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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/8

10:00 a.m., January 18, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
	M. Teijeiro
R. D. Erb	M. K. Bush
	M. Z. M. Qureshi, Temporary
T. Hirao	T. Yamashita
	Jaafar A.
	L. Leonard
	D. I. S. Shaw, Temporary
	H. A. Arias, Temporary
G. Laske	
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
	K. G. Morrell
	O. Kabbaj
F. Sangare	
M. A. Senior	J. L. Feito
J. Tvedt	A. Lindø
	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

B. Legarda, Consultant. Asian Department: K. A. Al-Eyd, R. G. Di Calogero, E. Gurgen, R. H. Nord. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, P. Dhonte, H. B. Junz, A. Leipold, V. Marie, G. A. MacKenzie, K.-W. Riechel, M. Xafa. Exchange and Trade Relations Department: M. Guitian, S. Kanesa-Thasan, R. Pownall. Fiscal Affairs Department: H. Bierman, G. Blöndal. IMF Institute: J. M. Davis. Legal Department: J. K. Oh, J. V. Surr. Research Department: A. D. Crockett, Deputy Director. Bureau of Statistics: K. W. Nahr. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: K. A. Hansen, S. M. Hassan, H.-S. Lee, W. Moerke, G. E. L. Nguyen, Y. Okubo, P. Péterfalvy, D. C. Templeman. Assistants to Executive Directors: J. Bullock, L. E. J. M. Coene, R. J. J. Costa, M. Eran, G. Ercel, V. Govindarajan, D. Hammann, C. M. Hull, A. K. Juusela, H. Kobayashi, S. Kolb, M. J. Kooymans, E. Portas, M. Rasyid, A. A. Scholten, Shao Z., S. Sornyanyontr, N. Toé, P. Verly, Wang C. Y., J. C Williams.

1. WESTERN SAMOA - 1983 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1983 Article IV consultation with Western Samoa together with a review under a one-year stand-by arrangement in the amount of SDR 3.75 million or 75 percent of quota, and a proposed decision concluding the Article XIV consultation with Western Samoa (EBS/83/271, 12/21/83; and Cor. 1, 1/12/84). They also had before them a report on recent economic developments in Western Samoa (SM/84/2, 1/5/84; and Cor. 1, 1/12/84).

Mr. Morrell made the following statement:

The Western Samoan authorities are in general agreement with the assessment in the staff report for the 1983 Article IV consultation with Western Samoa and review under the stand-by arrangement.

With a population of only 160,000, a limited resource base, and dependence on the production and export of a few agricultural products, Western Samoa shares with other small island economies many of the disadvantages of small size and geographic isolation. These problems contributed in no small way to the serious imbalances that emerged during the period 1980-82, which the Government's economic program seeks to address.

The staff paper indicates the very considerable progress that has been made so far. Program targets for 1983 have been met, in some cases comfortably. In particular, the major fiscal adjustment called for under the program has been more than achieved, with the overall deficit of the Central Government, including grants, declining from 15.7 percent of GDP in 1982 to 3.1 percent in 1983, compared with a program target of 5.5 percent. This overperformance was due partly to an excess of unprogrammed project-related grants over the higher development expenditure they allowed, but also to the collection of income tax arrears. Overall, revenues are estimated to have increased by as much as 31 percent over their 1982 levels.

Reflecting the strong fiscal performance, limits on net domestic assets of the banking system and net credit to the public sector to end-December 1983 look like being met comfortably, while some increased accommodation of private sector credit demands has been possible within the overall credit ceiling.

There has also been a major improvement in the performance of nonfinancial public enterprises reflecting some temporary factors, but also reflecting improved management practices, adoption of expenditure control measures, and more realistic pricing policies.

External targets have been broadly achieved, with the current account deficit as a percentage of GDP being reduced from 17.1 percent in 1982 to 13.6 percent in 1983, compared with a program target of 13.2 percent. Net repayments of arrears on government and government-guaranteed debt totaled SDR 2.9 million for the year as a whole, in line with the program target.

Given the focus of the 1983 program on external adjustment, no growth in real GDP and limited improvement in inflation performance were envisaged during 1983. A real GDP growth of 1 percent appears likely, on the basis of a strong increase in manufacturing output and greater import substitution. Inflation is expected to average 16 percent for the year as a whole, in line with the program objective. However, with the working through of adverse price influences in the third quarter, and reflecting the contraction of domestic demand, inflation in the last quarter of 1983 is estimated to be running at an annual rate of only about 8 percent. There were also important improvements during 1983 in fiscal administration, in the statistical base, and in monitoring and control procedures.

Substantial imbalances remain. The authorities see the adjustment effort very much in a medium-term framework and this is reflected in their continuing commitment under the program to fiscal and monetary restraint, a flexible exchange rate policy, maintenance of appropriate interest rates, and further improvement in the financial and managerial performance of public enterprises.

The external current account deficit is expected to decline further in 1984 to some 11 percent of GDP and an overall balance of payments surplus of SDR 3.4 million would be used to further reduce external payments arrears and rescheduled debt. Real GDP is projected to grow by about 3 percent while the rate of inflation is expected to decline markedly.

An overall fiscal deficit, including grants, of WS$4.3 million is budgeted for 1984, representing a further reduction from 3.1 percent to 2.4 percent, in terms of GDP. No net use of commercial bank credit by the public sector is expected in 1984. The 1984 budget was recently passed by the Parliament without amendment.

A number of important structural and institutional changes are planned for 1984. Transformation of the Monetary Board into an independent central bank should be completed in about mid-1984--the Central Banking Department is providing assistance with legislation and on the staffing side. An important tax reform, designed to broaden the tax base and improve elasticity of the tax system, will also be introduced during 1984. Legislation for these measures is currently before the Parliament.

It is of interest that the adjustment of interest rates has not yet led to a significantly greater mobilization of domestic financial resources or to increased workers' remittances. This would appear to reflect the limitations imposed by a relatively small monetized sector and a correspondingly narrow financial base. Within the financial system, however, the adjustment of interest rates has led, as would be expected, to an increase in the average length of deposit maturities.

The authorities remain committed to a flexible exchange rate policy. Although there was some real appreciation of the tala on a trade-weighted basis in the third quarter of 1983, the authorities regard this as a temporary phenomenon that will be corrected as the special influences which gave rise to a sharp acceleration of inflation in that quarter subside. Indications are that a sharp fall in the inflation rate in the last quarter of 1983 will be achieved. The authorities will of course continue to monitor developments in this area closely.

As noted, the authorities are very conscious of the need for continued adjustment over a period of years if a sustainable balance of payments position, with an acceptable burden of debt service, is to be achieved. The authorities greatly value the renewed relationship that has been established with the Fund in support of Western Samoa's medium-term adjustment effort. This relationship, and the success of policies under the present arrangement, owe much to the work of the staff, and we record the authorities' and our own appreciation of its efforts.

Mr. Hirao considered that the Western Samoan authorities should be commended for their comprehensive adjustment efforts under the stand-by program during 1983. The economy's external position had improved considerably, with a reduction in the current account deficit and a higher than expected surplus in the overall balance. In addition, real output had increased modestly following several years of negative growth, and inflation had decelerated as originally envisaged in the program. Perhaps the most striking progress had been made in the area of the public finances. The overall deficit on a commitment basis in terms of GDP had been reduced from about 16 percent to about 3 percent in 1983, and the Government's efforts to control expenditure and increase revenues in line with the program targets had been particularly commendable. Still, Western Samoa's external position remained weak and vulnerable to uncertain external developments, and he was therefore pleased by the authorities' commitment to continue the adjustment policies initiated in 1983.

On the fiscal side, he welcomed the authorities' intention to strengthen further the financial position of the Government in 1984, Mr. Hirao continued. The improvement in the financial position of the nonfinancial public enterprises in 1983 had been largely attributable to temporary factors; the authorities had therefore established the National

Economic Council in order to monitor more closely the operations of those enterprises. It was to be hoped that the work of the Council would lead to increased coordination of various public enterprise activities and to better control over their financing. Also welcome were the planned tax reforms, which would help to broaden the tax base and improve tax elasticities. The new tax system was expected to increase domestic resource mobilization and promote a more efficient allocation of resources in the medium term.

He took note of the authorities' intention to continue pursuing a flexible interest rate policy under which interest rates were expected to remain positive in real terms, Mr. Hirao commented. It would be important to monitor closely developments in neighboring countries in order to avoid interest rate differentials. In view of the need to promote savings and further mobilize domestic resources, the authorities should continue to keep interest rate policies under close review. Their intention to eliminate the foreign exchange allocation system during 1984 was commendable; such a step would enhance efficiency in utilizing limited foreign exchange resources, but it would have to be accompanied by the pursuit of appropriate fiscal and monetary policies in order to keep demand for foreign exchange at a reasonable level. Finally, he could endorse the staff appraisal of Western Samoa's economy and support the proposed decisions.

Ms. Bush said that she too was in broad agreement with the staff appraisal and could support the proposed decisions. During the previous Article IV consultation with Western Samoa--which had preceded the final negotiation of the current stand-by arrangement--the U.S. chair had called for urgent action on fiscal, interest rate, and exchange rate policies. The authorities had effectively implemented the policy agreed to in the 1983 adjustment program and, as a consequence, substantial progress had been made toward achieving the objectives of promoting sound economic growth and a sustainable balance of payments position. However, further adjustments would be necessary over the medium term, and she urged the authorities resolutely to implement the proposed adjustment measures for 1984.

On exchange rate policy, Ms. Bush expressed concern that the level of the exchange rate achieved in June 1983 had not been maintained for a sufficiently long period to allow for an adequate response by economic participants. The authorities had, however, reiterated their commitment to a flexible exchange rate policy, and had indicated that the real appreciation of the tala was temporary and should experience some correction as special influences subsided. She would welcome any further comment by the staff or Mr. Morrell on the expected correction.

Additional elements of the 1984 program that were vital to the success of the adjustment effort were the phasing out of the foreign exchange allocation system, the reform of the tax system, and a strengthening of monetary policy, Ms. Bush commented. The authorities' plans for establishing a central bank to enhance the quality of monetary policy management were to be welcomed. Also commendable was the creation of a National Economic Council, which was expected to increase coordination among the nonfinancial public enterprises and should help to improve their financial management.

Mr. Shaw said that he was pleased that the adjustment measures in Western Samoa were currently taking hold and that the authorities were committed to correcting the imbalances in the economy over the program period. Like others, he had been impressed by the fiscal performance and by the fact that program targets in the first six months of the year had been exceeded. Part of the success on the fiscal front had been due to the collection of income tax arrears, an event that was unlikely to be repeated in 1984; at the same time, however, the authorities had made significant improvements in expenditure control. Like Mr. Hirao, he could support the commitment to broaden the tax base and to implement tax reform measures, and he commended the authorities for rationalizing the activities of the public enterprises.

Monetary policy had been appropriate in support of the fiscal restraint, Mr. Shaw observed, and he welcomed the authorities' commitment to pursuing a flexible interest rate policy throughout 1984. As noted by Mr. Morrell, the adjustment of interest rates had not yet led to a significantly greater mobilization of domestic financial resources or to increased workers' remittances, but that might be due in part to a lagged effect. The expected reduction in the rate of inflation from 16 percent to below 10 percent during 1984 should produce real positive interest rates and increase the mobilization of domestic resources.

On the external side, Mr. Shaw said, he was concerned that the current account deficit, while expected to decline further in 1984, would remain high; and the debt service ratio was projected to be excessively high through 1986. Still, the authorities recognized the problem and seemed to be committed to taking corrective action. He particularly welcomed their commitment to eliminate external arrears in 1984.

A number of structural and institutional changes were also contemplated during 1984, Mr. Shaw continued. While adjustment over the medium term would be difficult, the commitment of the authorities to adjust certainly deserved Fund support, and he wondered whether they were looking toward a follow on program that would focus on needed structural changes. Finally, he welcomed the progress made to date under the stand-by arrangement and supported the proposed decisions.

Mr. Jaafar agreed with others that the authorities should be commended for the successful implementation of the stand-by arrangement thus far. The turnaround in public finance had been remarkable, and important progress had been made in improving Western Samoa's payments position.

Two areas of concern remained, Mr. Jaafar continued. First, while the authorities had made significant progress in bringing down the real effective exchange rate to a more appropriate level, the recent sharp gain in the exchange rate underscored the need for close monitoring. The authorities should remain vigilant and continue to promote a flexible exchange rate policy with the aim of achieving external competitiveness. Second, while the foreign exchange allocation system, which presently applied to all private sector imports, should be dismantled as soon as possible in order to eliminate distortions in resource allocation, caution should be exercised in eliminating the system so as to avoid instability arising from a higher demand for imports that could undermine the current adjustment effort.

Also of concern was the medium-term outlook for Western Samoa's economy, Mr. Jaafar remarked. Although substantial progress had been made in reducing pressure on the balance of payments, the high debt service burden would require continued restraint on imports. And exports would have to turn out significantly better than projected, given the expectation that the debt service ratio would fall from 45 percent in 1984 to only about 32 percent in 1986. The target of an 11 percent debt service ratio by 1988 including transfers was an ambitious one. Still, the measures contemplated or already implemented would contribute to promoting a more sustainable balance of payments position, and he encouraged the authorities to continue their efforts. Finally, he could support the proposed decisions.

Mr. Sangare observed that the economy of Western Samoa had registered significant improvements on many fronts, most notably in the financial position of the Government and in the external sector. It was clear, however, that the authorities would have to continue pursuing prudent policies aimed at stimulating economic growth--which had been negative in real terms for the past four years--and further consolidating the gains made in reducing imbalances in the financial sector. He thus welcomed the indication in the staff report that the authorities considered the present program to be only the first phase of a medium-term effort to improve the economy. The economic policies planned for 1984, which emphasized the continuation of fiscal and monetary restraint, together with an investment program that should maximize the use of the country's limited resource endowment, appeared to be steps in the right direction. However, as a small island economy, Western Samoa would need the continued assistance of the international community in the form of concessional aid if the authorities were to be successful in their effort to establish a basis for sustained economic growth and a viable balance of payments position.

For the immediate future, Mr. Sangare noted, GDP was projected to grow by about 3 percent in 1984, and the rate of inflation was expected to be cut in half from its present level. However, the balance of payments would remain weak in the face of unfavorable prospects for the country's exports, a situation that placed the economy in an uncomfortable position, given the high debt service burden. The medium-term outlook also pointed toward continuing balance of payments difficulties, although efforts to expand exports, diversify the economy, and develop import substitutes through the aid of a flexible exchange rate policy should make them more manageable.

While welcoming the general stance of monetary policy in Western Samoa, Mr. Sangare said that he had two specific comments to make on interest rates. First, according to the staff, the high interest rate had not had an effect on the size of savings and had not attracted funds from abroad. He was not altogether surprised; indeed, he had always stressed that, in many developing countries, the role of interest rates in the mobilization of resources and capital flows was more often than not circumscribed by other more powerful factors. Second, he was unable to determine whether the increase in lending rates--which had risen to 20 percent--had played any significant role in channeling resources to the most productive areas of the economy. He had noted that a large share of credit to the private sector had been used to finance trade. While returns in that sector might be sufficiently high to absorb the increase in lending rates, he wondered whether investment in other areas might not be dampened. Finally, like others, he was prepared to go along with the proposed decisions.

Mr. El-Khouri observed that performance under the 1983 program had been quite satisfactory. The authorities had implemented a number of important corrective measures to stabilize the economy; as a result, all the quantitative performance criteria had been met, and the output, inflation, and balance of payments targets had been achieved. Nonetheless, the economic and financial position of Western Samoa remained vulnerable. Output had been declining for a number of years, inflation was still high, and the external payments position continued to be structurally weak. In the circumstances, it was important for the authorities to persevere with their adjustment efforts in order to restore economic growth and achieve a viable balance of payments position over the medium term. Continued close cooperation with the Fund would be helpful in that regard.

While he could support the general thrust of the staff's recommendations for continued adjustment, Mr. El-Khouri said, he was unclear about what was being recommended with respect to lending by nonbank financial institutions. On the one hand, the staff was urging a close monitoring of credit in order to contain inflationary pressures; at the same time, it had stated in the Annex to SM/84/2 that lending by the nonbank financial institutions did not contribute to the creation of liquidity. Furthermore, the program contained no limits on such lending, and he would appreciate some clarification of the staff's position on the matter.

With regard to the operations of the World Bank Group in Western Samoa, Mr. El-Khouri noted that the latest credit commitment to Western Samoa by IDA had been made in November 1980; since that time, no member of the World Bank Group had made any commitments to Western Samoa. Given the country's need to diversify and expand its productive base, it would appear that Western Samoa could benefit from more assistance and advice from the World Bank. Finally, he could support the proposed decisions.

The staff representative from the Asian Department remarked that, in the view of the staff, the depreciation that had been effected in the spring of 1983 had restored the competitiveness that had been lost since

1979. Of course, some price increases had occurred in the wake of the depreciation, and those had been exacerbated by drought conditions that had not been foreseen at the time. It was worth noting, however, that prices had begun to decelerate quickly beginning in September 1983; and, during October and November--the last two months for which the staff had full information--prices had remained at their end-September level. Still, the matter of the exchange rate had been raised in the course of the consultation with the authorities, who had agreed that exchange rate movements would need to be closely monitored and that further action would be taken if warranted.

With regard to Mr. Shaw's question on the burden of the debt service ratio in Western Samoa, the staff representative agreed that the ratio was high. However, that was due mainly to an accumulation of arrears and the desire of the authorities to repay them over a short period of time. Excluding arrears, the debt service ratio was reasonably low. Moreover, negotiations were apparently progressing rapidly with a neighboring country to convert government and government-guaranteed debt to that country into a long-term investment in Western Samoa, which would reduce the debt service ratio over the next two or three years.

Prospects for the medium term were good, the staff representative considered. The planned reform of the public enterprises and the tax system should lead to a shift in the allocation of resources into export-competing and import-competing sectors and to an improvement in Western Samoa's balance of payments position.

Taking up Directors' questions on interest rates, the staff representative noted that, although the rates had been increased to 20 percent on consumer loans, the Development Bank of Western Samoa and other commercial banks had extended preferential rates for other purposes; for example, the Development Bank of Western Samoa charged only 8 percent on agricultural loans. It was too soon to tell whether or not there had been a pronounced shift in the mobilization of savings in Western Samoa because of interest rates, although it appeared that there had been a move toward longer-term maturities.

On lending by nonbank financial institutions, the staff was concerned that those institutions could contribute to aggregate demand in the economy, the staff representative continued. While they were not included in the monetary survey and did not create liquidity through their credit extension, the nonbank financial institutions did in fact contribute to aggregate demand, particularly by drawing on their overseas lines of credit. The staff was particularly concerned about one of those institutions, which had increased its lending substantially during 1983 as commercial banks had tightened their credit to the private sector.

It was true that World Bank credit had not been extended to Western Samoa since November 1980--mainly because of some difficulties in implementing particular projects, the staff representative commented. But the World Bank would be participating in the agricultural study mission organized by the Asian Development Bank and might later organize its own mission to study the possibility of extending a sectoral loan to Western Samoa focusing on agriculture. Finally, with respect to the possibility of the further use of Fund resources, it was fair to say that the authorities had cooperated fully in implementing the 1983 program and had sought the counsel and advice of the Fund. During the Annual Meetings and the consultation talks, the authorities had expressed keen interest in a further use of Fund resources; that matter would be explored during a staff mission to Western Samoa tentatively scheduled for March 1984.

Mr. Morrell, observing that the Western Samoan authorities had taken a number of measures both before and after the initiation of the stand-by program, considered that they had already made strong gains in the fiscal area by reducing the deficit to about 3 percent of GDP; and a further fall in the fiscal deficit was projected for 1984. Real reductions had been made in the number of people working for the civil service, and the authorities were committed to continuing their successful efforts to repay arrears. In addition, the Fund had provided technical assistance in preparing legislation--which was currently before the Parliament--for tax reform measures and for the establishment of a new central bank.

As mentioned by the staff, the authorities were keenly interested in pursing a further arrangement with the Fund, Mr. Morrell continued. They recognized that further adjustments were needed, and it seemed appropriate that their commitment to making them should proceed with Fund support.

With regard to questions on foreign exchange arrangements, Mr. Morrell noted that the increase in the real exchange rate had been due to particular factors in the third quarter of 1983, including the Pacific Games, the staging of which had had a major impact on the consumer price index. The authorities felt no need to adjust the rate for such temporary factors; on the other hand, given that the currency was closely pegged to the New Zealand dollar and that the rate of inflation in New Zealand at present was particularly low, the authorities would have to be careful to ensure that Western Samoa's competitiveness was not adversely affected.

A number of Directors had supported the authorities' proposal to remove the foreign exchange allocation system, Mr. Morrell recalled. The removal of such a system was consistent with Fund doctrine; however, Western Samoa's position was fragile and its reserves were low. In the circumstances, advice about proceeding to dismantle the foreign exchange allocation system should be given only on the clear understanding that the appropriate monetary and fiscal policies were in place and that sufficient reserves existed.

As mentioned by the staff, the authorities in Western Samoa had been holding discussions with the World Bank as well as with the Asian Development Bank and various bilateral donors, Mr. Morrell commented. The Asian Development Bank had been providing considerable assistance and would soon be mounting a mission to Western Samoa that included a World Bank observer. It was his understanding that, if the World Bank were to provide assistance, it would probably be in the form of a structural adjustment loan rather than a specific project loan.

The Chairman made the following summing up:

Executive Directors generally agreed with the appraisal contained in the staff report for the 1983 Article IV consultation with Western Samoa. Indicating their pleasure that all performance criteria under the stand-by arrangement had been observed, they commended the authorities for the considerable progress made during 1983. They observed that adjustment had resulted from the implementation of a comprehensive set of measures taken in the course of the year in the form of tax increases, expenditure controls, credit restraint, upward adjustment of interest rates, and pursuit of a flexible exchange rate policy. The substantial improvement in the financial position of the public enterprises was particularly welcomed.

Directors noted that the result of the adjustment policies had been a moderation of inflation in recent months, a modest rate of economic growth in 1983 following several years of negative growth, and improvement in the balance of payments position, aided also by an improvement in the terms of trade. The external current account deficit had declined significantly, and the overall balance had moved into surplus, enabling Western Samoa to repay a significant portion of its outstanding external payments arrears.

Directors warmly commended the Western Samoan authorities for their courageous policies but added that, despite the recent improvement in the external position, Western Samoa's balance of payments remained weak. Exports were narrowly based and covered only a small portion of the import bill. In addition, debt service obligations, including those of rescheduled arrears, would continue to claim a large share of the country's foreign exchange earnings during the next few years. In view of the structural weaknesses of the economy, the projected heavy debt service burden, and the remaining inflationary pressures, it was considered necessary to continue the adjustment process initiated in 1983. In that context, a number of Directors encouraged the authorities to sustain their efforts to broaden the tax base and improve financial administration, rationalize further the operations of public enterprises with the assistance of the recently established National Economic Council, increase the mobilization of domestic resources, revitalize and diversify exports, work toward the elimination of the foreign exchange allocation system, and strengthen monetary policy. In the latter context, the prospective establishment of a central bank was welcomed, as was the commitment of the authorities to follow a flexible interest rate policy geared toward real positive interest rates. Continued maintenance of a flexible exchange rate policy was also seen as indispensable as a means of channeling resources into the export-competing and import-competing sectors.

The intention of the authorities to persevere with the implementation of structural adjustment policies was welcomed, and it was hoped that Western Samoa would continue to receive the concessional foreign assistance--as well as assistance from the World Bank--needed for its development. The quality of the collaboration between Western Samoa and the Fund was particularly welcomed.

It is expected that the next Article IV consultation with Western Samoa will be held on the standard 12-month cycle.

The Executive Board then took the following decisions:

Decision Concluding 1983 Article XIV Consultation

1. The Fund takes this decision relating to Western Samoa's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1983 Article XIV consultation with Western Samoa, in the light of the 1983 Article IV consultation with Western Samoa conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Western Samoa has made substantial progress in eliminating outstanding external payments arrears. The Fund approves the retention by Western Samoa of the exchange restriction involved in the maintenance of external payments arrears until June 26, 1984.

Decision No. 7609-(84/8), adopted
January 18, 1984

Review Under Stand-By Arrangement

The Fund and Western Samoa have completed the review required under paragraph 3(b) of the stand-by arrangement for Western Samoa (EBS/83/105, Supplement 1) of Western Samoa's adjustment policies, including interest rate and exchange rate policies. The Fund finds that no new understandings are necessary regarding circumstances in which purchases may be made by Western Samoa under the stand-by arrangement.

Decision No. 7610-(84/8), adopted
January 18, 1984

2. <u>BELGIUM - 1983 ARTICLE IV CONSULTATION</u>

The Executive Directors considered the staff report for the 1983 Article IV consultation with Belgium (SM/83/255, 12/21/83; and Cor. 1, 1/16/84). They also had before them a report on recent economic developments in Belgium (SM/83/257, 12/29/83; and Cor. 1, 1/16/84).

The Chairman observed that, in the past, consultations had been conducted jointly with Belgium and Luxembourg; however, in response to remarks by Executive Directors during the 1982 consultation, the staff had held separate consultations with the two countries for the first time, and the reports on those consultations appeared as separate items on the agenda.

Mr. de Groote made the following statement:

> The adjustment program pursued by the Belgian authorities in close consultation with the Fund since early 1982 has achieved significant results in the two areas where the Belgian economy had been in disequilibrium, namely, the balance of payments and the public finances. The program involved a major shift in the distribution of national income, away from households and toward export-oriented enterprises. As a result, the share of profits in the national income, which had declined each year since 1973, regained in 1982 its 1974 level. Given the subdued state of the world economy during 1982 and 1983, one may therefore submit that the economy has responded very positively to the adjustment effort. The current account deficit fell from BF 155 billion in 1981 to less than BF 50 billion in 1983, an improvement equivalent to 2.9 percent of GDP, which can be considered remarkable given the prevailing climate. Despite a foreign demand that was less supportive than anticipated, this adjustment exerted a positive effect on economic activity: the GNP growth rate reversed its negative trend, rising by 0.7 percent in 1982 in Belgium, while dropping by 0.5 percent in the seven major OECD countries. However, this improvement was clearly insufficient to have a positive impact on the finances of the public sector.
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> The staff has identified three main factors that contributed to the improvement of the current account of the balance of payments: first, gains in export market shares resulting from rapidly improving competitiveness after the February 1982 devaluation of the Belgian franc and the accompanying wage restraint maintained in 1982 and 1983; second, stabilization of the terms of trade despite the devaluation; and third, marked improvement in the balance of services.
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> The gain in market shares was limited in comparison with the magnitude of the exchange rate adjustment. This limitation is mainly attributable in 1982 to the pricing behavior of exporters, who preferred to obtain an immediate increase in

profitability by means of price increases rather than waiting for a gradual improvement in profitability through volume growth of exports. This pricing behavior was prompted by the extremely low profitability of enterprises, which necessitated an immediate improvement to make up for several years of steeply declining profits. Uncertainty about how long wage moderation would be maintained and how long world demand would remain depressed threw doubt on the possibility of improving profitability rapidly enough by means of the alternative course of volume expansion. It is rather uncertain whether a different pricing policy could ever have produced larger gains in market shares, under conditions of low world demand. Still, the pricing behavior of exporters did serve to avoid any worsening of the trade balance through traditional J-curve effects, since this policy permitted stabilization of the terms of trade. Early data for 1983 seem to indicate that volume effects dominated price effects during that year: indeed, for the first eight months export volumes seem to have increased by 5 percent, while OECD imports grew by 3.2 percent in 1983, implying further gains in market shares. Import volumes fell during the same period by 5 percent, showing also clear gains in domestic market shares. The improvement in the services balance was mainly attributable to a reduction of the travel deficit and improvements in the transportation and insurance balances, reflecting the reduction of households' net disposable income and improved price competitiveness.

A much lower than expected level of external demand and the resultant weak domestic activity, are the main reasons why the February 1982 policy package failed to produce any substantial improvement in the fiscal imbalance, which rendered unattainable the Government's goal of reducing the public sector borrowing requirement to 7 percent of GDP by 1985. The Government was instead forced to take additional measures to avert a further deterioration of its deficit. But even in the face of these adversities, the Government did succeed in stabilizing the net financing requirement of the public sector. The public sector's deficit share in GNP declined slightly in 1982 for the first time since the early 1970s. A further marginal decline in 1983 brought it down to 15.2 percent of GNP.

The Government intends to continue its adjustment efforts in 1984, preserving the gains made so far in the area of the external balance and especially intensifying its effort to reduce the government deficit. The Government is fully aware that a continuation of the budget deficit at its present level is inconsistent with a healthy recovery of the economy. This deficit maintains a level of demand that permits those sectors sheltered from external competition to increase their prices beyond what is justified by increases in productivity. These price increases are thus translated by the indexation mechanism into wage increases throughout the entire economy. The competitiveness of the export sector is in turn adversely affected by higher input costs and higher wage costs. If the budgetary imbalance is not reduced it will lead back into the same vicious circle that caused the Belgian economy to deteriorate substantially during the second half of the 1970s. Indeed, the relatively high level of inflation in 1983 could be partly attributed to this demand pressure. Reduction of the budget deficit thus remains a primary objective of the authorities.

In view of the very high tax burden, an improvement in the budgetary situation will have to come mainly from further restraint of expenditures. Here, too, however, there is limited room for strong action, since interest payments now represent 14.4 percent of total government expenditures and other public consumption has already been pared to a minimum. Short of dismantling the Government, the sole remaining area for further compression of expenditures is that of transfers. Current transfers to households and enterprises represent 36 percent of total expenditures, or 23 percent of GDP. However, following the transfer of income from households to enterprises that resulted from the measures of February 1982, the Government is reluctant to impose a large new transfer of income from the household to the government sector. As was also pointed out by the OECD in its report on Belgium, the deflationary impact of such a transfer could quite possibly annihilate the expansionary surge from the export sector, worsening the already high rate of unemployment and further exacerbating the fiscal imbalances. The authorities therefore consider that only a gradual reduction of social transfers is compatible with the maintenance of an adequate level of domestic demand. The Government is holding disbursements under the present social security system constant while it works on a comprehensive plan for fundamentally overhauling the system to better accommodate the aging of the population in coming years on the basis of a form of financing that will be neutral in terms of its relative costs to labor and capital. This system would link contributions to the social security system to the value added generated by enterprises, rather than to wage costs.

It is the view of the authorities that the relative liquidity of the domestic financial markets, which permitted a steep reduction of external borrowing in 1983, will allow such a gradual reduction of the budget deficit. They are of the opinion that for the moment there is little danger of crowding out, so long as the level of investments remains unusually low; even if allowance is made for a gradual picking up of enterprise investment demand in 1984, they feel that any crowding out would be of short duration because the expansion in economic activity would improve fiscal receipts, reduce expenditures, and improve the budget deficit. Therefore, the authorities feel that keeping interest rates as low as possible in order to stimulate investment will pose no threat to their objective of minimizing external borrowing to fund the budget deficit. They feel that on balance the risk of too low a level of economic activity is greater than the risk of crowding out the private sector, and they therefore prefer to keep interest rates as low as possible. The volume of investment activity in the manufacturing industries did in fact decrease by 5 percent in 1983, and although some recovery is expected in 1984 the Government is understandably reluctant to narrow its chances by allowing interest rates to rise, particularly since most indicators of business activity showed some stagnation from mid-1983 onward.

This policy of relatively low interest rates is responsible for the weak position of the Belgian franc in the European Monetary System (EMS). There is the corollary risk of making the Belgian franc more vulnerable to speculation pressures. The authorities have shown in the recent past, however, that they will not hesitate to raise interest rates drastically to counter such speculation. There should therefore be no doubt in the market about the firm intention of the Belgian authorities to defend the present exchange rate within the EMS. These temporary increases in interest rates, regrettable though they may be, have a less negative impact on economic activity than constant high interest rates and will strengthen confidence in the Government's policies.

To further bolster the confidence of private enterprise, the authorities adopted a wage policy aimed at conserving the gains of the last few years in competitiveness and profitability. Although wage indexation has been fully established, the effects of price increases are being dampened by the use of a four-month sliding average. In addition, the resulting wage trends are being checked against a competitiveness norm based on wage increases in Belgium's seven most important trading partners. If the wage increases should exceed this norm, discussions will take place among the employers, the employees, and the Government with a view to holding the line on further wage increases. Measures to that end may include the temporary suspension of the indexation mechanism. The Government has already indicated that the present incomes policy will be maintained till the end of 1986 to ensure a balance in the external sector as economic activity increases. The competitiveness norm will be integrated in the sectoral wage agreements to be concluded in the summer of 1984. If this approach does not succeed, the authorities would impose the required wage moderation by law.

This assurance of continuing wage moderation in the years ahead, and of a gradual but continuous reduction of the budget deficit, should bolster private sector confidence and stimulate a revival of investment activity. Economic growth in Belgium should indeed be based on exports and investment for a number of years in order to reduce the high level of unemployment and further reduce the fiscal and external imbalances. The Government firmly intends to pursue its present policies, and to intensify its efforts, as required, to achieve an adjustment of the economy while making minimum use of deflationary actions to accomplish this adjustment.

Mr. Polak said that he welcomed the move toward separate discussions with Belgium and Luxembourg, countries that had experienced quite different problems over the years. Oddly enough, it might have been fruitful if the staff had held simultaneous consultations with Belgium and the Netherlands, a Benelux pair that had some remarkable similarities as well as some interesting differences.

In both countries, Mr. Polak continued, unemployment was appallingly high--about 15 percent--GDP growth had been low or nonexistent, and the budget deficits lay in the two-digit range--about 12 percent in the Netherlands and about 15-16 percent in Belgium. Although the two countries had a depressed level of investment, Belgium had a small current account deficit and the Netherlands a large current account surplus. Inflation in Belgium had been higher than in the Netherlands by about 5 percentage points in 1983 and would still be higher in 1984, by about 3 percentage points; not surprisingly, both long-term and short-term interest rates in Belgium were also higher. And in both countries, the ratio of government expenditure to GDP was extremely high, 63 percent in Belgium and 70 percent in the Netherlands.

Against that broadly similar background, the policy stance in the two countries was quite different, Mr. Polak commented. The aim of the authorities of each was to improve the business climate and to reactivate investment, but attention in the Netherlands was focused on reducing the budget deficit while in Belgium--following the structural measures taken in 1983--it was directed mainly at maintaining aggregate demand. The contrast was perhaps even more striking when it was recalled that the position of the Netherlands was stronger than that of Belgium in a number of areas, including the balance of payments, the exchange rate, international indebtedness, and inflation. Still, in spite of the difference in approach, the expected outturn for 1984 in the two countries was not strikingly different: a 2 percent or 3 percent increase in industrial production, some modest recovery in investment, and very little change in the government deficit as a percentage of GDP was projected for both Belgium and the Netherlands.

Turning more specifically to the Belgian consultation, Mr. Polak considered that a lasting reduction in unemployment was perhaps the most important of the goals of economic policy. He agreed with the authorities that only a revival of the sector that produced for the market could provide sustainable relief on the scale necessary. For that to happen, however, adequate profitability and competitiveness were essential. In that regard, he hesitated to comment on the Belgian experiment with work sharing, and he noted that his hesitation was apparently shared by the staff, which had stressed only the need for flexible implementation. Nonetheless, he would be following the experiment with great interest.

Major improvements had been made in the past two years in competitiveness and profitability in Belgian industry, Mr. Polak continued. Hence, some of the preconditions for a pickup in investment had been established, although he would not go so far as the staff in suggesting that the foundation for investment revival had been laid. Some very difficult problems remained to be resolved. For example, the current account was still in deficit at a time when investment was quite low; inflation was running at about 7 percent and might be on the increase; the wholesale price index had risen at a rather alarming 14 percent over the past six months; and he was concerned about the reintroduction of full indexation of wages, especially since there was a need for further improvement in the profitability of Belgian industry.

Given the problems he had mentioned, he was particularly worried about the stance of monetary policy in Belgium, Mr. Polak said; indeed, he had some difficulty in grasping what monetary policy was at present. The report on recent economic developments in Belgium (SM/83/257) contained no monetary figures for 1983, and there was at least a six-month delay in all monetary statistics for Belgium in International Financial Statistics (IFS). He was concerned that such a delay might be related to a lack of interest in monetary policy. In any event, it was clear that the central bank was playing a most accommodating role in meeting all the financial needs of the Treasury. On the assumption that Belgium would maintain the policy of a fixed exchange rate in the EMS and a strong currency option with the EMS--a policy that he could endorse--there was the danger of renewed excess demand in the sheltered sector and a spillover leading to erosion of profitability in the traded goods sector. Hence, he urged the authorities toward a stricter monetary policy and somewhat higher interest rates, if necessary, to reduce capital outflows and monetary financing of the public sector deficit, thus giving added credibility to exchange rate policy. The long-run beneficial effect of a stricter monetary policy should outweigh the direct short-term cost to the budget of higher interest payments. He noted in passing that the main reason for the lack of a revival of investment did not seem to be the level of interest rates, which were by no means low at present.

The problems of the budget were among the most difficult to resolve in Belgium, Mr. Polak considered. The authorities apparently felt that, since the persistent 16 percent of GDP deficit had recently become easier to finance, "...the urgency of reducing it has temporarily eased." Mr. de Groote had gone even further by stating that important expenditure cuts and tax increases were impossible, which implied a complete reliance on future GDP growth for reductions in the budget deficit. However, given the present level of real interest rates and low economic growth in Belgium--both of which might prevail for some time--further cuts in real expenditures would be required each year just to keep the deficit ratio from increasing, assuming that no action was taken on the tax front. In the circumstances, he agreed with the staff that there was an urgent need to reduce the level of real public spending. It was unfortunate that the staff had not described the gravity of the problem in quantitative terms; his own calculations showed that, to reduce the deficit to half its present level by 1989, real public noninterest spending would have to be reduced by 2 percent of GDP each year throughout the period.

The current situation in Belgium implied a triple threat to investment, including the threat of increased inflation, higher interest rates, and higher taxes, Mr. Polak said. Coming to grips with the bloated level of government spending would of course strike at the heart of the problem; however, even if some component of the solution were to be an increase in taxes, that would still be better than keeping the economy permanently under the paralyzing triple threat he had mentioned. Finally, noting that the Government was concerned about the impact of a reduced deficit on aggregate demand, he agreed with the staff that the more important negative factor in present circumstances was the effect on investment of current fiscal policies.

Mr. Lovato observed that Belgium exemplified the predicament of a mature industrial economy undergoing a momentous adjustment process in order to overcome external imbalances and domestic malfunctionings. As noted by the staff, cyclical strains had been linked with--and were deeply rooted in--difficulties of a more structural nature, which were common to other industrial economies and largely stemmed from the sluggish response to economic changes in the outside environment. Changing patterns in international trade and production, and movements in competitiveness and comparative advantages, could not be easily or quickly accommodated by an economic system characterized by an old industrial structure, institutional rigidities, and long established practices in public spending. Still, given Belgium's economic situation, he could not fail to observe with appreciation the intensity and skill with which the authorities had tried--apparently with some success--to implement wide-ranging adjustment measures in 1982 and 1983, including a sizable exchange rate correction, a temporary deindexation of wages, and a stabilization of the budget deficit. The beneficial effects of those policies, which had carried well into 1983, had been usefully documented in the staff paper, mainly in terms of the reversal in cost competitiveness trends and the recovery in the profitability of enterprises.

In the hope of spurring a pickup in private investment, the authorities had initiated a strategy for achieving a redistribution of disposable income from households to enterprises, Mr. Lovato continued. Unfortunately, the results had fallen short of expectations, and it had become clear that recovering profit margins did not necessarily lead to higher capital formation. He would welcome some elaboration on the specific causes of the continued stagnation of investment in Belgium, a matter on which there appeared to be some disagreement between the Belgian authorities and the staff. The authorities regarded the stimulative policies recently adopted as adequate to foster the desired recovery in private investment and to reorient the senescent industrial structure; they underscored, in particular, the increased gross profit margins and the fiscal incentives granted corporations. The staff, on the other hand, had stressed that public policies could not be supportive of investment activity until and unless public spending was curtailed. Such a curtailment was deemed to be a precondition for a self-sustaining recovery in domestic demand.

There also appeared to be differences of opinion on the wider issue of fiscal policy, Mr. Lovato commented. The authorities had emphasized the cyclical component of the budget deficit and were concerned primarily with the interrelationship between fiscal restraint and the path of demand and employment. Generally speaking, their preference was to rely on a pickup in aggregate activity to reduce the deficit, and they had indicated that they would consider some further cuts in public spending only if those cuts were phased in and linked with a cyclical pickup in activity. The staff, on the other hand, believed that continued large budget deficits and the recovery of economic activity were mutually incompatible and that there was no room for a gradual approach to the curtailment of public spending. In principle, he was inclined to accept the staff's arguments and he would prefer to see substantial cuts in the short run. However, he recognized that such cuts could not be easily implemented; given the social, institutional, and demographic complexities of the Belgian case, a gradual approach toward a reduction in social transfers--along the lines advocated by Mr. de Groote--might be more feasible.

On incomes policies, Mr. Lovato expressed interest in the new "double norm" mechanism for wage determination. Noting that the wage-setting process had returned to a fully indexed scheme, he wondered whether there was any consensus on the deindexation of price increases stemming from shifting terms of trade or changes in indirect taxation. Also, he had some difficulty interpreting the logic and purpose of the second "norm." The first clearly required that real wages should remain unchanged, while the second involved a complex mechanism geared toward maintaining cost competitiveness. However, unit labor costs, rather than wages, were what mattered, since productivity changes were bound to occur; moreover, the exchange rate should not be seen as a constant in the exercise to the extent that only wages were adjusted to attain the desired competitive position.

Commenting on external policy, Mr. Lovato welcomed the decline in official external borrowing brought about by the moderate reserve and capital account targets. The authorities' intention to persevere in further reducing external debt was also to be commended. Finally, like the staff, he noted with appreciation Belgium's liberal trade and payments policy, and he had no difficulty with its dual exchange market arrangement.

Mr. Laske observed that the adjustment process initiated in Belgium in early 1982 had led to impressive achievements, particularly the restoration of international competitiveness and a substantial improvement in the financial condition of enterprises. During 1983, the Treasury had been able to mobilize more domestic funds than in the past for the financing of the budget deficit, and the growth of real GNP had proved somewhat better than in other European countries. Those satisfactory results seemed to have had their origins mainly in two developments, which had been at the center of the authorities' adjustment effort: the downward correction in real wages; and the depreciation of the real effective exchange rate.

Despite the progress thus far, there were elements of the Belgian economy that continued to give cause for concern, Mr. Laske continued. High unemployment threatened to stall the Government's efforts to reduce the public sector deficit, investment activity in the business sector remained depressed, continued high public spending could undermine the beneficial effects of the wage moderation in recent years, and the rate of inflation in Belgium was significantly higher than in its important trading partners. Remarking on the general thrust of the authorities' policy approach, he observed that the original strategy of revitalizing the industrial sector--which included an effort toward wage restraint and a reduction of the public sector deficit--seemed to have been put on hold for the time being. It would be regrettable if the delay in implementing that strategy were to jeopardize the gains made thus far, particularly since those gains were the foundation on which a sustainable recovery could be built.

The temporary and partial deindexation in the wage determination process had produced the desired redirection of income toward the business sector, and the resulting strengthened profitability of enterprises justified the expectation of a pickup in business investment, even though that expectation had not been realized thus far, Mr. Laske said. Obviously, further reductions in real wages would be politically difficult to effect and might not be required, at least at present. Nonetheless, the reintroduction of full indexation could create problems, and he fully shared the reservations of the staff in that regard.

The unfavorable prospects for private sector employment underscored the need to preserve the recent gains in competitiveness, Mr. Laske considered. The double norm system built into the reintroduced indexation scheme might provide an adequate safeguard against the recurrence of losses in competitiveness for a short while; however, for the longer term, it might not prove to be an efficient solution to the problems of wage costs and inflationary pressures inherent in all indexation schemes. Some kind of a "competitiveness norm" might be worthy of consideration in the circumstances.

On the fiscal side, despite the improvement in industrial profitability resulting from the downward adjustment of real wages, business investment remained depressed, Mr. Laske noted. The main cause for the sluggish response of business investment to improved circumstances might well be the continuing high level of real public expenditures. The staff in its appraisal had succinctly analyzed the relationships between reduced wages, industrial profitability, and business investment, and it was clear from Mr. de Groote's statement that the Belgian authorities seemed to share many of the staff's concerns. Nonetheless, they felt that public sector demand must support economic activity and aggregate demand so long as foreign demand and private investment remained at unsatisfactorily low levels. There had been indications in recent months that a recovery was underway in the industrial countries and that steady progress was not unlikely. In the circumstances, the rationale for supporting the economy through additional public sector expenditure was perhaps no longer as strong as it might hitherto have been. The authorities should therefore perhaps give greater consideration to encouraging private investment and reducing the public sector borrowing requirement, especially as the possibilities for higher taxation had been nearly exhausted. Raising tax rates--either for direct or indirect taxes--would probably turn out to be counterproductive; indeed, the gains in business profitability in 1983 had been partially eroded by the increase in social security taxes. Higher taxation in general would cut into enterprise profitability and adversely affect the investment potential. The authorities should rather look toward reductions in expenditure to contain the budget deficit.

Of course, the social and political costs associated with high unemployment in Belgium provided the authorities with strong arguments against a deliberate and rapid reduction of public sector expenditure, Mr. Laske continued. Nonetheless, fiscal adjustment had become rather protracted, and the level of public spending and the interest burden of the public debt had assumed magnitudes that called for a determined effort to restrain public expenditures in order to slow down or stop further increases in the public sector debt. The Government's earlier efforts toward that end seemed to have weakened over time.

On interest rate and exchange rate policy, Mr. Laske remarked that, like other European countries, Belgium faced a dilemma in which exchange rate developments could force the authorities to pursue an interest rate policy that did not fully conform to the requirements of the domestic economy. Thus far, the Belgian authorities had been skillful in avoiding the dangers of that dilemma. It was their intention to keep the Belgian franc toward the bottom of the EMS band and to maintain interest rates at the lowest possible level, an approach that was consistent with their reserve and foreign borrowing objectives. However, there were a number of risks inherent in such an approach, and the authorities might do well to look toward greater flexibility. The interest rate adjustment in November 1983 and the more recent use of intramarginal EMS interventions seemed to suggest that the authorities were indeed implementing exchange and interest rate policies in a pragmatic way.

Mr. Leonard noted that the staff paper dealt with a phase in the management of the Belgian economy initiated in February 1982; much still remained to be done. Of course, the policy actions taken in that phase had resulted in a significant correction of adverse trends in the economy, but several important residual sources of weakness remained. The matter of primary interest for the Executive Board in its current discussion was the direction that economic policy in Belgium should take in future to safeguard the gains made thus far and to complete the process of correction; there were differences in approach as between the Belgian authorities and the Fund staff.

The major achievement of the authorities in the period under review concerned the external balance and the effort to reverse the long-term deterioration in the economy's competitive position, Mr. Leonard continued. The goal of improvement in those areas had been met to a great extent, although only qualified success had been achieved in improving the competitiveness of the manufacturing sector. The authorities had met yet another precondition for future growth by shifting the proportion of national income going to households and enterprises in favor of the latter. Moreover, private sector savings had increased and had enabled a larger part of the public sector's demand for funds to be met from domestic sources. On the fiscal side, progress had been modest. The past trend of rapidly rising public sector deficits had been arrested, but the shortfall between overall expenditure and revenue in 1983--and that in prospect for 1984--remained quite large. Indeed, the net borrowing requirement of the Government in 1984 was expected to be 15-16 percent of GNP, or about the same as it had been in 1983.

Thus far, the response of the economy to the forceful measures adopted by the authorities had been less than might have been hoped, Mr. Leonard commented. Exports had improved--largely through an increase in the share of sluggish external markets--and the current account deficit was estimated to have fallen from BF 199 billion in 1982 to BF 60 billion in 1983. Net private capital outflows also appeared to have been stemmed. Against that background, however, investment had merely stabilized, despite pay moderation and the shift in income in favor of enterprises. The easing in the rate of inflation had been slight, and future price movements remained uncertain. Unemployment was continuing to rise, and overall growth in GNP, although positive and welcome, had not provided the expected boost to government revenues and improvement in the public finances. The broad question at present for policymakers therefore was whether the measures employed thus far had effected sufficient changes in underlying economic conditions to provide the basis for balanced growth in future--even if it was to be less marked and slower in coming than might have been expected--or whether new, remedial action was called for.

The authorities and the staff shared much common ground in their approaches to future policies, Mr. Leonard considered. However, the inclination of the authorities was toward the support of aggregate demand in 1984 rather than toward further retrenchment. That inclination was evident in the restoration of wage indexation--albeit, within the limits of the double norm--in the limited recourse to further reductions in public expenditure, and in the direction of interest rate policy. Still, the approach of the authorities was understandable, particularly with respect to their desire to keep interest rates down. The rate of return in manufacturing enterprises relative to long-term interest rates was well below the level of a decade previously; while the ratio remained unfavorable, the tendency for companies to use profits to accumulate financial surpluses instead of undertaking investments was likely to continue.

With regard to the application of the double norm, the authorities were committed in their incomes policy to conserving the gains already achieved in competitiveness and profitability, Mr. Leonard continued. In the fiscal area, Mr. de Groote had stressed the Government's clear appreciation of the threat to healthy economic recovery posed by continued budget deficits at present levels; at the same time, he had adduced reasons why the reduction in the deficits--which, for the time being had to be effected through a containment of fiscal transfers to households--could only be gradual and was allowable because of the relative liquidity of the domestic financial markets. Even if the authorities' approach could be supported, it was in many respects precarious. For example, while application of the double norm should help to avoid losses in competitiveness, indexation of wages was itself likely to inhibit any further improvement in the profitability of the exposed sectors of the economy.

Continued public sector deficits could also lead to a deterioration in competitiveness through the familiar vicious circle of excessive demand, price increases in the sheltered economic sectors, and higher nonwage costs--including increased social security contributions--for manufacturers and exporters, Mr. Leonard considered. Even the expectation that the deficits would continue was likely to have an adverse effect on business confidence and investment decisions because of the implicit assumption that the deficits would ultimately lead to higher inflation with accompanying higher levels of taxation and interest rates. The staff was clearly aware of such dangers and had modified its approach to future policy in Belgium accordingly. The points made by the staff in support of its approach were well taken and deserved careful consideration. Both the authorities and the staff saw satisfactory recovery as dependent on more buoyant world trade and on the ability of the Belgian economy to take advantage of it. In closely aligning its policy recommendations with those requirements, the staff had been both consistent and prudent, and he could support the staff's view that, given the high export/import component of production, much of the effect of any fiscal stimulus would be lost abroad. Moreover, in the present trading circumstances, efforts to support aggregate demand carried the danger of high interest rates, which were an important element in the current weak economic performance. In the circumstances, it would seem wiser for the authorities to continue to concentrate on consolidating and even furthering, if possible, the progress that had been made.

Mr. de Maulde recalled that, on the occasion of the 1982 Article IV consultation with Belgium, a number of Directors had expressed skepticism about projected improvements in the economy. He was happy to note that that skepticism had been misplaced; nevertheless, because it was apparently so easy to be wrong about Belgium's prospects, caution should be exercised.

The success of the Belgian authorities during the past two years had been most evident in the rapid improvement of the external balance and the restoration of business competitiveness, Mr. de Maulde continued. The measures adopted in the wake of the devaluation of the national currency had resulted in a reduction in the current account deficit of BF 140 billion, so that the deficit at present was only about 30 percent of the level registered in 1981. He was pleased to note from Mr. de Groote's comments that Belgian exporters had taken a positive attitude toward the devaluation; by choosing immediate price increases rather than an uncertain expansion of sales, they had succeeded in flattening the traditional "J" curve so that export volume had expanded in due course. Moreover, improved confidence and higher interest rates had boosted foreign capital inflows so that the external borrowing requirement had dropped from 8 percent of GNP in 1981 to only 3 percent of GNP in 1983.

A related success story could be found in the restoration of the profitability of enterprises to the 1970-73 average, Mr. de Maulde commented. The 20 percent decline in hourly wage costs that had taken place over the past two years was unprecedented in a peace-time western economy. In passing, he noted that the staff might usefully have provided Directors with a comparison of current profitability in the manufacturing sector as between Belgium and other industrial countries. From Table 2 of SM/83/255, it was clear that the share of enterprises in disposable income had averaged 9.4 percent in 1983; he would have appreciated comparable figures for, say, the United States, the United Kingdom, Germany, France, and the Netherlands as a way of obtaining a better sense of Belgium's performance.

Despite the positive developments he had mentioned, much remained to be done, Mr. de Maulde remarked. The authorities continued to face the threefold burden of a heavy public debt, an aging population, and an unsustainable rate of unemployment. He had read with interest Mr. de Groote's suggestion to link firms' contributions to the social security system to their value added rather than to wage costs in order to make the financing of such transfers neutral with respect to the relative costs to labor and capital. However, he had some doubts about that approach; to impose additional charges on the capital element might well be counterproductive in terms of new investments and the modernization of the manufacturing sector. It was clear that expenditures had to be cut further somehow, and meeting that goal might require more courage than ingenuity. Certainly, the Belgian authorities had demonstrated in the past that they did not lack such courage; in that regard, he welcomed the recent vote of the Belgian Parliament to reduce the 1984 budget deficit to 11.5 percent of GDP from 12.8 percent in 1983.

On incomes policies, the Belgian authorities had found it politically impossible to avoid restoring the traditional system of wage indexation, especially as new elections would take place in the spring of 1984, Mr. de Maulde said. The Fund staff was concerned about the reintroduction of the indexation scheme and had noted that the recovery of profitability was incomplete, that old rigidities would be reinstalled, and that the Government's margin for maneuver in public tariffs and tax policy would be limited. Mr. de Groote, on the other hand, had insisted that the combined use of a four-month sliding average and of a "competitiveness norm" based on wage increases in Belgium's seven trading partners would make the wage indexation system quite innocuous. On balance, he sensed that the authorities had probably done the maximum feasible to limit the consequences of a regrettable but unavoidable decision; still, the reinstitution of the indexation system entailed serious risks for the future.

He had little to say about specific investment policies, especially as the Belgian authorities apparently did not believe in them, Mr. de Maulde commented. He regretted that they continued to extend financial assistance to declining industries instead of using available resources to promote diversification in growth sectors; nonetheless, from a practical point of view, it was difficult to see how they could have done otherwise, given the present level of unemployment. Finally, on exchange rate policy, he agreed with the staff that "the gains in competitiveness which have been achieved justify the policy of maintaining the stability of the Belgian franc within the EMS." The dual market mechanism had worked in such a way as not to cause partners or the Fund any worry, and the authorities should be commended for their approach. Like others who had admired the accomplishments of the Belgian authorities over a very short period, he hoped that their gains would not be as quickly lost in future.

Mr. Hirao said that he could support the thrust of the staff appraisal and could join those who had commended the progress registered by Belgium's economy over the past two years. The reversal in the deteriorating trend in industrial profitability and the restoration of hourly wage cost competitiveness to the 1970-73 average were encouraging, and the strong improvement in the external balance--which had been supported by a gain in export market shares and the stabilization of the terms of trade--was remarkable. Credit for those achievements should go to the Government's economic strategy, which included a suspension of wage indexation, a reduction in corporate taxes, and a reduction in the public sector borrowing requirement.

Unfortunately, investment activity had failed to pick up, Mr. Hirao continued. He agreed with the staff that an upturn in industrial investment was critically needed so that the gains made thus far could be transformed into a self-sustaining recovery. In order to secure such an upturn, it was crucial for the authorities to contain public expenditure. Total general government outlays had been equivalent to more than 60 percent of GNP, and public debt currently stood well over 100 percent of GNP. He had noted with interest the authorities' arguments that reductions in the public sector deficit would have to be phased in with a pickup in external demand and more buoyant domestic activity so that high employment, which was critical to financial viability, could be maintained.

He observed from SM/83/257 that the efforts of the authorities to cut the government deficit--initiated in 1982--had been frustrated by a spending overhang from the previous year, Mr. Hirao continued. In 1983, slower than forecast nominal GNP growth had again prevented the authorities from attaining their objective. In that respect, he shared the staff's concern that the present level of public expenditure created some momentum for tax increases, including business taxes. To the extent that public expenditure was not financed by additional taxes, higher monetary financing would be inevitable, and inflationary pressures would remain strong. And that combination of factors created a risk that the competitiveness of the industrial sector might be undermined.

Like others, he had noted with some concern the return to full indexation in Belgium, Mr. Hirao said. He could understand the argument that such a change was necessary to alleviate poor demand prospects--which were seen as the main obstacle to a recovery of investment and an upturn in employment--but he agreed with the staff that the resumption of indexation could entail the danger of reintroducing the rigidities associated with the full indexation system. Of course, the establishment of a double norm should prove helpful if utilized fully, and the staff's suggestion that the competitiveness norm should be defined for a period of two years was worth considering.

The authorities' intention to reduce external borrowing in 1984 and to eliminate it in 1985 was welcome, Mr. Hirao commented. If their intention was to be fully realized, it would be essential to reduce the public sector deficit as initially planned. Finally, with regard to interest rate management, he sympathized with the concern of the authorities that interest rate changes might have a significant impact on the public sector borrowing requirement, given the size of the public debt. He had also taken note of the staff's view that the effort to achieve the twin objectives of maintaining international reserves and restraining net private capital outflows ran the risk that abrupt changes in interest rates might be required. It was to be hoped that, with close monitoring of external sector developments and skillful management by the authorities, the continuity of financial policies, including interest rate management, would be maintained.

Mr. Erb considered that the Belgian authorities had made progress toward their primary goal, established in late 1981, of restoring the productivity, profitability, and competitiveness of the economy. The partial suspension of wage indexation in 1982 and 1983 had been an important step toward that end. As noted by other Directors, the current account deficit had improved considerably over the past two to three years, and the turnaround in private capital flows in the later part of 1983 had been an encouraging sign. The recent pattern of changes in the volume of exports and imports showed that there had been perceptible readjustment to the worsened terms of trade caused by the second oil shock; in each of the past four years, real export growth had exceeded real import growth. Moreover, improved competitiveness had enabled Belgium to improve its position vis-à-vis its major competitors in world markets.

Despite the progress made, there remained serious problems in the Belgian economy, Mr. Erb continued. First, there had been no recovery in investment; second, the resumption of full wage indexation in 1983 raised questions about the durability of the recent improvement in Belgium's competitive position; third, the continued high public sector transfers and the resulting fiscal deficits threatened economic recovery; and, finally, the foreign debt accumulated in recent years could pose problems for debt management in the future. If Belgium was to continue its progress toward restoring sustainable economic growth over the longer term, a resumption of fixed investment would be essential. Negative growth in gross fixed investment in each of the past three years, together with the decline in the investment/GNP ratio to only 17 percent in 1982, were worrisome signs.

The growth of capacity utilization, the improved financial position of enterprises, and the growing recovery of world demand might well offer prospects for better investment performance in Belgium in 1984, Mr. Erb commented. However, the return to full indexation and the continuing grave problem of the large public sector deficits--caused to a great extent by large-scale social transfers--threatened the longer-term prospects of the economy. An important step had been taken by the authorities in suspending full wage indexation during the past two years, and he agreed with the staff that the return to indexation, without any substantial change in the basic system, could eventually undo the progress achieved to date. Of course, the double norm idea of limiting wage increases in 1984 to those generated by the indexation system and to no more than the average wage increase in Belgium's seven principal trading partners should help to contain wage costs for another year; and Mr. de Groote's indication that the present incomes policy would be continued through end-1986 was encouraging. Nonetheless, he urged the Belgian authorities to consider ways in which the wage indexation system could be revised more fundamentally to limit its effects in perpetuating inflationary pressures and to reduce or eliminate the impediments created by the system for wage differentiation among various sectors, for the use of public tariff and indirect tax policy, and for resisting the adverse effects on the economy of external shocks.

The public sector deficit had proven to be an intractable problem in Belgium as in a great many other countries, both developed and developing, Mr. Erb considered. The authorities' success in stabilizing the public sector borrowing requirement at 16 percent of GNP for three years represented some progress; however, continued large deficits complicated control over monetary expansion, competed against private sector investment financing needs, contributed to inflationary pressures, and threatened the restoration of the external balance. The ratio of public expenditure to GNP had risen steadily each year from about 44 percent in 1974 to 64 percent in 1982. While the revenue/GNP ratio had also risen somewhat, it had not kept pace; and even if economic recovery in 1984 were to raise revenues sufficiently to encroach on the deficit somewhat, that would not resolve the underlying structural problems related to the growth of expenditures and, perhaps, to the composition of revenues.

An even more important element in the public deficit was the growth of transfer payments and of interest on the public debt, Mr. Erb remarked. Transfers had risen from 19 percent of GNP in 1974 to 27 percent in 1982, while interest payments had increased from 3.5 percent to 9.5 percent during the period. A large component of transfers to households was related to the growth of social insurance benefits; at the same time, between 1974 and 1982, the share of contributions by employers had fallen from 48 percent of the total to 34 percent, while employees' contributions had remained virtually unchanged at 25 percent of the total. The difference had been made up by an increase in state subsidies, from 24 percent of the total to 39 percent. Some decline in the social insurance costs to employers seemed justified as part of the effort to improve industrial competitiveness. However, the growth of state subsidies as a source of financing social benefits raised questions about the longer-term financial soundness of social programs, particularly given the persistent problem of large public sector deficits. It was encouraging in that respect to note that the authorities were working toward a comprehensive plan to overhaul the system.

On the revenue side of the budget, there had been a perceptible shift in the relative burden of taxation from indirect taxes toward direct taxes, Mr. Erb observed. Direct taxes had accounted for 14 percent of GNP in 1974 and had grown to 20 percent in 1982, while indirect taxes had risen from 12 percent to only 13 percent of GNP over the period. The authorities had decided that the tax burden should not be increased further, which seemed wise in view of the disincentives to productivity and savings that a further increase could create. However, an examination of the effects on consumption and savings of the present balance of direct and indirect taxation might be worth considering.

The staff had rightly focused attention on the rapid accumulation in recent years of foreign public debt and its unfavorable maturity structure, Mr. Erb recalled. The increase in the foreign public debt from $1 billion in 1977 to $23 billion by end-1983 was striking and, from a longer-term point of view, worrisome, especially since such borrowing had in effect been used to maintain high consumption standards rather than to finance an increase in the productive base. In sum, considerable progress had been made in adjusting the Belgian economy to recent changes in the world economic environment and in improving the economy's competitive position, and there were some prospects for further improvement with ongoing world economic recovery. However, there remained a number of disturbing and apparently structural imbalances in the economy including, in particular, the level of real wages and social transfers in comparison with those in other economies. Those imbalances had their roots in the attempt of the Belgian people to maintain a level of consumption that could not be supported by the country's productive base; indeed, efforts to maintain a high consumption standard appeared to have been undermining it. In the circumstances, it would appear that future economic growth could be jeopardized unless the Belgian people accepted the need for cuts in current consumption.

Mr. Tshishimbi said that he was in broad agreement with the staff appraisal, which showed that the economic situation in Belgium had deteriorated significantly over the past decade, with disequilibria in both the external and the public sectors. There were two main sources of those imbalances: first, a generalized loss of competitiveness and profitability of Belgian industry, which, in turn, had led to a large scale deindustrialization of the economy and had caused growing unemployment; and, second, a high level of public spending, which had been financed through a large public debt originating partially from abroad. Public spending had also contributed to the maintenance of high interest rates, which tended to crowd out private investment.

The policy measures adopted by the authorities in early 1982 had gone a long way toward reducing the disequilibria, Mr. Tshishimbi continued. The most significant progress had been made in the area of competitiveness of the manufacturing industry, owing to two major policy measures: the devaluation of the Belgian franc, and the partial deindexation of wages. Belgian unit labor costs had declined significantly in 1982, both in relation to industrial countries in general and to EMS countries in particular. Further declines had been recorded in the first half of 1983. The partial deindexation of wages had succeeded in containing the growth of real wages and, thus, had contributed to redistributing incomes away from wage earners in favor of enterprises, particularly in the export sector. As a result, the profitability of Belgian enterprises had been restored, and their share of disposable income had recovered to levels registered in the early 1970s.

The progress achieved in the competitiveness of Belgian export-oriented industry and the favorable developments in the terms of trade for the past two years had contributed to an improvement in the performance of the export sector, which, together with favorable developments in the services sector, had strengthened the external current account, Mr. Tshishimbi commented. The recorded deficit of the current account on a cash basis had dropped from around BF 200 billion in 1981 to BF 116 billion in 1982 and was expected to fall further to BF 60 billion in 1983. The policy measures in the 1982 program--which provided incentives to invest in Belgian franc-denominated assets--and the concurrent increase in investors' confidence had served to reverse the outflow of capital. Although caution should be exercised in interpreting capital flows, especially given the speculative trade flows that had characterized the EMS system, he tended to give credence to the indication in the staff report of growing capital inflows in the first half of 1983.

In the public finance area, positive results had been more limited, Mr. Tshishimbi considered. The trend of fast rising deficits had been arrested, and the share of the current expenditure in GNP had been stabilized. In the past, deficits had contributed to the buildup of a huge public debt, which had exceeded GNP at the end of 1982. The authorities' commitment to reduce both the deficit and the Government's borrowing requirements in the current fiscal year--albeit only marginally--were welcome. As Mr. de Groote had explained in his statement, a combination of a lower than anticipated external demand and slackened domestic activity had made it difficult for the Government to achieve a more substantial reduction in the deficit in 1983. Even the initial goal of reducing the borrowing requirement to 7 percent of GNP by 1985 seemed beyond reach; however, he welcomed both the authorities' determination to pursue their adjustment efforts and the emphasis they had placed on the reduction of the budget deficit. Given the high taxation rate, progress toward that goal would have to be achieved mainly through a gradual reduction in social transfers.

The unemployment rate in Belgium--about 15 percent of the labor force--remained the highest among European OECD countries, Mr. Tshishimbi noted, and prospects for improvement in 1984 were slight. It was difficult to generate employment without a full resumption of economic growth, which, in a depressed economy like that of Belgium, required new investment. Unfortunately, while Belgium experienced some success in restoring business profitability and competitiveness, those gains were not resulting in increased investment. The authorities were apparently in agreement with the staff that the public deficit should be reduced as a matter of the highest priority. In the monetary policy area, they were committed to maintaining interest rates at the lowest level compatible with the country's foreign exchange reserves and capital account targets.

The incentives for competitiveness and profitability created under the current program must be maintained for long enough to sustain the confidence of private investors, Mr. Tshishimbi continued. In that respect, the restoration of the full indexation of wages to the price index of goods and services had created legitimate apprehensions that the economy might soon find itself again entrapped in the vicious price/incomes circle that Mr. de Groote had mentioned in his statement. It was thus reassuring to learn that the Government had adopted an incomes policy that would not only dampen the effects of the price increases by using a four-month moving average but would also provide a mechanism to contain the wage increases within a competitiveness norm based on Belgium's major trading partners. Finally, he wished to express his appreciation for Belgium's contribution to development assistance. Despite the economic difficulties facing the country, the authorities had increased official development assistance (ODA) to 0.62 percent of GNP in 1983 and had committed themselves to reaching 0.7 percent of GNP in the near future.

Mr. Clark, indicating his general endorsement of the staff appraisal, said that he was pleased by the staff's analysis of Belgium's structural problems; that type of analysis deserved wider application in reports on other OECD economies as part of the Fund's surveillance function. In Belgium's case, the analysis might have been enhanced if it had been carried forward into the medium term and had included more on trade policy. He recalled that the Executive Board had agreed in April 1983, during its discussion of surveillance, that the coverage of trade policy matters in Article IV reports should be expanded. That guidance would seem to have particular relevance for an economy like that of Belgium, where trade policies might have implications for the process of industrial restructuring.

The measures taken by the authorities since the end of 1981 were to be welcomed, Mr. Clark continued. Both the external position and industrial competitiveness had greatly improved and, as the staff had noted, the critical issue at present concerned prospects for investment. Although the financial condition of enterprises had clearly strengthened during 1983, the recovery of profitability had been less than complete in the manufacturing sector. In seeking to promote investment, the authorities were right to stress the need for a sound general economic climate; toward that end, they should concentrate their efforts on containing labor costs while reducing the public sector deficit.

He shared the staff's reservations about the reintroduction of the full indexation of wages and endorsed the call for a more flexible system, which was important not only in terms of its immediate effect but also as a way of diminishing the psychology of indexation in the labor market, Mr. Clark indicated. In the previous Article IV report on Belgium, the staff had proposed a modification of the index so that wage earners were not fully compensated for increases in indirect taxes, public transfers, insured health costs, and so on. That idea seemed to remain valid, and he wondered why it had not been re-emphasized in the 1983 report.

On fiscal policy, Mr. Clark observed that, while the share of general government current expenditures in GNP had been stabilized in 1982 and 1983, the ratio remained uncomfortably high, indicating that additional corrective measures were needed. The authorities apparently believed that the total tax burden in Belgium had reached a limit and, if that was so, corrective action would have to be taken primarily on the expenditure side. The authorities were concerned about the possible deflationary impact of expenditure cuts; however, given the apparently generous system of social transfers, there might be room for some saving in that area without jeopardizing the basic objectives of the social security system. So far as the financing of the deficit was concerned, he noted that conditions had eased during 1983, although he took little comfort from that development. The authorities' simultaneous pursuit of a reduction in external borrowing and an increase in the reserves of the central bank left little room for maneuver. In that connection, the foreign reserve target should be accorded precedence, and close control over central bank financing of the public sector was essential. As a general point on the monetary side, he agreed with Mr. Polak that monetary policy had not been accorded the emphasis that it deserved.

Although the main factor in promoting investment must be the general economic environment, there was some role for policies that would encourage the switching of investment away from declining industries into areas with greater growth potential, Mr. Clark remarked. Recalling that certain measures had been announced in December 1983--including a wider role for export credits, tax concessions, and state participation in certain private sector companies--he would be interested in hearing the views of the staff and Mr. de Groote on whether those measures were expected to encourage industrial restructuring.

Mr. Senior commented that, like others, he could support the staff appraisal. The staff had rightly pointed to the key factor in understanding the performance of the economy over the past several years, namely, the profitability of private industry. Following a substantial decline in profitability and a corresponding erosion in the competitiveness of the national economy, the Belgian Government had embarked on a successful strategy of reducing real labor costs by means of a nominal devaluation, a suspension of wage indexation, and the granting of financial incentives to private enterprises. He wondered, however, whether the improved profitability of the industrial sector was sufficient to restore equilibrium to major sectors of the economy. Could the progress made in increasing the competitiveness of the national industrial machine be maintained or improved in the period ahead?

As for the recovery of the profitability of the manufacturing sector, Mr. Senior agreed with the staff that the gains made thus far, although substantial, were less than required for the long-term balance of the economy. There were several indicators that seemed to bear out that assertion. First, it seemed that only three fourths of the decline of the share of nonlabor incomes in value added through the 1970s had been reversed by 1983. A second indicator of inadequate levels of profitability was the relationship between the share of GDP accounted for by the public sector deficit and by the current account deficit, respectively. A public sector deficit equal to about 14 percent of GDP--which corresponded to a deficit of the current account of the balance of payments of about 1 percent and to a superavit of the private sector for the remaining amount--pointed to a conflict between the internal and external equilibrium of the economy. In other words, the progress achieved in curbing the current account deficit had been due, aside from improvements in price competitiveness that operated with a considerable lag, to the poor performance of private investment. It seemed clear, therefore, that significant gains in profitability were still needed if the economy was to accommodate normal levels of fixed capital formation without abruptly impairing the external balance. Another fact pointing to the need for further increasing the profitability of enterprises was the rise in unemployment that had taken place despite the growth in real GDP. That increase seemed to suggest that real wages remained greater than the productivity that would correspond to constant or higher levels of employment.

Those considerations indicated that the economy should be managed with a view to achieving further improvement in the profitability of industry along the lines of the past two years, Mr. Senior continued. That optimum policy, however, should be adapted to the degrees of freedom available to the authorities. One political constraint for the authorities was the unavoidable return to full indexation, and the staff had properly pointed out the shortcomings of such a system for an economy as open as that of Belgium. Even if real wages were to remain constant under the restored indexation scheme, the distortion of wage differentials and other rigidities associated with the indexation system would increase the natural rate of unemployment of the economy and adversely affect the tradeoff between unemployment and the external balance. The idea of ensuring that the behavior evolving from the indexation system would be corrected so that competitiveness of the economy was not eroded while an effort was being made to preserve the levels of competitiveness already achieved could not prevent rising unemployment associated with those levels.

The maintenance of external balance already required a considerable degree of domestic disequilibrium, Mr. Senior said, and that tradeoff could be adversely affected by the presence of wage indexation, even if the overall competitiveness was preserved. In any event, if the authorities must accept the restoration of the indexation system, they should operate other instruments under their control in order to secure the progress made in profitability. The crucial variables for the authorities were those that might be influential in curbing the public sector deficit.

Mr. de Groote had explained ways in which the public sector deficit could adversely affect profitability and competitiveness, and it was encouraging to note from his statement that a reduction of the deficit remained a primary objective. It was also encouraging to see that the fiscal policy mix contemplated by the Government was concentrated primarily on expenditures, particularly current expenditures.

In sum, Mr. Senior concluded, it was important to arrest the dangerous trends that had characterized the Belgian economy when the new Government had taken office. The persistence of a stagnating world economy and the strengths of Belgium's domestic trends had made it difficult for the authorities to attain all their objectives, particularly those related to fiscal performance. In the circumstances, he could strongly support the authorities' intention to subordinate their strategy to the maintenance and improvement of the levels of profitability of the industrial sector.

Mr. Tvedt remarked that the sharp deterioration in the performance of the Belgian economy in the 1970s had apparently been arrested in several important respects through the adjustment measures adopted in recent years. The initial steps taken by the authorities had been directed toward correcting the exchange rate and modifying the wage indexation system as well as toward restoring profitability in private enterprises. With a substantial improvement in competitiveness and a marked increase in the disposable income of private firms, the results thus far had been encouraging; and the outlook pointed to a further rise in the market shares of Belgian industry. Against that background, the change in the foreign balance was expected to provide a substantial positive contribution to overall activity in 1984 and, according to the staff, medium-term growth prospects had improved considerably. Of course, the realization of those prospects would hinge to a great extent on domestic economic performance. Although the authorities were determined to maintain their present competitiveness, the return to full indexation of wages appeared to carry with it significant risks. Moreover, given the rise in social security contributions and the reduction in working hours, developments in wage costs would need to be monitored closely by the authorities.

On exchange rate policy, he could support the authorities' intention to maintain the stability of the Belgian franc, Mr. Tvedt continued. However, such a policy would place a heavy burden on incomes policies, if relative unit labor costs measured in Belgian francs were to be maintained at their present level. To the extent that the return to full indexation also compensated for terms of trade losses and increases in indirect taxes, flexibility in the conduct of policies and the attempts to improve resource allocation might be hampered.

Measured in relation to GDP, investments in Belgium had recently fallen to low levels by comparison with investments in other industrial countries, Mr. Tvedt observed. Although private investment had been stimulated in various ways, investment activity in 1984 was expected to pick up only moderately. He agreed with the staff that public spending had probably reached a level that might cloud the outlook for private investment, but he accepted the fact that the scaling down of real public spending should be implemented only gradually. Nonetheless, with a public sector deficit that was one of the highest, in relative terms, among the industrial countries, reduction over an extended and indeterminate period--as suggested by the authorities--might aggravate the strain of recent years on domestic resources and hamper the authorities' flexibility in conducting economic policies.

Structural problems in the Belgian economy had long been a serious obstacle to any improvement in economic performance, Mr. Tvedt considered. Although profitability remained low by historical standards, the recent favorable developments in rates of return--notably in the manufacturing sector--should help to speed up the structural reorientation of Belgian industry. In that regard, he welcomed the authorities' determination to regard subsidies to industries facing structural difficulties as only temporary.

Mr. Jaafar, remarking on the significant improvement in the economic position of Belgium in the past two years, commended the authorities for the courage they had shown in implementing the policy package in February 1982 to restore external and domestic balance. Among the measures taken, the partial deindexation of wages had been both timely and appropriate and had been justified by its results. Indeed, it had completely restored labor cost competitiveness in industries by 1983 and had been responsible in large part for the 20 percent decline in wage costs. The cut in real wages had contributed to strengthening the financial position of industries, although recovery in profitability in the manufacturing sector had been less than complete. In that context, the return to full indexation in December 1983 had perhaps been premature or inappropriate.

The apparent deceleration in prices in 1983 had not been sufficiently rapid, Mr. Jaafar considered, and the suggestion that part of the recent increases in the price level had been of domestic origin was worrying in the face of a weak recovery in economic activity, especially at a time when gains in market shares were being made. He welcomed the authorities' determination not to allow gains made in wage competitiveness to be reversed--through the adoption of the double norm criteria--but he noted that any realistic increase in real wages would have to be commensurate with productivity and should be closely associated with the need to promote financial incentives to invest in a new plant and equipment. Wage competitiveness for 1984 was projected to remain unchanged and, while he took some comfort in that expectation, he was also aware of the warning from the staff about the risk of inflation from the noncompetitive sector of the economy that could spill over through indexation into wages and the input costs of industries. He would appreciate further clarification from the staff on that matter.

While taking note of the recovery under way in Belgium, he remained concerned that prospects for a return to more comfortable growth were not particularly bright, Mr. Jaafar commented. Investment outlays had been weak, in spite of various incentives and the gains made in business profit.

Part of the explanation for that weakness might well lie in the role of the public sector, which for the past several years had dominated the economy. Government spending on average had been in excess of 60 percent of GNP, which, for a developed country, was on the high side and left little room for the private sector to play an effective role. Furthermore, the average of a 16 percent public sector borrowing requirement (PSBR) over the past three years was not an encouraging sign for private investment activity. The high PSBR could have been due to crowding out, which would not be eliminated--in spite of an expansion in economic activity--so long as the public sector was competing for funds on a broad scale. Of course, with an expanding economy, more would be available for each sector; but the economy had not been expanding fast enough lately, and there was little scope for a more expansionary policy at present, in spite of the need to revive the economy and reduce unemployment. The currently high public expenditures precluded such an option by risking inflation and narrowing the attractiveness of private investment. In fact, a scheme for controlling expenditure in the medium term was a more appropriate step for promoting the conditions for growth. In that respect, the package of measures that had been implemented in February 1982 had been appropriate, and it was important for the authorities to continue to maintain competitiveness through wage restraint and by allowing increased profitability for business.

With regard to the staff's point that the public sector deficit would need to be funded mainly on the domestic market, Mr. Jaafar stressed that the primary objective should remain a containment of expenditures and a reduction in the deficit to more comfortable levels. Higher spending would only place greater pressure on taxes, which were already on the high side; and any additional tax could undermine private investment efforts. Resorting to external financing was equally difficult, given the high debt burden. Of immediate concern in that regard was the bunching of maturities and the high proportion of short-term debt. The authorities' intention to reduce external borrowing in 1984 and to eliminate it altogether in 1985 was welcome; however, given the deficit, he doubted that the target was a realistic one. Finally, he welcomed Belgium's commitment to an open and free trading system and he agreed with Mr. Clark that greater coverage of trade policies was needed in staff reports on important economies like that of Belgium. In passing, he also wished to express his appreciation for the efforts of the Belgian authorities to increase their share of official development assistance, despite the difficult economic circumstances.

Mr. Sangare commended the Belgian authorities for the successes they had achieved in implementing the courageous package of measures in 1981-82. Despite the progress made, he had the uneasy impression from the staff papers that the desired impact on most countries--including those in Western Europe--of the recovery in the world economy might be slow. Given the low output growth and the lack of a solid base for growth, there seemed to be a danger that the gains made thus far could easily be wiped out, which could in turn erode the political will and determination that had enabled the Belgian authorities to adopt decisive measures in the first place. The situation could be further complicated by the approach of an election year.

In Belgium's case, real GNP had grown by only 0.7 percent in 1982 and was expected to remain at the same level in 1983, Mr. Sangare continued. While the staff had commended the pickup in growth against the background of weak external and public sector demand, he himself was concerned about the low level of economic activity in 1983, particularly since the growth had not been sufficient to halt the deterioration in the unemployment situation. The increase in unemployment would no doubt exacerbate an already complex economic management problem for the Belgian authorities.

Full indexation had recently been restored, albeit in a modified form, after having been suspended in 1982 as part of a package of measures designed to stimulate output, exports, and investment, Mr. Sangare remarked. He could of course understand the social need for linking wages to the rate of inflation in one way or another, but he would appreciate hearing from the staff or Mr. de Groote some further elaboration on the impact of the modified form of indexation on productivity, competitiveness, and the labor situation.

Fiscal policy in Belgium remained expansionary and called for an increase in the public sector borrowing requirement, Mr. Sangare observed. The situation was worrisome, particularly since large budget deficits elsewhere had had the effect of driving interest rates and exchange rates to unrealistic levels, which had painful and disturbing consequences, particularly for the developing countries. Such increases could also "short-circuit" the fragile recovery that was currently under way; hence, a more appropriate monetary and fiscal policy would be welcome.

The staff's elaborate analysis of the 1982 devaluation of the Belgian franc illustrated the problems associated with the transmission mechanism when exchange rate action was taken, Mr. Sangare noted. The inclusion of such analysis in other staff reports in respect of various Fund-supported programs could be helpful in understanding how exchange rate actions were expected to contribute to adjustment and might also remove some of the misgivings that many Directors held about the appropriateness of devaluation. Finally, like others, he wished to commend the authorities for their continued effort to increase official development assistance despite the difficulties encountered in their domestic economy. It was gratifying to observe that ODA had amounted to 0.62 percent of GNP in 1983 and that an effort would be made to reach the global target of 0.7 percent as soon as possible.

Mr. Suraisry, endorsing the main points in the staff appraisal, considered that the Belgian authorities should be commended for their determined efforts to correct the underlying weaknesses in the economy through difficult policy choices. The large devaluation in February 1982 and the partial suspension of wage indexation since that time had produced encouraging results: the competitive position of the economy had been considerably strengthened, and much of the decline in industrial profitability had been reversed. Moreover, the external accounts had improved, and there were signs of a modest recovery in output. Still, the prospects for growth, inflation, employment, and private investment remained uncertain, and he agreed with the staff that the main task of the authorities at present was to consolidate the gains already made by following policies designed to promote a self-sustaining upturn in those areas, particularly in private investment.

He especially welcomed the progress made in stabilizing the public sector deficit, Mr. Suraisry continued. However, while a number of important steps had been taken to improve expenditure control, the public sector deficit and the public sector borrowing requirement remained at unsustainably high levels in relation to GDP, which could result in high monetary financing. That, in turn, could create inflationary pressures and weaken the recent gains in competitiveness. Hence, while he could understand the authorities' desire to reduce the deficit gradually, he hoped they would thoroughly explore the scope for further reductions, particularly through expenditure cuts.

A reduction in public expenditure was especially important in view of the recent return to full wage indexation, Mr. Suraisry considered. He hoped that the authorities would make every effort to apply the new wage norms in 1984 and to prevent any catch-up increases so as to avoid a recurrence of wage/push inflation and maintain Belgium's competitive position. Observance of the new wage norms should also help to set the stage for the much-needed recovery in private investment. He had been pleased to hear from Mr. de Groote that the current policy of wage restraint would remain in force through 1986; developments in the wage area should nonetheless be monitored closely.

On the external side, he could support the authorities' intention to maintain Belgium's competitive position by keeping the exchange rate stable, Mr. Suraisry commented. Attainment of the objective would require a combination of fiscal restraint, wage moderation, and cautious monetary policies on the domestic side. It was encouraging to note that the authorities had no intention of adding to the already high level of foreign borrowing and that they were taking every opportunity to improve the maturity structure of outstanding debt.

For the medium term, it was to be hoped that the authorities would press forward with their efforts to restructure the industrial sector and that they would phase out subsidies to declining industries, Mr. Suraisry remarked. While such an approach would inevitably involve costs in the short run, the long-term benefits for both Belgium and its main trading partners would be considerable. Finally, he welcomed the authorities' commitment to an open and free trading system and their continuing efforts to increase the share of official development assistance in relation to GNP.

Mr. Arias observed that Belgium had managed to maintain a relatively low inflation rate while achieving a rate of growth similar to those recorded in other industrial countries. The least satisfactory aspect of the Belgian economy concerned the unemployment situation, which was no doubt a consequence of the structural shift in industrial production.

In 1983, great strides had been made in the profitability of industry, and the budget deficit and the current account of the balance of payments had showed remarkable improvement, Mr. Arias continued. However, the budget deficit was still high, and he agreed with the staff that it should be further reduced through cuts in expenditures, particularly those related to unemployment compensation and transfers to households. The authorities had rightly argued that the deflationary impact of transfers of funds could inhibit the expansionary surge of the export sector and aggravate the public sector deficit; in the circumstances, a cautious policy toward the fiscal deficit should be adopted, with the focus on a longer-term decline in social transfers. The need for improvement in the labor situation was also a long-term problem that required fundamental and structural changes in the skills and training of the labor force.

He had been somewhat surprised that the staff papers had not presented a clear picture of the domestic liquidity situation in Belgium in 1983, Mr. Arias said. His impression from the comments of Mr. de Groote was that monetary policy had not contributed to a recovery of equilibrium with respect to overall developments in liquidity, but he would appreciate further elaboration by the staff. Also lacking in the staff papers was an analysis of the Belgian situation vis-à-vis EEC countries. Was Belgium growing faster and was her industrial trade doing better than the EEC average?

He shared the staff's concern about the results of the indexation system in Belgium, Mr. Arias continued. The lower level of inflation and the relatively high rate of growth provided evidence that indexation had the sort of beneficial effects claimed by the authorities. The 1982 devaluation had succeeded in large part without fermenting social and political unrest precisely because workers had been given some guarantee that partial indexation would mean a substantial decline in real wages. Finally, like others, he wished to commend the authorities for their intention and efforts to achieve the 0.7 percent target for official development assistance.

Mr. Zhang recalled that, in early 1982, an adjustment program had been introduced in Belgium to correct the serious imbalances that had begun to develop in the economy a decade earlier. By the end of 1983, significant progress had been achieved in a number of areas. For example, the control of prices and incomes had effectively restored the profit margins of enterprises and had prevented the emergence of a price/wage spiral following the devaluation. The share of disposable income of enterprises in GNP had recovered strongly, mostly in 1983, when it had been restored to the 1972-73 average; still, there had been a lag in the complete recovery of profitability in the manufacturing sector. In the area of public finance, the rapidly rising trend in the deficit had been arrested with the stabilization of general government expenditures. Since insufficient profitability of enterprises and a mounting budget deficit had been the most important factors responsible for the overall disequilibria in the Belgian economy, he could accept the staff's view that, as a result of improvements in those areas, the medium-term growth prospects for Belgium had improved considerably.

Unfortunately, Mr. Zhang continued, the short-term costs of the stabilization effort had been quite high, including a substantial fall in domestic demand in 1983. A restrictive fiscal policy, together with a decline in real household disposable income of more than 2 percent--stemming from the suspension of full wage indexation during 1982-83 and the reduction in transfer payments--had resulted in a large fall in private consumption. Domestic demand had remained stagnant, and the recovery of profitability had not proved sufficient to generate a significant increase in industrial investment. In the end, it had been the strong improvement in the external sector that had more than offset the fall in domestic demand and had resulted in a small increase in GNP in 1983. That small increase had been significant, however, because it had indicated a continuous upturn from the decline in GNP in 1981.

It was envisaged that the present adjustment and stabilization program--which had initiated the recovery--would gradually transform the Belgian economy and pave the way for self-sustained growth in future, Mr. Zhang continued. Realization of that objective, however, would require a vigorous upturn and a continuous expansion in industrial investment as well as a consistent industrial policy to restructure the decline in traditional industries. Unfortunately, the prospects for an immediate and large increase in investment were not good. At the present stage, in spite of the improvement in their financial position, enterprises remained hesitant to invest in circumstances of stagnating domestic demand. Hence, the maintenance of economic activity in 1984 would have to rely mainly upon foreign demand. The anticipated pickup in the world economy--and particularly the gradual recovery in Belgium's trading partners in 1984--would certainly help to alleviate the consequences of the insufficient domestic demand.

Given the recent improvements in the overall economic situation in Belgium, the authorities perhaps had considerably greater room for maneuver than in the past, Mr. Zhang considered. The Government should continue to take strong measures, namely, by further reducing the public sector deficit, maintaining the competitiveness of exports, following an effective incomes policy, and supporting employment. Success in those areas would be essential if steady and self-sustained growth was to be realized.

For 1984, fiscal policy would continue to be restrictive overall, Mr. Zhang noted. The rise in interest payments on national debt--amounting to about 10 percent of GNP--and the indexation of most current expenditures would continue to thwart the efforts of the authorities to reduce public sector deficits in spite of some increases expected in taxes and social security contributions. It remained to be seen whether the targeted reduction of the budget deficit by 1.5 percent of GNP would be realized. Monetary policy in 1984 would continue to be directed toward defending the exchange rate. Nominal interest rates were probably at their lowest level since 1979, but real interest rates should be reduced further in order to facilitate the revival of productive investment and residential construction and to carry forward with industrial restructuring. In the labor field, unemployment would probably be stabilized, mainly as a result of the Government's work-sharing policies, but unemployment would still be too high. Full wage indexation was to be restored in 1984, and it was not certain whether the Government would invoke further wage moderation. In that connection, a social consensus on overall objectives would be necessary. Finally, given the size and openness of the Belgian economy, the scope for action by the Government was somewhat limited. Experience had shown that domestic stabilization and adjustment efforts could be fully and effectively carried out only in a favorable international environment. With a continuing recovery in the world economy, the prospects for 1984 should improve.

Mr. Teijeiro stated that he was in general agreement with the staff appraisal. He had the impression from Mr. de Groote's statement and the staff papers that the Belgian authorities faced a hopeless situation on the fiscal side. He shared Mr. Polak's observations on the tendency of the deficit to grow, given the automatic growth of the interest service of the public debt. It would have been useful, in that respect, to have been presented with dynamic projections of the fiscal deficit under alternative scenarios. For example, he wondered about the cyclical components of the current deficit and the potential for fiscal improvements as the economy expanded. He would also have appreciated some information on the effect of an aging population on social security expenditures. Finally, in cases like that of Belgium in which the fiscal problem was quite serious, it would have been helpful to have been presented with projections of the automatic effect of current policies on the fiscal deficit.

The Executive Directors agreed to continue their discussion of the staff report for the 1983 Article IV consultation with Belgium 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/84/7 (1/16/84) and EBM/84/8 (1/18/84).

3. MAURITIUS - TECHNICAL ASSISTANCE

In response to a request from Mauritius for technical assistance, the Executive Board approves the proposal set forth in EBD/84/8 (1/12/84).

Adopted January 17, 1984

4. TANZANIA - TECHNICAL ASSISTANCE

In response to a request from Tanzania for technical assistance, the Executive Board approves the proposal set forth in EBD/84/9 (1/12/84).

Adopted January 17, 1984

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/9 (1/13/84) and EBAP/84/10 (1/16/84) and by an Advisor to Executive Director as set forth in EBAP/84/10 (1/16/84) is approved.

APPROVED: June 1, 1984

LEO VAN HOUTVEN
Secretary