Chapter 1
THE INTERNATIONAL ECONOMIC ENVIRONMENT

Canada and the international economic environment

The vigorous expansion of the economies of member states in the OECD during 1984 slowed to a growth rate of about 2.7 per cent in 1985. This slackening was due in large part to the reduction in the pace of economic growth in the United States from the 1984 rate of 6.6 per cent to 2.2 per cent in 1985. The slowdown in OECD growth resulted in a marked reduction in growth of world trade from 9 per cent in 1984 to under 3 per cent, and reduced the growth rates of developing countries to about 3.1 per cent from the previous year's 4 per cent. Canada's economy maintained a healthy rate of growth in 1985 at 4.5 per cent, down only slightly from a 5 per cent growth rate in 1984.

Inflation continued its steady decline to under 5 per cent in the OECD area for 1985. Steep falls in the price of oil in early 1986 reinforced this trend; consequently, OECD inflation was forecast to fall under 3 per cent in 1987, with virtual price stability (or even negative inflation) in some countries such as West Germany and Japan. Despite continued economic growth and good inflation performance, progress in reducing unemployment was slow. Previous rapid employment creation in the United States slowed markedly in 1985, while in Europe job creation was insufficient to offset labour market growth, so that employment continued to rise to about 11 per cent. Canada was one of only a very few countries to enjoy a strong job creation performance and a declining rate of unemployment.

The past year saw growing concern over international trade and financial imbalances, specifically the trade and current account surpluses of Japan and West Germany on one hand, and the deficits of the United States on the other. These imbalances increased the risks of abrupt destabilizing exchange rate swings, and exacerbated protectionist pressures, especially in the United States. Many observers saw the origin of these difficulties in large American budget deficits. Accordingly, international calls for action to reduce the deficit increased.

On the other hand, 1985 also saw a number of encouraging developments in the economic policies of major countries. The OECD Ministerial Council Meeting in April and the Bonn Economic Summit in May 1985 elaborated a package of economic policy initiatives which over time would reduce imbalances, improve confidence and help sustain economic growth. In subsequent months, considerable progress was made in implementing these agreements. Efforts to control and reduce US budget deficits began to make progress, notably through defence spending reductions and passage of the Gramm-Rudman legislation. In September the finance ministers and central bankers of the five reserve currency countries (G-5) agreed publicly to intervene in exchange markets to reduce the value of the US dollar, thereby speeding a re-alignment which had begun some months before. In October, US Treasury Secretary James Baker advanced a number of proposals for enhancing the international case-by-case strategy for managing the debt problems of developing countries. In November, GATT contracting parties agreed to establish a preparatory committee to begin work leading to the launch of a new round of multilateral trade negotiations. Finally in March 1986, the central banks of the three largest economies — the United States, Japan and West Germany — achieved a co-ordinated cut in their interest rates.

Early 1986 was thus a period of considerable optimism in international economic diplomacy. Positive economic developments and a more responsible, co-operative attitude among policy makers seemed to offer the best opportunity in many years to break free of the economic difficulties of the 1970s and early 1980s, and set the world economy once more on a path of sustained non-inflationary growth.

International financial and investment issues

Continuing the substantial progress in containing the problems associated with external debt service of many developing countries over the last three years, Canada participated actively in multilateral efforts to strengthen the debt strategy and in bilateral debt rescheduling negotiations. The external economic environment was less favourable in 1985 than in 1984 for debtor countries. The drop in world oil prices, while of benefit to oil-importing less developed countries (LDCs), had a negative effect on oil-exporting debtors (e.g. Mexico, Nigeria).

Latin America, with a large percentage of outstanding LDC debt — \$360 billion (US) out of a total \$860 billion — remained the focus of concern from the perspective of the need to safeguard the international financial system. Smaller debtors do not pose a threat to the international financial system, but the toll in human suffering, particularly in Africa, may be higher. Asian countries have generally weathered the debt crisis better than LDCs of other regions. Among East European countries, Poland will remain a problem debtor for the foreseeable future.

Since the October 1985 IMF-World Bank Annual Meetings in Seoul, the focus of attention of industrialized countries has been on follow-up to US proposals (the Baker Plan) to develop a more growth-oriented debt strategy. The United States proposed, *inter alia*, that continued structural adjustment efforts by debtors should be supported by increased lending from commercial banks and multilateral institutions. Canada supported this approach in subsequent meetings.

Since then, progress has been achieved on lending IMF Trust Fund reflows to the poorer debtor countries: the IMF has approved the establishment of a special account for this purpose. Consideration is being given in the World Bank to ways to supplement these funds. In addition, discussions leading to concrete improvements in IMF-World Bank co-operation