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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/30

10:00 a.m., February 27, 1985

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	
	M. K. Bush
J. de Groote	
B. de Maulde	X. Blandin
	M. Z. M. Qureshi, Temporary
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	
R. K. Joyce	L. Leonard
A. Kafka	C. Robalino
H. Lundstrom	A. Lindø
E. I. M. Mtei	A. Abdallah
	B. Jensen
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	
C. R. Rye	A. V. Romuáldez
G. Salehkhou	
	V. Govindarajan, Temporary
	T. A. Clark
	I. Angeloni, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

Asian Department: A. Ariyoshi. Exchange and Trade Relations Department: C. D. Finch, Director; A. B. Petersen. Fiscal Affairs Department: G. M. Bartoli, G. Blöndal. Legal Department: W. E. Holder. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; K. B. Bercuson, P. B. Clark, C. V. A. Collyns, L. E. DeMilner, S. V. Dunaway, J. Ferrán, E. Hernández-Cata. Advisors to Executive Directors: L. K. Doe, D. Hammann, G. E. L. Nguyen, P. Péterfalvy, G. W. K. Pickering, T. Sirivedhin, N. Toé, A. Vasudevan. Assistants to Executive Directors: E. M. Ainley, J. R. N. Almeida, J. de la Herrán, R. Fox, G. D. Hodgson, Z. b. Ismail, A. K. Juusela, H. Kobayashi, S. Kolb, A. Mustafa, W. K. Parmena, J. Reddy, D. J. Robinson, A. H. van Ee.

1. CANADA - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Canada (SM/85/28, 1/28/85). They also had before them a report on recent economic developments in Canada (SM/85/43, 2/11/85).

Mr. Joyce made the following statement:

This year's Article IV consultation with Canada comes at a particularly propitious time. The Canadian economy has continued to recover from the deep recession of 1981-82. Although growth was not as strong as in the United States and the recovery in some respects fell short of historical experience, Canada once again achieved one of the highest growth rates among industrial countries in 1984. There are, however, questions about the sustainability of the expansion in the medium term if major changes in policy are not introduced.

The consultations this year followed a change of government. The new Government, which took office in September, has announced certain policy changes and is re-examining a number of existing programs. The new Administration has expressed concerns about the programs and prospects for the Canadian economy, especially in the medium term, and has set out its views on the appropriate role that the Government should play in the economy.

In 1984, Canada continued to experience a strong recovery in economic activity from the relatively weak performance earlier in the decade. The principal sources of growth in GNP were higher consumer spending, especially on domestic goods, some increased stockbuilding, and a pronounced increase in exports, especially to the United States. An important feature of the recovery was a significantly improved performance in inflation, which by year-end was down to an annual rate of under 4 percent. The rate of increase in wages has similarly been reduced over the last three years, and unit labor costs in real terms continued to drop significantly in 1984.

In spite of this improved economic performance, the current recovery is only moderate by postwar standards and has been characterized by high unemployment and inadequate investment. The decline in the unemployment rate during this recovery has been considerably smaller in Canada than in the United States. The poor performance of investment to date can be attributed in large part to a high degree of excess capacity in many industries and a continued weak outlook for certain resource sectors. Continued high unemployment and the weak investment outlook are of concern to the authorities.

In 1985 and 1986, the Fund expects substantially slower growth in the Canadian economy than in the past two years. The staff look for a rate of increase in real GNP of 3 1/4 percent in 1985 and 2 1/2 percent in 1986. There are some differences of view, even within Canada, on the forecasts, especially the relative magnitude of growth in 1985 and 1986. Some economists, for example, think that growth in the United States, and hence in Canada, may be somewhat slower in 1985 than the Fund envisages. There are also differing views about the likely increases in productivity in the Canadian economy over the next two years and about the resulting employment effects. Government economists are a little more optimistic about the potential for employment gains, assuming that appropriate policy changes can be made. Overall, however, my authorities do not disagree fundamentally with the staff's assessment of the prospects for the next two years.

When the Government took office last autumn, it set itself four basic challenges. First, limit, and ultimately reverse, what it regarded as a massive buildup in the public debt. Second, review and redefine the role of Government in order to ensure that the scope of the Government's activities and its economic policies do not inhibit change and innovation. The aim of the Government is to reduce the degree of regulation while establishing a better framework for economic growth. Third, foster higher investment, greater innovation, increased international competitiveness, and a climate more conducive to private enterprise. Fourth, bring these changes about in as open and consistent a manner as possible, allowing for full consultation with the provinces and the private sector.

In the Government's initial economic statement, presented in the House of Commons on November 8, 1984, the Minister of Finance indicated that, while such fundamental changes would not come easily or quickly, the Government was taking immediate steps to deal with what it regarded as the most pressing problem: the magnitude of the fisal deficit. He emphasized, however, that these initial measures, chiefly expenditure reductions, would need to be followed by further fiscal action in 1985/86. Some of these additional measures, particularly those having to do with taxes, would have to be addressed in the budget this spring.

Prior to the measures announced in November, the Government projected the deficit for the fiscal year 1984/85 at C$34.5 billion on a public accounts basis, or some C$5 billion higher than originally estimated. The deficit in 1985/86 was expected to rise to C$37.1 billion, and the outlook for the rest of the decade was even worse. Even on the assumption of reduced U.S. budget deficits and, therefore, lower interest rates, the federal deficit was projected to remain at C$34-38 billion a year for the rest of the decade. This year, almost 50 percent of government borrowing is required just to cover interest costs. By 1990, unless corrective steps are taken, meeting the interest costs will require still higher levels of government borrowing.

The tax and expenditure measures announced by the Government at that time, while likely to have little effect in the present fiscal year, are expected to reduce the deficit by C$2.2 billion in 1985/86. At the same time, the Government initiated a searching examination of expenditures and revenues with a view to reducing fiscal deficits further in 1985/86 and through the remainder of the decade.

Since that time, as the staff paper points out, the Government has embarked on a number of structural changes aimed at improving the functioning of the economy and increasing the attractiveness of investment in Canada. It is the Government's intention to give more rein to the play of market forces in the economy with a view to increasing Canada's ability to compete in a freer world trading environment. Canada is supportive of international efforts to organize a new round of multilateral trade negotiations.

The Government recognizes that, if Canada is to take advantage of the new trading opportunities that will arise and, in conjunction with other countries, is to remove or scale down protectionist measures, it will be necessary to facilitate adjustment at home, give freer play to economic forces, and encourage new industrial and economic initiatives. This is a better way to secure growth in employment.

Among the measures taken or under consideration are:

(a) a series of tax and regulatory changes in the energy sector--some of which have already been made--that will permit freer energy pricing and, in respect of petroleum, encourage more efficient exploration. These changes will substantially modify Canada's national energy policy. The Government has also already moved to permit more flexible pricing of natural gas exports;

(b) a review of the role of all federal Crown Corporations to determine what changes can be made in their financing and operating procedures. The Government has already announced plans to sell off at least one major Crown agency, the Canadian Development Investment Corporation;

(c) introduction of legislation to replace the existing Foreign Investment Review Agency by a new body, Investment Canada, whose aim will be to encourage additional investment in Canada while liberalizing--and in some cases eliminating completely--the review requirements for foreign investments. Significant changes are also to be made in the National Energy Program to facilitate foreign participation in discoveries in offshore areas and in the so-called Canada Lands;

(d) termination of policies limiting increases in federally administered prices. A number of existing prices are being reviewed to determine the extent to which they accurately reflect true user cost. The public sector wage limitation program, terminated in June 1984, has not been reintroduced. Wages in the public sector will, in future, be determined by collective bargaining;

(e) a review of the unemployment insurance program, and of a number of other social insurance and social welfare programs. Modifications in some of these programs have already been announced.

The Government and the monetary authorities remain of the view that sustained economic prosperity cannot be achieved without a relatively stable price level and confidence that such stability will be maintained in the future. Although price performance has improved significantly over the last three years, further progress is required and it is necessary to maintain a record of policy actions that is consistently anti-inflationary.

The Bank of Canada has not set targets for the growth of the monetary aggregate M-1 since 1982. With continued financial innovation, there have been further shifts out of the types of deposits included in M-1, thus making that aggregate an unreliable guide for policy. Furthermore, as a result of these innovations, M-1A, which was originally conceived as a transactions-based aggregate, has been growing quickly with the transfer of savings deposit balances into one of its components--namely, daily interest checking accounts--thereby eroding its usefulness as an indicator of transactions-based monetary flows. The broader aggregates, M-2 and M-3, remain subject to problems of controllability and interpreation. The Bank of Canada, therefore, while continuing to monitor all these monetary aggregates, also looks at a broad range of other financial and economic indicators in making its decisions and gauging the appropriateness of the pace of monetary expansion. Among these indicators, changes in interest rates and in the exchange rate have been particularly important.

As the staff notes, the Government would like to see interest rates come down from their present high real levels, given the considerable degree of slack in the economy and the improvement registered in price performance. However, over the past year, Canada has faced pressures arising from the strength of the U.S. dollar against all currencies and high interest rates in the United States. As it has done in the past, the Bank of Canada has tried to adjust to those external financial strains by attempting to have part of their impact be absorbed by the exchange rate and part by interest rates. This strategy is followed because of the interaction between movements in interest rates and the exchange rate clearly demonstrated by the experience of 1984. In time, a rapid or substantial depreciation of the Canadian dollar would jeopardize the improvement in internal price performance and impede Canada's ability to reduce interest rates when the external financial environment made this possible.

The aim of monetary and intervention policies with respect to the exchange rate is to moderate upward and downward movements in the exchange rate, not to set the exchange rate. The exchange rate has at times moved substantially. Over the past year, the exchange rate against the U.S. dollar has varied from a high of 80.36 cents in February 1984 to a low of 71.15 cents on February 26, 1985. Against a basket of G-10 currencies, the depreciation of the Canadian dollar over this period has been of the order of 7 percent.

In sum, there is basic agreement between the Canadian authorities and the Fund, not only on the outlook for the immediate future, but also on what needs to be done to ensure sustained progress in the Canadian economy over the medium term.

Ms. Bush said that the strategy outlined by the Minister of Finance to strengthen confidence in the economy and maintain the gains made during the recovery seemed appropriate. Considerable progress had been made in reducing and containing inflation, and productivity had increased. Some progress had been made in containing government expenditure, the savings rate remained high, and the trade and current account balances remained strong, but the fiscal deficit was still large in relation to the size of the economy, and investment had been weak. Moreover, although employment had increased and the unemployment rate had declined during the recovery, the number of the unemployed was still high. The authorities had appropriately decided to deal with those problems by improving the fiscal balance and reducing the role of government; continued progress in the various areas that she had mentioned would hinge on the success of that strategy. Capital formation and employment could be expected to increase in response to a reduction in government involvement in various sectors of the economy, including the administration of foreign investment.

She agreed with the authorities that the needed fiscal adjustment could best be obtained by restraining spending, Ms. Bush continued. Some progress had been made: the growth in federal government expenditure had been reduced from 18.2 percent in 1982/83 to 8.3 percent in 1983/84.

Nevertheless, the share of federal spending in 1983/84--24.3 percent of GNP--remained fairly high and was only slightly below the figure of 24.6 percent recorded in 1982/83. The so-called 6/5 program of wage and price guidelines had contributed to the moderation of wages, but that progress had been partly offset by transfers to provinces for program financing and by the measures adopted in April 1983 to support job creation, training, and capital projects. Furthermore, it was estimated that total expenditure had increased considerably in 1984/85, compared with 1983/84, as a result of higher interest rates and an increase in oil compensation payments. While the 6/5 program had apparently been somewhat successful in restraining federal wages and had had a positive spillover effect on the private sector, the Government's job creation program presumably would increase wage compensation and total expenditures.

The staff had noted that oil compensation payments had also contributed to the growth in government expenditure, Ms. Bush remarked. The authorities had apparently decided to increase the petroleum compensation charge in order to slow the rate of increase in the deficit of the Petroleum Compensation Account. That action would ease the strain on government expenditure, but the most efficient solution was to eliminate the oil subsidies and the petroleum compensation system. The authorities had announced their intention of raising oil prices to market levels and eventually abolishing the cumbersome compensation system, and she hoped that they would do so in the near future. Those steps would help to reduce the strain on the budget and would free the energy sector of the hindrances created by the compensation system.

She doubted whether the government-sponsored job creation program would have any lasting effect on the unemployment problem, Ms. Bush said. Attention should be given instead to ways of solving the structural problems that had contributed to the high rate of unemployment. The staff should comment on the effect of structural rigidities on unemployment in Canada, and particularly the effects of the generous unemployment benefits, the high minimum wage rate, and practices that discouraged labor mobility. The future prospects for employment in the light of the increase in the working-age population and labor force participation rates would be helpful.

The authorities' intention to eliminate the Foreign Investment Review Agency was a positive step, Ms. Bush considered, but the plan to replace it with another review agency was a cause for concern, especially as the new agency, like its predecessor, would have considerable scope for screening investment. The practice of screening many small investments would be eliminated, but two thirds of all foreign investment in value terms and 91 percent of all direct acquisitions in value terms would continue to be subject to review. She hoped that the revisions of the investment review process would soon result in a considerable reduction in government involvement in foreign investment.

Banking system deregulation had created some difficulty in measuring the monetary aggregates, Ms. Bush remarked. Nevertheless, the authorities had managed to contain money growth by focusing on a variety of economic indicators, particularly the Canadian/U.S. dollar exchange rate. The monetary restraint had certainly contributed to the success in containing inflation, but the authorities had occasionally used interest rate adjustments to offset the downward pressure on the Canadian dollar. Understandably, movements in U.S. interest rates had occasionally influenced the Canadian authorities' decisions on interest rates, but the impact of interest rate adjustments on the exchange rate had been fairly short lived. The authorities might wish to take a longer-term view, which would involve assessing the efficiency of the real economy and taking steps to make that economy more attractive to investors. Further progress in eliminating restrictive investment practices--thereby stimulating investment--ending government involvement in energy and other sectors, and removing obstacles to private enterprise and innovation would establish the foundation for a more durable economic recovery and expansion. Over time, the exchange rate would respond to such actions.

The authorities' policy should pave the way for further progress, and she agreed with them that priority should be given to improving the fiscal position and to dealing with unemployment, Ms. Bush concluded. Removing structural rigidities and freeing the economy of government interference would help to reduce unemployment and would create a more favorable environment for investment and private sector growth. Such progress would establish the foundation for a durable economic expansion.

Mr. Alfidja remarked that the significant progress in 1983 had been maintained in 1984, when the rate of growth of real GDP had been nearly 5 percent, the rate of inflation had fallen to less than 4 percent, and the external current account position had strengthened. The inflation differential between the United States and Canada had been virtually eliminated, a development that was particularly welcome because it had been due to gains in productivity and moderation in wage settlements as well as to the restrained monetary policy implemented by the Canadian authorities.

Their intention to put into effect policies that would maintain price stability was clearly appropriate, Mr. Alfidja continued. Such stability would give the authorities some flexibility in formulating and implementing a monetary policy that would decrease interest rates and safeguard the value of the Canadian dollar. The difficulty in setting appropriate growth targets for some of the monetary aggregates should not be overemphasized. The use of a variety of financial and economic indicators as a guide for monetary policy decisions had proved to be adequate; the authorities had achieved their basic goals of reducing the rate of inflation while stimulating economic growth.

On the other hand, recent fiscal performance had been unsatisfactory, and the medium-term prospects, even under the most optimistic scenario, were worrying, Mr. Alfidja commented. The Federal Government's operational deficit had risen by 14 percent in 1983/84 to the equivalent of 6.2 percent of GDP, and a further deterioration was expected in 1984/85. He agreed with the staff that such a fiscal imbalance and the resulting financing requirement threatened the economic recovery. Action was urgently needed to restore medium-term fiscal viability.

Canada's bilateral official development assistance, which had a significant concessional element, was greatly appreciated by the countries in his constituency, Mr. Alfidja said. Canada's commitment to the multilateral development institutions was also welcome.

Mr. Fujino commented that since early 1983 the economy had recovered vigorously from the deepest recession of the postwar period. The rate of inflation, above 10 percent in 1982, had been reduced to approximately 4 percent in 1984, as the inflation differential with the United States had virtually disappeared. Moreover, real GNP was estimated to have grown by 4.9 percent in 1984, and the external current account had been in surplus. The moderation of inflation was particularly commendable, as it reflected the authorities' efforts to maintain a cautious demand management policy, including wage restraint. Further efforts were needed to consolidate those gains. Real interest rates were still very high, and the decline in the rate of unemployment in 1984 had been only moderate. The authorities had correctly stressed the need to cut the fiscal deficit substantially and to maintain a prudent monetary policy. He had found the large number of charts in the staff reports particularly helpful in assessing the medium-term trends in the economy.

The rate of economic growth in 1984 had been relatively high--4.9 percent--but the recovery had not been well balanced, Mr. Fujino remarked. There had been a turnaround in inventory investment and a strong rise in net exports, but business fixed investment had remained weak, even though corporate profits had grown rapidly since end-1982. The staff had suggested that the weak investment performance was attributable partly to the low capacity utilization rate, which had reached its lowest point in 1982; however, as the rate had reached almost 80 percent near the end of 1984, he doubted whether it was still a significant cause of the stagnation in investment. The staff had also suggested that energy-related investment had declined because of weak energy prices, but the relatively high real interest rates had probably been at least equally significant. High interest rates alone could not explain the difference in investment activity between Canada and the United States, but, faced with those rates, private corporations in Canada might well have favored investments in financial assets rather than in capital. Attempting to lower real interest rates through a more expansionary monetary policy would obviously be counterproductive. The rise in real interest rates since the end of the 1970s had coincided with growing fiscal imbalances that clearly called for determined fiscal policy action.

During previous recoveries in Canada, as well as during the present recovery, the unemployment rate had not fallen significantly, as the rise in employment had been offset by the growth in both the labor force and labor market participation, Mr. Fujino noted. In that connection, Canada's experience differed markedly from that of the United States. A further staff comment on the matter would be helpful.

In fiscal policy, the authorities' strategy was to cut the large fiscal deficit and to reduce government regulations and controls--particularly in energy and foreign investment--to help strengthen private initiative over the medium term, Mr. Fujino remarked. The growth of the fiscal deficit during recent years had been due mainly to cyclical factors, but, even when adjusted for those factors, the deficit was still equivalent to some 4 percent of GDP in 1984/85, and economic growth alone clearly would not eliminate it. The measures that were to be adopted forthwith to reduce the deficit were welcome, and he hoped that the authorities would formulate a more comprehensive and detailed plan to cut the deficit over the medium term. The authorities had correctly given first priority to expenditure restraint. In that context, they planned to re-evaluate the regional development program and to eliminate oil subsidies by liberalizing prices. Their intention to sell some of the unprofitable Crown Corporations to the private sector was welcome. Meanwhile, additional possible revenue measures should be studied.

Because of the difficulties since 1982 in interpreting the behavior of monetary aggregates, the authorities had been making monetary policy decisions on the basis of a variety of economic and financial indicators, including the exchange rate between the Canadian and U.S. dollars, Mr. Fujino observed. That strategy had generally been successful; the instability in the demand for money--particularly M-1--had been due mainly to the appearance of new banking facilities. The authorities might wish to pay more attention to the behavior of broader aggregates, such as M-2 or M-3, as was the practice in some other industrial countries, although the staff had noted that those broader aggregates also tended to be unstable. More detailed study of the problem seemed necessary.

Because of the strength of the U.S. dollar, monetary policymakers had faced the difficult choice of raising domestic interest rates or allowing the exchange rate to weaken, Mr. Fujino commented. An abrupt depreciation should be avoided, as it would seriously undermine the gains on the inflation front, but some flexibility in the management of the exchange rate was needed. The real exchange rate of the Canadian dollar, measured by relative unit labor costs, had significantly appreciated before 1983; the reversal of that trend in 1984, due to the reduction in the inflation rate, was welcome. The Canadian dollar had moderately appreciated in nominal effective terms during the previous several years. The authorities should take a variety of factors into account--including the exchange rate vis-à-vis the U.S. dollar--in setting their exchange rate policy.

He was pleased that the authorities had given a high priority to maintaining an open trading system, and that they intended to eliminate some of the protectionist import measures--including some in sensitive areas--in the coming five or six years, Mr. Fujino said. The authorities' intention to liberalize their treatment of foreign direct investment was welcome. They planned to eliminate the rigidity in the process of reviewing new investments. He broadly endorsed the staff appraisal.

Mr. de Maulde remarked that, although the overall performance of the economy had largely been positive, there had been a number of contrasting developments. On the positive side, GNP had grown by 4.5 percent, the rate of inflation had been reduced from 13 percent in 1981 to 4.5 percent in 1983 and 3.75 percent in 1984, and the trade surplus had risen from C$17.7 billion in 1983 to C$20.9 billion in 1984. On the negative side, the rate of unemployment had decreased only slightly and was still high--11 percent--and the level of investment remained far below that required by a dynamic industrial economy like Canada's. The ratio of investment to GNP in Canada--approximately 17 percent--was similar to that in the United States, but the ratio was rising much more rapidly in the United States, and in Canada it was much smaller than in other major industrial countries, such as France and Germany (20 percent) and Japan (28 percent). In addition, Canada's monetary and budgetary policies had caused interest rates to remain high and the budget deficit to continue to increase.

Some of the main features of the Canadian economy were its proximity to the United States and its status as a relatively new producer of raw materials, Mr. de Maulde went on. The economy's dependence on the U.S. market had increased in recent years. The ratio of exports to the United States to total exports had risen from 64 percent in 1980 to 76 percent in 1985, even though total Canadian exports with the exception of oil and automobile exports to the United States had fallen significantly over the same period. Moreover, Canada's abundance of raw materials was itself the source of some of the problems facing the economy: heavy investment was required to exploit the natural resources, but the downward trend in domestic savings and the upward trend in the budget deficit had choked off such investment.

It was essential to reduce the budget deficit sharply, Mr. de Maulde remarked. The present deficit, equivalent to more than 6 percent of GNP, was unsustainable. Apparently the authorities believed that, given the unemployment problem, the budget deficit should be reduced gradually, while the staff believed that a sharp cut was required in the near future, irrespective of the course of fiscal policy in the United States. He tended to agree with the staff, for three reasons. First, the economic conditions in which sharp budget cuts could be made might well become less favorable in coming months. Second, a new government had a freer hand to make such a move than a government that had been in office for some time. Third, a more vigorous budgetary policy would enable the authorities to undertake useful monetary policy initiatives.

In the circumstances, the authorities' line of reasoning for their exchange rate policy was difficult for him to understand, Mr. de Maulde went on. The Bank of Canada based its decisions on exchange market intervention essentially on a single indicator, namely, the exchange rate between the U.S. and Canadian dollars. That approach had been effective in containing inflation and in consolidating the success in that area in earlier years owing to the previous Government's incomes policy, but it tended both to make Canadian exports uncompetitive in foreign markets other than that of the United States and to increase the Canadian economy's dependence upon economic developments in the United States. Moreover, the present approach to exchange rate policy required very high real interest rates that discouraged investment and delayed the recovery of employment. In sum, the present mix of a lax budgetary policy and a strict monetary policy had net negative effects. A more rigorous approach to the public finances would enable the authorities to introduce into monetary policy the flexibility that was clearly lacking.

The comments by Mr. Joyce on Canada's industrial policy were useful, Mr. de Maulde remarked. The authorities' wish to conduct an active supply-side policy was welcome, as supply-side measures were particularly suited to a young industrial economy. Deregulation, innovation, and active support of private enterprise probably were more likely to be effective in Canada than in other countries, because of the greater potential profitability of investment in Canada, which enjoyed a kind of pioneering spirit. However, in encouraging deregulation, the authorities should not discard the incomes policy, which had been remarkably successful. In addition, the public effort to train professionals and increase labor skills should not be relaxed.

The authorities' intentions with respect to the system of screening foreign investment were welcome, Mr. de Maulde said. The present system was not sufficiently receptive to potential investors. Enterprises in France and other European countries seemed willing to revise their investment strategy in Canada's favor. Moreover, all Canada's trading partners welcomed the authorities' intentions to liberalize the trading system.

The Government had recently decided to make a substantial contribution to the Special Facility for sub-Saharan Africa, which was to be managed by the World Bank, Mr. de Maulde noted. The facility had been proposed by France and several other countries to fill the gap in regular official assistance to the region where the economic situation was critical.

Mr. Grosche commented that, since early 1983, the economy had been recovering strongly, and the rate of inflation had been decelerating. However, in the absence of major policy changes, the recovery might not be sustainable in the medium term. The growth of employment had slowed during the previous year, and the rate of unemployment still exceeded 11 percent. The recovery had been fueled to a considerable extent by stockbuilding and exports, and nonresidential investment had actually declined.

The new Government's economic strategy was designed to tackle structural problems, Mr. Grosche noted. Its main elements were a considerable improvement in the federal fiscal position, a review of the Government's role in the economy, the removal of obstacles to private sector activity, and a firm anti-inflation monetary policy.

The main challenge facing the authorities was in the fiscal area, where the prospects for the coming period were not encouraging, especially as the substantial fiscal deficit might cause private investment to be crowded out, Mr. Grosche said. In the absence of suitable policy action, the deficit was expected to fall only slightly in coming months, and that improvement was likely only if there were a sizable decline in U.S. interest rates. The policy measures introduced thus far fell far short of what was required, and he hoped that additional measures, particularly fiscal measures, would be introduced. He agreed with the staff that the authorities' gradual approach to reducing the budget deficit might be inadequate and that a comprehensive and detailed plan was preferable. Strong action should give investors confidence that the authorities were maintaining a steady policy framework, should stabilize demand for investment in consumer goods, and should make Canada less vulnerable to external developments in general and to the effects of U.S. budgetary and monetary policies in particular. The increase in the interest rate differential between Canada and the United States suggested that the degree of dependence of Canada's economy on the U.S. economy was not as fixed as might have been thought, at least in some respects.

He was particularly pleased that the authorities had allowed the price of oil in Canada to be determined by market conditions, Mr. Grosche commented. During the previous Article IV consultation with Canada, energy policy had been a source of controversy, and the new policy was welcome. The new stance on foreign direct investment was also appropriate, as it would help to increase the overall efficiency of the economy and might have a positive effect on the balance of payments. He agreed with the staff that the authorities should review their trade policy. As the staff had noted, requests for relief from import competition had not always been effectively resisted. The quantitative restrictions were particularly worrying, and their early elimination would lend credibility to the authorities' commitment to increasing efficiency and maintaining an open trading system. The authorities' deregulation effort was to be focused on certain key sectors, such as transportation and communications. In addition, the authorities planned to examine publicly owned commercial enterprises with a view to determining whether or not they could be sold. In that connection, he wondered whether a specific timetable had been worked out.

Monetary policy had played an important role in the substantial reduction in the rate of inflation, Mr. Grosche noted, but interest rates were still too high, and he shared the authorities' concern about the rates' adverse effect on investment. However, the authorities' room in which to act to reduce interest rates was restricted because of high interest rates in the United States and the strength of the U.S. dollar. Indeed, the Canadian authorities had less room for maneuver than other countries because of Canada's close economic ties to the United States. Of course, high interest rates were a problem in a number of other countries, and both budgetary and monetary actions were needed to solve it.

He understood the difficulty in setting targets for the growth of monetary aggregates, but the authorities should be urged to reintroduce such targets as soon as possible, Mr. Grosche said. Deregulation and financial innovation had added to the difficulty in interpreting monetary aggregates in other countries as well, but they had continued to establish targets for monetary aggregates. The practice of establishing such targets despite the difficulties in doing so had a positive effect on the economy as a whole, as it underscored the authorities' determination to steer a steady policy course.

There was a slight difference of opinion between the staff and the authorities on the appropriate exchange rate policy for Canada, Mr. Grosche noted. The economy's competitiveness apparently had not been adversely affected by the considerable appreciation of the Canadian dollar since 1980. However, if the authorities could not reduce the fiscal imbalance sufficiently, they would inevitably have to introduce a more flexible exchange rate policy to contain the pressure from the fiscal deficit on the balance of payments.

Mr. Nimatallah said that he agreed with the main points in the staff appraisal. The economy had made an impressive recovery from the deep recession of 1981/82, as output had grown strongly, inflation had been brought under control, and the external accounts had moved into surplus. Moreover, the short-term outlook was fairly encouraging.

However, there was considerable uncertainty about the sustainability of the recovery, since the federal budget deficit was large and growing, business investment remained weak by historical standards and in comparison with developments in the United States, and unemployment was still high, Mr. Nimatallah commented. The main policy challenge was to create the conditions for sustainable growth together with higher employment and price stability. To those ends, first priority must be given to strengthening federal finances. Continued government borrowing on the present scale would pre-empt private savings and undermine Canada's long-term growth prospects. The measures that the authorities had already taken to reduce the deficit in 1985/86 were welcome. As he had noted during the previous discussion on Canada, a clear and convicing plan to reduce the deficit steadily over the medium term was needed. Such a plan would send the correct signals to the business community and financial markets.

As to monetary policy, Mr. Nimatallah continued, the authorities' determination to control inflation was welcome. Their pragmatic reliance on a broad range of financial indicators, including the exchange rate, remained appropriate and sensible. Continued moderation in wages was also essential to preserve the recent gains on the inflation front. It was therefore important for the Government to set an example of continued wage restraint in the public sector and to encourage firms to link wage increases more closely to productivity gains.

The recent and prospective strength of exports supported the authorities' conclusion that Canada's competitive position remained satisfactory, Mr. Nimatallah commented. He agreed with Mr. Joyce that there were good reasons to maintain a flexible exchange rate policy, particularly in view of the continued strength of the U.S. dollar and uncertainties in the exchange markets.

The rather slight progress in reducing trade barriers in Canada during the previous year was disappointing, Mr. Nimatallah said. As the authorities themselves recognized, protection had delayed or impeded necessary structural adjustments in certain sectors. The authorities should be encouraged to resist domestic pressures for protection, and their plan to dismantle quantitative import restrictions as soon as possible was welcome.

The authorities should also be encouraged to maintain Canada's traditionally generous aid performance, Mr. Nimatallah remarked. He was pleased that Canada's official development assistance would reach the equivalent of 0.5 percent of GNP in 1985/86, and he hoped that the authorities would attempt to raise that proportion as the overall economic position improved.

In sum, the present state of the economy was good, but further progress was required, Mr. Nimatallah concluded. The authorities' various initiatives, particularly to encourage private investment, seemed adequately designed to increase competitiveness and efficiency in the medium term.

Mr. de Groote commented that the performance of the economy since the start of the recovery in early 1983 had been satisfactory. The buoyancy of the recovery had been due mainly to the economic upsurge in the United States, Canada's main trading partner, but the Canadian authorities had supported the domestic recovery with policies similar to those adopted in the United States. In both countries, Keynesian policies buttressed by a cautious monetary policy to control inflation had caused a substantial upturn in economic activity. The main issue at hand was how to sustain the recovery over the medium term. In that context, the Canadian authorities should pay attention to potential obstacles to a sustainable recovery, and the economic program outlined by the new Government seemed to go in the right direction.

The fiscal area obviously required the closest attention, particularly if Keynesian policies were to be applied throughout the business cycle, Mr. de Groote continued. He agreed with the staff that, in the absence of policy changes, the fiscal outlook was not bright: the budget deficit would decline only marginally in absolute and relative terms over the coming six fiscal years, and the debt would increase to the equivalent of more than half of GNP. Moreover, those projections were based on the optimistic assumption that the budget deficit and interest rates in the United States would decline. The authorities were aware that that assumption might well prove optimistic. Comprehensive measures were therefore clearly required, and he agreed with the staff that the measures that the authorities intended to introduce in the immediate future to cut expenditure and increase revenues would yield only marginal results in 1985/86, reducing the budget deficit by only C$2.2 billion. Both the magnitude of the reduction in the deficit and the timing of the measures designed to achieve it were significant. Apparently, the authorities were hesitant to follow through on their stated intentions in the fiscal area.

There was an urgent need to act quickly and vigorously in the fiscal area, Mr. de Groote continued. There were obvious dangers to the recovery, particularly the low rate of investment and the high interest rates. Canada's high rate of unemployment called for new investment, especially in the private sector, and the Government should avoid any crowding out of private sector initiatives and make every effort to keep interest rates from rising. The authorities' room for maneuver in the interest rate area was admittedly limited, as interest rates in Canada were strongly affected by those in the United States. Moreover, the authorities faced a dilemma, as they needed to keep domestic savings from leaving Canada but also had to improve the conditions for new investment in the country. They were making every effort to achieve their various objectives, but exogenous factors might well frustrate their efforts.

The recent steep decline in the exchange rate of the Canadian dollar against the U.S. dollar had placed strong pressure on Canadian interest rates, Mr. de Groote commented. Policymaking in Canada was unique in that the difficulty in defining proper monetary aggregates made it impossible for the authorities to use the traditional tool of monetary targets. The Bank of Canada based its monetary policy decisions on a variety of economic indicators, particularly the exchange rate between the Canadian and U.S. dollars. In any event, the results of the authorities' monetary policy had been positive; in particular, the rate of inflation had been reduced. The present policy approach should be maintained over the medium term in order to maintain price stability and reduce interest rates. The success of such efforts could be placed in jeopardy by the potential effects of the close economic ties between Canada and the United States; it was impossible to isolate Canada's domestic economic situation from external developments.

The new Government had begun a widespread effort to encourage deregulation, Mr. de Groote noted. The authorities intended to implement a comprehensive program of deregulation--covering wages, prices, energy policy, federally owned corporations, and such key sectors as transportation, communications, construction, and fisheries--to increase efficiency. The new Government also intended to improve Canada's external relations by further liberalizing trade and eliminating protectionist measures. In addition, foreign direct investment was to be encouraged under a new organization that was designed to be less bureaucratic than its predecessor. The authorities' various intentions were welcome and, if realized, would solve many of the problems facing the economy.

Despite the difficult fiscal situation, the authorities had maintained a relatively high level of official development assistance in relation to GNP, although the target of 0.7 percent of GNP was not expected to be reached for several years, Mr. de Groote noted. The authorities had continued to emphasize multilateral assistance, which still accounted for one third of Canada's total aid. Canada was to be commended for its particularly active involvement, through technical assistance, in many Caribbean and French-speaking developing countries, and for its participation in the World Bank's African Fund.

Mr. Rye commented that he basically agreed with the staff appraisal. Recent developments in the Canadian economy had been mixed. The inflation performance had been excellent--in recent months, it had been better than that of the United States--moderate economic growth seemed reasonably well established following the sharp recession of 1983, and the balance of payments appeared strong, at least on the surface. Those achievements were particularly commendable given the constraints on economic policy-making in Canada, and especially the close economic ties to the United States that made it difficult for the authorities to follow an independent course of policy action.

The staff and the authorities seemed agreed on economic strategy and objectives, Mr. Rye continued. The difference in their views seemed to center on questions of timing and phasing: the authorities preferred a more gradual approach than the staff, especially with respect to fiscal policy, trade liberalization, and, to a certain extent, exchange rate flexibility. The staff's position on Canada's fiscal policy was appropriate: the measures adopted by the authorities in November 1984 had constituted a step in the right direction and were therefore welcome, but the authorities could have made a more vigorous effort to begin the needed fiscal adjustment effort. The measures adopted in November 1984 were in themselves inadequate to reduce the massive fiscal imbalance. In the past, the authorities had given observers the impression that they were unable or unwilling to strain the complex network of political relations by taking genuinely decisive action to reduce expenditures and enhance revenues. He hoped that the opportunity available to the new Government--which had substantial public support--to take decisive action would not be allowed to slip away. The authorities clearly understood what was required of them, and the main question at hand was whether they were willing to take sufficiently vigorous action. He agreed with the staff that taking firm action forthwith on the fiscal deficit, even at the risk of some associated loss of short-term output growth, was the best way to ensure growth and a reduction in unemployment in the medium term.

Early action to reduce the fiscal deficit was required irrespective of the course of U.S. fiscal policy, Mr. Rye went on. Business fixed investment during Canada's recovery had been weak by historical standards, and any further upward pressure on interest rates would run the risk of pre-empting private savings and capital formation, thereby adversely affecting the prospects for longer-term growth. A better fiscal balance would probably enable the authorities to increase the spread between U.S. and Canadian interest rates while maintaining an appropriate exchange rate.

Fiscal restraint was the best way to create more room for maneuver in monetary policy in the short run, Mr. Rye said. The position of the staff and the authorities on the room for maneuver in monetary policy seemed oversimplified. There was probably at least a little more room than was implied in the discussion in the second paragraph on page 19 of the staff report. After all, the Canadian dollar was strong against all currencies other than the U.S. dollar, the monetary aggregates apparently were not moving in an inappropriate fashion, the rate of inflation was low, and real interest rates were high. The authorities' concentration on the relationship between the U.S. and Canadian dollars was understandable, but it could be overdone. In summing up the previous discussion on Canada at EBM/84/11 (1/20/84), the Chairman had noted that "Directors observed that for about a year and a half the Candian dollar had remained fairly stable in relation to the U.S. dollar in spite of a large decline in the interest rate differential between Canadian and U.S. assets."

The balance of payments data also suggested that the authorities might have overemphasized the relationship between the U.S. and Canadian dollars, Mr. Rye went on. The strength of Canadian exports was evident only in the U.S. market. The proportion of total exports directed to the United States had increased from 64 percent in 1980 to more than 76 percent in 1984; Canada's merchandise trade balance with the European Communities had recorded a deficit of C$1.2 billion in the first nine months of 1984. There was a deteriorating trend in Canada's service transactions, especially travel, interest payments, payments on short-term and miscellaneous long-term investments, and business services and other transactions. The increase in travel payments was a particularly clear indicator of the effects of the appreciation of the Canadian dollar against major currencies other than the U.S. dollar. It was especially important to note the year-to-year decline in recent years--except 1981--in Canada's net official international reserves owing to financing of the overall balance of payments deficit. The deficit had arisen largely because of unrecorded transactions under the category "errors and omissions," which had been persistently negative and, in 1983 and 1984, had been substantial. He wondered whether the authorities intended to further examine the trend in unrecorded transactions.

The authorities' actions and plans to remove obstacles to the effective working of the price mechanism were welcome, Mr. Rye said. They were intended to reduce government intervention and regulation, especially in the key sectors, including transportation, communications, construction, and fisheries. The strategy of concentrating government deregulation on key sectors was commendable and might well be applicable to other countries. The authorities also intended to examine the role of the Crown Corporations; in that connection, they were considering the sale of some Corporations to the private sector. Their efforts to bring domestic oil prices more closely in line with market-related prices were welcome.

The authorities were to be commended for the steps taken to liberalize the procedures for reviewing foreign direct investment, Mr. Rye commented. Their efforts should help to improve the trend in capital investment, thereby easing the problem of high unemployment and improving the economy's longer-term growth prospects.

Mr. Polak remarked that the authorities' rigorous approach to economic policy during the previous two years--compared with the approach in earlier years, which had caused stagflation--had produced strikingly favorable results, including a resumption of positive growth, an improvement in the balance of payments, and a reduction in the rate of inflation following a period in which many observers had concluded that there was little hope of cutting the rate to less than 10 percent.

The rate of real economic growth in Canada had nearly matched that of the United States, but the sources of growth in the two countries had differed considerably, Mr. Polak continued. Business investment had declined rapidly in Canada but had increased sharply in the United States. Canada had obviously benefited from the strong recovery in demand in the United States, which had enabled Canada to increase significantly its exports to the United States. Although imports had also increased, Canada's export-led recovery had been accompanied by an improvement in the current account.

Canada's competitive position in relation to industrial countries other than the United States had greatly deteriorated since 1980, Mr. Polak noted. Vis-à-vis the currencies of those countries, the Canadian dollar had appreciated in real effective terms by 60 percent, while it had appreciated only slightly vis-à-vis the U.S. dollar. Restraining the increasing overvaluation of the Canadian dollar against currencies other than the U.S. dollar would have implied a depreciation of the Canadian dollar vis-à-vis the U.S. dollar, which would have adversely affected domestic costs and prices in Canada. As a result, Canada's favorable inflation performance had been due to an exchange rate policy that had undermined the country's position in non-U.S. markets and to the relatively high interest rates needed to keep the Canadian dollar roughly in line with the U.S. dollar. The continued protectionist policies in Canada were perhaps a symptom of the overvaluation of the Canadian dollar. That the authorities had done little to dismantle the protectionism in Canada was regrettable. He agreed with the staff that the current import restrictions should be eliminated over the coming several years in order to improve the allocation of resources in Canada. The Canadian authorities should take advantage of the present favorable payments position to reduce protection.

The fiscal position and the high rate of unemployment were causes for concern, Mr. Polak said. The fiscal position had deteriorated despite the economic recovery in 1983/84, and the authorities and the staff agreed that steps should be taken to reduce the budget deficit. The authorities had announced measures to cut expenditures and raise revenues during the 1985/86 budget year, and they had indicated that, for the period beyond 1986, they preferred to concentrate their budget-reduction effort on expenditure cuts. He agreed with the staff that the authorities' intention of reducing the budget deficit by no more than 0.5 percent of GDP in 1985/86 was excessively gradual, and that an increase in revenue might be required to avoid heavy cuts in social programs. A strong and rapid fiscal adjustment effort might well be painful in a period of high unemployment, but he agreed with previous speakers that postponing the adoption of needed measures would make the required adjustment even more difficult at a later stage; stronger actions might be required when conditions for such actions were less propitious than at present.

Since end-1982, the authorities had ceased to use monetary targets as a policy tool, for movements in the aggregates had become unpredictable owing to financial innovations, Mr. Polak commented. There was some question whether a country that aimed at keeping the external value of its currency reasonably close to that of its major trading partner could afford to adhere to monetary targets. The Canadian authorities based their monetary policy decisions on a variety of economic indicators, particularly the exchange rate between the U.S. and Canadian dollars. As a result, in the exchange rate area Canada "leaned against the wind." Accordingly, when the U.S. dollar was appreciating, the Canadian authorities permitted interest rates to rise and reserves to fall; when the U.S. dollar was depreciating, the Canadian authorities permitted interest rates to fall and accumulated reserves. Monetary policy had made a significant contribution to reducing the rate of inflation in Canada.

Mr. Clark commented that the economy had continued the strong recovery from the trough of the recession in 1982. At the same time, the rate of inflation had fallen substantially. The main policy question in Canada, as in many other industrial countries, was how to sustain the recovery in the coming period. In that connection, he agreed with the staff that the authorities should reduce the fiscal deficit. The new Government's commitment to fiscal adjustment and the first steps taken in that area were welcome. It was noteworthy, however, that the unusually strong increase in exports during the recovery had been accounted for largely by exports to the United States, which were the equivalent of some 20 percent of final demand. Exports to other countries had actually fallen. The pattern of exports underscored the extent to which Canada, even more than the rest of the world, was dependent upon developments in the U.S. economy, and it brought into question Canada's competitiveness outside U.S. markets.

He generally endorsed the staff appraisal, Mr. Clark continued. The substantial fiscal deterioration in recent years was clearly illustrated by Chart 27 in SM/85/43, which showed that federal savings had declined by some 7 percentage points of GDP and had become heavily negative. The staff had clearly indicated the serious adverse effects in the coming period on both the level of government debt and government interest payments in relation to GDP should the authorities fail to take appropriate policy steps.

The staff's thorough discussion of the medium-term prospects for the federal deficit and of the implications for fiscal policy was welcome, and the staff's conclusions were appropriate, Mr. Clark commented. However, the staff could have usefully expanded the discussion of fiscal issues in the public sector as a whole, including the provinces and local authorities. For example, transfers by the Federal Government to the rest of the public sector had amounted to approximately one fourth of federal spending and 5 percent of GNP. The staff had implied that the fiscal impact of the performance of the Crown Corporations was substantial, and a further comment would be helpful.

Chart 10 in SM/85/43 and the inflation performance suggested that monetary policy remained tight, Mr. Clark said. There were still difficulties in analyzing the velocity of money in Canada; the introduction of further improvements in checking accounts might well have increased those difficulties. Still, the authorities should be encouraged to continue their search for a monetary aggregate that could be used as a target.

The authorities' intention to deregulate energy prices was welcome, Mr. Clark stated. They should be encouraged to take that step forthwith.

He shared the staff's concern about the possible longer-term deterioration in the external current account, particularly if a substantial slowdown in the U.S. economy were to occur, Mr. Clark said. That potential problem underscored the need to diversify exports away from the U.S. market and to re-examine Canada's competitiveness in markets other than the United States.

The authorities' efforts at further trade liberalization were welcome, Mr. Clark commented. In that connection, he hoped that any bilateral negotiations between the United States and Canada would fully take into account the interests of Canada's other trading partners. The legislation proposed in December 1984 to relax restrictions on foreign investment was also welcome. The overall liberalization effort should be extended to the banking sector.

In many respects, the Canadian economy was particularly difficult to analyze, Mr. Clark remarked. The economy had a unique mix of characteristics, as it was a producer of raw materials as well as a highly developed manufacturer and had a sophisticated service sector. Recent economic developments had clearly caused a large number of problems. The new Government had made a serious effort to address those problems, and further actions in the coming period were clearly required. The new direction of policies was welcome, and he hoped that it would be sustained.

Mr. Angeloni noted that the Canadian economy had just begun its third year of recovery from the deep recession of 1981-82. Thus far, the recovery appeared sustainable; neither the external accounts nor price developments were likely to constrain real growth in the near future. However, the failure thus far of the economic upswing to generate an increase in investment demand and employment to the desired extent--after the steep declines during the recession--was disappointing. He agreed with the staff that strengthening the recovery and reorienting the sectoral composition of demand in favor of capital formation were the main challenges facing the authorities. The staff had suggested that policy actions to meet those challenges should be based on a reduction in the fiscal deficit through expenditure restraint.

While he agreed with the staff that the current trends in Canada's public finances should be corrected, he was less convinced than the staff that reducing the fiscal deficit alone would be sufficient, Mr. Angeloni said. Cutting the deficit would give the authorities more room for maneuver in monetary policy and would sustain the credibility of that policy over time, but, in the absence of other measures, the deficit reduction would slow the expansion of economic activity and employment, even though it might provide some stimulus to private investment. If the authorities' policy measures were not to provide a net negative stimulus to economic activity, they should be comprehensive; accordingly, expenditure restraint would be significant, but only one element of the policy package.

The staff's analysis provided useful insights into possible effective policy combinations, Mr. Angeloni continued. For example, the Canadian economy was much more sensitive than the U.S. economy to real interest rates. While Canada had responded quickly to the upward pressure on real interest rates in the first half of 1984, the U.S. economy had continued to expand briskly, despite a similar increase in real interest rates in the United States. Canada's sensitivity to interest rates was particularly evident in the behavior of private residential and nonresidential investment and in stockbuilding, and was presumably due to the differences between Canada and the United States in the structure of investment incentives, such as interest deductibility, and depreciation rules. Additional information would be helpful in assessing the differences in after-tax real interest rates in Canada and the United States.

The staff had also noted that the close link between the levels of nominal interest rates in Canada and the United States was a part of the marked integration of the capital markets of the two countries, Mr. Angeloni remarked. Indeed, nominal rates were more important than real rates; in making their investment decisions, portfolio investors in each country were not affected by the location in which their investment was made. The link between nominal interest rates in the two countries was particularly evident in Chart 10 of the staff report.

The Canadian economy's considerable sensitivity to changes in real interest rates, and the close link between nominal interest rates in Canada and those in the United States, drastically reduced the Canadian authorities' room for policy maneuver and made the Canadian economy particularly vulnerable to external developments, Mr. Angeloni continued. If the rate of inflation in Canada were to be kept low, and if financial policies in the United States were to exert upward pressure on interest rates in that country, the Canadian economy must inevitably bear the burden of high real interest rates. The scope for independent management of interest rates in Canada was limited. As expenditure restraint in

Canada tended to exert downward pressure on interest rates, the Canadian dollar would presumably tend to depreciate; if the authorities resisted depreciation through a restrictive monetary policy, the beneficial effect of the fiscal restraint on private sector investment would tend to be lost. The staff could usefully comment further on the economic relationships and implications of the third scenario in Appendix VI of SM/85/43, in which the staff had suggested that reductions in expenditure would provide a substantial stimulus to private sector investment. He wondered whether that scenario included a depreciation of the Canadian dollar. If so, would the assumed extent of the depreciation be considered acceptable by the Canadian authorities, or would they probably choose to support the exchange rate by tightening monetary policy? If they preferred the latter alternative, he wondered whether the net effect of their policy would still be expected to provide the desired stimulus to investment.

In the circumstances, the authorities might wish to try to limit the effect of the real interest rates on private spending, Mr. Angeloni went on. That approach naturally seemed applicable to Canada's resource-based industries, because of their comparative advantage and the large export content of their output. In addition, the resource-based industries required an injection of new technology in order to counter increasing foreign competition. The staff should comment on the Canadian authorities' views on the introduction of supply-side measures.

Although the staff had correctly emphasized the need to reduce the fiscal deficit, that action alone would not be sufficient, Mr. Angeloni concluded. At the same time, a withdrawal of stimulus to the economy should be avoided. Comprehensive policies that included measures to improve the structure of capital incentives could help both to ease the constraint imposed by Canada's integration with the U.S. economy and to make the structure of capital incentives consistent with the employment and growth objectives.

Mr. Ismael remarked that the economy had maintained its strong growth momentum in 1984. Moreover, both price performance and the balance of payments had improved, productivity had increased substantially, and the rate of increase in wages had moderated considerably. The only significant disappointment was the lack of success in reducing the rate of unemployment, which was probably due in part to the weak business investment and the rigidities in the labor market.

He agreed with the staff that the need for fiscal policy correction was particularly important, Mr. Ismael continued. The federal deficit expected in 1984/85 seemed unsustainable, and corrective measures were required to reduce it. The fiscal measures that had been introduced thus far were not sufficient, given the large size of the fiscal imbalance. He agreed with the staff and previous speakers who had stressed that any delays in making the needed fiscal adjustment would merely add to the difficulty in reducing the deficit. In effect, the fiscal adjustment should be substantially front loaded. Moreover, given the somewhat limited scope for reducing expenditure, the fiscal adjustment might have to include both revenue and expenditure measures.

Monetary policy had helped to reduce the rate of inflation, and the present monetary policy stance seemed correct, Mr. Ismael remarked. The innovations in the financial markets had substantially reduced the usefulness of establishing monetary targets, and the Bank of Canada's present practice of basing policy decisions on a variety of economic indicators was appropriate. In a number of industrial countries, the scope for maintaining an independent interest rate policy to stimulate investment and growth was severely constrained by the implications of such a policy for the exchange rate. That limitation was particularly evident in Canada because of its close relationship with the U.S. economy. In the circumstances, interest rate policy in Canada was appropriately aimed at averting a sharp depreciation of the Canadian dollar against the U.S. dollar.

The intensification of protection in Canada was regrettable, Mr. Ismael said. A number of the members of his constituency, which had recently made painful efforts to adjust their economies, had been victims of Canada's restrictive trade policies. Resource allocation in Canada and economic adjustment in developing countries could be greatly facilitated by a reduction in Canada's import barriers.

Canada's record in providing official development assistance was exemplary, Mr. Ismael stated. He was pleased that the authorities intended to meet their aid target of 0.5 percent of GNP in 1985 and to increase it gradually to 0.7 percent. The authorities were considering a change in their policy in order to facilitate an increase in Canada's exports. The change implied that the authorities might make a shift toward tied aid in the future. Such aid was not necessarily objectionable, but the authorities should ensure that the quality of their aid did not deteriorate as a result of the proposed policy changes. The authorities certainly deserved to be commended for Canada's official development assistance, which had been generous and highly concessional.

Mr. Zhang noted that there was an unusual degree of agreement between the staff and the authorities about the present economic situation, the outlook for the economy, and the appropriateness of the authorities' policy objectives. He broadly agreed with the staff appraisal.

The powerful boost to the Canadian economy given by the U.S. recovery had been supplemented by the Canadian authorities' expansionary fiscal policy, Mr. Zhang continued. Because the rate of inflation had been falling, the authorities had been able to maintain a generally accommodating monetary policy. However, the recession in Canada had been relatively severe, and output in Canada, unlike that in other industrial countries, had not regained its previous peak until early 1984. Given the continued fairly strong economic growth, the moderate inflation, and the current account surplus, the outlook for the Canadian economy through end-1985 was generally favorable.

Recent fiscal developments had been a cause for some concern to both the staff and the authorities, Mr. Zhang continued. The objective under the 1984 budget of strengthening the incipient recovery had been achieved, but at the cost of a rather large fiscal deficit. Financing the deficit had not been particularly difficult, as private sector demand for credit had remained weak. During 1984, the authorities had introduced a package of measures designed mainly to reduce the deficit by cutting expenditures, but there had been a shortfall in personal income tax receipts and an increase in debt service charges, and the projected deficit for 1984/85 had therefore already been revised upward. Both the staff and the authorities believed that priority should be given to reducing the fiscal deficit, which exceeded 6 percent of GNP. The authorities were to be commended for their realistic approach to dealing with the fiscal imbalance. The Canadian authorities, unlike the authorities in some other industrial countries in a similar situation, clearly recognized that economic growth alone would not eliminate the structural fiscal imbalance, and that a continued rapid rise in public debt would pre-empt private savings, place upward pressure on interest rates, and crowd out private investment.

In the circumstances, the Canadian authorities felt that substantial fiscal action was required irrespective of the course of U.S. fiscal policy, Mr. Zhang went on. However, if U.S. fiscal policy action to reduce the deficit in the United States were not implemented properly or were insufficient to prevent interest rates in both countries from rising, the prospects for reducing Canada's deficit would worsen considerably. Furthermore, if the Canadian budget deficit were reduced in a context of high interest rates and a continued fiscal deficit in the United States, the resulting tendency for the outflow of funds from Canada to the United States to increase and for the inflow of funds to Canada to decrease would cause the Canadian dollar to depreciate.

Both the staff and the authorities believed that Canadian fiscal policy should be supplemented by a restrained monetary policy, Mr. Zhang remarked. However, the staff felt that Canada's monetary policy should be consistent with a steady reduction in the rate of expansion of nominal demand, to bring demand more closely in line with the rate of growth of potential output. He wondered whether a case could be made for attempting to reduce nominal GNP growth to less than 10 percent annually in the near future.

He was disappointed that the staff report did not adequately discuss the two main structural, medium-term adjustment problems that clearly required policy action, Mr. Zhang said. First, Canada's rate of unemployment was relatively high for an industrial country, and the staff did not expect it to be significantly reduced in the medium term. Unemployment of young persons was particularly serious. He wondered what steps the authorities had taken to deal with the unemployment problem, and whether the level of wages was a significant factor. The second structural problem had to do with the natural-resource-based industries, which had been particularly affected by the recession; they had experienced a cyclical downturn and faced long-term adjustment problems. In that connection, he wondered whether the authorities intended to adopt special adjustment measures. Were the authorities encouraging new investment in those industries? The staff should comment on the projected importance of those industries for Canada's external accounts in coming years.

Mr. Pérez commented that the overall performance of the economy during 1983/84 showed that it had clearly recovered from the severe recession. The improvements in the internal and external imbalances had been particularly notable. The rate of economic growth in Canada had been among the highest in industrial countries, and the rate of inflation had been reduced from 12.5 percent in 1980 to less than 4 percent in 1984. Moreover, the balance of payments had gradually strengthened, and unemployment had fallen, although only moderately.

The fiscal deficit was probably the most serious imbalance remaining in the economy, Mr. Pérez remarked. The authorities' intention to reduce the deficit, and their acknowledgement of the key role in the economy played by fiscal policy, were welcome and, indeed essential to increase the credibility of the adjustment program and support the public's positive expectations about the steadiness of the adjustment effort. Still, the authorities should try to make an even larger cut in the fiscal deficit than had been planned, despite the difficulties that would admittedly be involved. He agreed with the staff that the fiscal measures introduced thus far were inadequate in the light of the magnitude of the fiscal imbalance. The net total effect of the package of expenditure reductions would be a cut in the fiscal deficit of $2.2 billion, or 0.5 percent of GNP, in 1985/86. The Prime Minister had recognized the seriousness of the fiscal imbalance; he had admitted that the authorities' fiscal outlook was based on optimistic assumptions about the behavior of the U.S. economy, including sharp reductions in the U.S. budget deficit.

He agreed with the staff that the authorities should maintain the adjustment on the expenditure side and should introduce measures to increase revenues only if the fiscal imbalance were not promptly corrected, Mr. Pérez continued. A further comment on possible further steps on the expenditure side and the likelihood of an eventual increase in taxes would be helpful.

The fight against inflation in Canada had been based on a tight monetary policy, together with an active wage policy, Mr. Pérez commented. In the past, the implementation of monetary policy in Canada had been monitored by the movement in traditional monetary aggregates. However, the weak correlation between movements in those aggregates and in the main economic variables had led the authorities to pay more attention to other targets, particularly those for interest rates and the exchange rate. Achievement of the authorities' objective of a decline in interest rates had been strongly constrained by the further objective of avoiding a sharp depreciation of the Canadian dollar against the U.S. dollar. In fact, the level of interest rates in the United States provided a floor for Canadian interest rates. Having achieved remarkable price stability, the monetary authorities had shifted their attention to potential distortions from exogenous developments, in particular the adverse effects on domestic costs and prices of a depreciation of the Canadian dollar against the U.S. dollar. In that context, the authorities' decision to abandon the use of traditional monetary aggregates as monetary policy targets and to use instead such target variables as interest rates and the exchange rate was understandable. However, further efforts should be made to improve the interpretation of traditional monetary aggregates and to return eventually to the use of monetary targeting.

The strong trade balance was projected to continue, Mr. Pérez noted. The only doubtful aspect of Canada's trade policy was the level of protection. Indeed, measures adopted during 1984 had increased the degree of protection in the textile and footwear sectors. The measures that had come into effect on December 1, 1984 included a number of nontariff barriers. The authorities should be encouraged to maintain the economic recovery, persist in their efforts to curb the fiscal deficit, and take a firm position in favor of freer trade.

Mr. Lundstrom considered that Canada's recovery since 1982 from the serious recession had been remarkable. Canada's economic growth and inflation performances had roughly matched those of the United States, and unit labor costs had dropped significantly. Moreover, Canada's export performance had been very strong, although the unemployment rate was still high and the fiscal deficit remained large.

The Canadian economy had greatly benefited from the buoyancy of the U.S. economy, Mr. Lundstrom commented, and the economic environment seemed favorable for fiscal policy adjustment. He understood why the authorities felt that a reduction in the budget deficit might adversely affect unemployment in the short run, but he agreed with the staff that an excessively gradual approach could undermine confidence and hamper the future use of an active fiscal policy. The fiscal package designed to reduce the federal deficit by C$2.2 billion in 1985/86 was a first step in the right direction. He wondered whether the staff had any information on possible further steps in that area, including measures to increase revenue.

He agreed with the staff that the stance of monetary policy had been broadly appropriate, and with the authorities that in Canada strict targets for narrow monetary indicators like M-1 did not provide sufficient footing for a prudent monetary policy, Mr. Lundstrom said. The authorities had appropriately decided to use a wider range of indicators, particularly the exchange rate of the Canadian dollar vis-à-vis the U.S. dollar.

He agreed with the authorities that lower interest rates were desirable, particularly in view of the high rate of unemployment, Mr. Lundstrom remarked. High interest rates, together with considerable idle productive capacity, had produced rather moderate investment growth during the previous year. The recovery of profitability had been used to strengthen the corporate finances that had been weakened during the recession. The accumulation of liquidity in the business sector should be closely monitored to avoid the emergence of excess liquidity.

Recent export performance had been satisfactory, Mr. Lundstrom said. Given the strength of the trade and current account balances, the authorities should be encouraged to resist protectionist pressures and expedite the elimination of import restrictions.

He broadly agreed with the staff's assessment of the Canadian economy, including the outlook for the coming two years and the thrust of the policy stance, Mr. Lundstrom concluded.

Mr. Jensen said that he agreed with the staff appraisal. The Canadian economy had continued to perform well in difficult conditions, although developments in 1984 had been less impressive than those in 1983, when the economy had made a remarkable recovery from the severe recession and output had risen sharply. Economic growth had slowed since then, the rate of unemployment was still high, and the fiscal deficit had increased. However, the rate of inflation had been reduced, and the balance of payments had been strengthened. The increase in the consumer price index had fallen from double-digit figures in 1982-83 to some 4 percent in 1985, owing significantly to the continued monetary restraint and the moderation in wages. The external accounts had strengthened for the third consecutive year, as the trade surplus had increased in 1984 and the external current account had recorded a significant surplus.

However, Mr. Jensen went on, he harbored some doubt about the competitiveness of Canadian exports in markets outside the United States; in that connection, the authorities' exchange rate strategy was a cause for concern. In addition, there were difficulties in the fiscal sector, with investment, and in using monetary aggregates as policy targets.

The level of protection in Canada was also a cause for concern, Mr. Jensen said. As the Prime Minister of the United Kingdom had recently stated in her comments on protection by industrial countries and its effects on developing countries, industrial countries should not encourage developing countries to undertake economic adjustments unless the industrial countries themselves were willing to make such adjustments in their own economies. The four basic challenges that the authorities had set for themselves, according to Mr. Joyce's, and the specific measures that they intended to introduce, were welcome. However, the lack of more precise commitments regarding protection was disappointing. During the previous Article IV consultation with Canada, the Executive Board had expressed its serious concern about the growing protectionist pressures in Canada and had urged the authorities to resist them and to make an early effort to reduce import barriers. It was important to underscore the need of developing and newly industrialized countries for access to export markets. Canada's sophisiticated system of quantitative import restrictions seriously affected goods in which many developing countries enjoyed a comparative advantage and jeopardized the continued implementation of adjustment efforts by those countries.

The authorities were to be commended for their continued generous development assistance, Mr. Jensen commented. Despite the recently announced cuts in foreign aid for 1985/86, Canada's official development assistance would be the equivalent of 0.5 percent of GNP, and substantial real growth in aid flows was expected during the coming ten years. The concessional component of Canada's official development assistance and the proportion of its aid directed to multilateral institutions were larger than those of other member countries of the Development Assistance Committee.

Mr. Govindarajan remarked that the economy had continued to perform well in 1984, although the annual rate of economic growth had slowed to approximately 4 3/4 percent from 7 percent in 1983. Inflation had been contained, the present rate being roughly the same as that in the United States. The rate of unemployment was high and would undoubtedly be a cause for concern in the coming period. He agreed with the thrust of the staff appraisal and commended the authorities for several positive achievements in 1984.

The authorities were aware of the need to contain the fiscal deficit in the coming several years and had taken some steps to that end, Mr. Govindarajan commented. The implementation of monetary policy had generally been successful, despite the difficulty in using monetary aggregates as policy targets. He generally agreed with the staff's views on those major policy areas.

He also agreed with the staff that, if international trade were to be encouraged, countries like Canada should begin to reduce protectionist barriers, Mr. Govindarajan said. That conclusion was particularly applicable to countries that, like Canada, had enjoyed a strong recovery. The recovery in industrial countries could be transmitted to developing countries only when the access of developing countries to the markets of industrial countries was increased through the removal of trade barriers.

Given Canada's recent strong economic recovery and positive current account and trade balances, he would have expected the access of developing countries to Canadian markets to have been liberalized, Mr. Govindarajan went on. Instead, Canada's trade policy had been on the restrictive side, as the authorities had reintroduced a global quota on leather footwear, maintained the quota on nonleather footwear, erected nontariff barriers on clothing and textiles, and introduced procedures tending to discourage imports. The recently adopted Special Import Monetary Act was expected to deal with unfair competitive practices of foreign producers; its new procedures for handling complaints about dumping and subsidies were expected to simplify and expedite the processing of such complaints. Most of Canada's trade laws had been enacted with good intentions, but he hoped that the way in which they were implemented would not transform them into "nuisance barriers." The protectionist barriers should be eliminated not only to encourage developing countries' exports, but also to ensure efficient resource allocation in Canada and its trading partners.

The staff had noted that most of the relevant measures indicated that there had been a significant increase in the real effective value of the Canadian dollar from 1980 to mid-1984, Mr. Govindarajan remarked. Nevertheless, the authorities apparently regarded the competitive position of Canadian producers as broadly satisfactory. The staff report did not clearly describe the impact of Canada's exchange rate policy on its trade with countries other than the United States, particularly developing countries. He agreed with Mr. Polak that the large number of protectionist measures in Canada was probably evidence that the exchange rate was unrealistic.

The authorities' intention to meet the 1985 official development assistance target of 0.5 percent of GNP was welcome, Mr. Govindarajan said. Canada's aid as a proportion of its GNP had been 0.48 percent in 1979 and had fallen to 0.41 percent in 1982 before rising to 0.45 percent in 1983. Given Canada's strong recovery, he would have expected a steeper increase in official development assistance. The Government's decision to postpone from 1985 to 1990 the achievement of a ratio of official development assistance to GNP of 0.7 percent was regrettable, particularly in the light of the serious financing needs of many developing countries. In the past, Canada's aid had been very helpful to developing countries. The Government had also indicated that it intended to examine the link between trade and aid in order to determine whether its development assistance programs could play a more effective role in promoting Canadian exports. He hoped that any decisions based on that examination would ensure that the quality, as well as the quantity, of Canada's aid to low-income countries would not be reduced. In that context, the authorities' intention to continue emphasizing multilateral assistance and to retain the highly concessional elements of their aid was welcome. All the members of his constituency warmly appreciated Canada's concessional assistance.

Mr. Mtei commented that 1984 was the second year of recovery for the Canadian economy. Real GNP had increased by 4.75 percent, and the rate of increase in the consumer price index had declined to 3.75 percent, as wage increases had moderated, productivity had increased, and unit labor costs had fallen substantially. The external sector had benefited from the sharp rise in exports, although the persistently high rate of unemployment, the low level of business investment, and the large fiscal deficit suggested that the recovery might not be sustainable.

The expansion in final domestic demand had been relatively weak, Mr. Mtei noted. Business fixed investment had remained sluggish, and the strong increase in inventory investment, which had been stimulated by the liquidation of stocks during the recession, was expected to slow in the coming period. Moreover, the prospects for export expansion outside the U.S. market were not promising, because of the appreciation of the Canadian dollar vis-à-vis the currencies of industrial countries other than the United States. In the circumstances, a major shift in the composition of aggregate demand toward business fixed investment might be needed to sustain economic expansion. The authorities' intention to introduce measures to encourage private investment, including the deregulation of the energy, transportation, communication, fisheries, and construction sectors, and the rationalization of the Crown Corporations, was welcome. The authorities' plans to review federal programs that promoted industrial and regional development, together with the changes in government policy on foreign direct investment in Canada, should help to create an environment conducive to an increase in private sector activity in general, and business fixed investment in particular.

The persistent high level of unemployment, despite the continued moderation in wages and the substantial reduction in unit labor costs, might well be a reflection of the existence of structural rigidities in the labor market, Mr. Mtei said. The employment and training programs announced by the authorities, together with the declared policy of promoting investment and job creation in the private sector, should help to reduce unemployment.

The budget deficit had more than doubled in 1982/83, to 6 percent of GNP, and it had reached 6 1/4 percent in 1983/84, Mr. Mtei noted. A further deterioration was projected for 1984/85, and he agreed with the authorities that the actual fiscal outcome might be even less favorable, since the projections were based on optimistic assumptions about the U.S. economy, particularly reductions in the U.S. budget deficit and U.S. interest rates. The most worrying aspect of the fiscal deficit was its impact on public debt, which was expected to reach 52 percent of GNP by 1990/91 under the most favorable scenarios. The authorities recognized that the rapid expansion of public debt would not only crowd out private investment and add to the heavy burden of interest payments but also fuel inflationary expectations, thereby eroding confidence in the Government's economic program. While the authorities' concern about the need to reduce the fiscal imbalance was encouraging, the measures recently adopted did not go far enough to bring about a substantial reduction. The authorities should be urged to move quickly to implement further measures to reduce expenditure. They might also need to explore the possibility of adopting revenue-generating measures if the objective of substantially reducing the deficit were to be achieved in the near future.

The authorities were to be commended for their continued aid to low-income countries and for its highly concessionary element, Mr. Mtei said. However, the recent decision to curb official development assistance and to postpone meeting the target of 0.7 percent of GNP were regrettable, as developing countries in general, and low-income countries in particular, faced extreme hardship. He understood that Canada's difficult fiscal position had led the authorities to adopt those decisions, but he hoped they would be reversed. The authorities intended to establish a link between Canadian trade and aid, as a result of which Canada's development assistance would be tied to the promotion of its exports. Such a step could tend to diminish the effectiveness of Canada's foreign aid. Finally, he agreed with the staff appraisal.

Mr. Qureshi stated that he broadly agreed with the staff appraisal. The continuation of Canada's economic recovery for a second year from the deepest recession in the postwar period was encouraging. In 1984, employment, output, and productivity had increased significantly, while the rate of inflation had moderated further and the external current account had registered a surplus. The composition of the present recovery reflected the sharp turnaround in inventory investment and the substantial rise in exports. However, the performance of business fixed investment had been weak, and the rate of unemployment remained high. Accordingly, a strategy that emphasized investment promotion and employment expansion would be appropriate in order to maintain the momentum of recovery and to spread its benefits. That strategy would need to be implemented in a way that would be consistent with the prudent financial policies that had been instrumental in initiating the recovery and that would be essential for sustaining it. The Canadian authorities' policy efforts would be assisted by favorable policy developments in the United States.

The fiscal situation in Canada was a key problem area and could endanger the recovery if the projected large fiscal deficits were actually to materialize, Mr. Qureshi continued. The persistence of large deficits could keep interest rates high and raise expectations about future inflation, thereby adversely affecting private capital formation and economic growth in the long run. The authorities recognized the need to reduce the deficit, but the targeted pace of fiscal adjustment was slower than the staff had recommended. He understood the factors that limited rapid fiscal adjustment in Canada, but the adoption of an adequate deficit reduction policy package remained the prudent course of action to sustain economic growth.

The difficulty in interpreting and controlling monetary aggregates had continued to hinder their use as targets for monetary policy, Mr. Qureshi noted. Monetary policy decisions had been based on a variety of economic and financial indicators, particularly the exchange rate between the Canadian and U.S. dollars. The authorities' pragmatic approach to monetary control had succeeded thus far in reducing the rate of inflation, although the targeting of the exchange rate had limited the authorities' room for maneuver in adjusting interest rates and, to some extent, in promoting external competitiveness. While the authorities should continue to monitor the exchange rate, the question naturally arose how an adequately accurate assessment of the stance of monetary policy could be made without a clearer or more direct reference to monetary aggregates. The authorities should be urged to continue the search for a monetary aggregate that could be used in the formulation and implementation of monetary policy.

The authorities had reaffirmed their commitment to freer trade and their support of a new round of multilateral tariff negotiations, Mr. Qureshi observed. Their intention to remove existing quantititative restrictions within five to six years was welcome. However, little progress had been made thus far in import liberalization; indeed, restrictions against developing countries' exports--particularly textiles and footwear--had been maintained or strengthened.

The authorities' commitment to meet their 1985 official development assistance target of 0.5 percent of GNP was welcome, Mr. Qureshi said. Canada's aid record had been good, but the achievement of the 0.7 percent target for official development assistance had been postponed, and the tendency toward an increase in tied aid was a cause for some concern.

The staff representative from the Western Hemisphere Department, commenting on structural rigidities in the Canadian economy, remarked that the effects on employment of the rather generous unemployment benefits and minimum wages had been extensively studied in Canada. A number of studies suggested that the increase in unemployment compensation had caused the natural rate of unemployment to rise during the early 1980s, possibly by as much as 1 percentage point. Moreover, some studies had also suggested that differences in minimum wages among provinces had been a factor in the variation in unemployment rates among the provinces. However, the relationship had not been firmly established, and the impression of economists in Canada was that the provincial and federal minimum wage laws had not had a pronounced effect on the unemployment rate. There was a dual minimum wage structure at the provincial and federal levels: the minimum wage for young persons was lower than the minimum wage for adults.

There was considerable concern in Canada about the high level of unemployment among young persons, the staff representative went on. To some extent, the problem was unavoidable, as it reflected the level and composition of skills of younger persons and the relatively high tendency of such persons to change jobs. The same factors apparently were evident in the United States, where the rate of unemployment among young persons was also relatively high. A number of youth employment programs had been implemented in Canada, but economists doubted whether these programs could achieve a significant decline in the unemployment of young persons in the long run. In any event, there had recently been some shifting of funds in federal programs toward youth training.

Another element of structural rigidity was the apparent lack of geographic mobility of workers, the staff representative said. The rate of unemployment varied considerably from province to province, reflecting partly the mechanical application of the trend in federal wages in the capital to wages in the various provinces despite the significant differences in the cost of living in the provinces. A related problem was the apparent lack of portability of pensions.

The petroleum compensation charge had recently been increased, mainly in response to the rising deficit in the petroleum compensation account, which exceeded C$1 billion, the staff representative said. The deficit was traceable to the gap between petroleum compensation payments to refiners using imported or deregulated new oil priced at the international level, and charges levied on refiners using old oil subject to regulated prices. The significant increase in the petroleum compensation charge should reduce the petroleum compensation deficit to just $30-40 million in 1985/86. Nevertheless, the authorities were determined to move toward complete deregulation of prices in the oil sector. Accordingly, the mechanism of petroleum compensation payments and charges would eventually be eliminated.

The high real interest rates and the high rate of capacity utilization probably helped to explain the weak investment performance in Canada, the staff representative said, but they did not explain the significant difference between the behavior of investment in the United States and Canada. The staff suspected that the pickup of investment in Canada had been relatively weak because the decline in the effective cost of capital had been less sharp in Canada than in the United States. The measures to liberalize depreciation allowances adopted in the United States in 1981 had caused a major reduction in the effective corporate tax rate in the United States; no similar measures had been adopted in Canada in recent years. At the same time, the longer-term performance of investment in Canada was not dramatically different from that of the United States. Investment in Canada had been very strong in 1979-81, particularly in the energy sector, while investment in the United States had been weak. Moreover, surveys suggested that Canada's investment performance was likely to improve significantly in 1985.

The rate of unemployment had declined by nearly 1.5 percentage points during the first seven quarters of the recovery, the staff representative noted. The reduction was significant by Canada's historical standards. Hence, while the decline in unemployment in Canada had been much smaller than the decline in the United States, the striking element of that development was the very rapid fall in U.S. unemployment, not the fairly predictable drop in Canadian unemployment. The difference reflected the faster growth of the labor force in Canada than in the United States, and greater employment generation in the United States than in Canada. The difference in the growth in the labor forces between the two countries was due to both the faster growth in the working-age population in Canada and the sharper rise in the labor force participation rate in Canada. The stronger employment gains in the United States were due partly to the greater output growth in that country than in Canada, although productivity had grown more rapidly in Canada than in the United States.

There were difficulties in interpreting M-2 and M-3 as well as M-1, the staff representative said. There had occasionally been shifts between assets included in the broader aggregates that were difficult to predict and explain in the short run. Moreover, the demand for M-2 and M-3 was such that it would not provide the advance signals that were helpful in implementing monetary policy. In addition, M-2 was difficult to control. In both the United States and Canada, M-2 and M-3 included managed liabilities--namely, large time deposits in Canada, and negotiable certificates of deposit in the United States--and, in the very short run, the supply of those liabilities was affected by changes in corporate and government demand that could not be directly controlled by the monetary authorities.

The authorities had not yet announced a specific timetable for acting on their stated intention of reforming the Crown Corporations, the staff representative remarked. However, negotiations had already started on the possible sale to the private sector of the assets of the Canadian Development Investment Corporation, which included Canadair and de Havilland, two of the public corporations that had incurred the largest losses in recent years.

The sizable errors and omissions item in the Canadian balance of payments had been under investigation by the authorities and the staff, although with little success, the staff representative commented. While the movements in the item were difficult to explain, their large size suggested that they probably were not due to unrecorded current transactions alone. They were probably explained largely by unrecorded capital movements. Statistics Canada had several ongoing programs to improve the quality of various aspects of the reporting of Canada's balance of payments.

It was true that interest rates in Canada were strongly dependent on developments in the United States, the staff representative said. That issue was a sensitive one in Canada, where interest payments were not tax deductible and large upward movements in interest rates due to interest rate increases in the United States were a cause for great concern. The Canadian authorities and the staff did not have firm ideas about appropriate responses to that problem. It had been suggested that the Canadian authorities might decide to make mortgage interest payments tax deductible, as they were in the United States, thereby reducing Canada's vulnerability to interest rate movements abroad. However, that decision would have a significant budgetary cost and, as experience in the United States suggested, such a mechanism was difficult to eliminate after it had been in place for a number of years.

Another aspect of Canada's dependence on developments in the United States was the growing share of Canadian exports to that country, the staff representative continued. However, there seemed to be little that the authorities could do about it. Their intervention in the exchange market had been designed essentially to smooth exchange rate fluctuations, not to achieve a precise target for the exchange rate. The authorities felt that intervention had not resulted in an inappropriate exchange rate. They also felt that, in the long run, monetary policy could not have a significant influence on the real exchange rate, a view that the staff tended to share.

The staff's analysis of fiscal developments in Canada had been concentrated on the Federal Government for the same reason that its assessment of fiscal developments in the United States was focused on the position of the Federal Government there: because fiscal policy decisions affecting the overall economy were taken at the federal level rather than at the local level, the staff representative said. Provincial and local governments in Canada, like state governments in the United States, did not take decisions with a view to affecting directly the performance of the national economy; their decisions were aimed at influencing the local economic and financial situation. To be sure, an assessment of the overall balance between savings and investment in Canada had to take into account the financial position of the local and provincial governments as well as the position of the Federal Government, and the staff had done so in Appendix VI in SM/85/43. In any event, the fiscal imbalances of the provincial and local governments had not been large in recent years; accordingly, developments in the deficit of the general government had not differed fundamentally from developments in the federal deficit, as was shown in Chart 16 of SM/85/43. Still, the interaction between the finances of the Federal Government and the position of the provinces and local governments was significant; federal transfers to the provincial and local governments and hospitals accounted for some 20 percent of federal expenditure. Roughly one third of those transfers covered postsecondary education and health care, while one fourth covered contributions for safety net programs under the Canadian Assistance Plan, and one fifth covered provincial and interprovincial equalization payments. Transfers to the Crown Corporations accounted for C$4.5 billion. There had also been approximately C$1 billion in loans and advances to, and investments in, the Crown Corporations.

Under the third scenario in Appendix VI in SM/85/43, the real value of the Canadian dollar in effective terms was expected to remain constant, the staff representative explained.

The staff and the authorities had discussed a number of measures that could be said to fall under the supply-side category, such as deregulation, energy pricing, the approach to the Crown Corporations, and investment incentives, the staff representative remarked. No specific measures in that area had been announced yet, although the supply side of the economy was under review by the authorities.

The authorities had not taken steps to affect the distribution of Canada's international trade in general and the growing share of exports to the United States in total Canadian exports in particular, the staff representative noted. The only significant measures that had affected the geographic pattern of trade were the restrictions on imports of Japanese automobiles. The growing share of the United States in Canada's total exports reflected the appreciation of the Canadian dollar against overseas currencies but was also due to a significant extent to the considerably stronger recovery in the United States than in Canada's other trading partners.

The Bank of Canada based its monetary policy decisions on a number of economic and financial indicators, including the rate of inflation, the increase in GNP in nominal and real terms, long-term interest rates in Canada, and, to the extent they could be used, the monetary aggregates, the staff representative said. Their reliance on the exchange rate between the U.S. and Canadian dollars in implementing monetary policy should not be overemphasized.

The monetary authorities agreed that the analysis of developments in the monetary aggregates, and the setting of targets for those aggregates, were useful in the conduct of monetary policy, the staff representative from the Western Hemisphere Department commented. However, it was difficult in the short run to base monetary policy on monetary aggregates at a time when M-1 was declining by 1 percent per annum and M-1A was rising at an annual rate of 18 percent. The monetary authorities had not abandoned their search for a useful monetary aggregate. In the meantime, the authorities were also giving consideration to a number of financial and economic indicators for monetary policy. The exchange rate between the U.S. and Canadian dollars was one of the variables that the authorities took into account in making monetary policy decisions affecting the short run, but the authorities' approach to that variable was flexible; they did not have a specific, rigid goal for the exchange rate. Indeed, the exchange rate between the Canadian and U.S. dollars had depreciated by more than 10 percent since the end of 1983.

Mr. Joyce remarked that there was broad agreement that the fiscal deficit should be reduced as quickly as possible, and that the measures introduced in November 1984 had been short of what was required. Executive Directors had appropriately urged the Canadian authorities to proceed as quickly as possible to introduce further measures. The authorities themselves clearly wished to act as quickly as possible. However, it was useful to remember that the authorities had taken office fairly recently, in September 1984, and, although they had wished to move quickly, their room for maneuver had been limited. They could not have hoped to produce a new budget in the early stages of their new administration. At the same time, they had been aware that they could not afford to fail to take some action. Accordingly, the new Government had immediately made certain policy changes, thereby serving notice that it intended to make more sweeping changes in spring 1985. The authorities were working on the new budget. While it was too soon to know precisely which measures the authorities would propose under the new budget, they apparently preferred to reduce the budget deficit through expenditure constraint. Indeed, some expenditure cuts had already been made; additional ones would be more difficult to make, although cuts were probably easier to make during a recovery and by a new government than when the economic activity had slowed and the government had been in office for some time. At the same time, as Executive Directors had noted, the authorities would be able to gain room for maneuver in which to achieve their various economic and financial objectives only after the government deficit had been reduced. In that connection, the authorities could be expected to introduce tax changes, should they feel that such adjustments were necessary to reduce the deficit more rapidly than hitherto.

As Mr. Angeloni had noted, a reduction in the budget deficit might well have certain negative effects outside the fiscal sector, and there was no certainty that, as the Government pulled back, the private sector would pick up the slack, Mr. Joyce continued. The authorities would have to take that possibility into account in formulating the new budget. It was also important to note that the prospects for reducing Canada's budget deficit would be much worse if the deficit in the United States were not reduced. That was not to say that the Canadian authorities' budget policy would be determined by U.S. fiscal policy, but it was widely recognized in Canada that a sharp cut in Canada's budget deficit in the absence of a similar reduction in the U.S. budget deficit could pose difficult problems for the Canadian economy. For example, experience in 1984 had suggested that a sharp cut in Canada's budget in the absence of a reduction in the U.S. budget deficit was unlikely to cause Canadian interest rates to fall significantly without increasing the pressure on the exchange rate. Hence, unless the budgetary action by the Canadian authorities generated a surge of confidence, it would probably lead to a much more restrictive demand management stance that would significantly constrain aggregate demand in the short term. Nevertheless, the Canadian authorities would likely propose a number of decisive measures under the new budget to increase the effective control of the deficit.

The monetary authorities would certainly be willing to set targets for monetary aggregates if they could find usable aggregates, Mr. Joyce said. The authorities had no ideological reason for opposing the use of monetary aggregates as policy targets; they had simply been unable to find a target variable in which they could feel fully confident. They were maintaining the search for usable aggregates, but the prospects for finding one soon were not bright.

Executive Directors had recognized the limited room for maneuver in the exchange rate policy area, Mr. Joyce remarked. A sudden depreciation of the exchange rate should certainly be avoided.

The dependence of the Canadian economy on the U.S. economy was substantial and growing, Mr. Joyce commented. Some speakers had suggested that, when exports of automobiles and energy were excluded, Canada's export competitiveness was fairly weak. It was important to bear in mind that automobiles and energy products constituted a major portion of Canadian exports and that the market for another important element of Canada's exports--namely, forest products--had been depressed in the recent past.

The question whether Canada's economy was becoming excessively dependent on the U.S. economy had been an important one in Canada for some time, Mr. Joyce noted. In the past, Canadian authorities had attempted to offset the growing dependence on the U.S. economy by seeking closer trade ties with the United Kingdom and Europe. Most of those efforts had failed, probably because they had gone against the grain of economic reality: the U.S. market was substantial and close, and the economies were closely linked by common business customs and significant business contacts. Previous Governments had responded to Canada's considerable dependence on the United States by seeking broader free trade arrangements between the countries, and the new Government might well wish to make a more active effort in that connection. A commission was studying the future of the Canadian economy, and its chairman had indicated that the commission's final report might well include a recommendation for freer trading arrangements with the United States.

Canada's trade barriers were less extensive than some Executive Directors had implied, Mr. Joyce said. It was true that a number of measures had recently been adopted to inhibit trade, particularly in textiles and footwear, and that many of those imports were from developing countries that were obviously deeply concerned about the measures. It was also true that the restrictions inhibited the development of the exporting countries and were not in the best long-term interest of the Canadian economy. Still, the restrictions were a reflection of political realities in Canada. Furthermore, the restrictions had been adopted in accordance with both the multifiber arrangements that had been agreed between developed and developing countries under the GATT, and Article XIX of the GATT.

The discussions in Canada about closer links between Canadian aid and trade, owing to pressure from the business community, probably would not have the serious consequences implied in some Executive Directors' comments, Mr. Joyce remarked. An aid package was of course more attractive to the business community and taxpayers when it included some immediate benefits for them, but that did not necessarily mean that all Canada's aid would have to be tied, or that Canada's contribution to the international financial institutions would have to be reduced.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/29 (2/25/85) and EBM/85/30 (2/27/85).

2. BENIN - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with Benin to not later than March 8, 1985. (EBD/85/54, 2/21/85)

Decision No. 7915-(85/30), adopted
February 25, 1985

3. GABON - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with Gabon to not later than March 15, 1985. (EBD/85/56, 2/22/85)

Decision No. 7916-(85/30), adopted
February 26, 1985

4. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the proposal that Mr. Sengupta assume the positions on the Committee on Executive Board Administrative Matters and the Committee on Interpretations left vacant by the departure of Mr. Malhotra, as set forth in EBD/85/51 (2/20/85).

Adopted February 25, 1985

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/46 (2/25/85) is approved.

APPROVED: November 26, 1985

LEO VAN HOUTVEN
Secretary