TD Economics

Topic Paper

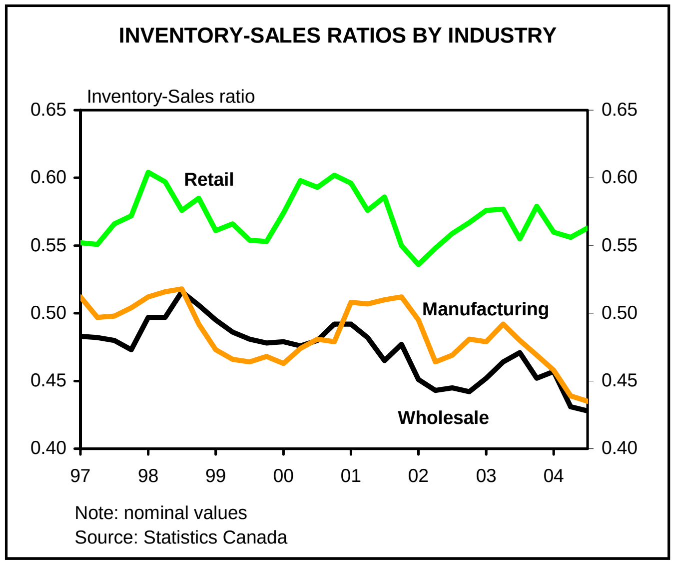
January 19, 2005

THREE REASONS INVENTORIES WILL LIFT THE ECONOMY IN '05

Despite a substantial third quarter surge, the level of business inventories in Canada was, on the whole, quite low in 2004. But all of this appears about to change: based upon three key drivers, we think 2005 should bring stronger inventory accumulation than recent years, boosting the level of business inventories out of the cellar. This, in turn, will help create the conditions necessary for moderate economic growth in Canada.

1) Inventory-sales ratio quite low

The present level of real business inventories sits at just 66.0 per cent of sales, the fourth lowest quarterly ratio on record (dating back to 1997), and well below the average of 69.4 per cent for that period. True, the inventory-sales ratio has exhibited a generally declining trend over the past eight years, likely reflecting greater supply-chain efficiency. But the present inventory stock as tracked by Statistics Canada is sufficiently depressed, even factoring in the underlying declining trend, as to point to a probable rebound in the ratio in the not-too-distant future. This observation holds true for both manufacturers and wholesalers, but not for retailers, who have an inventory-sales ratio little changed from 1997 (see chart).



2) The counter-cyclical inventory-sales ratio

As the Canadian economy decelerates over the next few quarters while adjusting to a stronger currency, we are likely to observe a cyclical rise in the inventory-sales ratio, a normal occurrence during periods of slower demand (see chart). Of course, from a mathematical perspective, as the denominator weakens, it shouldn't come as much of a shock that the ratio goes up. But this does tell us something useful – that inventory accumulation is less volatile than overall economic growth. For example, when the growth of demand (GDP less inventories) slows markedly, the growth in inventory accumulation normally only slows slightly, and with a modest lag. This corresponds to the idea that inventories act as a sort of overflow tank for suppliers who cannot instantaneously respond to the ebbs and flow of their customers.

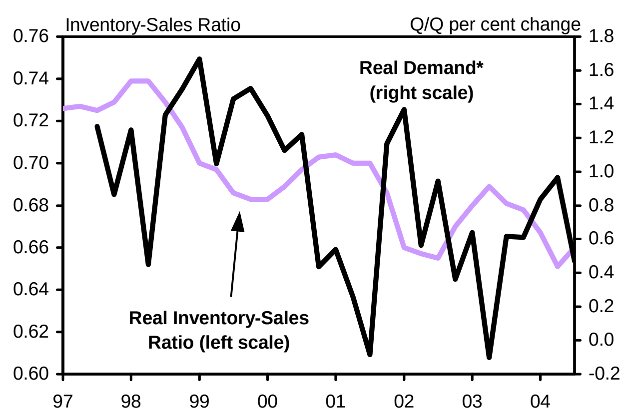
3) The import-inventory link

We have observed that a change in the value of merchandise imports exhibits a tight correlation with a change in the value of inventory accumulation (as illustrated by the accompanying chart). The elasticity between the two appears to be roughly 0.25 – in other words, every dollar increase in imports tends to be matched by a twenty-five cent increase in inventory accumulation. This makes a great deal of sense: when imports grow sharply, the overall economy is unlikely to be able to fully absorb the increase, and so a proportion must become inventory. A second link, with causality in the opposite direction, is that as inventory levels become undesirably low, businesses seek to replenish them by relying not just upon domestic products, but also upon imported products. The short of it is that by observing imports, we can speak with some insight into inventories (and vice-versa).

This intertwined relationship between imports and inventories has been acutely visible of late. In the third quarter of 2004, surging imports seemed destined to squeeze the life out of Canadian GDP growth, but ended up being neutralized by a huge run-up in inventories. Applying the knowledge of this relationship to the final quarter of 2004, the fact that imports appear to have plummeted (partly because of the unprecedented run-up in the previous quarter) does not necessarily signal stronger economic growth. This is because we believe a downward offset likely materialized in the form of weaker inventory growth, both due to the previously illustrated correlation with imports plus as a counterbalance against the prior quarter's largest surge in inventory accumulation in over two years.

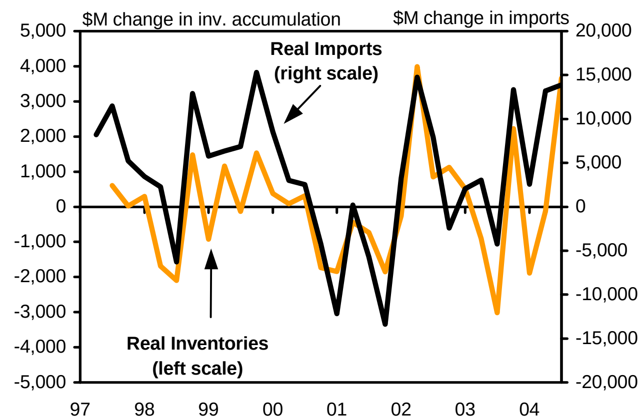
Based upon the third and fourth quarters of 2004, the reader would not be blamed for wondering whether imports and inventories should both be ignored altogether in that they seem to inevitably cancel each other out. But this thinking would be erroneous. The last two quarters of 2004 exhibited an uncharacteristically strong inventory response to imports; normally, inventories can only be expected to dampen imports – not to offset them altogether.

CANADIAN DEMAND VS INVENTORY-SALES RATIO



*Demand defined as real GDP less inventory accumulation
Source: Statistics Canada

INVENTORIES VS IMPORTS



Note: 1997 dollars
Source: Statistics Canada

Strong inventory accumulation in 2005

What does all of this suggest for the New Year? All three drivers foreshadow robust inventory accumulation in 2005. First, the unusually low level of the inventory-sales ratio – the result of weak inventory accumulation in 2004 – points to a possible turnaround. Second, the modest growth in demand in store for Canada in 2005 should also result in the inventory-sales ratio edging upward. Third, the stronger Canadian dollar signals good import growth for 2005, which should translate into a sizeable rate of inventory accumulation. As a result, we are looking for over $10B in inventory accumulation in 2005 – the fastest pace in five years. This inventory accumulation, in turn, should keep the Canadian economy from stumbling too jarringly during a challenging time for exporters.

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