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Minutes of Executive Board Meeting 93/173

2:30 p.m, December 17, 1993

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
M.-A. Autheman	M. Sirat
	D. Desruelle, Temporary
J. Bergo	J. A. Solheim
J. de Groote	
	T. Oya, Temporary
K. P. Geethakrishnan	A. Raza
J. E. Ismael	
	W. C. Keller, Temporary
A. Kafka	J. C. Jaramillo
K. Kagalovsky	
G. Lanciotti	J. Papadakis
K. Lissakers	M. W. Ryan, Temporary
	P. A. Merino, Temporary
A. Mirakhor	
	B. S. Dlamini
	D. A. Barr, Temporary
G. A. Posthumus	O. Havrylyshyn
	N. Toé, Temporary
	E. Wagenhoefer
	T. K. Gaspard, Temporary
	K. J. Langdon, Temporary
E. L. Waterman	A. M. Tetangco, Jr.
	B. Wei
	Wu H., Temporary
A. G. Zoccali	A. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant
T. S. Walter, Assistant

Also Present

IBRD: J. D. Walters, Europe and Central Asia Regional Office. African Department: M. Touré, Counsellor and Director. Central Asia Department: M. A. Evans. European I Department: M. C. Deppler, Deputy Director; C. J. Bismut, M. Huybrechts, F. M. Lakwijk, P. R. Masson, S. Oberg, M. G. O'Callaghan. European II Department: J. Odling-Smee, Director; E. Brau, Deputy Director; G. Berengaut, T. Catsambas, E. Hernández-Catá, A. Ouanes, M. Shadman-Valavi. External Relations Department: P.-M. Falcone. Fiscal Affairs Department: P. J. Perone. Legal Department: H. Elizalde. Monetary and Exchange Affairs Department: G. R. Iden. Policy Development and Review Department: M. Allen, R. Moalla-Fetini. Research Department: J. Baras. Secretary's Department: A. Leipold, A. Mountford. Treasurer's Department: K. M. Kenney. Office of the Managing Director: R. G. Saunders, Personal Assistant. Advisors to Executive Directors: M. A. Ahmed, A. Chang Fong, A. Cserés, G. Y. Glazkov. Assistants to Executive Directors: R. N. A. Ally, S. Arifin, J. A. Costa, G. El-Masry, J. C. Estrella, R. Ferrillo, N. P. Hahnemann, O. Himani, G. H. Huisman, J. Mafararikwa, S. G. McDougall, F. Moss, C. F. Pillath, R. K. W. Powell, N. Prasad, S. Rouai, F. A. Sorokos, T. Sitorus, L. Tase, A. Viirg, R. von Kleist, S. Vori, Wang X.

1. BELGIUM - 1993 ARTICLE IV CONSULTATION

The Executive Directors resumed from their previous meeting (EBM/93/172, 12/17/93) their consideration of the staff report for the 1993 Article IV consultation with Belgium (SM/93/244, 11/18/93; and Sup. 1, 12/14/93). They also had before them a background paper on recent economic developments in Belgium (SM/93/253, 12/3/93).

Mr. Jaramillo made the following statement:

As the staff report for the 1993 Article IV consultation with Belgium emphasizes, the relatively high overall fiscal deficit, coupled with a very high ratio of debt to GDP, led markets to question the sustainability of the peg of the Belgian franc to the deutsche mark when the exchange rate mechanism (ERM) was put to the test last July. As Belgium has an extremely open economy, exchange rate fluctuations in Belgium could significantly affect both domestic economic activity and prices. Consequently, continued currency depreciation could have induced unwelcome inflationary pressures. Furthermore, as indexation was widespread, the chances that this could have led to a price-wage spiral were not irrelevant.

Faced with a deteriorating situation, the Belgian authorities acted promptly to induce a change of course. Market reaction to the measures adopted indicates that the rapid policy response--a Belgian tradition--was clearly successful in reversing a potentially destabilizing trend.

That success notwithstanding, Belgium's still high ratio of debt to GDP enhances the chances of speculative attacks on the currency peg. In order to reduce this ratio, the authorities took the already mentioned actions to confront the fiscal deficit, including with respect to social security. These measures, equivalent to almost 1.5 percent of GDP, are obviously important steps in the right direction, as they impose limits on the growth of health care expenditure and curtail family allowances above certain income levels--items that had been growing at a rapid pace.

Some of the recently adopted measures, however, also tend to increase taxes beyond their present high levels. Consequently, little room remains now for further revenue increases, because Belgian taxes are high vis-à-vis other European countries, and because existing tax rates may already be distorting resource allocation. This leaves expenditure reduction as the only feasible course for future fiscal restraint, if such action were required to achieve the general government deficit target of 3 percent of GDP by 1996. Transfers to households, which still comprise a very large portion of overall public expenditure, can probably become an important source of further expenditure curtailment, through a better targeting of recipients and by increasing local responsibility for social expenditure.

Under present circumstances, there is not much leeway in Belgium for monetary policy. Because in practice the wider ERM band does not give the Belgian authorities much room to maneuver, growth incentives must come from structural adjustment, particularly in the labor market.

Lack of flexibility in labor markets has been a severe problem in Belgium for some time now, probably more so than in other European countries. The "global plan" addresses some of these rigidities, by reducing--or even eliminating--employer's social security contributions for certain employees, thus increasing the demand for this type of labor. However, much remains to be done regarding the labor market, including confronting the indexation issue. A welcome step in this direction is the exclusion from the relevant price index of items such as indirect taxes.

Notwithstanding the above, it seems clear from the staff report, the statement by Mr. de Groote, and this morning's discussion, that indexation is not an issue of major concern for the Belgian authorities. Moreover, there seems to be a general consensus about the overall social benefits of maintaining indexation mechanisms in place. The fact is that, despite widespread indexation, inflation in Belgium has been kept at remarkably low levels. Consequently, one of the major drawbacks to indexation--the increased probability of persistent and increasing inflation--has not been felt in Belgium. This raises the question as to why and how. We would appreciate it if the staff or Mr. de Groote could elaborate on this point, which is of more than academic interest.

Mr. Toé made the following statement:

During the Board discussion on the 1992 Article IV consultation with Belgium in December 1992, Directors stressed the urgent need for the Belgian authorities to embark on a credible fiscal adjustment path, with emphasis on expenditure-reducing measures and the removal of fiscally induced distortions. The need to deepen the structural reforms in order to improve the functioning of the labor market was also highlighted. We are encouraged to note that the authorities have moved promptly and have taken a number of policy initiatives geared to containing the growing fiscal imbalance and enhancing the flexibility of the labor market. Unfortunately, notwithstanding the important measures implemented under these policy initiatives, the fiscal accounts and the employment situation deteriorated further in

1993. Therefore, it is all the more appropriate that the staff focused the policy discussions in Brussels on measures to reduce public sector indebtedness, promote labor market flexibility, and enhance policy credibility.

I am in broad agreement with the staff appraisal, and I can associate myself with most of the comments made by previous speakers on the actions that need to be taken at this juncture to reposition well the Belgian economy in the European Union (EU).

In the fiscal sector, the adoption in June 1992 of the convergence plan, which was endorsed by all three levels of government, boded well for a successful conclusion of the fiscal adjustment process that was initiated in the early 1980s. Indeed, the plan provided an appropriate framework and a credible underpinning to the authorities' resolve to reduce the budget deficit in order to meet the fiscal deficit criterion set out in the Maastricht Treaty and to bring down substantially the public debt ratio. Since then, several new fiscal packages and a revised convergence plan have been adopted; yet, the fiscal objectives seem as elusive as ever. Admittedly, the pronounced cyclical downturn prevailing throughout Europe has been instrumental in the deterioration of the public finances; but the inability to rein in noninterest expenditures, in particular those related to the social security system, has played a critical role. Of course, this observation does not detract from the authorities' track record and the resolute manner in which they are addressing Belgium's fiscal predicament, and we certainly agree with Mr. de Groote that "the determined efforts of the present Government have enabled Belgium to emerge from the crisis with a better medium-term outlook than it would have had if no crisis had occurred."

As stressed during previous discussions on Belgium, the importance of adopting a fiscal strategy that puts greater emphasis on expenditure reduction cannot be overemphasized. We therefore welcome the adoption in late November 1993 of the global plan and its focus on achieving savings in social security expenditure. That financial markets reacted positively to the plan, as evidenced by the appreciation of the Belgian franc and the subsequent reduction in short-term interest rates following its announcement, is reassuring. However, the Governor of the National Bank's suggestion, soon after the global plan's adoption, that some slippage might be expected in the convergence plan's timetable--even though perhaps realistic and in line with the staff's own projections--raises some concerns, and heightens the need for strict adherence to the global plan.

A more active involvement of the Regions and Communities in the fiscal adjustment effort would also strengthen the prospects for the successful conclusion of the fiscal adjustment process. In this connection, it is encouraging to know from Mr. de Groote's statement that the Central Government has begun negotiations with the regional authorities toward this end. As a minimum, the Regions and Communities should strive to observe the deficit norms contained in the June 1993 report of the Conseil Supérieur des Finances. As their revenue stream is unaffected by the economic recession, we wonder whether a more ambitious contribution from them to the fiscal adjustment process is not warranted. Staff comments on this would be appreciated.

The staff report indicates that an assessment of the fiscal situation is being hampered by the increased reliance on debudgetizing some government operations. We would be interested in hearing from the staff or Mr. de Groote the rationale for the debudgetization process.

Much had already been said about the functioning of the labor market, and it is encouraging to note that the Belgian authorities have recognized the structural nature of the unemployment problem and are taking measures to address it, accordingly. The policy initiatives introduced in the 1992 and 1993 budgets are important first steps that need to be strengthened and complemented by further measures that give incentives for the unemployed to seek work and employers to create jobs. Here also, the Regions and Communities could shoulder more responsibility. Perhaps the staff could give a preliminary assessment of the likely impact of the recently approved White Paper on growth, competitiveness, and employment proposed by EC Commission President Delors on the employment prospects in Europe in general, and in Belgium in particular. Mr. de Groote informs us that his authorities had some inputs to the paper, so it would be interesting to know how the policies recommended interact with one another.

It is regrettable that Belgium's net official development assistance continued to decline in 1992, to just over one half of the UN target ratio of 0.7 percent of GNP. While it is understandable that special circumstances may have hampered Belgium's official development assistance performance in 1992-93, it is to be hoped that the authorities will stand ready to step up external assistance when the situation normalizes. However, I would emphasize that Belgium's strong support for the ESAF successor and its position on the issue of SDR allocations are clear indications of Belgium's commitment to global international cooperation, which is well appreciated by this constituency.

Mr. Mirakhor made the following statement:

We agree with Mr. de Groote that the enactment of the global plan has changed considerably the outlook for 1994 and beyond.

The authorities deserve to be commended for the vision and courage demonstrated in taking prompt and resolute action to re-establish confidence and place the economy firmly on a more sustainable path, while seeking to alleviate the imbalances in the structural area.

As Mr. Papadakis rightly notes, given Belgium's long tradition of consensus building, one is confident that all parties will agree that the plan provides a solid framework for restoring macroeconomic stability, strengthening the economy's competitive position, and enhancing employment and income opportunities. Questions as to whether or not the plan goes far enough should not detract from the fact that the authorities have clearly made an excellent start. Subsequent growth and interest rate outcomes may well call for additional efforts, and we welcome the authorities' intention to take whatever additional actions might be warranted by evolving circumstances.

The staff analysis in the background paper on recent economic developments and the Working Paper by Ioannis Halikias on the credibility of Belgium's exchange rate policy have spelled out the extent and depth of structural problems existing in the labor market. Policy recommendations to deal with these problems have concentrated on compensation and benefit measures. However, more attention needs to be paid to measures that would aim at enhancing the human capital content of the labor supply. It appears that this element is far more important in the Belgian economy than in other European economies with comparable labor market rigidities, not only because of its effect on growth, but also because of its importance to competitiveness.

While productivity gains have exceeded production growth for many years, as Mr. Kaeser points out, recent studies have shown that Belgium's comparative advantage is negatively correlated with human capital intensity. That is, Belgium has a comparative advantage in human capital-intensive goods when trading with developing countries, and a comparative disadvantage when trading with other EC countries having a more developed human capital base. If this conclusion is valid--and here I would appreciate staff comments--it has implications for competitiveness and for the trade pattern of Belgium. It would appear that, in addition to having a correct exchange rate policy, it may be useful to encourage trade expansion with non-EC areas. Additionally, as Belgium reinforces its fiscal consolidation efforts under the new policy regime, more room for maneuver should become available for greater emphasis on essential outlays in education and manpower training, which would enhance the human capital content of the labor supply.

The past two years have witnessed a precipitous decline in enterprise investment, of a cumulative 11 percent. As public expenditures are forecast to decline, measures may be needed to crowd in private investment in order to mitigate the demand-depressing effects of a declining fiscal deficit.

Mr. Solheim made the following statement:

I am in broad agreement with the staff appraisal, and I share most of the views expressed in the statements and by previous speakers.

The staff report clearly paints a picture of an economy affected by what may increasingly be characterized as the European *disease--serious fiscal imbalances, excessive public debt*, sluggish economic growth, and high and rising unemployment. What aggravates the situation in Belgium relative to elsewhere in Europe is the excessively high ratio of government debt to GDP. In fact, Belgium is an illustrative example of the adverse long-term consequences of building up excessive amounts of public debt.

I concur with the staff that the Belgian authorities should adhere to their goal of exchange rate stabilization around the deutsche mark parity. This is likely to be the best approach to achieving a lower interest rate level. For the sake of illustration, allow me to compare Belgium with Denmark, which has many similarities with Belgium, although fewer than is indicated by Mr. Autheman. While Belgium had a more narrow long-term interest rate spread than did Denmark vis-à-vis Germany before the recent currency unrest, the spread on the long-term interest rate--at over 90 basis points--is now more than two times the spread of Denmark. Also, the short-term spread for Denmark vis-à-vis Germany is now down to about 80 basis points, while Belgium's short-term interest rate differential seems to have widened sharply, to between 100 and 200 basis points. Even though the Government's recent global plan has been well received in financial markets, the continued high interest rate spreads point to the need for even further tightening of the budget deficit if public debt is to be reduced in such a convincing fashion that credibility will be restored.

The message of the staff report is in this respect clear and concise, and I broadly concur with staff's analysis and recommendations. The substantial fiscal measures taken in 1992-93 are commendable, but the heavy concentration on revenue-increasing measures is of concern. More emphasis on the expenditure side of the budget is warranted. Furthermore, the social security imbalance must be addressed, and the fiscal consequences of devolution need to be assessed, with the objective of including regional and local authorities more in fiscal consolidation efforts. The rise in public sector wages in 1993 is also of concern. It contributes to the deterioration in public finances, and should have been offset by fiscal measures.

With respect to structural and labor market policies, I accept that the authorities' approach of reaching an understanding with the social partners may be the best solution, given the specific historic features of the Belgian economy. However, this entails major risks with regard to both the speed and the thoroughness of the reforms, and it is essential that the goals set not be compromised away. It appears evident that a wide range of structural reforms and labor market measures will constitute prerequisites for stronger future economic development. All in all, and I am afraid that this may not be very reassuring, I see *many similarities with the problems of the Nordic countries.*

If some more narrow or stronger ERM is to be re-established and further progress is to be achieved toward European monetary union, stronger convergence efforts are called for from all EU member countries. In Belgium's case, substantial fiscal consolidation and structural adjustment in the labor market are the crucial ingredients in such a process. The authorities' announced global plan for employment, competitiveness, and social security is clearly a step in the right direction, and deserves our full support. However, whether this initiative will go far enough is an open question.

Mr. Gaspard made the following statement:

As all previous speakers and the staff have unequivocally noted, there is no doubt that the high and rising unemployment rate and the related fiscal deficit are the most serious problems that presently afflict the Belgian economy. They require quick and substantial remedial measures, which the staff is right in calling for--in particular, the need to curtail social security spending. The recent announcement by the authorities of a global plan, which aims at a reduction of wage costs and the fiscal deficit, is clearly welcome. However, I am not sure whether growth would benefit from the planned tax increases, given the expectation of a resumption of growth owing in part to an increase in consumer spending, and given the fact that Belgium is already a very highly taxed economy.

Despite negative growth in 1993, a growth rate of 1 percent is projected for 1994, to be led by stronger exports and firmer consumer spending. The recovery is to be underpinned by a monetary policy geared to maintaining a strong currency. However, this policy option may be inimical to the projected growth for next year. In fact, the relatively high interest rates that usually accompany such a strong franc policy can only add to the already heavy interest burden of the budget, and will hardly be conducive to an increase in consumer spending or investment. Indeed, a phenomenon of accelerating disinvestment, which has been taking place since 1991, is a worrisome development. Such rapid disinvestment appears to be prompted by a continuing fall in companies' profit margins and in the rate of industrial capacity utilization. Thus, a strong franc policy is not necessarily compatible with a rebound in private spending. Rather, the authorities are in a good position to relax their interest rate policy, given the margin of maneuver that is now afforded by the wider ERM band and, more important, by Belgium's successful external and inflation performance.

Belgium faces serious structural employment and fiscal problems, and especially a very low labor participation rate, but the economy is otherwise performing quite well. It is a very open economy, and all the major external account balances continue to be in surplus. The level of foreign reserves remains comfortable. More interestingly--and this is perhaps a curiosity or another paradox--the general government deficit, in terms of GDP, has systematically exceeded the average deficit for the EC countries in the last ten years. Yet the Belgian inflation rate has, equally systematically, been smaller than the average rate for the EC countries during the same period, and even the unemployment rate has become smaller since 1988. Mr. Jaramillo has already alluded to this phenomenon. This shows that the time is now opportune for Belgium to undertake a sustained structural adjustment process that the economy can accommodate relatively less painfully than could the economies of other European countries.

I wish the authorities well in the implementation of their global plan, and I thank the staff for its informative report. In this respect, I wonder why such detailed documents, which include all possible information on indices and rates, do not contain any information on the simple nominal exchange rate of the Belgian franc.

Mr. Waterman made the following statement:

After spending some time grappling with what was going on in Belgium, I was rather reassured today to learn from Mr. Autheman that the Belgian situation is indeed paradoxical; nevertheless, perhaps the situation is clearer to the existential mind than to the Anglo-Saxon mind.

I agree with the comments of other speakers on the fiscal situation, which is, indeed, very clear. While it is not everything, removing uncertainty about the budgetary situation and about how the budget deficit will be reduced will be important in its general impact on confidence, and in particular, its impact in narrowing the long-term interest rate differential between Belgium and other European countries. The global plan seems to be an important step in that direction, as sustainable short- and long-term interest rates are important in getting private investment to grow again in Belgium following the recent period of weakness.

On the positive side, the current account position suggests that domestic savings have been maintained relatively well during the recession, and company profitability also seems to be reasonably high compared with the rest of Europe.

An increase in private sector demand--both consumption and investment--is clearly needed to get the economy moving, and that should come in time with improved policy settings. As the staff papers and other comments have drawn out, while growth will be important, other structural and institutional changes are clearly needed in Belgium if there is going to be a sizable reduction in long-term unemployment. Other speakers have already dwelt at length on the need for greater flexibility in the labor market and reform of the system of wage indexation. I know from the Australian experience that wage indexation can bring benefits in terms of greater union cooperation and reduced industrial disputes, but it also has its costs, which need to be borne in mind by the authorities.

As in many countries, the position of the long-term unemployed is an important economic and social issue, but it is not one that is easily dealt with. The staff analysis draws out very usefully the importance of policy changes to encourage the long-term unemployed to become more active in seeking work; and also the importance of assisting them, through retraining and education, to re-enter the work force. It is clearly important to retrain people who have been out of the work force for a long time and to give them the experience of working again, but a balance has to be struck between that and getting people themselves to do more, by seeking work more actively. With regard to the latter, the generous unemployment arrangements in Belgium obviously warrant further review, and, as the staff suggests, they could be improved in a number of ways.

Victory may have many fathers, but I think that Mr. de Groote is a little premature in claiming it in the case of Belgium. The global plan may have been the act of consummation, but the unborn child will still require much nurturing and care to ensure the right outcome.

Mr. Al-Jasser made the following statement:

At the time of the last Article IV consultation with Belgium, the authorities had been successful in maintaining a low rate of inflation, and the outlook for the implementation of new structural measures and the reduction of the high debt ratio was promising. Unfortunately, this year's staff report paints a rather bleak picture of the performance of, and the outlook for, the Belgian economy. GDP is expected to record a decline of 1.7 percent in 1993, unemployment has increased to 9.5 percent, while public debt rose to an alarming 145.5 percent of GDP. In the meantime, expenditures are not showing signs of moderation or decline.

The challenge is therefore great, in particular as the authorities have very little room for maneuver. Moreover, the authorities cannot afford any slippages, especially because the loss of credibility in the case of Belgium carries an unusually high cost: every percentage point increase in the cost of borrowing translates into a rise in the fiscal deficit equivalent to 1.4 percent of GDP. Clearly, the problem facing the authorities is twofold: reducing the debt/GDP ratio while paving the way for sustained growth.

The performance of the economy over the past year cannot be due entirely to policy slippages. External circumstances--namely, the recession in Europe and the crisis in the European Monetary System (EMS)--are also to blame. To their credit, the authorities reacted promptly to these circumstances, and, as Mr. de Groote points out in his statement, Belgium is one of the few countries of the EU that did not allow its fiscal deficit to deteriorate significantly in 1993. Nevertheless, it is regrettable that this performance was achieved mainly through further revenue measures, rather than spending cuts. With revenues at 48.4 percent of GDP, any rise in taxation risks launching a vicious circle of slower growth and higher deficits.

Given the dramatic level of national debt, the 1989 Special Financing Law seems to complicate, rather than assist, the consolidation of public finances. There appears to be much room for the Regions to shoulder a heavier burden of the adjustment process. Most expenditure decisions are no longer made at the Federal level. Transfers to the Regions are independent of the business cycle, and are based on complex formulas that seem incongruous with the objective of debt reduction. Thus, the incentives are perverse: while the Regions and Communities are not responsible for revenue generation, the regional authorities receive an effectively predetermined amount to spend, thereby placing a low level of restraint on spending.

From the staff report, the only exception appears to be in the area of industrial policy, where the Regions have shown expenditure restraint. Indeed, sectoral subsidies have almost disappeared, and subsidies to private enterprises have become more selective.

By pointing out the problems relating to the Regions, I do not wish to appear as underestimating the need for measures by the federal authorities. In particular, the social transfer system, which consumes more than half of all noninterest expenditures, is in dire need of reform.

Table 10 of the background paper on recent economic developments shows that Belgium is the only OECD country in which unemployment benefits are of unlimited duration. To their credit, the authorities have made some progress in removing some beneficiaries from eligibility, but this process is legally complex. Belgian workers also enjoy "career interruption" benefits, under which, after approval, no unemployment registration is required, while benefits are received over a fixed period of time. What is also apparent from the nature of this system is that the authorities need to make the separation between unemployment compensation and income maintenance much more transparent.

The generous pension schemes are another expenditure item that the Government can ill afford. Pension benefits are not simply indexed to inflation, but are actually increasing in real terms over time. Given the recent 4.5 percent wage increase by the public sector, and the planned increase next year, public sector wage increases are certainly much more costly than they may initially appear.

An additional complicating factor is the fact that the social safety net in Belgium is not centrally administered, but has evolved, over time, from a number of ad hoc schemes. Accountability and control under such circumstances is very difficult. Another difficulty is the fact that the social partners, in part, determine social benefits. Again, the same theme seems to emerge: the Government raises revenue but is not in full control of expenditures, while those responsible for expenditures are not responsible for revenue generation.

That being said, I welcome the recently agreed measures described in the supplement to the staff paper and Mr. de Groote's statement. These are indeed steps in the right direction. Unfortunately, the immediate impact of this new package will include higher revenues. I am also concerned that, as the staff points out, many detailed measures to cut spending will still have to be worked out. Therefore, the importance of adhering to these targets cannot be overemphasized.

It is my hope that the authorities will be able to take the necessary measures in time to reap the benefits of the recovery in Europe.

Mr. Dlamini made the following statement:

It seems that economic performance in Belgium during 1993 faced a deteriorating trend in many respects. The growth of real GDP was affected by a deepening recession, inducing a decline in aggregate output of 1.7 percent, and a further worsening of the fiscal deficit. Also, the unemployment rate--already high compared with the rates prevailing in other countries of the region--continues to be a matter of major concern. However, it is heartening to learn from Mr. de Groote's statement that the decisive actions prompted by the crisis and considered by the Belgian authorities toward the end of the year are bearing some positive results. In particular, the reduction in short- and long-term interest rates is a development worth re-emphasizing, and bodes well for the reduction of the debt burden and for improving the prospects of growth.

Also encouraging is the fact that the authorities have finally decided to undertake the required measures to address the structural problems in the fiscal area and in the labor market that had been hindering the process of adjustment. In addition to measures proposed by the authorities to boost revenues and lower wage costs, particularly noteworthy is the emphasis placed by the authorities on returning the social security system to financial balance, mainly by curbing spending. While such actions may be considered most encouraging, and a step in the right direction for the achievement of the convergence plan target of a fiscal deficit of 3 percent of GDP by 1996, we fully endorse the staff's views that further efforts will be required to secure such a goal, especially in view of the excessively high ratio of public debt to GDP. What is questionable is whether the political and social acceptance needed to carry out such a plan has been secured. We would welcome some comments in this regard.

The fact that the authorities are proposing to consider further measures to reduce the existing distortions in the labor market, in addition to the ongoing actions of retraining and job creating programs for youth, is welcome progress. However, the adoption of a labor market policy that could address decisively the structural problems of the labor market is of paramount importance for the success of the fiscal adjustment effort that is under way, and it should be seriously considered by the authorities.

The commitment shown by the Belgian authorities to an early conclusion of the Uruguay Round of multilateral trade negotiations was commendable, and we believe that it must have contributed greatly to bringing the negotiations finally to a successful conclusion.

We note with regret the declining trend over the past years in Belgium's net official development assistance. It is our hope that, as soon as the circumstances allow it, Belgium will be able to increase its share of contributions toward the attainment of the official development assistance target of 0.7 percent of GDP set by the United Nations.

Mr. Merino made the following statement:

On the occasion of Belgium's last Article IV consultation, we highlighted the vulnerability of Belgium's fiscal position to a lower growth rate and higher interest rates. Since then, the Belgian economy has gone through very difficult times. The decline in the growth rate in 1993 has brought to the surface Belgium's difficult fiscal position. The problems have been exacerbated by market participants' increased doubts about fiscal sustainability, which have led to higher interest rates and the depreciation of the Belgian franc. Unfortunately, things often have to get worse before they get better, and this is probably what has been happening in Belgium this year.

The Government's successive efforts to reduce the deficit were overshadowed by the magnitude of the cyclical downturn, and the solid position that the Belgian franc had achieved was eroded during the last ERM crisis in July 1993 that led to the widening of the ERM bands. In the midst of this situation, the Government's gradualist medium-term strategy gained momentum toward fiscal consolidation. The authorities' determination to pursue fiscal adjustment, and their political will to implement it, was clearly evident in the approval of the global plan for employment, competitiveness, and social security by both houses of Parliament in November 1993. The global plan will complement the other important fiscal measures taken over the last year and a half, which were equivalent to about 3 percent of GDP and which will allow for the elimination of the social security deficit in 1994. The announcement of this plan has been well received by the financial markets. Since then, the Belgian franc has returned to well within its former narrow margins, and the National Bank of Belgium has been able to lower official interest rates on several occasions.

Despite the change in the broad picture of Belgium's fiscal situation, we should not forget that only with the full implementation of the fiscal measures announced, and with a strong economic recovery, will the target of a general government deficit of 3 percent of GDP by 1996 be achieved. However, we remain confident that the Government will react promptly if additional efforts are needed. We agree with the authorities and the staff about the need for a bigger contribution to the fiscal adjustment effort by the Regions and Communities, in the framework of a new federal structure.

With respect to the sensitivity of fiscal scenarios to interest rate developments, the threshold of short-term debt to long-term debt can change over time, bringing about savings in interest payments, on the one hand. On the other hand, interest payments on long-term bonds are highly dependent on the nominal coupon interest rate on the bonds at the time they were issued. Consequently, the interest rate on long-term bonds is not necessarily closely related to the present level of long-term interest rates. Therefore, it might be asked whether the conversion of old long-term bonds into new bonds, or other measures to the same effect--such as the early repurchase of old debt--could accelerate the reduction of the public deficit so that it could be eliminated by 1996. For example, between 1990 and 1992, about BF 2000 billion--more than 20 percent of gross public debt in 1992, and roughly 28 percent of GDP--was financed in the long end of the market, at an average interest rate of 9.5 percent. At present, bond yields are about 7 percent. I would welcome staff views on the possibility of changing the average maturity structure of the debt, and of converting old bonds into new ones without modifying the average maturity structure of the debt.

With regard to structural policies, the figure of 4 percent of GDP as labor market expenditures seems to be of great concern. Therefore, efforts should continue to reduce long-term unemployment. We know that the authorities are aware of that and are beginning to achieve results, as in the case of the part-time unemployed.

The changes implied in the labor market reform to tackle the fiscal cost of unemployment and the "insider-outsider" behavior of the Belgian labor market deserve our highest commendation. For the first time in 12 years, Belgium will lower the number of part-time unemployed persons who receive unemployment benefits. Moreover, the global plan will complement the measures already taken through a selective reduction of employers' social security contributions, which will promote employment creation.

We congratulate the authorities for their determination in tackling the problems they are facing, and we are happy to see, as Mr. de Groote's statement highlights, that "the crisis earlier in this year seems to have had salutary effects," and has enabled

Belgium to emerge from the crisis with a better medium-term outlook.

The staff representative from the European I Department stated that wage indexation in the Belgian context had not led to accelerating inflation, which was usually feared as a primary disadvantage of indexation, because of the firm exchange rate anchor. The stability of the anchor for policy had meant that indexation, per se, had not caused an upsurge and continuing acceleration of inflation. That consideration made it very important that the nominal anchor, through the exchange rate, be maintained.

Some of the measures that Belgium had been trying to accomplish had in fact appeared as objectives in the White Paper of the EC President, Jacques Delors, the staff representative confirmed. It would be premature to try to quantify the effect of those measures, however, because of the uncertainty surrounding the extent to which the measures would ultimately be put into practice.

It appeared, as Mr. Mirakhor had noted, that Belgium had a comparative advantage in knowledge-based industries, and the authorities' interest in developing those industries was clear, the staff representative noted. The objectives of enhancing the educational system and vocational training had been formulated with that interest in mind.

The performance of Belgium over the preceding decade or so had been very good, despite the large fiscal deficit, including a structural deficit of the general government, the staff representative continued. The seriousness of the problem was rooted in the early 1980s, when the general government deficit was very high and the debt ratio had begun to expand. Stabilizing and then reducing the debt ratio was a long and slow process. At the same time, the fiscal measures the authorities had implemented continuously since then had had an important impact, which had been seen in particular in increases in the primary surplus. Despite some slippages in the late 1980s, fiscal policy in Belgium had been on the right track since about 1983. That was not to say, of course, that more did not need to be done.

Regarding the restructuring of the public debt, it needed to be borne in mind that debt-management operations had been going on in Belgium for some time, with the conversion of long-term debt into new bonds at more favorable interest rates, the staff representative from the European I Department concluded. Whether or not replacing long-term debt with short-term debt could be considered to have favorable effects on the debt-service burden would depend on expectations about the evolution of interest rates fairly far into the future.

Mr. de Groote stated that the discussion had focused mainly on two topics, employment and fiscal problems. With respect to unemployment, the measures proposed in the global plan to fight unemployment represented a clear response to a historic situation. Indeed, the measures in that plan appeared to have been drawn almost directly from the staff's analysis of unemployment in Belgium contained in Annex I of the background paper on recent economic developments.

The main characteristics of the labor market situation in Belgium were presented in that analysis, Mr. de Groote commented. The unemployed did not influence the labor market because they did not represent an effective labor supply, so there was no downward flexibility in wages. The employed tried to ensure that they received wage increases, which employers could only grant if there was a productivity counterpart. Wage increases for the insiders were more likely to lead to labor shedding. Indexation and a multitier system of wage bargaining maintained the bias in favor of wage increases above productivity, affecting in particular unskilled laborers, who were not likely to be able to meet the increases in productivity that were required. Unskilled laborers were hurt even more as they lost the capacity to re-enter the labor market through the atrophying of what skills they had, which tended to become worthless rapidly in the absence of additional training.

Measures envisaged by the global plan tried to respond specifically to those problems by focusing on training, improving the supply conditions of labor, and acting on the demand for labor by reducing employers' social security contributions, especially for low-wage earners and young people, Mr. de Groote continued. The reduction of social security contributions for nonskilled workers would be particularly important, as at present, social security contributions could amount to about 10 percent of the employer's total wage bill. Labor retraining would improve the flexibility of the labor market and have positive implications for the public finances.

In reducing the social security contributions payable by employers for their employees, taxation was being shifted away from labor toward capital, through an increase in the withholding tax and in indirect taxes, such as excise taxes and the value-added tax, Mr. de Groote pointed out. While those structural measures were insufficient, they were part of what would be a long process of adjustment.

He had been particularly interested by Mr. Peretz's suggestions regarding ways to make labor markets more flexible and internationally competitive, Mr. de Groote noted. The Belgian authorities could endorse them all, and he was certain that some of them would be implemented before the next Article IV consultation with Belgium.

A few speakers had drawn attention to the fact that Belgium was the only country with unlimited unemployment compensation, Mr. de Groote recalled. Indeed, the Government-induced monster of complexity and inefficiency had to be tamed. The monster was aimed at protecting jobs and providing income support, but it had also increased the social division between the employed and the unemployed, and it had succeeded in reducing employment. The authorities were giving great priority to that issue. The measures in the global plan to tame that monster represented a first step toward the implementation of the objectives in the White Paper that had been adopted several days previously, and which responded so clearly to a growing awareness of the determinants of unemployment, as evidenced also by President Clinton's call for a special job summit for the Group of Seven industrial countries.

The priority given in economic policies to labor required, in Belgium and elsewhere, a profound change in the cultural attitudes of social partners and in policy options, Mr. de Groote emphasized. The reorientation of the burden of taxation toward increased taxation of capital, and toward a large share of indirect taxes in total tax increases, would have to be accepted. Seen from that perspective, the recent increase in real public sector wages was difficult to reconcile with the fledgling culture of wage flexibility. The global plan was not a collection of stopgap measures on labor; rather, the plan had a strong analytical basis, resting on a coherent approach to both the supply and the demand side of the issue. It would introduce many innovative changes in the fiscal treatment of labor. However, success would be easier if the other EC countries adopted similar measures--as was expected.

Belgium had a low ratio of capital investment in labor, much lower than many other countries, and therefore it would have a greater advantage in exporting more to non-EC countries than to EC countries, Mr. de Groote remarked. In that connection, it needed to be recognized that the Regions and Communities had particular responsibility for training activities.

With regard to fiscal policy and the question of whether or not the convergence plans for 1996 could be regarded as achievable by Belgium, the process of fiscal rehabilitation in Belgium had not proceeded with uniform vigor in a linear way since its inception in 1982, Mr. de Groote acknowledged. In 1982, the deficit had been equivalent to 16 percent of GDP, when the debt of parastatal organizations was taken into account. During the last year of the growth phase, fiscal revenue had not increased as much as could have been expected, and the reduction of expenditures had not been as decisive as initially decided. At present, the disappointing outcome for 1993 did not so much reflect policy weaknesses as a misjudgment as to the results of supply-oriented budget policies. The policy of growing out of debt by reducing taxes had not succeeded, as tax revenue had shown an unexpected less-than-unitary elasticity to income. The situation was now being taken firmly in hand by the present Government. Frequent readjustments of the policy base had been made in the course of the budgetary year in reaction to the exogenous slippages from the targets, owing, for example, to higher interest rates and the cyclical downturn in Western Europe. Those adjustments, although they implied some increase in taxation, had not restored government revenue to its previous level in terms of GDP--it was currently at 48 percent of GDP, while it had been over 50 percent of GDP in the early 1980s.

As soon as the deficit of the social security system had begun to snowball, the Government had reacted quickly by introducing a balanced set of corrective measures, sharing equitably the burden between spending reductions and revenue increases, Mr de Groote went on. Of course, the Government's room for maneuver was rather limited. The limits to direct tax increases seemed to have been reached, and he shared Mr. Autheman's view that the increase in the withholding tax had been excessive. Of course, indirect taxes had their limits as well in the European context. Privatization could be regarded no longer as an important source of additional income. Perverse effects could be expected with regard to the social security system if labor were to be taxed more heavily than it was at present. The Government's room for maneuver therefore hinged on the structural reform of social security in the framework of a multiyear budget, and on the contribution of the Regions and Communities to fiscal rehabilitation, which would take place by adjusting the transfer mechanism from the federal government. At present, that transfer was totally disconnected from business cycle conditions.

The achievement of the Maastricht convergence requirements, although requiring a number of measures that were in place, would depend heavily on the intensity of the recovery in Western Europe, Mr. de Groote commented. Under the most likely scenario, the divergence from the Maastricht convergence norms might not be greater than a fraction of 1 percent.

The large deficit in the public finances did not have a more pronounced influence on price stability because of the improvement in the public finances that had been characteristic since 1982, Mr. de Groote said. The Government simply carried over the burden from the slippages of previous periods. Moreover, the debt caused no balance of payments constraint and no inflation constraint, as the Government borrowed the totality of the debt-financing requirement domestically from households, which were always ready to lend to it. As the debt was not monetized, it had no inflationary impact. In the absence of Belgian Government debt instruments, Belgian households would simply purchase bonds from neighboring countries; it was not a matter of imposing a debt burden on the public. The real issue was the ability of the Government to find good arguments to show that, in spite of the immediate constraints on doing so, there were extremely strong reasons for reducing the deficit and the debt burden overall, as the debt burden reduced the share of total income that could be used for other purposes, in particular for public investment, which was extremely low.

A number of his colleagues had described the level of the public debt in Belgium as extraordinarily high, and some had indicated that Belgium had the highest level of debt in the industrial world, Mr. de Groote recalled. However, in looking at the debt figures, the debt of public enterprises was generally netted out: as in other countries, enterprises generally borrowed directly from the market. In the EC under the Maastricht norms, such a netting out was regarded as legitimate, because the counterpart of the debt was considered to be assets that grew in value over time. In Belgium, however, because borrowing for the public enterprises had always been done by the Government, public enterprise debt was not excluded from the total public debt. Accordingly, if public enterprise debt were excluded from the total public debt in Belgium, as it was in other EC countries, the debt ratio would fall to 125 percent of GDP from 150 percent of GDP. Moreover, the standard EC procedure for calculating the debt ratio did not take into account future liabilities of the Government. If they were taken into account, Belgium would be seen to be in the middle of the range, not the top, as the unfunded liabilities of the pension system were much smaller than the net debt in Belgium, while they were much larger than the net debt in all the other EC countries. That was explained by demographic factors, as the Belgian population overall had begun to age earlier than the populations of other EC countries, and in consequence the pension system had reached a stable situation earlier as well. Additional measures in the social pact, such as methods for computing the level of pensions and pension schemes for the public sector, would introduce further corrections in the public debt stock. Thus, when the correct methodological concepts were applied, Belgium could be seen as only a moderately indebted country.

The indexation system did indeed represent a number of paradoxes, as Mr. Autheman had suggested, Mr. de Groote agreed. That notwithstanding, it could be said that the system had a more moderate impact at present than it had had in the past, especially as a number of items on which taxes and duties had been increased had been removed from it. Also, a longer time period would be required before the indexation mechanism would be triggered. In the immediate future, there was no probability that the system would be abolished completely, as it had helped to preserve a social consensus. The negotiations between the social partners and the Government on the measures needed to implement the global plan had begun on that day, in particular, concerning the measures that remained to be taken by the social partners in respect of family allowances and health care. Those negotiations would not have been possible if the agents concerned had been living in a climate of tension.

Belgian official development assistance had been greatly influenced in the past by the country's special relations with a number of African countries, Mr. de Groote pointed out, and the political situation in those countries currently did not allow the authorities to continue with the same high level of assistance as before. However, the authorities were trying progressively to compensate for that by rechanneling part of their assistance to multilateral institutions.

He would transmit to the authorities his colleagues' recommendation that they should exercise the greatest vigilance over the implementation of the global plan, and that additional measures would probably have to be taken soon to achieve the Maastricht targets, Mr. de Groote concluded. The reform of the public finances and of labor market conditions had not come to an end. Belgium wished to meet the 1996 Maastricht convergence deadline, without creating obstacles to its competitiveness. It was always a difficult balance between consensus and leadership, and perhaps in the past, Belgium had leaned too far in the direction of searching for consensus. At the current juncture, however, it seemed that the country was leaning in the direction of stronger leadership, with a Prime Minister who did not fear to be unpopular; a Chairman of the Interim Committee, who held courageous opinions about the budget, in particular; and the Governor of the National Bank of Belgium, who exercised constant vigilance over the currency and the price level. He wished to express special gratitude to the Fund staff. There was probably no other industrial country in which the Fund had played such a decisive role at crucial moments of its economic policy decisions. Over the past 20 years, the Fund staff had influenced the country at three crucial junctures: the first in 1982, when the program that proposed the temporary suspension of indexation, an important reduction in real income, and a devaluation of the currency, had been put forward with the help of the staff, and been accepted; second, when the staff had convinced the Government and the central bank to adopt the anchor system for the Belgian franc; and finally, at present, as the staff assisted the Government to adopt measures for the rehabilitation of the social security system and the public finances.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. The recession in Europe and the crisis in the European Monetary System had highlighted the structural weaknesses of the Belgian economy related to both the fiscal situation and labor market inflexibility. These weaknesses had exposed the Belgian franc to downward pressures following the widening of the exchange rate mechanism bands. In the view of Directors, these circumstances made it even more urgent to undertake decisive fiscal adjustment, as well as structural policy initiatives. Directors recalled with approval Belgium's track record of steady adjustment over a number of years and the resolute emphasis on the economic fundamentals in the latest policy decisions. Directors welcomed the authorities' prompt response in the form of the recently announced global plan aimed at eliminating the social security deficit, improving competitiveness, and stimulating employment. They encouraged the authorities to define rapidly the details of the plan and proceed with their early implementation.

Directors noted that since the announcement of the measures, policy credibility had improved greatly, as evidenced by the strengthening of the Belgian franc against the deutsche mark, even in the context of sharp reductions of official interest rates. Long-term interest rates had also declined significantly. Directors viewed lower interest rates as especially important given the cost of servicing the large government debt, and in order to stimulate investment. Noting the high degree of openness of the Belgian economy, the rapid transmission of exchange rate changes into domestic costs, and the objective of European integration, Directors supported the authorities' emphasis on exchange rate stability with neighboring countries as an important component--along with strong fiscal measures--of their firm anti-inflationary policy.

Regarding the medium-term stance of fiscal policy, Directors welcomed the authorities' determination to aim for a general government deficit no larger than 3 percent of GDP by 1996. In fact, a number of Directors stressed that a lower target would be necessary in order to ensure the sustainability of the fiscal position. They noted that, given the magnitude of public indebtedness--gross debt had exceeded 140 percent of GDP--fiscal deficits had to be reduced to levels that would permit a stabilization, and then a sustained decline, in the debt ratio.

It was emphasized repeatedly during the discussion that the Regions and Communities should shoulder a larger part of the burden of fiscal retrenchment. Directors advised that deficit reduction should take the form of expenditure cuts in the light of the high level of taxation in Belgium. In this regard, regret was expressed about the recent decision to raise indirect taxes. Since social security spending had grown well above the potential output growth of the economy, the global plan had rightly focused on this aspect of the general government position. Even assuming that all the measures announced to balance the social security accounts would be fully implemented, other measures would have to be taken in order to lower the general government deficit to 3 percent of GDP. Some Directors questioned whether the announced social security measures were sufficient, and it was emphasized that social security reform would remain a central policy issue for years to come. Directors emphasized that, while the principle of basic social protection should be safeguarded, a thorough review of the whole social security system was needed, in order to make its cost more transparent and to target the neediest.

Labor market issues received much attention given the seriousness of the unemployment problem and the complexity of labor market reforms in the political and social context of Belgium. Directors agreed that a durable solution to the unemployment problem required renewed economic growth, but they pointed to a number of areas in which structural policies could improve the functioning of the labor market. In particular, Directors noted that unemployment insurance benefits were exceptionally generous, and they pointed to the large tax wedge between the employers' labor costs and the after-tax wage received by workers. Directors welcomed the partial reduction in charges for lower paid workers contained in the latest measures, as well as the anticipated moderating effect on wage increases of eliminating petrol, tobacco, and alcohol from the indexation formula. Nevertheless, Directors pointed to the inflexibility inherent in the indexation mechanism, and called both for further modifications to alleviate its effects and its eventual elimination, which was seen as a preferable approach to periodic wage freezes. Several Directors expressed doubt as to whether a reduction in real wages could be maintained over a period of three years. Directors welcomed the tightening of access to unemployment benefits, but it was stressed that a clearer separation between the cyclical short-term function of unemployment insurance and its redistributive income support function remained necessary. Directors believed that vocational training and apprenticeship programs could be extended, and that the Regions should be more closely involved in both the administration and funding of the programs.

Several Directors noted that Belgium's net official development assistance had declined further in relation to its GNP, and they encouraged Belgium to raise its official development assistance toward the UN target. Other Directors praised the substantial participation of Belgium in the financing of the successor to the enhanced structural adjustment facility (ESAF II).

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

2. REPUBLIC OF MOLDOVA - STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - SYSTEMIC TRANSFORMATION FACILITY

The Executive Directors considered a staff paper on the Republic of Moldova's request for a stand-by arrangement in an amount equivalent to SDR 51.75 million, and on the Republic of Moldova's request for a second purchase under the systemic transformation facility (STF) in an amount equivalent to SDR 22.5 million (EBS/93/177, 11/16/93; Sup. 1, 11/24/93; Sup. 2, 12/16/93; and Sup. 3, 12/16/93).

Mr. Posthumus made the following statement:

Today's meeting takes place three months after this Board discussed--and approved--the first purchase by Moldova under the STF (at EBM/93/133 and 93/134, 9/16/93). Through the determined and sustained efforts of my authorities, the program supported by the STF is broadly on track, and the quantitative criteria and benchmarks were observed. All prior actions preparing the introduction of a stand-by arrangement were implemented. As a result of these actions, and working in close cooperation with the Fund's staff and technical missions, my Moldovan authorities are now ready to request the second tranche under the STF, as well as the first stand-by arrangement.

I would like to limit myself in this statement to highlighting certain aspects that demonstrate the strong commitment of my authorities to continue their adjustment efforts. In my view, the Board may rest assured that Moldova fully deserves the support of the Fund and the international community. It is therefore a matter of great satisfaction that the EU, Japan, and the United States, as well as other countries and international organizations, have pledged to support Moldova's program in 1994 with balance of payments financing and technical assistance.

First and foremost, the national currency, the leu, was introduced according to schedule. The leu is now the only legal tender in Moldova and, except in the Trans-Dniester region, is widely accepted. Within two weeks after the introduction of the leu, confidence in the domestic currency returned, as evidenced by the slight appreciation of the leu vis-à-vis the U.S. dollar. The rate is now lei 3.7 per US$1, compared with the rate of lei 3.85 per $US1 in effect on November 29, 1993. The authorities will maintain the floating of the leu, and they are in the process of overhauling the foreign exchange regulations, in order to ensure current account convertibility.

Monetary policy is the core of the stabilization program, and the authorities will monitor closely monetary developments and observe the credit ceilings. The monetary program was on target; in order to attain this goal, with inflation still very high in October and November 1993, the National Bank of Moldova raised its financing rate from 170 percent to 250 percent.

During the first ten months of 1993, a major fiscal consolidation was achieved, broadly in line with the program. The 1994 budget has been approved by the Government and signed by the President. The major provisions of the budget law that are expected to strengthen the fiscal position of Moldova are the introduction of an excise tax on petroleum products and a significant broadening of the excise tax base--even beyond what was envisaged in the program. In parallel, the phasing out of subsidies will continue as scheduled.

Concerned about the considerable impact of the price increases on the most vulnerable groups of the population, the authorities designed and explicitly included in the program a social safety net.

Stabilization without structural change in the industrial, banking, and agricultural sectors would only lead to a stable but continuously shrinking economy, and therefore to an unsustainable situation. My authorities are aware of this, and they attach high priority to the implementation of their market-oriented reform program. Price liberalization will be fully achieved during the program period. This can be considered a very ambitious undertaking on the part of the authorities. Also, the full liberalization of trade is planned to be attained by mid-1994. I would like to convey the concern of my authorities that all of Moldova's efforts can be beneficial only if trade between the former Soviet Union (FSU) countries is also liberalized, and if their Western trading partners remove the tariff and nontariff barriers.

My Moldovan authorities recognize that the privatization process is difficult and time-consuming. The distribution of vouchers continues and is expected to be concluded by end-January 1994. The authorities are now preparing a number of auctions, after a successful pilot auction, of small-scale enterprises. The privatization of houses is going quite quickly, as 75 percent of housing is now in private hands, and the other privatization measures are progressing according to schedule.

All these aspects show clearly the determination of my authorities to implement the envisaged program. The circumstances under which it has to be implemented are not easy. The Trans-Dniester problem gets the highest attention of my authorities, and they are confident that, with the persistent endeavors of all parties involved, economic reintegration can finally be achieved. The energy situation continues to remain critical; therefore, the timely delivery of foreign assistance is essential to reduce the cost of adjustment for the population.

The program is comprehensive. However, the inherent institutional and technical weaknesses require continued technical assistance from the Fund, so as to help the authorities monitor and coordinate the implementation of the program.

Mr. Kagalovsky made the following statement:

Since adoption of the STF-supported program, the authorities of Moldova have embarked on the painful yet inescapable process of implementing a comprehensive program of structural adjustment. A number of significant steps have been taken.

Most targets set up in the STF-supported program were observed. Prior actions envisaged in the authorities' letter of intent have also been met. The authorities must be strongly commended for maintaining such a stance.

In particular, complete monetary independence was achieved after the national currency--the leu--became the sole legal tender, a measure that had been strongly recommended by the Fund and my authorities. This move has marked the birth of Moldova's own national economic policy.

Introduction of the national currency was rather timely, following a period of inflation hikes. During this period, major prices have been significantly adjusted toward underlying costs while subsidies have been reduced sharply. Additional measures that were included in the STF-supported program have produced, inter alia, a curb on unchecked preferential lending by the central bank, improvements in the authorities' fiscal position, and the streamlining and liberalization of currency exchange and trade regulations. All these steps must be commended, and the authorities should be further encouraged to speed up the pace of the urgently needed transformation.

Three months ago, during the discussion of Moldova's STF-supported program, this chair expressed a number of concerns. Let me recall some of them, in order to assess the evolution of the authorities' approach to the adjustment process.

The major concern was associated with a kind of dualism in the area of policy objectives, namely, a desire to both reach a comparatively low inflation rate and prevent a decline in output. To put it more precisely, there was a bias toward reaching the output objective, rather than maintaining a balanced dualism. Today, after comparing the indicators for end-1994 shown in the September paper with those shown in the paper before us, I find that this bias is rather unchanged.

Indeed, one can notice that the projected inflation rate has increased from 26.8 percent to 37 percent, despite an extremely sharp rise in prices in the fall of 1993. Also, the projected deterioration in the terms of trade with FSU countries has increased from 20.7 percent to 24 percent, and monetary aggregates are now projected to expand for the whole of 1994, instead of contracting in the first half of that year, as previously envisaged.

At the same time, the only indicator that remains unchanged is the rate of contraction of real GDP, which is 3 percent. This means that an unrealistic adherence to the rather incompatible goals is still in place.

Our other concern was whether Moldova would make use of the experience gained by other countries in transition, particularly those of the FSU. It seems premature to answer this question positively. For instance, approval of a six-month delay in the extension of value-added and excise taxes on imports was obviously a mistake that was made during the first year of economic reform in my country. For what reason did the Moldovan authorities maintain these erroneous regulations for an additional year?

The same considerations might be applied to other aspects of the authorities' program. It looks as though the timing of the implementation of some measures is too slow. For example, full and definite liberalization of all food prices could probably be carried out at once, particularly when bearing in mind the size of agriculture and food processing in Moldova's economy. Instead, a piecemeal method of liberalization has been adopted. Accordingly, I do not see any reason to wait until June 1, 1994 for the final removal of export quotas and licenses. We must admit, however, that the program envisages the rapid implementation of a variety of important steps, including, inter alia, the removal of state orders and the unification of the exchange regime.

Another somewhat bitter lesson from the history of the adjustment efforts of countries in transition is that the self-determination needed to announce reforms is sometimes not sufficient to keep them on track. The authorities should be ready to meet various challenges arising in this process--the risks associated with the harmful practice of labor shedding being among them. In this regard, I was disappointed to find neither estimates of projected unemployment nor budgetary costs of its likely growth in the staff papers.

Let me announce, at this stage of my intervention, my authorities' intention not to cease providing financial assistance to Moldova. There were different schemes for providing such relief: so-called technical credits, which were replaced by governmental credits after the second quarter of 1993; cash credits; the accumulation of payments arrears; the delivery of cheap fuels and natural gas; and the unlimited and preferential access of Moldova's exports to Russian markets--which is becoming more and more profitable for Moldova, along with the depreciation of the leu against ruble.

Our assistance took place before any other donors began their disbursements. Certainly, there will be some continuation in the coming year of financial assistance, the specific forms and amounts of which are being considered by my authorities.

By the way, as I have learned from Table 5 of Supplement 1, Moldova itself extended to Ukraine a rather significant loan, in an amount equal to 22.44 million dollars. Taking into account Ukraine's economic complications, this generous move is very commendable. Could the staff provide us with more detailed information on this credit and its conditions?

Finally, I must say that I find no obstacles to supporting the draft decisions. We hope that the difficulties presented in Supplement 2 of the staff paper will turn out to be only temporary.

Mr. Ismael made the following statement:

I note with concern the further deterioration of Moldova's economic condition. For the short term, it seems that this country will have to persevere while undergoing the hardships of transition. The main challenges confronting Moldova are how to arrest the continued deterioration of living standards owing to the initial output loss, and how to reverse the declining growth rate. It has to be recognized that the size of the initial output loss is usually determined by the scale of the prevailing structural distortions in an economy prior to its embarking on a transformation program. In the case of Moldova, this loss was further exacerbated by the shock in the terms of trade resulting from higher energy prices, reduced financial support, and the severe drought.

As a means of coping with the situation, I welcome the authorities' determination to step up the implementation of their stabilization and structural programs, including through the introduction of a separate currency, which will eliminate the adverse effects stemming from previous monetary arrangements. In this regard, however, it should be noted that there are still no money market or monetary instruments in place, which are essential to ensure the efficient implementation of monetary policy. Therefore, I recommend that, in addition to reforming the banking system, the financial sector be further developed.

With regard to the inflation rate, I am puzzled by the presentation of two different sets of inflation figures in EBS/93/177, Supplement 1. Table 1 on page 5 estimates the annual average inflation rates for 1993 and 1994 as 1,393 percent and 185 percent, respectively. Page 39 of this supplement also shows that the monthly inflation targets under the stand-by arrangement were set at an unspecified single-digit figure for 1993, and at 1 percent for 1994. Taken together, how should these figures be read? Does the staff mean to say that, without a stand-by arrangement, the inflation rates in 1993 and 1994 will reach 1,393 percent and 185 percent, respectively, while monthly inflation rates should and could be reduced with a stand-by arrangement to an unspecified single-digit figure in 1993, and even to 1 percent in 1994? If this is the case, are these targets not overambitious or even unrealistic? If this is not what the staff intends to convey, how can we reconcile these two different sets of figures? In any event, I would suggest that Table 1 would be much more readable if it included some explanatory notes to facilitate the tracing of the derivation of the figures.

With respect to commercial policy, the authorities set an objective of further trade liberalization to improve Moldova's external position. Quite contrary to this objective, however, the authorities introduced tariffs with an average rate of 15 percent on imports from countries not belonging to the Commonwealth of Independent States (CIS). The data indicate that non-CIS imports account for approximately 75 percent of Moldova's total imports.

This measure would in my view help increase government revenues at the expense of exports, because domestic producers would have to pay higher input prices. I would appreciate hearing the staff's comments on whether such a measure is justified.

As to Moldova's international competitiveness, I would appreciate it if the staff could provide an account of the underlying assumptions that would contribute to its anticipated improvement. In my opinion, such improvement would be difficult to attain, considering, among other factors, the country's obsolete capital stock, the strong inflationary pressure, the difficulties involved in obtaining imported raw materials, the higher energy prices, and the higher real average wage rate. Furthermore, the projected depreciation of the national currency falls short of the inflation rate, which will result in an overvalued exchange rate.

These observations underscore the strenuous challenges that Moldova is facing, which could be addressed by accelerating the implementation of the comprehensive program of stabilization and structural reform set by the authorities. The success of this program hinges on the availability of external financial support. With these remarks, I can concur with Moldova's request for the Fund's financial support.

Mr. Oya made the following statement:

I commend the Moldovan authorities for having intensified their economic reform efforts since the approval of the first purchase under the STF in September 1993, for having implemented all their policy commitments under the STF program, and for having observed all indicative targets and structural benchmarks under the program. I also welcome the authorities' efforts in preparing the ambitious program in consultation with the Fund, and in implementing all the prior actions required for approval of a stand-by arrangement. In addition, I commend the staff for its strenuous efforts in working on the program, and for providing, together with the World Bank staff, the necessary technical assistance and encouraging assistance from donor countries.

Moldova is suffering from the same adverse factors that are affecting all the states of the FSU, such as the energy shock and trade and payments disruptions. Moreover, Moldova experienced a political crisis related to the Trans-Dniester region, as well as a severe drought. What is more, Moldova has to import energy from other countries and has been sensitive to external shocks. In these circumstances, I believe that what is called for from the international community is the assignment of top priority to the maintenance of the economic reform momentum in Moldova and the provision of assistance, in consultation with the Fund, for the successful completion of the economic reforms. The loss of the economic reform momentum in Moldova would have an adverse spillover effect on the momentum of reform in other FSU states that are working in consultation with the Fund.

The stand-by arrangement for Moldova is very ambitious, and the authorities will have to walk a tightrope. The authorities are fully aware of what should be done to accomplish each of their objectives; however, as the staff rightly points out, the lack of administrative capacity may hamper the smooth implementation of policy measures in the program. I hope that the Fund will play a major role in the provision of technical assistance to strengthen the administrative capacity of the authorities.

In addition, I share the authorities' concern about the Trans-Dniester problem. The existence of a semiautonomous economy with a special monetary regime could disturb the smooth implementation of the program. It is encouraging to learn that, according to Mr. Posthumus's opening statement, the authorities are confident that economic integration can finally be achieved. However, it is still advisable that the authorities continue to pay the closest attention to this problem.

Finally, I would like to conclude by asking a question of the staff. I believe that trade diversification is crucial for sustainable growth in the medium term. I would appreciate the staff's comment on what Moldova is expected to export to non-FSU states in order to earn convertible currencies in the period ahead.

With these remarks, I support the proposed decisions.

Mrs. Wagenhoefer made the following statement:

We welcome the success of the December 15, 1993 pledging session organized by the World Bank in providing the needed financing assurances for Moldova. I specifically welcome the fact that the EU has finally shown its willingness to contribute to balance of payments aid for Moldova, with the consequence that this Board is now able to decide on Moldova's request for a stand-by arrangement, as well as for the purchase under the STF in support of its program.

While studying the documents before us, I was pleased with the way that the staff presents a well-balanced overview and covers very well Moldova's economic problems, as well as the main program objectives and the difficult medium-term perspective. I was particularly impressed by the many rather outspoken hints at the numerous risks and uncertainties involved in achieving the aims of the program, and at the risks surrounding the medium-term prospects of the Moldovan economy, including its capacity to repay the Fund. I was further impressed by the staff's very clear message that the Moldovan authorities are strongly committed to moving forward with the intended reforms and fiercely determined to stabilize the economy. I think that we have seen a proof of the authorities' strong commitment in the various recent measures that they have adopted--as the staff reports in Supplement 2 to the staff paper, which was circulated yesterday. I also welcome Mr. Posthumus's remarks in this respect in his statement.

I am in full agreement with the program objectives, which cover practically the full range of reforms needed for a country such as Moldova. The objective of achieving all these goals simultaneously by taking parallel action in each of these areas is interesting. It is indeed important to accelerate the reform process initiated under the STF, in order to bring down inflation as soon as possible--including by maintaining a firm stance on fiscal policies--to speed up structural reforms, and to build up gross international reserves. If implemented successfully, this program will certainly help to start the economic recovery, although the situation might remain difficult over the medium term.

However, in view of the experience with the initial delays in implementing the STF program--which were caused by the weak institutional capacity and the lack of experience in handling coordinated policy measures--we should be cautious regarding our own expectations. In my view, the staff has rightly stressed the major condition for the success of this program, namely, vigorous policy implementation. Besides the political will on the part of the authorities--which seems to be there, at least for the time being--the most important prerequisite for a vigorous implementation of the program is the existence of sufficient implementational and institutional capacity. The staff points out at the end of its appraisal that the authorities are still building up their capacity to implement and monitor the program. Given the additional--and, in my view, necessary--requirement that the authorities should be prepared to react swiftly to any signs that the program is not progressing as intended, further technical assistance and very close contacts between the staff and the authorities seem to me to be of great importance. I wonder whether the staff concurs with that view.

As the authorities are aiming high, I am concerned whether the ambitious program objectives can be achieved, given the present weak institutional structure in Moldova. I would like to have the staff's comment on this issue.

Let me emphasize a few points in this respect. First, on monetary policy, I fully agree with the staff that the key objective of the program will be to bring the high inflation rate quickly and sustainably under control. With the increase of the financing rate from 170 percent to 250 percent in November 1993, the authorities have already sent a clear signal to the market. It is clearly disappointing that, despite the intention to lower the inflation rate under the former STF program, the rate accelerated sharply instead. However, one has to acknowledge the various reasons for the unexpected increase of the price level. Besides the effect of the currency conversion in Russia, a larger than anticipated upward adjustment in administered prices and higher than foreseen energy prices also contributed to a large extent to the high rates of inflation. Accordingly, the guidelines under the new program will certainly be helpful for lowering inflation considerably--although I wonder whether the program is again not somewhat overambitious on this point.

Although we also welcome the indications that fiscal policy under the new program will be in line with the monetary program, we are somewhat concerned about the influence of the price liberalization intended to take effect at the end of 1993 and during 1994. This is not meant to suggest that price liberalization ought to be delayed in order to avoid additional inflationary pressure; however, I would appreciate the staff's comments on whether the effects of liberalization have fully been taken into account in the assumptions on monetary performance.

A substantial tightening of monetary policy will also depend on the defense against excessive credit demands. Therefore, the National Bank's performance in holding the line on preferential credit is of great importance. Naturally, this chair welcomes the authorities' intention to propose amendments to provide more independence to the National Bank in the implementation of monetary policy.

In this respect, two questions occur to me. First, according to our information, the National Bank is still not independent with respect to the Ministry of Finance. It would be worth knowing, for instance, whether the National Bank would be in a position to refuse credits to the Government if this were running counter to its monetary aims. Second, as I read on page 3 of the letter of intent, the authorities aim at strengthening the "operational independence" of the National Bank, subject to general oversight by Parliament. Now, this in itself is already--for a German at least--somewhat difficult to understand. Is there independence from the Parliament or not? Another aspect of this problem is whether the authorities intend to increase gradually its independence or whether they plan a more far-reaching reform of the National Bank. Perhaps the staff could comment and elaborate on the future role of the National Bank, and, in particular, on the steps envisaged to give it more independence.

We welcome the introduction--at a rate of lei 3.85 per US$1--of the new currency on November 29, 1993. The authorities have made an important step in taking over responsibility for their own monetary policy. As I understand it, the introduction of the new currency has been a success so far. Does this also imply--and I come back here to the question of management capacities--that management's abilities to handle the new money are by now sufficiently developed? On page 3 of Supplement 1, the staff mentions that monetary programming remains difficult for these reasons. I would appreciate staff comment on this point.

Let me now turn to fiscal policy. Given the fact that the weak fiscal position in the earlier part of the year was caused by the inelasticity of the tax system, the weak tax administration, the narrowness of the tax base, and the proliferation of tax holidays and exemptions, the new program rightly focuses on revenue-enhancing measures to achieve the ambitious fiscal target. We fully support the staff's recommendations on the establishment of a timetable for introducing new taxes and strengthening tax administration, and on the reduction of tax exemptions and privileges. On the expenditure side, the phasing out of consumer subsidies and the implementation of a cash compensation scheme will also be of major importance.

I welcome the fact that the Government is considering contingency measures to hold the line with respect to the fiscal position. Given the problems generated by the increases in energy import prices in Moldova, I wonder what the Government's intentions were when it introduced an excise tax on petroleum products as a contingency measure? Perhaps the staff could tell us more about the rationale of this measure.

On systemic reforms, we fully support the staff's recommendations in such areas as price liberalization, privatization, restructuring, and financial sector reform. I would also like to stress the importance of ensuring financial discipline by implementing the bankruptcy law. Of course, it is important to implement this law as early as possible. As far as I know, the bankruptcy law was already passed in mid-1992. Accordingly, I would like to know whether this delay is just another indication of Moldova's weak administrative capacity, or are there other aspects to be taken into account?

Finally, let me repeat that, as the staff has admitted very frankly, the risks of the program should not be underestimated. We hope that our concerns and doubts will prove irrelevant during the implementation of the program. We support the proposed decisions.

Ms. Lissakers made the following statement:

We are very pleased to support the Moldovan requests for a stand-by arrangement and a second tranche purchase under the STF. Moldova becomes the second republic from the FSU to enter into a stand-by arrangement and make a second purchase under the STF. This is an ambitious program that demonstrates the feasibility and scope for market transformation, and we would urge others in the FSU to follow Moldova's lead. The strong international support generated in support of the program at this week's pledging session bears particular mention, as it sends a strong message that the West will back up solid economic reform programs. Here, I would recognize the Managing Director's and the staff's efforts, in addition to those of the various other institutions and countries involved. We have been pleased to play a part in this international effort, which must now be matched by effective implementation on the part of Moldova.

I will focus my remarks on some of the main themes of the Moldovan adjustment program. As a preface, I would note the rapid progress toward market reform registered by Moldova despite extremely difficult internal and external conditions, which have contributed to a drop in output of some 50 percent since 1990. When seen in this context, the country's commitment to economic stabilization and reform is all the more commendable.

Moldova has made significant progress toward achieving its STF commitments, and we note the substantial prior actions that have been undertaken in preparation for this stand-by arrangement. These include the well-planned introduction of the national currency, accompanied by a strict monetary program; passage of a tough 1994 budget; further price liberalization; and the first steps toward establishing a liberal foreign exchange regime.

Cutting inflation under the new currency is at the core of the stabilization effort. Price pressures have been higher than programmed in recent months, as the staff notes, but the monetary program appears to be largely on track. The authorities have eliminated preferential credits, raised the refinance rate, and committed themselves to increasing the proportion of credit allocated by auction. Steady progress toward the program goal of 1 percent monthly inflation by end-1994 will be a top priority, and establishing the full independence of the National Bank is of particular importance in assuring success in these efforts.

However, I would echo Mrs. Wagenhoefer's concern about the ambitious targets that have been set in the areas of inflation and several other program targets, and I would endorse here the statement that this institution should be patient, while standing ready to move aggressively on the technical assistance front to shore up the institutional weaknesses of this FSU country, as well as others. I think that, as long as we see steady progress in reducing inflation, there should be some flexibility in the program--even if the laudable but quite ambitious target of a 1 percent monthly inflation rate is not fully achieved.

In the establishment of a liberal foreign exchange regime, which we strongly endorse, we would emphasize the importance of supporting the currency's value primarily through strong macroeconomic policies--and not by unnecessarily expending scarce foreign exchange to prop up its value.

Fiscal policy is on the right track in this respect. The authorities have agreed to a very ambitious deficit target of 3.5 percent for 1994--entirely financed through foreign and nonbank sources. Reducing expenditures on subsidies is a crucial part of this fiscal tightening. Bread and dairy prices have been raised, and energy price increases are to be passed through to consumers. This, of course, will influence the inflation performance, as already noted. Establishing a Treasury and improving tax administration are other key steps. It will also be important to continue to resist pressures to eliminate interenterprise arrears or subsidize agriculture excessively. However, as stated by Mrs. Wagenhoefer, one must be realistic about the possibility of slippage in achieving the precise fiscal target.

Structural measures will complement stabilization efforts. Of particular note is the ambitious goal of putting 45 percent of all state assets into private hands by end-1994. I must say that this target strikes me as perhaps excessively ambitious; if the authorities come close, one could be quite pleased. Again, I would say that steady progress would be eminently satisfactory. While we understand that there have been some delays, the authorities appear intent on accelerating the privatization program, in addition to imposing hard budget constraints on remaining public enterprises; both of these goals are greatly to be supported and applauded. Land privatization for general agriculture is also important, given the large agrarian sector and the need to boost exports.

Trade liberalization will contribute to a more dynamic private sector and a strengthened balance of payments. On this score, Moldova's trade partners must do their part to ensure the country's nondiscriminatory access to Western, as well as CIS, markets. It is also critical that Moldova's already stringently reduced imports not be further curtailed by delays in disbursements of donor assistance pledges, as this would contribute to a further drop in output and could also add to the inflationary pressures in the economy.

In closing, we would again commend the authorities for the progress made to date, particularly the courageous step of introducing the national currency. With this program, Moldova is making a significant leap forward toward establishing a viable market economy. We urge the authorities to make every effort to fully implement the program's policies.

Mr. Desruelle made the following statement:

I welcome this opportunity to discuss the Moldovan authorities' request for a stand-by arrangement. The authorities have shown great determination in their approach to reforms, first with the purchase under the STF, and now--only three months later--with this request for a stand-by arrangement.

The program presented by the Moldovan authorities is, in the view of this chair, a strong program. The financial targets are ambitious, as are the envisaged structural reforms. This implies that implementation of the program will be an arduous task.

Achievement of the program's targets will require very close and constant monitoring of both macroeconomic and structural developments. In this respect, we fully agree with Mr. Posthumus and previous speakers that continued technical assistance from the Fund will be required to help the authorities monitor and coordinate the program's implementation.

I have no difficulty with the general structure of the program. With respect to specific aspects, I welcome the measures included in the program to strengthen enterprise discipline, such as the Government's commitments not to request preferential credit or allocate resources for bailouts of interenterprise arrears, as well as its determination to recover for the budget the full domestic counterpart of foreign commodity loans.

The imposition of harder budget constraints on enterprises is likely to result in severe difficulties for a number of them. This, in turn, could induce these enterprises to run additional arrears with other enterprises or the authorities. To ensure that such behavior does not endanger monetary or fiscal objectives, it will be essential to closely monitor such arrears and, if necessary, take rapid action to check their expansion. This will most probably require a strict application of the bankruptcy law. Of course, the explicit inclusion of a social safety net in the program, which is commendable, should be quite helpful in this respect.

On monetary policy, I note that banks may presently not have all the appropriate incentives to respond to price signals, given the degree of concentration of the banking sector, the burden of nonperforming loans, and the ownership structure of many banks. To truly create a market mechanism for credit, it will therefore be essential to pursue efforts to restructure the banking sector and strengthen banking supervision. Also, it goes without saying that, to maintain a proper monetary policy stance, the National Bank should not issue--or be directed by any authority to issue--preferential credit.

Finally, on the budget, I note that the budget deficit reduction is mainly to come from the revenue side, through the imposition of new taxes and the extension of the base of existing taxes. Given the low ratio of revenues to GDP reached in 1993--and the need to make room for reform-supporting expenditures--this seems to be the right approach to fiscal consolidation.

The numerous new tax measures recently introduced may appear to create a rather haphazard tax system, but this may be understandable, given the urgent need to raise additional revenues. However, some of the tax measures, such as the surcharge on the value-added tax on exports to FSU countries and the new excises on what appear to be mainly imported products, seem to run directly counter to the measures of trade liberalization included in the program. I would appreciate the staff's comments on this issue.

I would also appreciate the staff's comments on the extent of the taxation of the agricultural sector. It would appear from Table 2 of Supplement 1 that the agricultural sector is still lightly taxed in comparison with its importance for the economy. I understand, however, that the review of tax exemptions, which is to be completed by end-1993, could have an impact on agricultural taxation.

Like Mrs. Wagenhoefer, I am pleased to note the strong backing of the international community for the Moldovan authorities' program of reform. This support is well deserved, as is the support of the Fund. I fully endorse the proposed decisions.

The Chairman said that he also welcomed the strong support recently demonstrated by the international community for the Moldovan program. However, in light of the difficulties that had been involved in catalyzing that support, he urged Directors to encourage their authorities to ensure that it was sustained, provided, of course, that Moldova maintained its adjustment efforts.

The staff representative from the European II Department said that, as a number of Directors had emphasized, the success of the authorities' adjustment efforts--including their ability to meet the criteria specified under the stand-by arrangement and the second tranche of the STF--would depend largely on their administrative capacity. Although gradually improving, administrative capacity was still weak, and the staff would continue to provide technical assistance in that area while coordinating its efforts with those of donor countries and other international organizations.

As to whether the program was perhaps overambitious, the commitment shown by the authorities in implementing the prior actions indicated that the program objectives were attainable, the staff representative added.

In the monetary area, the National Bank had demonstrated its independence from the Ministry of Finance by ending the practice of issuing preferential credit, the staff representative noted. Largely as a result, the monetary program was on track, with net domestic assets and banking system claims on the Government broadly in line with the targets.

With respect to fiscal policy, the staff representative commented, the Government's strategy--as a number of Directors had pointed out--was to strengthen revenue performance, with a view to reversing the sharp deterioration in the ratio of taxes to GDP. Accordingly, such steps as the introduction of a tariff on imports and the broadening of the excise tax base were not ad hoc measures, but integral parts of the overall tax reform strategy. In fact, the effect of the import tariff on the competitiveness of Moldova's industries might not be as detrimental as some Directors had envisaged, as the rate for raw materials was very low. Furthermore, energy products were not taxed directly; an excise tax had been imposed on energy products to rationalize the utilization of energy and accelerate investment in energy-efficient sectors.

In the area of structural reform, although some Directors had suggested that the pace of liberalizing food prices had been too slow, other speakers had considered it to have been too fast, the staff representative recalled. In reality, the process of liberalizing prices depended on the progress made in establishing a social safety net to protect the most vulnerable segments of society. The authorities therefore intended to liberalize completely the prices of bread, milk, and other products by mid-1994, by which time all facets of the social safety net were expected to be in place.

Finally, although the bankruptcy law had been introduced in 1992, the inadequacy of the legal framework underlying it had, in many cases, thwarted its implementation, the staff representative from the European II Department observed. Moreover, there had been some hesitation to enforce the law strictly in the early stages of the reform process. The authorities were reviewing the bankruptcy law, with a view to improving its implementation.

Mr. Wu made the following statement:

I appreciate the authorities' continued commitment to reform and the support that they have galvanized for stabilizing the economy. I regard these as two important factors in the success of the reform process. The authorities' good track record during the first purchase under the STF reflects this necessary strong commitment and support. As I agree with the thrust of the policy measures envisaged by the authorities in their request for a stand-by arrangement and second purchase under the STF, I will make only two brief comments.

First, I believe that the support of the general population is critical for the success of the economic transition. This can be activated only if the majority of people have benefited from the reform results. If the standard of living continues to deteriorate as a result of the continued decline in output and real incomes, this important support will be eroded.

At present, it is important to stabilize the macroeconomic environment, on the one hand, and continue the structural reform process, on the other. However, I find the inflation target to be rather ambitious, and I wonder whether such an undertaking is sustainable. While the intention is to send strong signals to the market that the authorities can attain macroeconomic stability, as clearly emphasized in the staff paper, the market may judge such action quite differently. Market participants may think that, as a result of the sharp tightening of monetary policy--supported by fiscal adjustment--recovery might be out of sight in the short run. In turn, the deteriorating living standards, together with the increase in open unemployment, would weaken the support of broad segments of the population. Obviously, that would not help the authorities' stabilization efforts.

It is not my intention to oppose the authorities' implementation of a tighter monetary policy stance when introducing a national currency. I think that this is critical. However, my concern is the tightness of the financial policy in the short run and the length of time that it should be pursued. In my view, macroeconomic stabilization should be achieved in the medium term, rather than too sharply in the short term. It should not be pursued at the cost of further sacrifice through a continuing deterioration in economic activity. To achieve financial stability as quickly as possible--no matter how well intentioned that goal may be--will increase the risk that the reform efforts will be jeopardized by the loss of critical public support. In this context, it would be more appropriate for the authorities to implement the program in a medium-term context.

Exceptional external financing can play a supportive role in the current transition, but sustained economic recovery and growth will ultimately depend on the accumulation and use of domestic savings. If output and real wages continue to decline, the income and wealth of the general population cannot be recovered and increased in the foreseeable future, and the domestic financial resources needed to move economic recovery and growth along a sustainable path will be lacking. In this regard, I also urge the authorities to take early action to restructure and modernize the financial sector, in particular, the banking sector.

Second, when the Board considered the request by Moldova for a purchase under the STF, I expressed my concern about a possible increase in open unemployment as a result of the tightened financial policies. Unemployment is a serious social problem. The underlying difficulty is in determining where these unemployed can be absorbed. The solution, in my view, lies in the nonstate sector, and I would like to know from the staff what the share of the state and nonstate sector is, in terms of output and employment. If the nonstate sector is still too small to absorb the large numbers laid off by state enterprises facing hardened budget constraints, widespread unemployment, together with deteriorating living standards, will exert increased pressure on an already difficult fiscal position and possibly hamper the authorities' course of reform.

Therefore, the immediate task of the authorities should be to nurture the nonstate sector through the establishment of new businesses and the privatization of the small state enterprises. At present, the mass privatization of medium-sized and large enterprises is not an ideal solution; however, restructuring will make them more autonomous and reduce the state's involvement in their day-to-day operations. Only when the nonstate sector has increased its absorptive capability can the state sector unemployed find proper job openings.

Mr. Barr made the following statement:

I welcome this request for a stand-by arrangement, and I can support it. I believe that this is an extremely strong program, which deserves the Board's full support. The authorities have taken a very bold reform stance, and the pace of reform has accelerated since the request for a purchase under the STF was approved. I do not think that anyone would doubt that, as Mr. Kagalovsky emphasized, there is still some way to go in a number of areas; however, I believe that there is a need to acknowledge that remarkable progress has been made already, both in terms of meeting the program targets and in implementing fully all the prior actions under the program.

We were pleased to see that, following the recent pledging meeting, the calculated financing gap now appears to be substantially filled. I believe that it is appropriate that the Fund is going ahead, notwithstanding the fact that specific commitments fell slightly short of the $155 million earlier identified. Clearly, in Moldova's case, the size of the gap is most dependent on energy import price and volume assumptions; the estimates of the gap may well be different in six months' time, and the authorities will need to adjust the program accordingly.

This illustrates a more general point that I wanted to raise in connection with the design of Fund-supported programs for the FSU republics, as well as a point made earlier by the Chairman. Moldova's circumstances in many respects are unique, and this program sets a precedent for a successful utilization of the STF leading to a stand-by arrangement. This will, I hope, have an important signaling effect on other states of the FSU, which are not this far forward in their programs. The international community has rightly made special efforts to complement Moldova's ambitious reform program; however, the Fund should not assume that balance of payments financing will be equally forthcoming in other cases, which will need to be treated on a case-by-case basis. What is perhaps required is greater flexibility in program design and less strict adherence to a necessarily arbitrary financing gap. Of course, the stronger and more sustained the adjustment process is, the quicker that private capital inflows will be forthcoming.

With respect to the program itself, I note that, despite adherence to the monetary targets in the STF-supported program, the outturn on inflation has been somewhat worse than programmed, owing to difficulties in estimating ex ante money demand. Mrs. Wagenhoefer has already mentioned a number of reasons for this situation. I wondered to what extent this raises more general questions, such as how much reliance we should be placing on the reliability of monetary programming and specific monetary targets, and whether there were any possible alternatives to the approach that has been taken. I also agree with some of the comments that Mrs. Wagenhoefer made on the National Bank, in particular, the importance of distancing it from the political pressures to loosen monetary policy.

I agree with most of the comments that have been made on fiscal policy. I would only ask the staff to assess the risk of the deteriorating situation in the Trans-Dniester area adversely affecting the program. I also wonder how closely this risk was linked to the choice of the currency used in that region.

Mr. Jiménez de Lucio made the following statement:

We join previous speakers in commending the Moldovan authorities for persevering with their ambitious reform program under exceptionally difficult economic conditions. Over the past three years, Moldova has suffered a major drop in real output and wages, a strong deterioration of its terms of trade, and high inflation. The authorities' response to such circumstances has been to resolutely pursue a program to stabilize the economy and accelerate the pace of structural reforms, as illustrated by the observance of all indicative targets and structural benchmarks under the STF, as well as the implementation of all prior actions envisaged under the program. We welcome the recognition of these efforts by the international financial community at the recent pledging session.

The authorities' most immediate task should be to lower and bring under control the present very high rate of inflation while continuing the process of price liberalization. Nonetheless, we consider the inflation target for 1994 to be overly ambitious and unlikely to be achieved. Tight fiscal and monetary policies must be applied to attain a significant decrease in the inflation rate. In this regard, we welcome the recent measures to increase tax revenues. However, caution needs to be exercised in estimating possible revenue increases from new taxes and improved tax collection. Contingency measures to offset potential revenue shortfalls seem well advised.

The rapid phaseout of subsidies on basic consumer goods requires that an effective social safety net be put in place to protect the most vulnerable segments of the population, and to ensure a minimum level of public support for the reforms. We are pleased to learn from the staff paper that this matter is given priority attention under the proposed program. Given the importance of domestic support for the success of adjustment programs, it would be worthwhile to evaluate the possibility of including a target related to social safety nets in future Fund-supported programs.

Moldova provides a good example of the difficulties associated with the transition from a centrally planned to a market-based economy, and, more important, of the need for long-term support from the international financial community to accomplish this transition. Indeed, Table 7 of Supplement 1 shows that, even with the continued implementation of sound economic policies, the country is expected to register a 6.1 percent current account deficit, and to have a level of gross official reserves equal to only one-and-a-half months of imports in 1997, namely, four years from now. These figures highlight the need for continued exceptional financing over the next several years and the critical importance of providing access for Moldovan goods in the major international markets.

Finally, with respect to the risks associated with the program, we share the staff's view that significant risks are entailed--which is only natural, given the expected big payoff. In addition to the risks mentioned in the paper, we feel that there are two other risks that deserve explicit consideration. First, there is the possibility of donor fatigue, given the severe budget limitations and high unemployment faced by most industrial countries, as well as the long period over which Moldova will require support from the international financial community. Second, there is the risk of a lack of domestic support to fully implement the adjustment program. These two risks are obviously closely related: for example, donor fatigue could force the authorities to further adjust internally, which, in turn, would very likely lessen domestic support for the program. Of course, we hope that these risks will not materialize; we look forward instead to seeing Moldova become in the near future a country with a rising standard of living and an example for other countries in transition to follow.

In closing, we would like to express our support for the proposed decisions.

Ms. Langdon made the following statement:

We would like to add our voice to the cheerleading chorus for the strength and commitment of the authorities' program. It certainly represents substantial progress in economic reform, and I have only three brief points to make for emphasis.

First, moving to positive real interest rates is the key to successful stabilization of the new national currency and progression to current account convertibility. As demonstrated by the experience of the Baltic states, when combined with other comprehensive measures, such action can lead, rather expeditiously, to a reduction in inflation, substantial repatriation of flight capital, and increases in international reserves; moreover, it can foster private savings and investment. We would encourage the authorities to introduce positive real interest rates as early as possible in the stabilization program.

Second, although the Government has managed so far to maintain a political consensus for rapid economic stabilization, there lies a risk that future parliaments may not be as cooperative. Accordingly, the introduction of measures to ensure the National Bank's independence and clarify its price stability mandate would strengthen the ability of the authorities to introduce comprehensive stabilization measures by depoliticizing the formulation of monetary policy.

Finally, as the staff notes in Supplement 1, the strong financial support provided by creditors to Moldova's economic program must now be matched by a vigorous implementation of policy actions by the authorities. In light of the admittedly weak administrative base, we would encourage the authorities to continue the ongoing close dialogue with the Fund's resident representative and the staff, which, as evidenced by today's request, has proved so beneficial.

Mr. Solheim made the following statement:

Let me begin by commending the authorities for taking all the prior actions needed for the approval of the stand-by arrangement and the second purchase under the STF. The authorities have shown their determination in pursuit of the transformation of the economy. Especially welcome is the news that the introduction of the new currency--the leu--has proceeded as planned, and that the conversion has been successful.

I am in broad agreement with the thrust of the analysis and recommendations in the staff paper, and I fully share the view that the authorities are confronted with enormous challenges, and that the program entails significant risks. Nevertheless, I welcome the authorities' determination in pressing forward with an ambitious program. Awareness of the risks involved enhances the prospects of a successful implementation of the program, and I should like to point to some areas that give rise to concern.

First, the much higher than programmed rate of inflation in both October and November 1993, although to some extent owing to special, transitional factors, is certainly worrisome. Against this background, I, like previous speakers, question whether the economic program for 1993/94 is not overly ambitious, especially as to the monthly inflation target set for end-1993. To achieve this target--and to achieve further progress toward price stability in 1994--requires immense efforts in immediately tightening monetary and fiscal policies, as well as determination in persevering with these policies during a period of difficult adjustments in the economy.

My second area of concern is the budget deficit and its financing. Attaining the goal of restricting the deficit to 3.5 percent in 1994 requires the successful implementation of a number of measures, not least on the revenue side. The uncertainty of the effects of the revenue-enhancing measures calls for special vigilance in monitoring and exercising firm control over expenditures if the deficit is to be kept within the agreed limit. The establishment of a proper treasury function should be given high priority. While we fully agree with the objective of utilizing the room for maneuver opened by the reduction in subsidies to build up a well-targeted social safety net, increases in expenditure in specific program areas need to be kept under close review, in light of the developments in the budget balance; moreover, timely responses to any deviations should be planned for at an early stage.

Even with the deficit on target, the authorities need to adhere to strict discipline, in order to avoid any financing of the budget from the banking system. The recent slippages in the central bank financing of the government deficit are a danger signal. The staff paper indicates that the authorities intend to avoid bank financing by relying partly on the development of nonbank financing instruments. I see the possibility of making these instruments attractive in the present circumstances, and even in the near future, as rather slim; I would welcome the staff's assessment of this situation.

My third concern is connected with the pace of privatization. It is encouraging to note from Mr. Posthumus's opening statement that the privatization of housing is progressing well. Also, plans for the sale of small-scale units and the preparatory work for auctioning medium- and large-scale enterprises are currently on track; however, the experience of other countries in transition indicates that the privatization process often meets with obstacles and becomes more time-consuming than originally envisaged. I welcome the awareness of the authorities as to the difficulties of implementing privatization, as stated by Mr. Posthumus. A rapid development of the private sector to establish a strong base for future growth is, of course, of crucial importance in Moldova.

Finally, I would like to comment on Moldova's long-term prospects, and on its external outlook. On the one hand, it is welcome and encouraging that the pledging session in Washington on December 15, 1993 largely succeeded in closing the financing gap for 1993/94. On the other hand, the problems and uncertainties in the medium term remain large. Even with the meticulous implementation of the program, the balance of payments outlook indicates the need for continued financial assistance of substantial magnitude. There is obviously no room for slippage; furthermore, the projected reduction in the financing gap toward the year 2000 rests heavily on the assumption of a sharp increase in foreign direct investment, starting as early as 1995. Could the staff comment on the realism of this, and, in particular, on the measures that are envisaged to stimulate such investments, including the establishment of an appropriate legal framework?

With these remarks, I support the proposed decisions.

Mr. Keller made the following statement:

We support the proposed decisions and welcome the commitment of the Moldovan authorities to this strong program of economic stabilization and structural reform. Indeed, with the recent introduction of the national currency, the most important preliminary action has been successfully implemented, and a number of measures have been taken to move toward a market-determined exchange rate. However, as several speakers have underscored, this program is also fraught with considerable risks and uncertainties. We welcome the staff's sound recommendations with respect to early discovery of, and remedial action for, possible shortcomings in implementation.

During the first nine months of 1993, the Moldovan authorities were able to manage fiscal developments by consolidating the fiscal position. While revenues fell in terms of GDP, particularly because of weak tax administration and some delays in tariff reform and extending the value-added tax to non-CIS imports, savings were achieved by reducing consumer subsidies on foodstuffs and strengthening fiscal administration. On this basis, we would encourage the Government to strongly pursue its strict fiscal policy by consolidating it along the lines of the new program.

Much emphasis is needed on the monetary policy side, so that control of the monetary aggregates can be tightened. The introduction of a new currency is a unique opportunity to enhance confidence in the authorities' monetary management and curb inflation decisively. Furthermore, to achieve this goal, the Moldovan authorities should strongly promote market forces and improve the legal framework, increase the National Bank's financing rates to market level, tighten general credit conditions, and, in particular, not provide preferential credits. Monetary policy should further be strengthened by establishing a more independent position for the National Bank, as well as by extending its credit supervisory capacity. In order to become an effective channel of financial intermediation, the banking system might need overhaul and modernization.

In order to contain the risks of the program, the authorities are well advised to prepare contingency measures. A tight monitoring of the reform program implies the improvement of the still weak macroeconomic data base, so that information in key financial areas would be readily available and timely action could by taken, if warranted.

The staff representative from the European II Department observed that, despite the authorities' adherence to the monetary targets, the inflation rate of 38 percent in November 1993 had been significantly higher than programmed. Nevertheless, it would be premature for the Government to de-emphasize the use of monetary targets on the basis of that outcome. The two currency reforms that Moldova had undergone during the year--Russia's currency conversion in July 1993 and the introduction of the leu in November 1993--had triggered a flight from Moldovan coupons and considerable panic buying, which, in turn, had generated the unexpected surge in inflation. However, it was expected that the authorities' continued implementation of the monetary program would eventually drive down the inflation rate. An encouraging sign in that respect was the appreciation of the leu in recent weeks; as the demand for cash balances in leus increased, inflation should begin to abate.

Potentially, nonbank instruments could be used to finance the budget, the staff representative remarked. Although, as one Director had pointed out, the interest rates currently offered were too low to attract significant nonbank financing, the authorities had provided indications recently that they would move to increase interest rates to positive real levels.

In the area of fiscal policy, the authorities had expressed their intention to act on the staff's recommendation and take contingency measures in the event of a revenue shortfall in 1994, the staff representative noted.

With respect to the possible impact of developments in the Trans-Dniester region, the staff representative from the European II Department commented, the program had been designed in such a way that it could not be jeopardized by a deterioration of that situation. Conversely, improved prospects for the Trans-Dniester region would strengthen the chances of the program's success.

The staff representative from the Policy Development and Review Department said that, after due reflection, the staff would respond bilaterally to the point made by one speaker on the treatment of financing gaps in the design of Fund-supported programs.

Mr. Posthumus remarked that the references made by a number of Directors, including Mrs. Wagenhoefer and Ms. Lissakers, to the apparent overambitiousness of, and risks connected with, the Moldovan program suggested that its implementation could in some way damage the economy. However, those concerns should be viewed in the context of the point made by Mr. Ismael, namely, that the initial output loss had been determined by the scale of the structural distortions prevailing in the economy prior to the beginning of the transformation program.

It should also be emphasized that Moldova had begun the transition to a market economy only after its centrally planned system had collapsed, Mr. Posthumus continued. In those circumstances, it was by no means obvious that a more gradualist approach would be either easier to implement or more effective in Moldova--or any of the other FSU republics--than the so-called shock-therapy approach. The larger fiscal deficits that would be tolerated in those countries under a gradualist approach would lead to higher inflation rates, which, in turn, would exacerbate the inequities in their social systems.

Moreover, Mr. Posthumus added, Moldova's program did not seem to be more ambitious in scope than those implemented in the Baltic states, where the results thus far had been very encouraging.

Finally, on behalf of the authorities, he wished to thank the staff for its assistance in preparing the adjustment program, Mr. Posthumus concluded. He hoped that the staff's continuing efforts would help Moldova through the coming difficult period.

The Executive Board then took the following decisions:

Stand-By Arrangement

a. The Government of the Republic of Moldova has requested a stand-by arrangement for a 15-month period in an amount equivalent to SDR 51.75 million.

b. The Fund approves the stand-by arrangement set forth in EBS/93/177, Supplement 4.

Decision No. 10539-(93/173), adopted
December 17, 1993

Purchase Transaction - Systemic Transformation Facility

a. The Fund received a request by the Government of the Republic of Moldova for a purchase equivalent to SDR 22.5 million under the Decision on the Systemic Transformation Facility (Decision No. 10348-(93/61) STF, adopted April 23, 1993).

b. The Fund approves the purchase in accordance with the request.

c. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 10540-(93/173), adopted
December 17, 1993

APPROVED: July 27, 1994

JOSEPH W. LANG
Acting Secretary