NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/42

10:00 a.m., March 19, 1984

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
	J. G. Schneider
	X. Blandin
	M. Teijeiro
R. D. Erb	
	S. R. Abiad, Temporary
	T. Yamashita
	Jaafar A.
R. K. Joyce	L. Leonard
	C. Robalino
G. Laske	
G. Lovato	
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	
	E. I. M. Mtei
	E. Portas, Temporary
J. Tvedt	
	T. A. Clark
	Wang E.

L. Van Houtven, Secretary
K. Friedman, Assistant

Also Present

African Department: J. B. Zulu, Director; R. J. Bhatia, Deputy Director; O. B. Makalou, Deputy Director; N. Abu-zobaa, E. A. Calamitsis, R. O. Carstens, F. d'A. Collings, S. E. Cronquist, A. B. Diao, M. G. Gilman, J. Kratz, S. Schiavo-Campo, R. T. Stillson, A. Tahari, A. C. Woodward. Asian Department: H. L. Mendis. Central Banking Department: L. E. Molho. European Department: L. W. Whittome, Counsellor and Director; P. B. de Fontenay, P. Dhonte, H. B. Junz, L. G. Manison, K.-W. Riechel, J. S. Van't dack. Exchange and Trade Relations Department: C. D. Finch, Director; D. K. Palmer, Associate Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; B. de Schaetzen, G. G. Johnson, S. Kanesa-Thasan, M. O. Tyler. External Relations Department: A. M. Abushadi. Fiscal Affairs Department: A. Tazi. Legal Department: G. P. Nicoletopoulos, Director; Ph. Lachman, J. M. Ogoola, J. V. Surr. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; M. D. Knight, P. R. Menon. Treasurer's Department: D. Williams, Deputy Treasurer. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, H.-S. Lee, G. E. L. Nguyen, Y. Okubo, I. R. Panday, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, J. Bulloch, Chen J., M. Eran, C. Flamant, I. Fridrikksson, V. Govindarajan, D. Hammann, J. M. Jones, A. K. Juusela, A. Koné, M. J. Kooymans, J. K. Orleans-Lindsay, G. W. K. Pickering, M. Rasyid, J. Reddy, D. J. Robinson, C. A. Salinas, A. A. Scholten, Shao Z., S. Sornyanyontr, Wang C. Y., J. C. Williams.

1. GROUP OF TEN DEPUTIES - REPORT BY STAFF

The Economic Counsellor noted that the G-10 Deputies had met at the Fund Office in Paris on March 15, 1984. The work program of the Deputies consisted of four subjects: the functioning of floating exchange rates, the question of how to strengthen multilateral surveillance with a view to promoting greater policy coordination and exchange rate stability, management of international liquidity, and the role of the Fund. At their meeting on March 15, the Deputies had held a preliminary review of the first three subjects. The discussion had been based on documents from international organizations, and later discussions were expected to be based on policy documents prepared by the Deputies.

The discussion on the functioning of floating exchange rates, including the causes of volatility in movements of exchange rates, the Economic Counsellor continued, had been based on the recently distributed staff paper entitled "The Exchange Rate System, Lessons of the Past and Options for the Future." The Deputies had also had before them an OECD paper on macroeconomic policies and exchange rates. The Fund staff paper had been well received, and there had been no dissent from the staff's main conclusion that the overall performance of the present exchange rate system had been remarkably good, given the harsh global environment, although there was substantial room for improvement.

The Deputies' discussion on surveillance had been based mainly on a staff paper entitled "Issues in the Assessment of Exchange Rates of Industrial Countries in the Context of their Economic Policies," the Economic Counsellor explained. The Deputies had also considered a paper prepared by the staff especially for the Deputies, entitled "The Organization and Substance of IMF Surveillance." They had also had before them an OECD paper on surveillance, and an EC paper on the European Communities' experience with mutual surveillance and monetary cooperation. The Chairman of the Deputies had asked him to seek the Executive Board's approval for the formal provision to the Deputies of the staff paper entitled "Review of the Document 'Surveillance over Exchange Rate Policies' and Annual Review of the Implementation of Surveillance" (SM/84/44, 2/15/84; and Sup. 1, 2/16/84).

The discussion on the management of international liquidity had been based on a BIS paper entitled "Reserves in International Liquidity," the Economic Counsellor said. The Deputies had mentioned that the topic was a technically challenging one, as it was difficult to distinguish between reserves and liquidity, particularly because of the growth of the Euro-currency market. There seemed to have been general agreement that the distribution of liquidity was unsatisfactory. The question of an SDR allocation had been addressed only indirectly by some of the Deputies.

The Deputies planned to meet again on April 13, 1984 in Washington, and on May 18, 1984 in Paris, the Economic Counsellor commented. The Ministers intended to meet in Washington on April 12, 1984 and in Rome on May 19, 1984. The Chairman of the Deputies planned to make a progress report to the Ministers at their meeting on May 19. The discussion in April was expected to center on the exchange rate regime and surveillance. The agenda for the May meeting of the Deputies remained uncertain and would be decided at their April meeting.

The Secretary said that the staff could circulate a short document with a request for approval, on a lapse of time basis, of the transmittal to the Deputies of SM/84/44.

The Executive Directors accepted the Secretary's suggestion.

2. MADAGASCAR - STAND-BY ARRANGEMENT - PROGRAM IMPLEMENTATION

The Executive Directors considered a staff paper describing Madagascar's performance under the stand-by arrangement approved on December 21, 1983, the performance criteria proposed for January-June 1984, and measures adopted affecting producer prices of agricultural commodities (EBS/84/45, 3/8/84).

The staff representative from the African Department made the following statement:

> The following information has been received by the staff since the issuance of EBS/84/45:
>
> The Central Bank of Madagascar has informed the staff that on March 17, 1984 the Malagasy franc was devalued by 13 percent (15 percent in local currency terms) against the currency composite to which it is pegged.
>
> This most recent exchange rate adjustment follows cumulative, periodic depreciations of the Malagasy franc totaling 33.4 percent since May 1982; the real effective exchange rate now stands approximately 22 percent below the May 1982 level. It will be recalled that, during the Executive Board's consideration of Madagascar's request for a stand-by arrangement on December 21, 1983, the question was posed as to the appropriateness of the exchange rate for the Malagasy franc. In the Chairman's summing up of that meeting (EBM/83/179, 12/21/83), it was stated that "the approach to exchange rate...policy should be not only more flexible but also more aggressive." The latest exchange rate action meets these concerns. Moreover, this action in the context of the authorities' flexible exchange rate policy should provide greater assurance that the balance of payments estimates for 1984 would be realized and that progress would continue to be made toward achieving longer-term viability in the external situation.

Continuing, the staff representative from the African Department said that the staff had received from the authorities a request asking the Fund to convene a meeting of potential aid donors to coordinate balance of payments assistance to Madagascar in 1984. If the Executive Board adopted the decision proposed in EBS/84/45, the staff would accept Madagascar's request and arrange an aid donors' meeting in Paris on April 5-6, 1984.

Mr. Alfidja recalled that the performance of Madagascar's economy had been discussed extensively at EBM/83/178 and EBM/83/179 (12/21/83). The decision approving the request for a stand-by arrangement had been contingent on the adoption of adequately remunerative prices for producers of various agricultural commodities, and on the conclusion of satisfactory arrangements for the financing of the estimated balance of payments deficit for 1984.

In pricing and marketing, Mr. Alfidja continued, the authorities had introduced, and were continuing to implement, extensive reform measures for rice and other items. The objectives were to liberalize as fully as possible the marketing of rice in all the producing zones of Madagascar before the end of 1985, provide higher remunerative prices to producers of paddy, and improve the coordination of the rice import policy with the domestic availability of paddy. Moreover, price controls for various agricultural commodities--including such export products as meat, fish, shellfish, sisal, and butter beans--had been eliminated, and sugar prices had been increased by 20 percent in real terms. Pricing decisions for cotton were to be left entirely to industry representatives.

The staff mission that had visited Madagascar in February 1984, Mr. Alfidja commented, had reviewed the prospects for the budget and the balance of payments in 1984. Treasury operations had been consistent with the authorities' intention to reduce the overall deficit to 5.5 percent of GDP, from 7 percent in 1983. In the external sector, the trade deficit--SDR 31.5 million--was the lowest in recent years, and the current account deficit had been even smaller than expected. The authorities had recently depreciated the Malagasy franc by 15 percent.

Commenting on the second condition for implementing the stand-by arrangement, Mr. Alfidja said that the authorities felt that they had shown their willingness to cooperate with the international financial community by introducing adjustment measures that went beyond the recommendations made by the Executive Board in December 1983. Hence, they strongly hoped that the international financial community, including the Fund and the World Bank, would cooperate with Madagascar by providing the financial assistance needed to sustain the ongoing adjustment effort.

Mr. Blandin remarked that the present staff paper confirmed the position that his chair had taken during the discussion on Madagascar on December 21, 1983. The staff had clearly shown that sizable adjustment had occurred in 1983 and that more was planned for 1984, as reflected in the reduction in the budget deficit to 5.5 percent of GDP in 1984, together with the expected decline in imports and increase in exports.

The staff projections for the external sector had been changed substantially, Mr. Blandin went on. Under programs for other countries that had been successfully implemented, the staff had erred on the conservative side in making its projections--a welcome change from earlier practices--and he wondered whether the projections for Madagascar were also conservative.

The adjustment in Madagascar had been made possible only by the authorities' firm commitment to the success of the Fund-supported programs, which had been based on a gradual but complete turnaround in economic and financial policies, Mr. Blandin remarked. The authorities were to be warmly commended for their constant efforts to make needed adjustments, particularly in pricing policy and marketing. Taken together, the various measures introduced by the authorities constituted a complete set of measures that should yield a substantial supply response in the coming one or two years. All the reforms, including those of the industrial sector, had been in the same direction, and would be bolstered by the recent devaluation of the Malagasy franc.

The stand-by arrangement had not called for a review of the exchange rate policy until the second review of the program in mid-1984, Mr. Blandin continued. However, the staff had estimated that action was needed in the exchange rate area before then, and the authorities had taken the commendable decision to follow the staff's advice, although they had not been formally obliged to do so.

The amount of Fund resources available under the stand-by arrangement in 1983 and projected for 1984--SDR 6.5 million and SDR 3.5 million, respectively--were far out of line with the strength of the adjustment effort and the magnitude of the balance of payments need, Mr. Blandin considered. Could the staff confirm that a purchase under the compensatory financing facility by Madagascar could be made soon? Such a purchase would be fully justified in the light of the shortfall in export earnings in 1983, which had occurred largely because of the reduction in exports of cloves to Indonesia, where the peak in its own production cycle had been reached. The export shortfall had clearly been due to factors beyond the control of the Malagasy authorities, and he hoped that the Executive Board would receive a request for a purchase by Madagascar under the compensatory financing facility before end-April 1984. A purchase under the compensatory financing facility would make the amount of the Fund's support appear more appropriate and would give a much clearer signal to Madagascar's creditors.

The Fund could not hope to play a catalytic role on behalf of Madagascar if its own contribution of financial resources were so small that the other potential sources of financing would be unable to close the country's external financing gap, Mr. Blandin observed. That outcome was particularly likely in the light of the inadequate amount of financing available from IDA as a result of the attitude of IDA's most important contributor. Because of the shortage of multilateral concessional financing, it was clear that additional money, catalyzed by the Fund, would have to be obtained from bilateral creditors. Accordingly, the Paris Club conditions would have to be generous, and even then a gap would remain; it would have to be filled during the coming donors' meeting. Member countries that had opposed increasing the amount of Fund assistance under the stand-by arrangement for Madagascar should be prepared to provide sufficient balance of payments assistance during the coming donors' meeting.

The previous Fund-supported programs for Madagascar, Mr. Blandin recalled, had failed because the assumptions about the country's capacity to repay external payments arrears through net cash payments had been unrealistic. As a result, Madagascar had failed to meet the performance criterion on external arrears, despite the adjustments that had been made in other areas. The recent discussion on Sierra Leone showed that the staff could make realistic assumptions. The staff had explained that a symbolic reduction in arrears would be sufficient in cases in which five conditions were met. First, the overall balance of payments position of the country concerned should be heavily strained; second, the reserve position should be weak; both conditions clearly applied to Madagascar. Third, due consideration should be given to the outstanding amount of arrears. Accordingly, it was reasonable to expect a quick and complete elimination of the arrears only when the outstanding amount was very small. When the amount was large, as it was in Madagascar, the Fund had to be more patient. Fourth, the arrears could be reduced through rescheduling as well as through net cash payments. Fifth, under the Fund's policy concerning arrears, merely the avoidance of any further increase in reserves could be acceptable in some cases. Those conditions should be fully applied in the present case. The Fund should carefully avoid taking an excessively rigid view on Madagascar's arrears, as to do so could cause the program to fail.

Mr. Lovato remarked that the authorities were making a substantial adjustment effort that had already shown results and was expected to create the conditions for sustainable growth in the medium run. The authorities were to be commended for the determination shown in implementing their adjustment program, and their request for additional assistance to cover the balance of payments gap was warranted.

In late 1983, Mr. Lovato noted, the staff had projected a slow narrowing of the balance of payments financing gap, estimated at SDR 165 million for 1984. The most recent projection showed even larger gaps up to 1987, with a peak at nearly SDR 200 million in 1985. As the gap was expected to persist in the medium run, it was important for donor countries to be prepared to offer sustained financial assistance; the amounts involved and their likely duration would depend on the decision taken by creditor countries in Paris Club meetings. When more detailed information on the likely pattern of rescheduling became available, the staff could usefully make projections on the evolution of Madagascar's financial needs and assess possible ways in which they could be met.

The evolution of Madagascar's trade position in the coming several years would depend substantially on the effect of the agricultural pricing policies that had been recently introduced, Mr. Lovato remarked. For instance, the supply-side effect of increased producer prices was expected to encourage import substitution, thereby reducing pressure on the balance of payments. Of course, supply-side effects were difficult to predict, and a further comment on the staff's assumptions underlying its projections would be helpful. In particular, the staff had projected no increase in imports in nominal terms through 1986. Did that projection depend mainly on assumptions concerning the supply-side effects, or on the introduction of ceilings by the authorities? Finally, the proposed decision was acceptable.

Mr. Erb said that the recent commendable adjustment of the Malagasy franc, together with the agreement already reached on producer pricing and marketing policies, provided adequate assurance of the authorities' intention to persevere in their adjustment effort. It was imperative to maintain the momentum of overall adjustment gained under the previous stand-by arrangement.

During the discussion on Madagascar in December 1983, Mr. Erb recalled, he had expressed his concern about the adequacy of the policies that the authorities had then intended to maintain in 1984 with respect to both the exchange rate and producer prices, and he was satisfied with the current policy stance in those areas. However, it would be important for the authorities to manage the exchange rate flexibly in the coming period in order to avoid a repetition of the rapid appreciation of the real effective exchange rate following the May 1982 devaluation. What concrete changes had the authorities made in their procedures to ensure that exchange rate adjustments would be made on a more timely basis in the future? Were the changes in the schedule of Fund reviews made to enable the staff to determine whether or not timely adjustments of the exchange rate were being made?

The actual outturn for 1983 with respect to overall government operations had been within the program targets, Mr. Erb noted. In 1984, overall government operations were expected to increase less rapidly than nominal GDP, a desirable outcome given the medium-term objective of reducing the relative size of the Government. Moreover, the overall deficit was to be reduced moderately in nominal terms; consequently, the budget deficit in relation to GDP was expected to fall from 7 percent in 1983 to 5.5 percent in 1984. The authorities would have to continue their rigorous management of government operations if the fiscal objectives were to be achieved.

Commenting on the balance of payments prospects for 1984, Mr. Erb said that the authorities had adjusted the 1984 import program to limit the deficit to roughly SDR 165 million, excluding possible rescheduling, extraordinary assistance, and Fund financing, and excluding any buildup in reserves. Donors and creditors, like the Malagasy authorities, would have to make a sizable effort in 1984.

Looking beyond the immediate challenge, Mr. Erb remarked, his authorities recognized that a major effort would continue to be required over the medium run by all the parties concerned. Continued credible efforts by the Malagasy authorities would facilitate the mobilization of financial support from bilateral and multilateral donors and creditors in the medium run, and his authorities hoped and expected to contribute to those efforts. In passing, he remarked that it was not appropriate to make reference in the course of discussions on individual country programs to the position of his authorities on the overall level of IDA resources.

Under the proposed decision, Mr. Erb noted, the timing of the reviews under the stand-by arrangement would be changed, and a fuller explanation of the implications of the changes would have been helpful. As he understood it, the policy actions that would have been the subject of the end-June 1984 review had in effect been taken; the full review of the performance under the arrangement was therefore to be shifted to August 1984. The proposed changes in the review procedures were acceptable.

Mr. Mtei considered that the case of Madagascar was straightforward. One of the essential requirements for the implementation of the stand-by arrangement had been met, with the increase in producer prices for agricultural commodities, and he had no difficulty in accepting the proposed decision.

The authorities' commitment to the adjustment program, Mr. Mtei continued, was clearly reflected in the introduction of a comprehensive strategy for the rehabilitation of the rice sector, and in the reform of the agricultural pricing policy. The resulting liberalization of the marketing system, the price deregulation, and the upward adjustment in various producer prices--by 8 percent to 47 percent--should increase domestic production, encourage nontraditional exports, improve resource allocation, and promote structural adjustment. The staff was obviously satisfied with the policy measures that the authorities had described in their letter of intent.

Madagascar's budget performance in 1983 had been consistent with the objective under the program of reducing the domestic financial imbalance, Mr. Mtei remarked, and all the revenue and expenditure targets and performance criteria for end-December 1983 had been met. The prospects for 1984 seemed to be in line with the program projections; the overall budget deficit was estimated at no more than 5.5 percent of GDP. The implications of those measures for economic activity and growth in the real sector were not fully clear to him, but they indicated the authorities' continued commitment to the adjustment program.

The balance of payments position was still difficult, Mr. Mtei noted. The unfavorable performance of traditional exports due to marketing difficulties had compelled the authorities to compress further the already low level of imports in order to remain within the program projections. The main import reduction was to affect food and capital goods. He hoped that the reduction in food imports had been offset by an increase in domestic food production; otherwise, the consequences of the adjustment effort for Madagascar's social fabric might be serious. The reduction in capital goods imports would certainly have implications for future economic growth, and there was clearly a limit on the extent to which that approach could be applied. At the present crucial stage, Madagascar needed substantial financial resources, particularly on concessional terms, both to tide it over to bridge the financing gap in the present difficult period without compromising future economic growth.

The manner in which Madagascar's program had been handled by the Fund was unsatisfactory, Mr. Mtei stated, and he hoped that it would not set a precedent. When the stand-by arrangement had been discussed in December 1983, he had expressed doubt about the efficacy of the Fund's catalytic role in Madagascar owing to the small size of the Fund's commitment and the small likelihood that rescheduling would provide the resources needed to close the financing gap on a timely basis. In fact, events had borne out his concerns. The program for Madagascar had in effect been held in abeyance by the Fund for four months. He hoped that the coming meeting of creditors and donors in Paris would solve the problem of the financing gap; otherwise, the program would continue to be held aside.

If a financing gap remained even after the coming meeting of donors and creditors, Mr. Mtei went on, it would be appropriate for the Fund to cover part of the gap by increasing to 100 percent of quota the amount of assistance available to Madagascar under the stand-by arrangement. The staff had clearly shown that the Government's adjustment program was strong and that the authorities were committed to implementing it despite all the difficulties involved. He was pleased that a number of Executive Directors were satisfied with the authorities' policy stance, and he hoped that they would permit the Fund to play a more positive role in line with his suggestion.

Mr. Clark stated that the proposed decision was acceptable. The authorities were to be commended for the measures introduced in agricultural producer prices and for their fiscal stance, which was consistent with the program targets.

During the discussion on Madagascar in December 1983, Mr. Clark recalled, he had remarked on the risk that, by the time that the program was implemented, the data on which it was based might be outdated. The measures introduced by the authorities and the complementary exchange rate adjustment recently made, together with the continuing close contact between the staff and the authorities, had, to some extent, mitigated his concern. However, satisfactory financing arrangements were still needed before the program could come into effect.

Although the timing of the reviews would be altered by the proposed decision, Mr. Clark noted, the schedule of purchases would not. What was the new link between the reviews and the drawings? Had the authorities considered the proposal made in December 1983 that they should seek the services of a debt coordinator?

Mr. Leonard said that the proposed decision was acceptable. The authorities' efforts to liberalize agricultural product marketing, to raise producer prices, and to coordinate rice imports with the availability of domestic inputs, were welcome. The depreciation of the Malagasy franc on March 17, 1984 was consistent with recommendations made during the December 1983 discussion in the Executive Board. Successful rescheduling of Madagascar's existing debt would require sympathetic understanding by creditors during the coming meetings of donors and the Paris Club.

Solving Madagascar's external payments problem would take time, Mr. Leonard remarked, and the proposed amount of assistance under the stand-by arrangement was appropriate. Increasing the amount would lessen the extent to which further Fund assistance could be provided in the medium term to meet Madagascar's balance of payments need and, indeed, might prevent the Fund from making a net contribution to Madagascar.

Mr. Laske recalled that the previous discussion on Madagascar had focused on structural imbalances. Because of the absence of sufficient corrective actions in major areas, the stand-by arrangement proposed in December 1983 had been approved only in principle. The price adjustments made in the agricultural sector since then were clearly moves in the right direction and met one of the two conditions for making the stand-by arrangement operative. The corrective prices were likely to give the appropriate market signals and appropriate incentives to producers. They should also help the balance of payments by stimulating exports and reducing agricultural imports. In addition, the recent exchange rate adjustment was consistent with the Executive Board's recommendations. The proposed decision was acceptable.

Madagascar's balance of payments position would continue to be tight for many years, Mr. Laske remarked. The external disequilibrium had been aggravated by the large external debt. In the light of the structural weakness of the external position, the Fund's role in Madagascar should be limited to that of a catalyst. Accordingly, financing by the Fund should be contingent upon an agreement by aid donors to make adequate contributions, and by official creditors in the Paris Club to provide sufficient debt relief.

The stand-by arrangement would become operative if the Paris Club rescheduling meeting were successful, Mr. Laske commented. The stand-by arrangement covered a significant part of 1985, and the staff should provide balance of payments projections for 1985 on the occasion of the next discussion of Madagascar's performance under the stand-by arrangement.

Mr. Jaafar stated that the proposed decision should be approved. Madagascar deserved the Fund's sympathy and support, as significant adjustment had been achieved, and the authorities were clearly committed to making further progress. The reforms already carried out, including the liberalization of agricultural prices and the recent devaluation, had made important contributions to the adjustment effort.

On the other hand, Mr. Jaafar went on, the financing and external debt positions seemed unsustainable over the medium term. The authorities were still finding it difficult to close the financing gap for 1984, and even if they could do so, the prospects for obtaining adequate financing for 1985 and beyond were worrying. The large debt service burden, projected at more than 60 percent of exports, could limit the scope for imports needed for development in the medium run.

The Fund, in collaboration with the World Bank and other institutions and bilateral donors, should help the authorities to handle the debt burden and achieve economic recovery, Mr. Jaafar considered. The authorities' emphasis on adjustment would have to be maintained, and making the stand-by arrangement effective would constitute an important step forward.

Mr. Malhotra said that he accepted the proposed decision. The staff report clearly showed that the authorities had taken adequate steps in agricultural pricing, the budget, and the exchange rate.

During the previous discussion on Madagascar, Mr. Malhotra commented, he had stated that the amount of proposed financing by the Fund was inadequate, and he wished to associate himself with the position of Mr. Blandin and Mr. Mtei on that matter. If the financing gap were not closed as a result of the coming meetings of creditors and donors, the Fund should provide additional support, particularly in the light of the substantial adjustment measures that the authorities had taken to strengthen their program.

Mr. Morrell stated that the proposed decision was acceptable. He agreed that one of the conditions for the coming into effect of the stand-by arrangement had been met, as the authorities had made adequate increases in producer prices of agricultural commodities.

The proposed quantitative performance criteria for end-April and end-June 1984 seemed appropriate, Mr. Morrell continued, and the package of measures aimed at further liberalizing agricultural marketing and at providing adequate producer incentives was welcome. The measures constituted a significant step toward making the needed structural improvements in the balance of payments, and there was substantial indication of the authorities' commitment to the adjustment program. The recent adjustment of the Malagasy franc was welcome. Moreover, the budgetary outcome in 1983 had been in line with the program targets, and all the performance criteria for end-December 1983 had been met.

The coming into effect of the stand-by arrangement should remain contingent upon the closing of the 1984 financing gap, Mr. Morrell remarked. The authorities should make some net cash payments to reduce the external arrears below the end-1983 level. He hoped that the donors' meeting to be arranged by the Fund would result in satisfactory financing of the payments gap. Given Madagascar's heavy debt, it would be inappropriate for the country to borrow on expensive terms. However, if the donors' meeting were not fully successful, the Fund should reconsider the extent of its financing under the stand-by arrangement. The staff should make every effort to resolve quickly the issue of the nature of the export shortfall, so that, if possible, Madagascar could make a drawing under the compensatory financing facility soon.

Mr. Suraisry said that the authorities were to be commended on the policy measures recently adopted to strengthen the agricultural sector. By enhancing the export potential and reducing agricultural imports, particularly of rice, the measures should have a positive effect on the balance of payments.

The quantitative performance criteria for end-1983 had been observed, Mr. Suraisry noted. The reduction in the domestic financial imbalances since 1981 had been substantial, and it was encouraging that the 1984 budget was in line with the program targets. In the light of the inflation and output targets and of the liquidity squeeze in 1983, the 1984 target for monetary expansion was appropriate, and the credit ceilings for the first half of 1984 were acceptable.

The staff had said that it considered the latest balance of payments projections to be realistic in the light of the policies that had been adopted, Mr. Suraisry commented. He hoped that Madagascar's encouraging performance thus far under the program would lead to the successful conclusion of the Paris Club and donors' meetings. The proposed decision was acceptable.

Mr. Abiad recalled that the provisions of the stand-by arrangement had been thoroughly discussed in December 1983. The measures introduced since then in agricultural pricing and marketing policies--particularly with respect to the price for rice--fulfilled one of the two conditions for the activation of the stand-by arrangement. Given the introduction of those measures, the recent exchange rate adjustment, and the observance of all the performance criteria for end-1983, he had no difficulty in accepting the proposed decision.

The staff representative from the African Department remarked that it was inaccurate to say that the program for Madagascar had been held in abeyance. Even though the stand-by arrangement had not been activated, there had been continuous discussions between the staff and the authorities on the evolution and implementation of policies; moreover, the performance criteria for end-1983 had been met, and other parts of the program had been implemented in accordance with the letter of intent. The continuous discussions between the staff and the major creditor and donor countries had kept the latter groups apprised of the problems facing Madagascar. At the time of the latest mission to Madagascar, the staff had concluded that, because of the continuous implementation of appropriate policies, the economic situation had continued to improve.

On the catalytic role of the Fund, the staff representative considered that it would be unfortunate to regard Fund financing as last resort in nature. Establishing the principle that the Fund should automatically increase the volume of assistance under a stand-by arrangement when the financing gap of the country concerned was not closed would be inappropriate. It was important to assess the size of the Fund's support in the light of a country's prospects. Accordingly, it was crucial to have in mind the likely length of the Fund's involvement in a country, the extent to which the country had already used Fund resources, the size of its current debt, and its ability to service a large debt to the Fund. The present size of the stand-by arrangement for Madagascar met those criteria. On the basis of its contacts with creditors and donors, the staff had reason to feel hopeful that Madagascar's financing gap in 1984 would be closed.

During the latest mission to Madagascar, the staff representative explained, the staff and the authorities had discussed the possibility of taking on the services of a debt coordinator. The authorities preferred to assess the results of the coming Paris Club meeting before deciding whether or not to hire a debt coordinator. At present, the authorities had no definite intention of appointing one.

The staff agreed, the staff representative said, that the curtailment of food imports should not be taken to the extent that it strained the social fabric. Under the program for 1984, the authorities intended to increase food imports other than rice by approximately 15-17 percent. The reduction in rice imports would be made possible by the increased domestic production following the liberalization effort and an increase in stocks. The total amount of marketed rice in 1984, including the reduced volume of imported rice, would remain at about 450,000 tons, the 1983 figure. The staff did not expect an undue shortage of food imports, particularly of rice, although the effects of the December 1983 cyclone lent some uncertainty to the outlook. The matter would certainly be examined fully during the next set of discussions with the authorities.

The stand-by arrangement for Madagascar did not include a performance clause concerning arrears, the staff representative remarked. However, the volume of arrears was large--about SDR 150 million--and its effects on the management of external reserves and foreign exchange flows could not be ignored. The staff planned to discuss the issue again with the authorities during the next scheduled review, by which time the amount of available external assistance should be known.

The proposed schedule of reviews did not differ markedly from the present one, the staff representative commented. Under the original schedule, the first review was to have been completed by end-March 1984, when a second purchase of SDR 6 million would have been available. Under the new schedule, the initial review would be completed in May or June 1984, and a purchase of SDR 6 million could be made. The second review under the original program was to have taken place before end-June 1984, and the related purchase was subject to the observance of performance criteria for end-June. Under the new schedule, the second review would still take place before end-June. The third review under the new schedule would take place on the same schedule as under the original plan, namely, in the final quarter of 1984, when the 1985 budget and performance criteria for the rest of the stand-by arrangement would be reviewed. Since the two schedules of reviews were basically similar, the staff had not thought it necessary to revise the schedule of purchases.

The staff felt that it would be more appropriate to assess the medium-term balance of payments prospects during the first complete review than at an earlier stage, the staff representative from the African Department explained. By then, the staff would have a better idea of the effects of the present policies and the outcome of the meetings of Madagascar's creditors and donors. The staff had thought that it was certainly safe to conclude that Madagascar would be dependent on external assistance for a long time, and that the aid would have to be concessional. Accordingly, a source of assistance other than the Fund would have to be relied on to fill the financing gap.

The Chairman commented that Executive Directors' disappointment about the amount of assistance under the stand-by arrangement was understandable, but the suggestion that the case of Madagascar had been mishandled was unwarranted. The Executive Board had agreed in late December 1983 that the stand-by arrangement could be implemented only if the Fund were fully satisfied with Madagascar's pricing policy. The staff mission had visited Madagascar soon after the December Board meeting and had quickly issued its report. The staff and the authorities had been in continuous contact, and the authorities had adopted a number of satisfactory and important measures.

Mr. Malhotra said that he was pleased that the staff felt confident that the financing gap would be closed. The results of the donors' and Paris Club meetings should be circulated to the Executive Directors. If a financing gap remained, the Executive Board should have an opportunity to reconsider Madagascar's case to see what further steps could be taken. The treatment of Madagascar should not be seen as setting a precedent; the Executive Board should consider each case on its own merits.

During the discussion in December 1983, Mr. Malhotra recalled, Executive Directors had expressed two main concerns about the proposed financing for Madagascar. First, some Executive Directors were worried that as Madagascar would have to repay considerable sums to the Fund in the coming years, the small size of new financing might even lead to net flow of funds from Madagascar to the Fund in some years. In fact, the size of the net flow of Fund assistance to Madagascar in several years would be very limited. On the other hand, there was a view that the Fund's role in Madagascar should be that of a catalyst, and that the amount of Fund assistance should therefore be relatively small. In fact, the proposed volume of Fund assistance under the stand-by arrangement was low, even if the validity of such a catalytic role were conceded, especially when a financing gap had been foreseen. Although the Fund need not be a source of financing of last resort, it should always bear in mind the need for pragmatic solutions to the financing problems facing members; accordingly, it might be appropriate to return to a case if it became evident that the financing gap of the country concerned had not been fully covered.

Mr. Mtei said that he had not meant to imply that the staff had mishandled the case of Madagascar. The Fund as a whole had mishandled the case by prescribing conditions that had resulted in the program's being kept in abeyance. Moreover, implementation would be further delayed even if the proposed decision were accepted. The Executive Board should be prepared to reconsider the volume of assistance under the stand-by arrangement if the financing gap were not closed by Madagascar's creditors and donors.

The Chairman, commenting on the reasons why the stand-by arrangement had not been implemented, noted that the pricing policy adjustments had been made only recently. In addition, the Fund could not make its resources available until there was greater certainty about the medium-term outlook for the balance of payments, the ability of the country to service its debt to the Fund, and the closing of the financing gap. The Fund had even taken the rather unusual step of organizing and chairing a donors' meeting for a member country, so that the stand-by arrangement could be implemented as quickly as possible. He strongly hoped that the donor countries would bear in mind the comments made during the present discussion on the need for additional resources, and that they would make them available at the meeting to be held in June 1984.

The staff representative from the African Department, responding to a question on the staff estimates for the balance of payments of Madagascar in 1984, explained that the staff had taken a conservative view of the country's imports and exports in 1984, and the estimates were likely to prove accurate. For instance, the staff estimate of 6,500 tons of clove exports reflected only contracts that had actually been signed. Negotiations on an additional 1,500-2,000 tons were well advanced. Imports were strictly controlled, mainly because of the foreign exchange constraint; therefore, if the balance of payments position deteriorated, imports could be reduced. There was some uncertainty about the precise extent of the damage to the rice crop caused by the recent cyclone, and new information could lead the staff to take another look at its estimates. On the whole, however, the estimates were fairly conservative, and no major surprises were expected.

The possibility of a purchase by Madagascar under the compensatory financing facility had arisen only during the latest staff mission to the country, the staff representative said. The main question was whether or not the clove export shortfall had been caused by factors beyond the authorities' control, and the staff was examining the import and export policies of the two countries involved. Every effort was being made to examine the issue as quickly as possible.

The staff representative from the Exchange and Trade Relations Department remarked that the case of Madagascar raised a general policy issue that the Executive Board might wish to examine on another occasion: the extent to which the Fund should play an active role in promoting agreement between a member country and its creditors and donors in cases in which such an agreement was a prerequisite for the implementation of an arrangement with the Fund. The issue, which had to do particularly with debt rescheduling, could perhaps be dealt with in the scheduled discussion of the staff paper on the Fund's role on the settlement of overdue obligations.

Mr. Wang said that he hoped that the staff's future work on Madagascar would reflect the comments made by Mr. Malhotra.

Mr. Alfidja commented that there was evidence that the export shortfall had been caused by factors largely beyond the authorities' control. He wondered whether the staff had meant to suggest that there was any doubt about that conclusion.

On page 17 of EBS/84/45, Mr. Alfidja noted, it was mentioned that the authorities felt that the pricing policy adjustments had probably strained the country's social fabric as much as could be tolerated. The Minister in Charge of Finance and Economy had stated: "It should be noted that the total income of a wage earner with dependents who is paid at the minimum wage is barely sufficient to cover his rice requirements at the current consumer price of FMG 165 per kilogram of imported broken rice." Pricing policy was of course a particularly sensitive element of the adjustment program. The authorities faced two constraints in pricing policy. First, the adjustments already made had had a large impact on the lowest income earners. Second, lenders had tried to impose certain conditions on rice prices. The second problem had been dealt with during the latest discussions in Madagascar. It was important to note that the pricing policy adjustments had been agreed only after the visit to Madagascar by a World Bank mission to discuss rice pricing policy.

The staff representative from the African Department, commenting on the export shortfall, recalled that there had been agreement in principle between Indonesia and Madagascar on the provision of a certain amount of clove exports; the main outstanding issue had been the precise price of the exports. Before the agreement could be finalized, Indonesia's clove production had turned out to be much larger than had been expected, and Indonesia had begun to accumulate clove stocks. Thereafter, Indonesia had appeared unwilling to make additional purchases of Malagasy cloves. Hence, the main question about the export shortfall was whether Madagascar might have been able to sell all its cloves if it had substantially reduced its asking price, well below the price that had been agreed in principle. The staff was looking into the matter.

The Executive Board then took the following decision:

1. On December 21, 1983, the Fund approved the request of the Government of the Democratic Republic of Madagascar for a stand-by arrangement (EBS/83/255) for the period ending on March 31, 1985 in an amount equivalent to SDR 33 million. Under that decision, the approval of the stand-by arrangement is to become effective on the date on which the Fund finds that:

(a) satisfactory arrangements have been made with respect to the financing of the estimated balance of payments deficit for 1984; and

(b) adequate increases in the producer prices of agricultural commodities have been adopted.

2. The Fund finds that condition (b) for the coming into effect of the stand-by arrangement has been met.

3. Pending fulfillment of condition (a) above and the consequent entry into force of the stand-by arrangement, Madagascar has consulted with the Fund regarding the quantitative performance criteria that would apply for the remaining period of the stand-by arrangement. The quantitative limits described in the memorandum annexed to the letter of February 23, 1984, from the Minister at the Presidency of Madagascar in charge of Finance and Economy shall be established as performance criteria for end-April 1984 and end-June 1984. The letter dated November 21, 1983 attached to the stand-by arrangement for Madagascar shall be read as modified and supplemented by the letter and memorandum of February 23, 1984. Accordingly:

(a) the references, in paragraph 4(a) of the stand-by arrangement, to paragraph 11 of the letter dated November 21, 1983, shall be read as references to the memorandum annexed to the letter of February 23, 1984;

(b) the reviews of the program required, pursuant to paragraph 4(c)(i), (ii), and (iii) of the stand-by arrangement, to be completed before March 31, 1984, June 30, 1984, and October 31, 1984, shall be completed before May 31, 1984, August 31, 1984, and November 30, 1984, respectively.

Decision No. 7650-(84/42), adopted
March 19, 1984

3. NETHERLANDS - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the Netherlands (SM/84/47, 2/15/84; and Cor. 1, 3/16/84). They also had before them a report on recent economic developments in the Netherlands (SM/84/58, 3/1/84).

Mr. Polak made the following statement:

The Netherlands authorities welcome the format chosen by the staff, which focuses sharply on the policy issues and the policy dilemmas that face the authorities. These issues and dilemmas have been perceptively outlined in the staff report. The staff's analysis leads it to conclusions with which the Netherlands authorities are fundamentally in agreement--with some exceptions, to which I shall refer below.

The approach to financial and economic policy of the present Netherlands Government, which took office some 16 months ago, is sharply focused on correcting the structural defects of the economy, including: the excessive size of the public sector, which has led to a suffocating burden of taxes and social security premiums and a severe public sector deficit; a maldistribution of national income that unduly favors wages over profits, incomes from various social security schemes over incomes from work, and consequently consumption over investment; and an overdose of regulatory activities that further hampers the development of the private economy.

These structural weaknesses are not unique in the Netherlands, and they have been recognized for perhaps half a decade as requiring attention. But until recently that attention has always been a divided one. Previously, the view had usually won out that cuts in government expenditures were not needed in good times and could not be accepted in bad times.

The hesitations of policy can be explained by the fact that the symptoms of this disease are in many respects the same as those of a cyclical shortfall of demand: declining output, low profitability, low investment, high unemployment. Thirty years of experience with Keynesian fine-tuning--an experience that had on the whole been quite successful--could not easily be shaken off by successive governments, by economists, or by public opinion when the familiar symptoms again made their appearance in the mid-1970s. It is, consequently, only now that demand management has deliberately and openly been brushed aside as a guide to policy, in favor of a persistent attack on structural weaknesses.

The change in approach has been facilitated by the accumulating evidence that the authorities did not have at their disposal the prerequisite for a flexible policy of demand management, viz., a reasonably good forecast how the economy would develop "on present policies." It has been noted that from 1978 to 1982, the forecast for the current account of the Netherlands' balance of payments was about right in one year only; for the other four years, the forecast missed even the sign of the balance. For five years in a row, tax receipts were overestimated annually by f. 5 billion (some 1.5 percent of GDP) on average. Predictions of changes in consumption in response to changes in real disposable income have proved wrong (e.g., in 1983) owing to unexpected, but important changes in the savings ratio.

The inference from these and other uncertainties has been to pay much less attention to forecasts of the likely variations in aggregate demand as the basis for economic policy, and to determine a firm policy course with an eye to medium-term developments and the correction of structural weaknesses. The aim is now to bring public finance under control, to increase the responsiveness of the market sector, and to increase employment by work sharing.

After a little over one year of this approach to economic policy, there are perhaps no striking results, but there is evidence that developments in public finances have been brought under control and are moving in the desired direction. Perhaps the most crucial variable, government expenditure as a percentage of net national income (NNI), 1/ is expected, in 1984, for the first time in many years, to show a decline by slightly over 0.5 percentage point. This would still leave the ratio for 1984 to 70 percent, eight years after the first tentative step was announced to slow the uncontrolled growth of this ratio, which stood then (in 1976) at almost 60 percent. There is also a small reduction in the "collective burden"; 2/ this implies that there has been only a modest reduction--by a fraction of 1 percent--in the budget deficit as a percentage of NNI.

It is planned that the bulk of the reduction of government expenditure for 1984, compared with 1983, will be applied to a reduction in corporate taxation. However, this particular attribution of the 1984 savings from the reduction in government expenditure reflects particular circumstances of the budget process rather than a deliberate tilt toward a smaller tax burden in favor of a cut in the deficit. In the budget memorandum of last September, the Government did not state a preference between these two possibilities; nevertheless, as the staff correctly reports, the main emphasis was on establishing a credible record of reducing the deficit. This is seen as crucial for stemming the steady rise of interest payments in the budget--itself a major cause of the tendency for transfer payments to increase (see Table 1 on page 4 of the staff report)--and to encourage further interest rate declines. The major economies in government spending aim at reducing incomes in the official sector and transfer payments to the nonworking part of the population. Apart from dealing with the problems of public finance, a start has been made with the difficult process of deregulation.

Some evidence that these policies are working can be noted. In conjunction with the recovery abroad, the success achieved in lowering inflation and interest rates, as well as some gains in

1/ NNI in recent years in the Netherlands approximately 90 percent of GDP.

2/ Tax and nontax revenues, and social security premiums.

competitiveness, an improvement in the economic climate has been brought about, as shown in Chart 1 in the staff report). Company accounts for 1983 generally show an improvement of profits or a reduction of losses, reflecting in part improved labor productivity and wage moderation. There has also been some modest improvement in the performance of the economy, both the actual performance in 1983 as compared with 1982, and the performance projected for 1984. These improvements relate to exports, output in manufacturing, and investment, with changes in private consumption remaining in the range of very small positive or negative numbers. Fourth quarter export volume in 1983 was 7.5 percent above that of a year earlier, while industrial production had recovered by 6 percent over the same period. Investment of enterprises increased by 6 percent in 1983 and, according to a survey of business plans by the Central Bureau of Statistics, is expected to show a further rise of 26 percent in 1984.

However, no improvement at all can as yet be foreseen in the number of unemployed, which is expected to rise by another 100,000 from 1983 to 1984 to nearly 900,000, or 15 percent of the labor force, after rising by some 150,000 in each of the three preceding years. The decline in employment has not yet come to a halt. The present, more favorable growth pattern has not yet created the prospect of an early resumption of employment growth and a sizable decline in unemployment, which must come about as the result of the correction of the deep-seated structural maladjustments that have developed over the past decade.

The Netherlands authorities have commented explicitly on a number of policy recommendations contained in the staff appraisal, and in particular on (1) the staff view that a necessary reduction in labor costs required to increase employment must be found in a reduction in direct taxes and social security premiums coupled with further reductions in social security benefits, (2) the staff view that greater flexibility in managing lay-offs is necessary, (3) a proposal to reduce the applicability of the investment premiums (WIR), and (4) the recommendation to set explicit goals for both the size of the public sector and a time path for achieving that size.

The Netherlands authorities agree with the staff on the importance of reducing the gap between take-home pay and labor costs by lowering social security benefits as well as premiums and direct taxes. They are engaged in reducing the benefits. However, they give some preference to using the savings thus obtained for reducing the government deficit and the consequent containment of interest payments in future years, over full restitution of these savings by lowering premiums and direct taxes.

The Government is promoting greater flexibility and scope for enterprises to manage their labor force, and they have requested the advise of the "Foundation of Labor," in which the social partners discuss such matters. The Foundation handed in its advice on March 1, 1984 and proposed that a decision of the competent authorities on requests for permission to dismiss workers will have to be rendered normally within four weeks. Only in exceptional cases, and when a second round of deliberations is necessary, will a period of some two months be allowed. The Government will shortly determine its position on this matter in the light of the recommendation received, weighing the necessity of increased flexibility against the requirements of maintaining an appropriate degree of job security. A further increase in flexibility is also expected from work-sharing arrangements as a means of alleviating the unemployment problem. While such arrangements do have some drawbacks, pointed out by the staff, their benefits seem important at a time when an increase in employment opportunities is not yet in sight, as long as they do not hamper the necessary recovery of profitability.

The authorities do not consider the staff proposals to reduce investment premiums (WIR) either desirable or practical. They agree that, in a situation of economic equilibrium, schemes such as accelerated amortization would be preferable. But the present situation is one of the disequilibrium, brought about by prolonged excess government expenditure and an extremely high share of wages in national income. These developments have led to a situation in which roughly half of private enterprises are experiencing losses, while the profits realized in the other half are extremely modest. In these circumstances, it is hardly realistic to write off more than half of the private sector. Moreover, analysis by the Central Planning Bureau has indicated that subsidizing investment by private industry is the most effective instrument in present circumstances, as some 600,000 enterprises receive investment subsidies under the WIR scheme. The staff's idea of making further investment premiums dependent on strengthening the balance sheet of particular enterprises runs into major problems of a practical nature, given the numbers involved.

Concerning the question of setting an explicit goal for the public sector, the Netherlands authorities point out that their approach contains an implicit norm and time path for the size of the public sector, viz., that the "collective burden" can no longer be increased and must in fact be reduced, and that the public sector borrowing requirement (PSBR) must be reduced by 1 percent a year over the medium term. Concentrating solely on an expenditure norm would imply accepting a larger deficit when revenue falls short of expectations, and this is seen as unacceptable. In fact, such shortfalls have led to additional budget cuts and temporary tax increases.

As in other countries, it has become clear in the Netherlands that the continuity of policy is crucial to its credibility. The staff correctly states in its appraisal that further progress toward recovery depends on perseverance by the Government in the basic policy approach that it has adopted, while the necessary political support for the government to do so depends in turn on evidence of positive developments in the economy.

Mr. Schneider said that the staff had clearly analyzed the structural imbalances of the economy and the particular difficulties in making policy choices due to the unusual combination of a current account surplus, a sizable government deficit, and a low rate of inflation. The goal of reducing the budget deficit could not be attained together with a decrease in the tax burden on the enterprise sector. Hence, a choice had to be made between the achievement of goals for the immediate future and the medium term.

The high rate of unemployment, the current account surplus, and the public sector deficit reflected the basic problem facing the economy, namely, a lack of domestic demand in general, and of investment demand in particular, Mr. Schneider continued. Indeed, the share of gross fixed capital formation in GDP had dropped more than 4 percentage points between 1978 and 1983, mainly because of the poor profit situation in the enterprise sector, which, in turn, stemmed from the combination of large wage cost increases, poor productivity growth, and the appreciation of the Dutch guilder. The main problem clearly had to do with profitability, rather than external cost competitiveness. Hence, the exchange rate had no role to play in the Netherlands' adjustment effort.

As a result of measures already introduced, Mr. Schneider went on, profitability had recently recovered somewhat, but it still remained much too low to lead to a general and sustained revival of investment. Wage moderation was therefore an essential ingredient of any adjustment effort, although the low inflation rate limited the room for maneuver in that area. The rate of inflation was less than 2 percent, and the authorities could be said to have succeeded too well in reducing it, as they had left themselves little room for the adjustment of real wages. Action should therefore be concentrated on reducing indirect wage costs, particularly the contribution of enterprises to the social security system.

The loss of fiscal revenues entailed by such measures, Mr. Schneider said, would of course have to be compensated by reductions in government expenditure to avoid a widening of the government deficit. He was not as convinced as Mr. Polak and the staff of the need immediately to reduce the fiscal deficit. In view of the depressed state of domestic demand, the high savings rate, and the current account surplus, a reduction in the government deficit was needed less urgently than a real reduction in government expenditure. He was not convinced that the credibility of the Government's policies depended crucially on reducing the government deficit. Instead, it depended on the Government's ability to roll back its share of expenditure in GDP. Setting explicit goals for reducing that share, together with a timetable for its attainment, might be a more effective way of enhancing the credibility of government policy than reducing the deficit.

If a reduction in the deficit itself were the chosen goal, Mr. Schneider said, a tax increase might be needed to give at least the appearance that fiscal policy was on course. Since reducing the tax burden on enterprises was more urgently needed than a reduction in the fiscal deficit, achieving the latter forthwith would amount to putting the cart before the horse. That conclusion implied that a revenue shortfall should nearly automatically lead to a corresponding reduction in expenditures. A revenue shortfall could be anticipated at the time of the mid-year budget review.

On the question of where to seek reductions in government expenditure, Mr. Schneider remarked that concentrating on social transfers would help to redress another major structural weakness, the maldistribution of income in favor of the social security scheme over incomes from labor. The authorities had already taken steps in that direction, but much remained to be done before the situation could be significantly improved. Cutting public expenditure would create room to strengthen the financial position of the enterprise sector through lower social security contributions or other tax reductions.

The measures that he had mentioned were prerequisites for a sustainable recovery of economic activity that would ultimately result in increased employment and a reduction in the public sector deficit, Mr. Schneider stated. In the final analysis, the problem of unemployment could be solved only by generating new employment, not by applying labor-sharing formulas. That was not to say that labor-sharing schemes might not be welcome as a temporary means of absorbing excessive unemployment, but there was the danger that their use could lead to delays in implementing other measures, such as increased labor mobility, which were essential to improving the employment picture.

Labor-sharing schemes did not by themselves reduce the wage costs of enterprises and could make the task of reducing such costs more difficult, Mr. Schneider went on. Indeed, labor-sharing schemes implied a reduction in real per capita income without a reduction in the labor costs of enterprises. Reducing the wage costs of enterprises was essential to achieving the required reindustrialization, as it would increase the share of profits in national income.

There was an increasing tendency in Europe to view labor-sharing schemes as a way of dealing with the present high rates of unemployment and low rates of economic growth, Mr. Schneider noted. It would therefore be useful to have the staff elaborate in somewhat greater detail on the economic consequences of such schemes in comparison with schemes for achieving a faster decline in real wages and an increase in labor mobility.

He basically agreed with the views of the staff and the authorities on monetary policy in the Netherlands, Mr. Schneider said. The available monetary and financial data did not provide a clear view of the origin of the liquidity in the economy or of the forms in which it was held. That situation was rather surprising, as the Netherlands had traditionally been a pioneer in the development of statistics.

The high rate of private sector financial savings seemed to have come mainly from enterprises, a conclusion that confirmed that the subdued level of domestic demand was due mainly to the low rate of investment, Mr. Schneider remarked. He agreed with the staff that the ample liquidity in the economy was not a cause for concern, as it was held mainly by enterprises, and their use of the liquidity would signal a welcome revival of investment activity. Despite the ample liquidity, the authorities should try to lower interest rates whenever the exchange rate permitted them to do so, in order to stimulate investment. The staff had shown that interest rate reductions could have a powerful effect because of the rather large debt of the enterprise sector.

Revitalization of the enterprise sector was the cornerstone of any meaningful adjustment policy in the Netherlands, Mr. Schneider considered. Monetary, fiscal, and incomes policies should be oriented toward increasing the profitability of the enterprise sector. At the same time, labor market rigidities should be eliminated. Entrepreneurs could not be expected to make labor-creating investments when they knew that they would be unable to shed labor if those investments turned out to be less profitable than they expected. Such potential costs constituted a heavy brake on renewed investment. Job security provided by existing regulations was rather illusory, since jobs disappeared when enterprises went bankrupt. It was of course difficult to remove such rigidities during a period of declining real wages, but it was an essential step on the path to employment-generating growth.

The adjustments that would have to be made in the Netherlands, like those in some other European countries, would take time to yield the desired results, Mr. Schneider remarked. That conclusion underscored the urgent need to implement the required measures as soon as possible. The Government had already taken steps in the right direction.

Mr. Lovato said that he basically agreed with the staff's analysis. The Netherlands was an example of a mature industrial economy beset by a deep-seated malaise, not merely by cyclical problems. Hence, he agreed with the staff that achieving a recovery of domestic economic activity depended on consistent and forceful application of government policies designed to correct the underlying maladjustments, including the size and growth rate of public sector spending, the proper performance of enterprises, and the workings of markets and market stimuli in a mixed economy with substantial government intervention.

The worrying declining trend in business profitability had apparently been reversed through cuts in corporate profit taxes and falling real wages, Mr. Lovato remarked. That development, together with the improved international competitive position and the strengthened financial balances of companies, should generate the desired upturn in investment spending and in aggregate demand, which had experienced a prolonged recession. In the long run, sustained growth and higher employment could be attained only if the economy redistributed resources from households to enterprises in order to shift the emphasis in demand from consumption to investment and the structure of output from the service sector to the manufacturing one. To those ends, maintaining consistent policies affecting the budget, incomes, and the labor market would be of paramount importance.

He agreed with the staff, Mr. Lovato went on, that the authorities should maintain fiscal restraint, in contrast with the past piecemeal practice of temporary tax increases designed to offset expenditure overruns. Although he harbored some doubt about the usefulness of the general idea of the optimal size of the public sector, he agreed with the staff that the authorities should set a goal for a public sector size that would be compatible with a viable and desirable growth path for the economy. On the other hand, there was some merit in the authorities' argument that the focus of fiscal policy should be on the deficit, rather than on expenditure.

It would be useful to have a further comment on one of the paradoxes that the staff had highlighted, namely, the coexistence of an expanding public sector deficit and a large and growing current account surplus, Mr. Lovato commented. At first glance, the public sector deficit did not seem to be a relevant part of the macroeconomic picture that was usually the subject of Fund surveillance; in particular, it seemed to have no significant effect on the current account, the inflation rate, or the exchange rate, despite the accommodating monetary policy. The accounting identities shown in Table 30 of SM/84/58 showed that the public sector deficit had been more than offset by the financial surpluses of households and enterprises, but the identities did not furnish a satisfactory explanation of the paradox.

The nonenergy trade balance had been in deficit in 1982, Mr. Lovato observed. Had there also been a deficit in 1983? How did the staff view the longer-term trend in natural gas output and exports and their contribution to the trade balance?

The Government's determination to tackle the thorny problems in incomes and labor market policy was welcome, Mr. Lovato remarked, although its efforts had fallen short of the introduction of an explicit statutory incomes policy. The rate of unemployment would probably remain high for a while, and it would be unwise to try to solve the problem through budget measures designed to accelerate the recovery. There was a clear need to compress total labor costs further, and to that end the authorities had no choice but to cut employment and social security benefits in order to boost firms' demand for labor by reducing the large gap between wages paid to employees and labor costs incurred by employers. The staff's arguments concerning the minimum wage and work incentives were well taken.

Labor-sharing schemes had recently become widespread in the Netherlands' industrial sector, Mr. Lovato observed. The staff statement on page 18 of SM/84/47 that "the decision to deal with the unemployment problem through the shortening of work time and labor sharing...seems to imply acceptance that growth prospects are meager at best" painted a misleading picture of the authorities' view on labor sharing. No one expected work-sharing arrangements to solve the unemployment problem in any country. Only a high-growth economy could accomplish that task. However, as long as an economy was stagnating or growing sluggishly, such arrangements could play a useful role, especially if they did not lead to cost increases.

Mr. Hirao said that the encouraging signs of recovery were the result of the authorities' policy efforts and the recovery abroad. The deteriorating trend in business profitability, domestic demand, and employment seemed to have come to an end. Economic growth had been negative in 1981 and 1982, but had become positive in 1983 and was expected to increase in 1984. Those positive developments had been helped by the strong export performance which, in turn, had been due to the improved competitiveness of industry following the wage moderation and the decline in the rate of inflation. The flexible monetary policy, the firm fiscal policy, and the improvement in business and consumer confidence had increased the potential for a revival of domestic demand. In order to sustain the initial upturn in economic activity, the Government must continue and consolidate its medium-term policy effort to reduce the major imbalances in the economy.

He broadly agreed with the staff appraisal, Mr. Hirao went on. One of the major structural problems was the steadily growing size of the public sector and the rapidly rising public sector deficit. Public sector expenditure in relation to net national income had increased during the previous two decades, reaching almost 70 percent in 1983, the highest among OECD countries. The bulk of the increase in public expenditure had been transfer payments, which accounted for more than 30 percent of net national income.

The sharp increase in the public sector deficit from 4.5 percent of net national income in 1980 to 11.5 percent in 1983 had been accompanied by a decline in domestic demand, rather than an increase, as would normally have been expected, Mr. Hirao continued. Those developments suggested that a large increase in public expenditure, particularly in transfer payments, would not help to stimulate domestic demand and would instead undermine the vitality of the private sector. The public sector apparently had grown to such an extent that there was no room for discretionary expansion. He agreed with the staff that the first priority should be given to cutting expenditure with a view to reducing the size of the public sector. The authorities had made strenuous efforts in that direction, but there had unfortunately been a tendency to expenditure overshooting that had had to be offset by an increase in the tax burden.

Far-reaching cuts in social spending and other budget categories were proposed under the 1984 budget, but even with those reductions, social transfers were budgeted to rise by 2 percent. Cutting expenditures was a difficult task, but much more should be done in that area.

To achieve sustained economic growth led by domestic demand, and particularly by private sector investment, Mr. Hirao said, it would be most important to improve the business environment. Halting the erosion of business profitability was of course an instrumental part of the effort to restore business confidence. The erosion of profitability had occurred over such a long period that the recovery could not be expected to occur in the short run. It would be particularly important to restore business confidence in the ability of the Government to maintain the present policy course.

Labor market rigidities would also have to be tackled, Mr. Hirao remarked. The staff had shown that the erosion of business profitability and the rapid increase in unemployment were due largely to the continuous rise in the real wage costs over the previous decade. The significant progress that had been recently made in moderating wages by cutting public sector wages while liberalizing statutory wage controls in the private sector was certainly welcome, and further steps in that direction could perhaps be taken. As the authorities had maintained, the scope for further reductions in direct real wages might be limited, particularly in view of the low rate of inflation. As a result, the main emphasis in the labor market area would have to be on reducing indirect labor costs. The ratio of unemployment benefits to wages in the Netherlands was still high by international standards, though some progress had been made in that area in the 1984 budget. As the staff had suggested, the authorities might wish to consider the possibility of reducing the minimum wage.

Work-sharing arrangements apparently did not have a sizable effect in generating employment, Mr. Hirao commented. On the other hand, he tended to share the staff's concern that such arrangements might help to intensify existing rigidities in the labor market by making it more difficult for employers to reduce redundant workers; such arrangements might also prove costly during the recovery of domestic demand. A degree of flexibility in implementing work-sharing arrangements seemed to be called for. Finally, the authorities were to be commended for having firmly resisted protectionist pressures and for having eliminated all restrictions on capital imports.

Mr. Laske remarked that, after several years of stagnation, or even recession, economic activity in the Netherlands had begun to recover, although at a somewhat slower pace than in other industrial countries. Most of the impetus for the recovery had come from the external sector, but recently private sector investment had also made a contribution. Private and public consumption were expected to show little vigor in 1984, and the positive signs in the economy in general did not conceal that the Netherlands still suffered from serious structural imbalances and distortions. Tackling those problems must remain the principal task of economic policy both in the near future and in the medium term.

An upswing in world demand and more favorable domestic growth were likely to facilitate the implementation of policies designed to deal with the underlying maladjustments, Mr. Laske continued. Given the serious nature of the problems facing the economy, a conflict might arise between short-term and longer-term objectives. In the immediate future, domestic demand would be somewhat negatively affected by present policies, but that development should be accepted as a means of creating a sound basis for sustained medium-term economic growth.

The present policies appeared to be in the right direction, Mr. Laske said. There was an urgent need to re-establish private sector confidence in the authorities' determination to persevere with policies that held the promise of correcting the maladjustments in the economy over the medium term.

The main problems facing the economy, Mr. Laske remarked, were the public sector imbalances, the rigidities in the labor market, and the unfavorable distribution of domestic activity between consumption and investment. Those maladjustments were a reflection of the serious shortcomings in the system of incentives for economic performance. Although the recent changes in fiscal policy were encouraging, the continuing high absorption of resources by the public sector indicated that the factors creating and maintaining the maladjustments were still present. The large public sector deficit was a particular cause for concern; at almost 12 percent of national income in 1983, it had been among the largest in Europe.

The increase in the public sector deficits had been due in part to cyclical factors, Mr. Laske noted, but the deficits were clearly a heavy burden, and expenditure restraint was difficult to achieve. Even if the assumed substantial reduction in the budget deficit were achieved, the share of tax revenues absorbed by interest payments would continue to increase. Given the present targets for the public deficit, debt service expenditures were likely to grow faster than total public expenditure, thereby further limiting the flexibility of fiscal policy; all other categories of expenditure would have to grow at a lower rate than GDP in order to keep the share of public expenditure in GDP constant. The scope for noninterest expenditure to grow was particularly small.

Containment of the deficit was by itself not a sufficient objective, Mr. Laske went on. The authorities must limit--or even reduce--public sector expenditure if the growing trend of absorption by the public sector of national income were to be stopped and reversed. In 1982 the equivalent of more than two thirds of GDP had been channeled through the public sector, whose share in GDP had increased from 36 percent in 1960 to more than 70 percent in 1983, the largest share in any major country; its detrimental effects on private sector activity and responsiveness to market signals were hardly surprising.

With the 1984 budget, Mr. Laske noted, the authorities had launched a determined effort to break the upward trend in the growth of the share of the public sector. Even though the budgeted reduction would be fairly small, it would be important, as it would constitute the first step in the right direction. Further retrenchment of expenditure in coming years would be a prerequisite for the continuous strengthening of private sector activity. The retrenchment must be accompanied by a shift in the structure of expenditure. In particular, cuts in all categories of expenditure--consumption as well as transfers to households and enterprises--would be required. The decision to cut a number of social benefits, which were generous in comparison with other countries, was encouraging. The reduction in public sector salaries had created room for some lowering of business taxes and social security contributions, thereby providing relief for enterprises and strengthening their depleted profit-generating capacity.

In the past, the authorities had usually reacted to missed expenditure targets by raising revenues, Mr. Laske recalled. In the recent past, that approach apparently had not changed fundamentally, despite the basic reorientation of fiscal policy. If the need arose, the authorities apparently would prefer raising taxes to cutting spending further. Such a reaction to the potential failure to meet the target for the budget deficit would probably reduce flexibility and profitability in the private sector, rather than contribute to revitalizing the sector. That outcome would be particularly regrettable because the tax burden of 55 percent was already among the highest of all industrial countries. The measures adopted in 1984 and those planned for 1985 to lower business taxes would provide only temporary relief if the authorities were unable to bring spending under better control.

Although monetary policy had been accommodating, Mr. Laske said, the Netherlands had recorded some of the lowest rates of inflation among industrial countries, and interest rates were lower than in most other countries. The large current account surplus and the market's confidence in the stability of the guilder had enabled the authorities to tolerate the emergence of a considerable interest rate differential vis-à-vis other countries. Both the price stability and the relatively low interest rates would help the revival of private investment when the other essential prerequisites for it were present, including investor confidence in a consistent fiscal policy, and also relief from cost pressures. At the same time, the slightly expansionary monetary policy would provide the scope needed to strengthen the business sector. In the circumstances, including the rather moderate nature of the economic upswing, the danger of rekindling inflationary pressures seemed relatively small. However, a more pronounced revival of investment spending could quickly lead to stronger competition between public and private credit demand, thereby posing the familiar danger of crowding out private borrowers. That conflict could be avoided if the planned reduction in the public sector deficit in the medium term could be achieved.

The high rate of unemployment, particularly among young persons, was very worrying, Mr. Laske remarked. The generosity of unemployment and other social benefits probably disguised the actual redundancy of labor; the official unemployment rate probably understated the actual situation. The existing imbalance in the labor market was reflected in the 150 percent increase in unemployment during the previous three years and in the growing duration of unemployment. Unlike some other countries, in the Netherlands unemployment had not leveled off with the intensification of the cyclical recovery.

He agreed with the staff, Mr. Laske continued, that high wage costs was one of the main causes of the substantial unemployment in the Netherlands. Intense wage pressure had been reinforced by the cost pressure arising from the steadily growing labor force. Despite the moderation in wage developments in recent years, some decline in the contribution of wage costs to value added had occurred only in 1983, after having risen by as much as 10 percentage points to reach nearly 76 percent in 1980. The connection between increasing wage costs and the heavy shedding of labor was reflected in the fact that bankruptcies had been one of the main reasons for layoffs in the Netherlands. There had been a substantial shift in income distribution between labor and capital following the removal of the statutory incomes policy in 1983. That removal had been needed to strengthen the profitability of private enterprises, without which sufficient private investment was unlikely to occur.

Real wage costs in the Netherlands were still high in comparison with those in its trading partners, Mr. Laske noted, and the process of reducing labor costs would have to be continued in order to provide the incentives needed for the creation of new jobs. However, general wage moderation might not be sufficient to improve labor market conditions; changes in the wage structure would be needed to restore sufficient labor mobility. Experience in other countries with apprenticeships and training schemes paying wages below those for active jobs suggested that there were ways of solving the seemingly intractable problem of unemployed young persons.

The imbalances in the incentive structure were reflected in the relationship between minimum wages and unemployment benefits, Mr. Laske commented. Despite the recent reductions in unemployment benefits, the continued excessively small difference between them and workers' income could provide a disincentive to the active seeking of employment. Given the large extent to which the number of unemployed persons exceeded vacancies, a reduction in unemployment benefits would not improve the labor market situation immediately, but it would influence future choices between employment and unemployment and help to lower the collective burden.

Reductions in work time and the introduction of work-sharing arrangements had been used by the Government to help to alleviate problems in the labor market, Mr. Laske observed. In major sectors of the economy, including the public sector, reductions in working time had been accepted in place of nominal wage increases. According to the staff, the employment-creating effect of those arrangements in the private sector was rather small, and the further shedding of redundant labor could probably be prevented. The success of the authorities' present approach seemed to hinge crucially on its cost neutrality, which might well be severely tested once the recovery gained strength and the demand for labor increased. It would be regrettable if the job-sharing arrangements introduced additional inflexibility into the economy and were a future source of cost-push pressure. The dangers inherent in such arrangements might be limited if they were introduced at the enterprise level and were kept sufficiently flexible.

Since 1980, Mr. Laske remarked, the share of gross fixed investment in GNP had fallen by more than 4 percentage points, to a historically low level. To brighten the prospects for job creation and growth, the trend in gross fixed investment should be reversed. To that end, an improvement in business profitability over the medium term was required. In that context, the main factors were wage costs and the collective burden, both of which had contributed to the disappointing performance of private sector investment. The authorities' intention to transfer resources from the household sector to the enterprise sector was therefore welcome. However, strengthening the financial position of enterprises by a permanent reduction in business taxes, rather than by the continued provision of subsidies, would both reduce the danger of channeling resources through public transfers to potentially inefficient operations, and provide incentives for profitable production and investment.

Mr. Clark stated that he broadly endorsed the staff appraisal. The Netherlands economy continued to show an unusual and worrying pattern of imbalances, namely, a large and growing fiscal deficit, and a substantial current account surplus. The underlying cause of that combination seemed to be the extent to which private sector activity and absorption had been depressed by the lack of confidence, rigidities, and high real interest rates. Some of the same factors had obviously caused the high level of private sector saving. Of equal concern, however, was that, while the general character of the imbalances had been evident for some time, there had been little progress in reducing them.

In addition to problems with income distribution and sector financial positions, Mr. Clark went on, the economy faced structural problems, particularly in the labor market and the social security system. The success in containing nominal wage increases was welcome, but there was still a pressing need to encourage both greater mobility, and more flexibility in determining wage differentials. The present generous social security benefits seemed more than the economy could support and were out of line with the scale of similar benefits in most other industrial countries.

The main challenge facing the authorities, Mr. Clark considered, was to restore the momentum of economic activity without provoking a resurgence of inflation. That task would certainly not be easy, as the problems to be tackled were both substantial and deeply ingrained. Priority should be given to reducing the fiscal deficit, in order to encourage a decline in real interest rates and to promote investment, cutting public expenditure from its present extraordinarily high percentage of net national income, reducing taxes, if possible, and eliminating the rigidities in the labor market.

In commenting on fiscal policy, Mr. Clark noted, the staff had noted two distinct but related issues. First, public expenditure, at some 70 percent of net national income, severely restricted the ability of the economy to adapt to market signals and required very high rates of personal and corporate taxation that reduced incentives to employ and, in conjunction with the generous social security scheme, also reduced the incentive to work.

The second issue, Mr. Clark went on, was the fiscal deficit, which had risen from about 7 percent of net national income in 1980 to 11 1/2 percent in 1983 and was projected at 12 percent in 1984. Financing the deficit had absorbed about two thirds of the new funds raised in the capital market in 1983, thereby placing upward pressure on interest rates, especially long-term rates. A study by the Netherlands Bank suggested that a rise in long-term rates affected corporate cashflow some seven times more than a rise in short-term rates. Moreover, by adding substantially to the public debt, the fiscal deficits increased the difficulty in bringing public finances under control in the medium term. Even if the fiscal deficit remained at the 1983 level, interest payments would reach 8 percent of net national income by 1988 and account for more than 20 percent of government revenues. That the authorities had apparently abandoned their medium-term strategy for reducing the fiscal deficit to 7 1/2 percent of net national income by 1986 was particularly disappointing; they undoubtedly ran the risk of, inter alia, constraining any resurgence in business confidence. The alternative of seeking a reduction of 1 percentage point each year seemed a rather modest substitute.

Commenting on public expenditure, Mr. Clark said that he fully agreed with the staff emphasis on establishing targets for expenditure reduction. The authorities had introduced a number of politically courageous measures in that direction in 1983, but they had served only to bring expenditure back within the estimates for the year, and had not accomplished a reduction. Expenditure in 1984 was programmed to rise by more than 8 percent, and would still remain at 70 percent of net national income. A substantial further cut was clearly needed, particularly in social security payments. The staff reports could have usefully included a breakdown of public expenditure and revenues. The staff description of unemployment benefits suggested that they were extremely generous in both the amounts paid and the length of time of the payments. In addition, the scope of the capital investment law, which the staff suggested was not particularly effective, might be reduced.

On the revenue side, Mr. Clark went on, the cuts in business taxes, particularly the reduction in employers' social security contributions, which had constituted a major part of the high indirect wage costs, were welcome. Further reductions might be a useful way of stimulating employment.

The staff had noted that, despite three years of wage moderation, the share of labor income in total income had remained at more than 90 percent in 1983, Mr. Clark remarked. At the same time, unemployment had risen to some 14 percent, and employment had fallen, owing largely to business closures. Those facts underscored the need for further wage restraint, which, given the low rate of inflation, might involve cuts in nominal wages.

The authorities had made substantial progress in breaking the link between public and private sector wages and in eliminating the statutory incomes policy, Mr. Clark commented. The result should be an increase in flexibility in the setting of wages; in particular, there should be a better relationship between wages and productivity. A reduction in the minimum wage and a scaling down of unemployment benefits would enhance work incentives in general, and would encourage employers to hire young workers in particular.

He shared the staff's doubts about the usefulness of creating jobs by shortening the workweek, Mr. Clark remarked. The empirical evidence suggested that direct employment-creation effects thus far had been small. In addition, job sharing might actually reduce the ability of industry to adapt to changing conditions, as workers would tend to call for a reduction in hours in order to stave off redundancies.

It would be useful to know how important the share of large multinational companies had been in total recorded company profits, Mr. Clark commented. Although the external current account position was not a cause for concern at present, a fuller discussion of developments and trends in trade flows would also have been useful. Finally, an examination of the financial flows that had been the counterpart of the rather unusual pattern of sector balances would have been helpful.

Mr. Jaafar said that the staff reports clearly showed that the main task facing the authorities was to reduce the size of the public finances and the fiscal deficit. Government expenditure had reached the equivalent of some 70 percent of net national income in 1983. The large size of government expenditure had caused a number of well-known problems, including rigidities that were deeply imbedded in the economy. It would be difficult to roll back public expenditures to a more reasonable level, especially as many of them were welfare expenditures.

The recent cut in overall expenditure was not sufficiently large to achieve a significant decline in the share of expenditure in net national income, Mr. Jaafar went on. The amount of expenditure planned for 1984 was similar to the amount actually spent in 1983. The staff had suggested that, while the authorities saw the need to cut spending in order to increase the flexibility in the economy, they were acutely aware of the potential adverse effects on domestic demand. Experience in other countries had clearly shown that it was preferable to maintain policy restraint in the current stage, even at the expense of employment and output in the short run, in order to ensure sustainable growth later on. Indeed, the same policy advice that was widely being given to developing countries was applicable to the Netherlands. The Netherlands authorities needed to make significant progress in controlling public finances, and their determination to do so was commendable. Their performance should be reinforced and extended, particularly as there was evidence of improvement in the economy.

The seriousness of the structural component of public expenditure, Mr. Jaafar continued, was underscored by the social security benefits, which, at some 89 1/2 percent of take-home pay, were among the highest in Europe. Although the benefits were commendable for social reasons, he fully agreed with the statement on page 12 of SM/84/47 that "there can be no doubt that these social security provisions have contributed to keeping the participation of women in the Dutch labor force the lowest among OECD countries and easy access to generous disability schemes has lowered participation rates generally." Reducing the social security benefits was essential not only to reduce the public expenditure burden, but also to introduce more flexibility into the labor market, thereby helping to stimulate the profitability and investment needed to encourage a sustained recovery.

On the public sector deficit, Mr. Jaafar said that the increase in the public sector financing requirement from 10 percent in 1982 to 11.6 percent in 1983 had occurred together with an increase in the collective burden to some 56 percent in 1983. Although an improvement on the expenditure front would somewhat ease the collective burden, as had recently occurred in Japan, the Netherlands authorities had tried to reduce the rising debt service burden by lowering the public sector borrowing requirement. Growing debt service payments over the medium term would add to the difficulty in servicing the debt; a debt service burden could gather its own momentum, thereby compounding the structural problems facing the economy. There seemed to be little room for raising revenues, given the large tax burden; further information on the matter was needed before a final judgment could be made.

The authorities were to be commended for the progress made in moderating wage growth, which had contributed to the loss of competitiveness and the growing rigidities in the economy, Mr. Jaafar observed. The present high rate of unemployment had presumably helped to contain any unwarranted excess wage demands. That progress was particularly welcome in the light of the highly centralized nature of wage bargaining in the Netherlands and of the past tendency toward wage indexation. The recent evidence of some decentralization of wage bargaining was a significant development, and continued and stronger evidence of reduced use of indexation would constitute a major breakthrough in labor relations in the Netherlands, where unemployment had risen to a record level and the rate of inflation had decelerated dramatically.

In the light of the importance for domestic monetary stability of the stable exchange rate between the guilder and the deutsche mark, Mr. Jaafar remarked, the subordination of monetary and interest rate policies to the achievement of the exchange rate objective was understandable. However, in the present circumstances, including the low rate of inflation, the high rate of unemployment, and the restoration of exchange rate stability, there seemed to be some leeway for monetary expansion; therefore, the present somewhat relaxed monetary stance was welcome, as it should help to stimulate investment. The authorities' room for maneuver would however become more limited as private sector business expanded. That conclusion underscored the pressing need to reduce the fiscal deficit. Moreover, the authorities would have to be vigilant in conducting monetary policy and would have to be prepared to pull back if necessary on monetary growth if the liquidity overhang appeared excessive.

The authorities were to be commended for having removed restrictions on capital imports and for maintaining liberal trade policies despite the economic difficulties, and particularly the record-high rate of unemployment, Mr. Jaafar said. Their efforts to encourage other members of the EC to remove trade barriers or to prevent their establishment were welcome. The allocation of 1.2 percent of GNP to development assistance for 1982-84 was also welcome. He hoped that the decrease to 1.1 percent in 1984 would be a temporary deviation from the long-term trend of aid by the Netherlands.

There were still areas where progress was needed, Mr. Jaafar concluded, but the recovery and the strength of the external sector had improved the outlook for the economy. That welcome development should ease somewhat the required adjustment effort.

Mr. Tvedt recalled that in its previous report the staff had projected a reduction in GDP in 1983 as a result of a continued substantial decline in private consumption and a further flat performance of fixed investment. In fact, both private consumption and investment had picked up--the real foreign balance having made a substantial contribution--and the growth performance had been much better than expected. Moreover, in 1984 a further increase in total output--mainly as a result of stockbuilding and increased private investment--was expected, and for the first time in several years total domestic demand was expected to increase. The decline in profitability in the business sector was thought to have come to a halt, and the downward trend in employment also might have come to an end. According to OECD projections, the gain in foreign market shares in 1984 would be substantial for the second consecutive year. Hence, in important areas the economy had performed significantly better than expected; the short-term prospects had improved substantially and were in line with the average for other smaller industrial countries.

Nevertheless, Mr. Tvedt went on, the large imbalances in the budget and the labor market were approaching record levels. Expenditures had risen even faster than the sharp increases in the total tax burden, creating a substantial adjustment problem. Given the comparatively high income of the people and the absence of balance of payments constraints, the potential clearly existed for restoring a better balance between public and private sector activities, preferably by cutting expenditures. The authorities had already taken commendable steps to contain expenditures, but the burden of the public sector on the economy was still substantial, and he agreed with Mr. Clark that the apparent relaxation of the goal of reducing the public sector deficit to 7 1/2 percent of net national income in 1986 was an unfortunate deviation from the publicly announced policy targets; it would certainly not lend credibility to the authorities' claim that they were tackling the various problems with determination.

Although the staff had not presented a breakdown of public expenditures, Mr. Tvedt remarked, it appeared that transfer payments constituted a major structural problem. Such problems were characteristic of many other industrial countries, but both the relative size of, and the rigidity in, transfers in the Netherlands had given them a special significance. Unemployment and other nonwork benefits were high by international standards. On a number of previous occasions, it had been noted that excessively generous unemployment benefits could create important labor market rigidities and imbalances and were a possible cause of the sharp increase in the so-called full-employment unemployment rate in many countries. Widening the differential between unemployment benefits and wages appeared to be an important means of increasing labor market flexibility. In the circumstances, he agreed with the staff that the widening of the differential in the Netherlands should preferably be achieved by reducing benefits.

In the light of the high rate of unemployment, Mr. Tvedt commented, the authorities had decided to alleviate the problems in the labor market by shortening work time and through labor sharing. His authorities in Denmark had studied the impact on unemployment of reducing weekly working hours. The study, which was based on certain assumptions and involved technical and highly debatable calculations, suggested that, without compensation for the loss of income, a reduction by one hour in the workweek could have a substantial positive effect on employment; when the elimination of idle capacity was taken into account, it could also have a beneficial effect on the balance of payments and GDP growth. However, in the study it had been emphasized that the most fruitful way of using reduced labor supply as an instrument to relieve unemployment was to develop more flexible schemes for early retirement, part-time work, and sabbatical leave, rather than to shorten the workweek. In a sense, sharing of work implied sharing of incomes. Work sharing involved difficult political, social, and economic problems and probably could not realistically be expected to contribute to a substantial reduction in unemployment.

While he saw several problems with a general reduction of work time, he was not as pessimistic as the staff about its usefulness, Mr. Tvedt continued. Moreover, while he agreed that increased wage differentiation had certain benefits, he had some difficulty in endorsing the staff's conclusion that a shortening of work time would tend to impede the move toward wage differentiation. What evidence did the staff have to support its argument on page 18 of SM/84/47 that "experience has shown that mismatches in the labor market appear in the Netherlands at very early stages of any upturn"? He wondered whether that problem was more important in the Netherlands than in other countries. For instance, on the basis of unit labor costs in local currencies for 1970-79, labor cost increases in the Netherlands had been significantly lower than in most other industrial countries; the unemployment rate had generally been below or equal to the industrial country average.

He agreed with the staff that the economic situation in the Netherlands was characterized by several paradoxes, Mr. Tvedt concluded. On the one hand, there had been some unfavorable developments, but on the other the authorities had achieved low wage and price increases, a comfortable competitive position despite the strong currency, large external current account surpluses, and relatively low interest rates. On several previous occasions, some speakers, particularly the Executive Director for the United Kingdom, had suggested that the Fund should examine structural problems of member countries to a greater extent. Although the problems facing the Netherlands economy seemed to be essentially structural, they were of concern to many different member countries and deserved more attention than they had previously been given. Finally, the authorities were to be commended for their liberal trade policies and substantial official development assistance.

Mr. Erb remarked that the staff reports and Mr. Polak's opening statement had shown the shift in economic strategy away from demand management in favor of a persistent attack on structural weaknesses. He agreed with the staff appraisal.

Given the steady decline in the ratio of gross fixed investment to GNP in 1979-82, Mr. Erb said, it was easy to understand the authorities' concern about business profitability. The initial evidence of recovery in 1983 and the forecast of a further rise in economic activity in 1984 were encouraging. However, through the first half of 1983, the recovery had centered on transport equipment, while the growth of machinery and equipment investment had remained negative. A more favorable pattern of the recovery in the manufacturing sector would include a revival of investment in machinery and equipment, and he agreed with the staff that the continued efforts by the Government to restore business profitability by removing disincentives would be an important factor in business confidence and in investment decisions. However, like the staff and some previous speakers, he doubted whether it was desirable to use direct government subsidies, for example, in the form of investment premiums.

The rise in the rate of unemployment to 14 percent, one of the highest among industrial countries, Mr. Erb noted, and the decline in employment in recent years, were due largely to the rather rapid growth of the labor force and to the continued high wage rates. He agreed with previous speakers who had mentioned the need for further cuts in real wages. As for work sharing, he agreed with the staff that the employment-creating effects of such measures were uncertain, and that such arrangements could have adverse effects on productivity if they created an impediment to flexibility in varying the number of hours worked, especially in the critical early stages of economic recovery. The staff had wisely underscored the importance of the need for more wage differentiation if the Dutch economy were to be able to respond promptly to new economic growth and job-creation opportunities. The possibilities for improving work incentives by reducing the very high income-replacement rate under the unemployment insurance system, of increasing job creation by reducing the minimum wage and introducing training measures, and of increasing labor mobility through less rigid regulations on dismissals, were worth serious consideration by the authorities.

The main problem in the public sector deficit was clearly on the expenditure side, Mr. Erb commented. The authorities had perhaps been excessively prompt in resorting to tax increases in response to expenditure overruns. The ratio of public expenditure to net national income was expected to rise by 6 1/2 points between 1980 and 1984; of that total, 4.2 points would be due to transfers to households and the rest to rising interest payments. The rapid growth in transfers to households underscored the great extent to which the social insurance system had become both a mechanism for redistributing income and a major problem with respect to the structure and size of the Government. In 1982, more than 41 percent of disposable personal income had consisted of transfers to the Government, while direct taxes and social security contributions had taken away more than 44 percent of such income. The growth of interest payments had constituted another problem, as they had already absorbed nearly 12 percent of central government revenues in 1983; the staff had estimated that such payments would pre-empt nearly 22 percent of such revenues by 1988 if the deficit remained at the 1983 level.

The authorities were to be commended for having contained inflation and maintained a strong external sector while continuing the liberal trade and payments regime, Mr. Erb considered. Some important progress had been made in improving the prospects for reviving productive private investment, and the Netherlands might be able to reach a more acceptable level of real economic growth. However, major reductions in the high rate of unemployment were unlikely to occur in the absence of more dramatic treatment of the high level of public transfers and real wages.

Mr. Teijeiro recalled that, during the previous discussion on the Netherlands, he had welcomed the change in emphasis from demand management fine-tuning to dealing with structural weaknesses. He had agreed that the growth of government transfers had been the cause of the problems facing the economy, particularly because an important share of the increased cost of the welfare system had been borne by business profits, and because the welfare system had had negative effects on labor supply. Transfers had reduced the efficiency of resource allocation by artificially encouraging the movement of resources away from the manufacturing sector and toward less productive sectors, such as services.

He had maintained, Mr. Teijeiro continued, that the problems facing the economy should be solved in various stages. Accordingly, first priority should be given to shifting the burden of the welfare system--including the cost of the inefficiencies that it introduced--to wage earners in order to restore business profitability to levels equivalent to those prevailing in other markets. The need for such action was urgent, as it was a precondition for changing the business climate and for providing signals of the success of the present stategy.

In the second stage of the effort to correct the problems, Mr. Teijeiro said, there should be changes in the tax structure to reduce the distortions that had been introduced by the differential between labor costs and take-home pay. For instance, the substitution of general consumption taxes for payroll taxes could reduce the incentive for labor to move away from organized employment toward less controllable sectors such as services, where payroll taxes could be avoided. In the third stage, the benefits under the welfare system should be reduced. It was unrealistic to expect rapid reductions in welfare transfers, but reductions would have to be made to reverse the negative effects on the labor supply, the savings rate, and the growth rate in the long run.

At the time of the previous discussion on the Netherlands, Mr. Teijeiro commented, he had wondered whether a more flexible exchange rate policy would not be appropriate, given the size of the disequilibria in the economy. A flexible policy still seemed called for. It was difficult to see how the imbalances could be eliminated in a reasonable time in a context of a low rate of world inflation and positive increases in labor costs in nominal terms.

It would be useful to have a further comment on the reduction in labor costs that would be needed to restore profitability to a level equivalent to that prevailing in other major economies, Mr. Teijeiro continued. The magnitude of the needed adjustment should be an important factor in the decision on the appropriate exchange rate policy. It could provide a rough idea of the wage deflation necessary to restore equilibrium and of the time that would be involved in the process of adjustment under different scenarios of world inflation and the behavior of domestic nominal wage costs.

In exchange rate policy, Mr. Teijeiro said, he did not agree with the staff conclusion that "the large current account surplus and the increase in competitiveness associated with wage moderation and low inflation prevent the use of the exchange rate instrument to increase profitability and overall demand." The large current account surplus was not an indicator of competitiveness. As the staff had noted, "the rising current account surplus is largely the result of a fall in investment outlays which cannot be remedied until there is definite improvement in the operating conditions in the business sector." In any event, the recent increases in competitiveness seemed very small in comparison to the size of the imbalances at the beginning of the 1980s.

The case that the staff had made for the advantages of a fixed peg of the guilder to the deutsche mark in the present circumstances was unconvincing, Mr. Teijeiro considered. On page 10 of the staff report, it was noted that the Netherlands Bank authorities felt that the firmness of the Dutch guilder determined the scope for a reduction of interest rates; lower capital costs, in turn, were considered a crucial condition for increasing investment and would have positive effects on the competitive position of enterprises as well. While there was scope for maintaining nominal interest rates at levels similar to those in Germany, what mattered for investment and the position of enterprises was the level of real interest rates. Because the exchange rate between the deutsche mark and the guilder was fixed, real interest rates would be determined by the degree of domestic deflation that was needed to achieve the required adjustment and to eliminate the imbalances in the economy. It could be argued that, given the adjustments to be made, real interest rates would be higher with a fixed peg to the deutsche mark than under a realignment of the peg, provided that it was large enough and was accompanied by consistent fiscal and monetary restraint to eliminate expectations of a further realignment. The negative effect on interest rates of the realignment of March 1983 constituted an argument against excessively small devaluations that could not convince the market that further exchange rate adjustments would be unnecessary.

He agreed with the staff, Mr. Teijeiro said, that a piecemeal approach to adjustment might not be sufficient, as the behavior of private business would probably change only after there was greater certainty about the ability of the Government to maintain its present policy stance. The Government's ability to continue its policies would depend in turn on the quick response of the private business sector. Hence, a vicious circle could develop unless more decisive policy action were taken. The best step to take first would be to accelerate the reduction in welfare payments and pass on the savings in the form of a reduction of taxes on business and an increase in profitability. If significant cuts in nominal welfare payments could not be made in a short period, the alternative of greater exchange rate flexibility was worth considering.

Mr. Portas considered that the authorities should be commended for maintaining prudent policies that had resulted in an improvement in the economic environment, and in placing the economy in a better position to recover and make continued progress in the medium term. The policies maintained during the previous several years, supported by the economic recovery abroad, had produced low inflation rates, declines in domestic interest rates, gains in competitiveness, and a strengthening of the balance of payments. Policies aimed at achieving wage moderation and improvements in labor productivity had helped to arrest the deterioration in business profitability, thereby placing the economy on a sounder footing for improving investment performance. The prospects for continued improvement in investment in 1984 were encouraging. Not surprisingly, however, given the structural nature of the fiscal and unemployment problems, the most recent policy actions of the authorities under their new approach had yielded only marginal gains in the employment and fiscal areas.

He agreed with the staff, Mr. Portas continued, that the measures planned under the 1984 budget to cut public spending were positive steps, but that further cuts were needed, particularly in social benefits. For social reasons, such cuts were difficult to make, but they were needed to eliminate one of the main sources of structural problems. At the same time, he agreed with the authorities on the need to eliminate other structural weaknesses of the budget, which, like the excessive social benefits, had resulted from the past behavior of internal and external factors and were at present a constraint on fiscal policy action.

The authorities' intention to reduce the collective burden, particularly by actions that would have a bearing on the structure of demand, was welcome, Mr. Portas remarked. The tax reductions under the budget, which were expected to stimulate private investment and profits, were also welcome. Those actions, together with further cuts in social security payments, would help to reverse the unfavorable pattern that had emerged during the previous decade, when consumption had grown more rapidly than investment. However, the staff had noted that no further tax relief for enterprises was expected in 1985, and that cuts in social security payments that were to have been made in 1984 were being postponed. Furthermore, the decision to reduce corporate taxation in 1984 had been a response to specific circumstances rather than a part of a larger effort to reduce the tax burden. He wondered whether the special conditions that were reflected in the 1984 budgetary process were likely to recur in subsequent years. In any event, it was clear that the emphasis that the authorities were placing on narrowing the public sector deficit was essential to reversing the increase in interest payments, another structural element of the budget that further limited present and future fiscal policy action.

Continuing, Mr. Portas said that he agreed with previous speakers who had said that, given the present trends in the economy, excessive emphasis on a quick reduction in the deficit mainly through limited expenditure cuts could have unfavorable effects on growth potential and employment, as the staff had indicated in its appraisal. In view of the depressed domestic demand and the low rate of inflation, he agreed with the staff that greater emphasis on reducing the size of the public sector, and less stress on reducing the public sector deficit, would have a more favorable impact on growth and employment.

As the staff had stressed, Mr. Portas commented, unless employment benefits and related benefits were reduced from the present high levels, so that the margin between unemployment benefits and employment earnings was narrowed, attempts to reduce unemployment would have only marginal effects. In order to reduce labor costs further, it was clearly necessary to close the gap between unemployment benefits and employment earnings, particularly in view of the limited room for further reducing real wages. Significant progress had already been made in eliminating some rigidities in the labor market, and further flexibility was likely to be gained as a result of some of the negotiations on layoffs.

The introduction of work-sharing arrangements to reduce rigidities in the labor market and unemployment was also welcome, Mr. Portas said. Although those schemes might not have had a significant effect on unemployment thus far, their introduction had had the benefit of strengthening the system of social partners. It was too early to determine the impact of work-sharing arrangements on labor costs and unemployment in the Netherlands. The authorities were approaching the social partners system in a cautious way, given their experience with it, and together with the social parties they were making needed changes to adapt the system to the specific characteristics of the Netherlands markets. An excessively heavy reliance on work sharing as a means of improving employment opportunities should be avoided. As the staff had indicated, there was no conclusive evidence in the Netherlands or other countries of significant increases in employment resulting from work-sharing arrangements, although it was recognized that, if certain conditions were met, substantial gains could be achieved in the medium term.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/41 (3/14/84) and EBM/84/42 (3/19/84).

4. GABON - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/84/81 (3/14/84). Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1983 Article IV consultation with Gabon to not later than March 28, 1984.

Decision No. 7651-(84/42), adopted
March 16, 1984

5. ARAB MONETARY FUND - TECHNICAL ASSISTANCE

In response to a request from the Arab Monetary Fund for technical assistance, the Executive Board approves the proposal set forth in EBD/84/69 (3/7/84).

Adopted March 14, 1984

6. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 83/140 and 83/141 are approved. (EBD/84/70, 3/8/84)

Adopted March 14, 1984

b. The minutes of Executive Board Meetings 83/142 through 83/144 are approved. (EBD/84/72, 3/9/84)

Adopted March 15, 1984

c. The minutes of Executive Board Meetings 83/145 and 83/146 are approved. (EBD/84/74, 3/12/84)

Adopted March 16, 1984

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/32, Supplement 1 (3/14/84), EBAP/84/48 (3/13/84), EBAP/84/49 (3/14/84), and EBAP/84/52 (3/15/84) is approved.

8. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/84/50 (3/14/84) is approved.

APPROVED: August 30, 1984

LEO VAN HOUTVEN
Secretary