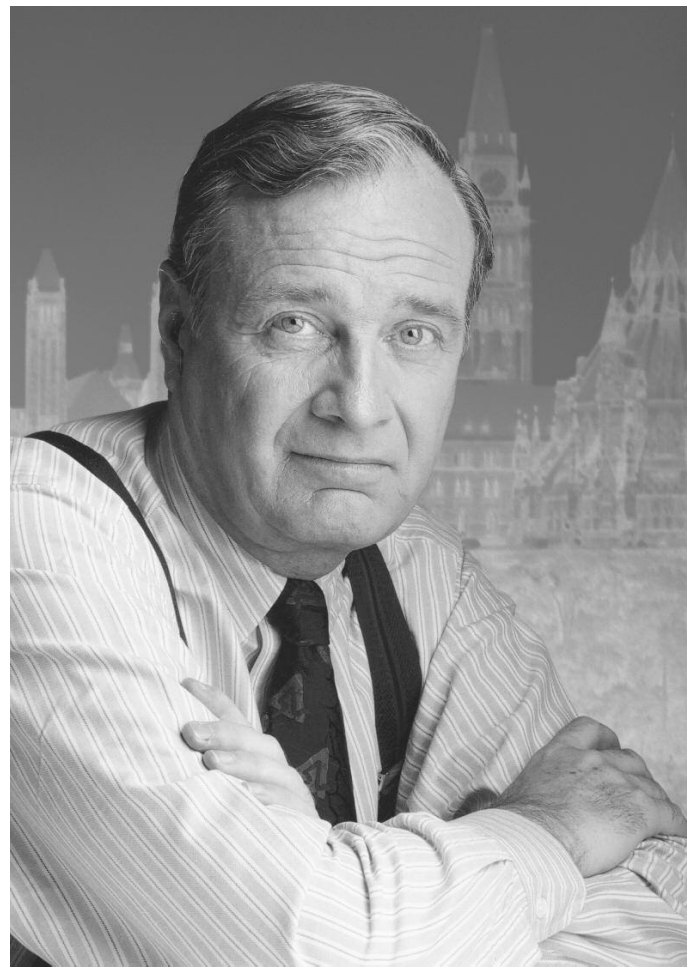
Regaining Canada's Fiscal Levers

Interview with the Honourable Paul Martin

In 1993, Canada's fiscal situation was one of the worst among the G7 countries, with a federal budget deficit of over 6% of GDP and an accompanying stock of government debt at roughly 70% of GDP. Though the debt-to-GDP ratio has fallen only slightly, the annual budget deficit is on target to being eliminated—in a sustainable way—sometime over the next 12 months. The man behind the fiscal levers for the past 4 years has been the Honourable Paul Martin, Canada's Minister of Finance. In this interview, Paul Martin discusses his views on the role of government, the politics of fiscal responsibility, reforms to the public pension system, and the continuing problem of Canada's high unemployment rate. He was interviewed by Christopher Ragan, Editor of World Economic Affairs.



WORLD ECONOMIC AFFAIRS: Many countries faced with persistent fiscal deficits are re-evaluating the role of government in their economy. Canada is viewed internationally as having struck a sensible balance between government and the market. And thus the way Canada deals with this issue is of some interest globally. What principles govern the way you think about the appropriate level of government in the economy?

Martin: First of all, it is important to emphasise that the role of government should not only be looked at in terms of domestic pressures but also with regard to what is happening internationally. How a government's responsibilities to its citizens are circumscribed by international agreements, by technological change, or by globalisation are also a very important part of the question you are asking.

But within the context that you are asking, my view is that governments should do only those things that they can do better than anyone else, and they should ensure that others—other levels of governments or institutions in the private or voluntary sectors—do those things they can do better. I believe very much in the positive role of government, but when government tries to be all things to all people it sometimes fails in its fundamental job. And that is one of the things that happened in Canada and elsewhere. Governments pursued highly inappropriate macroeconomic policies and allowed themselves to build up huge levels of debt.

WEA: When you look at the evolution of Canada's social programmes, are there particular successes that might be relevant for other countries?

Martin: Absolutely. Our system of Medicare, despite the strains that it is now facing, is a great success. Our system of old-age pensions is also a great success. The best evidence of this is that, over the last several years, the real income of

senior citizens in this country, relative to the overall workforce, has risen dramatically. The fact that in this country we don't have the degree of income inequality that exists in the United States is due, in large part, to the success of our social programmes.

WEA: Were there any significant mistakes in the development of Canada's social programmes?

Martin: Yes, there were. But they pale in comparison to other mistakes governments made. For example, the failure to understand that if you are going to run deficits in bad times, you'd better eliminate them in good times; or the failure that governments around the world made in the early 1970s to understand that the productivity improvements and the tremendous growth that had been generated in the previous 20 years were not going to continue. The fact is that for many years governments continued to govern as though nothing significant had occurred—either because they failed to recognise the facts or because they decided not to recognise them. These were the seeds of our problems, and they are far greater than anything that arose out of the social programmes.

I believe very much in the positive role of government, but when government tries to be all things to all people it sometimes fails in its fundamental job.

WEA: Does the process of globalisation place challenges on the government's ability to provide social programmes?

Martin: Clearly yes. One of the reasons is that globalisation has constrained governments' ability to pursue *good* government, I think it is now incumbent upon governments to come together a great deal more to strengthen global governance. A good example is the OECD study now underway to examine ways in which governments can avoid beggaring each other through competitive taxation policies.

WEA: You mentioned the issue of competitive taxation. Does globalisation mean that Canadian social programmes will be driven down to US levels in an attempt to compete with lower US taxes?

Martin: No, absolutely not. I do doubt that countries in the long run will be able to have highly differentiated tax policies, simply because capital is so mobile. But I say "no" so unequivocally because of the reasons for the Canada-US tax differential. Taxes are higher in Canada than in the US for two basic reasons. First, our social programmes are more generous. People can very clearly take that into account when comparing taxes in the two countries, and they will eventually conclude that it is worth it to pay some extra taxes in order to have decent education and health care. That part of the tax differential is not a problem. The second reason our taxes are out of line with those in the US—and this is certainly a problem—is that our public debt is out of line with that in the United States. But that excessive debt has nothing to do with our social programmes—it came from too many years of following inappropriate macroeconomic policies.

WEA: Some people would claim that much of your success at the federal level has been achieved simply by off-loading the problems down to the provincial level.

Martin: It's absolutely not true. First, the reductions in federal transfers to the provinces are, in many cases, proportionately smaller than the reductions in provincial transfers to the municipalities. Second, some provinces are *cutting taxes* by more than we cut transfers. For example, in Ontario where the pressures are the greatest on social programmes, we cut transfers by C$1 billion whereas the province is cutting taxes by C$4.5 billion. And in other provinces, such as Alberta, they are declaring surpluses. But if a province is declaring a surplus or cutting taxes, then it must look inward for the source of its cut-backs, not at what we have done. Third, if you look at the reasons for the decline of the deficit, in terms of cutting expenditures, the federal government cut itself more than it cut the provinces—and it cut itself earlier than it cut the provinces.

It is now incumbent upon governments to come together a great deal more to strengthen global governance.

WEA: You have often said that your views on social programmes were strongly influenced by your father, who was instrumental in building Canada's public health-care system. What direction do you think Canadian social policy should take over the next dozen or so years? Do you see any significant challenges?

Martin: Yes, there are certainly challenges. We have got to do for children what we have been able to do for seniors. The level of child poverty in this country is a disgrace, and there has got to be a great national effort to directly deal with that. Also, despite the fact that our economy was initially built through mega projects, we now have to understand that investment in education is a prime economic and social tool. Those are only two areas, but there are many others. The fact that with an ageing population we are more and more asking each succeeding generation to take care of their parents or ageing relatives means that society has to come to grips with this. Another area is the huge need to allow the physically disabled to operate on as level a playing field as we can possibly create. These are all things that the government must examine.

Politics and Fiscal Responsibility

WEA: From 1984 to 1993, the Conservative government of Brian Mulroney preached the need for deficit reduction. Yet in their time in office, the average federal budget deficit was still about 4% of GDP. The Liberals have now been in office for only 4 years and have already made significant progress on the fiscal front. It appears the deficit will be eliminated—in a sustainable way—sometime in the next year or so. My first question is a bit negative. Why did it take 18 months to produce a budget that showed significant progress in terms of planned deficit reduction?

Martin: First of all, I would challenge the premise of your question. We did a great deal in the first budget. That is when the first major cut-backs in defence spending took place. It's also when the first major changes to the unemployment-insurance programme took place. The second point is that we clearly outlined that the 1994 budget was simply the first stage and that the second stage was going to be the 1995 budget.

We took office in the beginning of November 1993 and had to bring down a budget in February 1994. But when you bring down a budget in February, it is put to bed considerably earlier. So we had less than 60 days to put that budget together, and we put it together on the basis of a set of numbers that were dramatically worse than we had anticipated when we took office. We never blamed anybody for the numbers, but we took office with a new cabinet and essentially 60 days later we finalised a budget. There is a physical limit to what you can do, which is why we said the 1994 budget was just the first stage.

The way the Tories (and many governments around the world) dealt with deficit reduction was to "slash and burn"—such as a 10% cut across the board. The reason that we couldn't deal with all of these matters in the first 60 days, and that it took the first year to put the 1995 budget together, is that we recognised that the answer was not an across-the-board cut, but instead to redefine the role of government. The problem of government overspending was that the government had not asked itself "what is our role?" We were a new government. In order to deal with that question, we had to have an extensive investigation into the role of government led by new cabinet ministers who were taking charge of an existing system. That's what Programme Review was all about. Programme Review was not simply about cutting spending; it was about redefining the role of government.

There is a further point. We knew that our success would be totally dependent upon our ability to re-establish credibility in the government's projections and in its ability to hit them. And we knew we couldn't do that within 60 days. One of the real shocks to me as Minister of Finance, when I first came in, was that when I went to the markets and said "I'm going to do this" they responded with "Your predecessors said the same thing and they didn't do it—why should we believe you?" When we first came to office, we knew we had to build that credibility.

WEA: Why have you been able to achieve such success in deficit reduction when the Conservatives before you couldn't?

Martin: The fact of the matter is that public opinion was ahead of the politicians. We did not have to convince the public of the need to deal with the nation's financial health—the public wanted us to do it. Very much so. In fact, this sentiment was there at the beginning of the first Tory mandate. But the Tories didn't do the job. They went heavily into the free-trade negotiations and their attention was diverted. The public's resolve then waned somewhat but resurfaced and really began to crystallise in the middle of the second Tory mandate, carrying through to our term in office. One of the reasons the public was very upset with the Tories is that they talked a good game but didn't deliver.

People will eventually conclude that it is worth it to pay some extra taxes in order to have decent education and health care.

WEA: With the arrival of budget surpluses in the near future, you will face two broad choices. Some people argue that taxes should be lowered or expenditures raised; others stress the need for continued surpluses to reduce the stock of public debt. How do you view this choice?

Martin: There are several aspects of the problem that must be taken into account. The single most important issue is the economic circumstance of the time. For example, if the economy is already overheated, you must ask whether it makes sense to add further stimulus, or whether it makes more sense to put the brakes on. The second issue is whether it is the reduction of debt

that is your ultimate goal or whether it is the reduction of the debt-to-GDP ratio. And if it is the ratio that matters, then what is the best way to reduce it?

We have set out a rule of thumb as to how we will deal with the surpluses. Our approach is that surpluses will be split 50-50 over the mandate—between spending on the one hand and tax and debt reduction on the other. But it's important to understand this does not mean we are going to engage in large spending increases. Our overriding goal is, first of all, not to declare victory before it has been won and, second, to consolidate that victory so that we never get into difficulty again.

We recognised that the answer was not an across-the-board cut, but instead to redefine the role of government.

WEA: You had the view when you came into office that Canada's debt-to-GDP ratio was too high. And you think it's still too high today, hovering somewhere around 70%. What is a sensible level for the debt-to-GDP ratio?

Martin: I have refrained from picking a specific target. I think the Maastricht threshold of 60% is too high. And 20 years ago we were at 20%. So it seems to me that somewhere within that range is where the appropriate number probably lies. My main goal right now is to put us on a course that will steadily reduce the debt-to-GDP ratio—not an immediate target but instead a process that will see it continuously decline.

WEA: Many economists argue that Canada's debt problems originated from an overly zealous approach to counter-cyclical fiscal policy, whereby the benefits of short-run stabilisation dominated the thinking but the costs of long-run debt accumulation were largely ignored. Is there still a role for discretionary fiscal policy to stabilise the economy?

Martin: Though it is incontrovertible that governments in the past continued to run deficits when they shouldn't have, it is equally clear that in the future there will always be a need for automatic stabilisation. Government policy can't be done in the abstract. Economic policy has got to be done in the light of the economic circumstances of the time. There is always going to be a need for responsive fiscal policy.

Low Inflation and High Unemployment

WEA: In the late 1980s and early 1990s, the Bank of Canada embarked on a policy of "price stability". Inflation fell from 5% in 1989 to 2% in 1992, and has remained below 2% since then. The Bank is now viewed as one of the more vigilant of the world's central banks. As the Minister of Finance, you are ultimately responsible for monetary policy in Canada, even though the Bank has considerable autonomy in the management of its day-to-day affairs. Did the disinflation of the early 1990s affect your ability to accomplish your goals on the fiscal side?

Martin: In my term in office, it was not a major factor. Where the problem lay was before I took office, in that the Bank embarked on a very tight monetary policy prior to a sound fiscal policy being put in place. The cart was put before the horse. So we ended up with a higher debt load than should have been the case.

WEA: Some people argue that Canada should not have pursued disinflation so vigorously when the US was not doing the same. Do you think the Canadian disinflation was made more difficult by the fact that the US did not follow as aggressive a policy?

Martin: I don't necessarily agree with that view. One of the reasons we have lower interest rates today compared to the United States is that we've got lower inflation. So the pay-off is there.

My main goal right now is to put us on a course that will steadily reduce the debt-to-GDP ratio.

But let me make a more general point. In my view, the Bank's reputation for being very vigilant about inflation is a major asset. We paid a tremendous penalty to get inflation down in this country, greater than what was necessary. I said this when we were in opposition. But having paid that penalty and won that war, it would be a terrible mistake to have to fight it again. We now have in this country an anti-inflation stance that does immense benefit, and we should never lose it. So my argument is not with where we arrived, but how we got there. If you take a look at monetary policy over the last few years, however, I think it has been very appropriate to the Canadian circumstances. I applaud the Bank for what it has been able to do.

WEA: Some economists have argued that the Bank's rhetoric on price stability is dangerous and that the Bank has gone too far in fighting inflation. There is a view that a more moderate inflation—say 3% to 4% instead of 1% to 2%—may result in permanently lower unemployment. Do you think Canada's very low inflation rate is a possible explanation for its stubbornly persistent unemployment?

Martin: I believe there is an appropriate target for inflation. And I think it is the one we have right now [1%-3%]. I will have the opportunity next year to sit down with the Governor of the Bank of Canada to see if it continues to be appropriate. But in today's circumstances, the target we established, when the Governor and I took office in 1993, is the right target.

WEA: In thinking about real-world fiscal and monetary policy, do you place much emphasis on the concept of NAIRU (non-accelerating inflation rate of unemployment), or the "natural" rate of unemployment?

Martin: No. I think it is theoretically interesting but of very little practical relevance. As we have seen in the United States, the Federal Reserve has consistently been able to test NAIRU and find it much lower than what most economists predicted. That is why I view it as theoretically interesting but of little practical consequence. It is a shifting sand.

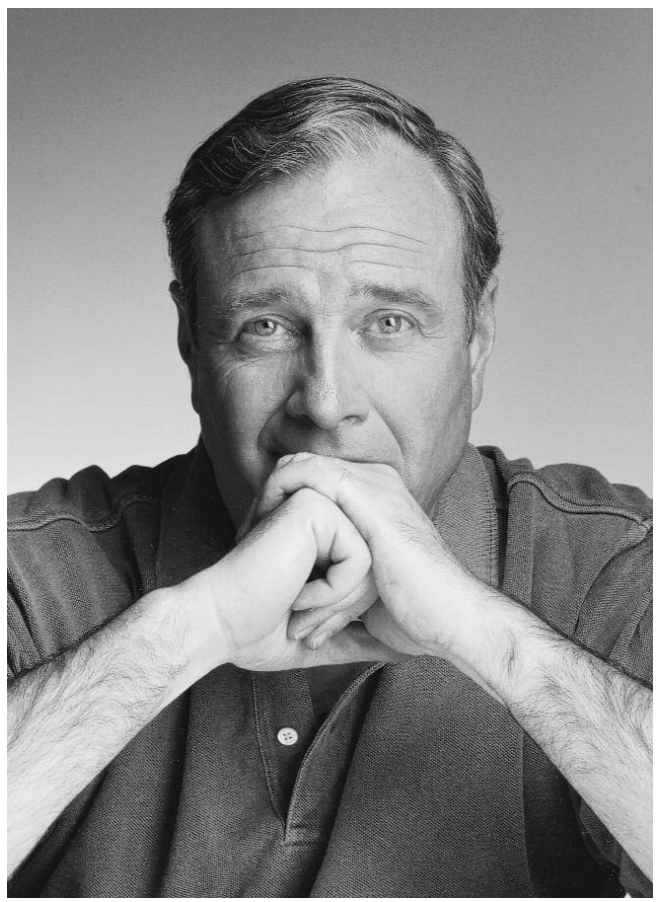
WEA: Do you have anything to take its place?

Martin: What it really comes down to is that you should not allow yourself to be governed by a rigid rule that works

well in a computer model but doesn't really work well in a world that is continually changing. We really must remember that the tools of measurement are still pretty inexact. It is very important for economists to constantly be pushing the yardsticks, but those that are making the policy decisions have got to understand that theoretical models are not necessarily going to lead in real life to the consequences predicted in the model. If you want to interpret that as a shot at economists, so be it.

WEA: Let's turn to an explanation for Canada's unemployment. It has been stubbornly persistent at high rates—about 9%-10% in recent years. Adjusted for the position in the business cycle, we have seen a steady upward trend in Canadian unemployment over the past 30 years. Even more notable is the dramatic difference between the Canadian and US unemployment rates. What is your explanation?

Martin: There are three basic reasons, and the first goes back to our earlier discussion of the slowdown in productivity growth in the 1970s, which is clearly a major factor in the unemployment rate. We have not had the productivity growth in Canada that they have had in the United States. This is something that we really have to work on in this country. Second, in the 1990-91 recession and its aftermath, we went through a far deeper and far broader period of poor economic performance than did the US. Our economy and Canadians were traumatised by it. Economies are based on confidence, and one of the reasons the US has had so much better a record recently is that they didn't go through the trauma to the same extent. The third reason is that Americans have clearly opted for job creation and are prepared to pay a penalty in terms of increasing inequality, a price Canadians are not prepared to pay. My own view is that it is a trade-off we ought not to accept. The goal of government policy ought to be to have a steadily declining unemployment rate without sacrificing the equality of opportunity. As we go ahead, that has got to be one of the driving forces to succeed.



Rethinking the role of government.

WEA: Your mention of increasing inequality in the US brings us to the issue of labour-market flexibility. What do you think of the view that Canada's high unemployment rate, relative to that in the US, is caused by our less flexible labour markets, and that chipping away at unemployment insurance and other labour-market policies is important?

Martin: That is part of the answer, which is why the reforms of the unemployment-insurance system were important. Where I would disagree with many people is that it is the whole answer. Among other reasons are our debt and the level of taxation being higher than in the United States, which makes it difficult to design proper adjustment policies. But my own belief is that we do have the capacity in this country for bringing our unemployment levels down to where we are very competitive with the US, without sacrificing the middle class.

We now have an anti-inflation stance that does immense benefit, and we should never lose it.

Prospects for Long-Term Growth

WEA: Part of governments' fiscal and monetary policies are aimed at dampening the business cycle, but arguably a more important part is the design of policies that encourage long-run economic growth. What is the most important thing governments can do to promote long-term growth?

Martin: First of all, make sure that the preconditions for that growth are there, which means sound macroeconomic policies, which is what we have done. Eliminate public deficits, keep inflation low, keep interest rates low, bring taxes down, and minimise regulation. All of that, in my opinion, should not be a *goal* of government policy—it should be a *sine qua non.* Having done that, the role of government then ought to be to invest, or make sure that the country is investing, in those things that lead to long-term economic growth. And those things are very clear—education, research and development, an open trade policy. Those are the things that lead to long-term economic growth. Make sure that you have a climate that welcomes innovation, that seeks change.

A country that does that is a country that is going to succeed—which is why the distinction between social policy and economic policy is so artificial. A good health-care system, for example, is as important to the development of a strong economy as it is to social well-being.

WEA: Many economists are quite taken by the idea that some industries have positive spill-overs onto other industries, and are thus worth subsidising. What do you think?

Martin: If you are engaged in an industry that is important to your economy, and other governments are subsidising their firms in that industry, then you are going to have to do that too, because what you have to do is ensure a level playing field. This is one of the reasons there should be a lot more intergovernmental co-operation on not doing that sort of thing. In the end it is certainly distorting, and should not be done. The problem is that sometimes you have to meet one distortion with another distortion. But in the long run, government assistance to industries by providing a basic research-and-development infrastructure and a good trading environment is far more important than any individual subsidy.

Government policy can't be done in the abstract. Economic policy has got to be done in the light of the economic circumstances of the time.

WEA: You have said that some industries should be subsidised domestically if they are being subsidised abroad. Let's suppose they are being subsidised by foreign governments. What's wrong with our deciding not to subsidise the domestic industry and instead to benefit from the lower prices financed by foreign taxpayers?

Martin: That is a perfectly valid course depending upon the industry and its importance to your economy. If you are dealing with an industry in which you are clearly very successful—in the absence of subsidies—then I think you are justified in providing the money to offset the foreign subsidies. But if it's not an important industry, then I accept your proposal.

The dynamism of change is now such that economies are re-inventing themselves constantly, and governments that get in the way of that re-invention are governments that slow down the process of innovation within their country. That is why the winners-and-losers syndrome is a bad syndrome. It is why you are much better off to provide technological infrastructure that allows individual entrepreneurs to come to the fore.

WEA: There is compelling evidence that countries with higher private saving rates tend also to be countries with higher growth rates. Public policies toward saving are thus very important. Do you think there are reasons to be concerned that the private sector saves less than what is socially desirable?

Martin: Yes, but again it is only part of the answer. Our biggest problem over the last couple of decades has not been the level of Canada's private saving—it has been the level of public-sector dissaving, which we are now in the process of correcting. But equally important is the degree to which we are building up a technological asset base. This technological asset base—the ability to innovate—is becoming more and more important. And there is often a tendency not to realise how increasingly important that is in terms of the development of a strong economy.

Reforms in the Public Pension System

WEA: As is true in many countries with pay-as-you-go public pension systems, demographics and productivity growth have conspired against the Canada Pension Plan (CPP). With fewer young workers relative to old, and with per capita income growth considerably slower than in the past, there are serious concerns regarding the long-run solvency of Canada's public pension system. Can you first explain what policies you have implemented to maintain solvency in the system?

Martin: As a result of the actions taken by ourselves and the provinces, we have forestalled an increase in the CPP contribution rates to 14% by moving toward fuller funding over a 5-year period, bringing the rate up to 9.9% from the current rate of 5.8%. This will provide Canadians with the confidence that the CPP will be there for them when they retire, confidence which was on the wane.

NAIRU is theoretically interesting but of very little practical relevance.

WEA: Given those increases in contribution rates, are you concerned that young workers will view CPP as an increasingly poor investment and that this will create political pressures to have a more serious overhaul of the public pension system?

Martin: I very much wish that 10 years ago the federal and provincial governments had addressed this issue. And if they had addressed it then we would not have the large unfunded liability that we have now. There would still be an unfunded liability, but it would not be nearly as large. But I do believe we and the provincial governments have now taken action in time to avoid the problem that you described from occurring.

That unfunded liability exists and we can't simply wish it away, any more than we can wish the national debt away. And if it were not funded out of the CPP it would have to be funded out of general tax revenues. And funding this out of general tax revenues would impose upon subsequent generations the same tax burden. Unfortunately, there is no magic wand to make it disappear. What we have done is to say that we'd like to have full funding, but to go to full funding would impose an unbearable level of contributions—so by going to 'fuller' funding we are going part way there and we are doing it on the basis of setting contributions that we believe future generations will be able to absorb.

I should add that eventually, a few decades down the road, the demographics will swing around in our favour, as the percentage of working-age people in the population rises. But I won't be around when that happens. I'll be long gone.

WEA: Is a move toward a fully funded system—as occurred in Chile—a possibility?

Martin: That is essentially where we are going, except that we are doing it by spreading it out. But we are not deferring the problem the way the previous

generation's governments did, hiding our eyes and saying it does not exist. We are saying that we've got to go to fuller funding. But I don't believe that complete full funding is the answer because that would impose upon the next few generations an unbearable burden.

You mentioned the Chilean system in your question. One problem with the Chilean model, which they are now finding, is that with increased longevity of the population, the annuities that are being provided do not last long enough to cover the longer lifespans. And so people are actually taking their money out of the retirement-income system. They are going to have a major problem.

WEA: Would you also be concerned about the private management of funds if Canada were to adopt the Chilean system?

Martin: The private management of funds in Canada has been very successful, and it is there for a large section of these retirement funds, and that is very good. But that doesn't mean that we should go fully in that direction. The CPP has a lower administrative cost because of the benefits arising from pooling over the entire population. Also, the government stands behind the Canada Pension Plan—but it cannot stand behind private market developments. You are asking your question following 5 or 6 years of major bull markets; would you be asking the same question if this were following 2 years of bear markets?

Wrap-Up

WEA: You have the been the Finance Minister for 4 years and are very popular. Critics on the right concede that you have been much more sensible than what they expected from a Liberal Finance Minister. Critics on the left, who have been largely persuaded of the problems of public indebtedness, grudgingly admit that you have done a good job. With only slight overstatement, you have even become the darling of the international financial community. What's your secret? Is there something that you have personally done that was not done by your Conservative predecessor?

Martin: Well, first, I had the support of the Prime Minster, without which no Finance Minister can operate. And to be quite honest and fair to Michael Wilson, he did not have that support. Second, deficit reduction has never been an end in itself for us, and we have never taken any joy in what we have had to do—and people understand that. I think what people really understand is that we are all in this together and that we are doing it because we have to, not because we want to.

If you believe that government has a positive role to play, then seeing your country totally in the hands of market forces because you have so beggared yourself is very much a concern.

WEA: For decades the Liberals have been in a position to the left of the Conservatives on the political spectrum. Deficit reduction, rightly or wrongly, is viewed as a right-wing issue. Did this give the Liberals credibility in preaching the need for fiscal responsibility whereas the Conservatives were simply viewed as ideologues?

Martin: There are two issues. I don't think that people questioned our motives. They understood that we were doing it because we had to and not because we wanted to, and they understood that the sacrifices they were asked to make were not being imposed by ideologues, but that these were sacrifices any Canadian, if placed in the job as Finance Minister, would be likely to deem necessary. So I think that was a major help.

As Finance Minister you immediately have to learn that there are no special cases.

The second issue has to do with your view of the role of government. If you do not believe that the government has a positive role to play, and you think that market forces alone should dictate not only the financial but also the social well-being of the country, then economic sovereignty is of less concern to you. If, on the other hand, you believe that government has a positive role to play, then seeing your country totally in the hands of market forces because you have so beggared yourself is very much a concern. It then becomes very much an issue of regaining some of the levers that we have lost.

And I'll tell you, that was very important for me. I come from the private sector, and I believe in market forces. I just don't happen to think that market forces provide all of the answers to a society. One of the really difficult things when we took office and thought about investing in education, or in research and development, or cutting taxes, was to recognise that these alternatives were no longer open to us. The high debt levels removed those choices. What I wanted to do was to give us back the freedom of choice. Your earlier questions regarding what to do with budget surpluses are very valid questions. I am simply delighted that we are now in a position to have such a debate.

WEA: What do you think is required in the making of a successful Finance Minister?

Martin: Absolutely the support of the Prime Minister. The pressures to do things other than what the Finance Minister deems fit are great. Everybody is a special case. I can't tell you the number of times I have heard in the last four years, "Do the right thing Minister, but I'm a special case." As Finance Minister you immediately have to learn that there are no special cases. And if you do not have the support of the Prime Minister you cannot withstand those pressures. That is the first thing.

The second thing is a population that understands what has to be done. There is no doubt that national consensus on the goals of governing, which are important in anything the government has to do, are crucial when you go through the kind of changes that we have gone through.

WEA: I suppose I won't ask you about any plans to become the next Prime Minister.

Martin: Right now, I am having a lot of fun doing what I do. I really enjoying being the Finance Minister.

WEA: It certainly shows. Thank you for spending time with me today. ◆