TD Economics

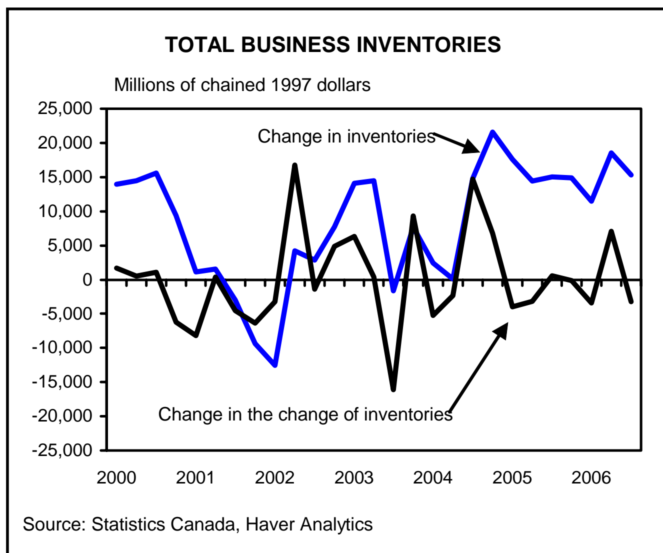
Special Report

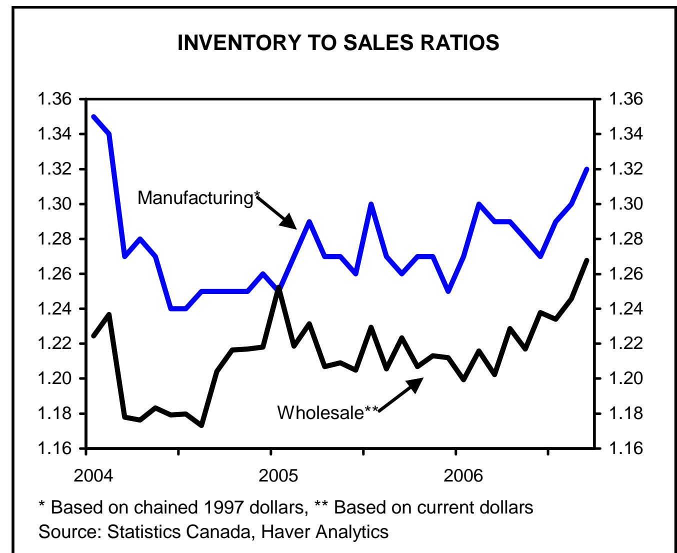
December 1, 2006

A MEA CULPA AND OUTLOOK FOR INVENTORY INVESTMENT IN CANADA

In yesterday's commentary for Canada's third quarter gross domestic product (GDP) many economists (ourselves included) erroneously noted that inventory investment had fallen in the third quarter of 2006. However, a more careful read of the release from Statistics Canada reveals inventory investment remained positive in Q3 but increased at a slower rate than in the previous quarter. The cause of this mix-up can be parsed equally between the analysts who pour through the 37 page document in a very short period of time and Statistics Canada who have provided a less-than clear footnote for the relevant line item.

Inventory investment is a tricky component of GDP to wrap one's head around. Unlike the other components such as consumption and business investment, it is the change in inventories that matters for GDP. With the objective of measuring the total output of an economy, including the change in inventories covers the situation where a firm is unable to sell all it produces. While the sales are counted as consumption, the remainder ends up being added to inventories which is included in GDP. The added complexity arises when you want to estimate the growth of GDP. Since inventory investment is already measured as a change in the level of GDP, the change of the change is what matters for the growth of GDP. It was the change of the change that Statistics Canada reported in the table which we thought was just the change.





At the end of the day, the implication for economic growth remains the same as the lower pace of inventory investment shaved approximately a percentage point from real GDP growth in Q3. While part of this deceleration may reflect a reaction to the run-up in the previous quarter, it is possible that given the strength observed in con-

sumption, production may have been insufficient to meet the demand, necessitating a dip into inventories. Taken at face value, this suggests that inventories may be rebuilt in the final quarter of the year and therefore lead to a bounce back in real GDP growth. However, this view is tempered by the fact that inventory to sales ratios remain elevated relative to previous quarters, suggesting that firms may be unwilling to invest more in their inventory positions. As a result, real GDP growth in Q4 may not see the same type of recovery that typically follows periods of slower inventory investment. The most likely scenario, especially given the weak -0.3% handoff in September, is that real GDP growth remains around the 2.0% mark in the final quarter of the year.

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