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February 13, 1986

To: Members of the Executive Board

From: The Secretary

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

The attached supplement to the staff report for the 1985 Article IV consultation with Canada, which is scheduled for discussion on Friday, February 14, 1986, has been prepared on the basis of additional information.

Mr. Hernández-Catá (ext. 8486) or Mr. Clark (ext. 8493) 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
Supplementary Information and Information Notice

Prepared by the Western Hemisphere Department
and the Exchange and Trade Relations Department

Approved by E. Wiesner and J. T. Boorman

February 12, 1986

The recent evolution of the real effective exchange rate of Canada, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. This index shows that as of January 1986 the Canadian dollar had depreciated in real effective terms by more than 10 percent since the conclusion of the 1984 Article IV consultation (February 27, 1985), the last occasion on which the Executive Board discussed Canada's exchange rate policy. The real effective depreciation since February 1985 is estimated to have been 10.1 percent.

From its peak in January 1984 to January 1986, the real effective value of the Canadian dollar is estimated to have dropped by 13.1 percent, reversing more than half of the real appreciation that had taken place from the second quarter of 1980 to January 1984. The nominal value of the Canadian dollar rose by 4.1 percent in effective terms from the second quarter of 1980 to January 1984; during this period it fell by 6.3 percent against the U.S. dollar. During the two years ended in January 1986, the Canadian dollar depreciated by 13.4 percent in effective terms and by 11.2 percent in relation to the U.S. dollar. Downward pressure on the Canadian dollar was particularly strong in the second half of January 1986 and in the first few days of February; from January 17 to February 4, the value of the Canadian dollar fell from 71.40 U.S. cents to 69.13 U.S. cents, but it has rebounded since then to 71.49 U.S. cents on February 12.

Exchange rate developments in Canada in the past few years are described in the recently issued staff report on the 1985 Article IV consultation discussions (SM/86/1) and the report on recent economic developments (SM/86/16). The weakening of the Canadian dollar over the past year has occurred against the background of rapid economic growth and relatively moderate inflation. On the basis of monthly indicators, it appears that the growth of real GNP in the fourth quarter of 1985 will exceed 5 1/2 percent (annual rate), following a rise of 4 3/4 percent (annual rate) during the first three quarters of the year. 1/ During 1984 and early 1985, consumer prices rose at broadly similar rates in Canada and in the United States--Canada's major trading partner. Canadian prices have tended to rise a little faster in recent months, however, owing partly to increases in excise taxes; during the 12 months ended December 1985, consumer prices rose by 4.4 percent in Canada compared with 3.8 percent in the United States.

The interest rate differential between 90-day commercial paper in Canada and in the United States was negligible during most of 1983 and early 1984, but it started to widen in May 1984 and peaked at more than 2 percentage points in February 1985. The differential narrowed to less than 3/4 percentage point in October 1985, but it has risen since then, and in January 1986 it exceeded 2 3/4 percentage points. In the first week of February, the differential rose further, to more than 3 percentage points.

The current account of the Canadian balance of payments registered surpluses ranging from $1.7 billion to $2.7 billion in the period 1982-84. During this period Canada's trade surplus was unusually large, owing in part to special factors affecting trade in automobile and energy products and the strong recovery of the U.S. economy in 1983-84. The current account shifted from a surplus of $1.4 billion in the first half of 1985 to a deficit of almost $6 billion (annual rates) in the third quarter. This shift reflected the rapid growth of the Canadian economy relative to other major countries (including the United States) and the pickup in business fixed investment in Canada--a component of total expenditure that is particularly import intensive.

As indicated in SM/86/16 (pp. 20-23), the behavior of the Canadian dollar during the past two years is not well explained by historical relationships. In particular, it was noted that from the fourth quarter of 1983 to the third quarter of 1985 the Canadian dollar had depreciated against the U.S. dollar even though interest rate differentials generally had moved in favor of Canadian assets, inflation differentials between Canada and the United States had narrowed, and Canada's current account had been in surplus through most of the period. 2/

1/ Labor market indicators suggest continued strength of economic activity in early 1986. Employment rose by just over 1 percent in January and the unemployment rate fell to 9.8 percent, from 10 percent in December 1985.

2/ The difficulty in explaining exchange rate behavior is not, of course, unique to the Canadian dollar. For example, the real effective appreciation of the U.S. dollar from mid-1980 to early 1985 cannot be fully explained on the basis of changes in real interest rates and balance of payments variables. (See SM/85/209, Supplement 1, Appendix IX.)

Changes in fundamental economic conditions also do not appear to explain fully the continued depreciation of the Canadian dollar since the third quarter of 1985. To be sure, the substantial deterioration of the current account in the third quarter of 1985 probably contributed to the downward pressure on the Canadian dollar. It should be noted, however, that this deterioration had been generally anticipated, and the impact on markets of its announcement (in November 1986) may therefore have been limited. Recent declines in the world price of oil may also have led to some downward revision in market expectations for Canada's current account balance and for the value of the Canadian dollar. However, this effect is unlikely to have been very large in view of the size of Canada's net exports of oil. 1/

Some of the downward pressure on the exchange rate also may have resulted from the problems faced by a number of small Canadian banks. In September 1985, two western Canadian banks--the Canadian Commercial Bank (CCB) and the Northland Bank--were declared insolvent, the first bank failures in Canada in more than 60 years. These two institutions had been heavily involved in energy and western Canadian real estate lending, two sectors where asset values have declined substantially in recent years. Both CCB and Northland had received secured advances from the Bank of Canada. In addition, the CCB had received financial assistance through an infusion of funds from federal and provincial governments and from other Canadian banks. In the end, however, the support provided was not sufficient to prevent the bank failures. In the wake of these failures, the federal government undertook to guarantee those deposits not covered by federal deposit insurance. Subsequently, other small Canadian banks have experienced liquidity problems as a result of large deposit withdrawals, and in two cases these problems were resolved through bank mergers.

In a statement to Parliament on February 6, 1986, Canada's Finance Minister stated that the levels of the exchange rate in the early days of February were clearly below what was justified by fundamental developments in the country's balance of payments and did not reflect the healthy state of Canada's overall economic performance. He noted that the downward pressure on the Canadian dollar in recent months had been resisted by intervention in foreign exchange markets and by a rise in domestic short-term interest rates. He added that forceful action by the Bank of Canada--in both the domestic and foreign exchange markets--in the early days of February had resulted in a strengthening of the Canadian dollar. He stressed that the Government was prepared to continue and to reinforce its intervention in the foreign exchange market

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1/ Canada's net exports of energy in the first three quarters of 1985 were at an annual rate of $10.2 billion, of which $3.5 billion represented net exports of petroleum and products. It should be noted that Canadian exports of natural gas and hydroelectricity are not likely to be significantly affected by the drop in oil prices in the short run because of the prevalence of long-term contracts.

in order to promote orderly conditions and counter speculative pressure. To this end, actions had been taken to increase Canada's official reserves by US$2.4 billion. The Minister reiterated the Government's commitment to achieve an orderly and significant reduction in the fiscal deficit and said that monetary policy will continue to be directed at keeping inflation under control.

Canada: Real Effective Exchange Rate and Related Series 1/

(Indices: 1980 = 100)

	Real Effective Exchange Rate 2/ 3/	Nominal Effective Exchange Rate 2/	Relative Normalized Unit Labor Costs (Local Currencies)	Normalized Unit Labor Costs	Exchange Rate (U.S. Dollars per Canadian Dollar) 2/
Quarterly					
1981					
I	103.7	99.4	104.3	109.4	98.0
II	108.1	101.2	106.8	113.6	97.5
III	109.9	102.0	107.8	116.4	96.5
IV	112.1	102.7	109.2	119.8	98.1
1982					
I	111.6	102.2	109.2	122.4	96.7
II	109.4	100.2	109.2	124.0	94.0
III	111.0	101.0	109.9	126.0	93.6
IV	114.2	103.3	110.6	127.1	94.9
1983					
I	114.9	103.1	111.4	128.5	95.3
II	116.6	103.4	112.7	129.5	95.0
III	119.1	104.4	114.1	130.6	94.8
IV	119.5	104.1	114.7	131.7	94.4
1984					
I	119.1	103.0	115.6	133.6	93.1
II	116.4	100.2	116.2	134.2	90.4
III	116.7	100.2	116.5	135.0	89.0
IV	116.9	100.9	115.9	135.1	88.7
1985					
I	115.8	99.8	116.0	135.8	86.4
II	111.9	97.3	115.0	135.9	85.4
III	111.1	96.3	115.4	136.7	86.0
IV	107.5	92.8	115.7	137.9	84.8
Monthly					
1985					
Feb. 4/	116.1	100.1	116.0	135.8	86.4
Mar.	113.3	97.9	115.7	135.9	84.5
April	112.6	97.7	115.3	135.9	85.7
May	111.5	97.0	115.0	135.9	85.0
June	111.7	97.2	114.9	136.0	85.5
July	111.8	97.1	115.1	136.3	86.4
Aug.	111.0	96.2	115.4	136.7	86.1
Sept.	110.5	95.5	115.7	137.2	85.3
Oct.	109.1	94.2	115.8	137.6	85.6
Nov.	107.6	93.0	115.7	137.9	84.9
Dec.	105.7	91.4	115.7	138.2	83.8
1986					
Jan.	104.4	90.3	115.7	138.5	83.1
Percentage change					
Feb. 1985- Jan. 1986	-10.1	-9.9	-0.2	2.0	-3.8

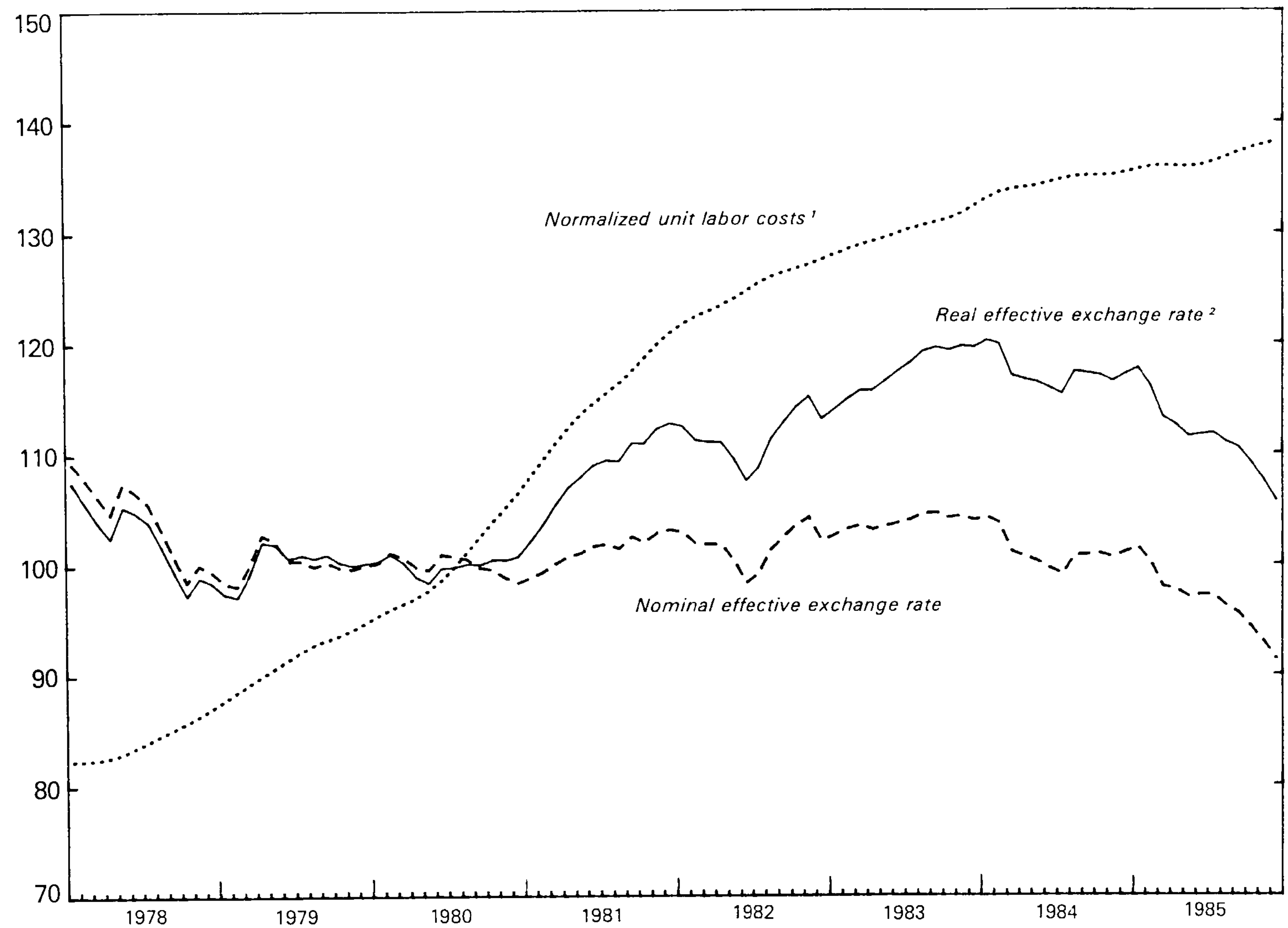
Source: Information Notice System.

1/ For a description of the weighting scheme used in the Fund's measures of cost and price comparisons for manufacturing, see the notes to that table in *International Financial Statistics*.
2/ Increases mean appreciation.
3/ Using normalized unit labor costs in local currency terms.
4/ Date of latest consideration by Executive Board.

CANADA

REAL EFFECTIVE EXCHANGE RATE AND RELATED SERIES

(1980 = 100)



Source: Information Notice System.

[1]Seasonally adjusted.

[2]Trade weighted index of nominal effective exchange rate deflated by normalized unit labor costs; increase means appreciation.