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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 73/89

10:00 a.m., August 31, 1973

F. A. Southard, Acting Chairman

Executive Directors	Alternate Executive Directors
	M. Garadaghipour, Temporary
L. B. Brand	S. Lampe
R. Bryce	
G. Bueso	
W. B. Dale	C. R. Harley
	F. K. Hussein, Temporary
	B. Martins
K. Kawaguchi	M. Wakatsuki
B. Kharmawan	
	T. de Vries
C. Massad A.	
	H. R. Monday
	P. Giorgeri, Temporary
	W. M. Tilakaratna
A. K. Rawlinson	
	L. Fuenfgelt
	H. G. Schneider
	C. Beaurain
	S. Nana-Sinkam

W. L. Hebbard, Secretary
B. J. Owen, Assistant

Also Present

Siew Hong Choi, Executive Director, International Bank for Reconstruction and Development. African Department: J. G. Keyes. Asian Department: A. Abadjis, J. Ahrensdorf, A. G. Chandavarkar, S. Kanesa-Thasan. Exchange and Trade Relations Department: E. Sturc, Director; C. D. Finch, Deputy Director; G. G. Johnson. Fiscal Affairs Department: S. K. Chand. The IMF Institute, Participants: T. O. Bah, I. K. Nabe. Legal Department: A. S. Gerstein, Deputy General Counsel; G. Nicoletopoulos, Deputy General Counsel; N. S. Narayana Chari, J. V. Surr. Middle Eastern Department: J. W. Gunter, Acting Director; A. K. El Selehdar, Deputy Director; A. Buira-Seira, I. Hassan, D. B. Noursi, J. Rose. Research Department: G. I. Brown, M. Gurfinkel, N. Kaibni. Treasurer's Department: D. S. Cutler, A. Watkins. Western Hemisphere Department: J. Del Canto, Director; E. W. Robichek, Deputy Director; S. T. Beza, J. R. Hewson, F. van Beek, G. Yadav. Advisors to Executive Directors: M. Shein, J. B. Zulu. Technical Assistants to Executive Directors: C. J. Batliwalla, B. Brock, J. C. Coleman, J. A. Crosby, J. A. H. de Beaufort Wijnholds, B. P. Eap, F. García-Palacios, V. N. Mudaliar, C. C. Ozumba, Ó. Pétursson, I. Plenderleith, W. Sanner, E. W. Shann, A. Takahashi, J. R. Vallet, M. A. Wasfy.

1. GUINEA - SCHEDULE OF REPURCHASES

The Executive Directors considered a request from Guinea for a schedule of repurchases, together with the staff's analysis and recommendation (EBS/73/282, 8/27/73).

Mr. Monday referred to the statement on page 2 of the staff paper, noting that recorded exports had not increased, mainly because of the wide differential between official and parallel market prices which had encouraged the outflow of goods through unofficial channels. Since he doubted the existence of statistics to support that view, it would have been preferable to say that unrecorded exports were partly--not mainly--the reason for the lack of increase in exports. As for the relief from foreign debt service payments obtained under recent agreements with Western European countries, which was also mentioned on page 2, it might have been better not to use the word "Western."

The Executive Directors turned to the proposed decision, which they approved.

The decision was:

> Guinea has proposed that repurchase in respect of the purchase equivalent to SDR 4,200,000 on May 26, 1970 (Executive Board Decision No. 3048-(70/44), adopted May 22, 1970) be made in three installments equivalent to SDR 600,000 each not later than August 20, October 20 and December 20, 1974 and three installments equivalent to SDR 800,000 each not later than January 20, March 20 and April 20, 1975. The Fund agrees to the proposal of Guinea.

Decision No. 4046-(73/89), adopted
August 31, 1973

2. CANADA - 1973 ARTICLE VIII CONSULTATION

The Executive Directors considered the staff report for the 1973 Article VIII consultation with Canada (SM/73/193, 8/3/73, and Sup. 1, 8/29/73). They also had before them a report on recent economic developments in Canada (SM/73/200, 8/14/73).

Mr. Bryce made the following statement:

> The staff has circulated three first-rate papers based on its consultations with Canadian authorities in June. The report on the consultations is relatively brief, clear, and judicious in its appraisal--qualities we have come to expect from this team. The

review of recent economic developments I have found to include such well selected data and to be so well analyzed and written that it causes me to think there is a better case for such regular reviews of already well documented economies than I have argued in the past. Finally, Supplement 1 brings the facts and figures so fully up to date that there is no need for me to add to it in this brief statement. The Canadian Parliament is presently assembling in order to deal with the nationwide railroad strike, and if there are important policy developments I will report on them to the Board.

My authorities in Ottawa have no serious criticism of the facts or analysis in the staff report. They recognize that, as the report makes clear, the Canadian economy is now operating closer to capacity than it has for years; indeed, they feel it is approaching the limit of safety. They appreciate, as I do, that the staff reports set forth the Canadian views fairly, and take them into account, even on such abstruse matters as the problems of applying to the Canadian balance of payments the Fund's multilateral exchange rate model.

There remain some differences of view between the staff mission and the Canadian officials about the prospects for the next year or so. The Department of Finance in Ottawa expects a decline in the rate of growth of demand in Canada down to about sustainable levels even without changes in policy, while the staff report reflects the mission view that further restraining action is necessary. On the prospects for Canada's international payments, the staff expects the current account to be in approximate balance next year, while the Canadian authorities expect it will remain in deficit, although the two groups in Ottawa mainly concerned differ quantitatively in their forecasts because of different appraisals of the prospects for the U.S. economy in 1974 and of the effects on Canadian trade of the exchange rate changes which have occurred in 1973.

In regard to policy, I might sum up the change in approach over the past six months by saying that in February the first priority was still to increase employment, and inflation was the main constraint; now the attitude in Ottawa, it seems to me, is to give priority to containing inflation without worsening the unemployment situation. The Canadian monetary authorities do not disagree with the appraisal and recommendations of the staff in regard to monetary policy. In regard to fiscal policy, there is at present no disposition in Ottawa to go beyond the efforts to restrain expenditures referred to in the first full paragraph on page 8 of the consultation report. This view is based in part on the absence of a conviction that tax increases are necessary at this time to restrain demand to tolerable levels but also takes into account the danger that increased taxes, on top of the higher food prices that have caused such widespread concern, would increase the likelihood of substantially larger wage demands and settlements. The Canadian authorities recognize the potential instability of the wage position, to which the staff directs attention on page 18 of its report, and are giving priority to efforts to avoid upsetting it.

The Canadian authorities have taken note of the staff's recommendation that incomes policy again merits consideration. Ten days after the staff issued its report the Prime Minister stated publicly that, "Inflation is a world-wide problem that Canada cannot solve alone. Price and income controls were reconsidered and rejected as inappropriate in present circumstances." This subject is likely to be debated at the current emergency session of Parliament, as the main opposition party has been repeatedly urging controls on prices and incomes. While it is conceivable that a change of policy on controls will take place, it seems to me unlikely at this time. So much of the increase in prices is now coming about as a result of specific international shortages of food and raw materials that one could not expect to control price levels effectively in such an open economy as Canada. It would be difficult at the best of times to achieve effective wage controls in Canada as no cooperation can be expected from the unions. But until the present sharply rising food prices have clearly levelled out and other consumer price increases have been seen to remain close to the trend levels of recent years, one could really have little hope of success in establishing effective wage controls. It seems to me possible that the circumstances may be more favorable sometime in 1974, and perhaps the necessary public consensus in favor of controls could then be developed, but current economic conditions and parliamentary uncertainties seem to me to preclude action at this time.

Canadian exchange rate policy continues to be to permit the market to determine the value of the Canadian dollar, subject only to such intervention from time to time as is necessary to preserve an orderly market. In the present circumstances, I think one cannot expect an early Canadian undertaking to maintain the rate within specified margins, but experience has indicated that the market maintains a remarkably stable rate vis-à-vis the U.S. dollar. I have already in a more general context informed the Board of my views about the difficulty of determining and maintaining an appropriate floating rate that would yield balance of payments equilibrium over the medium term, i.e., "over the various phases of the cycle taken as a whole." While Canada provides a case in point which Executive Directors and staff will wish to consider, I would expect the choice of approved standards for floating to be discussed further in a broader context. Meanwhile, my Canadian authorities welcome the concluding judgment of the staff expressed in the final sentence of the report.

Mr. Bryce added that the legislation to be considered by Parliament to terminate the nationwide railroad strike was likely to be similar to earlier legislation. It would award to the workers concerned, as a minimum settlement, what had been the majority recommendation of a conciliation board which had met earlier in the year, namely, an 8 per cent increase in wages in each of two years; that was approximately the level of prevailing settlements among organized labor. Any further increase would be left to compulsory arbitration, or to collective bargaining if there was any possibility that that would succeed. Since the Government needed the support of one or another of the two principal opposition parties, it might have to accept amendments to the legislation in order to get it passed. The unions had already shown their resentment at not receiving any assurance that they would receive more than the conciliation board had offered.

Mr. Dale remarked that the sharp fall in the unemployment rate, despite the increase in labor force participation, was the most welcome event of 1973. The main problem was how to slow down the economy. Since it appeared that fiscal action on the revenue side was not likely--and it was difficult to fault the Government on that score, given the wage situation--monetary policy was very much to the fore.

The interaction between monetary policy and the exchange rate was of great interest, Mr. Dale noted. He wondered how much official tolerance there would be for an appreciation of the rate in the event that the staff projection of the pressures on the economy came closer to the mark than that of the Canadian authorities, and a tighter monetary policy began to produce higher interest rates in Canada than elsewhere, and especially than in the United States. The staff was projecting strong pressures on the economy, whereas the Canadian authorities anticipated that policies already in force would bring the rate of expansion down to a sustainable rate.

Commenting on the balance of payments, Mr. Dale said that there appeared to be a persistent although variable net short-term capital outflow. That might be a residual element in the balance of payments, but a continuing outflow might in some sense indicate a generally too lax monetary policy, assuming that the flows were interest sensitive. He wondered to what extent they were in fact sensitive to interest rate developments, and how the Canadian view toward the structure of their balance of payments fitted in with the phenomenon of persistent short-term capital outflows.

As to intervention policy, Mr. Dale said he was inclined to agree with Mr. Bryce on the relative merits of judging exchange rate policy in accordance with views about the medium-term balance of payments versus the views of the markets, whatever those might be.

Miss Fuenfgelt remarked that the economic situation in Canada seemed to be even more difficult to evaluate than in earlier years. While she could not agree with the staff appraisal on all points, as far as it emphasized the need for a stronger policy of price stabilization, she fully supported the staff view. To some extent, an attitude of fatalism toward price developments seemed to prevail in Canada. That was reflected on page 7 of SM/73/193 where it was said that the recent acceleration in the rate of inflation in Canada was viewed as part of a world-wide phenomenon, and also on page 17 in the staff appraisal where it was noted that perhaps the best that could be hoped for in respect of prices was the avoidance of an appreciable escalation in their rate of increase. Mr. Bryce had suggested that there might be a silver lining on the horizon when he had said that it now appeared as if priority was being given to containing inflation without worsening the unemployment situation. It would be well in line with the world-wide need to reduce inflation if the restrictive measures that had already been taken were to be intensified. Such a policy seemed presently to be without great risk either to growth or to employment. The situation in the labor market had improved considerably, and the rates of GNP expansion and capacity utilization were so high that it was difficult to imagine a sudden turnaround.

Developments since the 1972 Article VIII consultation, Miss Fuenfgelt continued, had shown that some of the provisions of the unemployment system had affected the willingness to work. The abolition of those provisions in the meantime was welcome. Unemployment was still fairly heavily concentrated in certain areas of the country. Fiscal measures would obviously be better suited to deal with those regional differences than monetary measures, since the latter had an impact on the economy as a whole and did not allow for the possibility of fine tuning. There were, however, political difficulties to be taken into account. The budget for 1973 contained several new measures both on the income and on the expenditure sides. The reduction of import duties on certain foods and goods was worth mentioning, because although the decision had been made on a temporary basis for one year, the measure should not only help to dampen inflationary price pressures but should contribute to the further liberalization of international trade.

In view of the problems arising in connection with fiscal and monetary policy, Miss Fuenfgelt noted the staff belief that incomes policy might be one way to cope with inflationary price expectations and wages and prices in general. Mr. Bryce had made forceful arguments against introducing an incomes policy under prevailing conditions in the food and raw material sector, arguments which she found convincing. Recent experience in other countries, especially with the stop-go approach, had not been encouraging. To introduce an incomes policy at a time when it might be ineffective would do more harm than good, and would rule out its consideration at a more appropriate time.

More should and could still be done in the field of monetary policy, Miss Fuenfgelt noted. The large expansion of credit and of the money supply were not evidence of real pressure on the monetary side, and she did not share the staff apprehension that a tight monetary policy might result in an overkill and that the authorities should steer a middle-of-the-road course. Stabilization measures had to be convincing and for that purpose sometimes had to be drastic and to be taken speedily. Since the monetary field was the only one open for such action at present, the authorities should not be reluctant to use the available instruments. Short-term interest rates had been relatively low in the recent past, at least compared to those in the United States and in the Euro-Market, so that a tight money policy and higher interest rates were also not likely to do any harm from the point of view of the balance of payments. Mr. Dale had referred to the extent to which short-term capital was sensitive to interest rates. In the past, capital movements in Canada had been interest sensitive, although there appeared to be a change in the long-term sector where the interest rate differentials had been high during the last few years and where capital movements seemed not to be showing the same sensitivity as during the 1950s, for instance.

The valuation of the Canadian dollar had been discussed in the staff report, Miss Fuenfgelt added. As Mr. Dale had mentioned, it had to be seen in close connection with interest rate policy and interest rate differentials. It was amazing that the Canadian dollar had depreciated since the beginning of the year by 3 per cent to 7 per cent, dependent on the models used for the conclusions. The fact that the Canadian float was considered to be a clean one illustrated the problems of defining what was clean and what was less clean. The doubts she had expressed in 1972 about Canadian balance of payments aims persisted. From the point of view of stability, more courageous monetary action would be in the Canadian interest and in that of its trading partners. Some upward pressure on the Canadian dollar would seem to be normal, from the point of view of both domestic stabilization policy and international relations.

Mr. Rawlinson said it was clear that the Canadian authorities, like many others, faced the difficult problem of considering what to do on the basis of conflicting indications. He considered that they were right not to rush to take new action until they saw more clearly how the situation developed. He agreed with Mr. Dale, however, that the interest rate situation was important because of its link with the balance of payments.

There were two points in the staff report about which he had reservations, Mr. Rawlinson noted. First, a minor point on an important subject, he regretted the inclusion in yet another staff report of a vague recommendation of an incomes policy. It would be better in his view to avoid those words: instead, the staff should concentrate on advancing specific proposals; if it did so, the political and practical problems involved in the area would become evident.

The second point of concern to him, Mr. Rawlinson remarked, was related to the discussion of the exchange rate. He agreed with the staff conclusion, namely, that the current policy of the Canadian authorities was sensible. Having reached that conclusion, however, the discussion in the staff report of the medium-term outlook was unsatisfactory in a number of respects and moreover showed that discussions in the Executive Board on exchange rate policies were in a very early stage. He wished to endorse Mr. Bryce's comments on the subject.

Mr. Beaurain commented that he would be the last to challenge the staff's view on the difficulty of assessing the position and prospects of the Canadian economy. It illustrated the care with which objective indicators should be used; to retain only one of them was likely to be misleading, while recourse to a set of different indicators would generally provide conflicting signals.

The acceleration of the rate of inflation was a preoccupation that was by no means unique to Canada, Mr. Beaurain said. The authorities recognized frankly that they were not prepared to curb the increase in prices at the risk of jeopardizing growth and antagonizing the trade unions. The element of fatalism in that attitude, to which Miss Fuenfgelt had referred, was admittedly somewhat universal with regard to price increases. The staff had rightly come up with the logical answer that in theory an incomes policy was called for, but unfortunately lack of social support did not make that a promising avenue. It might be regrettable, but the Canadian authorities had the full understanding of his authorities on that score, since they had experienced similar difficulties.

He did not deny, Mr. Beaurain added, that as the staff had put it in their appraisal, monetary policy could make a meaningful contribution to the achievement of a deceleration in the growth of demand. On the other hand, he wondered whether such a restrictive monetary action, if not coupled with other measures in the budgetary and fiscal fields, did not carry the risk of unfavorable consequences on employment in the most vulnerable parts of the country, thereby running contrary to the avowed wishes of the Canadian Government to ensure a better economic equilibrium between the various provinces. In his opinion, budgetary and fiscal measures could, more easily than monetary measures, take into account the necessity of reducing regional economic disparities. Moreover, budgetary modifications did not generally exercise the direct effects on interest rates and capital movements that usually accompanied changes in monetary policy. He was aware of the political difficulties that might arise from a budgetary and fiscal policy that differentiated between various provinces; however, he believed that such a policy would best contribute to the short-term as well as to the long-term needs of the country.

Dealing with the exchange rate, Mr. Beaurain said that he had been interested in the staff view that the Canadian dollar was somewhat undervalued. He recalled that at EBM/73/1 on January 5, 1973, Mr. Dale had expressed the view that a continuation of the float would be more opportune than the resumption of a par value, since the latter would result in an undervalued rate. It was puzzling that the float--a clean one--had resulted in an undervalued rate, and it was not clear to him why the float continued to be preferable to the resumption of a par value for the Canadian dollar. His authorities regretted that the 1973 Article VIII consultation with Canada had not been concluded with a draft decision. The Executive Board had taken a decision on January 5, 1973 which in mild language had invited Canada to resume a par value. The absence of a draft decision on the consultation had come as a surprise and would undoubtedly be taken in some circles as an indication that the Fund was not particularly eager to play its normal role as custodian of the Articles of Agreement.

Mr. Kawaguchi remarked that the up-to-date information provided in Supplement 1 to SM/73/193 showed that the expansion of the Canadian economy appeared to be continuing at considerable speed. Although provisional data for the second quarter showed signs of slackening, the slowdown might be temporary after the sharp increase in the first quarter; the rate of price increases certainly gave no evidence of deceleration. There seemed to be little doubt that the Canadian economy was nearly running at full capacity. Under the circumstances, he shared the staff's view that early and substantial restraining action seemed to be required. The case for fiscal restraint was obvious since fiscal policy for 1973 had been based on an appraisal of the economy prior to the current sharp upturn. Apart from the inflexibility of fiscal policy, which was to some extent inevitable, he had been struck by the authorities' apprehension with respect to the behavior of banks in operating at only two speeds. When the immediate task of curbing excessive expansion fell to monetary policy, the cost of excessive apprehension might not be insignificant.

On the delicate problem of incomes policy, Mr. Kawaguchi felt there were good grounds for the staff's concern about the danger of a wage/price spiral in Canada and that traditional demand management policies might not be sufficient to cope with it, even if they were implemented with reasonable success. On the other hand, it was well known that incomes policy was strong medicine and that various prerequisites were called for if it was to work effectively without serious side effects. Those preconditions were not close to being met in Canada, and he agreed with Mr. Bryce's cogent argument on the issue.

As to exchange rate policy, Mr. Kawaguchi said that while he was in principle in favor of the concept of a medium-term equilibrium rate, he was inclined to think that the concept could not be applied mechanically in all cases. There seemed to be a spontaneous limit for the fluctuation of the Canadian dollar vis-à-vis the U.S. dollar, because of the close geographic and economic relationship between Canada and the United States. The market might well weigh that relationship more heavily than a medium-term equilibrium rate derived from a computer. He had therefore been convinced by the concluding judgment of the staff on Canada's exchange rate policy.

Mr. Brand said that, as others had noted, the domestic position of Canada was by no means unique. The economy appeared to be rapidly approaching full capacity utilization, but the level of unemployment was still quite high by international standards. The emphasis had been on monetary rather than on fiscal restraint, and the underlying trend in prices had been sharply upwards. Several other economies fitted that description.

The rapid upturn in the Canadian economy was illustrated with particular force in Chart 1 of the report on recent economic developments, Mr. Brand commented. If the staff was correct in saying that the gap between potential and actual output was quite small, there could be little doubt that the rate of price increase in the year ahead would be disturbingly high. Unfortunately, as the staff had pointed out in the appraisal, the recent high level of private investment was unlikely to increase capacity greatly until 1974. The combination of an expansionary fiscal and a restrictive monetary policy was not unknown elsewhere in the world, and was not likely to prove any more successful in Canada. In a situation of high domestic demand and high interest rates, a currency, which if anything seemed undervalued, could hardly be welcome to the Canadian authorities.

He agreed with the staff, Mr. Brand continued, that from the medium-term outlook the Canadian dollar appeared to be somewhat undervalued, even given the recovery of both the U.S. dollar and the Canadian dollar over the last month. The depreciation of the Canadian dollar by between 3 per cent and 7 per cent since the beginning of the year was hard to understand. Over the last two years, it had depreciated by 20 to 40 per cent against many major European currencies, by 20 per cent against the Australian dollar, and by 15 per cent against the currencies of Spain and Portugal. As a guide to market thinking about the present rate, the Canadian dollar was quoted at a three-month premium of 2.69 per cent on the forward exchange markets.

The exchange of views between the staff and the Canadian representatives recorded in SM/73/193 underlined an important difference in fundamental attitudes, which Mr. Bryce had emphasized both in his statement and at EBM/73/88 (8/29/73), Mr. Brand observed. The thrust of the Canadian view was given on page 15 of the staff report; it was argued in essence that the exchange rate should be determined by short-term market forces and that the market should preferably decide the exchange rate, even if that rate was inappropriate in the medium term. On the other hand, the staff had argued that the exchange rate should be kept at a level that would maintain medium-term external equilibrium, noting as a bonus that at present that would help to attain domestic equilibrium as well.

The debate was really about whether clean floating was better than managed floating, Mr. Brand considered. His personal belief was that clean floating over a long period of time had little to recommend it. Exchange rates could not be left for speculators and short-term market forces to determine. The rate would react too easily to temporary forces and to unwarranted speculation. As a result, it would give incorrect price signals to domestic producers and lead to unhealthy international disputes between countries in different phases of the business cycle. The chances of Canada fixing a par value in the near future were clearly nonexistent, and had been so for some time, as he had stressed in previous interventions. He commended the staff for being forthright enough to argue that the Canadian dollar was undervalued at present. Such frank staff appraisals would be needed in the future if the Fund was to be able to carry on an effective surveillance of exchange rates. However, the corollary of the staff view was either that the nature of the intervention by the Canadian authorities was holding down the market value of the Canadian dollar, or that the authorities should do something about an undervalued currency. At EBM/73/1, when the Executive Board had discussed Canadian exchange rate policies, he had taken a position between Mr. Dale's view that the Canadian dollar was then undervalued and Mr. Bryce's view that it was overvalued. He had since come to a rather different conclusion.

Looking ahead over the next year, Mr. Brand remarked that monetary policy would be tightened and capital inflows might therefore be encouraged. There had also been a sharp strengthening in the trade position in the last few months. It would be difficult to avoid the conclusion that the present exchange rate might not be sufficiently high to ensure medium-term equilibrium. He had therefore found himself siding with the view of the staff and with that of the forward exchange market--where the Canadian authorities were presumably not intervening--in which the Canadian dollar was at a premium of over 2.5 per cent.

Mr. Nana-Sinkam observed that the staff report outlined clearly how the Canadian authorities, who had been the first in the developed world to introduce effective policies of fiscal and monetary restraint, had been tackling the problem of restoring reasonable price and cost stability alongside economic expansion, and with somewhat sophisticated techniques. After a temporary setback in the third quarter of 1972, the economy had resumed its brisk growth although its basic course over most of the past two years gave no sign of changing radically in 1973: rapid expansion in real output was still accompanied by persistently high unemployment and inflationary pressures. It was not surprising that the Canadian authorities were having difficulty in dampening down wage increases, since all developed countries had had more evident success in keeping down prices than increases in the cost of labor. It was to be hoped that Mr. Bryce's expectation of more favorable circumstances in 1974 would in fact be realized to help the authorities resume their effective control of price increases. While the major structural problems causing unemployment remained, Mr. Bryce had indicated that concern was being turned to the effects of inflation. Although price increases had become apparent for a number of raw material imports, thus in turn accentuating the rise in wholesale prices, the substantial increase in food prices was potentially more serious. It posed a more immediate and direct threat to general wage and price levels, because it had its principal effect on lower income groups, particularly in a year when many union contracts would be renegotiated.

Economic performance was generally good, and unemployment had shown some improvement, Mr. Nana-Sinkam continued, but with the spectre of cost/push inflation, and having rejected wage price controls for the present due to the well-founded reasons presented by Mr. Bryce, the authorities had introduced a series of responsive but responsible fiscal policy measures in mid-February. The question was to know whether further uncertainty would not definitely hamper the rate of growth, even though the ultimate effectiveness of those fiscal measures in reducing unemployment, curbing inflation, ensuring continued growth and solving the structural problems in the economy might be debatable. A certain degree of inflation seemed to be the price that had to be paid in order to hold the level of unemployment to a minimum. If the trend was not controlled, however, inflationary expectations and patterns of behavior would make it difficult in the longer run to reverse the process without a net loss to the community. The staff recommendation for a reconsideration of general demand management and an incomes policy therefore seemed justified, although it was difficult, given current economic conditions and parliamentary uncertainties to see how they could be applied.

With respect to unemployment figures, Mr. Nana-Sinkam asked whether the large number of unemployed, at a time when employers were having difficulty filling jobs, might not be the result of an overly generous unemployment insurance program. Furthermore, he asked whether present methods of computing unemployment data took into account those members of the labor force who did not want permanent jobs.

On the external front, Mr. Nana-Sinkam observed that the interim measures imposed on the world's monetary and economic activities as a result of international monetary crises, while they had taken the Canadian floating system out of its isolated orbit, had also left the Canadian economy remarkably unscathed.

In conclusion, Mr. Nana-Sinkam paid special tribute to the Canadian authorities for their great efforts in increasing financial and other assistance to developing countries, despite the hectic international monetary scene and current national economic conditions. Already in 1972, official development assistance, which was increasing steadily in absolute value, had a 97 per cent grant element, and Canada was therefore well ahead of the new Recommendation on Terms and Conditions of Aid adopted by DAC in October 1972, to take effect from January 1973.

Mr. de Vries agreed that excess demand in the Canadian economy had begun to create difficulties, and that restrictive measures were necessary. In his view, those measures should be clearly restrictive and should preferably work in the short run since budgetary policy was not likely to be able to make a rapid contribution. He joined the staff and previous speakers in accepting monetary policy as the instrument to be used in the near future.

Regarding exchange rate policy, Mr. de Vries said that he had listened with great interest to Mr. Brand's comments on clean versus managed floating. He himself had given considerable thought to that matter, and had reached the same conclusion as Mr. Brand. An exchange rate that was determined by a clean float was not likely to be a medium-term equilibrium rate, certainly not at all times, and it would therefore give wrong signals to the economy and give rise to an uncalled for reallocation of resources. To discuss medium-term exchange rates was therefore a matter of great significance.

Moreover, the interrelationship between the balance of payments and monetary policy was important, Mr. de Vries commented. Having come to the conclusion that a restrictive monetary policy was necessary, the staff estimates showing that the Canadian exchange rate was somewhat undervalued were of significance. A restrictive monetary policy would, of course, lead to upward pressure on the exchange rate. It was essential to know that that pressure would not move the exchange rate to a level where, within the limits of human knowledge, it would not be out of line with the medium-term level but rather that it would move toward that level or perhaps be temporarily slightly above it. The room for maneuver that existed reinforced his conclusion that it was appropriate to pursue a restrictive monetary policy. The movement of the exchange rate would perhaps provide additional help in dampening demand through its effects on the current account.

The recommendation of the staff that monetary policy in Canada should aim at expansion in line with medium-term goals seemed to him to be a minimum target, Mr. de Vries added. If the circumstances peculiar to Canada resulted in sudden credit stringency, short-term money would no doubt be likely to flow in from the United States, thus limiting the otherwise harsh effects.

As to incomes policy, Mr. de Vries remarked that it was indeed difficult to advise authorities on how to pursue such policies. While it was agreed that an incomes policy would be desirable, if it were effective, experience showed how difficult it was to achieve. Sensible advice about the particular form an incomes policy should take was most likely to come from national authorities themselves. It seemed to him, however, that a precondition of an effective incomes policy was the elimination of tensions that were in the process of building up on the demand side; otherwise, an incomes policy would be more difficult, or perhaps even impossible, to implement.

Mr. Kharmawan commented that the less developed members of the Fund had been disappointed in their expectation that much could be learned about the conduct of economic policy from staff reports on developed countries. The frustrations appeared to be the same in both developed and developing countries, and the only guidance to be found in the experience of industrial countries was usually of a negative and not of a positive nature. Incomes policies, for example, had been advocated in many circles, but they were not easy to implement, as previous speakers had said, because they were difficult to define and subject to political constraints that were not always easily recognized.

Referring to the divergence of views between the staff and the Canadian authorities on the likely growth of demand in the Canadian economy, Mr. Kharmawan noted that the staff was more pessimistic about maintaining growth at sustainable levels without changes in policy, whereas the Canadian authorities were more pessimistic than the staff about the current account position. He wondered how the authorities viewed the relationship between the deficit they expected on current account and their belief that demand could be kept at an appropriate level without further measures of restraint.

Finally, Mr. Kharmawan paid tribute to the Canadian authorities for their liberal stand on aid to developing countries.

Mr. Bueso observed that, as the staff report had brought out, the Canadian economy had staged a recovery from the mild slowdown of 1969/70, under the stimulus of expansionary financial policies, to attain a rate of expansion in the following two years that was slightly faster than the economy's potential. However, unemployment had persisted at a high level and had only shown signs of receding at the end of 1972 and during the first quarter of 1973 when economic activity had accelerated sharply. Meanwhile, the situation on the price side continued to be bleak, with no sign of any easing in the fast pace of inflation. Under those conditions, the authorities were faced with the difficult task of steering the economy on to its long-term growth path. In that respect, he had no hesitation in aligning himself with the staff view that an incomes policy merited consideration, and added that it was not unusual for the staff to make policy recommendations to developing countries that were politically difficult to carry out.

Discussing the external sector and the outlook for the exchange rate, Mr. Bueso supported the position taken by Mr. Beaurain. The interesting analysis in the staff report showed how difficult it was to arrive at a judgment on the appropriateness of an exchange rate.

In conclusion, Mr. Bueso praised the Canadian authorities for their increasing efforts on behalf of the less developed countries through their foreign assistance program. Not only had the share of the net flow in relation to GNP risen, but a similar trend had been registered in the grant element of official assistance.

Mr. Massad remarked that on page 17 of its appraisal the staff had said that it was not possible to give an unequivocal answer regarding the effects of monetary restraint because the lags were variable and therefore some components of spending might be affected without much delay. He wondered whether that meant that the lags were different for different components, or that they changed over time. In the latter case, it would become difficult to have a monetary policy, especially if the nature of the change was unknown. However, he assumed that the former was meant, and if so, it would be most interesting to know what the lags were for each component.

As for the longer standing discussions about rules versus discretion in monetary policy, Mr. Massad noted that on page 18 of the appraisal the staff had come out in favor of rules, in stating that it might be advisable to concentrate on achieving a rate of monetary expansion to fit the requirements of the medium run on the basis of well-known arguments about leads and lags in monetary policy which might widen cyclical movements if monetary policy followed short-run considerations. He asked the staff whether it had any evidence to back up what appeared to him to be an interesting and important conclusion.

Finally, Mr. Massad observed that there was no proposed decision on the 1973 Article VIII consultation with Canada. He hoped that all consultations would be concluded with a decision.

The staff representative from the Western Hemisphere Department, in response to Mr. Dale, said there was probably no question that short-term capital flows were interest sensitive, although it was often difficult to pin down the effect simply to interest rate variations or differentials. In some instances, interest rates might move in a fairly uniform way among countries, but the monetary stances of the different authorities might affect the size of the flows on short-term account. Long-term capital flows also had shown considerable sensitivity to credit market conditions, although it was sometimes difficult to isolate that effect. The staff had felt in the past that there was a built-in but variable amount of short-term capital outflow, but that assumption needed to be re-examined. Finally, it was difficult to speak of the short-term capital account as a whole, since it included the balancing item.

As to incomes policy, the staff representative said that it had been discussed over a number of years with the Canadian authorities and points of view might appear to be more polarized than they actually were. Hopefully, it was clear that the staff did not think of incomes policy as a substitute for demand management or for handling problems of price pressures arising from conditions of excess demand in truly competitive markets. The main justification for incomes policies was to help in coping with situations in which business and labor were able to exercise market power, as well as to deal with cases in which the expectational factor became important. While demand factors, in Canada and elsewhere, had become major elements in the recent surge of prices, there was hope that those tendencies might be reversed. The issue the staff had tried to focus on was that wages might be scaled up in the interim, thereby setting a new floor to the rate of inflation. As to suggesting specific ways for carrying out an incomes policy, it was difficult for the staff to indicate in detail how a country might most effectively implement an incomes policy, given the social and political considerations involved. In that regard, as Mr. de Vries had remarked, sensible advice about the particular form an incomes policy should take was most likely to come from national authorities themselves.

In reply to Mr. Nana-Sinkam, the staff representative agreed that the coexistence of high rates of unemployment and tightness in parts of the labor market might be partly a consequence of the unemployment insurance arrangements. In addition, it was important to note that two sectors of the labor force--young people and women--had made particularly large contributions to its rapid growth. There was therefore the problem of matching available labor with the kinds of jobs being created. In addition, persons seeking part-time work were included in the labor force statistics.

Turning to the question raised by Mr. Kharmawan, as to how the staff and the Canadian authorities reconciled their respective outlooks for the current account with their estimates of demand, the staff representative explained that although the staff report had drawn attention to the problem of autonomous demand forces, the staff had not predicted that total demand would get out of hand. Measures of monetary restraint had already been put into effect, and presumably further steps would be taken if necessary. As for the relationship to the current account position, the comments in the report were along the lines of the world economic outlook papers which had been based on the assumption that, in general, members would handle their demand growth problems with a reasonable amount of success, and, in any event, that their achievements in that respect would not be markedly out of line with each other.

In regard to the suggestion by Mr. Massad that the monetary policy recommendations of the staff were in the realm of rules and not of discretion, the staff representative said that those recommendations should not be viewed as a doctrinal position, but as fitted to the particular situation under examination. The discussions with the authorities had indicated the difficulties of shifting policy from one setting to another, and therefore the staff had felt it advisable to center attention on the achievement of a policy suitable not only for the months immediately ahead but for a longer period. As to the way in which monetary policy affected spending, the reference in the appraisal was to the fact that the lags were different for different components of spending. Various studies in that area suggested that the effect came fairly quickly in some instances, but lagged considerably in others.

On the concept of an exchange rate that seemed suitable for the medium term, the staff representative agreed with Mr. de Vries on the importance of rendering such a judgment to provide a basis for evaluating policies that influenced the rate. In one sense, looking at the rate over the medium term could be seen as no more than an attempt to analyze the effects of exchange rate changes, taking into account the lags, in an effort to foresee the implications over a period of time.

Finally, the staff representative noted that in light of the discussion at EBM/73/88 on special consultations on exchange rate policies, which was to be resumed in October, it had not been thought appropriate to bring forward a decision on Canada's exchange rate policy at the present time.

Mr. Bryce expressed his appreciation of the comments made by Executive Directors.

In response to Mr. Dale's remarks on the sensitivity of capital flows to interest rates, Mr. Bryce said there was no doubt that money market flows in particular were interest sensitive. The record of quarterly changes in those movements could be seen in Table 37 of SM/73/200, in the last three lines under the heading "Non-Residents' Holdings of Canadian Assets." They fluctuated in considerable part because of changes in interest rates and in monetary conditions. To understand those short-term flows in relation to the balance of payments, it had to be borne in mind that the Canadian financial market was almost entirely an open one. It was subject to two or three guidelines set by the Government some years earlier so that Canada did not serve as a channel for U.S. capital to reach third countries. The market was large, closely related to that of the United States, and was highly sensitive to interest rates. The figures for "Other Short-Term Capital" in Table 37 were not broken down but included unidentified movements as well as considerable holdings by Canadian residents. The net foreign currency claims on nonresidents of the chartered banks was another item in that table that was worth noting. It appeared as though the banks themselves took a substantial net position in the market, but it had to be remembered that those were spot holdings with nonresidents which were offset by the banks' spot holdings with residents. A substantial complication was that Canadian residents often maintained foreign currency accounts with Canadian banks in Canada. In addition, there were future purchases and sales. Table 37 showed clearly that in 1970, 1971, and 1972, the spot positions of banks vis-à-vis nonresidents had fluctuated widely.

To understand the interest sensitive nature of those short-term flows, Mr. Bryce added that it should also be borne in mind that although there was only a small number of banks in Canada, three or four of them were large enough to compare with all but the largest banks in the world. They were substantially engaged in Euro-currency markets and moved capital freely not only from Canada to other countries, but between other countries as well. While those capital movements were interest sensitive to a considerable degree, other motivations including exchange rate considerations, could also be of relevance. A question that was often asked was where, when the market served to maintain the rate of the Canadian dollar in a stable relationship with the U.S. dollar, that showed up in the Canadian balance of payments. The answer would be that, in Table 37, it showed up not so much in the figures on commercial paper, which were mostly hedged, as in the figures on bank holdings.

As far as interest rates on loans were concerned, Mr. Bryce remarked that while Canadian banks were lending at considerably lower rates than American banks, the nature of the Canadian banking system forestalled any considerable movement of capital. Canadian market letters suggested that banks in Canada were rationing credit to some degree, rather than raising interest rates. The lower interest rates in Canada were no doubt one reason why banks sought to place funds in the Euro-dollar market or in the United States, within the limits allowed by the guidelines.

Turning to the question of how to achieve an effective monetary policy, Mr. Bryce referred to the difficulties experienced by the Bank of Canada in ensuring that the banks applied the appropriate degree of restraint, as mentioned in the staff report. The banks were highly competitive, particularly in the way in which they granted credit; that was one reason why it was so hard for the Bank of Canada to achieve a moderation in the rate of expansion of the money supply. The central bank relied on the control of liquidity--both in the form of reserves and liquid assets generally--in order to control the size of the money supply. However, since Canadian banks had a large supply of funds which were being turned over regularly, it was hard to control effectively the volume of their deposits and loans by controlling their general liquidity. Moreover, the liquid asset ratio of the banks could decline substantially at times. While liquidity was as tight as it had been for some years, the money supply was still rising, as pointed out in Supplement 1 to the staff report. The Bank of Canada was making a real endeavor to achieve a slower rate of monetary expansion and bank credit, without bringing it to a halt; but was encountering real problems of an institutional nature in doing so.

It was interesting to note Mr. Bryce added, that the interest rate on mortgages in Canada was at an extremely high level, around 10 per cent per annum, but nevertheless, housing starts were also at record levels.

It was clear from the staff report, Mr. Bryce thought, that if the effort to control the domestic situation led to higher interest rates, the Canadian authorities would not feel that that was unreasonable under the present circumstances.

As to the general structure of the balance of payments, Mr. Bryce commented that the heavy international indebtedness of Canada had always led to a strong desire to balance the current account. In addition, serious unemployment problems over the past decade, with the exception perhaps of one or two years, had added to the wish to avoid a major deficit on current account because that tended to worsen the employment situation. If in the decade to come, Canada's resources were to be substantially developed, the problem of whether to import capital on a large scale, both in real terms through a current account deficit as well as in financial market terms, would become chronic. Elaborate studies were being made on individual projects, such as the proposed gas pipeline up the Mackenzie River, in order to explore the interrelation between problems of financing and of supply and the effect on the structure of the balance of payments and on interest rates and exchange rates. The present general balance of payments policy of the Government was still based on the hope of being able to achieve a current account surplus that was adequate to cover aid flows that did not appear in the current account.

In regard to regional unemployment, Mr. Bryce agreed that fiscal policy was the best way to deal with it, insofar as that was possible. Basically, the authorities relied on the expenditure side, although at present the trade policy implications of fiscal measures had to be watched with care, in Canada as well as elsewhere.

As to the labor market and the relation of unemployment to unemployment insurance, Mr. Bryce said that it was inevitable in a country with a highly developed social security system for there to be less pressure on individuals to seek employment, particularly when the only work available was unpleasant. It was part of the price to be paid for a humane social security system, but it complicated the economic management of the country and gave rise to a type of unemployment that in fact reflected the absence of desirable jobs. In addition, the provincial governments, with the support of the Federal Government, had elaborate welfare systems which provided allowances based on need. For heads of families with several children it almost paid not to work, if one could only get relatively low wages.

On incomes policies, Mr. Bryce said he had little to add to his statement, except to agree that the need for an incomes policy was due to the fact that markets for goods, for labor, and perhaps for financing as well, were not fully competitive. For that reason, expectations played a large role. The use of market power was not likely to disappear; people would not give up collective bargaining, nor would governments enforce a strict anticartel policy, for example. An incomes policy was a measure that went only half way, in an effort to persuade those wielding power in the market to use it with restraint. It was therefore natural to find advice being given on all sides to introduce incomes policies. In 1970, the Canadian authorities had obtained the voluntary cooperation of the business community in holding down prices, but the trade unions had not cooperated. A Royal Commission had examined the subject exhaustively for years and had concluded that mandatory price and wage control measures would probably be needed from time to time, but that they could only be effective if there was a consensus of public opinion in favor of them. That was not the case at present, although irritation about food prices might encourage it.

Mr. Beaurain repeated that he had not been convinced by the argument of the staff that a draft decision should not be prepared, pending the outcome of consideration by the Executive Board of the staff paper on special consultations on exchange rate policies. Since the discussion held on August 29 had been inconclusive, there appeared to be a legal void, namely, between the time that a decision on the Canadian exchange system had been adopted on January 5, 1973, and some unspecified future date. At EBM/73/88, Mr. Rawlinson had put forward an alternative to the suggestions made by the staff in SM/73/139 which, if applied in the future, would result in reports on a global rather than on a country-by-country basis. In the event that that suggestion was adopted, he wondered how it would be possible to conclude such joint consultations with recommendations addressed to a single country. Special consultations of that nature could not be a substitute for the consultations normally held in the past, which had been concluded with draft decisions. For those reasons, he regretted the absence of a proposed decision on the consultation with Canada.

The Acting Chairman explained that the staff had felt there was enough uncertainty among the Executive Directors with respect to policy on the floating rates of major countries to make it advisable not to come forward with proposed decisions during a period when some of the aspects brought out in the staff paper on special consultations were still under discussion.

The Executive Directors concluded their consideration of the 1973 Article VIII consultation with Canada.

3. IRAQ - 1973 ARTICLE XIV CONSULTATION

The Executive Directors considered the staff report and proposed decision for the 1973 Article XIV consultation with Iraq (SM/73/196, 8/6/73). They also had before them a report on recent economic developments in Iraq (SM/73/205, 8/23/73).

Mr. Hussein submitted the following statement on behalf of Mr. Deif:

The staff report before us strikes, in contrast to earlier ones, a particularly optimistic note. I am in general agreement with the staff appraisal and commend the proposed decisions for the approval of the Executive Directors.

While Iraq is endowed with rich resources, the performance of the economy has for a long time been considerably below its potential. An important factor in this performance has been the slow growth, in comparison with other producers in the area, of oil production and exports. The staff is right in relating the inadequate growth of the oil sector to the difficult relations Iraq had with the foreign concessionaire over a long period of time. The uncertainties associated with these difficult relations underlined the vulnerability of the balance of payments. In those circumstances, an important objective of economic policy has been the minimization of this vulnerability by maintaining external reserves at a high level. With the satisfactory settlement with the concessionaire early this year and because of the favorable outlook for the oil industry, the Iraqi authorities can look forward to a period of sustained high rate of economic growth.

The Iraqi authorities moved quickly and courageously to make difficult adjustments in economic policy during the crisis period in 1972/73. Only with the benefit of hindsight can the question be raised as to whether the post-nationalization austerity measures were excessive. As the staff points out, at the time these measures were taken the Iraqi authorities could not quantify the implications of nationalization for oil receipts nor foretell the duration of the crisis period. Indeed, the prudent policy of the Iraqi authorities might have been a factor in shortening this period.

The degree of flexibility of economic policy in Iraq is also demonstrated by the actions taken by the authorities after the settlement with the concessionaire. Restrictive fiscal measures were eased with respect to the remaining period of fiscal 1972/73 and the additional restrictions on imports and current payments were rescinded. The stance of fiscal policy for 1973/74 is clearly expansionary. While the planned growth in current outlays is limited, development expenditures could reach twice the level of

1972/73. There will also be reduced reliance on external resources in financing the budget. The import program for the year was increased sufficiently to accommodate the stepped-up development effort. Despite this, the balance of payments is projected to continue to be in a very favorable position because of the expected sharp increase in foreign exchange earnings from the oil sector. The expected growth in oil production in 1973/74 also assures a very satisfactory rate of real economic growth. All in all, Iraq can look forward to a prosperous 1973/74. Based on projections of the growth of oil production in the coming years, the economic outlook for the medium term is also favorable. Iraq has now a good opportunity to devise policies aimed at the attainment of the full potential of the Iraqi economy under conditions of internal and external balance. I feel confident this opportunity will be seized.

With these brief remarks it remains for me to say that the staff reports give a fair and accurate survey of the discussions held in Baghdad in May 1973, and I wish to thank the staff for its efforts.

Mr. Dale observed that both the staff report and Mr. Deif's statement took note of one central development over the last year, namely, the fully satisfactory settlement reached in February 1973 between Iraq and the Iraq Petroleum Company with respect to matters that had been under discussion for some time. That was welcome because it eased relations in a number of directions. In addition, it would allow Iraq in future to make full use of its rich endowment of oil resources to develop the country's potential.

Miss Fuenfgelt noted that Mr. Deif, in referring to Iraq's external reserves, had said that an important objective of economic policy had been to minimize the vulnerability of the balance of payments by maintaining those reserves at a high level. The staff report contained a short paragraph on page 13 about Iraq's policy on the investment of its growing reserves and the authorities' intention to take into consideration the interests of the international community and the stability of the international monetary system. It would, however, be interesting to have more detailed information than the staff report gave about investment policy in the past and about the intentions of the authorities for the future.

The Deputy Director of the Middle Eastern Department explained that the main point of emphasis in the discussion with the Iraqi authorities had been that in deciding on the type of asset to be acquired and in shifting from one type of asset to another, the interest of the international monetary system should be taken into account. As to investment policy in the past, although adequate information was not available, foreign exchange reserves had basically been invested in financial assets (bank deposits and government securities) denominated in the currencies of the main reserve countries. There had, however, been shifts in recent years into other currencies.

The Executive Directors turned to the proposed decision, which they approved.

The decision was:

1. This decision is taken by the Executive Directors in concluding the 1973 consultation with Iraq pursuant to Article XIV, Section 4, of the Articles of Agreement.

2. The Iraqi economy's performance in 1972/73 was adversely affected by the decline in oil production and exports. The uncertainties associated with the developments in the oil sector prompted the authorities to reduce public sector investment and other outlays. On the other hand, agricultural production rose substantially due to favorable weather conditions, and activities in the industrial and construction sectors increased. On balance, a very small increase in the real gross product seems to have been realized.

3. The severity of the austerity measures taken by the authorities in June 1972 and the fact that the period of difficulty proved to be a short one led to an improvement in the budgetary position and the realization of a substantial surplus in the balance of payments. In addition to reductions in government expenditures, these measures included new restrictions on imports and other current payments. Mainly reflecting the large balance of payments surplus, private liquidity rose sharply, leading to pressures on domestic prices.

4. The economic outlook for 1973/74 is very favorable. The settlement with the oil concessionaire has paved the way for possible major increases in oil production and exports. The expected rise in the Government's oil income will permit a large stepup in the public sector's investment effort while the budget and the balance of payments are likely to show surpluses.

5. The fairly liberal trade and payments policies previously pursued by Iraq were modified in mid-1972 by intensification of restrictions. However, the additional restrictive measures imposed at that time were eliminated in early 1973. The Fund welcomes this reduction in restrictive practices and believes that it is in Iraq's interest to further liberalize the trade and payments system. The favorable outlook for external finances should permit such a policy.

Decision No. 4047-(73/89), adopted
August 31, 1973

4. MALAYSIA - 1973 ARTICLE VIII CONSULTATION

The Executive Directors considered the staff report and proposed decision for the 1973 Article VIII consultation with Malaysia (SM/73/180, 7/24/73). They also had before them a report on recent economic developments in Malaysia (SM/73/204, 8/20/73, and Cor. 1, 8/24/73). Mr. Siew Hong Choi, Executive Director of the International Bank for Reconstruction and Development, was present.

Mr. Kharmawan made the following statement:

After a year of rather slow growth of GNP in 1971, the Malaysian economy picked up momentum during 1972, registering a growth rate of 6.1 per cent at current prices, which was not too far from the annual growth target of the Second Malaysia Plan (1971-1975). This economic performance in 1972 was achieved despite adverse exogenous influences, such as depressed prices and demand for most of Malaysia's major exports for the greater part of the year, notably rubber and palm oil, rising prices for imports, and the resultant deterioration in the terms of trade by about 10 per cent. The maintenance of growth momentum under these adverse conditions attests to the resilience of the economy and the generally well-oriented domestic policy responses to external factors, particularly the shift to a countercyclical posture for fiscal policy and the use of appropriate monetary measures.

The general outlook for 1973 shows a good prospect for substantial improvement over the preceding year, in view of the sharp recovery in export prices since September 1972. However, as the staff has pointed out in its concise and excellent report, the emergence of inflationary trends, due partly to reasons not of their own making, and the persistence of a high volume of unemployment remain the main areas of policy concern. The authorities are keenly aware of the need to curb inflation as well as to increase employment opportunities, and they have already implemented numerous measures aimed at achieving these ends.

Unemployment is a problem confronted by most developing countries; in fact one of the main purposes of development is to use available labor to the fullest, both for economic and social reasons. As in most other developing countries, a common feature with respect to unemployment in Malaysia is that it is concentrated among persons in the younger age group seeking clerical and other low-grade white collar jobs, while there exist shortages of high-grade technical and managerial personnel. Despite the substantial growth rate which Malaysia managed to achieve successively over a number of years, the unemployment problem persisted. The rural area in most developing countries is characterized by underemployment.

The rise in manufacturing industries and the growth of urbanization are instrumental in attracting rural-urban migration of younger age groups. But the rate of growth of manufacturing activities in Malaysia and elsewhere was not enough to absorb the large influx of younger people, thereby turning underemployment among smallholders in rural sectors to more apparent unemployment in urban centers. Be that as it may, the Malaysian authorities give a very high priority to an employment policy aimed at both stimulating aggregate employment opportunities and correcting regional imbalances in the employment pattern. Deliberate efforts are being made to accelerate job opportunities in the agricultural sector through land settlement schemes. In addition, other measures already adopted to tackle the unemployment problem include intensive programs of vocational and technical training, a ceiling on individual earnings on overtime work, the abolition of the payroll tax, the introduction of a labor utilization tax relief incentive, and assisted migration to areas of labor shortage in Sabah. Moreover, in view of the drive for more effective family planning, the technical assistance of the IBRD and ILO to assess and identify areas of labor-intensive technology suitable for local circumstances, and the recent noticeable improvement in plan implementation capacity, the seriousness of the unemployment problem should be gradually lightened.

The efforts made by developing countries to absorb unused human productive capacity deserve the attention and support of the international community. A new and specific development strategy seems to be required to solve this more structural than cyclical problem of unemployment in the less developed countries.

Inflation, on the other hand, is a new phenomenon for the Malaysian economy. After a decade of near price stability, with annual increases in price of just over 1 per cent, a record price increase of 5.6 per cent was registered over the year ended April 1973. Although it is still well below the rates of inflation prevailing in most other countries, this sudden leap in inflation is regarded by the Malaysian authorities as alarming in itself; however, what is of greater concern to them is that the so-called inflationary psychology, due in part to circumstances not of their own making, may gradually take root, making price inflation more difficult to cure. The authorities, realizing that accelerating government expenditures, and excess liquidity as well as supply constraints,have all contributed to the price rises, have already taken monetary, fiscal, and import liberalization measures to control this trend. However, rising prices in Malaysia are to a certain extent symptomatic of a developing country with an open and free economy that cannot be wholly insulated from world-wide inflationary trends and from the exchange rate changes of the industrial countries.

The emergence of "imported inflation" is a cause for concern to the authorities; the decisions to maintain the gold parity of the Malaysian dollar in February 1973, and the recent upward floating of it, were taken to moderate the domestic impact of imported inflation to some extent. However, the authorities are greatly concerned over the impact on Malaysia's exports of the effective appreciation of the Malaysian dollar, which is currently estimated to be well over 7 per cent compared to the pre-Smithsonian period; this is especially so for an economy like Malaysia which is faced with highly competitive fluctuating markets for its primary exports, and, of late, with rising prices of imported goods.

Budgetary operations, as the staff has pointed out in its report, have been increasingly used as countercyclical policy instruments in recent years: in view of the relative stagnation in private investment during the past two years, public investment was increased during 1971 and 1972 by 24 per cent and 40 per cent, respectively. However, the Government being committed to the acceleration of social and economic development and the eradication of unemployment, only limited flexibility is available on the expenditure side. It is therefore the authorities' view that greater scope for maneuver exists on the revenue side of the fiscal field. Consequently, their efforts were concentrated on improving the tax system and its administration. In addition to the imposition of a 5 per cent sales tax (which was raised in 1973 to 10 per cent on luxury items) and the initial move toward a more market-oriented interest rate régime (in the form of a tender system for treasury bills introduced from August 15, 1973)--for both of which the Malaysian authorities are grateful to the Fund for the technical assistance it rendered--many other new revenue measures were undertaken, as mentioned in the staff report. However, the authorities are aware of the accentuation of inflationary pressure due to some of the new revenue measures such as the sales tax and the increases in import and excise duties. The authorities have already initiated moves to make taxation more responsive to current changes in GNP, and more in this line is under consideration, in view of the recent increase in size and efficiency of fiscal administration staff. Technical assistance from the Fund will be sought for reviewing the level and structure of import duties.

In the field of monetary policy, the authorities are cognizant of the need to effectively regulate the growth of money supply, in view of the large increase in domestic liquidity. The recent amendments to the Central Bank of Malaysia Ordinance (1958) and the enactment of the Banking Act of 1973 (which were approved by the Parliament and came into force on April 15, 1973) will provide greater flexibility in credit controls through variation in reserve ratios which, as the staff pointed out, seemed to be the most potent credit control instrument in the Malaysian conditions. With a view to absorbing excess liquidity, interest rates for 9-month and 12-month deposits with commercial banks were raised on August 1, 1973 from 6 per cent and 6 1/4 per cent, respectively, to 6 1/2 per cent and 7 per cent. Also, with effect from August 1, 1973, savings deposits with borrowing companies will no longer be subject to maximum rates; and borrowing companies will be free to quote their own interest rates. These measures are intended to make it more attractive for the public to deposit their money with banks and borrowing companies for longer periods and thereby arrest the recent tapering off in the growth rate of the private sector's holdings of fixed deposits. In addition, with effect from August 16, 1973, the minimum liquidity ratio of banks was raised from 20 to 25 per cent.

In order to curb inflationary pressure, the Government of Malaysia announced on August 17, 1973 the removal of import restrictions and quotas on about 60 items, which include steel products, household fittings, sugar confectionary, cloth, various chemicals, etc. These items may now be freely imported into Malaysia.

With respect to the external sector, although during 1972 the trade surplus declined slightly and net payments on services and transfers increased by SDR 30 million, Malaysia's balance of payments showed an overall surplus of SDR 50 million. Although Malaysia's net external reserves represented about eight months of retained merchandise imports, the assessment of its level should take into account the openness of the economy, the freedom of trade and payments, the wide fluctuations in export earnings and the pressing need for development financing.

In conclusion, I wish to thank the staff for its well-balanced analysis of the Malaysian economy, and state that the Malaysian authorities accept generally the staff appraisal on pages 14 and 15 of the report.

Mr. Rawlinson agreed that the main problem facing the Malaysian authorities was inflation, although its degree was low by international standards. The Malaysian authorities were to be commended for their previous success in avoiding inflation. There had been a rapid increase in money supply in the past year, a difficulty that had been heightened by the overall budget deficit, and some easing of inflationary pressures might be sought in that latter area.

His authorities took an optimistic view of the prospects for Malaysia, Mr. Rawlinson continued. On external policies there were several points he wished to mention briefly. First, as recorded in the staff report, the period under review had seen the ending of the sterling agreement between Malaysia and the United Kingdom: that was a mild cause for regret. Second, the revised exchange control policy that had been introduced following that decision, and the floating of the Malaysian dollar, were entirely reasonable and offered no grounds for criticism. Third, the same was true of the present exchange rate policy of Malaysia. Fourth, the removal of certain import restrictions and quotas, mentioned by Mr. Kharmawan in his statement, was a welcome move. It was not only a correct response to the development of inflationary pressures but a desirable move in itself from an international viewpoint.

Mr. Dale commented that despite some adverse factors, such as reduced prices for certain exports, the rate of economic growth in Malaysia in 1972 had been satisfactory. Price increases and continued unemployment were the main problems. There had been a noteworthy increase in the authorities' capability to carry out and to vary public expenditure, which had reduced the economy's vulnerability to exogenous variations, although it might also have contributed to the emergence of inflation. Monetary policy had also become more active, and he welcomed the recent moves toward greater use of competitive and flexible interest rates.

He had been interested and heartened to note, Mr. Dale added, that the staff had suggested on page 2 of its report that the Malaysian authorities might consider stepping up the size of their development effort, in view of the unemployment problem. No doubt that was also linked to the sensible staff view that there might be a need for tax action in the relatively near future.

Mr. Kawaguchi said that he had been impressed by the efforts of the Malaysian authorities to develop various anticyclical fiscal and monetary instruments. As the staff had mentioned in its appraisal, with which he generally agreed, Malaysia's economic performance in 1972 had been satisfactory in terms of annual growth targets. That was no doubt to be attributed to the well-oriented fiscal policy.

In facing the emergence of inflationary trends, Mr. Kawaguchi noted that the Malaysian authorities intended to screen public sector projects in addition to the steps that had already been taken to postpone housing projects for government employees, another example of the appropriate implementation of fiscal measures. Although he understood that the constraints on flexibility in government expenditure might make a restrictive fiscal policy less effective than an expansionary one, he trusted that the Malaysian authorities would continue their discreet fiscal measures in the current circumstances.

In addition to the welcome increase in the size and efficiency of the inland revenue staff, Mr. Kawaguchi agreed with the suggestion of the staff to base tax assessments on current income instead of on the preceding year's income. It might contribute to making the tax system more responsive to changes in GNP. In that connection, he asked the staff for more detailed information about the proposed change from a "world income" basis to a "derived income" basis assessment.

As to monetary policy, Mr. Kawaguchi considered that the Malaysian authorities should be commended for having provided more flexible ways to control credit. He agreed that the power given to the central bank to vary reserve ratios for different banks would be the most potent instrument for the control of credit in Malaysia.

Dealing with the external front, Mr. Kawaguchi said that he understood the decision of the authorities to float the Malaysian dollar. The movement toward a steady diversification of external reserves had been mentioned on page 13 of the staff report. While the purpose was admittedly to protect the capital value of those reserves from changes in the exchange rates of reserve currency countries, he hoped the trend toward reserve diversification would not lead to uncertainty or become inconsistent with the orderly functioning of the international monetary system. It would be useful to receive more information on that point, if it was available.

Mr. Brand commented that the performance of the Malaysian economy during 1972 had been satisfactory, but hardly spectacular. While the annual growth target of the Second Malaysia Plan had been achieved, the specific targets of the Plan seemed fairly conservative. For instance, as the staff had noted on page 19 of recent economic developments, the employment target was modest; it implied an increase in the absolute number of unemployed by 46,000 to 321,000 by the end of 1975. Despite the depression of prices and earnings from Malaysia's main exports in 1972, the balance of payments remained strong. Reserves had increased, to represent over eight months of merchandise imports. Fortunately, the stagnation of private investment in 1972 had been compensated for by a large increase in public expenditure, illustrating an encouraging improvement in the implementation capability of the public sector.

Externally, Mr. Brand noted that 1973 was clearly going to be a boom year. Rubber exports rose 25 per cent in volume terms in the first quarter of 1973, compared with a year earlier. In addition, prices of rubber and of many other commodities were at much higher levels than in 1972. He understood that there had been encouraging oil strikes off the coast of Malaysia recently, while the expansion of exports of manufactured goods would increase foreign exchange earnings in future. Given the strong external position and the level of unemployment, a higher real growth rate of GNP seemed called for. Since public expenditure had been expansionary in 1972, the main problem appeared to be the need to take measures to encourage private investment and to ensure a wider provision of credit to smaller customers.

The continued rapid rise in estimated development expenditure in 1973, shown in Table 1 on page 8 of the staff report, was well justified in his view, Mr. Brand added. That table showed a high level of bank financing of the overall deficit. Due to the unexpected commodity price boom, he wondered whether revenues would not exceed forecasts. External reserves could be run down somewhat without danger, and he noted that the level of external borrowing was low by international standards. It could not be assumed that high commodity prices would continue indefinitely, and care needed to be taken to avoid another large rise in the money supply on the 1972 scale. The shift toward more positive regulation of excess liquidity was therefore welcome.

The emergence of inflationary trends in the Malaysian situation was probably unavoidable, especially as a result of international developments, although, Mr. Brand said, he had noted the staff view that cost-push factors were not yet important. The upward movement of the Malaysian dollar seemed justified, given the internal inflation and the strong external position. He would be interested in any information the staff could provide on how the float of the Malaysian dollar was being managed. He assumed that no real exchange market existed and that in practice the central bank fixed a rate for the Malaysian dollar each day. He wondered whether the aim was to keep reserve levels roughly constant, or to achieve a certain effective exchange rate against currencies of major trading partners.

Mr. Tilakaratna remarked that Malaysia's economic performance in 1972 had been adversely affected by low prices and a lack of demand for many of its exports, especially rubber and palm oil, but it had nevertheless been a satisfactory performance. The rate of price increase had been modest in terms of the experience of other developing and industrial countries, but high when viewed against Malaysia's past record. The authorities attributed that increase to the rising cost of imports, but the staff stated at the top of page 5 of SM/73/180 that the average monthly index of import prices had risen at approximately the same rate in 1971 and 1972. He asked for further clarification of that point.

In the field of public finance, Mr. Tilakaratna said that he also found it difficult to reconcile the figure given on page 7 of the staff report for net bank lending to the public sector in 1972 of M$572.6 million with Table 1 on page 8 which indicated a decline in net bank financing of the government budget. It appeared that reliance on bank financing would be heavy in 1973. There had also been a marked increase in bank credit to the private sector in the second half of 1972, and over the year as a whole, money supply had risen by 28 per cent, a trend that had to be watched with great care. In general, however, the Malaysian authorities were aware of the problems facing their economy and were following sound policies.

The staff representative from the Asian Department, in reply to Mr. Kawaguchi, explained that the proposed changeover to a "derived income" basis of income tax assessment had been motivited primarily by two factors. First, there were administrative difficulties in enforcing a tax base defined with respect to "world income," arising, among other factors, out of the need for a multiplicity of double taxation agreements. Second, the Malaysian authorities felt that improved incentives would be offered to investors, both foreign and domestic, as a result of the change.

In response to Mr. Brand, the staff representative noted that detailed information was not available on the current policy of the Malaysian authorities with regard to the management of the float. It was understood that for the time being, the authorities were concerned with maintaining orderly trading conditions. The staff did not know whether or not the authorities had a specific exchange rate in mind.

The analysis with respect to the import price index, the staff representative explained in response to a question by Mr. Tilakaratna, had been intended to indicate that in addition to imported inflation, which had been exercising pressure on the domestic price level, internal pressure had also been a factor. An exaggerated importance should not therefore be attached to the behavior of the import price index by itself.

The figures in Table 1 on the financing of the overall deficit, to which Mr. Tilakaratna had referred, were provisional, the staff representative added. There was not yet any clear information on the breakdown of the residuals.

Mr. Kharmawan thanked Executive Directors for their observations, which he would not fail to convey to his Malaysian authorities.

The appreciation expressed for the countercyclical policy that the Malaysian Government had been able to introduce to offset the lack of adequate investment in 1972 was of course a welcome feature, Mr. Kharmawan remarked. However, governments were able to resort to such policies only if they had comfortable reserves at their disposal. In that connection, the reserve position of Malaysia had made it easier for the authorities to undertake those counterbalancing policies .

The Executive Directors concluded their consideration of the 1973 Article VIII consultation with Malaysia.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Directors without meeting in the period between EBM/73/88 (8/29/73) and EBM/73/89 (8/31/73).

5. MANAGING DIRECTOR - SHIPMENT OF PERSONAL EFFECTS

The Executive Board approves the recommendation set forth in EBAP/73/198 (8/27/73).

Adopted August 29, 1973

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/73/199 (8/28/73) and EBAP/73/200 (8/28/73) is approved.

APPROVED BY THE EXECUTIVE BOARD:
Meeting 73/116, December 12, 1973

FRANK A. SOUTHARD, JR.
Acting Chairman

W. LAWRENCE HEBBARD
Secretary