

# Canada: Surprise jump in capacity utilization (Q3)

Potentially challenging assumptions feeding into the output gap.

**Canada's capacity utilization number for Q3/10 was up rather smartly at 78.1% vs. a revised second quarter's 76.9% (up from 76%). And although the rate of change is softer than previous quarters, it bested the street median forecast at 76.5% by a wide margin, as well as our own slightly more optimistic 76.6%. Also out at 8:30 was the national balance sheet accounts release for Q3/10 in which consumer debt to disposable income rose to a new historical high of 148.1%.**

## The facts

A steep rise in manufacturing utilization rates from 78.7% to 81.2% accounted for the bulk of the pick up. Of particular note, higher rates in the primary and fabricated metals businesses, machinery, transportation equipment, and computer and electronic products all contributed significantly to the improved picture. Not overly surprising given improved picture on auto sales, interest in commodities and the general recapitalization taking place amongst Canadian businesses.

Interesting to note that the surprise pick up in utilization rates came on the back of a soft quarter for growth. Recall that the Canadian economy put in a disappointing quarter, growing by a paltry 1.0%q/q ann. To us it suggests that the measures on capacity utilization may have been slow to remove obsolete capacity given the accelerated pace of technological change. So too may it have been the case that some of the capacity that has been idled by recession should have previously been considered as permanently lost.

Regardless of the mix of factors behind the utilization numbers, today's report underlines the fact that even under the conditions of a rather austere economic recovery in which growth rates are characterized at best as incremental, even restricted rates of GDP growth will continue to chip away at the output gap given Canada's very poor track record on growing productivity.

## Implications.

From a monetary policy standpoint there is room to suggest that the output gap maybe closing faster than the BoC estimated in its economic update from October. At the time the BoC felt that the output gap would be closed by the end of 2012. In today's report there is room to perhaps cheat that forward.

Also out at 8:30 was the national balance sheet accounts (an accounting of national net worth) which reflected a sharp rise in the ratio of household credit to personal disposable income to 148.1% up from 143.4% in Q2/10. Now to be fair, in Q2/10 disposable income was driven higher by government HST rebate cheques being issued in BC and Ontario. A one off event that was not repeated in Q3/10.

Regardless, rising levels of household debt have become quite literally front page news in Canada and while the BoC seems content to let administrative forces move to the fore (the Federal government is looking at potentially raising minimum down payments for the purchase of a home along with reducing amortization periods) we would suggest that it will take changes in the cost of funding debt to materially curb consumer behavior. At the end of the day, consumer behavior (borrow and spend) is a response to the pricing signals for money that is encouraging consumer leverage. On that basis, real change in consumer

behavior needs to see complimentary policy initiatives both administrative, but also in terms of rate policy and the pricing money.

Higher rates in capacity utilization and a pressing need to redirect consumer behavior keep the door open to monetary policy change in 2011. Our forecast continues to look for a March rate hike.

The bottom line.

At 78.1%, capacity utilization is running well ahead of the cyclical low of 68.7% experienced in the Q2/09, although still well back of the pre crisis trend at around 85%.

# Disclosure appendix

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