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January 3, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Canada - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Canada which will be brought to the agenda for discussion on a date to be announced.

Mr. Hernández-Cata (ext. 8486) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

CANADA

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Consultation with Canada

Approved by E. Wiesner and C. David Finch

January 2, 1986

A Fund mission held Article IV consultation discussions with representatives of Canada in the period October 24-November 6, 1985. The Canadian representatives in the discussions included Mr. M. Wilson, Minister of Finance, Mr. G. K. Bouey, Governor of the Bank of Canada, and senior officials from the Department of Finance, the Bank of Canada, the Department of External Affairs, the Department of Energy, Mines, and Resources, the Department of Regional and Industrial Expansion, Investment Canada, and the Ministerial Task Force on Program Review. The mission had informal meetings at the Economic Council of Canada and the Conference Board of Canada. Mr. M. Massé, Executive Director for Canada, participated in the meetings. The Fund mission consisted of E. Hernández-Catá, K. Bercuson, P. Clark, L. DeMilner, S. Dunaway (all WHD), and J. McLeod (Secretary-WHD). The previous Article IV consultation was conducted in Ottawa in November 1984 and was concluded by the Executive Board on February 27, 1985.

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

I. Recent Economic Developments

After a severe recession from mid-1981 to the end of 1982, economic activity in Canada began to recover in early 1983 (Chart 1). As indicated in the tabulation below, the rise in Canada's real GNP during the 11 quarters of recovery through the third quarter of 1985 was slightly lower than the average recorded during previous postwar recoveries. However, real GNP growth during the present upswing was stronger in Canada than in the United States (Chart 2). The rate of expansion of total domestic demand in Canada during the present recovery was a little above the historical average, but was below the very rapid rise recorded during the same period in the United States. Aggregate demand in both countries was boosted by fiscal policy during the recent expansion; in Canada the ratio of the cyclically adjusted federal deficit to GNP is estimated to have increased by 2 1/2 percentage points from 1982 to 1985.

(Percentage changes)

	Canada		United States
	Present Recovery 1/	Average Post-war Recovery 2/	Present Recovery 1/
Real GNP	15.7	16.1	13.4
Net exports 3/	-0.4	0.1	-4.2
Total domestic demand	15.8	14.4	17.7
Inventories 3/ 4/	5.4	0.7	1.7
Final domestic demand	10.1	14.0	15.6
Personal consumption	13.1	15.5	12.1
Durable goods	37.3	26.1	37.1
Other goods and services	8.3	14.2	8.5
Residential construction	40.7	13.1	49.5
Nonresidential investment	-1.8	14.9	34.5
Government purchases 4/	4.3	8.8	11.4

Real GNP increased by 7 percent during the first year of the recovery (from the fourth quarter of 1982 to the fourth quarter of 1983); this was significantly above the 6 1/4 percent rate registered during the same period in the United States and close to the average growth recorded during the early phases of previous upswings in Canada (see tabulation below). Over the following seven quarters (through the third quarter of 1985), output increased steadily at an annual rate of 4 1/4 percent, close to the average growth experienced in similar stages of earlier Canadian recoveries. By way of comparison, the growth of output in the United States came down from an annual rate of 8 1/4 percent during the first half of 1984 to an annual rate of 2 percent during the following five quarters.

1/ Eleven quarters following the recession trough in the fourth quarter of 1982.

2/ Average of changes during the first 11 quarters of recoveries measured from 1954:2, 1957:4, 1961:1, and 1975:1.

3/ Change as percent of real GNP in the quarter preceding the beginning of the recovery.

4/ Data for the United States are adjusted to exclude transactions by the Commodity Credit Corporation. Government purchases include expenditure by provincial and local governments in the case of Canada and by state and local governments in the case of the United States.

In the initial phase of the recovery, economic growth in Canada was led by a particularly sharp turnaround in inventory investment (following an unusually sharp liquidation during the recession) and by rapid increases in expenditures on consumer durables. Residential construction also was strong, reflecting temporary incentive programs as well as a decline in mortgage rates during 1982-83. In the second year of recovery, the expansion was sustained by continued rapid growth in consumer durables and a strong performance of exports. At the same time, residential construction slowed significantly, reflecting in part the expiration of incentive programs. The growth of exports of goods and services fell substantially during the first three quarters of 1985, but the expansion of output was sustained by very rapid growth of total domestic demand, led by the continued strength of spending on consumer durables and a pickup in business capital formation. Residential construction increased sharply, owing in part to a drop in mortgage rates of 3 1/2 percentage points from mid-1984 to the summer of 1985.

(Percentage changes from fourth quarter to fourth quarter)

	1982	1983	1984	1985 1/
Real GNP	-4.9	7.1	4.3	4.7
Net exports 2/	2.2	-0.3	2.3	-3.1
Total domestic demand	-6.4	6.8	2.0	8.6
Personal consumption	-1.5	4.9	3.3	5.9
Durable goods	-3.0	15.4	8.0	13.7
Other	-1.2	2.8	2.2	4.1
Government	-0.2	0.7	3.6	0.1
Residential construction	-5.2	12.8	1.2	32.1
Nonresidential investment	-12.6	-9.7	0.6	11.1
Inventories 2/	-3.2	4.6	-0.9	2.1
Memorandum:				
U.S. real GNP	-1.9	6.3	4.7	2.8

While spending on consumer durables has provided impetus to the economy throughout most of the recovery, the growth of other components of personal consumption expenditure has been modest by the standards of previous expansions. The personal saving rate, which had risen substantially during the recession and reached a peak of 15 1/4 percent in 1982, declined to an average of 13 1/4 percent in 1983-84 and to a

1/ Changes from the fourth quarter of 1984 to the third quarter of 1985, at annual rates.
2/ Contribution of the change in net exports (or inventories) to the growth of real GNP.

little under 13 percent in the first three quarters of 1985, but it remains quite high by historical standards.

As indicated in Chart 3, business nonresidential fixed investment was unusually sluggish in the first two years of the recovery. This sluggishness reflected the high level of real interest rates, considerable unused capacity following a period of vigorous expansion of investment in 1979-81, and the deterioration of corporate balance sheets during the early 1980s. In addition, investment in energy and other resource sectors--which normally accounts for a large part of total investment in Canada--was depressed by the weakness in commodity prices. The pickup in business fixed investment, particularly nonresidential construction, during the first three quarters of 1985 reflected in part the decline in real interest rates since mid-1984. Investment in the energy sector increased substantially, perhaps in response to the new Government's initiatives to deregulate energy prices and to reduce the burden of taxation on energy production.

Employment grew by 3 3/4 percent during the first year of the economic recovery, and the unemployment rate declined from nearly 13 percent in December 1982 to just above 11 percent in December 1983 (Chart 4). The unemployment rate remained broadly unchanged during 1984 as the growth of employment slowed. Employment picked up during the first 11 months of 1985, and by November the unemployment rate had declined to just over 10 percent; however, it remained well above the range of current estimates for the natural rate of unemployment. 1/

Canada's wage-price performance has improved considerably in the past several years. Inflation, as measured by the 12-month rate of increase in consumer prices, declined from nearly 13 percent in mid-1981 to 4 percent in November 1985 (Chart 5). The inflation differential with the United States, which in 1982 was about 4 1/2 percentage points, declined substantially during 1983 (Chart 6). During 1984 and early 1985, consumer prices rose at broadly similar rates in Canada and in the United States, but Canadian prices have tended to rise a little faster in recent months owing partly to increases in excise taxes. The four-quarter change in the GNP price deflator fell from a peak of 12 1/2 percent in the first quarter of 1980 to less than 2 percent in the third

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1/ Estimates provided in the recent report by the Royal Commission on the Economic Union and Development Prospects for Canada (the "MacDonald Commission") suggest that the natural rate of unemployment may have risen from a range of 4 to 5 percent in the 1950s and early 1960s, to 6 to 7 percent in the early 1970s, and to 6 1/2 to 8 percent at present. This rise has been attributed in part to demographic changes (including a rising proportion of youth and women in the labor force) and to the increased generosity of the unemployment insurance system brought about by legislative change in 1971. These issues were analyzed in Appendix I to SM/83/9.

quarter of 1984, before picking up to 3 1/2 percent in the third quarter of 1985.

Wage increases (including cost of living adjustments) in major collective bargaining settlements averaged about 3 1/2 percent (annual rate) in 1984 and the first three quarters of 1985, compared with 4 3/4 percent in 1983 and 10 1/4 percent in 1982 (Chart 7). Unit labor costs were unchanged during the first year of recovery (Chart 8), as wage increases matched productivity gains. During 1984 and the first three quarters of 1985 unit labor costs rose moderately, reflecting a cyclical slowdown in productivity growth.

The current account of the Canadian balance of payments moved into surplus in 1982 for the first time in nine years, as the recession dampened import demand (Chart 9). With the recovery of economic activity, the surplus narrowed from $2 3/4 billion (3/4 percent of GNP) in 1982 to $1 3/4 billion in 1983; the surplus rose to more than $2 1/2 billion in 1984 but shifted to a small deficit in the first three quarters of 1985 (see tabulation below). The merchandise trade surplus widened from $17 3/4 billion in both 1982 and 1983 to $20 3/4 billion in 1984. The rapid growth of exports during 1983-84, which reflected largely the strength of demand in the United States, outpaced a vigorous expansion of imports. In particular, exports of automobiles and energy products increased strongly during this period, as U.S. demand for autos shifted toward the relatively large models produced in Canada and as the Canadian authorities eased restrictions and reduced taxes on petroleum exports.

Canadian International Transactions

(In billions of dollars)

	1981	1982	1983	1984	1985 1/
Current account balance	-6.1	2.7	1.7	2.6	-1.0
Trade balance	7.3	17.8	17.7	20.7	17.7
Invisibles, net	-13.4	-15.1	-16.0	-18.1	-18.7
Long-term capital, net 2/	-0.2	7.7	2.3	2.0	0.8
Short-term capital, net	15.8	-10.1	1.9	-0.1	1.6
Statistical discrepancy	-8.7	-1.6	-4.8	-6.4	-3.0
Changes in net official reserves 2/	1.1	-1.4	1.0	-1.9	-2.8

1/ First three quarters at annual rates; current account transactions are seasonally adjusted.

2/ Net of long-term foreign currency borrowings or repayments by the Government of Canada associated with international reserves.

The trade surplus fell to an annual rate of $17 3/4 billion in the first three quarters of 1985; the growth of exports slowed from its extraordinarily rapid pace in 1984, owing largely to the slowdown in U.S. demand. The rise in Canadian imports was fairly strong in this period, reflecting in part the pickup in nonresidential business investment--a component of demand that is particularly import-intensive--and the strength of demand for automobiles. The deficit on service transactions and transfers increased from $15 billion in 1982 to $18 billion in 1984 and to $18 3/4 billion (annual rate) in the first three quarters of 1985, owing largely to rising net payments of investment income.

Following a small net outflow in 1981, the balance on long-term capital flows shifted to a record surplus in 1982, reflecting substantial new issues of Canadian securities abroad and a sharp drop in direct investment outflows. Net inflows of capital fell in 1983 and remained at approximately the same level in 1984 before declining in the first three quarters of 1985. During 1985, there was a large net outflow of direct investment capital associated with the purchase by a domestic concern of the Canadian operations of a major multinational oil company, and with large acquisitions of foreign firms abroad by Canadian companies. The increase in these outflows more than offset a sharp rise in foreign purchases of Canadian securities as Canadian corporations and provincial governments significantly stepped up their placements of bonds abroad. During 1984, Canada's net external liabilities rose by $11 billion (roughly the same rise as during 1983) to a year-end position estimated at $158 billion (37 1/2 percent of GNP). 1/

The effective value of the Canadian dollar (MERM weights) fell by 2 percent from December 1983 to December 1984; a 5 1/2 percent decline in terms of the U.S. dollar was partly offset by an appreciation of 5 percent against other currencies. During 1985, the Canadian dollar depreciated by 10 percent in effective terms and by 5 1/2 percent against the U.S. dollar.

In February and early March 1985 the Canadian dollar--along with other major currencies--came under heavy selling pressure against the U.S. dollar. Differentials between Canadian and U.S. short-term interest rates widened as the Bank of Canada sought to moderate the effects of such pressure (Chart 10). Subsequently, the Canadian dollar recovered somewhat against the U.S. dollar although it depreciated against other major currencies. As exchange market pressures eased, interest rate differentials narrowed, particularly after mid-year. By September 1985, the effective value of the Canadian dollar was 5 percent below its December 1984 level; its value in terms of the U.S. dollar was about 3 1/2 percent lower than in December. From the G-5 announcement

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1/ The difference between the change in Canada's net international liability position and the current account balance reflects net retained earnings from direct investment, changes in the valuation of assets and liabilities, and the statistical discrepancy in the balance of payments.

of September 22 through the end of 1985, the Canadian dollar depreciated by 1 3/4 percent relative to the U.S. dollar and by 6 percent in effective terms.

Following a substantial improvement in 1977-80, the competitive position of Canadian producers deteriorated during 1981-83. The real effective value of the Canadian dollar (measured in terms of relative normalized unit labor costs in manufacturing) rose by more than 19 percent from the fourth quarter of 1980 to the fourth quarter of 1983; it increased by 8 3/4 percent relative to the U.S. dollar and by 55 percent relative to other major currencies (Chart 11). Since late 1983, the Canadian dollar has depreciated in real terms. In the fourth quarter of 1985, the real value of the Canadian dollar was estimated to be 11 1/4 percent lower than in the fourth quarter of 1983 in effective terms; it was 9 3/4 percent lower against the U.S. dollar and 15 3/4 percent lower relative to other currencies.

As has been the practice for many years, the Canadian authorities have intervened in exchange markets in order to moderate movements in the Canadian dollar. Net official reserves declined by US$1 1/2 billion in February 1985, as the Canadian authorities provided support for the Canadian dollar in exchange markets (Chart 12). With the subsequent easing of pressure on the Canadian dollar in relation to the U.S. dollar, net reserves rose by more than US$1 billion from the beginning of March to the end of July 1985. This increase was reversed during the following four-month period; a particularly sharp drop in net reserves took place in November, when the Canadian dollar came under renewed selling pressure in exchange markets.

II. Economic Outlook

The staff's preliminary projections for the Canadian economy through the end of 1987 were prepared in connection with the current World Economic Outlook exercise. These projections are based on the assumption that real GNP in the United States would grow by about 3 percent during 1986 and 2 3/4 percent during 1987 and that the GNP deflator in the United States would rise by about 4 percent during 1986 and a little under 3 3/4 percent in 1987. 1/ With regard to economic policies in Canada, it is assumed that the Bank of Canada will maintain a policy of monetary restraint aimed at consolidating the progress made in reducing inflation, and that the real exchange rate between the Canadian and the U.S. dollar will remain at its level in early December 1985. The forecast also assumes that the Canadian Government will fully implement its plan to reduce the federal deficit as announced in the May 1985 budget; this plan envisages reductions in the cyclically adjusted federal deficit of $5 1/2 billion (1.1 percent of GNP) in 1986 and $1 billion (0.2 percent of GNP) in 1987.

1/ Unless otherwise noted, rates of growth referred to in this section are on a fourth-quarter to fourth-quarter basis.

On the basis of these assumptions, GNP in current prices is expected to grow by 6 1/2 percent during 1986 and 1987, compared with an increase of 9 1/2 percent during 1985. In real terms, the growth of GNP would slow from 5 1/4 percent during 1985 to 2 1/4 percent during 1986 before rising to 3 percent during 1987. 1/ The projected deceleration of output growth in 1986 reflects the substantial withdrawal of fiscal stimulus expected to take place in that year. There would be some further modest tightening of fiscal policy in 1987, largely in the form of expenditure restraint. However, the expiration of temporary surtaxes on personal and corporate income would contribute to a pickup in investment and consumer spending in 1987.

Economic Outlook

(Percent change from fourth quarter to fourth quarter)

	1984 2/	1985	1986	1987
Nominal GNP	7.1	9.4	6.4	6.4
Implicit price deflator	2.6	4.0	4.0	3.2
Real GNP	4.3	5.2	2.3	3.0
Net exports 3/	2.3	-0.7	-0.2	-0.3
Total domestic demand	2.0	6.1	2.5	3.4
Consumption expenditure	3.3	5.3	1.5	2.6
Government expenditure	3.6	0.7	2.1	2.3
Residential construction	1.2	30.6	-2.1	4.6
Nonresidential fixed investment	0.6	11.4	5.3	6.9
Inventories 3/	-0.9	--	0.5	0.2

Consumption expenditure is estimated to have risen by 5 1/4 percent during 1985, led by an increase of more than 10 percent in expenditure on durable goods. Total consumption would grow less rapidly during 1986 owing to the introduction of indirect taxes announced in the May 1985 budget (including a 1 percentage point increase in the sales tax that went into effect in January 1986) and to the imposition of a temporary surtax on personal income. In addition, the growth in auto sales, which had been very strong during the past three years, would come down during 1986. During 1987 the growth of consumption expenditure would pick up moderately owing to the effects on disposable income of the expiration

1/ On a year-over-year basis real GNP is projected to increase by 3 1/2 percent in 1986 and 3 percent in 1987, compared with 4 1/2 percent in 1985 (see Table 1).

2/ Actual.

3/ Contribution to the growth of real GNP.

of the personal income tax surcharge. The rise in government expenditures would be fairly slow through the forecast period, mainly as a result of fiscal restraint at the federal level.

Following an estimated rise of more than 13 percent during 1985, nonresidential business fixed investment would slow during 1986 reflecting the deceleration in aggregate demand resulting from the withdrawal of fiscal stimulus in 1986. Faster growth would resume in 1987, partly in response to a projected decline in real interest rates.

The GNP price deflator would rise by 4 percent during both 1985 and 1986 compared with 2 1/2 percent during 1984. This acceleration would reflect in part the transitory effects of the imposition of indirect taxes. The rate of price increase would decelerate to 3 1/4 percent during 1987; increases in wage costs are expected to remain moderate in the face of continued high levels of unemployment. Employment is projected to rise by 2 1/2 percent in 1986 and by 2 percent in 1987. The labor force would grow at approximately the same rate as employment during this period, owing in part to a rising trend in labor force participation. In these circumstances the unemployment rate is expected to remain broadly unchanged in 1986-87 at about 10 percent.

The deficit in the external current account is expected to widen from $1/2 billion in 1985 to $2 billion in 1986 and to $4 billion in 1987 (see Table 1). This deterioration would reflect a shift in the composition of domestic demand toward import-intensive components (such as investment in machinery and equipment) and the diminishing influence of the special factors that have favorably affected Canadian automotive and energy exports. It would also reflect further increases in net investment income payments.

Over the medium term (1988 to 1991), real GNP is projected to grow at an average annual rate of 3 percent, somewhat faster than the estimated growth of potential output. The rate of increase of the GNP deflator would average just under 3 1/2 percent. The decline in the federal deficit projected in the May 1985 budget is expected to make room for business investment, which would grow as a share of GNP over the period 1988-91. At the same time, there would be an increasing reliance on foreign savings and the current account deficit would reach about 1 1/2 percent of GNP by 1991.

III. Economic Policies

1. Introduction

In concluding the discussions on the Article IV consultation with Canada in February 1985, Executive Directors welcomed the continued expansion in the Canadian economy and the further progress made in reducing inflation which reflected in large measure the restrained monetary policy pursued by the Bank of Canada. At the same time, Directors observed that Canada's unemployment rate had remained high, and that investment had been slow to recover. Directors also noted that after two years of economic recovery, the Federal Government continued to run a very large fiscal deficit, and that interest rates in real terms remained high. They expressed concern that the continuation of these fiscal trends was creating uncertainty about the direction of economic policy and might endanger the sustainability of the expansion. They noted with approval the fiscal measures announced in the Government's November 1984 Economic Statement, but felt that these measures needed to be followed promptly by a plan to achieve a major strengthening of the federal fiscal position over the medium term.

Since last February, the Canadian economy has continued to expand at a fairly rapid pace, and there has been a rise in private investment following several years of weakness. Monetary policy has continued to aim at controlling inflation, and--in spite of the increases in excise taxes and the depreciation of the Canadian dollar that have taken place--there has been no significant acceleration of wages and prices. With regard to fiscal policy, in the May 1985 budget the Government announced a variety of measures aimed at a substantial improvement in the federal fiscal position over the medium term. Some of these measures already have been introduced, but there have been some difficulties in the implementation of the fiscal plan, and the outlook is for continued large deficits over the medium term. The Government has introduced policies aimed at improving efficiency by reducing the role of government in the economy and by strengthening the working of the price mechanism. This has been particularly the case in the energy sector, but important measures also have been adopted with regard to foreign direct investment and to the management and ownership of federal Crown corporations.

2. Fiscal policy

a. Background

The federal deficit increased from $24 billion in fiscal year 1982-83 to almost $37 billion (8 3/4 percent of GNP) in fiscal year 1984-85. 1/ This deterioration in the fiscal position occurred in spite of the recovery and reflected in part the effect of measures designed to stimulate the economy that were introduced in the April 1983 budget. It

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1/ Fiscal years run from April to March. Unless otherwise noted, the fiscal numbers provided in this section are on a public accounts basis. On a national income accounts (NIA) basis, the federal deficit increased from $22 billion in 1982-83 to $32 1/4 billion in 1984-85 (Chart 13). The public accounts deficit differs from the NIA deficit largely because it does not include the balances on unemployment insurance and federal employees' pension accounts. Details on the various measures of the federal deficit were provided in Appendix V to last year's recent economic developments paper (SM/85/43).

also reflected a rapid increase in net interest payments stemming from the combination of high interest rates and the continued buildup in the federal debt. As indicated in the following tabulation, the cyclically adjusted federal deficit (which is measured only on an NIA basis) widened from 2 3/4 percent of GNP in 1982-83 to 5 1/4 percent of GNP in 1984-85.

Federal Fiscal Position: Recent Developments and Projections

	Federal Deficit				
	Public Accounts Basis		NIA Basis (Percent of GNP)		Federal Debt 1/
Fiscal Year	(Billions of dollars)	(Percent of GNP)	Unadjusted	Cyclically Adjusted	(Percent of GNP)
1982-83 2/	24.0	6.7	6.0	2.7	34.3
1983-84 2/	31.8	8.1	6.3	3.5	39.6
1984-85 2/	36.8	8.7	7.5	5.2	45.4
1985-86	34.8	7.7	6.0	4.3	49.7
1986-87	31.1	6.5	4.8	3.1	53.2
1987-88	33.0	6.4	4.5	3.0	56.4
1988-89	35.0	6.4	4.8	3.5	59.2
1989-90	35.0	6.0	4.5	3.4	61.4
1990-91	33.5	5.4	3.7	2.9	62.7

b. The November 1984 Economic Statement

In November 1984, the recently elected government presented to Parliament an Economic Statement. The main ingredient of the strategy outlined in the Statement was an effort to reduce the federal deficit by controlling the growth of federal expenditures.

At the time of the Statement, the Government presented a forecast of the federal deficit under the assumption of no policy changes. According to this status quo projection, the federal deficit would rise from $34 1/2 billion (8 percent of GNP) in fiscal year 1984-85 to $37 billion (8 1/4 percent of GNP) in 1985-86. In relation to GNP, the deficit would decline over the rest of the decade, but would still be about 6 percent in 1990-91; the ratio of the federal debt to GNP--which had risen from about 17 percent in 1974-75 to more than 45 percent in 1984-85--would continue to increase and would reach 63 percent in 1990-91. Several measures were announced which were intended to lower the federal deficit in 1985-86 by $2 1/4 billion (1/2 percent of GNP) relative to the status quo estimate. Further measures were to be taken after the Government had completed an extensive review of fiscal

1/ Net federal debt, defined on a public accounts basis.
2/ Actual.

programs with the intention of achieving a $10-15 billion reduction in the projected level of federal expenditure by 1990-91.

c. The May 1985 budget

In May 1985, the new Government presented its first budget to Parliament. This budget included a significant revision in the fiscal outlook from that contained in the November 1984 Economic Statement, reflecting to a large extent changes in the underlying economic assumptions. According to the May budget projections, nominal GNP would grow at an annual rate of about 6 1/2 percent from 1987 to 1990 (compared with the earlier projection of more than 7 1/2 percent); real GNP growth would average 3 percent (compared with the earlier projection of 3 1/2 percent), and the unemployment rate would decline to 8 1/2 percent in 1990 (instead of a little over 7 percent). On the basis of these revised medium-term projections the staff estimated that, in the absence of policy measures, the deficit would remain above 8 percent of GNP through 1990-91, while the federal debt would rise to over 72 percent of GNP by that year.

The budget presented in May 1985 introduced a number of revenue and expenditure measures. These measures, together with those announced in the November 1984 statement, would lower the federal deficit by $4 1/2 billion in 1985-86 and by $20 billion in 1990-91 relative to what it would have been in the absence of fiscal action. The measures would increase revenue by $4 1/4 billion and reduce program expenditures 1/ by $11 1/4 billion in 1990/91. These cuts in the primary deficit (the deficit excluding interest payments) would, in turn, lead to a reduction of $4 1/2 billion in debt interest charges in 1990-91. On the revenue side, the measures included an increase of 1 percentage point in the sales tax and a broadening of its base; partial deindexation of personal income tax brackets and exemptions; and temporary corporate and personal income tax surcharges. On the expenditure side, the main reductions were to come from management initiatives, including cuts in federal employment, and reductions of federal transfers to provinces and to persons. As a result of these measures, it was estimated in the budget that the federal deficit would decline from $36 billion in 1984-85 (8 1/2 percent of GNP) to $33 3/4 billion in 1985-86 and to $30 billion (5 percent of GNP) in 1990-91, by which time the debt to GNP ratio would have risen to 63 percent.

d. Fiscal outlook

The Canadian representatives explained that the outlook for the federal deficit in the near term had been affected by certain unexpected developments since the budget was released. First, outlays associated with the failure of two small Canadian banks (see section 3 below) would

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1/ Program expenditures are defined as total budgetary expenditures excluding public debt charges.

raise expenditure by approximately $1 billion in 1985-86. The Canadian representatives indicated that further action would be taken to hold the deficit in that fiscal year at the level projected in the budget. Second, the reduction in personal transfers envisaged in the May 1985 budget had involved a controversial proposal to partially deindex old-age security payments. After the budget was presented, this proposal met with strong political opposition and was subsequently withdrawn by the Government. To offset the impact of this decision on the deficit through 1987-88, the Government announced an extension of the corporate tax surcharge and an additional rise in gasoline taxes.

Developments since May 1985 also have led to a somewhat more pessimistic appraisal of the medium-term fiscal outlook. The withdrawal of partial deindexation of old-age security payments will raise expenditures by an estimated $1.6 billion in 1990-91. As indicated above, the near-term effects of this measure would be largely offset by tax increases but a net shortfall of $1.2 billion would remain by 1990-91. The Canadian representatives indicated that they intended to take further measures to make up for this shortfall, but such actions have yet to be announced. As a result of these policy changes and of adjustments to the underlying economic assumptions, the deficit by 1990-91 is now projected at $33 1/2 billion--$3 1/2 billion above the May budget projection and about the same level as in 1985-86 (Chart 14). The staff pointed out that, even assuming full implementation of all the measures that had been announced, the ratio of the federal debt to GNP was now expected to rise to nearly 63 percent in 1990-91 (Chart 15), a level almost as high as that envisaged in the November 1984 status quo projection.

In the discussions, the staff asked whether the deficit-reduction measures that had been announced would be sufficient to achieve the Government's objectives. For example, on the basis of current assumptions, the medium-term goal of stabilizing the federal debt in relation to GNP would not be achieved by the end of the budget projection period in 1990-91. The staff observed that if the debt to GNP ratio were to be stabilized at, say, 58 percent by the end of this decade, additional deficit-reduction measures in the order of 1 percent of GNP would be required.

Looking at the fiscal problem in a somewhat different way, the staff noted that the need for further action to improve the fiscal position was also indicated by official projections for the cyclically adjusted federal deficit. These projections suggest that the ratio of the structural deficit (NIA basis) to GNP would decline by 2 1/4 percentage points from 1984-85 to 1990-91. In the latter year, however, the structural deficit would still amount to approximately 3 percent of GNP, indicating that the federal government would continue to absorb resources that could be used to finance private investment.

The budgetary projections presented in the May 1985 budget were based on a mid-range scenario for domestic and international economic developments over the medium term. The staff found this scenario to be internally consistent and plausible, but observed that the outcome might turn out to be less favorable, even if the international economy were to unfold as assumed. Specifically, the staff noted that the growth in output needed to achieve the decline in the unemployment rate projected to take place from 1985 to 1991 would require a substantial increase in productive capacity. In the view of the staff, there was a risk that the expected improvement in the fiscal position would not be sufficient to provide the resources needed to finance the required level of investment. Indeed, on the basis of cautious assumptions regarding technological progress and the behavior of private saving, the staff had estimated that additional cuts in the federal deficit (perhaps in the order of 1 1/2 percent of GNP) would be needed to ensure that the required expansion in the capital stock could be financed with domestic saving. 1/

The Canadian representatives agreed that there was an element of risk in their medium-term projection and that the planned reduction in the absorption of saving by the federal government might turn out to be insufficient. Some officials felt that the crowding out of capital formation by government deficits would not take place because, given the openness of the Canadian economy, the required saving might be obtained by borrowing from abroad. They added, however, that an increasing reliance on foreign saving would pose a problem, because it would mean that a rising share of national output would need to be devoted to servicing the foreign debt.

The Canadian representatives went on to say that their objective was to arrest, and then to reverse, the rise in the federal debt in relation to GNP, and they recognized that the measures announced in the May 1985 budget would not be sufficient to achieve these goals. They were determined to take additional measures, but they anticipated that political resistance would be strong.

The measures announced so far had emphasized expenditure restraint, in line with the Government's objective of limiting the role of the public sector in the economy. Indeed, Canadian officials observed that the budget plan would reduce program expenditure in relation to GNP from 18 1/2 percent in 1984-85 to less than 15 percent in 1990-91. However, they were concerned that it might not be possible to achieve further deep cuts in program expenditure, given existing international commitments in the areas of defense and official development assistance. Therefore, additional efforts to cut the deficit might have to rely mainly on revenue measures.

1/ This issue is discussed in Appendix VI to the recent economic developments paper.

The Canadian representatives noted that the primary deficit was expected to drop sharply during the remainder of the decade and to change to a surplus in 1990-91 (see Chart 14). Thus, the substantial overall deficit that would remain in that year would be more than accounted for by interest payments. The Canadian representatives felt that the correction of the remaining fiscal imbalance would not require a further reduction in program expenditure in relation to GNP, but rather might be dealt with through a temporary rise in the ratio of federal revenue to GNP. The staff observed that, while tax financing was clearly preferable to deficit financing, large tax increases were likely to have adverse effects on incentives to work and invest. The staff suggested that more could be done to reduce program expenditure, for example, in the areas of social programs and federal-provincial transfers.

3. Monetary management

The basic goal of monetary policy in Canada has been the achievement of sustained economic expansion and long-term price stability. From 1975 until late 1982, monetary policy was implemented on the basis of a target range for the narrow monetary aggregate, M-1. In recent consultation discussions, Bank of Canada officials have indicated that the monetary aggregates (and particularly M-1) have been unreliable guides for policy because of continued instability in the relationship between the aggregates, nominal income, and interest rates; in their view, this instability had resulted from financial innovations such as the introduction of interest bearing checkable accounts.

The difficulties in interpreting the behavior of the aggregates are illustrated by the recent large differences in monetary growth rates. For example, M-1 rose by less than 1 percent during 1984 while M-1A (which includes interest bearing checkable accounts) increased by more than 20 percent (Chart 16). Over the 11 months ended in November 1985, M-1 rose by 9 1/2 percent while M-1A increased by about 40 percent. Thus, the two measures of monetary growth continued to exhibit considerable divergence during 1985, but both measures indicated a substantial acceleration in relation to the previous year. Bank of Canada officials explained that while the continued rapid growth of M-1A appeared to reflect an ongoing response to the incentives offered by interest bearing checkable accounts, the acceleration of M-1 was associated in part with a large negative float that has developed since mid-1985. 1/

1/ The float measures the value of checks (and certain other items) that have been deposited or cashed but not yet collected from the bank on which they were drawn. To avoid double counting, the float is subtracted from the gross measure of demand deposits outstanding to obtain the appropriate measure of M-1. Typically the float is a positive number, but it has been negative since mid-1985. The emergence of a negative float appears to have reflected a rising tendency on the part of certain banks to debit deposit accounts before checks have been presented for payment.

In the absence of monetary targets, the Bank of Canada has been conducting policy with reference to a variety of indicators, with particular attention being paid to the exchange rate and to interest rates. In the current economic setting of considerable economic slack and moderate inflation, the strategy of the monetary authorities has been to seek a reduction in the level of interest rates so long as this does not threaten the progress being made in reducing inflation. The Bank of Canada's ability to lower interest rates has been constrained, however, by the need to resist sharp downward movements in the exchange rate; in the view of the Bank, a sharp depreciation of the Canadian dollar relative to the U.S. dollar might undermine the achievement of greater price stability and risk a loss of confidence that would make it difficult to achieve a lasting reduction in interest rates. Bank officials have stressed that a decline in domestic interest rates relative to U.S. rates must be gained by improving confidence and economic performance in Canada; it cannot be achieved by pursuing an expansionary monetary policy, as this would result in a depreciation of the Canadian dollar and a rise in inflation.

Officials of the Bank of Canada were somewhat reassured that the depreciation of the Canadian dollar over the past year had not led to significant pressures on costs and prices. They added, however, that the Bank could not afford to be unconcerned about the exchange rate and its implications for inflation. In this regard, there was agreement between Bank officials and the staff that the continued moderation of wages and prices had reflected not only the existing degree of slack in the economy but also the perception that the Bank was determined to resist downward pressures on the Canadian dollar.

A major financial development in 1985 was the failure of two relatively small western Canadian banks in September. These two institutions had been heavily involved in real estate and energy lending, two sectors where asset values have declined substantially in recent years. These bank failures--the first in Canada in more than 60 years--occurred in spite of considerable financial support by the Government. In addition to advances supplied by the Bank of Canada, the federal Government undertook to guarantee those deposits not covered by federal deposit insurance. In the wake of these failures, other small Canadian banks have experienced liquidity problems as a result of large deposit withdrawals. These problems have led to the merger of one troubled bank and to considerable support by the Bank of Canada for another.

The Canadian representatives said that the financial position of the rest of the banking system, and particularly that of the large commercial banks, appeared to be sound. They expected that the advances made by the Bank of Canada to the two banks that failed would be recovered in full, and noted that this episode had not raised major problems for the conduct of monetary policy. They added that there was considerable public discussion concerning the need to improve bank inspection and supervision. A special commission of inquiry is presently conducting an investigation of the handling of the bank failures and is expected to make recommendations for changes in the inspection system. In addition, legislation has been proposed for strengthening the system of deposit insurance.

4. Other domestic policy issues

a. Energy policy

In the November 1984 Economic Statement, the new Government made a commitment to dismantle the provisions of the National Energy Program that for five years had regulated most aspects of energy pricing in Canada. In March 1985, the federal government negotiated an agreement, referred to as the Western Accord, with the oil producing provinces of Alberta and Saskatchewan which resulted in the removal of price controls on crude oil in June 1985. The federal government also agreed to undertake substantial changes in the taxation and incentives that apply to the energy sector. In the May 1985 budget, the Government introduced proposals to remove the Petroleum and Gas Revenue Tax, the Oil Export Charge, and the Canadian Ownership Special Charge, and to phase out the Petroleum Incentive Payments program. 1/ To offset in part the net loss of federal revenue associated with these measures, an excise tax of 2 cents per liter was imposed on all transportation fuels effective September 1985.

In November 1985, the Government announced an agreement with the natural gas producing provinces to reduce government controls over natural gas prices and export volumes. Under the agreement, export volume restrictions are removed for short-term contracts and export prices will no longer be tied to the Toronto city gate price. Domestic prices will be deregulated after a one-year transition period.

b. Crown corporations

Part of the new Government's strategy for economic renewal announced in the November 1984 Statement was to undertake a thorough review of the activities of 57 federal Crown corporations. One of the key objectives of this review was to earmark for privatization those corporations that had a commercial value but no basic public policy purpose. Crown corporations with no commercial value and no effective policy role would be dissolved. The operations of the corporations retained by the Government would be rationalized in order to improve the quality, and lower the cost, of the services provided to the public.

Considerable progress has been made in the pursuit of these goals over the past year. Six Crown corporations have been closed and two others are in the final stages of dissolution. Sales or agreements to sell have been entered into with regard to four corporations: Northern

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1/ These changes are described in detail in Appendix III of the recent economic developments paper.

Transportation Company was sold in June, most of the Government's interest in the Canada Development Corporation was sold in September, and agreements to sell Canadian Arsenals Ltd. and de Havilland (a major aircraft producer) were announced in December. Negotiations over the sale of Teleglobe Canada (an overseas telecommunications company), Eldorado Nuclear Ltd., and Canadair are being actively pursued with expectations that sales agreements will be concluded in the near future. It is estimated that receipts from the sales already concluded will add $1/2 billion to government revenue in the present fiscal year and $350 million in the next fiscal year. Of the entities sold, de Havilland was the only corporation receiving a significant government subsidy (a total of $700 million since 1982).

5. <u>The exchange rate and the balance of payments</u>

In the discussion of exchange rate issues, the Canadian representatives noted that the real effective appreciation of the Canadian dollar from 1980 to 1983 had adversely affected the competitive position of Canadian producers. This loss in competitiveness had been reflected primarily in the trade balance with countries other than the United States. However, Canadian exports to the United States also had been affected. Excluding automotive and energy products, which had been influenced by special factors, the Canadian share of world exports to the United States had declined since 1980. The Canadian representatives noted that the real effective value of the Canadian dollar had fallen during 1984 as a depreciation relative to the U.S. dollar had more than offset a further appreciation against other currencies. During 1985, Canada's overall competitive position continued to improve, but the improvement had been particularly large in relation to countries other than the United States.

Canadian officials observed that the real exchange value of the Canadian dollar against the U.S. dollar was now below its level in 1979 (when Canadian producers were judged to be very competitive) although it was well above this level against other major currencies. The staff pointed out that the assessment of Canada's overall competitive position should focus primarily on the average, or effective, real value of the Canadian dollar rather than on specific bilateral exchange rates. The Canadian authorities agreed with this view and added that it would therefore be inappropriate to seek competitiveness gains in overseas markets by bringing about a depreciation of the Canadian dollar in relation to the U.S. dollar.

The Canadian representatives expressed some surprise that the Canadian dollar has not shown greater strength in relation to the U.S. dollar in the period following the September 1985 G-5 announcement. They felt that this might have reflected the banking problems Canada had been experiencing. In commenting on the G-5 announcement of September 22, the Canadian representatives agreed with the objective of achieving a better alignment of exchange rates and welcomed the decline in the effective value of the U.S. dollar that had taken place. They were encouraged by the recognition that the U.S. fiscal imbalance needed to be corrected, but observed that the policies to implement that objective still needed to be put in place.

With regard to the current account, the Canadian representatives observed that Canada's strong trade position since 1982 had reflected special factors affecting auto and energy trade and the rapid growth of the U.S. economy. These factors were not expected to continue to play an important role in the period ahead. Canadian officials anticipated a narrowing of the merchandise trade surplus; as a result, the current account would move into deficit in 1985 and the deficit would widen in 1986. Some improvement in the current account balance was expected after 1986, reflecting some strengthening in the competitive position of Canadian producers.

The Canadian representatives indicated that there had been no change in Canada's strategy regarding exchange market intervention. Intervention continued to be directed at smoothing out erratic fluctuations in the exchange rate between the Canadian and U.S. dollars. It has been conducted in a broadly even-handed manner, aiming at moderating abrupt movements in the exchange rate in both directions (see Chart 12).

6. Trade policies

In the discussion of trade policies, the Canadian representatives noted their continued interest in obtaining wider and more secure access to foreign markets, particularly the United States. To this end, the Prime Minister had announced in late September that Canada would seek to negotiate with the United States the broadest possible package of mutually beneficial reductions in trade barriers between the two countries. 1/

Canadian officials stated that removing nontariff barriers and dealing with trade regulation were the most important issues in such bilateral talks from Canada's point of view. In particular, Canada would seek to reach new understandings with the United States on subsidies, dumping, and safeguard actions and on government procurement. The Canadian representatives emphasized that any comprehensive agreement with the United States would have to be consistent with Canada's obligations under the GATT. They expected that the talks probably would begin early in 1986 and that it would take two to three years before an agreement would be concluded.

1/ In December 1985, the U.S. Administration asked Congress for authority to negotiate a free trade arrangement with Canada. Under the Trade and Tariff Act of 1984, the congressional committees given responsibility for reviewing such requests have 60 days to decide whether to deny negotiating authority to the President.

The Canadian representatives stressed that Canada remained committed to a new round of multilateral trade negotiations (MTN) and would continue to play a leading role in promoting and preparing for such talks. They noted that the areas of most interest to Canada in a new MTN round were trade in agricultural products, natural resources, and services; subsidies and countervailing duties; and safeguard actions. In their view, there were no major areas of potential conflict between bilateral discussions with the United States and multilateral trade negotiations. Indeed, they thought that bilateral negotiations would be complementary with a new round of MTN.

With regard to existing Canadian restrictions on imports, the Canadian representatives indicated that quotas on footwear were scheduled to expire at the end of November 1985. 1/ In July, the Import Tribunal had concluded in a report on the domestic shoe industry that (with certain exceptions) termination of the quotas would not be injurious to domestic producers. It recommended that quotas be allowed to expire as scheduled on all footwear except in the case of certain shoes for females, for which quotas would be phased out over a three-year period. At the time of the consultations, Canadian officials were confident that the action recommended by the Import Tribunal would be adopted. On November 20, the Government announced its decision to follow the Tribunal's recommendation. In making the announcement, the Minister for International Trade noted that the lifting of the quotas was expected to give rise to a short-lived surge in imports, but that Canada would mitigate the effects of such a surge by conducting consultations with its principal footwear suppliers.

The Canadian representatives indicated that there was considerable pressure from segments of the domestic industry to impose global quotas on textile and clothing imports. The Government had taken some actions to tighten the administration of bilateral textile agreements within the context of the Multifiber Arrangement (MFA), but it had resisted taking more general measures against imports on the grounds that the needs of the domestic industry could best be addressed in the context of negotiations on a new MFA. Officials said that a panel of four Cabinet ministers had been established to develop the Government's position and its negotiating strategy for a new MFA. With regard to automobile imports from Japan, the Canadian representatives stated that there had been no formal extension of the voluntary restraints on Japanese exports to Canada which expired in March 1985. However, both the Canadian and Japanese Governments had reached an understanding that sales of Japanese cars would grow in line with the expansion of the Canadian market, and both Governments expected that these sales would not exceed 18 percent of the market during the period from April 1, 1985 to March 31, 1986.

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

7. Other external economic issues

In the area of foreign investment in Canada, new legislation was enacted in 1985 that substantially altered the provisions of the Foreign Investment Review Act. Under the new law, the Foreign Investment Review Agency was renamed Investment Canada, and the agency's role was changed to promoting new investment in Canada and to reviewing only a limited number of investment proposals. Investments in new businesses in sectors other than those deemed "culturally sensitive" are now exempt from review, although notification is still required. 1/ The review process is also eliminated for foreign takeovers of existing Canadian firms whose assets are below specified thresholds. Moreover, the criteria for approval of large foreign takeovers have been liberalized and strict time limits have been established for the review process. The Canadian representatives said that a primary concern of Investment Canada was how Canada could attract new international investment. They added that programs were being developed to make investors aware of existing opportunities in Canada. Although it was too early to judge the impact of the new law, officials saw some indications of renewed interest in foreign investment in Canada.

In the May budget, the Canadian Government reiterated its intention to raise spending for official development assistance (ODA) from 0.5 percent of GNP at present to 0.7 percent of GNP by 1995-96, with an intermediate spending target of 0.6 percent of GNP in 1990-91. 2/ To meet these objectives, the budget proposed significant increases in foreign assistance while spending in other areas was curtailed. Canadian officials acknowledged that there would be pressures to restrain the increase in ODA in the period ahead. They stated that, as in the past, a large portion of assistance would be extended on a concessional basis and would be directed to the poorest of the developing countries.

IV. Staff Appraisal

The economic situation of Canada has improved significantly over the past year. The growth in real GNP during the year ended the third quarter of 1985 exceeded by a wide margin the average registered at similar stages of previous Canadian recoveries. The economic expansion also has become more balanced; while the growth of exports has slowed, business fixed investment has picked up following several years of sluggishness. Inflation dropped substantially in the past several years, and the continued strength of economic activity has not been

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1/ "Culturally sensitive" sectors include book and periodical publication and distribution; film and video production and distribution; and music production, publication, and distribution.

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

associated with any appreciable upward pressure on prices and costs. At present, the rate of inflation in Canada is not significantly higher than in the United States.

In spite of the improvement that has taken place, concerns remain about the economic situation. Even though the unemployment rate has dropped by almost 3 percentage points from its peak in late 1982, it remains high at a little over 10 percent of the labor force. Moreover, in spite of corrective measures announced during the past year, the fiscal outlook continues to be worrisome.

The major challenge faced by economic policy at this juncture is how to achieve a lasting reduction of unemployment while extending the progress made toward the goal of price stability. There is agreement between the Canadian authorities and the staff that an effective response to this challenge cannot be found in the pursuit of expansionary demand policies. Given the size of the federal deficit and the continued buildup in the federal debt, there is clearly no room for maneuver on the fiscal side. Moreover, monetary policy must continue to be aimed primarily at the longer-term objective of bringing down inflation.

A strategy designed to achieve satisfactory growth of output and employment in an environment of price stability must involve a large reduction in the federal deficit to make room for private investment and to improve confidence in economic policies. This fiscal effort must be coupled with steps to improve the efficiency of resource allocation by increasing the role of market mechanisms, removing distortions, and encouraging innovation. In the past year, the Government has made a great deal of progress in these areas, but it is clear that much remains to be accomplished, particularly with respect to the fiscal situation.

At the time of the November 1984 Economic Statement, several measures were announced which were intended to lower the federal deficit, and additional measures were announced in the May 1985 budget. However, the impact of these measures on the deficit in the near term was partly offset by outlays associated with the failure of two commercial banks. For the medium term, the measures that have been announced so far were expected to reduce the deficit in 1990-91 by about $20 billion from the level it otherwise would have reached. However, because of major changes in the economic outlook, it was projected in May that the federal deficit would still amount to $30 billion (or a little less than 5 percent of GNP) in 1990-91. Developments since May 1985 have led to a somewhat more pessimistic appraisal of the medium-term fiscal outlook, and the deficit for 1990-91 is now projected at $33 1/2 billion. Thus, under present assumptions, the reduction in the level of the deficit from now to 1990-91 would be very small and the federal debt would continue to rise in relation to GNP during this period.

In view of the revised outlook for the deficit and the federal debt, it appears that a larger fiscal correction will be needed to achieve the macroeconomic objectives pursued by the Canadian authorities. For example, the Government's intermediate goal of stabilizing the federal debt in relation to GNP would not be achieved by 1990-91 and might require further deficit reduction measures on the order of 1 percent of GNP. Additional measures to reduce the use of domestic saving by the federal Government also would be required to achieve the growth in investment and output consistent with the decline in the unemployment rate envisaged in the official medium-term projections.

The staff believes that a more rapid implementation of corrective fiscal measures would have significant advantages. A more heavily front-loaded fiscal plan would achieve an earlier and more pronounced deceleration of the federal debt, would yield greater savings in the form of interest payments, and therefore would result in a larger reduction in the deficit over the medium term. Furthermore, rapid and visible progress in bringing down the deficit is more likely to lead to a significant improvement in confidence than the promise of budget savings in the more distant future. Such an improvement in confidence should encourage the private sector to take advantage of the reduced absorption of resources by the Government, and thus help to cushion the near-term effects on economic activity resulting from the withdrawal of fiscal stimulus.

Last November, the Government stated its intention to deal with the fiscal problem primarily by acting on the side of expenditure. Even allowing for the effect of recent measures to offset the impact of reindexation of old-age security payments--which tilted the fiscal effort somewhat in the direction of tax increases--the mix of spending and revenue measures so far has remained well balanced. The staff welcomes the emphasis placed on expenditure restraint, as this would serve to reduce the role of government in the economy and thus to improve efficiency. At the same time the staff agrees with the Canadian authorities that, in view of the magnitude of the fiscal problem and the difficulty in achieving deep cuts in program expenditures, measures on the revenue side may well be unavoidable. However, it will be important to ensure that the emphasis on expenditure restraint is preserved and that any additional revenue measures avoid unfavorable effects on incentives to invest. In this connection, the existing wide range of tax preferences might be examined further with a view to raising revenue while improving the efficiency of resource allocation.

Turning to monetary issues, the restrained policy pursued by the Bank of Canada in the past several years has succeeded in bringing about a large reduction in inflation and in keeping wage and price increases at relatively low levels during the economic recovery. The staff shares the view expressed by the Bank of Canada that the difficulties in interpreting the behavior of the aggregates, particularly M-1 and M-1A, preclude a return to monetary targeting in the near future. Yet, the staff feels that movements in the aggregates--interpreted in the light of other economic and financial indicators--are still worthy of some attention, as they could provide an early warning of incipient inflationary pressures. The rapid growth in the monetary aggregates during 1985 is worth noting in this regard, although it has reflected in part the effects of financial innovations.

To be sure, the danger of an acceleration of inflation appears to be remote at present. There is a substantial degree of slack in the economy, commodity prices are weak, and wage settlements have remained moderate. As the economy continues to expand, however, it will be difficult to ascertain the point at which cost-price pressures are likely to develop because measures of resource utilization are imperfect and because the strength of inflationary expectations cannot be gauged with confidence. Against this background, the achievement of further progress in the direction of price stability will require a monetary policy aimed at a steady reduction in the trend rate of expansion of nominal demand toward the long-run rate of growth of potential output.

The current account of Canada's balance of payments has been strong during the early stages of the recent economic recovery, but it has weakened substantially in the first three quarters of 1985 as the rise in domestic demand has outpaced the growth of GNP. The current account most likely moved into deficit in 1985, and the staff expects the deficit to widen over the next two years. Over the medium term, the outlook for the current account will depend crucially upon the progress made in improving the federal fiscal position. Failure to reduce the absorption of saving by the federal government could lead to a substantial widening in the current account deficit and to the confidence problems that might be associated with a buildup in Canada's external indebtedness. Moreover, this situation would result in a rising debt-service burden, which would mean that a higher proportion of Canadian production would have to be channeled abroad. Early action to strengthen the federal fiscal position would be the best way to ensure that the competitiveness of Canadian producers does not deteriorate and that an excessive widening in the current account deficit is avoided.

In the past year, the Canadian Government has taken steps to foster economic efficiency and to remove impediments to the working of market forces. In the energy area, the measures announced in the Western Accord have greatly eased the regulatory burden imposed under the National Energy Program, eliminated costly and inefficient programs, and provided a tax regime that should encourage investment and growth in this sector.

The staff welcomes the changes that have occurred in the area of foreign direct investment. The major streamlining of the review process together with Investment Canada's new mandate should ensure that decisions affecting the flow of foreign capital into Canada will be based primarily on considerations of economic profitability. The staff also welcomes the steps taken to improve the operations of federal Crown Corporations and the ongoing efforts aimed at selling to the private sector a number of corporations for which public ownership cannot be justified.

In the area of foreign trade, the past several years have seen a rising tide of protectionist sentiment in many industrial countries. In this environment, the reaffirmation of Canada's commitment to free trade is heartening. Canada's support for an early round of multilateral trade negotiations is particularly encouraging as such negotiations would provide the best way to defuse protectionist pressures and to foster a freer and more efficient trading system. The staff also notes Canada's intention to enter into negotiations with the United States with the aim of liberalizing trade between the two countries. The staff is concerned about potential conflicts between these two approaches, but it notes the view expressed by Canadian officials that bilateral negotiations would not interfere with--and indeed might reinforce--the progress toward multilateral trade liberalization.

Turning to specific trade issues, the Canadian Government recently decided not to renew import quotas on footwear, subject to certain exceptions. This decision should benefit Canadian consumers, reduce the danger of retaliation by other countries, and help to demonstrate that protectionist pressures can be effectively resisted. However, the staff is concerned that there may be a tendency to replace formal restrictions on imports of footwear with less clearly defined and less transparent barriers. A similar concern arises with regard to imports of automobiles from Japan. This tendency would be inconsistent with Canada's commitment to free trade and should therefore be resisted. The staff would also urge the Canadian authorities to refrain from imposing quotas on textile imports and, instead, to take action to liberalize trade in these products.

In the area of foreign aid, the Government's objective of raising the ratio of official development assistance to GNP at a time when other government programs are being curtailed is commendable. The staff welcomes Canada's continued efforts to extend a substantial proportion of its bilateral aid to the poorest developing countries and to maintain a large concessionary element in its development assistance program.

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

Canada - Fund Relations

(As of December 31, 1985, unless otherwise indicated; in millions of SDRs)

I. Membership Status

(a) Canada became a member of the Fund on December 27, 1945.
(b) Canada has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement.

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 2,941.0 million

(b) Total Fund holdings of member's currency: SDR 2,454.8 million (83.5 percent of quota)

(c) Fund credit: None

(d) Reserve tranche position: SDR 486.2 million

(e) Current Operational Budget (December 1985-February 1986) (maximum use of currency): Purchases: SDR 7.0 million
Repurchases: SDR 25.5 million

(f) Lending to the Fund (amounts):

	Limits	Out-standing	Uncalled
GAB	892.5	--	892.5
SFF	173.6	160.9	--
Enlarged Access	--	--	--
Total	1,066.1	160.9	892.5

III. Current Stand-by or Extended Arrangement and Special Facilities

No use of Fund credit during the last ten years.

IV. SDR Department

(a) Net cumulative allocation: SDR 779.29 million

(b) Holdings: SDR 198.4 million (25.5 percent of net cumulative allocation)

(c) Current Designation Plan (December 1985-February 1986) (amount of maximum designation): SDR 123.0 million

V. Administered Accounts

Not applicable

VI. Overdue Obligations to the Fund

None

B. Nonfinancial Relations

VII. Exchange Rate Arrangements

The authorities in Canada do not maintain margins in respect of exchange transactions, and exchange rates are determined on the basis of demand and supply conditions in the exchange market. However, the authorities intervene from time to time to maintain orderly conditions in the exchange market. There are no taxes or subsidies on purchases or sales of foreign exchange. On December 31, the exchange rate of the Canadian dollar, as determined by the Fund under Rule 0-2(a), was SDR 0.651448 per Canadian dollar.

IX. Last Article IV Consultation

The staff report for the 1984 consultation with Canada (SM/85/28) was considered by the Executive Board at EBM/85/31 (February 27, 1985). Canada is on a 12-month consultation cycle.

X. Technical Assistance

None

XI. Resident Representative/Advisor

None

Statistical Issues

Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Canada in the December 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Canada (on tape), which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in December 1985 IFS
Real Sector	- National Accounts	Q1 1985
	- Prices (Consumer Price Index)	August 1985
	- Production (Industrial)	May 1985
	- Employment	Q1 1983
	- Earnings	Q1 1983
Government Finance	- Deficit/Surplus	July 1985
	- Financing	July 1985
	- Debt	September 1985
Monetary Accounts	- Monetary Authorities	September 1985
	- Deposit Money Banks	July 1985
	- Other Financial Institutions	Q2 1985
External Sector	- Merchandise Trade: Value	August 1985
	Prices	August 1985
	- Balance of Payments	Q2 1985
	- International Reserves	October 1985
	- Exchange Rates	October 1985

Table 1. Canada: Selected Economic Indicators

(Percentage changes from preceding year, except as indicated)

	1981	1982	1983	1984	Est. 1985	Proj. 1986	Proj. 1987
Gross national product (in volume)	3.3	-4.4	3.3	5.0	4.5	3.6	2.9
Consumer expenditure	1.7	-2.0	3.1	3.7	4.8	2.6	2.3
Government spending	2.5	1.2	0.1	3.4	2.2	1.4	2.2
Residential construction	3.9	-21.0	25.3	-4.2	16.2	11.5	2.0
Nonresidential business fixed investment	7.7	-9.1	-13.0	0.6	6.5	8.2	5.9
Final domestic demand	2.9	-3.3	0.8	2.9	4.9	3.5	2.8
Stockbuilding 1/	1.0	-3.3	2.6	0.6	0.2	-0.2	0.3
Total domestic demand	3.9	-6.5	3.4	3.5	5.0	3.2	3.0
Foreign balance 1/	-0.5	2.7	-0.4	1.3	-0.2	0.3	-0.1
Employment, costs, and prices							
Employment	2.8	-3.3	0.8	2.5	2.8	2.5	2.0
Unemployment rate (percent)	7.5	11.0	11.9	11.3	10.6	10.1	9.9
Labor income per person employed 2/	12.4	10.6	4.6	3.5	4.0	4.3	4.0
Output per person employed 2/	0.5	-1.2	2.4	2.5	1.7	1.1	0.9
Labor income per unit of output 2/	11.8	11.9	2.1	1.0	2.3	3.2	3.1
GNP deflator	10.6	10.3	5.3	2.8	3.4	4.2	3.3
Consumer price index	12.5	10.8	5.8	4.4	3.8	4.5	3.4
Merchandise trade							
Export prices	6.3	0.8	-1.3	1.0	2.7	2.4	3.0
Import prices	10.6	2.2	-3.9	5.6	4.3	5.0	3.8
Terms of trade	-3.8	-1.4	2.7	-4.3	-1.6	-2.4	-0.7
Volume of exports	3.6	-0.7	8.8	22.2	4.3	2.5	2.4
Volume of imports	2.7	-15.3	14.1	18.5	7.1	1.5	2.8
Current external transactions (in billions of dollars)							
Trade balance	7.3	17.8	17.7	20.7	18.0	17.3	16.9
Services balance	-14.9	-16.5	-16.8	-19.1	-19.6	-20.5	-22.3
Net transfers	1.5	1.4	0.8	0.9	1.1	1.2	1.4
Current account balance	-6.1	2.7	1.7	2.6	-0.5	-2.0	-4.0

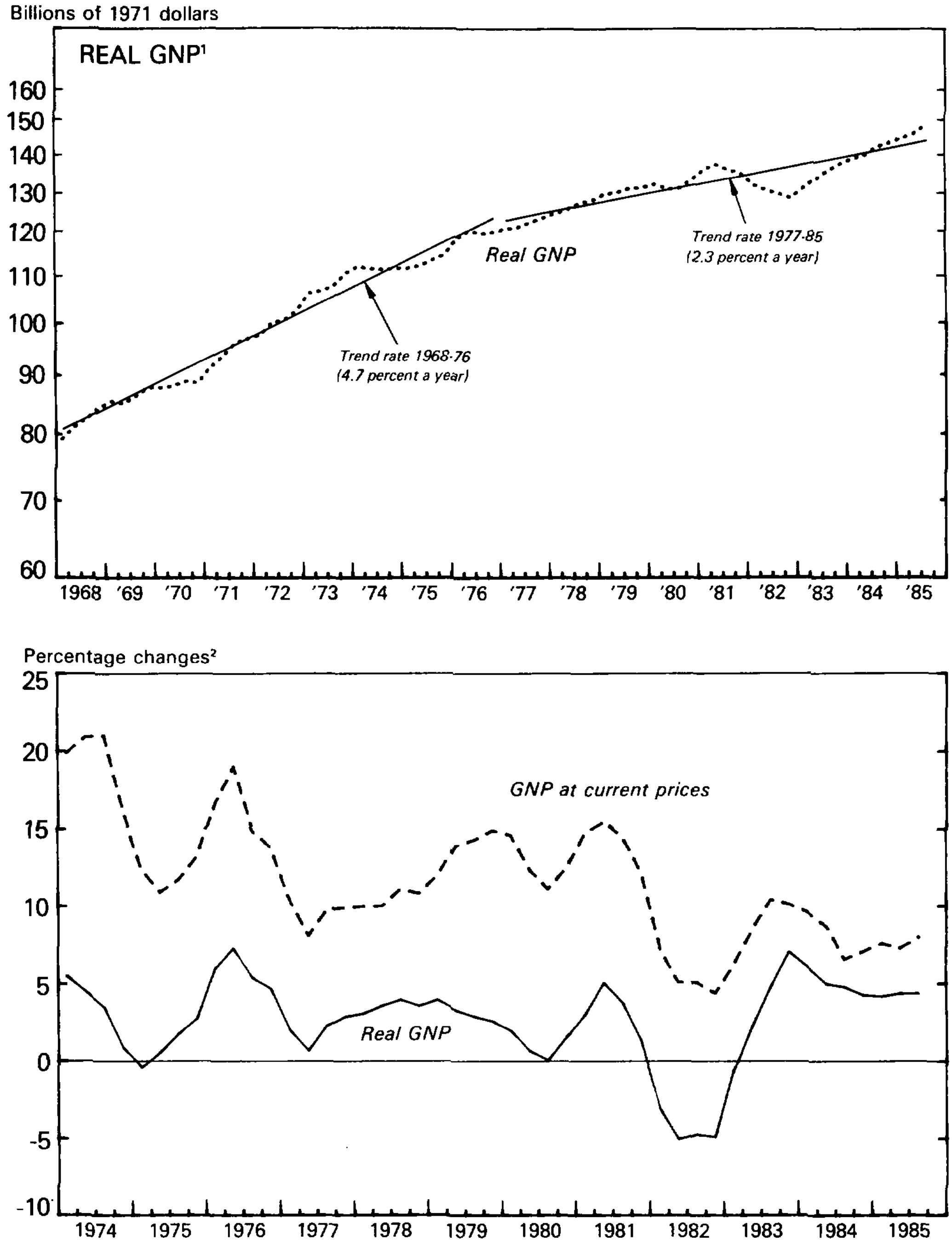
1/ The figures indicate the change in stockbuilding, or the change in the foreign balance, as a percentage of GNP in the previous year; that is, they indicate the contribution of these elements to the growth of GNP.

2/ Overall economy.

CHART 1

CANADA

GROSS NATIONAL PRODUCT



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

CHART 2

CANADA

CYCLICAL COMPARISONS: REAL GNP, INVENTORIES AND NET EXPORTS

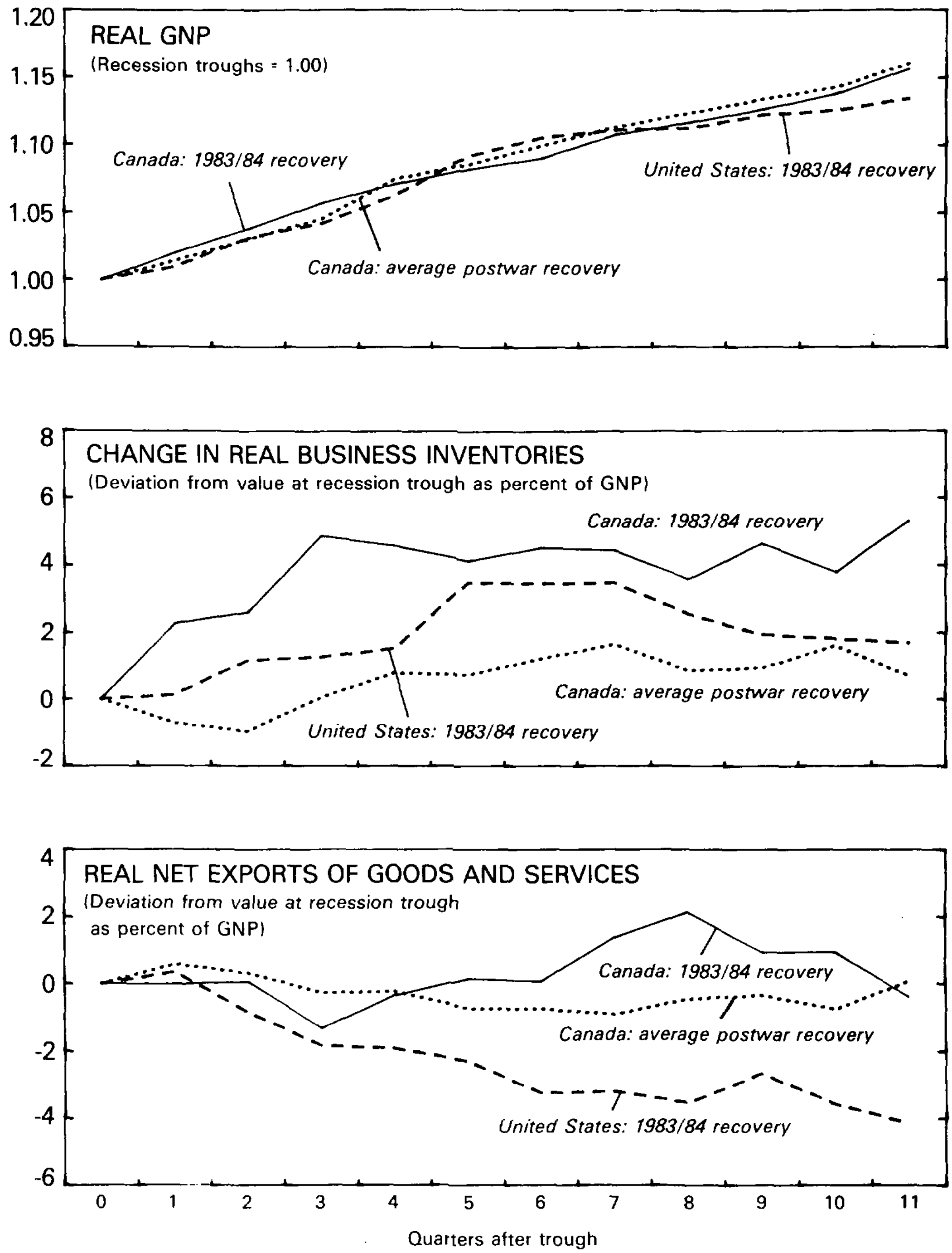


CHART 3

CANADA

CYCLICAL COMPARISONS: REAL FINAL DOMESTIC DEMAND AND BUSINESS FIXED INVESTMENT

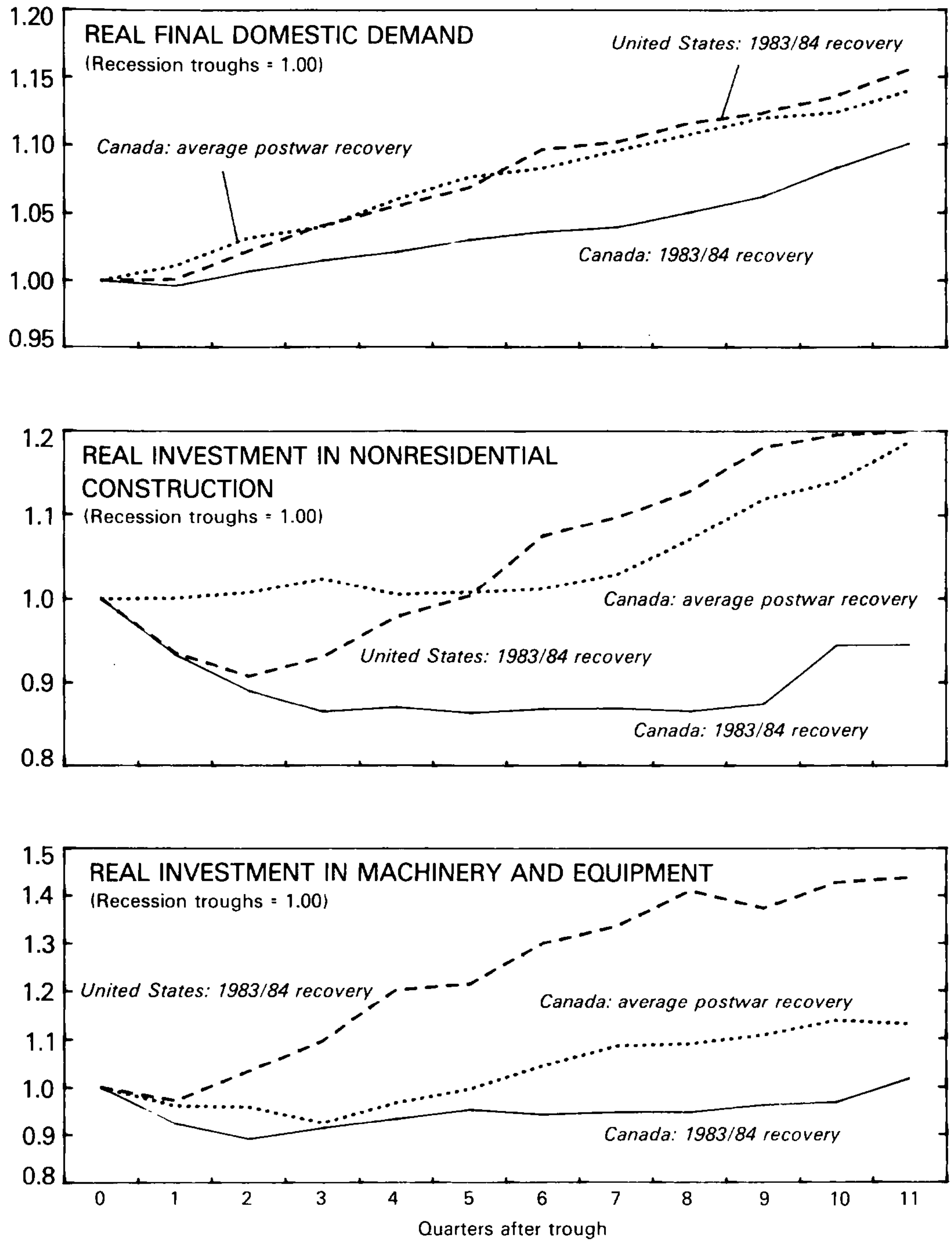
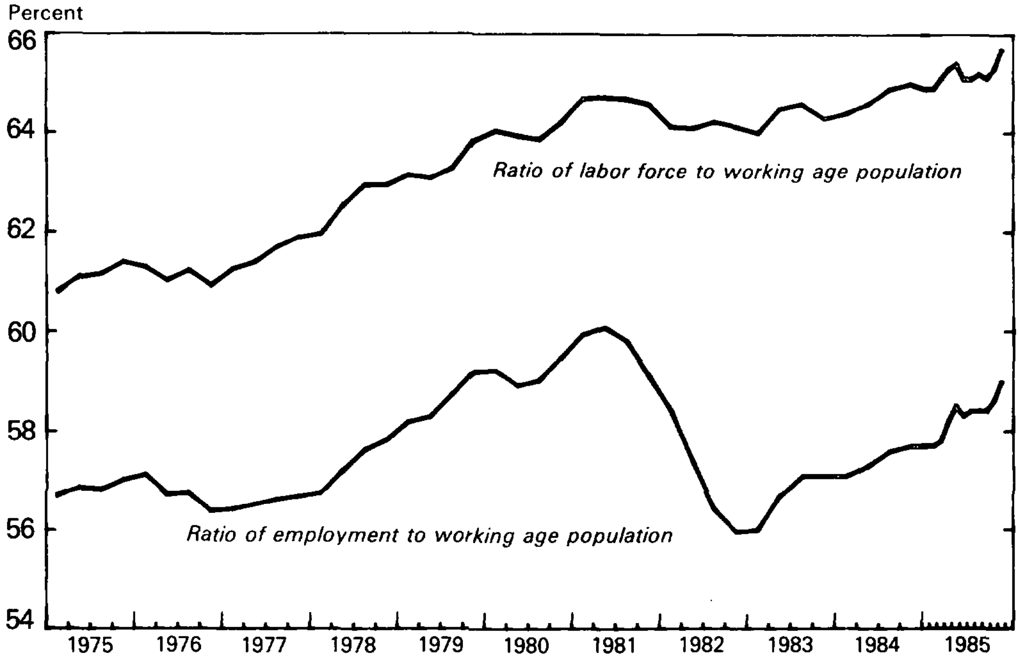


CHART 4

CANADA

LABOR FORCE, EMPLOYMENT AND UNEMPLOYMENT



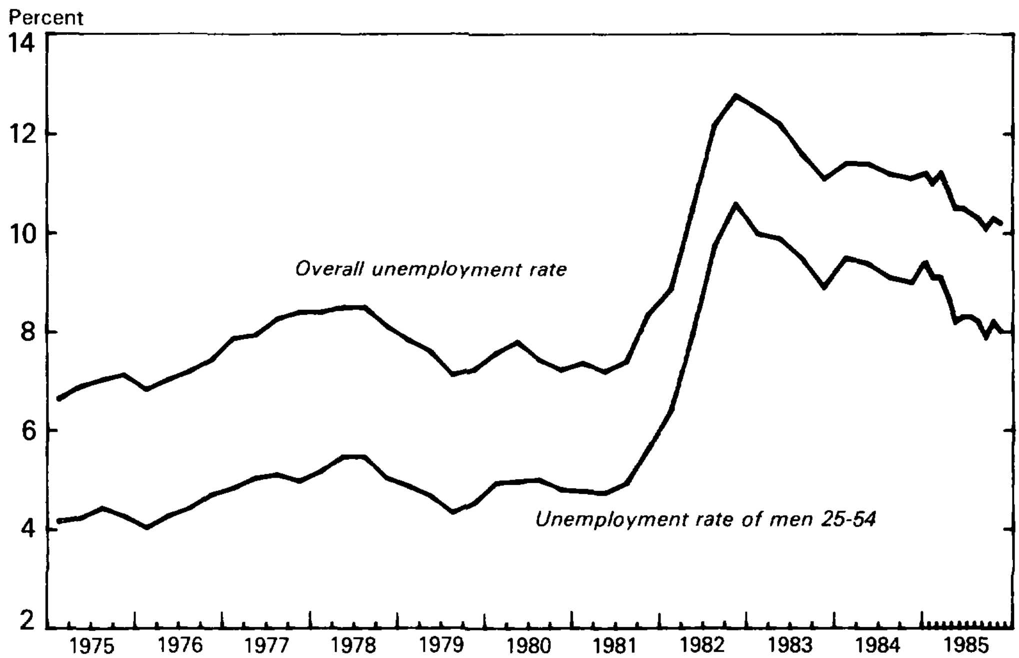
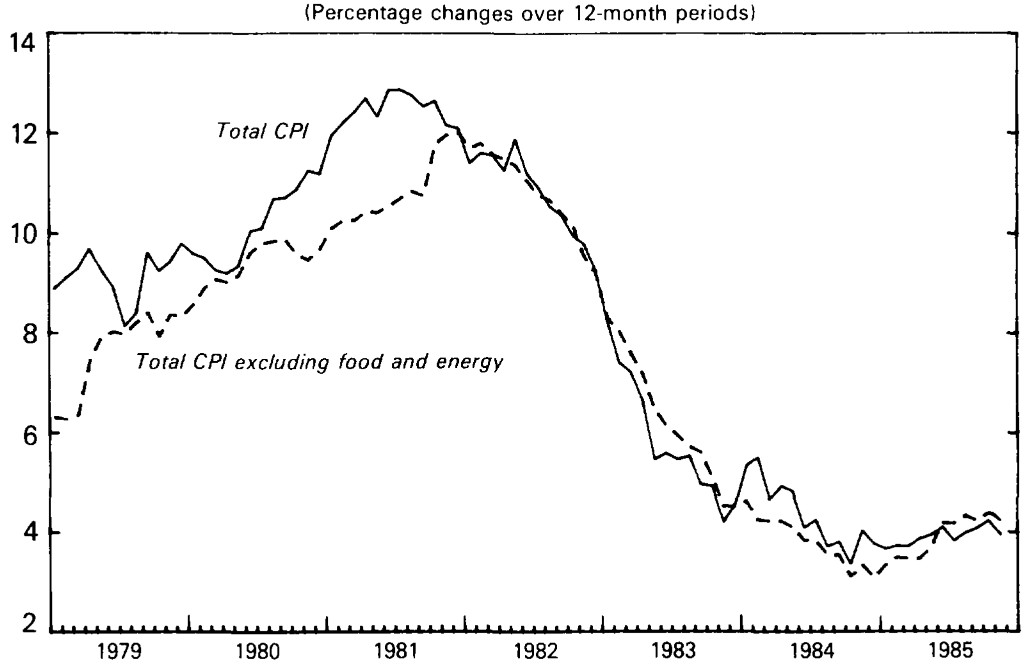


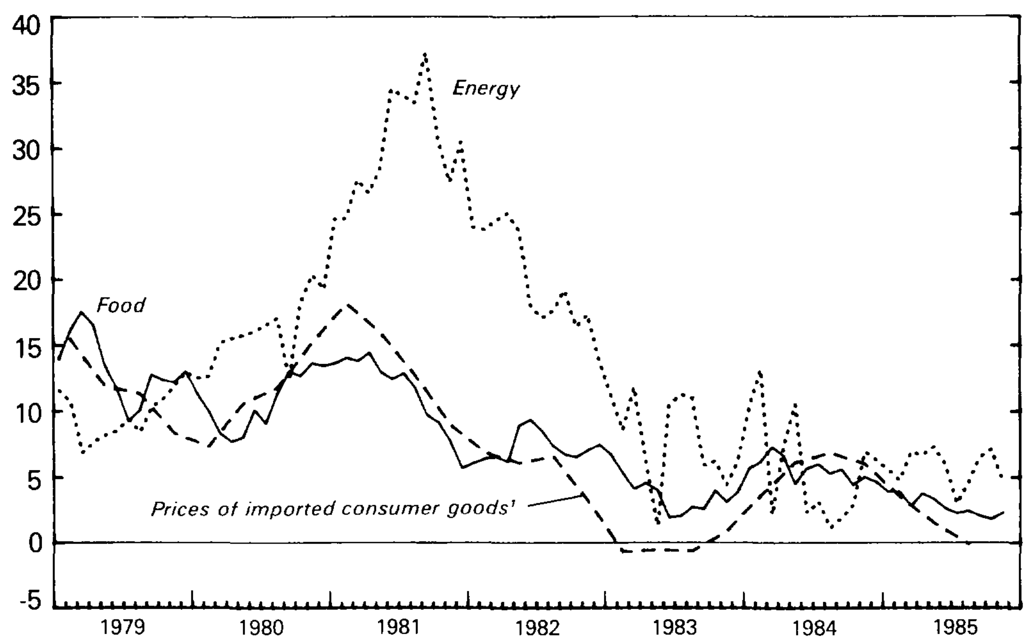
CHART 5

CANADA

CONSUMER PRICES

(Percentage changes over 12-month periods)





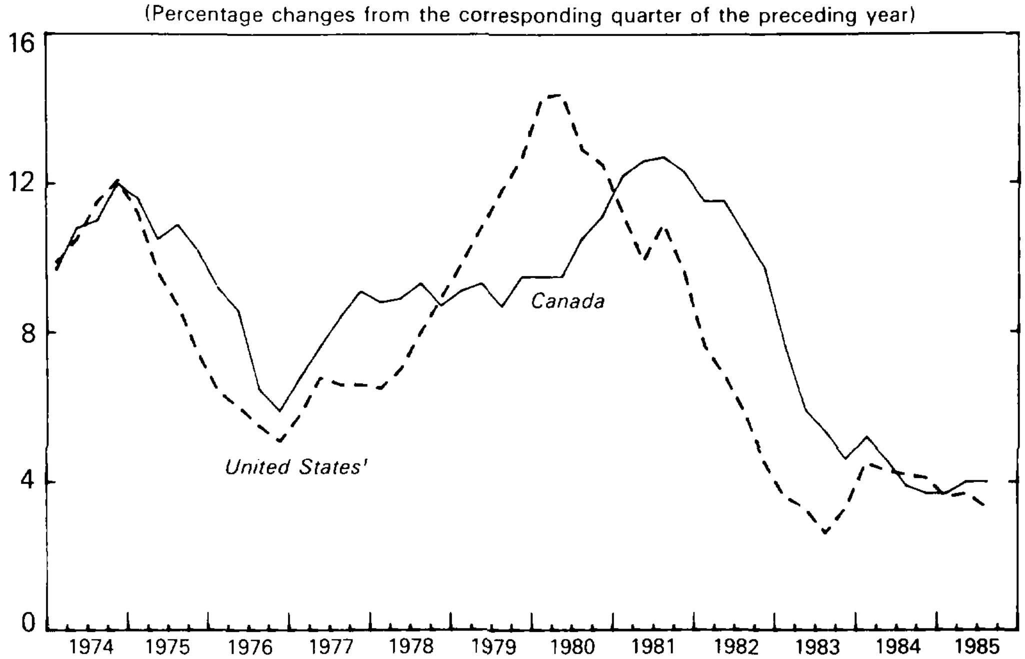
[1]Percentage change from the corresponding quarter of the preceding year

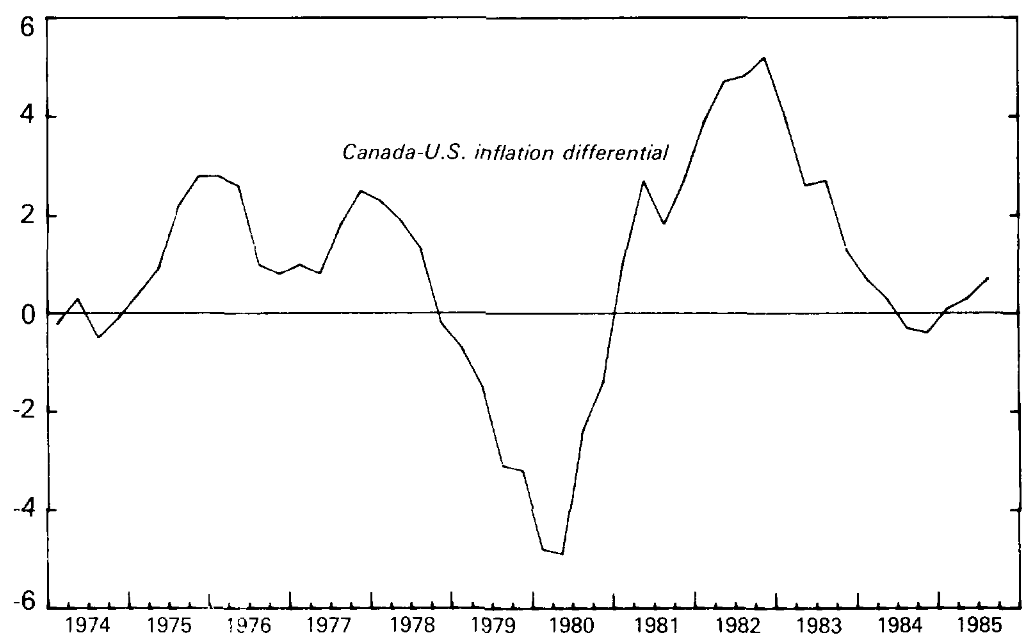
CHART 6

CANADA

CONSUMER PRICES, ALL ITEMS: COMPARISON BETWEEN CANADA AND THE UNITED STATES

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





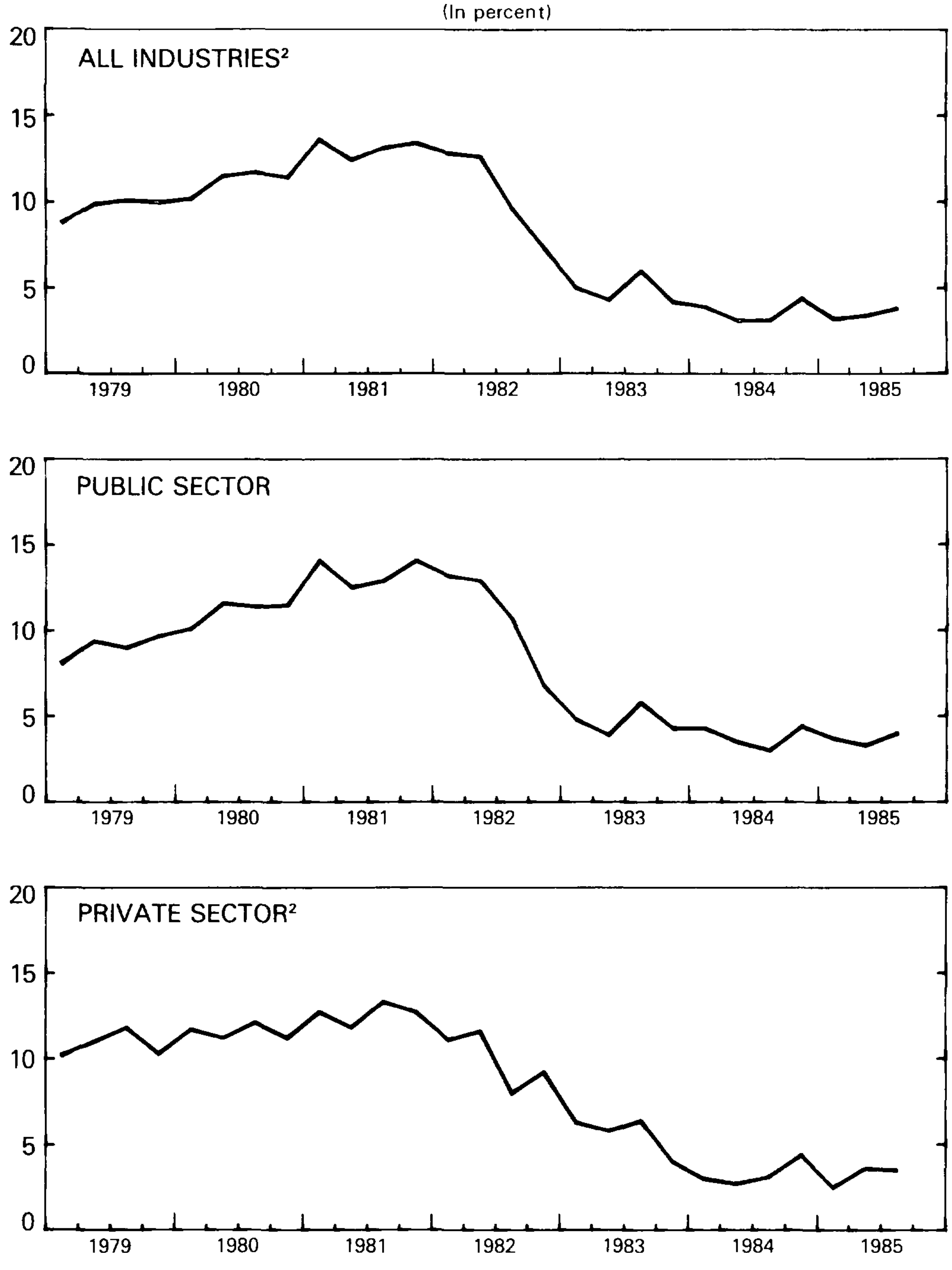
[1] For all urban workers

CHART 7

CANADA

WAGE SETTLEMENTS[1]

(In percent)



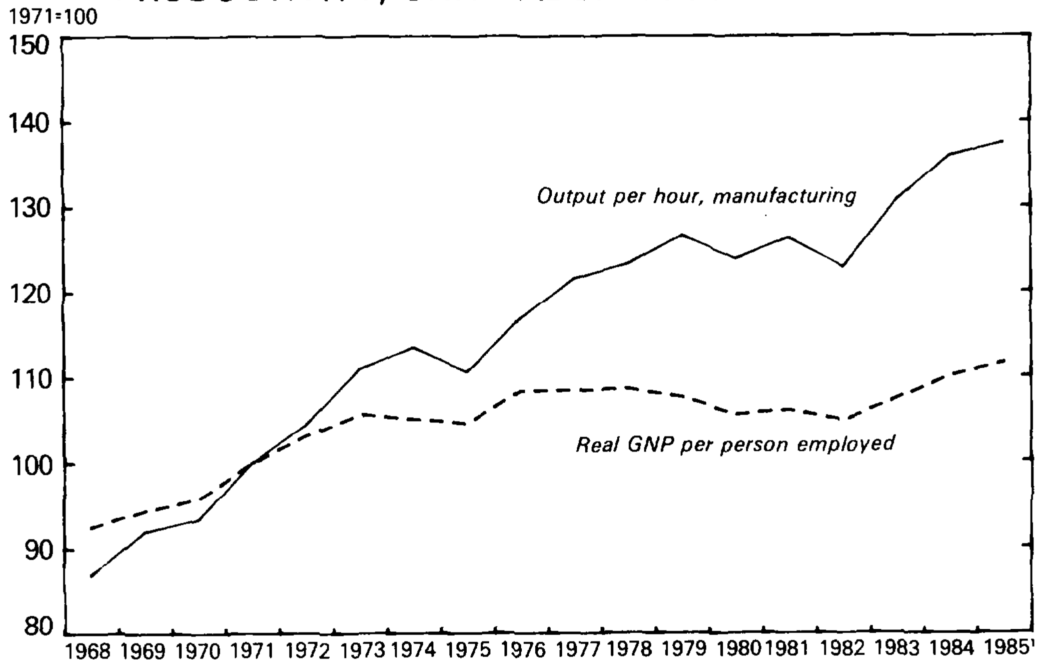
[1]Compound average annual increase in base rates of pay over the life of an agreement called for in new wage settlements covering 500 or more employees concluded in the period.

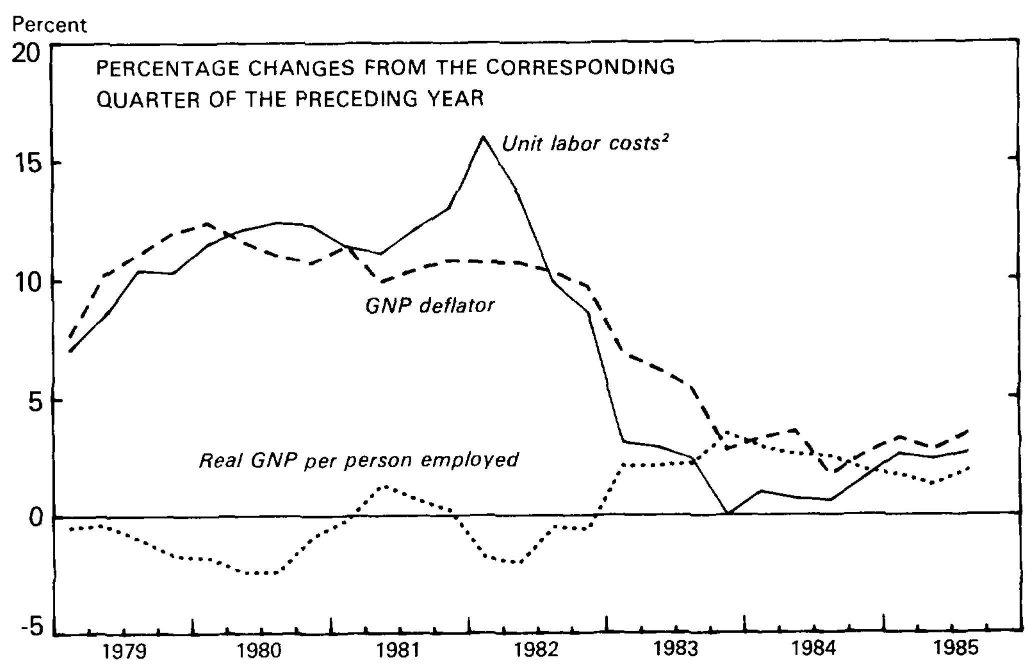
[2]Data before 1983 excluded construction.

CHART 8

CANADA

PRODUCTIVITY, UNIT LABOR COSTS AND PRICES



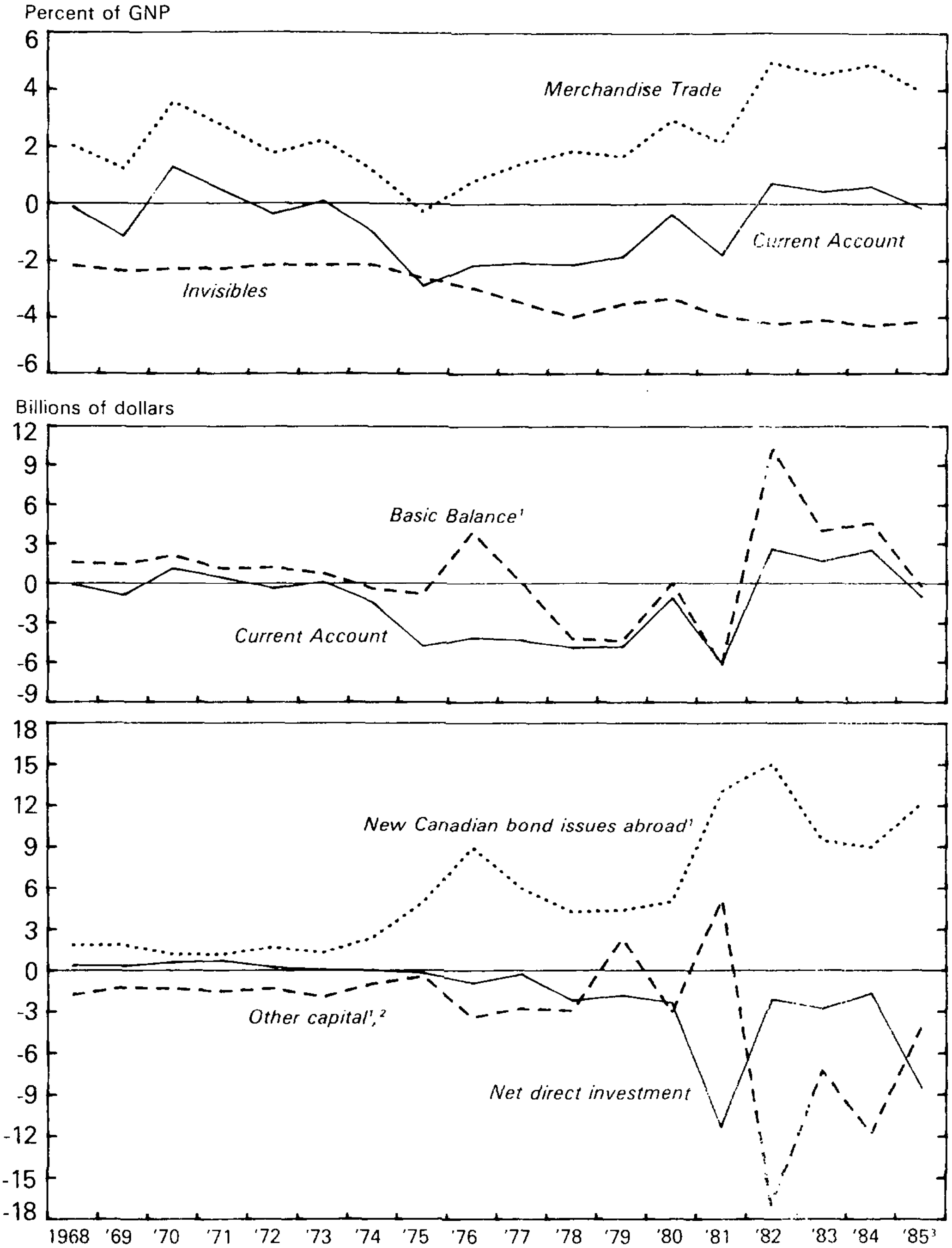


[1] Average for first three quarters of the year.
[2] Ratio of wages, salaries and supplementary labor income to real GNP.

CHART 9

CANADA

BALANCE OF PAYMENTS



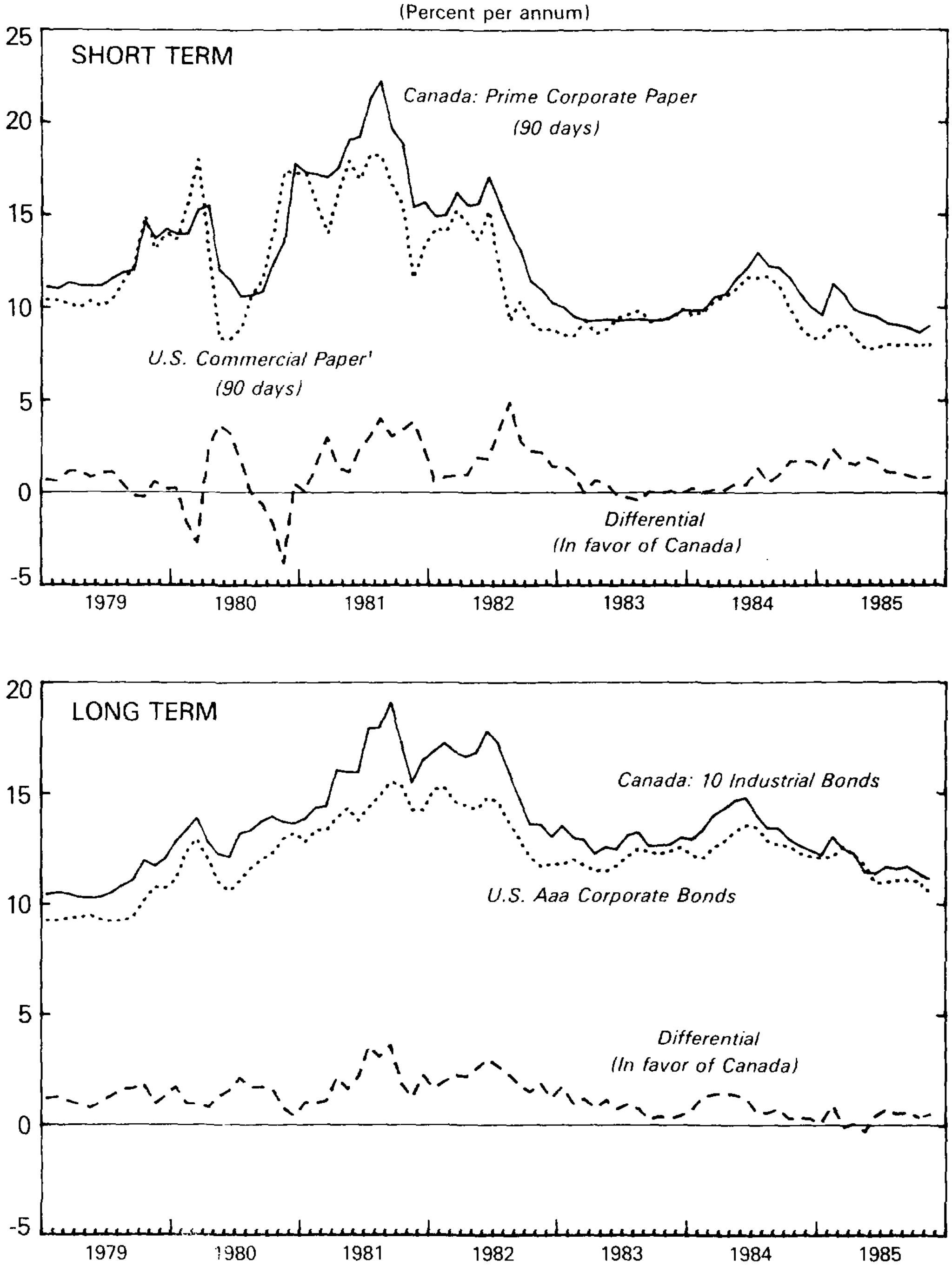
[1] Net of long-term foreign currency borrowings or repayments by the Government of Canada associated with international reserves.
[2] Includes errors and omissions.
[3] First three quarters of the year at annual rates, current account transactions are seasonally adjusted.

CHART 10

CANADA

CANADA—U.S. INTEREST RATE COMPARISONS

(Percent per annum)



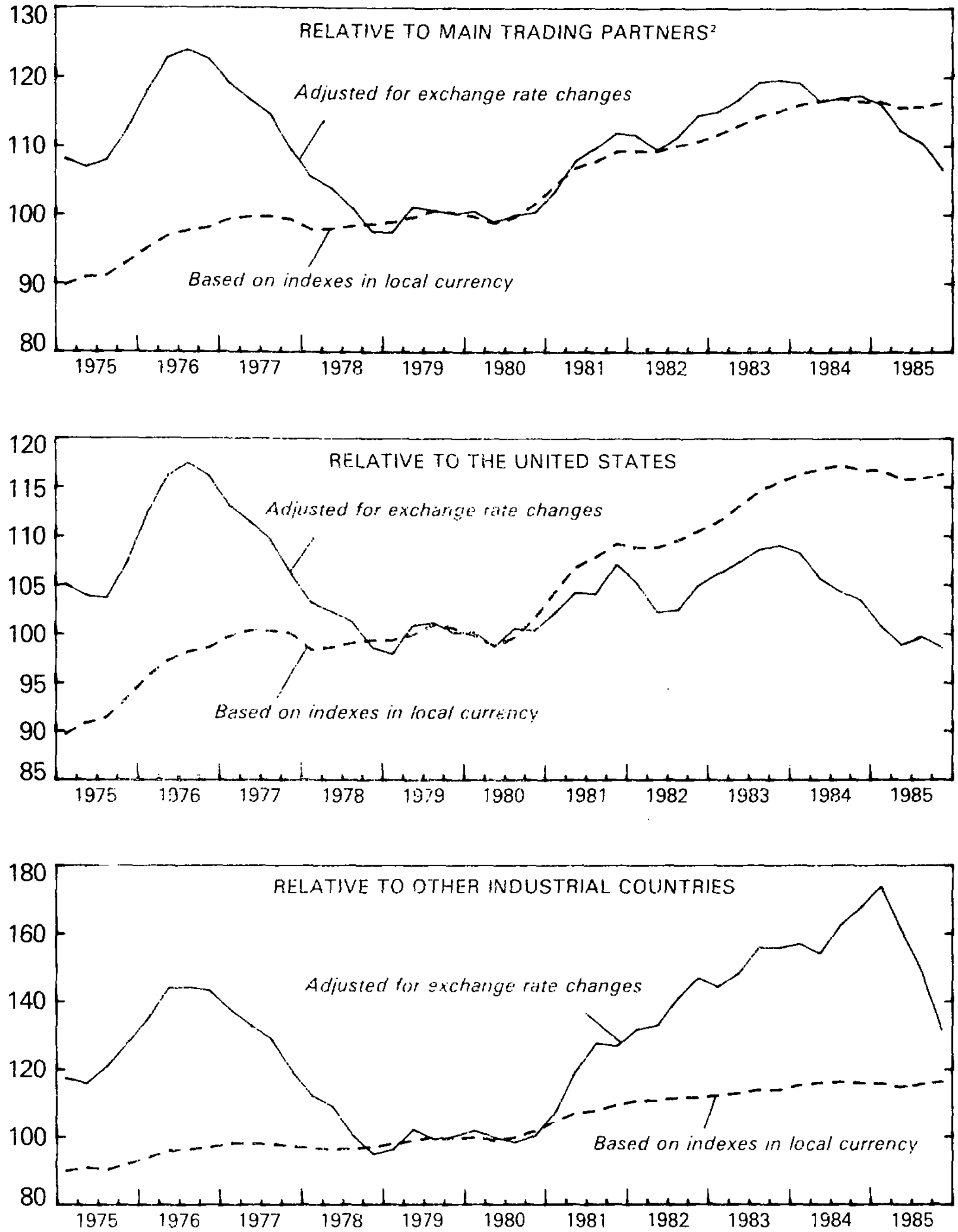
[1] Adjusted to a 365-day true yield basis from a 360-day discount basis.

CHART 11

CANADA

COMPETITIVENESS IN MANUFACTURING[1]

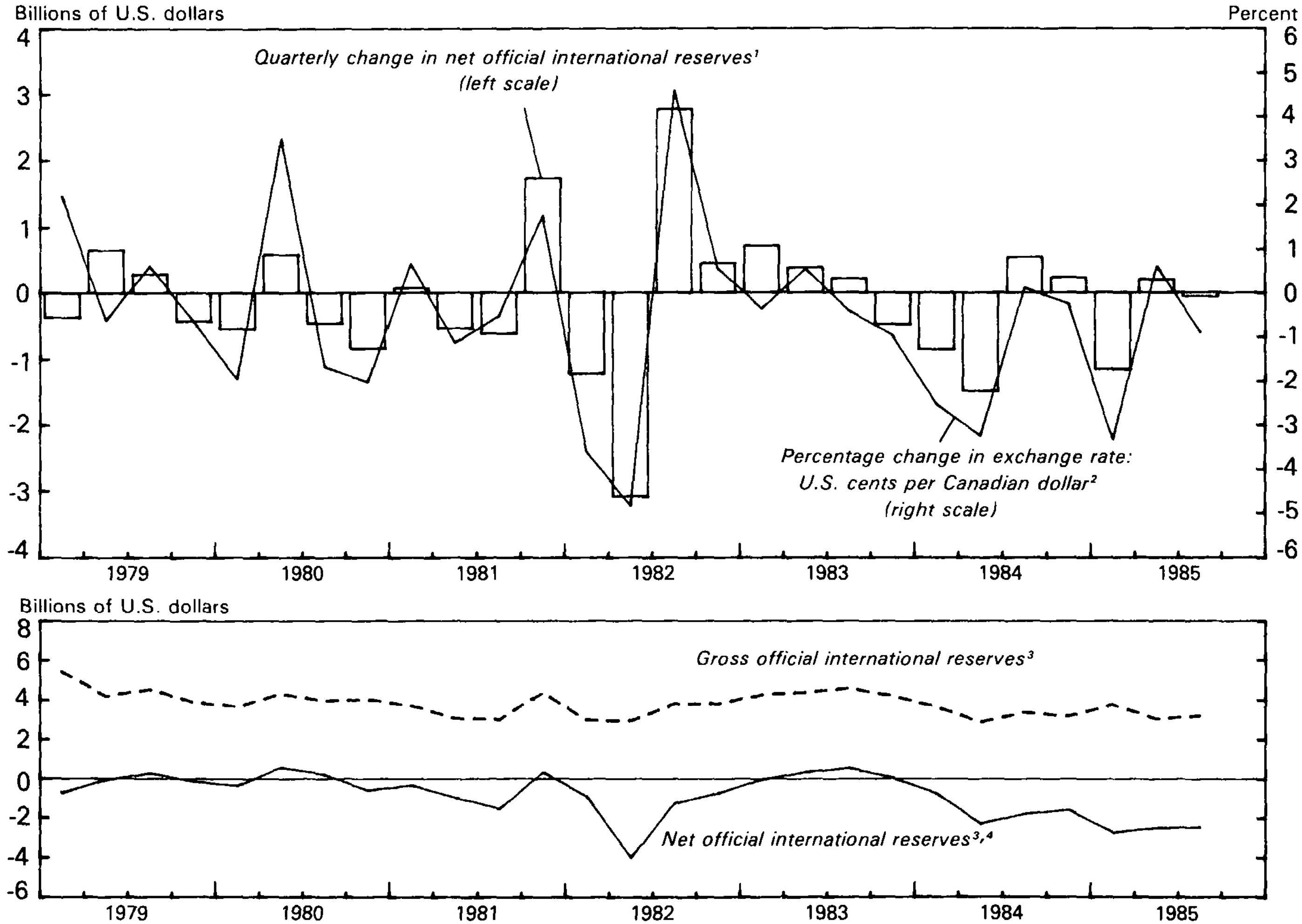
(Ratios of Canada's index to competitors' index 1980=100)



[1] As measured by relative normalized unit labor costs.

[2] Weighted averages of the corresponding data for Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States. The weights, which are based on disaggregated trade in manufacturing for 1980, take account of both bilateral and third market effects.

CHART 12
CANADA
OFFICIAL INTERNATIONAL RESERVES

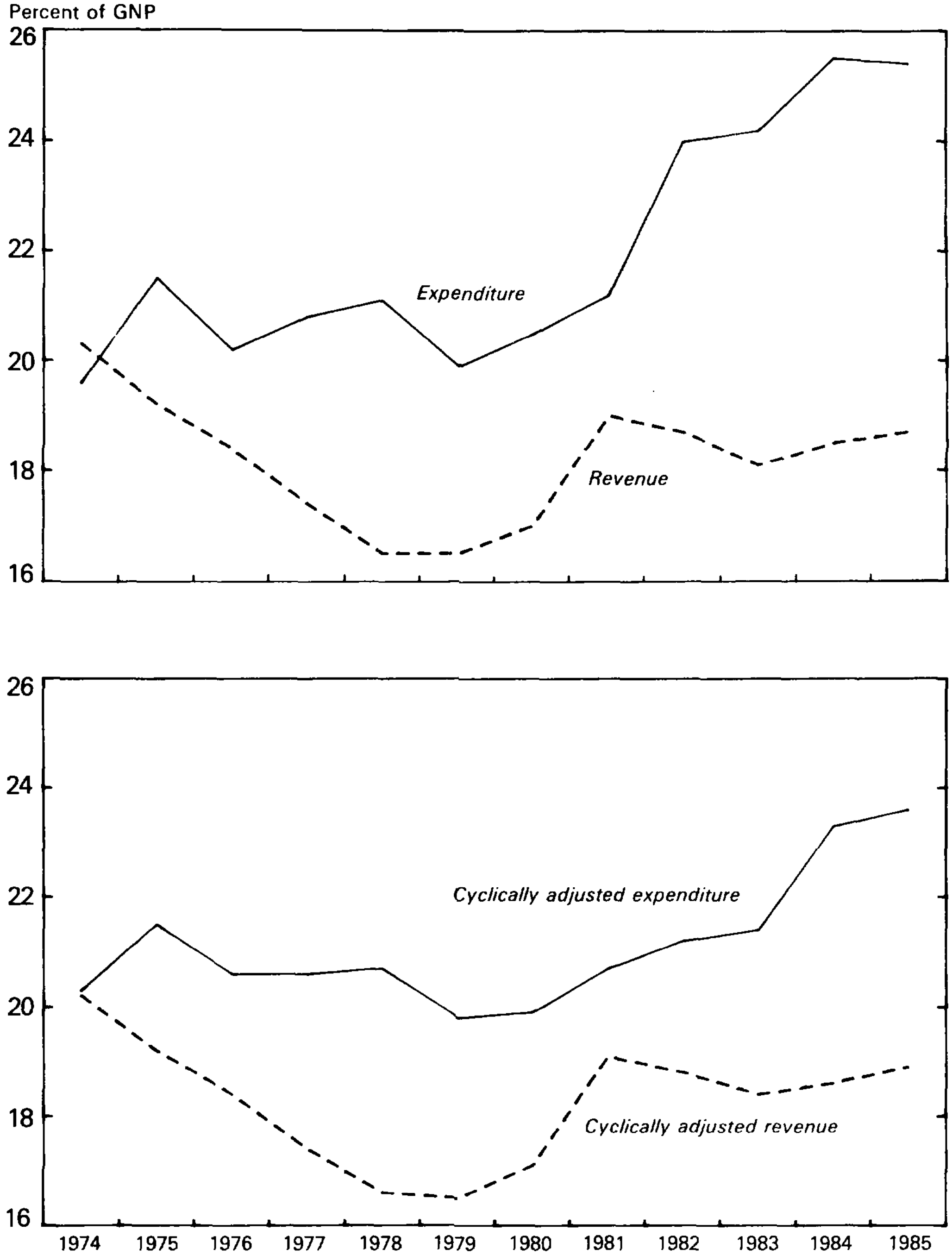


[1]Net of use of stand-by credit facilities with banks and of long-term borrowing by the Government of Canada, and adjusted for valuation changes. Allocations of SDRs and profits realized on the sale of gold are excluded.
[2]Based on the noon rate in the Canadian market in the last day of each quarter.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

CHART 13

CANADA

FEDERAL GOVERNMENT OPERATIONS[1]

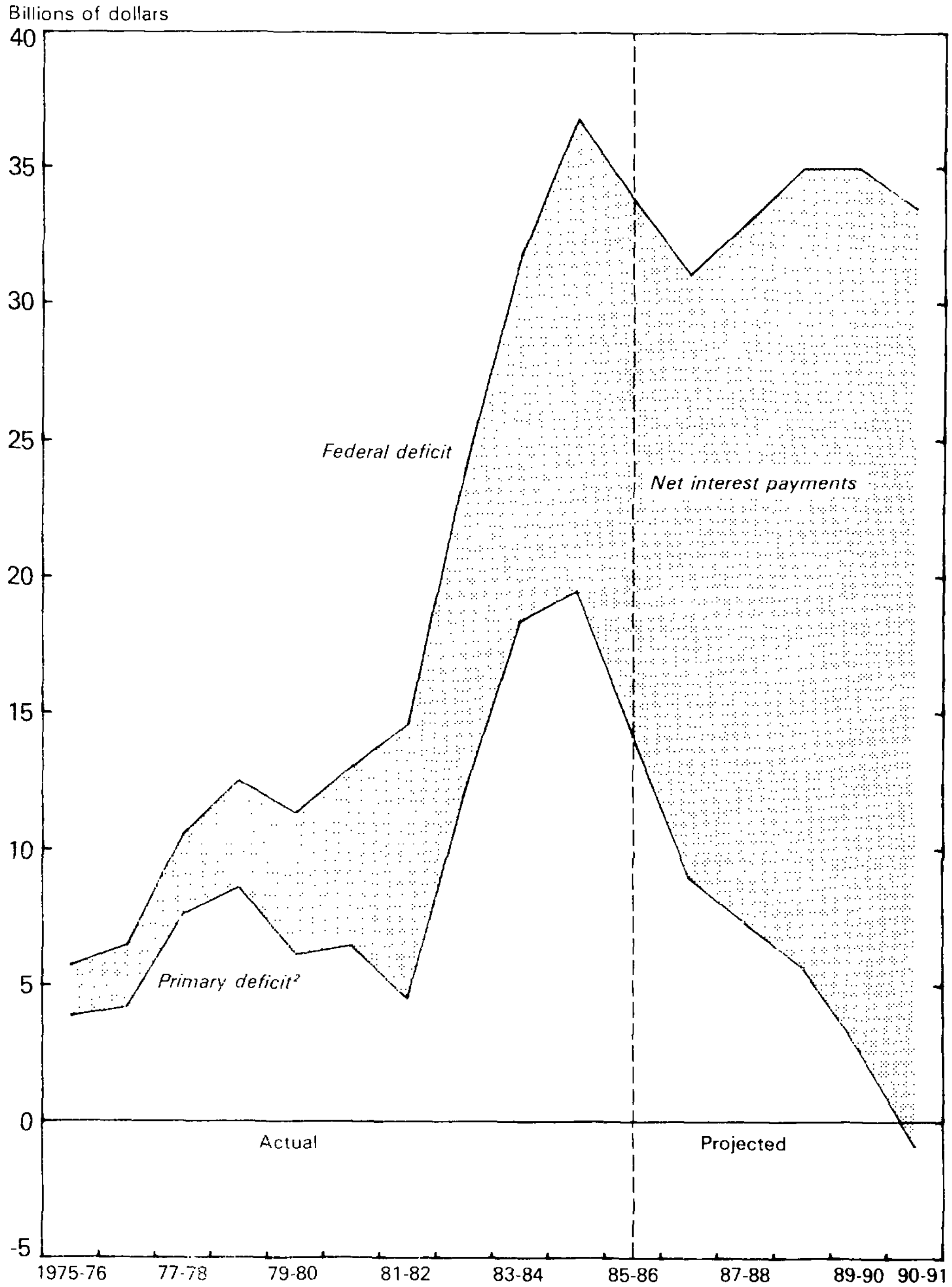


[1] On a national income accounts basis.

CHART 14

CANADA

FEDERAL FISCAL OUTLOOK[1]



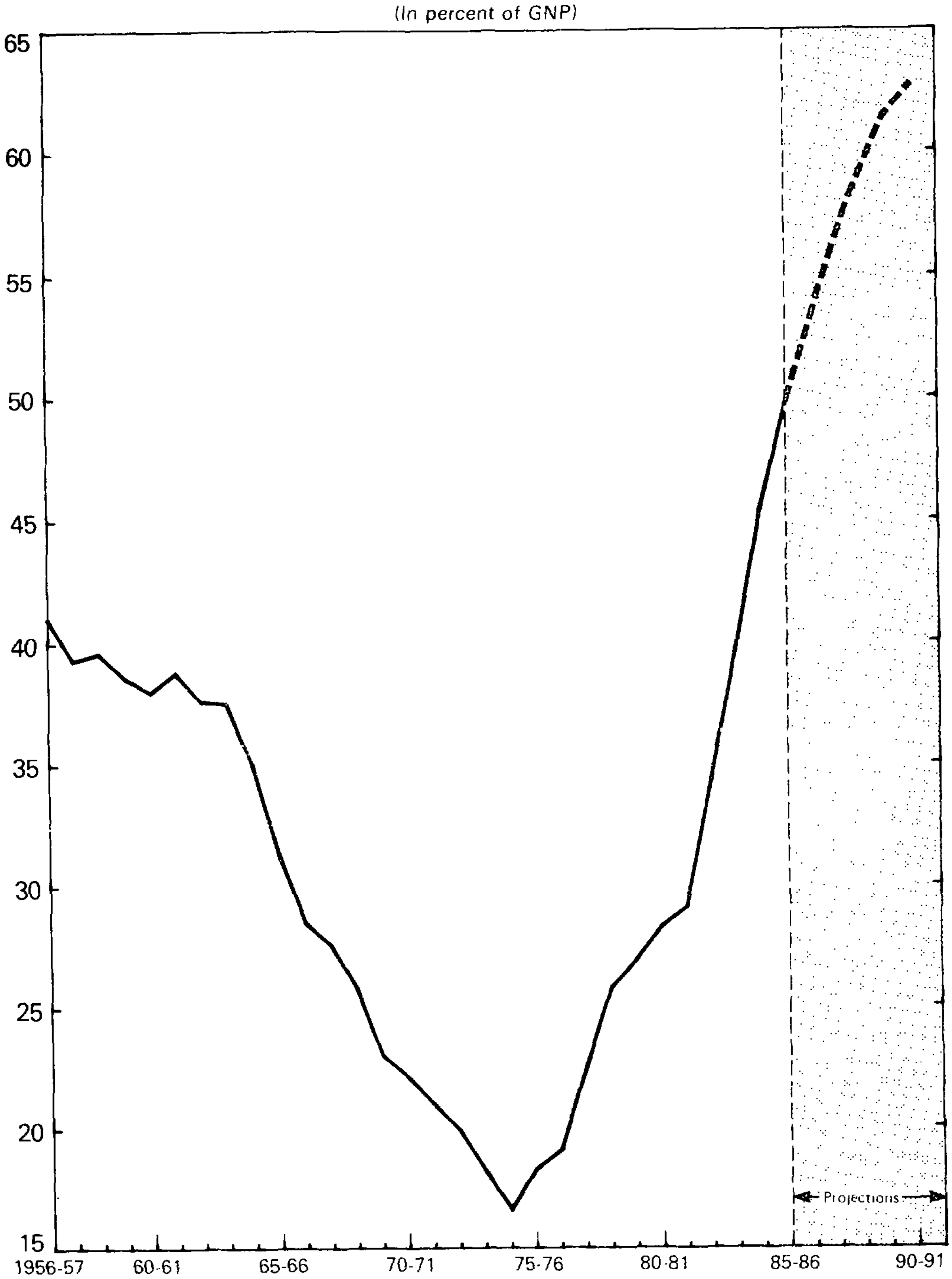
[1] On a public accounts basis.
[2] Federal deficit less net interest payments on the Federal debt.

CHART 15

CANADA

OUTSTANDING FEDERAL PUBLIC DEBT[1]

(In percent of GNP)



[1]Gross public debt less net recorded assets measured on a public accounts basis.

CHART 16

CANADA

RATES OF GROWTH IN MONETARY AGGREGATES

(Percentage changes over 12-month periods)