FOR AGENDA

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December 14, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Belgium - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Belgium, which has been tentatively scheduled for discussion on Friday, January 11, 1985.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Riechel (ext. 572979) or Mr. Leipold (ext. 573743).

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INTERNATIONAL MONETARY FUND

BELGIUM

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with Belgium

Approved by L. A. Whittome and Eduard H. Brau

December 13, 1984

Article IV consultation discussions were held in Brussels from October 17 to 29, 1984. The staff team included Messrs. P. Dhonte, K. W. Riechel, A. Leipold, J. Van't dack and Ms. A. Evans as secretary (all EUR). The mission met with the Governor of the National Bank, members of the Government, and representatives of the National Bank and the Administration. Mr. J. de Groote, Executive Director, and Mr. L. Coene, Assistant to the Executive Director, attended the meetings as observers.

Belgium has accepted the obligations of Article VIII, Sections 2, 3, and 4.

The last Article IV consultations were discussed by the Executive Board at EBM/84/8 and EBM/84/9 of January 18, 1984.

I. Background

A year ago in reporting on the Belgian economy for the 1983 Article IV consultations, the staff noted significant accomplishments and deep remaining weaknesses. One element of great concern was an extremely high rate of unemployment of over 14 percent. The ongoing recovery of corporate profitability had corrected a root cause of the decline in employment and was a highly welcome result of deliberate government policies centered on a partial suspension of wage indexation in 1982-83, in support of an 8.5 percent devaluation of the Belgian franc within the EMS in February 1982. This adjustment had improved relative unit labor costs in manufacturing by 18 percent in the two years to end-1983. It had also curbed the external current account deficit and slowed down the previously excessive buildup of foreign debt. However, a sluggish growth in world demand has restrained the growth of output, with adverse implications not only for unemployment, but also for the public finances whose deficit, in its broadest measure, was equivalent to 15 percent of GNP for the third year in a row. Uncertainty about the prospects for a revival of activity had led to a policy of low interest rates which weakened the Belgian franc within the EMS.

In its discussion of the report, the Executive Board shared the staff view that a basis for a self-sustaining recovery of activity had been established and considered that the recovery would best be served by a tightening of financial policies, and particularly a reduction of the public sector deficit.

The expected recovery of activity took hold in 1984 as GNP rose by 1.5 to 2 percent over the level of 1983. This upturn did not rest on a further increase in public expenditure. In fact, after exclusion of interest payments, real public expenditure declined. Rather, the upturn was based on exports and private investment including the first pickup in residential construction in five years (Table 1).

Table 1. Belgium: Selected Data, 1981-84

(Percentage change)

	1981	1984 1/
GNP (at constant prices)	-1.2	1.8
Contribution to growth of:		
Public expenditure 2/	1.3	-1.5
Private investment	-2.8	0.8
Industrial production 3/	-2.7	5.0
Consumer price index	7.6	6.4
Unemployment (increase, in thousands)	86.0	23.4
Unemployment rate (percent of labor force)	11.2	14.9
General government deficit (percent of GNP)	16.1	13.8
Total public debt 4/ (percent of GNP)	117.9	145.0
Current account balance 5/(percent of GNP)	-4.3	-0.6

Sources: Data provided by the authorities; and staff estimates.

1/ Estimates.
2/ Total noninterest expenditure of general government, deflated by the CPI.
3/ Excluding construction.
4/ Including publicly guaranteed debt.
5/ Belgium only. NIA basis.

The recovery of investment was all the more encouraging as it was accompanied by a stabilization of private sector employment following five successive years of decline. This came about through a higher level of activity, an implementation of various worksharing schemes, and a much increased use of part-time work, facilitated by a reform of unemployment compensation.

Following its suspension in 1982-83, full wage indexation was reintroduced in January 1984 and wage adjustments occur each time the reference index, which is a lagged moving average of the consumer price index, moves by over 2 percent from its previous threshold. The deceleration of the CPI to 6.4 percent for the year average, compared with 7.7 percent for 1983, was primarily due to the deceleration of import prices, and still left a differential of 1.5 percent compared with the average of industrial countries. There was no catch-up in wages to compensate for their reduction in real terms and for the compression of the wage structure over the previous two years. Wage norms in effect through the end of 1984 banned wage increases in excess of the sum of the cost of living plus normal wage drift and also limited the increase in labor costs to no more than the exchange rate adjusted average of Belgium's seven main trading partners. Hourly wage costs were increased by higher employer social security charges, and by reductions in hours worked, and rose by 8.5 percent for the year average, as opposed to 6.3 percent in 1983. However, taking into account exchange rate changes, that increase did not exceed the average for the seven major partner countries.

After a strong reduction of the current account deficit of the Belgium-Luxembourg Economic Union (BLEU) to BF 28 billion (0.7 percent of GNP) in 1983, the current account improvement was slowed in 1984 by some deterioration in the terms of trade, while the pickup in investment led to a recovery in imports. Long-term capital outflows of the resident sector continued to increase. The deficit on current account and long-term capital transactions was broadly offset by official external borrowing, and much of the variations in the external reserves of the National Bank reflected the volatility of short-term capital flows.

Major financial policy decisions of 1984 were in close conformity with the Executive Board's analysis. As regards public finances, the Government defined in March 1984 a three-year program to reduce the treasury borrowing requirement from the equivalent of 12.6 percent of GNP in 1983 to the equivalent of 7 percent in 1987. In 1984 however it was only possible to prevent a widening of the treasury deficit, which was stabilized at the nominal level of 1983, so declining to the equivalent of 11.5 percent of GNP. The budget for 1985, which was discussed in Parliament at the time of the mission, seeks a reduction of the treasury deficit to the equivalent of 10.4 percent of GNP. Monetary policy was also tightened in the course of 1984, leading to an improvement of the position in the EMS of the Belgian franc, which however remained persistently weak within the EMS. The spread between the official and the financial Belgian franc rates, which peaked at over 4 percent at end-February 1984, has been less than 2 percent since mid-April. This result has been helped by a tighter management of short-term interest rates. Long-term interest rates, which are almost exclusively determined by the Treasury as the predominant borrower on the capital markets have, however, been kept at a level which does not ensure a sufficiently attractive after-tax return on Belgian franc assets against comparable foreign currency securities, especially after the increase of withholding tax in Belgium from 20 to 25 percent. As a result net private long-term capital outflows remained substantial, with particularly heavy investment in ECU-denominated securities.

II. Report on the Discussions

The upturn in private sector demand and the Government's program to reduce the treasury deficit provided the background to the discussions. The recovery of private demand provided an opportunity to address a fiscal imbalance which had become unsustainable and therefore likely to hamper confidence and to undermine rather than sustain the recovery. The mission therefore fully supported the setting of a fiscal target designed to control the rise in public debt and interest payments and emphasized the need to support this strategy with a firm interest rate policy.

1. Incomes and employment policies

The authorities considered that Belgium's present competitiveness was adequate and indicated that a main objective of their policies was to maintain its level while keeping the exchange rate of the Belgian franc stable within the EMS. The wage norms which had protected cost competitiveness in 1984 were due to expire at the end of the year. Given the risk of a catchup of wages, an extension of these norms appeared necessary and the authorities were preparing legislation to maintain the ban on real wage increases in 1985-86 and maintain competitiveness during these years at the average level of 1982-84.

Despite the stabilization of private sector employment in 1984 the authorities remained deeply concerned about the labor market situation, especially as a further increase in unemployment had to be expected in 1985. Besides continued emphasis on cost competitiveness, they had therefore encouraged the social partners to consider the generalization of a 38-hour work week and to agree on a new worksharing program. Moreover, they had introduced draft legislation to ease hiring and firing and lower the related costs to employers, and had also proposed new regulations for a more flexible setting of workhours. The measure of competitiveness under the new wage norms would take account of the productivity increases that would be obtained from the planned elimination of labor market rigidities. The mission welcomed this concept, but observed that with both full indexation and the competitiveness norm, the negotiation of wage settlements in Belgium was over-regulated.

The authorities acknowledged these rigidities and stated that the gradual narrowing of the inflation differential with partner countries would eventually allow a return to less regulated forms of wage determination.

2. Industrial policies

Belgium maintains an open trading system within the common commercial policy of the EC but extends heavy financial support to enterprises, amounting to the equivalent of 6.5 percent of GNP in current and capital transfers, including net lending. The mission therefore focused the discussion of trade issues on the formulation of industrial policy. The authorities believed that a sound overall macroeconomic policy was the best setting for industrial growth. However, claims of regional policies had been considered to justify extensive subsidization of transportation services, absorbing about 2 percent of GNP. Moreover, given the poor growth and employment performance of recent years, widespread support to ailing industries (absorbing over 1 percent of GNP) had been deemed necessary. This support, which was subject to EC approval, was increasingly linked to structural adjustment measures which required a burden-sharing by all parties concerned. The steel and textile sectors were telling examples of these efforts. Other aids mainly consisted of tax and financing incentives for investment. More recently, the authorities had encouraged high-technology industries and the introduction of modern automation. A "Recovery Law" of July 31, 1984, provided special incentives in this respect.

The mission observed that, on balance, industrial policy measures tended to favor a substitution of capital for labor and thus conflicted with the employment targets. The authorities acknowledged this, but pointed to the urgent need to stimulate investment and strengthen the financial structure of enterprises. Moreover, they noted that their incentive schemes fulfilled specific functions, e.g., favoring the location of new enterprises in high unemployment areas or encouraging venture capital.

3. Fiscal policies

The main feature of the government program to reduce the public sector deficit was a partial disindexation of earnings and of social transfers to the benefit of the social funds and the Treasury. In the public sector, the first 2 percent cost of living adjustment would be omitted each year for all cash outlays on wages and social benefits. In the private sector, gross wages would rise as provided by the indexation mechanism, but the first 2 percent cost of living increase each year would be paid into a public fund, primarily to relieve the Treasury of the financing of unemployment compensation. Such adjustments were designated as "index jumps". They were made in 1984; they would take place in early 1985; and there was an agreement in principle to put them in effect in 1986 if the objectives of the program required it. Subsidiary features in the package included additional reductions of the state's operating expenditures, and a tightening of social security entitlements.

The whole package was designed to reduce the treasury's borrowing requirement to the equivalent of 7 percent of GNP by 1987. The authorities explained that a great deal of the recent efforts at fiscal consolidation had been frustrated by the ever-rising burden of interest payments (Table 2). They had concluded that as a priority the ratio of debt to GNP needed to be stabilized. Since this ratio was in the order of 100 percent in respect of the debt of the Treasury, stabilization required a deficit no larger than the increase in nominal GNP, which was assumed to average 7 percent over the medium term. Taking into consideration the policies of the other subsectors of the Government, that same target would also need to apply to the financial balance of the public sector, excluding net lending. 1/

Table 2. Belgium: Public Finance Indicators

(In percent of GNP)

	1981	1982	1983	1984 1/	1987 2/
General government deficit 3/	16.1	14.9	15.5	13.8	8.0
General government outlays 3/	63.0	63.9	63.6	62.2	56.6
Interest payments	(8.0)	(9.4)	(9.6)	(10.4)	(11.6)
Net lending	(3.1)	(3.8)	(3.3))		
				)(51.8)	(45.0)
Other	(51.5)	(50.9)	(50.7))		
Treasury deficit	12.6	13.0	12.6	11.5	7.0
Treasury debt	67.4	79.0	89.4	94.9	102.0

Source: Data provided by the Belgian authorities and staff calculations and estimates.

1/ Staff estimates.

2/ Staff projections, based on the Government's medium-term fiscal targets (see Appendix IV).

3/ Including net lending.

1/ The most frequently quoted measures of the public sector deficit include net lending to the business sector and for this reason show a substantially larger deficit than the SNA measure. The authorities recognized that this approach imparted some bias in international comparisons, but thought that their conservative approach was more appropriate to Belgian circumstances, given that much of the net lending had been to declining industries.

The staff accepted this objective which met the minimum requirement of recovering control of the momentum of public debt. Projections reproduced in Table 2, Chart 1, and Appendix IV indicated that under the program's objectives, the debt of the Treasury would peak at the equivalent of 102 percent of GNP in 1987. The adjustment would require an average annual decline of real noninterest expenditure of the Central Government of 2.9 percent in 1984-87--i.e., about 12 percent in total--corresponding to an annual decline of somewhat over 2 percent for the real noninterest expenditure of general government, about in line with the outturn for 1984. However, the projection was sensitive to alternative assumptions for foreign demand and interest rates, and in a number of alternative scenarios, additional expenditure restraint would be required.

The authorities indicated that the central government budget for 1985 was fully in line with their fiscal adjustment program. As for the other levels of Government, they added that a law of 1982 required the provincial and municipal governments to balance their accounts by 1988, or else to face a loss of fiscal autonomy to the Central Government. The social security funds were implementing in small cumulative steps the overall design which had been developed in the previous year, and which involved notably a revision of the rules for cumulating benefits and tighter budgetary procedures for the control of medical costs. Finally, the financing of ailing enterprises and of some public investment by financial institutions outside the budget would be discontinued.

The mission questioned the balance of the adjustment measures between revenue increases and expenditure cuts, noting that on a net basis, the share of revenue-raising measures was over 40 percent of the total adjustment, and suggesting that, given the high level of taxation, expenditure restraint was the desirable way to reduce the deficit. The authorities accepted that the tax burden had reached a very high level in Belgium. They justified the imposition of index jumps by the overriding objective of reducing the deficit and the requirements of social equity.

4. Monetary policy

The authorities confirmed that the main objective of monetary policy in Belgium remained the defense of the exchange rate within the EMS, and interest rate management remained the main operational instrument. As in 1983, an objective had been formulated--although not published--for the central bank's net foreign assets, which were again set not to decline. The authorities viewed this as a minimal objective, with some reserve accumulation being actively welcome after three successive years of reserve losses. The external reserve target implied no further financing of the Treasury by the Central Bank. Since the demand for base money was very sluggish in Belgium and since the two main assets of the Bank consisted of international reserves and claims on the Treasury, credit to the Treasury crowded out reserves.

The authorities noted that, given the external reserves target, they could respond to emerging exchange rate pressures by (a) raising short- and/or long-term interest rates or (b) engaging in compensatory foreign borrowing. The appropriate response depended on the nature of the imbalance. If it arose from current account transactions, it was advisable to borrow abroad, rather than attract capital inflows via interest rate policy. If on the other hand the imbalance stemmed from short-term capital outflows, it would be appropriate to adjust the short-term interest rate differential though this would not be effective at times when the outflow was dominated by expectations of exchange rate changes. Finally, long-term capital outflows were seen to call for higher long-term rates on Belgian franc issues or increased external borrowing; to finance such outflows out of short-term inflows would not constitute a stable financing pattern.

The mission noted that the slippage in the 1983 monetary program, when reserves had fallen by BF 22 billion, could be attributed to some delay in adjusting interest rates in the second half of the year. It furthermore noted that in the past the Central Bank had not been able to adequately control its domestic assets, as financing of the Treasury had assumed a quasi-automatic and permanent nature. The authorities stressed that in both respects there had been important shifts in 1984. In the first place, short-term interest rate management had become decidedly more cautious; despite the easing of exchange rate tensions since April 1984, official rates had not been reduced from their relatively high level and an adequate short-term differential in favor of the Belgian franc had been maintained. Secondly, the Treasury had limited its recourse to central bank financing, and the outstanding amount of special advances had actually declined slightly in the first nine months of the year; furthermore, the National Bank had managed interest rates so as to eliminate arbitrage incentives for commercial banks to use rediscount facilities to purchase short-term public securities. The authorities noted that, as a result of the above policy stance, the National Bank's reserves had increased by BF 60 billion in the first nine months of 1984.

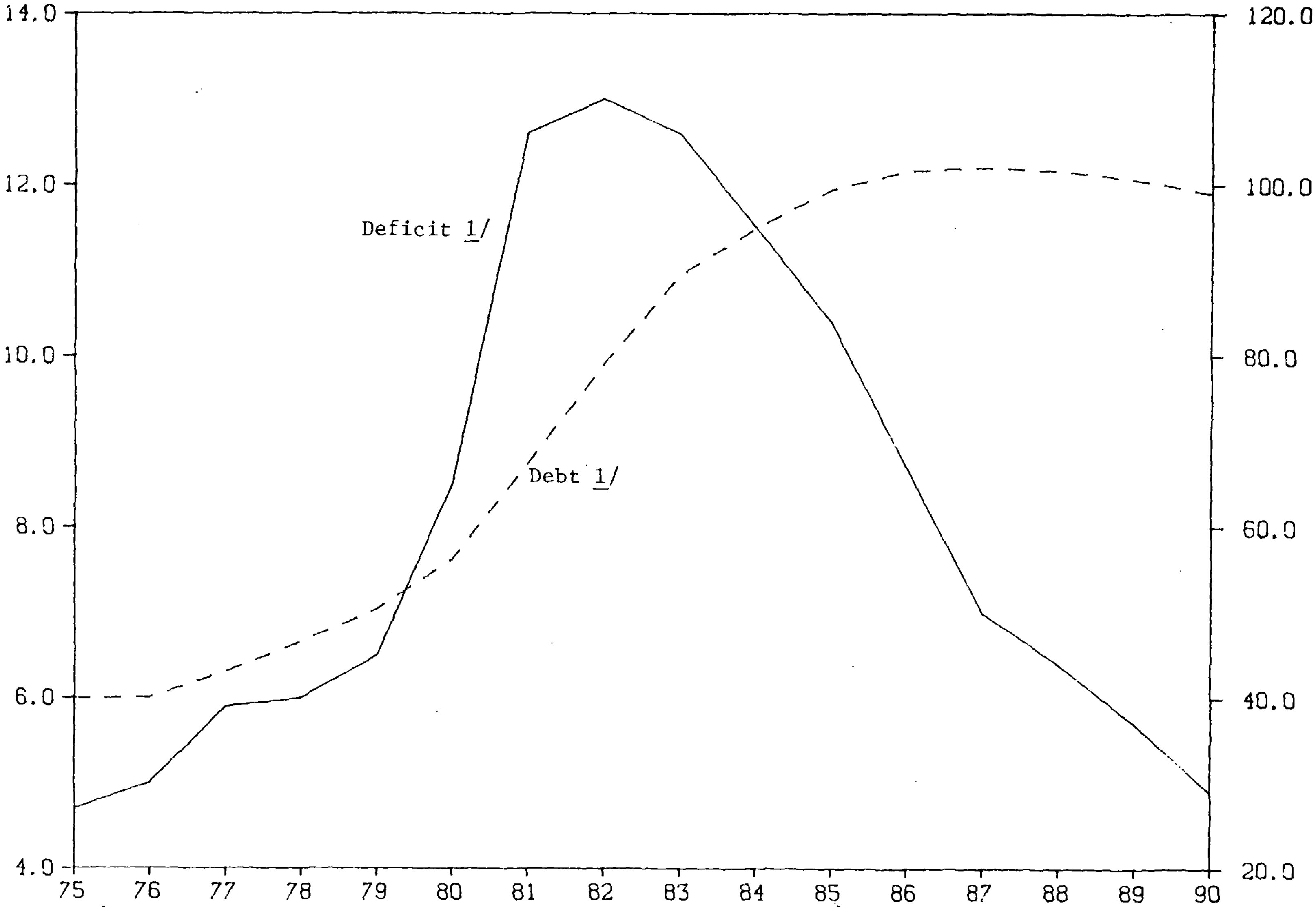
The mission welcomed these developments, and pressed for this firmer stance to be maintained in the future. It noted, however, that the conduct of monetary policy in Belgium was hampered by the lack of competition in the financial system, the segmentation of financial markets, and the dominance of the public sector on the bond market, with long-term interest rates being largely shielded from developments at the short end. No overall policy thus governed the term structure of interest rates and the yield curve was consequently much more volatile in Belgium than in partner countries (Chart 2). The mission felt that, given the double constraint on central bank financing and on the continued accumulation of the external debt, the bulk of the public sector's financing requirement would have to be met on the domestic long-term market, by means of sufficiently attractive yields. In contrast, the Treasury had been able to raise only 15 percent of its needs on the domestic bond market in the first nine months of 1984.

Chart 1

BELGIUM

Central Government Deficit and Debt

(In percent of GNP)



Source: Data supplied by the authorities and staff projections.

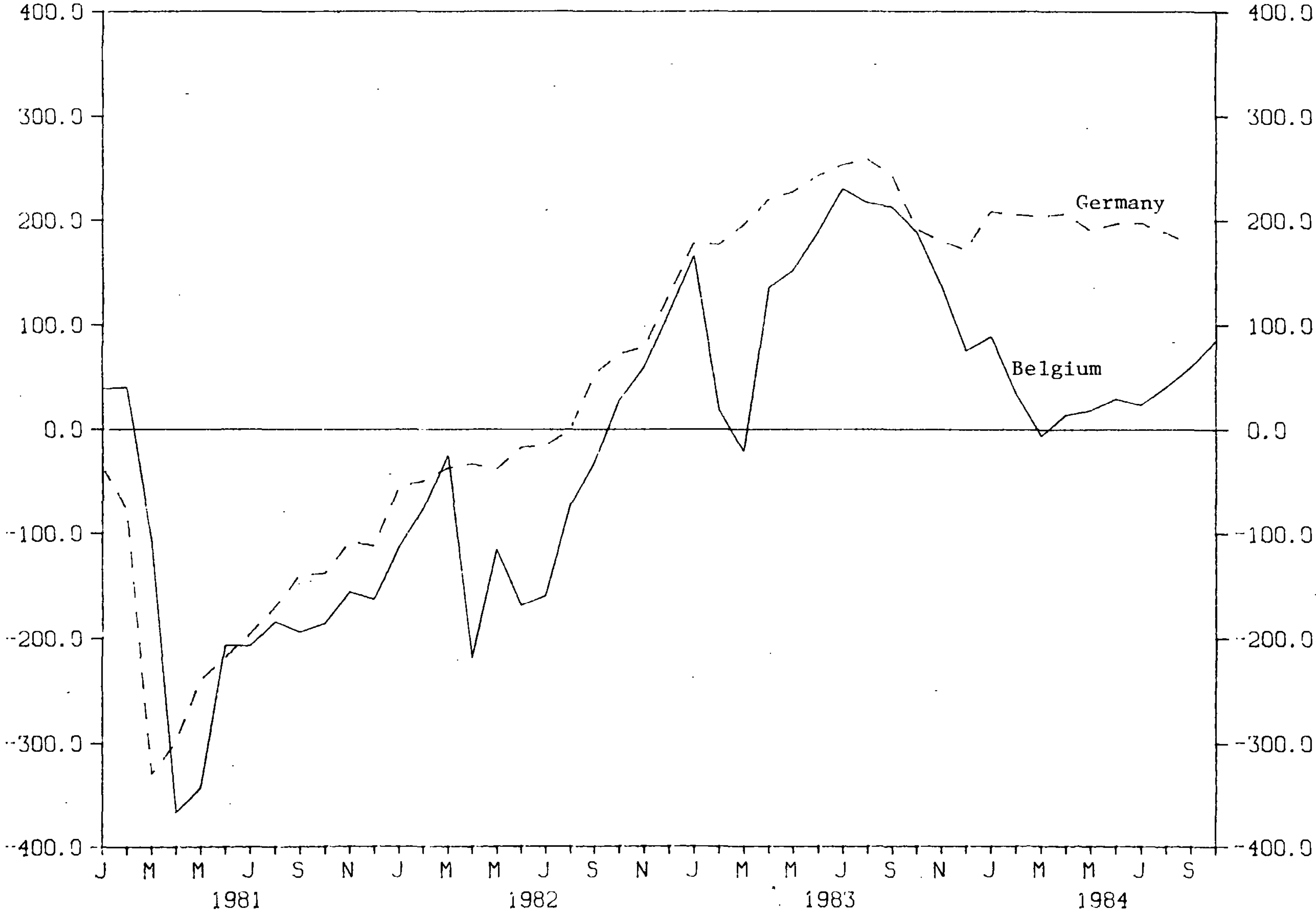
1/ Data for 1984 are based on most recent available information on likely outturns. Data for 1985-1990 are based on scenario A of the staff projections as described in Appendix IV.

Chart 2

BELGIUM and GERMANY

Term Structure of Interest Rates, 1981-84

(In basis points) 1/



Source: IMF, International Financial Statistics.

1/ Difference between government bond yield and three-month money market rate.

The authorities accepted these criticisms in part. They noted that there was enough responsiveness of certain key deposit rates to changes in rates on treasury certificates to elicit a response in short-term capital flows. They further observed that there was no concern over the level of external debt in the short run, so that the stability of the National Bank's reserves could be guaranteed by a mix of external borrowing and short-term interest rate adjustments, and not by interest rate policy alone. They accepted that the persistence of net long-term capital outflows was indicative of insufficiently attractive domestic long-term interest rates--especially given withholding tax considerations. They noted, however, that they faced strong political and budgetary constraints in raising long-term rates, given the impact of such rates on investment and mortgage lending rates and on the cost of funding the public debt. They were consequently hopeful that a more attractive yield differential could result from a decline in foreign rates.

5. External policies

As indicated above, the authorities confirmed their intention to continue to maintain a "zero position" for the Belgian franc in future EMS realignments. They recognized, however, that the persistently weak position of the Belgian franc within the system could pose potential problems for the practical observance of such a policy. The relative position of the Belgian franc in the EMS band reflected a policy choice not to intervene intramarginally, a policy which the authorities viewed as being in the spirit of the system. The Belgian franc's position within the EMS had nevertheless improved considerably after March 1984, a development which was attributed to the firmer short-term interest rate policy being followed; the authorities indicated that this more cautious stance in short-term interest rate management would be maintained in the future.

With respect to the dual exchange market arrangements, the authorities noted that the structure of payments which had emerged in recent years tended to impair the rationale of the system and to detract from its effectiveness in protecting the National Bank's reserves. Various legal exceptions to a complete separation of the two markets and the inevitable evasions and leakages had combined to significantly raise the amount of current receipts going through the free market (typically investment income and settlements in bank notes) and of capital outflows going through the official market (with strong variations in banks' spot positions). The market for the financial franc was thus structured so that considerable current receipts financed equally considerable capital outflows. The authorities did not however feel that the time was as yet ripe to dismantle the dual market arrangements without recourse to forms of capital controls, which they eschewed. They felt that the abolition of the system would require the achievement of a more balanced external position (on current and private capital flows combined), a greater room for maneuver on both short- and long-term interest rates, and a better control over bank liquidity. Although they did not have a policy directed at maintaining the spread between the official and financial rates within any predetermined range, they expected their general policies to result in a spread of less than 2 percent in normal circumstances. This had in fact been the case since mid-April 1984.

The authorities noted that the only change in the exchange system since the last consultation related to the decision to give the ECU equal status to that of other convertible foreign currencies dealt on the regulated market, and to quote it officially on the Brussels exchange market. Although the authorities viewed with some concern the strong interest of Belgian investors in ECU-denominated securities, they had taken the decision in order to accommodate the needs of the growing private market in ECU.

The authorities emphasized the importance of international developments for a small and very open economy such as that of Belgium, and stressed their belief that the larger industrial countries should give due consideration to the international repercussions of their domestic policy choices. They feared that while competitive devaluations were no longer frequent, they had possibly been replaced by what they termed "competitive wage restraint." Such a policy, if practised generally, could entail a widespread and mutually reinforcing deflationary effect. They welcomed the fact that the German authorities had not tightened monetary policy in the face of the strengthening of the U.S. dollar. Movements of the U.S. dollar did not have a considerable impact on the Belgian franc's effective rate, and the authorities were far from certain as to the possible effects of any fall in the dollar rate on the Belgian economy. They noted however that prospects for stability in the EMS were to some extent dependent on the dollar's future evolution.

The authorities reiterated their commitment to an open and free trade system. Official development assistance (ODA) had since 1981 remained at a constant 0.59 percent of GNP, and an equivalent figure was contained in the 1985 draft budget.

III. Outlook

Projections of economic activity into 1985 and thereafter are dependent on the estimated impact of the fiscal adjustment program. The program implies a significant direct withdrawal of stimulus from the economy. However, the staff's projections assume that the direct negative effects are to a fairly large extent offset by positive confidence effects on both household and business spending. In addition, the staff's forecast, in accord with the authorities, has retained the assumption of a continued buoyancy of export market growth and an unchanged level of international competitiveness of the Belgian economy.

On this basis, real GNP can be expected to grow by up to 1.5 percent in 1985. As in the preceding years, the largest contribution to growth would come from the foreign balance. Consumer expenditure would drop on account of the reduction in real disposable income that would follow the fiscal adjustment. However, this effect would be cushioned by a fall in the household savings ratio. Residential construction is expected to remain fairly strong in 1985, which is the last year for which a VAT rebate will apply to construction. Business investment is forecast to increase at a high rate (3.5 percent) owing to a catch-up demand and to the improvement in the overall economic climate, domestic and foreign. Industrial production, growing at a 4 percent rate, would remain the strongest contributor to economic growth. The increase in economic activity and work-sharing and other employment programs allow some moderate increase in employment to be expected. However, unemployment would continue to rise owing to the growth in the labor force and, at 15 1/4 percent of the civilian labor force, would remain amongst the highest in industrialized countries. Inflation is projected to drop from 6 1/2 percent in 1984 to 5 1/2 percent in 1985, a development which will narrow the differential with other industrial countries from 2 percentage points in 1984 to half a percentage point in 1985. The trade and current account balances of the Belgium-Luxembourg Economic Union would improve in 1985 at an accelerating pace owing to sluggish imports and a continued strong growth of exports. The trade balance is expected to move from a deficit of some BF 10 billion in 1984 into a surplus of BF 50 billion in 1985; and the current account from near balance in 1984 into a surplus of over BF 60 billion.

IV. Staff Appraisal

The upturn of the Belgian economy in 1984 is a gratifying response to the adjustment effort of recent years. Improved competitiveness has permitted industrial output growth of over 5 percent. It is particularly comforting that domestic demand was supported by an increase in private sector investment and that activity could rise despite a withdrawal of government stimulus. Perhaps the most welcome result was the stabilization of private sector employment after five years of decline. The long-awaited pickup of foreign demand which triggered these early results could only be effective because the ground had been prepared by domestic adjustments and because confidence was supported by the tightening of fiscal and monetary policies in 1984. Meanwhile, unemployment remains high and rising, the industrial structure is still in need of modernization, and the public sector deficit continues to be unsustainably large. The successes which have been achieved so far are therefore an encouragement to set new goals for the retrenchment of public expenditure and the restoration of greater flexibility to the economy.

An essential and welcome policy development in 1984 was the design and the initial implementation of a three year program to reduce the treasury deficit to the equivalent of 7 percent of GNP, a target which is also deemed to apply to the public sector as a whole. The intent of this target is to put an end to the spiraling burden of interest payments by stabilizing the ratio of central government debt to GNP at somewhat above 100 percent. While the targeted deficit will still be very high by the standards of industrial countries and Belgium's historical performance, it can be temporarily accomodated by the high financial surplus of the private sector and is consistent with a stabilization of external debt. The multi-annual character of the program is also useful to assure the needed continuity and predictability of policies.

The design of the fiscal adjustment program involved a new form of partial wage disindexation in order to benefit the public sector. Greater emphasis on expenditure reductions would certainly have seemed preferable, if only because the reference to index jumps condones indexation. More generally, it is apparent that the level of public expenditure in Belgium is so high that, through various channels, it distorts incentives, entertains inflation and undermines competitiveness. It is therefore of particular comfort that real public expenditure, excluding interest payments has begun to decline. The staff believes that economic conditions will be improved if this reduction can be sustained at an annual rate of at least 2 percent. The staff must fear furthermore that there is some likelihood, particularly under the less favorable scenarios for the international environment, that further measures will be required to achieve the fiscal balance target and would urge that such action be fully based on expenditure restraint.

The response of industrial production to the pickup of foreign demand suggests that the real effective exchange rate of the Belgian franc lies at a broadly adequate level. With a large fiscal deficit and a high public debt, continued confidence in the sustainability of exchange rate policies is also essential. The weakness of the franc in late 1983 illustrated the risks of maintaining domestic rates at the lowest possible level. The staff therefore highly welcomes the change in emphasis in the conduct of monetary policy in early 1984, as the monetary authorities chose to maintain a somewhat higher short-term interest rate differential in order to strengthen the franc within the EMS. In the staff's opinion this course of action is necessary to allay adverse exchange rate expectations. Together with a continued emphasis on cost competitiveness, this policy testifies to the authorities' determination and capacity to maintain the stability of the exchange rate of the Belgian franc in the EMS.

Long-term interest rates have not been allowed to reflect the change in emphasis in the management of short-term rates. The resulting instability of the yield curve undermines the efficiency of monetary policy. This anomalous situation is at odds with the Government's determination to guarantee a stable financial environment and to ensure the continued attraction of franc-denominated public sector issues. More attractive yields on long-term public securities would bear witness to this determination. They would reduce monetary financing and its inflationary impact. They would also take some pressure off short-term interest rates, and this would cushion their impact on the debt service costs of the Treasury. They would finally reduce long-term private capital outflows, so that the need for external compensatory borrowing by the Treasury would diminish. Altogether, the double constraint on central bank financing and external borrowing makes it desirable to meet most of the public sector requirements on the domestic long-term market by offering sufficiently attractive returns.

The lag in adjusting long-term interest rates in a situation of sustained net outflows of long-term capital is only one of the rigidities which affect the Belgian economy. It is another telling indication of the lack of flexibility in the economy that the continuation of strict wage norms will remain a necessary safeguard for both 1985 and 1986. Wage pressures inherited from the previous adjustment effort--which reduced real wages and compressed wage differentials--are being sustained by the wage moderation now being imposed in order to contain the public sector deficit. The constraints on the adoption of more market oriented interest rate and incomes policies among others are largely financial in nature, and would be more easily dealt with at a lower level of public expenditure. The implementation over the past several years of policies which have strengthened the financial position of enterprises provides a good basis to limit the high direct transfers from the public sector to enterprises and to move to a more market regulated allocation of resources.

The staff welcomes the authorities' commitment to an open and free trade system and their continuing efforts to raise the share of development assistance in GNP.

The staff notes that the discount of the franc on the financial market has not been in excess of 2 percent in recent months, so that the dual market arrangement does not normally constitute a multiple currency practice, and hopes that the policies of the authorities, notably their interest rate management, will maintain this situation in the future.

It is recommended that Article IV consultations with Belgium be held on the standard 12-month cycle. The authorities have requested that the consultation cycle be shifted to a February basis. It is therefore recommended that the next Article IV consultation be held in February 1986.

Table 3. Belgium: Basic Data on the Economy

	1981	1982	1983 1/	1984 2/	1985 2/
			(Changes in percent)		
Demand and supply (volumes)					
Private consumption	-1.4	1.1	-2.0	-0.5	-0.8
Public consumption	0.9	-1.6	-0.7	--	--
Gross fixed capital formation	-14.5	-2.6	-4.9	3.9	2.6
Final domestic demand	-3.7	-0.1	-2.3	0.4	0.1
Stockbuilding 3/	-0.4	--	0.2	0.3	0.2
Total domestic demand	-4.1	-0.1	-2.1	0.6	0.2
Exports of goods and services	8.7	2.6	3.0	4.5	3.8
Imports of goods and services	4.1	1.6	-0.5	3.1	2.3
Foreign balance 3/	3.0	0.8	2.5	1.2	1.3
GNP	-1.2	0.7	0.5	1.8	1.4
Industrial production 4/	-2.7	-0.1	2.4	5.0	4.0
Manufacturing output	-2.3	0.5	3.1	5.2	4.0
			(In thousands)		
Employment and unemployment 5/					
Labor force (civilian)	4,068	4,088	4,091	4,107	4,124
Employment (civilian)	3,614	3,552	3,502	3,495	3,498
Employment of enterprises	2,978	2,927	2,879	2,883	2,888
Unemployment	454	535	589	612	626
Unemployment rate	11.2	13.1	14.4	14.9	15.2
			(Changes in percent)		
Prices, wages and incomes					
GNP deflator	5.3	7.0	6.0	5.0	5.0
Consumer price index	7.6	8.7	7.7	6.4	5.5
Terms of trade	-4.7	-0.1	-1.1	-1.4	--
Hourly wage costs (manufacturing)	8.9	5.3	6.3	8.5	7.0
Unit labor costs (manufacturing)	3.1	0.1	2.1	3.5	3.4
Real disposable income (households)	--	-1.9	-1.2	-0.4	-1.8
Real per capita wages and salaries	-1.2	-0.9	-2.3	0.6	-0.1
Personal savings ratio (level)	15.7	14.3	15.0	14.9	14.0
			(Changes in percent)		
Monetary aggregates 5/					
Monetary base	1.6	--	3.6	2.7	...
Money (M1)	2.3	3.9	8.7	5.3	...
Money plus quasi-money (M2)	6.4	7.1	8.3	9.4	...
Domestic credit	12.8	11.2	14.2	13.2	...
Private	6.7	2.3	4.7	5.7	...
Government	19.2	19.7	21.9	18.4	...
			(In percent per annum; period averages)		
Interest rates					
Three-month market rate	15.4	13.2	10.4	11.7 6/	...
Government bond yield	13.7	13.6	11.9	12.1 6/	...

Table 3. Belgium: Basic Data on the Economy (continued)

	1981	1982	1983 1/	1984 2/	1985 2/
			(In percent of GNP)		
Public finances					
General government					
Expenditure	63.0	63.9	63.6	62.2	61.9
Revenue	46.8	49.0	48.1	48.4	49.9
Financial balance	-16.1	-14.9	-15.5	-13.8	-12.0
(In percent of gross private savings)	(73.6)	(72.1)	(66.6)	(61.1)	(55.0)
Interest on the public debt	8.0	9.4	9.6	10.4	11.3
Transfers to households 7/	22.8	22.8	23.5	23.2	22.8
Transfers to enterprises 8/	6.3	6.5	6.3	6.5	6.3
Debt 9/	117.9	129.5	141.3	145.0	150.0
(External debt) 9/	(16.3)	(23.8)	(27.3)	(29.5)	(34.0)
Central Government (Treasury)					
Expenditure	40.9	42.9	41.9	41.1	40.1 10/
Revenue	28.3	29.8	29.3	29.6	29.7 10/
Financial balance	-12.6	-13.0	-12.6	-11.5	-10.4 10/
			(In billions of Belgian francs)		
Current account 11/					
Trade balance	-134.3	-108.9	-40.3	-10.0	50.0
Services balance	27.1	51.3	67.1	70.0	75.0
Current account balance					
Excluding official transfers	-122.5	-75.3	17.4	49.0	113.0
Including official transfers	-155.5	-113.5	-28.2	-1.0	63.0
(In U.S. dollars)	(-4.7)	(-2.6)	(-0.6)	(--)	(1.1)
(In percent of GNP)	(-4.0)	(-2.9)	(-0.7)	(--)	(1.3)
			(Changes in percent)		
Exchange rates and competitiveness					
U.S. dollar rate	-21.0	-18.7	-10.8	-11.5 13/	...
Nominal effective rate (MERM)	-6.8	-9.8	-4.0	-3.6 13/	...
Real effective rate 12/	-7.3	-14.3	-5.5	-3.0 14/	...

1/ Partly preliminary.
2/ Staff forecast.
3/ Contribution to growth.
4/ Excluding construction.
5/ Through the year changes; for 1984, changes over 12 months to June 1984.
6/ Average of first 9 months.
7/ Current transfers.
8/ Current and capital transfers.
9/ Including publicly guaranteed debt.
10/ Draft budget.
11/ Belgium-Luxembourg Economic Union (BLEU).
12/ Unit labor costs in manufacturing in common currency.
13/ First three quarters.
14/ First two quarters.

Belgium - Fund Relations

(As of October 31, 1984)

I. Membership Status

Belgium has been a member of the Fund since its inception on December 27, 1945. Belgium accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund agreement as from February 15, 1961.

A. Financial Relations

II. General Department

(a) Quota: SDR 2,080.4 million

(b) Total Fund holdings of Belgian francs:
SDR 1,593.1 million (76.6 percent of quota)

(c) Fund credit:
None

(d) Reserve tranche position:
SDR 487.4 million

(e) Current operational budget:
Transfers: SDR 26.4 million; Receipts: SDR 11.4 million

(f) Lending to the Fund (SDR millions):

	Limits	Outstanding	Uncalled
GAB	595.0	--	595.0
SFF	8.4	8.4	--
Enlarged access	155.0	38.0	117.0
Total	758.4	46.4	712.0

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

No use of Fund credit during the last 10 years.

IV. SDR Department

(a) Net cumulative allocation: SDR 485.25 million

(b) Holdings: SDR 395.99 million, or 81.6 percent of net cumulative allocation

(c) Current Designation Plan: Limit: SDR 28.6 million; Holdings: 0

V. Administered Accounts

Not applicable

VI. Overdue Obligations to the Fund

None

B. Nonfinancial Relations

VII. Exchange Rate Arrangements

Belgium forms a monetary union with Luxembourg in which the Belgian and the Luxembourg franc are at par. The two countries have a dual exchange market. In the financial market, through which most capital and some current transactions are channeled, the franc is allowed to float freely. In the official market, a maximum margin of 2.25 percent is maintained between the Belgian and Luxembourg francs and the currencies of other countries participating in the European Monetary System (EMS), with the exception of the Italian lira for which the margins are 6 percent.

VIII. The last Article IV consultation:

The staff report for the 1983 Article IV consultation with Belgium was considered by the Executive Board (EBM/84/8 and EBM/84/9, 1/18/84). No decision was taken at the time with regard to the dual exchange market arrangements. It was decided that the next Article IV consultation with Belgium would be held on the standard 12-month cycle.

Belgium - Statistical Issues

1. Coverage, currentness, and reporting of data in IFS

		Latest Data in November 1984 IFS
Real Sector	- National Accounts	1983 (partial)
	- Prices	September 1984
	- Production	June 1984
	- Employment	n.a.
	- Earnings	Q2 1984
Government Finance	- Deficit/Surplus	June 1984
	- Financing	May 1984
	- Debt	July 1984
Monetary Accounts	- Central Bank	September 1984
	- Deposit Money Banks	Q2 1984
	- Other Financial Institutions	1981
External Sector	- Merchandise Trade: Values	February 1984
	- Merchandise Trade: Prices	February 1984
	- Balance of Payments	Q1 1984
	- International Reserves	July 1984
	- Exchange Rates	July 1984

During the past year, the reporting of data for inclusion in the IFS has been excellent.

2. Outstanding statistical issues

Monetary accounts

Data for deposit money banks are available only on a quarterly basis; thus only quarterly monetary survey figures are published in IFS. The possibility of publishing monthly national source figures for money and quasi-money is being considered; these data, however, are on a different basis compared with the quarterly data appearing in IFS.

Merchandise trade

Trade data are uncurrent--there is a six-month delay in the reporting of data for both IFS and DOTS.

Medium-Term Public Finance Developments

The two illustrative scenarios of medium-term public finance developments in Table 4 are based on the following main assumptions. Nominal GNP growth is set at 6.6 percent in 1985 (as assumed in the draft budget) and at 7 percent per annum thereafter (split into 4.5 percent deflator and 2.4 percent real growth). Export growth for goods and nonfactor services is projected at 7.6 percent in 1985 and at 7 percent a year for the remainder of the projection period. The average interest rate on the public debt in 1985 is the rate implicit in the budget (10 percent); it is set to remain constant in real terms for the rest of the projection period.

Scenario A assumes adherence to the March 1984 fiscal adjustment program, with a steady reduction in the Treasury's net financing requirement from 11.5 percent of GNP in 1984 to 7 percent in 1987, and a corresponding fall in the general government borrowing requirement over the same period to 8 percent of GNP (the difference corresponding to net lending, with local authorities and the social security funds--after central government transfers--being broadly in balance). Revenue figures for 1985 are derived from the budget, the standard 1.2 elasticity to nominal GNP is assumed for 1986, and a constant tax and para-tax pressure (unitary elasticity) is assumed thereafter, embodying the authorities' commitment to introduce indexation of tax assessment brackets once the treasury's deficit reaches 9 percent of GNP. On this basis, total fiscal pressure stabilizes at some 50 percent of GNP. Given the dynamics of the debt and of interest payments, adherence to the adjustment path implies an average annual real cut in noninterest expenditure (deflated by GNP prices) in the 1984-87 period of 2.9 percent at central government level and 2.3 percent for the general government. The projections of Scenario A assume that, once the adjustment program's targets are achieved in 1987, real noninterest expenditure (at both central and general government level) remains constant to the end of the projection period.

Scenario B assumes a fairly sharp slippage from the multi-annual adjustment program, with no cut in real noninterest expenditure being effected as from 1985. The other main assumptions remain unchanged, so that no secondary impact from the slippage on GNP growth, interest rates, etc., is considered. On this basis, the program's target for the central government deficit would be achieved only in 1993.

The external debt projections (covering total public debt in foreign currencies, of all maturities, but excluding publicly-guaranteed debt) are based on the assumption of an availability of domestic financing for the public sector equal to 7 percent of GNP as from 1985. Given a fairly stable domestic financial asset formation of 12-13 percent of GNP (under appropriate interest rate management), such a figure would allow the private sector's new domestic liabilities to return to a level of some 5-6 percent of GNP, after having being compressed severely in recent years. The average interest rate on the external debt is set at 9 percent throughout, and the standard assumption of unchanged exchange rates

Table 4. Belgium: Medium-Term Public Finance Developments, Illustrative Scenarios, 1984-1990

(In percent of GNP, unless stated otherwise)

	1984	1985	1986	1987	1988	1989	1990	1993
			Scenario A: Application of March 1984 adjustment program					
Central government								
Net financing requirement	11.5	10.4	8.7	7.0	6.4	5.7	4.9	
Interest payments	8.4	9.4	9.2	9.4	9.4	9.3	9.2	
Debt outstanding	94.9	99.4	101.6	102.0	101.6	100.6	99.0	
General government								
Net financing requirement	13.8	11.9	10.0	8.0	6.9	5.7	4.4	
Interest payments	10.4	11.3	11.6	11.6	11.5	11.4	11.1	
Debt outstanding	120.4	124.8	126.7	126.4	125.0	122.5	118.8	
External debt 1/								
Amount outstanding, gross	23.4	26.8	28.1	27.2	25.3	22.3	18.2	
Debt service ratio 2/	2.9	3.8	5.0	8.9	8.5	7.0	6.0	
			Scenario B: Slippage from March 1984 adjustment program					
Central Government								
Net financing requirement	11.5	11.9	10.8	10.4	10.0	9.5	9.0	7.2
Interest payments	8.4	9.5	9.5	9.8	10.1	10.4	10.5	10.7
Debt outstanding	94.9	100.9	105.1	108.7	111.5	113.7	115.3	116.0
General Government								
Net financing requirement	13.8	13.7	13.0	12.2	11.4	10.5	9.5	6.0
Interest payments	10.4	11.4	11.9	12.2	12.5	12.7	12.8	12.4
Debt oustanding	120.4	126.7	131.4	135.0	137.6	139.1	139.4	133.9
External debt 1/								
Amount outstanding, gross	23.4	28.7	32.8	35.9	37.9	38.9	38.8	32.1
Debt service ratio 2/	2.9	3.9	5.4	10.1	10.8	10.6	10.9	7.4

Source: Staff estimates and calculations.

1/ Total public sector debt in foreign currencies, all maturities (excluding publicly-guaranteed debt).

2/ Interest payments on total debt plus amortization of medium- and long-term debt, as a percent of exports of goods and nonfactor services.

during the projection period is maintained. The amortization schedule for external medium- and long-term debt is derived from the known schedule for (central government) debt outstanding at end-August 1984; a two-year grace period and 20 percent linear amortization is assumed for the debt incurred thereafter. Given the great number of assumptions program, with no cut in real noninterest expenditure being effected as from required, the nature of the above projections can only be illustrative.

In the discussions, the authorities contested the existence of a link between the public sector deficit and net private capital outflows except to the extent that the imbalance in public finances could be a factor undermining confidence. They noted that the current account was in near balance, which indicated that the total financial surplus of the private sector was by definition sufficient to cover the public sector financing requirement. The net private sector capital outflows were seen to be the result of a process of portfolio diversification, to be regulated by appropriate interest rate management. They therefore tended to project external debt accumulation as the sum of projections for the current account and the private sector capital balance. As an empirical matter however, they agreed that over the medium term the current account had to be in surplus, and that interest rate management would control net private capital outflows. Their implicit projection of external debt was thus comparable to that of the staff.