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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/10

10:00 a.m., January 20, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	
	M. Teijeiro
R. D. Erb	M. K. Bush
	D. C. Templeman, Temporary
	M. Z. M. Qureshi, Temporary
T. Hirao	T. Yamashita
	Jaafar A.
R. K. Joyce	L. Leonard
	H. A. Arias, Temporary
	G. Grosche
	W. Moerke, Temporary
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
	O. Kabbaj
F. Sangare	
M. A. Senior	J. L. Feito
J. Tvedt	K. A. Hansen, Temporary
	T. A. Clark
	J. Bulloch, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

Asian Department: J. T. Boorman, R. H. Nord. European Department: L. A. Whittome, Counsellor and Director; P. Dhonte, A. Leipold, K.-W. Riechel, K. A. Swiderski. Exchange and Trade Relations Department: G. G. Johnson, R. Pownall. Fiscal Affairs Department: G. Blöndal, B. J. Nivollet. Legal Department: P. L. Francotte. Research Department: M. D. Knight. Western Hemisphere Department: S. T. Beza, Associate Director; K. B. Bercusson, D. L. Budhoo, C. V. A. Collyns, L. E. de Milner, J. Ferrán, E. Hernandez-Cata, Y. Horiguchi, L. R. Kenward, F. Pham. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, K. A. Hansen, H.-S. Lee, G. E. L. Nguyen, Y. Okubo, D. I. S. Shaw. Assistants to Executive Directors: I. Angeloni, M. Camara, L. E. J. M. Coene, R. J. J. Costa, G. Ercel, G. Gomel, V. Govindarajan, D. Hammann, C. M. Hull, J. M. Jones, H. Kobayashi, S. Kolb, M. J. Kooymans, G. W. K. Pickering, A. A. Scholten, Shao Z., N. Toê, Wang C. Y.

1. LUXEMBOURG - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Luxembourg (SM/83/264, 12/28/83). They also had before them a report on recent economic developments in Luxembourg (SM/83/265, 12/30/83).

Mr. de Groote made the following statement:

> This is the first time that consultations with Luxembourg are being held separately from those with its partner in the Belgian-Luxembourg Economic Union (BLEU). My Luxembourg authorities have expressed their general concurrence with the analysis presented by the staff and acknowledge that their views are comprehensively reflected in the staff report.
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> The main problem of Luxembourg's economy is the surplus capacity in the steel sector, which again faced weak foreign demand throughout 1982 and 1983. Great efforts are being undertaken through the cooperation of the social partners to implement the designated structural adjustments in a smooth manner. The measures to be applied require broad financial assistance from the Central Government. The Government has chosen to follow its traditional policy by using increased taxes and budgetary reserves to finance the restructuring of the steel sector, rather than resorting to borrowing. However, continuation of these policies will become problematical, since in the view of my authorities the tax burden has now reached a limit.
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> In the framework of the restructuring, the drop in the output of the steel sector is to be compensated by the development of the nonsteel industrial sector and the continuing growth of the banking sector. Development in the nonsteel industrial sector was mainly achieved through the use of fiscal incentives. The growth of the banking sector was to some extent made possible by the expansion of the Eurobanks into the retail business and by their ability to attract a larger share of private resources. There is some doubt, however, whether this trend will be able, in the near future, to compensate for the cutback in the loan syndication business. The authorities are conscious of the importance to the economy of the banking sector and are constantly striving to improve the overall legal, fiscal, and monetary infrastructure on which it rests.
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> The openness of Luxembourg's economy leaves it quite vulnerable to external price trends. It is therefore a primary goal to contain the domestic components of inflation. We must thus recognize the importance of the politically courageous decision, taken as a consequence of the February 1982 devaluation of the Belgian and Luxembourg currencies, to replace the system of automatic wage adjustments linked to price changes by small

stepwise adjustments not linked to price increases. However, since wage and price formation have remained basically free, wage drift has partially offset the beneficial effects of this wage adjustment formula. Moreover, the trade sector readjusted its margins following the period of the price freeze, and the freeze on net trading profits in 1983 was less effective than expected. Also, there seem to be some market segments lacking the desired level of competition and displaying a tendency to monopolistic behavior. These factors may partly explain why the inflation rate in Luxembourg is higher than the industrial country average.

The Luxembourg authorities fully realize that they are faced with a fundamental structural adjustment of the economy. In formulating their policies, the authorities hold to a long-term perspective and avoid resorting to short-term measures that would provide only temporary relief. A favorable international environment is of course essential to the success of these policies. So far, the authorities have already absorbed 75 percent of the required reduction in the steel sector without loss of employment and without a large financial burden. Further adjustments, such as those expected for 1984, will require a larger financial intervention, but this will be temporary. The Luxembourg authorities do not think that they can afford a larger budget deficit with the present current account surplus. This surplus has been shrinking continuously in recent years; until the structural adjustment of the economy is fully implemented, the authorities prefer to follow cautious policies, as they have done in the past, and to resort as little as possible to borrowing.

Mr. de Maulde remarked that the Luxembourg economy appeared healthy. Most countries would envy its GDP per capita of $11,000, its unemployment rate of 1.6 percent, and the absence of official external liabilities. He commended the Luxembourg authorities for successfully restructuring their economy in recent years. By 1985, the burden of supporting the steel sector would decrease significantly, bringing the budget deficit to a negligible percentage of GDP, a welcome development. The current heavy reliance on the banking sector entailed new risks, as Mr. de Groote had mentioned. In light of Luxembourg's remarkable success in diversifying from steel into banks, it would be interesting to know whether thought had been given to the kinds of activity into which it might be possible to diversify from banking, should the time come for such action. His only criticism concerned the level of official development assistance, which, at 0.12 percent of GDP in 1982, with further reductions expected in 1983 and 1984, was very low; the Luxembourg authorities would be well advised to take a fresh look at the question. He welcomed the recent creation of the Luxembourg Monetary Institute, which would be the Fund's agent in Luxembourg and the depository for the Fund's holdings of Luxembourg francs.

Mr. Senior said that he agreed with the staff's appraisal. Macroeconomic management of the Luxembourg economy had been geared to facilitating the restructuring of the productive base by shifting resources from heavy industry toward service activities. Demand policies had, therefore, been guided wisely by long-term considerations and had not impaired the process of broadening and diversifying the real economy. The authorities should be commended for that strategy, which would continue to be the basis of their policies in the future. The decline in the output of the steel sector had been compensated to date mainly through the growth of the banking sector associated with the expansion of the Eurobanks. He understood that Eurobanking activity was now shrinking or, at least, growing at a much lower rate than in the past. He invited the staff or Mr. de Groote to comment on the prospects for Eurobanking activity and its bearing on the restructuring of the Luxembourg economy.

Mr. Moerke stated that his authorities welcomed the separate Article IV consultation with Luxembourg. It provided the opportunity to look more intensely at developments in a small but interesting economy. The results of the authorities' efforts to restructure the economy were impressive and commendable. Despite heavy losses of employment in the steel sector, unemployment had been held at a relatively low level. The authorities' fiscal stance had been prudent. The adjustments in real wages through changes in the indexation mechanisms and incomes policy similar to Belgium's had helped to safeguard the economy's competitiveness. The Monetary Association Agreement with Belgium, which provided the framework for the conduct of monetary and exchange rate policy, had worked satisfactorily. He supported the authorities' intention to maintain the franc in the zone of the most stable currency within the European Monetary System (EMS). The authorities believed that future exchange rate adjustments would have to be guided by the overall economic situation in Belgium and Luxembourg. In light of the potential for differing economic developments in the two countries, there might be good arguments for not maintaining the Luxembourg franc at par with the Belgian franc at all times. In that regard, he had some sympathy for the views expressed by the staff. However, it had been suggested that considerable costs might be involved in following such an approach; he invited the staff to comment further on the question.

Mr. Leonard noted that current and prospective difficulties facing the Luxembourg economy were severe. Further contraction of the steel sector was in prospect, future expansion of the banking sector could scarcely take place at the rapid pace of recent years, employment was no longer rising, and the future health of the economy required diversification into new areas of activity. Furthermore, the rate of inflation was higher than the average for industrial countries. The situation underscored the relevance of the remarks made by Mr. Moerke with regard to the exchange rate.

However, he was confident that the resourcefulness and commitment that the Luxembourg authorities had shown in adapting the economy over the past decade would not falter, Mr. Leonard continued. They had a large measure of freedom from fiscal and external constraints as a result of the sound management policies pursued to date. In addition, the issue of unemployment and living standards did not press upon them as closely as upon the authorities of other European countries; he believed, therefore, that Luxembourg would successfully confront its present problems.

The staff's comments on the need for effective and continued wage restraint, particularly for strict observance of the norms defined for 1984, deserved support, Mr. Leonard suggested. In continuing to limit the public sector deficit, fiscal policy should move from raising revenue as a proportion of GNP to containing the growth of expenditure. In regard to the active employment policy being pursued by the authorities, he hoped that the expedient of maintaining excess labor in the steel industry would be phased out, as suggested in SM/83/264. Early retirement and the more liberal application of the rules relating to disability also involved economic costs, although presumably they were considered acceptable in Luxembourg because the costs were relatively small. He invited the staff to confirm that point. He looked forward to hearing of further progress in the diversification of the Luxembourg economy on the occasion of the next Article IV consultation.

Mr. Polak commented that the staff provided evidence that close attention to the Luxembourg economy was worthwhile. Although the ratification in March 1983 of the Monetary Association Agreement with Belgium had settled the issue of possible monetary independence, in turn diminishing the importance of Luxembourg's exchange rate policy, there remained a number of differences between Belgium and Luxembourg that justified the separate Article IV consultation. While the inflation rate was about the same as in Belgium, budgetary policy was more conservative. The budget deficit was usually about 1 percent of GDP, although in one recent year there had been an increase to 4 percent for a compelling reason, namely, the refinancing and reorganization of the steel industry. The attitude of the authorities in the two countries toward policy also appeared somewhat different. For example, Mr. de Groote's remarks about Luxembourg did not apply as readily to Belgium: "In formulating their policies, the authorities hold to a long-term perspective and avoid resorting to short-term measures that would provide only temporary relief."

Given the absence of an independent exchange rate policy, Mr. Polak continued, the outlook for Luxembourg depended strongly on nominal wage developments to maintain competitiveness. Some of the data and the rationale presented by the staff with regard to current wage policy were puzzling. In SM/83/264, the staff referred to a 4 percent reduction in real wages in 1982 and 1983 taken together. OECD figures, however, showed a 5.5 percent increase in real wages in 1982 for a large group of wage earners. Had developments been so different in 1983 that the two statements were compatible? He invited the staff to comment further. Wage policy was based on repeated step increases of 2.5 percent, independent of the rate of inflation, the reason for which was not entirely clear; however, he commended the authorities' decision to limit the increase in 1984 to one step, following three increases in 1983. He hoped that the system allowed for sufficient flexibility should wage developments in Luxembourg's trading partners turn out to be different from expectations, and that the policy would be guided by experience.

The comprehensive plan worked out for the steel sector in 1983 was welcome, Mr. Polak considered, as was the prudent way in which the authorities handled the budgetary consequences of the plan. He understood that steel output had been about 6.4 million tons in 1974, and that it had been reduced to about half by 1983. However, it was proposed to reduce capacity by only about 15 percent to about 4.5 million tons. He invited the staff to comment on whether it was reasonable to expect so strong an upturn in the demand for Luxembourg's steel as to make such a cut in capacity sufficient.

The authorities should be encouraged to stay on the narrow path of fiscal discipline, Mr. Polak remarked. The policy had served Luxembourg, and other countries, well; no experiments with deviations from such a path were warranted. In view of possible further increases in outlays on pension funds and on the steel sector, it would be necessary to contain the growth of other expenditures by limiting the growth of entitlements. Finally, it was disappointing that a country that made so much money from international banking contributed so little to official development assistance, as Mr. de Maulde had pointed out. The reported level was 0.12 percent of GDP, with the expectation that it would decline.

Mr. Hansen said that he agreed with the staff appraisal. Given the importance of the export sector and the steel industry, it was noteworthy that overall activity, including the labor market, had performed much better in Luxembourg than in most other countries. In addition, the Luxembourg authorities had so far conducted the restructuring of the steel sector and the diversification of the economy with success. Although the outlook suggested some decline in activity, the generally healthy state of the economy and the authorities' determination to continue to diversify it were encouraging. Given Luxembourg's importance in international banking, he welcomed the establishment of the Luxembourg Monetary Institute and the emphasis that the authorities were placing on its activities.

Mr. Suraisry remarked that the authorities' policy choices were limited by the small, open nature of the economy and by the close economic and financial ties with Luxembourg's neighbor, Belgium. The authorities had followed and continued to follow generally prudent policies well designed to deal with Luxembourg's difficulties. The main challenge was posed by the serious problems in the steel industry. It was encouraging that the authorities were implementing a comprehensive plan to modernize and restructure that sector. Although heavy budgetary costs were involved in the short term, the long-term benefits should be considerable. He also welcomed their successful efforts at diversifying into other industries and promoting international banking.

The authorities' continuing attempts to bring inflation under control should be commended, Mr. Suraisry continued. Fiscal policy had traditionally been restrained, and there had been a return to a structurally balanced budget in 1984. He agreed with the staff that there might be scope to reduce the growth in entitlement spending over the medium term. Continued wage restraint would also be vital to keep inflation down and to maintain the economy's competitive position. On the monetary side, the recent establishment of the Luxembourg Monetary Institute should make it possible to follow a more active credit policy. However, that development would "not significantly alter the institutional framework for the conduct of monetary policy," in the staff's words. He also welcomed the recent improvement in the prudent supervision of the banking system, action that should strengthen the operational basis of that important sector of the Euromarket. Given the extent of the problems in the steel sector, it was arguable that the 18-month consultation cycle proposed by the staff might be too long. Finally, he agreed with other Directors that the low figure for official development assistance was surprising.

Miss Bulloch remarked that her authorities believed that the exercise of Fund surveillance would be enhanced by the holding of Article IV consultations with Luxembourg separate from those with Belgium. At the same time, they continued to see advantages in joint consultations in certain situations, for example, among some members of the East Caribbean Currency Area. With regard to the timing of the next Article IV consultation with Luxembourg, she accepted that the 18-month cycle appeared to have been established as suitable for small economies, but, like Mr. Suraisry, she was not fully convinced that it was appropriate in the present case. Luxembourg's economy would need to be considered in conjunction with that of Belgium, which was on the 12-month cycle. More important, the difficulties outlined by the staff suggested that consultations should be more frequent than every 18 months.

Commenting on the staff's appraisal, Miss Bulloch said that she agreed that priority should be given to policies aimed at facilitating structural adjustment. The staff struck the right note in warning against policies that could crowd out the resources needed for new productive activities during the period when the steel industry was being run down. The staff report could have benefited from a more rigorous medium-term assessment, covering, in particular, the conditions for the development of a diversified and competitive economy and the constraints on domestic adjustment that followed from the integration of monetary and exchange rate policies with those of Belgium. Perhaps the staff could look further at that question on the occasion of the next Article IV consultation.

Mr. Templeman observed that in several important areas the Luxembourg economy had performed well in recent years. Faced with a declining steel industry, which had posed grave restructuring problems in a number of industrial countries, the Luxembourg authorities had made considerable progress in developing alternative sources of economic growth and employment. Diversification had occurred, particularly into international banking, but also into other services and into other nonsteel industries. At the same time, a serious effort was being made to modernize the remaining smaller steel industry. An unemployment rate of less than 2 percent was striking in the present world environment. In addition, fiscal management had remained prudent, public debt as a percentage of GDP had been stable, and Luxembourg had almost no foreign public debt.

Continued slow or negative growth, especially in the steel industry, and a rather rapid rate of inflation were less favorable aspects of recent economic developments, Mr. Templeman continued. The staff suggested that, following negative growth of GDP in 1982 and 1983, marginally negative growth was again in store in 1984 and that inflation would probably decelerate only slightly. Gross fixed capital formation had been negative in the previous three years, although much of that development was said to be the result of weak investment in the steel sector. It would be interesting to know in more detail what had been happening to investment in nonsteel sectors.

Because the exercise of monetary policy was limited by the openness of the economy and by the monetary arrangements with Belgium, and because fiscal policy was already rather cautious, Mr. Templeman remarked, much of the burden of containing domestic inflationary pressures fell on wage restraint. The suspension of wage indexation in 1982-83 and continued suspension of the system in 1984 in favor of predetermined limits on the number of step increases allowed each year represented an interesting experiment in that regard. The policy appeared to have slowed down the increase in hourly wage rates, at least temporarily. Was more information available on the authorities' plans for the period beyond 1984? The staff correctly isolated the key role of wage restraint in combating domestically generated inflation and in achieving the goal of exchange stability that the authorities had set for themselves. Indeed, the appreciation of the currency in real effective terms since mid-1982, although modest, might serve as a warning that the future role of wage indexation needed to be carefully assessed.

At a time when many countries were faced with grave and persistent budgetary problems, the prudence that the Luxembourg authorities had traditionally shown in that area was encouraging, Mr. Templeman went on. In recent years, the ratio of central government deficits to GDP of only 1-2 percent, except in 1983, was a notable achievement. For the future, the four guidelines set by the authorities--no increase in real expenditures, maintenance of "structural balance" in the budget, reconstitution of budgetary reserve funds, and pursuit of economic diversification and social welfare--were worthy of support. The growth in the ratio of revenues to GDP, from 30 percent in 1970 to 40 percent at present, supported the authorities' view that fiscal pressure, especially direct taxation, was already quite high. The past pattern of incurring surpluses on current operations large enough to finance a substantial share of public capital expenditures should be maintained. Expenditure control was, thus, left as the key policy variable. Close monitoring of expenditure trends would be required to ensure that the growing pressure on pension funds and possible further financing needs in the steel sector did not undermine budgetary restraint.

Luxembourg had a record of persistent current account surpluses in its balance of payments, Mr. Templeman noted. While he appreciated the concern expressed by the authorities about an inflationary impact from the 1982 devaluation, subsequent events had demonstrated the usefulness of that measure in helping to encourage both the growth of services that generated foreign income and the diversification of merchandise exports. Finally, the creation of the Luxembourg Monetary Institute in June 1983 would not have a major effect on monetary policy. However, the bank regulatory role of the Institute was important at a time when the prudent supervision of foreign lending had become increasingly important both to the stability of national banking systems and to international monetary stability.

The staff representative from the European Department, responding to Directors' questions regarding the diversification of the Luxembourg economy, noted that the banking industry had been a strong sector in recent years. Within the sector, the authorities were making a determined effort to develop more employment-intensive lines of activity, such as trust business and personal accounts. They were also aiming at a more diversified structure of economic activities in general, including the maintenance of a sizable steel sector and at the development of other industrial activities. Tradable nonbanking services represented another area that the authorities were looking to. Luxembourg already had a strong position in telecommunications, and there were plans to expand that industry further, as well as to develop such services as insurance. It was expected that the growth of tradable services would be a major component of future economic growth. However, the staff did not have specific macroeconomic data on investment in the nonsteel industrial sector, as one Director had requested. The available evidence, such as reports on new business being created and the amount of investment and employment thus generated, indicated a moderately rising trend in recent years. Those private sector activities were supported by official efforts, such as the creation of industrial zones and the scouting of foreign businesses that might be interested in investing in Luxembourg.

The development of the steel industry in Luxembourg was conducted within the context of the European Communities' steel policies, the staff representative continued, as well as in close coordination with the Belgian steel industry, in which the main steel producer in Luxembourg had important interests. Recently, important arrangements had been arrived at between the Luxembourg producer and two major Belgian steel concerns. However, the staff did not have detailed information with which to assess the appropriateness of Luxembourg's steel capacity program.

One Director had requested clarification of the data on real wages, the staff representative recalled. The information presented in SM/83/265 covered the development of real wages in the economy as a whole in the previous two years, taking into account the reductions in pay that had been put into effect in the steel sector, where they had been particularly pronounced. Insofar as the data presented by the staff differed from OECD data, the explanation had to lie in differences in coverage; for example, it was possible that the OECD data focused on developments in the banking sector and in minimum wages, which had risen in real terms.

The question of whether, and under what conditions, the Luxembourg franc might float independently of the Belgian franc had been raised, the staff representative observed, although it had been noted that such a policy could entail heavy costs, particularly the risk that interest rates might have to be raised sharply. The authorities had borne two considerations in mind when considering the question. First, because the inflation trend in Luxembourg was hardly different from that in Belgium, if it were assumed that the aim of an independent float of the Luxembourg franc was to achieve a higher exchange rate than the Belgian franc, there would need to be a major policy effort initially to reduce the rate of inflation; higher interest rates would probably be one element in such an effort. A second consideration related partly to the short term, and partly to the longer term. As a financial entity Luxembourg was relatively small by international standards: it was also an extremely open economy, particularly as far as financial transactions were concerned, with large resident holdings of foreign currency and, to some extent, large nonresident holdings of francs. Furthermore, the authorities would, at the outset of a decision to float the currency, be holding no reserves. There was, therefore, a potential for considerable volatility in the exchange market, while there would be no means of countering speculative movements through the use of reserves. Thus, the instrument that would have to be used, possibly very strongly, would be interest rates.

A number of relevant points had been put forward regarding the suggested consultation cycle, the staff representative from the European Department added. The staff was quite open to holding more frequent conversations with the Luxembourg authorities.

Mr. de Groote said that his Luxembourg authorities were determined to continue their efforts at economic diversification, including into such areas as financial services, particularly international insurance, in which they were developing an important network through liaison with European and U.S. companies. There were also good prospects of expanded investment in high technology sectors. With regard to the high capacity in the steel industry, Luxembourg hoped to expand its production of specialized steel products through the arrangements with the Belgian steel industry and the industry in the Lorraine Basin. Those arrangements were benefiting from support by the European Community.

Directors' strong support for the authorities' strict budgetary stance was encouraging, Mr. de Groote continued. The authorities now faced a difficult period, because they wished to avoid as far as possible the financing of government expenditure through borrowing, particularly external borrowing. However, they also considered that the limits of taxation were being reached. Thus, the only solution was to reduce expenditures, although there might be a strictly temporary resort to borrowing if it turned out to be absolutely necessary. There had been a substantial reduction in consumers' real income in 1983, of about 4-5 percent. The authorities did not believe that the same effort would be required in 1984; they had framed wage policy accordingly. On the question of banking supervision, the support expressed by Directors for the Luxembourg Monetary Institute was welcome. The authorities wished to exercise prudent control of the development of international banking activity and to strengthen the position of Luxembourg's banks.

Commenting on the length of the Article IV consultation cycle with Luxembourg, Mr. de Groote suggested that the issue might be left to the best judgment of the staff and management. There was no need to take an a priori decision at present. An 18-month cycle could be considered appropriate for a country of Luxembourg's size, if there were no major problems. On the other hand, if the authorities believed that a one-year cycle was justified, they could consult with the staff and management, and a decision could be communicated to the Executive Board at the appropriate time. His Luxembourg authorities attached great importance to the Fund's advice, and, like his Belgian authorities, they communicated the results of the consultations to the public through the media and took account of the Fund's assessment in their formulation of policy.

The Acting Chairman made the following summing up:

Directors commended the Luxembourg authorities for achieving a major restructuring of the economy over the past few years. They noted that a successful diversification of activities toward financial and other internationally traded services had allowed for continued increases in employment despite the losses incurred in the steel sector. The medium-term emphasis of economic policy formulation in Luxembourg was commended.

Directors observed, however, that continued structural adjustment would be a demanding process. They noted the record of wage moderation in Luxembourg, and stressed the importance of observing the wage norms defined for 1984 in order to prevent an erosion of competitiveness and to bring about a decline in the rate of inflation. They commended the authorities for avoiding, in contrast to many other countries, the emergence of large fiscal deficits. It was considered that, in the light of the existing tax burden, fiscal policy should shift from raising additional revenue to containing the growth in entitlements.

Directors commended the creation of the Luxembourg Monetary Institute, now the Fund's fiscal agent, and noted the importance of its role in overseeing the international banking sector. Directors also noted the renewal of the Monetary Association Agreement with Belgium, and observed that the authorities' emphasis on a stable exchange rate provided an additional reason for achieving a deceleration of the domestic components of inflation. Directors expressed the hope that Luxembourg would raise official development assistance from its present very low level.

In light of the comments made by Directors, the timing of the next Article IV consultation with Luxembourg will be determined in a flexible manner--with an outside limit of 18 months--taking into account ongoing developments.

The Executive Directors concluded the 1983 Article IV consultation with Luxembourg.

2. CANADA - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Canada (SM/83/258, 12/23/83). They also had before them a report on recent economic developments in Canada (SM/84/9, 1/10/84).

Mr. Joyce made the following statement:

My Canadian authorities are appreciative of the staff's work in connection with the 1983 Article IV consultation. The report presents a fair and well-balanced analysis of Canadian economic developments, and they do not disagree fundamentally with the staff's views about the future or the policy problems that will need to be addressed. However, I would like to present some additional information that has come to hand since the consultation and emphasize one or two aspects of government policy.

There has been a dramatic improvement in the Canadian economy in the course of the past year. No doubt this improvement has been assisted to a considerable degree by the speed and magnitude of the recovery in the United States, but the policies of the Canadian Government have also made a significant contribution. Employment, output, and productivity in Canada have all risen from the extremely low levels which characterized the recession, and inflation has also moderated considerably. The 1981-82 recession in Canada was particularly severe, and output actually fell in 1982 by nearly 4.5 percent in real terms, or by 6.5 percent from the start of the recession in mid-1981. Clearly, the social and economic consequences of the downturn have not yet been fully offset, and there remains considerable slack in the economy. Unemployment is high, and nonresidential investment continues to be weak.

Real output in the third quarter of 1983 was some 4.8 percent higher than in the same period in 1982, and it is now expected that at year-end the rate of increase in GNP may have exceeded 6 percent. As the report points out, the strongest sources of growth in 1983 were personal expenditures on durable goods, housing, and the turnaround in inventory investment.

In 1984, growth of real GNP is expected to slow and to be in the 3-4 percent range by the fourth quarter. While personal consumption will remain strong, particularly in the early part of 1984, investment in housing and in inventories will not provide as much support as last year. Nonresidential business fixed investment, however, which declined in 1982 and again in 1983 in real terms, is expected to continue to recover. My authorities, however, are not convinced that the rate of growth will necessarily reach 5 percent.

In these circumstances, overall employment again is expected to increase in 1984. Most of the increase to date has been in the goods-producing industries. The unemployment rate also improved steadily last year, coming down from a high of 12.75 percent in December 1982 to 11 percent in December 1983. The rate is expected to fall further in 1984, possibly to about 10.5 percent or less by year-end, still high by traditional standards. Despite strong growth in employment, labor productivity (real GNP per person employed) rose in 1983 and is projected to continue to rise in 1984.

Canada also made considerable progress in reducing inflation in 1983, as both wage costs and prices decreased steadily through the year. Consumer prices on a year-over-year basis increased by only 4.2 percent in November 1983 compared with 8.3 percent in January 1983. However, prices are still increasing at a faster rate than in the United States, although the inflation differential narrowed in 1983 and is currently about 1-3 percentage points. The size of wage settlements also fell significantly. Major wage settlements--without cost of living adjustments--negotiated during the third quarter of 1983 averaged 5.7 percent, compared with 10.2 percent a year earlier and over 13 percent in 1981. The improvement in wage performance undoubtedly resulted in part from the continued high level of unemployment. It also reflected continued restraint by management and labor in the face of the Government's 6/5 wage/price program.

On the external side, the recent merchandise trade figures for November 1983 indicate that the trade surplus in 1983 remained high in spite of the economic recovery. Strong growth in exports is expected to continue in 1984, with demand being more broadly based than in 1983. Imports will also be somewhat higher in 1984, and the pickup in business investment is expected to lead to stronger growth in machinery and equipment imports. The service deficit will continue to widen, partly as a result of higher interest payments and dividends. The authorities agree with the staff that the current account will move into deficit in 1984 from the present expected surplus of $1 billion in 1983.

The main focus of Canadian economic policy is to sustain the economic expansion currently under way and to reduce, in a lasting fashion, the level of unemployment. Both objectives must be pursued in ways that will not compromise the continuing implementation of responsible fiscal and monetary policies.

The Government, while comitted to ensuring progress in reducing federal deficits over the medium term, concentrated in the previous budget in April 1983 on supporting the economic recovery. A four-year Special Recovery Program (SRP) to stimulate both private and public investment was adopted with a view to accelerating economic growth and encouraging the provision of new capital facilities, which would increase the economy's competitiveness and generate new jobs. In order to address the issue of deficits over the medium term in a realistic way, the Government committed itself to measures on two fronts. First, on government expenditures, the Government undertook to reduce total outlays as a share of GNP in a steady fashion through FY 1986/87. Second, certain tax measures were announced that would increase personal income taxes in future years. These changes were to take effect gradually as the recovery firmed.

The authorities appreciate the staff's concern that continued high government deficits and the resulting public sector borrowing requirements might displace private investment over the medium term. However, the issue is not clear. Given the low average rate of capacity utilization projectd for the next several years, a somewhat lower than average rate of investment would not be surprising, at least in the immediate future. Moreover, if account is also taken of other levels of government, the total public sector deficit is smaller than the federal deficit and is coming down at a faster rate. Finally, the Canadian authorities are still of the view that since domestic interest rates in Canada are strongly influenced by U.S. interest rates, a reduction in the federal deficit would not necessarily permit a lowering of Canadian interest rates, at least in the short term. Finally, a reduction in the federal deficit at this time might not necessarily be fully offset by increases in private investment. The situation admittedly bears watching. My authorities, however, are firmly of the view that the cyclically adjusted deficit must be brought down over the medium term.

The current government program of direct restraints on wages for federal employees and guidelines on prices established under federal jurisdiction ends in June 1984. The Government is consulting with private sector groups and other major players in the economy on ways to build upon the successes of the existing program. The authorities believe that continued restraint at the federal level has been helpful in providing leadership to other levels of government and to the private sector. They are convinced that continued progress is required in moderating price and wage increases. Canada certainly cannot remain competitive if its costs continue to rise faster than those of its competitors.

On monetary policy, the staff raises questions about the present approach to monetary management in Canada, although it does recognize that the policies pursued by the Bank of Canada have been a major factor in moderating inflationary pressures.

Since November 1982, the Bank of Canada has not had targets for growth based on the narrow monetary aggregate. Financial innovations had made M-1 an unreliable guide for policy. This continues to be true today. Moreover, the use of existing broader monetary aggregates as targets has not proved satisfactory, since such measures are subject to problems of interpretation and controllability. The Bank of Canada has also undertaken extensive research on alternative aggregates but to date has not been able to produce one that can satisfactorily be used as a target. In these circumstances, the Bank continues to make use of a wide range of indicators. It may be that this method of formulating monetary policy does not provide a cast-iron guarantee against a cumulative drift in nominal demand. The Bank is aware of this danger. However, there do not seem to be grounds for particular concern in present circumstances. The rate of inflation has fallen more rapidly than expected, and indeed continues to decelerate. Moreover, it is unlikely that significant inflationary pressures will re-emerge from domestic sources at a time when the unemployment rate remains close to 11 percent. Finally, the Bank of Canada has demonstrated in the past a willingness to take unpopular, although necessary, decisions about tightening monetary policy when this appears to be required.

A last word on the exchange rate: the Canadian dollar has remained relatively stable against the U.S. dollar over the past year. The authorities do not have a rigid view of the appropriate level for the exchange rate, although they believe that a major depreciation of the Canadian dollar at this time would be more likely to damage rather than help Canada's economic performance. They will continue to pursue an exchange rate policy sufficiently flexible to take account of inflation differentials between Canada and its major trading partners as well as shifts in other fundamental variables.

Ms. Bush noted that, after experiencing a severe recession in 1981 and 1982, the Canadian economy had begun a recovery in 1983, as evidenced by the estimated 3 percent growth in GNP in 1983 compared with the 4.4 percent contraction in 1982. Other factors indicative of the strong recovery were improvements in productivity, unit labor costs, and inflation. Bringing down and controlling inflation had been among the key elements of policies pursued by the authorities to turn the economy in the right direction. In 1980, they had begun implementing restrictive monetary policies that had assisted in dampening inflation, as indicated by the GNP deflator, which had declined from about 10 percent in 1981 and 1982 to 6.2 percent in 1983, and which was expected to decline further to 4.9 percent in 1984.

However, innovations in the types of deposit accounts offered to individuals and corporations had caused difficulties in measuring M-1, the traditional monetary target, Ms. Bush continued. Consequently, the Central Bank had shifted its focus to interest rates and to economic and financial variables affecting those rates. She hoped that the new method of managing money growth would prove to be an adequate substitute for the tracking of M-1 in achieving money growth targets compatible with the authorities' goal of economic expansion. The authorities had clearly shown sufficient commitment to arriving at a reliable method of monetary policy management, as indicated by the Central Bank's testing of the correlation of other aggregates with nominal income and interest rates. Furthermore, Mr. Joyce had reminded Directors that the Bank of Canada had previously demonstrated its readiness to take the required actions with regard to monetary policy. She commended the authorities' commitment and sympathized with their efforts in that area, as her own authorities had experienced similar problems with money supply data as a result of innovations in the banking system and in types of accounts.

The staff had expressed concern about the growth of nominal GNP in double-digit figures in 1983, Ms. Bush observed, and about the adequacy of current methods of monetary policy management for bringing back that growth into the single-digit range. She emphasized that, while restrictive monetary policy was likely to have some negative effect on real growth, the focus of that policy should be on controlling the inflation component of GNP. Given the objective of convergence of U.S. and Canadian inflation rates, and assuming that prices remained relatively stable in the United States, how much emphasis would the authorities or the staff place on monitoring the U.S. dollar/Canadian dollar exchange rate as a guide to monetary policy management?

The authorities had also sought to control inflation by the introduction of an incomes policy in the form of the 6/5 program for the Federal Government, Ms. Bush noted. The staff's analysis in Appendix I of SM/84/9 indicated that the 6/5 program had caused a reduction in the average annual increase in new wage settlements in the public sector of 2 percent. In the commercial sector, the reduction had been 1.25 percent, resulting from carryover effects of the 6/5 program and from "guidelines." The 6/5 program and the guidelines appeared to have had a dampening effect on wage/price demands. On the other hand, the authorities pointed out that the policies might have acted as a floor to wage settlements. They should take those potentially opposing consequences into consideration as they reviewed arrangements that might be put in place to follow the 6/5 program. Maintaining restraint on federal wages could certainly contribute to the aim of holding down federal expenditures; such restraints would send signals to the provincial governments and to the commercial sector. However, controls should not be made mandatory beyond the federal sector; even guidelines could have distorting and unintended effects.

In addition to efforts to control federal sector wages, Ms. Bush went on, the authorities were making other adjustments in the fiscal area; they cited "sunset" provisions on certain new spending initiatives, intended to have a dampening effect on expenditures over time. She agreed that expenditure restraint was needed, particularly with regard to programs that had contributed to rigidities in the labor markets. The April 1983 budget provided for additional spending on public sector capital projects and for a revision in tax policy calling for broader utilization of the investment tax credit. Tax incentives for private sector capital investment should contribute to the authorities' economic growth objectives.

However, it was questionable whether the Government's spending on capital projects would have the desired effects of sustaining lower levels of unemployment and whether it was the most efficient use of capital. Might not the resources used for that purpose by the Federal Government be best left available to the commercial sector. Would the efficiency and return of such projects warrant such a use of capital by the federal sector?

On the revenue side, the authorities had announced increases in manufacturers' sales taxes, excise taxes, and personal income taxes, Ms. Bush remarked. She agreed with the staff that revenue-raising measures should not fly in the face of the objective of minimizing the adverse effects on incentives to save and to invest. She hoped that the authorities would fully evaluate the effect of such tax increases on the potential for sustaining attractive savings rates such as the 14.5 percent of GDP registered in 1982 and the 12.5 percent of GDP estimated for 1983. The staff correctly suggested that the conditions that had led to higher personal savings between 1979 and 1982 were no longer present. However, savings incentives could also take the form of positive inducements rather than the negative inducements, such as the high level of unemployment and the general contraction of the economy, that had recently been experienced.

She supported the staff's suggestion that the present was an opportune time for the authorities to consider dismantling the pricing system contained in the National Energy Program, Ms. Bush stated. They had already made adjustments in the program that appeared to allow prices of that portion of "old oil" produced between 1974 and 1980 to rise to world levels. As the trend in world prices had narrowed the gap between prices in Canada and world prices, the unification of the two sets of prices should be considered as a means of ensuring efficient resource allocation.

Mr. de Maulde commented that the staff report contained welcome information. Results in a number of major areas were impressive. He welcomed in particular the slowing of inflation, which had reached an 11-year low of 4.2 percent in November 1983, the restoration of a current account surplus of 0.5 percent of GNP, and the resumption of the growth of activity to about 3 percent in 1983, with 5 percent forecast for 1984.

On the monetary side, Mr. de Maulde continued, the staff had discussed at greater length than necessary the various aggregates that could theoretically be used as targets. The important point was that the policy of monetary restraint had been pursued despite the abandonment of M-1 targeting in late 1982. The information in Table 16 of SM/84/9 showed clearly that the rate of growth of M-2 had declined continuously since then. On the whole, the Canadian authorities had succeeded in adjusting in time to derive the full benefit of the recovery in the United States. The adjustment had been carried out skillfully and steadily. He was particularly impressed by the incomes policy implemented by the Federal Government, which had undoubtedly played the major role in the adjustment. The authorities' success should encourage a greater appreciation of that policy instrument by the Fund staff.

The main problem facing the Canadian authorities at present was unemployment, which was forecast to remain distressingly high for the near future, Mr. de Maulde considered. Perhaps a major reason for unemployment's remaining inelastic to the resumption of economic growth lay in the structure of the productive sector. It appeared strange that almost 75 percent of exports were of raw materials or low value-added products. Automobile exports, which made up most of the remainder, constituted a peculiar item. A strong case could be made in Canada, if not in certain other countries, for an active industrial policy aimed at diversifying the export base and, more generally, taking better advantage of the educational skills of the Canadian labor force. The current low rate of investment in the productive sector made such action all the more desirable. The existence of a four-year Special Recovery Program had been referred to by Mr. Joyce, but there had apparently been no mention of the program in the staff papers; he invited Mr. Joyce to comment further on the subject.

Commenting on the federal fiscal deficit, Mr. de Maulde remarked that its present size of about 3.7 percent of GNP was relatively high, even taking into account the rate of unemployment. However, the numbers did not necessarily tell the whole story. If the deficit arose mainly from administrative overheads and so-called structural rigidities, it had to be eliminated as fast as possible. If, on the contrary, it included a high proportion of expenditures for job creation, manpower training programs, and incentives to investment, caution would have to be exercised. He appreciated the official development assistance efforts of the Canadian authorities, into which they put not only money but a great deal of expertise and imagination. They were doing an extremely good job in many areas of the world, and his own authorities were proud to cooperate in such assistance with the Canadian agencies.

Mr. Hirao observed that the Canadian economy had shown an improved performance in 1983. Output and employment had recovered more vigorously than expected, and progress in reducing inflation had been more rapid than projected a year earlier. The current account of the balance of payments had recorded a surplus, and net international reserves had risen. The Canadian authorities should be commended for that progress, especially the progress made in moderating inflation, which reflected their efforts to pursue cautious demand policies and a program of wage restraint.

Despite the progress in many important areas, Mr. Hirao continued, the authorities continued to face the challenging task of economic policy management. Real interest rates remained high by historical standards, and the unemployment rate was expected to decline only slightly in 1984. At the same time, as the authorities were aware, inflationary expectations appeared to remain relatively strong, and the possibility of a resurgence of inflation could not be ruled out. In order to attain sustained economic expansion and a lasting reduction in employment, he hoped that the Canadian authorities would continue their efforts in 1984 to consolidate the gains achieved in 1983.

Commenting on wage policy, Mr. Hirao said that he shared the authorities' view that the 6/5 program had contributed significantly to the slowdown of inflation. The wage guidelines appeared to have had a significant impact on wage settlements in the private sector. It was difficult to assess the need for a follow-up arrangement upon expiration of the 6/5 program in mid-1984. It would certainly be helpful if the Government could give a clear indication to the public of its firm commitment to the pursuit of anti-inflationary objectives. However, extension of wage and price controls might run the risk of setting a floor in certain wage settlements and increasing distortions once economic recovery took hold. Any arrangements that might be adopted should allow for a degree of flexibility, particularly in prices.

In view of the difficulties faced since about 1982 in interpreting the behavior of monetary aggregates, Mr. Hirao went on, the authorities had been making monetary policy decisions on the basis of a variety of economic and financial indicators. Among such indicators, the authorities had been paying close attention for some time to the exchange rate between the Canadian dollar and the U.S. dollar. Apart from the difficulty in assessing the tightness of the present stance of monetary policy, the authorities would be faced with an extremely difficult choice between raising domestic interest rates and allowing the exchange rate to weaken if, for example, U.S. interest rates should rise. In such an event, it would not be advisable to resist a temporary increase in interest rates; on the other hand, a degree of flexibility regarding the exchange rate would also have to be retained in view of the need to maintain competitiveness. He joined the authorities in hoping that a decline in U.S. interest rates would be brought about so that their room for maneuver would be increased. In any event, if inflationary pressures should increase in the future, the authorities might be required to take timely action, as they had done in the past.

A structural fiscal deficit of the size envisaged would have adverse implications for private capital formation and for the economy's long-run growth performance, Mr. Hirao remarked. On the basis of the information in Chart 15 in SM/83/258, he was concerned about the pace of growth of expenditures, relative to revenues, as a percentage of GNP; efforts to curb public spending should be given priority, although the needed adjustment in the fiscal balance might also require measures on the revenue side. The authorities had presented a plan to reduce the deficit over the medium term at the time of the April 1983 budget. He hoped that they would pursue further their efforts to reduce the deficit steadily in the framework of a realistic medium-term plan.

The Canadian authorities stressed the importance of an open and stable international credit environment, Mr. Hirao noted. He hoped that they would seize every opportunity to resist protectionist pressures and to continue to give priority to strengthening the multilateral trade and payments system.

Mr. Suraisry stated that the Canadian economy had gone through a difficult period since mid-1981. However, the situation had improved considerably during 1983. Output had risen, unemployment had declined, and the rate of inflation had come down significantly. The current account had moved into surplus, and the Canadian dollar had been stronger. The picture was far different from what it had been at the time of the previous Article IV consultation. He commended the authorities for those impressive achievements, which could be traced, in great part, to the firm pursuit of appropriate adjustment policies.

The outlook for growth and employment in 1984 was also encouraging, Mr. Suraisry continued. The main cloud on the horizon was the persistence of high inflationary expectations. There was a risk that the recovery could be undermined by a renewed outbreak of inflation. The authorities recognized that risk, and he welcomed their determination to maintain business confidence and to encourage private investment in the period ahead. More specifically, the authorities would have to find a prudent middle course between too much stimulus and too much restraint in the three main areas of incomes policy, monetary policy, and fiscal policy. With regard to the first, it was encouraging that the 6/5 program had been successful. The wage/price guidelines had had a substantial influence on private as well as on public sector settlements. The Canadian experience showed that a well-designed incomes policy could be an effective supplement to more traditional demand management measures.

The authorities currently faced the difficult task of deciding what to do when the guidelines expired in June, Mr. Suraisry observed. Further mandatory controls could lead to distortions and create problems with the trade unions. At the same time, continued wage moderation was essential to preserve the recent gains on the inflation front. He hoped that the Federal Government would be able to give a firm lead on wages. Mr. Joyce's statement confirmed that intention; he invited the staff or Mr. Joyce to provide additional information on the authorities' plans in that critical area.

Turning to monetary policy, Mr. Suraisry suggested that the authorities' firm stance in recent months had been a major factor behind the moderation of wage/price pressures. He fully supported the present objective of seeking a rate of monetary expansion sufficient to accommodate increasing use of resources in the context of continued price stability. That goal would not be easy to achieve, particularly because monetary management was complicated by the effects of developments in the United States, and by difficulties in interpreting and controlling the monetary aggregates. However, the authorities' pragmatic and cautious approach, taking account of a number of indicators, including the exchange rate, appeared sensible in present circumstances. He sympathized with their wish to reduce interest rates further, but the scope for doing so was limited as long as U.S. interest rates remained high and inflation in Canada remained above that in the United States.

On the fiscal side, Mr. Suraisry went on, the authorities had tried to balance the short-term objective of stimulating growth with the longer-term objective of reducing the public sector deficit. Because the recovery was currently under way, more emphasis should be given to the second objective. He welcomed the intention to raise revenues and to improve expenditure control in the April 1984 budget. The staff had expressed concern that the authorities were not doing enough to reduce the deficit; there was clearly a risk that continued large deficits would weaken the effectiveness of monetary policy, add to inflationary pressures, and crowd out much needed private investment. A convincing medium-term strategy to bring the deficit down would send the right signal to the business community and the financial markets.

Canada's external competitive position remained satisfactory, Mr. Suraisry considered, and a major depreciation of the Canadian dollar would be counterproductive at present. There were, however, uncertainties regarding the current account, capital flows, and the terms of trade; the authorities had good reasons to maintain a degree of flexibility in those areas. It was disappointing that little progress had been made in removing protectionist barriers; he encouraged the authorities to do so as soon as possible and to resist new protectionist pressure. He agreed with the report issued by the Government in August 1983 that Canada would benefit fully from international trade only if the necessary structural adjustments were made in the industrial sector. Finally, Canada's official development assistance had fallen from 0.52 percent of GNP in 1978 to 0.4 percent in 1982. He hoped that the authorities would do everything that they could to raise the percentage closer to their target of 0.7 percent over the coming few years. The staff had also drawn attention to the conditionality that Canada was introducing into certain aid programs; he understood that the issue would be thoroughly explored by the Task Force on Concessional Flows.

Mr. Clark said that he generally endorsed the staff's appraisal. Like other Directors, he welcomed the success of the Canadian authorities in bringing down the rate of inflation and thereby providing the basis for the upturn in activity that was currently in train. The 6/5 wage policy appeared to have made a helpful contribution to curbing pay increases. Some form of wage restraint in the public sector should be maintained when the present policy ended in June; he shared Mr. Hirao's views on the need for greater flexibility. The main lesson from the United Kingdom's experience was that such an approach to wage determination needed to be supported by an anti-inflationary stance in macroeconomic policy as a whole.

In that regard, Mr. Clark remarked, great importance should be attached to the maintenance of monetary control. He recognized the difficulties that the Canadian authorities faced in interpreting the monetary aggregates, but he hoped that they would continue their efforts to find an acceptable substitute for M-1. In an environment in which interest rates were necessarily much influenced by developments in the United States, it was perhaps all the more important to have some measure of the consequences for domestic financial aggregates.

Perhaps the greatest concern arose in fiscal policy, Mr. Clark suggested. It was open to question whether the planned reduction in the cyclically adjusted deficit was adequate. Moreover, the projected reduction in the actual deficit depended heavily on a more favorable economic environment in terms of lower interest rates, rising activity, and higher energy prices, rather than on specific fiscal action. The projections could well turn out to be too optimistic. In sum, further measures to reduce prospective budget deficits were required.

Commenting on oil prices, Mr. Clark observed that the present situation appeared to involve only minor divergences from world prices and that there appeared to be a good opportunity to close the gap completely. More generally, he hoped that the Canadian Government would pursue its measures to reduce price distortions in the economy; he welcomed the move to bring real transport rates into line with costs.

The U.S. dollar had appreciated significantly in the three months since the Fund had held discussions with the Canadian authorities, Mr. Clark noted. The problem of competitiveness against economies outside North America had thereby worsened. With regard to trade policy, it was encouraging that the government report in August 1983 had reaffirmed Canada's commitment to free trade. He hoped that action would match intention. Similarly, with regard to the capital account, he hoped that the restrictions on foreign direct investment could be further eased.

Greater coverage of medium-term and structural issues would have been welcome in the staff's analysis, Mr. Clark commented. In particular, there had been little net improvement in productivity in Canada since 1976, as Mr. de Maulde had pointed out, a record that compared unfavorably with that in the other major countries. The recent improvement in 1983 appeared to have been primarily cyclical. It would be interesting to know how the Canadian authorities were approaching the question and whether the staff foresaw a better outlook for productivity growth in the longer term than had occurred in recent years.

Mr. de Vries suggested that the Canadian economy was difficult to analyze because it was so complex in many respects. For example, there was a desire to have a policy independent of the United States, even though the two economies were interdependent. Furthermore, internally, the Central Government had to take account of the wishes of the powerful provincial governments. There were also two major languages in Canada, with differing historical and cultural traditions, a further complicating factor. Finally, Canada's economy was, in part, industrial and, in part, primary producing. It was not surprising, therefore, that policy might not be as clearly focused as would be desirable.

The policies pursued since 1982 had been most encouraging, Mr. de Vries continued. Inflation had been reduced, the competitive position had been improved, demand and production had increased, and the balance of payments position had become stronger. However, while quite important successes had been achieved, much remained to be done. In particular, inflationary expectations in Canada remained higher than in a number of other countries.

Against that background, the lack of a clear focus for policy was a matter of concern. Mr. Joyce's statement that "the main focus of Canadian economic policy is to sustain the economic expansion currently under way and to reduce, in a lasting fashion, the level of unemployment" was clear as far as it went but did not say how those objectives were to be achieved.

To quote Mr. Joyce again, Mr. de Vries went on, the Government "is committed to reducing federal deficits over the medium term." However, Mr. Joyce also stated that the current budget was designed to stimulate the economy. The question arose, therefore, what the real focus of budgetary policy was. He was encouraged by Mr. Joyce's statement that the Government had undertaken to reduce total outlays as a share of GDP in a steady fashion through FY 1986/87; he hoped that that element in budgetary policy would be emphasized.

Commenting on monetary policy, Mr. de Vries considered that the position was even less focused. Although the staff discussed at length the technical difficulties in the conduct of policy, it did not provide a clear description of the concrete objectives of the policy. A similar case could be made with regard to exchange rate policy. No one exchange rate regime could be said to be appropriate for all currencies. Some currencies, particularly the major ones, could be floated or managed in a flexible manner. For others, the emphasis should be on stability vis-à-vis the currencies of the country's trading partners. Another factor to be taken into account was whether the currency in question was important for the world economy as a whole, or whether its influence was primarily domestic. In the case of the Canadian dollar, which fell into the latter category, the emphasis should be put on stability. The Canadian dollar had originally been allowed to float against the U.S. dollar in order to achieve a degree of independence, but the reality was that the two economies were very interdependent, and the floating exchange rate regime had done little to alter that fact. It would be better, therefore, for the Canadian authorities to take a realistic view of the situation. He understood the authorities' desire not to allow a drastic depreciation of the Canadian dollar against the U.S. dollar. However, insofar as such a development influenced internal prices, it would be more appropriate to take domestic measures to stop Canada's inflation rate from rising faster than that of the United States than to have to correct inflation differentials at a later stage through exchange rate adjustment.

Mr. de Groote commented that the staff had presented a balanced report on the Canadian economy. The authorities were to be congratulated on their efforts to improve the economy's performance. He recalled that during the previous Article IV consultation with Canada (EBM/83/20, 1/26/83), most Executive Directors had expressed concern about the downward trend of the economy. The recent strong recovery of the U.S. economy together with the measures implemented by the Canadian authorities, especially in wage and monetary policy, had made an important contribution to the achievement of good results. Consideration now had to be given to the central question of what measures were most appropriate for supporting the recovery and for reinforcing the external impetus given by developments in the United States. Because inflationary expectations remained relatively high and unemployment continued to be above normal levels, financial policies would play an important role in the coming years in sustaining economic growth. Serious consideration would have to be given to a combination of measures that would maintain a sufficient degree of budgetary stimulus while avoiding a rekindling of inflationary pressures.

Maintaining the ratio of investment to GNP was one of the most important preconditions for sustaining the recovery and reducing the unemployment rate, Mr. de Groote suggested. High interest rates and a decline in private savings in relation to GNP had limited the possibility of reducing the budget deficit, which had reached 6.6 percent of GNP in 1983 and was expected to drop to 5.8 percent in 1984. The Canadian authorities held the view that the correlation between interest rates and the deficit was relatively weak in Canada, because Canadian interest rates were so strongly influenced by interest rates in the United States. Therefore, they had a good deal more room for maneuver with respect to fiscal policy alternatives than would be possible in other industrial countries as they implemented their four-year Special Recovery Program aimed at stimulating public and private investment. It was understandable that the authorities did not wish to reduce too sharply the budgetary stimulus at the present stage of the cycle, although they would be wise to take such action later. The impact of such measures should be carefully monitored by watching developments in the external current account position. The unemployment rate would continue to be a source of concern during 1984, and the authorities could not be expected to pursue deflationary policies in the present circumstances. Such policies would be counterproductive.

The staff's analysis of the 6/5 program in Appendix I of SM/84/9 had been extremely helpful, Mr. de Groote considered. Several Directors had expressed reservations about the program during the previous Article IV consultation; however, the results to date showed that the 6/5 program had had a significant effect on wage settlements in both the private and the public sectors. Whether or not to continue it beyond 1984 was an important choice facing the Government. Labor productivity, which had been declining until the second quarter of 1982, had increased by about 3 percent in 1983. In SM/84/9, the staff provided some reasons why productivity had been poorer than during the decade following World War II. He invited the staff or Mr. Joyce to provide further information on the policies aimed at increasing labor productivity in the future.

Turning to the management of monetary policy, Mr. de Groote observed that the work on the definition of alternative monetary aggregates to be used as a guide for policymaking had not produced good results and that the Bank of Canada's decisions on monetary policy had consequently been based on interest rate and exchange rate developments. He congratulated the authors of DM/83/85 (12/28/83)--"Monetary Control: A Comparison of U.S. and Canadian Experience, 1975-79"--who had revealed, with some dismay, the interesting finding that, in the absence of regulation, an interest rate ceiling like the U.S. Regulation Q and a long-term interest elasticity of money demand, estimated to be three times greater in Canada than in the United States, had caused monetary growth in Canada to deviate from targets. He did not share the authors' assumption that such a development was to be deplored from a theoretical viewpoint. The interest rate and exchange rate approach to monetary control, based on a variety of economic and financial indicators, succeeded better in Canada, and therefore appeared more appropriate than a focus on M-1 or M-2 as targets. In the monetary area, as in the fiscal area, Canada appeared to be an example of a country that was difficult to explain but in which the outcome of policy was reasonable. He congratulated the authorities for their pragmatic approach. Finally, he commended the authorities for Canada's contribution to official development assistance and for the high degree of concessionality that it contained.

Mr. Sangare noted that the Canadian economy was expected to continue to do well in 1984 following the turnaround in 1983 from what had been described as the deepest recession since the 1930s. The news was welcome not only for Canada, but also for the world economy, which was very much in need of momentum from the industrial countries.

Recent developments in Canada were interesting on two other counts, Mr. Sangare considered. They showed that administered pricing in the public sector, if used properly in conjunction with fiscal and monetary restraint, could help in the fight against inflation. He had been particularly interested in the fact that the authorities had made a conscious effort, sometimes through moral suasion, to prevent prices from increasing while steps were being taken to contain the growth in wages. Such an approach contrasted with that used in many stabilization programs in which prices were generally moved upward while wages moved downward or were held constant. He invited the staff to comment on what lessons might be drawn from the Canadian approach.

Second, the fiscal stance of the Canadian authorities appeared to justify the fears expressed by many countries that economic recovery did not happen through some kind of "spontaneous combustion," even where a successful campaign had been waged against inflation, Mr. Sangare observed. From the beginning, the authorities had adopted a medium-term outlook with regard to fiscal policy, and they had tried to strike a balance between the need to reduce the high rate of unemployment--a problem that the Canadians were attempting to address through increased capital spending and tax incentives so as to encourage private sector investment--and the need to contain the budget deficit in order not to choke off economic growth over the medium term. He had gained the impression that the staff would have preferred a more restrictive approach. However, the decision of the Canadian authorities to run a controlled deficit while establishing a trend for its reduction over the medium term was a policy worth trying as it might provide a useful comparison with the traditional view that had been taken toward implementation of fiscal policy, particularly in Fund-supported programs.

The view of the Canadian authorities that protectionism ought to be discouraged was welcome, Mr. Sangare continued. However, he urged them to bolster that view with concrete action to remove existing barriers to trade. As to assistance to less developed countries, he welcomed their continued commitment to the goal of increasing official development assistance as a percentage of GNP, and he had no difficulty in accepting the general principle that foreign aid could be most effective when it was spent on good projects. However, he was concerned about the policy of making bilateral assistance contingent on World Bank approval of a country's investment strategy and on the agreement on an adjustment program with the Fund. He was not sure on what basis the Bank could be taken as a final arbiter of the appropriateness of an investment program in any given country. Some projects that might be attractive in terms of basic human needs might not meet the appraisal criteria of the Bank, or of the Fund. He hoped that such a situation would not result in those projects' failing to qualify for Canadian bilateral assistance. With particular reference to the Fund, which concentrated on balance of payments assistance, he hoped that the new policy would not imply that Canada would require a prior stamp of approval from the Fund for its policies, even if it did not have a balance of payments need.

Mr. Senior said that economic developments in Canada over the previous two years had reflected the cyclical sensitivity of the country's industrial structure. After having experienced rates of inflation greater than other OECD countries until 1981, Canada had undergone a severe contraction during 1982. By the end of that year, unemployment had reached unprecedented levels, fiscal performance had deteriorated markedly, and inflation had continued to be greater than in many other industrial countries. Against that background, the strength of the pickup in activity and employment as well the price stability that had characterized the recent behavior of the economy were welcome events.

The staff and Mr. Joyce had both made a balanced assessment of the relative roles played by external forces and by domestic cost and demand factors, Mr. Senior continued. There was little doubt that developments partly reflected the strength and the pattern of the recovery taking place in the U.S. economy. However, the authorities had responded prudently to cyclical developments in the United States over the previous two years. They had conducted economic policy efficiently, thereby permitting the beneficial effects of economic developments in the United States to flow into Canada. In particular, the cautious management of demand policies had played an important role in the successful macroeconomic outturn of 1983. In addition, the marked deceleration in both wages and the prices of productive inputs in 1983 had allowed the restoration of competitiveness, particularly in relation to the United States, and appeared to have arrested the increasing trend in unemployment. Although it could be argued that wage and price guidelines had also played a part in those results, wage and price restraint had primarily been the result of the excess of labor and other productive inputs in mid-1982.

Differing views on the relative responsibilities of external factors, domestic demand policy, and incomes policies in the past would lead to differing emphasis and judgments regarding the choice of policy instruments for the period ahead, Mr. Senior remarked. If the restraint of nominal wages and other incomes had been primarily the result of the sharp slowdown of economic activity and the appreciation of the exchange rate, as he believed, demand policies would have to be characterized by the determination and steadiness needed to prevent excessive wage and other cost increases during the current recovery phase. During that phase, guidelines or mandatory arrangements for prices or productive factor markets would probably be either ineffective or counterproductive if unaccompanied by firm demand policies, all the more so because the major risk that threatened stable and sustained growth in Canada was the resumption of high inflationary expectations; it should be borne in mind that high expectations were not abated when inflation declined as a result of a sharp contraction of economic activity. Monetary and fiscal policies would have a difficult and delicate task in the period ahead, having to take account of the desire to reduce unemployment, on the one hand, and the need to contain inflationary pressures so that the gains in employment would not be ephemeral, on the other.

With those considerations in mind, Mr. Senior went on, he had paid close attention to the difficulties that the monetary authorities had experienced in interpreting monetary aggregates and the abandonment of quantitative targets to frame monetary policy. Difficulties in interpreting monetary policy were certainly not confined to Canada. Indeed, they had been common to all industrial countries during a period in which the financial infrastructure had been modified in order to deal better with the inflationary environment. The changes in the financial structure were reflected in the increasing weight in monetary aggregates of instruments paying market-related rates of interest. Among other things, that development meant that interest rates did not measure, as they had done in the past, the opportunity cost of holding money. The historical statistical relationships among monetary aggregates, interest rates, and nominal income no longer held. Observers would have to wait until the wave of financial innovations and deregulation had passed to examine stable, new, empirical relations among those variables. Therefore, the renewed attention that the authorities were paying to interest rates was fully understandable. Nevertheless, he agreed with the staff's comment that upward changes in interest rates might be constrained by political considerations, in which case an upsurge in inflationary pressures would not be dealt with through effective monetary restraint. In that regard, Mr. Joyce's point that high unemployment would prevent significant inflationary pressures stemming from domestic factors was relevant.

However, significant inflationary forces could be imported if the fears of, or hopes for, a depreciation of the U.S. dollar materialized, Mr. Senior suggested. If such a depreciation were to come about, a monetary aggregate that could be used to explain monetary policy and eventually to brake the excessive growth of nominal demand would be greatly needed. Given the degree of integration of Canada's financial markets with those of the United States, the monetary authorities should pay close attention to interest rate developments at all times. However, he urged them to continue their efforts to find a quantitative aggregate suitable for monetary management. In that regard, he invited the staff to comment on the authorities' view regarding the use of domestic credit, or another debt instrument, as a relevant variable for targeting monetary policy. In principle, given the openness of the Canadian economy and the degree of integration with the U.S. economy, the relationship between credit and nonimal GDP could be expected to be stable; it appeared to be very stable in the United States.

On fiscal policy, Mr. Senior said that the size of structural deficits currently envisaged might have negative implications for private investment. The absorption of an excessive share of domestic savings to finance the federal deficits might also have adverse implications for economic productivity by allocating private savings to less efficient uses than might otherwise have occurred. The deterioration in productivity in Canada had been more marked than in almost all other major OECD countries. In the medium and long term, fiscal discipline was highly correlated with productivity growth. In that regard, it should be recognized that high U.S. interest rates hindered rapid progress toward fiscal balance. A reduction in the federal deficit would not necessarily permit a lowering of Canadian interest rates, which had to parallel those in the United States. In turn, a reduction in the deficit at a time of high interest rates was, necessarily, a slow process that had to be framed in a medium-term perspective. Finally, he commended the Canadian authorities for their commitment to development aid and encouraged them to open up their trading system further.

Mr. Qureshi stated that the Canadian economy had seen an encouraging turnaround in economic activity and a substantial further reduction in inflation in 1983. The staff had described in detail the policies and circumstances, including favorable developments in the U.S. economy, that had made possible the positive outcome, as well as the mix of policies needed to sustain the recent gains in economic performance. He was in broad agreement with the thrust of the staff's analysis.

Commenting on monetary management, Mr. Qureshi remarked that the staff had correctly noted, and the Canadian authorities appeared to agree, that, because inflationary pressures and expectations had not receded fully, the task for monetary policy in present circumstances should be to achieve a rate of monetary expansion that permitted an increasing utilization of economic resources but was also consistent with preserving and extending the progress made against inflation. More specifically, however, the suggestion by the staff that interest rates would have to be raised in the near future was less clear, unless interest rates in the United States began to rise again. He invited the staff to comment further on the question.

The staff had also stated that the source of its concern about the monetary situation was the rapid growth in nominal GNP that had taken place during the first three quarters of 1983, Mr. Qureshi continued. However, there was no indication whether that development posed an immediate or near-term threat to the progress made and continuing to be made against inflation. In that regard, Mr. Joyce had noted that there appeared to be no grounds for particular concern at present. The rate of inflation had fallen sharply in 1983 and was projected to fall further in 1984. Besides, the relatively large increase in nominal demand in 1983, which had accompanied a sharp upturn in real economic activity during that year, could be expected to decelerate with the projected slowing in the pace of recovery in 1984. It might also be useful to bear in mind the possible adverse effects of a rise in interest rates on the revival of investment at the present stage of the recovery. Elsewhere in the paper, the staff had noted that domestic interest rates appeared to be too high on the basis of the present cost-price situation, and that the high interest rates had been a factor in hindering the recovery of business fixed investment.

There appeared to be greater scope for improving the stance of policy in public finance, Mr. Qureshi considered. The envisaged reduction over the coming three years in the federal deficit, which had risen sharply since 1981, was a step in the right direction. The authorities' preference for gradualism in trimming the federal deficit was understandable in view of the severity of the recent recession and the prevailing high unemployment. The targeted pace of fiscal adjustment might, however, need to be reconsidered in light of the staff view that it would still leave a structural deficit of a magnitude that could have adverse implications for private capital formation and longer-run growth prospects. The staff had noted the authorities' position, which Mr. Joyce had also referred to, that, in assessing the impact of the fiscal deficit on the overall balance between savings and investment, it was important to take into account both the relatively high personal savings rate in Canada and the fact that the deficit of the overall or consolidated government sector was smaller than that of the Federal Government alone. In response to that point, the staff had correctly noted that the large increase in the personal savings rate in recent years could be temporary. It might also have been noted that, even when account was taken of the two factors mentioned, and notwithstanding the recent increase in private savings, public sector claims on private savings continued to appear to be relatively large. In the December 1983 OECD Economic Outlook, the ratio of the budget deficit of the consolidated government sector to gross private savings was shown to have been higher in Canada in both 1982 and 1983 than in any other major industrial country except Italy, and the position was projected to continue in 1984.

The 6/5 wage program provided an illustration of the useful role that a carefully designed and flexible incomes policy could play as a complement to demand policies in combating inflation, Mr. Qureshi went on. Because inflationary expectations were said to be far from adequately subdued, there would be a case for retaining a flexible set of wage price guidelines for some time to come. In regard to the exchange rate, the staff made the point that the large appreciation of the Canadian dollar, alongside the U.S. dollar, vis-à-vis the currencies of other industrial countries over the previous two years had not greatly affected Canada's exports through a weakening of its competitive position. The staff also noted that Canada's share in manufactured exports of seven major industrial countries had increased over the same period. A somewhat different picture emerged, however, when account was taken of the performance of Canadian manufacturers in all their export markets; according to OECD commodity trade statistics, published in the December 1983 Economic Outlook, Canadian manufacturers had been losing market shares since 1981. He invited the staff to comment further on the point. It was also relevant to note that part of the recent increases in Canada's exports might be attributable to special or temporary factors.

While the stress laid on the maintenance of an open trading system in a 1983 Canadian Government report on trade policy was reassuring, Mr. Qureshi remarked, the additional protectionist measures of recent years and the continued strength of protectionist pressures gave cause for concern. Some of those measures affected goods that were important exports of developing countries, including the heavily indebted countries. Finally, although the ratio of official development assistance to GNP had been falling in recent years, the authorities' reaffirmation of their desire to raise the ratio to 0.7 percent by the end of the 1980s was encouraging.

Mr. Doe said that substantial progress had been made toward economic and financial adjustment in Canada in 1983 following a period characterized by a high rate of inflation, an increase in the unemployment rate to almost 13 percent in 1982, and a contraction in economic activity. Economic activity in Canada appeared solidly on the recovery track, reflecting primarily the effects both of the Government's efforts to fight inflation and of economic growth in the United States. Real GNP was estimated to have grown by 3 percent in 1983, following a 4 percent contraction in 1982, and was expected to remain healthy in 1984. Inflation had slowed down markedly, and employment was gradually picking up.

An interesting major contributory factor to the slowdown of the inflation rate had been the sharp decrease in unit labor costs in 1983, Mr. Doe continued. The persistence of inflationary expectations in the economy would suggest that the policy of wage restraint should be vigorously pursued. He welcomed the progress achieved under the 6/5 program, and he supported the Government's commitment not to adopt an accommodating fiscal policy should the pressure for higher wages intensify. Furthermore, the combination of the prevailing high unemployment and underutilized productive capacity should help to hold down production costs and, consequently, price increases.

Commenting on fiscal policy, Mr. Doe welcomed the authorities' recognition that large budget deficits of the magnitude recorded in FY 1982/83 would adversely affect the long-term growth prospects of the economy. He shared Mr. Joyce's observations regarding the factors that limited the possibility of rapid fiscal adjustment in Canada. However, he also agreed with the staff that, in order to strengthen the growth potential of the Canadian economy, especially in capital formation, the implementation of revenue-increasing and expenditure-curbing measures should be of prime importance. It was interesting that the Canadian authorities shared the view that budget deficits had to be reduced over the medium term.

The often generous official development assistance that Canada provided to developing countries should be acknowledged, Mr. Doe suggested. In particular, despite the severe budget constraints faced by the Government, it had remained committed to providing development assistance equivalent to 0.7 percent of GNP.

Mr. Lovato stated that the significant progress made by the Canadian economy in 1983 on the road to recovery was welcome. Compared with the outlook a year earlier, performance had been better than expected: there had been an increase in employment and a noticeable decline in inflation. If supported by appropriate policy actions, those conditions should constitute a firm basis for establishing stable and balanced growth in the years to come.

In assessing the relatively favorable scenario and identifying possible areas of danger and uncertainty, Mr. Lovato continued, he was in broad agreement with the staff appraisal. In particular, he shared the view expressed by the staff on page 15 of SM/83/258 that the task currently facing the authorities was how to "consolidate the gains made in restoring confidence and reducing inflation," and, it might be added, to extend those gains evenly throughout the economy. Economic policies would have to be consistent with one another in the effort to preserve the current momentum without causing a reacceleration of inflation.

The importance of incomes policy lay in the fact that it allowed the policymaker to have separate control over the level of economic activity and the rate of inflation, Mr. Lovato considered. During the 1981-82 recession, the 6/5 program implemented by the Canadian authorities had certainly been successful in reducing labor costs more than the existing slack in the labor market would naturally have suggested; the point was clearly demonstrated in the econometric analysis in Appendix I of SM/84/9, although it was possible that the effects of the program might have been somewhat overestimated owing to the difficulty of capturing the extent of the reduction in expected inflation.

In the current recovery, Mr. Lovato went on, it was of the utmost importance that some form of guidelines for wage restraint should remain in place in order to avoid the negative effect that an improvement in the employment situation might produce on the price front. It was particularly important because the rate of labor force participation often tended to remain temporarily low, relative to the historical trend, following a cyclical upturn; Chart 2 in SM/83/258 appeared to show some evidence of that phenomenon. In such circumstances, the increase in employment rapidly reduced the slack in the labor market and could easily give rise to cost-push pressures. Therefore, the Canadian authorities should continue to exert some form of control over labor costs either through a wage policy in the public sector or simply through moral suasion.

Turning to fiscal policy, Mr. Lovato said that he agreed with the staff's concern about the increase in the public sector deficits. According to the official estimates, the ratio of the cyclically adjusted federal deficit to GNP would decline only slightly through 1987. Furthermore, the information in Table 15 in SM/84/9 indicated that the consolidated public sector deficit, having been lower than or roughly equal to public gross capital formation between 1978 and 1981, had become substantially higher in 1982 and 1983. It would be interesting to know whether the Canadian authorities regarded that development as transitory, and particularly what their fiscal projections implied for the current portion of the public sector balance in the years ahead. That was the crucial measure for Directors to consider when evaluating the compatibility of fiscal policy with noninflationary growth.

The problems faced by the Canadian authorities in the conduct of monetary policy in recent years were, to some extent, typical of industrial countries, Mr. Lovato observed, as many of them had been experiencing a degree of instability in monetary aggregates in connection with relatively large fluctuations in interest rates arising from financial innovations. In such circumstances, it would be a mistake to adhere strictly to aggregate targets, the meaning and economic relevance of which was rapidly changing; on the contrary, attention should be devoted to a broader set of indicators of monetary and credit conditions. Directors would agree that the policy of restraint begun in late 1980 had had a substantial effect in moderating cost-push pressures. However, the establishment of favorable conditions for sustained economic growth required a combination of gradual monetary expansion and tight fiscal conditions. In the light of such considerations, he shared the Canadian authorities' concern about the current high level of interest rates. Any chance of reduction in those rates compatible with exchange rate stability should be promptly exploited.

Canada's current conditions, as well as its rich endowment of natural resources, contained all the major ingredients for spontaneous, steady economic growth led by private forces, Mr. Lovato suggested. The authorities' efforts in the present phase of the cycle should be directed toward maintaining favorable conditions for that process, rather than providing a direct stimulus, while maintaining a stable domestic and external value for the currency.

Mr. Tvedt remarked that in the preceding 12-18 months the Canadian authorities had been quite successful in reducing the rate of inflation and in bringing about a recovery of economic activity. The strength of the recovery was reflected not only in the data on economic growth but also in a considerable recovery of corporate profits after a pronounced fall in 1981 and 1982. However, important problems loomed on the horizon.

The recent improvements in the Canadian economy had primarily been the result of moderate wage settlements since 1982 and a firm monetary policy on the domestic side, and the positive effects of the U.S. recovery on the external side, Mr. Tvedt considered. Important as those improvements were, the challenges facing the Canadian authorities remained formidable. Despite recent declines, unemployment remained at an extraordinarily high level, the structural budget deficit was sizable and would remain so for the foreseeable future, inflationary expectations continued to be strong in the judgment of the authorities and the staff, the outlook for wage developments beyond the middle of 1984 was most uncertain, and protectionist demand and tendencies were growing.

In view of the high unemployment, low capacity utilization, and strong underlying wage pressures, Mr. Tvedt continued, the initiative taken by the Government in 1982 with the introduction of the 6/5 program had beem appropriate and the results appeared impressive. While a mandatory incomes policy could hardly be pursued much longer than envisaged in the program, it was still of the utmost importance to contain wage increases in the period ahead to prevent a pickup in wage demands once the program had expired. He had gained the impression from the staff papers that such an outcome would be difficult to achieve, both because of potential spillover effects from excessive wage settlements in certain sectors and because of the apparently deeply entrenched inflationary expectations. He invited the staff to comment further on the factors that lay behind those high expectations and on the reasons why they had not abated to a greater extent. In the present circumstances, in which unemployment remained high and the reduction in inflation had accompanied the 6/5 program, the Government might be in a strong position to influence wage settlements in the direction of moderation.

An evaluation of the success of the 6/5 program had to take account of what would have happened in its absence, Mr. Tvedt suggested. The staff described the strong inflationary expectations and the danger of excessive wage settlements. On that basis, the only conclusion that could be drawn from the staff analysis was that, despite the tremendous slack in the economy, wage increases would have been much larger over the previous two years if the program had not existed. However, it should also be stressed that the impact of such mandatory rules or guidelines would be brief unless they were accompanied by appropriate policies in other areas.

The difficulties that the authorities had encountered in attempting to control the monetary aggregates were understandable, Mr. Tvedt went on. In the circumstances, their approach was an example of pragmatism. The room for maneuver had also been constrained by developments in the United States. The staff believed that the growth of money demand might have to be curtailed by a timely increase in interest rates that would, in its view, signal the authorities' commitment to anti-inflationary goals. He was not sure that the staff was correct, because it was difficult to conclude that monetary policy was insufficiently tight. He fully agreed that it had been appropriate to accommodate the acceleration in the demand for narrow money in 1983, given declining inflation and interest rates. Furthermore, in the Canadian setting, an early increase in interest rates might not necessarily dampen inflationary expectations; indeed, it could have the opposite effect.

Commenting on fiscal policy, Mr. Tvedt observed that the authorities faced the difficulty of the structural deficit, on the one hand, and the desire to stimulate economic growth and to reduce unemployment, on the other. He agreed with their leaning toward the latter course of action, but the structural deficit would have to be addressed in the medium term. Interest rates in the United States possibly exerted a greater influence on Canadian interest rates than did the Canadian budget. Nevertheless, in view of the prospects for continued high U.S. interest rates and the authorities' belief that Canadian interest rates were too high, a reduction of the structural deficit should become an important objective.

The strength of protectionist tendencies in Canada was a cause for concern, Mr. Tvedt continued, particularly the "domestic content" rules that were not being resolutely resisted by the Government, if his impression was correct. He urged the authorities to withstand all restrictive pressures. Liberalization measures, such as exempting from import quotas women's shoes of size 10-1/2 and above, as mentioned in SM/84/9, inspired humor rather than confidence in the authorities' commitment to free trade. In sum, despite the impressive improvements in the Canadian economy, the room for maneuver remained limited, and the Government continued to face formidable challenges, of which the containment of wage pressures was the most important. If the authorities did not succeed in that area, there would undoubtedly be a pickup in inflation, an upsurge in unemployment, and a consequent overwhelming strengthening of protectionist forces, all of which would be to the detriment of Canada and the world economy as a whole.

Mr. Grosche stated that the Canadian authorities should be congratulated for the better than expected performance of their economy, especially the reduction in inflation and the improvement in the current account. Those impressive developments had obviously been helped by the recovery in the United States, but, as Mr. Joyce had pointed out, the readjustment of domestic policies had also made a significant contribution. However, serious problems remained, particularly the continuing high level of unemployment and the related problem of considerable unused capacity, which, in conjunction with high real interest rates, had hindered a prompt recovery of business fixed investment. It was of the utmost importance the Canada should continue to consolidate the gains made so far and to refrain from more expansionary fiscal policies. Because inflationary expectations remained high, expansionary policies might result in nominal rather than real growth.

The authorities were right in not extending the mandatory wage controls beyond the Federal Government, Mr. Grosche considered. A generalization of the policy might entail the risk of serious distortions in labor markets. He recalled Mr. Prowse's comment on the occasion of the 1983 Article IV consultation with Australia (EBM/83/162, 11/23/83) to the effect that an incomes policy was successful only when it was not really needed. With regard to trade policy, the strong protectionist pressures among the Canadian public were a matter of deep concern. The measures under consideration, such as the "domestic content" proposals for the auto sector, tended to increase prices for the Canadian consumer and would scarcely be conducive to the creation of new jobs. It was also regrettable that the Canadian authorities had so far taken no significant steps to remove existing trade barriers, despite their commitment to an open trading system. The changes in administrative procedures in 1982 aimed at streamlining the review of foreign investment applications were welcome. A further easing might help to restructure the economy and create more jobs. The regulations that maintained a price differential between the domestic price of blended oil and the international price should be discontinued. The staff pointed out that such action could be taken at present without significant short-term disruptions. The authorities ought not to miss that opportunity. In addition to the beneficial effects mentioned by the staff, such a measure would help to reduce Canada's high per capita energy consumption.

Commenting on monetary policy, Mr. Grosche reiterated his authorities' view that prudence was required, particularly with regard to wages. Because the shift in money demand had apparently petered out, the authorities should work hard on the development of a monetary aggregate sufficiently reliable to be used as a guide for policy. It was true that restrictions were imposed by the close interrelationship with the U.S. dollar, but the authorities' current approach entailed serious risks. Merely steering interest rates could lead to a considerable increase in money volume and, thus, to a revival of inflationary expectations. However, the assurances given by Mr. Joyce in his statement were encouraging.

The outcome of the deficit-reducing measures in April 1983 appeared modest, Mr. Grosche added. The current performance of the Canadian economy warranted a stronger reduction in the public sector deficit. A more pronounced decrease would reduce the demand pressure in the capital market and would also free resources for other internal and external uses. Internally, the recovery of investment could be effectively supported; externally, the overall position could be strengthened by reducing the need for foreign finance, a point that was particularly important because the current account was expected to move into deficit again.

Mr. Zhang stated that, in contrast to most other industrial countries, Canada had experienced in 1983 an unexpectedly rapid recovery from the deepest postwar recession. However, the recovery had followed the traditional pattern. The slowdown of inventory decumulation had provided the initial impetus, and consumer expenditures had then become the main force of expansion. Private consumption had risen in 1983 by 3 percent, in contrast to a decline of 2.1 percent in 1982. The main factors responsible for the rise had been declining inflation, pent-up demand, and a fall in the savings ratio. Total gross fixed investment had remained stagnant, because a large upsurge of residential construction had not been enough to offset the continued decline in fixed investment. The real foreign balance had deteriorated in 1983 as a result of a larger increase in imports than in exports, a consequence of the relatively rapid and early recovery in Canada. The foreign sector had, therefore, generally exerted a negative impact on the present phase of recovery. For 1983 as a whole, real GNP had increased substantially by 3 percent, in constrast to a decline of 4.4 percent in 1982, thereby placing Canada among the few countries to lead the recovery in the industrial world.

Developments in other fields had also been generally satisfactory, Mr. Zhang continued. The rate of capacity utilization had increased. Employment had recovered, having increased continuously in 1983, and average hours worked had been rising. The sharp reduction in both external and internal pressures had led to a marked deceleration of inflation. The slowdown in wage settlements and the recovery in production had contributed to a fall in unit labor costs in manufacturing and to prospects of improved profits. Fiscal policy had contributed to the recovery in 1983. The strategy behind the FY 1983/84 federal budget had been to impart an immediate stimulus to the depressed economy, but to follow a more restrictive course in later years once economic growth had got under way. Thus, in 1983, there had been an increase in the budget deficit, which had exerted a strong short-term expansionary effect upon the economy. The Special Recovery Program had also helped to boost economic activity.

Monetary policy in 1983 had focused more directly on interest rate and exchange rate objectives, Mr. Zhang observed. There had been a narrowing of the gap between U.S. and Canadian interest rates. Experience had shown that, in balancing external and internal objectives, the authorities found that the scope of monetary action in Canada remained constrained by monetary developments in the United States, which thereby often tended to accentuate the conflict between those two objectives.

The prospects for the Canadian economy in 1984 were good, Mr. Zhang considered, because the expansion would continue and become more broadly based. Given the expected strength of the recovery, business fixed capital formation was expected to pick up considerably in 1984, although high real interest rates would be an unfavorable factor. Consumer demand would remain strong; government consumption would increase. The process of inventory decumulation would be reversed, and accumulation would begin. In contrast, the foreign balance would probably remain weak. However, because of the close economic connection with the United States, both the course of interest rates in the United States and the strength and path of the U.S. recovery would be bound to affect domestic economic developments in Canada in 1984.

The staff had provided a competent and informative analysis, Mr. Zhang commented, but a number of points could be clarified. First, could the monetary management of the Canadian authorities keep nominal demand expansion on a path consistent with the restoration of price stability, irrespective of what was happening in the U.S. economy? If it could, was it in the interest of the long-term development of the economy that it should? Second, was there a need for independent action to bring nominal GNP growth to a single-digit rate in the near term? What would be the impact of a slowdown in economic activity and higher interest rates in the United States? In that connection, what did the staff mean by "timely" when it referred to "timely action in raising interest rates" at the end of the first full paragraph on page 16 of SM/83/258?

Referring to the final paragraph on page 10 of SM/83/258, Mr. Zhang asked whether the staff was suggesting that interest rates in Canada could be lowered further in relation to those in the United States by reducing the Canadian federal deficit, and whether it supported that view by the statement that "the expansion of recent years indicated that the interest rate differentials between Canadian and U.S. assets could move in a considerable range." Fourth, had the narrowing of interest rate differentials not been due to the improvement in confidence brought about by policy changes in areas such as energy and foreign investment? Fifth, what results could be expected if the Canadian authorities sought to reduce the federal deficit in the context of a large U.S. deficit and high U.S. interest rates? In such an event, was it correct to believe that there would tend to be an increase in the outflow of Canadian funds and a decrease in the inflow of foreign funds that would, in turn, provoke a depreciation of the Canadian dollar?

Mr. Malhotra remarked that the healthy turnaround in the performance of the Canadian economy since the time of the previous Article IV consultation was a cause for satisfaction. Output had grown as expected, employment had increased somewhat, and there had been a substantial decline in the rate of inflation. As Mr. Joyce had noted, recovery in Canada had undoubtedly been helped by recovery in the United States, but it was also clear that the policies of the Government of Canada had furthered the process. The staff's analysis of the impact of the 6/5 wage program was interesting, and he agreed with other Directors that that policy had on the whole been successful. He invited Mr. Joyce to comment on the evolution of the policy after mid-1984.

There appeared to be differences between the views of the staff and those of the Canadian authorities in several areas, Mr. Malhotra continued, particularly with regard to fiscal policy. The staff appeared to believe that the deficit was too high and should be reduced more rapidly than the Canadian authorities thought necessary. The matter was obscure; it had been, at least in part, the basis for Mr. de Vries's comment that there was a certain lack of focus in the authorities' policies. However, that remark should be seen in the context of Mr. de Vries's earlier statement that Canada's economy was complex and was passing through a difficult period. What Mr. de Vries had characterized as a "lack of focus" in policies could be a redeeming feature in the present circumstances.

It had been suggested by Mr. Joyce that, currently, the high public sector borrowing requirement was not impinging on the demand for credit by the commercial sector, Mr. Malhotra noted. It was important to nurture the recovery at the present delicate stage. A rapid reduction in the fiscal defict could weaken the recovery. The gradual approach indicated by Mr. Joyce was a more pragmatic alternative. However, inflationary expectations remained deeply embedded in the Canadian economy, and, therefore, the situation would require constant monitoring. The authorities would have to ensure that those expectations did not become stronger.

Commenting on monetary policy, Mr. Malhotra observed that, although the earlier mechanisms for monitoring the growth of monetary aggregates had had to be abandoned in the light of financial innovations, monetary policy had been sufficiently restrained. The decline in the inflation rate was evidence of that restraint. It would be interesting to learn how the search for an appropriate monitoring device was proceeding, or whether it had been given up and the authorities intended to continue the present practice of making judgments by watching several indicators having a bearing on monetary policy.

The Canadian authorities' room for maneuver through interest rate policy appeared to be limited, Mr. Malhotra considered. Apparently, Canadian interest rates were influenced strongly by those in the United States. It would be interesting to see whether business fixed investment would pick up substantially in the next phase of the recovery. The staff suggested that it would, and Mr. Joyce appeared to agree. However, it was possible that the continuing high rates of interest would have an inhibiting effect on that phase of recovery. Furthermore, given the limitations on interest rate policies, the monetary aggregates needed to be monitored all the more effectively; hence his interest in the development of new monitoring mechanisms.

Developments in the external sector had been satisfactory so far, Mr. Malhotra observed. The balance of payments had improved, and the current account was in surplus, although it was expected to move into a small deficit in 1984. The staff considered, and Mr. Joyce agreed, that it was not advisable to make a discrete adjustment in the exchange rate at present even though the rate of inflation in Canada was higher than in its major trading partners. The approach was appropriate in the given circumstances; it was not always right to decide such questions with reference merely to price differentials. He welcomed Mr. Joyce's statement that the Canadian authorities would continue to be flexible on exchange rates.

He agreed with those Directors who had favored the raising of Canada's domestic petroleum prices to the level of international prices, Mr. Malhotra went on. He also shared the view that there appeared to be a gap between intention and action with regard to freedom of international trade. More needed to be done in that area.

The continued commitment of the Canadian authorities to reaching the target of 0.7 percent of GDP for official development assistance was appreciated, Mr. Malhotra remarked. Recently, however, there had been a decline in the level of aid, perhaps because of budgetary difficulties; he hoped that the position would be reversed. He also welcomed the Canadian authorities' commitment to multilateral aid and their view that it should not decline further. They were to be congratulated on the degree of concessionality in their aid. However, the idea that conditionality attached to bilateral assistance should be extended was a matter of concern. Insisting that a recipient country's policies should be "certified" through approval by the World Bank or by the Fund before assistance was provided would lead to considerable rigidities and delays. There already existed forums in which a country's overall policies were discussed each year, such as the consultative groups presided over by an official of the World Bank and attended by representatives of donor countries. To make aid dependent on the views of one institution or another would only make the position more complex, and it could be counterproductive.

The Executive Directors agreed to resume their discussion in the afternoon.

3. INTERIM COMMITTEE - 1984 SPRING MEETING

Mr. de Groote stated that he had been asked by the Chairman of the Interim Committee to clarify for Executive Directors remarks attributed to the Committee Chairman on the question of whether or not there should be a meeting of the Committee in the spring of 1984. The Chairman had said to the newspaper Handelsblatt that he personally favored the holding of a meeting of the Committee in the spring, but that he had not yet consulted with the Managing Director of the Fund or with other members of the Committee. He had suggested that, in his view, there were a number of topics that might be discussed, such as how to spread the recovery under way in the United States to other industrial countries, how developing countries might take advantage of the recovery, the debt situation of developing countries, and the role of commercial banks. However, he had not mentioned the position of the authorities of any individual country. He had alluded to the fact that "in Washington," meaning by that remark "in the Fund," there was apparently some opposition to a meeting of the Interim Committee in the spring, but he had not expressed any view on the position of the U.S. authorities. Indeed, the Committee Chairman was aware that the U.S. authorities were completely open-minded on the question. The Committee Chairman had spoken to the U.S. authorities regarding the newspaper report, and he had also cautioned the newspaper to be more careful in future in interpreting his remarks.

Mr. Erb said that his authorities had asked him to emphasize that they were not opposed to holding an Interim Committee meeting in the spring of 1984; if held, the meeting would be a useful opportunity to discuss world economic developments and to take stock of the current adjustment efforts of member countries. While they were willing to participate in the meeting, they remained open-minded; if a consensus developed not to have such a meeting, they would be willing to go along with that consensus.

The Executive Directors took note of the remarks by Mr. de Groote and Mr. Erb.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/9 (1/18/84) and EBM/84/10 (1/20/84).

4. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 83/104 and 83/105 are approved. (EBD/84/6, 1/12/84)

Adopted January 18, 1984

b. The minutes of Executive Board Meetings 83/106 and 83/107 are approved. (EBD/84/10, 1/13/84)

Adopted January 19, 1984

5. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/84/12 (1/19/84) is approved.

APPROVED: June 6, 1984

LEO VAN HOUTVEN
Secretary