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December 21, 1983

To: Members of the Executive Board

FroM: The Acting Secretary

Subject: Belgium - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Belgium, which has been tentatively scheduled for discussion on Wednesday, January 18, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Leipold, ext. 73743.

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INTERNATIONAL MONETARY FUND

BELGIUM

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983
Consultation with Belgium

Approved by L. A. Whittome and Subimal Mookerjee

December 21, 1983

Article IV consultations with Belgium were held in Brussels from October 5 to 17, 1983. The staff team consisted of Messrs. Dhonte, Leipold, Riechel, Ms. Xafa (all EUR), and Ms. de Korver (ADM) as secretary. The team met with the Governor of the National Bank, Mr. Godeaux; the Minister of Finance and Foreign Trade, Mr. de Clercq; the Minister of Economic Affairs, Mr. Eyskens; the Minister of the Budget, of Scientific Research and of the Plan, Mr. Maystadt; the Minister of Social Affairs and Institutional Affairs, Mr. Dehaene; and officials of the National Bank and the Administration. Mr. de Groote, Executive Director, and Mr. Coene, Assistant to the Executive Director, attended the meetings as observers.

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

I. Background

1. The recovery program

The Government which took office following the general elections of November 8, 1981 was confronted with a declining GNP, a large external current account deficit and a soaring public sector borrowing requirement, (exceeding, respectively, 4 percent and 16 percent of GNP in 1981) sharply rising unemployment, and accelerating inflation.

The Government's strategy to redress this situation was built on the premise that the root cause of the deteriorating economic performance of Belgium was the declining profitability and competitiveness of industry. The strategy accordingly sought to achieve a redistribution of disposable income from households to enterprises in order to stimulate output, exports and investment. The program designed for this purpose was articulated around an 8.5 percent devaluation of the Belgian franc against other EMS currencies (except the Danish kroner) on February 22, 1982. It included a partial suspension of wage indexation to consumer prices through the end of 1982, the extension of financial incentives to enterprises (such as a reduction of the corporate profit tax, and tax relief for the issue of new shares) and a plan to reduce the public sector borrowing requirement to about 7 percent of GNP in 1985.

In the course of 1982, it became apparent that the recovery would not be strong enough to stem the loss of private sector employment. As a quid pro quo for a large scale work-sharing program therefore, the partial suspension of wage indexation was extended into part of 1983. Full indexation only becomes effective in December 1983 under a more flexible formula using a four-monthly moving average of the CPI as the reference index.

2. Competitiveness and profitability

Belgian hourly labor cost competitiveness 1/ deteriorated by 35 percent from the early 1970s to 1979 (Table 1 and Chart 1). This deterioration contributed to a loss of price competitiveness, and to a sharp drop in profitability. In 1980 and 1981, differences in wage behavior and the depreciation of the effective exchange rate (MERM basis) improved labor cost competitiveness by 11 percent, but the share of disposable income of enterprises 2/ in GNP did not rise, and profitability remained depressed.

Table 1. Belgium: Exchange Rate and Profitability Indicators for Manufacturing

(Indexes 100 = 1970-73 average)

	1979	1980	1981	1982	1983 1/
Effective exchange rate (MERM)	118.8	119.0	111.0	100.1	96.9
Relative hourly compensation 2/	135.4	133.3	120.0	102.3	95.6
Relative export prices 3/	104.2	104.5	99.3	94.3	92.8
Nonlabor income as percent of value added (index)	82.1	75.4	79.3	84.4	92.7

Sources: IMF, International Financial Statistics; data provided by the authorities; and staff estimates.
1/ Staff estimates.
2/ Compared with seven main trading partners; adjusted for exchange rates.
3/ Compared with 19 trading partners; adjusted for exchange rates.

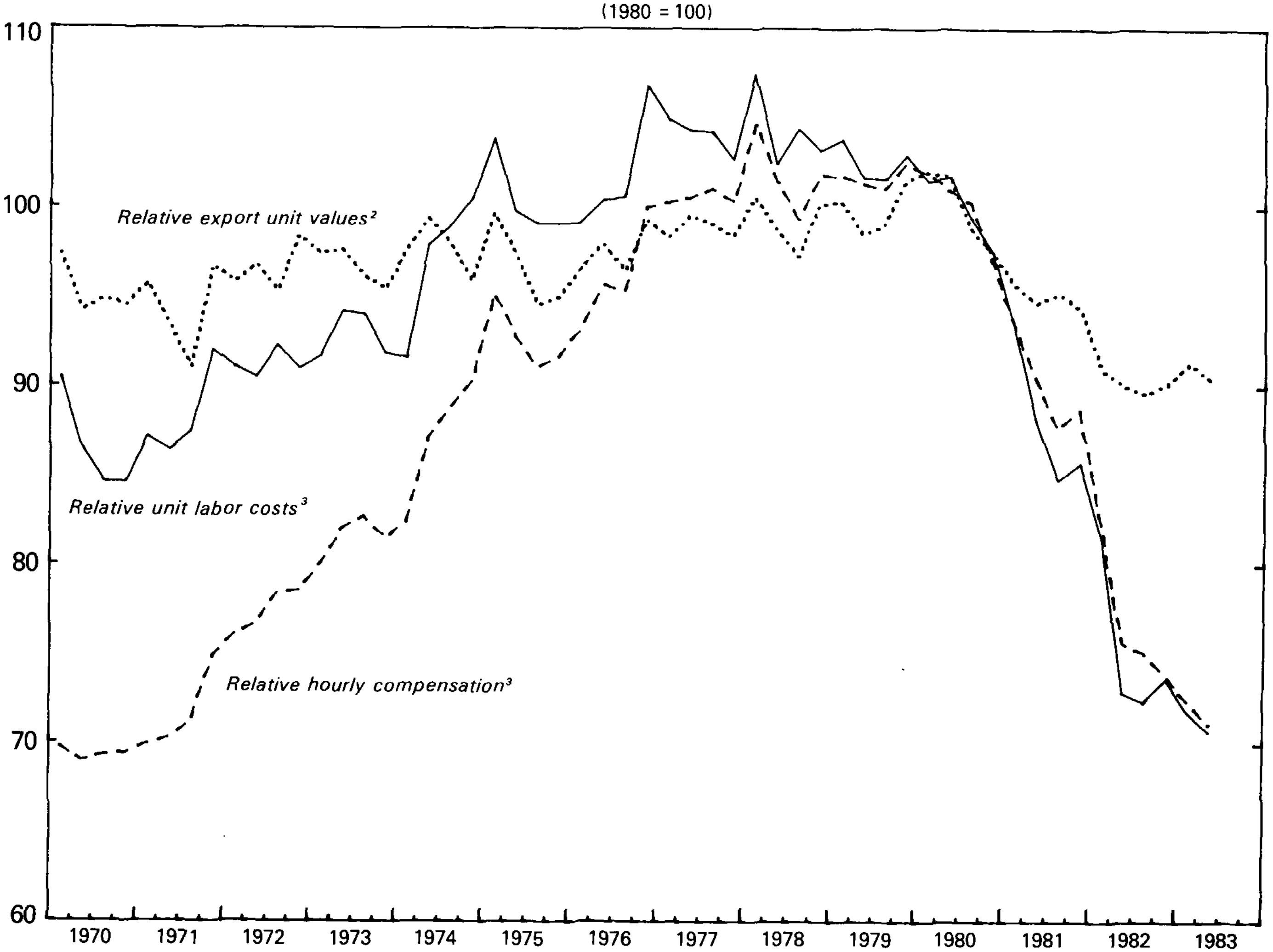
1/ An indicator of competitiveness that is more comprehensive and usually more appropriate is the index of relative unit-labor costs in manufacturing. In the case of Belgium during the period under review, however, the latter index is distorted (for the purposes at hand) by the nature of the shrinkage of the Belgian manufacturing sector over the past decade or so--a process in which the elimination of firms or lines of production afflicted by poor productivity performance tended to impart an upward bias to the movement of the standard indices of manufacturing output per man-hour, and hence a downward bias in the available indices of manufacturing unit labor costs.
2/ Gross operating surplus less interest, dividends and taxes.

CHART 1

BELGIUM

INDICATORS OF COMPETITIVENESS[1]

(1980 = 100)



Source: International Monetary Fund, *International Financial Statistics*.
[1]In manufacturing.
[2]Compared with all partner countries; in common currency.
[3]Compared with seven most important partner countries; in common currency.

The remaining gap in labor cost competitiveness was closed by 1983; in two years, relative hourly wage costs declined by 20 percent, of which about one half can be directly attributed to the measures of February 1982. The share of disposable income of enterprises in GNP recovered strongly, mostly in 1983, when it returned to its 1970-73 average (Table 2).

Table 2. Belgium: Distribution of Disposable Income

(In percent of GNP)

	1970-73 Average	1979	1980	1981	1982	1983 1/
Households	74.3	76.5	78.1	81.3	79.8	78.2
Enterprises 2/	9.4	7.4	6.9	6.5	7.7	9.4
Public sector	15.8	15.5	14.1	11.0	11.3	10.9
Rest of the world	0.5	0.6	0.9	1.2	1.2	1.5

Sources: Data supplied by the authorities; and staff estimates and calculations.

1/ Staff estimates
2/ Before capital transfers.

However, as regards specifically the manufacturing sector, the recovery of profitability appears to have been less than complete. Staff estimates suggest that only three quarters of the decline of the share of nonlabor incomes in value added through the 1970s was reversed by 1983. Similarly, estimates of the rate of return on capital suggest that its relationship to the long-term interest rate remains less favorable than ten years ago. Due to time lags and low rates of capacity utilization, the improvement in labor cost competitiveness, was first (in 1981 and early 1982) reflected in lower relative prices, and unit margins only improved after mid-1982, perhaps because the rate of capacity utilization had by then risen perceptibly.

3. Public finance

The public sector borrowing requirement rose from 12 percent of GNP in 1980 to over 16 percent in 1981, and, contrary to the Government's intention, remained at about that level through 1983. 1/ However, the past trend to rapidly rising deficits was arrested. For the first time in many years, the share of general government current expenditures in GNP was stabilized in 1982 and 1983 albeit at a very high level; total general government outlays were equivalent to nearly 65 percent of GNP in 1982, of which close to 10 percentage points were for interest payments alone.

The accumulation of deficits has led to a strong build-up of public debt (equivalent, including publicly guaranteed debt, to 127 percent of GNP at the end of 1982), and over 1978-82 interest payments have risen six times as much as unemployment compensation. Part of the public debt has been accumulated in foreign currencies. Official foreign currency liabilities, including those issued with a public guarantee, were equivalent to US$20.5 billion or 24 percent of GNP at the end of 1982, compared with 7.7 percent at the end of 1980. Close to half the debt in foreign currency is short-term; amortization payments scheduled on the medium- and long-term debt average BF 22 billion for 1984 to 1986; they rise to an average of BF 128 billion in the next two years, and decline thereafter.

The budget for 1984, which was submitted to Parliament in October 1983, targets a reduction in the central government's borrowing requirement to 11.5 percent of GNP, from the 12.8 percent of GNP estimated for 1983. For the second year in a row, current expenditure--excluding interest payments--is to decline in real terms. However, expenditures of the General Government as well as its borrowing requirement would remain about unchanged, relative to GNP.

4. Financial flows

The higher disposable income of enterprises has led to little additional investment. For several years, enterprises have accumulated financial surpluses as low investment and high real interest rates led them to consolidate their balance sheets. This trend was

1/ This figure includes net lending equivalent to 3 to 4 percent of GNP in the past three years. By subsectors, the Treasury records the largest deficit (a borrowing requirement of about 13 percent of GNP), the balance being attributable in roughly equal shares to the local authorities and to the so-called "debudgetized" sector, which covers the State's contribution to the financing of semi-public entitites and ailing enterprises. Social security funds are broadly balanced.

continued in 1982 and 1983, when the financial surplus of the business sector rose by three points of GNP (Table 3), raising the surplus of the private sector by an equivalent amount.

Table 3. Belgium: Sectoral Financial Balances

(In percent of GNP)

	1970-73 Average	1979	1980	1981	1982	1983 1/
Financial surplus or deficit (-)						
Households	11.6	5.7	6.3	10.1	9.2	9.7
Enterprises 2/	-3.9	0.4	1.0	1.6	2.7	4.8
Public sector 2/	-5.2	-8.9	-11.9	-16.2	-15.7	-16.0
Rest of the world	-2.5	2.8	4.6	4.5	3.9	1.5

Sources: National Bank of Belgium; and staff estimates and calculations.

1/ Staff estimates.
2/ After capital transfers.

In addition, higher interest rate differentials and improved confidence in the Belgian franc, especially after the March 1983 EMS realignment, improved the attractiveness of Belgian franc investments relative to foreign placements. As a result, the flow of domestic resources to resident financial institutions rose to an estimated 14 percent of GNP in 1983, while private borrowing from these institutions may have dropped to 1 percent of GNP (a drop of over seven points in four years). Altogether, the domestic funds available to finance the public sector may have increased to about 13 percent of GNP. The shortfall of funds to be financed through official external borrowing and drawings on reserves accordingly dropped from 8 percent of GNP in 1981 to an estimated 3 percent in 1983 (Table 4).

Table 4. Belgium: Flow of Funds

(In percent of GNP)

	1970-73 Average	1979	1980	1981	1982	1983 1/
1. Domestic funds available to public sector	5.7	3.7	5.8	7.9	11.5	13.0
Resources of resident financial institutions 2/	(12.8)	(12.1)	(11.1)	(11.1)	(13.2)	(14.0)
New borrowing by private sector 3/	(7.1)	(8.4)	(5.3)	(3.2)	(1.7)	(1.0)
2. Public sector borrowing requirement	4.5	8.9	11.9	16.2	15.7	16.0
Shortfall of funds (1)-(2)	-1.2	5.2	6.1	8.3	4.2	3.0

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

1/ Staff estimates.
2/ Total domestic asset formation by nonfinancial agents, including in foreign currencies, with resident financial institutions.
3/ Total increase in private sector liabilities to Belgian financial intermediaries.

5. The external balance

The counterpart to the rising business financial surplus, and to the increased attractiveness of Belgian franc investments, was a sharp reduction in the external deficit on current account and private capital outflows. For the Belgium-Luxembourg Economic Union as a whole 1/ this deficit was reduced from BF 356 billion in 1981 to BF 31 billion in the first half of 1983. On a cash basis, the current account deficit dropped from BF 199 billion in 1981 to BF 43 billion in the first half of 1983, and is forecast at BF 60 billion for that year. Three main contributions to this improvement were a gain in market shares, which sustained export volumes despite weak market growth; the stabilization of terms of trade despite the devaluation, after two years of sharp declines; and a marked improvement in the balance on services, notably for travel. Net private capital outflows remained large in 1982 and in the first quarter of 1983, owing in part to a few large transactions; following the EMS realignment of March 1983, a net inflow was recorded in the second quarter.

1/ Separate balance of payments data for Belgium and Luxembourg are not available.

The reduction of the deficit on current account and private capital was reflected in 1982 in reduced reserve losses by the National Bank (BF 38 billion in 1982 against BF 96 billion in 1981) and in a stabilization of net official external borrowing. Further reserve losses in the first quarter of 1983 were more than reversed in the second quarter, while official external borrowing after the EMS realignment was mostly for the purpose of improving the maturity structure of the debt.

6. Activity and prices

Several developments exerted a depressing influence on activity in 1982 and 1983. The partial 1/ disindexation of wages itself had a direct negative impact on disposable incomes of households; in terms of annual averages, it reduced real monthly wages by 2.1 percent in 1982, and an additional estimated 3.8 percent in 1983. Due to carry-over effects it will entail a further reduction of 1.2 percent in 1984. Foreign market growth in volume averaged 0.5 percent in these two years, as against 4.5 percent in 1980-81, while increases in real current public expenditure were held to 1 percent as against 4 percent in 1980-81.

Despite these depressing influences, real GNP recovered slightly from a 1.2 percent decline in 1981 to an estimated growth of 0.7 percent in 1982 2/ and, according to staff estimates, may rise further in 1983. Two main contributions were the gain in export market shares, resulting from improved competitiveness, and a stabilization of investment expenditure, following a major decline in 1981. The recovery, however, was not sufficiently strong to prevent a continuing increase in unemployment to over 14.5 percent of the labor force by mid-1983.

Given the background of weak external and public sector demand, and of declines in real wage earnings, even this weak recovery of GNP is gratifying. Available data do not presently permit knowledge of the extent to which it may reflect improved supply conditions resulting from the adjustment of real wage costs, as envisaged in the Government's strategy. Improved wage competitiveness must have been a factor explaining the gains in market shares in 1982 and 1983. It may also have eased the pressure to increase labor productivity, and it may therefore have moderated the losses in employment; as evidenced in Chart 1, the accelerated labor shedding, characteristic of Belgium through the 1970s, ceased (but was not reversed) when wage competitiveness ceased to deteriorate. The improvement in profitability however,

1/ The disindexation of wages was partial insofar as the portion of wages and salaries below a certain minimum remained fully indexed. For economy of expression, the word "partial" will henceforth be dropped from the text.

2/ It is possible that the initial official estimate may be revised downward, perhaps to zero GNP growth in 1982 with a slight decline in domestic demand.

as noted previously, is more recent, and so far there is no evidence that it has significantly reduced the number of business failures or contributed to the stabilization of business investment. Still, the gains in market shares recorded in 1982 and 1983 make it clear that the improvement in the current account by 3 points of GNP between 1981 and 1983 did not exclusively proceed from a reduction in domestic demand.

Consumer prices rose by 8.7 percent in 1982, reflecting notably a 14.5 percent increase in import prices and decelerated, but slowly, in the first months of 1983. By the summer it became apparent that the deceleration was not quite as rapid as could have been expected on the basis of import and labor cost developments. Increases in the price of domestic services notably outpaced increases in export prices, suggesting that inflation was of domestic origin.

II. The Policy Discussions

The authorities noted that the cut in real wages had strengthened the financial condition of enterprises, and felt that the continued rise in unemployment had undermined support for the wage restraint policy. They concluded that until the time of new elections, which are due before the end of May 1985, there could be no further policy-induced reductions in real wages. They generally accepted that the public sector borrowing requirement was too high. They feared however that, given weak foreign and domestic demand, reductions in public expenditure could have an excessive deflationary effect, and they noted that easier domestic financing conditions have temporarily eased the urgency of reducing the public sector deficit.

1. Income policies

The authorities were satisfied that their policies had achieved the targeted redistribution of income to the business sector. As competitiveness had been restored, poor demand prospects were seen as the main obstacle to a recovery of investment and to an upturn in employment. This reasoning was seen as justifying a return to full wage indexation at the end of 1983 albeit by a slightly modified formula. The stabilization of real wages would improve domestic demand prospects and encourage investment, allowing some withdrawal of support by the public sector.

The authorities were determined that the gains in wage competitiveness which have been achieved should not be reversed, and in particular that there should be no catch up in wages following the return to indexation. To guard against this risk, they had established a "double norm", which they will enforce until the end of 1984. The first norm prohibits wage increases other than those resulting from indexation. The second norm stipulates that even then, wage cost increases in Belgium should in no case exceed the average of the seven major partner countries, expressed in a common currency.

The staff noted that the gains in business profitability, while large, still appeared to be insufficient to provide strong incentives to business investment. It accepted however that the return to full indexation was a political constraint, and focused on the need to preserve the gains which had been achieved. With emphasis on the manufacturing sector, it noted that domestic inflation appeared to have frustrated some part of the improvement in competitiveness and profitability in that sector which could have been expected on the basis of the devaluation and the wage disindexation. The staff further observed that the reduction in real monthly wages (totaling 7 percent over the partial disindexation period) would only be partly reflected in lower hourly wage costs, as working hours would be reduced by 2.5 percent while increases in social security contributions would add 2.2 percent to the wage bill by 1984.

The authorities explained that disindexation through the end of 1982 had been sufficient to restore the competitiveness of enterprises. Continued disindexation in 1983 had therefore been primarily intended to promote employment through a reduction in working hours, associated with compensatory hiring. This scheme was implemented flexibly, so as to leave hourly labor costs as well as the total wage bill unchanged, and was expected to raise employment in late 1983 or early 1984 by 45,000. The increase in social security contributions finally was seen as an alternative to a higher public sector deficit or to further reductions in benefits, at a time when the higher business savings were not resulting in commensurate increases in investment. The authorities noted, however, that even with these additional charges they expected wage cost increases in 1984 to be broadly in line with developments in partner countries.

2. Investment policy

The authorities relied on market mechanisms to secure the needed recovery of investment and to achieve the restructuring of the industrial sector. They explained that the main thrust of the Government's investment policy was to improve the macroeconomic environment. In addition to the income policies of 1982-83, corporate tax rates had been reduced and fiscal incentives for business and housing investment had been introduced. Corporations had been granted deductions on corporate taxable income up to a certain percent of investment, and fiscal incentives had stimulated the equity market. Housing investment had benefited from a 9 point reduction in VAT rates, effective through end-1985, and, in 1984, would benefit from income tax adjustments. They did not believe that additional measures would be useful, and they considered that the most effective policy was to sustain the recent improvement in profitability and to offer the assurance of a stable business climate.

As an exception, specific financial assistance would continue to be extended to industries facing particularly acute structural problems (steel, textiles, shipbuilding, coal and glass). The authorities were determined that this assistance should be temporary, and be designed to foster rather than to retard the restructuring of these sectors. In the textile industry, restructuring was almost complete; it had entailed a heavy cost in terms of employment.

3. Fiscal policy

The initial objective of halving the public sector deficit between 1982 and 1985 is now out of reach. The authorities noted that this objective had been ambitious and based on the assumption of relatively buoyant growth, especially of foreign demand. Against the background of the actual trend of activity, the stabilization of the deficit relative to GNP, since 1981 constituted, in their view, a measure of success and reflected a substantial effort to improve expenditure control. Still, they considered that the present level of the deficits was excessive, and remained committed to reduce it over the medium term. They thought moreover that the total tax pressure had reached a limit, and that marginal income tax rates in fact were too high.

On this basis, the discussion centered on the appropriate stance of expenditure policy. The staff focused on the conditions that would best support an upturn in industrial investment, which was seen as a critical step in engineering a self-sustaining recovery of domestic demand. From that viewpoint, it appeared that the present level of public expenditure was excessive. It created a momentum for tax increases, and had indeed already led to increases in social security taxes. The portion of expenditure increases not financed by higher taxes accommodated a high rate of domestic inflation, notwithstanding higher interest rates than would otherwise be necessary. These factors were thought to undermine the competitiveness of the industrial sector, and to reduce the scope for profitable investment opportunities. The staff saw evidence in the experience of the late 1970s that this combination of factors had contributed to the deteriorating economic performance of Belgium, even though the pressures of taxation and the public sector deficit were less than at present.

A main concern of the authorities however, as in the discussion of their incomes policies, related to the path of aggregate demand and of employment. They argued notably, from studies which had been made for a medium-term reform of the social security system, that high employment was critical to the financial viability of the system. They felt accordingly that the reduction of the public sector deficit would have to be phased in with a pick up of external demand and a more buoyant domestic activity. In their view, the risk of excessive deflation in the context of a more sluggish world environment, and the greater domestic financing now available justified this approach, which was more gradual than that originally envisaged. They observed that the repercussions on domestic activity of weak external demand limited the economic and political scope for public expenditure cuts, particularly at a time when real wage incomes were already being reduced. They considered that the Government's own expenditure had been reduced to a minimum and saw little scope for further reductions in economic transfers. Further reductions in the financing requirement would therefore have to result from an upturn in activity, and from adjustments in social security transfers. The trend increase in social security transfers, however, was very strong, due in particular to the aging of the population.

As regards the financing of the borrowing requirement, the authorities observed that it had become much easier in 1983 as a result of the rising financial surplus of the private sector and of the increased attractiveness of Belgian franc investments. The share of domestic financing of the Treasury's deficit had risen from about one half in 1981 and 1982 to some three-quarters in the first eight months of 1983. Furthermore, domestic long-term funds could well cover half of the Treasury's financing requirements in 1983, against only 6 percent in 1981 and 13 percent in 1982. They agreed that these relatively easy conditions reflected the dramatic drop in the private sector's demand for funds and that continuing public deficits of the current magnitude would not be compatible with a recovery of activity. They expected however that economic recovery would expand the taxable base and boost receipts, so that any financing strains would probably be of a temporary nature.

4. Monetary policy

The discussion of monetary policy centered around the reconciliation of continuing large public sector deficits and of an improvement in the external balance. The authorities had set themselves a twin target of allowing no loss of net international reserves of the National Bank in 1983 and of restraining net private capital outflows at BF 60 billion for the year. These targets implied a readiness to adjust interest rates, but entailed also a significant reduction of external borrowing by the public sector.

The authorities observed that monetary financing of the Treasury had contributed to losses of net foreign assets amounting to BF 96 billion in 1981 and BF 38 billion in 1982, reducing net official reserves, including gold, to BF 206 billion (SDR 4 billion) at the end of that year. They considered this to be a minimum level for reserves and they were therefore determined that the access of the Treasury to the National Bank should be restrained.

They considered that interest rate management was an effective instrument to control private capital flows, and they had not hesitated in the past to use it in periods of exchange rate tension. Primary reliance on this instrument in past periods, when the domestic shortfall of funds was large, would have required unacceptably high interest rates. However, with the prospect of an improved financial position of enterprises, it became apparent in the course of 1983 that the relative contribution of interest rate policy could be larger than in the past. Accordingly, the authorities had set themselves a target ceiling for net private capital outflows in 1983.

Given a forecast current account deficit of BF 60 billion, the twin target for reserves and private capital flows implied a reduction of official external financing from BF 256 billion in 1982 to BF 120 billion in 1983. A large part of the domestic shortfall of funds required to finance the PSBR had, since 1979, been raised abroad, either directly by the Treasury, or through resident banks. The resulting increase in debt was viewed with concern. Therefore, even though the PSBR has not been reduced to the initially planned extent, the authorities still intended to discontinue net external borrowing in 1985. However, they recognized that external developments might cause some tension on the exchange markets. In that case, they stood ready to step up temporarily the Treasury's external financing, in order to protect the external position of the National Bank without having to increase domestic interest rates to detrimental levels.

Within this framework, they still sought to secure the lowest possible level of interest rates. Improved confidence in the Belgian franc after the March 1983 EMS realignment had allowed a gradual decline in short-term and long-term interest rates and in interest rate differentials. In September, the National Bank had not followed the increase in official rates in Germany and the Netherlands. The staff questioned this approach, arguing that it could cause the markets to doubt the authorities' determination to achieve their objectives for official reserves and the exchange rate, and for external borrowing. The staff further took the view that this policy entailed a higher level than would otherwise probably be necessary of monetary financing of the Treasury, which was seen to sustain domestic inflation and to fuel the deficit on current account and private capital which the authorities sought to contain. The authorities, however, noted that, given the size of the public debt, interest rate changes had a significant impact on the PSBR. They argued moreover that market expectations of a steady decline in long-term interest rates since the March 1983 EMS realignment had facilitated the placement of long-term Treasury bonds. As the spread with short-term rates was narrow, an increase in short-term rates could thwart this development.

5. External policies

The authorities emphasized that the gains in competitiveness that had been achieved were sufficient to assure external balance, and that they intended to preserve the present level of competitiveness, not to increase it.

For this reason, the exchange rate policy followed on the occasion of the EMS realignments since February 1982 had been to maintain a "zero position" of the Belgian franc within the EMS. While the markets had appeared at first to expect further downward adjustments of the franc, the reflow of private sector capital after the March 1983 realignment was seen as a clear indication that the credibility of this policy had been established. The authorities were fully committed to maintain this policy. They explained that the position of the Belgian franc, at the bottom of the EMS band for most months since the February 1982 realignment, resulted from their policy of keeping interest rates at the lowest level compatible with the reserves and capital account targets.

The authorities noted that in recent years the evolving structure of payments within the dual exchange market arrangements had led to a growing surplus on the current transactions channeled through the financial market, which had in turn allowed the financing of rising net private capital outflows through that market. This had been essentially due to the growing importance of receipts settled in banknotes (which must go through the free market) and of inflows of investment income (for which a choice of markets exists). While these significant exceptions to a rigid separation of the two markets undermined the overall rationale of the system, the authorities still felt that in periods of exchange rate tensions the arrangements reduced incentives for private capital outflows. While they kept the system under constant review, they felt that it could not be suspended or usefully substituted. Since April 1983, the discount of the Belgian franc on the financial market has remained below 2 percent. In May of 1983, in view of heavy capital inflows, the authorities authorized financial intermediaries to channel capital receipts to the official market.

The authorities were committed to an open and free trade system and pointed out that their assistance to ailing enterprises was consistent with this commitment.

Official development assistance of 0.59 percent of GNP in 1981 was kept at that level in 1982 and raised to 0.62 percent in 1983. Despite the domestic economic difficulties, the authorities remained committed to reaching a target of 0.7 percent in the near future.

III. Outlook

Staff projections suggest that the rate of consumer price increases might decelerate slightly from 7.8 percent in 1983 to 6.5 percent in 1984. Although this rate of increase is somewhat in excess of the official forecast, projections of partner country wage developments and the usual technical assumptions on exchange rates indicate that wage competitiveness would remain broadly unchanged. The inflation differential in national currencies, based on GDP deflators, would close from

1.9 percent in 1983 to 0.9 percent in 1984. A major risk, however, is that inflation in the noncompetitive sectors of the economy would continue to exceed cost developments, and would be transmitted to wage formation and input costs for industry.

Return to full indexation will lessen the pressure on real disposable income of households, allowing for a stabilization of private consumption, after a drop of about 3 percent in 1983. Further support to activity would result from an expected upturn in foreign market growth from 1 percent in 1983 to 3 percent in 1984. With some further gains in market shares reflecting the lagged contribution of improved competitiveness, real GNP growth would be positive, allowing--together with the implementation of the work-sharing schemes--for a stabilization of private sector employment.

The gradual increase in the rate of capacity utilization together with the consolidation of balance sheets, set the stage for a moderate upturn in private investment. The private sector demand for funds is however likely to remain weak. On the assumption that interest rate policy in 1984 will be designed to control private sector net capital outflows, the public sector would again be able to fund most of its borrowing requirements on the domestic market.

Public debt in foreign currencies, including public guarantees was equivalent to US$20.5 billion or 24 percent of GNP at the end of 1982. Net borrowing may amount to the equivalent of US$2.5 billion in 1983, and, under the above assumptions, to a somewhat lesser amount in 1984. At that rate of increase, the accumulation of foreign debt would lose its explosive character and there would be scope for a consolidation of the short-term debt, taking into account the bunching of maturities in 1987 and 1988. The authorities have furthermore indicated their intention to discontinue net external borrowing by 1985. The ratio of external debt to GNP would then peak at around 28 percent at the end of 1984, entailing an interest burden of 2.7 percent of GNP or 4.2 percent of exports of goods and nonfactor services in that year.

IV. Staff Appraisal

The adjustment effort of the past two years has corrected deep weaknesses in the Belgian economy. Hourly wage cost competitiveness has been restored to its 1970-73 average, and much of the deterioration in industrial profitability experienced through the 1970s has been reversed. These achievements considerably improve the medium-term growth prospects. The balance of current and private capital transactions has strongly improved, and external borrowing has been sharply reduced. The results for activity have so far been less favorable notably as regards investment. It is clear, however, that the correction of the external imbalance, which was urgent in any case, was achieved at a much higher level of activity than could have been consistent with an alternative strategy of pure demand restraint.

The urgent need now is to transform these successes into a self-sustaining recovery of activity. For this the critical issue is an upturn in industrial investment. A consolidation of corporate balance sheets, an increase in capacity utilization, and improved prospects for foreign demand are encouraging signs that the preconditions for a pickup in investment have been established. Because this pickup is critical, the staff believes that public policies must be guided mainly by their impact on investment prospects.

The staff believes, that the level of public spending in Belgium today is so high that it compromises the prospects for the upturn in industrial investment. High public spending only provides limited support to demand for domestic industrial products (since half of industrial output is exported, and half of the domestic absorption of these products is imported). At the same time, it undermines the competitiveness of Belgian industry for a number of reasons. It creates a pressure to increase taxes, including business taxes, and already social security tax increases have reversed a substantial part of the benefit from wage moderation. For the part which is reflected into public sector deficits, it results into higher monetary financing, or into higher interest rates. Higher monetary financing accommodates inflationary pressures in the noncompetitive sectors of the economy, which increase procurement costs for industry and, especially with the return to full indexation, feed into higher labor costs. The combination of reduced competitiveness, due to additional taxes or input and wage costs, and higher interest rates has an adverse impact on investment prospects which, in the staff's opinion, far outweighs the limited demand support from high public spending. The staff therefore believes that there is an urgent need to reduce the level of real public spending in order to consolidate the progress which has been achieved so far and to retain the best prospects for a self-sustaining recovery of domestic demand. This need is all the more urgent in view of the imminent return to full indexation, which limits the scope for further improvements in industrial profitability, and fully exposes the industrial sector to inflationary pressures developing in the noncompetitive sectors of the economy.

The staff notes the return to full indexation, although the recovery of profitability is incomplete. A main danger in the resumption of this practice lies in the reactivation of the rigidities which are associated with this system. Full general indexation does not sufficiently allow for differences in economic conditions among sectors of the economy, shifts to the industrial sector the whole onus of external shocks, and limits the Government's options for public tariffs and tax policy. The staff would urge the social partners to search for a more flexible system; it would also urge them to reduce all the other rigidities in the labor market, which are ultimately detrimental to employment. In particular, the work sharing schemes must pay full attention to the increases in labor costs that would result from an inflexible implementation.

None of the recent gains in competitiveness can be lost. The continued rise in unemployment demonstrates the need to preserve them totally. For 1984, the "double norm" system offers a safeguard, which must be used fully. However, the risk of a wage push which would reverse the restraint of the past two years extends beyond 1984. Its very existence can only dampen business confidence. The staff believes therefore that it is extremely important to maintain a "competitiveness norm" for the period after 1984, and that, in order to provide a stable environment, this norm must be defined for a period of two years.

The gains in competitiveness which have been achieved justify the policy of maintaining the stability of the Belgian franc within the EMS. Over the longer term, this policy requires the absence of a wage explosion, and a deliberate retrenchment of public spending. In the shorter term, it will require a cautious management of the financial aggregates. The staff fully supports the authorities' target of maintaining the net foreign assets of the National Bank above a minimum level in all cases. In view of the recent increase in foreign currency debt, the staff further generally welcomes the authorities' intention to reduce external borrowing in 1984 and to eliminate it in 1985. However, such a target may prove overly ambitious, given that the public deficit has not been reduced to the initially planned extent. In no case should it be allowed to endanger the foreign reserve target.

The public sector deficit will need to be funded to the fullest possible extent on the domestic market. In this respect, the policy of seeking at all times to achieve the minimum interest rates consistent with the targets for reserves and the capital account, and to allow the franc to remain at most times near the floor of the EMS band, runs the risk of requiring abrupt changes in interest rates, and of undermining the credibility of the exchange rate policy. The staff believes, therefore, that interest rate management should stress the continuity of financial policies, and should visibly reflect the authorities' determination to retain full control of the financial aggregates.

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

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

It is recommended that the next Article IV consultation with Belgium be held on the standard 12-month cycle.

Fund Relations with Belgium

(As of October 31, 1983)

Date of membership:	December 27, 1945
Quota:	SDR 1,335.0 million. Belgium has consented to the proposed new quota of SDR 2,080.4 million.
Fund holdings of currency:	SDR 1,034.9 million (77.51 percent of quota)
Gold distribution:	556,289.958 fine ounces
SDR position:	Holdings amount to SDR 610.0 million, or 125.7 percent of net cumulative allocation.
Lending to the Fund:	Supplementary financing facility: Credit line: SDR 150 million Actual borrowing: SDR 12.33 million
Exchange system:	Belgium forms a monetary union with Luxembourg in which the Belgian and the Luxembourg franc are at par. The two countries have a dual exchange market. In the financial market, through which most capital and some current transactions are channeled, the franc is allowed to float freely. In the official market, a maximum margin of 2.25 percent is maintained between the Belgian and Luxembourg francs and the currencies of other countries participating in the European Monetary System (EMS).
Last Article IV consultation:	The staff report for the 1982 Article IV consultation with Belgium and Luxembourg (consultations for the two countries were combined at the time--SM/82/177, 8/25/82) was considered by the Executive Board (EBM/82/133, 10/8/82). No decision was taken at the time with regard to the dual exchange market arrangements.

Basic Data

Population (mid-1982): 9.85 million
GNP per capita (1982): US$8,670

National accounts (in BF and as a percentage of GNP)

	1975		1982	
	BF	Percent	BF	Percent
Private consumption	1,421.1	61.1	2,599.6	66.6
Public consumption	388.4	16.7	740.1	19.0
Gross fixed capital formation	512.1	22.0	666.9	17.1
Exports of goods and services	1,156.5	49.7	3,132.7	80.3
Imports of goods and services	1,139.7	49.0	3,226.6	82.7
GNP	2,325.8	100.0	3,902.9	100.0

	1980	1981	1982	1983 1/
Demand and supply (volumes)	(Changes in percent)			
Private consumption	2.1	1.4	1.1	-3.0
Public consumption	1.6	0.9	-1.6	-1.5
Gross fixed investment	5.0	-14.5	-2.6	-1.7
Final domestic demand	2.6	-3.7	-0.1	-2.5
Stockbuilding 2/	-0.9	-0.4	--	0.3
Total domestic demand	1.7	-4.1	-0.1	-1.2
Exports of goods and services	7.6	8.7	2.6	3.5
Imports of goods and services	5.9	4.1	1.6	-0.5
Foreign balance 2/	0.9	3.0	0.8	2.9
GNP	2.6	-1.2	0.7	0.7
Industrial production 3/	-0.9	-2.5	-0.5	1.5
Manufacturing output	-1.2	-2.5	-0.5	2.4
Employment and unemployment	(In thousands; mid-year)			
Labor force	4,172	4,189	4,220	...
Employment	3,837	3,757	3,708	...
Unemployment	336	432	512	...
(In percent of civilian labor force) 2/	9.1	11.2	13.1	14.5
Prices and incomes	(Changes in percent)			
GNP deflator	4.3	5.3	7.0	7.5
Consumer price index	6.7	7.6	8.7	7.8
Terms of trade 3/	-3.4	-3.2	0.1	...
Hourly compensation (manufacturing)	9.6	8.1	5.3	5.6
Unit labor costs (manufacturing)	6.1	2.6	0.5	2.4
Real disposable income (households)	2.4	0.6	-1.8	-2.1
Personal savings ratio (level)	15.4	16.2	14.8	15.0

	1980	1981	1982
Public finances	(In percent of GDP)		
General government 4/			
Expenditure	57.5	62.4	63.5
Revenue	45.7	46.3	47.9
Financial balance	-11.8	-16.1	-15.6
(In percent of gross private savings)	56.9	74.9	75.1
Central government financial balance 5/	-8.5	-12.5	-12.9
Balance of payments 6/	(In billions of Belgian francs)		
Trade balance 7/	-109	-109	-93
Services balance	3	2	27
Net private transfers	-11	-15	-11
Net official transfers	-27	-33	-45
Current account balance	-144	155	-122
(In percent of GDP)	(-3.9)	(-4.0)	(-3.0)
Net private capital flows	1	-201	-162
Net public capital flows	154	258	256
Change in net reserves of National Bank	27	-96	-38

1/ Staff projections and/or estimates.
2/ Annual averages
3/ Ratio of deflator of exports of goods and services to deflator of imports of goods and services; national accounts definition.
4/ National accounts definition.
5/ Administrative basis.
6/ Belgium/Luxembourg Economic Union (BLEU).
7/ Including third country trade.

Belgium: Illustrative Medium-Term Debt Projections

(Public and publicly guaranteed debt in foreign currencies)

	1983	1984	1985	1986	1987	1988	1989	1990
Current account (in percent of GDP)	-1.5	-1.0	--	1.0	1.0	1.0	1.0	1.0
External debt, gross 1/ (in percent of GDP)	26.0	26.9	26.7	25.6	24.6	23.7	22.8	22.0
Debt service ratio 2/	4.3	4.2	5.1	5.8	10.3	9.1	6.1	5.6

Source: Staff estimates and calculations.

1/ Public and publicly-guaranteed external debt.
2/ Interest payments on total debt plus amortization of medium- and long-term debt, as a percent of exports of goods and nonfactors services.

Note: These illustrative medium-term debt projections are based on the following main assumptions. Nominal GDP is assumed to rise by 7.5 percent in 1984 and by 8.5 percent a year thereafter. Export growth for goods and nonfactor services is projected at 5.4 percent in 1984 and at 8.5 percent a year thereafter, reflecting an assumption of constant market shares in 1985-90. The projections also use the standard assumption of unchanged exchange rates during the projection period, while implicit interest rates are assumed to decline by two points to 10 percent from 1984.

The projections embody the Government's policy to use interest rate management to contain net private capital outflows, which are assumed to be equivalent to 1.5 percent of GDP a year through the projection period. The authorities intend to discontinue net external borrowing by the Treasury after 1984. It is assumed however that non-governmental entities will continue borrowing with a public guarantee at a rate equivalent to 0.5 percent of GDP. These assumption require a current account surplus equivalent to 1 percent of GDP.

It is further assumed that the public sector borrowing requirement will decline by 2 percent of GDP a year beginning in 1985 in order to make room for the targeted improvement in the current account, as well as for a gradual pickup in investment by enterprises. This adjustment however would not be sufficient to allow a current account surplus in 1985, and net borrowing by the Treasury would only be discontinued from 1986. The calculations are sensitive to assumptions on investment behavior and the financial balance of enterprises. However, alternative developments in this respect can to some extent be offset by compensatory adjustments in fiscal policy.