materials in the intermediate stage of production. Typically these materials account for between 60% and 70% of Canada's total merchandise exports. Thus in the late 1970s strength in the export and business fixed investment sectors somewhat masked the underlying softening trend in other key sectors of the economy, notably consumer spending and residential construction.

23.2 Influence of the 1970s on the early 1980s

Effects of inflation. The economic performance of the early 1980s was very much shaped by the inflationary environment of the 1970s. Investment in the natural resource sectors with the exception of agriculture continued strong through 1980 (Table 23.2). Capital formation by mines, quarries and oil wells grew by over 49% in current dollars in 1980. Investment in the forestry sector was also strong, growing by 14% in 1980 following 24.9% growth in 1979. In addition to the commodity price boom, inflation had an indirect effect on investment in other sectors such as manufacturing, which grew by 31.9% in current dollars in 1980.

Because of the growing concern about inflation, businesses were pushing investment projects ahead before interest and building costs escalated further. As inflationary pressures began to ease in 1981, capital spending in some sectors such as forestry began to slow or decline. But in other sectors such as manufacturing and energy where prices remained firm, capital spending continued to grow at a robust rate in 1981 (31.4% in manufacturing and 19.5% in hydro and gas). In these sectors investment projects often were so large that work which had begun in 1979 or 1980 continued into 1981 thereby serving to buttress the 1981 investment figures.

The investment boom in the late 1970s and early 1980s was a major source of new job creation, and employment continued to grow at a solid pace of over 2.5% into 1980 and 1981. At the same time the general trends of lower productivity and lower real wage rates, which began in 1977, continued (Tables 23.3 and 23.4). Manufacturing, trade and services industries contributed most to the overall decline in productivity. Thus, despite gains in employment, consumer expenditure did not grow at rates comparable to previous economic expansions. Between 1977 and 1981 the highest annual real growth (that is, growth adjusted for inflation) in consumer expenditure was 2.6%, considerably below the average annual growth of 6% for the non-recessionary years between 1950 and 1976.

Higher interest rates. The experience of the 1970s had an important impact on participants in the financial markets. As the inflation rate continued to climb through much of the 1970s, savers began to realize that they were not earning a return that was as high as the inflation rate on most goods. On the other hand, borrowers were able to profit from the fact that what they were buying with borrowed money was often rising in price more than enough to offset the interest costs on loans. Hence, people began to learn that it was more advantageous to borrow and buy on credit than to lend. As the inflationary psychology continued into the 1980s, borrowers became more anxious to borrow while savers became increasingly reluctant to save. In order to obtain additional funds, borrowers were forced to offer savers higher rates of interest. This was one of the major reasons for the sharp jump in interest rates in the 1980s (Table 23.5).

Control of monetary growth. As inflation persisted, monetary authorities in both Canada and other industrialized countries resolved to bring down inflation. Since accelerating money supply growth had preceded an acceleration in the inflation rate throughout the 1970s, financial market participants and central bankers alike became more sensitive to the rate of monetary growth. Consequently, in late 1979 the Federal Reserve Board (FRB) of the United States announced that it intended to focus its attention on controlling the growth of the money supply rather than on smoothing out interest rate fluctuations. In general the FRB was successful in bringing down monetary growth from 1980 to 1982. For example the growth of M1, or the amount of currency and bank demand deposits held by the general public, declined from 7.7% in 1979 to 6.6% in 1982. During this period, because of the weakness in the Canadian dollar vis-à-vis the US dollar (Table 23.5), Canadian monetary policy was considerably more restrictive than that of the United States. Canadian money supply growth as measured by M1 fell from an annual rate of growth of 10.1% in 1978 to 0.6% in 1982. Foreign exchange market conditions and a more restrictive monetary policy by the Bank of Canada led to a sharp increase in the interest rate differential between Canada and the United States (Table 23.5). The deceleration in monetary growth and a deep-rooted fear of inflation on the part of financial market participants combined to produce the highest ex-post real rates of interest that had been seen in North America for some time. The ex-post real rate of interest, which is simply the actual market rate of interest on a given financial instrument such as a term deposit or treasury bills, less the actual rate of inflation over the holding period of that same instrument, is a measure of the cost of borrowing when inflation is taken into account. The ex-post real interest rate on 90-day Government of Canada treasury bills is shown in Chart 23.1.

Volatile economic activity. Volatility in interest rates and money supply growth were major factors contributing to fluctuating economic activity in the early part of the 1980s. Table 23.6 shows the