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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/28

3:00 p.m., February 4, 1983

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

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	C. Taylor
J. de Groote	
	A. Le Lorier
	M. Teijeiro
	T. A. Connors, Temporary
M. Finaish	T. Alhaimus
	I. R. Panday, Temporary
	Y. Okubo, Temporary
R. K. Joyce	M. Casey
	J. R. N. Almeida, Temporary
G. Laske	
G. Lovato	C. P. Caranicas
	V. K. S. Nair, Temporary
	S. El-Khouri, Temporary
J. J. Polak	T. de Vries
	K. G. Morrell
G. Salehkhou	
	E. I. M. Mtei
M. Senior	
J. Tvedt	
Zhang Z.	Wang E.

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

Also Present

Asian Department: U. Baumgartner, G. Szapary. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, B. de Schaetzen, P. Dhonte, H. B. Junz, M. Reichardt, J. S. Van 't dack, R. H. van Til, M. Xafa. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; D. J. Donovan, M. R. Kelly. External Relations Department: A. M. Abushadi. Fiscal Affairs Department: G. Blöndal, K. W. O'Connor. Legal Department: J. K. Oh, J. V. Surr. Middle Eastern Department: A. K. El Selehdar, Deputy Director; R. K. Basanti, F. Drees, S. H. Hitti, Z. Iqbal, H. E. Jakubiak, M. Shadman, M. Yaqub. Research Department: A. D. Crockett, Deputy Director. Advisors to Executive Directors: S. R. Abiad, M. A. Janjua, P. Kohnert, H.-S. Lee, P. D. Péroz. Assistants to Executive Directors: H. Arias, L. Barbone, J. Bulloch, M. Camara, L. E. J. Coene, G. Ercel, G. Comel, M. Hull, P. Leeahtam, W. Moerke, J. G. Pedersen, G. W. K. Pickering, M. Z. M. Qureshi, J. Reddy, C. A. Salinas, J. Schuijer, D. I. S. Shaw, H. Suzuki, M. Toro, A. Yasseri.

1. PAKISTAN - 1982 ARTICLE IV CONSULTATION AND PROGRAM UNDER EXTENDED ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/83/27, 2/4/83) their consideration of the staff report for the 1982 Article IV consultation with Pakistan and the program under the extended arrangement (EBS/83/3, 1/6/83; and Sup. 1, 2/3/83). They also had before them a report on recent economic developments in Pakistan (SM/83/14, 1/21/83).

Mr. Joyce congratulated the Pakistan authorities on the successes that they had recorded, particularly with respect to the continued growth in real terms of GDP and, indeed, the expected growth for 1983, which was higher than the average over the previous few years. Growth had occurred not only in manufacturing, but also in agriculture. Moreover, the authorities were to be congratulated for bringing down the rate of inflation quite sharply while remaining within the fiscal and monetary targets. They were also to be commended for some of the key policy steps taken during the previous year, particularly for depreciating the rupee and untying it from the U.S. dollar, for taking further limited steps toward import liberalization, and for raising the prices of oil and gas and of agricultural products. He welcomed the decision to phase out fertilizer and water subsidies. Shortfalls in performance in some areas could be attributed to the weakness in the world economy and the worsening of the terms of trade, which had affected exports and, hence, the balance of payments. In addition, bad weather had reduced output in certain sectors of agriculture. There was also the weakness in tax revenue, which reflected the narrowness of the tax base and the fall in customs receipts accompanying the fall in imports.

As for the third year of the program under the extended arrangement, he shared many of the concerns expressed by speakers at the previous meeting, particularly those by Mr. Laske and Mr. Taylor, Mr. Joyce continued. Like them, he was concerned that the optimistic forecasts for export growth and a recovery in remittances would not prove justified. He was also concerned about the fiscal outlook, especially in view of the slow progress in reforming the tax system and the weakness in collecting revenue evident in the first half of the current fiscal year. As others had pointed out, the outlook in the fiscal area was dependent upon securing increases in energy revenues and upon holding the line firmly against new expenditure. In addition, he was concerned about the large resort to bank financing by the Government for budgetary support in the first six months of the present year.

Nevertheless, the real problem was that, although the authorities had met all the requirements of the program to date, and were likely to continue to do so in 1983, Pakistan's adjustment would not only be incomplete by the time the program ended, but, in some key areas, would clearly be insufficient, Mr. Joyce went on. Consequently, Pakistan was likely to fall short at least of the original targets set for the program. The failure to perform would be especially significant in three areas. First, the ratio of investment to GDP at the end of the program period would continue to be comparatively low, and indeed at 16.4 per cent would be no higher than in 1979/80. Similarly, the ratio of gross domestic savings to GDP would have declined from 5.5 per cent in 1979/80 to 5.2 per cent at the end of the program, as against the original projected rate of 8.8 per cent. Thus, a great deal needed to be done.

He welcomed the announcement of action to be taken by the authorities, such as the decision to shift the priority in public investment to agriculture and infrastructure, the associated decision to provide greater opportunities for the private sector, especially in manufacturing, and the decision to improve the efficiency of public enterprises, whether through restructuring or through divestment, Mr. Joyce said. Indeed, Mr. Finaish had pointed out that the authorities had worked out with the World Bank a revised three-year development program that enshrined some of those decisions. Could Mr. Finaish say whether the authorities regarded the present levels of investment as adequate? If not, what further steps were they planning to try to generate higher investment in the future? Moreover, like Mr. Erb and Mr. Laske, he would appreciate any further information about what the authorities had in mind for improving the savings ratio.

The second area was that of the fiscal balance, particularly the need to restructure the tax base, Mr. Joyce continued. He welcomed the authorities' intention to reduce their reliance on national trade taxes and to improve the structure of the tax system. Like Mr. Laske, however, he noted that there had been little progress in that area to date. He would like to have further assurance that steps would be taken fairly quickly, because failure to do so put the program at risk.

The third area was that of the external balance, Mr. Joyce remarked. Pakistan's success in attaining a sustainable external balance would clearly depend upon a number of factors, not all of them external. It would also depend upon the authorities' success in pursuing their objectives with respect to savings and investment, fiscal changes, and the further freeing of prices.

Certainly, the authorities themselves were well aware of the seriousness of the structural problems that Pakistan still faced, and certainly they were chagrined at not yet having been as successful as they had originally hoped, Mr. Joyce observed. He was thus glad that the authorities had affirmed their intention to continue the adjustment efforts beyond the period of the present arrangement. As some of the countries that he represented were also having trouble meeting their adjustment targets, he understood that, in a number of countries, it was often impossible within the fairly short time of an extended arrangement to introduce the changes that might be called for in the program. The authorities' intentions might be good, but legislative delays might turn out to be more drawn out than expected, or, if the policies were introduced, it might take longer than originally estimated to implement them. Therefore, matters tended to proceed more slowly than the Fund might wish. In addition, adjustment was often made more difficult by world conditions.

The prospects were that the Pakistan program would end with the job only half completed and with little indication of how sustainable the present growth rates were likely to be through the medium term, Mr. Joyce pointed out. As Mr. Erb, Miss Le Lorier, and Mr. de Vries had said at EBM/83/27, the shortcomings in the program raised broad questions about the working of extended arrangements in general. In Pakistan, he would hope that, by the time of the midyear review, some of the defects could be remedied; at that time, the Board should not only take a new look at what lay ahead for the rest of the present year, but also seek a better understanding of the medium-term outlook for Pakistan. Such a medium-term understanding was becoming increasingly important in all of the countries in which there were major extended arrangements, in the third and final year of those arrangements, so that the Board would begin to get some idea of the country's future relations with the Fund.

At the time of the midyear review, Mr. Joyce remarked, he hoped that the Pakistan authorities would be able to come forward with some concrete evidence of steps that were being taken or had been taken to expand future investment and savings, to bring about greater freedom of prices, and to revitalize the tax base. In conclusion, he could support the proposed decisions.

Mr. Zhang also expressed support for the proposed decisions. During the previous several years, as a result of successfully implementing a comprehensive program of economic reform, the Pakistan authorities had maintained a high rate of growth and had introduced basic adjustments into the structure of the economy, an effort for which they ought to be commended. In the external sector, performance had improved considerably for several years, but had been adversely affected in 1981/82 by the continuing recession in the world economy as well as by a further deterioration in Pakistan's terms of trade.

It was gratifying to know that a principal objective in the 1982/83 program was to sustain the momentum of the economic reform that had been built up during the previous two years, Mr. Zhang commented. Policies to be introduced were expected to contribute even more to achieving the Government's economic policy targets. He wished the authorities success in their efforts. Nevertheless, he trusted that, in implementing the program, the Government would give sufficient allowance to the effects on Pakistan's economy of the continued world recession and the increase in protectionism abroad.

Finally, he had a technical question concerning the rate of saving, Mr. Zhang said. The figures on page viii of SM/83/14 showed that the ratio of gross national savings to GNP was not really small, varying as it did from 10.6 in 1978/79 to 12.3 in 1980/81. Even given the per capita income of the country, those ratios were quite high. Of course, the gross domestic savings ratio was low, and not merely because of rather large income payments abroad. Those factors should be taken into consideration in judging the savings ratio.

Mr. Panday noted that Pakistan's economy had attained a satisfactory growth rate of 6.2 per cent in output in 1981/82, thus maintaining an average annual growth rate of more than 6 per cent for the past five years. Although agricultural output had declined in 1981/82 because of bad weather, the revival of investment in both the public sector and the private sector had contributed to ensuring sustained growth in the economy. The major stimulus to growth had come from expanded activity in manufacturing, whose contribution to GDP had risen from 9.9 per cent in 1980/81 to 12.4 per cent in 1981/82. Notable progress had also been made in curtailing the rate of inflation: the rise in the end-period price level had shown a sharp decline to 8.5 per cent in 1981/82 from 15 per cent in 1980/81.

The Pakistan authorities were to be commended for broadly fulfilling all the fiscal objectives of the program, Mr. Panday continued. The fiscal deficit had increased slightly in 1981/82 as a result of a revenue shortfall owing to lower collections of customs duties and sales taxes on imports, which had virtually remained stagnant in that year. Despite the fiscal difficulty, the authorities were to be congratulated for limiting domestic bank financing of the deficit to the programmed level of 2 per cent of GDP. Their efforts to keep the fiscal deficit at a lower level should be continued with vigorous efforts toward mobilizing more revenue. The authorities' intention to remove further sales tax exemptions and strengthen the tax administration to plug leakages and improve tax collection were welcome.

The authorities had introduced several measures to bring the country's financial system into line with Islamic principles, Mr. Panday remarked. Profit-and-loss-sharing systems had been introduced in the credit market to reorient financial activities toward noninterest-bearing operations. Developments in those systems would be of interest to all Directors. Indeed, the tight demand management stance taken by the authorities in 1981/82 had had beneficial effects on controlling the rate of inflation and preventing a further deterioration in the balance of payments position. The authorities' intention to continue the tight monetary stance in 1982/83, limiting their resort to domestic bank financing to 1.8 per cent of GDP, 0.2 per cent lower than in 1981/82, was laudable. It would make more bank resources available to the nongovernment sector, and it seemed to be compatible with the Government's policy of assigning a greater role in investment to the private sector.

The ratio of the current account deficit to GDP had increased from 3.2 per cent in 1980/81 to 4.5 per cent in 1981/82 and was expected to remain at about 4 per cent in 1982/83. The current account deficit had widened sharply, mainly due to a 17 per cent export shortfall reflecting a difficult external environment, the loss in competitiveness owing to the appreciation of the rupee, and a lower rate of increase in net private transfers. An improvement in the performance of the external sector was a prerequisite for maintaining sustained economic growth in the future. Greater effort should be concentrated on expanding exports by further improving the competitiveness of Pakistan's commodities. The shift from a pegged rate system to a flexible exchange system on January 8, 1982 should be followed by further needed adjustments to improve export performance, strengthen the payments position, and maintain the encouraging pace of growth in the economy.

Mr. Caranicas expressed his satisfaction with the procedure of simultaneously taking up an Article IV consultation report and the program under an extended Fund arrangement. Pakistan's economic performance during the past few years had been outstanding. A revival of investment, in both the public sector and the private sector, combined with a decline in inflation and widespread gains in output, could only be regarded with envy by other Fund members that were struggling to adjust in the current international environment. In a world of uncertainty subject to unexpected jolts, there was little room for complacency. However, the Pakistan authorities and the Fund could surely draw positive conclusions from the experience of the program thus far in formulating the medium-term policy framework for stabilization and structural adjustment.

In the area of public finance, there had been some slippages and setbacks, Mr. Caranicas considered. Little headway had been made in reforming the tax system so as to broaden the revenue base and increase the scope for indirect and direct taxation relative to trade-based duties. Actually, the degree of dependence of tax collection on import duties appeared to have been growing recently. He shared the staff's concern on that topic and wondered whether Pakistan's policymakers intended to take new initiatives to address that deep-seated imbalance in the fiscal system.

In a related area, he appreciated the reforms initiated in the structure and operations of public sector enterprises, Mr. Caranicas noted. The adoption of a performance evaluation system and the design of an incentive mechanism to be introduced in 1983 were critical steps in enhancing managerial efficiency and financial viability in those enterprises. The staff papers did not provide enough information about the role of the public enterprises in the pattern of industrial investment in Pakistan. In particular, the public sector's share of gross investment had been steadily declining since 1979/80. Was that declining trend expected to persist? With regard to domestic investment and savings, the aggregate figures, as proportions of GDP, had been persistently below targeted levels, and gross capital formation, although more buoyant in 1981/82, had still seemed inadequate. The revised target for the current year, involving as it did an increase of almost 11 per cent in domestic investment spending, did not seem attainable. Probably, only a fraction of it was expected to come from capital formation, as opposed to inventory accumulation. Table 2 on page 3 of SM/83/14 presented figures for gross domestic savings and gross national savings as percentages of GDP and GNP; was the huge difference between the two relevant ratios, 6 per cent and 12 per cent, attributable to workers' remittances? How were the two ratios to be interpreted in judging the country's aggregate propensity to save?

On the external payments outlook, Mr. Caranicas noted, two crucial developments had been the transition to a regime of managed floating in mid-1982 and the subsequent depreciation of the real exchange rate of the rupee together with a continuing phased program of import liberalization. The current account deficit for 1982 had been larger than projected, and export earnings had actually declined, while remittances had increased only modestly. An offsetting influence had been exerted by the shortfall in imports, which he found difficult to reconcile with the continued growth in output and the impact of further import liberalization. He was thus perplexed about the forecasts for the current year, which postulated a 5.5 per cent rise in imports. By contrast, the export forecasts were well grounded. Remittances, which were roughly equivalent to merchandise exports, were presumed to rise by 15 per cent. Perhaps the staff could explain the reasons for such a strong showing. He would also welcome further information on the exchange rate regime recently chosen by Pakistan. Was there an explicit pegging of the rupee to a currency basket, or did the U.S. dollar continue to be in effect the dominant reference currency, a feature perhaps warranted by the currency composition of Pakistan's foreign trade flows?

He fully agreed with the staff's belief that the program for 1982/83 would extend the progress already made toward improving the functioning of the Pakistan economy and restoring equilibrium to the balance of payments, Mr. Caranicas commented. He supported both the Article IV consultation decision and the decision on the program under the extended arrangement, and had no objection to the proposed amendment to the decision.

Finally, Mr. Caranicas observed, in 1982 Pakistan had concluded with Iran a bilateral payments agreement subject to Article VIII. In the Economic Policy Memorandum transmitted by the Government of Pakistan, (Attachment II to EBS/83/3), he had read the following: "With regard to the banking and payments arrangement which Pakistan recently entered into with Iran, the Government will not incorporate any features which constitute exchange restrictions under Article VIII in the event this agreement is renewed after it expires in May 1983." In other words, the passage represented a commitment for an arrangement that would have expired at the time the Pakistan authorities were saying that the practice would be discontinued. He would appreciate further comments on that point.

Mr. Senior commended the Pakistan authorities for the efficient management of their economy and the success attained under the program. They had implemented policy measures to adapt the economy while avoiding an interruption of economic growth because of structural imbalances. Real output growth had been 6.2 per cent in 1981/82, maintaining the average rate attained during the previous four years, while inflation had declined significantly. An increase in investment activity, both public and private, was a particularly welcome development. Those achievements were explained by the efficient combination of demand management policies and supply-oriented policies adopted by the authorities. During the past two and one half years, the pursuit of tight demand management policies had resulted in a moderate expansion of domestic liquidity, contributing to a significant reduction in the rate of price increases.

The progress made in public finances had been broadly in accordance with the program targets, notwithstanding the lower than expected revenue from indirect taxes, Mr. Senior went on. In the fiscal field, the authorities had implemented a series of policy measures consistent with the objective of enhancing resource allocation, including the removal of a number of sales tax exemptions as well as increases in the producer and consumer prices of public goods and services so as to improve the cost-price structure. Increases in spending for agriculture, rural development, and energy had also created better conditions for stabilizing private investment. Other supply measures--including a new floating exchange rate policy and a more liberal stance on foreign trade--had also been adopted with the intention of gradually removing structural imbalances in the economy.

Notwithstanding those favorable developments, Pakistan's balance of payments position had become worse than expected, Mr. Senior continued. Weak world demand, lower competitiveness for Pakistan exports, delays in some projects, and a shortfall in net private transfers explained the deterioration of the external receipts during the second year of the program. However, there were some indicators pointing to a greater than expected improvement in the current account position.

As Mr. Finaish had pointed out, the authorities had decided to establish a new floating exchange rate system to improve the competitive position of the Pakistan economy, Mr. Senior remarked. From end-1981 to January 1982, the real effective depreciation of the rupee had amounted to 17 per cent. As the staff had indicated, the improved competitiveness resulting from the depreciation had already favorably affected many manufactured and semimanufactured exports, which had expanded at an annual rate of 22 per cent during the first half of 1982/83. If the trend continued, Pakistan's current account deficit for the last year of the program could be lower than originally projected.

To carry on with the progress already made in correcting the imbalances in the economy, the authorities had adopted a series of policy measures dealing with price rationalization and trade, such as increases in the prices of petroleum products and reductions in import tariffs, Mr. Senior said. At the same time, they continued to carry out further financial restructuring of some public sector enterprises, laying the basis for a more lasting improvement in public finances over the medium term. In order to improve public finances further, he agreed with the staff that definite progress should be made in broadening the tax base and thus avoiding greater dependence on taxation of import duties.

In sum, the program for the last year of the extended arrangement was working satisfactorily, Mr. Senior concluded. The measures adopted aimed at continuing the progress already achieved by gradually removing structural imbalances, and they were consistent with the objectives of sustainable growth and a viable balance of payments position.

Mr. Connors joined those speakers who wished to put special emphasis on import liberalization, and on trade distortions, such as export rebates, during the next scheduled review of the program with Pakistan. He would also like the authorities and the staff to review the suitability of the exchange rate. Even if the rate was, in some sense, correct at present, presumably a different exchange rate would be appropriate at a lower level of protection.

In regard to external financing flows to Pakistan, the Fund had been asked to provide a relatively large amount of financing compared with the World Bank or the International Development Association (IDA), Mr. Connors continued. The World Bank and IDA had disbursed $98.4 million to Pakistan in 1981 and $204.2 million in 1982; the Fund had provided $315 million in 1980/81 and $358 million in 1981/82, and was expected to provide somewhat more than that amount in 1982/83. In fact, Pakistan's total outstanding debt to the World Bank and IDA at the end of 1982 had been $1.4 billion, a figure hardly different from the amount to be made available to Pakistan under the extended arrangement. Like Mr. de Vries, he was thus led to wonder about the implication of such an arrangement for the revolving character of Fund resources.

The staff representative from the Middle Eastern Department said that the questions asked by Executive Directors could be grouped under five headings: first, the structural aspects of the program with the Fund; second, the demand management aspects of the program; third, the balance of payments projections; fourth, the external trade regime, particularly exchange rate policy and import liberalization; and fifth, the dates of drawings under the program.

As to the structural aspects of the program, many Directors had referred with some disappointment to the relatively low level of domestic savings and investment, the staff representative went on. Mr. Erb had asked specifically whether the staff had views on ways in which savings could be promoted. The authorities themselves were in a position where, for reasons other than macroeconomic ones, they wished to move away from fixed interest rates as a means of mobilizing resources within the economy. They faced three handicaps in mobilizing savings: the relatively high rate of inflation until quite recently, the lack of an adequate institutional infrastructure to mobilize savings, and the relatively large demand by the public sector on the pool of savings available in the economy.

As several Executive Directors had remarked, the rate of inflation in Pakistan had come down substantially, and, for the most recent 12-month period, the rate of consumer price inflation had been only 4.5 per cent, the staff representative observed. The rate might be pushed up a bit later, as the delayed effects of exchange rate adjustment came through, but it was a lower underlying rate of inflation than the staff had been expecting. That lower rate should improve somewhat the atmosphere for savings mobilization.

In addition, recognizing that interest rates subject to ceilings were not sufficiently attractive to mobilize savings, the authorities were instituting an Islamic financial system, the staff representative explained. The system essentially involved a rate of return that was not prescribed in advance but represented a sharing of the yield on investment between entrepreneurs and those providing financial resources. The participation feature should lead to higher rates of return to savers. As one Director had remarked, the actual rate of return paid on profit-and-loss-sharing accounts, which was declared ex post rather than ex ante, had in fact turned out to be higher than the ex ante rate of return on savings instruments with a fixed rate of interest. More generally, the authorities' intention was to establish a mechanism through such profit-and-loss-sharing accounts whereby effective yields or returns could be determined by the balance between savings and investment rather than predetermined and subject to government ceilings. The authorities hoped that the new Islamic system would be more conducive to mobilizing savings than the previous system of fixed interest rates, which, as the authorities themselves would recognize, had on occasion been held too low.

As for the Government's role in mobilizing savings, the staff's view had been that the overall government deficit had been disappointingly high, the staff representative continued. In projections prepared at the beginning of the three-year program, the staff had envisaged a much more substantial decline in the overall government deficit than had in fact come about. Thus, although the Government had been successful in keeping to its bank financing targets, it had achieved that goal to some extent by issuing savings instruments, other than those held by banks, that had pre-empted the pool of savings in the private sector. Thus, the staff would view an improved fiscal position as an important element in mobilizing savings in the economy.

On a more technical matter, Mr. Zhang and Mr. Caranicas had both referred to the puzzlingly large discrepancy between national savings and domestic savings, the staff representative noted. By convention, the great bulk of remittance inflows into Pakistan were accounted for as part of national savings rather than as part of consumption, so that they added substantially to the calculated savings ratio.

Another aspect of structural reform in Pakistan to which several Directors had referred was energy prices, the staff representative observed. Some had said that the objective for natural gas prices--gas being perhaps the most single important energy source in Pakistan--seemed to be modest and somewhat delayed. The objective of reaching two thirds of international prices by 1988 had been set by the Pakistan authorities in agreement with the World Bank. When consulted, the Fund staff had expressed reservations about the modesty of the goal, but it had no specific expertise in considerations governing the prices of individual energy sources. When the Fund staff had discussed short-term adjustments in prices with the authorities, it had suggested that they should make the degree of adjustment that seemed warranted in the short-term circumstances facing the economy rather than be governed by a pre-existing agreement with another institution. It should be pointed out that the 30 per cent increase at the beginning of 1982, followed by a further 23 per cent increase at the beginning of 1983, represented a total compound adjustment of 60 per cent in a little over 12 months. Given the obvious political difficulties in moving rapidly on energy prices, the staff had concluded that the adjustment represented a useful beginning, especially at a time when the rate of domestic inflation had been under 10 per cent.

A question had been asked by Mr. Sangare whether the planned decline in public sector investment would have an adverse impact on activity in the industrial sector, the staff representative remarked. It had to be recognized that the Government's strategy of withdrawing from direct involvement in manufacturing and letting the private sector take up the slack did raise a risk that, during an interim period, there might be some slackness in activity. The reduction in public sector investment in manufacturing had not yet been fully made up by the private sector. The authorities were aware of that possible shortcoming and were trying to generate possibilities for new activities in manufacturing, particularly in connection with the completion of the steel mill, which would create opportunities for downstream enterprises in steel fabrication. Private sector investment in general had grown substantially in the previous two years.

The World Bank staff, which had investigated the question from a resource balance standpoint, and the Fund staff were in agreement that the physical and financial resources of Pakistan were fully adequate to attain the investment targets, the staff representative said. Inventory investment was projected to be a much smaller component of total capital formation in 1983 than in the previous two years.

Turning to demand management under the program, the staff representative recalled that several Directors, notably Mr. de Groote, had referred to the high rate of growth of current expenditure. Part of the explanation was that, following a year in which debt rescheduling had been in effect and interest payments on foreign debt had been low, Pakistan was now entering a year in which external debt was to be fully serviced. The large jump in external debt service payments was thus essentially a return from an abnormally low level to a more normal level. Nevertheless, the rate of growth of current expenditure was substantially above the rate of growth of GDP.

The relatively high degree of recourse to bank financing by the Government in the first part of the year had been mentioned by Mr. Joyce, and Mr. Taylor had raised the question whether the Government could come back to within the ceilings by the end of 1983, the staff representative continued. For the reasons given in EBS/83/3, Supplement 1, the staff was reasonably confident that the Government would be able to do so. The measures taken to increase energy prices, which had come into effect in early January 1983, would have a substantial impact on government finance. Thus, the authorities should meet the ceilings for March and June.

Several Directors had questioned whether the staff's assumptions for the balance of payments were not perhaps optimistic, the staff representative observed. As far as possible, the assumptions had been those underlying the World Economic Outlook exercise. Since the staff mission had returned from Pakistan, additional information had become available. Remittances had grown by 37 per cent in the first five months of the year, against the annual target of 15 per cent. In part, the growth represented a rebound from an abnormally low level in the corresponding period of 1981/82, which had been affected by adverse speculation about an exchange rate change. Nevertheless, the remittance figure for 1982/83 might well turn out to be higher than the staff estimate.

Pakistan's exports seemed to be lower than expected, which was a disappointing development, as a number of Directors had said, the staff representative went on. However, there had been an encouraging response by price-sensitive exports to the adjustment in exchange rates. As noted in EBS/83/3, Supplement 1, exports of nontraditional manufactures had grown by 22 per cent in the first six months of 1982/83, although the year-on-year projection made by the staff had been for only a 15 per cent increase.

The impact of lower oil prices on the balance of payments had been mentioned by Miss Le Lorier and Mr. Laske, the staff representative recalled. It was true that there were offsetting effects in Pakistan. There was the direct and immediate effect of lower prices paid for imports of oil, if prices did indeed fall, and there was also the corresponding effect on workers' remittances, which was much more difficult to quantify, as a result of slower economic activity in the oil exporting countries because of lower oil prices. The staff estimated that a 10 per cent reduction in oil prices would have a direct beneficial impact on Pakistan's balance of payments of more than $100 million in the first year. The impact on workers' remittances would be much more difficult to quantify, but in the staff's judgment it would take longer to become apparent and might perhaps be smaller, in part because most of the remittances sent to Pakistan now came from Saudi Arabia, and it was doubtful whether that country's domestic spending on investment would be affected to the same extent as its foreign exchange earnings. About 50 per cent of total remittances to Pakistan in 1982 had come from Saudi Arabia, and the figure was likely to be larger in 1983. In addition, another 10 per cent or so of the remittances came from Western Europe and North America.

A question about speculation in foreign exchange had been asked by Mr. de Groote, the staff representative noted. He agreed that speculation did complicate interpretation of the most recent trends in exports, imports, and remittances. When comparing the latest six-month period with the corresponding period one year previously, the staff had to take account of the speculation that had depressed receipts in the earlier period. Thus, the 6 per cent rate of growth in remittances to which several Directors had referred might well be an underestimate of the underlying growth during 1982.

The implied degree of import substitution in the program was substantial, and Mr. Caranicas had wondered whether it was in fact achievable, the staff representative continued. In fact, there were a number of specific projects, including the Karachi steel mill and cement and fertilizer plants, that made the staff reasonably confident that the degree of import substitution implied in the program was realistic.

A specific question had been asked by Mr. Nimatallah whether another Fund program with Pakistan would be necessary, the staff representative said. The staff's projections for 1983/84--the year following the program--were for an overall balance of payments deficit of about $200 million. The two final drawings from the Fund would fall in that fiscal year, if the program were approved. Pakistan would thus not have reached full equilibrium, particularly since the amounts drawn from the Fund would have to be repaid in subsequent years. Nevertheless, if the trend of improvement projected for the industrial world and for oil importers were sustained, the staff would judge that the prospects for Pakistan in 1984/85 and beyond would be close to equilibrium. Yet a position of equilibrium might not be sufficient to generate the resources needed to repay the substantial drawings on the Fund. For that reason, the mission that would return to Pakistan in May 1983 would be considering whether additional exchange rate measures would provide the improvement required for making Pakistan's position sustainable over the longer term.

Several questions had been raised about Pakistan's external trade regime, the staff representative recalled. Mr. Taylor had asked what the third-year objectives of the program were for trade liberalization. Beyond the specific objectives to which the authorities had already agreed--to remove protective bans from a further 20 per cent of industrial production, as well as to convert from a positive to a negative import list system--they intended to reach agreement on a pattern of tariffs that would be consistent with the program's goal of liberalization. In other words, they intended to set tariffs at a level that, while continuing to provide a basic measure of protection for domestic industry, would nevertheless represent a spur to improvements in competitiveness and would permit necessary inputs of capital and intermediate goods. At present, the World Bank was conducting a study on effective protection with the Pakistan authorities, and the Fund staff expected that, during the May review, enough material from that study would be available to enable the Fund to enter into some clearer understandings with the authorities. Those understandings would be reported to the Executive Board following the review.

Several Directors, among them Mr. Erb, had asked whether tariffs in Pakistan were too high, the staff representative remarked. Perhaps some had gained the impression that tariffs had been set so high that liberalization had become meaningless. It should be pointed out that the tariffs on cement had been lowered at the outset of the program period: more than $100 million worth of cement, over 25 per cent of domestic consumption, had been imported in the first 12 months of lower tariffs. Subsequently, the authorities had shaded up the tariff in order to strike what they considered a better balance between domestic and foreign production but had nevertheless allowed a substantial role for imported cement. The staff did not yet have any information on how well cotton yarn imports had responded to the most recent reduction in the tariff.

In response to Mr. Caranicas, the staff representative said, the Pakistan authorities did have a currency basket for determining the value of the rupee, but the staff did not know the contents of the basket in complete detail. The staff had operated on the assumption that a certain currency basket was used by the authorities, who had confirmed that it was approximately the basket that they did use. They preferred to use a basket that contained 59 currencies, a practice that had struck the staff as being somewhat ambitious in its coverage. The staff had a rough idea of the weight assigned to each currency.

Referring to Mr. de Vries' question about the dates of the drawings mentioned in the extended arrangement, the staff representative from the Middle Eastern Department explained that, in writing the arrangement, the staff had intended that, if the Board approved the arrangement, there would be a first drawing immediately, a further drawing in May based on the March ceilings, and a drawing in August based on the June ceilings and on satisfactory understandings reached during the May review to be presented to the Board during July or August. In addition, the review would involve the establishment of ceilings for August 31, and any drawings after that date would be dependent on Pakistan's having observed the ceiling set for August 31. The last drawing would probably be made in October. Finally, Mr. de Vries had also asked how the Pakistan authorities had missed two drawings. Without going into details, he wished to say that it had not been because the staff had judged that the program had gone off track. Rather, it had been caused essentially by delays for a variety of reasons in reaching agreements on the specific contents of the third-year program.

The staff representative from the Exchange and Trade Relations Department recalled that Mr. Caranicas had asked whether the Pakistan authorities realized that the bilateral payments agreement with Iran constituted a restriction under Article VIII at the time they had concluded the agreement. The answer was that the authorities had not so realized. The main reason was that the agreement between Pakistan and Iran, as well as a similar agreement between Turkey and Iran, had replaced a tripartite arrangement that had existed between Pakistan, Iran, and Turkey; that arrangement had not been regarded by the Fund as a restriction on current payments as defined under Article VIII. The present agreement between Iran and Pakistan was considered to involve a restriction because it permitted inconvertible balances up to $10 million.

Mr. Finaish noted that the performance of the Pakistan economy had to be evaluated within the context of the targets and objectives of the arrangement with the Fund. Thus, he would accept some of the critical remarks made by Executive Directors as relevant policy advice for the longer term rather than as strictures on the degree of implementation under the extended arrangement. Moreover, developments in the Pakistan economy could not be isolated from the international setting: the recession, protectionism, developments in the region, and the presence in the country of about 3 million refugees. Directors should keep those factors in mind when evaluating Pakistan's performance and giving advice for the future. Furthermore, it should also be remembered that the recent history of Pakistan was characterized by some serious and rapid developments. The staff had agreed with the authorities that the structural reform had to be gradual if the broad consensus required for its effective implementation was to be maintained. In addition to political constraints, the pace of adjustment should be related to past history, institutional constraints, the possible impact on low-income groups, and the changing international economic setting. Thus, if Directors wished the ongoing change in economic policy to succeed, they should make sure that the recommended speed of adjustment was feasible.

Some Executive Directors appeared to believe that the program with Pakistan might have been too weak to start with, Mr. Finaish went on. In fact, the demand management measures had been strong, and the scope of the structural reforms had been wide: they had covered the exchange rate, import liberalization, adjustments in the producer and consumer prices of agricultural and energy products, a reduction in subsidies, a reform of public sector enterprises, measures to increase private investment, and tax reform. The authorities had made significant progress in each of those areas, in line with the Fund program. The authorities did recognize that the achievement of their medium-term goals of structural reform and a viable balance of payments position would require more time in the present international economic environment, and, therefore, they expected to continue their adjustment effort beyond the period of the present extended arrangement.

Already Pakistan had attained an annual average growth rate of 6 per cent for five consecutive years, had reduced the inflation rate to 4 per cent, and had devalued the rupee by over 17 per cent in real effective terms, Mr. Finaish noted. The balance of payments deficit and the budget deficit had been reduced substantially since the preprogram period. The overall balance of payments outcome had been broadly in line with what had been foreseen at the outset of the program. The projected deficit on current account at the end of the program would represent a large reduction from the level before the program had begun, and the balance of payments outcome would have been even better except for a considerable worsening of the international economic situation. The authorities continued to be confident that their policies, including the present flexible exchange rate policy, would restore a viable external position for Pakistan over the medium term.

Industrial exports had achieved a 22 per cent annual growth rate, Mr. Finaish continued, although there had been a decline in exports of certain commodities, notably cotton and rice. The Rice Export Corporation had recently signed agreements for selling high-quality rice to Saudi Arabia, Kuwait, and Qatar. An agreement for supplying 30,000 tons of rice to Oman was to be signed soon.

As for import liberalization, Mr. Finaish noted, the authorities had taken measures fully consistent with the quantitative targets set in the program, both for total imports and for intermediate and capital goods. Some Directors had stated that those measures were inadequate. Nevertheless, given Pakistan's history, including the pattern of industrial development and the political and other difficulties inherent in removing existing forms of protectionism for a range of industries supplying a large share of total output, the degree and scope of import liberalization should not be underestimated. The proportion of capital goods still subject to restrictions at the end of the program period would be small. Items in the categories of capital goods, intermediate goods, and raw materials that would remain protected were mainly intermediate goods that could be provided by domestic industries. Of course, the authorities were concerned with protecting employment in certain industries, an aspect of import liberalization on which Mr. Malhotra had made particularly perceptive remarks. In any event, the Pakistan authorities were moving in the right direction. He was surprised that Directors representing Pakistan's trade partners were offering advice that their authorities were not themselves following.

The authorities recognized the need to improve the structure of the tax system by broadening the tax base and improving the elasticity of taxes with respect to GDP, Mr. Finaish pointed out. In the 1981/82 budget, the authorities had introduced a number of structural measures supported by a reform of sales and excise taxes. As a result, revenue from sales taxes on domestic production had risen by 65 per cent over 1980/81 and by 40 per cent over the budget target, in spite of the reduction in the standard rate from 20 per cent to 12 per cent. The result was principally attributable to a change in the system of collection, and administration that had considerably reduced tax evasion. In addition, a number of sales tax exemptions had been removed. The Central Board of Revenue was reviewing the question of the remaining sales tax and excise tax exemptions as well as moving a number of levies from specific to ad valorem rates. The Central Board was actively considering removal of further sales tax exemptions, improving administration, introducing sales tax at the retail rather than the manufacturing stage, and dealing with cottage industries and unorganized sectors. The measures approved by the authorities in those areas were to become effective in the 1983/84 budget.

In the 1982/83 budget, Mr. Finaish observed, the authorities had introduced the ushr, a 3.75 per cent levy on agricultural production that was the first broad-based agricultural tax ever introduced in Pakistan. The ushr would be collected by local committees and councils and would be used in the locality to finance education and health care and to help the poor. The expectation of both the authorities and the staff was that people would be motivated to pay the tax because it was a religious tax and because it would be spent locally. As with the Zakat Fund and the profit-and-loss-sharing scheme, measures along Islamic lines such as the ushr should prove effective and had already shown some benefit.

While the national rate of saving projected for 1982/83 would represent an increase of about 1 1/2 percentage points over the rate for 1978/79, it was true that the rate remained relatively low, Mr. Finaish said. The authorities attached considerable importance to the objective of increasing the national propensity to save. However, a sustained and substantial increase in the rate of saving took time, as several of the important determinants of the rate of saving--like per capita income, the degree of financial sophistication, and cultural and institutional factors--changed rather slowly. Nevertheless, to the extent that the rate of saving was influenced by the rate of inflation and the rate of return on financial assets, factors that could change more rapidly, further improvements in the rate of saving could be expected in the near future. For instance, the staff had noted the increasing willingness to hold money balances as a result of the recent decline in consumer price inflation, a development that could be expected to have a beneficial effect also on other types of financial asset accumulation. Another promising development had been the large increase in the previous two years in small savings, partly as a result of improvements in the characteristics of small savings schemes. There was also some evidence that savers had responded favorably to the newly opened profit-and-loss-sharing accounts with commercial banks. The increasing emphasis being placed on promoting investment opportunities in agriculture and on stimulating private investment in industry should also have a favorable effect on entrepreneurial savings, both in rural and in urban areas.

Some Directors, among them Mr. Laske, had referred to the prices of water, gas, energy in general, and fertilizer, Mr. Finaish recalled. In the past four years, water charges had been raised three times. The authorities' objective was to recover the full cost of operation and maintenance by the end of the 1980s. Furthermore, measures were being introduced to reduce those costs. As part of the program approved recently, water charges would be increased at least once every two years. Fertilizer prices had been adjusted on October 5, 1982, long before the time scheduled in the program. The Government still intended to eliminate subsidies on fertilizers by mid-1985; the adjustments made so far were in line with that objective. In adjusting the price of fertilizer, the authorities took note of such factors as fertilizer offtake and the producer prices for agricultural commodities. An additional increase in the price of fertilizer in the near future could be counterproductive and could reduce offtake as well as reduce production.

The Pakistan authorities had recently undertaken measures in energy pricing, taxes, and administration to provide greater incentives for exploring and developing new oil-bearing and gas-bearing fields, Mr. Finaish remarked. As for oil, a system that related producer prices for incremental supplies from proven fields to international prices had been introduced in November 1981 and would be reviewed by March 31, 1983. The Government's policy continued to be to pass through to domestic consumers all cost increases for imported and domestic petroleum products, including higher costs due to changes in the exchange rate. Prices had been raised by 6.5 per cent at the end of 1981 and again by 2.2 per cent on January 9, 1983. At the same time, a 23 per cent increase in the consumer price of gas had also gone into effect. That was part of the authorities' commitment to increase the price of gas to two thirds of international prices for fuel oil equivalent by 1986. For producer prices, the authorities were implementing a policy under which prices of new gas would be related to international fuel oil prices. It was to be noted that the recent increase in the prices of gas and oil had led to strikes and demonstrations in Pakistan.

Finally, on the question of the revolving character of the Fund's resources raised by Mr. de Vries, Mr. Finaish explained that, on the basis of experience, there was no reason for concern about Pakistan.

The Chairman made the following summing up:

Executive Directors noted the broadly successful implementation of the 1981/82 economic and financial program under the extended arrangement. They observed that the domestic economy had again shown substantial growth and that Pakistan had now completed five years during which real growth had averaged 6 per cent a year. Although bad weather had slowed overall growth in the agricultural sector, self-sufficiency in major foodgrains had been maintained. In the industrial sector, growth had accelerated sharply, and the investment ratio had recovered to a level near the program target.

Directors welcomed the authorities' continued commitment to restrained fiscal and monetary policies. They observed that, despite shortfalls in tax revenue and external budgetary financing, government borrowing from the banking system had been held to the program target of 2 per cent of GDP. This result, and the successful implementation of the authorities' credit plan, had contributed to containing monetary expansion to a level below the program forecast. In this context, they noted that by end-year the rate of inflation had fallen substantially.

Directors expressed concern over the widening of the current and overall balance of payments deficit in the most recent period, especially as the original payments projections had envisaged a greater degree of import liberalization than had yet taken place. While the somewhat disappointing export performance reflected in part a difficult external environment and a weakening of the terms of trade, it also had resulted in part from competitive difficulties arising from the appreciation of the rupee. In this regard, Directors endorsed the adoption of the flexible exchange rate policy.

While noting that progress had been made in 1981/82 in implementing structural reforms, several Directors stressed a number of areas where further action was, in their view, required: prices for domestic natural gas, and major agricultural inputs, remained out of line; the performance of savings and investment had been disappointing; and difficulties had been encountered in implementing the envisaged reforms of the tax system and the public enterprises. In a more general vein, the suggestion was put forward, for possible consideration at a later date, that the pace of disbursement of Fund assistance under extended arrangements might be more closely linked to the pace of effective implementation of structural reforms.

Turning to the adjustment policies incorporated in the third-year program, some Directors thought that the momentum of adjustment appeared to be slowing down. The continuation of a high overall budget deficit, and in particular a high rate of growth of current expenditure, was viewed with concern. In this context, some Directors also expressed concern over the limited progress made, thus far, toward reforming and broadening the tax system, and pointed to the need for considerable action in this area in next year's budget. The rising burden of external debt repayment on the government budget was also noted with concern. Directors questioned whether the recent adjustments in energy-related prices were sufficient to enable the 1982/83 fiscal objectives to be achieved, and whether they represented adequate progress toward the goal of correcting price distortions in the economy; they stressed the need for continued progress in this area. Directors also expressed the need for more effective expenditure control.

With regard to monetary policy, the more stringent targets included in the third-year program appeared appropriate for containing inflation, although care would need to be taken to ensure that savings incentives were adequate, particularly in light of efforts to Islamize the financial system. Directors observed that the current and overall balance of payments positions were forecast to improve this year, due in large part to a recovery in the growth of remittances. They also noted the high growth rate recorded over the first half of the year for manufactured exports. While external competitiveness had improved over the past 12 months, the authorities would nevertheless have to remain vigilant to ensure that the incentive for exports was maintained. In this connection, some Directors noted that certain exports continued to benefit from export rebates. They stressed that reliance on exchange rate policy was a more efficient way to reallocate resources to the export sector, and urged the phasing out of industry-specific incentives.

Directors commended the Pakistan authorities for their commitment to proceed as planned with their import liberalization program despite the difficult world environment and rising protectionism abroad, as well as the weakening last year in the external position. However, several Directors stressed that the pace of liberalization seemed hesitant and slow. Moreover, the tariffs applied to the recently liberalized imports still appeared high, and a substantial proportion of domestic industry remained protected by bans. Further progress in this area of import liberalization, therefore, remained necessary, and it was important that the major reforms of the trade and tariff system planned for the start of 1983/84 be fully implemented.

In sum, Directors commended the Pakistan authorities for their commitment to the extended arrangement and for the success achieved in various areas in implementing the program under difficult external circumstances. It seemed possible, however, that the objectives of the extended arrangement would not be fully achieved, and that a significant external imbalance would remain at the end of the program period. They urged the authorities to regain the momentum of adjustment and, in particular, to tackle with determination the structural reforms that were vital to ensure balanced growth of the economy in the longer run. In this respect, the mid-term review of the program, scheduled for May 1983, would be an important test.

Extending his remarks, the Chairman observed that, to the extent that some structural elements of the program were not implemented, it might be better to stretch out the use of Fund resources in order not to concentrate too many of those resources in a period in which structural problems still remained. The Board would be looking into that interesting notion on the occasion of its more general reviews.

The staff representative from the Exchange and Trade Relations Department, in response to a question by Mr. de Vries, explained that the language used in paragraph 3(b) of the decision on the program under the extended arrangement was identical to language used in previous decisions in connection with medium-term reviews of such programs. The language was fully consistent with paragraph 3 of the letter from Pakistan's Minister of Finance.

The Chairman observed that paragraph 5 of the proposed decision on the program under the extended arrangement appeared in Supplement 1 of EBS/83/3.

The Executive Board then took the following decisions:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to Pakistan's exchange measures subject to Article VIII, Section 2, and in concluding the 1982 Article XIV consultation with Pakistan, in the light of the 1982 Article IV consultation with Pakistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Pakistan has recently entered into a bilateral payments agreement with a Fund member which is subject to approval under Article VIII. The Fund notes Pakistan's intention not to renew this agreement in a form which retains features that are inconsistent with Article VIII. In the circumstances, the Fund grants approval of the restrictions or multiple currency practices inherent in the bilateral payments agreement until May 31, 1983.

3. The Fund hopes that Pakistan will continue to pursue policies that will facilitate a relaxation of restrictions on payments and transfers for current international transactions and that further progress will be made toward eliminating the bilateral payments agreements with three Fund members.

Decision No. 7319-(83/28), adopted
February 4, 1983

Program Under Extended Arrangement

1. Pakistan has consulted with the Fund in accordance with paragraph 4c of the extended arrangement (EBS/81/222, Sup. 1, 12/4/81) and paragraph 3 of the letter dated November 1, 1981 attached thereto, in order to reach understandings with the Fund regarding policies and measures that Pakistan will pursue and to establish performance criteria subject to which purchases may be made by Pakistan during the period after November 23, 1982 through the end of the extended arrangement.

2. The letter dated January 5, 1983 from the Minister of Finance of Pakistan together with the annexed memorandum shall be attached to the extended arrangement for Pakistan, and the letter dated November 1, 1981 together with the annexed memorandum shall be read as supplemented and modified by the letter dated January 5, 1983 together with the annexed memorandum.

3. Accordingly, Pakistan will not make purchases under the extended arrangement:

(a) during any period after November 23, 1982 in which

(i) the data at the end of the preceding period indicate that the ceilings on the increase in (1) net claims on Government or (2) net domestic assets of the domestic banking system described in paragraphs 6e and 7a, respectively, and Table 1 of the memorandum annexed to the letter of January 5, 1983, or

(ii) the ceilings on the contracting of government or government-guaranteed foreign debt described in paragraph 8f of the same memorandum are not observed; or

(b) after August 1, 1983 if any understandings deemed by the Fund to be necessary have not been reached pursuant to the review mentioned in the second and third sentences of paragraph 3 of the letter dated January 5, 1983; or

(c) after August 31, 1983, if the performance criteria established in consultation with the Fund as contemplated in paragraph 3 of the attached letter of January 5, 1983 are not being observed.

4. Purchases under the extended arrangement for Pakistan shall not, without the consent of the Fund, exceed the equivalent of SDR 635 million until May 16, 1983; the equivalent of SDR 730 million until August 15, 1983; and the equivalent of SDR 825 million until September 30, 1983.

5. The Fund finds that, in view of Pakistan's intention expressed in the last sentence of paragraph 8e of the Economic Policy Memorandum of the Government of Pakistan for 1982/83 (EBS/83/3, 1/6/83), no additional understandings other than those stated in this decision are necessary regarding further purchases under the arrangement.

Decision No. 7320-(83/28), adopted
February 4, 1983

2. NETHERLANDS - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with the Netherlands (SM/82/244, 12/30/82; Cor. 1, 2/2/83; and Sup. 1, 2/2/83). They also had before them a report on recent economic developments in the Netherlands (SM/83/2, 1/6/83).

Mr. Polak made the following statement:

As in the case of previous consultation reports, the Netherlands authorities want to express their appreciation for the staff's excellent analysis of financial and economic developments in the Netherlands and for its keen insight into the problems with which the Netherlands Government is faced. The authorities are also in general agreement with the staff's recommendations for economic policy; I shall refer to a few points on which there is some difference of view between them and the staff.

The staff paper expresses well the central problem of the Netherlands economy and the limited room for maneuver that the authorities have in economic policy. Broadly speaking, the economic difficulties of the industrial countries in Europe have developed along a common path over recent years, and the Board has discussed them in the context of many consultation papers, as well as in our World Economic Outlook sessions. Against this background, what is perhaps most striking in the Netherlands is the extent of the relative deterioration of its situation in a number of major respects. Extremely successful in the 1950s and the 1960s, the Netherlands kept about in line with the other Common Market countries through the early part of the 1970s. Since then, developments in the Netherlands have been even less satisfactory than in most other members of the European Communities (EC), as measured by the decline of investment and consumption, the lack of growth or actual declines in output, the erosion of profitability of industry, and--partly on account of a strong growth of the labor force--the rise of unemployment, both open and thinly concealed by the cover of excessive use of generous disability provisions.

These unfavorable developments have had as their counterpart such features--which would be enviable if they had occurred by themselves--as a low inflation rate, wage moderation, the maintenance of a good competitive position in spite of a strong currency, a large current account surplus, and low nominal interest rates.

As in many other industrial countries, the problems in the Netherlands, though they have been aggravated by the worldwide economic situation, are not primarily cyclical in origin. They are due, rather, to a number of other causes that can probably best be described, collectively, as structural.

One of these is the distribution of exports, in terms both of commodities and of countries of destination, which is not such as to ensure for the country the strongly rising trend of export demand that it enjoyed in preceding decades, even when the world economy recovers. The abundant supply of natural gas since the mid-1960s, while adding some 6 per cent of national income to government revenue, has brought with it some of the handicaps to other industries that are common to many exporters of energy.

For the economy as a whole, severe structural problems have arisen from the persistent growth of the public sector in the 1960s and again in the 1970s, with public sector expenditure accounting now for over two thirds of national income. The impact on the economy of this increased expenditure has been twofold. First, it has induced an almost equally rapid growth, as a proportion of national income, of the tax burden in the widest sense, including social security premiums. With higher rates of taxation and premiums, incentives to work were reduced and tax morale undermined; and a sharp rise of benefits for nonwork, such as unemployment, sickness, and invalidity, exercised similar disincentive effects. But in spite of increased rates, taxation did not fully keep pace with the rise in expenditure, so that the public sector deficit grew at an alarming rate, from a modest 1.5 per cent of national income in 1973 to about 9 per cent in 1982. Government debt as a percentage of national income, which had been declining since the end of the war to a low of about 40 per cent in 1977, will again reach about 70 per cent, the 1963 level, by the end of this year. At an average interest rate of about 10 per cent a year, this would mean that the increased interest burden alone would account for a rise in the deficit of about 3 percentage points of national income.

Against this background, views as to what can be achieved by government policies have become much more modest than they were in the 1950s and 1960s. At that time, official and professional opinion in the Netherlands strongly believed that suitably designed government policies, operating through a sufficient number of economic instruments, could steer the economy close to a desired optimum path. For some time, this approach did indeed achieve remarkable successes. But it is being realized that this approach is no longer valid. It is now felt that national macroeconomic policy cannot do much to lighten the weight of unemployment, which burdens the Netherlands even more severely than other industrial countries, and more generally, that governmental attempts to guide the economy by regulation, taxes, subsidies, etc. may well have been far in excess of the optimum.

In the circumstances, financial and economic policies have been heavily focused on cutting down the fiscal deficit, with primary emphasis on containing and reducing government expenditure. As the staff correctly states on page 14 of SM/82/244, reduction of the deficit cannot reasonably be pursued by increases in the tax burden; indeed, the size of that burden is part of the structural problem. The staff's comment on page 8 that the Government "abandoned" its policy not to increase the tax burden by its recent decision to increase indirect taxes and social security contributions somewhat overstates the case: these increases are seen as short-term deviations from an unchanged medium-term target of stabilizing, indeed lowering, the collective tax burden.

The largest element in the rise of government expenditure has been caused by a steep increase in transfer payments to individuals. But an important place is also taken by transfers to enterprises, which increased sixfold from 1973 to 1981. In part, these transfers represented subsidies or loans to individual enterprises in difficulties, and the staff's cautionary words about such transfers are well taken. But since 1980, more than half of the total consists of investment premiums, which unlike previous schemes for investment tax credits and accelerated depreciation, are available to profitable and nonprofitable firms alike. In the present depressed situation of the Netherlands economy, the latter firms cannot be regarded as necessarily or even predominantly uneconomic. Contrary to the view of the staff, the Netherlands view is that these premiums do encourage investment, a view supported by econometric findings. Given the low level of investment, the premium system is seen as an efficient way to stimulate domestic investment. It acts, in a sense, as a corrective to the unfavorable macroeconomic conditions where nearly half of all enterprises make losses. The large capital export from the Netherlands is in part an indication of the unfavorable climate for investment at home, and the premiums also serve as a means of tilting the balance in favor of investment at home.

In the effort to reduce the fiscal deficit, a policy of low interest rates is obviously of crucial importance. The Netherlands has, therefore, used its room for policy maneuver to bring interest rates down as much as possible. Its exchange rate policy--to maintain the value of the guilder against that of the deutsche mark--is, inter alia, addressed to that end. So is the medium-term policy of lowering the deficit by 1 percentage point a year from 1984 to 1986, thus creating the expectation of reduced future recourse of the Government to the capital market. The large surplus on current account--though in no sense constituting a policy objective--has produced an inflow of liquidity and has thereby also exercised a downward influence on interest rates. These various conditions and policy positions have been quite successful in bringing about a sharp decline in interest rates, which are now even below those in Germany; a recent large long-term government issue was placed at an effective interest rate of just under 7.5 per cent.

The same exchange rate policy has also been helpful in containing inflation; the estimated increase for 1983 in the consumer price index is 2.5 per cent, and that for the GDP deflator 1.7 per cent. The moderation of prices and wages--employees' compensation is expected to increase by less than 1 per cent in 1983--has made it possible for the Netherlands to achieve a modest improvement in its international competitiveness in spite of the persistent strength of the guilder in the European Monetary System (EMS). That strength has, accordingly, not prevented some improvement in the Netherlands' share in its export markets.

Wage moderation has made little dent so far in the profitability of enterprises. What has been achieved is that the share of labor in total income, after rising steadily during the 1970s (see page 16 of SM/83/2), has stabilized since 1980. The same thus holds for the combined share of rents, interest, and profits. As interest rates were rising at least through mid-1982, the implication is that profitability was further eroded during this period so that it is now zero for industry as a whole. From this starting point, a major increase in profits of the private sector is a precondition for restoring sustainable growth. Given the social and political factors involved, this will of necessity take time. The restoration of profitability would, moreover, need to be supplemented by measures providing more scope for labor mobility and by a decisive liberalization of the regulatory climate.

Extending his remarks, Mr. Polak noted that the present consultation was the first time in more than two years that the Executive Board had had an opportunity to discuss the Netherlands. The reason was that the staff of the European Department had been overburdened in recent years. There had been definite plans for the consultation to take place in April 1982. Unfortunately, the staff's preoccupation with other countries had made postponement necessary.

Mr. Laske stated that the Netherlands was facing serious economic difficulties similar to those of other industrial countries, especially some of the smaller ones. Over a number of years, economic developments and policies in the Netherlands seemed to have gone in the wrong direction, and large structural problems had arisen. Priority had to be given to correcting those fundamental maladjustments. The high level of income, as well as the absence of energy-induced external payments problems, should enable the authorities to tackle their structural shortcomings with determination. The task could not be accomplished under a crash program; it would require a medium-term solution.

The country's problems were largely due to expansion of the public sector, Mr. Laske went on. The authorities had already undertaken commendable efforts to reduce that expansion, but the burden imposed by the public sector on the economy had continued to increase, a development that undermined productive capacity and pushed private sector activity into the background. Chart 1 on page 4a of SM/82/244 showed that the share of public expenditure in GDP had risen from less than 40 per cent in 1965 to over 65 per cent in 1982. Table 11 on page 16 of SM/83/2 showed that the share of total fixed investment in GNP had fallen from about 25 per cent in 1971 to less than 18 per cent in 1981. In 1982, gross fixed investment had decreased by a further 5.2 per cent, having declined by as much as 14 per cent in 1981. Attempts to improve the budgetary position by raising taxes and social security contributions had contributed to eroding the profitability of private industry, where a large number of enterprises were in dire straits.

Another cause for serious concern was the deterioration in the structure of public expenditure, which might provide an explanation why the considerable growth of the public sector had not improved employment, Mr. Laske commented. On the contrary, unemployment in 1982 had risen to 12.4 per cent, and a further increase was to be expected in 1983. There was in addition a substantial amount of hidden unemployment, estimated by the staff at about 6 per cent. However, the steady increase in the labor force during the past 20 years, because of demographic factors, had made the task of the authorities in tackling the employment problem more complicated in the Netherlands than in some neighboring countries.

Table 23 on page 39 of SM/83/2 showed that, while gross investment by the public sector had increased about threefold between 1965 and 1980, domestic income transfers had risen ninefold in the same period, and interest payments on the swollen indebtedness of the public sector had also risen rapidly, Mr. Laske said. He agreed with the staff that the momentum of public expenditure and the pressure exerted by the public sector deficit had reached a point that would preclude a sustainable recovery of private economic activity. The main task facing the authorities was to restore a better balance between private sector activity and public sector activity, or, in other words, a better balance between productive and redistributive activity.

Therefore, Mr. Laske continued, he welcomed the high priority given by the Government that had taken office the previous November to stabilizing and then reducing the collective burden imposed by the public sector, and to cutting the public sector deficit. Considering the substantial unemployment, a steady reduction of the deficit in the medium term was preferable to a shock approach. The planned reduction of the public sector borrowing requirement by 1 percentage point a year from 1983 to 1986 was certainly desirable and should be achievable. In view of the already high tax burden, the deficit should be reduced primarily by gaining control over spending. He was encouraged to read in the staff paper that measures adopted to cut the budget deficit were focusing on current spending. The authorities would do well to reverse the approach of the past, when spending cuts had tended to move the structure of public expenditure in the direction of consumption at the expense of public investment.

The authorities did not seem confident that the targets of the 1983 budget could be achieved, given the unpromising prospects for a revival of economic activity, Mr. Laske remarked. The Organization for Economic Cooperation and Development (OECD) was even forecasting negative growth in the Netherlands' GDP of as much as 1.5 per cent. Should growth turn out to be less favorable than expected, the likelihood of a further deterioration in the fiscal position could not be excluded; that likelihood reinforced the arguments made in favor of determined and continued expenditure restraints. Did the staff tend to share the Organization's pessimistic forecast for growth in 1983? How far would the authorities allow the budget deficit to rise before imposing additional spending restraints?

As for monetary policy, the authorities had skillfully made use of the leeway created by the emergence of a current account surplus in 1982, Mr. Laske observed. The liquidity inflow associated with the favorable shift in the balance of payments and a decline in interest rates abroad had enabled the authorities to reduce domestic interest rates. The profit position of enterprises, as well as the budgetary position of the Government, had benefited from lower rates without endangering the gains that had been made in containing inflation. Unfortunately, however, the downward move in interest rates had been confined to the shorter-term rates, while longer-term ones appeared to have remained undesirably high. Large public sector borrowing requirements had certainly acted as an impediment. He was glad that the Netherlands Bank had not tried to force down long-term rates by monetary financing of the public sector deficit, an action that would no doubt have negatively affected domestic and foreign confidence in the guilder.

Participation in the European Monetary System had clearly served the Netherlands well, Mr. Laske said. Apart from widening the scope for reducing short-term interest rates beyond the normative differential between guilder rates and deutsche mark rates, their strong-currency program had helped to contain inflation and to maintain the international competitiveness of exports. Nonetheless, that policy needed stronger support from fiscal policy, and he was glad that the authorities were determined to provide it.

Turning to wage policies, Mr. Laske recalled that Mr. Polak had said that wage moderation had made little dent so far in the profitability of enterprises. He himself would note that while the growth of nominal wages had been reduced significantly, since 1981 the possibility for higher business profits unfortunately seemed to be offset by higher social security taxes and higher interest costs. Therefore, continued wage moderation was urgently needed. In view of the relatively low rate of inflation, the Government's intention to freeze public sector wages in 1983 did not seem to impose an excessive burden on civil servants. It would be crucial for wage formation in the private sector to move on more or less the same lines. He basically agreed with the staff's opinion that a move away from centralized wage determination would be desirable, since the effect of that system had not been convincing; but he had doubts whether such a change could, under present circumstances, be brought about. Experience in many industrial countries, including his own, suggested that organized labor found it difficult to accept large differentiations in wage increases among various sectors of the economy. Wage restraint covering the entire economy of the Netherlands, regardless of the profit position of individual enterprises, might therefore be the approach most likely to maintain the social consensus.

Mr. Lovato agreed with Mr. Polak that the situation confronting the Netherlands, although complicated by cyclical factors, was difficult to improve because of the deep structural nature of some of the problems. Indeed, the Netherlands had a mature economy, and some of its features strongly contrasted with the problems besetting other industrial countries. On the positive side, the current account of the balance of payments was in sizable surplus, the inflation rate was low, and the guilder was strong, despite a large and growing public sector deficit, which tended to be linked to high inflation and a high current account deficit. Yet the macroeconomic identities made it clear that those good features were counterparts of the bad ones, especially the low level of investment.

The staff had identified two main sources of imbalance--the size of the government sector together with the resulting burden of taxation, and the rigidities in the labor market, Mr. Lovato went on. While adjusting those two features would be the key to a successful recovery in the Netherlands economy, he did agree with some of the differing viewpoints expressed by Mr. Polak. It was difficult to determine, a priori, what the optimal size of the public sector should be. Social goals, preferences in income distribution, and a host of other considerations played a role in defining the size, which could not be considered too high or too low per se. Nevertheless, many of the reasons behind the steady growth of the public sector's share of GDP to the high figure of 67 per cent were not what could be considered optimal, or even desirable. A large part of the increase had been due to the rise in transfer payments to individuals. He would have preferred to see a cyclically adjusted estimate of those expenditures, and also of the overall budget deficit. Those data were useful in judging the stance of fiscal policy, and he personally found it odd that such estimates were produced and used in Article IV consultation discussions for some countries, but not for others. Could the staff shed more light on the point? He tended to agree that at least some of the social transfer programs would have to be brought under control if the burden of taxation were not to increase further. Could the staff or Mr. Polak say whether the authorities intended to change the indexation of social benefits, and in particular whether the link to wages was likely to be severed?

He agreed with Mr. Polak's criticism of the staff's attitude toward the subject of premiums to enterprises for investment, Mr. Lovato continued. Particularly at a time of recession, when the profitability of enterprises was low or negative for cyclical reasons, traditional tax breaks for investors lost much of their effectiveness in stimulating investment.

Profits after taxes had been declining, Mr. Lovato noted, a development that could be one of the explanations for the poor performance of investment in the Netherlands. He had, however, been struck by the exceptional restraint in demand for higher real wages, which had in fact declined since 1979. Did the staff have any more information about profits before interest and taxes, or about the behavior of markup costs, which were definitely crucial variables in determining what the suitable course of action should be to restore business profitability? He strongly suspected that margins must have been constant or rising, so that the main way to restore the profitability of business had to come from a decrease in the financial burden. Thus, he welcomed the decision of the Netherlands authorities to use the current account surplus to achieve a reduction in interest rates, as mentioned by Mr. Polak in his statement.

On incomes policy, Mr. Lovato said, he was not sure that he could share the staff's view on government interference. There were clearly dangers in the pursuit of such policies, among them the compression of the wage scale. Nevertheless, in particular circumstances and for a short time, the overall results of such policies in containing inflation and stimulating external competitiveness should not be undervalued. Moreover, the faith in freely functioning labor markets had been shaken more than once by outcomes not at all consistent with anti-inflation policies.

Mr. Taylor began by noting that an unusually long time had passed since the most recent consultation with the Netherlands; he hoped that the Fund could carry out more regular consultations with the country in the future. The staff papers spoke of falling output, rising unemployment, and high public spending, as well as sizable public sector deficits, extensive transfer payments, labor market rigidities, and a struggling and noncompetitive private sector. While those characteristics were obviously shared to some extent by many countries, they were relatively new for the Netherlands and perhaps therefore more difficult to deal with. At any rate, the country had a mature industrial economy with major structural shortcomings, some of which had arisen during the 1970s, when it had benefited from large windfall increments of North Sea oil and gas. He had used the word "increments" to mean that those resources had become valuable when the price of energy had risen sharply in the 1970s. The United Kingdom was experiencing similar problems, and his authorities were only too well aware of the difficulties in trying to sort them out.

He was in broad agreement with the staff analysis of the Netherlands economy and with the remedies put forward, Mr. Taylor continued. The authorities should make a sustained effort to reduce structural distortions and, as Mr. Laske had said, to give top priority to reducing the size of the public sector. They would also have to attend to the worrying public sector deficit, which had reached 9 per cent of GNP. He therefore commended the authorities for their intention to achieve a steady reduction over the next three years. As there was little scope for measures on the revenue side--because private businesses were already suffering from a steady rise in the tax and social security burden, and because corporate profitability had slumped--the emphasis should be put on reducing public spending. Should the authorities persevere with the measures that they had been carrying out, they would in due course be rewarded by a fall in long-term interest rates, which would be a direct benefit to corporations.

The Netherlands had achieved a greater degree of success than many trading competitors in promoting the twin objectives of domestic price stability and exchange rate stability, and monetary policy had played an important role, Mr. Taylor observed. The Netherlands economy was fortunate to be a neighbor of the German economy, in which the inflation record had been good over the years. In those circumstances, it made sense to pursue policies aimed at maintaining a stable relationship between the guilder and the deutsche mark, an important function of monetary policy in the Netherlands. The consequence was that there had to be close links between short-term interest rates for the guilder and the deutsche mark, so that the authorities had little scope for an independent monetary policy.

In the previous year, the authorities had been able to take advantage of not only reductions in the deutsche mark rate but also the leeway deriving from a much improved current account and a stronger guilder, Mr. Taylor remarked. It had been a useful step to reduce slightly the comparative short-term rate of interest, but there might be only limited room for moving farther in that direction. As previous speakers had said, there was also still a problem with high long-term interest rates. As international long-term rates on the deutsche mark and the U.S. dollar came down, the problem for the Netherlands might be diminished. However, the evolution of long-term rates also depended on the Netherlands authorities' ability to contain the public sector deficit, failing which they would find it difficult to finance the deficit without having inflationary effects on the money stock.

The relative stability of the exchange rate and the good inflation performance had led to improved external competitiveness in the previous three years, Mr. Taylor noted. The improvement contrasted strongly with the experience of, say, the United Kingdom or France, where the inflationary performance had been much less good. Given the improved competitive position, the weakness of domestic activity, and the contribution of North Sea gas, it was no surprise that the current account had moved into quite large surplus in the past year or so. He had missed in the staff papers a discussion of the contribution made by North Sea natural gas to the balance of payments position. In particular, would the position suffer or benefit as a result of weaker energy prices?

The staff had correctly put forward the view that the high degree of social consensus in the country and the authorities' success with incomes policy had been bought at the cost of increasing structural distortions in the economy, Mr. Taylor commented. In particular, the compression in wage scales and the maintenance of a high minimum wage, together with other rigidities in the labor market, were associated with a fairly centralized approach to wage restraint. While incomes policy had played a role in containing inflation, he agreed with the staff recommendation that the Government should involve itself less with detailed arrangements in the labor market and should try to encourage a less rigid system of wage determination. The Government should also phase out the large transfer payments to corporations, designed to sustain them in circumstances in which a longer-run calculation of the economic case for keeping them going would suggest that they should be allowed to senesce.

The staff made no reference to its appraisal of price controls, Mr. Taylor noted. Although those controls might have been helpful in the past by curbing inflationary expectations and thus contributing to wage moderation, many of the markets concerned were now so weak that the authorities could perhaps safely consider removing the controls. At any rate, did the staff have a view on the usefulness of winding down price controls in the Netherlands?

In sum, Mr. Taylor said, the short-term outlook appeared somewhat gloomy. The authorities needed to act firmly on the fiscal side and to make structural adjustments. In some respects, however, the economy was in a strong position to benefit from the worldwide recovery, when it came, and it would be unwise for the authorities to undertake a major expansionary shift of policy. As Mr. Laske had said, they should move gradually in the medium term toward overcoming their problems, particularly those arising from an overextensive public sector.

Mr. de Groote commented that the Netherlands displayed probably the most interesting case of illness affecting developed industrial countries, and the most disquieting one. It was the most interesting in the way a doctor might find a cancer interesting or beautiful, and it was the most disquieting because of the continuing degradation of the economy in spite of a favorable balance of payments position, effective wage policies, and improved export competitiveness in a country known for the quality of its organization and the competence of its traders and workers. Could it be that the natural gas bonus had merely precipitated the current situation and that neighboring countries were bound to follow the same pattern, or would those countries, together with the Netherlands, be able to reverse the trend? He believed that the chances for reversing the tide could materialize only under conditions of overall world recovery and that the Netherlands would then have to take decisive credit, fiscal, and social security measures, which, together with the sound policies already followed in the exchange rate, prices, and wages, might give the authorities a chance gradually to alleviate structural shortcomings.

The situation in the Netherlands was indeed highly paradoxical, Mr. de Groote said, not only because of the unusual relationship between some variables--such as a high balance of payments surplus accompanying a high budget deficit--but also because of the doubts that the situation raised about the effectiveness of the adjustments traditionally recommended by the Fund. After all, the Netherlands had demonstrated an increase in competitiveness and a favorable evolution of prices and costs coinciding with a fall in profitability and the continuation of disinvestment. Had the authorities carried out adjustment policies in the wrong direction? Would there have been more investment and a greater chance of structural recovery in the future if the exchange rate had been more flexible, or if the authorities had reflated? As there were a great number of competent economists and research institutes in the Netherlands, and as many famous economists from the country took part in Fund activities, he was sure that the issues being examined by the Board had been carefully analyzed. He would therefore limit himself to five observations dealing with Fund recommendations and Fund policies.

First, the material presented by the staff showed that a more expansionary policy would hardly have influenced investment positively, Mr. de Groote noted. The depressed state of investment seemed to be related to the distribution of value-added by enterprises, many of which appeared to have lost any incentive to invest further. Reflation would, moreover, have prevented the economy from achieving the important results attained in moderating the rise in prices. With the present linkage between indirect wages and prices, a reflationary policy might have been a failure in restoring investment in the long term. Second, the staff made it clear that the economic situation in the Netherlands would be worse once recovery started if the authorities had not re-established a sound price and cost basis for taking advantage of the expansion of export demand when it came about.

Third, Mr. de Groote recalled, at a time when the world economy had still been expanding, the authorities had not taken structural measures that were required to restore the share of profits in value-added by enterprises through reducing welfare contributions and shrinking government spending as a percentage of total spending, accordingly reducing the burden of taxation on corporations and individuals. The effects of pensions, unemployment compensation, and subsidies to some enterprises had compounded the problem. It was impossible to solve the problem until recovery had started. As Mr. Polak had convincingly demonstrated, the current world recession narrowed the authorities' scope for action. In other words, criticism of economic policies in the Netherlands should be directed not at the present phase but rather at the previous phase of the cycle, when natural gas euphoria and social security comfort had drawn attention away from the need to reduce government spending at a time when it would have been easy to do so. The volatility of governments, and the long period separating each government from the next, also might not have provided the most convincing circumstances for reform.

Fourth, the authorities would be able to act on the structural imbalances in the Netherlands only in a world context different from the present one, Mr. de Groote went on. Therefore, the real issue was whether they would soon be in a position to modify the distribution of national income and take advantage of the world recovery. The groundwork had already been laid in wage and price moderation. However, unless a fundamental reorganization of the social security system were already envisaged with the intention of implementing it as soon as circumstances allowed, he did not see how the recovery could induce a pervasive restoration of private investment. Employers' contributions to financing social security had amounted in 1982 to about 40 per cent of the total cost of the system. Those contributions nullified the effects of the reduction in real wages and in labor costs that the authorities had successfully brought about. The steady decrease in the productivity index would be reversed only if the contributions made by enterprises to social security were substantially reduced. It was also worth noting that social security supported increasingly more so-called disabled workers, who now exceeded the unemployed in number. He wondered whether the conditions for eligibility for disabled status could be tightened up, so that that anomaly would be eliminated before other aspects of the social security reform were put into practice at the beginning of the recovery.

The indicators of competitiveness given in Table 42 of SM/83/2 might be somewhat misleading, Mr. de Groote considered. It was true that total exports had increased by 2.5 per cent in 1982 over 1981, despite an

18 per cent decrease in the volume of gas exports. If the employers' contribution to the social security system could be reduced, those indicators would become more positive, and exports of nongas commodities would be further boosted, especially exports of agricultural goods, chemicals, and metals. The linkage between wages and social security benefits as a large component of the present budget was, in his view, the hard core of the Netherlands' structural problems, far more than monetary or exchange rate policy. Acting on the problem at the very beginning of the recovery should be socially more acceptable, inasmuch as an increase in the number of employed workers and an increase in the total wage bill would counterbalance the next reduction in real per capita wages, a process that probably had to continue for a while.

Fifth, he doubted whether the adaptation of the social security system and the resulting change in public finances would be applied rapidly enough for an improvement unless credit policy were qualitatively oriented, from the beginning of the recovery, toward financing investments and unless the authorities gave special fiscal incentives to the private sector, Mr. de Groote remarked. A more accommodating stance of monetary policy might then have to accompany those measures in the first phase of the recovery.

In conclusion, Mr. de Groote said, it was for his authorities a source of pride that Mr. Ruding, who had played an important role in the Executive Board, was now in charge of the finances of his country. Belgium and Luxembourg were especially interested in the success of his endeavors.

Miss Le Lorier commented that the prospects for 1983 and beyond were somber. The forecast of price increases, at only 2.5 per cent, could be taken as a symbol of the authorities' success in the fight against inflation, or it could illustrate that the Netherlands was experiencing deflation. GDP was expected to decline for the third year in a row, and the slight deceleration of the fall in domestic demand was not to be accompanied by sufficiently supportive foreign demand. Thus, the moderation of nominal price rises could be viewed more as a worrying symptom than as a satisfactory outturn. Even if, as Mr. Polak had said, the deterioration in the real economy could be largely described as structural, she was tempted to think that the policy response might perhaps evolve over time, as eloquently argued by Mr. de Groote during the discussion of the World Economic Outlook.

At the Board's seminar on oil exporting countries, Mr. Polak had suggested that the Netherlands shared some of their characteristics, Miss Le Lorier recalled. He had notably mentioned that the expansion of welfare payments was directly related to the much-envied state of being an energy exporting country, and he had stated earlier at the present meeting that other industries had been handicapped by the abundant supply of natural gas. It was clearly essential for the authorities to try to correct the working of the perverse mechanism that had been at work. On the one hand, the number of people eligible for various benefits for disability, sickness, and unemployment had grown at an annual rate of 6.4 per cent between 1965 and 1980, while total employment had been growing at 0.8 per cent a year. On the other hand, the extremely high rate of unemployment and its concentration among young people seriously constrained the progress that could be made in controlling the growth of social spending. After all, the number of unfilled vacancies had dropped sharply.

Incidentally, Miss Le Lorier remarked, she had had some difficulty in reconciling the statement in SM/83/2 that the mismatch between supply and demand in the labor market had been less prevalent in recent years, with the statement in SM/82/244 that the positive effects of a revival in world demand would quickly be frustrated by bottlenecks in the Netherlands economy. She was unsure whether such a risk could be attributed to inadequate training or to a traditional reluctance toward geographical mobility. Whatever the reasons, was there not a justification for financial involvement by the public sector, on top of possible deregulation, that could at best substitute for other forms of social transfers? Moreover, the rate of growth in the labor force was one of the highest in Europe.

The staff pointed to another structural rigidity--the insufficient differentiation in income differentials associated with the high minimum wage--that might explain part of the deindustrialization going on in the Netherlands and the high rate of unemployment, Miss Le Lorier observed. A social consensus appeared to be extremely difficult to achieve on widening income differentials. Perhaps there was a way of achieving such widening marginally through the tax system. The relative attractiveness of public sector salaries could also be worth correcting on the grounds that public employees were better protected from unemployment. Contributions by public employees to unemployment schemes could help to narrow the gap. Perhaps Mr. Polak could say whether the conditions for the intended discontinuation of the statutory wage policy were likely to be met. To what extent might there be a trade-off between inflation and wage differentiation? It certainly appeared to be true downward and might also be true upward, provided that a limit was put on indexation mechanisms.

The optimal rate of inflation need not be the same over time, even in a given country, Miss Le Lorier considered. If inflation that did not feed on itself, to use the definition proposed by the Director of Adjustment Studies during the discussion of the World Economic Outlook, were indeed a necessary lubricant for growth, would it be entirely inappropriate to tolerate a rate of price increase somewhat higher than 2.5 per cent?

She agreed that the public sector deficit had to be contained, Miss Le Lorier said. She could endorse the view that there was more scope for reduction on the expenditure side than on the revenue side. It was extremely difficult to spell out a desirable level for the deficit in 1983. Without wishing to be pessimistic, she would suggest that, given the recent forecasts, modesty in the objective for the fiscal deficit might be not only more credible but also a necessary evil to prevent a total collapse of domestic demand and output. On a more technial point, it might be worthwhile to try to modify substantially the budgetary procedure. The intended reductions in the budget were estimated starting from projected levels rather than actual ones and were supposed to be implemented during the fiscal year. That practice might be responsible for a large part of spending overruns and could perhaps be amended.

The structure and the financing of the deficit would also have to be dealt with, Miss Le Lorier considered. As to the structural component, she agreed that the pattern should shift toward more productive expenditure, and she associated herself with the comments made by Mr. Polak on the validity of investment-supporting schemes. It was difficult to assess whether they brought about measurable additionality to the global level of investment, or whether they entailed projects that were not always worthwhile in the long run, but those imperfections were considerably outweighed by the need to protect the country's potential for growth over the medium term. As SM/83/2 made clear, the share of imports in total domestic demand for industrial products had increased from an average of 39 per cent in the mid-1970s to 51 per cent in 1981, as domestic demand had outpaced potential output growth. On the other hand, substantial outflows had been registered in 1981 both on account of long-term private capital transactions by the private sector and on account of direct investment. The paradox was germane to the one, mentioned by the staff, of rising external surpluses and expanding public sector deficits. The economy of the Netherlands appeared to be faced with an acute need for investment and with a lack of opportunities to invest, for both residents and nonresidents. There thus appeared to be few convincing arguments against a voluntary and selective approach by the authorities in favor of investment opportunities. More theoretically, a case might be made for having an amount of investment premium equal to the amount of government revenue derived from natural gas, a practice that might lessen some of the handicaps attributable to the energy surplus.

The subject of financing the public deficit led her to a more cyclically oriented observation on the stance of monetary policy and the level of interest rates, Miss Le Lorier said. In her view, the high level of real interest rates fully justified the recommendation that the authorities use their room for maneuver as much as possible. The external constraint had been extremely costly for the Netherlands, and she hoped that the recent easing of monetary conditions, particularly in Germany, would be continued. The buildup in the current account surplus of the Netherlands also added to the authorities' leeway. Chart 3 on page 10b of SM/82/244 showed that the spread in government bond yields between the Netherlands and Germany had become positive only after 1975. That development coincided roughly with the emergence of less than satisfactory developments in the real economy of the Netherlands. One partial explanation might be found in the widening of the public deficit, but that observation led her to consider how the deficit was financed. Was it really unacceptable to prefer more bank financing and less capital market financing if such a policy were to prove helpful in bringing down interest rates? From the point of view of liquidity positions, the policy would not necessarily result in a greatly different outcome. Moreover, as the staff had noted on page 10 of the same paper, more public bonds meant fewer nonmonetary resources for the banking system. The validity of the distinction between monetary and nonmonetary resources of the banking system was in practice arguable. There seemed to be little difference for the overall liquidity of the economy between different mixes of bank financing and capital-market financing of the public sector. She would appreciate staff comments on the point.

She had no difficulty with the staff analysis and recommendations, Miss Le Lorier continued. She had been struck by the evolution of the real economy, which should have an important bearing on the Fund's suggestions for structural improvements. It remained to be determined how cyclical developments might help to accelerate or to threaten the implementation and ultimately the effects of structural action. The international environment, and more specifically interest rates, had so far been extremely costly to the Netherlands.

After all, the weakness of total domestic demand, and its composition, were both a manifestation and a cause of the structural problem, Miss Le Lorier concluded. However, they had cyclical effects that could not be overlooked. One idealistic solution might be one in which the three parties--entrepreneurs, employees, and central bankers--could agree on adequate wage growth and guarantee a given level of interest rates. In the absence of such a solution, the authorities should attempt to bring down interest rates, particularly long-term ones, without neglecting the contractionary impact of the structural fiscal adjustment.

Mr. Casey noted that little had changed since the previous consultation with the Netherlands. The recent record of productivity and unit labor costs in manufacturing industries had been quite good, although it had been achieved largely at the expense of unemployment and a shakeout of labor. Nevertheless, businesses were making no profits--even incurring losses--and investment was falling, features presumably attributable to high interest payments on corporate debts outstanding and also to high social security taxes. Like Mr. Lovato, he would prefer more information on profits of the corporate sector before interest charges and before taxes, if it could be provided. More generally, he wondered what motivated entrepreneurs in the Netherlands to produce and to export. Economically speaking, it did not seem to be rational behavior and in any event could not long continue. The fiscal deficit would have to be brought down to allow interest rates to fall and to give the private sector breathing space. Anyone who thought that an ongoing expansionary stance of fiscal policy helped to stimulate output and employment should look at the experience of the Netherlands.

Indeed, because of structural impediments, any recovery in aggregate demand might quickly encounter bottlenecks and thus lead to instability, Mr. Casey considered. Public sector expenditure was approaching the astounding figure of 70 per cent of national income. There was little scope for further increases in tax revenue, even energy-related revenue.

Nevertheless, despite repeated attempts, it had proved impossible to curb the growth in public spending, especially in transfer payments. The public sector also absorbed more than 70 per cent of capital market funds. The private sector was of course reacting predictably. Businesses were exporting capital, and households were hoarding resources for precautionary reasons. Had there been any trend toward emigration of skilled people from the Netherlands?

As other speakers had mentioned, the economy of the Netherlands was suffering from severe structural problems, Mr. Casey remarked. There were few market incentives to work, save, or invest. Instead, a sort of surrogate system of government incentives had grown up that had been entirely counterproductive.

Features like low inflation, wage moderation, maintenance of competitiveness, and a substantial current account surplus might appear superficially impressive, but they were unsustainable and indeed were somewhat cosmetic, Mr. Casey stated. For example, the low inflation rate was due in large part to the strong exchange rate policy and the link of the guilder to the deutsche mark. Wage moderation and sustained competitiveness had been achieved at the expense of unemployment, especially youth unemployment, and also at the expense of a compression of wage scales and disincentives to training and personal ambition. It was noteworthy as well that absolute wage levels remained high by international standards. The strong external position of the Netherlands reflected better terms of trade, a collapse of capital goods imports, and a panoply of aids to ailing export industries that apparently were producing the wrong goods for the wrong export markets. In that respect, he wondered what investment premiums could really achieve beyond maintaining the status quo. None of those superficial achievements was sustainable over the medium term.

The economy of the Netherlands had begun the process of deindustrialization, which meant the erosion of productive potential and its replacement by unproductive forms of activity, or even inactivity, Mr. Casey observed. The situation was dynamically unstable and had worrying implications for prices, employment, and the balance of payments in the medium term, as the gap between aspirations and resources continued to widen. It was difficult to understand how a country that was well endowed with natural resources, and whose people had a strong tradition of hard work, innovation, and economic talent, had been mismanaged to such an extent.

Despite those critical remarks, he had the impression that the new Government was beginning to make the needed adjustments, especially in diminishing current government spending, Mr. Casey concluded. He wished the authorities well on the long road back, and he agreed with Mr. Laske and others that rejuvenating a senescent economy did take rather a long time.

Mr. Tvedt observed that, when reading the staff paper, he had been surprised and puzzled at the same time. He had been surprised by the extraordinarily critical and acrimonious tone of the paper, and he had been puzzled because he still failed to see why economic circumstances had apparently gone so wrong in the Netherlands. The staff had not dealt sufficiently with the real problems, and should have written a more thorough analysis of the background behind the apparent paradox of rising external surpluses and increasing public sector deficits.

He agreed with the staff that the rise in the current account surplus was largely the result of a fall in investment outlays, Mr. Tvedt continued. Yet the staff failed to explain investment activity in the light of relatively low interest rates and excellent wage and cost developments by international standards. That development clearly indicated that a fall in the inflation rate was not a sufficient condition for sustainable growth. Regrettably, the staff tended to focus on the size of the budget deficit and the increasing role of the public sector, which was blamed for undermining the productive capacity of the economy.

The staff appraisal said that government programs of financial aid to enterprises ought to be phased out, Mr. Tvedt said. However, according to Mr. Polak's statement, the authorities believed that investment premiums encouraged investment, a view supported by the econometric findings in Appendix I of SM/83/2. He would be interested in hearing further comments by the staff and Mr. Polak on the matter. The staff also stated that the authorities had been unable to contain, let alone reverse, the growth of claims by the public sector on domestic resources. Yet in reality, public consumption and gross investment in relation to GNP had remained fairly stable in recent years. As Mr. Polak had pointed out, the main problem with public expenditure was the sharp rise in transfer payments.

The public sector deficit was a topic of grave concern, Mr. Tvedt pointed out. He had been encouraged to learn, however, that the most recent estimate for the public sector borrowing requirement for 1982 had been revised downward to 9 per cent of net national income, against the previous projection of 10.3 per cent. Did the staff still feel that the 1983 borrowing requirement of 10.8 per cent was too optimistic? On monetary policy, he had been pleased to learn that the authorities would use the leeway created by the current account surplus to reduce interest rates further. The money supply had accelerated in late 1981 and had reached 10 per cent in the year to July 1982, a development that had increased the liquidity ratio somewhat. He fully supported the flexible policy of the monetary authorities, but would be interested if the staff or Mr. Polak could provide some more recent data on developments in the money supply.

Incomes policy had been successful in bringing down the growth of wage and price increases, Mr. Tvedt considered. The recent revised official forecast for 1983 showed an increase in the consumer price index of only 2.5 per cent, against 5.7 per cent in 1982. It was clear from the papers that the staff did not favor government interference in setting wages and prices, but, in the absence of any statutory incomes policy during 1982, the economic situation in the Netherlands would probably have turned out much worse. The staff also seemed insistent on less government involvement in setting labor market policy. Frankly, he found it quite cynical to ask for less involvement in the labor market when the country had an unemployment rate of 16 per cent. As Mr. Polak had mentioned, what seemed to be called for was new measures providing more scope for labor mobility, coupled with perhaps more manpower training. Finally, he welcomed the authorities' firm determination to maintain the high level of development assistance, despite severe budget constraints.

Mr. Teijeiro remarked that it had been rightly emphasized in the Board that the current world economic situation could not be explained simply by deficient aggregate demand, but that declining profitability and structural problems were also important. The Netherlands economy provided a clear example of such shortcomings. While it was difficult to ascertain the relative importance of the various factors, the low level of profits and investment seemed particularly worrisome, and they did reflect the growth in government spending and intervention. The public sector appeared to have expanded too far, producing an unsustainable redistribution of income. Clearly, if capital did not obtain a reasonable profitability compared with opportunities abroad, it would flee, as it was fleeing from the Netherlands.

Also remarkable was the reallocation of resources that had occurred in the previous ten years, Mr. Teijeiro went on. According to page 13 of SM/83/2, there had been a decline in GDP shares of sectors like manufacturing, agriculture, and construction, together with an increase in the GDP shares of other services from 17.8 per cent in 1971 to 26.1 per cent in 1981. On page 15 of the same paper, the share of manufacturing in total employment was shown to have declined from 28 per cent to 22 per cent, while the share of other services had risen from 18.7 per cent to 24 per cent.

One hypothesis would be that the reallocation of resources was a natural development explained by shifts in comparative advantage; thus, it might be argued that the Netherlands economy had to go through a process of deindustrialization and to specialize more in providing services, Mr. Teijeiro commented. The second hypothesis was that deindustrialization was not a natural development at all but was rather a product of government intervention. Several developments supported the second hypothesis: the growth in public employment, the expansion of the welfare state, and the increase in the tax burden. Those developments indicated that an accurate picture of the Netherlands economy would show that taxes had continuously increased and that the burden of taxation could not be passed on to wage earners because increasing public employment and employment insurance had substantially diminished the pressures for adjustment in the labor market. In addition, trade unions could have played an important role in preventing the remaining pressure for adjustment from showing up in wages paid by large industrial firms.

Thus, Mr. Teijeiro said, the remaining pressure of excess labor supply seemed to have been exerted on the nonunionized sector of the economy. That fact, coupled with the smaller degree of regulation and tax compliance, would explain the explosive growth of the "other services" sector. The information on page 19 of SM/83/2 supported that conclusion. The staff said that while the share of labor in manufacturing had risen from 66 per cent in 1971 to 76 per cent in 1981, the labor share in other services had fallen from 55 per cent to 52 per cent. Therefore, wages in sectors other than manufacturing could have fallen substantially, and labor productivity in the nonunionized sector might be substantially lower than in the manufacturing sector. Could the staff or Mr. Polak comment on which activities were included in the "other services" definition and whether his suppositions on relative wage movements were supported by additional data?

There was no doubt that the world economic situation could explain many of the current developments in the Netherlands economy, but domestic difficulties had exacerbated the already existing disequilibrium, Mr. Teijeiro remarked. A do-nothing strategy, based on waiting for the world recovery to trigger growth in output that would allow a reduction in public spending and deficits in relative terms, was particularly somber. It was usually difficult to reduce public sector spending during a recession, when there tended to be heavier pressures on government to commit itself to activities that the private sector was unwilling to undertake; the excess saving of the public sector could provide the theoretical justification for the continuous growth of that sector.

Given the low ratio of owned capital to debt, he wondered whether the risk of major business failures could also affect the banking system, Mr. Teijeiro asked. From any point of view, a recovery in profits was an essential condition for economic activity to start to improve. Without the right incentives, particularly in the traded goods sector, investment would not recover, unemployment might increase, and only the public sector would hire new workers, with the consequence of a continued fall in productivity. The disequilibrium would increase, and the postponed adjustment in real wages could be even greater.

Having arrived at that conclusion, Mr. Teijeiro continued, he wondered whether the present exchange rate policy was appropriate. A more flexible policy would be an important instrument to bring about a change in relative prices and income distribution in order to give proper incentives to investment. In fact, one source of the Netherlands' current problems seemed to be a lack of consistency between the exchange rate policy and the expansion of public sector spending. It was unlikely that consistency could be restored by reducing nominal public expenditure, and it also seemed hopeless to wait for growth in the private sector to shrink the public sector in relative terms at a time when all the incentives were in place for further reducing the private sector. Therefore, a more flexible exchange rate policy was appealing in present circumstances, particularly because the recession could dampen the inflationary impact of movements in the exchange rate and because current unemployment would also reduce pressures for wage adjustments.

A more flexible exchange rate was not the only way to change relative prices as desired, Mr. Teijeiro said. Had the Netherlands authorities considered measures such as a change in the tax system to replace employers' payroll payments by a general consumption tax? That tax would be less flexible than the exchange rate policy, but it could allow room for maintaining the assumed benefits of a pegged exchange rate between the guilder and the deutsche mark. Such flexibility could prove important if it were necessary in the future to cope with developments such as an appreciation of the deutsche mark vis-à-vis other European currencies or the U.S. dollar.

In any event, the immediate need was for a restoration of profitability, the implication being that wages would have to pay for the inefficiencies that had accumulated during the previous decade, Mr. Teijeiro suggested. Given the mobility of capital, the authorities would do well to restore profitability as soon as they could. After that first change, the economy would be left with the problem of incentives to work, since the entire burden of the welfare state and government regulations fell on wage earners. At that stage, there would be no improvement without making structural reforms. At the end of his statement, Mr. Polak had recognized that a major increase in the profits of the private sector was a precondition for restoring sustainable growth, but he had added that, given the social and political factors involved, the increase in profits would of necessity require a good deal of time. Although the seriousness of the present situation ought to shorten that time for adjustment, he himself wondered whether a more flexible exchange rate might produce the minimum required adjustments in an implicit way and without much political debate.

The staff representative from the European Department, replying to questions from Executive Directors, commented that some of the questions asked about the flexiblity available to the authorities in responding to high unemployment rates and the continuing downward movement of capacity utilization led her to ask when the medium term began. It was difficult to keep saying that the authorities had to deal with the problems except that the present was never a propitious time.

In his statement, the staff representative observed, Mr. Polak had said that the staff had made the harsh comment that the authorities had abandoned their goal to reduce the tax burden by their recent actions. Perhaps "abandoned" was too sharp a word. Nevertheless, government after government had come into office saying that it would reduce the tax burden, which it had proclaimed a primary goal of policy; year after year, the tax burden had risen, at least if taken in the wider sense of including social security contributions as well. The staff might have done better to say that it was chagrined that current policies seemed to represent a continuation of that trend, rather than the abandonment of the goal; however, as long as that goal remained a moving target, there was little difference in fact.

A question had been asked on the role of incomes policy in the Netherlands, the staff representative recalled. The staff was not saying that incomes policy had played no role in the good inflation performance.

However, the cost in terms of compression of the wage scale had been such that the staff did not believe that any market signals could be properly transmitted to the labor market any longer. An incomes policy would be a suitable tool under certain circumstances, but if the authorities wished to secure the structural corrections that they were seeking, there had to be a freeing up of the labor market.

While at The Hague, the staff had questioned the usefulness of the price control system, the staff representative explained. The Netherlands authorities had maintained that, because of the competitive situation in the market, profits currently were not being impinged upon by the price control system, which was part of the overall policy of the Government. The authorities did not wish to abandon price controls. The staff believed that they were probably necessary to obtain good results on the wage front.

On the questions regarding investment premiums, again, the staff was not saying that there was no place for the investment incentives being given by the Government, the staff representative went on. Yet, large and continuous amounts of scarce public resources were being transferred to the enterprise sector. It was not as if investment premiums had been introduced only a few years previously; rather, they had been replacing other investment schemes that had relied on public resources. The staff had wondered what kind of resource allocation was being obtained by the continuous subsidization of enterprise investment activities, and also how much of the industrial structure was a result of such subsidization. With those thoughts in mind, the staff had considered that a sunset legislation approach to investment premiums would be useful, and that they could, and should, be selectively phased out over time. With respect to the econometric studies that had shown the usefulness of some of those premiums, she wished to point out that the results showed rather high coefficients, but a low R^2.

Questions had been asked about the price of natural gas and the effect of lowering that price on the Netherlands economy, as well as about the contribution of gas to the balance of payments, the staff representative continued. The energy balance was about even in the Netherlands, and exports amounted to about f. 40 billion. The current assumptions underlying the revisions shown in SM/82/244, Supplement 1, were for a 10 per cent fall in the price of coal oil and an associated fall in the price of natural gas. The price drop would reduce budget revenue by about f. 2 billion directly, a figure equal to 0.7 per cent of net national income. In addition, the improved inflation performance, compared with earlier projections, depended totally upon that fall in oil prices. If the Netherlands did achieve lower inflation, budget revenue would fall, since a large part of it came from turnover taxes. Thus, there would probably be a larger budget deficit. At the same time, there would of course be an offsetting effect on economic activity, since people would have more expandable income. However, given the sad condition of the enterprise sector, overall profitability would have to increase substantially before the Government would obtain greater tax revenue. Thus, the projected fall in oil prices would mean a considerable worsening of the budget position.

Having been an early subscriber to the high-employment budget calculations, it chagrined her to say that, for the Netherlands, the calculations would not be terribly useful, again because of the intertwining of the structural and cyclical problems in the Netherlands, the staff representative remarked. Although the staff could not say what the optimal size of the public sector was, the staff did know when it had grown too big, and there was no question that it had done so in the Netherlands.

The drop in unfilled vacancies in the labor market had been cyclically related, the staff representative explained. Since the late 1970s, there had been no improvement in labor market flexibility but actually a movement in the opposite direction. There was still a strong chance that, soon after a decent rise in capacity utilization, mismatches in the labor market would again emerge. The low participation rate of women in the labor force might well have something to do with the relatively low productivity in the Netherlands, despite the high degree of labor sharing. On a related point, public employees did not make contributions to the national unemployment scheme.

As to the financing of the public sector deficit, the staff representative said, the staff would have thought that the Government's reliance on the bond market for financing was helpful to enterprises, which were exceedingly short funded. Quick relief would be obtained for the cash flow in the enterprise sector from the rapid decline in short-term interest rates on loans made by banks. Mr. Laske had pointed out that the stickiness of long-term rates was a problem. She herself would note that the recent new issue by the Netherlands Government at 7.5 per cent had shown that quite a considerable reduction had occurred in the long-term rate, which in the previous several weeks had turned out to be rather less sticky in a downward direction than it had appeared in 1982.

The changes in the structure of the labor force and the shift to the services sector in the Netherlands were both much in line with what had been observed in a number of other industrial countries, particularly those in which financial intermediaries played a considerable role, the staff representative commented. It was not so much differences in wage developments, but rather differences in demand structure and comparative advantage that had moved the services sector into greater prominence in the Netherlands as well as in a number of other countries.

She would agree that the low ratio of owned capital to debt posed a risk of business failures and an associated risk to heavy lenders to such businesses, the staff representative remarked. In particular, about half the labor force was currently employed in enterprises that were not making any profits and had not been making any for some time. Nevertheless, the Netherlands was the seat of a number of large multinational corporations, so that the question of the capital/debt structure and the involvement of the worldwide banking system became somewhat more complicated than it would be in most other countries.

Some Directors had asked whether there might be room for a more flexible exchange rate policy, the staff representative recalled. At the moment, given the size of the current account surplus, it was hard to foresee a fall in the exchange rate of the guilder. Depreciation did not appear to be a policy option at present.

One Director had asked whether some of the social security taxes, particularly the unemployment tax, might be converted into a general consumption tax, the staff representative said. She thought not. After all, there was already a high value-added tax, as agreed within the European Communities. Moreover, given the good state of private consumption, it might be unwise to impose such a totally regressive tax, particularly if the authorities were concerned that a social consensus might be formed to bring about greater wage differentiation. She would have thought that it would be easier to achieve greater wage differentiation than to impose such a regressive tax.

On profits before taxes, anyone who considered the inverse side of the question--the evolution of labor's share in income--could still see the dominance of the wage side rather than the side of taxes and interest rates, the staff representative continued. During the previous two years, the room for maneuver created by the moderation in wages had largely been taken up by the rise in interest rates, which had also been linked to a large assumption of short-term debt. That variable was thus tied into the sad state of enterprises and a decline in their own resources that they were able to deploy.

The current forecast made available by the Netherlands authorities, largely based on lower import prices deriving from lower oil prices, showed that the outlook was somewhat less gloomy in the short term than it had been previously, the staff representative from the European Department concluded. Thus, the Fund staff would be reluctant to agree that a large shortfall about equal to the 1982 shortfall was likely to occur in 1983, in contrast to the forecast made by the OECD. Nevertheless, the medium-term assessment by the OECD did not differ greatly from that by the Fund staff.

Mr. Polak thanked Directors for their comments. He further stated that the great majority of questions raised by Directors had been answered by the staff. For that reason, and in order not to prolong the meeting at a late hour, he intended to deal on a bilateral basis with any remaining questions.

The Chairman made the following summing up:

> Executive Directors noted that the success of the Netherlands in moderating the growth of nominal wages and keeping inflation in hand had unfortunately been achieved against the background of continual weakening of output and investment performance and a sharp rise in unemployment, together with a strong increase in the public sector deficit. Directors pointed to the erosion of

profitability in the non-energy sector and the worrisome growth of government expenditures to about two thirds of GDP as the major contributing factors to the present imbalances. They remarked that the low profitability was associated with low capacity utilization but was rooted in excessive labor cost increases during the 1970s. Directors noted that the external surplus largely resulted from the weakness of investment outlays and did not detract from the need for a rigorous and effective management of domestic spending. They supported the authorities' policy of regaining control of public expenditures and the deficit, the more so since there was no expectation that the trends could be changed by a cyclical recovery alone, even though the economy was well poised to take advantage of a revival of world demand.

Directors argued that the increasing share of domestic resources taken up by the Government had severely stifled activity in the private sector. Directors accordingly welcomed the authorities' intention to reduce the public sector deficit progressively after 1983, and they agreed that this action should not entail a further rise in the tax burden. In this context, they observed that the incomes policy, which had led to significant wage moderation and an improvement in the competitive position of Dutch industry over recent years, had been accompanied by a rise in social security contributions from employers and employees. This, combined with an international rise in interest rates, had frustrated to a large extent the Government's objective of improving the profitability position of the non-energy sector. Rather, it was felt that the objectives of reducing the share of government expenditures in GDP and the public deficit could best be served by reducing the level of social expenditures.

The shrinking of the income gap between employed and unemployed, which had taken place over the last decade in response to social policies, had negatively affected work incentives. Directors noted that this development was compounded by a flattening of the income distribution among employed workers. Several Directors therefore welcomed the attempts of the Government to base its incomes policy in 1983 on voluntary wage moderation rather than on statutory rules, as had been the case in the early 1980s. In their view, this new direction of incomes policy was a necessary step toward creating flexibility in the labor market and in the economy in general.

Present rigidities also stem from excessive regulation and past pricing policies. While industrial policy could be a helpful tool to achieve a structural reorientation of the productive sector, some Directors expressed concern that too much public financial assistance to enterprises might be allocated to failing enterprises.

The strength of the guilder within the EMS had significantly facilitated the implementation of a policy of wage moderation and inflationary control. Monetary policy had used the leeway afforded by the current account surplus to reduce short-term interest rates, but Directors also observed that long-term interest rates had been more sluggish or sticky in their downward trend, partly as a result of the large demand placed by the Government on the capital market. While under present circumstances this did not seem to have crowded out loan demand from other sources, it was necessary to ensure there would be room for the private sector once economic activity was rekindled.

Directors also commended the Dutch authorities for maintaining a high level of official development assistance, especially in the present difficult circumstances.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/27 (2/4/83) and EBM/83/28 (2/4/83).

3. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the proposal set forth in EBD/83/28 (2/2/83).

Adopted February 4, 1983

APPROVED: July 21, 1983

JOSEPH W. LANG, JR.
Acting Secretary