NOT FOR PUBLIC USE

04

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/20

3:00 p.m., January 26, 1983

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

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	C. Taylor
	E. M. Ainley, Temporary
J. de Groote	H. G. Schneider
	A. Le Lorier
A. Donoso	M. Teijeiro
	C. Dallara
	M. Z. M. Qureshi, Temporary
	Jaafar A.
	T. Yamashita
R. K. Joyce	M. Casey
	J. R. N. Almeida, Temporary
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
	J. E. Suraisry
	J. Schuijer, Temporary
A. R. G. Prowse	K. G. Morrell
	A. Yasseri, Temporary
	M. Camara, Temporary
M. A. Senior	
	L. Vidvei
Zhang Z.	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

B. Legarda, Consultant. Asian Department: H. Neiss, Deputy Director; K. A. Al-Eyd, C. M. Browne, R. G. Di Calogero, R. J. Hides, S. Shah. Exchange and Trade Relations Department: S. J. Anjaria, G. Belanger, C. F. J. Boonekamp, H. M. Flickenschild, M. Guitian, K. M. Huh, S. Kanesa-Thasan, F. L. Osunsade, P. J. Quirk, P. Sukachevin. Fiscal Affairs Department: D. C. Mcdonald, O. Tsukahara. Legal Department: J. G. Evans, Jr., Deputy General Counsel; A. O. Liuksila, J. K. Oh. Research Department: C. F. Schwartz, Associate Director and Director of Adjustment Studies; P. R. Menon. Western Hemisphere Department: E. Wiesner, Director; K. B. Bercuson, C. V. A. Collyns, L. E. DeMilner, J. Ferrán, E. Hernandez-Cata, Y. Horiguchi, L. R. Kenward, J. R. Marquez-Ruarte, L. Mendras, E. C. Suss. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: C. J. Batliwalla, S. El-Khouri, M. A. Janjua, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: R. Bernardo, L. E. J. Coene, T. A. Connors, G. Ercel, M. Hull, M. J. Kooymans, W. Moerke, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, E. Portas, J. Reddy, C. A. Salinas, D. I. S. Shaw, J. C. Williams, Zhang X.

1. CANADA - 1982 ARTICLE IV CONSULTATION

The Executive Directors resumed from the previous meeting (EBM/83/19, 1/26/83) their consideration of 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. Donoso said that an analysis of the staff reports revealed an economy characterized by a reduction in the relative prices of tradable goods combined with reductions in demand. Those elements together appeared to be producing a reduction in inflation, but at a high cost in terms of production and employment. The exchange rate had been more or less stable during 1979 and 1980, and had depreciated against the U.S. dollar by only 5 per cent between the last quarter of 1980 and the end of 1982. According to the staff, the Canadian dollar had appreciated in effective terms, by 9 per cent in 1981 and 1982, as both it and the U.S. dollar had appreciated against the currencies of other industrial countries.

The effective appreciation of the Canadian dollar might be even stronger if account was taken of the international prices of Canada's tradable goods instead of a combined index of prices of the countries with which Canada traded, Mr. Donoso added. As shown in the table on page 19 of SM/83/9, in 1982 the implicit price deflator of Canadian exports had increased by 0.2 per cent and the implicit price deflator of Canadian imports by only 0.8 per cent. In referring to the competitive position of Canadian producers in that context, the staff had mentioned a reduction of 22 per cent in the effective value of the Canadian dollar adjusted for unit labor costs in manufacturing relative to the currencies of 13 other industrial countries from the end of 1976 to the end of 1978. After that, the effective value of the Canadian dollar adjusted for changes in unit labor costs had risen by 48 per cent in relation to industrial countries other than the United States from the end of 1978 to the third quarter of 1982. From 1981 to 1982, there had been a marked improvement on both the trade account and the current account of the balance of payments. Clearly, the reason for those developments, alongside the apparent appreciation of the Canadian dollar, was the large reduction in demand. He tended to agree with the staff view that demand restraint would have to be maintained in order to achieve real success in reducing inflation, as it was inadvisable to rely on the present degree of slack in goods and labor markets to achieve a continued reduction in the rate of price increase.

However, Mr. Donoso continued, the effort to contain inflation was having negative effects on fundamental aspects of the economy. There was increased unemployment, and the related pressures for additional public expenditures at a time when the reduction in GNP was reducing government revenues. In the presence of constrained aggregate demand, the resulting public deficit was also weakening the position of the private sector by reducing available financing. The financial problems of private enterprises that the staff perceived were worrying. It appeared especially important to avoid resorting to protectionist measures in response to the pressures that tended to develop in circumstances like those being experienced in the Canadian economy. In that respect, it was significant that Mr. Joyce had indicated that the protectionist trade measures introduced by the Canadian authorities were intended to be temporary.

The staff was forecasting a modest performance for the Canadian economy in 1983, Mr. Donoso remarked, and he tended to agree. The economy would probably not resume rapid growth until the targets relating to inflation had been met and more relaxed demand policies could be pursued. Given the present economic difficulties, a more ambitious approach to wage restraint might be appropriate. It was not clear that with a constant exchange rate vis-à-vis the U.S. dollar, the 6/5 program could give enough room for a more relaxed demand policy, at least if the present situation of the current account of the balance of payments was to be maintained. Of course, it would be difficult to reduce the rate of wage increase more than was contemplated. However, given the objectives of the Canadian authorities in terms of the recovery of production and employment and the reduction of inflation, every effort should be concentrated on containing wages. Further success in that respect might even make it possible to permit the Canadian dollar to depreciate somewhat without giving any impetus to inflationary expectations.

Mr. Prowse noted that there were both cyclical and structural elements in Canada's problems, which were similar to but in some ways more difficult than those faced by other industrial countries. There had clearly been a long-term decline in performance, which had accelerated in the past few years. As noted in the staff reports, real growth had been 5.3 per cent a year between 1965 and 1975, but only 2.3 per cent a year from that time until 1982.

One aspect of that decline was the collapse in corporate profits since 1979, and the associated virtual collapse in business investment in 1981 and 1982, Mr. Prowse continued. The productivity of the work force had also declined. It was difficult to see how those discouraging trends could be reversed, but it would have been helpful to have more specific advice from the staff on how to ensure a recovery in business investment and productivity, especially as the prospects for greater profitability were more promising than they had been. The decline in business investment and profitability seemed to be closely related to the rise in real interest rates, as the charts provided by the staff showed.

Perhaps monetary policy had not only been given an excessive load to carry in controlling inflation, but had also been expected to achieve too many objectives, Mr. Prowse considered. The three objectives of monetary policy had been to control the growth of monetary aggregates, to take account of the impact of real U.S. interest rates on the exchange rate, and to consider the impact on the real economy of policies relating to the exchange rate and inflation. The latter objective seemed to have been given the lowest priority. He recalled that during the discussion in the Executive Board of the 1981 Article IV consultation with Canada (EBM/82/26, 2/26/82), he had been alone in arguing that directing monetary policy toward the maintenance of a broad exchange rate objective was having several undesirable effects, one of which was the severe impact on real economic activity. There had been a considerable increase in the amount of capital inflows of a financial rather than of an investment nature. He had therefore been encouraged by Mr. Lovato's remarks at EBM/83/19, which seemed to support his own view that the attempt to manage the exchange rate was imposing severe and possibly unjustifiable costs on the real economy.

Real interest rates were high, in the present state of the real economy, Mr. Prowse observed; international competitiveness was unsatisfactory, despite the improvement in the current account, which was due to the low level of economic activity; and it therefore seemed to him that the exchange rate should be allowed to adjust accordingly. Lower real rates of interest could then be maintained, at least in the transitional period of adjustment. He recognized the great dilemma of policy for Canadian economic managers at the present time, but he was unable to see how that dilemma could be overcome, in the present state of the economy, merely by tightening monetary policy and by seeking in the short term to achieve a marked reduction in the fiscal deficit.

There was also a critical need to deal with the growth in wages and in incomes, Mr. Prowse added. Thus, the 6/5 program seemed to be central--as a short-term and flexible policy instrument--to ensuring a better performance of the Canadian economy. As in many other industrial and non-industrial countries, low levels of investment and profitability were due largely to the rise in wages and incomes, and it was hard to foresee how Canada's medium-term economic problems could be resolved unless the 6/5 program was successful. The profit situation would also be improved, as he had already indicated, by some adjustment to the exchange rate associated with a somewhat lower level of real interest rates.

Finally, Mr. Prowse asked whether there were sufficiently severe structural imbalances in the Canadian labor market to call for measures to ensure a greater degree of labor mobility. According to the staff, the cyclically adjusted or "natural" rate of unemployment was 7 per cent or 8 per cent.

Mr. Vidvei made the general observation that the staff appraisal might incline unduly toward restraint, for which after all there was perhaps a less pressing need in Canada than in most other industrial countries. He shared the initial reaction--to which Mr. Joyce had referred--of senior Canadian officials who considered the staff views doctrinaire. Furthermore, the way in which the staff had expressed itself in its reports had surprised him because of the apparent failure to observe the basic scientific principle of distinguishing between facts, theories, and personal assessments.

The sharp drop in real GDP in 1982, and the corresponding sharp rise in the unemployment rate, had been discouraging, Mr. Vidvei continued. The outlook for 1983 indicated only a modest recovery in economic growth while the unemployment rate was expected to continue to rise to the very high level of about 13 per cent. Those developments were not promising, either for Canada or for the world economic community. With a surplus in its balance of payments, Canada should be one of the countries in a position to stimulate its economy and thereby contribute to the recovery of world trade and economic growth. He would have appreciated it if the staff had considered the Canadian case from that viewpoint.

However, from other points of view, some features of the Canadian situation were encouraging, Mr. Vidvei observed. He welcomed the 6/5 program introduced in the budget in June 1982. In passing, he wished to draw the attention of the Executive Board to the favorable result of the wage and price controls in effect from 1975 to mid-1978, which showed that incomes policy could be effective. Nevertheless, given the present 4-5 per cent difference in the Canadian rate of inflation vis-à-vis that of the United States, the program should have been a 5/4, or even a 4/3 program. All things considered, the 6/5 program did represent a key element of the authorities' anti-inflationary effort, which he hoped would be successful. The effect on wages in the private sector was still an open question, but he appreciated the hopeful information that Mr. Joyce had given on the latest developments.

On labor market policy, Mr. Vidvei noted, the so-called natural rate of unemployment had been calculated at 7.5 per cent in the second quarter of 1982. It would be interesting if either the staff or Mr. Joyce could give a further explanation of that rate, which was surely a record among the major industrial countries. For example, were there major structural problems in the Canadian labor market? In that context, he had been pleased to learn from Mr. Joyce that the Government would continue to play an active role in such areas as industrial modernization, manpower retraining, and resource development.

As for monetary policy, Mr. Vidvei observed, Canada's case seemed to underline the reasons for a reappraisal of the usefulness of monetary targeting. The changing Canadian attitude seemed to be indicative of a more pragmatic approach to monetary policy, which was welcome. He was less sure of the advantage of developing a new monetary aggregate to replace the M-1 concept that had been abandoned earlier. However, the staff had warned that the present approach might not offer sufficient protection against an unintended easing of monetary policy. Against the background of a high level of unemployment, the recent progress in dealing with problems of inflation, and an unexpected surplus on the balance of payments, the authorities should at least be prepared to ease their stance on monetary policy. The staff, in his opinion, was leaning too much toward restraint.

With respect to fiscal policy, Mr. Vidvei agreed with the staff that the recent increase in the deficit gave rise to some concern. Again, however, he felt that the staff was tending to be doctrinaire in noting in its appraisal that "persistence of large deficits is bound to have adverse consequences for capital formation and the sustainability of economic recovery, both by pre-empting savings and by giving rise to uncertainty about policies." That statement appeared to be built on assumptions and on wishful thinking. Nowhere in the staff report had the assumed adverse consequences been documented. On the contrary, during 1982, government spending had been possibly the only component--apart from the external balance--that had contributed positively to growth. The unemployment rate, which had been 10.9 per cent in the past year, was expected to rise to nearly 13 per cent in 1983, indicating a very low capacity utilization in Canada. In contradiction to the view of the staff, it had been reported on page 10 of SM/82/240 that the Canadian authorities were not concerned about the effects of the deficit on financial markets because the economy was weak, and personal savings were strong. To be convinced, one had only to take note of the increasing trend in the personal savings ratio shown in Table 2 of the report on recent economic developments (SM/83/9). An inquiry into the economic history of other countries would also not confirm the validity of the staff statement.

More generally, Mr. Vidvei believed, there was an urgent need for a more considered approach to government deficits, and not only in Canada. Deficits should, inter alia, be considered with reference to the possible stage of the economic cycle, unused capacity, the savings behavior of other sectors of the economy, and so on. The issue of fiscal policy was so complicated that it had to be analyzed on the basis of the actual economic situation in different countries. Thus, it was difficult to find generally valid theories on which a country could base its fiscal policy. Although the matter would more appropriately be discussed in connection with the world economic outlook, Canada's situation showed a clear need for the Fund to make an effort to improve its fiscal analysis.

Finally, Mr. Vidvei observed, it was not encouraging that Canada, along with some other countries, had resorted in recent years to sector-specific protectionist measures. In light of a possibly successful incomes policy, and a continued surplus on the balance of payments, he could only hope that the authorities would find enough room for maneuver to reverse that trend. He also hoped that Canada would avoid a fall in transfers of development aid as a percentage of GDP.

The staff representative from the Western Hemisphere Department, in answer to questions from Executive Directors on Canada's economic situation and outlook, said that the staff had mentioned the substantial reduction in the rate of inflation, which had been corroborated by the additional information provided by Mr. Joyce at the previous meeting. Yet the evidence so far covered only a relatively short period, and the rate of inflation in Canada remained much higher than in the United States. As noted in the staff report, the difference was about 4-5 per cent; the annual rate of increase in the consumer price index in Canada had been 8 per cent during the three months through November 1982, and it was reasonable to expect the reduction in the rate of inflation to continue in 1983. Although there had been a larger decrease in the rate of inflation in the United States, the difference in the underlying rates in the two countries might not be as great as the recent changes in consumer prices suggested, and it would not be surprising if by the end of 1983 the inflation differential between the two countries was down to 2-3 percentage points. The staff's forecast, which was consistent with recent trends, was based on the assumption that the policies followed in 1982 would be broadly maintained. Another important factor behind the staff's price forecast was the continuing large degree of slack in the economy. It was true that there had been little movement toward a lowering of the rate of inflation until mid-1982, but it was also true that most of the increase in labor market slack had been recorded in the spring of the year, and on that basis an earlier improvement with respect to inflation could not reasonably have been expected.

Nevertheless, the staff representative continued, the 6/5 program was obviously important. In fact, in the appraisal in the staff report for the 1981 Article IV consultation, the staff had strongly recommended policies geared in particular to restraining the growth in the wages of federal employees in the expectation that such policies would help create the atmosphere for a better wage performance in the private sector as well. It was hard to know whether or not the program should have been adopted before June 1982; for such measures to be successful, they had to be assured of fairly widespread acceptability. There was no doubt that the increase in unemployment in the first half of 1982, and the perception that Canada's problems had become severe, had created the conditions for a favorable reception of the 6/5 program. Even the degree of opposition shown earlier by the labor unions seemed to have become less strong. There was always, of course, the possibility under programs of that kind that the wage guidelines might become a floor rather than a ceiling. But the 6/5 figures should not be considered lax; in fact, they were sufficiently different from the 12-14 per cent rates of wage increase provided by settlements in 1981 and early 1982 to have had the anticipated effect of impressing upon the public the need for dramatic action.

The 6/5 program applied only to prices set by the federal government agencies, the staff representative added. Basically, the aim was to limit increases in those prices quite strictly in order to ensure acceptability of the program by the private sector. To grant too many exceptions would create a problem of credibility. The authorities were concerned, however, that the program should not be too rigid, and provision had been made for exceptions if they were warranted. So far, the Cabinet had approved only one significant exception.

For the private sector, the guidelines were completely voluntary, the staff representative noted. The inducements for obtaining compliance, to which reference was made in the staff report, would be of the sort that would avoid rigidities. The authorities would be willing to use government policies, for instance, with respect to government loans or loan guarantees, to favor companies adhering to the provisions of the program. The reference in the appraisal to potentially unfavorable effects on the federal finances was not to additional expenditures but to the consequences of a lag in the adjustment of the prices charged by Crown corporations.

The behavior of wages after the 6/5 program ended would depend on the situation in the labor market at the time, the staff representative said, and probably also on the development of real wages in the intervening period.

If the staff's forecasts with respect to inflation were realized, the staff representative continued, there should be room on the basis of present policies for a moderate recovery of output in the period ahead. Both the staff and Canadian officials had been expecting a rate of growth during 1983 of 3 per cent. Canadian officials had expected the recovery to start in the last quarter of 1982, and on that basis they had projected a higher year-on-year growth than that envisaged by the staff, but the latest indications pointed to the continuing weakness of the economy in the latter part of 1982.

As to evidence of the direction of economic activity, the staff representative added, there had been some upward movement in housing starts, partly as a reflection of government policies that had either been put in place or expanded in the two budget exercises of 1982. On that basis, the staff expected that the housing sector would make a positive contribution to demand in the coming year. Data through October 1982 for the whole economy and through November for the manufacturing sector showed that inventories had continued to decline, although it was reasonable to assume that the trend would end soon. The staff's forecast had not assumed a large inventory accumulation, but rather a swing from the large and fast pace of liquidation. In sum, it would be correct to state that there were as yet no clear signs of a strong movement toward economic recovery. Indeed, fixed business investment in real terms was expected to continue to decline in 1983, partly because of low profits and large unused capacity, as mentioned by Mr. Prowse and illustrated in Chart 3 of SM/83/9.

Taking up the key policy issues, the staff representative said that there was no disagreement between the staff and the Canadian authorities on the appropriate basic theme of policy, namely, to have the economy move in the direction of sustained growth, and in order to achieve that result, to eliminate the inflation problem. The staff was by no means insensitive to the serious unemployment problem faced by Canada; rather, its main concern was how to find the best way to restore an adequate economic performance in the coming years and to eliminate the unemployment problem.

The staff's clear view was that it was appropriate to maintain policies of demand restraint, the staff representative mentioned. A shift toward easier policies was likely to undo some of the progress made in the past year in reducing inflation and would be likely to place in jeopardy the entire process of restoring a more satisfactory economic performance. In arriving at that view, the staff had given weight to the effects of policies on expectations; although it had not pretended to be able to measure those effects in any precise way, it was satisfied that the effects were large and that the risks were there. In that respect, developments in the second quarter of 1982 had been discussed in some detail in various places in the staff report. There had been serious pressures in the exchange market at that time, and inflationary expectations had risen as a result of rumors that there would be a shift in policies. The budget introduced in June 1982 had successfully stemmed those rumors, because it had reiterated the general thrust of demand policies followed until that time and had in a sense strengthened the anti-inflation policy by introducing the 6/5 program. In the second half of 1982 the exchange market had responded favorably to the June budget, and also to additional measures along similar lines adopted in October 1982. As noted in the staff report, the effort to reduce inflation had involved heavy costs in the past few years, and it would be risky to change course when the benefits of that effort were beginning to be realized and a better performance of output and employment could be foreseen in the period ahead.

Official estimates of the cyclically adjusted fiscal balance, the staff representative commented, pointed to an increase in the deficit of about 1 per cent of GNP in the current fiscal year, following several years of restraint. Notwithstanding serious shortcomings in any calculation of cyclically adjusted fiscal balances, it did not seem incorrect to say that fiscal policy had been generally restrained during the entire period, in the sense that it had avoided giving substantial stimulus. Most industrial countries had been following a similar policy, which represented a break with the practice in past postwar recessions. The staff supported that general policy approach because, previously, shifts in policy at the time when slack began to appear had led to an escalation of inflationary pressures from cycle to cycle; industrial countries had been right in trying to break that process.

In referring in the staff report to the problems posed by large fiscal deficits, the focus had been on the medium term and not on the present fiscal situation, the staff representative added. It was difficult to measure the structural and cyclical components of the present fiscal deficit; the Canadian Department of Finance had estimated that of a deficit of about 5 per cent of GNP, about one third would be structural and two thirds cyclical. Those ratios would of course differ depending on the estimate that was used for the degree of slack in the economy. But the main point was that, based on estimates of the performance of the economy for the next five years or so, the fiscal deficit was likely to stay more or less within the present range, in the view both of the staff and of other observers of the Canadian situation. Consequently, the economic recovery might not be sustainable, because large deficits indubitably absorbed savings and affected the possibility of expanding investment. Incidentally, it was because of the staff's emphasis on the medium term that its general policy advice to the Canadian authorities had not changed much from year to year, although the contents of successive staff appraisals certainly had been influenced by the extent to which the economic situation or government policies had changed over time. The focus being on the medium term, the staff had suggested that the Canadian authorities should be prepared with a plan to adapt the tax system in such a way as to minimize the disincentives to savings and investment, and at the same time to try to draw up a plan for reducing the rate of growth of spending in such a way as to curtail certain programs that seemed to give rise to market rigidities.

The two rounds of spending reallocations announced in 1982 might yield benefits in terms of higher employment, the staff representative noted, but the effects were not likely to be large given that total spending was not to be raised in any major way. The staff supported the decision not to increase spending, particularly because the progress made in reducing inflation was far from being consolidated. Although it would be possible to raise output and employment by means of a major shift toward fiscal stimulus at the present time, the results might not be long lasting and the policy was likely to be unsustainable; after a while, the authorities probably would be facing ever larger deficits and a more intractable inflation problem, without any significant gains as regards output and employment. The fiscal deficit would be as difficult to reduce as at present, with the rigidity of the fiscal position being increased by a much larger debt burden and a much larger item in the budget for interest payments, neither of which would be easily amenable to reduction.

Responding to specific questions, the staff representative said that the estimated natural rate of unemployment of 7 per cent or 7.5 per cent was not seriously challenged in Canada. Apart from the traditional reasons, including the large size of the country and even the length of the winter, during which many activities stopped, there was evidence that expansion of social security programs, particularly the unemployment insurance scheme, had affected the natural rate of unemployment. It should be noted, however, that those programs had been tightened somewhat in the past three to four years. Perhaps because of that tightening, the staff estimated that the natural rate of unemployment, which had been over 8 per cent at the end of 1978, had since been falling.

Information was not available on the proportion of fiscal expenditure that was subject to indexation, the staff representative said. However, programs that were formally indexed probably accounted for about 20 per cent of public expenditure, although there were of course many other programs under which spending adjusted with the rate of inflation. As to the effect of the 6/5 program on government spending, it was estimated that it would be reduced by some Can$300 million. The largest effect of the 6/5 program on the fiscal position would be an increase in revenue--of probably more than Can$1 billion--because of the limitation imposed on the indexing factors used for the purpose of determining income tax liabilities. Of course, that estimate was based on certain assumptions about the rate of inflation and was thus subject to some degree of uncertainty.

As for the suggestion that the Canadian authorities consider announcing tax increases for the future, as had been suggested, might be done in the United States, the staff representative noted that there were differences in institutional arrangements between the two countries that would have to be taken into account.

It was difficult for the staff to look in detail into the provincial finances, the staff representative explained in response to Mr. Laske's request for additional information. As noted briefly in the staff report, the Department of Finance estimated that the provincial finances were expected to improve substantially in the period ahead. The provinces had traditionally been in surplus, although they had moved into a small deficit in 1982, both because of problems in the large deficit provinces such as Quebec and Ontario, and because Alberta, the main surplus province, had been granting tax concessions to the energy sector to improve its profitability. The prospect of a large provincial surplus was based on the assumption that the international oil price would be unchanged in U.S. dollar terms in 1983 and then rise by nearly 10 per cent a year in the following three to four years (implying a 2 per cent yearly increase in real terms). On the basis of that assumption, which the staff considered to be on the high side, the revenue of the energy-producing provinces would be rising substantially. At the same time, the Department of Finance estimated that the deficit provinces would reduce their deficits. Although the staff was hardly in a position to analyze the provincial finances in any detail, it would try to improve the information in that area in future consultation discussions.

As he understood it, the staff representative continued, the Bank of Canada was continuing the search for a new monetary aggregate to be used as a guide for policy. It would be preferable to develop an aggregate that would represent basically transactions balances. However, because of changes in financial technology, those balances included many interest-bearing deposits, which made it difficult to find an aggregate that would maintain a fairly stable relationship with interest rates and with nominal income. The staff agreed with Bank of Canada officials that it would be difficult to operate with a broad aggregate, because of problems of both interpretation and controllability. Moreover, there was no evidence to suggest that broader aggregates like M-2 would be more stable in relation to income and interest rates than the narrow aggregates.

It would not be correct to say, the staff representative continued, that the Bank of Canada had at any time followed a monetarist policy. The Bank had felt throughout that monetary policy had its effect on the economy through interest rates. The problem had been that the rising inflation and instability during the 1970s had made it increasingly difficult to reach judgments about the appropriate level of interest rates. In that situation, the Bank of Canada had felt that setting a target for M-1 offered some assurance that the interest rates that developed were more or less appropriate. The recent shift away from M-1 as an instrument of monetary policy was related to the increase in velocity, to which Mr. de Maulde had referred. Obviously, the demand for money had changed, largely but not solely because of improvements in technology, with the result that velocity had risen. It was true that monetary policy had been influenced by developments in the United States, as had been pointed out by Mr. Tshishimbi, but their influence had to be seen in the light of the considerable weight attached to the exchange rate by the Bank of Canada in setting monetary policy. However, it was not clear to what extent it had been necessary for the authorities to change their policy because of exchange rate considerations; although M-1 had been rising less than had been provided for in the target ranges set by the Bank of Canada, it could be argued that--after adjustment for a reasonable estimate of the shift in the demand for money to which he had referred--M-1 had been within the target range. Certainly, estimates of the shift varied over a broad range. But, everything considered, it seemed that monetary policy had been broadly consistent with targets set by the Bank of Canada.

As had been noted in the staff report, the use of real interest rates as one of the main guides to policy in the absence of a monetary aggregate posed the risk of an unintended easing of policy, the staff representative observed. The staff had therefore suggested that the Bank of Canada should be careful not to underestimate expected inflation or the level of real interest rates that would be appropriate as the situation evolved. In fact, it should be noted that the Bank of Canada itself did not refer to the concept of real interest rates, but rather talked of interest rates in relation to the rate of inflation, although to some extent the difference was only one of semantics. It was important to note that, depending on how real interest rates were evaluated, they might be fairly low at present. Short-term market rates were currently below 10 per cent, and the rate of inflation was perhaps about 8 per cent, on the basis of the consumer price index for the past three months, and probably higher on the basis of wage settlements. Real interest rates might thus be estimated to be about 1-2 per cent. A different conclusion could be reached if the calculation was based on the prime bank rate, which was currently 12 per cent, or other rates.

A number of special factors had kept exports at a fairly high level in 1982, the staff representative explained. Following a weak performance in 1981 due to transportation and other problems, wheat exports had strengthened considerably as Canada had entered into a large trading contract with an Eastern European country. Despite the weak demand in the United States for automobiles, the auto sector in Canada had benefited from the opening of a large facility that produced auto parts, as well as a demand shift in the United States toward larger automobiles in 1982 compared with 1981, as a large proportion of Canada's production capacity was in large automobiles. There had also been some increase in natural gas exports. It was of course interesting to note that the net export volume had been rising.

It was difficult to evaluate the competitive position of Canada, although the evidence available to the staff suggested that vis-à-vis the United States, it had not changed much in the past three to four years, the staff representative noted. However, there had recently been a large decline in competitiveness vis-à-vis overseas industrial countries. An issue that arose in that regard was how Canada should manage its exchange rate to avoid the problems created by strong movements in the U.S. dollar in relation to the currencies of other industrial countries, as had happened in the past three years. The staff tended to agree with the Canadian authorities that there was little that could be done when those exchange rate movements were very large. For instance, in a situation in which the U.S. dollar appreciated against the currencies of overseas industrial countries by close to 50 per cent, for Canada to maintain a stable exchange rate in average terms would have meant a depreciation of the Canadian dollar in relation to the U.S. dollar of about 10 per cent and a depreciation in relation to the currencies of those other countries of not much less than 40 per cent. The depreciation of the Canadian versus the U.S. dollar would no doubt have caused significant problems, and it was not certain that the smaller but still sizable deterioration in the competitive position of Canada vis-à-vis other industrial countries would have made that much difference.

As for the suggestion by Mr. de Vries that Canada might have done better by fixing the Canadian dollar in terms of the U.S. dollar, the staff representative recalled that when Canada had adopted a floating rate in 1970, it had been benefiting from a large capital inflow and was moving into a strong balance of payments position, reflecting in part the inappropriateness of U.S. policies from the Canadian point of view. In fact, for a while in the early 1970s the Canadian economy had performed better than that of the United States in many respects, although in the more recent past that had not been the case. The appropriateness of Canada having a fixed exchange rate relationship with the U.S. dollar was largely a matter of judgment about the future development of U.S. policies. In any event, no movement in that direction would seem advisable until there had been a greater convergence of economic performance in Canada and the United States.

Canada's external debt situation had been covered in somewhat more detail in the report on recent economic developments than in the past because of the greater general interest the debt issue had acquired, the staff representative commented. The fact that it had not been mentioned in the staff appraisal was due to the absence of any basic disagreement between the staff and the Canadian officials. As long as Canada maintained an exchange rate that was not unduly influenced by large official borrowing or by large market interventions, it was difficult to envisage problems arising from growing foreign debt, since capital flows were being determined in general by market forces. The large increase in external debt at the same time that the current account of the balance of payments was either in equilibrium or close to equilibrium meant that the composition of the capital account had changed, partly as a result of the policy of Canadianization, which had led to a fall in direct investment. Nevertheless, there was no strong reason to believe that those changes would have serious implications over the long run, although at certain points in time they might make the management of the balance of payments somewhat more difficult.

Overseas development assistance would continue to rise in 1984/85, the staff representative noted. As the staff understood it, Canada had reduced the estimated amount of aid to be granted to less developed countries without affecting the ratio of ODA to GNP, inasmuch as the estimated growth of the economy in the period ahead had been lowered. On that basis, Canada was still on the way to reaching the target of 0.5 per cent of GNP in aid by the mid-1980s.

As for Canada's pricing policy under the National Energy Program, the staff representative stated, if international prices were to decline, domestic wellhead prices for old oil would, in principle, be brought down at some point to 75 per cent of the international price. However, it was not possible to anticipate how the authorities would react if they were confronted with that situation.

Much of what Mr. de Groote had said on productivity had been very much in the mind of the staff in its advice to Canada, which had been directed basically at the need to improve productivity, the staff representative from the Western Hemisphere Department commented. The factors affecting the performance of productivity had been examined in previous consultation reports, and because there was no important new evidence, the earlier material had not been repeated in the staff reports. It was obvious that a significant determinant of productivity was the capital/labor ratio, and the staff had therefore placed great emphasis on providing incentives for investment to improve that ratio. The inflationary environment of the 1970s had also adversely affected productivity, and it was in that light that the staff had also stressed the need to reduce the rate of inflation.

The Chairman noted that according to Table 15 of the report on recent economic developments, the consolidated public sector had been in deficit from 1977 to 1982. Yet GNP had been increasing over the same period. The rate of inflation had increased from some 8 per cent to 12 per cent. He recalled vividly the view that had been widespread in Canada during the previous year that it was the constant budgetary deficits--in amounts that were not negligible--that had embedded inflationary expectations in the Canadian economy, for which a heavy price was being paid at present. While it was always easier to accept the need for automatic stabilizers in years of negative growth, it should not be overlooked that lax fiscal policy in previous years of positive growth had led to an accumulation of structural deficits that had strongly affected the trend of public spending and were weighing heavily in the curtailment of expenditure at present.

Mr. Joyce expressed appreciation to the Executive Directors for the depth of their understanding of the difficulties facing his Canadian authorities. Although the discussion had focused on Canada, it had usefully begun to open up some questions that had a broader bearing on the world economic outlook, and that would become of even greater relevance as countries collectively approached the point of economic upturn. Since it was not known how rapid and sustained that upturn would be, the question was to determine the appropriate policies to be followed in the transitional period.

The issue had been raised by Mr. Laske, Mr. Joyce remarked, of why Canada's problems had been so much worse than those of other countries in 1982. Undoubtedly, part of the reason was that the difficulties of the times had been made more difficult by the delay in the adjustment process; only in the last few years had Canada begun to put into effect the energy price increases that inevitably had to be allowed to flow through the system. Consequently, prices had been driven up higher in the most recent period. There were also a number of other factors, including the sharp increase in interest rates in the United States, that had kept Canadian interest rates higher than might have been necessary for solely domestic economic reasons. The automatic stabilizers had been allowed to run their course; there had been none of the discretionary tax cuts introduced in the United States. Finally, with the benefit of hindsight, it might have been better if employers had not held on to labor during the minirecession in the first and second quarters of 1980. When the current recession had begun, the dishoarding of labor had started in earnest, with dramatic consequences, but at the same time with useful effects in terms of inflation and wage expectations.

The budgetary measures taken in June 1982 were estimated to have had no major net impact on the budget deficit in 1982/83, Mr. Joyce observed in response to a question by Mr. Kafka. A number of the major tax changes introduced in the November 1981 budget had proved politically controversial and had had to be modified or withdrawn in June 1982, at which time they had been offset by other measures to reduce spending. Finally, in October 1982, further changes had been made in spending priorities, but increased expenditure in some areas had once more been offset by decreased expenditure in other areas.

Estimating the cyclical component of the public sector deficit was at best an indicative exercise, Mr. Joyce remarked, as the staff representative had mentioned. The authorities had estimated that without any change in current policies, the cyclically adjusted deficit would be reduced in 1983. It was a difficult concept to handle, of course, and the structural component of the deficit was even more difficult to define because it was not necessarily the residual, and might for instance include an element due to inflation. An adjustment also had to be made for deferred tax payments.

As to whether there were structural elements in the pattern of expenditures, or in other words, social programs that Canada could no longer afford or that were inducing labor rigidities, Mr. Joyce continued, the authorities would agree that there was at least room for considering some adjustments over the medium term. Yet, if greater rather than lesser growth was anticipated over the medium term, it might not be so necessary to dismantle social programs. Labor rigidities, particularly those of a geographic origin, were more of a problem in a country as vast as Canada.

The idea of announcing future tax measures, along the lines suggested recently in the United States, might not be as feasible politically in Canada, where the duration of parliaments and of governments was less certain, thus making an appropriate timetable difficult to devise, Mr. Joyce noted.

Consideration was being given to the possibility of finding a broader monetary aggregate to replace M-1, which had been difficult to interpret for over a year, Mr. Joyce noted. So far, the relationships had not been sufficiently stable to make a more extensive concept useful. Certainly, it was an advantage to have a touchstone, which was how the Bank of Canada had always regarded even M-1. In devising interest rate policy, the Bank of Canada had and would continue to look at a variety of factors, including the exchange rate. In general, a reliable measure did make it possible to establish a target zone, thereby enabling monetary authorities to defend their position; but target ranges had never been given as much importance by the private sector as in the United States.

The 6/5 program was becoming central to the effort to return the economy to a path of noninflationary growth, Mr. Joyce observed. The problem of how to phase out the program would eventually have to be faced. The program would also only work in the right policy framework. It had operated effectively so far because it had caught the imagination of the man in the street, dramatizing in a way that had not previously been possible the limits beyond which the economy would be placed at risk. Lower figures than 6/5 would have been less credible. As the staff representative had pointed out, there had been only one specific exception to the program with respect to prices, involving tariffs for natural gas shipments. Compliance with the program had not been made a matter of inducement in the sense that all contracts with the Federal Government had called for so-called voluntary adherence to the 6/5 rule. But in reality there was considerable psychological and public pressure to comply with the program. Even trade unions were finding it increasingly difficult to lead their membership in opposition to the 6/5 program, because the rank and file were out front in realizing that excessive wage demands would result in either interminable strikes or possibly plant closures and loss of jobs.

No doubt it was helpful, when there were a number of large and small countries in a given region, as in Europe, to have a system in which the relationship between the various national currencies was clearly defined, at least until a crisis developed, Mr. Joyce continued. But Canada and the United States were in a one-to-one relationship in which the parts were vastly unequal. Canada had had a floating rate for some time, as the Deputy Managing Director had noted at the previous meeting, and had been fairly well served by it. A floating rate offered a little more room for maneuver, although a close eye had to be kept on developments in the United States, because the Canadian dollar could not be allowed to move too far or too rapidly; in fact, it was the rapidity of any change in the rate rather than the magnitude of the movement at any given time that was of greatest concern. The Canadian authorities maintained the constant stand that they had no view as to what an equilibrium rate might be; there probably was one, and it varied from time to time, but it was not definable purely in terms of purchasing power parity because of the large influence of capital flows. There again, the authorities had developed an ability to judge instinctively whether or not the rate was slipping too fast, in which case intervention was used and subsequently, if necessary, changes in domestic policy were introduced, the lead factor being by way of interest rate adjustments. Ultimately, the Canadian dollar/U.S. dollar rate would tend to find its own level.

Canada did worry from time to time about its competitive position vis-à-vis other countries and would like to diversify its exports to the rest of the world, Mr. Joyce remarked. But it would not wish to improve its position in those respects at the cost of interfering with its ability to compete in the U.S. market or at the cost of unnecessarily exposing the Canadian economy to imported inflationary pressures that it could not control. Exchange rate policy in Canada was therefore essentially conducted within a flexible relationship with a continental neighbor that provided perhaps more limited room for maneuver than other countries had, in a field in which the room for maneuver was in any event limited.

The National Energy Program was being actively carried out, Mr. Joyce observed. Canada's energy policy was based essentially on an assumption with respect to international oil prices. The 2 per cent a year increase in real terms that was envisaged at present might not appear particularly realistic. However, nothing had happened recently to lead his authorities to change their view that Canada, as a major oil producing country, should try to the extent possible to pursue policies enabling Canada to be as self-sufficient as possible in oil. The implications of that policy were the need to stimulate exploration and development of oil resources, to encourage the use of other sources of energy, and to reduce the overall consumption of energy. In the latter respect, Canada had recorded some success. Future developments on the international oil markets were hard to judge, but if there was any likelihood of price stability for oil over the coming decade, the Canadian authorities would not change their present policy view. If large changes in international oil prices took place in the near future, the Canadian Government would unquestionably wish to review the pricing formulas used at present under the National Energy Program.

The Chairman made the following summing up:

> In their discussion of Canada's economic situation, Executive Directors noted that policies of restraint had succeeded in checking the momentum of inflation, although inflation rates remain high, particularly when viewed against price developments in the United States. Unfortunately, the fight against inflation has been accompanied by a severe recession, and unemployment has risen to a worrisome level of nearly 13 per cent. At the same time, the weak productivity performance was a cause for concern. The adoption in mid-1982 of wage-price guidelines was welcomed by many Directors. These guidelines have helped to moderate inflationary expectations and have thus speeded up the movement toward lower rates of wage and price increase. It was noted in this regard that incomes policies can play and have played a useful role when applied together with policies of demand restraint. Most Directors stressed that the Canadian authorities should continue to give high priority to the fight against inflation, inasmuch as the achievement of sustained economic growth and a lasting reduction of unemployment depended to a large extent on success in dealing with the inflation problem.

Directors noted that the federal fiscal deficit had increased substantially in the past year, reflecting to a considerable extent the economic downturn. They took note of the view of the Canadian authorities that perhaps some easing of fiscal policy may be called for in the short run if the economy failed to revive sufficiently, but that there would be no weakening in the fight against inflation. Some Directors were in sympathy with that view. However, many Directors, while agreeing that the working of the automatic stabilizers should not be blunted, cautioned against discretionary measures aimed at stimulating demand in present conditions. Such measures, in their view, could endanger the anti-inflation effort in an environment in which inflationary expectations remain strong, and therefore possibly compromise the prospects for sustained growth and a revival of private investment. Directors expressed concern about the structural component in the growth of government outlays and in the budget deficit, and they therefore encouraged the Canadian authorities to formulate policies for the medium term that would help ensure a reduction in the fiscal deficit.

Directors observed that in recent months interest rates in Canada had declined substantially, as they had in the United States, reflecting mainly the moderation of inflationary pressures and the deepening of the recession. Directors noted that the Bank of Canada had recently abandoned the target for M-1 because of problems with the interpretation of that aggregate. Directors underlined the difficulties and risks involved in the implementation of monetary policy in present circumstances, and urged the Canadian authorities to be cautious in their assessment of monetary conditions in order to avoid an unintended easing of policy. Many Directors encouraged the authorities to continue the search for a new monetary aggregate that could be used in the conduct of policy. The point was also stressed that Canada's need for capital, in order to secure an adequate growth of productive employment in the long run, has obvious implications for interest rate policies.

In general, Directors supported the desire of the authorities to avoid significantly sharp changes in the external value of the Canadian dollar. They also understood that the necessary flexibility in this area would continue to prevail.

Several Directors stressed the need for Canada to resist protectionist pressures, and called for a rollback of recent import restraint measures as soon as possible. Directors welcomed the increased flexibility in the operation of the Foreign Investment Review Agency, but some concern was also expressed about remaining restrictions involved in the policies of the Agency.

Finally, the high priority given by the Canadian authorities to development assistance was commended. They noted that despite a recent cut in the level of commitments, Canada's development assistance was continuing to increase in real terms.

2. WESTERN SAMOA - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Western Samoa, together with a decision concluding the 1982 Article XIV consultation (SM/82/245, 12/30/82). They also had before them a report on recent economic developments in Western Samoa (SM/83/5, 1/7/83).

The staff representative from the Asian Department noted that as mentioned in the footnote on page 9 of SM/82/245, the status of the proposed 1983 budget had been put in doubt following the resignation of the Government on December 21, 1982. A new Prime Minister had been appointed on December 29, 1982, and he and his Cabinet had assumed office the following day. The staff had since been informed that the Government planned to submit a revised budget to Parliament on February 7, which would be "as effective as the earlier budget." That earlier budget was the one described in the staff report. The Prime Minister, who was also the Minister of Finance, might announce other stabilization measures in his budget speech.

Mr. Prowse made the following statement:

The Western Samoan authorities regard the staff report and appraisal as balanced and fair; I fully share this endorsement of the staff's exceptionally clear and concise report. In particular, the authorities do not disagree with the staff's views on the need for adjustment, or the appropriate steps to achieve it. Much of what is needed is expected to be embodied in the budget for 1983, which indeed does very importantly reflect the discussions between the staff and the authorities in the second half of 1982.

The budget has been delayed briefly because of political developments but is now expected to be presented to the Legislative Assembly on February 7. I should add that the Government is considering introducing additional stabilization measures at that time, which would also reflect the impact of the discussions with the staff mission. As the staff notes, this budget is also expected to implement important elements of the tax restructuring package recommended by the Fund's experts in 1981.

To repeat, I have no problems with the staff analysis, but is may be helpful to the Board in considering the current and prospective economic situation in Western Samoa to recapitulate the basic structure of this small country. It may be stating the obvious to note that Western Samoa is far from being a developed country. It is a very small island state, dependent on a few agricultural products and with a limited commercial sector; in many respects, it is still a subsistence economy. The size of the country is such that delay in the arrival of one ship can have an enormous disruptive impact on activity in the economy.

The industrial potential of Western Samoa, however, is limited; its future will be in agriculture; at the moment it is essentially a two-crop economy--copra and cocoa--and agricultural diversification will take time.

To compound the difficulties of economic management and adjustment, there are some significant socioeconomic factors. In particular, the system of land tenure is not particularly conducive to encouraging productivity; the bulk of the land is owned and operated under the village system, and there can be a lack of incentive for individuals to invest money or labor or to begin improvements because the land is communally owned.

It is perhaps worthwhile mentioning all this for there is a danger when recommending certain policy prescriptions for some of the smaller members of the Fund of forgetting that they do not have the same economic infrastructure, or the same financial and banking sectors, as the larger and more sophisticated countries. The tools of monetary and fiscal policy do not have the same speed of operation (indeed they may scarcely exist at all) and are not free of constraints to the same extent. Importantly, too, the administrative structure is limited in number and capacity. Thus, understanding and, indeed, sympathy must be exercised when passing judgment on such a member's performance.

More specifically, when considering Western Samoa's economic accounts one can scarcely overemphasize the impact of external factors. It is worth remembering, for example, when considering such things as the budget and the external accounts, that Western Samoa receives relatively substantial amounts of financial assistance from other countries. That may perhaps be a somewhat technical point. Overwhelmingly important in our considerations of the real economy, however, is the brutal fact that movements in Western Samoa's terms of trade have been severely adverse between 1979 and 1982--Chart 6 of the staff paper illustrates that vividly, but it may sharpen the point to note here that its export prices fell 40 per cent over the period while import prices rose 35 per cent.

The authorities of course regret these adverse external circumstances, but also accept them as the reality which must be adapted to. They are acutely aware of the decline in the economy over the last three years, the less than satisfactory performance under two Fund-supported economic and financial programs (in 1980 and 1982), and, in particular, the need to deal with the problem of arrears in external payments. As the staff notes, there are at present some ad hoc arrangements with the oil companies to reduce arrears (most of which in fact are owing to the oil companies) but it is accepted that more needs to be done here as elsewhere.

There have been some very difficult years in the political economy of Western Samoa but the prospects now are better than for a long time that economic management will get back on track.

I believe the forthcoming budget will be evidence of the authorities' concern and good faith. It is my hope that that evidence together with this Article IV consultation will be the basis for early discussions between the authorities and the Fund staff regarding the possibilities for further Fund assistance to Western Samoa. I think that is also the hope of the Western Samoan authorities.

Mr. Ainley said that he fully endorsed the well-balanced appraisal in the staff report and also supported the proposed decision. It was clear that there was little likelihood of improvement in the foreign trade account in the immediate future. The authorities therefore had little alternative but to adjust domestic policies. Like the staff, he believed that domestic adjustment could be done most effectively within the framework of a comprehensive set of stabilization measures; in that respect, he had been encouraged by the remarks of the staff representative.

More specifically, Mr. Ainley continued, the high level of the budget deficit could not be sustained over the medium term. There again, he welcomed the helpful observation by Mr. Prowse that the budget to be introduced in February should reflect the recent discussions with the staff. The efforts being made to strengthen and broaden the tax base went in the right direction. He urged the authorities to act quickly to reduce current expenditure and suggested that it would also be prudent to ensure that capital expenditures were matched more closely to external project assistance. Particular emphasis should be given to the need to improve both the financial position and the management of the parastatal enterprises. Those enterprises commanded a large share of national resources but had not as yet generated a commensurate return.

On monetary policy, Mr. Ainley remarked, a reduction of the high rate of growth of domestic credit expansion and the accompanying inflationary pressures would depend in large part on the ability of the authorities to restrain budgetary expenditure and avoid excessive recourse to domestic financing of the deficit. He shared the concern of the authorities, mentioned on page 11 of the staff report, about the effects of the present level of interest rates on domestic savings and on private capital inflows, especially workers' remittances. Bank deposit rates should be raised substantially, as the staff also had noted, so as to ensure a more balanced allocation of resources. He wondered whether the authorities had given any consideration to introducing quantitative or qualitative guidelines for local banks with the aim of directing credit to productive sectors of the economy.

It seemed likely that there would again be a sizable overall balance of payments deficit in 1983, Mr. Ainley noted. Given that prospect and the uncertainties regarding the terms of trade, sustained efforts would be required to strengthen the export sector. In particular, he agreed with the staff that early exchange rate action could be beneficial in preventing a further erosion of recently increased producer prices and other export incentives. The authorities might also find it difficult to attract sufficient short-term external finance while payments arrears remained outstanding. He therefore joined the staff in urging the orderly elimination of those arrears.

Finally, Mr. Ainley mentioned that he had been struck by Mr. Prowse's call for understanding in passing judgment on the performance of a small island economy. It was a plea that was very much in line with his own more general comment during the discussion of the 1982 Article IV consultation with Fiji (EBM/83/18, 1/24/83), and in particular, his suggestion that it might be useful if the staff could examine the extent to which small island economies faced common problems and the possibility of drawing general lessons for the design of adjustment policies and/or adjustment programs for the members concerned.

Mr. Jaafar considered that Mr. Prowse had provided the perspective in which developments in all small island economies should be evaluated. There was limited potential for industrial development in almost all the small island economies in the Pacific. Agricultural development was inhibited by the communal system of land ownership, which did not provide much incentive for people to invest money or labor in land development. The large size of the subsistence sector also meant that the Government's revenue base was usually very limited. That, together with an underdeveloped financial system, also meant that the scope for interest rate policy implementation and financial savings stimulation was extremely narrow.

The most important causes of the serious difficulties of Western Samoa, Mr. Jaafar stated, were an expansionary fiscal policy that had to be brought under control and the deterioration in the external terms of trade, as noted in the staff report. The most effective way of reducing the fiscal deficit, he considered, would be to focus on expenditure control. The scope for raising additional revenue in a predominantly subsistence economy must be very limited, and the burden of taxation no doubt fell too heavily on the relatively small modern sector, so that incentives tended to be eroded rapidly. Improvements in tax administration could be of some help, but should not be outweighed by the need for tighter expenditure controls.

There was little that Western Samoa could do to reverse the adverse movement in its terms of trade in the immediate future, Mr. Jaafar continued. In the longer run, however, the country must try to diversify its economy to prevent it from being affected by movements in the prices of its few export commodities. In that context, a depreciation of the tala might be an appropriate way to offer incentives for export diversification and to maintain adequate incentives to the producers of existing export items. However, incentives alone would not suffice; the authorities would have to tackle the structural problems of the economy. The main potential for growth and diversification was in the agricultural sector, which could not be realized until the present land tenure system was revised. The fisheries sector might also have a certain potential that could be developed.

Finally, Mr. Jaafar noted, a substantial part of Western Samoa's population had settled in New Zealand, a development that had been both beneficial and detrimental. Skilled manpower had been drained from Western Samoa, but at the same time, pressures developing in the resource-poor island had been relieved. Certainly, the pressure on the labor market had been eased. Western Samoans who had settled in New Zealand had also made a financial contribution to the home economy, and he shared the staff view that greater incentives should perhaps be provided to increase the flow of savings to Western Samoa from emigrant nationals.

Mr. Dallara expressed his broad agreement with the staff appraisal and supported the proposed decision. The series of developments that had led to the current critical economic situation in Western Samoa had been laid out clearly in the staff report. It was imperative for the authorities to move resolutely to implement a comprehensive adjustment program along the lines set forth in the staff appraisal. It was encouraging that the authorities also recognized the need for urgent action and were apparently taking a number of steps to begin to adjust the economy.

It would be necessary first, Mr. Dallara continued, for the adjustment measures embodied in the 1983 budget to be fully carried out, including the necessary close monitoring of expenditures, needed revenue measures, and supportive monetary policy. While some of the elements of an earlier proposed tax reform package had been incorporated in the 1983 budget, others had not; for instance, the broadly based sales tax. He hoped that the authorities would give consideration to that particular measure as well as to other possible aspects of the tax reform package in order to put in place a more comprehensive revenue base. While he certainly recognized the difficulties faced by many small open economies, the problems brought on by an overexpansionary fiscal policy were not confined to them. In fact, it could be argued that the potential benefits of fiscal restraint might be more quickly and more fully reflected in the external sector of a small open economy, with supportive exchange rate and credit policies, than in a larger closed economy.

As for the further adjustment action that might be needed, Mr. Dallara went on, there appeared to be a clear necessity for an increase in interest rates. He understood from the staff report that the authorities were considering increases in both lending and deposit rates, and he encouraged the authorities to take steps in that direction.

A more flexible exchange rate policy was also called for, Mr. Dallara stated. The intention of the authorities to pursue such a policy was mentioned in the staff report, and was welcome. But the serious erosion of competitiveness resulting from past exchange rate and inflationary developments led him to inquire whether a flexible exchange rate policy was sufficient in the circumstances. He would encourage the authorities to take whatever action might be necessary to restore competitiveness and to ensure that the economy also benefited in the form of appropriate supportive pricing policies. Like Mr. Ainley, he also stressed the need for a broad-based review of all policies relating to the parastatals, which obviously played an important role in the economy but had not always had a positive impact on economic developments.

Finally, Mr. Dallara encouraged the Western Samoan authorities to make every effort to move toward the orderly resolution of their external payments arrears problems; he noted with encouragement that steps were being taken in that direction. Nevertheless he could not help but be struck by the bleak prospects facing the Western Samoan economy. They seemed to underscore more than ever the need for implementation as soon as possible of appropriate adjustment policies.

The staff representative from the Asian Department noted that although there were probably no well-established guidelines to encourage banks to lend in any particular pattern, the differential range of interest rates described on page 35 of the report on recent economic developments should encourage lending to finance development projects in Western Samoa. Banks were also encouraged to give more mortgages to stimulate investment in housing.

The Western Samoan authorities were aware of the condition of the state enterprises, the staff representative observed. With the assistance of the World Bank, the Asian Development Bank, and other interested aid donors, those enterprises were being examined closely. Some measures had already been taken, as described in the staff report, to strengthen the financial position of state enterprises, and their economic health should improve in 1983.

The reference in the staff report to a flexible exchange rate policy was meant to suggest to the authorities that they should take significant action as soon as possible, the staff representative from the Asian Department explained, to be followed by a more flexible policy so as not to erode whatever gains might be achieved. He understood that the authorities agreed with the staff assessment in that respect.

Mr. Prowse said that the real effective depreciation of the exchange rate--by about 25 per cent between 1979 and 1982--was notable. The prospect of flexible exchange rate management had been established, the authorities having recognized the clear impact of the exchange rate on the domestic economy. The issue had been handled in a most understanding manner between the staff and the authorities. In the period ahead, the exchange rate should be operated in a more realistic way.

Some de facto attempts were made to direct credit, Mr. Prowse remarked, but it was indicative of the early stage of development of the financial infrastructure that Western Samoa had no central bank. The functions of a central bank, so far as they were exercised, were in the hands of a foreign-owned commercial bank that tended to dominate the financial scene. Indeed, a potential constraint on government spending arose from the fact that the commercial bank held the government overdraft. But another prospective encouraging aspect of the present situation of Western Samoa was that an independent monetary authority was virtually ready to become operational. There were many foreign experts in Apia at present, not only to deal with fiscal problems but also to establish an appropriate monetary authority.

The relationship between the Fund and the Western Samoan authorities had changed for the better recently, Mr. Prowse observed. The prospects of a realignment of economic policy and management were much more promising, thanks to the sensitive and effective way in which the staff had handled discussions with the authorities. As he had implied in his opening statement, the forthcoming budget would reflect the staff's impact, based on its genuine interest and commitment to assisting the member. He hoped that the basis had been established for an ongoing dialogue between the Fund and the member that would result in benefits not merely in terms of the availability of Fund resources, but perhaps more importantly, in terms of the advice that the Fund could offer.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the thrust of the staff appraisal contained in the report for the 1982 Article IV consultation with Western Samoa.
>
> Directors observed that the small size of the country, its remote location, and its limited resource base made it particularly vulnerable to a deterioration in the international economic situation, and especially to a sharp worsening of the external terms of trade experienced in recent years. However, they also observed that, despite the steady intensification of economic and financial difficulties during the past several years, the corrective measures that were introduced had not been timely, or sufficiently strong and comprehensive, to bring about the necessary internal adjustment and set the external current balance on a sustainable path. Exchange rate management had not been sufficiently flexible; public spending had been far in excess of available financial resources; and extensive borrowing from the domestic banking system had become necessary to finance the large government deficits and substantial losses of state enterprises.
>
> Directors concurred in the staff's view that fiscal policy should be the main element in Western Samoa's efforts to restore financial stability. They noted with satisfaction that the draft

1983 budget would contain significant revenue-raising measures and a tax restructuring package, and that it would call for strict control over expenditure and the operations of the state enterprises so as to minimize recourse to domestic bank borrowing. The need for a broadening of the tax base was emphasized. The envisaged tightening of fiscal and monetary policies needed to be accompanied by appropriate upward adjustment of interest rates, in particular, so as to encourage remittances by Western Samoan workers abroad.

Since little improvement can be expected in the external current account in the short run, and the overall balance of payments is likely to remain in deficit for some time, it was stressed that adjustment policies should be sufficiently strong and consistently pursued until financial stability is restored.

Directors urged early and realistic action in the area of exchange rate policy. They also stressed the importance of a rapid and orderly elimination of external payments arrears in the process of moving toward balance of payments viability.

The Executive Board then took the following decision.

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to Western Samoa's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1982 Article XIV consultation with Western Samoa, in the light of the 1982 Article IV consultation with Western Samoa conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that the exchange system of Western Samoa involves restrictions on payments and transfers for current international transactions, of which those evidenced by payments arrears are subject to approval under Article VIII, Section 2(a). The Fund urges the authorities to eliminate payments arrears as soon as possible.

Decision No. 7315-(83/20), adopted
January 26, 1983

3. ANNUAL REPORT ON EXCHANGE ARRANGEMENTS AND EXCHANGE RESTRICTIONS, 1983 - PART ONE - OUTLINE

The Executive Directors considered a proposed outline for Part One of the Annual Report on Exchange Arrangements and Exchange Restrictions, 1983 (EBD/83/1, 1/3/83).

Mr. Ainley underscored the importance attached by his authorities to the Report, which was an integral part of the Fund's surveillance responsibilities, as well as a valuable source of information. The proposed outline was generally acceptable, although he did wonder whether it might not be more practical to rearrange the sections in Chapter III to deal first with exchange and payments restrictions that were within the Fund's competence before taking up import controls and other measures that were not within the Fund's jurisdiction.

Continuing, Mr. Ainley offered several suggestions designed to make the Report as clear and as informative as possible. First, he hoped that full account would be taken in the section on bilateral payments arrangements of the Executive Board's discussion of the question (EBM/82/123, 9/20/82; SM/82/169, 8/17/82). As he had stated at that time, as full a picture as possible should be given in the Report of the extent of members' reliance on such arrangements. It would therefore be useful to include data on the value of transactions under those arrangements, as well as on the number of arrangements in existence, which by itself gave only limited information about their importance. He also wondered whether it might not be possible to cover the effects of bilateral arrangements on third countries. He recognized that those effects were difficult to quantify, particularly in the aggregate, and they might best be handled in individual reports for Article IV consultations. Nevertheless, the Report on Exchange Arrangements and Exchange Restrictions could surely make a general reference to the often harmful effects of bilateral arrangements on other Fund members. It would also be helpful to include a review of countertrade arrangements in line with the views expressed by himself and a number of others at the discussion at EBM/82/123.

It would be useful to include in Chapter III a separate section dealing with discriminatory practices, Mr. Ainley considered. In the past, those practices had been categorized under multiple currency practices, but experience had shown that discriminatory arrangements could sometimes take the form of exchange restrictions. At the same time, a distinction could be drawn between discriminatory exchange restrictions and other forms of exchange restrictions; he was aware that the staff had traditionally regarded discrimination as a serious form of restriction and had quite rightly had difficulty in recommending such practices for approval by the Executive Board. While he recognized the sensitivity of the area, it should be possible for the staff to come up with a separate, neutrally worded description of such practices.

The significance of classifying members by Article VIII or Article XIV status would be better brought out, Mr. Ainley suggested, if the staff could identify those members that had eliminated all or most of their transitional restrictions in practice but had not yet adopted the obligations of Article VIII. That would be a useful way of showing the progress being made toward the Fund's objective of full convertibility.

Finally, Mr. Ainley commented, the Report would be more informative if it made fuller reference than in the past to the length of time during which the various exchange restrictions and multiple currency practices had been in effect. He recognized that the Report would concentrate on changes in those arrangements in 1982, but considered nevertheless that it would be helpful to give a general idea of how permanent or how transitional the various arrangements were.

Mr. Prowse endorsed the statement by Mr. Ainley, including his reference to the value of the Report, which was a most helpful reference document. He also agreed that it might be advisable in future to focus more on bilateral arrangements, and especially on the countertrade practices that were rapidly emerging as a major factor in trade in the Asian region.

The Report on Exchange Arrangements and Exchange Restrictions correctly stressed the introduction of new measures and their effects, Mr. Prowse observed. Understandably, little was said about the changing impact of existing measures, which could have a more serious effect if circumstances changed. It would no doubt be hard to bring out that point clearly in general terms, and it might perhaps not be appropriate to do so in the Report. Nevertheless, he wondered whether it could be mentioned, perhaps in Chapter II on main developments, that the movement of prices for some commodities had heightened the effect of existing restrictions and exchange arrangements, so that a more comprehensive view of their impact could be given.

Finally, Mr. Prowse observed, the effects of such restrictive measures on trade in primary commodities, including agricultural products, could perhaps be brought into closer focus. His intention was not to expand the Report into a comprehensive discussion of international trade, but simply to take note of some of the effects that he had described.

The staff representative from the Exchange and Trade Relations Department said that he would have no difficulty accepting Mr. Ainley's suggestion to reorder the sections in Chapter III. The results of the Executive Board's review of bilateral payments arrangements would of course be reflected in the Report. It would, however, be difficult to take into account the effect of such arrangements on third countries. To include a separate section on discriminatory practices might also raise a sensitive issue because countries would have to be mentioned by name. Reference would continue to be made to such practices in the section on exchange restrictions.

Although the focal point of the Report was on changes in restrictions during 1982, the staff representative added, an effort could be made to indicate how long restrictions had been in effect on a country-by-country basis, although that too would be a very difficult undertaking. An evaluation of the changing effect of existing measures would be conceptually difficult. More emphasis could perhaps be given to the effects of restrictions on trade in agricultural products, which were already covered in the Report.

The Executive Board concluded its consideration of the proposed outline of the Annual Report on Exchange Arrangements and Exchange Restrictions, 1983, which it approved, in light of the discussion.

The decision was:

The Executive Board agrees that the structure of the 1983 Annual Report on Exchange Arrangements and Exchange Restrictions shall be along the lines set forth in the attachment to EBD/83/1 (1/3/83).

Adopted January 26, 1983

APPROVED: July 1, 1983

LEO VAN HOUTVEN
Secretary