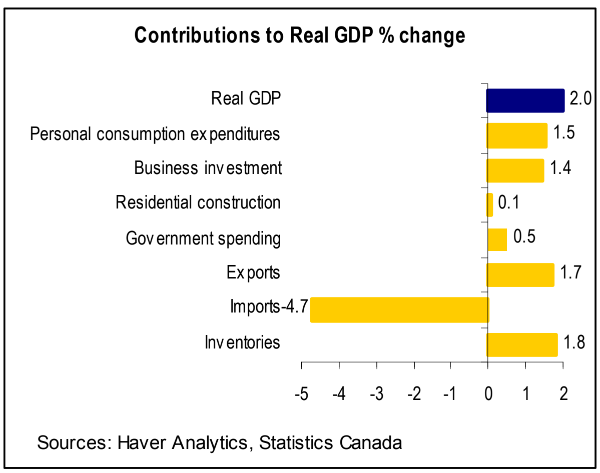
Q2 GDP Growth: More Than Meets the Eyes





As expected, economic activity advanced at a slower pace in the second quarter. After surprising most markets participants in the first quarter with robust growth of 5.8% (annualized quarterly change), the real GDP posted weak growth of 2.0% by the end of Q2 and a scant 0.2% from May to June. While these results are weaker than the 2.5% anticipated, growth in real activity in Canada in the second quarter was stronger than in the US (1.6%). Domestic demand outpaced the real GDP by 3.5%, partly owing to corporate investments in machinery and equipment.

First, household contribution to growth was weaker in Q2 2010 at 1.5 percentage points compared to 2.5 points in Q1 2010. Strong job creation in Q2 2010, at 175,000, did not necessarily translate into increased personal spending. Consumption grew a tepid 2.6% after three straight quarters of approximately 4% growth. Residential construction was also weaker than in previous quarters. In fact, following the withdrawal of some temporary factors that prompted Canadian households to push ahead with major projects, such as new home purchases or renovations to existing homes, residential construction edged up only 1.2% after surging more than 20% in Q4 2009 and Q1 2010. Lastly, disposable income grew substantially in the second quarter – 15% – the biggest increase since Q1 2006 as a result of lower income taxes for individuals (-39%). The renovation tax credit gave Canadian taxpayers bigger tax refunds in Q2 2010 for the 2009 taxation year. As such, the savings rate jumped from 3% in Q1 2010 to 5.9% in Q2 2010, the highest rate in 10 years. And yet households did not bump up their spending, opting instead to hold on to this additional money and reduce their demand for credit. Indeed, household borrowing fell from $102B to $91B – which reflects the reversal of the upward trend in debt that began in Q1 2009.

Businesses, for their part, upped their investments in machinery and equipment by a whopping 30%, the sharpest increase since the end of 1996. Moreover, they also finally straightened out their nonresidential investments (1.0%) after six straight quarters of declines. This contribution by businesses to economic growth, 1.4 percentage points – almost equal to that of households – bodes well for a more balanced economic recovery, even if it remains modest. In addition, the stock accumulated by businesses has more than doubled, helping to boost the real GDP by 1.8 percentage points. The value of inventories has soared from $6B to $13B, another sign that businesses are confident about the economic recovery, especially manufacturers who have increased their stock for the first time since Q4 2008.

With such lively domestic demand, seeing imports outpace exports once again is not much of a surprise. On one hand, investments in machinery and equipment made by Canadian companies literally propelled imports higher by more than 16%. On the other, the growth in the external economy, especially in the US, was less favourable for Canadian exports, which posted growth of only 6%.

All in all, this quarterly report on national accounts suggests that we are not immune from the US economy's weak performance. While it remains difficult to foresee a sharp growth in exports, domestic demand will continue to stimulate the economy and households' ability to manage their personal finances should see real consumption advance quite nicely in the medium term. In short, while today's report may seem disappointing at first glance, a more in-depth analysis shows some encouraging signs that should allow Governor Carney to raise the policy rate from 0.75% to 1.00% on September 8, 2010. That said, the downsize risks weighing on the real economy south of the border are such that further rate increases beyond that scheduled for September 8 are not foreseeable for at least the next six months.

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