

Canada's Economic Performance

During the period from 1984 to 1989, the Canadian economy grew faster than any other G-7 economy except Japan's. Employment growth in Canada, over the same period, was the fastest. The strong growth of domestic demand in Canada throughout the current expansion has pushed the economy to, or above, its capacity to supply goods and services.

The primary threat to sustained economic growth has been the emergence and persistence of substantial inflationary pressures. In Canada, as in all other G-7 countries, these pressures increased in 1989 relative to the previous year. In 1989, Consumer Price Index (CPI) inflation in Canada rose by nearly one percentage point over the 1988 rate. Developments in interest rates and Canada's trade position also reflect clearly the demand pressures associated with the economy's robust growth over the last several years. Recent signs of moderation in the rate of expansion of the Canadian economy, however, hold out prospects of lower inflation and interest rates, and an improvement in trade performance.

Investment spending has been a leading contributor to the current economic expansion. Growth of investment spending in 1989, although more restrained than in 1988, remained faster than that of any other component of domestic demand.

The sizable import component of machinery and equipment spending meant that the buoyancy of investment in 1989 contributed to a large increase in imports. After posting a surplus of \$6.9 billion in 1988, real net exports declined to a deficit of \$5 billion in 1989, a swing of 2.7 percent of GDP. Other factors contributing to this decline were a moderation of demand growth in the U.S., a reduction in wheat exports following the 1988 drought, and continued strong growth of other components of domestic demand in Canada.

In addition to the deterioration in the nominal trade balance, net investment income paid to non-residents increased to \$4 billion. As a result, the current account deficit widened substantially in 1989, reaching a record \$22.3 billion (at annual rates) in the fourth quarter. For 1989 as a whole, the current account deficit was \$19.7 billion, up from \$10.3 billion in 1988.

The pressure exerted by the strong growth in demand on the economy's productive capacity is also reflected in the recent behaviour of prices. The CPI inflation rate increased from 4.1 percent in 1988 to 5 percent in 1989 and continued at that rate into 1990. Moreover, the increase in inflation in 1989 occurred despite a steady appreciation of the Canadian dollar over the course of 1989.

Some signs of easing in product markets, however, are becoming apparent. The backlog of unfilled orders has declined from peaks established in mid-1989, while the rate of industrial capacity utilization has fallen in each of the last five quarters.

The tightness in labour markets experienced in 1989 continued into 1990. This has led to a marked increase in wage growth in almost every province. At the same time, sluggish productivity growth has meant that increased wage costs have been translated into increased unit labour costs. In the fourth quarter of 1989, unit labour costs were 6.9 percent above the level a year earlier.

Responding to increasing inflationary pressures in early 1989, short-term interest rates climbed and then stabilized for most of the year. Signs of emerging weakness in the U.S. economy led to a decline in short-term U.S. interest rates of almost 200 basis points over the course of the year.

The short-term interest rate differential between Canada and the U.S. (on 90-day commercial paper) increased to about 400 basis points by the end of the year and contributed to the rise of the Canadian dollar. Continuing inflation pressures and some instability in exchange markets precipitated a further rise in Canadian short-term interest rates in early 1990, as a result of which the interest rate differential rose to over 500 basis points.

Demand pressures in Canada remain strong relative to the economy's capacity to produce goods and services. An easing in demand growth would have a beneficial impact on interest rates, inflation rates, and the external balance. It would also help to create an environment in which the benefits of the structural reforms undertaken in recent years would become apparent. These reforms include those to the income tax system in 1988, the Free Trade Agreement with the U.S., the replacement of the Federal Sales Tax with the Goods and Services Tax, the Labour Force Development Strategy, deregulation in a number of sectors and the privatization of a number of Crown corporations.