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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/19

10:00 a.m., January 26, 1983

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

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	C. Taylor
J. de Groote	
B. de Maulde	A. Le Lorier
A. Donoso	M. Teijeiro
	C. Dallara
	T. Alhaimus
	Jaafar A.
	T. Yamashita
R. K. Joyce	M. Casey
A. Kafka	
G. Laske	
G. Lovato	C. P. Caranicas
R. N. Malhotra	
	J. E. Suraisry
	T. de Vries
A. R. G. Prowse	
G. Salehkhou	
	M. Camara, Temporary
M. A. Senior	
	L. Vidvei
	Wang E.

L. Van Houtven, Secretary
R. S. Laurent, Assistant

Also Present

Asian Department: Tun Thin, Director; J. T. Boorman, R. J. Hides. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; M. Guitian, G. G. Johnson, S. Kanesa-Thasan. Fiscal Affairs Department: G. Blöndal, D. C. Mcdonald. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; C. F. Schwartz, Associate Director and Director of Adjustment Studies; A. D. Crockett, Deputy Director; G. I. Brown, K.-Y. Chu, P. R. Menon. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; K. B. Bercuson, L. E. De Milner, J. Férran, E. Hernandez-Cata, Y. Horiguchi, L. R. Kenward, J. R. Marquez-Ruarte, L. Mendras, B. C. Stuart, E. C. Suss, E. V. Zayas. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: S. R. Abiad, J. R. N. Almeida, C. J. Batliwalla, J. Delgadillo, S. El-Khouri, P. Kohnert, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, H. Arias, L. Barbone, R. Bernardo, T. A. Connors, M. K. Diallo, G. Ercel, M. Hull, M. J. Kooymans, W. Moerke, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, J. G. Pedersen, G. W. K. Pickering, E. Portas, J. Reddy, J. Schuijer, D. I. S. Shaw, H. Suzuki, J. C. Williams, A. Yasseri.

1. SRI LANKA - PURCHASE TRANSACTION - BUFFER STOCK FINANCING FACILITY - INTERNATIONAL NATURAL RUBBER AGREEMENT

The Executive Directors considered a request by Sri Lanka for a purchase equivalent to SDR 5.8 million under the buffer stock financing facility (EBS/83/2, 1/4/83; and Sup. 1, 1/21/83).

Mr. Malhotra noted that Sri Lanka was making its first purchase request in respect of the compulsory contributions that it had made to the cost of acquisition of the buffer stock established under the International Natural Rubber Agreement (INRA). The request met all the requirements of the buffer stock financing decisions. Sri Lanka's balance of payments need had been clearly established: the current account deficit was estimated to have widened to SDR 653 million in 1982, and gross reserves had declined to SDR 284 million at end-October 1982, mainly because of a continued further deterioration in the terms of trade, despite a sharp cutback in fiscal expansion during the year. The request also met the test of cooperation, for the authorities had demonstrated their commitment to cooperate closely with the Fund in seeking solutions to their present payments difficulties. A staff mission currently in Sri Lanka was helping the authorities to formulate an adjustment program beginning in 1983. In the past, Sri Lanka had closely cooperated with the Fund in a strong adjustment program involving a stand-by arrangement and an extended arrangement, both of which had been concluded successfully.

Mr. Dallara expressed support for Sri Lanka's request. He had one question relating partly to the nature of the request, but mainly to its presentation. During the Executive Board discussion the previous August on Sri Lanka's request for a drawing under the compensatory financing facility (EBM/82/118, 8/25/82), he had raised a number of concerns regarding the country's general economic situation and the broad direction of policy. Like other Directors, he had noted the substantial deviation that had apparently occurred from the laudable policy path followed during the last year of Sri Lanka's extended arrangement with the Fund, and he had joined other Directors in urging prompt corrective action to avoid an economic crisis. At present Sri Lanka was again requesting use of Fund resources, albeit only for a small amount. It was his understanding that the use of the buffer stock financing facility essentially called for the same degree of cooperation with the Fund as did drawings for the first 50 per cent under the compensatory financing facility. During a recent Board discussion of another request for use of resources under the buffer stock financing facility, he had asked that material on cooperation should be provided in the documents outlining such requests, since the essential purpose of that requirement was to ensure that Fund resources were used in a manner consistent with the purposes of the Fund and were thus safeguarded.

In the light of those considerations, Mr. Dallara continued, he had been disappointed that the staff documents contained no information on the current policy stance of the Sri Lanka authorities. Of course, he welcomed the authorities' assurance, contained in the cable conveying the request for the drawing, that they intended to cooperate with the Fund in finding solutions for their balance of payments problems. He understood that there were tangible reasons for being confident that the authorities would take meaningful action to address those problems. In that connection, he welcomed the information provided by Mr. Malhotra. Could the staff provide any additional information on the current stance of policies in Sri Lanka, and give some indication of how requests for buffer stock financing were handled?

Mr. Prowse said that Sri Lanka's request clearly met the requirements of the buffer stock financing facility, and he supported the proposed drawing. The International Natural Rubber Agreement, showed what such arrangements could do to protect producers of primary commodities in uncertain market circumstances. However, those arrangements required the backing of all the major consuming and producing countries, as well as international institutions, especially the Fund.

The problems of Sri Lanka, as outlined in the World Bank's 1982 World Development Report, were perhaps typical of a country specializing in exports of raw materials, but they nonetheless appeared extreme, Mr. Prowse remarked. For more than 20 years, Sri Lanka had experienced an almost continuous worsening in its terms of trade. In 1980, the country had found itself with a product volume some 70 per cent higher than in 1960, an increase in per capita investment, and strong capital inflows. Yet per capita consumption in 1980 had been 10 per cent less than in 1960, a development largely attributable to the extraordinarily difficult external trading environment. Given that environment, the effects of the Rubber Agreement and the Tin Agreement, together with the contribution that the Fund's buffer stock financing facility could make, were invaluable.

Mr. Salehkhou observed that the request by Sri Lanka fulfilled all the requirements for a buffer stock purchase. The continued deterioration in the external terms of trade, which had declined by 30 per cent between 1977 and 1981, and by another 6 per cent in 1982--mainly because of the impact of world recession on exports and of repeated droughts on imports--had led to huge current account deficits in the previous five years and upset all government efforts at adjustment. Those efforts had been supported by an extended arrangement with the Fund under which the authorities had taken a series of unpopular and painful measures to correct the various economic imbalances and secure a smooth transition from a stagnant state-controlled economy to a largely market-oriented one. Yet despite the substantial progress achieved in correcting price distortions, liberalizing trade, stimulating investment growth, and significantly reducing unemployment and dependence on foodgrain imports, Sri Lanka's performance under the extended arrangement had been adversely affected by a decline in the terms of trade. The extended arrangement had not succeeded in greatly alleviating the pressure on the balance of payments or on reserves. If not fully successful, the program had by no means been a failure. The authorities had implemented all the measures included in the program as well as an additional series of measures in 1981 to cope with unexpected developments, thus providing a good example of their cooperation with the Fund in attempting to find solutions to their external difficulties. He supported the proposed purchase.

Mr. Yamashita noted that in 1982 Sri Lanka's current account deficit had widened and its overall balance of payments had continued to show a deficit. Thus, the country had a balance of payments need. Furthermore, the authorities had made the request within the time limit prescribed in Board Decision No. 7246-(82/147), adopted November 12, 1982, namely, not later than 90 days after the date of the decision, for contributions made before the decision had been taken. Therefore, the proposed purchase was fully justified.

He welcomed the authorities' intention to cooperate with the Fund in trying to find solutions to their balance of payments difficulties, Mr. Yamashita went on. Like Mr. Dallara, he wished to recall the discussion held at the time of the most recent Article IV consultation with Sri Lanka (EBM/82/118, 8/25/82), when the Chairman said in his summing up:

> Directors urged the authorities to improve the course of economic policies so as to address the present issues and to consolidate the remarkable progress realized in the context of the courageous and fundamental reforms introduced since 1977. Failure to adjust swiftly could prove to be costly and could impair the future prospects for a resumption of durable and noninflationary growth.

Mr. Jaafar indicated his support for Sri Lanka's request to finance its compulsory contributions to the buffer stock for rubber. In his assessment of Sri Lanka's balance of payments position, the country met the Fund's requirements for such a drawing. Sri Lanka had entered into a one-year stand-by arrangement with the Fund in 1978, and an extended arrangement for 1979-81 had been completed successfully. Sri Lanka had thus cooperated with the Fund in seeking solutions to its balance of payments difficulties.

Mr. Wang expressed warm support for Sri Lanka's request for use of Fund resources under the buffer stock financing facility.

Mr. Alhaimus stated that he supported the draft decision, as the request met all the requirements of the relevant buffer stock decision.

Mr. de Vries stated that he could support the proposed decision with no reservations whatsoever. He would be interested in holding a discussion before long on developments in Sri Lanka, and in seeing how the newly elected Government in Sri Lanka would perform.

Mr. Caranicas joined previous speakers in supporting the proposed decision. He fully agreed with Mr. Prowse's statement. It should be recalled that when, 15 to 20 years previously, the Executive Board had decided to help primary producing countries that had difficulties with exports of primary products, the decisions on the compensatory financing facility and on the buffer stock financing facility had represented a radical change in Fund policies. Under present circumstances, he supposed that the Fund would continue to exert leadership in finding solutions to countries' present-day difficulties.

The staff representative from the Asian Department noted that the staff paper on Sri Lanka's request for a drawing under the compensatory financing facility, which had been discussed by the Board the previous summer, had mentioned certain measures taken by the authorities at that time. In retrospect, the staff believed that those measures had helped to improve the situation somewhat more than had been expected. Since that time, Sri Lanka had held two elections: a presidential election and a referendum on the current representation in Parliament. The President had made a strong showing in both those elections and appeared to have received a mandate for the policy stance supported by the Fund since 1977. Following the elections, in early January 1983, the Minister of Finance and senior officials had visited Washington, during which time they had held discussions with both the World Bank and the Fund. During those discussions, which included meetings with the Managing Director, the Sri Lanka Minister of Finance had agreed that there was a need, and indeed an opportunity in view of the Government's new position, to take strong adjustment measures.

At the same time, detailed discussions had been held between senior officials of Sri Lanka and the Fund staff on what the outline of those measures might be, the staff representative remarked. On the basis of those discussions, a staff team was currently in Sri Lanka conducting preliminary discussions with the authorities on a possible stand-by arrangement. As the staff had begun the discussions only the previous day, he was unable to provide further details. Nevertheless, the timing was propitious. The Government was operating on a continuing resolution in the first quarter of 1983, as the calendar year and the budget year were the same in Sri Lanka. There was thus an opportunity for the staff and the authorities to discuss the new budget that would take effect in April under the terms of the stand-by arrangement, should the negotiations prove successful.

The Deputy Managing Director observed that, while none of the individual decisions qualifying a particular buffer stock such as that for tin or rubber made direct and explicit reference to cooperation, the basic decision establishing the Fund's buffer stock financing facility (Decision No. 2772-(69/47), 6/25/69) read:

> The Executive Board, having considered the staff study on "The Problem of Stabilization of Prices of Primary Products," decides that the Fund will be prepared to extend assistance to members in connection with the financing of international buffer stocks of primary products in accordance with the principles and subject to the quantitative limits set forth in Chapter III, Section 2, and Annex A of Part II of the study.

The word "principles" in that decision referred, among other things, to an observation made in the study that the requirement of cooperation was part of the basic approach to the compensatory financing decision. Therefore, it had always been understood that the requirement of cooperation with the Fund did apply to buffer stock purchases. That being the case, papers on buffer stock purchases ought to emphasize somewhat more a discussion of cooperation, and they should perhaps include a separate section on that topic.

The Chairman expressed agreement with the suggestion made by the Deputy Managing Director. The paper before the Board said merely that the request from the authorities would include a statement that Sri Lanka would cooperate with the Fund. The Fund should treat the question more fully.

Mr. Malhotra said that he hoped that the discussions currently under way between the Fund staff and the Sri Lanka authorities would be successful and that the Executive Directors would have the opportunity to discuss another Fund program with Sri Lanka.

The Executive Board then took the following decision:

1. The Fund has received a request by the Government of Sri Lanka for a purchase equivalent to SDR 5.8 million under the Decision on Buffer Stock Financing Facility: The Problem of Stabilization of Prices of Primary Products, Decision No. 2772-(69/47), June 25, 1969, as amended by Decision No. 4913-(75/207), December 24, 1975, and the Decision on Buffer Stock Financing Facility: International Natural Rubber Agreement, Decision No. 7246-(82/147), November 12, 1982.

2. The Fund determines that this purchase would be consistent with the decisions referred to in (1) above, notes the representations of Sri Lanka, and approves the purchase in accordance with the request.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 7314-(83/19), adopted
January 26, 1983

2. CANADA - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Canada (SM/82/240, 12/29/82). They also had before them a report on recent economic developments in Canada (SM/83/9, 1/12/83; and Cor. 1, 1/17/83).

Mr. Joyce made the following statement:

I would like to thank the staff for the detailed and comprehensive papers that it has prepared in connection with the 1982 Article IV consultation with Canada (SM/82/240 and SM/83/9). My authorities broadly agree with the analysis and with most of the policy views set out in these reports.

Like many other industrial countries, Canada has experienced a pronounced economic slowdown over the last four years, unemployment has reached very high levels, productivity performance has continued to be weak, and, until recently, strong inflationary pressures persisted. The slowdown in the Canadian economy can be attributed, in part, to weak world demand, accentuated by Canada's dependence on U.S. markets, and, in part, to tight domestic policies aimed at reducing inflation. The deterioration in economic performance has been most severe during the last year; real GNP in the third quarter of 1982 declined to a level below that prevailing four years earlier.

The Canadian Government remains committed to providing a solid foundation for a durable economic recovery. Monetary and fiscal policies are directed toward combating deeply entrenched inflationary expectations. Particular emphasis is put on restraining the growth of government spending. While economic recovery is expected to come mainly from the private sector, the Government will continue to play an active role in areas such as industrial modernization, manpower retraining, and resource development.

Recent developments and prospects

National accounts data are not yet published for the fourth quarter, but it is expected that real GNP will have fallen by close to 5 per cent in 1982, continuing the downward trend that has persisted since the second quarter of 1981. All areas of domestic demand have been weak, particularly investment in housing, machinery and equipment, and nonresidential construction, which have been severely affected by the high interest rates. Although it is difficult to identify turning points in economic activity, there is reason to expect some mild recovery starting in the first quarter of 1983. The most likely sources of growth would be improvement in consumer spending, some turnaround in areas that have been weak, such as housing, and at least some slowdown in the rate of inventory liquidation that has been taking place. Real GNP growth is expected to be between 1.0 and 1.5 per cent in 1983, tending to gain strength through the year in line with recovery in the U.S. economy.

As a result of the current weak economic performance, employment has fallen sharply by just over 5.0 per cent between mid-1981 and December 1982. Despite this shakeout of labor, output per worker fell by 2 per cent last year following the general trend that began in mid-1978. It is expected that the number of Canadians at work will increase by about 1.0 per cent through 1983, but because of demographic effects on the labor force the unemployment rate is expected to increase from its current level of 12.8 per cent.

Wage costs have improved noticeably in 1982 from the peak levels in 1981, largely in response to slack in the labor and goods markets, and to the Government's 6/5 wage policy, discussed below. Major wage settlements (without cost of living adjustments) for all industries negotiated during the third quarter of 1982 were increasing at an annual rate of 10.2 per cent compared with an annual rate of 13.8 per cent a year earlier.

Although the rate of inflation as measured by the consumer price index continued to remain unacceptably high in 1982, the rate of inflation has been moderating in the past few months, and during the fourth quarter of 1982 was under 8 per cent on an annualized basis. It is expected that inflation will slow to 7.0 per cent in 1983 and by year-end may be below 6.0 per cent. The inflation differential between the United States and Canada, after widening to 4.6 percentage points in 1982, is expected to narrow to about 3.0 percentage points in 1983.

On the external side, the current account balance improved steadily through the first three quarters of 1982, largely as a result of significant strengthening in the merchandise trade balance. The improvement in the trade balance reflected primarily a weakening in imports, notably in crude petroleum, but also some export growth, mainly automobiles, agricultural products, and energy. The long-term capital account continued to show a pattern of large surpluses in 1982 reflecting continuing large issues of Canadian bonds abroad and a return to the more historical pattern of inflows of foreign direct investment. The staff forecast calls for the current account to continue in surplus of about US$3.0 billion in 1983.

Policy developments

The Government took direct action in the June budget to restore confidence in the economy. Measures were initiated that would reduce inflation, encourage growth in output and productivity, and combat the high levels of unemployment. The key element was to set a limit of 6 per cent on wage increases in the federal sector in the year beginning July 1, 1982, and 5 per cent in the following year. The 6/5 wage formula has been extended to cover government pensions, family allowances, old age security payments, and indexation factors applicable for income tax purposes. This policy has received substantial support from most provincial governments and many private sector companies. In late October, the Minister of Finance in an economic statement to Parliament announced a series of additional policy measures, including a Can$500 million program to help individuals and communities hardest hit by unemployment. Other measures included Can$150 million to encourage housing investment and a further Can$400 million to contribute to the expansion of western Canadian rail capacity. These measures are being financed through a reallocation of Can$1.1 billion in existing expenditures. Consequently, they will not add to the deficit over the two coming years. At the same time, unemployment insurance premiums were increased to offset part of the growing costs of the program to the Government arising from the severity of the recession.

The federal budgetary deficit forecast (national income accounts basis) for 1982/83 has risen to an estimated Can$22.4 billion (6.3 per cent of GNP) from Can$10.0 billion (3.0 per cent of GNP) in 1981/82, due largely to the operation of automatic stabilizers. Federal government expenditures as a share of GNP will increase to 25.3 per cent in 1982/83 from 22.3 per cent in 1981/82 reflecting, in part, large increases in personal transfers. The ratio of federal expenditures to GNP had, in fact, been quite stable for the last several years. Federal revenues will fall marginally to 19.1 per cent of GNP in 1982/83 compared with 19.3 per cent in 1981/82, reflecting weak GNP growth. These trends largely largely reflect cyclical developments, however, and the Government remains committed over the medium term to contain the growth in public spending to rates below the trend growth of GNP.

Monetary policy over the last few years has been directed toward ensuring a pace of monetary expansion that is consistent with reasonable price stability. This required a considerable rise in short-term interest rates. Nominal interest rates have softened over the last several months as U.S. rates have come down and as inflationary pressures have receded. Real interest rates are still fairly high by historical standards; further decreases in interest rates will depend largely on continued progress in bringing down inflation.

For a number of years, there had been a stable relationship between the narrowly defined money supply--M-1 (currency and demand deposits), interest rates, and the trend in total spending in the economy. In light of this, monetary developments were assessed with reference to a target growth for M-1 but never to the exclusion of other relevant domestic and external developments. The system of targeting M-1 growth was not regarded as either automatic or sacrosanct.

In a speech on November 29, the Governor of the Bank of Canada announced that the Bank would no longer have a target range for M-1. In fact the M-1 target had not been providing particularly useful policy guidance to the authorities for some time because of innovations in banking practices. These changes led to major and continuing shifts in the money balances held by individuals and businesses for making payments out of demand deposit accounts and, hence, altered the significance of the M-1 targets.

It is important to stress that the decision to stop using M-1 reflected technical considerations and did not signal a change in the thrust of monetary policy. As in the past, monetary policy will continue to be conducted with reference to a broad range of financial and economic indicators including movements in interest rates, inflation, and the exchange rate. The Bank of Canada is continuing to search for ways to make more effective use of specific monetary aggregates.

After some important fluctuations in mid-1982, the Canadian dollar has traded in a relatively narrow range over the last few months. At year-end, the exchange rate was 81.3 U.S. cents per Canadian dollar, representing a 3.6 per cent depreciation from the closing rate in 1981. Market intervention continues to be limited to dampening short-term exchange rate deviations and preserving orderly market conditions. Although no attempt is made to adhere rigidly to an exchange rate target, my authorities believe that under present circumstances a significant change in the exchange rate would not be appropriate.

Canada remains concerned about the continued pressure that exists in most countries to resort to protectionist trade measures. These pressures are greater at a time of low growth and high levels of unemployment. In one or two exceptional cases the Government has felt obligated to take emergency steps to limit the rate of increase in import penetration. Such measures are intended to be temporary.

Canada continues to attach high priority to assisting development efforts in nonindustrial countries.

New procedures under the Foreign Investment Review Act were announced in the June 1982 budget. These include a simplification of the internal review process and a broadening of the criteria by which cases may qualify for an abbreviated review. These measures have left the broad objectives of the Act unchanged, but have already resulted in shortening of the review process and an increase in the approval rate.

On energy policy, the National Energy Program, adopted in October 1980, has already achieved substantial success in reducing Canada's longer-term dependence on imported oil and in encouraging greater energy conservation. During 1982 additional steps were announced to achieve further reduction in the use of oil and to encourage increased domestic production of both oil and gas. The success of these measures in the immediate future will depend upon developments in international oil prices. Meantime, Canada remains a net exporter of energy.

The Minister of Finance intends to bring down a new budget within the next few months. The considerations raised by the staff during the Article IV consultation process will serve as a useful input in the preparation of the budget.

Extending his remarks, Mr. Joyce observed that the latest figures on the cost of living, which had yet to be published, showed that, in December 1982, there had in fact been no increase in the consumer price index, at least on a seasonally unadjusted basis. On a seasonally adjusted basis, the increase would have been of the order of 0.5 per cent. On another point, performance on wage settlements was somewhat better than the staff report would indicate. The report said that wage settlements in the unionized private sector were still in the double-digit range. Again, the latest information--unavailable when the staff report had been written--showed that, in October and November, wage settlements had provided for less than a 10 per cent increase, and all indications were that increases were declining rapidly.

The initial reaction of senior officials in Ottawa had been that the staff report was perhaps a trifle rigid and doctrinaire in the overall policy views expressed, Mr. Joyce stated. The sentiment in Canada, both in official circles and in the private sector, was coming round to the view that the present size of the federal deficit should not be allowed to mesmerize the authorities. The idea that further tightening of the fiscal stance was called for would not command support in Canada at present, given the magnitude of the fall that had already occurred in real GNP, the continued high levels of unemployment, and the need to nurture business confidence if the recovery was to succeed. Business and financial leaders in Canada were not calling for a further reduction in the deficit. They accepted that the current federal deficit was largely inevitable, that it mainly reflected cyclical factors, and that, if anything, the deficit might grow further if the economy showed no signs of recovery in the next few years, or if the recovery turned out to be mild or unsustainable. The debate in Canada was not whether, in such circumstances, the federal deficit would increase--the automatic stabilizers would ensure that it would--but rather whether some easing of fiscal policy might prove necessary if the Canadian economy showed signs of sluggish revival, or no revival at all, in the near term.

Nothing in what he had said should be taken to imply any weakening of the authorities' resolve to fight inflation, Mr. Joyce remarked. Nevertheless, his authorities believed that, with the degree of slack currently in the economy, some reconsideration of fiscal policy requirements for the near term might be needed. Despite the continuing debate on the right course for the immediate future, the authorities continued to recognize the risks involved if medium-term policy did not lead to a reduction in the deficit.

Mr. Taylor observed that 1982 had been a mixed year for Canada. Clear progress had been achieved toward the Government's main objective of reducing inflation in both prices and wages. Those welcome developments suggested that tighter monetary policies and the sensible approach to incomes restraint were at last paying off and moving Canada nearer to the lower inflationary pattern of other major industrial countries. Unfortunately, those welcome price developments had been accompanied by a severe recession, with output falling by almost 5 per cent and employment by 3 per cent. After several years of deficits, Canada's current account had returned to surplus, but the deficit in the federal government budget had risen sharply, from 3 per cent of GNP in 1981/82 to an expected 6.3 per cent in 1982/83. The sharp fall in GNP since the middle of 1981 appeared to have been led by sharply reduced investment demand. There had been a substantial stock drawdown combined with much lower residential construction activity and lower fixed investment by businesses.

The staff's projections for a modest recovery in 1983 assumed that there would be a 10 per cent year-on-year increase in construction, Mr. Taylor noted. If he had understood Mr. Joyce correctly, the authorities' own projections were similar, although they were less disposed to believe that the stock drawdowns had ended. Could the staff or Mr. Joyce interpret the latest indicators in those areas and say whether the forecasts for stocks and residential construction were still on track? Specifically, were there indeed signs that the stock drawdowns had ended? Looking somewhat further ahead, he would like to hear more about the Canadian authorities' opinion on the sources of economic revival and the extent to which reducing inflation might be an important factor in restoring economic growth. He would also like to hear the views of the authorities and the Fund staff on the prospects for reducing inflation further and keeping it under control.

The Canadian Government emphasized the use of the 6/5 wage guideline as a way of overcoming double-digit inflationary expectations, Mr. Taylor observed. By contrast, the staff laid more stress on the effects of weaker demand and higher unemployment when analyzing the country's inflationary prospects. Could the staff or Mr. Joyce say whether any difficulties were foreseen when the incomes policies eventually were lifted, or whether normal wage increases would accelerate when unemployment fell? In that connection, the fall in labor productivity by about 5 per cent in 1978 appeared to be largely a cyclical effect; if so, the implication would be that a recovery in output would not lead to an early rise in employment. Conceivably, a structural shift might be taking place in the economy.

Since net output per employee was relatively low, there might be less effective slack in the labor force than might appear on the surface; even so, the Government's intention to avoid mandatory controls on wages was probably correct for Canada, Mr. Taylor remarked. There was of course a need to rebuild incentives and profit levels in the private sector, and he welcomed the authorities' acknowledgment of that need. Regrettably, experience in many countries had shown that wage ceilings tended to become norms that promoted wage rigidity. Nevertheless, there had been a large decline in real wages in Canada since 1978, and a further decline was projected for 1983. Therefore, he wondered whether there might be considerable latent pressure building up for a wage push when activity revived.

As to supply-side policy and producer incentives, the authorities did not intend to raise the price of oil discovered before 1981 to full international levels, Mr. Taylor observed. He would support the staff's recommendation that the authorities should reconsider that decision, since expenditures on imported oil were undesirable because of their short-term effects on the fiscal position. In the long run, Canada would need to move away from oil-intensive methods of production, as other consuming countries were already doing.

The fiscal deficit had been rising sharply as a proportion of GNP, Mr. Taylor noted. Although he would agree with Mr. Joyce that a large part of the increase could be attributed to the operation of automatic stabilizers, the staff's analysis of the dangers of the authorities' becoming hooked on large fiscal deficits should be heeded. There might well be a growing structural component in the federal deficit calling for steady correction over time. The authorities might boost confidence considerably by firmly demonstrating their resolve to make sure that the fiscal deficit did not get out of bounds. Admittedly, the high personal savings rates showed low demand for private sector financing and low capacity utilization, so that public borrowing was, for the time being, unlikely to crowd out the private sector's financing needs. He also understood the authorities' reluctance to take fiscal measures that might be seen as jeopardizing the modest and, perhaps, fragile recovery hoped for in 1983. Nevertheless, if output grew by 1.5 per cent or better in 1983, and if that improvement were followed by a further pickup in 1984, as the authorities hoped, they might be advised to make an early start in reducing the potential for longer-term crowding out of the natural forces of economic recovery. He thus welcomed the statement by Mr. Joyce on the risks if medium-term policy did not lead to any reduction of the deficit.

Turning to monetary policy, Mr. Taylor considered that it was not entirely coincidental that the authorities of three major industrial countries--the United States, Canada, and the United Kingdom--seemed to have decided in 1982 to attach rather less significance to the behavior of a single monetary aggregate. They had become dissatisfied with the usefulness of a single variable as a guide to monetary conditions, partly owing to innovations in the financial system.

In view of the suggestion made by the Bank of Canada that the present approach to monetary policy might be fairly temporary and that it would be amended or altered if an adequate new monetary target were formulated, Mr. Taylor remarked, he wished to point out that there were risks inherent in setting monetary policy in the present manner, a point also brought out by the staff appraisal. Specifically, the approach might not give enough protection against an unintended easing of monetary policy. His own authorities continued to believe that the announcement and the firm pursuit of an appropriate monetary target, or a small group of targets, had value as an indication of the authorities' firm commitment to a counterinflationary policy, especially when high inflationary expectations were strongly entrenched. He would therefore counsel the Canadian authorities not to abandon altogether their adherence to some suitable form of monetary target.

As to Canada's external policies, he welcomed the relaxation in the Foreign Investment Review Agency's definition of small businesses, Mr. Taylor continued. The authorities had clearly made a series of efforts in the recent past to reassure international and domestic business interests that Canada had many attractive investment opportunities. With regard to trade policies, he expected that the Federal Government would help to promote and operate a trading and investment system. He welcomed the interesting discussion of capital flows in SM/83/9, but, as a general point, staff reports on industrial countries would benefit from a somewhat more explicit assessment of the degree to which domestic capital markets were open.

He would endorse the staff's view that exchange markets operated best when there were firm domestic stabilization policies, Mr. Taylor said. He took that view to mean that exchange markets in countries with reasonably developed financial systems would, by March, deliver what might be called the correct exchange rate from the viewpoint of competitiveness and longer-term development objectives, provided that prudent and sustainable domestic policies were followed. Canada's objective would probably be best furthered by policies designed to foster competition in domestic markets, by a reduction in the scope of government regulations, and by adjustment to social programs that were judged to have added to labor market rigidities. Suitable action in those fields could do much to allay any thought there might be about the need for a further real exchange rate adjustment in due course.

Mr. de Vries said that although he agreed with the staff that the authorities' exchange rate policy created no problems for other countries, there might well be exchange rates that would create problems for the country setting them. Thus, it meant little to say that the exchange rate for the Canadian dollar created no problems for other countries; indeed, he wondered whether, at whatever level it was set, the exchange rate could create major problems for other countries. The real question was whether the exchange rate policy was suitable for Canada itself. Had it been wise for the Canadian authorities, several years previously, to sever the link between the Canadian dollar and the U.S. dollar? What had the authorities gained from that policy, which they had pursued over a number of years?

He did not intend to suggest that fixed exchange rates were always preferable, Mr. de Vries explained. It could be concluded that flexibility among the main currency areas--East Asia, North America, and Western Europe--might be a good thing, but that greater exchange rate stability might be needed within each of those areas. Indeed, in Europe, national authorities had made great efforts to maintain exchange rate stability. The countries of Western Europe had different languages, different histories, and different traditions, but the peoples of Western Europe did not feel that their identity or their freedom was being greatly impaired by the establishment of a relatively stable exchange rate system among their countries. He therefore wondered whether it had been to Canada's advantage to attempt to follow an independent exchange rate policy. Was the currency area that Canada represented large enough to allow the advantages of such a policy to outweigh the disadvantages? After all, inflation in Canada was considerably higher than in the United States. He had been able to identify few advantages for Canada in following an independent policy. He hoped that the staff or Mr. Joyce could point out any advantages to such a policy and indicate what leeway it had provided for Canada. He tended to believe that it had provided very little.

On budgetary policy, Mr. de Vries continued, he had noted with great interest Mr. Joyce's moderate statements. From the indications that he had received, his Netherlands authorities tended to side with the staff on the question. In many countries, both structural and cyclical considerations entered into analyses of the budgetary position and often conflicted with one another, so that the discussions were often confused. On the other hand, the Keynesian view was that the budgetary position had a large effect on aggregate demand, and he still believed that view to be basically correct. As Mr. Joyce had said, some expansionary impetus on the budgetary side would lead to a resumption of growth owing to expanded aggregate demand. By contrast, structural considerations might work in a different direction.

The anticyclical policies pursued in the United States in the 1930s by President Roosevelt had been little understood at the time, Mr. de Vries recalled. It was, however, well documented that any stimulus to demand that President Roosevelt had attempted to give to the U.S. economy had resulted in reducing business confidence, and therefore in reducing private investment and private demand, thus largely canceling out the Government's efforts to stimulate the economy. At present, the mechanism of fiscal stimulus was much better understood. In the meantime, government finance in many countries had developed severe structural disequilibria. It might thus be that attempts by national authorities to stimulate the economy might trigger reactions in the private sector similar to those that had occurred in the U.S. private sector in the 1930s. In other words, given large structural deficits, if governments tended to expand those deficits, even for cyclical reasons, decision makers in the private sector might come to fear that the budget would go even further out of control and that endless inflation was in prospect.

In Canada, if it were merely the operation of automatic stabilizers and the weakness in tax revenue that had created the budget deficit, there might be a great deal to be said for a moderate stance on the part of the authorities, Mr. de Vries commented. Yet it appeared that the deficit was also attributable to a large rise in expenditure that might not be totally related to the business cycle. Canada was thus faced with the difficulty of keeping its public finances under control. The effective budgetary stimulus would probably be limited because it would be counteracted by a negative reaction from the private sector.

The strengthening in Canada's balance of payments had been caused mainly by a weakness in domestic demand, and the strength in the balance of payments was therefore more a sign of weakness than of strength, Mr. de Vries went on. Again, sluggish investment had also contributed to the "strengthening" of the balance of payments. Unfortunately, if demand and investment were to expand, the balance of payments would weaken again.

He welcomed the 6/5 wage policy for public sector employees and hoped that it would be successful, Mr. de Vries said. It had in fact led to reduced wage claims. Yet Mr. Joyce had cited some worrying figures: while wage settlements had been increasing at an annual rate of 10.2 per cent, prices in roughly the same period had risen by 8 per cent, while output per worker had fallen by 2 per cent. There thus seemed to be a tendency for output per worker to fall and for wage raises to outstrip the rate of inflation. More improvement was definitely needed.

All countries should resist protectionist pressures, Mr. de Vries noted. The staff had done well to point out that Canada--which, like the Netherlands, was extremely dependent on international trade--would be greatly harmed if protectionist tendencies were to gain the upper hand, and that Canada had a special interest in trying to fight such tendencies and set a good example for other countries.

Mr. Dallara expressed agreement with the staff appraisal. Canada was without a doubt suffering from a severe recession and high unemployment. However, given Canada's relatively high rate of inflation in the recent past, it would be shortsighted to relax monetary and fiscal policies unduly. Wages had clearly been increasing at rates incompatible with a return to reasonable price stability. In view of the high degree of unionization and other structural problems, wage increases had begun to moderate only at relatively high rates of unemployment. Indeed, it was disturbing that wages in the unionized private sector were still increasing at a time when so many people were out of work. It was at least encouraging that the rise in prices was beginning to slow. To bring nominal wages down to acceptable levels, the Government would have to pursue restrained monetary and fiscal policies. He had no problems with the 6/5 program, so long as the Government could limit possible distortions to a relatively low level, and so long as the Government provided a suitable monetary and fiscal framework.

In addition to the extensive unionization, labor market rigidities in Canada seemed to be exacerbated by government policies, Mr. Dallara considered. The federal and provincial governments maintained extensive industrial and social assistance programs aimed at reducing disparities between regions in unemployment, income, and other indicators of economic performance. The industrial assistance programs--such as loans, grants, and subsidies--appeared to encourage surplus labor to remain in areas in which there was underemployment, thus allowing for a continuation of mismatches between supply and demand in the national labor force and to some extent preventing the process of wage determination from operating as efficiently as it might. Those without jobs could usually qualify for Canada's unemployment insurance program, a scheme that might be overgenerous and that might also be a factor in higher job turnover and longer durations of unemployment. Government incomes programs might, therefore, contribute to the downward rigidity of wages and, hence, to chronic inflation.

Monetary policy had to continue to support the objective of lowering inflation, Mr. Dallara recommended. While there were problems with the monetary aggregates, like the staff he was concerned about the abandonment of aggregate targeting, even though M-1 itself might no longer be particularly useful. Perhaps Mr. Joyce or the staff would care to comment on possible replacements for M-1 as a target. The alternative of targeting real interest rates was no easy task in current circumstances, given the difficulties in estimating expected inflation.

The fiscal situation in Canada, as in other countries, was clearly worrisome, Mr. Dallara continued. His comments on fiscal policy applied to the medium term. While the larger part of the fiscal deficit was attributable to cyclical factors, there would still be a relatively big fiscal deficit even at some notional level of full employment, at least in the medium term. The Canadian authorities should direct their efforts toward eliminating the noncyclical part of the fiscal deficit. It might have a positive effect on markets if the Government made its medium-term plans known at an early stage. Since government expenditure appeared to have acquired a momentum of its own, he would like to know what proportion of fiscal expenditure was automatically adjusted to reflect the cost of living. Could the staff assess the effects of the 6/5 program on fiscal expenditure?

Before touching on external sector policies, he would like once again to record his support for allowing domestic energy prices in Canada to reach international levels, Mr. Dallara said. Distortions that arose from holding down energy prices should not be underestimated.

The exchange rate policy pursued by the Canadian authorities appeared to be broadly appropriate, Mr. Dallara commented. He had listened with interest to Mr. de Vries' comments on the subject. He agreed with the staff assessment on the suitability of the exchange rate policy.

Turning to other external sector policies, he continued to be concerned about Canadian restrictions imposed on certain international transactions, Mr. Dallara remarked. Canada and the world economy benefited from a relatively open international economic and financial system. The authorities were to be commended for streamlining the review process of the Foreign Investment Review Agency, but his authorities continued to be concerned about the way in which the Agency operated and the impact that it might have on foreign direct investment. Canadianization of the oil and gas industry also had to be causing significant distortions and souring the climate for foreign investment. Again, while Canadianization had slowed somewhat, it nonetheless appeared to have been institutionalized, and he hoped that the authorities in Canada would continue to review such policies with a view toward reducing the restrictions that remained. Regrettably, trade restrictions had intensified in the present difficult environment. All countries should do their best to avoid such policies, and he urged the Canadian authorities to continue to try to maintain a trade regime with few restrictions.

Mr. de Maulde noted that Mr. Joyce had said, "My authorities broadly agree with the analysis and with most of the policy views set out in these reports." If he correctly understood the words "broadly" and "most," they meant that Mr. Joyce did not fully agree with the analysis or the policies recommended, a point on which he would tend to agree with Mr. Joyce. SM/82/240 consisted of three parts: first, a review of past developments; second, a summary of the discussions with the Canadian authorities; and third, the staff appraisal containing projections for the Canadian economy in 1983. With respect to the staff analysis of past developments, it was obvious that, in 1983 as in previous years, the Canadian economy was influenced by two fundamental structural considerations: its proximity to the United States, and its status as a producer and exporter of commodities. Those considerations explained most of the developments in 1982, and it was quite surprising that the report contained only a brief mention of them.

At the top of page 16 in SM/82/240, Mr. de Maulde observed, the staff had said that inflationary momentum had been arrested, attributing the development to a slowdown in the goods and services markets and the effect of the 6/5 program. He could not agree with the view that the slowdown of inflation in Canada was due primarily to the economic slowdown and rising unemployment, and only secondarily to the implementation of an innovative incomes policy. Rather, the basic reason was that the authorities had established a bold and intelligent incomes policy. Had it been established earlier, perhaps some of the economic damage done through the current policy approach could have been avoided, especially if such a policy had been associated with complementary measures geared to encourage employment and investment.

The Canadian authorities had adopted a flexible monetary policy based not on theory but on observed developments in credit, interest rates, and the exchange rate, Mr. de Maulde remarked. In reading the report, he had had the impression that neither the authorities nor the staff regarded the policy as shameful, a view that struck him as somewhat curious. In fact, once the Canadian authorities--like the authorities of their great neighbor to the south--had set up what they called "financial innovations," which meant a number of measures making it completely impossible to continue a traditional monetarist policy, the staff appeared to have decided that the introduction of those "innovations" meant that the monetary policies followed by the Canadian authorities had necessarily been those that they ought to have followed. He would add that it would be interesting to see--apart from figures for monetary aggregates--some reference being made to the velocity of circulation of currency, which had no doubt been considerably affected by changes in the modality of public and entrepreneurial deposits.

In the discussion of fiscal policy, the staff had noted a deficit equivalent to 6.3 per cent of GNP, which was presented as an alarming figure, Mr. de Maulde continued. Obviously, those results were much lower than the forecasts made by both the Canadian authorities and the staff in the previous year. The staff had also said that, quite apart from any automatic change in the deficit, it was the responsibility of the authorities to stimulate the economy; yet that stimulus was to be restricted to 1 per cent of GNP. In view of the extent of unemployment and undercapacity in Canada, fiscal stimulation limited to 1 per cent of GNP seemed slight.

He had nothing to add to the staff recommendations for Canada, because they appeared precisely the same as the recommendations made in the 50 or so consultation reports discussed during the previous year, Mr. de Maulde said. They did not seem to deal with the particular position of Canada. As for the economic outlook, there was again a difference of view between the staff and Mr. Joyce. The staff predicted GNP growth of about 3 per cent, a stabilization of employment, and a reduction in the inflation differential between Canada and the United States, developments that were supposed to occur through a classic program of higher consumer spending, residential construction, and liquidation of inventory. Such developments depended on structural factors, especially the evolution of the U.S. economy.

The economic recovery had been supposed to begin in autumn 1982, Mr. de Maulde recalled. However, if recovery in the United States were once again delayed or were insufficiently strong, the Canadian authorities would have to decide whether they should revise downward their objectives for growth, employment, and inflation, or whether they should stick to their objectives and consequently take the further measures necessary to carry them out. Mr. Joyce had said clearly that the Canadian authorities would not hesitate to opt for the second choice, a decision with which he himself fully agreed. The authorities would find that strategy achievable for two reasons. First, unlike the United States, Canada had a healthy balance of payments position; he did not agree with Mr. de Vries' analysis of Canada's balance of payments. In 1982, for example, despite the appreciation of the Canadian dollar on the exchange market, there had been a sizable expansion of Canadian exports. Second, the 6/5 incomes policy had reduced the danger that fiscal policy would be eased, or interest rates reduced, to stimulate growth.

Like other Directors, Mr. de Maulde continued, he was glad to hear from Mr. Joyce that the protectionist measures recently imposed in Canada were temporary, and he hoped that they would be removed as soon as the first effects of recovery became apparent. Finally, his authorities were pleased that Canada would continue to place high priority on providing aid to developing countries. France was happy to be associated with Canada, the Scandinavian countries, and Italy in the special fund for the International Development Association, designed to keep up a high level of aid flows into developing countries despite the shortfall in the U.S. contribution.

Mr. Senior commented that, during the past year and a half, the intensity of the recession in Canada had been far more pronounced than the authorities had expected: unemployment had reached record postwar levels, and only recently had inflation rates slowed significantly. While during the 1970s the economy of Canada had evolved in a way quite similar to that of other industrial countries, economic conditions at present were more serious in Canada than elsewhere. In assessing the causes underlying the performance of the Canadian economy, Directors should keep in mind its high degree of integration with its major trading partners, a feature that narrowed the scope for independent policy formulation. As pointed out by the staff and Mr. Joyce, the world recession together with domestic policies of demand restraint had adversely affected output and employment in Canada.

During the past year, Mr. Senior continued, the fiscal deficit had grown sharply, partly as a result of depressed oil markets and high interest rates in the United States. Those high rates not only affected Canada's fiscal position, increasing debt service payments, but, by pushing up domestic interest rates, had also slowed economic activity in major components of final domestic demand that were sensitive to interest rate developments. As Mr. Joyce had said, housing, machinery, equipment, and nonresident construction had been particularly slowed by high interest rates, and there had been a rapid drawdown of inventories. A fall in interest rates could help to reactivate businesses in those fields.

On the expenditure side of the budget, transfers to provinces and other costs of some statutory programs had increased, Mr. Senior noted. Moreover, during the past year the authorities had introduced measures to support the creation of new jobs and other social programs. While those measures appeared to be justified, given the lower than expected level of economic activity and the high rate of unemployment, the authorities also recognized that a further weakening of the fiscal position might impair their credibility in undertaking to fight inflation. He thus welcomed the adoption of the 6/5 program as a means of breaking inflationary expectations and speeding up the adjustment to lower rates of wage increases; the program had received support from the provinces and businesses. As Mr. Joyce had said, most of the increase in social programs would be financed by a reallocation of existing expenditures.

As pointed out by the staff, monetary policy had undoubtedly contributed both to the recent moderation of inflation and to a slowdown of growth in nominal demand, Mr. Senior went on. However, the inflation rate was still four or five percentage points higher than in the United States, a difference that had important policy implications given the high degree of integration of the Canadian economy with the U.S. economy. He agreed with the staff and the Canadian authorities that a lasting reduction in inflation was needed for sustained growth of output and employment in the medium term. Thus, government policies needed to be maintained on an anti-inflationary track. While prudent policies of restraint were still required, there would also seem to be room for improvement in the overall policy mix in order to reduce the adverse effects of such policies on economic activity and employment without exacerbating inflationary pressures.

He agreed with the staff that the authorities needed to improve the fiscal position, Mr. Senior said. A further easing of fiscal policy with the aim of stimulating the economy could give rise to a severe problem of confidence. Recognizing the danger, the authorities had made some progress in reducing or reallocating current expenditure, for which they were to be commended. Nevertheless, further efforts were still required. Perhaps a more neutral fiscal policy stance, or no fiscal stimulus as opposed to the estimated stimulus of 1 per cent of GNP in 1982/83, would be suitable. He did wonder, however, whether further restraint in the fiscal position would be too costly in affecting output and employment if monetary policy also continued to be restrictive or if further restraint were contemplated. As the staff had pointed out, the restrictive monetary policy stance, while reducing inflation, had also reduced output and employment. Without wishing to advocate an expansionary policy stance, he agreed with the authorities that the degree of overall restraint could be lessened if considerable progress were made in reducing inflation, as in fact the latest data suggested, and if the economy remained weak. Again, the close interrelationship between the Canadian and the U.S. capital and labor markets limited the scope of measures that could be adopted in Canada. Nevertheless, a somewhat more flexible monetary policy, in combination with a more restrained fiscal policy, could favorably affect overall output and employment without triggering a recurrence of inflationary pressures.

The National Energy Program adopted in October 1980, and the measures adopted by some provinces during 1982, had already produced some substantial achievements, particularly in greater energy conservation, Mr. Senior noted. The authorities should be commended for those efforts, as well as for the high priority they continued to attach to the flow of official development assistance to developing countries. Canada had assumed a major role among industrial countries in international economic cooperation and would surely continue that role in the future.

Mr. Tshishimbi remarked that he was in general agreement with the assessment made by the staff of the performance of the Canadian economy. During the previous decade, that performance had been quite uneven, with an obvious declining trend that had worsened in 1982, when real GNP was estimated to have declined by some 5 per cent. As the staff had pointed out, the decline had been brought about by policies designed to combat inflation by curtailing domestic demand. With the decline in output, unemployment seemed to have reached unacceptable proportions; the authorities had chosen to eliminate inflationary expectations, the worse of two evils. The authorities had themselves initiated measures of demand restraint by applying the 6/5 wage policy to the federal sector and by recommending the same policy to the rest of the economy. They had intended to reduce the Federal Government's deficit from about 2.5 per cent of GNP during fiscal year 1981/82 to 1.7 per cent of GNP in 1982/83. Despite the additional measures announced by the Government in October 1982, the deficit of the Federal Government was now expected to reach about 6.3 per cent of GNP in 1982/83.

The Government had thus decided to finance new job-creation programs in order to alleviate the burden of unemployment and to revive the economy, Mr. Tshishimbi observed. To accommodate that objective, energy programs had been reduced by about \$660 million, development assistance by about \$245 million, and defense programs by \$230 million. For countries in his constituency, among the main beneficiaries of Canadian development assistance, $245 million could make a great difference. He therefore appreciated Mr. Joyce's statement that the Canadian authorities were still committed to the development efforts of nonindustrial countries. In view of the observation on page 54 of SM/83/9 that the ratio of official development assistance to GNP had increased in 1982, could the staff or Mr. Joyce say whether and to what extent that ratio would continue to increase in 1984/85?

The Canadian authorities had been concerned about the implementation of monetary policy, Mr. Tshishimbi noted. As Canada had a gigantic neighbor to the south with monetary problems of its own and as Canada had introduced a number of innovations into the banking system, he could appreciate the difficulty that the authorities had experienced in trying to carry out monetary policy at a time when M-1 had become a much less effective indicator than previously. The staff had also indicated that the Canadian authorities were going to undertake a study of new indicators for their monetary policies. Because the same problem appeared to prevail in other countries, could the Fund staff also help to make similar studies?

Mr. Yamashita recalled that, one year previously, the Chairman had summed up the 1981 Article IV consultation with Canada by saying that Executive Directors felt that the Canadian authorities were correct in giving the highest priority to reducing inflation, even though the economy had been moving into recession; the achievement of sustained growth and a lasting reduction in unemployment would depend largely on their success in curbing inflation. In 1982, it was encouraging that the inflationary momentum had at least been arrested. The development of a large degree of slack in the goods and labor markets as well as the 6/5 program seemed to have contributed greatly to curbing inflation. Nevertheless, the rates of increase in wages and prices remained high, and the staff paper stated that the danger of a resurgence of inflation did not seem remote. He agreed with the staff and the Canadian authorities that, since a lasting reduction of inflation was needed for sustained growth of output and employment over the long run, policies needed to be maintained on an anti-inflationary track. In the general strategy to curb inflation, there were three areas of importance.

First, he welcomed the authorities' initiative to break the expectation that inflation would remain high and to speed the adjustment to lower rates of wage increase in the form of the 6/5 program, Mr. Yamashita continued. It was encouraging that the program had received substantial support from provincial governments and from business. The econometric analysis by the staff in Appendix I of SM/83/9 showed that there was a discrepancy between the forecast values and the actual values of wage increases in the recent past, something that might well be indicative of a fairly large downward revision in inflationary expectations. To the extent that such a program was effective in changing expectations about future wages and prices, especially in the private sector, it would facilitate the transition to reasonable price stability. In any event, he agreed with the staff that the program provided no leeway for any relaxation of demand management policies, which could make a contribution only if they were applied within a general policy framework conducive to reducing inflation.

Second, the considerable tightening of monetary policies since late 1980 had helped to contain inflationary pressures and had helped interest rates to come down substantially from the unprecedented levels reached in the spring and summer of 1981, Mr. Yamashita said. Since the authorities had abandoned M-1 as the intermediate target for monetary policy, the staff understood that the Bank of Canada was currently setting policy largely on the basis of views on the level of interest rates suitable for the expected course of inflation, provided that the exchange rate came under no substantial pressure. The staff put forward the view that that approach might not offer sufficient protection against an unintended easing of policy. The Canadian monetary authorities had been working on a new aggregate that could serve as a guide for policy, taking into account the need for monetary targeting as economic recovery took hold. Like other Directors, he would appreciate any additional comments that the staff or Mr. Joyce might care to make on the need for monetary targeting.

Third, Mr. Yamashita noted, the fiscal deficit had risen sharply in the past year. The staff argued that in the absence of any action to raise revenue or cut expenditure, substantial deficits would continue for the next several years. He shared the staff's view that the persistence of large deficits was bound to have adverse consequences for capital formation and the sustainability of economic recovery in the long run. According to the staff (page 10 of SM/82/240), the Canadian authorities believed that most of the present fiscal deficit could be explained by cyclical factors. In the light of the table on the operations of the consolidated public sector on page 35 of SM/83/9, he tended to agree with the Canadian authorities that the large deficit of the public sector in 1982 appeared to have been due mainly to the sharp reduction in the growth of nominal GNP and the sharp deceleration in revenue associated with it. Nevertheless, from a long-term perspective, he was not completely at ease with the growth of expenditure, which seemed destined to remain at a high level. In that regard, the Chairman's summing up at the 1981 consultation, which had noted the desirability of stepping up efforts to curb and control spending, might still be valid: a substantial reduction in the deficit during the next few years would be critically important in paving the way for sustainable growth in the long run. Like other speakers, therefore, he was encouraged by Mr. Joyce's statement that the authorities remained committed over the medium term to containing the growth in public spending.

Mr. Kafka observed that, over the previous four years, Canada had suffered from persistent inflationary pressures combined with rising unemployment, which had become one of the major problems of economic policy. Fortunately, the balance of payments had not been a matter of concern: the current account balance had recorded a surplus of 0.5 per cent of GNP in the first three quarters of 1982. It was also clear that there had recently been major progress in the fight against inflation; the authorities were to be congratulated on their wage and salary program.

One of the few examples of a successful incomes policy, it seemed particularly significant since Canadian labor in all sectors, including the public sector, was more militant than in the United States.

Despite the extraordinary increase in the rate of unemployment since the 1981 Article IV consultation, Mr. Kafka continued, he was not sure to what extent the authorities had been right to withdraw some of the tax measures proposed in the November 1981 budget. As other speakers had noted, the depth of the fiscal deficit had both cyclical and structural aspects. Perhaps, in view of Mr. Joyce's statement, the authorities would do well not to think of immediate tax increases but to consider the American idea of enacting tax increases to be triggered automatically at some future time. The suggestion that government programs should be reviewed with the objective of reducing economic distortions in the Canadian economy, and the staff's insistence on a general cutback in government regulation, seemed extremely sensible. Those ideas were probably even more important than the 6/5 program.

Regarding monetary policy, variations in banking practices had prejudiced the use of M-1 as an indicator of the demand for money, Mr. Kafka said. The staff was correct in encouraging the Canadian authorities to pursue their search for other indicators; a measure of monetary aggregates was probably needed to avoid misleading expectations about future rates of inflation.

The tendency to protectionism that existed in Canada, while the country was by no means the worst offender, was troublesome, Mr. Kafka concluded. Canada was a large market, after all. He was grateful for the still-generous Canadian attitude toward providing official assistance to developing countries.

Mr. Laske said that he had no difficulty in endorsing the staff appraisal, although he did have some sympathy for the Canadian authorities' belief that, on one point or another, the staff might have been less flexible than the authorities would have liked. Economic developments in Canada presented another example of the difficulties that industrial countries were facing in attempting to adjust to changing external circumstances. The task was particularly complicated when the problems had their origin not only in detrimental external occurrences but also in the generous expansion of social programs and domestic spending as well as in excessive wage increases. In Canada, that formidable challenge had been made even more complex by the authorities' limited room for maneuver owing to the heavy dependence of the economy on variations in the cyclical position of the U.S. economy, a point on which Mr. de Maulde had offered interesting observations. The strong tie to the U.S. economy might be an additional reason why Canada's economic performance had been less favorable than that of other industrial countries: it was particularly worrisome that the substantial decline in the growth rate and the simultaneous increase in unemployment had so far been accompanied by only a modest decline in the rate of inflation. It was small consolation that other industrial countries had fared little better, but Canada's problems appeared all the more disturbing because little relief from the pressing problem of unemployment appeared to be in sight.

Wage increases not matched by commensurate gains in productivity had obviously contributed greatly to the problem, Mr. Laske considered. The problem had been compounded by the delay in tightening monetary policy when the rate of inflation in Canada had begun to overshoot the rate in the United States. Finally, deeply entrenched inflationary expectations, nurtured by too little monetary restraint and too much fiscal generosity, had played a contributing role as well. None of those problems seemed amenable to a quick solution. Unemployment would most likely continue to be high, and inflation was unlikely to recede to the U.S. level any time soon.

There were, however, positive aspects in the Canadian economy that offered hope for a more broad-based improvement in the future, Mr. Laske pointed out. There had been a large swing in the current account of the balance of payments from a deficit of $5.3 billion to a surplus of $2 billion. He found it interesting that the volume of imports of goods and services had undergone a large decline since mid-1981, while the volume of exports had shown little change. Considering the slackening of the world economy--especially in the United States, Canada's most important trading partner--the country seemed to have increased its share in export markets. To what extent could that development be ascribed to exchange rate movements?

According to the staff, the competitive position of the manufacturing sector in Canada had improved by nearly 50 per cent since the end of 1978 in relation to manufacturing in industrial countries other than the United States, Mr. Laske noted. On page 3 of SM/82/240, the staff had said that the cost position of Canada in relation to those countries at present was hardly different from the position in 1976 and was more favorable than it had been in the 1960s and early 1970s. Yet he had noted from Chart 10 in the same paper that Canada's competitiveness in manufacturing had gone through a dramatic shift from 1976 to 1982. Did the staff intend to imply that Canada's relative cost position in 1979 and 1980 might have been too favorable to be sustained over a longer period?

As for the Canadian policy strategy, he fully agreed with the authorities that there was a continuing need for policies that aimed at breaking the still-prevailing inflationary sentiments in the country, Mr. Laske went on. Only by achieving that goal could a solid basis for durable recovery be laid. In particular, he welcomed the 6/5 program, which was important for diminishing inflationary pressures and improving profits in the private sector. Fortunately the 6/5 program was supported by the provincial governments and by the business sector, so that its chances for nationwide success were not being undermined by any narrow regional interests. He did have two questions about that policy. So-called exceptional circumstances were mentioned by the staff as a possible justification for larger price increases than would normally be admissible under the 6/5 program, and he wondered what kind of exceptional circumstances the authorities had in mind. After all, the term "exceptional circumstances," was expandable and could become the norm rather than the exception. Moreover, the staff had mentioned inducements to compliance with the 6/5 programs; did the staff consider the inducements to be adequate, since they involved only public expenditure?

There had been a considerable tightening in monetary policy over the previous two years, but inflationary pressures had begun to recede only recently, Mr. Laske remarked. Two explanations for that phenomenon were possible. Perhaps the imposition of monetary restraint had made itself felt with an exceptionally long time lag because restraint had been applied in a somewhat hesitant fashion. On the other hand, the Canadian authorities might have followed a monetary indicator that had proven to be ineffective because it indicated a degree of tightness that in reality had not existed in the economy. He agreed that technical reasons might make it necessary to change the monetary indicator from time to time, when the behavior of banks and bank customers made the indicator in use obsolete as an instrument of control.

For more than a year, Mr. Laske noted, the Canadian authorities had been looking for a new monetary indicator, after abandoning M-1 for understandable reasons. At present, monetary policy appeared to be conducted by the old-fashioned but not altogether ineffective method of influencing interest rates, where the suitable level was more a matter of day-by-day judgment. That policy might well fit the circumstances of the moment, when uncertainties about the future course of the world economy were plentiful. For the long haul, however, he would think it advisable for the Bank of Canada to formulate a new monetary target, which should be more broad-based than the M-1 measurement used previously. The new measurement should be less prone to erratic jumps because of shifts of funds among various maturities, so that the authorities were never sure how close to or how far away from money, in the narrow sense, those funds were. Could Mr. Joyce provide more information about the current thinking of his authorities on the problem and any progress they had made in developing such a new instrument of policy formulation?

He fully endorsed the fiscal stance of the authorities, who had correctly avoided giving any additional stimulus beyond what was already provided by the automatic stabilizers, Mr. Laske said. As unemployment was not expected to improve soon, and as a significant upturn in foreign demand was unlikely, any attempt to stimulate the economy would tend to rekindle inflation, to worsen even more a fragile business climate, and to create less rather than more employment. Indeed, perhaps the best advice that could be given to the Canadian authorities was to stay the course.

Some difference of view existed between the staff and the authorities about the cyclical component of the budget deficit, Mr. Laske noted. The degree to which the authorities should take measures to reduce the deficit depended on the weight of the cyclical component. In case the more pessimistic view of the staff--which assumed a small cyclical component but a large structural component--should turn out to have been the more realistic one, the Canadian authorities would be well advised to consider additional measures for restructuring public finances to further the growth potential of the Canadian economy and to keep transfer payments in check. As in many other industrial countries, questions arose about the generosity of the social security system, including the unemployment benefits. On another point, could the staff say why it expected the financial position of the provinces to improve substantially in the period ahead?

It was desirable for the Canadian authorities to speed up the process of increasing energy prices toward international levels, Mr. Laske recommended. The arguments put forward by the authorities on the difficulty of undertaking such a move were not altogether unconvincing. In fact, considering the events that had taken place the previous weekend at the meeting in Geneva of the Organization of Petroleum Exporting Countries, he wondered at what level international energy prices would be in the future.

Considering the exchange rate, Mr. Laske said that the Canadian authorities had basically relied on monetary policy to stabilize the rate for the Canadian dollar vis-à-vis the U.S. dollar and had intervened only sparingly to smooth out excessive variations. He could fully endorse their course of action. Given the heavy interdependence between the real economy and the credit and capital markets in Canada and the United States, any more significant depreciation of the Canadian dollar would appear to be an unsuitable response to Canada's present difficulties, chiefly because the potential adverse consequences would most likely include a worsening of inflation and unemployment.

The competitiveness of Canadian industry appeared to be more or less appropriate, given the volume of exports in 1982, Mr. Laske commented. The problem with the export sector was mainly structural. Canada's manufactured products for export fit primarily the U.S. market, while other countries were mainly markets for Canadian raw materials; those two facts might provide little room for an active exchange rate policy. Strengthening the competitiveness of Canadian products might make the country's manufactures more attractive to markets besides the U.S. one, thus helping to diversify the current trade pattern and to make the Canadian economy's response to changing cyclical positions more flexible. It could also have beneficial consequences for the exchange rate.

Mr. Lovato observed that, although the Canadian economy had its own peculiarities deriving from the wealth of primary commodities with which it was endowed, it was suffering from the malaise that was affecting other industrial countries. As in other member countries of the Organization for Economic Cooperation and Development, unemployment had reached record levels: even if the optimistic scenario for 1983 were to come about, the amount of idle resources should remain high for some time. In Appendix I to SM/83/9, the staff outlined an even more worrisome prospect: unemployment reaching almost 13 per cent, nonresidential business fixed investment dropping by 15 per cent for the second straight year, and the only stimulus to demand coming from stockbuilding and residential construction. He agreed with Mr. Joyce that the slowdown in the Canadian economy could be attributed in part to weak world demand and in part to tight domestic policies aimed at reducing inflation, but Executive Directors should remember that the first depended on the second, since world demand was composed of aggregate demand in each individual country.

The main problem confronting the Canadian authorities was how to put the economy on a better course without refueling inflation, or perhaps even while reducing it, Mr. Lovato commented. He therefore commended the commitment of the Canadian Government to pursuing monetary and fiscal policies directed toward combating deeply entrenched inflationary expectations. The Fund staff seemed to have an exceedingly cautious and pessimistic attitude on that question: the staff appraisal warned that "experience from many countries suggests that markets react quickly to indications of a reduced commitment of the authorities to policies of demand restraint." That statement might well have been true in other countries in the past, but he wondered whether in current circumstances the Fund ought to maintain the same scale of priorities. After all, the high degree of unused resources in Canada might well allow for a reasonable stimulus to investment, restructuring, and productivity without endangering the goal of reducing inflation. In particular, a successful incomes policy, as the Government's 6/5 wage policy promised to be, should, in view of the large amount of slack existing, provide the basis for a prudent reversal of strategy in a less restrictive direction, without causing undue reactions from the public.

Indeed, most of the chances of success for the program depended on the results of the incomes policy, Mr. Lovato remarked. While Mr. Joyce had stated that the 6/5 wage formula had received support from most provincial governments and many private sector companies, he had not found any hint about what the reaction from the unions had been. He would appreciate any comment on the unions' attitude, especially since the staff had said that the rate of increase in wages remained high and that wage settlements in the unionized private sector were still in the double-digit range. It was nonetheless reassuring that, according to Mr. Joyce, wage settlements in October and November had provided for increases under 10 per cent and that wage increases were now falling rapidly.

He endorsed the Canadian authorities' evaluation of the fiscal policy stance after cyclical factors had been eliminated, Mr. Lovato went on. The staff's objection--that a full employment deficit might not be a relevant concept since Canada was unlikely to reach full employment soon--seemed to miss the point. One of the immediate effects of demand restraint was to increase the size of the public sector deficit, so that it would be unreasonable to tighten policies further in response to those deficits. Thus, a deficit of the order of 6 per cent of GNP, even though nominally large, was not the result of irresponsible fiscal management. Nonetheless, he would support the staff's recommendation that the authorities should make adjustments in those social programs that were deemed to have added to the rigidity of labor markets. On the whole, the fiscal stance seemed appropriate; he would like to hear more comments on the use of development funds to support ailing industries. The large drop in productivity during 1982, at a time when unemployment had been rising, was certainly worrisome, and aid to unprofitable industries could only delay the structural adjustment of the Canadian economy to changing economic conditions.

On monetary policy, Mr. Lovato said, he welcomed the authorities' decision to shift from trying to control an unstable aggregate, whose role was subject to changes, to managing credit and money in a manner that pragmatically considered real interest rates and exchange rates. Only a dogmatic approach could justify the continued pursuit of a nondiscretionary monetary policy, whose validity in any event was questionable. Clearly, an easing of short-term interest rates would be more than useful in present circumstances, particularly in view of the reduced pressures from abroad.

Even though he appreciated the flexibility of the authorities' attitude toward the exchange rate of the Canadian dollar, in all fairness he would have preferred a more in-depth discussion of the suitability of the current exchange rate, Mr. Lovato concluded. Both Chart 10 in SM/82/240 and Chart 13 in SM/83/9 showed that, no matter what indicator of competitiveness was used, a substantial deterioration had occurred over the past few years. Although the current account was now in surplus, that development was due mainly to the severity of the recession in Canada. A continued loss in competitiveness could hinder balanced growth of the economy in the future, thus making the external constraint more evident. In that respect, he agreed with the staff that the Government should promote an open trading and investment system. Since the current weakness in world demand was the result of the attitude taken by all individual countries, it would be self-defeating for any country to expand the scope of protectionist measures. Even though national authorities had to face strong pressures in that direction, he urged them to resist and to regard as temporary the protective measures already taken. Were Canada's measures to be maintained, in the end they would do more harm, both to the country and to the world economy, than the relief that they seemed to bring about temporarily.

The Deputy Managing Director assumed the chair.

Mr. de Groote noted that in the first three quarters of 1982, labor productivity had fallen by about 2.25 per cent. There had been productivity losses since 1978 with some cyclical swings, while labor productivity had hardly changed between 1973 and 1981. In interpreting that development, the staff had especially stressed the slowdown in the growth of the capital/labor ratio. That development was one of the structural factors common to many small and medium-sized industrial countries like Canada, and was attributable in part to the entry of women in greater force into the labor market, the expansion of employment in services, and, as had been stressed in the 1981 consultation, the poor productivity performance in energy-related industries and in resource industries such as metal, mining, and forestry. In those industries, according to the Bank of Canada, a significant part of the slowdown in productivity growth had been attributable to the rise in the price of energy. Therefore, in Canada, labor was relatively more abundant than capital. One implication was that the large wage increases granted in previous years could not be regarded as having led to deindustrialization, as the staff implied in some passages. He did not claim that those wage increases had been welcome, but rather that there was a cause for deindustrialization other than the increase in real wages.

Another implication was that the slow growth of capital in relation to labor was due to an inadequate supply of financial resources, Mr. de Groote continued. In that respect, Canada could be considered a developing country, not only because it had exceptional needs for infrastructure development, but also because it lacked sufficient resources to finance such development. Canada thus had either to attract more foreign capital or to increase domestic savings, or both. As interest rates had to be high to attract domestic savings, the situation that he had described seemed to require the management of credit flows rather than the management of monetary targets. Yet a delicate balance had to be found: if interest rates climbed too high, the investments that Canada needed so badly would be discouraged. The authorities might seek inspiration from the Japanese experience with interest rates, for the Japanese combined a favorable treatment of savings with inducements to invest. From that perspective, it made good sense to regard interest rates as targets of monetary policy, which amounted to much the same thing as taking credit flows rather than the quantity of money as targets of monetary policy.

The Canadian situation could not be explained without admitting that there were important labor market rigidities, a feature that explained why abundant labor did not lead in the medium term to more investments, Mr. de Groote noted. Therefore, some reduction in the real rate of increase of wages had to be envisaged. He especially welcomed the decision taken by the Canadian authorities to pursue their incomes policy. Regrettably, some elements of indexation had been included in the 6/5 policy, which moreover applied only to public sector employees. The average wage increase over the next two years would therefore be determined by the behavior of private sector employers and nonunion workers, so that the increases would probably exceed the programmed levels and would adversely affect labor costs. Could the staff provide more information on the prospects for wage movements in the next few years?

At present, the authorities felt no need to adjust the value of the currency, Mr. de Groote observed. They wanted to continue the fight against inflation, which would become impossible if the Canadian dollar were depreciated. Moreover, exports were still sufficiently competitive, as shown by the surplus on the current account, a theme on which Mr. de Maulde had made an interesting observation. There remained the question raised by Mr. de Vries whether the authorities should peg the

Canadian dollar to the U.S. dollar. There was in the Executive Board a long tradition of requests by Canada for approval of autonomous exchange rate policies. The Acting Chairman would no doubt recall that in the early 1950s Mr. Rasminsky, former Governor of the Bank of Canada, who at the time had been an Executive Director of the Fund, had begged the Board for days to be allowed approval for a 4-5 per cent margin of fluctuation for the Canadian dollar to allow for capital flows. The principal reasons cited by Governor Rasminsky had been the need to isolate the Canadian market and obtain the required amounts of capital inflows in order to avoid excessive inflows in some circumstances and to increase inflows in other circumstances. Mr. de Vries' recommendation that the Canadian authorities peg their dollar to the U.S. dollar would be valid if the authorities had decided not to change the exchange rate for a long time, but in fact it appeared that the policy was only temporary. It should be abandoned progressively in favor of a policy that would attract more capital in a more lasting way.

In the light of Canada's capital needs and the great availability of labor in relation to capital, Mr. de Groote said, he did not entirely follow the staff's reasoning that, in the absence of money targets, enough liquidity might be created to jeopardize the fight against inflation. He would say rather that there was at present an insufficient supply of lendable funds in Canada, so that the authorities were justified in selecting an interest rate policy that attracted the funds. They would be able to achieve that goal only if they abandoned monetary targets and practiced some sort of selective orientation of capital flows domestically, perhaps following the French example, with interest rates and structural credit ceilings oriented toward the longer-term needs of the Canadian economy. Thus, policy would bear more on credit flows and on interest rates than on monetary targets as such.

The most critical element in the forecast for 1983 was the estimated unemployment rate of 13 per cent, the highest rate among industrial countries, Mr. de Groote concluded. He agreed with Mr. de Vries that the effect of any budgetary stimulus would probably be quite limited. The answer might lie in stimulating internal savings and attracting external capital. The increases in capital flows from abroad would have only a limited effect on the inflation rate in Canada, since there was high unemployment and an obvious need for adjustment to new techniques. Finally, the authorities were to be congratulated for their exceptionally generous attitude in the provision of official development assistance.

The Acting Chairman recalled that Mr. Rasminsky had ended his tenure as Executive Director the day before he himself had assumed his duties, but he remembered reading the transcript of the 1951 discussion referred to by Mr. de Groote. In 1965, the authorities had floated the Canadian dollar, he understood, because they had experienced massive capital inflows and had lost control of monetary policy; in 1970, they had floated for the opposite reason, because they had experienced massive capital outflows. Indeed, Canada had been floating its currency for roughly two thirds of the Fund's entire history; it was probably the most experienced floater among the larger members of the Fund.

Mr. Suraisry recalled that, for a number of years, the main difficulty that had faced the Canadian economy had been the persistence of a high rate of inflation. As inflationary pressures had intensified, the authorities had adopted a mix of policies designed to break the inflationary psychology that had been gripping domestic markets. In recent months, the authorities' policies had begun to show success as inflationary pressures had been considerably reduced, an achievement for which the authorities were to be commended. The rate of growth of M-1 had slowed considerably. While there might be methodological differences about the suitability of targeting one monetary variable rather than another, there could be little doubt that the reduction in the growth of M-1 had contributed to the slowdown in the growth of aggregate demand and inflation. Moreover, the table on page 29 of SM/83/9 showed that the fiscal stance had shifted toward restraint during the four years ended in 1981/82. However, the ratio of the budget deficit to GNP was projected to rise to 6.3 per cent in 1982/83. While it was understandable that Canada's fiscal position would weaken in a period of economic stagnation and that the Government would want to provide some fiscal stimulus in a recession, fiscal policy had to be conducted with care to avoid setting off another burst of inflation. He had been glad to hear from Mr. Joyce that the authorities were committed to bringing inflation more firmly under control, and that any relaxation in fiscal policy necessitated by continuing slackness in the economy would not occur at the expense of achieving a low rate of inflation.

The authorities' cautious demand management policies had been successfully supplemented by a flexible incomes policy, Mr. Suraisry continued. On several occasions in the past, his chair had expressed support for the use of an incomes policy in fighting inflation, provided that the policy was informal and administered flexibly, and provided that it was used to supplement prudent demand management policies, not to substitute for them. Those conditions had been satisfied in Canada. He was glad that the 6/5 program had received considerable support from the provinces and from business. Nevertheless, the program would ultimately depend on the authorities' ability to achieve a further reduction in the inflation rate.

As to foreign trade policies, Mr. Suraisry remarked, he agreed with the staff that the spread of protectionism posed a serious threat to the world economy, so that it was essential for countries to refrain from intensifying restraints on imports and to roll back restrictive protectionist measures. He hoped that the Canadian authorities would find it possible in the future to curtail the restrictions that they had imposed. They were to be commended for their determination to achieve a ratio of official development assistance to GDP of 0.5 per cent by the mid-1980s, despite the recent cutback in budgetary allocations for foreign aid caused by the difficult economic conditions. Finally, he was confident that the thrust of the authorities' policies would enable them to achieve moderate growth and reduced inflation.

Mr. Malhotra noted that previous speakers had focused on the federal fiscal deficit of Canada. Some speakers had suggested that the deficit could play little role in stimulating the economy, while others had noted that only recently had inflation in Canada shown signs of declining. He would say that, subject to certain caveats, fiscal stimulation continued to have a role to play. In assessing whether such stimulation was justified under a given set of circumstances, he wished to examine fiscal deficits in light of overall monetary growth, bearing in mind any slack or lack of demand in the economy. It had been suggested that the increase in the deficit should address essentially cyclical movements rather than add structural increases into the budget. In the Canadian case, the contribution of demand to inflation was probably low. The rate of unemployment was high, and there was slack in the economy. Under the circumstances, deficit spending could be employed as an instrument for stimulating the economy.

It was, however, open to debate whether the abrupt increase in Canada's fiscal deficit would add structural elements to the budget or whether the increase in spending could be phased out later, Mr. Malhotra said. In a period of slack, revenue tended to go down, and it was not always wise at such a time to raise taxes to expand revenue; if the additional expenditure had an impact on demand, thus stimulating activity in the private sector, it would be an effective instrument to employ. The only worry was that the reduction in inflation still appeared to be fragile, so that there was need for caution.

The Canadian authorities were to be commended for their continued commitment to development assistance, Mr. Malhotra remarked. Their aid was all the more noteworthy because Canada had been experiencing budgetary constraints.

In view of worldwide trends in energy, Mr. Malhotra asked, how did the Canadian authorities intend to address energy pricing issues in the medium term? Like Mr. de Groote, he was also interested in the guidelines for wage settlements in the public sector. Did the authorities believe that those guidelines would have a major impact on settlements in the private sector? How great would the impact of the wage policy be if it were limited to the public sector alone?

Mr. Jaafar observed that the output of the Canadian economy had declined substantially, while the unemployment rate had risen to 11 per cent in 1982 and was expected to rise further to 13 per cent in 1983. Although there had been some decline in the rate of price rises, it appeared too temporary to allow the authorities to take more forceful measures to stimulate the economy without rekindling inflation. Thus, they were correct in their understanding that a sustained economic recovery was unlikely to take place unless inflation were brought under control. Only through a combination of restrictive monetary and fiscal policies, together with wage restraint, could inflation be reduced.

As in many other industrial countries, the burden of fighting inflation in Canada had fallen a little too heavily on monetary policy, Mr. Jaafar remarked. By contrast, fiscal policy had been expansionary, so that the fiscal deficit had risen from about 2.5 per cent of GNP in

1981/82 to 6.3 per cent in 1982/83. One of the major sources of fiscal problems was the large and growing cost of social programs, which tended to come under greater pressure at times of economic recession, when productivity and government revenue both declined while unemployment increased. Nonetheless, in order to improve the fiscal situation and bring inflation under control, government expenditure would have to be restrained, and the tax effort would have to be intensified. He therefore noted with concern the authorities' intention to widen the already high fiscal deficit in the event of a weak recovery and in the absence of any program to raise revenue or cut expenditure. A large deficit was bound to have an adverse effect on investment. He therefore supported the staff view that an expansionary fiscal policy on a larger scale, as envisaged by the authorities, would be counterproductive.

High wage costs had also been an important contributing cause to the high rate of inflation, Mr. Jaafar considered. He welcomed the 6/5 wage program; although it was not legally binding, the authorities were optimistic that it would be successful. Could the staff be more specific about the response that the program had received so far from organized labor?

He had noted the difficulty that the Canadian authorities faced in choosing a suitable monetary target, and that they had decided to give up the M-1 target in the light of recent innovations in banking, Mr. Jaafar said. Indeed, many other countries were faced with similar problems. In the circumstances, he welcomed the pragmatic approach of the Bank of Canada under which it monitored developments in a broad range of economic indicators and paid particular attention to developments in exchange rates and short-term interest rates compared with inflationary expectations, which might be difficult to quantify.

He found three subjects to be of concern, Mr. Jaafar continued. The first related to the increasing protectionist tendencies, which were not in the long-run interest either of Canada or of the international community. Although protectionism was a tempting course of action in difficult times, countries should make every effort to resist it. The Canadian authorities ought to take measures to liberalize trade for the benefit of both Canada and the world economy.

Second, Mr. Jaafar observed, the staff had estimated Canada's current outstanding external debt at about $110 billion, equivalent to one third of GNP. The Canadian authorities appeared not to be concerned either about the size of the country's foreign debt or about the trend. He had not seen any staff assessment of Canada's external debt position in the papers, and he would appreciate it if the staff could evaluate for Executive Directors both the size and the trend in Canada's external debt situation.

Third, he wished to express concern about the decision of the Canadian authorities to cut back on official development assistance, Mr. Jaafar concluded. In the past, many developing countries had benefited from generous Canadian aid. In the past few years, those beneficiary countries had been hard hit by the world recession and the weakness in demand for their exports. In those circumstances, they had a need for foreign assistance greater than ever before. The level of foreign assistance given by Canada continued to be higher as a proportion of GNP than that given by many other industrial countries, and the Canadian Government and people were to be complimented for their generosity.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/18 (1/24/83) and EBM/83/19 (1/26/83).

3. EXECUTIVE BOARD - TRAVEL ALLOWANCES

The Executive Board approves the proposal set forth in EBAP/83/31 (1/21/83).

Adopted January 24, 1983

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/83/32 (1/24/83) is approved.

APPROVED: July 1, 1983

LEO VAN HOUTVEN
Secretary