CHAPTER 23

REVIEW OF THE ECONOMY

In many respects, the performance of the Canadian economy in the early 1980s has been substandard. For example, real gross national product (GNP), the inflation adjusted value of all goods and services produced, grew at an average annual rate of 4.7% from 1960 to 1979 but managed only a 0.8% annual average growth between 1980 and 1983. The unemployment rate climbed to double-digit levels in 1982 and 1983, twice the rate that prevailed in the late 1960s and early 1970s. Another feature of the Canadian economy in the early 1980s was its increased volatility. It went into recession in the first two quarters of 1980, then recovered from mid-1980 to mid-1981 only to relapse into a deeper recession lasting until late 1982. In 1983 the economy began to recover again. As a comparison, during the period from 1960 to the end of 1979 there were also two recessions and two recoveries. On the brighter side, although the inflation rate reached very high levels in the early 1980s, in 1983 it fell to its lowest level since 1972. To the extent that some of the problems with Canada's economic performance in the early 1980s were created by the high inflation rates of the late 1970s and early 1980s, the improved inflation performance in 1982 and 1983 could be a good omen for the Canadian economy for the middle to late 1980s.

23.1 A glance back at the 1970s

Rising inflationary expectations. To gain some perspective on why the economy performed as it did in the early 1980s, it is helpful to consider some of its key features in the period 1973-79. After having been consistently under 5% throughout the 1960s and early part of the 1970s, the annual inflation rate as measured by the consumer price index (CPI) climbed to double-digit levels by 1974 and 1975. Although the inflation rate eased in the 1975-76 period, it fell no lower than 7%. Thus, even at its lowest point in the mid-1970s the inflation rate was still higher than during the 1960s and early 1970s. As inflation increased there was a growing expectation among the public that it would continue at high levels. One of the most noticeable areas in which inflationary expectations were increasing was energy prices. The combination of the creation of the OPEC cartel, political tension in the Middle East, and general uneasiness about the ability of world energy supplies to keep pace with demand fostered expectations that oil prices would continue to rise at a faster pace than the general inflation rate. Since energy is an input in the production process, escalating oil prices were generally expected to keep the overall inflation rate at high levels. Shortages in many raw materials led to a hoarding psychology and a commodity price explosion resulted in 1973-74. After some easing of inflationary pressures in the wake of the 1974-75 recession, commodity prices were once again climbing sharply by the late 1970s.

Aggregate demand. From 1977 to 1979 wage rates in general did not keep pace with the inflation rate, as measured by the CPI. Part of the problem with real wages (that is, wages adjusted for inflation) was a steady deterioration in productivity as measured by output per worker (Table 23.3). The decline in real wage rates served to restrain growth in consumer expenditure. From 1977 on, growth of consumer spending remained well below the levels associated with previous economic expansions. In addition to declining real wages, interest rates began to move up to levels not experienced in the 1960s and early 1970s. These factors contributed to a steady decline in residential construction in the years after 1976.

A boom in spending on non-residential construction and machinery and equipment helped sustain the economy in the late 1970s. Many raw material producers sought to capitalize on the boom in commodity prices in 1973-74 and again in the late 1970s by expanding production capacity. Hence the commodity price boom contributed to a capital spending boom. The strength in natural resource industries contributed to investors aggressively bidding up stock prices of energy and mining companies which, in turn, further encouraged capital formation in these sectors. Investment by raw material producers created a strong demand for related products such as pipelines, steel and heavy equipment so investment in other sectors benefited as well. In addition to its favourable impact on capital spending, the heavy world demand for raw materials, associated with the commodity price explosion, was a boon to Canadian exports of raw materials and