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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/20

10:00 a.m., February 22, 1989

R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
F. Cassell	
Dai Q.	
	C. S. Warner
	J. Prader
	P. Péterfalvy, Temporary
	J. M. Jones, Temporary
E. V. Feldman	
	M. A. Fernández Ordóñez
	N. Kyriazidis
	A. M. Othman
M. R. Ghasimi	
G. Grosche	
	Hon C.-W., Temporary
	L. E. N. Fernando
	A. Vasudevan, Temporary
	J. Hospedales
M. Massé	
Mawakani Samba	
	I. A. Al-Assaf
J. Ovi	M. Fogelholm
H. Ploix	D. Marcel
G. A. Posthumus	
C. R. Rye	
	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
D. J. de Vos, Assistant

Also Present

Asian Department: D. A. Citrin. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; P. A. Acquah, M. R. Kelly. Legal Department: J. K. Oh. Research Department: Y. Harada, E. Hernández-Catá. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; K. N.-O. Andersson, S. A. Coorey, L. P. Ebrill, O. J. Evans, Y. Horiguchi. Advisors to Executive Directors: M. B. Chatah, W. N. Engert, P. O. Montórfano, B. A. Sarr, M. A. Tareen, R. Wenzel. Assistants to Executive Directors: J. R. N. Almeida, R. Comotto, E. C. Demaestri, B. R. Fuleihan, J. Gold, J. Heywood, L. Hubloue, A. Iljas, K.-H. Kleine, J. K. Orleans-Lindsay, V. K. Malhotra, M. Pétursson, A. Rieffel, C. Schioppa, M. J. Shaffrey, Shao Z.

1. CANADA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Canada (SM/89/8, 1/11/89). They also had before them a background paper on recent economic developments in Canada (SM/89/18, 2/1/89; Sup. 1, 2/3/89; and Sup. 1, Cor. 1, 2/7/89).

The staff representative from the Western Hemisphere Department said that recent data indicated that the Canadian economy remained strong. Employment had risen substantially over recent months, and the unemployment rate had declined, from 7.8 percent in November 1988, to 7.6 percent in January 1989. Housing starts in January 1989, at an annual rate of 236,000 units, were considerably higher than the average level reached in the fourth quarter of 1988, although the relatively mild winter might have been a factor in that respect. The 12-month rate of change in the overall consumer price index had been 4.3 percent in January 1989, up from 4 percent in December 1988. Excluding food and energy, the 12-month increase had been 5.4 percent in January 1989, up from 5.1 percent in December.

With respect to developments in the external sector, monthly merchandise trade data for October and November 1988 showed that the trade surplus had narrowed substantially in the fourth quarter of the year, the staff representative continued. The staff's estimate for the current account deficit in 1988 of Can$9 billion--implying that the deficit would increase in the fourth quarter from the average level of the first three quarters--therefore seemed to be quite reasonable.

Despite the strength of the economy indicated by the most recent data, the continued rise in short-term interest rates in 1989 remained the primary reason why the staff still expected economic activity to decelerate over the course of the year, the staff representative added. A small decline in consumer and business confidence, and a reported retreat in consumers' buying intentions for big ticket items seemed to lend some support to that view.

Mr. Massé made the following statement:

> The consultation process and the resulting staff reports have very usefully complemented my authorities' deliberations on policy and economic analysis. In general, they share the views of the staff; and I would like to offer some remarks to help clarify their position on the central issues.
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> Fiscal policy continues to be the key issue facing my authorities. When the current Government first took office in September 1984, the fiscal deficit stood at 8.6 percent of GDP. Since that time, under the Government's medium-term strategy, the deficit has declined by 3.5 percent of GDP. The current fiscal situation should be reviewed in the light of this important accomplishment.

The staff argues that fiscal policy needs to be tightened and that the official status quo fiscal projections of October 1988 underestimate the magnitude of the likely deficit problem in the absence of policy action. Largely accounting for the differences in the fiscal outlook are different views on the path of interest rates in a status quo policy environment, and an unusually low provision of expenditure reserves in the official projection. With respect to interest rates, my authorities have revised their outlook upward to reflect recent developments. This revision is mainly to short-term rates over the first few years of the projection horizon, and has raised the projected status quo fiscal deficit, particularly over the short term. Nevertheless, a difference still exists between the views of the staff and my authorities over the medium term.

In this connection, the staff and my authorities appear to be working with somewhat different assumptions on the pace of fiscal consolidation in the United States--a key consideration, given the close links between the U.S. and Canadian economies. My authorities are assuming a somewhat greater degree of U.S. fiscal consolidation over the medium term than is the staff. This, in turn, has an important impact on the interest rate outlook for both the United States and Canada. Moreover, my authorities' analysis suggests a greater responsiveness of interest rates to a given cut in the fiscal deficit than is implied by the staff's model, which, in turn, reinforces the process of fiscal consolidation. Thus, they believe that Canadian interest rates could decline below the levels projected by the staff over the medium term, even in a status quo Canadian policy environment. Notwithstanding, an upside risk to the fiscal deficit forecast is acknowledged. Moreover, even on the basis of the official status quo projections, the fiscal situation remains difficult.

My authorities generally agree with the staff's concern about not including provisions for replenishing fiscal reserves over the medium term. However, from a tactical perspective, building reserves into the fiscal projections can be counter-productive during a period of restraint. Reserves are generally used to fund new expenditure initiatives, and building them explicitly into the fiscal framework increases the risk that new initiatives would be found. Thus, by excluding reserves, an additional measure of discretionary control over spending on new initiatives is introduced by ensuring that any new initiatives would be financed through reallocations of existing expenditure or would be postponed.

The staff recommends that the fiscal stance be tightened by an ambitious program of front-loaded, discretionary deficit reduction. My authorities agree with the staff on the need for further substantial progress on fiscal consolidation and on

the desirability of front-loading the deficit reduction as much as possible. In this connection, the Government is currently engaged in an extensive and intensive effort to identify means of reducing the deficit. The areas suggested by the staff where cuts could be achieved are among a broader array of options currently under consideration. In this regard, however, it is worth noting that there are important constraints. After four years of fiscal restraint, most of the easy and large expenditure cuts have been made; revenue options are limited somewhat by recent and prospective tax reform initiatives; tax increases have already played an important role in reducing the deficit; and, in some cases, tax rates are close to levels that could trigger a shift in economic activity to other countries with lower tax rates. Nevertheless, my authorities believe that the forthcoming budget will demonstrate their commitment to continuing fiscal consolidation.

An additional important step toward achieving further progress on fiscal consolidation has been taken with the establishment of a new Cabinet committee on expenditure review, chaired by the Prime Minister. This committee is charged with ensuring the appropriate management of the expenditure framework, given the priorities of the Government. In the current environment, this means identifying expenditure cuts to reduce the deficit, and overseeing the implementation of expenditure reductions. Given that the expenditure review committee is a Cabinet one, its decisions will be final.

The long-term goal of Canadian monetary policy continues to be the achievement of stable prices, which, as the staff notes, will help the economy operate with the greatest possible efficiency. In the past year, domestic demand/supply conditions have tightened, and inflationary pressures have intensified. In response, monetary conditions have been tightened to curb the pressures of excess demand. Despite the fact that inflation has not increased (on a consumer price index basis), neither has it moved closer to my authorities' long-term goal. However, monetary policy remains committed to taking actions in a timely manner, both to discourage inflationary pressures and to achieve sustained progress toward price stability.

In the implementation of monetary policy, the Bank of Canada pays close attention to a range of indicators, including monetary and credit aggregates. In particular, the M2 and M2+ monetary aggregates have been used as policy guides internally--along with other variables--given their close relationship to movements in total spending. However, at the policy level, active consideration has not been given to establishing formal published targets for these aggregates, since work at the Bank of Canada has drawn attention to the size of random money demand shifts and has raised concerns about the controllability of

these aggregates. In this connection, the appendix prepared by the staff on money demand in Canada is seen as corroborating some of the Bank's own concerns about the appropriateness of a return to monetary targeting.

The staff has noted that relatively less weight is being attached to the exchange rate as a guide for policy than in the past. This reflects primarily the increased concern about inflation arising from excessive domestic demand pressures. In addition, the Governor of the Bank of Canada has noted that variables like exchange rates and interest rates should be viewed as policy channels, with a view to achieving the central objective of monetary policy, good domestic price performance. At the same time, it is noteworthy that the strength of raw materials prices in 1988 relative to 1987 prices made a major contribution to the appreciation of the Canadian dollar.

My authorities agree with the staff that some impediments to the efficient operation of Canadian markets remain. However, since 1984, when the Government made the reduction of impediments to efficiency a priority for action, considerable progress has been made. Deregulation of the energy and transportation sectors, replacement of the Foreign Investment Review Agency by Investment Canada, privatization, stage one of tax reform, and the Free Trade Agreement (FTA) with the United States are examples of important steps that have been taken already to improve the functioning of markets in Canada. In addition, financial sector deregulation is being implemented and reform of the sales tax is yet to come. Furthermore, as regards trade policy, the Government remains firmly committed to the Uruguay Round of multilateral trade negotiations, and will continue to play a leading role in the negotiations. Achieving further progress in reducing structural impediments on all fronts remains a priority of the Government.

In a supplement to the background paper, the staff has prepared an interesting appendix on the structural determinants of the natural rate of unemployment in Canada. The staff presents the results of econometric work showing the natural rate of unemployment to be about 8 percent, which is consistent with the results of work done recently by my authorities as well. However, my authorities' work also suggests that some potential exists for the natural rate to decline over the medium term. Factors pointing in this direction are the declining share of youth in the labor force, and the emerging trend of a lower average duration of unemployment, and, hence, less structural unemployment. Additional positive influences include some regional broadening of employment growth--which will result in relatively greater job creation in regions with the highest unemployment rates--and the impact of less generous unemployment insurance benefits, as lower unemployment reduces eligibility

for extended benefits. Consequently, my authorities believe that there is some scope for unemployment to decline over the medium term without necessarily being associated with an acceleration in inflation.

My authorities support the work that the staff has done on alternative medium-term scenarios. Their own research shows that deficit reduction can create an environment of lower interest rates and lower inflation, which would put the economy in a better position for sustained growth over the medium term. Of particular interest are the illustrations of the importance of credibility, front-loading of adjustment, and the interaction between monetary and fiscal policies. My authorities feel that the medium-term scenarios should be interpreted broadly and largely qualitatively to suggest the appropriate general direction of policy. However, as noted above, their analysis would suggest that deficit reduction could lead over the medium term to a somewhat lower path for interest rates than the staff's scenarios indicate.

Similarly, my authorities' medium-term outlook projects a smaller current account deficit than is shown in the staff's baseline outlook. To some degree, this is related to the differing views on the fiscal prospects discussed above. However, in addition, good relative inflation rate performance in Canada, an assumption of some real price increases for key Canadian export commodities, a moderating pace of import-intensive capital goods spending, and an assumed depreciation of the Canadian dollar against overseas currencies are also important aspects of the expected current account improvement.

My authorities share the staff's views that fiscal policy is the central issue and that they face a considerable fiscal problem. Moreover, my authorities feel that further substantial progress toward fiscal consolidation is needed and that a front-loaded response would be appropriate. They have indicated that their commitment to continuing fiscal consolidation will be reflected in the forthcoming budget, which my authorities believe will demonstrate the will to take difficult decisions.

Mr. Warner made the following statement:

In my authorities' opinion the staff report contains a thorough and accurate analysis of the Canadian economy. We are in substantial agreement with the staff appraisal, especially with the conclusion that the authorities need to re-establish some momentum in their efforts to reduce the federal budget deficit. We also share the view of the staff on the importance of maintaining a restrained monetary policy, and of implementing further structural reforms.

Broadly speaking, the authorities are to be congratulated for another year of solid economic performance. Sustained GDP growth coupled with a falling inflation rate, a declining unemployment rate, and shrinking fiscal deficits since 1984 are impressive achievements. We strongly commend the authorities for their commitment to restoring price stability, to removing structural constraints, and to achieving fiscal balance. During the past year, there have been some especially favorable developments: growth has notched down to a more sustainable rate, business investment has been strong; the labor force has been fully employed; the current account deficit has narrowed; and the Canadian dollar has strengthened. The major cloud on the horizon appears to be inflationary pressure: average wage increases have been rising; capacity utilization is approaching previous peaks; and the federal budget deficit remains unsustainably large.

One of our major concerns in the area of fiscal policy is that the pace of reductions in the federal budget deficit appears to have slowed markedly in 1988. Indeed, the authorities' budget forecast in October 1988 projected a higher deficit as a percent of GDP for 1989/90 compared with that projected for the current fiscal year. We concur with the staff's conclusion that there appears to be little choice but to cut expenditures in order to reduce the deficit. Transfers to persons as a percent of GDP rose sharply during the 1982 recession, but have yet to drop significantly, despite seven years of strong economic growth. At the same time, we congratulate the authorities on the success of the "provincial and local governments and hospitals sector" in eliminating its fiscal deficit.

Perhaps the most striking information in the staff report is the table on page 6 containing projections of the federal government fiscal deficit and of the corresponding ratios of federal debt to GDP under current policies. Specifically, the table shows the ratio of federal government debt to GDP rising from about 50 percent in the mid-1980s to about 60 percent in the mid-1990s, based on the estimates of both the staff and the authorities, with the latter using somewhat more optimistic assumptions. We strongly support the staff's recommendation that the authorities should seek to bring the deficit below the path indicated in these projections and thereby to free up resources that will make the private economy more productive, and to assure some flexibility for discretionary public spending for priority purposes in the future.

The staff repeatedly notes that monetary policy has become more restrictive. At the same time, the monetary authorities have declared that monetary policy is conducted on the basis of a number of measures, only one of which is growth in monetary aggregates. Nonetheless, we see that M2 grew at an annual rate

of more than 12 percent in the second half of 1988. The staff attributes this rapid growth in money demand to the strength of the economy and to the decline in rates on money market assets through March 1988. Mr. Masse and the staff could usefully elaborate on the causes and implications of the recent growth in monetary aggregates.

With respect to external policies, we noted with some interest the widening of the current account deficit in the staff's medium-term baseline projection. In isolation, we might share the staff's concern about this trend. In the context of current efforts to reduce global payments imbalances, however, we wonder whether it is not a helpful trend. The staff could usefully comment on this point.

My chair's views on Canada's current account deficit have been influenced further by the country's rising foreign exchange reserves. Since 1986, Canada's reserves have more than quadrupled, from US$4 billion to US$16 billion. Holdings of U.S. dollars alone have increased in the same period from US$2.3 billion to US$12.5 billion. The staff notes that the authorities view intervention as a means of moderating fluctuations in exchange markets. The authorities have also taken the position that intervention, even backed by appropriate monetary and fiscal policies, has little lasting impact on the value of the currency. Yet the large accumulation of reserves since 1987 does not appear to have been entirely consistent with stated policy objectives. Instead, the sustained buildup of reserves suggests a pattern of comparatively one-sided intervention, with the effect of limiting upward movement of the Canadian dollar. Mr. Massé and the staff could usefully comment on whether the Canadian dollar is being allowed to reflect its true strength.

On the subject of structural policies, we are interested in the implementation of the second stage of Canada's tax reform program, involving the introduction of a federal sales tax. The staff or Mr. Massé should elaborate on the implications of this shift for the competitiveness of Canadian producers in the context of the FTA with the United States. 'th respect to the FTA more directly, we appreciate the review of literature, presented in Appendix IV of the background paper, analyzing the impact of that Agreement on the Canadian economy.

With respect to labor policies, we were interested in the view of the staff, developed in Appendix VI of the background paper, that Canada is "within range" of the natural rate of unemployment and by the paragraph in Mr. Massé's opening statement pointing to the potential for the natural rate to decline over the medium term. In this connection, the staff report also notes substantial regional disparities in unemployment rates, and the existence of government programs that appear to hinder

labor mobility. Does this suggest a need for structural reforms? For example, with greater regional mobility of labor, it might be possible for Canada to achieve higher levels of employment and output without exacerbating inflationary pressures.

In comparing the alternative scenarios presented by the staff, we were impressed by the benefits associated with primary deficit cuts in the range of 2 1/4 to 2 1/2 percent of GDP. In this connection, we were encouraged by the reference in Mr. Massé's opening statement that his authorities will demonstrate their commitment to continuing fiscal consolidation in the forthcoming budget. We certainly wish his authorities well in this regard, and hope that other countries will be able to benefit from Canada's example in their own fiscal consolidation efforts.

Mr. Cassell said that he could endorse the staff's assessment, and noted that many of the complex problems described were found in other developed economies, making the staff report and its technical annexes of considerable general interest.

The Canadian economy was at a critical juncture, Mr. Cassell remarked. The strong economic performance of the past six years had come up against capacity constraints, most evidently in the labor market, and the personal savings rate had been falling. There was thus a clear danger that the current fiscal stimulus to nominal income growth would increasingly be reflected in higher inflation, instead of in further real growth, thereby undermining longer-term performance.

Moreover, failure to reduce the fiscal deficit and to stabilize public debt might make fiscal consolidation more difficult in the future, Mr. Cassell commented. At the very least, it exposed economic policy to unforeseen developments in international interest rates, as the medium-term projections demonstrated. The authorities could be diverted from longer-term goals by the short-term exigency of having to finance a rapidly growing interest burden. If fiscal adjustment were delayed, the eventual cost was likely to be much higher.

It was disappointing that the very creditable start made in fiscal consolidation had stalled in the past budget, Mr. Cassell noted. Indeed, there appeared to have been some slippage. Contingency reserves and revenue overshoots had been used to finance expenditures in the period preceding the recent general election, and budget assumptions had proved to be too optimistic. His main concern was that the authorities should envisage more than just limited fiscal adjustment over the next two years. The front-loaded fiscal adjustment recommended by the staff seemed especially sensible, both in economic and political terms. He was therefore encouraged by Mr. Massé's opening statement that the authorities believed that further substantial progress toward fiscal consolidation was needed,

that a front-loaded response would be appropriate, and that the forthcoming budget would demonstrate the Government's will to take difficult decisions.

There were particular problems in Canada in leaving too much of the burden of restraining demand to monetary policy, Mr. Cassell stated. As in the United Kingdom, monetary aggregates had often been very difficult to interpret. He noted the current attention being given by the authorities to M2 and M2+ as indicators of monetary conditions and that there was no intention of targeting those aggregates at present. He was interested in knowing more precisely what role was envisaged for M2 and M2+ in relation to other monetary indicators. The staff report noted that somewhat less attention was currently being placed on the exchange rate than in the past, a point that only highlighted the dilemmas that the monetary authorities could face when confronted with rising inflation and a weakening external account. The marked appreciation of the Canadian dollar over the past two years had undoubtedly assisted the authorities in keeping inflation in check, but it was also a factor in the less than satisfactory outlook for the current account deficit.

The external deficit had been contained in 1988 by temporary factors, and was expected to start widening again, Mr. Cassell added. The loss of competitiveness resulting from the real appreciation of the Canadian dollar and from that threatened by increased inflationary risks therefore came at a particularly inopportune time. While he endorsed the authorities' willingness to raise interest rates to combat inflation, the current state of the Canadian economy was not one in which the appropriate mix would be a lax fiscal policy and a tight monetary policy.

Canada was one of a number of industrial countries that had been implementing far-reaching structural reforms, Mr. Cassell continued. Especially in view of the capacity constraints, he strongly urged the authorities to speed the next stage of structural reform--not least, in tax reform, financial liberalization, and the removal of distortions in the agricultural and labor markets.

There was also a need to complete the work of the U.S.-Canada FTA at the multilateral level, as only with global competition could the full benefit of that agreement be reached, Mr. Cassell pointed out. In that respect, the authorities' clear commitment to the successful conclusion of the Uruguay Round and their recent action on imports from the Far East were encouraging. There were obviously interesting parallels with the current process of internal liberalization in the EC. He saw no reason why there should be any difference in Directors' expectations about the process in North America and in Western Europe.

While the Board could look back on a further year of good performance by the Canadian economy, it must also look at the current capacity constraints and the consequent threat of higher inflation, Mr. Cassell suggested. It would be dangerous to leave the task of resisting that threat entirely to monetary policy; there was a clear need in the current

situation to reduce the fiscal deficit. He endorsed the staff's recommendations in that direction, and welcomed the indications given by Mr. Masse that the forthcoming budget would demonstrate the authorities' commitment to continuing fiscal consolidation.

Mr. Péterfalvy said that he had read the staff report and Mr. Masse's opening statement with considerable interest and with growing recognition of how closely related developments and problems in the two major North American economies were. Considering the public debate on the FTA in the United States, and in Canada especially, he was even more convinced that the Agreement did not as much create a new situation, but, instead, regulated a special relationship between two relatively integrated economies. The U.S.-Canada FTA was nevertheless welcome, and he believed that, just as it would be difficult to conceive of Belgium outside of the EC, so would it be to keep Canada's economy separate from that of the United States in any manner without detrimental impact on the economic development of the two countries. On the basis of the aforementioned points, the problems that he would elaborate on might sound familiar to those that he had dealt with in connection with the Board discussion on the Article IV consultation report for the United States (EBM/88/130 and EBM/88/131, 8/29/88).

Despite some improvements over a few years in the current decade, the budget deficit had been, and would remain Canada's main problem in the foreseeable future, Mr. Péterfalvy considered. The staff was correct that the deficit was of a structural nature and would require corrective measures involving structural policy changes. Unfortunately, as the staff had rightly pointed out, current policies might result in a medium-term trend of higher than anticipated deficits of 1 1/4 percent of GDP a year.

To achieve a deficit reduction, the needed structural measures should obviously be concentrated on the expenditure side of the budget, and the spending cuts per se would have to be concentrated primarily on the welfare state aspects of the Canadian budget, mainly on transfer payments and subsidies, Mr. Péterfalvy explained. He referred first to the labor programs that the staff in some respects believed were impeding interregional labor mobility. Agricultural subsidies were another possible area for cutting expenditure, although agricultural spending cuts were not commonly made in other countries, including Canada's southern neighbor. He hoped that the political problems relating to the needed extensive cuts in the involvement of the Canadian Government in the agricultural sector would not be greater than those encountered in several developing countries, where similar measures had been greatly advocated by many Directors.

While reiterating the need for expenditure cuts, he could not but concur with the staff's view that the revenue side of the budget should also be considered for action, Mr. Péterfalvy added. However, he did not see the need for increasing revenues. On the contrary, the size of the budget relative to the Canadian economy was comparatively large, and it would thus be desirable to cut the high concentration of the budget in

the national economy. The needed streamlining of the tax system that had been suggested by the staff could most certainly result in less revenues and, consequently, less government intervention in the economy. Nonetheless, Directors knew that less intervention in an economy should not necessarily be regarded as negative.

He agreed with the notion that the aim of monetary policy should be the achievement of price stability, Mr. Péterfalvy stated. As suggested earlier, however, if fiscal restraint were implemented and the budget thereby stopped derailing monetary policy effectiveness, that policy could take over the role of sustaining an acceptable growth rate in the economy, instead of concentrating predominantly on resisting the inflationary pressures that could, if he understood correctly, emanate from insufficient fiscal restraint. A possibly related decline in interest rates and the accompanying expected greater depreciation of the Canadian dollar vis-à-vis the U.S. dollar could bring about the desired fall in the Canadian current account deficit and increase the country's competitiveness with its southern neighbor. In any event, fiscal restraint should facilitate the integration of the two economies on positive terms.

The staff had rightly pointed out that a favorable outcome to the not too serious Canadian situation required a combination of appropriate fiscal, monetary, and structural policies, Mr. Péterfalvy concluded.

Mr. Grosche made the following statement:

> I broadly endorse the staff analysis and recommendations, and have views very much in line with those of Mr. Warner and Mr. Cassell. In evaluating policy performance in Canada, one is always aware that the country's economy remains in many respects closely linked to that of its neighbor to the south. And progress in increasing the efficiency of Canada's economy depends largely on developments in the United States.
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> Nevertheless, there is a lot that the Canadian authorities can and should do to rectify domestic imbalances. In the first place, this holds true for fiscal policy. Despite some welcome progress over the past three years, Canada's fiscal position has been markedly weaker than in the majority of other G-7 countries. While it was politically very difficult to go ahead with a bold fiscal plan in an election year, a tightening of spending plans should no longer be delayed. Ideally, one would hope that the authorities follow the course of front-loaded action outlined by the staff under its second scenario. As illustrated in that scenario, bold measures to cut spending should result in highly beneficial effects over the longer run, and would not even significantly dampen economic activity in the short run. Such measures would stabilize the ratio of debt to GDP, which is necessary for maintaining macroeconomic stability; interest payments are already limiting fiscal policy's room for maneuver quite markedly. In addition, the growing net public

debt has the potential of negatively affecting Canada's external accounts. Equally important are the implications for business confidence and future expectations, for capital formation and medium-term growth. In other words, spending cuts would prevent a destabilizing public sector demand on savings. And, it must not be forgotten, such cuts would help the monetary authorities in their difficult fight against inflation.

It is regrettable that the timing of this Board discussion does not permit taking into account the fiscal stance that will be adopted in the new fiscal year. I am encouraged, however, that Mr. Masse's authorities agree with the staff on the need for further substantial fiscal action, and I look forward to the forthcoming budget. Further information about it would be appreciated, as soon as Mr. Massé can make it available to Directors.

On monetary policy, I have almost nothing to add to the comments made by the representatives of the Bank of Canada during the discussions with the staff. In particular, I should endorse their determination "not to repeat the experience of the late 1970s when monetary policy frequently was criticized as being too tight but, in retrospect, proved to have provided insufficient restraint to keep inflation in check."

The pragmatic course steered by exchange rate policy to date seems to have been quite appropriate. I fully endorse the Bank of Canada's view, as expressed in Mr. Massé's opening statement, that "variables like exchange rates and interest rates should be viewed as policy channels, with a view to achieving the central objective of monetary policy, good domestic price performance." Like the authorities, I am convinced that good domestic price performance is a key element for balanced future growth. I am also confident that the authorities will monitor closely external competitiveness and take timely action if an erosion of competitiveness were to occur.

The FTA with the United States is welcome, and should result in lower consumer prices and expanded market opportunities. More rapid growth in North America would lead to greater trade creation. However, one possible risk of the trade agreement is that demand may be diverted from lower-cost foreign suppliers who remain outside the Agreement. A worldwide, multilateral lowering of trade barriers would reduce this risk. It is therefore welcome that the authorities attach great importance to fostering multilateral trade liberalization, and have taken some concrete steps toward freer international trade.

To conclude, Canada's leadership role in catalyzing the cooperative efforts of other members in support for Guyana are highly appreciated by my authorities.

Mr. Feldman made the following statement:

The medium-term strategy pursued by the authorities since 1984 remains appropriate. Considerable progress has been made since then, and economic performance in 1988 was generally favorable, with a relatively high rate of real growth, a further decline in the unemployment rate, and an inflation rate similar to that in Canada's trading partners. Nonetheless, the reduction of the fiscal deficit has been slower than expected, and relatively little progress is anticipated in this area over the next couple of years. The burden of public debt is high by industrial country standards, and is expected to increase in coming years. Moreover, while some important structural reforms have been undertaken or are contemplated, a number of rigidities still remain, hindering the achievement of employment and growth objectives in the long run.

The challenge facing the authorities is to expand the supply capacity of the economy and, at the same time, to maintain restraint on demand. The need for raising aggregate supply is heightened not only because the rate of capacity utilization is close to its peak, but also because of the still relatively high rate of unemployment, especially in certain regions of the country. In any event, the economy has been recording high rates of real domestic demand growth over the past four years. Despite the fact that such growth over the past two years has been fueled mainly by considerable private fixed investment, the staff still believes--as on the occasion of the 1987 Article IV consultation (EBM/88/15, 2/3/88)--that further substantial reductions in the fiscal deficit, continuation of a monetary policy aimed at containing inflationary pressures, and additional structural measures to improve economic efficiency are required.

As Mr. Massé points out in his opening statement, his authorities share the staff's view that fiscal policy is the central issue, that further substantial progress toward fiscal consolidation is needed, and that a front-loaded response would be appropriate. The staff recommends that the front-loading be strong, with action concentrated in the next two fiscal years. In the staff's view, spending reductions should be given priority, with particular attention being paid to cuts in transfer and subsidy programs. Action on the revenue side should also not be excluded as a possibility.

Although the growth of public debt has clearly been high during the past several years, and the fiscal outlook for the next couple of years does not appear to be very encouraging, I agree with the authorities that it is becoming increasingly difficult to cut public expenditures and to increase fiscal revenues. I wonder whether a strong front-loaded cut in fiscal stimulus is appropriate, since the still high level of unemployment is calling for further expansion of economic activity. Instead, Canada could reduce the fiscal deficit by following a less front-loaded pace of fiscal adjustment than the one proposed by the staff, and sustain the current path of growth through enhancing the supply capacity of the economy, preferably by using measures that have a regional orientation. While I recognize the dangers of a relatively large fiscal deficit and an increasing public debt, the staff projections show that sustaining growth through action on the supply side would permit the Government to grow out of its debt in no more than five to six years without a major front-loaded reduction in the nominal value of the existing fiscal deficit. Perhaps a rapid fiscal adjustment would be desirable; but as Mr. Massé points out, Canadian policymakers are facing important constraints. After four years of fiscal restraint most of the easy and large expenditure cuts have been made, and revenue options are now limited.

An expansion of the economy's capacity should be pursued through structural measures aimed at further reducing unemployment and promoting efficient use of human resources. Labor flexibility and mobility should be fostered, especially because regional disparities in the unemployment rate have remained large, notwithstanding continued strong growth of overall output and employment. In this connection, the staff's econometric analysis shows, in broad coincidence with recent Canadian work, that the natural rate of unemployment is about 8 percent. The staff or Mr. Massè may wish to comment on the consistency of these results, and Mr. Massé may elaborate on his reference to there being some scope for unemployment to decline over the medium term without necessarily causing an acceleration in inflation.

Structural reforms in the fiscal and trade areas could also be helpful. In the fiscal area itself, efforts to accelerate the implementation of the second stage of tax reform should be pursued. In the trade area, the FTA between Canada and the United States should enhance the confidence of private sector investors and raise the level of Canada's real GDP. I hope that the implementation of the Agreement is fully consistent with the advocacy by Canada and the United States of trade liberalization in a multilateral context. Trade diversion effects of the Agreement should be avoided, and the growth of imports from the rest of the world should be monitored carefully. As a means

of expanding trade with developing countries, the authorities should limit protectionist practices, particularly in agricultural trade.

Mrs. Ploix made the following statement:

The state of the Canadian economy gives me a sense of déjà vu. At the discussion of the 1987 Article IV consultation with Canada (EBM/88/15, 2/3/88), I expressed satisfaction with the progress made in terms of growth, investment, and employment, but was concerned about the risk of overheating in the economy and the limited progress made in reducing the budget deficit. This year, as in the previous one, I am obviously gratified with the fine performance of the Canadian economy, exemplified by continuing steady growth--although at a rate much lower than in 1987--strong investment, continued improvement in the employment situation, and the containment of inflation. Yet, I again note that little progress has been made in reducing the budget deficit, and that there are some signs of renewed inflationary pressure.

Reduction of the budget deficit must clearly be the top priority of economic policy. The persistence of that deficit necessarily increases the debt burden, which is already very heavy--interest payments alone are slightly larger than the deficit--creating a snowball effect that could be difficult to halt and that could impede the expansion of investment at a time when the saving rate has declined markedly. The authorities have worked hard on this problem; in the three years since 1985, the federal budget deficit has been reduced from 8.5 percent of GDP to about 5 percent of GDP. But this trend was interrupted in 1987/88, with the deficit stabilizing at about 5 percent of GDP and with no progress being made since then. Against this background, the authorities' forecasts for the next five years may seem overly optimistic; they anticipate that the deficit will fall to 2.7 percent of GDP by 1993/94, even though they plan no significant policy changes. Moreover, these predictions are based on assumptions of favorable economic developments, especially with respect to interest rates. Yet even if the authorities' scenario proves realistic, the adjustment would be very gradual, with the ratio of debt to GDP stabilizing in three or four years at best; if I recall the Board's discussion on Canada the previous year, however, this stabilization should take place by 1990.

In these circumstances, I fully support the staff in urging the authorities to take significant action quickly in the fiscal field. Such action is essential to assuring the credibility of their budget policy, preserving the confidence of investors, and permitting an easing of interest rates. The second scenario

prepared by the staff shows the advantages of such a strategy, which would also have very little recessionary effect. I fully recognize that front-loaded fiscal adjustment is not an easy task, but, nonetheless, the authorities should explore every possible path. As I see it, this means not only taking action with respect to the level of expenditure, but also not hesitating to consider action on the revenue side.

It is gratifying to note the improvement in the fiscal condition of local governments, which are currently showing a small surplus. However, the surplus in the pension funds fell sharply in 1988. Considering Canada's demographic structure, the staff or Mr. Massé could usefully comment on the financial outlook of the pension funds for the coming years.

Monetary policy has an important role to play in controlling domestic demand and in preventing a resurgence of inflation. In view of the historically very high level of capacity utilization, and of the wage pressures that have been observed recently, vigilance is certainly called for. In this regard, the authorities' existing monetary policy seems pragmatic and appropriate. The somewhat lower priority given by the authorities to the objective of exchange rate stability is understandable in the current situation. The question one can ask is whether, under current conditions, the objectives of fighting inflation and maintaining exchange rate stability might not eventually conflict with each other, particularly considering the lack of progress in the budget area. Neither must the Board lose sight of the fact that any tightening of monetary policy will, with interest costs being high, make the condition of government finances slightly worse. It is clear that monetary policy, however prudent, must not bear the entire burden of adjustment by itself.

As for the external sector, I again see relatively large differences between the staff's forecasts and those of the authorities. These differences are not necessarily surprising, because they reflect those relating to the reduction of the budget deficit. As the staff points out, the current account imbalance finds its essential counterpart in the government deficit, which makes the fiscal deficit all the more worrisome. I think I also discern a difference between the staff and the authorities on the competitive outlook for Canadian companies, especially on the consequences of the Canadian dollar's appreciation over the past two years. The staff could usefully comment on this.

I also wish to stress the need to continue strengthening and broadening the foundations of the Canadian economy. The authorities are to be complimented on the major effort that they have made in recent years to do just this, through tax reform,

deregulation in certain sectors, and the conclusion of a free trade agreement with the United States, among other measures. I urge them to continue pursuing this path; I am thinking in particular of the second phase of the tax reform, which should have significant favorable effects on growth, and which, I hope, will be applied as broadly as possible. In addition, could more not be done to reduce rigidities in the labor market, especially the obstacles to interregional mobility?

The authorities are to be commended for their efforts in Guyana. I refer especially to Mr. Massé, who, as chairman of the support group, is playing a major role in the process.

Mr. Rye made the following statement:

The Canadian economy continues to perform relatively well, and the key economic indicators present a generally gratifying picture of recent developments. Although growth has moderated, unemployment has fallen, and the current account deficit has declined.

In the face of this continuing prosperity, criticism might seem carping. However, it does seem clear that underlying inflationary pressures have intensified with the continued buoyancy of private sector demand. The authorities currently face the need to contain and to try and reduce inflation, while ensuring that the measures taken to achieve this goal do not have an excessively adverse impact on economic activity. It appears that monetary policy, at least, is playing its full part in the fight against inflation; indeed, it is probably being asked to do too much, with potentially quite adverse consequences.

This brings one quickly to the fiscal side where, as has been usual with Canada over recent years, most of the real questions lie. In 1988, the majority of Directors stressed the need for fiscal consolidation and saw that a reduction in fiscal stimulus would be appropriate. Since then, the underlying fiscal adjustment has been minimal, and has made little contribution to moderating demand and thereby to reducing inflationary pressures. Looking ahead, the staff's projections to 1994--which are based on more realistic assumptions than those of the authorities--reinforce the conclusion that the fiscal area is the one in which action is needed.

It is true that Canada does not appear to be under any great pressure, whether from financial markets or other areas, to slow the growth of its debt. No doubt, it is tempting for the authorities to conclude that they can essentially carry on as before with a less than optimal mix of policies. However,

this would be a high-risk strategy. Under current policies, any downturn in the economy would leave the authorities with very little room for maneuver--and as Directors have seen in other cases, sentiment in financial markets can reverse very quickly indeed.

With the economy still growing strongly and the elections completed, it appears to be a propitious time for undertaking fiscal adjustment. I agree with the staff's suggestions on how to reduce the deficit--that is, to concentrate on expenditure cutting, while being prepared to contemplate revenue-raising measures to the extent necessary. I agree also that, given Canada's very mixed record of fiscal restraint, such a strategy would need to carry substantial front-loading for it to be credible.

I note Mr. Massé's reference to the establishment by the Cabinet of an expenditure review committee. As I understand it, the committee's mandate is "to ensure that the Government's expenditures continue to be directed to its highest priorities and that expenditure control continues to contribute to deficit reduction"--not very "fighting" words! However, the next budget will be the test of the authorities' resolution.

In passing, I note the authorities' acknowledgment of the political difficulties involved in cutting the large budget outlays devoted to assisting agriculture, and their hope that the discipline of an international agreement involving the elimination of trade barriers and subsidies will be sufficient for that purpose. Obviously, such an agreement is at best some distance away; and that prospect does not in my view provide good grounds for delay in at least beginning to tackle the problem of agricultural support on a unilateral basis. On a more positive note, I welcome the lifting of import quotas on some items, particularly cars from Japan and Korea, as examples that other countries might well follow.

Reverting to the budget, there seems a strong case for the authorities to proceed vigorously with introducing a broad-based value-added tax. In this regard, I note the successful experience of the New Zealand authorities in introducing a single-rate value-added tax with no exemptions as a model worth emulating, which suggests that the list of exemptions in Canada should be restricted to those announced so far. At the same time, the manufacturers' sales tax should be removed.

On structural policies, it suffices to say that I support the conclusions of the staff. My authorities, while welcoming the U.S.-Canada FTA, believe that it is important that third country concerns are also given consideration to prevent the implementation of the Agreement from acting to those countries'

detriment. Third country concerns in this regard have been heightened by the strong indications given by Canadian officials that some of Australia's entitlement under the long-standing Canada-Australia Trade Agreement could be overridden by the FTA.

In conclusion, I too must admit to a feeling of deja vu. More than most members of the Fund, Canada is well placed to consolidate its fiscal situation without having to sacrifice growth or employment to any great degree. For a number of years the Board had been urging the authorities to do so--to little effect thus far. I hope that Mr. Masse's encouraging assessment of the prospects for real fiscal reform will indeed prove to be justified.

Mr. Fernández Ordóñez said that the profile assumed by economic indicators during 1988 made it difficult, at first, to evaluate the performance of the Canadian economy during the year. The average increase in GDP in 1988 had been slightly higher than that recorded in 1987, but if one considered fourth quarter changes, GDP growth had dropped substantially from 6.1 percent to 3.1 percent. The same tendency had been evident with respect to other variables, such as the increase in industrial production, which had been higher on average in 1988 than in 1987 (6 percent versus 5 percent), but less so if one considered the actual increase from December 1987 to December 1988, with the rate dropping from 8 percent to 2 percent, respectively.

The indicators of inflation had not been unambiguous either, Mr Fernández Ordóñez observed. The GDP deflator and consumer price index had declined in 1988 in comparison with 1987, while inflation rate performance in general compared with that in the United States improved considerably during 1988. The only indicator of inflation that had worsened slightly was the nonfood-nonenergy price index. Nonetheless, the authorities had been concerned about a possible acceleration of inflation, and had reacted by using two related instruments. First, short-term interest rates had jumped from 8.8 percent to 11.2 percent in 3 months; and second, the currency had appreciated in 1988. That appreciation in effective terms had been the result of the authorities' policy. The positive effects on inflation rate performance of allowing the currency to appreciate could be anticipated, but its effects on growth were less clear, and could eventually provoke a slowdown. To avoid the danger of a recession, he agreed with the staff that additional measures should be implemented. Above all fiscal policy should be emphasized, not only for its effects over the short term, but also for its effects over the long term.

While he understood that no substantial measures could have been taken in an electoral year, such as in 1988, the postelectoral period should be used to cut the fiscal deficit considerably, Mr. Fernández Ordóñez stated. Attention should be directed to both the expenditure and revenue areas, as the deficit could not be cut

"with scissors that had only one blade." In that connection, the Canadian Government, not having promised to forgo tax increases, would have an easier task than the authorities in its neighboring country. The example of the United Kingdom's fiscal deficit reduction efforts, perhaps the most successful example of fiscal adjustment, could be followed. In recent years, the U.K. Government had even reduced taxes, although, during the first two years in office of the current Administration, revenues had been increased by the equivalent of more than four percentage points of GDP.

Further structural measures could be helpful to the Canadian economy, one of them being the liberalization of trade, Mr. Fernández Ordóñez added. Canadian imports as a percentage of GDP were relatively low for a country of 25 million people. It seemed obvious that substantial gains in efficiency could be achieved with positive results for inflation and growth performance if trade were liberalized. He was aware of and appreciated the positive attitude of the Canadian Government in the Uruguay Round of trade negotiations but, unfortunately, in the current case, as in others, those negotiations were having the perverse effect of preventing any government from taking unilateral measures to reduce protectionism.

The conclusion of Appendix I on private savings behavior was a cause for concern, especially as the staff study seemed to be excellent and exhaustive, Mr. Fernández Ordóñez continued. The substantial drop in private savings from 18 percent of GDP in 1982 to 8 1/2 percent of GDP in 1988 was explained mainly by the reduction in inflation. It would be dangerous if the idea was spread that the Fund thought a reduction in inflation had a negative effect on private savings. A drop in private savings in the Netherlands had been mentioned during the Board's discussion of the Article IV consultation report (EBM/89/14, 2/13/89). Moreover, considering that the staff report for the Article IV consultation with the United Kingdom had described a decrease in U.K. private savings, and given that there had been a significant fall in U.S. private savings during the latter years of the previous Administration, those coincidences were worth studying. It was curious that the decline in private savings had been recorded in countries where the governments had, as one of their main priorities, increasing such savings and had, in fact, implemented policies aimed to that end. Perhaps different explanations could be found for private savings behavior in those countries; but it was the privilege of the Fund to detect such parallel phenomena, to look for their causes, and to decide if they were only coincidences.

The Appendix on the U.S.-Canada FTA clearly showed the benefits of that Agreement for the Canadian economy, Mr. Fernández Ordóñez noted. His chair believed that those benefits would indeed come about and, more important, the Canadian people were convinced of the positive effects of the Agreement, as demonstrated in the past election. Nonetheless, the Fund should study the effects of its members' policies on the rest of the world, in this case, the effects of the FTA. Unfortunately, at first view, the consequences of that Agreement on the rest of the world were not positive. The FTA was a very different case from the single market being built in Europe. The suppression of nontariff barriers in Europe would

be extended to all countries and would have positive effects not only on European companies, but also on export companies in the rest of the world. When the single market had been completed, a German company, for example, would be able to sell its products in all EC countries without needing 11 authorizations from 11 administrations. The same situation would apply to an American or Canadian company. In the case of the U.S.-Canada FTA, the situation was different, because the suppression of tariffs and quotas were only for the benefit of U.S. and Canadian companies, and foreigners could not benefit from them. That was why the effects of the Agreement on other countries should be monitored.

He commended Canada for putting its bilateral aid on a wholly grant basis and for the decisive role it was playing in the collaborative strategy for Guyana, Mr. Fernández Ordóñez added.

Mr. Hon said that he agreed broadly with the staff's assessment of the Canadian economy, and he welcomed the continued economic expansion of the past two years after the slowdown in 1986. He agreed with the staff that the economy was currently operating at full employment, and that signs of building inflationary pressure were evident, particularly on the wage front. The authorities' recognition of that problem and of the need to moderate demand growth to a more sustainable rate was gratifying. In particular, the Bank of Canada was to be commended for steadfastly holding to a course of monetary restraint to counter inflationary pressure.

One could not fail to note that the demand pressure came primarily from the fiscal deficit, Mr. Hon remarked. The authorities had to be commended for their no small achievement of reducing the fiscal deficit from 8 1/2 percent of GDP in 1984/85 to 5 percent in 1987/88. However, the momentum of fiscal consolidation had recently been brought to a halt, as the budgets for 1988/89 and 1989/90 forecast a deficit of 4 1/2 percent of GDP. That setback had become an increasing cause for concern; the staff had noted rightly that the fiscal outlook had worsened over the past few months, with short-term interest rates rising sharply and the prospect for corporate profits being dimmed by weaker oil prices and a stronger Canadian dollar. The timely recommendation by the staff for the authorities to adopt a drastic fiscal adjustment plan in the order of about 2 1/2 percent of GDP was therefore welcome. In that connection, he took note of the authorities' disagreement with the staff on the path of interest rates in a status quo policy environment, and especially on the pace of fiscal consolidation in the United States, a close economic partner of Canada. Nonetheless, he considered that both the authorities and the staff were correct in agreeing that the fiscal deficits remained large and that they constituted the key issue facing the authorities. He therefore welcomed the authorities' assurance that the forthcoming budget would demonstrate their commitment to continuing fiscal consolidation. The establishment of a Cabinet committee on expenditure review, chaired by the Prime Minister, had surely demonstrated the importance attached by the authorities to the crucial issue of the fiscal deficit.

The authorities had a good track record in economic management and had made great progress in dismantling a number of impediments to the efficient operation of the economy, Mr. Hon commented. In view of that record, he was optimistic that a fiscal deficit reduction plan would soon be developed, taking into account the staff's recommendations.

The authorities were to be commended for the progress made in trade liberalization, and he urged them to speed up the liberalization of imports of textiles and clothing, Mr. Hon stated. The authorities' exemplary record on official development assistance and their leadership role in the aid effort for Guyana were also commendable.

Mr. Al-Assaf made the following statement:

Over the past few years, the authorities have been able to reduce the fiscal deficit and to embark the economy on an impressive path of growth. However, more recently, capacity utilization has reached close to 90 percent, thereby making inflation the most immediate concern, a point that is reinforced by the most recent figures provided by the staff. In a medium-term context, the persistence of large fiscal deficits and the maintenance of a low savings rate will reduce growth rates, increase the already large ratio of debt to GDP, and widen the external deficit. Hence, there is a clear need to contain aggregate demand and to remove the structural impediments to greater economic efficiency.

To date, the main tool for combating inflation has been monetary policy, which has been successful in preventing a worsening of inflationary expectations, as indicated by the inverted yield curve. However, the increase in interest rate differentials between Canada and the United States has led to an appreciation of the Canadian dollar, which has adversely affected the already deteriorating current account balance. It is therefore evident that, while monetary restraint is an important element of the overall policy package, fiscal contraction is the essential component for sustained growth and improved price performance. In Canada's case, fiscal action could best be front-loaded, as it would provide a more credible anti-inflationary policy and would also ease interest rates, which would have a positive feedback effect on the deficit. Furthermore, front-loading would be politically more feasible or easier to undertake, as it would coincide with the initial period of the Government's new mandate. More important, with the ratification of the U.S.-Canada FTA, a reduction in public absorption would enable private investors to take full advantage of the expanded market, without imposing excessive strains on domestic resources. While I understand the underlying reasons for a difference of view between the staff and the authorities on the medium-term outlook, it would seem more prudent for the authorities to adopt the staff's more cautious outlook.

On the U.S.-Canada FTA itself, I hope it will prove to be a first step toward a more open multilateral trading system. Hence, while I am encouraged by Canada's recent removal of some nontariff barriers, I urge the authorities to take further action in the remaining highly protected areas. Such action would divert resources from the protected sectors to more efficient ones, and would reduce the likelihood of trade diversion resulting from the FTA.

The area of structural reform is crucial in that it will play an essential role in reducing the fiscal deficit and containing inflation. Since 1984, the authorities have undertaken significant structural measures. Nonetheless, the recent decline in the savings ratio is a cause for concern; and, in this connection, I urge the authorities rapidly to implement the second phase of tax reform. Other speakers have already highlighted the benefits of such a reform, and I will not repeat them.

Despite the decline in the unemployment rate to well within the natural rate, the rate, at 7.8 percent, remains high, especially considering the current degree of resource use. While I was interested in the suggestion that the natural rate could decline over time, further measures to improve the functioning of the labor market remain essential. And although I appreciate the delicate political considerations involved, they should not overshadow the potential benefits that would result from substantial reductions in budgetary outlays, including a far more efficient allocation of resources. These benefits are all the more significant, given the current financial and resource constraints that the economy is experiencing.

Despite the significant measures that the authorities have undertaken since 1984, further efforts in the fiscal and structural areas are needed. I am encouraged by the authorities' willingness to undertake such measures, and I look forward to the forthcoming budget which, as Mr. Massé indicates, will reflect their commitment to undertaking difficult decisions. I hope that it will not be at the expense of their official development assistance.

Mr. Vasudevan made the following statement:

The authorities deserve to be commended for the manner in which they have managed the economy during 1988. As in 1987, both real GDP growth and inflation rate performance turned out to be satisfactory--at about 4 percent, coincidentally. The unemployment rate has declined, and the staff observes that, at 7.8 percent, it is near to estimates of the natural rate. Moreover, the fiscal deficit declined in relation to GDP.

The key issue facing the authorities is identified correctly by the staff as "how to contain the growth of demand while acting to strengthen the supply side of the economy in order to enhance the prospects for continued economic expansion and improved price performance." The staff appraisal--with which the authorities do not seem to disagree--focused on front-loaded fiscal correction, continued monetary restraint, and further structural reforms. My chair also does not have much of a problem with the staff appraisal, and agrees with Mr. Massé's analysis of recent developments in the Canadian economy and of the authorities' thinking on different aspects of economic performance.

With capacity utilization being high, and almost at the level of its previous peak, it is necessary to create additional productive capacity in different areas in which market demand is expected to be high. For this to occur, domestic investment will have to rise. The staff's excellent appendices to the background paper show that both the household and business saving rates declined over recent years. There is also a prospect of a further deterioration in the general government balances. In the face of these two factors, the relevant issue is how the need for additional investments can be met and sustained. Would investment be sustained by a further fall in the prices of investment goods, as has happened since 1984, owing mainly to technological advances in the field of office machinery and equipment? The staff could usefully comment on this concern. The staff's studies also illustrate the interesting point that the fall in the household saving rate since 1982 is related closely to the deceleration in price increases. Is this something unique to Canada? What are the fundamental reasons for the relationship observed between household savings and inflation, and has such a relationship been found in any other country?

Appendix IV to the background paper shows that caution needs to be exercised in judging the impact of the U.S.-Canada FTA on Canada's economic performance, in view of the sensitivity of general equilibrium and macroeconomic models to a number of assumptions. Yet, in the medium-term scenarios, the Agreement is assumed to have a positive impact on growth (Table 7 of Appendix VIII). In the context of the divergent results of the empirical studies made thus far, the staff might comment on why it has assumed that the Agreement will have such a positive growth impact. Moreover, the staff could usefully comment on the effect that the Agreement will have on domestic investment and its productivity. Besides, how would the staff view the role of the Agreement in a multilateral context? This is especially important, as Canada's estimated growth rates over the medium term are likely to be lower than have been achieved in recent years.

Canada's performance with respect to official development assistance has been commendable. I would, however, urge the authorities to persevere in achieving the UN target for official development assistance of 0.7 percent of GNP. The authorities' decision to put bilateral aid on a wholly grant basis is greatly appreciated, as is the leadership role that Canada has assumed in coordinating the intensive collaborative efforts to assist Guyana in having a growth-oriented adjustment program and for becoming current with the Fund.

Mr. Kyriazidis made the following statement:

At the time of the 1987 Article IV consultation discussion in the Board (EBM/88/15, 2/3/88), Directors expressed the view that the authorities' main task was to sustain the rate of growth and to expand productive capacity, thereby avoiding the emergence of inflationary pressures and reducing unemployment. Judged on the basis of this criterion, the performance of the Canadian economy in 1988 has to be considered as satisfactory. The rate of growth was sustained well above that forecast at the time of the previous consultation, investment continued to expand vigorously, productivity rose appreciably, and unemployment fell further. Moreover, the monetary authorities have responded appropriately to the tightening of demand and supply conditions and have maintained full confidence in the Bank of Canada's ability to prevent a resurgence of inflation over the medium term, as indicated by the current inverted yield curve in Canadian financial markets. The authorities should be warmly commended for all of these positive achievements.

The staff identifies three areas of weakness in recent economic developments in Canada: lack of significant further progress toward fiscal consolidation since 1987; emerging signs of unfavorable cost-price developments--reflecting the rapid growth of domestic demand at a time of high capacity utilization--and the widening current account deficit.

The fiscal situation is obviously a matter of deep concern to the authorities, as evidenced by Mr. Massé's detailed opening statement. However, it must be recognized that the authorities' record in the field of fiscal consolidation since 1984 is, indeed, impressive, and I agree with Mr. Massé on the need to view the fiscal picture in the light of this fact. Nonetheless, an impression that the process has stalled should be avoided, even though the need for further fiscal consolidation might appear at this stage--in view of the magnitude of the adjustment in 1984--to be dictated mainly by the medium-term structural adjustment strategy and by the need to support monetary policy in the effort to go beyond the stabilization of inflation at some positive, low rate of inflation to price stability itself.

However, the emergence of capacity constraints and the appearance of signs of a possible revival of inflation suggest that further fiscal consolidation has a high priority.

There are some differences of opinion between the authorities and the staff on medium-term fiscal prospects and, specifically, on the implications of a status quo attitude. As presented by Mr. Massé, the authorities' case is convincing, particularly with respect to the constraints on government action and the market perceptions of the effects of fiscal policy. In fact, the staff's assumptions underlying the medium-term fiscal scenario, and particularly those with respect to the behavior of interest rates, appear to be excessively pessimistic. These assumptions imply a very vigorous, if not violent response to lack of fiscal adjustment, and a relatively weak response to fiscal cuts. For example, in at least one of the medium-term scenarios, a precipitous rise in interest rates is posited in the status quo case, which could only be justified if the overall fiscal position were such as to undermine the credibility of monetary policy over the medium term, and reverse the current state of expectations on inflation. This is not the case.

Nevertheless, given the degree of exposure of the Canadian economy to external shocks and the apparent emergence of inflationary strains, my chair agrees with the staff and Mr. Massé that the fiscal situation is a cause for concern even under the more optimistic assumptions of the authorities. I therefore support the staff's view that further fiscal consolidation, preferably on a front-loaded basis, should be pursued as vigorously as possible. Moreover, emphasis should be placed on expenditure cuts, including in those areas indicated by the staff. Even so, revenue measures are also strongly recommended, barring those that might undermine the tax reform program, from which the authorities expect important, favorable supply-side effects. I share the staff view that there is room for such revenue increases, and believe that the measures suggested merit serious consideration. The authorities' readiness to envisage such revenue increasing measures is encouraging. What appears to be crucial at this stage is a demonstration of commitment by the authorities to the effort toward further fiscal consolidation. In this respect, their past record, coupled with Mr. Massé's statement of their views with respect to the tenor of the forthcoming budget are very encouraging.

There is no doubt that little progress has been made on the inflation rate front in Canada over the past three years. After the considerable improvements recorded in 1984-86, the rate of inflation has stabilized at a positive, albeit moderate level. However, there are signs at present that the situation might start to deteriorate. A particular cause for concern is the

fact that the industrial product price index and unit labor costs have risen appreciably in 1988. The consumer price index, excluding food and energy, is also clearly pointing upward. Furthermore, inflation prospects in Canada depend crucially on the evolution of prices in the United States, which adds another element of uncertainty to the picture. These developments appear to reflect the tightening supply and demand conditions in the Canadian economy, to which the monetary authorities have responded rapidly in tightening monetary conditions. They have also allowed the Canadian dollar to appreciate in real effective terms in line with their view that exchange rates--like interest rates--should be viewed as policy channels in the period of the achievement of the central objective of monetary policy, good price performance.

As indicated clearly to the mission, there is no doubt about the monetary authorities' determination to combat inflation. However, I do concur with the staff that it would be undesirable to rely exclusively on monetary policy for fighting inflation, given the risk of a "hard landing" that such a policy mix might entail. Support from the fiscal sector will therefore be required, providing an added character of urgency to the need for progress in fiscal consolidation. My chair is confident that progress will be forthcoming, as the authorities are clearly aware of the importance of the interaction between monetary and fiscal policy in containing inflation without unduly slowing the economy.

The structure of the Canadian balance of payments in 1988 shows a healthy trade surplus. Despite the appreciation of the Canadian dollar, a large trade surplus against the United States has been recorded in 1988, concentrated--as in the case of Canada's other major bilateral trade deficits--in the capital goods sector. The current account deficit is therefore caused by large net investment income and nonfactor services outflows. In this context, one should also note that Canadian companies continue to invest abroad, thus causing a net direct investment outflow, which is basically financed by portfolio inflows. The structure of the balance of payments is therefore in line with the basic characteristics of the Canadian economy. However, to the extent that the main domestic counterpart of the current account deficit is government dissaving, the staff--on the basis of current real effective exchange rates--expresses some concern at the prospect of the current account deficit increasing to 3 percent of the GDP by 1993. Official current account projections are more favorable. Given the uncertainties inherent in such forecasts, it is difficult to make any judgment on the matter. What one can say is that whatever the figure, there is no likelihood that any financing strains and, therefore, any sustainability question might arise. The authorities, I believe, view the current account prospects correctly through

the angle of adjustment. Given that the widening of the external deficit has its counterpart in the declining trend of private saving--particularly at a time when private sector investment is increasing--the authorities' implementation of their commitment to reducing the federal deficit will eliminate the dangers perceived by the staff from the prospective widening of the current account deficit. That point assumes, of course, that there is no serious deterioration in competitiveness. On this basis, I see no danger if Canada continues to be a substantial net importer of real resources in the coming years, as its ability to utilize efficiently foreign savings and, therefore, to service protracted capital inflows cannot be doubted.

The authorities are to be congratulated in the area of structural reform. In this connection, while I note the encouraging information given by Mr. Massé on the likely trend of the unemployment rate, I wonder whether a more active employment policy could be undertaken, focusing on increasing the adaptability of labor supply to the changing structure of economic activity and on enhancing the mobility of labor in response to changes in its geographical distribution.

Mr. Mawakani made the following statement:

The Canadian economy generally continued to perform well in 1988, with solid gains being recorded in output, employment, and the external current account. My chair commends the authorities for following policies that have been conducive to such performance, especially as these policies have enabled the economy to grow at a more sustainable pace in 1988 than before. Inflationary expectations have thereby been reduced, despite the fact that capacity utilization has almost been at a peak. The task facing the authorities in 1989 is, as mentioned in the staff report, "to contain the growth of demand while strengthening supply." In that respect, the authorities will need to strike an appropriate balance between policies that will maintain moderate growth in demand while ensuring that restrictive policies do not lead to a recession. There is, however, a possibility of this happening if monetary policy has to carry the full burden of adjustment. Since all of the medium-term scenarios presented by the staff indicate that measures to reduce the deficit will have a positive effect on the overall economic performance of Canada over the medium term, there seems to be a case for fiscal policy playing a greater role.

It is worth recalling that in 1984, the authorities adopted a courageous stance of fiscal restraint, and introduced important measures that have been largely instrumental in bringing down the federal fiscal deficit. As noted in Mr. Massé's opening statement, substantial progress has been

made in restructuring the federal budget, especially on the expenditure side. Since 1984, total expenditure as a percentage of GDP has fallen continuously, while, at the same time, total revenues in relation to GDP have increased moderately. Therefore, the policy of expenditure restraint that has so far been followed successfully must be maintained if the objective of stabilizing the ratio of public debt to GDP is to be achieved.

Furthermore, it might be advisable to speed up the introduction of the second stage of tax reform and to make its coverage as broad as possible. In any event, further steps need to be taken to reduce the deficit, if only to relieve some of the burden on monetary policy and to contribute to alleviating pressure on interest rates.

It is encouraging to note that there was broad agreement with the authorities on the important role that fiscal policy should play in the Canadian economy over the medium term. In this regard, I welcome Mr. Massé's information on the recently created high level expenditure review committee, chaired by the Prime Minister. This important action, combined with those contemplated in the forthcoming budget, will undoubtedly demonstrate the authorities' strong commitment to fiscal consolidation.

The Bank of Canada has done an impressive job in pursuing an anti-inflationary policy, and I welcome its commitment to the long-term goal of attaining price stability. However, it has to be stressed that monetary policy should not carry an unduly heavy burden of adjustment. Higher interest rates are already contributing to the appreciation of the Canadian dollar and are thereby having an adverse effect on the competitiveness of the economy. In that connection, I note that the staff's medium-term projections indicate the possibility of a widening of the current account deficit by 1993. But above all, the focus of policy should be on the potential adverse effects of high interest rates on investment and growth.

The FTA with the United States took effect in January of this year. While I welcome the Agreement, I wish to repeat my chair's concern that the FTA should not lead to more trade diversion than trade creation. In any event, I welcome the authorities' reaffirmation of their strong support for the current multilateral trade negotiations, and note from the staff report the recent elimination of remaining quotas on footwear. This is a positive step and I hope that the authorities will take similar actions in the areas of textiles and clothing.

The authorities are to be commended for the leadership role they have played in coordinating the support group for Guyana,

particularly Mr. Massé for his important role as chairman of that group. Moreover, the Government's initiative of shifting its bilateral official development assistance onto a wholly grant basis and its intention of forgiving the official development assistance debts of 13 sub-Saharan countries are very much appreciated. One can only hope that this example will be followed by other governments.

Mr. Ghasimi made the following statement:

I thank the staff for circulating its report six weeks ahead of the current discussion, and broadly agree with its appraisal and recommendations.

From the staff papers and Mr. Massé's opening statement, it appears that the Canadian economy is continuing to enjoy an extended expansion for the sixth consecutive year. I note, in particular, the gains in output, the sizable increase in capacity utilization, and the steady reduction in unemployment. These impressive performances have been achieved so far without aggravating inflationary pressure. Moreover, I commend the authorities for their continued adherence to structural reforms, which they rightly consider to be of some importance for enhancing economic efficiency.

The driving force behind the expansion of output during the past four years has been the growth of domestic demand. As a result, the personal saving rate, which was relatively high in the early 1980s, dropped rapidly, reaching its lowest level in a decade in 1988. The impact of the declining personal savings trend, coupled with the persistent budget deficits is naturally being reflected in a confirmation of Canada's status as a capital importing country, and has implied somewhat greater reliance on foreign savings. Indeed, such reliance is exerting a negative impact on the balance of payments through the increase in debt service payments. It hardly needs emphasizing that reliance on foreign savings, if maintained over the medium term, will also be detrimental to any fiscal adjustment. I therefore hope that the authorities will pay particular attention to the issue, and will consider and implement the required corrective actions for restoring more appropriate levels of domestic savings.

The staff has rightly pointed out that the existing budget deficit in Canada is largely of a structural nature, noting that its level is more than accounted for by interest payments. This assessment is particularly pertinent in view of the projected increase in the already high ratio of public debt to GDP. Like the staff, I believe that, in the absence of policy changes, the fiscal outlook could further deteriorate in view of the high

sensitivity of the fiscal position to rising interest rates. Since the authorities are aware of the potential dangers of a status quo fiscal policy, it would be most appropriate for them to give their full consideration to the staff proposal aiming at a fiscal adjustment program containing primary deficit cuts exceeding Can$10 billion. To this end, there is some scope for spending cuts in the areas of transfers and subsidies, and I encourage the authorities to consider revenue enhancing measures to strengthen the momentum of fiscal adjustment. Needless to say, a policy of fiscal adjustment will support monetary policy in containing excess demand and inflationary pressure.

On structural policies, I support the staff's recommendations aimed at strengthening the functioning of markets. Particular emphasis should be devoted to addressing the high unemployment rate and to the existing disparities among regions. As for trade policy, one would hope that the recent FTA between Canada and the United States will not reduce imports from the rest of the world. In any event, the authorities should build on the progress made in trade liberalization by easing restraints on textiles and clothing.

The authorities are to be commended for their achievements in the area of official development assistance, and particularly for their decision to shift their bilateral aid wholly to a grant basis. I hope that the required fiscal restraint will not adversely affect the authorities' commitment to increasing their official development assistance to 0.7 percent of GDP. The authorities' initiative in coordinating the cooperative approach to assisting Guyana is commendable, and I urge other industrial countries to undertake similar leadership roles.

Mr. Yoshikuni made the following statement:

The staff has provided the Board with a report that is concise and to the point, and with appendices that are comprehensive and sophisticated. I broadly support the thrust of the staff report, and fully agree with the staff's view that economic developments in Canada over recent years have generally been favorable, without the country having any serious difficulties. Nevertheless, there are underlying problems that give the authorities little room for maneuver in their short-term economic policy management. With the economy operating at full capacity--as evidenced further by the data just provided by the staff representative--both fiscal and monetary policy should aim at slowing the pace of domestic demand. The authorities should, at the same time, proceed with structural adjustment, including trade liberalization in accordance with the FTA with the United States.

With respect to fiscal policy, I fully support the staff's recommendation for enhancing the pace of budget deficit reduction through front-loaded tightening measures. The need for advancing fiscal restraint measures is made all the more important by the fact that the unemployment rate is already below its natural rate. The steady rise in basic consumer prices, excluding food and energy, along with the increasing trend in unit labor costs, suggests the danger of a price-wage spiral arising.

Nonetheless, I generally sympathize with the authorities' position, as explained by Mr. Massé, on the medium-term need for replenishing reserves. In fact, it would seem to be desirable to accumulate such reserves in order to lay the basis for sound fiscal policy management. From the viewpoint of the actual budget planning process, however, it is not always helpful, or is even counterproductive at times, to specify in advance the amounts to be set aside as reserves, since it would provide the legislature with strong reasons for proposing new expenditure initiatives. If there is any room for reserve accumulation, it could be incorporated into the scenario implicitly by deducting a reasonable amount from the revenue side as a safety margin.

The staff is correct in noting that the increase in short-term interest rates has contributed to long-term interest rate stability by forestalling inflationary expectations. This is well reflected in Chart 20 of the background paper. At the same time, however, the chart shows that both short- and long-term real interest rates are high by historical standards. This might be interpreted as a sign of overburdened monetary policy, and it underscores the need for further fiscal tightening given that high real interest rates exacerbate the fiscal deficit. To end this vicious circle, the authorities should start by reducing the fiscal deficit, not by lowering interest rates.

The idea of setting targets for M2 or M2+ should be viewed with caution. As analyzed clearly in Appendix II of the background paper, there are many technical difficulties to re-establishing monetary targets and to keeping them under control. Judging from the experience of Japanese monetary policy, I generally feel that monetary targeting should be based on a flexible judgmental approach, and should avoid excessive rigidity in its implementation. An econometric model is useful for identifying the relative effects of economic variables on the demand for money, but should not be relied on as the sole objective device for determining monetary targets, in view of the relatively high standard errors involved. In light of these considerations, the Bank of Japan has opted for publishing quarterly forecasts instead of strict targets for year-on-year increases in broader money (M2+ and certificates of deposit), with a view to preventing short-term fluctuations of monetary aggregates from complicating the conduct of monetary policy.

At any rate, monetary targeting should be predicated on careful considerations of public acceptability and the ability of a central bank to measure and control monetary aggregates.

The verification of the U.S.-Canada FTA is welcome. At the same time, I strongly hope that the Agreement will contribute not only to the economic welfare of Canada and the United States, but also to that of the world economy as a whole. According to Appendix IV, the available econometric models generally confirm the positive welfare effects of the FTA on the Canadian economy, but do not refer to the effects on the rest of the world. The staff could usefully comment on this point or give Directors estimates of the effects involved. In this connection, the staff's analysis of Canada has given good insights into not only the Canadian economy, but also into the economies of other G-7 or G-10 countries.

I join other Directors in commending Mr. Massé for his efforts in the intensified collaborative approach for assisting Guyana.

Mr. Hospedales noted that growth in Canada had been remarkably buoyant and strong over the past five years, with the economy growing at an average rate of 4.3 percent a year. Given the high rate of capacity utilization at present, it was not surprising that the unemployment rate had fallen appreciably to its current level of about 5 percentage points below the recession peak. Notwithstanding those positive developments, a number of concerns remained, namely, the inflationary pressures that were being generated, the disconcerting fiscal outlook, and the rise in short-term interest rates. The sustained economic recovery was therefore beset by significant downside risks. The authorities would thus be well advised to consider carefully the staff's policy advice and recommendations--which he broadly endorsed--and set in train an appropriate policy mix for containing the growth of the economy, thereby enhancing the prospects for continued economic expansion and improved price performance.

Reconciliation of those somewhat conflicting objectives would involve a considerable degree of political courage and management skills, Mr. Hospedales continued. Such skills, which the authorities had demonstrated over recent years, were in much greater need than before, since restoring better economic balance under the existing circumstances would involve the further reduction of the external current account deficit. If strong growth of business fixed investment was to continue, domestic savings would have to rise. This was particularly important if the economy was to take advantage of the considerable opportunity presented by the recently concluded FTA with the United States, and to achieve the envisaged increase in the level of Canadian GDP over the long term.

However, a key policy problem lay in the fact that gross private savings had fallen by about 2.7 percentage points of GDP over the past

four years, and the analysis of Canadian household behavior in Appendix I did not provide any indication that a positive rate would resume over the near term, Mr. Hospedales observed. Tax reform initiatives to encourage savings had been adopted recently, but further steps in that direction were desirable. Nonetheless, a strengthened fiscal strategy had to bear a larger part of the adjustment burden.

In the circumstances of Canada, the process of gradually reducing the federal budget deficit within a medium-term policy framework was appropriate, but had become highly vulnerable in view of the adverse swings in interest rates and the high ratio of debt to GNP, Mr. Hospedales commented. Every effort should be made to ensure that the medium term deficit path envisaged by the authorities should remain as was. Even more, if interest rates were to come down and private business investment was to be sustained, public savings should be strengthened. An important step in that direction would be a firm commitment by the authorities to reconsider their current budget strategy and to examine all possible avenues on both the spending and revenue sides for bringing the deficit back to a declining path. Given the authorities' commitment to strengthening fiscal consolidation, as elaborated by Mr. Massé, the authorities should find particularly helpful the scenarios elucidated in Appendix VII evaluating the implications of alternative fiscal deficit reduction packages on reducing the risks of financial tensions and on laying a solid framework for long-term growth.

Of course, a generally more restrictive fiscal stance would avoid the problem of overburdening monetary policy in the overall policy mix for combating inflation, Mr. Hospedales stated. Such overemphasis could have adverse implications for interest rate developments and could provoke a slowdown in activity, which would not be in the interests of Canada or the global community. The substantial steps taken by Canada on the micro and structural fronts, such as energy market reform, freer trade markets, tax reform, and a general relaxation of regulations should further enhance economic efficiency and serve to sustain noninflationary growth.

Canada's support for the current multilateral trade negotiations and its commitment to bringing the Uruguay Round to a successful conclusion were appreciated, Mr. Hospedales added. The authorities' spending on development assistance, particularly at a time of fiscal stringency, was also welcome. Moreover, his chair wished to put on record its deepest appreciation for the leadership role played by Canada and by Mr. Massé in the international collaborative approach for resolving the arrears problems of Guyana.

Mr. Posthumus made the following statement:

The recommendations of the staff have my chair's full support, and I commend the staff for making such a clear and ambitious proposal for reducing the fiscal deficit, including front-loading of the measures to be taken. In the Canadian situation, correction of fiscal policy seems necessary to

decrease inflationary pressure, to safeguard growth over the somewhat longer term, and to support balance of payments adjustment. Front-loaded fiscal adjustment would also bring the trend growth of government debt and government interest payments under control. Would it not be marvelous if all these lofty goals could be attained by just bringing down the budget deficit!

For the time being, however, the monetary authorities are confronted with a much more complicated situation, and the staff apparently as well. The current account of the balance of payments is in substantial deficit, and has been for three years. Moreover, the Canadian dollar appreciated by a substantial 10 percent in 1988, in addition to its strengthening in 1987. This appreciation was, at least, partly caused by high interest rates. The intervention policy aimed at moderating fluctuations in the exchange rate between the U.S. and Canadian dollars has, at times, led to U.S. dollar purchases that have strengthened the U.S. dollar when other central banks have been selling U.S. dollars to prevent its excessive appreciation.

The authorities are of the view, to quote Mr. Massé, "that variables like exchange rates and interest rates should be viewed as policy channels, with a view to achieving the central objective of monetary policy, good domestic price performance." The substantial appreciation of the Canadian dollar has obviously contributed to a lower inflation rate in Canada. Monetary policy, and perhaps intervention policy, however, apparently contributed to strong and accelerating monetary growth, thus creating the potential for renewed inflation. This situation is perhaps marginally better than one involving a depreciating Canadian dollar, which would--in a situation of high capacity utilization--have led immediately to a higher rate of inflation. In the absence of fiscal correction, the monetary authorities' dilemma is clear enough.

Nonetheless, I cannot really share the view expressed on page 11 of the staff report that the Canadian approach to issues relating to the exchange rate does not seem to have been inconsistent with international efforts toward the reduction of external imbalances. Recent international coordination efforts indicate that stability of exchange rates is, to an extent, a policy goal subscribed to by the Canadian authorities. If so, exchange rates cannot be an instrument of national policies at the same time. The Canadian authorities, however, view both exchange rates and interest rates as policy channels to achieve good domestic price performance.

An inconsistency seems to be involved in this respect, for which several reasons could be offered. One is that monetary policy, as noted by the staff, is indeed severely overburdened.

Another reason might be that, in the absence of an anchor for pegging the Canadian dollar, the authorities cannot be certain that exchange rate stabilization alone is a sufficiently reliable policy for supporting their anti-inflationary stance, which, itself, I fully support. Moreover, intervention seems to play a somewhat ambiguous role in the policy package. With these observations, on which the staff could usefully comment, I support the staff appraisal.

The authorities and Mr. Massé are to be commended for their courage in taking up the complicated task of chairing the support group for Guyana, which might earn them praise in the Board. One would hope that Directors' authorities will come forward in support of this operation.

Mr. Dai said that he was in broad agreement with the thrust of the staff appraisal. It was commendable that Canada's economic performance had continued to improve in many respects in 1988. The basic economic problems had generally remained unchanged from those considered by the Board in its discussion of the 1987 Article IV consultation report (EBM/88/15, 2/3/88).

During 1988, Canada had maintained a more rapid growth rate than the average rate achieved in other major industrial countries, Mr. Dai noted. The strong growth in output and continued job creation had reduced unemployment to its natural rate. Moreover, the federal budget deficits had been reduced to about 5 percent of GDP in the most recent fiscal year, from 8 1/2 percent of GDP during 1984/85. Nonetheless, there had been some signs that inflationary pressures were mounting, owing to a further rise in the degree of resource use. He agreed with the staff that the main challenge facing the authorities was how to contain the growth of demand while acting to strengthen the supply side of the economy, thereby enhancing the prospects for continued economic expansion and improved price performance.

To keep inflation in check, there was a clear need to moderate demand growth to a more sustainable pace, and it thus was essential that anti-inflationary demand-management policies, involving both fiscal and monetary policy, be maintained, Mr. Dai continued. However, given some of the constraints of the fiscal situation, monetary policy had to play a larger role in the fight against inflation. The steps taken by the Bank of Canada to increase monetary restraints in 1988 seemed to have been appropriate.

At the same time, the authorities' concern about a possible recession from overtightening of monetary conditions was understandable, Mr. Dai remarked. Thus, effective monetary management would also depend on adequate progress being made on the fiscal front, and on the preservation of confidence. The fiscal adjustment plan suggested by the staff was generally appropriate. While measures should be taken to raise revenues,

it appeared appropriate for the authorities to emphasize adjustment on the spending side, with particular attention being given to cuts in transfer and subsidy programs that distorted the functioning of markets.

He concurred with the staff that trade liberalization was undoubtedly one of the most effective policy instruments for improving economic efficiency and increasing market flexibility, Mr. Dai stated. Recent moves by the authorities to reduce further import restrictions were welcome. He hoped that those moves would be followed by further action, particularly in such areas as textiles and clothing.

Canada's continued efforts in carrying out its aid program for developing countries had always been impressive, Mr. Dai concluded. He welcomed the authorities' recent decision to put their bilateral aid on a wholly grant basis and their reaffirmation to meet their official development assistance targets. Canada was also to be commended for its leading role in coordinating the support group under the intensified collaborative approach for Guyana.

Mr. Fogelholm made the following statement:

The staff report allows the Board to view economic developments in Canada from two perspectives: the national and the international. From an international and perhaps a more static perspective, one can end up concluding that economic performance in Canada has not been particularly good. With the exception of the growth rate, all other economic indicators--the inflation rate, unemployment rate, general government balance, and current account balance--compare unfavorably with the averages of the G-7 countries.

While true, this is obviously not the whole story. To complete the picture, one must recognize the positive developments that are reflected in many indicators over the past three years, and also acknowledge the progress that has been generated by structural policies, particularly in opening up the economy to foreign competition--a consequence of which will be enhanced competitiveness of the Canadian business sector. Thus, one can also rightly claim that the Canadian economy has performed well over recent years, which, I believe, is a fairer assessment.

Regardless of one's point of view, problems still exist and need to be addressed. This need is clearly recognized by Mr. Massé in his sober opening statement, depicting the challenges lying ahead. Not the least surprising, the pace of fiscal consolidation has been the central issue for discussion between the authorities and the staff; a continuing fiscal deficit of the current magnitude undoubtedly poses a major threat to balanced economic development over the medium term. However, there is not much that one can add to the debate within Canada, and between the authorities and the staff, and to what

has been said by other Directors. The advice of an outsider is simple and easy to formulate: aim for more fiscal cuts instead of less, as economically speaking, no risks are involved. The case for deficit reduction is particularly persuasive in the Canadian situation, considering the clear implications of the deficit for demand and inflation on the one hand, and interest rates and foreign exchange rate developments on the other.

With respect to the latter relationship, Canada's dependence on trade with the United States is extremely high. The substantial decline in the trade surplus with the United States since 1985 is attributed by the staff in the background paper primarily to a fall in the value of energy exports and, more recently, to the strength of Canadian import demand. Strangely enough, the 16 percent appreciation of the Canadian dollar vis-à-vis the U.S. dollar was not given as a factor behind the widening trade imbalance. Is it the staff's view that Canadian industry has, despite the appreciation of the currency, been able to maintain its competitiveness, particularly in relation to U.S. corporations? In addition, Ca ada's price performance in relation to that of the United States has improved little since 1985; in fact, for certain indicators, such as wage increases and the GDP deflator, there has recently been some worsening. And looking ahead, Canadian exports can expect little help from the U.S. economy, which, in the years to come, has to cope with its own twin imbalances, implying only negative effects for Canadian exports to the United States. In this type of situation, the current level of interest rates and the accompanying high value of the Canadian dollar seem to spell difficulties for Canadian exporters and Canada's trade balance.

Another conclusion can be drawn from this: it is clearly in Canada's interest to look beyond North America and try to secure access to markets in Europe and elsewhere. The authorities' commitment to the multilateral trade negotiations is thus not only reassuring, but also logical.

The most recent information provided by the staff is a further indication of an imminent overheating of the Canadian economy. This overheating should be corrected basically through fiscal policies. Excessive reliance on monetary policies would only aggravate the situation. In particular, it would run counter to the authorities' objective of allowing for a depreciation of the currency, and would have the aforementioned negative consequences for Canadian exports. In this context, the staff could usefully comment on whether I am correct in assuming that the underlying inflation rate--which is mainly caused by domestic demand and capacity constraints--is actually higher than the figures indicate, owing to the fact that the appreciation of the currency should have had a moderating effect on price developments?

On structural policies, I support the staff's recommendations. I would only note that, during the 1987 Article IV consultation discussion on Canada (EBM/88/15), my chair welcomed the steps proposed by the staff for reducing agricultural subsidies. The staff should comment on whether the avowed goals were achieved, and if further reductions in subsidies are envisaged for the current year.

The staff is to be commended for its analysis of household savings behavior. The decline in the household savings rate is a particular cause for concern in many countries, including those in my constituency. The main factor behind the rise in the household savings rate in Canada--the increase in the inflation rate--is unfortunately not a development that one would wish to emulate in achieving higher savings. I therefore listened with interest to the comments of Mr. Fernández Ordóñez and Mr. Vasudevan, and I would like to support them in asking the staff to undertake further studies and reviews on savings behavior in different countries, as such studies can be most useful for countries that are trying to cope with insufficient domestic savings in situations of disinflation.

Mr. Othman made the following statement:

Over the past few years, Canada's economic performance has been impressive, with real GDP rising by 4 percent in 1987, and by 6 percent on a fourth quarter to fourth quarter basis. During the first three quarters of 1988, output growth, while moderating somewhat, has remained strong, the unemployment rate has fallen rapidly--although from a high level--and the rate of inflation has come down to a level broadly comparable to that in other industrial countries. Meanwhile, the external current account deficit, despite edging up in 1987, narrowed significantly in the first three quarters of 1988.

However, it appears from the staff that these positive trends might not continue to hold for very long, given the fact that the economy is operating at or very close to full capacity, that the personal savings rate has fallen to its lowest level since 1983, and that there are still fairly large differentials in regional unemployment rates. In these circumstances, I agree fully with the staff report that the principal challenge facing the authorities over the next few years will be to improve supply capacity, while maintaining restrictive demand-management policies, especially with respect to fiscal policy.

The authorities have made significant progress in the fiscal area, as is clearly stated by Mr. Massé in his opening statement, but the improvement envisaged over the next two years seems modest at best. Meanwhile, public debt as a ratio of GDP

continues to rise. The latter is of particular concern, since the growing net public debt has the potential for undermining the fiscal position by leaving it vulnerable to future adverse interest rate shocks, in addition to having a negative effect on the external position. In view of this risk, and as the three scenarios presented in the staff report clearly show, maintaining the status quo is the authorities' least desirable fiscal policy option. In fact, if recent economic gains are not to be put at risk by renewed inflation, the authorities have to take firm action on the fiscal front.

In this connection, I share the staff's view that the fiscal adjustment effort will have to be front-loaded, with priority being given to further expenditure cuts, particularly in the area of transfer and subsidy payments. Such spending helps to feed the deficit, and also leads to distortions in the economy by impeding the adequate reallocation of resources. In this context, I welcome the establishment of the new Cabinet committee on expenditure review. Moreover, on the revenue side, while the tax reform effort under way is welcome, I join the staff in encouraging the authorities to take additional measures to enhance revenue performance.

With respect to monetary policy, I fully endorse the view that its main aim should remain the containment of inflation. The monetary authorities have proven to be highly successful in achieving a credible stance among market participants. The Bank of Canada, much to its credit, has acted promptly to restrain monetary expansion and thereby to offset the rapid increase in aggregate demand. Of course, effective monetary management will also depend largely on the degree of progress on the fiscal front.

In the area of structural reform, the authorities should give priority to increasing the efficiency of the labor market--particularly labor mobility--because the unemployment rate appears to have reached its natural rate, and any further reductions would require the elimination of structural and institutional constraints.

This chair welcomes the authorities' reaffirmation that Canada will continue actively to support the current multilateral trade negotiations and to bring the Uruguay Round to a successful conclusion. I commend the authorities for eliminating quotas and quantitative restraints on certain imports, and encourage them to take similar steps in other areas, such as textiles and clothing. This would not only serve to improve economic efficiency and increase market flexibility, but would also serve to reduce the risk of trade diversion resulting from the U.S.-Canada FTA.

Canada is to be commended for its recent decision to improve the effectiveness of its aid program by putting it on a wholly grant basis. Also welcome is the authorities' commitment to reaching their targets for official development assistance; my chair hopes that they will continue along this commendable path in the future.

Mr. Jones said that, with the economy operating at or near full employment and with the potential for accelerating inflation, there was little argument that the reduction of the budget deficit had to be a central part of the Government's medium-term economic program. The central question was the appropriate speed of fiscal adjustment. The structural nature of the budget deficit had increased the difficulty of achieving fiscal adjustment through spending cuts, and as Mr. Massé had explained in his opening statement, easy and large expenditure cuts had already been made, and revenue options were somewhat limited. However, the situation was helped by the fact that the authorities had not ruled out revenue increases. The authorities had to persevere in their efforts to improve the fiscal position as well as to expand productive capacity, so that the burden of containing inflation and inflationary expectations did not fall solely on monetary policy. It would be unfortunate if the latter happened, because of the potential negative impact on growth.

The authorities' efforts to resist protectionist pressures and their decision to provide all bilateral aid in the form of grants were welcome, Mr. Jones added. Moreover, their leadership role in coordinating aid efforts to Guyana in the context of the new collaborative approach for dealing with the arrears problems of developing countries was also commendable, and the practical lessons drawn from that experience could be instructive to the membership at large.

The staff representative from the Western Hemisphere Department, noting the comment made on a possible exaggeration of the threat of renewed inflation, said that wage increases had recently been drawing substantial attention from the authorities as a major indication of a possible acceleration of inflation.

Continuing in that vein, the relationship between inflation and domestic savings had been of particular interest to Directors, the staff representative observed. To the extent that it failed to reflect changes in savings caused by inflation, the measured savings rate on a national accounts basis effectively did not measure "economic savings" or changes in net wealth position. In the Canadian context, whether "economic savings" should be affected by changes in inflation rates was not clear, because nominal interest rates on financial instruments were free to move, and, indeed, did adjust to any indication of higher or lower inflation rates. In many developing countries, in contrast, nominal interest rates were more rigid and therefore high rates of inflation tended to reduce the overall savings rate. The interaction of tax systems and inflation usually tended to cause savings rates to decline, but in the case of

Canada, the income tax system had been indexed since the early 1970s, and had, in principle, therefore neutralized any such effect.

The higher investment needed for future growth should be financed through higher domestic savings resulting from fiscal adjustment, instead of counting on a further decline in the relative price of capital goods, the staff representative added. Many uncertainties were involved in measuring, inter alia, the relative prices of computers, and with respect to how long such prices would continue along their recent favorable path. Moreover, he disagreed with an observation that Canada's high rate of growth had been the only good aspect of its performance in the context of the G-7; in terms of the changes that had taken place since the past recession, particularly from late 1984, Canadian performance in terms of fiscal deficit and unemployment rate reduction compared favorably with that of other major industrial countries.

Nevertheless, the fiscal deficit remained structurally high at 5 percent of GDP, and the prospective rise in the ratio of debt to GDP was not small, the staff representative considered. It was therefore prudent for policymakers to assume that fiscal developments along the line of the official status quo outlook could have a negative impact on financial and exchange markets. The medium-term scenario had not exaggerated the possible financial market tensions that might arise from the unfavorable fiscal outlook. As for the impact of prospective demographic trends on fiscal policy, and specifically the Canada Pension Plan, he noted that the pension plan had been in a small surplus equivalent to about 0.5 percent of GDP over the past few years, and was expected to continue along that path over the medium term. And while the prospective demographic changes could subject the Plan to some pressure over the longer term unless changes were made to the benefit formula or to contributions, the Government had a system for examining the position of the Pension Plan every five years and for making a determination on whether benefits and/or contributions needed to be modified. In any event, Canada should aim at increasing national savings and investment so that its aging population could be supported by higher labor productivity.

It was difficult to give precise reasons for the rapid growth of M2 and M2+ in the latter part of 1988, the staff representative indicated. Those developments were in contrast to the trends observed in the early part of the year, when the growth of the monetary aggregates had been relatively moderate. In the current case, analysis was complicated by the substantial increases in interest rates, which should eventually moderate the expansion of M2. Evaluating the tightness of current Canadian monetary policy on the basis of interest rate changes was also difficult, because that issue dealt with the stance of policy, not with changes to that stance. That was the price that had to be paid for there being no reliable monetary aggregate. Nevertheless, given the broad approach of the Bank of Canada over the past few years, it was certainly the case that any indication of an upsurge in inflation would be dealt with promptly and decisively, so that inflation performance would not deteriorate.

As regards the role of M2 in monetary policy, the staff representative commented that the rate of growth of that aggregate was one of a variety of important indicators. The authorities used monetary aggregates as an indicative policy guide, meaning that if there were persistent deviations from the expected path of those aggregates, the authorities would take them into account in deciding the appropriate direction and magnitude of monetary policy corrections. The importance of monetary aggregates over recent years had increased with the improved predictability of their behavior compared with that in the early 1980s, but even so, owing to numerous continuing problems, the authorities had decided appropriately not to target such aggregates.

As for the comment made by a Director that the prospective widening of the current account deficit over the medium term would be helpful for reducing the U.S. current account deficit and thereby for improving the world economic outlook as a whole, one should keep in mind the relative sizes of those deficits, the staff representative cautioned. The Canadian current account deficit was envisaged to increase over the medium term by about US$4 billion from its current level of about US$7-8 billion, compared with the U.S. current account deficit in 1988 of approximately US$130 billion. An increasing current account deficit in Canada would thus help U.S. external adjustment to some extent, but not substantially. The best contribution that Canada could make to sustained international growth and to the world economic outlook was through putting its own house in order by adopting appropriate policies.

He shared the concern expressed about the outlook for both competitiveness and the current account, the staff representative stated. And even though it was correct that the current account prospect was not a cause for concern to the extent that foreign savings were utilized efficiently, the experience of the 1950s and 1960s compared with that of the 1980s demonstrated clearly that Canada had recently been using foreign savings more to finance public sector dissaving than to increase investment. As was indicated in the medium-term scenarios, fiscal policy should be the most effective instrument for reducing the external vulnerability of the economy and for lessening pressure on the real exchange rate.

He did not agree that Canadian intervention policy had been in the direction of trying to fix the exchange rate at an artificial level, the staff representative stated. On the basis of the staff's discussion with the authorities, it was clear that the Government's intervention policy had been one that could be characterized as "leaning against the wind." That approach, combined with the wind that had blown persistently in one direction had resulted in a large accumulation of net reserves. The obverse had happened in the past when the "wind" had blown in the opposite direction. In any event, he agreed with the authorities that intervention had only a temporary effect on the exchange rate, even when combined with more fundamental policies. The appreciation of the Canadian dollar since September 1986 had been due to the combination of firm anti-inflationary policy, with some favorable impact from commodity price trends.

Intervention by the Bank of Canada had not had a direct impact on the growth of monetary aggregates, as intervention operations had been sterilized automatically, the staff representative noted. Nonetheless, he agreed that too much of a burden had been placed on monetary policy, which was finely balanced between different objectives.

The second stage of tax reform would have some effects on Canadian competitiveness, especially given that the cost of corporate operations would be reduced by the fact that business inputs would no longer be taxed, given the introduction of a new sales tax system, the staff representative remarked. Moreover, to the extent that the user cost of capital would thereby be reduced, Canadian business would increase investment and would become more efficient over time. If those effects were perceived as permanent, however, he suspected that the exchange market would take them into account by changing the nominal exchange rate. In any event, structural measures should be looked at as a welfare gaining device, instead of as a means for achieving specific objectives, such as those with respect to competitiveness.

The staff's study of the natural rate of unemployment in Canada contrasted with the authorities' findings in concluding that changes in labor force composition would not provide scope for the natural rate to decline, the staff representative indicated. The sure means of dealing with the issue was to adopt policies that would reduce the natural rate over the medium term, such as involving changes to the unemployment insurance system.

The staff did not have statistical evidence based on a general equilibrium model of the possible impact of the U.S.-Canada FTA on the world economy, the staff representative commented. While it might not be the best suited model for structural analysis, the MULTIMOD demonstrated that the Agreement would have a favorable impact on the rest of the world, primarily through the higher U.S. and Canadian imports that would result from the two countries' higher national incomes under the Agreement.

Agricultural subsidies had been large in 1988, and comprised several elements, the staff representative concluded. While the staff expected those subsidies to decline somewhat in 1989, it was slightly less optimistic than the authorities were about the likelihood of a major decline in the subsidies over the medium term. Those declines would have to entail policy decisions.

Mr. Kyriazidis said that when he had referred to the effect of the fiscal deficit on monetary policy credibility, he had been referring to the magnitudes involved in the case of Canada compared with those in a number of more serious cases that the Fund had examined. Monetary restraint had been sustained in Canada despite the substantial fiscal deficit. Furthermore, in emphasizing that foreign savings should be used efficiently, he had assumed the implementation of further fiscal adjustment. The current account deficit was an adjustment problem not a financing one.

The staff representative from the Exchange and Trade Relations Department, noting Directors' comments on the possible adverse impact of the U.S.-Canada FTA on third countries, said that she certainly agreed with the need to monitor carefully the implementation of the Agreement. With respect to the comment made that the reduction in nontariff barriers under the FTA did not apply to third countries while those in the 1992 EC single market program ostensibly did, the situation was not as clear cut as suggested. In both agreements, there were reductions in some nontariff barriers that would not be applied to third countries, for instance, the liberalization of government procurement practices. In the case of the FTA, most reductions in nontariff barriers applied at the border, as well as tariff cuts, applied to foreign companies operating in the United States and Canada. Even so, some reductions in nontariff barriers would not be applied to third countries. In the case of the internal market program of the EC, some liberalization measures, when implemented, would automatically become available to third countries; the best example of such a measure was the proposed elimination of border controls. However, other measures contained in the single market program, such as the elimination of Multifiber Arrangement quotas, by country within the EC, and possible local content rules would change the EC's regime vis-à-vis the rest of the world. Until the EC made a decision on what its new commercial regime would be in the post-1992 period, it was unclear how such changes would affect the rest of the world. Thus, the impact of that agreement on third countries should also be monitored.

The empirical studies to date suggested that the income and trade creating effects of the FTA would outweigh any trade diverting effects, although the Agreement might have a negative impact on particular sectors or particular countries, the staff representative continued. The point to keep in mind was that some of the more important measures were related to services and foreign investment, and to the new dispute settlement procedure that had been agreed between Canada and the United States, the impact of which was difficult to quantify for both countries. Estimates for third countries in that respect were not available.

Mr. Fernández Ordóñez noted that he had made a general point in his intervention on the need for the Fund to study the effects of member country policies on others. In particular, in view of the importance of having one market, he had tried to explain that when, for example, American products entered Spain, they were free to move throughout the EC, whereas foreign goods entering Canada via the United States would be subject to tariffs.

Mr. Massé said that the authorities had found the movement of M2 and M2+ to be unreliable indicators of future changes in nominal GDP--especially over the short run--and thus regarded those monetary aggregates as poor guides to action. Moreover, the current large accumulation of reserves had to be seen in the context of how long the current upward pressure on the Canadian dollar would last, and whether the US$4 billion in reserves in late 1985 when the Canadian dollar had been forced down to US$0.69 by speculative pressure had been sufficient. At that time, the

Canadian Government had had to borrow to supplement its reserves, and he therefore believed that the average level of reserves should be higher than US$4 billion.

It was certainly correct that regional disparities had led to a natural rate of unemployment that was higher than in the United States, Mr. Massé remarked, albeit, the rate had recently declined slightly. Many different kinds of factors complicated the level assumed by the natural rate of unemployment in Canada. There were considerable cultural differences between regions, which the Government did not try to reduce owing to its policy of multiculturalism. Different languages and, apparently, differing views of the work ethic in certain regions obviously did not contribute to perfect labor mobility. The Government's regional programs were based on the general attitude that it was better to bring work to where people were living, instead of vice versa. In the short term, that assumption might well result in a potential growth rate that was slightly lower than it would otherwise be, but a decision had clearly been made that the trade-off between the growth rate and social levels of satisfaction was worthwhile, leading to slightly higher regional unemployment rates and the rationale for the Government's regional programs. Some of the problems encountered by the staff in analyzing regional unemployment came from the very quick reflows of labor in Canada. For instance, workers in New Brunswick might move to a rapidly growing area such as Toronto, but on hearing news that unemployment was declining in their home region of New Brunswick, would move back to that area, thereby slowing the decline in the region's unemployment rate.

There was no doubt that the authorities were clearly committed to tightening fiscal policy, although that would first have to be confirmed at a political level, Mr. Massé stated. He would distribute a summary of the next budget to Directors. The views of the Board had indeed influenced the Government's policies in the past, and Directors could be sure that the comments made at the current discussion would be an input into the authorities' decision making.

The Acting Chairman made the following summing up:

Executive Directors agreed with the general thrust of the staff appraisal in the report for the 1988 Article IV consultation with Canada.

Directors commended the Canadian authorities for the continued strong performance of the economy since the conclusion of the last Article IV consultation, and observed that the degree of resource use had risen further, and that the economy was currently operating in the neighborhood of full employment. However, these developments had been accompanied by a sizable current account deficit, a declining competitive position, a decline in the personal savings rate, tight monetary conditions, and signs of an increase in inflationary pressure. Thus, the economy was at a critical juncture at which policy had to focus

on controlling the expansion of demand while strengthening the supply side of the economy. It was the overwhelming view of Directors that the key policy requirement was a substantial reduction in the federal budget deficit, which remained large and was placing an undue burden on monetary policy in containing pressure on resources. Noting the close relationship between the Canadian and U.S. economies, a number of Directors expressed the hope that such a fiscal adjustment would be complemented by decisive budgetary action in the United States.

Directors expressed concern over the latest official fiscal projections on the basis of policies currently in place, which pointed to a significant rise over the next few years in the federal deficit in nominal terms, and a halt in the decline in the deficit in relation to GDP. Even if the deficit were to decline over the medium term in line with official projections, the ratio of debt to GDP would rise to a level that would leave the budget position very vulnerable to adverse interest rate swings.

Accordingly, Directors welcomed the indications given that the Canadian authorities agreed that fiscal policy was the central issue and that substantial front-loaded progress toward fiscal consolidation was needed. They were encouraged by the prospect that the forthcoming budget would demonstrate the will of the authorities to take difficult decisions. While not ignoring the possible short-run impact of fiscal retrenchment on economic activity, Directors generally took the view that a front-loaded fiscal adjustment plan should serve to enhance market confidence, lessen pressure on interest rates, and strengthen long-term growth prospects.

Directors said that in formulating a fiscal package, emphasis should be placed on expenditure measures, particularly in the area of spending programs that distorted the functioning of markets. Many speakers noted, however, that, given the size of the task, action on the revenue side could not be excluded. There appeared to be the necessary scope for raising revenue without frustrating the basic objectives underlying the Government's recent tax reform efforts.

Directors supported the Bank of Canada's aim of making further progress toward price stability and therefore considered the steps taken to tighten monetary conditions over the course of 1988 as appropriate. Looking ahead, Directors stressed that a policy of continued monetary restraint would be required, particularly in view of the high level of resource utilization. A flexible approach to the conduct of monetary policy was generally endorsed, and the authorities' concerns about the appropriateness of a return to rigid monetary targeting were noted.

Directors welcomed the measures that had been taken in the area of structural policy in recent years. A number of speakers noted that early implementation of the reform of the sales tax system would be desirable. Completion of the reform of the financial system that had been under way was also viewed as important. In addition, the increasing constraint on resources highlighted the importance of further structural steps to reduce obstacles to regional and sectoral adjustment--including fiscal incentives--and to increase labor market flexibility. Particular attention was drawn to the need to reduce agricultural subsidies.

Directors generally supported the Canada-U.S. Free Trade Agreement and agreed with the assessment that it would bring net benefits to Canada. However, several Directors expressed concern about the potential for trade diversion resulting from the FTA. Directors welcomed the active participation of Canada in support of the current round of multilateral trade negotiations as well as the steps that Canada had taken to remove barriers to trade in recent years. Directors urged the authorities to continue efforts to reduce trade restrictions, particularly in certain highly protected sectors, such as textiles and clothing.

Directors took note of differences between the official and staff projections for the external current account, which derived mainly from differences in certain key assumptions. It was clear that the more favorable outcome envisaged in the official projections would require substantial fiscal adjustment, continued monetary restraint, and additional measures to enhance the flexibility of costs and prices. In that context, Directors also noted the Canadian view that the exchange rate and interest rates were policy channels to achieve a good domestic price performance.

Directors commended Canada for its continued high level of official development assistance, for the recent decision to put its bilateral aid program wholly on a grant basis, and for its leadership role in the support group for Guyana. They also welcomed the reaffirmation by the authorities, as expressed in the staff report, of their aim to meet their targets on development assistance, despite the serious fiscal constraints.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/19 (2/17/89) and EBM/89/20 (2/22/89).

2. PEOPLE'S DEMOCRATIC REPUBLIC OF YEMEN - 1988 INTERIM ARTICLE IV CONSULTATION DISCUSSIONS - DECISION CONCLUDING 1989 ARTICLE XIV CONSULTATION

1. The Fund takes this decision in concluding the 1989 Article XIV consultation with the People's Democratic Republic of Yemen, in the light of the staff report on the 1988 Interim Article IV consultation discussions with the People's Democratic Republic of Yemen (SM/89/33, 2/10/89) conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The People's Democratic Republic of Yemen continues to maintain restrictions on payments and transfers for current international transactions, as described in SM/89/34 (2/13/89), in accordance with Article XIV, Section 2. The Fund urges the authorities to take appropriate measures to simplify the exchange system as soon as possible.

Decision No. 9086-(89/20), adopted
February 21, 1989

3. LIBERIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

Paragraph 4 of Decision No. 9014-(88/162), adopted November 2, 1988, shall be further amended by substituting "February 24, 1989" for "February 17, 1989." (EBD/89/47, 2/15/89)

Decision No. 9087-(89/20), adopted
February 17, 1989

4. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

Paragraph 4 of Decision No. 9006-(88/158), adopted October 24, 1988, shall be further amended by substituting "February 24, 1989" for "February 17, 1989." (EBD/89/46, 2/15/89)

Decision No. 9088-(89/20), adopted
February 17, 1989

5. VIET NAM - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

Paragraph 4 of Decision No. 9037-(88/175), adopted December 7, 1988, shall be amended by substituting "March 8, 1989" for "within three months from the date of this decision." (EBD/89/52, 2/16/89)

Decision No. 9089-(89/20), adopted
February 21, 1989

6. ZAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY - POSTPONEMENT

Paragraph 4 of Decision No. 9012-(88/160), adopted October 26, 1988, shall be further amended by substituting "March 13, 1989" for "February 17, 1989." (EBD/89/48, 2/15/89)

Decision No. 9090-(89/20), adopted
February 17, 1989

7. RELATIONS WITH GATT - RELEASE OF INFORMATION TO GATT DISPUTE PANELS

In response to a request by the Chairman of three GATT dispute panels, the Executive Board approves the recommendation by the Committee on Liaison with the CONTRACTING PARTIES to the GATT relating to the transmittal of information as set forth in EBD/89/51, 2/16/89.

Adopted February 17, 1989

8. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 88/115 through 88/119 are approved. (EBD/89/41, 2/13/89)

Adopted February 17, 1989

b. The minutes of Executive Board Meetings 88/122 through 88/126 are approved. (EBD/89/42, 2/14/89)

Adopted February 21, 1989

9. <u>EXECUTIVE BOARD TRAVEL</u>

Travel by Executive Directors as set forth in EBAP/89/44 (2/16/89) and by an Assistant to Executive Director as set forth in EBAP/89/45 (2/16/89) is approved.

APPROVED: September 1, 1989

LEO VAN HOUTVEN
Secretary