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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/4

10:00 a.m., January 11, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	B. Goos
J. E. Ismael	Jaafar A.
	L. Leonard
A. Kafka	
	A. Lindå
R. N. Malhotra	A. S. Jayawardena
	A. Vasudevan, Temporary
	A. Abdallah
F. L. Nebbia	B. Jensen
	J. E. Suraisry
P. Pérez	
J. J. Polak	T. de Vries
	A. V. Romuáldez
G. Salehkhou	
	T. A. Clark
S. Zecchini	
Zhang Z.	Wang E.

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

Also Present

European Department: L. A. Whittome, Counsellor and Director; P. Dhonte, A. Knobl, A. Leipold, G. A. Mackenzie, K.-W. Riechel, J. S. Van 't dack, M. Xafa. Exchange and Trade Relations Department: J. T. Boorman, J. A. Clement. Fiscal Affairs Department: G. Blöndal. Legal Department: P. L. Francotte, J. V. Surr. Research Department: M. D. Knight. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, G. R. Castellanos, L. K. Doe, K. A. Hansen, H.-S. Lee, G. E. L. Nguyen. Assistants to Executive Directors: J. R. N. Almeida, W.-R. Bengs, L. E. J. M. Coene, J. de la Herrán, J. J. Dreizzen, G. Ercel, G. D. Hodgson, Z. b. Ismail, H. Kobayashi, S. Kolb, M. Lundsager, R. Msadek, J. A. K. Munthali, J. K. Orleans-Lindsay, W. K. Parmena, D. J. Robinson, C. A. Salinas, Shao Z., A. J. Tregilgas, A. van Ee, P. Verly, Wang C. Y., B. D. White.

1. BELGIUM - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with Belgium (SM/84/271, 12/14/84). They also had before them a report on recent economic developments in Belgium (SM/84/279, 12/26/84).

Mr. de Groote made the following statement:

My authorities broadly agree with the staff's analysis and with most of its conclusions. As has become the practice in recent years, they have communicated those conclusions to the media. The public discussion that followed this communication centered on the need to restore the financial soundness of the budget, and illuminated more clearly the considerable improvement that has occurred in Belgium's underlying economic climate.

The staff has rightly stressed the gains achieved in tackling Belgium's fundamental problems. The adjustment program launched in February 1982, over the past two years, has restored adequate conditions for renewed growth; and this, in turn, has provided the ground for a more resolute correction of our public finances. Indeed, in early 1982 my authorities considered a rapid correction of the fiscal imbalances to be impossible, with an umemployment rate of nearly 15 percent, so long as conditions for the positive development of the two most important potential sources of growth, exports and investment, were not restored. The adjustment measures undertaken in 1982 and 1983 have borne the desired fruits in 1984, as witnessed by the evolution of industrial production, investment, and exports. These successes have enabled the authorities to start the second phase of the adjustment program, aimed at the recovery of the public finances. This recovery is envisaged in two stages: the first target, to be reached in 1987, will be the reduction of the fiscal deficit to 7 percent of GDP. At that figure, the growth of public debt and interest payments in relation to GDP will stabilize. This target is only an intermediate target: it is the firm intention of my authorities to continue reducing the deficit beyond that point in order to free resources for private productive investment and establish a safety margin for unforeseen eventualities.

Whether the speed of the adjustment thus envisaged is appropriate is a matter of judgment. The Belgian government agrees with the staff's view that a reduction of noninterest expenditures of 2 percent a year in real terms is required to achieve the 1987 target, and they are striving to do so. They consider that this is the most they can hope to accomplish without aggravating the present unemployment situation. Belgium cannot, on its own, pursue expansionary policies in order to permit a more ambitious reduction of public expenditures. A small, open economy such as

Belgium's depends heavily on external demand to sustain domestic economic activity during a period of high unemployment coupled with a still precarious position of the external current account. The Government feels that it is becoming difficult for Belgium to achieve the needed results, in an environment where her main trading partners are pursuing policies that rely primarily on export and investment as motors of economic growth, and are continuing to apply restrictive fiscal and monetary policies even though their inflation has subsided, their net public sector borrowing requirements are low, and their current accounts are in balance or in surplus. If sufficient external demand is lacking, a small, open economy could in principle boost domestic activity through competitive devaluations: such a policy is compatible neither with our views nor with our commitments undertaken through membership in international institutions, and can therefore not be considered.

As to the mix of measures for reducing the public deficit, my authorities agree with the staff that, given the already high rates of taxation, it is preferable to emphasize restraint on expenditures. The present mix is very much influenced by considerations of social equity and expediency in budgetary results. The main instrument used so far has been the so-called index jumps, by which the first 2 percentage points of annual wage increases resulting from the system of wage indexation are not paid to the wage earner but ceded to the budget instead. The resultant wage moderation in the public sector ensures an immediate reduction in public sector expenditures. Since greater wage moderation in the private sector would have further improved the profitability of enterprises, which is already considered sufficiently restored without immediately benefiting the budget, the system further provides that enterprises will also cede a sum corresponding to the first 2 percentage points of wage indexation each year to a special account in the budget. In this way, wage moderation in the private sector has an immediate positive effect on the budget through raising some additional revenues, without imposing any additional burden on the wage costs of enterprises. This system, already applied in 1984, will be continued throughout 1985 and in all probability through 1986 as well. These measures are supported by additional restraint on expenditures, particularly on social security, where entitlement rules are being tightened and the cumulation of benefits restricted.

So far, the adjustment program is on track. The Belgian Government firmly intends to adhere to it. In a few weeks, a budgetary control exercise will review the 1985 budget in the light of the most recent developments and likely course for the rest of the year. The Government has decided to take additional steps, mainly on the expenditure side, if any deviation from the expected adjustment path is detected.

With respect to monetary policy, my authorities have heeded the Board's advice given at the previous Article IV consultation and allowed interest rates, particularly at the short-term end of the spectrum, to reflect a more appropriate degree of monetary restraint. The ensuing relative rise in short-term interest rates was not echoed in the long-term rates, which are dominated by the public sector. Their hesitation to allow long-term interest rates, which at 12 percent are already high in real terms, to rise further, stems from the awareness that government bond yields dominate long-term rates and thus have a direct effect on the price of investment credit and mortgage loans, two sectors expected to contribute positively to economic activity. The Government is fully aware of the risk of capital outflows inherent in a policy of low long-term interest rates, but, in its view, the preponderance of risk lies rather in an inadequate resumption of investment than in capital outflows. Now that international rates are heading down, it is considering the possibility of improving the structure of interest rates by a more guarded lowering of long-term rates.

My colleagues in the Board might have the impression, after the consultation discussions of recent years, that the adjustment of the Belgian economy is too gradual and excessively subject to government intervention. On that point, the magnitude and structural nature of the imbalances that have affected the Belgian economy over the last decade mean that their correction cannot be achieved through a simple reversal of policy stances; it involves the creation of new relationships and more appropriate mechanisms for allocating resources among households, enterprises, and Government in a growth-oriented perspective.

Our system of social consensus and indexation has made a positive contribution over the postwar period to achieve the structural transformation of the Belgian economy from a rather traditional economy oriented toward coal and steel to a more diversified and modern production system. While trying to achieve the structural changes required, the Belgian Government wants to pursue its traditional concern for a fair distribution of income. The notion of solidarity underlying this concern requires that appropriate attention be given to those who will be affected by the envisaged structural changes.

A new economic organization cannot be established overnight; it must be achieved gradually and has to be closely monitored by the authorities in order to ensure the simultaneous attainment of the sometimes conflicting objectives of social solidarity and economic growth. Once the new mechanisms for income determination have begun to take shape, it is the authorities' intention to relax their hold on income relationships and allow a freer play of market forces in determining the allocation of resources.

The staff has correctly underlined the rigidities in the financial markets and the labor markets, of which the authorities are fully aware. As part of this structural change, these rigidities will gradually be eliminated.

Mr. de Maulde commented that Belgium was a textbook case of an open economy that after benefiting in the 1960s and the early 1970s from rapid growth in the world economy, had thereafter suffered greatly in the following decade. Belgium also illustrated the difficulties encountered by European countries, with their traditional industries, aging population, and high unemployment. Consequently, Belgium demonstrated that some European countries remained potentially resourceful and that given a clear political will, those countries could overcome their difficulties. On balance, he tended to be more optimistic about Belgium's economy than at previous consultations.

During 1983, the adjustment program undertaken in the wake of the devaluation of the Belgian franc in February 1982 had begun to show results, Mr. de Maulde noted. Certain indicators such as the current account and the profit margins of enterprises already had begun to improve. In 1984, the favorable trend had continued, and the authorities had begun to find the right answers to the main problem areas. He particularly welcomed the slowdown in inflation, the quasi-elimination of the current account deficit, and the rise in the rate of economic growth. On the whole, the authorities' gradual approach to adjustment was working. They were preparing the ground to derive the full benefit from the pickup in foreign demand.

Nevertheless, a number of weaknesses remained, particularly on the structural side, Mr. de Maulde observed. Despite the beginning of a contraction in public expenditures, their share in GNP--at 62.2 percent--remained excessive. The authorities should have first tried to reduce the deficit by cutting expenditure rather than by increasing revenue, given the already high burden of fiscal taxation, and especially of direct taxation, which greatly exceeded the average of members in the European Communities. Two major components of public spending--social security and transfers to enterprises--had shown no declining trend in the past few years. He therefore welcomed the authorities' commitment to reducing the Treasury borrowing requirement to 7 percent of GNP by 1987 as well as their intention to bring down the public debt, as interest payments were accounting for a growing share of the overall budget.

He was glad to hear from Mr. de Groote that at a time when international interest rates were heading down, the authorities were considering the possibility of improving the structure of interest rates in Belgium by a more guarded lowering of long-term rates, Mr. de Maulde went on. Despite the good results achieved on the trade balance, however, Belgian exporters seemed not to have fully taken advantage of the improvement in competitiveness in terms of market shares during 1983 and 1984. Perhaps

that improvement indicated that the profitability of exporters abroad had been restored, clearly an advantageous development. On exchange rate policy, the previous year had been rather calm in the European Monetary System (EMS), and the Belgian franc had performed well. Considering the sharp reduction in the margin between the commercial rate and the financial rate for the franc and given the numerous loopholes inherent in such a system, there was a strong case for unifying the rates by eliminating the dual exchange market, although the Belgian authorities were reluctant to do so.

The figures on unemployment in Belgium, already disquieting, were expected to remain so in the near future, Mr. de Maulde noted. Mr. de Groote had correctly observed that problems such as the fiscal deficit and interest rates had to be examined bearing in mind the overall need to find a solution to the problem of unemployment. Incomes policy, previously a cause for concern given the theoretical establishment of full indexation in 1984--was being managed skillfully in such a way as not to affect the cost-competitiveness of the country. The staff was advocating the retention of that policy and the present wage norms. Furthermore, the present system of social transfers, though ingenious, appeared quite complicated; he did not wish to question its proper functioning, but wondered whether some efforts at streamlining might bring better results. Finally, public support for industry had risen to 6.5 percent of GNP. The Government subsidized almost everyone, so it might have difficulty in making a sufficient effort should such an example of industrial policy actually be needed. Nonetheless, there had been no erosion in Belgium's gain in competitiveness during 1984; industrial investment was picking up, and job layoffs had halted in the private sector.

Mr. Ismael said that the upturn in the Belgian economy in 1984 was a result of the adjustment efforts pursued in 1982 and 1983. The increase in domestic demand had been supported by a rise in private sector investment, despite a withdrawal of government stimulus. Furthermore, employment in the private sector had stabilized after five years of decline; only two years previously, the private sector had been uncompetitive as well as unprofitable. Nonetheless, the weaknesses noted by Executive Directors at the 1983 Article IV consultation were still present; the most pressing ones were the unsustainably large public sector deficit and the rising rate of unemployment.

The authorities were to be commended for their incomes and employment policies, Mr. Ismael remarked. Whereas rapid increases in wages had contributed at one time to Belgium's loss of competitiveness, the authorities recently had achieved remarkable progress in slowing their growth. He could fully support the authorities' efforts to extend the wage norms, which were due to expire at the end of 1984, and he appreciated their deep concern about the labor situation in 1985.

Although it was understandable that owing to regional policies, the authorities would extend heavy financial support to ailing enterprises, especially at times of poor growth and low employment, the support had

continued for quite some time, Mr. Ismael noted. Efforts to eliminate subsidies would be essential for strengthening the finances and operations of Belgium's industrial enterprises, because that way they could retain their corporate profitability and external competitiveness. Furthermore, by reducing support to ailing enterprises, the authorities could diminish public expenditure and lessen the heavy burden on public sector finance. Was it possible to quicken the pace of adjustment in that area? Nonetheless, he supported the authorities' efforts to modernize the industrial structure through the use of capital and high technology.

As the staff report made clear, the main area of concern remained the size of the public sector and its deficit, Mr. Ismael continued. By the standard of industrial countries, the size of the public sector was too large. Even the overall cut in spending would not be sufficient to achieve the kind of progress needed to sustain long-term growth. Not only was the target of reducing the Treasury deficit to 7 percent of GNP by 1987 inadequate, but it would be quite difficult to achieve, as borne out by the Government's experience during the past two years of high expenditure on interest payments. A more determined effort was required; a more ambitious target should be in place. As there had been no progress in cutting the public sector deficit, the authorities should persevere in their efforts at fiscal consolidation, especially in view of the ever-rising burden of interest payments, and should seek to narrow the deficit by imposing restraints on expenditure rather than by raising taxes. Moreover, they should lower the social security benefit in order to diminish public expenditure and introduce greater flexibility into the labor market.

Recently the Banque Nationale de Belgique had made shifts in managing its external reserves, Mr. Ismael said, but the authorities needed to maintain an even firmer stance in the future. They should also try to foster greater competition in the financial system. If the current level of long-term capital outflows persisted, the authorities' efforts to finance the public debt by issuing long-term issues would be jeopardized, unless they endeavored to correct the long-term interest rate policy.

The authorities relied on the two-tier exchange system in order to promote the stability of the exchange rate for the Belgian franc vis-à-vis the country's principal trading partners, Mr. Ismael noted. They should pursue that objective without a two-tier exchange system. Furthermore, with the spread between the two rates remaining at less than 1 percent since mid-July 1984--a result of the authorities' decision to firm short-term interest rates in order to support the re-emerging trust in the Belgian franc--the two-tier system might well be unified.

Although progress was required in certain basic areas, the outlook for the economy had improved, given the successes achieved so far and the strong recovery in the external sector, Mr. Ismael concluded. The improvement in the outlook should ease somewhat the further adjustment efforts that had to be made by the authorities. He wished to commend them for

their commitment to continuing official development assistance (ODA) at 0.6 percent of GNP for 1984 and 1985. Their commitment to achieving the target of 0.7 percent of GNP deserved full praise.

Mr. Grosche commended the authorities for their progress in pursuing adjustment. As severe imbalances still prevailed, however, the stabilization efforts needed to be continued with determination. The size of the public sector deficit continued to be relatively large, and the already high public debt continued to rise, Mr. Grosche continued. Moreover, only a minor reduction in the relative size of the public sector had been achieved so far.

Belgium's economy had reacted less than other countries to the worldwide recovery, Mr. Grosche observed. Economic growth in 1984 had been relatively weak; the unemployment rate had risen further to the extremely high figure of nearly 15 percent, with a further small rise in prospect for 1985. Despite heavy financial support given to enterprises by the Government, the industrial structure still stood in need of modernization. Indeed, rigidities in the financial as well as the labor markets were still prevailing.

The public sector deficit remained unsustainably large, and further reductions in it ought to be a matter of high priority, Mr. Grosche noted. The authorities shared that view, for they were directing the second phase of the adjustment program toward the recovery of public finance. However, he doubted whether the goal of stabilizing the ratio of public debt to GNP by 1987 could be considered sufficient in view of Belgium's high internal and external debt: the 7 percent target should be considered a minimum requirement. Additional cuts in real public expenditure seemed indispensable, particularly if interest rates and economic growth turned out to be less favorable than expected. Indeed, on page 7 of the paper, the staff noted that the objective of stabilizing public debt could be attained only if the annual average decline of real noninterest expenditure by the Central Government reached 2.9 percent.

Prudent fiscal policy should be accompanied by further wage restraints, Mr. Grosche remarked. Renewed wage pressures would endanger the fragile international competitiveness of Belgium as well as intensify already severe unemployment. Therefore, he fully supported the authorities' intention to prepare legislation designed to maintain the ban on real wage increases for another two years. Could the staff or Mr. de Groote point out any developments regarding that? Furthermore, the strategy of wage restraint should continue to be supplemented by the employment policy measures, which had apparently already produced some positive results. They could be successful in the long run, only if future wage settlements did not impede the hiring of new workers. With the reintroduction of full indexation in January 1984, as well as the existence of the competitiveness norm, the negotiation of wage settlements in Belgium seemed overregulated.

With regard to the conduct of monetary policy in 1984, Mr. Grosche concluded, he shared the staff's general positive assessment. The authorities should try to meet most of the public sector borrowing requirement in the long-term domestic financial market. However, he had certain doubts whether that goal could best be achieved by means of sufficiently attractive yields, for the high outflows of long-term private capital were attributable--apart from tax considerations--to a certain lack of confidence in the stability of the Belgian franc and in the authorities' capability to reduce the public sector deficit. To counter such a lack of confidence, the authorities would have to set yields so high that they might have negative implications for investment as well as for the interest burden or the public debt. Therefore, it might be better to consider some structural changes in the capital markets with a view to mobilizing more long-term capital for domestic use.

Mr. Pérez commented that despite the authorities' success in attaining remarkable results in the balance of payments and investments--mainly during the past two years--some imbalances remained, chiefly in the public sector and the labor market. That any remained at all reflected the size of the imbalance that the authorities were striving to correct. He broadly agreed with the staff appraisal.

The Belgian economy depended greatly on the behavior of the external sector, Mr. Pérez noted. After two years of good results, the gains in competitiveness seemed considerable: progress had been made on the current account, and, more important, the projections for 1985 indicated further improvements in the external side of the economy. There was a close relationship between the results obtained so far and developments in wage policy. Another key factor strongly influenced by wage policy was the profitability of private firms, since wages constituted a major element in determining final unit labor costs. The system of index jumps was likely to make the maintenance of Belgium's competitiveness compatible with the increase in public revenue.

Another issue connected with wage policy was unemployment, Mr. Pérez continued. The labor market situation was far from what it should be, especially if compared with employment and wages in Belgium's trading partners. Many small industrial countries were experiencing high unemployment; the best antidote was the attainment of steady growth rates supported by sustainable private investment. The Belgian economy had been carefully preparing the ground through increases in profitability and competitiveness; perhaps the moment had arrived to reap some benefits from those developments. The change in the trend of gross fixed capital formation was a clear sign of the authorities' success, as was the rise in industrial and manufacturing production.

The public sector deficit in Belgium was part of a pervasive consequence of the crisis affecting the international community, Mr. Pérez commented, since huge deficits had arisen as a result of demand management policies aimed at offsetting the depressive effects of the crisis. Belgium had not excaped. The borrowing requirement of General Government

in relation to GNP had nearly quadrupled between 1974 and 1981, reaching 15 percent. The authorities had a greater likelihood of bringing the Treasury deficit down to 7 percent by 1987 currently than in 1982, when they had proposed to achieve it by 1985. The treatment given to the problem as a medium-term aim was quite suitable. He was pleased to note from Mr. de Groote that the 7 percent target was only an intermediate objective and that the authorities were going to take further steps beyond 1987.

As to the main fiscal measures contemplated in the program, the current balance between revenue increases and expenditure cuts was perhaps not the most convenient one, Mr. Pérez said. The authorities should shift the burden of adjustment toward expenditure because taxation in Belgium was already high, and revenue-raising measures were becoming progressively more difficult to carry through effectively.

Monetary aggregates were not used as targets in Belgium, Mr. Pérez noted. The main objective of monetary policy was still the stability of the exchange rate for the franc, and interest rates had been the main instruments used. Use of a single policy instrument to attain two targets simultaneously usually produced conflict, as the objectives became interdependent. In Belgium, the current artificially low long-term interest rates had caused major capital outflows. Consequently, promoting investment by raising interest rates had to be balanced with the effects on Belgium's capital account. Nevertheless, the authorities should adopt a more realistic policy with respect to long-term interest rates, raising them to make them more attractive. A greater availability of capital for investors should offset at least partly the initial adverse effects on investment of a rise in interest rates.

Mr. Alfidja expressed agreement with the staff's evaluation of the Belgian economy. The authorities had steered the economy back toward a satisfactory growth. In 1984, GDP had expanded at a rate exceeding the cumulative growth achieved during the preceding two years, on account of much higher investment and gains in exports. The 4 percent rise in gross capital formation was all the more remarkable after a decrease during 1981-83 estimated at 22 percent. Moreover, the upturn had occurred against the background of continuing heavy borrowing by the Government. The recovery of investment had been stimulated by lower long-term interest rates, prospects of sustained demand for Belgian exports, and the effect of labor legislation and other laws aimed at improving the profitability and operating environment of public and private enterprises. The authorities had been encouraging investment in high-technology industries as well as modern automation; in general, capital was being substituted for labor, a practice that could be in conflict with the Government's employment objectives. Although he could understand the rationale for encouraging high-technology and capital-intensive industries, the pursuit of such policies would make it more difficult to attain the employment targets. Therefore, the authorities should carefully consider the mix between incentives for modern technology and incentives for higher employment.

One of the main causes of improved income position of many companies, and thus the larger investments that some of them had been undertaking, was the restraint on wage increases provided to workers in 1984, Mr. Alfidja continued. The low wage growth agreed to by labor unions had helped to rein in production costs and improve the profitability and competitiveness of Belgian exports, notwithstanding a restraining effect on aggregate demand. The authorities were aware of the need to avoid any increase in real wages and were taking steps toward achieving that goal during 1985-86.

He shared the concern expressed by several Executive Directors at the large Treasury deficits, Mr. Alfidja noted. Fiscal imbalances of the size experienced by Belgium contributed to inflationary pressures, translated into a borrowing requirement that competed with financing needs of the private sector, complicated the implementation of monetary policy, and threatened to postpone the restoration of external balance. The Government intended to reduce such imbalances and given the high rate of taxation, the brunt of the fiscal adjustment should fall on expenditure. An effective policy of wage moderation would contribute greatly to restraining expenditure growth, and such a policy would be complemented by plans to deal with other categories of expenditure such as transfers and subsidies. The overall policy of fiscal restraint needed to be supported by an appropriate monetary policy designed to provide suitable conditions for investment, sustained growth, and export expansion.

Despite the halt in the decline in private sector employment, the rate of unemployment was still on the rise, Mr. Alfidja commented. The complexity of the problem precluded both rapid and long-lasting solutions. He could only urge the authorities to persevere in their efforts to improve employment. In conclusion, he supported their commitment to a free international trading system and appreciated their effort to maintain official development assistance despite the difficulties confronting the economy.

Mr. Leonard recalled that when the Executive Board had discussed Belgium one year previously, it had been unclear whether the authorities would continue the corrective policies begun in 1982 or whether they were contemplating some easing. They were to be congratulated for maintaining their approach toward reducing the public sector deficit and tightening the monetary stance. Aided by favorable developments--except for the deterioration in the terms of trade--their commitment to adjustment had modestly benefited the economy during the previous year.

The authorities were still faced with two sensitive issues in incomes policy and employment policy, Mr. Leonard continued. Although the return to full pay indexation in January 1984 could have undermined adjustment, the "double norm" for pay limits had worked satisfactorily and suggested that the sensitivity of the authorities and the moderation and good sense of the trade unions should serve the economy well. To introduce, as the authorities had done, some differentiation in policy application between

the public sector and the private sector normally created difficulties. He would have welcomed some comment in the staff papers on the reaction of public sector employees to the differentiation and whether it might give rise to problems in the months ahead.

Under the double norm, there was a limit on labor cost increases to no more than the exchange-rate-adjusted average increase among Belgium's main trading partners. That had been well used by the authorities to maintain competitiveness through the adoption of the work-sharing measures, Mr. Leonard remarked. He hoped that the return to half-indexation and the absence of a large gain in competitiveness in 1984, after large gains in 1983, did not point to the future course in Belgium's cost-competitiveness, and that the relative cost advantage, won over recent years, could be kept.

The authorities were handling questions of pay determination with a sure touch, and he could respect their feel for what was possible and what was not, Mr. Leonard said. Nevertheless, as the staff observed, dangers to Belgium's competitiveness and, in turn, to employment lay in the extent of government intervention in pay regulation. In an industrialized economy with an unemployment rate at 15 percent and rising, the idea that there was any need to maintain a legislative ban on real wage increases was scarcely compatible with the flexibility of producers and the mobility of labor that were called for to effect a transition for declining industries to new areas of production. Instead of preserving rigidities through regulation, the authorities should unbind the labor market and allow differentials that would encourage the flow of resources, human and financial, from unprofitable to profitable sectors. Temporary expedients such as work sharing should not divert attention from the more deep-seated causes of unemployment.

As the public sector deficit had averaged more than 15 percent of GNP from 1981 to 1983, a three-year program had been instituted to reduce the Treasury borrowing requirement from 11.3 percent of GNP in 1984 to 7 percent by 1987, when the general government deficit was projected to fall to 8 percent of GDP, Mr. Leonard went on. However, the program was backloaded, and in 1985 the expected net financing needs of the General Government would still be high, at 12 percent of GNP. Therefore, substantial additional efforts would be needed in following years to meet the 1987 target. The target itself was not far within the limits of what was desirable, allowing little if any room for slippage if developments turned out to be less favorable than foreseen. The authorities were planning for too large a part of the fiscal adjustment to derive from an increase in the tax burden, for government revenue currently amounted to almost half of Belgium's GNP. In exploring other possibilities, the authorities might give some thought to reducing subsidies to enterprises, which in 1983 had equaled 3.7 percent of GNP.

Smaller budgetary deficits and the consequent reduction in Treasury recourse to central bank financing should strengthen the authorities' monetary control and support the Belgian franc in the EMS. The widening of the differential between short-term interest rates in Belgium and those elsewhere had helped to support the franc, and there were good grounds for a similar widening in long-term interest rates as well. However, the authorities were understandably reluctant to raise long-term rates because the rise might choke off investment and construction--central to the strategy for growth and employment--and because of the implications of high long-term interest rates for public finances. There was also a reasonable prospect that long-term rates elsewhere would fall, but if they did not, further adjustment, probably not greatly conducive to growth, would be called for. He had been surprised to hear from Mr. de Groote that a reduction in international long-term rates might induce the authorities further to bring down long-term rates in Belgium; such a course of action would aggravate the anomalies of the present interest rate policy, preserve incentives to capital outflows, and weaken the franc.

In conclusion, he could generally support the Belgian authorities' policies, Mr. Leonard stated. He recognized the individual, organic nature of the processes at work in the economy and the strong element of judgment involved in decisions bearing on them. In a few respects, current policies might be strengthened or the emphasis slightly shifted. The authorities were running some risks, and much depended on external developments; Mr. de Groote's comments on that topic should be taken to heart by Belgium's industrial trading partners.

Mr. de Vries expressed broad agreement with the staff appraisal; developments in Belgium had taken a turn for the better as a result of the adjustment program. First, the authorities had carried out a welcome tightening of monetary policy, bringing short-term interest rates more closely into line with those prevailing elsewhere, but the large budget deficit continued to complicate their efforts. Specifically, the anomaly in the interest rate structure, designed to facilitate the financing of the budget deficit, might have the unfortunate side effect of promoting capital outflows. During the first nine months of 1984, according to calculations made by the Netherlands authorities, only 15 percent of Belgium's budget deficit had been financed by nonmonetary creation.

He could agree with the staff and other Executive Directors on wage policy in Belgium, Mr. de Vries remarked. Unfortunately, the reintroduction of wage indexation had made any further reduction in real wages nearly impossible. His Netherlands authorities were concerned that the introduction of work sharing and a shorter workweek in Belgium would lead to increases in real wages that would then become subject to the indexing mechanism, hence becoming irreducible. As shown in Table 10 of SM/84/279, profits had begun to decline again in the fourth quarter of 1983; in addition, the system of index jumps--under which the first 2 percentage points of indexed wage increases would accrue to the Government--might lead to an unwillingness by workers to accept further moderation. The

number of workers had stabilized, and there had been a great increase in part-time work, so that economic activity had declined further during 1984. He fully supported the exchange rate policies pursued by the authorities.

There were a number of economic resemblances between Belgium and the Netherlands, including high unemployment and large budget deficits, Mr. de Vries noted. The Belgian authorities were more inclined to stimulate the economy, while the Netherlands authorities were more inclined to a restrictive budget policy. Nonetheless, recent outturns in the two countries had been similar, perhaps because in both, government expenditure as a proportion of GNP was exceedingly high, and the authorities were unable to reduce it. In any event, the authorities could not reduce the deficit by higher taxes, because the already-high rates of taxation were part of the problem and could not be the solution.

Another similarity between Belgium and the Netherlands, Mr. de Vries concluded, was the pervasive feeling that unless the Government regulated nearly all forms of economic activity, events would not proceed in an optimum fashion. Mr. de Groote had said that new economic organizations had to be closely monitored by the authorities in order to ensure the simultaneous attainment of the sometimes conflicting objectives of social solidarity and economic growth. While he understood the philosophy behind that statement, one that was prevalent in the Netherlands as well, it was based nonetheless on a belief that had become largely an illusion in the present-day world.

Mr. Clark considered that the Belgian authorities faced three main challenges: first, to reduce the public sector deficit and to stabilize, then reduce, the ratio of public debt to GDP; second, to cut unemployment; third, to bring about an orderly, thoroughgoing restructuring of industry. Although those objectives were difficult to reconcile in the short term, progress had been made in the past two years. The authorities had been able to keep much closer to their target for the Treasury deficit in 1984 than in 1983, and employment was stable or perhaps even rising slightly. The resumption of GDP growth, the improved current account position, and the increases in exports and industrial production were also welcome.

Despite the progress achieved, the economic situation in Belgium remained unsatisfactory, Mr. Clark went on. In particular, it would be crucial for the authorities to stick to their medium-term fiscal targets, an undertaking that might well require further cuts in expenditure, particularly if international interest rate trends turned out to be unfavorable. The Belgian authorities had too many targets and not enough instruments, a gap that might be leading to inconsistency in policies on wages, competitiveness, and the exchange rate. In addition, if the authorities held down long-term interest rates in order to reduce their debt service payments, problems were likely to arise with noninflationary financing of the public sector deficit. For example, the authorities had been able to meet only 15 percent of their financing needs on the domestic bond market during the first nine months of 1984.

He had detected a few hints in the paper that the authorities were delaying measures in some fields, apparently in the hope that conditions would improve, Mr. Clark continued. For instance, on interest rates, the staff stated on page 9 of the staff report that the authorities hoped that a more attractive yield differential could result from a decline in foreign rates. Likewise, on page 38 of the paper on recent economic developments, the staff noted that the authorities had been undertaking operations on the public debt directed at delaying interest rate payments. Without those operations, his rough calculations suggested that the fiscal deficit for 1985 would be higher by up to 1 percentage point of GDP. Could the staff or Mr. de Groote comment on the prospects for the authorities meeting fiscal targets in later years, when the payments that they had been delaying began to fall due?

Table 3 in the staff report showed that interest on the public debt, together with transfers to households and enterprises, accounted for over 40 percent of GDP, Mr. Clark observed. Transfers in particular looked like an area in which savings might be made; could the staff say whether the authorities were proposing any further measures? In particular, the system of unemployment benefits was quite generous by international standards, possibly encouraging a higher rate of unemployment.

He endorsed the staff's comments on interest rate policy on pages 8 and 9 of the staff report, Mr. Clark noted. Holding long-term interest rates below market levels not only exerted undesirable immediate effects on capital outflows, but also merely delayed the time at which the authorities would be forced to make necessary reductions in public expenditure.

The decline in consumer price inflation during 1984, together with a projected further decline in 1985, would bring the inflation rate in Belgium into line with that in other industrial countries, Mr. Clark said. As at the 1983 consultation, however, he was concerned about the persistence of wage indexation, not only because it tended to undermine Belgium's competitiveness but also because the rigidity in real wages was likely to make it harder to reduce unemployment. Although he recognized the political problems involved in any curtailment of wage indexation, had the authorities given any further consideration to the idea suggested in previous Article IV consultations of excluding changes in the terms of trade and indirect taxes from the index?

He would have welcomed further discussion of exchange rate policy in the staff paper, since the Belgian franc, although stable within the EMS, had been recurrently weak, Mr. Clark noted. However, the present size of Belgium's external debt, at about 30 percent of GDP, was not an immediate concern. Nevertheless, the ratio had been rising fast in recent years and had increased further in 1984. Such a development again underlined the importance of establishing appropriate domestic interest rates and making progress in reducing the fiscal deficit.

In addition, he would have welcomed further discussion by the staff on the authorities' plans for industrial restructuring and how they might achieve consistency between such a policy and other priorities, such as increasing employment and promoting fiscal restraint, Mr. Clark concluded. Perhaps Mr. de Groote or the staff could make further comments on that topic. Perhaps next year's documentation could include a longer discussion of restructuring as part of the paper on recent economic developments. In conclusion, while welcoming the progress achieved by the authorities during the previous two years, he felt--perhaps more strongly than the staff--that the country's position remained vulnerable and that more decisive action, particularly in public finance, was necessary.

Mr. Fujino commented that the upturn in the Belgian economy since the 1983 Article IV consultation reflected both improved external conditions and the authorities' adjustment efforts. Particularly encouraging were the pickup in private investment and the stabilization of private employment after several years of decline. The recovery of corporate profitability in 1984 had made possible growth of 1.8 percent in GNP and of over 5 percent in industrial output, attainments attributable to the world recovery and improved confidence in Belgium's private sector, supported by a tightening of fiscal and monetary policy. Still, the unemployment rate remained among the highest in industrial countries, and progress in fighting inflation had been painfully slow. To sustain the momentum of economic recovery led by private investment, the authorities had demonstrated their determination to curtail the fiscal deficit, mainly through expenditure restraint and a firm stance in monetary policy. He could generally endorse the staff appraisal.

Although the increase in the consumer price index (CPI) had decelerated to 6.4 percent in 1984, the gap between the rate of inflation in Belgium and that in industrial countries generally had narrowed only slightly, Mr. Fujino went on. The position of the Belgian franc within the EMS had improved in recent months, but, in order to defend the currency over the medium term and maintain a zero position in future EMS realignments, the authorities would have to combine a flexible interest rate policy with sufficiently low inflation. During the early 1980s, the strongest cause of inflation had come from increases in import prices. Thus, given the need to maintain the competitiveness of exports, any further depreciation of the currency would risk accelerating the rate of inflation, probably the reason that such a course had been rejected by Mr. de Groote in his statement. A relatively accommodating monetary policy associated with an excessive fiscal deficit and various structural rigidities--like overregulated wage determination and substantial financial support to enterprises, including structurally ailing industries--would be the major battlegrounds in the fight against inflation. Financial support for enterprises was increasingly linked to structural adjustment measures, but he would have welcomed a fuller discussion on how much support would be required to restructure ailing industries.

The extremely high unemployment rate remained one of Belgium's most intractable problems, Mr. Fujino continued. Although private employment had recently stabilized, the rate of unemployment was still rising, especially reflecting the growth in female participation in the labor market. The lengthening of the duration of unemployment also indicated that the situation had not yet begun to improve. Perhaps both supply and demand factors contributing to the problem could be examined. On the supply side, a more detailed analysis of unemployment compensation and its impact on labor participation would be needed. As female participation had constantly risen while the female unemployment rate had been high and rising, he could not but feel that the entry of women into the labor force had been partly encouraged by the generous unemployment compensation in Belgium. During the most recent Article IV consultation with the Netherlands, the staff had provided an interesting international comparison: in Belgium, unemployment compensation for a "typical worker" equaled about 67 percent of his income, below the figure for France, the Netherlands, and Germany, and above the figure for the United States. Perhaps it would be better to examine the overall generosity from various viewpoints, such as how unemployment compensation related to combined household income. Therefore, he looked forward to a comprehensive international comparison of unemployment compensation and its relation to the rate of unemployment. In any event, the recent measures taken to tighten benefits represented steps in the right direction.

Perhaps the most important issue on the demand side was the overregulated system of wage determination, Mr. Fujino said. Unless that rigidity were eliminated, it would be difficult to expect a long-lasting expansion of private employment. He thus welcomed the reintroduction of partial wage deindexation in the form of index jumps, which should be regarded as an important first step toward further liberalization. The existence of wage norms was a useful safeguard for Belgium's international competitiveness.

Despite some reduction over the past few years, the fiscal deficit, amounting to 11.5 percent of GNP in 1984, remained excessive, Mr. Fujino considered. At the present stage of economic recovery, a reduction in the deficit seemed particularly important to provide adequate credit for the private sector while maintaining price stability. The authorities should adhere to the medium-term fiscal adjustment program and reduce the deficit to 7 percent of GNP by 1987. The figure should be considered a minimum target; even after it was achieved, public debt would remain at about 100 percent of GNP, an exceptionally high proportion by any standards.

As the staff and many Executive Directors had said, the authorities should pursue fiscal adjustment by placing greater emphasis on reducing expenditure, as government outlays exceeded 60 percent of GNP, Mr. Fujino said. As in many other industrial countries, the maturity of the economy as well as the high standard of welfare benefits seemed to have eroded the vitality of private investment during the previous decade. Thus, in pursuing expenditure restraint, the authorities should emphasize cuts in

current social transfers; the partial deindexation of social security transfers was quite welcome. On the revenue side, he had noted with interest measures to raise withholding taxes on interest and dividends from 20 percent to 25 percent, at the same time excluding them from income tax declaration. The new rate still appeared rather low, and he did not see why the measure was supposed to yield BF 15 billion, if income from interest and dividends had been included in previous tax declarations.

Belgium's current account balance was expected to improve further in the coming years, reflecting a continued strong growth of exports, Mr. Fujino observed. Nonetheless, long-term capital outflows, which had to be financed by official external borrowing, might continue in coming years without the authorities taking any policy action. The official view was that there was no immediate threat from the external debt, but the authorities should be careful in view of the present heavy burden of interest payments on domestic borrowing. To a large extent, the present long-term capital outflows seemed to reflect an after-tax interest rate differential. The authorities should make their utmost efforts to secure attractive domestic long-term rates, although he could understand the difficulties involved in view of the exceptionally large fiscal deficit.

He shared the authorities' opinion that the rationale for maintaining the two-tier exchange system had been weakening since it had become increasingly difficult to separate transactions between the two markets, Mr. Fujino concluded. He thus hoped that greater room for maneuvering interest rate policies would enable the authorities to unify the exchange markets in the near future.

Mr. Zecchini remarked that the development of the Belgian economy over the past year showed how several difficult years of perseverance in adjustment efforts could create the conditions for balanced, durable growth. After taking painful but necessary measures for three years, Belgium had succeeded in lowering the inflation rate from 7 percent to 5 percent and in restoring equilibrium to the external current account while maintaining a moderate but rising rate of GNP growth and stabilizing employment. In part, those positive results represented the lagged effect from the incomes policies pursued mainly through a suspension of wage indexation and a depreciation of the Belgian franc, both in 1982 and 1983, together with the 1984 recovery in world trade and a deceleration in import price increases.

The progress made so far had been uneven, as some sectors had been insufficiently affected, Mr. Zecchini continued. For instance, Belgium's public finances were still in a far from satisfactory position; industrial policy was still directed toward subsidizing ailing industries; wage policy each year had to deal with the possibility of a catch-up in real wages to compensate for the reductions made in the previous year. Further progress was required in order to pass from the present stage of stabilizing the economic cycle to the more exacting task of redressing some structural elements.

On the wage front, the freezing of the indexation mechanism and its partial neutralization through index jumps in 1984 had played a central role in reducing inflationary pressures, enhancing external competitiveness and boosting investment in fixed capital, Mr. Zecchini remarked. In 1984, the net contribution made by the wage norms had decreased, as it would continue to do unless the norms were strengthened and extended until 1985-86. In 1984, a reduction in the workweek, coupled with an increase in social security charges on employers, had partly offset the beneficial effects of the wage norms, resulting in an 8.5 percent rise in hourly wage costs, compared with 6.3 percent in 1983. The slower rise in Belgium's CPI in 1984 had been attributable mainly to the slowing rises in import prices, and the strong recovery in private investment had been attributable to an expansion in external demand. As those external circumstances could not last long, the Belgian authorities should proceed to extend the wage norms and ban real wage increases by building on the tradition of social consensus, especially in view of the latent inconsistency between the objectives of maintaining competitiveness and keeping the exchange rate of the franc stable within the EMS, on the one hand, and allowing for the rising trend in labor costs, on the other. At least in the short term, that trend might stem from the generalization of a 38-hour workweek and also the new work-sharing program. Apart from gains in productivity, which depended heavily on rising economic activity and demand, the authorities had available no other tool for stabilizing competitiveness except more stringent discipline on real wages. In that respect, the rate of inflation in Belgium remained higher than that in the country's two main trading partners in the European Communities, and it was projected to remain that way, although less so, in 1985. If the growth of international demand and exchange rate movements were less favorable than in 1984, wage restraint would continue to be the fundamental means of achieving both targets at the same time. The Belgian authorities seemed to be aware of the problem when expressing their fear of "competitive wage restraint." Could Mr. de Groote confirm that impression and perhaps explain what course of action the authorities would follow in such an eventuality?

The actual implementation of parallel efforts was even more to be desired on the budget front than in incomes policy, as the adjustment process had just emerged from the initial planning stage, Mr. Zecchini said. The authorities had already taken a significant step by adopting a three-year adjustment program. Stabilizing the ratio of public debt to GNP was a minimum but acceptable objective. Given the burden of interest payments, a reduction from 1984 to 1987 of about 6 percentage points in the ratio of the general government financing requirements to GNP could be viewed as a sufficiently ambitious goal in aggregate terms, consistent with the need for fiscal stabilization. Furthermore, real interest rates no higher than the growth rate of real GNP would be a determining factor in keeping the budget deficit at a constant proportion of nominal GNP, thereby achieving the objective set by the authorities.

Some doubts remained about the sectoral distribution of the effort to reduce the deficit, Mr. Zecchini noted. As the staff had said on page 7 of SM/84/271, expenditure restraint would be the desirable way to reduce the deficit, given high rates of taxation and the large share of public expenditure in GNP. In addition, Table 20 in SM/84/279 revealed that the authorities were not considering any reductions in public subsidies to the productive sector, a compartment of expenditures that had recently expanded to almost 6.5 percent of GNP in 1983, including both current and capital transfers. To the contrary, there were indications that public incentives to investment should increase during the fiscal program. The joint objectives of revitalizing the most efficient productive sectors and narrowing the public deficit by cutting expenditure strongly suggested that subsidies should be included in the fiscal adjustment program. Could Mr. de Groote explain why they had been excluded so far?

Monetary policy in Belgium was carried out through administrative instruments, Mr. Zecchini observed. He agreed with the reservations expressed by the staff on that system; many other European countries had recently moved toward deregulating the financial markets, generally achieving greater efficiency in intermediation and the provision of financial services. By the way, a market-oriented conduct of monetary policy was not necessarily associated with the adoption of targets for aggregates as opposed to interest rates, the choice depending merely on relative importance of instabilities deriving from different sectors of the economy. If the authorities believed that interest rates were more useful operating variables than monetary or credit aggregates, they could pursue an interest rate policy under a more liberal system. In such circumstances, however, the desired target for interest rates should be made consistent with the conduct of fiscal and monetary policies. By contrast, the current system--in which all residual government bonds were automatically purchased by banks--did not provide adequate incentives for discipline in the conduct of public financial policies.

There was a high degree of leakage between the two exchange markets maintained by Belgium, as might be expected from similar experiences in other countries, Mr. Zecchini concluded. Such leakage might explain why, in the absence of any specific policy, the spread between the two exchange rates for the Belgian franc had shrunk to less than 2 percent in normal circumstances. Given the small difference, it was unclear what function that dual arrangement could perform. Why was the staff not advocating the discontinuance of Belgium's dual exchange market, as it had done in similar circumstances in other countries?

Mr. Suraisry generally endorsed the main points in the staff appraisal and commended the authorities for their determined adjustment efforts in recent months. They had had to make hard policy choices, but the combination of wage moderation and fiscal restraint had yielded encouraging results: private investment had risen, external competitiveness had improved, and a modest, export-led recovery was under way. The

outlook for the economy had become more favorable than for some time, so that the authorities had laid a good basis for tackling the difficult problems that remained. Unemployment was high and rising; the industrial sector was in need of modernization; and the public sector deficit continued to be unsustainably large. Consequently, the objective should be to promote steady growth and new employment opportunities in the private sector, within a framework of continued financial stability.

Sustained efforts would be required to reduce the public sector deficit, in line with the authorities' medium-term strategy, Mr. Suraisry went on. Already, progress had been made in stabilizing the deficit as a proportion of GDP and there were far-reaching moves to limit spending by local governments and control the rapid growth in social security payments. However, the continued high level of public spending would add to the heavy burden of public debt, which was already pre-empting a large share of Belgium's resources, as shown in Table 24 of the paper on recent economic developments. To preserve their gains, the authorities would have to improve the structure of public finances and reduce the debt burden--tasks that would require continued cutbacks in all areas of current spending, both immediately and over the medium term, to reduce the size of the public sector.

A firm monetary stance was needed for domestic as well as external reasons, Mr. Suraisry considered. The authorities intended to limit central bank financing of the budget deficit in 1985; they should finance a larger part of the deficit by noninflationary means, perhaps through long-term bond issues. Institutionally, the effectiveness of monetary policy was hampered by rigidities in the financial system, and he hoped that the authorities would examine ways of making it more competitive and efficient.

Continued wage restraint would be essential to maintain the recent gains in competitiveness, Mr. Suraisry said. Therefore, he supported the authorities' decision to extend the present wage norms and to ban real wage increases for two years. Unfortunately, the system of wage determination had become complex and heavily regulated, features that in other countries had led to distortions and strong pressures for catch-up increases once such regulations were removed. As the Belgian authorities were well aware of those risks, they should explore, together with business and labor, the scope for phasing out wage rigidities so that future wage increases could be linked more closely to gains in productivity.

Cautious domestic policies would help the authorities to maintain a stable exchange rate for the Belgian franc within the EMS, Mr. Suraisry suggested. That objective of stability was appropriate, particularly in view of the recent and prospective improvement in Belgium's external accounts. The authorities were well placed to rebuild reserves and limit any further increase in the already high amount of foreign borrowing.

The authorities should take advantage of the present recovery to tackle structural weaknesses and improve resource allocation, Mr. Suraisry commented. It would be particularly important for them to press ahead in trying to restructure the steel and textile sectors and phase out subsidies to ailing industries. If those efforts were combined with measures to enhance labor mobility and appropriate incentives for private investment, the long-run benefits to the country could be considerable. Finally, he commended the authorities' commitment to an open trade system and their continued efforts to expand the share of official development assistance (ODA) relative to GDP, despite budgetary constraints.

Mr. Dallara commented that since the 1983 Article IV consultation, Belgium had continued to make slow but steady progress toward its objectives for growth, inflation, and the external position. The authorities had restored a real rate of growth, continued to reduce inflation, and virtually eliminated the current account deficit. Particularly striking had been a rise of nearly 4 percent in gross fixed investment during 1984--after a three-year decline--as well as the stabilization of employment in the private sector after a five-year decline. Thus, Belgium's investment efforts, supported by the favorable world economic environment, were beginning to bear fruit. Nevertheless, as had been clearly pointed out in the staff paper and by other Executive Directors, serious problems remained, most notably the large public sector deficit and the high rate of unemployment, both clearly related to heavy involvement by the Government in the economy.

As to the problem areas, Mr. Dallara said, first, that despite modest success in 1984 in reducing the general government deficit, still it had equaled nearly 14 percent of GNP and, indeed, had remained at some 15 percent of GNP during the past four years. The ratio of expenditure to GNP had reached 62 percent in 1984, only 2 percentage points lower than its peak in 1982. There was a growing burden of interest payments on the public debt, the share of which in GNP had grown by nearly 7 percentage points between 1974 and 1984 and which currently pre-empted more than 20 percent of Treasury revenue. Moreover, transfer payments to households had grown relative to GNP. Those figures highlighted the importance of the Belgian authorities' decision early in 1984 to reduce the Treasury and public sector deficits to some 7 percent of GNP by 1987, especially by reducing the impact on the budget of cost of living adjustments on public and private sector wages as well as on social benefits. Stabilization of the ratio of Treasury debt to GNP at about 100 percent would also represent some progress in arresting the previous upward movement, but the ratio would still be very high by international standards. Like the staff, he welcomed the multiyear character of the fiscal policy commitment, which could well have positive effects, particularly in helping the private sector to make its own economic decisions. Nevertheless, he shared the staff's concern that the authorities might have to take more forceful action to achieve their fiscal goals in the three-year program. Regrettably, they had made little progress in alleviating the burden of taxation, which remained at 49 percent of GNP and was set to rise slightly in the coming year.

He was impressed with the success achieved since the temporary suspension of wage indexation in 1982/83 but was dissatisfied with the continuation of the basic system of indexation, Mr. Dallara noted. Both hourly nominal wages and unit labor manufacturing costs had risen in 1984 at rates in excess of those registered in 1982 and 1983. Although some modest recovery in nominal and real wages might be justified, inflationary pressures might still resurge as long as the basic system of indexation remained in place. The continued imposition of wage norms set by the Government in order to suppress the natural effects of indexation was unwise. What was the authorities' current position regarding continued use of wage norms compared with the possibility of a permanent, fundamental reduction in indexation itself? The need for such mechanisms ought to decline to the extent that continued progress could be made in reducing inflation through fiscal and monetary restraint and through a recovery of private investment and productivity growth.

He was skeptical about such approaches as work sharing and any industrial policy involving strong, direct action by the Government, Mr. Dallara commented. Could the staff or Mr. de Groote provide a further assessment of the Belgian experience with sharing work, the 38-hour workweek, and the other special measures aimed at increasing employment and reducing the high unemployment rate?

He welcomed the tightening of monetary policy, especially short-term interest rate policy, Mr. Dallara said. The use of short-term interest rates as a tool for helping to achieve exchange rate stability did fall within the framework of the EMS. Given the extremely open economy of Belgium, however, the authorities needed to pay attention to long-term rates and to the problems created in financial markets by recent changes in yield, as a means of staunching persistent outflows of private capital. Of course, the authorities needed to give priority to reducing the public sector's financing demands on the market generally. At least until they had achieved greater success in reducing the deficit, they would have to make longer-term debt instruments more attractive in order to avoid further monetary financing and a further buildup of foreign debt.

Belgium's adjustment efforts in the favorable world economic environment of the past year had helped considerably in restoring balance to the external accounts and had also stimulated economic growth, Mr. Dallara remarked. In order to prolong adjustment, the authorities would have to continue to narrow the gap between Belgium's inflation rate and that of its major trading partners, a task that would probably not prove easy. Therefore, he had been puzzled by the allusion to competitive wage restraints as a potentially worrisome means for countries to improve their competitive positions. He had found the discussion of the future of Belgium's dual exchange market to be rather ambiguous. If the rationale for the use of that device had been impaired, or reduced, or altered in recent years, it was unclear why the authorities were not considering abolishing it.

In sum, Mr. Dallara said, Belgium had made progress toward economic recovery during the past few years. The authorities should not relax their adjustment efforts by taking advantage of the margin of maneuver that they had gained or the encouragement that could come from successful reactions by the economy to policy changes in certain areas. Rather, they should deal with the economic rigidities that remained and continue to expand the flexibility of the economy in responding to opportunities.

Mr. Lindå recalled that at the 1983 Article IV consultation discussion, the Executive Board had commended the Belgian authorities for having made substantial progress in correcting two major imbalances, the declining profitability of enterprises and the widening of the current account deficit. Therefore, the Board had thought that the prospects for Belgium's taking advantage of the expected recovery in the world economy were much better than previously, and those expectations had largely been met by developments during 1984. Activity had become more buoyant, with a continued major contribution to overall growth coming from the change in the real foreign balance, despite a less favorable relative cyclical position than in 1983. Capacity utilization had picked up, and private capital formation had recovered from the depressed levels of previous years. A further improvement in the current external account was estimated for 1984, although at a slower pace; following years of decline, private sector employment appeared to have stabilized.

One of the most important problems in Belgium was the imbalance in the labor market, Mr. Lindå considered. With an unemployment rate among the highest in the OECD in recent years and with prospects for a further rise in 1985, he welcomed the authorities' intention to introduce legislation that could make the functioning of the labor market more flexible. The authorities were fully aware that to achieve sustainable relief of unemployment, adequate profitability and competitiveness would be crucial. Indeed, profitability had improved substantially in recent years but was still considerably lower than in the early 1970s; the most recent estimates of the profit rate in manufacturing pointed to a renewed deceleration. According to the staff analysis in Appendix II of the paper on recent economic developments additional years might well be required before profitability could reach more normal, sustained rates at which a substantial increase in capacity might be expected. That analysis appeared to contrast with Mr. de Groote's statement that the authorities considered profitability to have already been sufficiently restored.

One important precondition for an improvement in profitability would be the maintenance of competitiveness, Mr. Lindå remarked. Even while recognizing that point, the authorities regarded Belgium's competitiveness as adequate: between 1983 and 1984, hourly wage costs had risen, but, owing mainly to exchange rate changes, Belgium had maintained its competitiveness vis-à-vis its seven major trading partners, suggesting a potential for export market gains. However, according to OECD estimates, Belgium appeared to have lost market shares since 1982; in contrast, the staff's analysis suggested some improvement in recent years. Could the staff

clarify the divergence? In any event, the authorities' firm commitment to safeguarding the stability of the franc, combined with the objective of maintaining competitiveness, would require a tight rein on domestic cost expansion. The fairly modest increase in unit labor costs in recent years largely had been due to strong productivity growth, which had decelerated recently. As domestic costs had shown an upward trend since 1982, a firmer stance on incomes policies could be required in the future.

Like Mr. Clark, he would have appreciated a followup of the analysis of Belgium's structural problems contained in the staff report for the 1983 consultation, Mr. Lindå continued. During that discussion, several references had been made to the structural problems of the industries, and Executive Directors had encouraged the authorities to scale down the extensive subsidization of ailing industries. The authorities continued to believe that mainly through sound macroeconomic policy would industrial performance be supported and expanded. If the recent rise in the export/import ratio for investment goods continued, it could indicate the emergence of a more modern and competitive structure of production in Belgium.

In many countries, problems relating to the budget were the most difficult ones to solve, Mr. Lindå went on. By any measure, the public sector deficit in Belgium was one of the largest in the industrial world, and the targeted deficit would continue to be high even after the introduction of the three-year program. Persistent deficits of such a size added to interest payments and increased pressure for tax increases or spending cuts, while also fueling inflationary expectations. Endorsing as he did the gradual approach to bringing down the deficit, he also realized--given the size of the problem--that a reduction over an extended, indeterminate period was bound to pose a threat to achieving a sound overall macroeconomic performance. The urgency of reducing the deficit had temporarily eased because of high liquidity in the private sector. That was less persuasive than it might be in view of the current size of the deficit and rising private real investment. Given the large share of public sector expenditures in the economy as well as the high rates of taxation, the authorities should concentrate deficit-reducing measures on public spending.

A significant share of public spending was taken up by social security transfers, Mr. Lindå noted, and the authorities had included in the March 1984 fiscal program a series of measures designed to bring better balance to social security finances. In his statement at the 1983 Article IV consultation, Mr. de Groote had alluded to plans to overhaul the system fundamentally, including one proposal to link social security taxes to the value added generated by enterprises instead of linking them to wages. What had happened to that proposal?

The most recent OECD forecast projected that the Belgian economy in 1985 would grow somewhat faster than envisaged by the Fund, mainly owing to a larger contribution from private consumption, Mr. Lindå said. Although recognizing that the underlying demand and supply series applied

by the two organizations were different, he would like to hear from the staff about any differences of opinion on the impact of fiscal measures on households' real disposable income.

He could support the staff appraisal, Mr. Lindå concluded. In several respects, developments in the Belgian economy had been encouraging, but some large imbalances remained. The strategy of stretching adjustment over time appeared to be in accord with the present prospects for an international economic recovery. Nevertheless, if a less favorable outlook emerged, some reorientation of the current policy stance might be called for.

Mr. Zhang recalled that on the basis of consultations with Belgium during the past two years, he could appreciate the staff's assessment that the upturn in the economy in 1984 had been a gratifying response to recent adjustment efforts. He could also accept the staff's assumptions for its 1985 projections. Real GNP was expected to grow by roughly the 1984 rate; developments in enterprise profits and the public sector deficit would continue to be favorable; the outlook for inflation and the foreign balances looked promising. Meanwhile, high unemployment, which would rise as a result of growth in the labor force, remained the most worrisome area.

The expansion of economic activity had continued to rely mainly upon the stimulus of export demand, Mr. Zhang remarked. Perhaps such dependence was unavoidable in view of the existing rigid structure of production in Belgium. Therefore, the present stabilization program would be ineffective in the longer run unless a path could be charted for future economic growth: apart from measures to reduce costs and increase competitiveness, Belgium's structural production had to be adequate and flexible enough to meet shifts in domestic and foreign demand. In other words, the country needed a new and comprehensive industrial policy for modernization that must go beyond restructuring crisis-stricken industries like steel and textiles. The Government had begun to adopt some measures in that direction such as various tax concessions and financing incentive schemes for investment as well as the linking of financial aid to adjustment by industries. The Government should expand its incentives for research and information to enterprises working on advanced technologies. Nonetheless, under the specific circumstances of the country, official efforts in that direction could be hampered by the openness of the Belgian economy and the strong domestic regionalization of industries that tended to limit the Central Government's role. Furthermore, the present industrial investment policy, favoring a substitution of capital for labor, might eventually come into conflict with the employment targets.

Overall economic development in 1985 would continue to be dominated by the implementation of the three-year stabilization plan, introduced in 1984 to cut the Treasury deficit and thus to maintain the equilibrium of public finance, Mr. Zhang noted. The maintenance of a restrictive fiscal policy was particularly important because public expenditure in Belgium was so high that in a variety of ways it distorted incentives, aggravated

inflation, and reduced competitiveness. Indeed, public expenditure, excluding interest payments, had begun to decline; some revenues, such as the levy on wages, had increased. Given the existing high rates of taxation, the prospective narrowing of the deficit would have to continue to come from expenditure restraint, but the scope for reducing expenditure was limited because of its effects on unemployment. Nevertheless, the authorities were expected to carry out the reduction in net borrowing.

The authorities would continue to direct monetary policy toward defending the exchange rate through adjustments in short-term interest rates, Mr. Zhang continued. The Government's decision not to allow long-term rates to increase was appropriate, as any rise at present would have adverse effects on private investment and on the cost of government borrowing. However, keeping the rates relatively low would encourage capital outflows.

The rate of unemployment had risen in 1984 in spite of brisker economic activity and various work-sharing schemes, Mr. Zhang remarked. In 1985, a new work-sharing agreement to be negotiated between management and unions would emphasize part-time work, but unemployment was still expected to rise, mainly on account of an increase in the labor force. Unemployment would remain one of the most serious structural imbalances and could have no easy or quick solution. As a result of the return to full indexation at the end of 1983, wage growth had accelerated during the first half of 1984, but the trend would probably not continue in 1985 owing to the introduction of a new levy on wage incomes. The success of income redistribution and work-sharing measures would require sustained efforts by the authorities and the continuation of a social consensus on overall objectives by the social partners.

A restrictive fiscal policy would result in a reduction of direct stimulus to the economy, Mr. Zhang pointed out. Private consumption was likely to stagnate, while the growth of private investment might be low because of sluggish growth and high interest rates. As in 1984, the growth of GNP would thus depend upon improvements in Belgium's foreign balances. Available figures indicated that there had been a continued narrowing of the current account deficit in 1984 compared with earlier years and that the trade balance was expected to register a surplus in 1985.

Since 1982, the Belgian Government had endeavored to improve an economy characterized by both short-term instability and deep-seated structural imbalances, Mr. Zhang concluded. Positive results had already been achieved in income recovery and stabilization. The main structural imbalances were no different from those confronted by other mature industrialized countries. However, because of Belgium's smallness and great openness, the scope of policies that could be adopted to redress the imbalances would be more restricted because of the influence of exogenous factors. Consequently, the expected results of such policies would be achieved only if the international environment continued to improve.

Mr. Abdallah observed that during the past year, developments in Belgium's economy had been generally favorable, growth having been stronger than during the previous two years. The upturn in economic activity, based mainly on strong industrial output in the export sector, could be considered encouraging. Industrial output had benefited from adjustment measures initiated in 1982 that had helped to restore competitiveness. The rate of inflation had been coming down also, although it was still higher than in other industrial countries. Unless the rate of inflation were brought into line with that of its trading partners, Belgium could once again lose its competitive position. Therefore, the authorities should pursue policies that would promote a continued deceleration in the rate of inflation. Among other things, they should re-examine the wage and salary indexation policy that had been suspended in 1982 and reinstated with modifications in December 1983.

Projected to rise to 15.2 percent in 1985, the rate of unemployment in Belgium remained one of the highest in industrial countries, Mr. Abdallah continued. The upturn in economic activity had not been enough to halt a further increase in the rate of unemployment, despite a recovery in private investment in 1984 accompanied, after five successive years of decline, by a stabilization of private sector employment. Such a rate of unemployment had become burdensome on public finance, because the authorities had tried to set up programs to absorb some of the labor force while maintaining costly unemployment benefit schemes.

The authorities would continue to cope with unemployment because there was no clear solution in sight, Mr. Abdallah said. The problem derived from both supply and demand factors. The crucial development on the supply side was a continuing influx of female job seekers into the labor market. Although women's desire to develop careers was understandable, the influx had been encouraged by an unemployment compensation scheme that was comprehensive, fairly generous, and unlimited in duration. As indicated in the footnote on page 7 of the paper on recent economic developments, such benefits recently had been made increasingly dependent on household income, a consideration not previously taken into account. Some elaboration on what that change implied and what further steps might be taken by the authorities would be helpful.

On the demand side, a partial solution would depend largely on how strong the economic growth already under way would turn out to be and how long it was likely to persist, Mr. Abdallah continued. In part, the solution also would depend on how wage settlements were reached, so that labor shedding would not be encouraged by high wage awards.

Adjustment in Belgium was rendered more difficult because the country's main trading partners were pursuing policies that relied primarily on exports and investment as motors of economic growth, Mr. Abdallah remarked. In addition, they were continuing to apply restrictive fiscal and monetary policies even though the rate of inflation in those countries had subsided, their net public sector borrowing requirements were low,

and their current accounts were in balance or in surplus. The point made by Mr. de Groote underscored the argument--adduced many times by developing countries regarding the lack of symmetry in the existing international monetary system--that the burden of adjustment was borne almost exclusively by deficit countries. There was no doubt that moderate expansion by surplus countries would ease that burden and contribute to faster growth of world trade.

Finally, the Belgian authorities were to be commended for their continuing effort to raise official development assistance, despite the difficulties facing the economy, Mr. Abdallah said. At about 0.6 percent of GNP, although slightly below the UN target, Belgium had indeed become a substantial donor. Therefore, better economic prospects in that country were likely to spill over to developing countries.

Mr. Nebbia observed that the program launched in February 1982 had restored adequate conditions for renewed growth and in time would help Belgium to obtain sounder fiscal finances. Large imbalances still remained, however, particularly in the fiscal, exchange rate, and financial areas. For the third year in a row, the public sector deficit was equivalent to about 15 percent of GNP. According to the staff report, public expenditure in Belgium was so high that it distorted incentives, aggravated the rate of inflation, and undermined competitiveness. Heavy support for enterprises accounted for the equivalent of 6.5 percent of GDP in current capital transfers, of which extensive subsidization of transportation services was responsible for 2 percent of GDP and widespread support for ailing industries for 1 percent of GDP. Such expenditures continued to burden fiscal management. In addition, the Banque Nationale de Belgique was hindered from adequately controlling its assets, financing of the Treasury deficit having assumed a quasiautomatic and permanent nature. The exchange rate continued to be supported through borrowing abroad, especially when imbalances occurred in the current account. Furthermore, unemployment remained high and was rising, while the industrial structure was still in need of modernization.

Because of the magnitude and structural nature of the imbalances that had affected Belgium during the past decade, they could not be corrected by a simple reversal of policy stances, Mr. Nebbia remarked. The authorities were faced with many problems and had only a few tools to work with. Therefore, he agreed with Mr. de Groote's remark on gradual intervention by the Government in adjustment.

Salary indexation had been reintroduced in Belgium, Mr. Nebbia continued. The policy was self-defeating. However, the authorities might have introduced such a policy in order to avoid further social unrest and to ensure that the burden of adjustment was borne not only by workers.

Belgium maintained restrictive trade practices in certain commodities under the EC's Common Agricultural Policy, in textiles under the Multi-Fiber Arrangement, and in imports of certain industries such as steel

under the EC's Common Commercial Policy, Mr. Nebbia noted. Other than general recommendations for a more open and free trading system, the staff papers included no specific references to trade liberalization by the Belgian authorities. The distortions that protectionist policies introduced into markets were well known, as was the damage caused by them. In particular, it was much more difficult for indebted developing countries than for Belgium to obtain access to international capital markets in order to finance current account deficits. He would have liked to see the staff include a more accurate assessment of that critical issue.

However, the Belgian authorities expressed concern on page 10 of the staff paper with respect to the importance of international developments for small, open economies, Mr. Nebbia went on. The larger industrial countries should give due consideration to the international repercussions of their domestic policy choices. Indeed, such repercussions should be taken into account when other countries' external difficulties were being discussed by the Executive Board.

In conclusion, he understood the difficulties faced and the progress shown by the Belgian economy and welcomed the gradual approach pursued by the authorities, Mr. Nebbia said. He encouraged them to persevere in their efforts to improve Belgium's financial and economic situation.

Mr. Romuáldez expressed general agreement with the staff appraisal, particularly on the stress given to the importance of the authorities continuing in strengthening their adjustment efforts. The program adopted at the beginning of 1982 had produced some major improvements in 1983, which had been strengthened in 1984. The authorities had begun a difficult, crucial adjustment program. The successes achieved so far were an encouragement to set new goals for retrenching public expenditure and restoring greater flexibility in the economy; however, the progress achieved so far represented only a first step. Most of the improvement to date had been associated with external developments, especially a pickup in foreign demand. Great challenges remained even after nearly three years' pursuit of an adjustment strategy--the relatively subdued state of employment, output, growth, exports, profitability, and investment.

The stabilization of private sector employment during 1984 could be attributed to the implementation of various work-sharing schemes and to expanded use of part-time jobs, as much as to a higher level of economic activity, Mr. Romuáldez considered. Could the staff comment on the extent of the improvement associated with work-sharing? Was it real or illusory, seeing that the unemployment rate was still expected to rise some 15 percent to 16 percent in 1985? Again, the recovery in output by 2 percent during 1984 had been quite modest in comparison with the rises in most other industrial countries. Moreover, although better than in previous years, Belgium's export performance remained relatively poor, as shown in Chart 17 of the paper on recent economic developments, despite a marked improvement in the country's competitiveness over the past three years.

Even though profitability had improved greatly during the previous two years, it still fell considerably short of the rate observed in the early 1970s, despite large-scale elimination of marginal firms and massive labor shedding, Mr. Romuáldez remarked. As a result, the share of investment in GDP was still small, even after an upturn in 1984. Despite wage restraint, inflation in Belgium during 1984 had remained above the rates registered in other industrial countries, by 2-3 percentage points in the first half of the year and by 1.5 percentage points in the second half.

Thus, the general economic circumstances in Belgium were such that the authorities' adjustment efforts, although laudable for what they had achieved, needed to be both sustained and increased, Mr. Romuáldez suggested. Admittedly, for countries with such high foreign exposure, future results would be largely contingent on the international environment, but the authorities should make strengthened efforts on the domestic front to achieve their goals. The scope for strengthening adjustment efforts seemed particularly broad with respect to wage, industrial, fiscal, and monetary policies.

Given the risks of a catchup in wages, which would jeopardize much of the progress achieved since 1982, the extension of the wage norms through 1986 was welcome, Mr. Romuáldez said. Nonetheless, it might be worthwhile for the authorities to consider that a meaningful reduction in unemployment required a more flexible wage determination mechanism which, in turn, required the deindexation of wages. He agreed with the staff that one indication of lack of flexibility in the economy was that the continuation of strict wage norms would remain a necessary safeguard for both 1985 and 1986. He had also noted the authorities' view, reported on page 10 of the staff report, that competitive devaluations had been replaced by what they termed "competitive wage restraint" and their conclusion that such a policy, if practiced generally, could entail a widespread and mutually reinforcing deflationary effect. Was not a point being missed here, that wage restraint had played an essential role in the efforts of trading-partner countries to correct imbalances?

Belgium's industrial structure was in urgent need of modernization, Mr. Romuáldez said, as there was a serious mismatch between Belgium's productive system and world demand. Did the staff have any comments on the role that tax and financing incentives could play in stimulating investment, further strengthening the financial structure of enterprises, fulfilling special functions such as favoring the location of enterprises in high-unemployment areas, or encouraging financial capital? A more extensive investigation or a more in-depth treatment of industrial policy was called for. For example, what were the Belgian authorities contemplating under their program for restructuring industry?

Other Executive Directors had correctly observed that the public sector borrowing requirement (PSBR) was still quite high, Mr. Romuáldez continued. The staff had been fully justified in suggesting that, given already high rates of taxation, restraints on expenditure were a desirable

way to reduce the deficit. As reducing the share of the public sector in the economy would have beneficial supply-side effects, the objective of fiscal policy should be broader than merely reducing the PSBR. Indeed, real public expenditures had already begun to decline, but only if interest payments were excluded. Furthermore, the cutback in public expenditure to its 1981 proportion of GDP had been the result mainly of substantial reductions in the relative rate of capital expenditure.

Monetary policy did not appear to have been consistently tight enough, Mr. Romuáldez remarked. The rise in liquidity over the past year or two had no doubt inhibited the deceleration of inflation and had fueled capital outflows, which, if they were to increase, could cancel out the improvement registered in the current account. Therefore, he welcomed the tightening of monetary policy in 1984, which mainly had involved stricter management of short-term interest rates. However, long-term rates had not been allowed to reflect that change. More attractive yields on long-term public securities would reduce monetary financing of the budget deficit together with its inflationary impact and would reduce long-term capital outflows as well. The conduct of monetary policy in Belgium was hampered by the segmentation of financial markets and the low degree of competition in the financial system. Could the staff comment on the statement on page 59 of the paper on recent economic developments that the slower pace of financial innovation was probably attributable to the absence of extensive regulations and the consequently diminished incentive to circumvent such constraints through novel practices? Presumably, the authorities could not avoid international constraints on the financial system by introducing extensive regulations. Had the staff or the authorities any views on how the financial system could be made more competitive and innovative?

The Belgian authorities deserved commendation for their continued contributions to ODA, Mr. Romuáldez concluded. Like Mr. de Maulde, he hoped that their response to the challenges before them would include some simplification of the two-tier exchange rate system.

Mr. Salehkhou recalled that the real sector of the Belgian economy had benefited in 1984 from the economic consolidation carried out a year earlier in areas such as corporate profitability, private investment, and a decline in the Treasury deficit as a proportion of GNP. Industrial activity, helped by construction, had picked up considerable momentum. With the prevailing favorable climate of corporate profitability, overall activity was expected to show a further acceleration in 1985. A reduction in unemployment required further job-creating projects to be effected through new investments. Although private investment had responded well to the more favorable environment, public sector investment had not kept pace and was expected to remain weak throughout 1985 and 1986. The lackluster performance of public sector investment went in tandem with the financial position of the public sector, which had continued to weaken.

A seemingly unexpected development had been the decline in private productive investment, reflecting a contraction in domestic consumer demand and divergences between short-term and long-term interest rates, so that financial assets had become relatively more attractive than business ventures, Mr. Salehkhou noted. The diverse sectoral pattern of industrial investment could be attributed to a restructuring going on in Belgium, presumably away from primary metals toward automated technology. That development should be viewed in the light of a steady slide in industrial employment in Belgium, unlike other OECD countries, and also in the light of the Government's inclination for capital-intensive industries. What had been the factors influencing or dictating such changes?

The effects of wage indexation appeared to have been favorable in 1984, although the rate of inflation, which had declined slightly as a result of a deceleration of import prices, had still been higher than the OECD average, Mr. Salehkhou said. With the strong growth in productivity, unit labor costs had declined. The ongoing inflationary pressures, in the absence of external and wage considerations, were attributed mostly to a large increase in the profit margins of enterprises, which in turn had come about at the expense of wage earners and household income. Such an inflationary impact deriving from improved profitability, however, was not common to other OECD countries.

The authorities' restrictive stance since 1982 had resulted in stabilizing the fiscal deficit and setting a target for a gradual reduction in the public sector borrowing requirement, Mr. Salehkhou continued. In the 1985 draft budget, special measures had been envisaged to slow down noninterest expenditures, increase total receipts, and stabilize the Treasury's net financing requirement. Notwithstanding the goal of reducing the fiscal deficit to 7 percent of GNP by 1987, interest payments as a percentage of GNP were estimated to rise to 11.6 percent, on a Treasury debt slightly higher than total GNP. Under the planned adjustment, there would be a 2 percent annual reduction in government spending.

In recent years, Belgium's monetary policy had been geared to exchange rate considerations within the European Monetary System, Mr. Salehkhou noted. The authorities had correctly switched from a constrained stance to a more relaxed one with the 1983 realignment within the EMS and the improvement in the current account. Notwithstanding the gradual relaxation, domestic financial instruments remained attractive in terms of yield, vis-à-vis other European financial assets; the private sector's preference for domestic asset formation testified to the appropriateness of the policy under current circumstances. After some slippages in the 1983 monetary program, the Government had regained greater control in 1984 over the Treasury's recourse to central bank financing.

In the external sector, the current account of the balance of payments had shown continued improvement in 1983, owing to an increase in the financing capacity of households and an improvement in financial

balances in the corporate sector, Mr. Salehkhou recalled. International price and cost competitiveness had also improved, bringing gains in market shares.

The trend in trade policy in some industrial countries had been toward greater support of domestic industries, Mr. Salehkhou observed. Those countries belonging to economic unions had shown a tendency toward more protectionist policies as a result of the necessity to abide by group decisions. Notwithstanding Belgium's commitments to the EC and the economic union with Luxenbourg, the authorities should allow developing countries greater access to their markets and provide more rewarding trade opportunities. Finally, he welcomed their intention to increase official development assistance to 0.7 percent of GNP.

Mr. Vasudevan expressed general agreement with the staff appraisal. Belgium's competitiveness had improved in 1984, helped largely by the Government's policy of wage restraint. As practiced in Belgium, wage indexation had disallowed wage increases above recent cost of living increases and had also disallowed catch-up wages designed to compensate for a reduction in real terms over the previous two years. Wage restraint would have to continue in 1985 in order to preserve Belgium's competitiveness. What progress had been made in regard to legislation banning wage increases? Was it the only way in which wage restraint could be exercised?

Indications were that the unemployment rate would rise to over 15 percent in 1985, Mr. Vasudevan went on. To reduce that problem, the authorities should ease the existing rigidities in the labor market. However, unless economic activity picked up more substantially, it would be difficult to obtain a reduction in the rate of unemployment. How much of the unemployment rate was due to existing workhour and recruitment practices? As there had been some substitution of capital for labor, to what extent could unemployment be reduced over time if labor-absorbing production techniques were pursued without adversely affecting the related goals of maximizing output and profit?

For the past two years, the authorities had succeeded in reducing the fiscal deficit, Mr. Vasudevan noted. While commending them for the reduction, he was still concerned about the wide fiscal gap; the large share of the Government in GNP posed a structural problem. The authorities' first step in addressing it should be to reduce the fiscal deficit. Despite the planned program of action--entailing moderating income through index jumps, freezing public investment in real terms at the 1984 level, reducing operating expenses of the state, raising taxes and eliminating tax exemptions or privileges, and tightening social security entitlements--Treasury debt would grow from the already high figure of 95 percent of GNP in 1984 to 102 percent of GNP by 1987. The staff had worked out a scenario showing that, if any slippage should occur in the multiyear fiscal adjustment, the target for the fiscal deficit of 7 percent of GNP might be attained only in 1993. The present adjustment plan assumed an annual decline in real noninterest expenditure by the public sector of

over 2 percent in 1984-87, an extrapolation of the result attained in 1984. As the assumptions about foreign demand and interest rates implied in the authorities' program could well turn out to be less than accurate, and as revenue-sharing measures were supposed to account for over 40 percent of the total adjustment, restraint on expenditure would have to be much tighter than envisaged in order to achieve the desired fiscal deficit by 1987. Although for expenditure restraint in principle--perhaps through cutbacks in transfers and subsidies--he was not sure where the ax would fall and how deep the cuts should be. Could the staff elucidate?

So far, the main inducement to economic activity in Belgium had come from foreign demand rather than domestic demand, Mr. Vasudevan said. The authorities would have to find ways to promote a better balance between the two. The authorities' monetary stance in 1984 had contributed to the strengthening of the Belgian franc within the EMS, Mr. Vasudevan remarked: the short-term interest rate differential had been made more favorable to the Belgian franc, and the Treasury's recourse to central bank financing had diminished. Given the targets for external reserves and the constraint on central bank financing, the only practical way of meeting the financing requirements of the public sector would be to raise loans from the public through long-term bonds sold at attractive rates of interest. Such bonds would raise the costs of debt servicing to the Treasury but could also take some pressure off short-term interest rates and contribute to drawing in some of the long-term private capital that had been flowing out of the country. Some increase in long-term rates would hardly block a resumption of investment, for the policy of wage restraint had helped to push up corporate profitability and had led to some recovery of private investment in 1984. With price increases expected to moderate and restraint likely to continue, profits should rise, making possible a further pickup in investment.

The authorities were committed to maintaining official development assistance at 0.6 percent of GNP in 1984 and 1985 and that they planned to achieve a target of 0.7 percent of GNP in future, Mr. Vasudevan continued. They were to be commended for their commitment.

Despite the authorities' intention to reduce fiscal deficits and pursue wage restraint, the economic recovery in Belgium had yet to gather momentum, Mr. Vasudevan concluded. In 1985, the rate of growth was expected to fall to 1.4 percent; the inflation rate might decelerate but would still be higher than in Belgium's principal trading partners. Belgium's unemployment rate being the highest among industrial countries, the authorities could reverse it only by addressing structural issues in a more fundamental manner.

Mr. Alhaimus agreed that the upturn in the Belgian economy was encouraging, particularly the growth of industrial output, the rise in private investment, and the stabilization of private sector employment. Economic policymakers had to persevere in their attempts to deal with the still-high rate of unemployment, structural deficiencies in industries,

and the unsustainably large public sector deficit. He agreed with other speakers on the need to accelerate the speed of adjustment, notwithstanding the progress made in implementing the 1982 adjustment program. As Mr. de Groote had said, it was the authorities' intention to take further measures, particularly fiscal ones, to ensure that adjustment remained on track.

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

2. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. de Vries upon the completion of his service as Alternate Executive Director.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/3 (1/9/85) and EBM/85/4 (1/11/85).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/3 (1/8/85) and EBAP/85/4 (1/9/85) is approved.

APPROVED: October 23, 1985

LEO VAN HOUTVEN
Secretary