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**PERFORMANCE OF THE
CANADIAN ECONOMY**

Department of Finance

June 1990

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- ° Inflation is the most serious economic problem facing Canada today.
- ° Underlying this inflation problem are significant cost pressures in labour and product markets, pressures which have been manifest in a deterioration in Canada's international competitiveness.
- ° Broad measures of an economy's cost competitiveness, such as "unit labour costs", show the serious deterioration in our international competitive position.
- ° Canadian unit labour costs have consistently outpaced those in the U.S.; the deterioration in Canada's cost competitiveness with Japan and Germany is even more pronounced.

Inflation/Competitiveness Problems

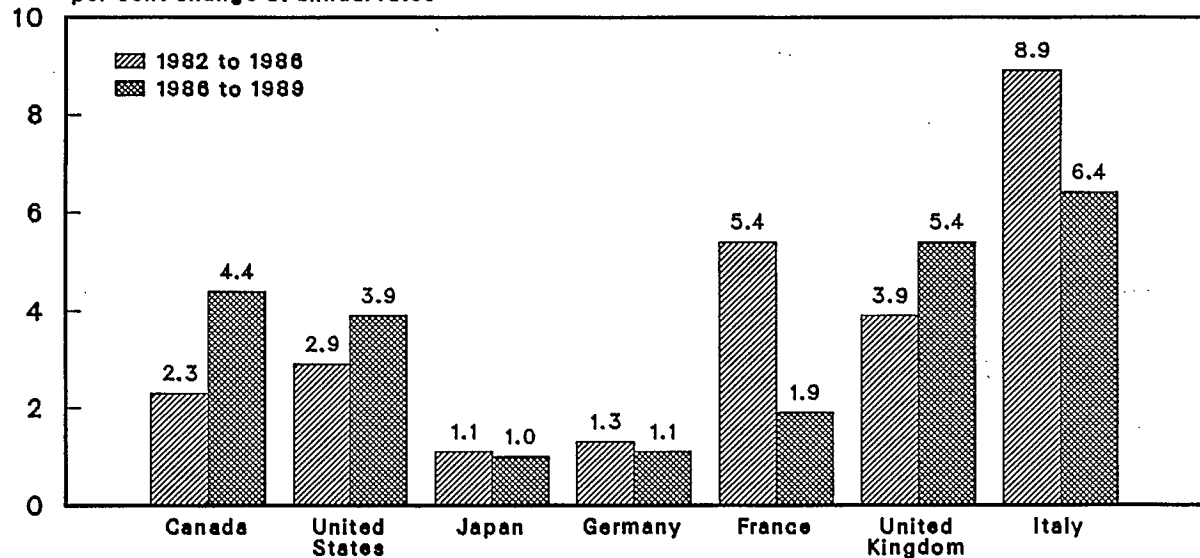
Growth of Unit Labour Costs Canada-U.S. Comparison

per cent year over year, commercial sector



Growth of Unit Labour Costs Measured In Domestic Currencies

per cent change at annual rates



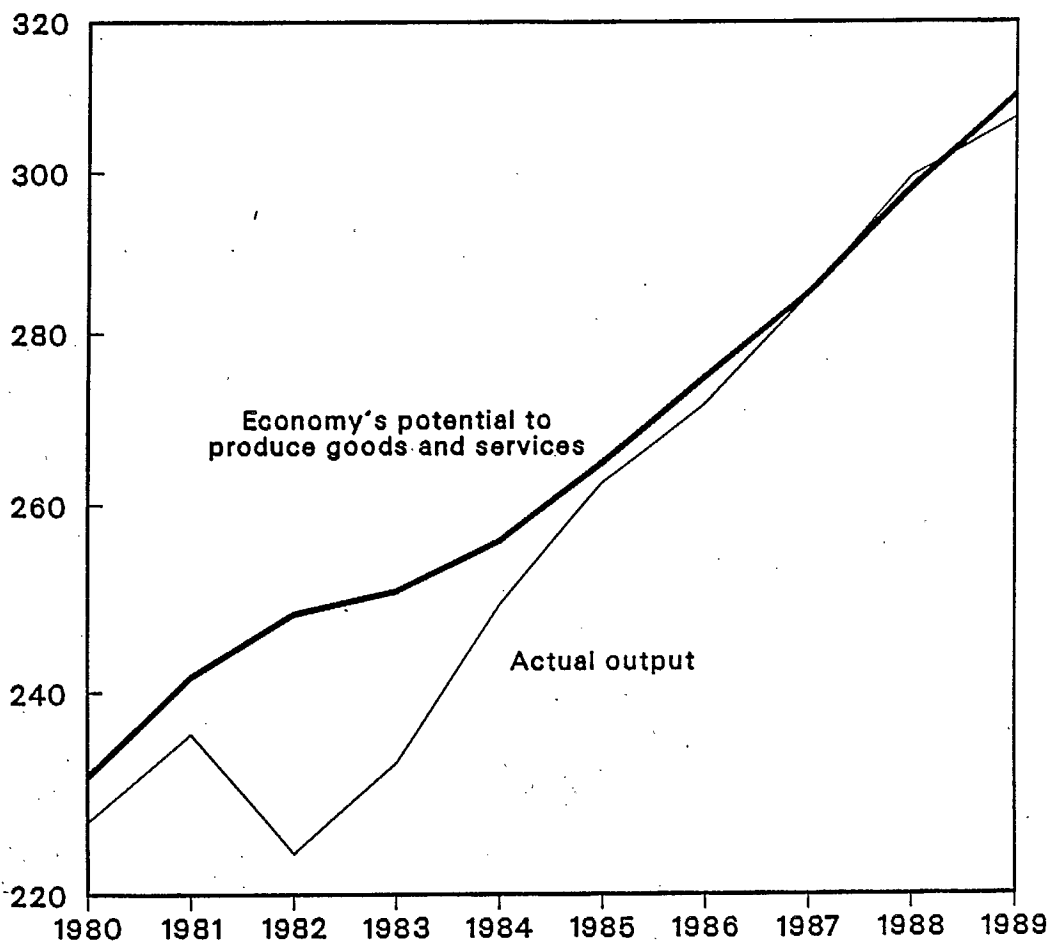
Source: OECD, *Economic Outlook*, December 1989.

- ° Strong growth over the 1983-86 period eliminated most excess capacity that was present in the Canadian economy following the 1981-82 recession.
- ° By late 1987, demand rose above capacity in many sectors, causing a surge in imports and leading to strong pressure on wages and prices.
- ° This placed upward pressure on interest rates and in turn, the federal deficit.
- ° Overall growth slowed to 2.1% on average in the last three quarters of 1989, below the economy's growth potential. However, the level of economic activity remains close to the economy's potential.

Excess Demand

Potential and Actual Real Gross Domestic Product*

billions of 1981 dollars



* For the commercial sector of the economy.

- ° Excess demand pressures are evident in both labour and product markets.
- ° The rate of capacity utilization has been at or above its longer-term average since mid-1987.
- ° The overall unemployment rate is currently at its lowest level since the late-1970s.

**CAPACITY UTILIZATION RATES
NON-FARM GOODS-PRODUCING INDUSTRIES
(PER CENT)**

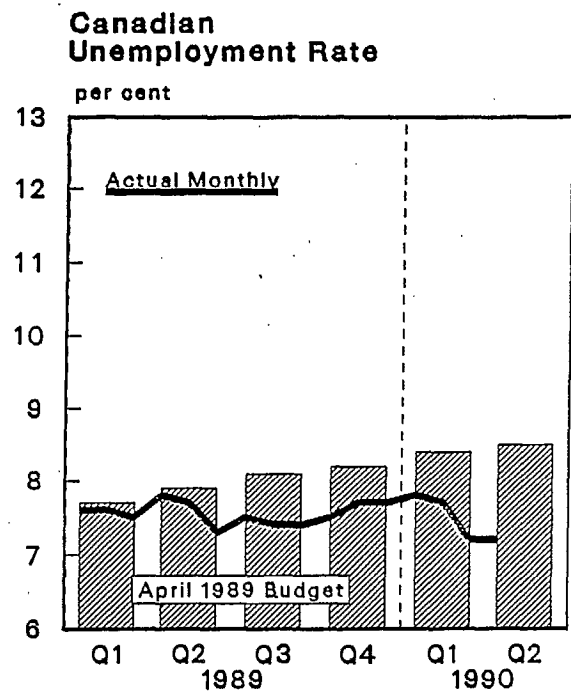
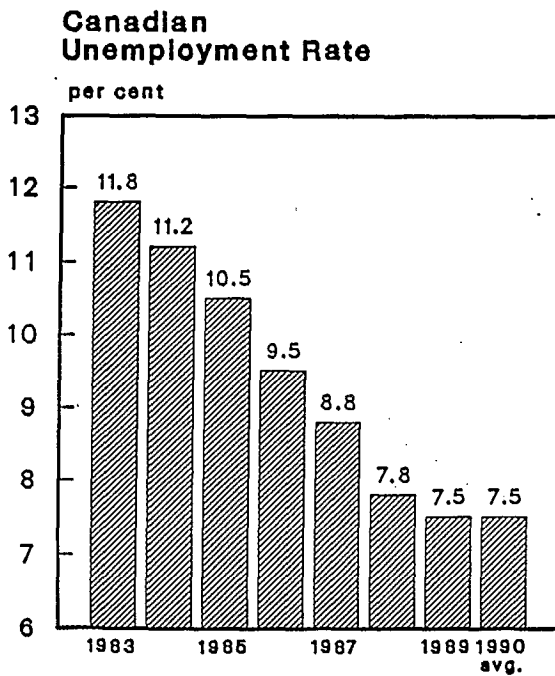
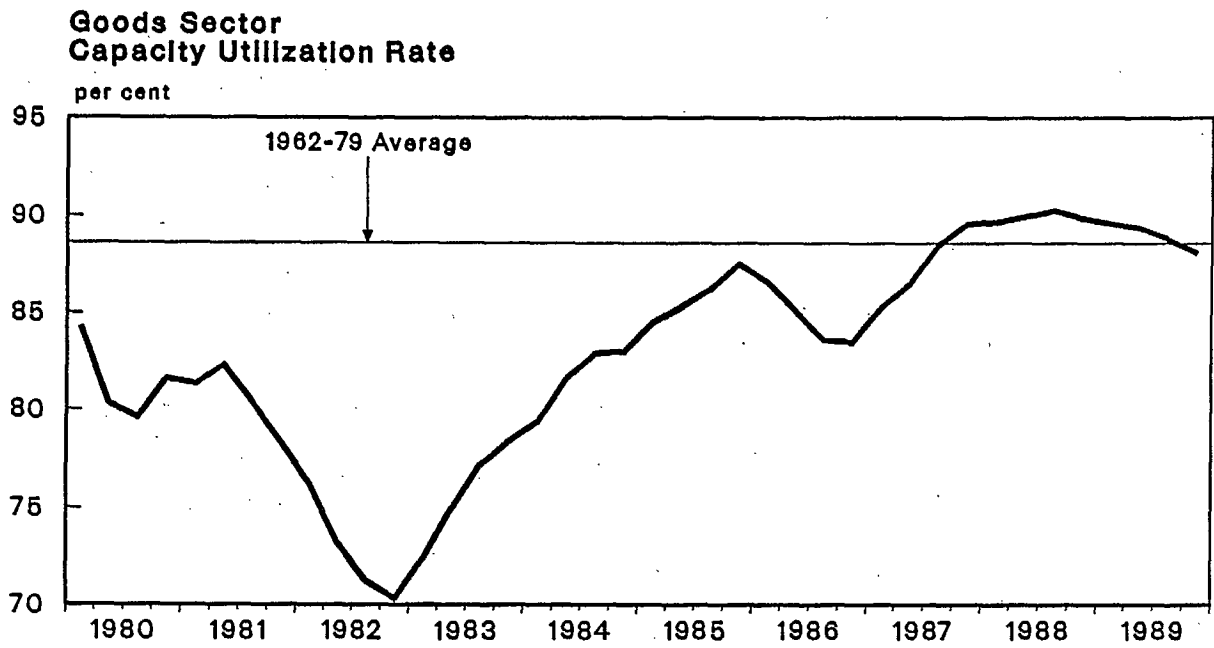
	1962-79	1986	1987	1988	1989	1989			
	<u>Average</u>					<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>
Total	88.6	84.7	87.5	90.0	89.0	89.6	89.4	88.8	88.1
Mining	85.9	72.6	75.9	80.2	78.3	78.6	79.2	78.0	77.5
Manufacturing	89.4	87.1	88.5	90.3	89.0	89.5	89.6	88.0	87.9
Non-durables	90.7	91.0	92.9	93.3	91.9	92.4	92.5	91.7	91.2
Durables	88.2	84.2	85.2	88.2	86.9	87.5	87.6	87.0	85.6
Electric power, gas	91.0	91.8	94.5	92.7	90.0	91.2	90.1	89.3	89.5
Construction	89.8	86.4	92.1	96.5	97.4	98.3	97.1	97.2	97.0
Energy	87.2	75.9	78.8	81.3	80.1	80.4	80.7	79.9	79.6
Total excluding energy	89.1	86.7	89.5	92.1	91.3	91.9	91.7	91.1	90.4

Source: Bank of Canada

EMPLOYMENT GROWTH AND THE UNEMPLOYMENT RATE

	1989			1990			
	<u>Oct.</u>	<u>Nov.</u>	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>	<u>Apr.</u>
Employment (Y/Y % change)	2.0	1.9	1.5	1.3	1.7	1.3	2.2
Unemployment rate	7.5	7.7	7.7	7.8	7.7	7.2	7.2

Excess Demand



- ° Domestic demand is the best indicator of a buoyant economy. By late 1987, domestic demand began to exceed the economy's capacity to supply goods and services.
- ° The strength in domestic demand has been widespread, but particularly noticeable in business and residential investment.
 - » Non-residential business investment has been the leading source of growth over the past five years, pushing investment's share of GDP to a record high level. The investment boom has been fuelled by the opportunities arising from the government's structural initiatives and continued capacity constraints in many product markets.
 - » Residential housing construction has been very strong and continues at a level at or above demographic requirements.

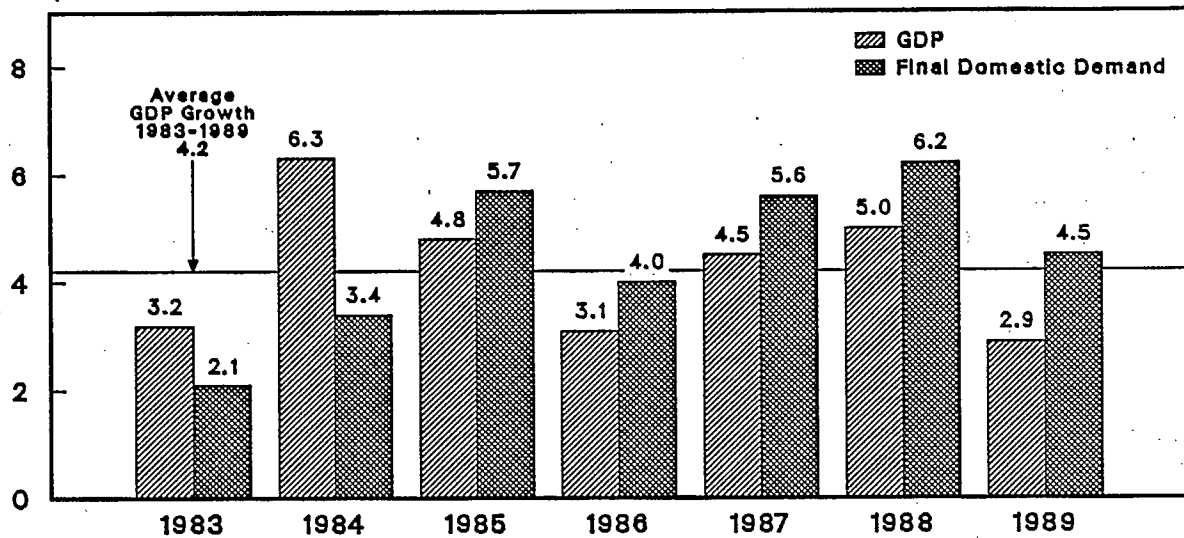
HOUSING STARTS
(thousands, annual rates)

	1989			1990			
	<u>Oct.</u>	<u>Nov.</u>	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>	<u>Apr.</u>
Total	219	212	224	220	225	226	199

Excess Demand

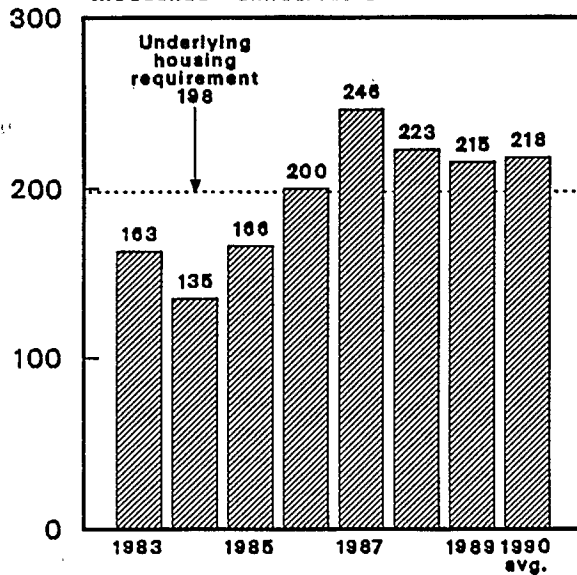
Growth in Real GDP and Real Final Domestic Demand

per cent



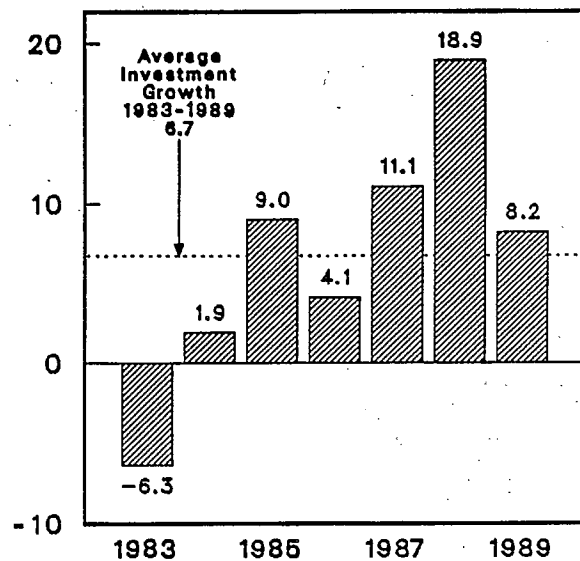
Housing Starts

thousands - annual rates



Growth in Real Business Non-Residential Investment

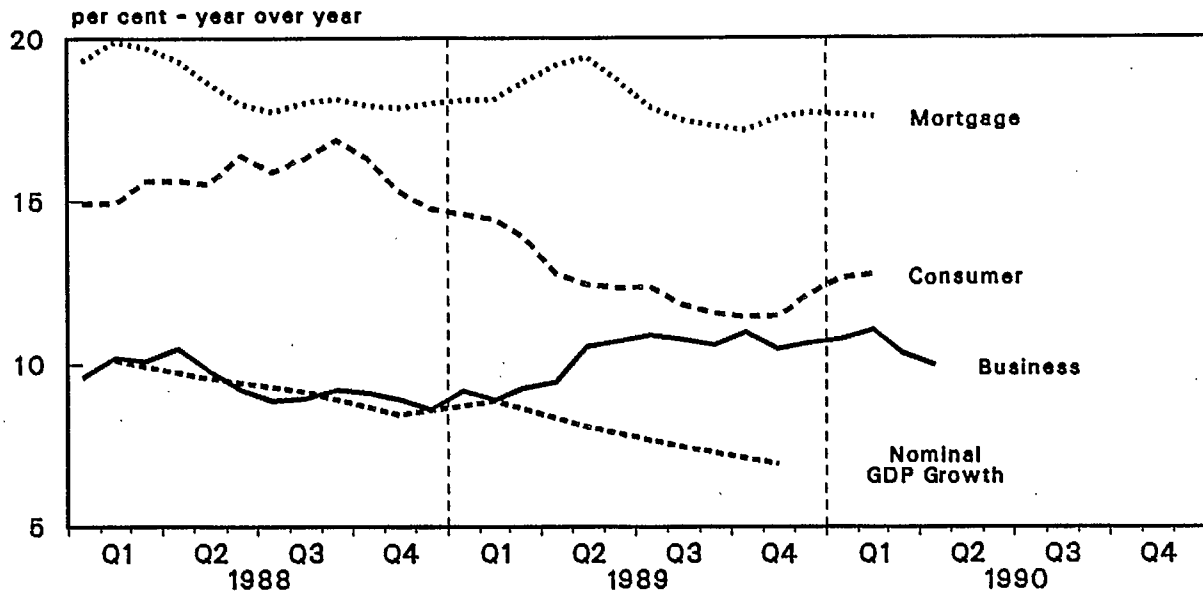
per cent



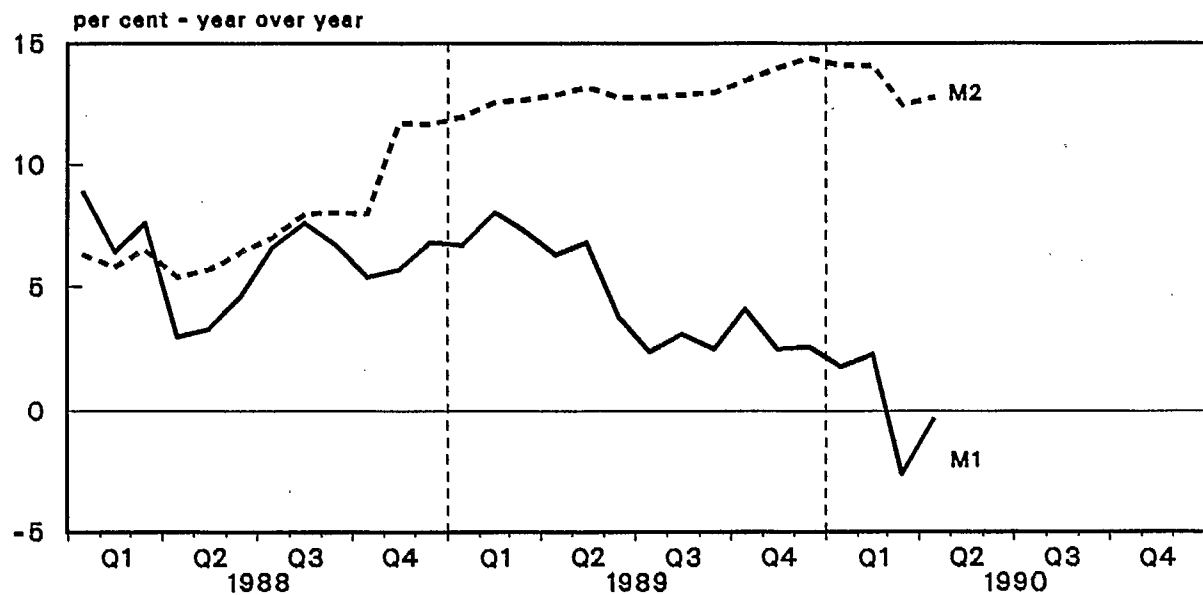
- ° The strength in domestic demand is mirrored in rapid credit expansion.
- ° This expansion is evident in all credit markets -- business, consumer and mortgage. It is particularly strong in the mortgage market, a reflection of the strength (until just recently) in this sector.
- ° To date, there is no clear evidence of an easing in credit demand, particularly on the part of households, as credit growth continues to far outpace increases in nominal GDP. This is exerting considerable strain on the financial positions of both the corporate and personal sectors.
- ° The broadly defined monetary aggregate M2, which is closely related to economic activity, continues to grow very strongly.

Excess Credit Growth

Growth In Credit Demand



Growth In Money Demand

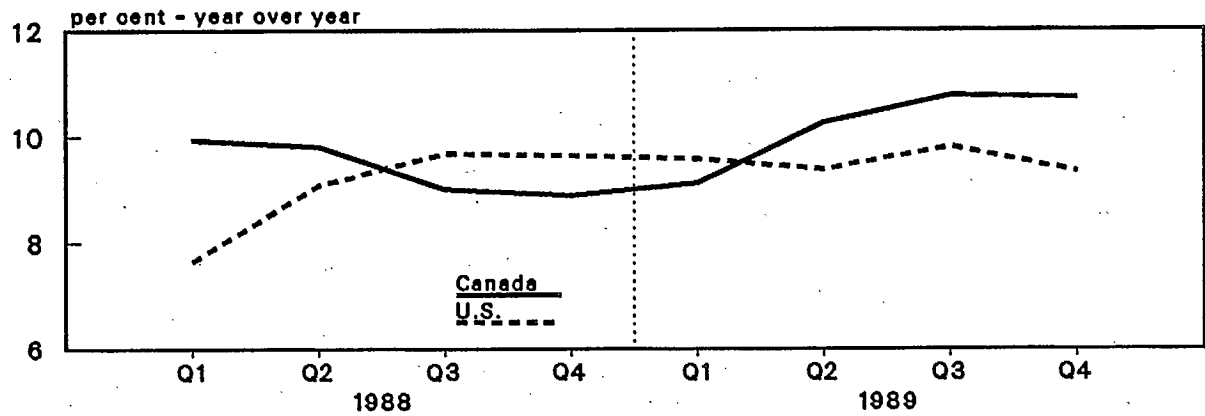


- ° The strength of credit demand in Canada in the last two years -- and the strength of underlying excess demand and inflation pressures -- is particularly evident when compared to the U.S.
- ° Both mortgage and consumer demand for credit in Canada are increasing at a rate roughly double that of the U.S.
- ° Business credit growth in Canada has remained strong and now exceeds that in the U.S.

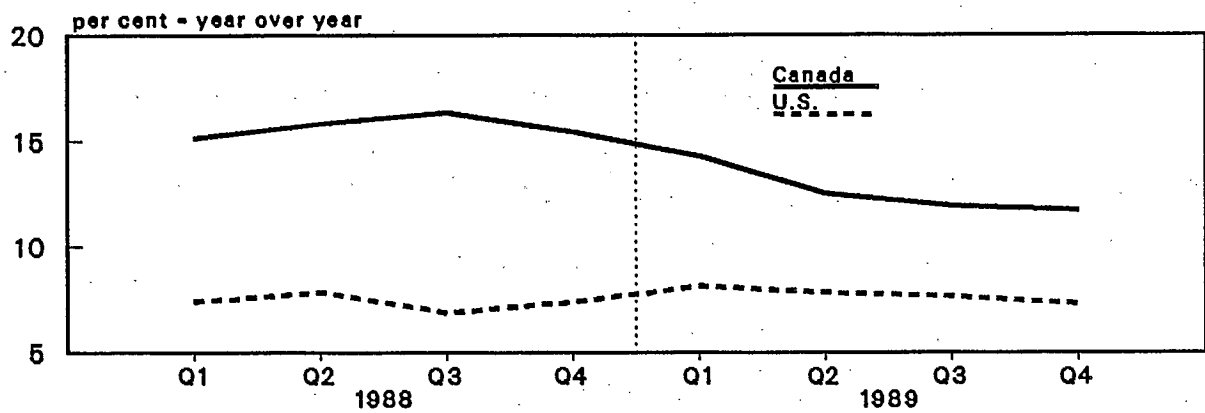
Excess Credit Growth

Aggregate Credit Demand Canada and the U.S.

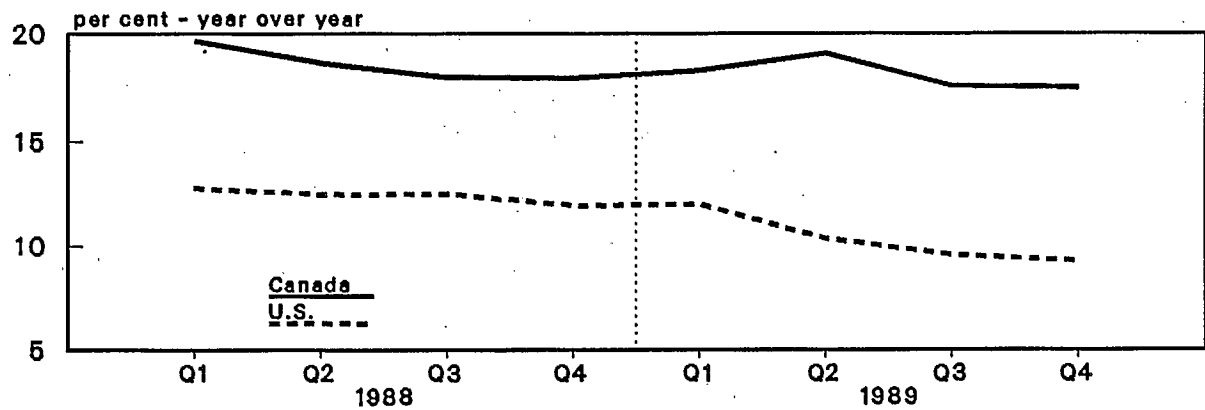
Business Credit



Consumer Credit



Residential Mortgages



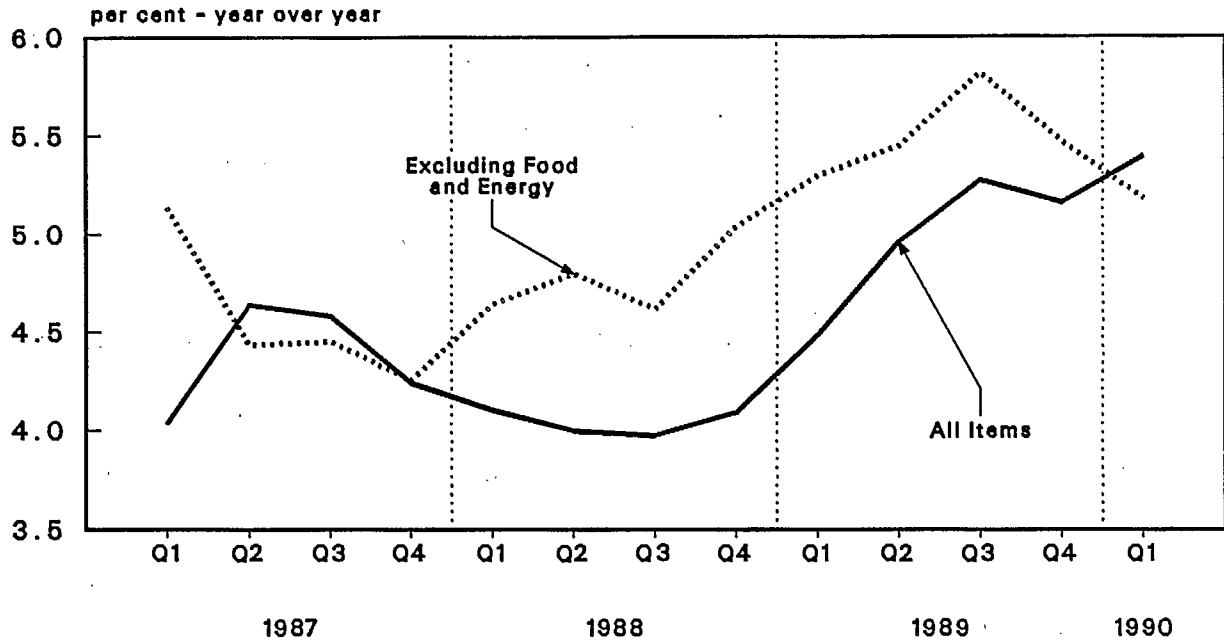
- ° Both the overall rate of inflation and the underlying rate -- excluding food and energy -- have steadily risen over the past two years.
- ° When looked at from its components, both goods and services inflation rates rose sharply over this period. Services-sector inflation has consistently been higher than that in the goods sector, as the rate of increase in the latter has been significantly restrained in part by the appreciation of the exchange rate.
- ° Although the goods inflation rate jumped in the first quarter of 1990 due to the impact of the Florida frost on food prices, this was a transitory effect and food price inflation has recently moderated.

INFLATION RATE, CANADA
(per cent, year-over-year)

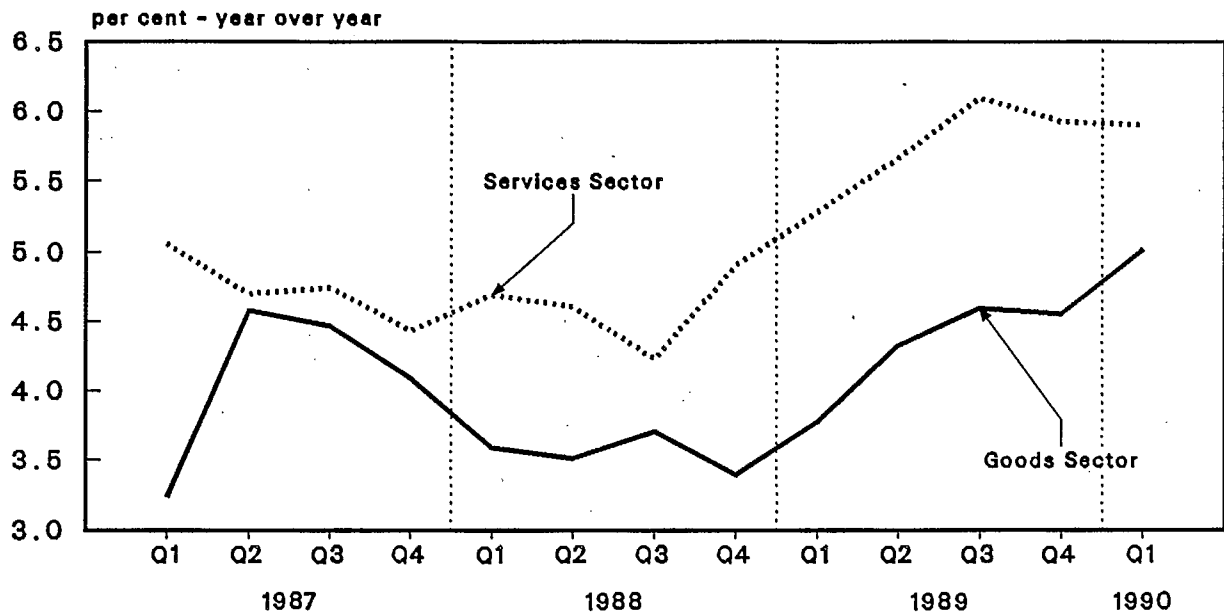
	1989						1990			
	July	Aug.	Sept	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
All items	5.4	5.2	5.2	5.1	5.2	5.1	5.5	5.4	5.3	5.0
Food	4.1	3.1	2.9	3.3	3.7	3.4	4.8	4.9	5.0	3.9
Energy	4.4	6.0	5.8	6.2	7.5	7.3	9.0	9.7	10.0	9.8
All items excluding food and energy	5.9	5.7	5.8	5.6	5.4	5.4	5.4	5.2	4.9	4.9
Services	6.1	6.1	6.1	5.9	5.8	6.0	5.9	6.0	5.7	5.7
Shelter	7.2	7.2	6.7	6.8	6.7	6.7	6.8	6.8	6.5	6.0
Goods	4.8	4.5	4.5	4.6	4.7	4.4	5.2	4.9	4.9	4.4
Durables	5.0	4.5	4.6	4.1	2.9	2.7	3.0	2.5	2.1	1.1
Semi-durables	4.7	4.5	4.8	4.4	4.1	3.2	3.7	2.3	2.8	3.0
Non-durables	5.4	5.2	5.0	5.4	6.0	5.8	6.9	7.1	7.3	6.7

Inflation Indicators

CPI Inflation Rate



CPI Inflation Rate - Goods and Services Sector



- ° Inflation is clearly a national problem.
- ° The national inflation rate increased in 1989, but more worrisome is the fact that eight of the ten provinces experienced a rise in inflation over the past year. The only exceptions are Ontario, where the inflation rate has declined, and Quebec, where it has remained unchanged.
- ° Seven provinces have inflation rates above the "national average".

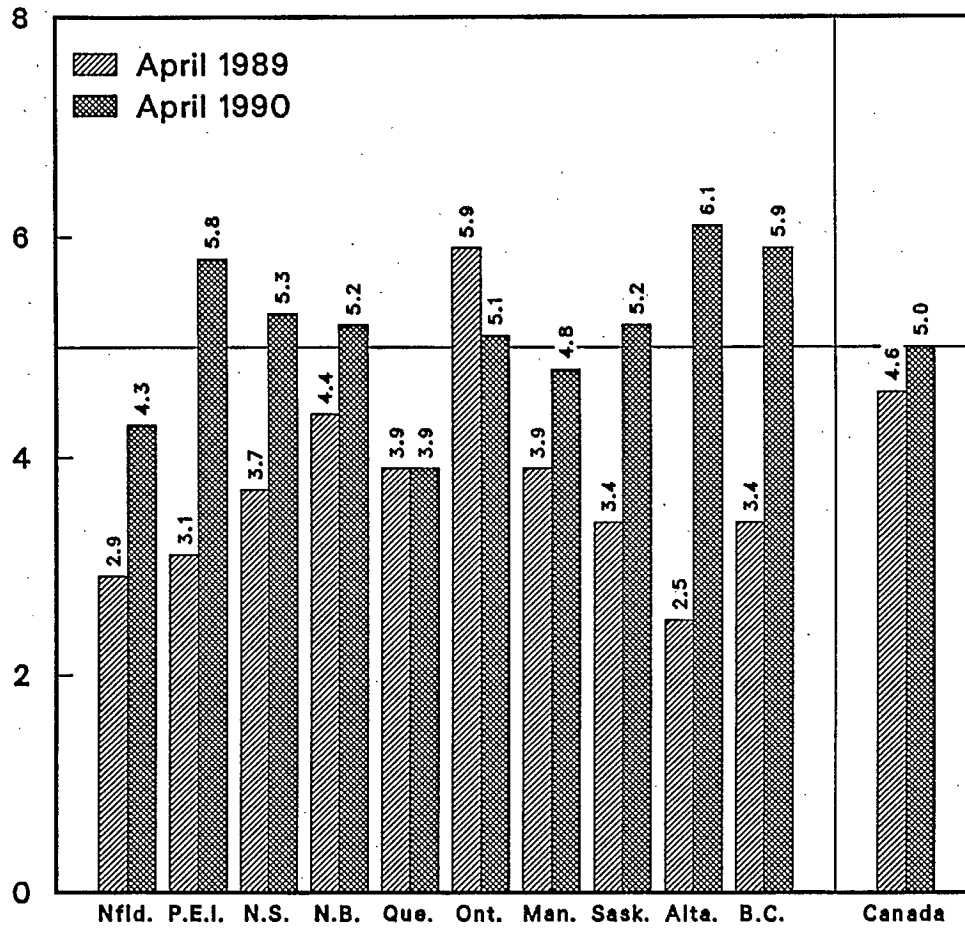
CPI BY PROVINCE
(per cent, year-over-year)

	1989						1990			
	<u>July</u>	<u>Aug.</u>	<u>Sept.</u>	<u>Oct.</u>	<u>Nov.</u>	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>	<u>Apr.</u>
Canada	5.4	5.2	5.2	5.1	5.2	5.1	5.5	5.4	5.3	5.0
Newfoundland	4.0	4.0	4.0	4.1	3.9	4.4	4.9	5.1	4.9	4.3
P.E.I.	4.3	3.3	4.4	3.9	4.6	4.6	5.1	5.4	5.2	5.8
Nova Scotia	5.2	4.7	5.1	4.9	4.8	5.2	5.0	5.8	6.0	5.3
New Brunswick	5.4	5.3	4.9	4.9	4.7	4.9	4.9	5.7	5.7	5.2
Quebec	5.0	4.5	4.5	4.5	4.5	3.9	4.8	4.4	4.5	3.9
Ontario	6.1	5.8	5.8	5.7	5.7	5.6	5.9	5.8	5.6	5.1
Manitoba	5.6	5.1	4.7	4.2	5.1	4.4	4.8	4.9	4.8	4.8
Saskatchewan	5.2	5.0	5.2	4.6	4.8	4.6	4.5	5.1	5.0	5.2
Alberta	5.0	5.0	5.2	5.2	5.5	6.2	6.5	6.3	5.7	6.1
B. Columbia	4.5	4.8	4.8	5.1	5.1	5.5	5.6	5.8	5.7	5.9
Canada excluding Ontario	4.9	4.7	4.8	4.7	4.8	4.7	5.2	5.1	5.0	4.9

Inflation Indicators

CPI By Province

per cent - year over year



- ° Inflation rates in both Canada and the U.S. have increased noticeably since early 1988.
- ° While the inflation rates in the two countries are relatively similar, the appreciation of the Canadian dollar through 1989 masks to some extent the underlying price pressures in Canada.
- ° Sharp declines in corporate profit margins in Canada -- and to a lesser extent in the United States -- over the past one-to-two years have constrained the rate of inflation during this period.

CPI INFLATION RATE - UNITED STATES
(per cent, year-over-year)

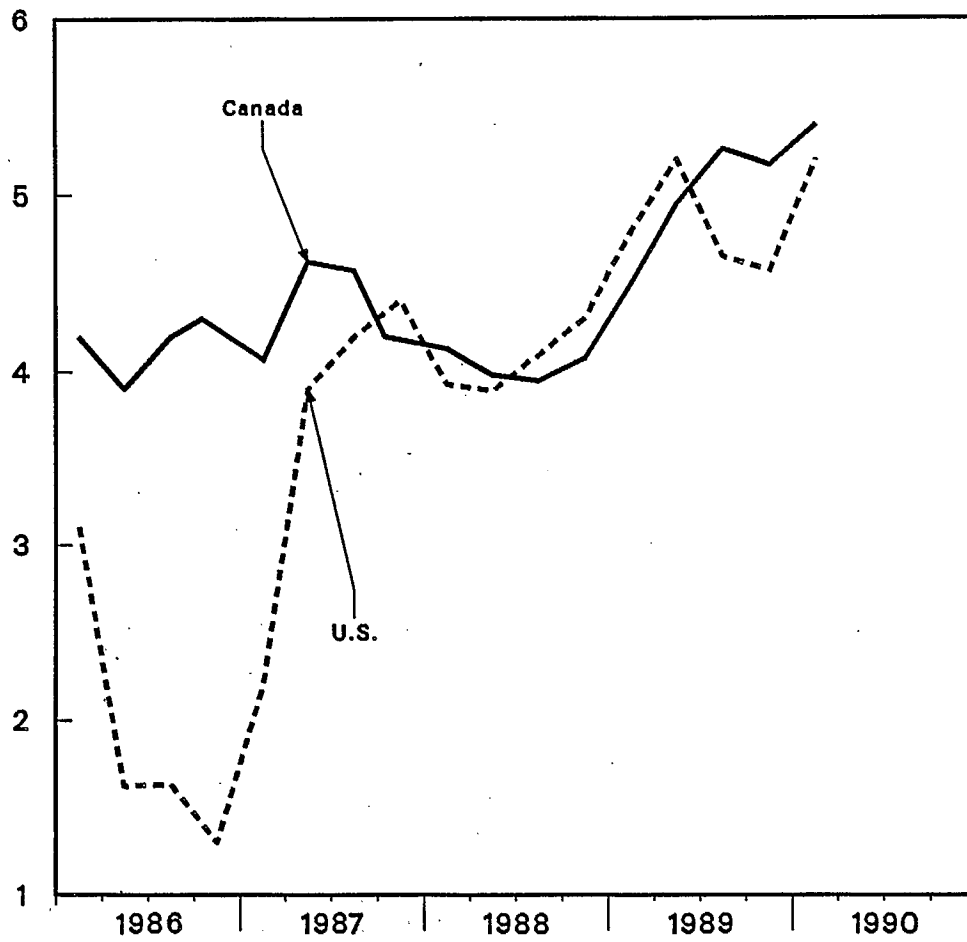
	1989						1990			
	<u>July</u>	<u>Aug.</u>	<u>Sep.</u>	<u>Oct.</u>	<u>Nov.</u>	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>	<u>Apr.</u>
All items	5.0	4.7	4.3	4.5	4.7	4.6	5.2	5.3	5.2	4.7
All items excl. food & energy	4.6	4.4	4.3	4.3	4.4	4.4	4.4	4.6	4.9	4.8

CPI INFLATION RATE - CANADA
(per cent, year-over-year)

	1989						1990			
	<u>July</u>	<u>Aug.</u>	<u>Sep.</u>	<u>Oct.</u>	<u>Nov.</u>	<u>Dec.</u>	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>	<u>Apr.</u>
All items	5.4	5.2	5.2	5.1	5.2	5.1	5.5	5.4	5.3	5.0
All items excl. food & energy	5.9	5.7	5.8	5.6	5.4	5.4	5.4	5.2	4.9	4.9

Inflation Indicators

Canada-U.S. CPI Inflation Comparison
per cent - year over year



- ° Underpinning the rise in inflation, and the major risk to an early and substantial reduction in inflation, has been a marked deterioration in underlying cost pressures.
- ° Virtually all measures of wage costs have shown sharp increases since early 1988.
 - » Unit labour cost growth has more than doubled, rising from about 3% in 1988 to nearly 7% by the end of 1989.
 - » Wage settlements have also accelerated sharply since early 1989, and are currently in the 6% range compared to about 4½% in 1988.
 - » Growth in average labour income per employee has now reached 7.5%.

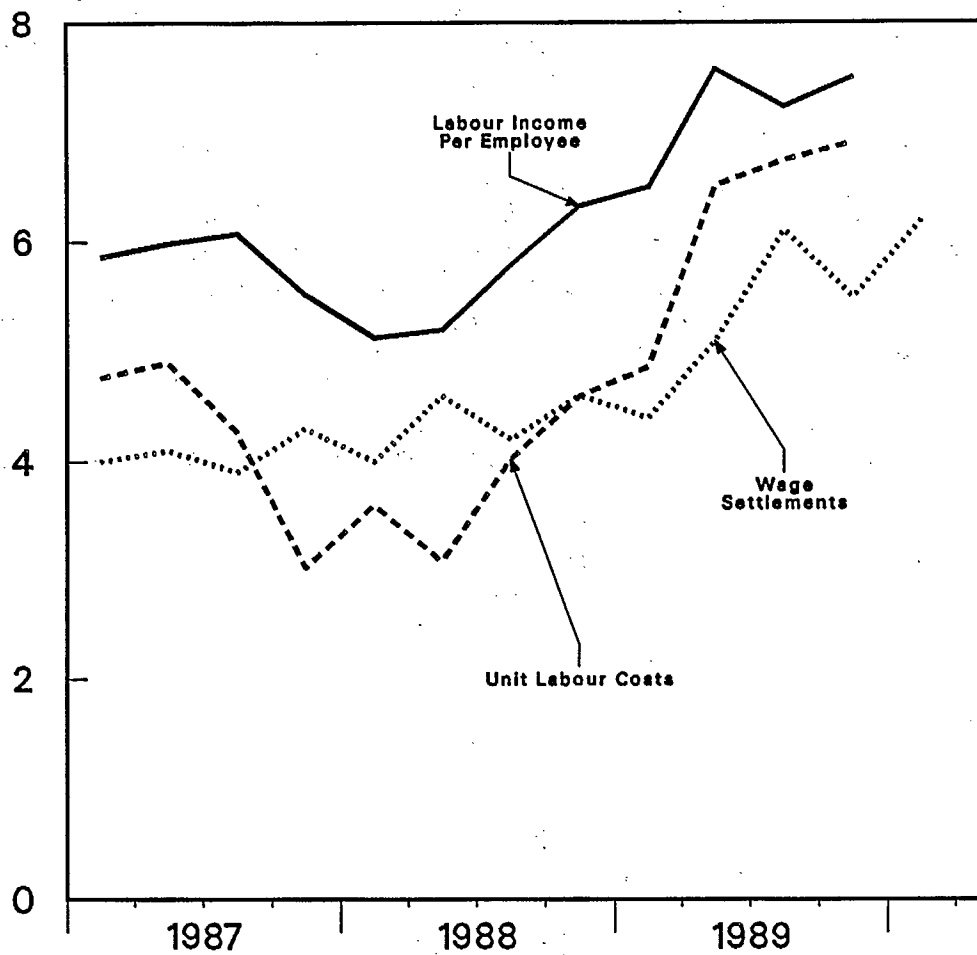
WAGE SETTLEMENTS
(per cent, year-over-year)

	1988		1989				1990
	<u>Q3</u>	<u>Q4</u>	<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>	<u>Q1</u>
Canada total	4.2	4.6	4.4	5.1	6.1	5.5	6.2
Private sector	5.1	4.8	4.7	5.6	4.4	5.7	5.7
Manufacturing	4.9	4.6	6.1	5.4	5.0	6.1	5.5

Underlying Inflation/Cost Pressures

Wage Pressures

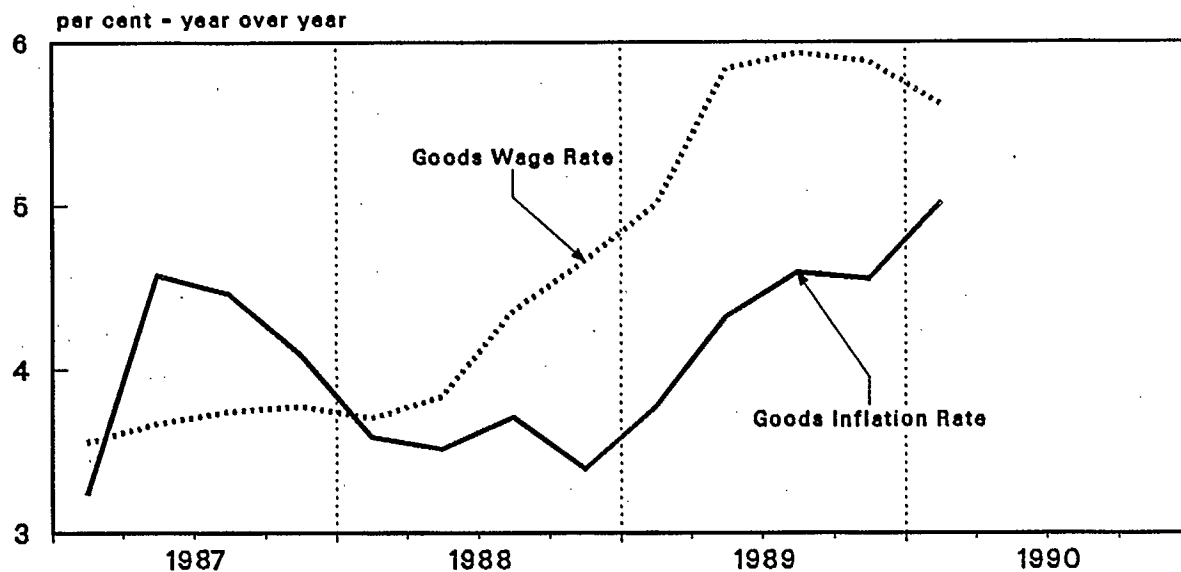
per cent - year over year



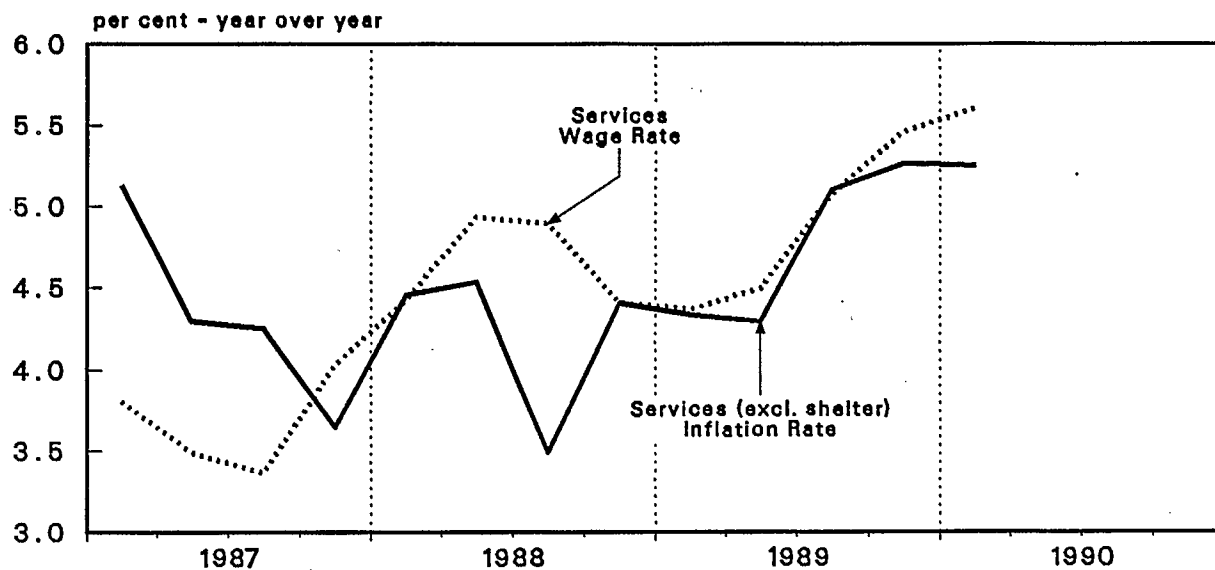
- ° Looking at the different behaviour of prices and costs in the goods and services sectors provides some insight into the current inflation problem.
- ° Wage costs in the goods sector have strongly outpaced the rate of inflation in this sector since early 1988, contributing to a sharp decline in profit margins. However, these margins have now been squeezed to an unsustainably low level, and in the absence of an easing in labour cost pressures, inflation in the goods sector will accelerate.
- ° Services-sector inflation has shown little moderation while wage costs have increased in tandem with prices in this sector.

Underlying Inflation/Cost Pressures

Inflation Rate versus Average Hourly Earnings in the Goods Sector



Inflation Rate versus Average Hourly Earnings in the Services Sector

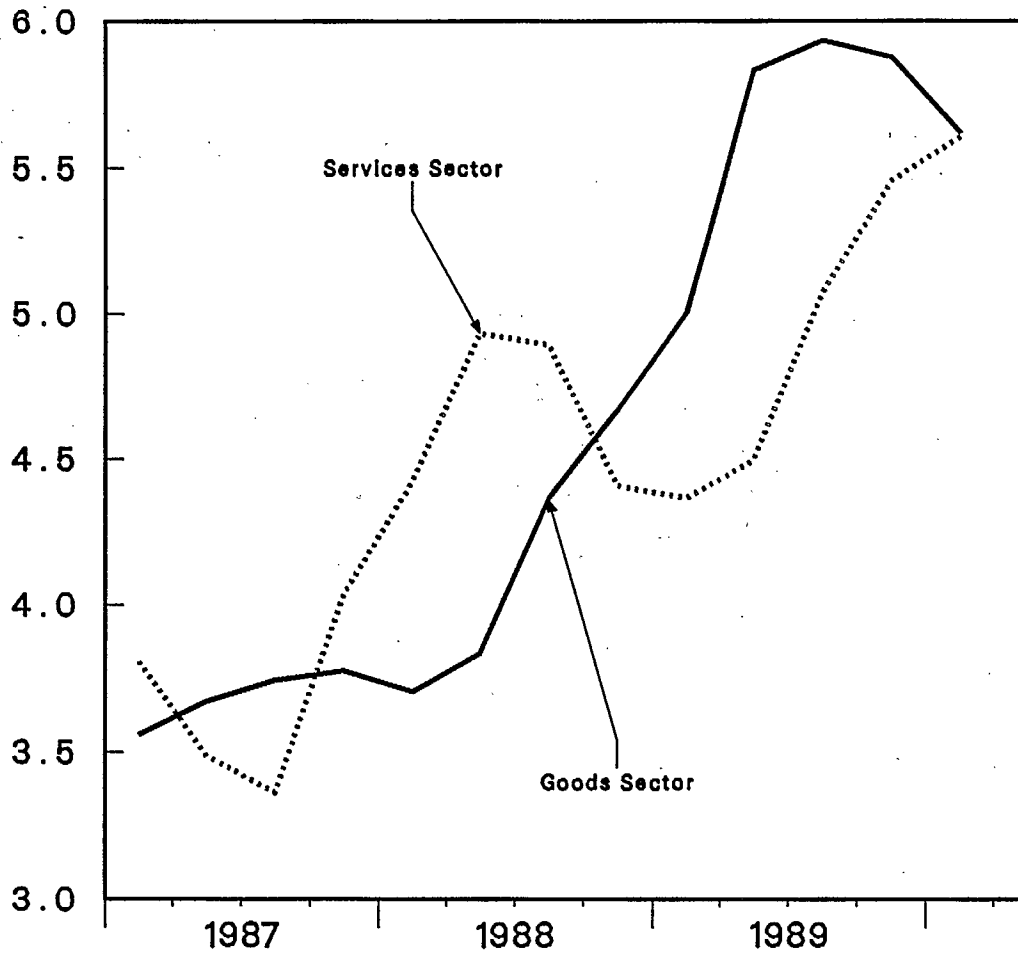


- ° The impact of excess demand in labour markets is clearly evident by the rapid rise in wage costs.
- ° Beginning in late 1987, wage pressures increased sharply in both the goods and services sectors; the annual rate of increase rose from about 3.5% in late 1987 to nearly 6% in early 1990.

Underlying Inflation/Cost Pressures

Average Hourly Earnings Goods and Services Sector

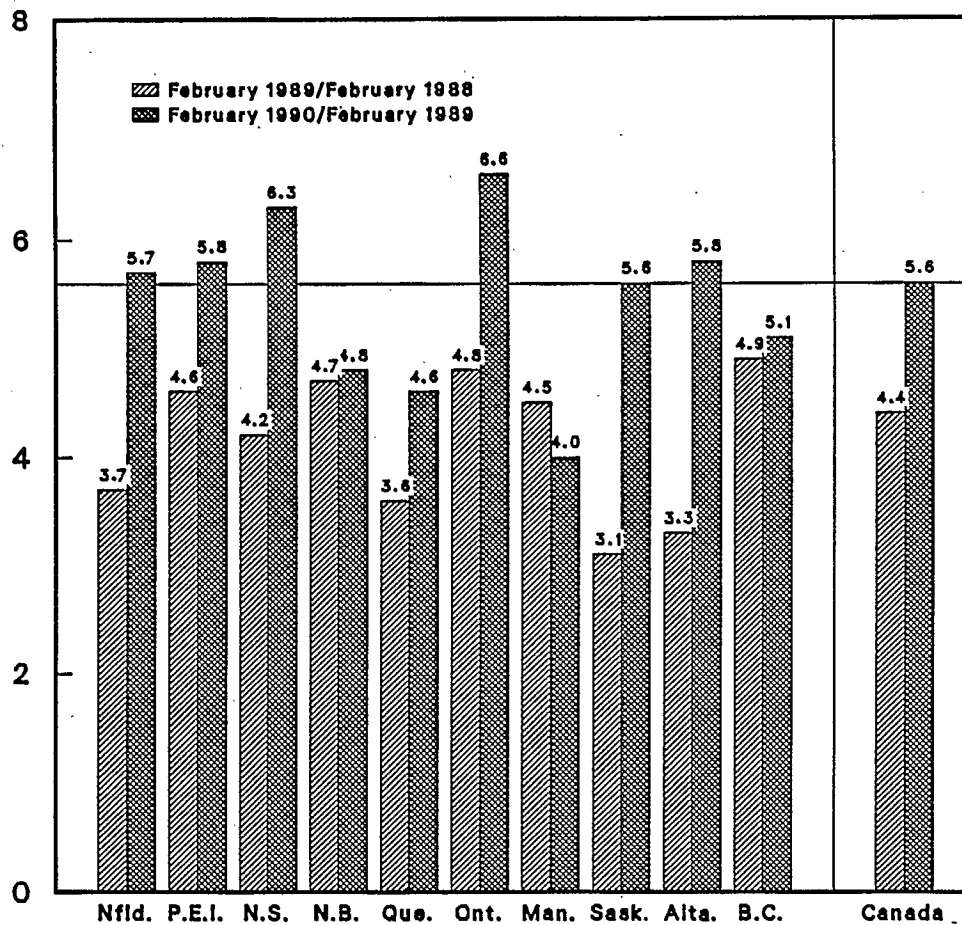
per cent - year over year



- ° Just as inflation is a national, not a regional problem, similar trends are evident in wage costs.
- ° Average hourly earnings nationally were up substantially over the past year, and increased in all provinces except Manitoba.
- ° Six provinces have recorded increases in average hourly earnings at or above the "national average".
- ° The strongest increases have occurred in Saskatchewan and Alberta (2.5 percentage points), Newfoundland (2.0 percentage points) and Ontario (1.8 percentage points).

Underlying Inflation/Cost Pressures

Average Hourly Earnings - By Province per cent

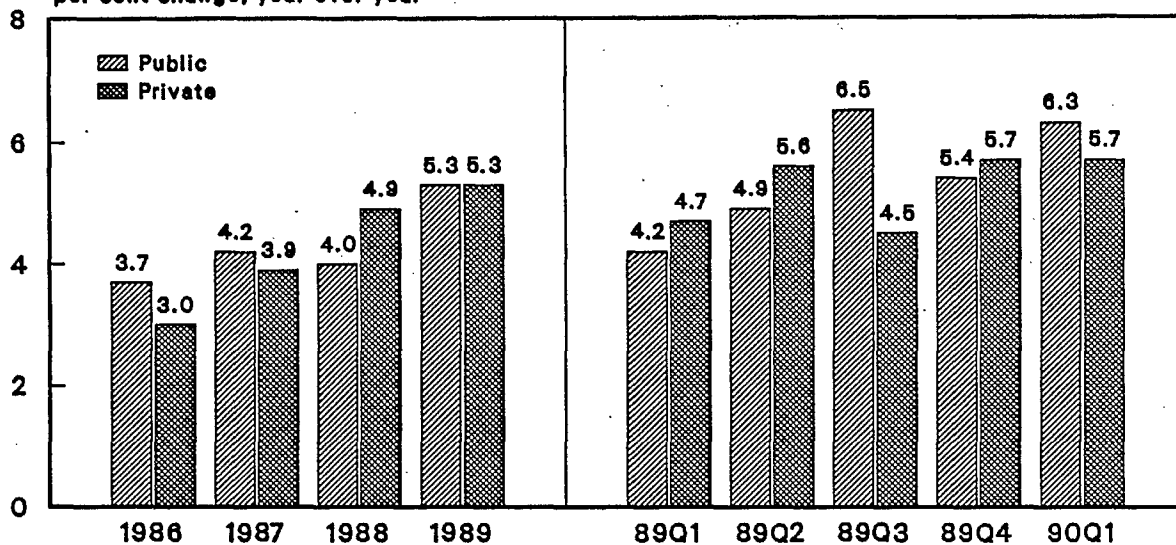


- ° Examining the wage cost problem from a private versus public sector perspective is also useful.
- ° Public sector wage settlements, which had lagged those of the private sector in 1988, accelerated through 1989 and are currently outpacing those of the private sector; this has occurred despite an acceleration in private sector settlements during the past three years.
- ° This acceleration in public sector settlements reflects strong increases in the PLH sector; PLH wage settlements rose to 6.5% while federal settlements have remained stable at 4.2%.

Underlying Inflation/Cost Presures

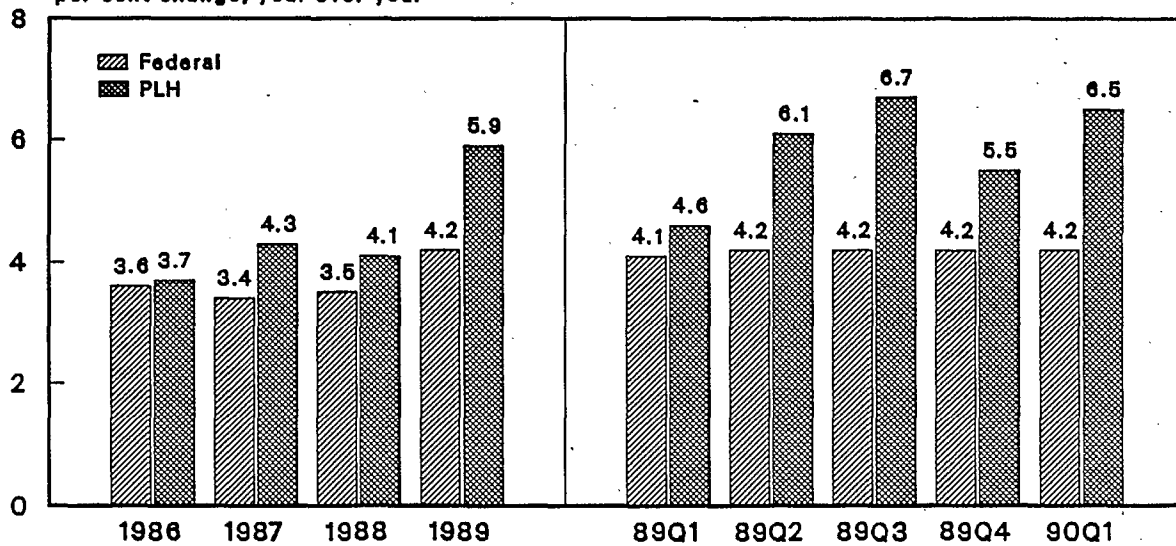
Public and Private Sector Wage Settlements

per cent change, year over year



Public Sector Wage Settlements

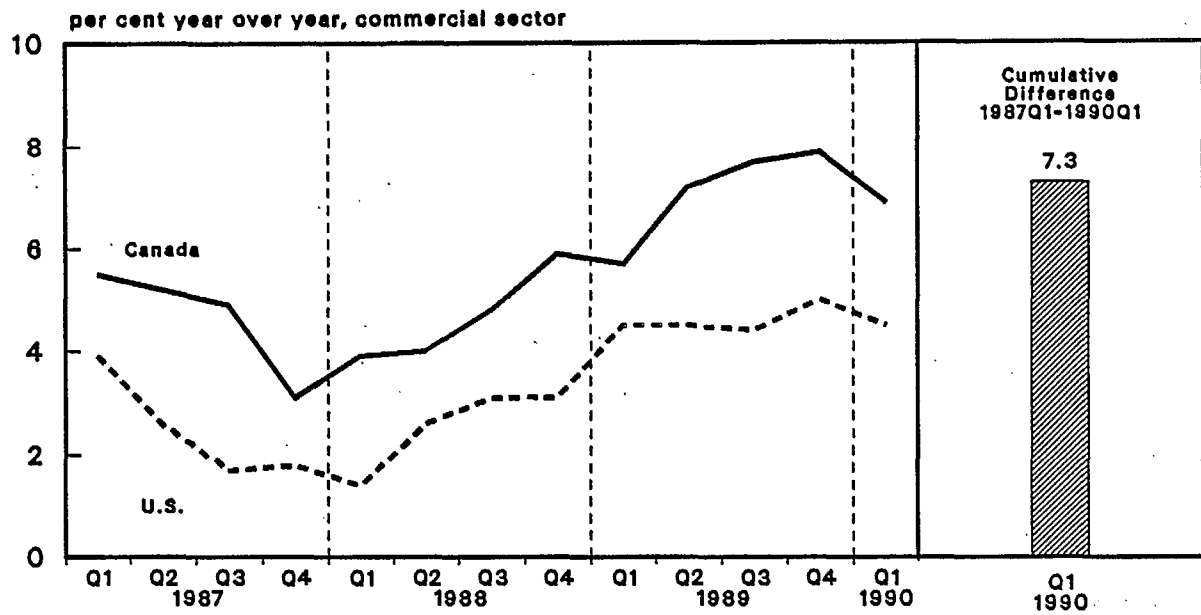
per cent change, year over year



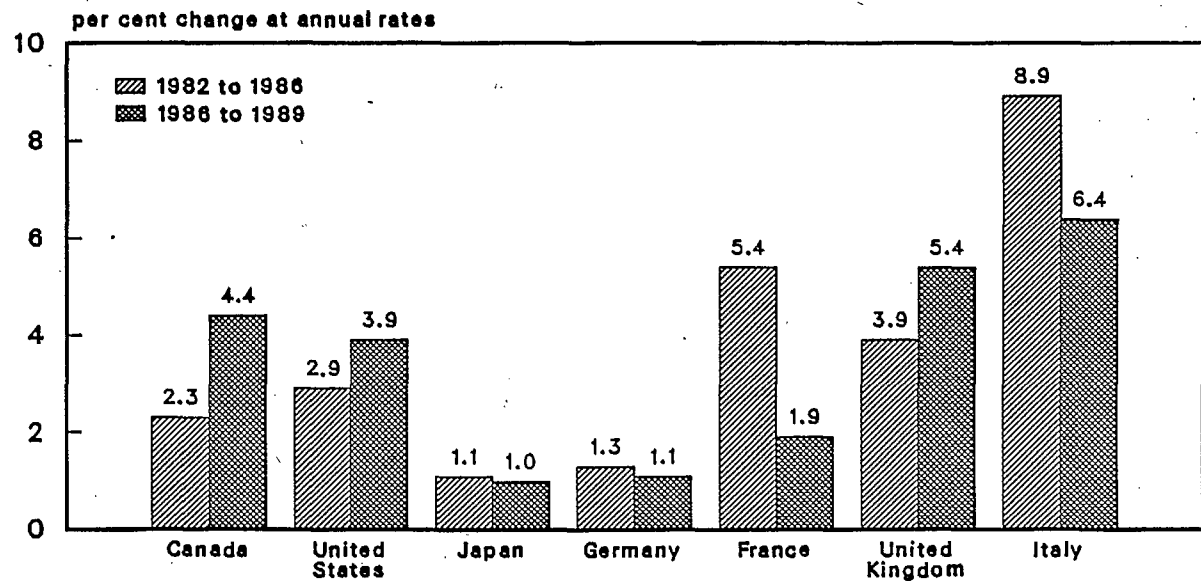
- ° Broad measures of an economy's cost competitiveness, such as "unit labour costs", show the serious deterioration in our international competitive position.
- ° Canadian unit labour costs have consistently outpaced those in the U.S.; the deterioration in Canada's cost competitiveness with Japan and Germany is even more pronounced.

International Comparisons Worsen

Growth of Unit Labour Costs Canada-U.S. Comparison



Growth of Unit Labour Costs Measured in Domestic Currencies



Source: OECD, *Economic Outlook*, December 1989.

- ° Domestic demand growth has been significantly stronger in Canada relative to the U.S., giving rise to greater capacity constraints, and hence, underlying inflation pressures.

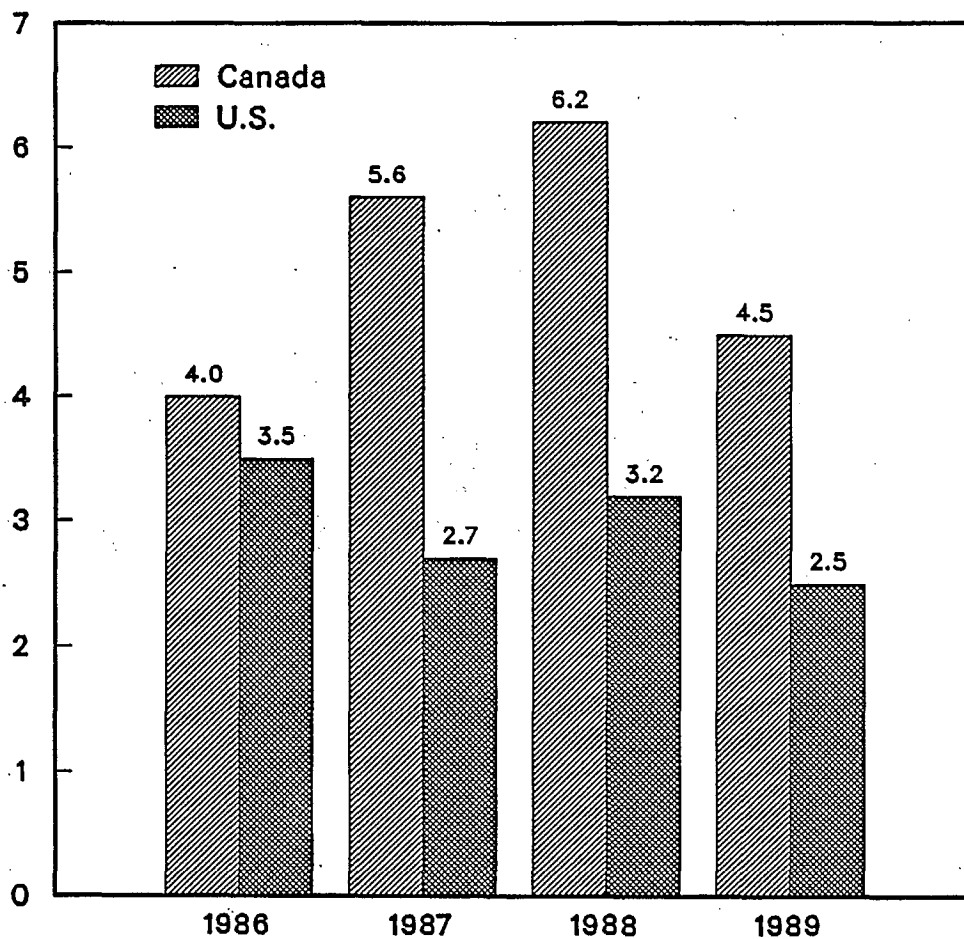
FINAL DOMESTIC DEMAND - KEY COMPONENTS
CANADA - U.S. COMPARISON
(per cent growth)

	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1989</u>			
					<u>Q1</u>	<u>Q2</u>	<u>Q3</u>	<u>Q4</u>
					(quarterly growth, annual rate)			
CANADA								
Final domestic demand	4.0	5.6	6.2	4.5	5.4	2.7	1.1	7.0
Consumer expenditures	4.2	4.9	4.3	4.0	2.6	4.6	1.7	5.4
Residential investment	13.3	16.4	4.6	4.1	15.1	-16.5	6.4	15.5
Non-residential business investment	4.1	11.1	18.9	8.2	14.3	6.3	-7.2	11.4
UNITED STATES								
Final domestic demand	3.5	2.7	3.2	2.5	1.2	2.7	3.2	0.1
Consumer expenditures	3.9	2.8	3.4	2.7	2.0	1.9	5.6	0.5
Residential investment	12.2	-0.4	-0.3	-2.9	-5.0	-12.3	-9.2	-1.1
Non-residential business investment	-3.3	3.9	8.4	3.3	6.9	8.6	5.2	-5.4

International Comparisons Worsen

Canada - U.S. Final Domestic Demand Growth Comparison (Real Terms)

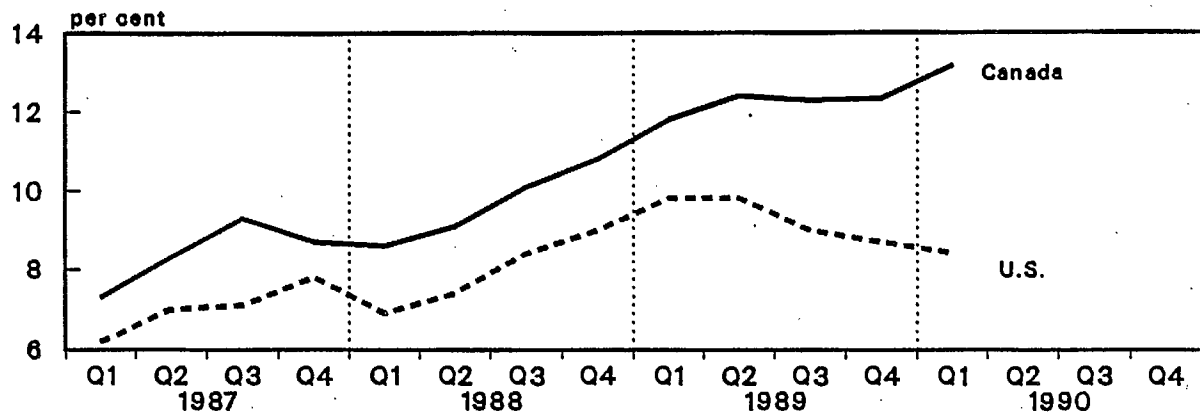
per cent - year over year



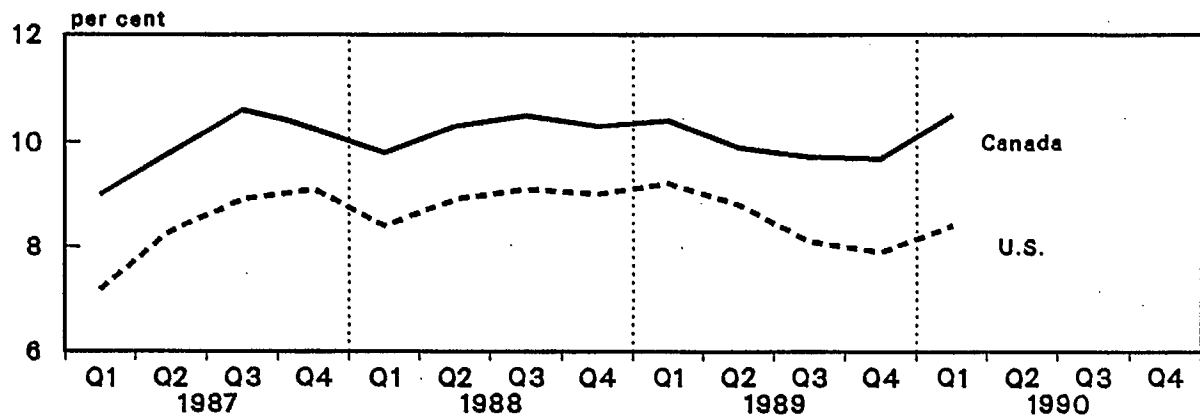
- ° As significant and escalating wage and price pressures confronted a firm monetary policy, interest rates rose steadily in both Canada and the U.S.
- ° Over the past year, although U.S. rates have eased somewhat, those in Canada have continued to rise in response to an acceleration in underlying cost and price pressures.
- ° The Canadian dollar steadily appreciated vis-a-vis its U.S. counterpart from the beginning of 1987 to year-end 1989, rising about 15%. Recently, the value of the Canadian dollar has declined somewhat.

Significant Policy Tightening

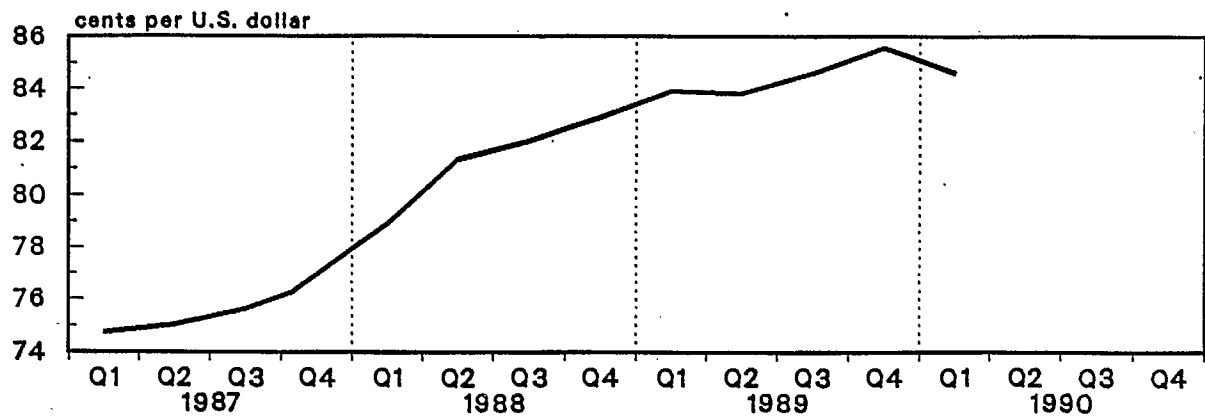
Canada-U.S. Short Term Interest Rates



Canada-U.S. Long Term Interest Rates



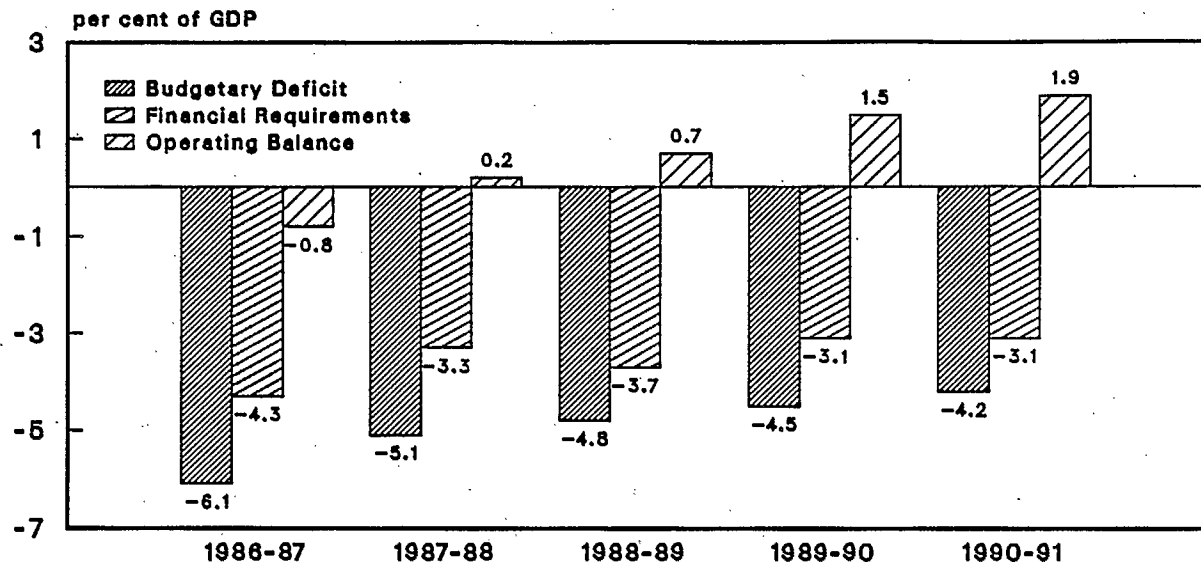
Canada-U.S. Exchange Rate



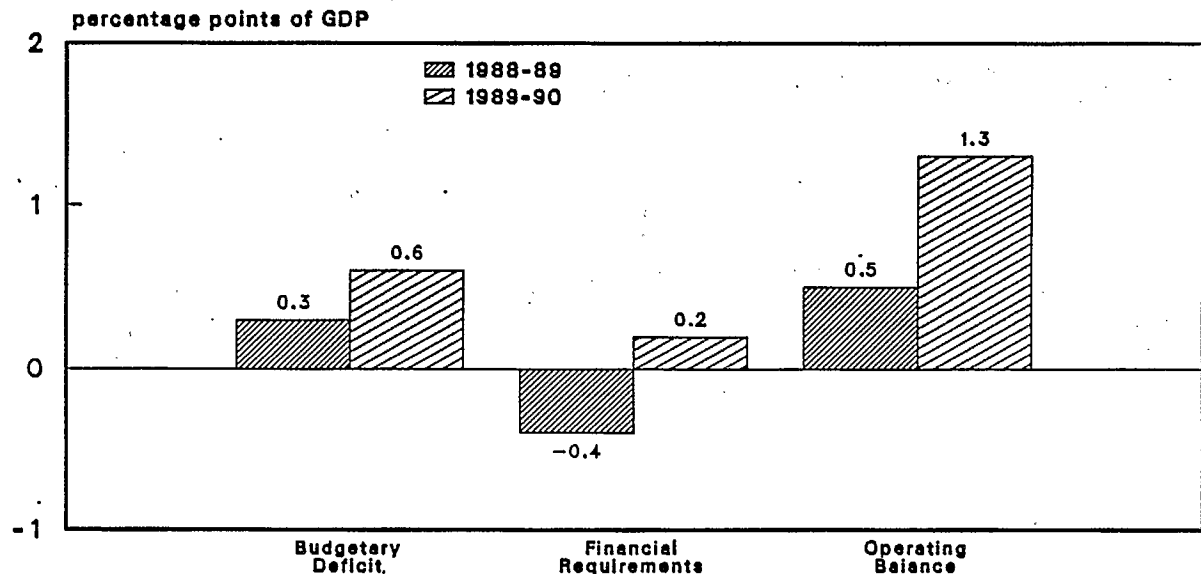
- ° To help restrain inflationary pressures and provide scope for sustainable declines in interest rates, fiscal policy has been tightened significantly since 1987.
- ° The extent of the restraint is evidenced by the growing operating surplus; that is, the difference between government revenues and ongoing program expenditures.
- ° Reflecting mainly actions to restrain program spending, the operating surplus has grown as a percentage of GDP from 0.2 per cent in 1987-88 to 1.5 per cent in 1989-90. This represents an increase of nearly \$9 billion.

Government Fiscal Position

Federal Fiscal Stance



Cumulative Change in Fiscal Stance In 1988-89 and 1989-90



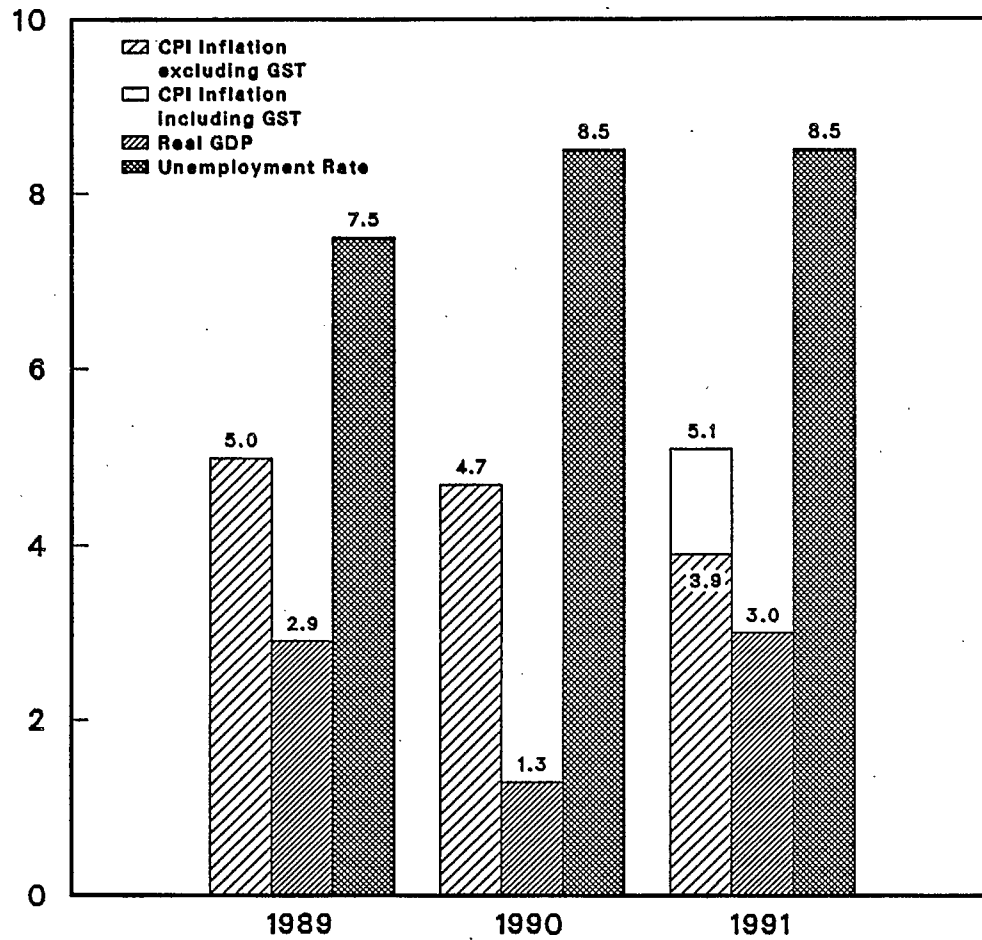
Positive sign indicates movement toward restrictiveness.

- ° The government's fiscal and monetary policies are targeted at creating the conditions necessary for sustainable economic growth.
- ° Output growth is forecast to weaken this year with the unemployment rate rising to 8.5% by year-end. This will ease inflationary pressures and lay the foundation for sustained economic expansion.

Outlook

Canadian Economic Outlook February 1990 Budget Projections

per cent

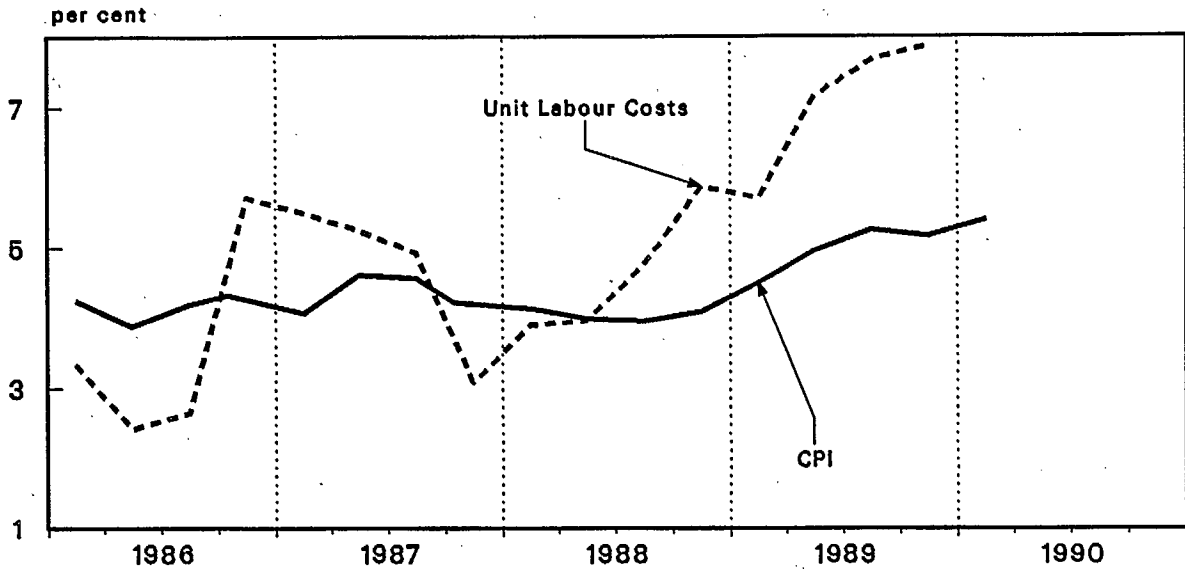


° The underlying inflation risks are greater in Canada than in the U.S.

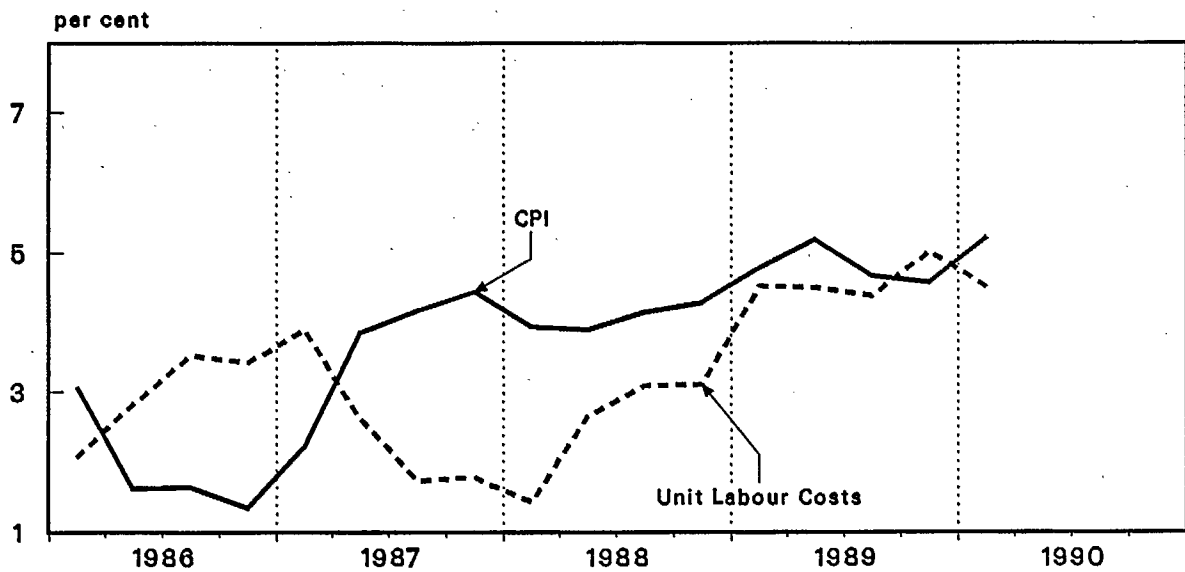
- » In the U.S., labour cost increases are currently tracking the rate of inflation.
- » In Canada, however, growth in unit labour costs are significantly stronger than the current rate of inflation, posing a risk of an acceleration in prices in the near term.

Competitiveness Risks Increasing

Growth In Prices and Costs: Canada



Growth In Prices and Costs: United States



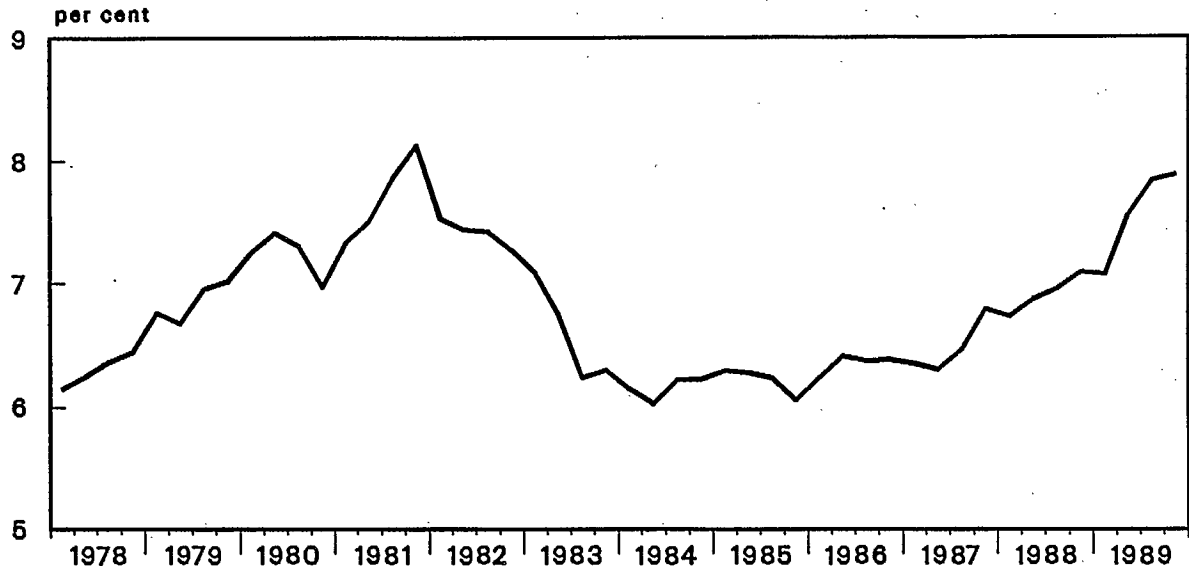
- ° Substantial increases in household borrowing in recent years, combined with increased borrowing costs, have pushed consumer debt burdens to levels similar to the early 1980s. A reduced pace of household borrowing is essential to reverse this situation.
- ° Similarly, corporate profit margins have declined dramatically since late-1988. The key to restoring corporate balance sheet positions is to control unit labour cost pressures.

INDUSTRIAL CORPORATIONS PROFIT MARGINS
(per cent)

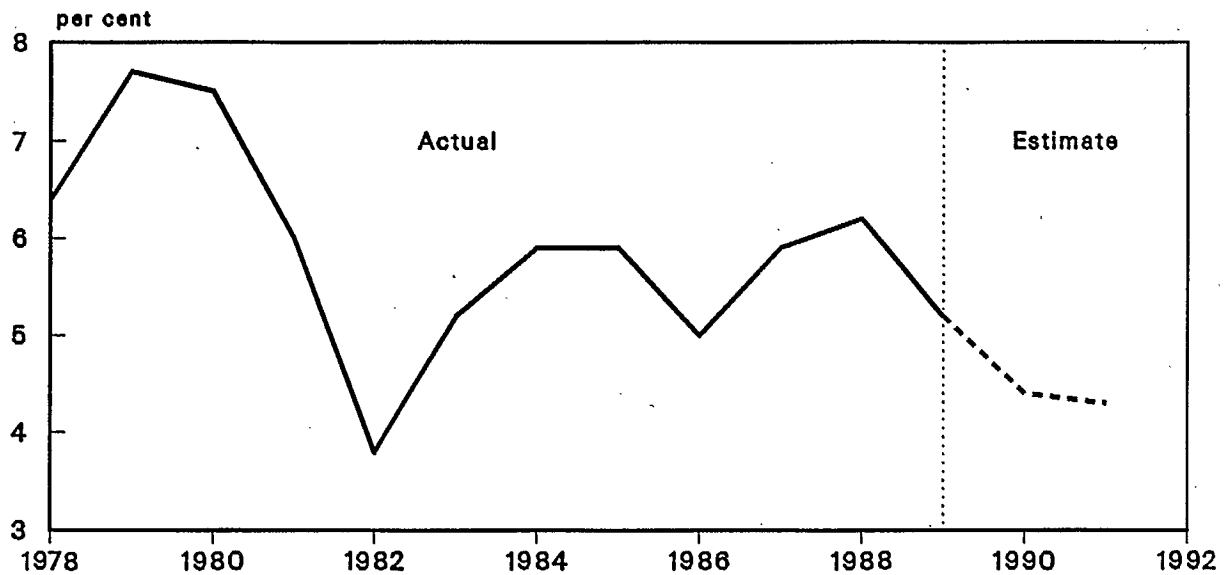
	1977-87 <u>Average</u>	<u>Q1</u>	<u>Q2</u>	1988 <u>Q3</u>	<u>Q4</u>	<u>Q1</u>	1989 <u>Q2</u>	<u>Q3</u>	<u>Q4</u>	1990 <u>Q1</u>
All industries	5.92	6.22	6.11	6.25	6.07	5.80	5.39	4.89	4.88	4.33
Resource	13.08	12.21	13.15	12.37	13.01	11.92	10.52	9.16	8.52	7.19
Non-Resource	4.78	5.43	5.18	5.46	5.18	5.01	4.72	4.35	4.42	3.97

Competitiveness Risks Increasing

**Interest Costs on
Consumer and Mortgage Credit
Relative to Personal Disposable Income**



Industrial Corporations Profit Margins



° Divergent trends in the cost-price situation in the goods and services sector are also evident in employment and output.

» Goods-sector output growth has slowed significantly in recent quarters while the slowing in the services sector has been far less pronounced.

» Employment has declined over the past year in the goods sector. In contrast, services employment continues to grow strongly.

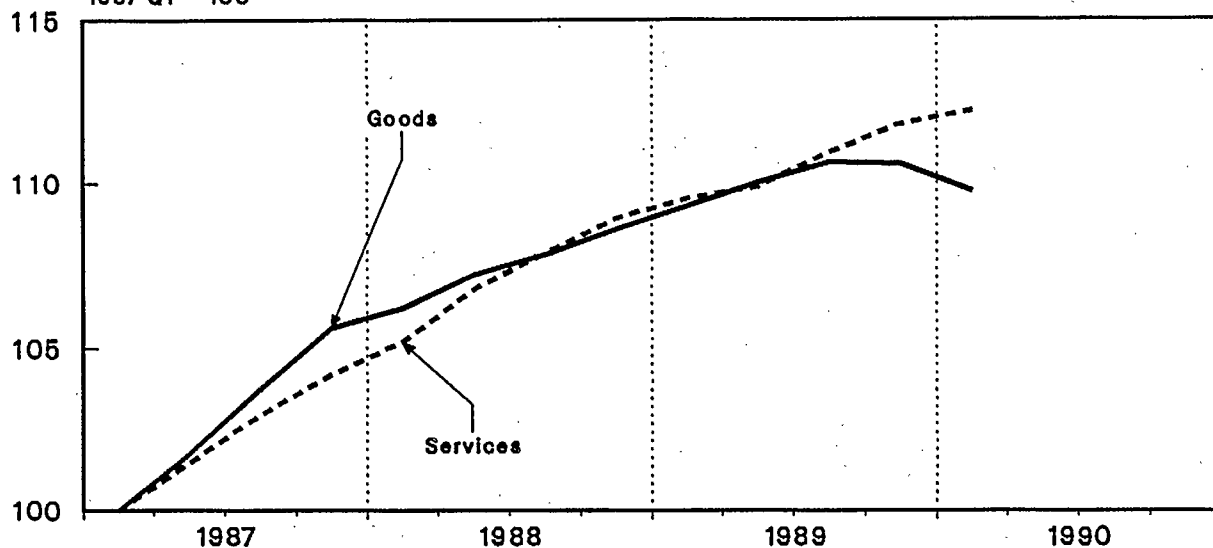
EMPLOYMENT BY TYPE OF INDUSTRY
(year-over-year per cent change)

	<u>1988</u>	<u>1989</u>	<u>1989</u>		<u>1990</u>				
			<u>Q3</u>	<u>Q4</u>	<u>Q1</u>	<u>Jan</u>	<u>Feb</u>	<u>Mar</u>	<u>Apr</u>
Goods sector	4.0	1.2	1.6	-0.2	-0.8	-0.9	-0.9	-0.8	-0.7
Agriculture	-3.7	-3.6	2.7	-2.3	-0.4	-1.1	0.0	0.0	3.8
Other primary	3.5	-2.0	-3.6	-7.8	-3.2	-4.0	-1.5	-4.0	1.1
Manufacturing	4.3	1.0	0.6	-0.9	-2.8	-2.4	-2.3	-3.6	-5.9
Construction	7.9	5.2	3.6	6.1	5.8	5.3	3.2	9.1	11.1
Services Sector	2.9	2.3	2.3	2.7	2.4	2.2	2.8	2.1	3.3
Transp., commun., utilities	0.6	6.3	7.7	7.4	1.3	2.8	1.8	-0.6	0.9
Trade	3.4	0.8	0.1	2.0	2.1	1.2	2.7	2.6	2.0
Finance, insur. & real estate	4.3	0.7	0.4	6.3	5.2	7.5	5.0	3.1	3.9
Business & personal services	3.7	2.2	1.4	1.7	2.6	1.9	2.9	3.0	5.5
Public admin.	0.2	4.3	10.1	0.6	0.2	1.3	1.0	-1.6	-0.7

Competitiveness Risks Increasing

Gross Domestic Product (at factor cost) 1987 to 1990*

1987 Q1 = 100



*1990 Q1 is an average of January and February data.

Employment 1987 to 1990

1987 Q1 = 100

