Economy takes a breather; rate hike seen 'sooner rather than later'

By David Parkinson
December 1, 2017 – *The Globe and Mail*

The Canadian economy moderated in the third quarter of the year, taking a breather from its blistering pace of earlier in the year, as exports and home construction slowed while consumer spending continued to drive growth.

Statistics Canada reported that Canada's real gross domestic product grew at an annualized pace of 1.7 per cent in the quarter, on a seasonally adjusted basis, less than half of the growth rate that the economy posted in each of the first two quarters of the year. Economists had expected the pace to slow to more sustainable levels in the latest quarter, following a second-quarter growth spurt of 4.3 per cent. (The second-quarter figure was revised down slightly from an originally reported 4.5 per cent.)

The third-quarter growth rate was the slowest since the 2016 second quarter. Nevertheless, it marked the fifth consecutive quarter of growth for the Canadian economy, the longest streak since 2014.

"Canadian growth was always poised to cool after a monster first half," said Canadian Imperial Bank of Commerce economist Nick Exarhos in a research note.

However, real GDP in September, the final month of the quarter, grew 0.2 per cent month over month, slightly better than economists had expected. The increase, reversing August's 0.1-per-cent decline, marked the strongest performance since June, and indicated that the economy was regaining momentum entering the final quarter of the year.

The third-quarter slowdown was primarily due to a steep 10.2-per-cent annualized decline in exports, which reversed course after having been a key driver of growth in the second quarter. Exports look to have been weighed down by a less favourable exchange rate for the Canadian dollar, which rose more than 10 per cent against the U.S. dollar between early June and mid-September, spurred by rising interest rates from the Bank of Canada.

Meanwhile, investment in residential structures fell 1.4 per cent annualized, evidence of a cooling in key housing markets following regulatory changes designed to raise the bar on mortgage approvals and slow foreign investment.

On the other hand, household consumption remained a strong driver of the economy, up a better-than-expected 4 per cent annualized. And investment in non-residential structures, machinery and equipment rose at a 3.7-per-cent annualized pace, evidence of continued strong business investment – considered a key element in sustaining Canada's current economic expansion.

"Aside from the drop in exports, the news was mostly good," said David Madani, senior Canadian economist at Capital Economics, in a note to clients.

"All told, we wound up with a much more 'normal' pace of growth, consistent with an economy entering the mature phase of the economic cycle," said Brian DePratto, senior economist at Toronto-Dominion Bank, in a research report.

The third-quarter growth was just slightly below the 1.8 per cent that the Bank of Canada had estimated in its most recent quarterly Monetary Policy Report, released in late October. In the same report, the central bank projected that growth in the fourth quarter would pick up to a 2.5-per-cent pace.

Economists said the solid September growth rebound puts the economy on a good track to come close to the central bank's target.

"The data is still pointing to a slowing in underlying GDP growth from the outsized pace from mid-2016 to mid-2017, but is also still fully consistent with our – and the Bank of Canada's – view that growth will be sustained at a modestly above-trend 2 per cent pace going forward," said Royal Bank of Canada senior economist Nathan Janzen in a research report.

The slowdown in the third quarter has fuelled considerable speculation about how long the Bank of Canada might delay its next rate increase, after raising rates twice during the second quarter. But the 1.7-per-cent growth pace is still above the central bank's estimate of "potential output growth" – the rate at which it believes the economy can grow without triggering rising inflation, a critical concern for a central bank that relies on inflation targeting to guide its rate decisions. Expectations of a modest acceleration in growth in the fourth quarter indicates that the economy continues to perform above potential, which will add inflationary pressure and keep the central bank on track to raise interest rates further next year.

Economists said the Bank of Canada will likely take particular note of wage data in the GDP report, as rising wages are typically a key catalyst for inflation. Employment compensation grew at a brisk 5.2-per-cent annualized pace in the quarter, its strongest growth in three years.

The strong wage indicators came at the same time that Statscan also reported, in a separate release, that employment surged by 80,000 jobs in November, and unemployment fell to a nine-year low of 5.9 per cent – further indication that a strong labour market could accelerate inflation in the coming months.

Economists said that while the Bank of Canada remains unlikely to raise rates at next Wednesday's rate announcement, the GDP and jobs report, taken together, put a January rate hike squarely on the table.

"Today's reports all support another rate hike coming sooner rather than later," Mr. DePratto said.