Canada: Excess Production Capacity Is Quickly Being Absorbed

As the Bank of Canada (BoC) mentioned in its May 24 statement, “the BoC’s three measures of core inflation remain below 2% and wage growth is still subdued, consistent with ongoing excess capacity in the economy.”

That said, even though it’s undeniable that the Canadian economy still has excess production capacity, many signs point to it being gradually absorbed. Real GDP’s annualized quarterly growth has held steady at an average of close to 3.5% since mid-2016. This pace is well above the growth potential, which the BoC established at between 1.0% and 1.6% for 2017. As such, the negative output gap in place since the Great Recession of 2008–2009 was absorbed fairly quickly. The average of the two BoC measures went from -2.1% in the second quarter of 2016 to only -0.8% in the first quarter of 2017.

The same phenomenon was observed in the industrial capacity utilization rate for the Canadian economy, which returned to 83.3% in the first quarter of 2017. The utilization rate has thus moved above its historical average for the first time since the Great Recession.

In the labour market, although certain measures indicate that salary growth remains relatively weak, the situation could change. The larger unemployment rate\(^1\), which includes discouraged searchers, waiting workers and involuntary part-time workers, fell again in May, reaching its lowest level since October 2008.

**IMPLICATIONS**

The gradual absorption of excess production capacity is good news for the Canadian economy. However, it implies that upside pressure on prices could sharpen in the coming years. In these conditions, and with its very expansionist monetary policy, the BoC will eventually have to steel itself to reduce economic growth stimulus. However, there are still major uncertainties surrounding the economic outlook, and weakness in core inflation provides good flexibility in managing monetary policy. That should convince the BoC to extend the status quo on its key interest rates for some time.

\(^1\) After seasonal adjustments.