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December 23, 1983

To: Members of the Executive Board

From: The Acting Secretary

Subject: Canada - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Canada, which has been tentatively scheduled for discussion on Wednesday, January 25, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Hernández-Catá, ext. (5)8468.

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INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Consultation with Canada

Approved by E. Wiesner and C. David Finch

December 22, 1983

A Fund mission held Article IV consultation discussions with representatives of Canada in the period October 19-31, 1983; Canada has accepted the obligations of Article VIII, Sections 2, 3, and 4. The Canadian representatives in the discussions included Mr. M. Lalonde, Minister of Finance, Mr. G.K. Bouey, Governor of the Bank of Canada, and senior officials from the Department of Finance, the Bank of Canada, the Department of External Affairs, the Department of Energy, Mines, and Resources, the Department of Industry, Trade, and Commerce, the Department of Employment and Immigration, and the Foreign Investment Review Agency. The mission had informal meetings at the Economic Council of Canada and the Conference Board of Canada. Mr. R.K. Joyce, Executive Director for Canada, participated in the meetings. The Fund mission consisted of J. Ferran, E. Hernandez-Cata, Y. Horiguchi, L. DeMilner, C. Collyns (all WHD), and S. Dobson (Secretary-ADM).

This report is organized as follows: Section I reviews recent economic developments; Section II summarizes the discussions on economic prospects and policies; and Section III contains the staff appraisal. Appendix I presents the staff's economic projections for 1984 and Appendix II provides information on Canada's relations with the Fund. The charts referred to in the text appear at the end of the report.

I. Recent Economic Developments

Following an escalation of inflation beginning in 1979, a tightening of demand policies--together with a weakening of U.S. demand--led to a slowdown of economic activity which turned into a sharp contraction after mid-1981 (Chart 1). Over the six-quarter period ended in the fourth quarter of 1982, real GNP declined by 6 1/2 percent and employment fell by more than 5 percent, with the unemployment rate rising from about 7 percent in mid-1981 to a postwar peak of 12 3/4 percent in December 1982 (Chart 2). The 1981-82 recession in Canada was the deepest since the 1930s and was more severe than that experienced recently in the United States.

Starting in the second half of 1982, substantial progress was made in reducing inflation, and economic recovery began in early 1983. Real GNP rose at an annual rate of 7 1/2 percent during the first three quarters of 1983, owing primarily to a sharp turnaround in inventories but also to a rise in residential construction and purchases of consumer durables. There was a sizable increase in employment, and by November 1983 the unemployment rate was down to 11 percent.

The 12-month rate of increase in the consumer price index fell to just under 5 percent in October 1983 from 10 percent a year earlier and a peak of nearly 13 percent in mid-1981 (Chart 3). Wage increases under contracts without COLA clauses declined from an average of 13 1/4 percent in 1981 to slightly less than 6 percent in the second quarter of 1983 (Chart 4). There has been a sharp drop in the rate of increase in unit labor costs during the past year, reflecting a rebound in productivity as well as the deceleration in wages (Chart 5). The inflation differential between Canada and the United States has narrowed from a range of 3-6 percent (depending on the indicator used) in the middle quarters of 1982 to a range of 1-3 percent in the third quarter of 1983 (Chart 6).

The current account of the balance of payments shifted from a deficit of about 1 1/2 percent of GNP in 1981 to a surplus of more than 3/4 percent of GNP in 1982, the first surplus in nine years (Chart 7). The improvement was more than accounted for by a rise in the merchandise trade surplus that resulted from a sharp cyclical decline in imports and special factors affecting automotive exports and energy imports. The deficit in the services balance, which had exceeded 4 percent of GNP in 1981, increased further in 1982. In the first three quarters of 1983 the current account surplus declined to a rate of about 1/2 percent of GNP as merchandise imports were boosted by the strength of domestic demand and the deficit in the services balance continued to widen.

Following a sizable drop from 1976 to 1981, net inflows of long-term capital increased in 1982. Issues of Canadian securities abroad were bolstered by continued large financing requirements of provincial entities and wide interest differentials between Canadian and U.S. dollar-denominated bonds; furthermore, direct investment outflows--particularly those related to acquisition by Canadian residents of foreign-owned corporations both in Canada and abroad--fell off sharply. Net inflows of long-term capital declined in the first three quarters of 1983; there was a substantial drop in new security issues abroad, perhaps in response to a narrowing of yield differentials between Canada and the United States. After increasing by Can$17 billion during 1981, Canada's net external liabilities declined slightly in 1982 (to a year-end level of Can$97 billion) as a rise in foreign holdings of long-term Canadian bonds was offset by an increase in net short-term assets abroad.

The value of the Canadian dollar in terms of the U.S. dollar fluctuated within a narrow range over the 12 months ended November 1983, following its recovery from a low point in June 1982 (Chart 8). The appreciation of the Canadian dollar in the summer of 1982 reflected in part a widening in the short-term interest rate differential in favor of assets denominated in Canadian dollars, which reached a peak of 6 percentage points in August 1982. Subsequently the short-term differential narrowed, and in recent months it has virtually disappeared. In effective terms (MERM weights), the Canadian dollar appreciated by 7 1/2 percent from June 1982 to November 1983, following a depreciation of 3 1/4 percent during the first half of 1982. After a large increase in the second half of 1982, Canada's official net international reserves rose moderately in the first three quarters of 1983, with the cumulative increase since mid-1982 offsetting the decline in the first half of that year when the Canadian dollar was under downward pressure (Chart 9).

On the basis of various indicators of the real exchange rate of the Canadian dollar, it appears that Canada's competitive position vis-a-vis the United States may have deteriorated a little during the period 1979-83, following a marked improvement during 1977-78 (Chart 10). Canada's unit labor costs in manufacturing relative to those of the United States (adjusted for exchange rate changes) have risen by 2 percent since the end of 1978. Meanwhile, Canada's unit labor costs increased by more than 50 percent in relation to those of industrialized countries other than the United States. The bulk of this increase has taken place in the past three years, during which the Canadian dollar appreciated sharply (along with the U.S. dollar) against the currencies of those countries. Notwithstanding the recent deterioration, the competitive position of Canada in relation to those countries at present is not materially different from that in 1976 (see bottom panel of Chart 10). It should also be noted that Canada's share in manufacturing exports of major industrial countries has increased from 4 3/4 percent in 1979 to 6 percent in the first half of 1983.

II. Summary of the Discussions

1. Economic outlook

The Canadian representatives said that since early 1983 economic activity had recovered in an environment of continued moderation of cost-price pressures, a stable exchange rate, and a strong current account position. In general, output and employment had recovered from their recession troughs more vigorously than had been envisaged by most forecasters, and the progress in reducing inflation also had been more rapid than expected.

The Canadian representatives said that the strong recovery of the U.S. economy and the reduction in U.S. inflation had been major factors behind the improved performance of the Canadian economy.1/ However,

1/ Movements in GNP and industrial production in Canada, the United States, and other major industrial countries are compared in Chart 11.

economic policies in Canada also had played an important role in moderating inflationary pressures and, more generally, in improving private sector confidence. They noted that the inflation differential between Canada and the United States had been substantially reduced since late 1982, and that this had reflected the combination of cautious demand policies and a program of wage and price restraint. The improvement on the inflation front had made possible a sizable decline in interest rates, and in recent months there had been a significant reduction in unemployment.

On the assumption that the U.S. economy would stay on a path of recovery, Canadian officials expected a continuation of economic growth in Canada in the period ahead, albeit at a slower pace than during the first half of 1983. The forecast of the Department of Finance was for output to grow a little more than 4 percent (annual rate) from mid-1983 to end-1984. The slowing in the pace of the recovery in the latter part of 1983 and into 1984 would reflect a smaller contribution of inventory investment and a decline in residential construction following the expiration of temporary fiscal incentives that had boosted housing investment in the first half of 1983. High real interest rates along with considerable unused capacity had hindered the recovery of business fixed investment.1/ However, it was expected that investment would pick up during 1984 on the basis of a substantially improved corporate cash position and a projected decline in real rates of interest. The unemployment rate was expected to decline from 11 3/4 percent in the third quarter of 1983 to around 10 3/4 percent by the end of 1984. Finally, the rate of increase in the GNP price deflator would come down from an estimated 6 percent during 1983 to 5 1/2 percent during 1984.

Canadian officials observed that the prevailing high rate of unemployment could be expected to exert continued downward pressure on wage and price inflation. However, there was some concern that relatively large wage settlements in certain sectors could spill over into other sectors as the recovery took hold. The mission noted that, notwithstanding the existence of a large degree of slack in labor markets, the risk of a generalization of wage pressures seemed to be significant at this juncture because inflationary expectations appeared to have remained relatively high. There were indications (including the level of long-term interest rates and certain wage settlements) that inflationary expectations had dropped considerably less than actual inflation--which would not be surprising given the short period that had elapsed since inflation had been brought down from high levels. Canadian officials agreed that inflationary expectations remained relatively strong and volatile, and that the possibility of a resurgence of inflation could not be ruled out. They stressed that an intensification of wage pressures would not be accommodated by financial policies but they feared that, in those circumstances, such pressures might result in a squeeze of output and employment.

1/ Indicators of interest rates in nominal and real terms are presented in Chart 12.

2. The 6/5 program

To assist demand policies in the effort to reduce inflation, in the budget presented in June 1982 the Government introduced a set of wage-price guidelines (the 6/5 program). This initiative reflected the concern of the Government that, unless rapid progress were achieved in reducing wage increases and moderating inflationary expectations, the pursuit of policies of demand restraint would entail severe costs in terms of unemployment and output foregone. The 6/5 program, which is to remain in effect through June 1984, consists of legislated limits on the increase of federal wages and government administered prices as well as voluntary guidelines for wage-price behavior in the rest of the economy. Wage increases in the federal sector were limited to 6 percent over the year ended June 1983 and are subject to a 5 percent ceiling over the year ending June 1984. The same ceilings apply to the indexation of personal income tax brackets and exemptions and to certain transfer payments. Government administered prices are similarly restrained, with larger increases allowed only in exceptional circumstances.

The Canadian representatives said that the 6/5 program thus far had contributed significantly to the slowdown of inflation. Following the lead of the Federal Government, most provinces had implemented wage-price restraint programs of their own, which in some cases were stricter than the federal program. In general, Canadian officials expressed the view that these developments had contributed to the abatement of expectations about inflation by convincing market participants that the Government was firmly committed to anti-inflationary objectives. Officials remarked that, given the large degree of slack in the economy, a substantial moderation of inflation might have occurred even without the 6/5 program, and it could not be ruled out that the guidelines might have acted as a floor in certain wage settlements. Nevertheless, there was little doubt that the decline in inflation would have been less rapid in the absence of the program.1/

The Canadian representatives indicated that the Government was now considering arrangements that might be put in place upon the expiration of the 6/5 program in mid-1984. They said the Government was opposed to the extension of mandatory controls to the provincial and private sectors on the grounds that such an extension would carry the risk of creating distortions as the economy recovered. At the same time it was possible that, without any follow-up arrangements, there would be a pick-up in wage settlements and an acceleration of prices as markets might become less convinced of the Government's commitment to reducing inflation.

1/ An analysis of recent wage settlements and the impact of the 6/5 program is provided in Appendix I of the recent economic developments paper.

Canadian officials in general felt that continued restraint of federal wages would be helpful in achieving further progress on the inflation front. Although, in principle, wage restraint could be achieved without the assistance of any specific program, the adoption of some kind of guidelines would give a clear signal to the rest of the economy and hence would help to moderate cost-price pressures in general. Without the credible leadership of the Federal Government, provincial governments would find it more difficult to pursue policies of wage restraint. On the kind of program that would be appropriate, the Canadian representatives said that guidelines without legislative mandate would be less likely to convince markets of the Government's resolve, but continued application of a compulsory program might cause problems in the area of labor management relations in the federal sector. The Canadian representatives also said that federal employees should not be expected to bear a disproportionately heavy burden in the fight against inflation.

3. Monetary management

The Canadian representatives said that the policy of monetary restraint pursued by the Bank of Canada in the past few years had been a major factor in the moderation of wage-price pressures. Starting in late 1980 monetary policy was tightened considerably; interest rates rose to unprecedented levels and nominal GNP began to decelerate in the second half of 1981. Canadian officials observed that the progress made on the inflation front since the latter part of 1982 had made it possible to achieve a substantial reduction in interest rates while avoiding any downward pressure on the Canadian dollar in foreign exchange markets. Officials of the Bank of Canada stated that the objective of monetary policy in present circumstances was to achieve a rate of monetary expansion consistent with a rising utilization of economic resources in a context of increasing price stability.

In recent years, the conduct of monetary policy in Canada has been complicated by instability in the relationship of money to interest rates and income. This instability appeared to reflect shifts in the demand for money associated with a process of financial innovation. The increasing difficulty in interpreting the behavior of the monetary aggregates led to the announcement in November 1982 that the Bank of Canada had abandoned the practice of specifying growth targets for M-1; at that time the Bank explained that this action was taken for technical reasons, and did not signal a change in the stance of policy.

Bank officials noted that the shifts in the demand for money that had undermined the usefulness of M-1 as an indicator for policy appeared to have moderated in the first half of 1983. The very rapid growth in M-1 from November 1982 to June 1983 was not out of line with historical relationships, given the decline in interest rates that had taken place and the rise in total spending during the first half of 1983.1/ Indeed,

1/ Movements in M-1 are illustrated in Chart 13.

Bank of Canada officials had expected a temporary acceleration in the demand for narrow money as inflation and interest rates came down. They felt that if this acceleration had not been accommodated, the recovery of economic activity might have been impaired. Bank of Canada officials went on to note that M-1 growth had slowed sharply in the third quarter of 1983, perhaps signaling that the adjustment to past declines in inflation and interest rates had been completed. They added, however, that the recent behavior of M-1 also suggested a resumption of the process of financial innovation; a shift away from M-1 (notably from personal current accounts into daily interest checking and savings accounts) appeared to be underway and this was once again affecting the reliability of that aggregate.1/

Since the abandonment of targeting on M-1, Bank officials had been working on the definition of an alternative monetary aggregate to be used as a guide for policy, but they indicated that the results so far had not been encouraging. The staff of the Bank of Canada had been experimenting with M-1A, a transactions-based aggregate somewhat broader than M-1.2/ While for the last few years forecasting errors for M-1A were found to be smaller than for M-1, these errors were judged to be too high for M-1A to be considered a useful guide in the conduct of monetary policy. Furthermore, a more disaggregated analysis had revealed that the relatively good forecasting performance of the equation relating M-1A to income and interest rates reflected offsetting although unrelated prediction errors for the major components of this aggregate.

As regards the broader monetary aggregates, such as M-2, Bank officials continued to believe that they were not suitable guides for policy because of problems of controllability and interpretation. To be sure, M-2 was correlated with nominal income and interest rates, but the stability of this relationship was affected by changes in the degree of financial intermediation through the banking system; furthermore, M-2 (unlike M-1) did not provide much of a lead on the national income data. In conclusion, Bank officials said that while they continued to pay close attention to several monetary indicators, they did not believe it would be possible to return to a policy framework centered on the monetary aggregates in the near future.

Bank officials said that, in practice, monetary policy was now conducted in a similar way as in the period prior to the autumn of 1975, when the Bank had formally begun to target on M-1. Under the present approach, the Bank made decisions on interest rates on the basis of a variety of economic and financial indicators. For some time the Bank had been paying considerable attention to the exchange rate between the Canadian and U.S. dollars, although it was emphasized in the discussions

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1/ Appendix V of the recent economic developments paper focuses on the problems of interpreting the monetary aggregates by analyzing the predictive performance of money demand functions.

2/ The composition of the various monetary aggregates is described in Appendix V to the recent economic developments paper.

that the Bank had not adopted an exchange rate target and that views about the exchange rate were not rigid. For the past year and a half monetary policy had sought to achieve a gradual reduction in interest rates while avoiding a sharp depreciation of the Canadian dollar. In the event, the reduction in Canadian interest rates (and in the interest rate differential between Canadian and U.S. assets) had occurred in an environment of exchange rate stability.1/ Bank officials emphasized that this result had not required substantial effort on the part of the Bank and that there had been no intention to fix the exchange rate within a specified band.

Bank of Canada officials said that on the basis of various economic indicators (including the rate of unemployment and the progress achieved in reducing inflation) the present level of domestic interest rates appeared to be too high; further reductions in interest rates would be desirable provided they were warranted by Canada's cost-price performance and they did not lead to undue downward pressure on the Canadian dollar in exchange markets. Bank officials thought that it would be difficult to achieve this result as long as U.S. interest rates remained high and as long as inflation was higher in Canada than in the United States. They also remarked that the recent strength in the current account of Canada's balance of payments had helped to sustain the value of the Canadian dollar, and that the scope for lowering Canadian interest rates in relation to U.S. rates would be reduced if the current account were to weaken.

Bank officials were hopeful that there would be some decline in U.S. interest rates in the period ahead which would increase the Bank's room for maneuver. If, instead, U.S. rates were to increase, the Bank would be faced with the dilemma of allowing either a depreciation of the Canadian dollar or an increase in domestic interest rates. In that event, the Bank would probably take part of the pressure on domestic interest rates and part on the exchange rate, as it had done at times in the past. Also, it was clear that interest rates would have to rise if inflation in Canada were to make a comeback. A concern in this regard was that, because of political considerations, it might be difficult to allow Canadian interest rates to rise. In such a situation, a monetary aggregate that could be used to explain monetary policy would be greatly missed.

4. Fiscal developments and prospects

The budget that was introduced in April 1983 aimed at supporting the recovery in its early stages while ensuring progress in reducing the federal deficit over the medium term. The budget contained new measures designed to foster the growth of employment in 1983 and 1984, including additional spending on public capital projects and tax incentives for fixed investment by the private sector. For the following two years, the budget called for a modest withdrawal of stimulus with

1/ Canadian and U.S. interest rates are compared in Chart 14.

a view to improving the federal fiscal position; revenue would be strengthened through a 1 percentage point increase in sales tax rates in late 1984 and expenditure would be reduced in relation to GNP, in part as a result of "sunset" provisions attached to the new spending initiatives. The Canadian representatives said that there had been few major surprises since the presentation of the April budget and that fiscal policy appeared to be well on track. They added that the Government would seek early legislative action on the tax increases proposed in the budget. More generally, it was fully understood that firm implementation of the budget plan was essential for the credibility of fiscal policy.

The staff observed that the deficit-reducing measures of the April budget were expected to have a relatively small effect on the federal fiscal position. Indeed, most of the projected decline in the federal deficit from 1984 to 1987 would stem from an increase in the degree of resource utilization, a reduction in interest rates, and a recovery of revenue from the energy sector. According to the latest estimates by the Department of Finance, the federal government deficit (national income accounts basis) would rise from 5.7 percent of GNP in 1982 to 6.6 percent (Can$26 billion) in 1983 before coming down to 5.8 percent in 1984 and to about 3 percent by 1987. The ratio of the cyclically adjusted federal deficit to GNP would widen somewhat in 1983 but it would stabilize at 3.7 percent in 1984 and then come down gradually to about 2.5 percent in 1986-87.1/

The Canadian representatives were concerned that continued large deficits might affect the performance of the economy over the long term, but recalled that the April 1983 budget contained measures that would reduce the deficit over time. While they thought it would be desirable to strengthen these measures in the context of a policy aimed at enhancing economic growth in the long run, they felt that action to bring about a substantial reduction in the deficit at this stage of the recovery would not be appropriate given the prevailing level of unemployment. It was also noted that Canada was in a pre-electoral period--elections are to be held by February 1985 at the latest--and that in such a situation the scope for increasing taxes or scaling down some of the spending programs would be limited.

1/ On the whole, the difference between the latest estimates of the Department of Finance and the numbers contained in the April 1983 budget is not large. Three factors affecting the revisions are: (i) a somewhat stronger recovery than had been anticipated; (ii) revisions in the national income accounts made in June 1983 which resulted in lowering the estimated output gap and thus the estimated cyclical component of the deficit; and (iii) offsetting factors in the energy field, including downward revisions in the assumptions for the growth of world oil prices and demand, and the June agreement between the Federal Government and Alberta (which increased projected federal revenue). Recent trends in fiscal operations are illustrated in Chart 15.

The Canadian representatives commented that, in relation to GNP, the size of the federal deficit in Canada and its expected path over the medium term were not very different from comparable estimates and projections in the United States, but they noted that Canada had a much higher personal savings rate than the United States. Furthermore, in assessing the impact of the public finances on the overall balance between savings and investment, it was important to take into account the fiscal position of all levels of government. They recalled that the Canada and Quebec Pension Plans would continue to show surpluses, although the size of these surpluses would decline steadily after 1984; they also noted that the combined fiscal balance of the provincial and municipal governments was expected to shift from small deficits in 1983-84 to moderate surpluses in 1986-87. The Canadian representatives added that the objective of avoiding the crowding out of investment had been an important consideration in the design of fiscal policy. The measures introduced in the April budget, they said, had deliberately aimed at stimulating investment (both public and private) rather than consumption and had thus differed from the traditional type of fiscal stimulus.

The mission observed that, even when all levels of government were taken into consideration, public sector savings would probably be weaker in the next several years than in the period from the mid-1950s to the late 1970s by some 3 percentage points of GNP. It was unlikely that this decline would be offset by a rise in private savings in relation to GNP. The mission noted that the substantial increase in the personal savings rate from 1979 to 1982--which appeared to have reflected a sharp rise in real interest rates coupled with heightened uncertainty about employment and incomes--had been partially reversed in the first half of 1983.1/ As the Canadian economy continued to recover and some of the special influences that raised the propensity to save in the early 1980s faded away, it was not unreasonable to expect that the personal savings rate would fall back toward its earlier levels. Since it would not be prudent to rely on foreign savings to a greater extent than in the earlier period (when the deficit in the current account of the balance of payments averaged about 1 3/4 percent of GNP), it appeared that the ratio of investment to GNP in the period ahead would be significantly smaller than the historical average.

A question was raised during the discussions concerning the likely impact on the level of interest rates of changes in the fiscal position. The Canadian representatives remarked that interest rates in Canada were strongly influenced by U.S. interest rates (and therefore by the mix of policies in the United States). For this reason, the response of domestic interest rates and private spending to a cut in the fiscal deficit

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1/ The ratio of personal savings to GNP averaged a little more than 8 percent in the period from the mid-1950s to the late 1970s and 13 percent in the period 1980-82. It is estimated that this ratio will come down to about 12 1/2 percent in 1983, from a peak of 14 1/2 percent in 1982.

in Canada might be quite small, and thus the effect of fiscal restraint would be felt primarily in a reduction of economic growth, at least for some time. The mission observed that, while the integration of capital markets in North America limited the extent to which interest rates in Canada could diverge from those in the United States, the experience of recent years indicated that interest rate differentials between Canadian and U.S. assets could move over a considerable range. Furthermore, a reduction in the fiscal deficit would make room for an improvement in Canada's external current account position, thus mitigating the short-run impact of the fiscal adjustment on output and employment.

5. Energy policy

In June 1983, the Federal Government concluded a new energy price agreement with the province of Alberta. Previously, the price of most Canadian crude oil was subject to a ceiling of 75 percent of the international oil price. With the decline in nominal and real world oil prices that occurred in 1982 and early 1983, the authorities were faced with the alternative of rolling back domestic oil prices or modifying the agreement. The decision reached was to ratify the current price of regulated oil (now at about 83 percent of the world price) and to expand somewhat the quantity of oil qualifying for the world price. Canadian officials said that the average (blended) price of domestic crude oil was estimated to have risen to 90-95 percent of the world market price (depending on the definitions used), up from 75-80 percent a year ago. Under present arrangements, however, the gap between international and domestic prices would widen again if world market prices were to rise.1/

Natural gas prices will continue to be held to 65 percent of the equivalent wholesale price of oil but some increase in producers' prices will result from a gradual removal of the gas excise tax. In addition, a new pricing policy has been instituted to help sustain Canada's natural gas exports to the United States.

6. The balance of payments and the exchange rate

In the discussion of balance of payments developments, the Canadian representatives remarked that the shift to a substantial current account surplus in the past two years had reflected temporary factors, and in general they expected the current account position to weaken as the Canadian economy continued to recover. The merchandise trade balance remained strong in the first half of 1983, owing to the interaction of cyclical developments in Canada relative to the United States and the commodity composition of Canadian external trade. Canadian exports of construction materials were boosted by strong housing demand in the United States while the weak performance of business fixed investment

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1/ Information on production, consumption, and trade of energy products, as well as on changes in the arrangements governing the energy sector, is provided in Appendix II of the recent economic developments paper.

in Canada--which was not unusual in the early stages of a recovery--limited the growth of imports. Canadian automotive exports increased sharply in 1982 and the first half of 1983 in response to a strong rise in the demand for automobiles in the United States--a rise that was particularly pronounced in the case of large cars, which make up a significant part of Canadian production at present.

The Canadian representatives noted that the outlook for the terms of trade was a major element of uncertainty in projecting the future course of the current account. On the basis of a relatively optimistic forecast for costs and prices in the United States and other industrial countries, it was possible that large increases in commodity prices would not take place. In such circumstances, Canada's terms of trade were unlikely to improve significantly and the current account might move into deficit in 1985, and perhaps as early as 1984. In general, there was agreement that the current account would weaken in the period ahead. Long-term capital inflows would be fairly large in the next several years, reflecting in large part external borrowing by corporations and provincial entities, but these inflows probably would be well below the exceptionally high levels registered in 1982. The basic balance had shifted from a deficit in 1981 to a sizable surplus in 1982, but a considerable drop in the surplus would occur in 1983 and further, albeit smaller, declines were expected in subsequent years.

The Canadian representatives felt that the strength of the current account and of the basic balance had contributed significantly to the firmness of the Canadian dollar in foreign exchange markets, although the progress made in bringing down inflation also had been an important factor. There was also a view that the value of the Canadian dollar had been bolstered by the improvement in confidence brought about by policy changes in areas such as energy and foreign investment. As was mentioned above, the exchange rate between the Canadian and U.S. dollars has changed little since late 1982, in spite of the elimination of the short-term interest rate differential between Canadian and U.S. assets. Looking ahead, the Canadian representatives did not rule out that there might be some depreciation of the Canadian dollar if the basic balance weakened and inflation remained higher in Canada than in the United States. It was noted that the objective of exchange market intervention continued to be the smoothing of exchange rate fluctuations and the avoidance of disorderly market conditions. In recent months intervention had been very small in reflection of the stability of the Canadian dollar.

The Canadian representatives explained that the combination of a stable nominal exchange rate between the Canadian and U.S. dollars and relatively higher inflation in Canada appeared to have resulted in some deterioration of the competitive position of Canada vis-a-vis the United States. The deterioration had been much more pronounced in relation to Canada's overseas trading partners, reflecting the appreciation of the Canadian (and U.S.) dollars vis-a-vis other major currencies. However, they felt that competitiveness had not been a major factor restraining

Canadian exports. They noted that exports to the United States (by far Canada's major trading partner) had been quite strong and that the proportion of manufactured products in Canadian exports to overseas markets was small. On the whole, the Canadian representatives were confident that competitiveness was not a serious problem at present; they felt that any attempt to alter the exchange rate between the Canadian and U.S. dollars in order to avoid an appreciation in relation to third currencies was likely to be counterproductive because it would have adverse effects on the domestic cost-price situation. Looking ahead, Canadian officials said that competitiveness might become a problem if inflation in Canada were to remain significantly higher than in the United States. In that event, they added, it would be important to retain a degree of exchange rate flexibility.

7. Other external economic issues

In August 1983, the Government issued a report on trade policy which stressed that an open and stable international trading environment was a key element in ensuring the economic well-being of Canada. The Canadian representatives said that in promoting such an environment priority would continue to be given to the strengthening of the multilateral trade and payments system. They saw a need to avoid new protectionist measures and to pursue the long-term objective of removing existing restrictions. Unless necessary structural adjustments were allowed, Canada would fail to benefit fully from international trade. At the same time Canada would avail itself of its rights within the GATT and would maintain a legislative and regulatory framework (similar to that in place in other countries) to deal with unfair and injurious competition.

The Canadian representatives recalled that the trade policy report referred to the possibility of extending sectoral free-trade arrangements with the United States beyond the auto sector. Such arrangements would expand the market available to certain Canadian industries and provide a necessary competitive stimulus. They felt that in a number of sectors--such as textiles, urban transportation equipment, and petrochemicals--there was significant scope for rationalization of production within North America.

The Canadian representatives said that in the past year the Government had been able to contain the spread of protectionism despite strong pressures for additional action. They noted that protectionist pressures had remained intense notwithstanding the rapid expansion of economic activity since early 1983, as the unemployment rate had remained high. They added that many of the existing restrictive measures had been adopted to facilitate adjustment in sectors that were seriously affected by import competition, and decisions to dismantle such measures should take into account the length of time required to achieve meaningful adjustment.1/

1/ A description of measures adopted in the foreign trade area in the past year is provided in Appendix III of the recent economic developments paper.

The Canadian representatives said the restraints on auto imports from Japan originally had been prompted by the fear of diversion into the Canadian market in the wake of a similar arrangement involving Japan and the United States. With the deepening of the recession in 1982, however, the drastic reduction in domestic car sales became a key factor in the Government's decision to maintain the restraints. The Canadian representatives remarked that, although the Canadian auto sector was again operating at high rates of capacity utilization, pressures on the Government to take further action on Japanese auto imports were in fact intensifying. In this connection, they drew attention to domestic content rules that had been proposed by a private sector task force and were currently under consideration by the Government. They noted that imports from Japan accounted for 20 percent of the Canadian car market and that the domestic content of such imports was very small; unless this situation was altered, they added, strong protectionist pressure in this sector was likely to persist. They also pointed out that the Government had been engaged in discussions with Japan aimed at inducing investment by Japanese automobile producers in Canada.

With regard to the Foreign Investment Review Agency, the Canadian representatives recalled that in June 1982 the Government had announced certain changes in administrative procedures with a view to streamlining the process of reviewing investment applications. As a result of these changes, in the past year there had been a substantial drop in the backlog of pending cases--in spite of a large increase in the number of applications--and the rejection rate had come down to 5-6 percent from 10-12 percent in the previous few years.

The Canadian representatives said that the Can$1/4 billion reduction in budgetary allocation for aid through FY 1984/85 announced in the June 1982 budget did not affect progress toward the goal of raising official development assistance to 1/2 percent of GNP by FY 1985/86.1/ The aim was to provide 0.7 percent of GNP in ODA by FY 1989/90, although this objective was on a "best efforts" basis rather than a firm commitment. Concerning the distribution of ODA, the intent of the Government was to resist a further drift away from multilateral aid, which now accounts for 30 percent of the total compared with 40 percent in the mid-1970s. In discussing recent developments in aid policy, Canadian officials referred to the use of conditionality as an important aspect of certain ODA programs. Their view was that the effectiveness of foreign aid in promoting development depended on the quality of domestic policies in the receiving countries. They noted that Canada was in the process of negotiating a bilateral program that would be contingent on World Bank approval of the receiving country's overall investment strategy and on satisfactory progress in that country's negotiations of an adjustment program with the Fund.

1/ Information on development assistance in recent years is provided in Appendix IV of the recent economic developments paper.

III. Staff Appraisal

In the period 1981-82 economic policy making in Canada was put to a severe test. Inflation remained stubbornly high while unemployment rose sharply, the inflation differential with the United States widened, and there were recurring downward pressures on the Canadian dollar in exchange markets. Starting with the budget of June 1982, the Government has shown heightened concern about inflation by resisting pressures to introduce a significant dose of fiscal stimulus and by establishing wage-price guidelines which are mandatory for the federal public sector. Moreover, the Government has gradually adjusted the course of policy in areas such as energy pricing, foreign investment, and corporate taxation. In reflection of the positive response to these policy changes and favorable developments in the United States, economic activity in Canada has recovered since early 1983 and cost-price pressures have moderated further.

The major economic issue confronting Canada at present is how to consolidate the gains made in restoring confidence and reducing inflation in order to enhance the prospects for sustained economic expansion and a lasting reduction of unemployment. Because inflationary expectations appear to have remained relatively high, there is a risk that wages might accelerate even while unemployment remains substantial. Quite appropriately, the Canadian authorities have indicated that they would not accommodate excessive wage demands by easing financial policies; giving clear signals to the general public of the authorities' determination in this regard would help to dampen expectations about inflation and to lessen the dangers that the growth of output and employment would be thwarted.

Turning to specific policy areas, the staff is in broad agreement with the view expressed by the Canadian authorities that the wage-price guidelines have been a useful complement to demand policies in bringing down inflation. Looking ahead, the staff would emphasize the importance of achieving further moderation of wage increases in the federal sector in order to exert continued downward pressure on inflation. This would help the other levels of government in the pursuit of restrained wage policies and would give a strong indication to the private sector. As regards the arrangements that might be put in place upon expiration of the 6/5 program in mid-1984, the staff concurs with the authorities that the option of extending mandatory controls beyond the federal sector should be ruled out, since generalized controls could lead to increasingly severe distortions as the economy recovers. In general, any arrangements that might be adopted should allow for a degree of flexibility, particularly in respect of prices.

The policy of monetary restraint pursued by the Bank of Canada has been a major factor in the moderation of wage-price pressures in the past few years. However, monetary management has been complicated by difficulties in interpreting the behavior of the monetary aggregates, and issues arise as to how monetary policy should be conducted. Since the abandonment of targeting on M-1 in late 1982, Bank officials have been working on the specification of an alternative monetary aggregate sufficiently reliable to be used as a guide for policy, but this objective has thus far proved to be elusive. For some time, the Bank has acted to prevent significant movements in the exchange rate, although Bank officials have stressed that their views about the level of the exchange rate are not rigid. They indicated that, at present, decisions about interest rates are made on the basis of a broad range of financial and economic indicators.

It is not clear whether the present approach to monetary management provides adequate protection against a cumulative drift in nominal demand expansion away from a path consistent with the restoration of price stability. In this regard, the very rapid growth of nominal GNP during the first three quarters of 1983 is a cause for concern. The staff would emphasize the need to bring such growth back to the single digit range in the near term and would note that achievement of this objective might call for a temporary increase in interest rates. Timely action in raising interest rates to help restrain demand growth would provide a signal of the authorities' commitment to anti-inflationary goals and would thus reduce the risk that interest rates might have to be raised by larger amounts at a later date.

According to official estimates, the cyclically adjusted federal deficit would peak at about 3 3/4 percent of GNP in 1983-84, before declining to 2 1/2 percent of GNP in 1987. This decline would presuppose implementation of the revenue raising measures announced in the April 1983 budget and the pursuit of a policy of tight expenditure control. While the reduction in the cyclically adjusted deficit that is envisaged starting in 1985 is a step in the right direction, the proposed reduction of fiscal stimulus is relatively small.

The prospect of continued large federal borrowing requirements even as the economy moves back to high levels of resource utilization may generate uncertainty about the future course of policies and, in particular, endanger the credibility of monetary policy. More fundamentally, structural deficits of the size envisaged would pre-empt savings and have adverse implications for private capital formation and for the economy's long-run growth performance. Accordingly, the staff would emphasize the need for a convincing plan to eliminate the federal deficit over the next few years; this would imply a return to the fiscal performance to which Canada had been accustomed before the mid-1970s.

In designing measures to improve the fiscal position, the key consideration should be their impact on the economy's long-term growth potential. In this light, efforts to curb public spending should be given priority, although the needed adjustment in the fiscal balance may also require measures on the revenue side. Limiting the growth of expenditures would not only reduce pressure on resources and make room for private capital formation but also might help reduce distortions in market mechanisms; in this regard, it might be desirable to focus on certain government programs that have contributed to increase rigidities in labor markets. As for the means of raising revenue, the choice of measures should take into consideration the objective of minimizing the adverse effects on incentives to save and invest.

The staff shares the views of Canadian officials on the importance of maintaining an open trading system. The staff notes, however, that no significant steps have been taken by Canada to remove existing barriers to trade, and that there is a threat of additional protectionist measures. In particular, the domestic content proposals for the auto sector which are currently under consideration are very disturbing. It might be pointed out in this regard that the automotive industry in Canada is presently operating at a high level of capacity utilization and that its profit situation has improved substantially. In the area of energy policy, the small differential existing at present between the domestic blended price of oil and the international price affords an opportunity for unification of the oil price system without significant short-term disruptions. Such an action would help remove uncertainties about future changes in government policies and would improve the allocation of resources.

For some time exchange market intervention by the Canadian authorities has aimed at dampening exchange rate fluctuations and preserving orderly market conditions. Intervention has been relatively small since late 1982 as exchange rate variability has declined. In the past few years the Canadian dollar has appreciated along with the U.S. dollar in relation to other major currencies, in real terms as well as in nominal terms. However, Canada's overall competitive position appears to be satisfactory. This view is supported by estimates of the real effective exchange rate of the Canadian dollar and by information on Canada's share in manufacturing exports of major industrial countries. In these circumstances, the staff agrees with Canadian officials that an attempt to lower substantially the value of the Canadian dollar in relation to the U.S. dollar--for example, in order to improve Canada's competitive position in third markets--would be ill-advised since it would compromise the price stabilization objective. Nevertheless, the staff considers that it would be desirable to retain a degree of exchange rate flexibility, particularly if inflation were to remain higher in Canada than in the United States.

In the past two years the current account has been bolstered by temporary factors, and most projections indicate it will weaken over the next few years, although it would remain strong by historical standards. To be sure, it cannot be taken for granted that a more substantial deterioration of the current account will not occur, particularly if the fiscal deficit remains large. If such a situation were to develop, achievement of a sustainable balance of payments position would seem to call for a strengthening of the public finances.

It is recommended that the next Article IV consultation with Canada be held on the standard 12-month cycle.

The Outlook

The staff has prepared a preliminary forecast of the Canadian economy through the end of 1984 in connection with the current World Economic Outlook exercise. The forecast is based on the assumption that the recovery under way in the United States will continue into 1984, albeit at a somewhat slower pace than during 1983; that the rate of inflation in the United States will not change much from 1983 to 1984; and that the international price of oil will remain constant in nominal terms through the end of 1984. As regards domestic policies, it is assumed that the Bank of Canada will maintain a policy of monetary restraint, with the exchange rate of the Canadian dollar in terms of the U.S. dollar remaining approximately at its current level. The forecast also assumes that the stance of fiscal policy will be broadly along the lines set out in the April 1983 budget.

On the basis of the broad assumptions just outlined and the underlying trend of private demand, the growth of GNP in current prices is expected to be a little more than 9 percent during 1984 (from the fourth quarter of 1983 to the fourth quarter of 1984), down from an increase of nearly 12 1/4 percent during 1983. The rate of increase in real GNP would slow to about 4 percent during 1984, from just under 7 percent during 1983, reflecting a smaller contribution of inventory investment; on a year-over-year basis real GNP would rise by 3 percent in 1983 and by 5 percent in 1984.

The rise in the GNP price deflator would be around 5 percent during both 1983 and 1984. The rate of increase in wages and salaries would show little change from 1983 to 1984, but the rate of growth in unit labor costs would rise owing to a slowdown in the growth of productivity. Employment is projected to increase by 2 1/4 percent during 1984 after rising by 4 percent during the first year of the recovery. The unemployment rate would decline from a little more than 11 percent in November 1983 to about 10 1/4 percent by the fourth quarter of 1984.

After a sizable drop during 1982, final domestic demand in real terms is expected to show an increase of 3 1/2 percent during 1983 before slowing to 3 percent during 1984; on a year-over-year basis it would grow by 4 percent in 1984 compared with less than 2 percent in 1983. The growth of spending on consumer durables and residential investment was strong in the early phase of the expansion but it is projected to moderate in the second half of 1983 and in 1984. Business fixed investment would begin to recover toward the end of 1983 and would strengthen in the course of 1984.

The foreign balance in real terms is expected to deteriorate in 1983 and in 1984. The rate of increase of exports would moderate during 1984 reflecting the reduced momentum of demand for housing and automobiles in the United States. On a year-over-year basis, however, there would be a small rise in the growth of exports. The rate of growth of imports would rise in 1984 owing partly to a pickup in investment in machinery and equipment--a component of expenditure which has a particularly high import content. The terms of trade are expected to improve slightly in both 1983 and in 1984. In current prices, the merchandise trade surplus would decline from Can$17 billion in 1983 to Can$15 1/2 billion in 1984. The deficit on services would continue to widen in 1983 and 1984, although at a slower pace than in the preceding two years when there were large increases in interest payments. In all, the current account would move from a surplus of about Can$1 billion in 1983 to a small deficit in 1984.

Canada: Selected Economic Indicators

(Percentage changes from preceding year, except as indicated)

	1978	1979	1980	1981	1982	Est. 1983	Proj. 1984
Gross national product							
(in volume)	3.6	3.2	1.0	3.4	-4.4	3.0	5.0
Consumer expenditure	2.6	2.0	1.0	1.9	-2.1	2.9	3.7
Government spending	1.1	-0.5	0.8	0.4	1.3	0.4	4.5
Residential construction	1.7	-2.7	-5.8	5.1	-23.1	29.2	4.1
Nonresidential business							
fixed investment	1.0	12.7	7.4	7.6	-11.2	-8.3	5.2
Final domestic demand	1.9	2.7	1.6	2.7	-3.9	1.6	4.1
Stockbuilding 1/	0.2	1.3	-1.9	1.0	-2.8	2.2	1.3
Total domestic demand	1.7	4.0	-0.2	3.7	-6.7	3.8	5.4
Foreign balance 1/	1.2	-1.1	1.0	-0.3	2.7	-0.8	-0.4
Employment, costs, and prices							
Employment	3.4	4.0	2.8	2.6	-3.3	0.6	3.0
Unemployment rate							
(percent)	8.4	7.5	7.5	7.6	11.0	11.9	10.6
Labor income per							
person employed	5.8	8.3	10.2	12.5	11.0	5.2	4.9
Output per person							
employed	0.2	-0.8	-1.7	0.7	-1.2	2.4	2.0
Labor costs per unit							
of output	5.5	9.1	12.1	11.7	12.4	2.7	2.9
GNP deflator	6.7	10.3	11.1	10.6	10.1	6.2	4.9
Consumer price index	8.8	9.2	10.2	12.5	10.8	5.9	5.6
Merchandise trade							
Export prices	8.8	21.0	16.7	5.9	0.5	-0.5	3.8
Import prices	13.5	14.3	16.9	10.5	2.1	-1.5	3.4
Terms of trade	-4.1	5.9	-0.2	-4.2	-1.6	1.0	0.4
Volume of exports	10.2	1.6	0.7	3.4	-0.4	6.7	8.0
Volume of imports	4.0	9.1	-4.5	2.2	-15.8	11.3	12.6
Current external transactions (in billions of dollars)							
Trade balance	4.3	4.4	8.8	7.4	18.3	17.2	15.6
Services balance	-9.3	-9.9	-11.1	-14.7	-16.8	-17.2	-17.6
Net transfers	0.1	0.7	1.3	1.6	1.4	1.0	1.5
Current account balance	-4.9	-4.8	-1.1	-5.8	3.0	1.0	-0.5

1/ The figures indicate the change in stockbuilding, or the change in the foreign balance, as a percentage of GNP in the previous year; that is, they indicate the contribution of these elements to the growth of GNP.

Fund Relations with Canada

(Position as of November 30, 1983)

Date of membership:	December 27, 1945
Status:	Article VIII.
Quota:	SDR 2,035.5 million.1/
Fund's holdings of Canadian dollars:	84.7 percent of quota.
General Arrangements to Borrow:	The maximum commitment of Canada is equivalent to SDR 165.1 million; the full amount was available.2/
Supplementary Financing Facility:	The maximum commitment of Canada is SDR 200 million; SDR 73.8 million was available.
SDR Department:	Canada's holdings of SDRs amounted to SDR 246.6 million, representing 31.6 percent of its net cumulative allocation.
Gold distribution:	941.4 thousand fine ounces.
Exchange system:	Since May 31, 1970, all exchange transactions involving the Canadian dollar have taken place on the basis of a unitary fluctuating exchange rate. On November 30, 1983, the rate of the Canadian dollar, as determined under Rule O-2(b), was SDR 0.768121 per Canadian dollar.
Last consultation:	The Staff Report for the 1982 Article IV consultation with Canada (SM/82/240, 12/29/82) was considered by the Executive Board at EBM/83/20 (1/26/83).

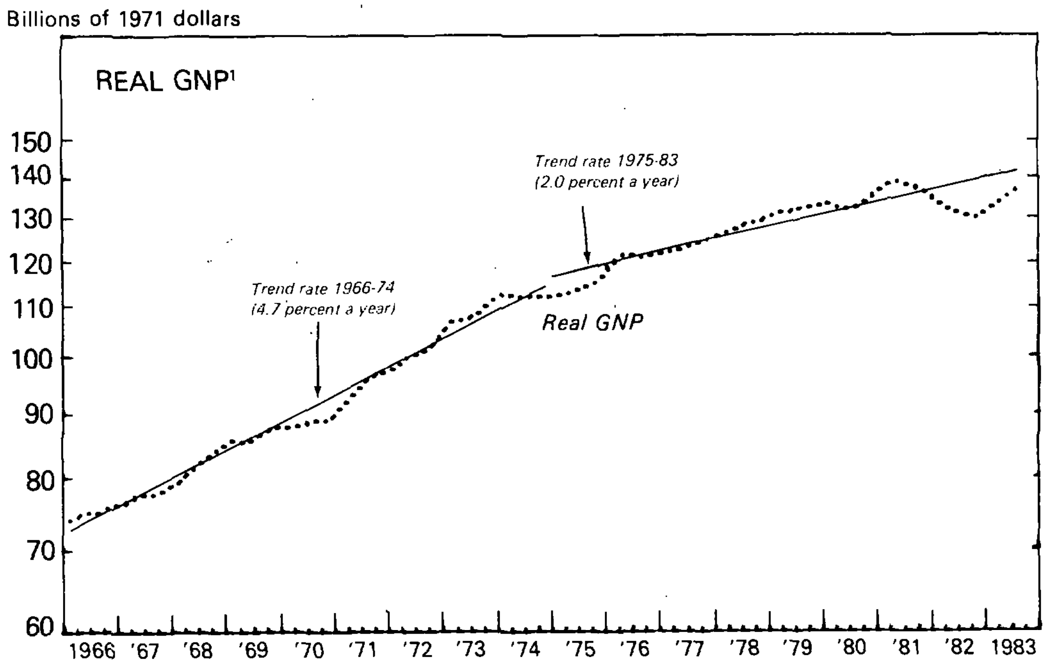
1/ As of November 18, 1983 Canada has consented to the quota increase to SDR 2,941.0 million under the Eighth General Quota Review.

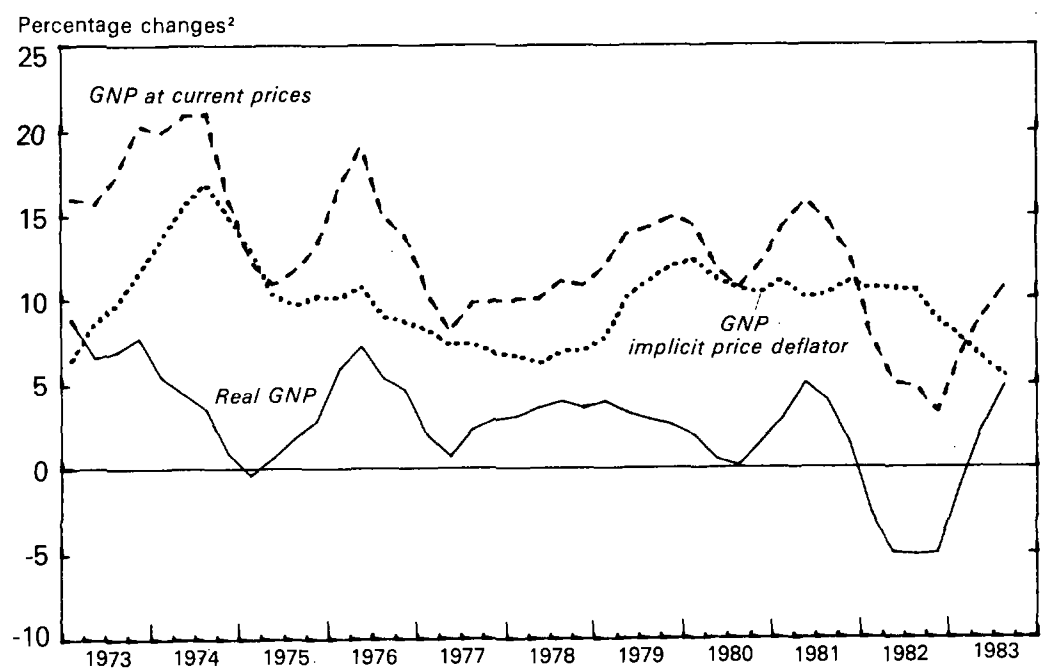
2/ As of December 5, 1983, Canada has consented to increase its credit commitment under the General Arrangements to Borrow to SDR 892.5 million.

CHART 1

CANADA

GROSS NATIONAL PRODUCT



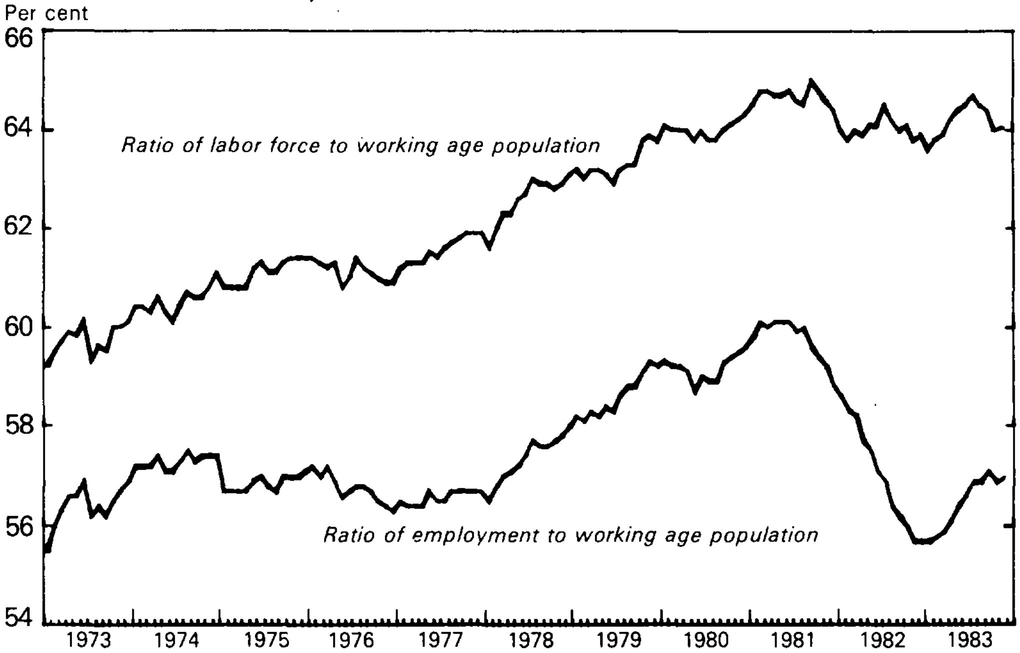


[1]Seasonally adjusted at annual rates.
[2]Percentage changes over the corresponding period of the preceding year.

CHART 2

CANADA

LABOR FORCE, EMPLOYMENT AND UNEMPLOYMENT



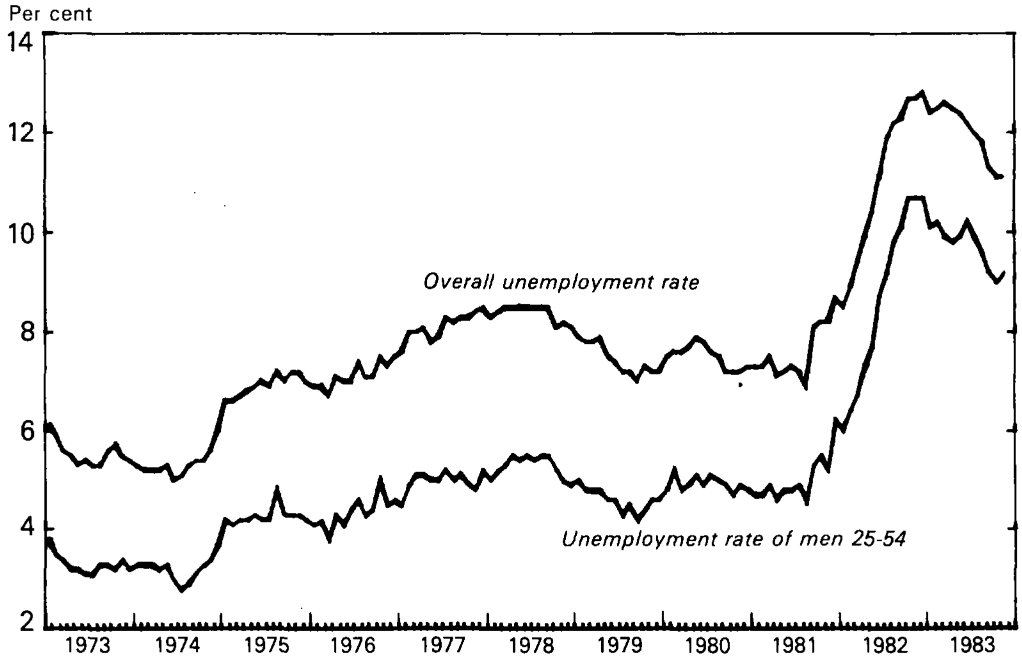


CHART 3

CANADA

CONSUMER PRICES

(Percentage changes over 12-month periods)

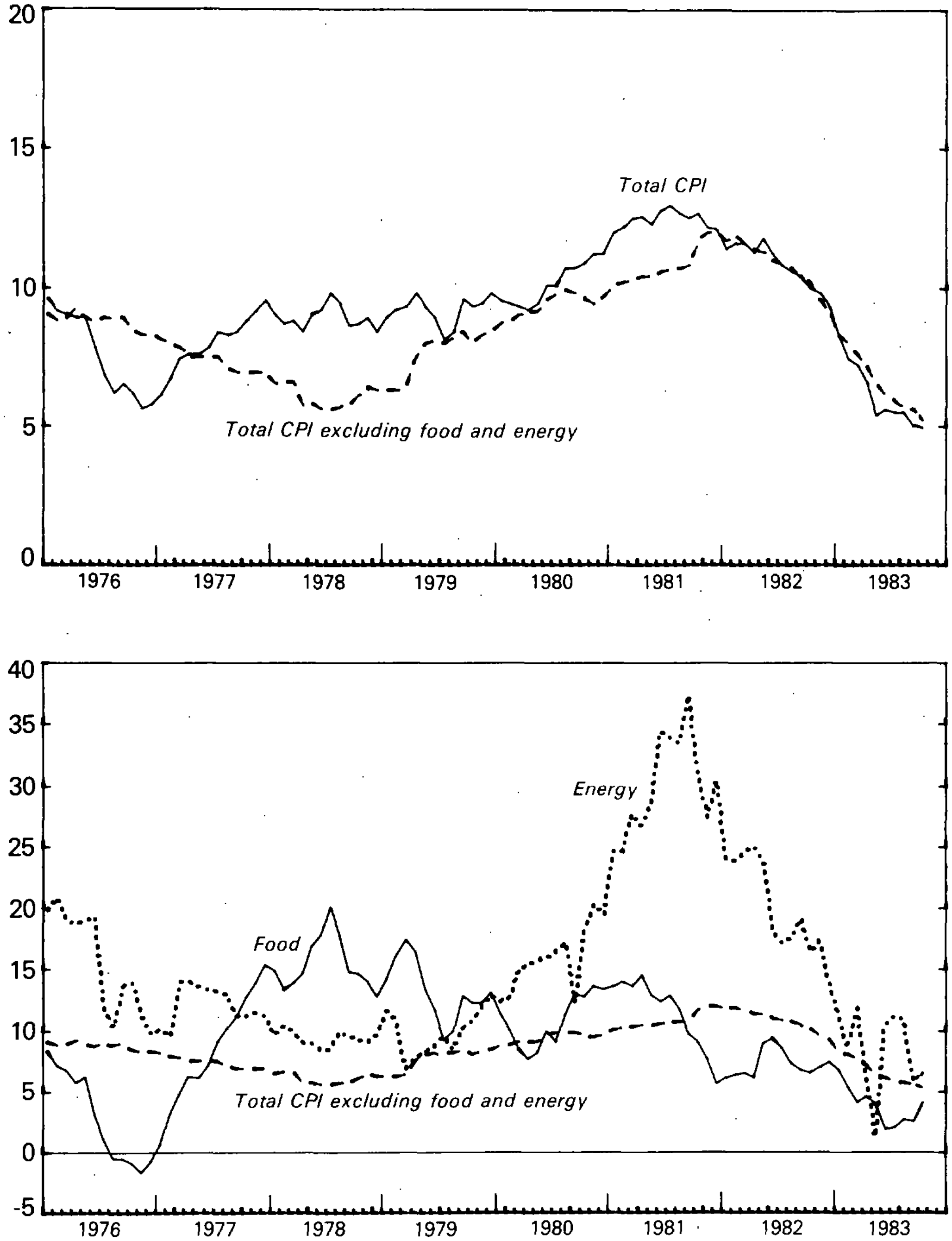
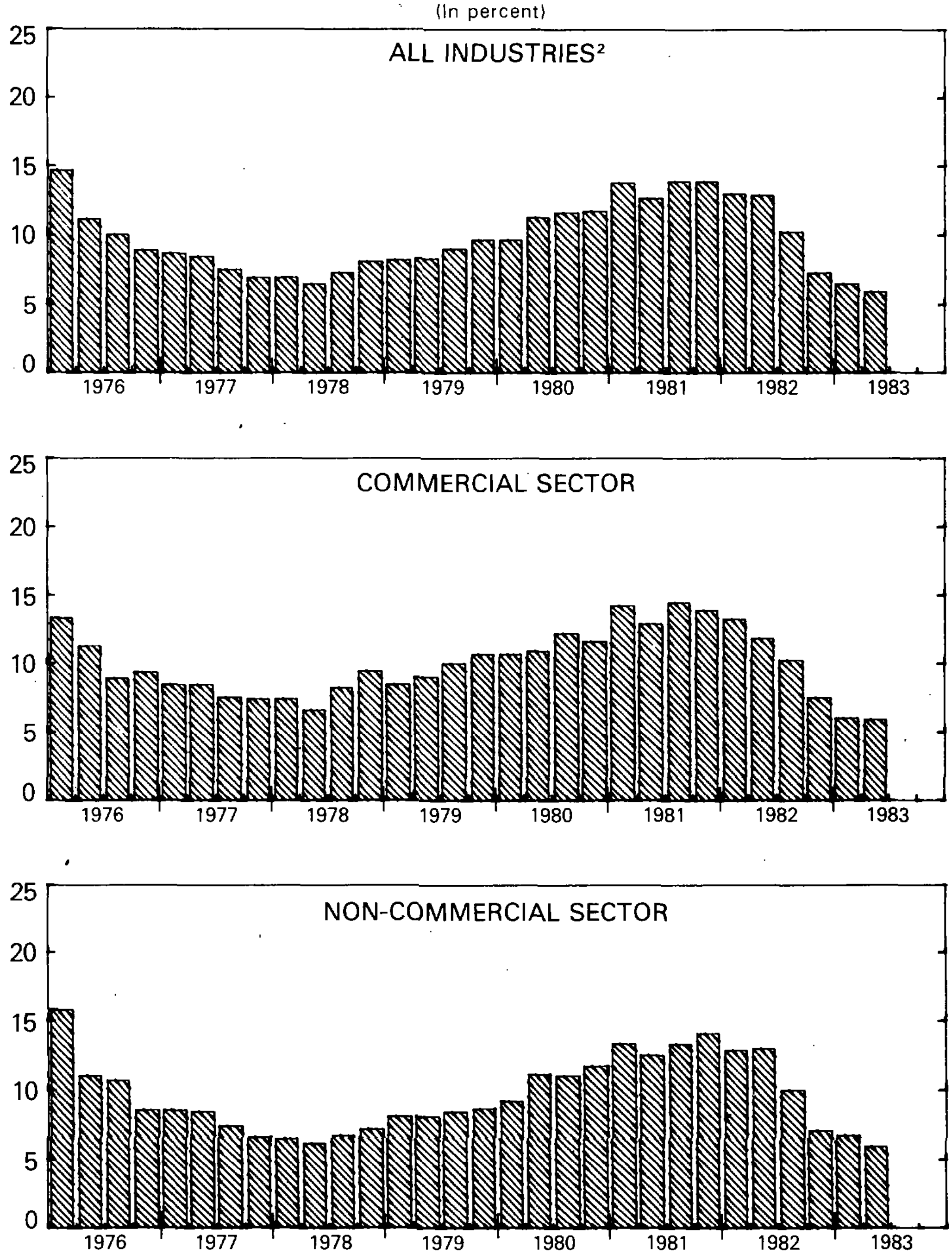


CHART 4

CANADA

WAGE SETTLEMENTS[1]

(In percent)

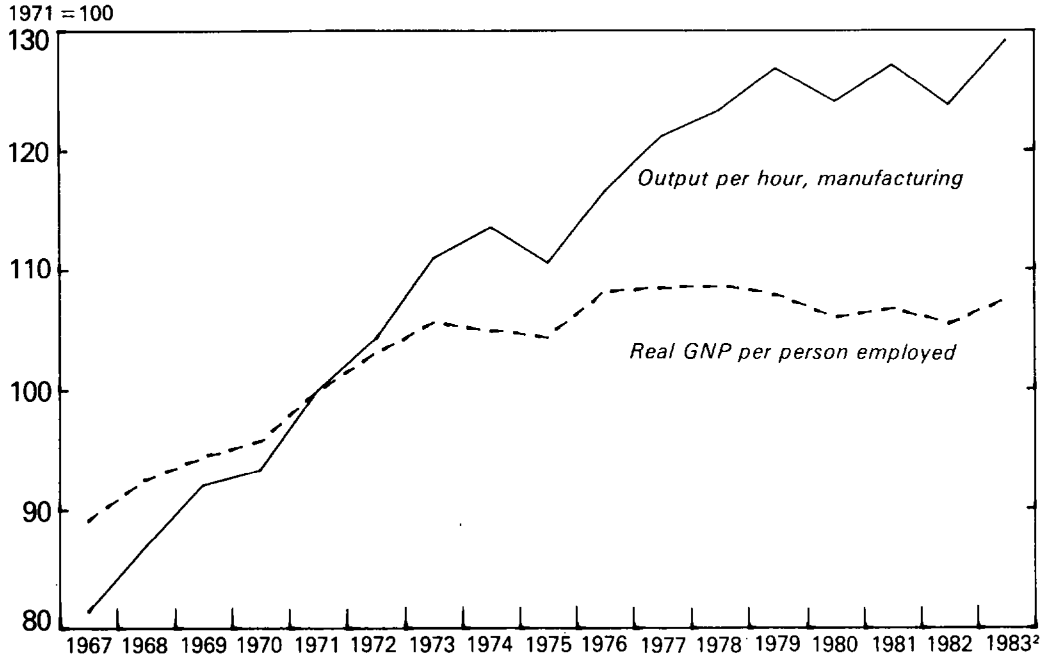


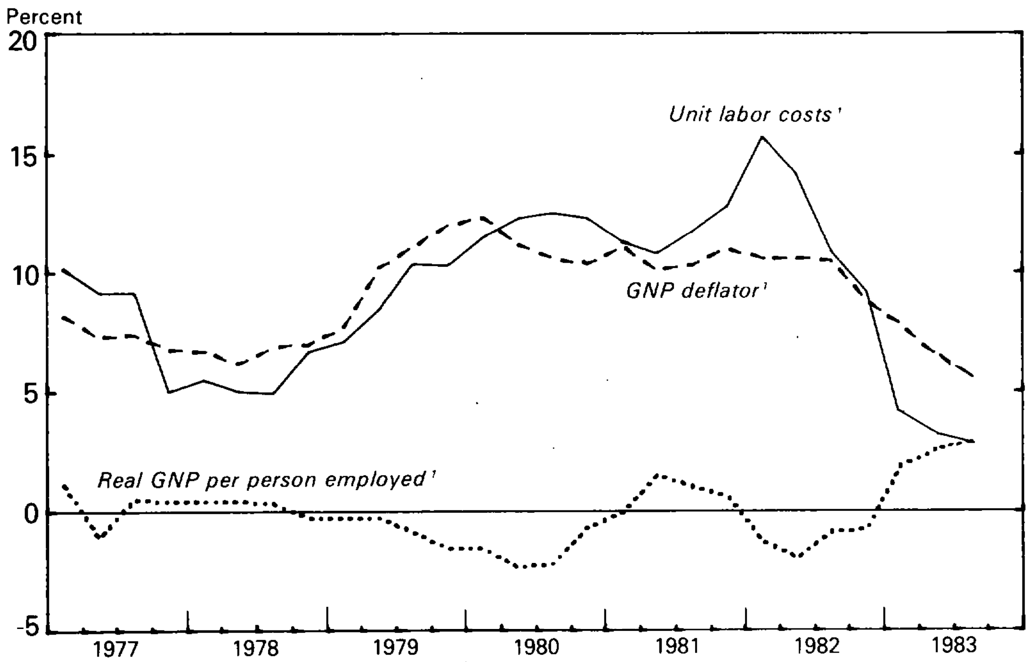
[1]Compound annual increase in base rates of pay called for in new wage settlements (without COLA clauses) concluded in the period, covering 500 or more employees.
[2]Excluding construction.

CHART 5

CANADA

PRODUCTIVITY, UNIT LABOR COSTS AND PRICES





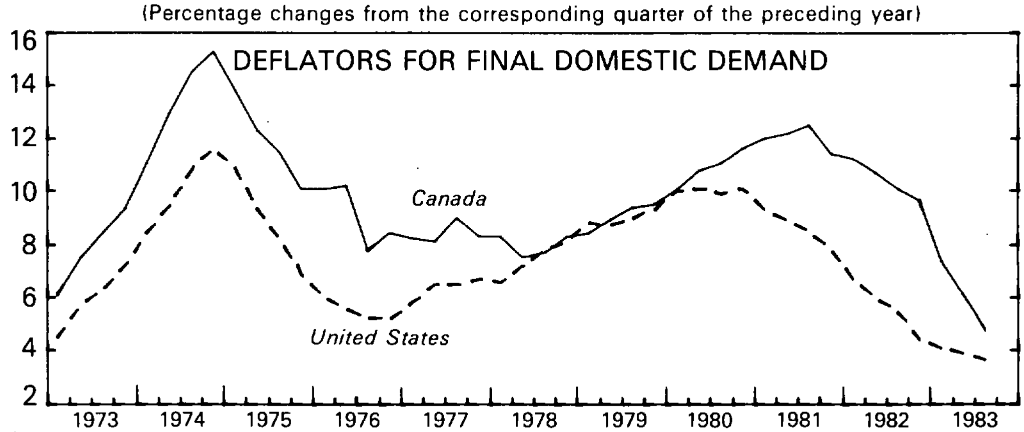
[1]Overall economy. Percentage changes from the corresponding quarter of the preceding year.
[2]Average for first three quarters of the year.

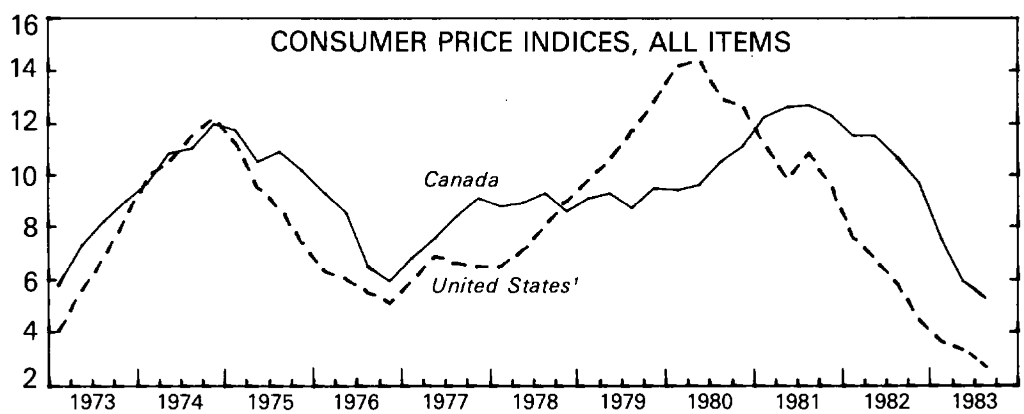
CHART 6

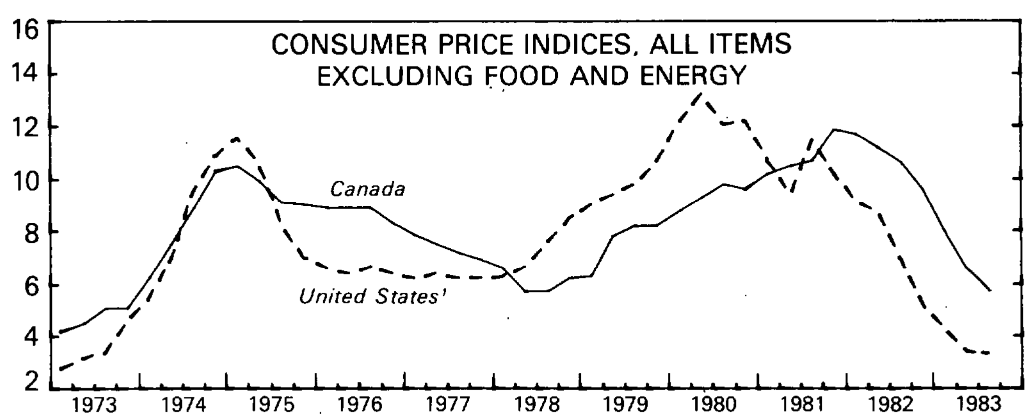
CANADA

PRICE MOVEMENTS: COMPARISON BETWEEN CANADA AND THE UNITED STATES

(Percentage changes from the corresponding quarter of the preceding year)





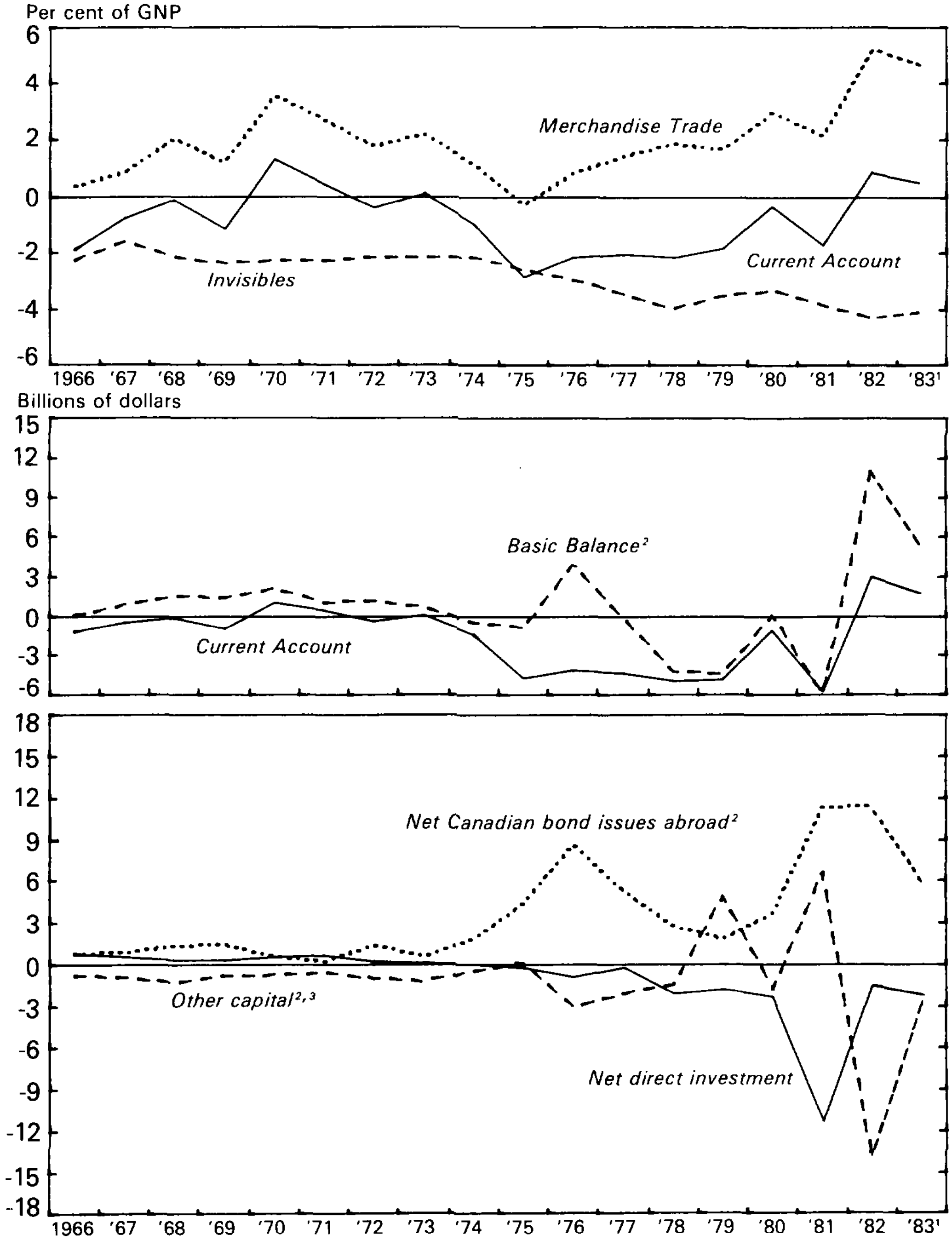


[1] For all urban workers.

CHART 7

CANADA

BALANCE OF PAYMENTS



[1] First three quarters of the year at annual rates.

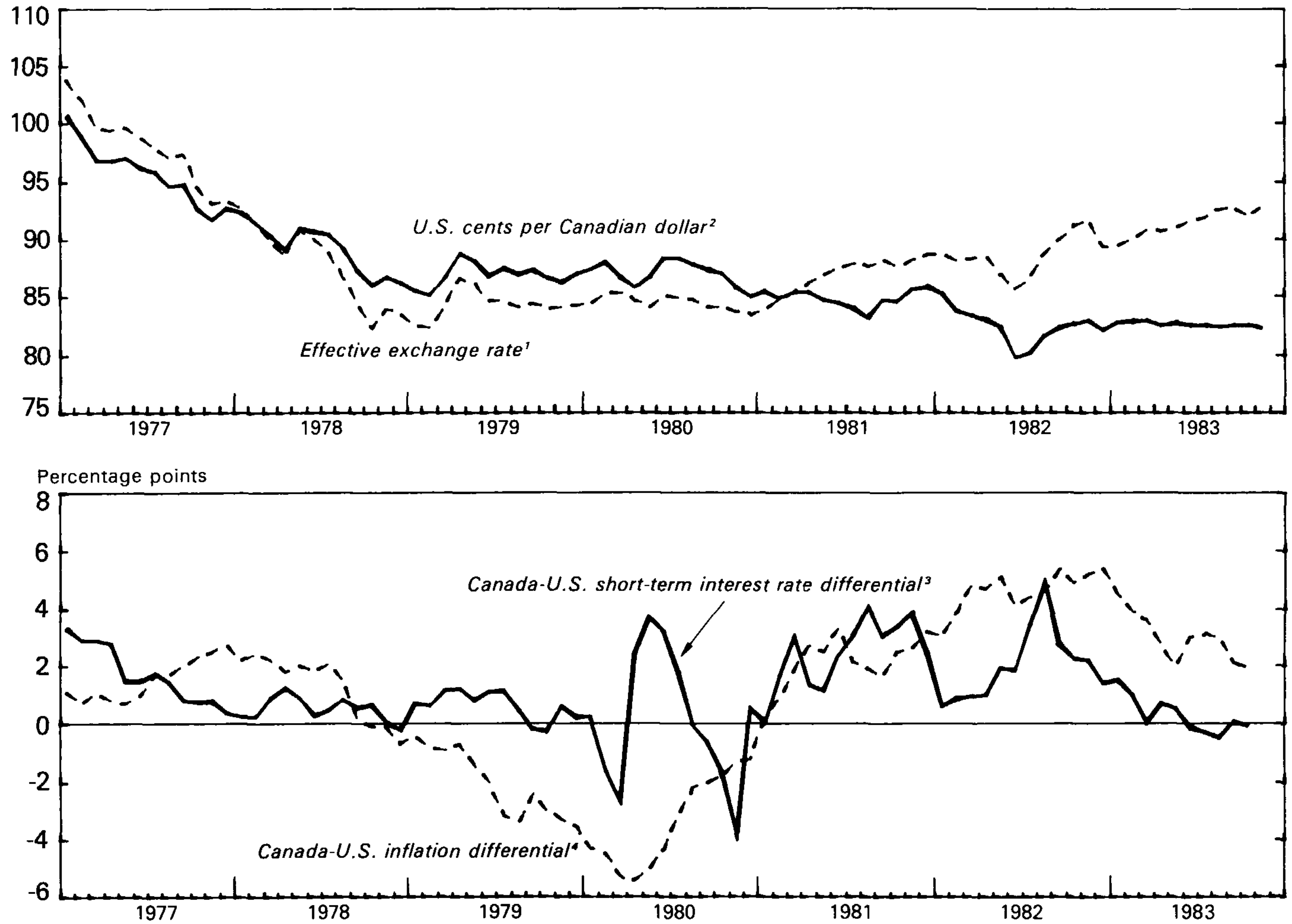
[2] Net of foreign currency borrowings by the Government of Canada to bolster international reserves.

[3] Including errors and omissions.

CHART 8

CANADA

EXCHANGE RATE FOR THE CANADIAN DOLLAR

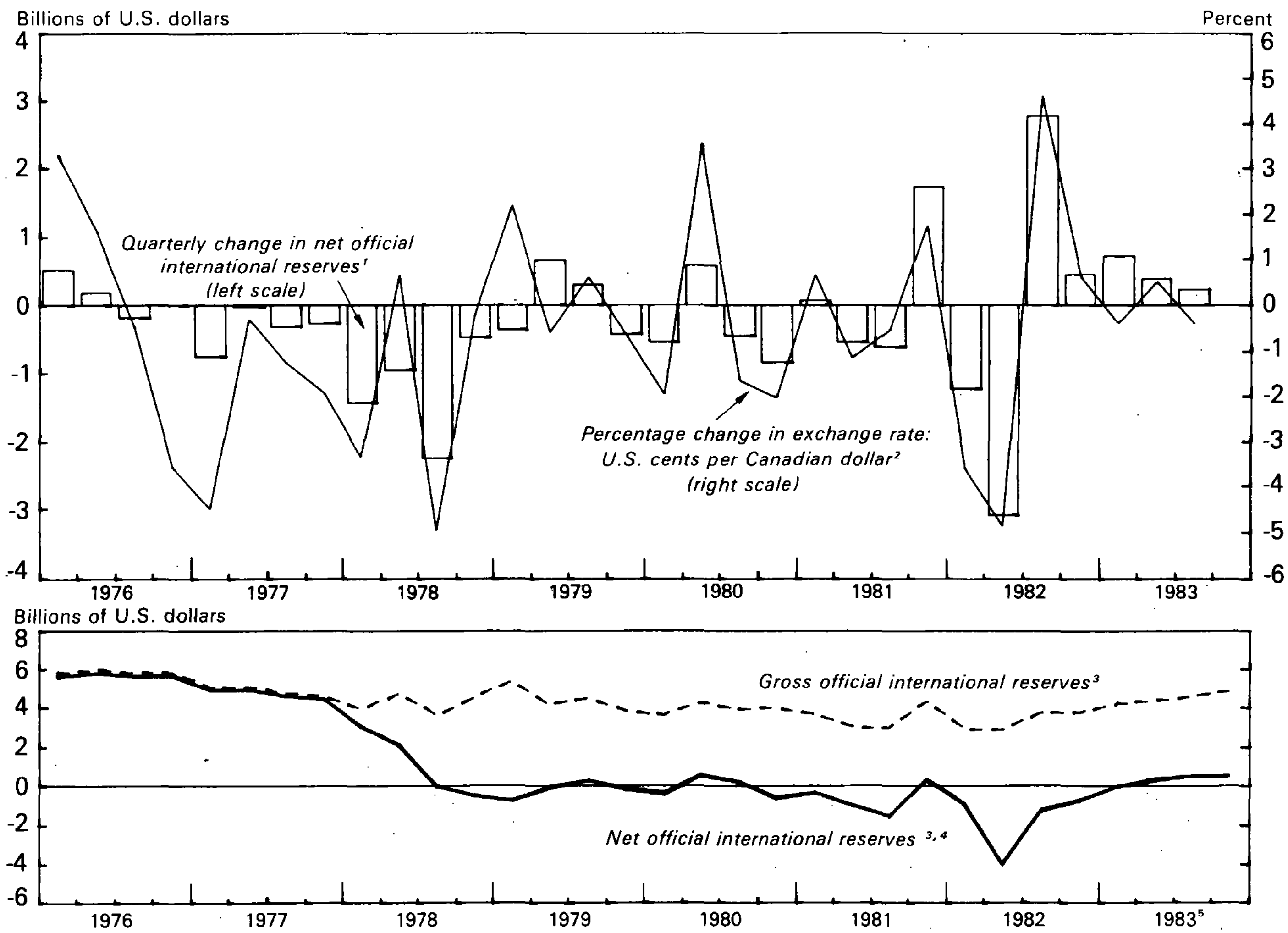


[1]Monthly averages computed using weights implicit in the multilateral exchange rate model (MERM).
[2]Monthly averages of noon rates in the Canadian market.
[3]Interest rate on prime corporate paper (90 days) in Canada minus rate on commercial paper (90 days) in the United States.
[4]Based on percentage changes over the preceding 12 months in total consumer price indexes.

CHART 9

CANADA

OFFICIAL INTERNATIONAL RESERVES



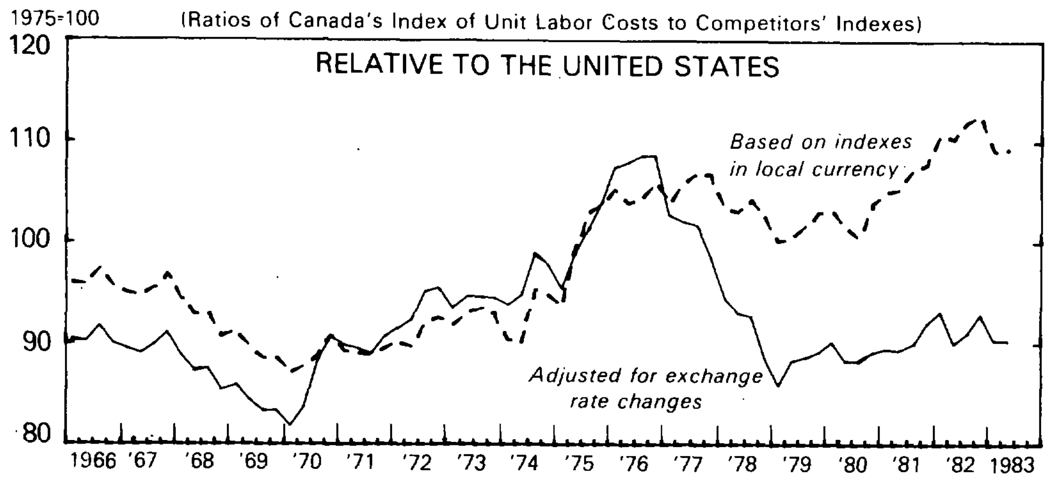
[1]Net of use of stand-by credit facilities with banks and of long-term borrowing by the Government of Canada, and adjusted for valuation changes. Allocations of SDRs and profits realized on the sale of gold are excluded.
[2]Based on the noon rate in the Canadian market in the last day of each quarter.
[3]Gold holdings are valued at SDR 35 per ounce.
[4]Gross official international reserves net of outstanding long term foreign currency borrowings by the Government of Canada and drawings under stand-by facilities with banks.
[5]The last observation corresponds to the end of November.

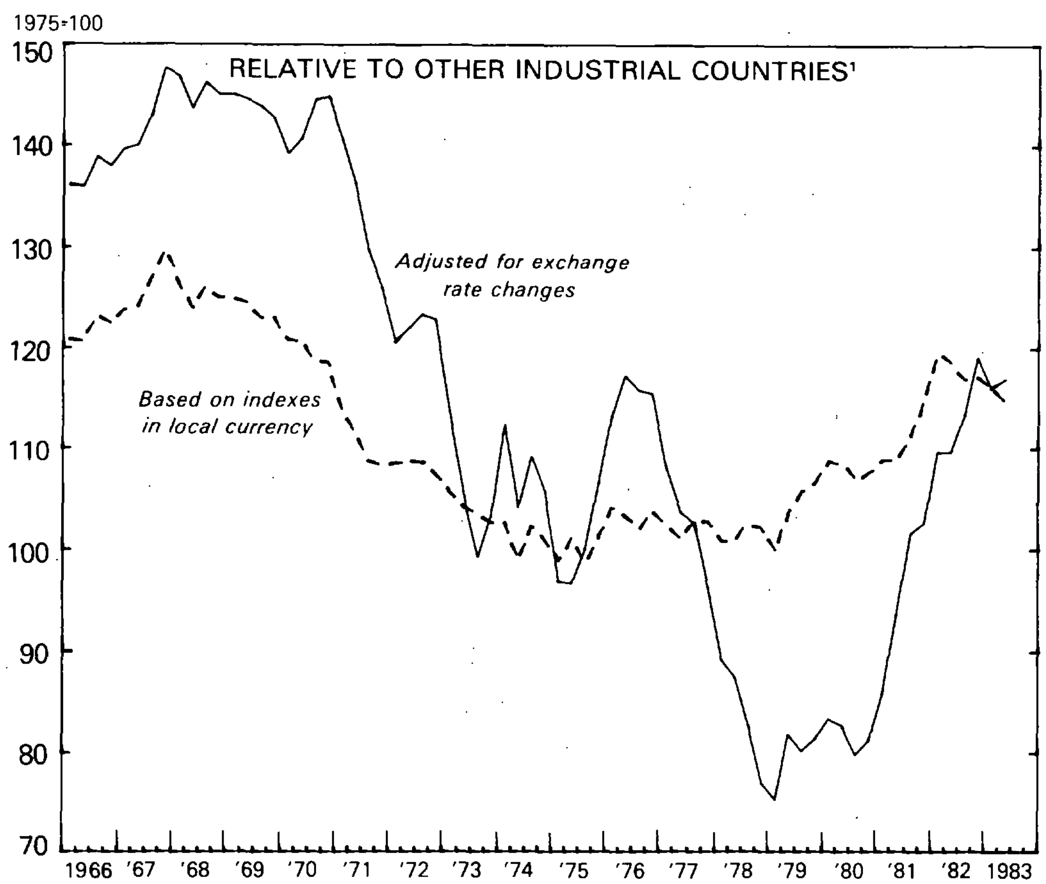
CHART 10

CANADA

INDICATORS OF COMPETITIVENESS IN MANUFACTURING

(Ratios of Canada's Index of Unit Labor Costs to Competitors' Indexes)





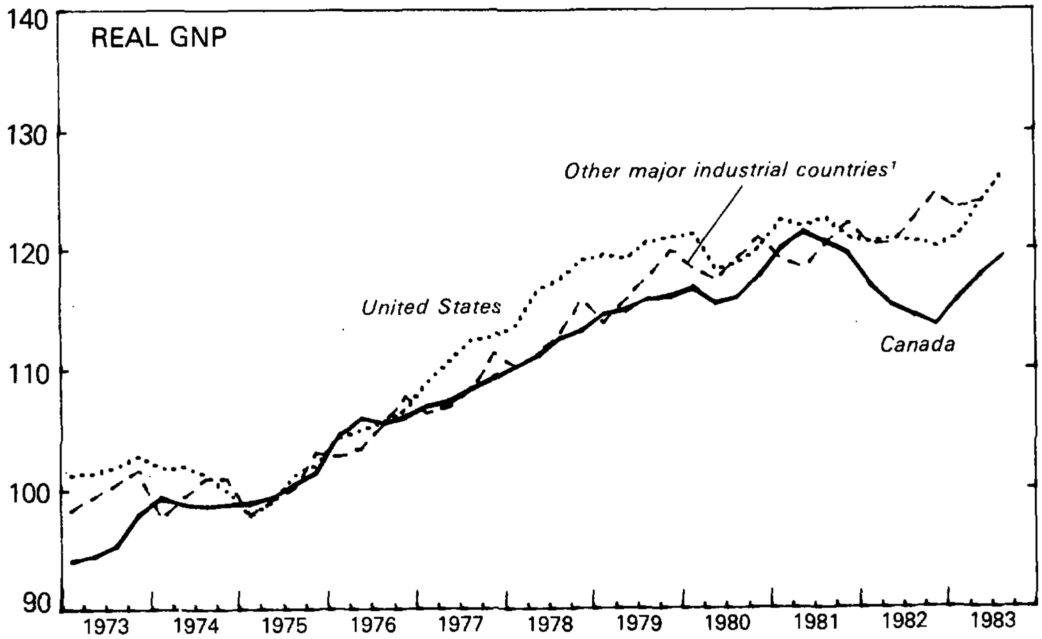
[1]Weighted average of the corresponding data for Austria, Belgium, Denmark, France, Germany, Italy, Japan, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom. The weights, which are based on disaggregated trade in manufacturing for 1975, take account of both bilateral and third market effects.

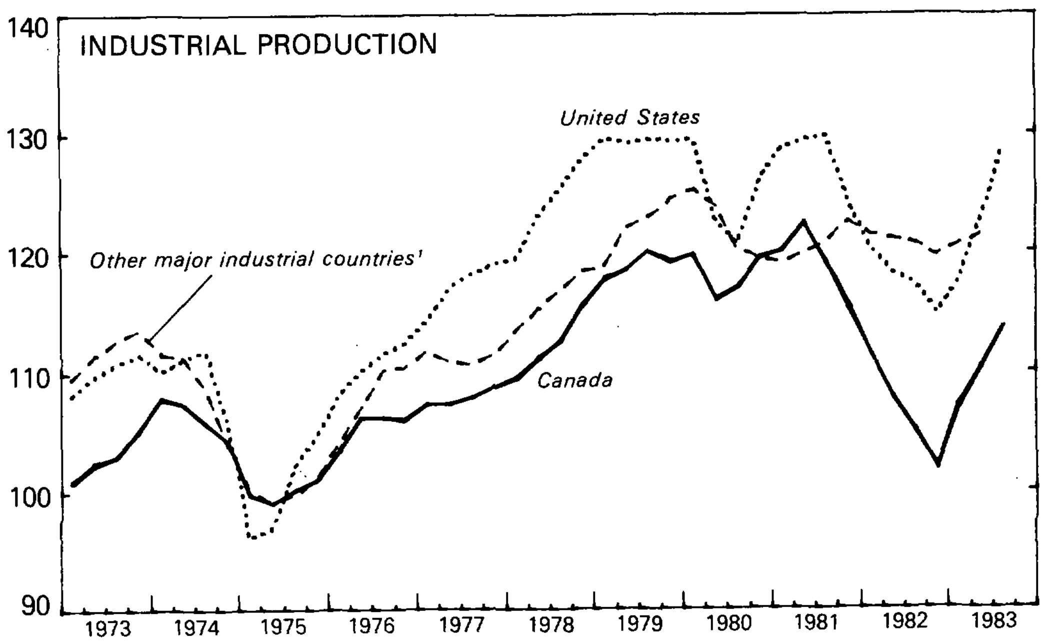
CHART 11

CANADA

OUTPUT IN MAJOR INDUSTRIAL COUNTRIES

(1975=100)





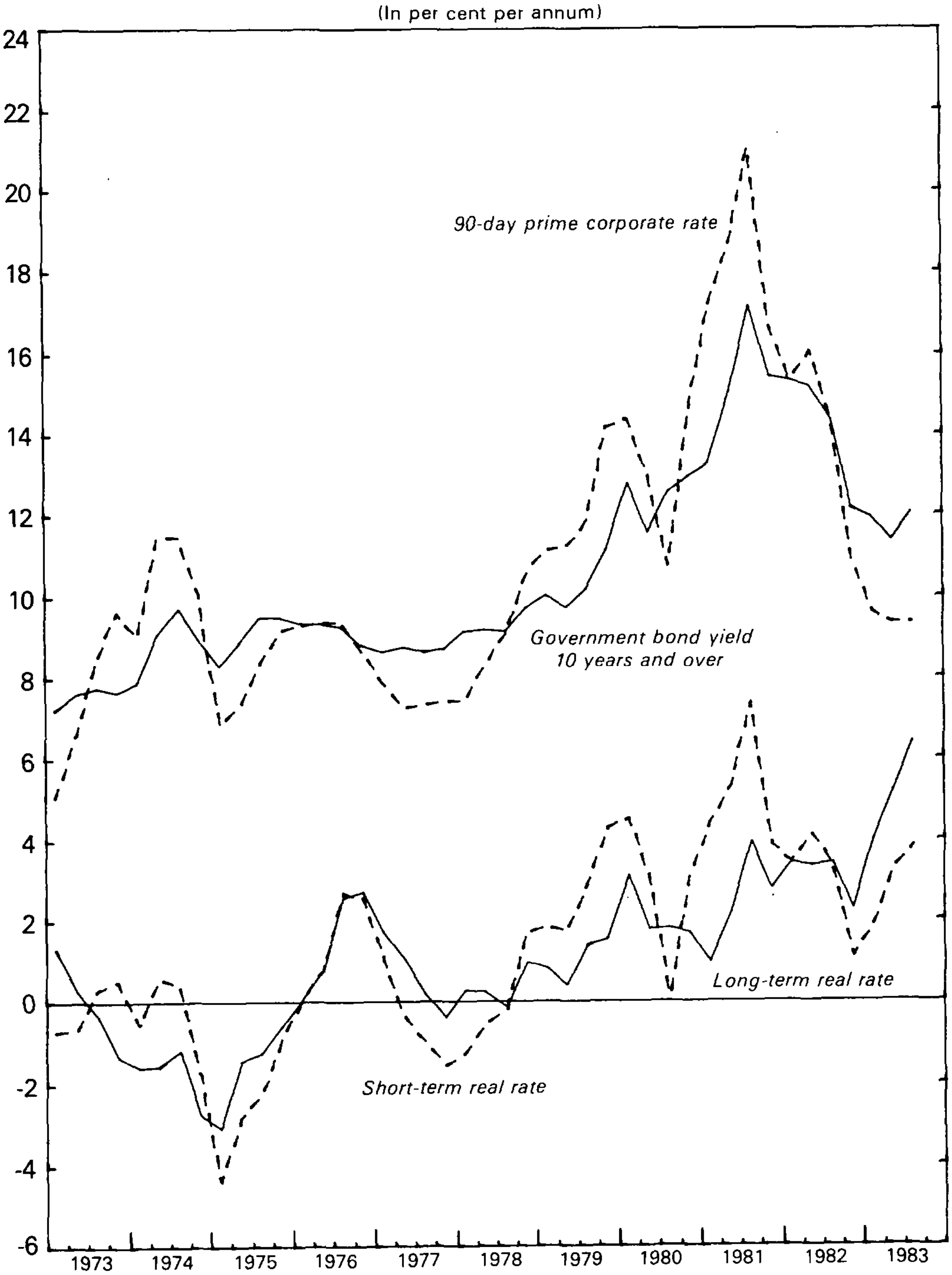
[1]Weighted average for France, Germany, Italy, Japan, and the United Kingdom.

CHART 12

CANADA

SHORT AND LONG-TERM INTEREST RATES IN NOMINAL AND REAL TERMS[1]

(In per cent per annum)



[1] Real interest rates are defined as nominal rates deflated by the increase in the consumer price index during the year ended in the current quarter.

CHART 13

CANADA

M-1 AND M-1A

(In billions of dollars)

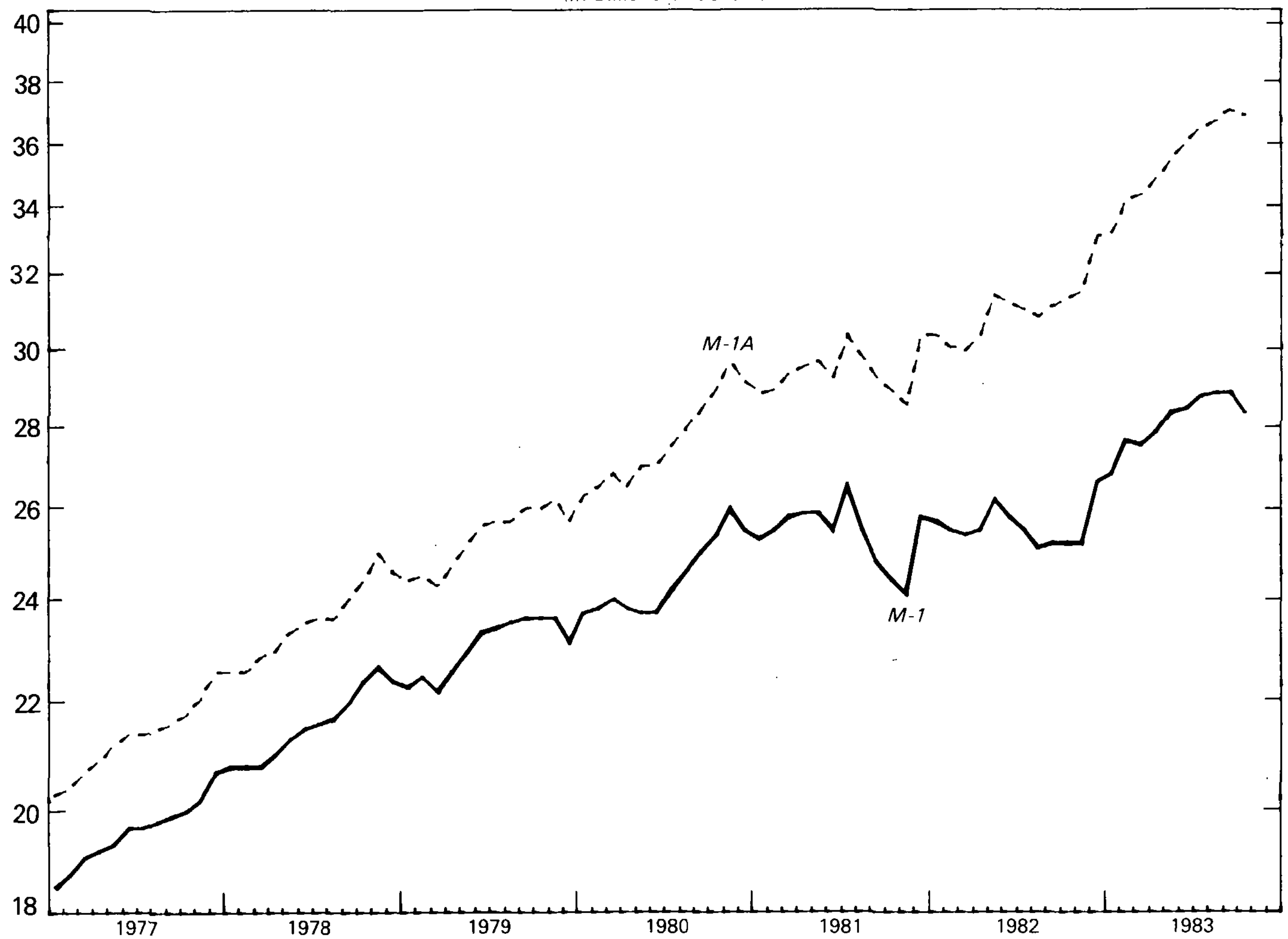
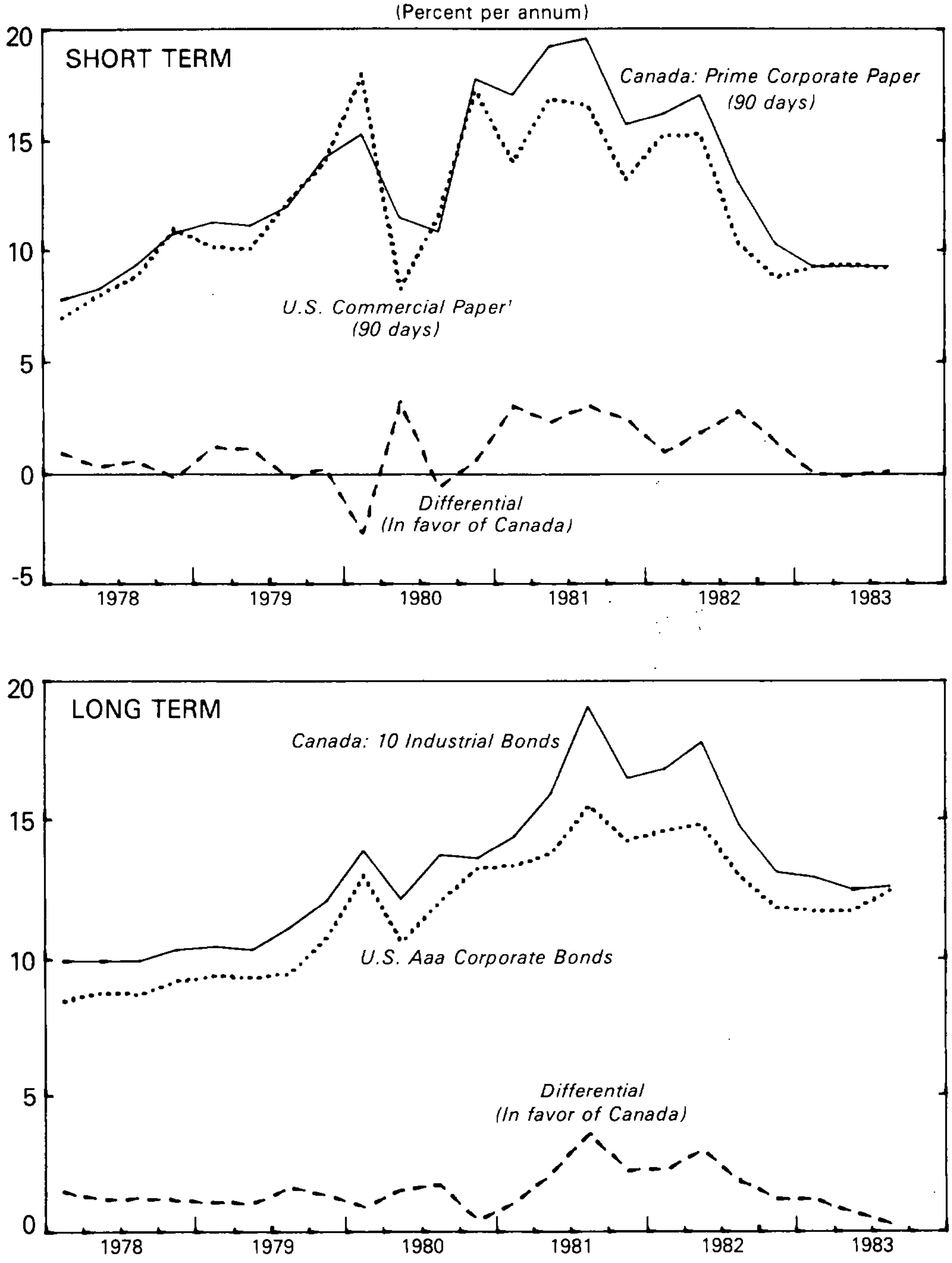


CHART 14

CANADA

CANADA—U.S. INTEREST RATE COMPARISONS

(Percent per annum)

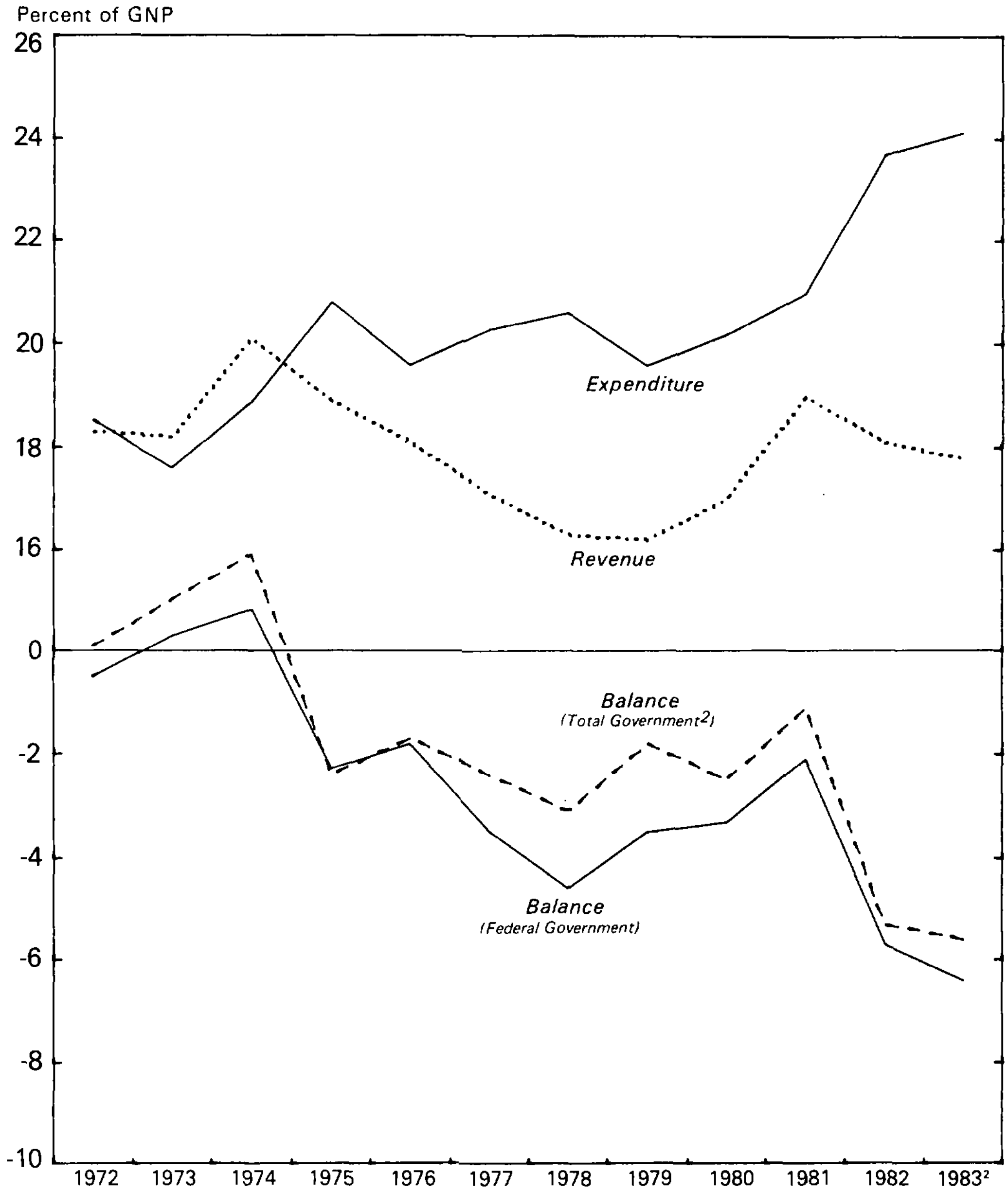


[1]Adjusted to a 365-day true yield basis from a 360-day discount basis.

CHART 15

CANADA

FEDERAL GOVERNMENT OPERATIONS[1]



[1]On a national income accounts basis, calendar years.
[2]Includes the Federal Government, the provincial and local governments (including hospitals), and the Canada and Quebec pension plans.
[3]First three quarters of the year, seasonally adjusted at annual rates.