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Minutes of Executive Board Meeting 95/43

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Executive Board Attendance

P. R. Narvekar, Acting Chairman

Executive Directors

M. Al-Jasser

I. Clark

K. P. Geethakrishnan

J. E. Ismael

D. Kaeser

W. Kiekens

G. Lanciotti

K. Lissakers

H. Mesaki

A. Mirakhor

C. Saito

S. Schoenberg

A. S. Shaalan

E. L. Waterman

J. de Beaufort Wijnholds

Zhang M.

Alternate Executive Directors

M. Sirat

B. Andersen, Temporary

V. J. Fernández

A. Ruocco, Temporary

G. F. Murphy

D. Z. Guti

J. Shields

R. Kannan, Temporary

K. Link

R. F. Cippa, Temporary

A. Chang Fong, Temporary

H. A. Barro Chambrier

J.-C. Obame, Temporary

J. M. Abbott, Temporary

Y. Y. Mohammed

V. Verjbitski, Temporary

J.-H. Kang

H. Petana, Temporary

Song J., Temporary

L. Van Houtven, Secretary and Counsellor

T. Ranaweera, Assistant

Also Present

IBRD: R. P. Nallari, Latin America and the Caribbean Regional Office.  
European I Department: M. C. Deppler, Deputy Director; B. B. Bakker,  
U. Baumgartner, I. Halikias, F. M. Lakwijk, L. J. Lipschitz. Legal  
Department: R. C. Baban. Policy Development and Review Department:  
M. Allen, Deputy Director; A. C. F. J. Houben, C. Puckahtikom. Secretary's  
Department: A. Mountford. Statistics Department: A. M. Bloem. Western  
Hemisphere Department: B. C. Stuart, Deputy Director; J.-P. Amselle,  
H. Arbulu-Neira, E.-G. H. Lim, P. Neuhaus, L. Schmitz, A. J. Tweedie,  
R. C. Velloso. Advisors to Executive Directors: S. K. Fayyad,  
T. K. Gaspard, J. Justiniano, J. Leiva, M. F. Melhem, M. J. Mojarrad,  
T. Oya, R. Rainford, K. Sundara, A. V. Vernikov. Assistants to Executive  
Directors: S. Al-Huseini, P. I. Botoucharov, M. A. Brettschneider, D. Daco,  
D. Desruelle, C. Duenwald, J. C. Estrella, H. Golriz, A. Guennewich,  
J. Hamilius, M. A. Hammoudi, G. H. Huisman, C. Imashev, P. Jilek, T. Kanada,  
G. A. Kyriacou, N. Laframboise, J. Mafararikwa, J. Pesola, F. A. Schilthuis,  
G. Schlitzer, V. Trivedi, R. von Kleist, Wang Y., A. Wechsberg,  
Zubir bin Abdullah.

1. KINGDOM OF THE NETHERLANDS - NETHERLANDS - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with the Netherlands (SM/95/67, 4/5/95). They also had before them a background paper on recent economic developments in the Netherlands (SM/95/76, 4/18/95, and Sup. 1, 4/20/95).

Mr. Wijnholds made the following statement:

Fund surveillance on the Netherlands has always been of an excellent level, and the Dutch authorities highly regard the staff's advice. This year's report on the 1995 Article IV consultations provides no exception to this well-established tradition. On the one hand, the staff properly points to the successes of macroeconomic and financial policies in the beginning of the 1990s, including the achievement of keeping on track with scheduled government deficit reduction despite a slowdown in economic growth. On the other hand, the staff underscores, and rightly so in our view, that making the Netherlands economy structurally healthier requires additional measures in the coming years.

On the economic situation, the staff's projections of continuing economic growth in 1995 and 1996 are very similar to those of my authorities. There are some discrepancies as regards 1995 inflation with the staff's estimates--2.5 percent--being somewhat higher than the current projections in the Netherlands--2 percent. One reason for these differences is to be found in the recent real appreciation of the guilder. The other side of the coin is the suppression of economic activity in the short term; the recent depreciation of the dollar may result in a negative effect of about 1/2 of 1 percent of GDP. However, my authorities believe that detrimental effects on activity in the longer term could be quite limited, because of positive influences on real wages and consumption.

As to fiscal policy, the Cabinet of Ministers strictly adheres to the new fiscal strategy which aims at a decreasing trend in real expenditures over the period 1995-1998. This approach is meant to strike at the root of the budgetary problem, namely, the continuous upward pressure on expenditures in the past. At the same time, further deficit reduction may be expected from using part of the windfall revenue gains stemming from higher than anticipated economic growth. In addition, the expenditure-focused strategy, annual indicative ceilings have been set for the budget deficit. These underscore the necessity of keeping the deficit under control. Although in the current phase of the business cycle considerable margins exist between deficits and ceilings, such margins could quickly disappear in the event of a slowing down of economic growth. If such circumstances prevail,

actual deficit ceilings will come to play a more direct role again in the budget discussions.

It is against the background of these budgetary principles, and in view of lower than expected expenditures--windfall gains of about f. 3 billion, mainly in the social security sector--that the cabinet has recently been able to take some first important decisions about the budget for 1996. Although the 1996 budgetary process must be completed in September, for the first time in the cycle of annual budget preparations, the main decisions for the next year's budget have already been taken. The measures constitute a mix between lowering the collective burden and reducing the budget deficit. The following are the most important measures: (1) social security benefits will be fully linked to contractual private wages, at a cost of f. 700 million. This measure is the more or less automatic outcome of existing legislation that prescribes such a linkage once a certain ratio of inactive/active labor force has been reached; (2) taxes will be further reduced, at a cost of f. 300 million; (3) expenditures will be raised in some specific areas of domestic affairs, such as criminality prevention, at a cost of f. 300 million; (4) outlays in infrastructure will be increased, at a cost of f. 600 million. These outlays are financed through a special investment facility funded from privatization proceeds.

If these measures are fully implemented, the aggregate reduction of the collective burden for 1995 and 1996 will be about f. 9 billion, equal to the amount in the Coalition Agreement for the full four-year period--1995-98. It should be emphasized that the framework of real expenditure reductions remains intact as the new measures were made possible by lower than envisaged expenditures in other areas. The rather stringent policy of real expenditure curtailment thus will be fully adhered to. My authorities agree with the staff that a durable reduction of the collective burden should coincide with a lowering of the deficit and debt position. Continued budgetary consolidation remains one of the key objectives of the Netherlands Government, also with an eye to the third stage of European Monetary Union (EMU).

One final word on the fiscal situation concerns the distinction the staff makes between higher tax and social security revenues. Such a distinction does not play an important role in the current political environment in the Netherlands. There is widespread consensus that, in the event of windfall gains in social security contributions, premia in this area should be reduced automatically.

As to monetary and exchange rate policy, my authorities appreciate the staff's support for the strategy aimed at price and exchange rate stability, that is, through the irrevocable link

between the guilder and the deutsche mark. Recent turbulence on exchange markets has not affected the guilder. In fact, the strength of the guilder made it possible recently to lower the rate on special advances of the Netherlands Bank slightly to 4.4 percent. Long-term interest rates in the Netherlands are almost equal to those in Germany; accordingly, real interest rates are relatively low indeed--according to European standards.

In regard to the labor market, reducing the still too high level of unemployment is a major policy challenge for the new Government. To help redress the problem, a series of measures have been taken, including lowering the tax wedge for minimum wage earners; reforming the disability and other social security laws; becoming more selective in making collective bargaining arrangements legally binding; and augmenting employment programs. Some of these measures are still under consideration, and it is somewhat early to assess their effect on the labor market. In addition, one should take into account that over the years the policy of delinking wages and social security benefits has resulted in a substantial relative reduction in social security benefits. This has led to high job creation rates--in comparison with other European countries--particularly at the lower end of the wage scale. Concerning social security reform, policies are presently aimed at reducing the new entrants, and to a lesser extent at reducing the levels of social security payments.

The Acting Chairman wondered how the Netherlands had managed to reduce the budget deficit while lowering the collective burden.

Mr. Wijnholds said that the Cabinet had decided to implement measures for reducing the collective burden by about f. 9 billion over a four-year period, starting in 1995. At the same time, pending the finalization of the budget in late summer, a number of decisions had been taken in the spring to reduce government expenditures, as a result of which, the authorities expected to reduce the budget deficit--defined according to Maastricht criteria--to 3.5 percent of GDP in 1995 and 2.5 percent in 1996, and improve the respective debt/GDP ratios. Furthermore, buoyant revenues would also help to reduce the projected budget deficit in 1996.

Mr. Shaalan made the following statement:

The staff should be commended for a very clear set of papers on the economy of the Netherlands. I have little to add to the analysis and policy recommendations, with which I agree for the most part. However, I have the following comments.

The economic recovery since late 1993 and the consistently low inflation record of the Netherlands owe much to the pursuit of a judicious monetary policy, with its unwavering focus on controlling inflation through the tight link of the guilder with

the deutsche mark, supported by steady fiscal consolidation even during the economic downswing. The judgment of the markets on economic policies and prospects has been clearly positive, interest rates are among the lowest in Europe and almost identical with German interest rates, and in periods of currency turmoil the guilder was generally not under pressure.

There is little doubt that the authorities' monetary policy would not have been so effective without the support of the sustained fiscal consolidation efforts of recent years. Although the actual and structural deficits marginally increased in 1994, it was nonetheless the first year since the mid-1970s to witness a notable fall, and the beginning of a downward trend, in the high public debt/GDP ratio. It is important to note in this regard that a deutsche mark norm for the exchange rate and inflation objectives in the Netherlands entails a fiscal norm requiring that fiscal performance at least match that of Germany. This would call for a stronger fiscal consolidation effort, especially as interest rates have started to rise slightly above Germany's since late 1994, possibly signaling some loss in confidence. Furthermore, inflationary pressures may increase following the expected closing of the output gap associated with the projected strong growth in corporate investment and output in 1995 and 1996.

This brings me to the issue of the utilization of the anticipated increase in fiscal revenue over which there is a difference of opinion between the staff and the authorities. I can agree with the staff's view that the authorities' preference for using the extra proceeds to alleviate the collective fiscal burden would be appropriate only if the increase in tax revenue were of a more permanent rather than cyclical nature. I can also agree that a better alternative would be to use the extra revenues to reduce the deficit and debt. The staff assesses, however, as "misplaced" the authorities' position in this regard. I find this to be rather too strong a characterization. The authorities' view has indeed merit in that the collective fiscal burden is already quite high in the Netherlands, and we should not underestimate the benefits of a reduction in market distortions that would result from a lighter fiscal burden. Moreover, the authorities have recently started to target a decline in real general government spending, with an effective ceiling on the fiscal deficit, and this strategy will not be affected by the reduction of the collective burden, as Mr. Wijnholds reassures us in his statement. This consideration should allay any concern about a future deterioration in the fiscal position.

My final comment relates to the generous social security benefits and the associated rigidities in the labor market. These pervasive problems in industrial, especially European, economies have led this Board to reiterate, on numerous occasions, its



concerns about their adverse impact on unemployment levels and general economic performance. These concerns are even more relevant in the case of the Netherlands, which has produced an inflation and growth performance constantly superior to the European average since the late 1980s, but which has not been very successful in addressing a serious structural unemployment problem. Thus, the labor market in the Netherlands is characterized by a low participation rate, which is among the lowest in Europe, a very high incidence of voluntary part-time work, and an equally high "broad" unemployment rate, which was estimated at 26 percent in 1993. These figures are indicative of deep-rooted structural rigidities and call for early and sustained corrective measures by the authorities.

A strengthening of structural measures would be opportune at this juncture because, in addition to a favorable overall financial and economic environment, the social and political environment in the Netherlands seems to be also receptive to strengthened structural policies. This favorable political and social environment is underlined by the general fiscal and structural reform policy stance of the present coalition Government and by the agreement of the unions on the need to slow wage increases. The strengthening of structural policies would consolidate the economic gains of recent years, including the decline in unemployment. Above all, it would greatly enhance the economic prospects of the Netherlands well into the long term, for it would then establish a third strong pillar of a strong economic policy, which now rests on a successful monetary policy and a determined strategy of fiscal consolidation.

Mr. Murphy made the following statement:

The central government deficit will be up somewhat in 1995 over 1994, the general government deficit should show a very slight fall, and the structural component is also expected to be up a little. The collective burden is on the way down, and gross public debt/GDP will be little changed. The economic conjuncture for these developments embraces a sharing in the strong showing of GDP growth in the European Union (EU), with inflation held well in check, while the unemployment situation remains grave.

In terms of fiscal policy, the Dutch authorities are marking time at present. A key question for policy must be whether or not marking time is enough to maintain the formidable record of currency and financial market stability which has been achieved in recent years. This in turn comes down to the choices that the authorities face in distributing cyclical revenue gains between deficit and debt reduction, on the one hand, and reduction of the collective burden, on the other hand, and their longer-term plans for fiscal consolidation.

The Board discussion on last year's Article IV consultation and the staff report for this year suggest that the authorities need to switch the emphasis of their policies toward a preference for public debt reduction rather than further alleviation of the collective burden.

The staff marshals well the arguments in favor of such a preference: the appropriateness of letting automatic stabilizers work from a cyclical perspective; the absence of room for maneuver in face of potential recession--or other shock, one might have added--if gradualism is pursued and Maastricht criteria are to be respected; the need for debt reduction to maintain confidence, notably with Germany reducing its deficit; and, long-term factors linked to demographics and the social security system.

The staff might also have built its case on a backward look at the successful long-term achievements of policy in the Netherlands. The guilder/deutsche mark rate has remained stable for over a decade. Monetary policy was used judiciously in that period to support exchange rate coordination. This was brought out in last year's discussion when the Netherlands model was held up as an example because the authorities were willing to move expeditiously and sufficiently on the defensive, while asymmetrically exercising caution in reducing rates. However, even the committed deployment of interest rates to support the exchange rate link would not be sufficient to account for the latter's unique stability. Part of the policy explanation for that stability lies in the long-term fiscal adjustment process. A striking diagram of this appeared in the 1994 OECD Report (Diagram 11, page 44) showing--albeit with a hiccup in transition from one government to another in the mid-1980s--a systematic ratcheting down of the central government budget deficit. The record is remarkable on another count: the relatively close alignment of stated policy intent and outcome at all stages which is presumably a key ingredient in the building of long-term credibility. The general government deficit approach reveals a much less even performance, but then it depends on what yardstick markets are using to judge commitment and outcome. The lesson from all of this is that the gains from sustained past fiscal effort should not be undermined by slowing down at this point, while there is still much to be done as evidenced by the debt/GDP ratio of about 80 percent.

Another consideration in relation to the relative emphasis that might be put on deficit/debt reduction rather than reduced collective burden arise from the--admittedly artificial--constraints imposed by the Maastricht process. If inroads are not made into the level of public debt sooner rather than later, risks will be created in the form of a potential perception that the job

to be done as regards the level of public debt and adequate progress toward the norms is becoming too onerous.

All in all, I support the thrust of what the staff is saying, although I would not be an extremist on this. Some short-term reduction in collective burden may be part of the price of successfully managing the ongoing transition, but the emphasis should shift more decisively to deficit reduction, which will facilitate burden reduction in due course. Mr. Wijnholds's statement gives some indication of a mixed approach by his authorities, but I cannot really determine from the 1996 figures which way the wind is blowing in relation to the basic choice.

Without going into details, let me welcome the reform of the budget exercise and the expenditure focus which is now evident.

I have already adverted to monetary policy. The exchange rate link has been used very successfully as a target, supported ably by interest rate adjustments. The policy should continue.

Finally, I turn to structural measures, and the brief comment I make is not a measure of their importance in the case of the Netherlands. The dramatic labor market statistics tell their own story. Much more is required by way of adjustment to generous benefit schemes, and the restoration of incentives to hire, especially at the bottom end of the labor market. The comfort that I take from this year's staff report is that there appears to be much more happening in addressing structural problems than was signaled in earlier reports. This is welcome and should be carried further as quickly as possible.

Mr. Obame made the following statement:

The staff papers for the 1995 Article IV consultation with the Netherlands and Mr. Wijnholds's helpful statement underscore the continued good progress made by the Dutch authorities on the macroeconomic front and on structural reforms, particularly with regard to the labor market. Indeed, the economic recovery that begun in the second half of 1993 appeared to have gained momentum. Owing to the prudent policies being followed by the authorities, in 1994 economic growth was sustained, thus preventing inflationary pressures from building up. Moreover, the current account surplus was strengthened, and further flexibility was achieved in the labor market.

As I am in agreement with the staff appraisal and policy recommendations, I shall be brief and confine my remarks to a few points for emphasis on the fiscal sector and the unemployment issue before concluding with some comments on official development assistance.

On the fiscal sector, despite the slight increase in both the general government actual and structural deficits in 1994, we note that the Dutch authorities maintained their spending discipline, which allowed for a 1 percent decline in the expenditure/GDP ratio and enabled the debt/GDP ratio to be reduced further. However, the fiscal deficit as well as the collective burden of taxes and social security premiums are among the highest by European standards. Therefore, the fiscal consolidation plan put forward by the authorities, with its emphasis on expenditure reduction, in particular social security spending, is welcomed. In this respect, we commend the authorities for the steadfast implementation of their fiscal adjustment program. We note also the conservative assumption made regarding the growth prospects of the economy. As this growth is likely to be exceeded over the next two years, we support the staff's view that the authorities should let automatic stabilizers work and that additional fiscal revenue, if any, should be used to reduce the fiscal deficit and the public debt rather than lower the collective burden. We particularly agree with the argument that at about 80 percent of GDP--or to be precise, 78.2 percent in 1994 as mentioned by Mr. Wijnholds earlier-- public debt is too high, and a substantial effort would need to be made so as to meet the Maastricht convergence criteria for the third stage of EMU. In this connection, the prospects for only a marginal reduction in the public debt/GDP ratio by 1996 are not reassuring.

On the unemployment issue, we are pleased to note that the structural measures introduced by the authorities in the labor market since the early 1990s have led to a recovery of employment in 1994, as witnessed by the increase in the number of workers employed through temporary agencies. Despite this progress, the level of unemployment remains high, particularly if considered under the concept of broad unemployment. In this regard, the emphasis placed by the authorities on redressing this problem is welcomed, and we support the measures already introduced or those contemplated by the authorities, outlined by Mr. Wijnholds.

Finally, the Netherlands authorities should be commended for their continued good record on official development assistance over the past years. However, for 1994, we note that no data were provided on official development assistance in the staff papers. Neither is there any information on the authorities' intention for the medium term. Could the staff or Mr. Wijnholds indicate how official development assistance in 1994 compares with 1993, and what the likely effect will be, if any, of the fiscal consolidation strategy on the level of official development assistance?

Mr. Kiekens made the following statement:

The countries of my group have much in common with the Netherlands, so it is little wonder that I share the views expressed by Mr. Wijnholds in his informative statement about the importance of better international economic cooperation and coordination for small, open economies. I also share his appreciation of the high quality of the staff's advice.

It is pleasant to start the new season, after the spring meetings, with a case exemplifying the pursuit of sound policies. The Netherlands Article IV consultation sets an especially positive tone, because the Dutch economic performance has been impressive throughout the 1990s.

Despite cyclical weakening in 1993, real GDP still grew by some 0.5 percent where most other European countries experienced severe declines. In 1994, economic activity rebounded vigorously. The slowdown in economic activity in the early 1990s did not interfere with continued reduction of the general government deficit. Indeed, the unfavorable effects of the cycle in the early 1990s were more than offset by the reduction of the structural deficit. Inflation in the Netherlands is still one of the lowest in Europe, and wage moderation continued in 1994. Since the mid-1980s, Dutch job creation has been growing faster in the Netherlands than in most other countries, although since 1993 it could no longer absorb the additional new workers. Consequently, the Dutch unemployment rate remains below the EU average, and its favorable divergence has been widening, especially since 1990.

With this favorable performance as background, the staff identifies two problems, very common in Europe, that mar the structural soundness of the Dutch economy, namely, the fiscal position and labor market conditions. In view of their linkage to demographics and to the social security system, the staff is right to consider these problems in a medium-term perspective.

The new Government, which took office in August 1994, has made progress toward consolidating the Netherlands' good performance by switching to an expenditure-based system. This reduces the potential for procyclic fiscal policy implied by deficit targets. The former system required numerous ad hoc adjustments in spending that disturbed the smoothness of the budget process and distorted the composition of government expenditures. Expenditure-reduction efforts are appropriately aimed at social security outlays, which have a large impact on the budget and distort the labor market.

Although the new fiscal strategy has many advantages, the outcome of the ceiling calculated for the general government deficit may not be ambitious enough to satisfy the timetable for convergence under the Maastricht Treaty. The authorities themselves are aware that the budget for 1996, the year when convergence is to be evaluated, will be the acid test of whether this plan, based on a thorough reform of the social security system, is effective. In fact, in 1995 the general government deficit will decline only slightly to 3.25 percent of GDP, while the structural deficit will increase by some 0.5 percent of GDP. In addition, in light of the nominal growth of GDP, a deficit of 3.0 percent may be too high to steadily reduce the debt/GDP ratio toward the 60 percent Maastricht target. Mr. Wijnholds mentioned, at the beginning of the meeting, that the debt/GDP ratio was 78.2 percent in 1994 and is projected to be 78.4 percent in 1996. In view of these figures, I can certainly understand Mr. Duisenberg's advice, the President of the Netherlands Bank, to reduce the deficit to 1 percent of GDP.

There may be large windfall gains in 1996, when the staff expects GDP to grow by 2.7 percent instead of the fiscal plan's assumed 1.2 percent. But this 2.7 percent growth figure is based on the assumption that real exchange rates would stay at their January 1995 level, whereas the real effective exchange rates of the deutsche mark and a group of closely linked currencies have appreciated over the past few months by about 5 percent. Unless these changes are reversed in the immediate future--which I believe is not very likely--output growth may suffer, especially in open economies with a high price elasticity of exports. Mr. Wijnholds points out that the positive wage and consumption effects of the increase in the effective exchange rate of the guilder could offset the damage. Could the staff comment on whether its growth forecast of 2.7 percent remains valid in light of recent exchange rate developments?

I also note the authorities' willingness to allocate these windfall gains to lowering the deficit and agree with the staff that the public debt ratio of about 80 percent calls for doing so. The Maastricht convergence criteria call for a steady reduction of the public debt ratio, a goal the Netherlands can achieve only by allocating additional tax revenues to the purpose. This is a difficult decision: the supply side could be greatly strengthened by reducing the high and worrisome "collective burden," but without immediate reduction of the debt ratio, financial market confidence will ebb. Nor is the dilemma relieved by any long-term trade-offs between debt reduction and tax reduction. In the longer term, the demographic challenge requires the Dutch authorities to build up the budgetary reserves necessary to safeguard future generations from a ballooning collective burden.

Unemployment should stay at the top of the Netherlands' policy agenda, not only because of its social implications but also because large social security expenditures have been a major obstacle to fiscal consolidation. Although the Netherlands' standard unemployment rate is below the EU average, a broader definition of unemployment gives a substantially higher rate of about 25 percent of the labor force. In addition, the share of the Dutch labor force receiving disability benefits far exceeds the share in any other OECD country. The exclusion of such a large part of the population from the economy cannot be maintained for long.

Unlike other European countries, the GDP-driven employment growth in the Netherlands has increased since the mid-1980s. The background paper shows that the favorable employment performance is at least partly the result of slower productivity growth than in other European countries. The sluggishness of productivity growth stems from both slower labor shedding in the traditional sectors and a stronger shift of economic activity to the services sector whose productivity is generally lower than productivity in the manufacturing sectors. The staff's view that demand is shifting toward nontradable goods is confirmed by the central bank's last annual report and by OECD figures, which both show that in the Netherlands the services sector creates more jobs and employs more people than in most OECD countries.

In 1994 employment decreased for the second year in a row, as international competition brought efficiency rationalizations and a rapid productivity increase to the services sector. This may foreshadow a falling off in the service sector's ability to create jobs in the coming years. Remedial measures include structurally increasing labor market flexibility, reducing the tax wedge at the low end of the tax scale, and reducing disincentives to hiring. The delinking of social security benefits from wages has greatly reduced those benefits and stimulated job creation.

My final point has to do with the high level of savings in the Dutch economy. Forced savings through the nonimposition of pension premiums has provided good results in the Netherlands and might be considered by countries whose savings levels are particularly low. I agree with the staff that the tax system, especially with respect to the taxation of dividends paid by enterprises, should be revised to eliminate distortions affecting savings/investment behavior. I recognize that the business savings are quite high in the Netherlands. Could the staff tell us if the same is true of household savings?

The structural strong points of the Dutch economy--its high savings level, current account surplus, strong currency, and relatively low inflation--position it fairly well for addressing

the few remaining weaknesses--the large structural component of public spending and high unemployment. Recent progress in these two areas has not yet been consolidated, and I wish the authorities every success in doing so.

Mr. Mirakhor said that Mr. Kiekens had drawn attention to the interrelationship between the labor market and the foreign exchange market. The real exchange rate was capable of creating a wedge between production prices and consumption prices, thus creating a wedge between real product wage and real consumption wage. Consequently, a change in the terms of trade might increase or decrease the tax and the premium wage in the labor market. He wondered what the staff had to say about that issue.

Mr. Ismael made the following statement:

It will not be surprising that, like earlier speakers, I will focus my comments on fiscal policy and the labor market, but, rather than being repetitive, I believe that each of us has looked and will look at the problem from different angles.

Let me first comment on fiscal policy. From what I can observe, the Netherlands has been more successful than most other European countries in pursuing fiscal consolidation in the recent difficult period. However, not enough has been done to reduce public debt. The public debt/GDP ratio has reached a high rate of 80 percent last year, well above the target of 60 percent that EU members have to meet to join the European Monetary Union by 1999. In addition, the collective burden--the share of taxes and social security contributions in net national income--has remained well above the OECD average and the ceiling set by the Coalition Accord, thereby holding back the economy and the labor market in particular.

The Government's fiscal intention should therefore be more ambitious. The Dutch Government's plan to cut spending by some f. 10 billion in the next two years and f. 9 billion more in the following two years is a step in the right direction. However, the deficit will fall to only 3 percent of GDP this year from 3.7 percent last year. Therefore, I agree with the President of de Nederlandsche Bank in his recent statement that the Government should further reduce the deficit to 2.7 percent this year to enable a "structural reduction" of the deficit that would facilitate faster cuts in the overall debt.

These targets should be easily beaten. The 1994 deficit undershot expectations, owing to higher than expected revenues, and this is likely to be repeated in 1995, because the Government has assumed cautious GDP growth of 2 percent compared with a forecast for growth in the region of nearer to 3 percent this year. As long as all revenue windfalls are used to reduce the



deficit further rather than to avoid the hard questions about changes in the overgenerous welfare system, the timing of the stabilization of the public debt/GDP ratio--which under the Government's plan does not occur until 1997--could be brought forward. At the same time, this would reduce the budget's sensitivity to interest rate movements and anticipate monetary union in a responsible way.

The labor market, which has disability and involuntary part-time work as its most striking features, is now unquestionably the weak spot of an otherwise fundamentally healthy economy. As the greater part of the unemployment is of a structural nature, it cannot be expected to be corrected by economic growth alone. Indeed, the pickup in GDP in 1994 has thus far had little impact on employment. After a sharp fall in the first half of 1994, unemployment backed up in the second half, ending the year at 7.4 percent, only slightly better than when the year started.

This year, employment creation should accelerate, helped by the ambitious government plan to create 350,000 jobs over the next four years. But I believe it will make little impact on the unemployment rate because, in addition to the normal flow of entrants to the labor market, changes to the welfare system will shift claimants from disability to unemployment benefits. I agree with the conclusions of the OECD report that a comprehensive, in-depth, multiyear reform is needed, with the objective of reducing the labor costs, redressing the incentive balance between working and not working, and improving labor force skills and competencies, in all cases at the lower end of the market.

Finally, as growth in 1994 has been propelled largely by exports, let me also touch on the export prospects in light of the increased guilder strength. The expected continued strength of the deutsche mark, coupled with the close guilder/deutsche mark link, imply an effective appreciation of the guilder. I believe that this will not be a major negative factor for the economy for the following two reasons. Dutch manufacturers apparently have already been successful in cutting their prices in order to compete. In addition, the continuing moderation in wage settlements, coupled with increases in productivity, running at nearly 10 percent much of last year, should offset any loss in competitiveness and allow export growth to benefit from the rising trend in world trade. As a result, the outlook for prices in 1995 will remain relatively benign, and inflation could move further downward this year, either converging with, or at least barely exceeding, that in Germany. On this basis, 1995 should, mark another year of solid growth.

Mr. Kiekens said that, in order to fulfill the Maastricht policy convergence criteria, the Netherlands was required to reduce external debt to a maximum level of 60 percent of GDP. Noting the projected increase in the debt/GDP ratio in 1995, he hoped that the Netherlands would be as successful as Belgium in reducing the external debt to GDP level.

Mr. Wijnholds replied that the debt/GDP ratio, which had been 78.2 percent in 1994, was expected to increase to 78.8 percent in 1995, and decrease thereafter to about 78.4 percent in 1996. He hoped that the debt/GDP ratio could be further reduced in the future.

Mr. Schoenberg made the following statement:

We join the staff in congratulating the Dutch authorities for their success in achieving a number of very important policy goals during the past few years, namely, the reduction of the fiscal deficit despite an unfavorable economic climate, adequate price stability, a strong currency, and a strong current account position, as well as the implementation of some initial measures to reverse the excessive growth of the welfare state.

We also agree with the staff appraisal on the issues that still have to be resolved: the Netherlands has not yet fulfilled the Maastricht convergence criteria on the fiscal deficit and the stock of public debt, the overgenerous welfare state puts a heavy burden on the public budget and the economy as a whole, and labor and product markets remain subject to rigidities that impede their efficient functioning.

I would like to add some more detailed remarks on fiscal policy, the labor market, and monetary policy.

On fiscal policy, I welcome Mr. Wijnholds's assurance that continued budgetary consolidation remains one of the key objectives of the Netherlands Government. Both Mr. Murphy and Mr. Kiekens have rightly observed, however, that the Netherlands is marking time at present. Although we have no doubt that the Government will eventually be able to reduce the budget deficit to below 3 percent of GDP and achieve a decline in the debt/GDP ratio from its current rather high level, we wish to note that the Maastricht criteria as such are rather unambitious during an economic upswing coupled with very favorable external conditions. To gain some leeway for more difficult economic times, the budget deficit should be reduced further. In this connection, we join the staff in welcoming the switch to an expenditure-based medium-term fiscal strategy, which appropriately focuses on the high level of public expenditure. Mr. Wijnholds stresses in this context the objective of striking at the root of the budgetary problem--the continuous upward pressure on expenditures in the past. We support, therefore, the staff's view that cyclical

revenue gains should be used fully at this stage to reduce the deficit rather than to lower the collective burden. Mr. Murphy listed additional arguments for such a line of action.

Concerning the labor market, we were alarmed by the fact that the Netherlands has one of the lowest net participation rates adjusted for hours worked in Europe (Chart 5). As in so many other industrialized countries, the overly generous welfare system is probably at least partly responsible for this phenomenon, which squeezes public budgets from two sides--through lower contributions on the income side and higher costs on the expenditure side. We have taken note of the steps the Government has undertaken thus far; perhaps the staff or Mr. Wijnholds could comment on the newest developments in this area. We urge the authorities to earnestly consider the staff's suggestions and implement them where feasible.

As for monetary policy, it is well known that we fully support the strategy the Netherlands authorities have chosen to follow. This is especially apparent from the fact that the Netherlands and Germany have entered into a formal agreement maintaining the bilateral intervention obligations at the old 2.25 percent band when all other exchange rate mechanism of the European Monetary System (ERM) fluctuation bands were widened in July 1993. Against this background, the presentation of the Dutch monetary policy in the staff document can give rise to misinterpretations, as Mr. Shaalan's statement illustrates. As in many other cases, the staff appraisal fails to clearly distinguish between the ultimate target of monetary policy--price stability--and the intermediate target. As the staff points out in the background paper, the bilateral exchange rate with the deutsche mark currently constitutes the sole intermediate target of the Dutch monetary authorities. The staff appraisal, therefore, is somewhat ambiguous in this regard: "a monetary policy remaining true to the objective of price and exchange rate stability." This characterization of monetary policy could imply two inappropriate conclusions, namely, that the authorities should try to reach more than one final target at the same time and that one of the twin targets should be general exchange rate stability. If that were the case, then Mr. Shaalan's observation that, "a deutsche mark norm for the exchange rate and the inflation objective in the Netherlands would also require a fiscal norm requiring that fiscal performance at least matches that of Germany" would be quite persuasive. In reality, however, the Netherlands and other countries, such as Austria, which are following very closely the exchange rate movements of the deutsche mark have not been following fiscal developments in Germany in a similarly close manner--and rightly so. By steering clear of the heavy budgetary consequences of German unification, for instance, they avoided--to a large extent--the ensuing inflation increase in Germany and also

experienced for some time lower interest rates than those prevailing in Germany.

Mr. Al-Jasser made the following statement:

The prudent adjustment policies by the authorities of the Kingdom of the Netherlands over the past decade have been paying handsome dividends. Substantial improvement in the fiscal position, along with sound monetary policy, has greatly enhanced confidence. As a result, the Netherlands was spared the speculative attacks on its currency despite the turbulence in the currency markets over the past two years. In addition, over the past few years, the Netherlands has posted on average both higher growth and lower inflation than the EU averages.

The challenge facing the authorities at this time is to sustain the current economic expansion while maintaining the enviable performance on the inflation front. On the one hand, this task should be facilitated by the improved policy mix as well as the progress made in reforming the labor market. The strong global growth outlook should also bode well for growth prospects.

On the other hand, as an open and relatively trade-dependent economy, the turbulence in the currency markets poses serious risks to the Netherlands. Indeed, the recent appreciation in the real effective exchange rate of the guilder, especially if it persists, could have significant implications for competitiveness. Although the economy's ability to compete does not seem to have been adversely affected by the real effective exchange rate appreciation during 1992-94, there are a number of important factors that raise some concern at this juncture. First, the recent appreciation of the guilder took place in a very short span of time; second, the gains in competitiveness realized during 1987-91 have already been reversed; and third, the room for maneuver for Dutch exporters to further reduce profit margins has diminished. Thus, additional progress on the fiscal and labor market fronts would be critical to enhance economic efficiency and productivity.

There is no doubt that substantial improvement has been made in the fiscal area. Nevertheless, both the fiscal deficit and the debt burden remain high. The need for further progress in these areas is underscored by the changing population demographics.

In view of the high overall collective burden in the Netherlands and the desirability of reducing such a burden, further fiscal adjustment would necessarily fall on expenditure consolidation. In this connection, the authorities' medium-term plan to reduce real expenditures by an average of 0.7 percent per year during 1995-98 is welcome.

The authorities' emphasis on reducing social security expenditures is indeed appropriate. In addition to allowing for a reduction in both the fiscal deficit and the collective burden, such a plan reduces some of the features that discourage employment creation and foster disincentives to work. It is important, however, that further reductions in the collective burden await the implementation of expenditure cuts. In this connection, I agree with the staff that cyclical revenue gains should be used to reduce the deficit and the high public debt. This is especially relevant, in view of the expected increase in the structural deficit in 1995.

Important progress has also been made in the structural reform area. The ongoing labor reform program is a major step in the right direction. Nevertheless, this may be an opportune time for the authorities to make even more ambitious reductions in both the collective burden and social benefits, especially those that promote disincentives to work. Such an action would further reduce the labor cost wedge and enhance employment prospects. Achieving the full benefits of the emerging labor market reform would be greatly supported by product market deregulation. In this connection, the authorities' medium-term program to address this issue is encouraging.

The Netherlands' record in the provision of official development assistance is commendable. Moreover, its role in promoting free trade, both within the European Union and globally, is noteworthy. An open trading environment will facilitate a more self-reliant development in the developing countries and countries in transition and enhance global efficiency and income.

Mr. Sirat made the following statement:

At the outset, I would like to commend the staff for a set of extremely interesting papers whose relevance goes in fact beyond the Dutch case, and here I have in mind wage moderation and current account surplus on which I will have a few comments.

But, first, let me address the main question raised in the staff appraisal--fiscal consolidation--and comment briefly on monetary policy.

On fiscal consolidation, the case for further fiscal consolidation seems to be impressively demonstrated, on economic grounds. Mr. Murphy's statement summarizes it very well. In particular, I agree with him and with Mr. Shaalan that fiscal strategy should not appear as potentially inconsistent with the ultimate aim of monetary policy--the third stage of European Monetary Union.

Nevertheless, I have some sympathy also for the reluctance of the authorities to fully use the windfall revenue to reduce the fiscal deficit in 1996. My sympathy is based on the following reasons:

I note that in 1993 growth was lower than initially expected and that the Government then took different additional fiscal measures to keep the deficit on track, as their strategy was then one of fiscal deficit targeting. Overall, I believe that the authorities did an impressive job in reducing the fiscal deficit even in a period of slow growth, compared with what was achieved in many other European countries, including my own. In such a context, I can imagine the attractiveness of parallelism.

Moreover, it is a mathematical fact that the debt/GDP ratio improves as nominal growth increases, that is, in a country with low inflation such as the Netherlands, as real growth increases. Therefore, it can be argued that a higher than forecast growth has a windfall effect not only on fiscal revenue but also on the debt/GDP ratio, which is the main concern here;

I am not sure we would, or indeed should, advocate that in a context of lower growth automatic stabilizers should come into play, in view of the tight schedule for arriving at the third stage of EMU. In a sense, such a development is one more argument for a greater fiscal consolidation so as to leave more room for maneuver later on, but it certainly makes it more difficult to explain why those stabilizers should come into play in a context of greater growth.

I would certainly encourage the authorities to try to establish a consensus for a more rapid decrease in fiscal expenditures than forecast under their present fiscal strategy. Such a policy would give them additional credibility and additional room for maneuver during cyclical downturns. But, in view of the extremely high level of the collective burden, I cannot say I am especially surprised or shocked by the choices for the 1996 budget, described by Mr. Wijnholds, inasmuch as I understand such choices should not worsen the fiscal deficit target for 1996. Indeed, from the most recent figures provided this morning by Mr. Wijnholds, I understand the deficit would be notably reduced.

On monetary policy, as implicitly noted in the staff report, there is little to say, in view of the remarkable credibility attained by the present strategy of a close link between the guilder and the deutsche mark, which allows the economy to benefit from some of the lowest interest rates in Europe.

Let me just note in passing that I found extremely interesting the chapter in the background paper explaining how increases in the real effective exchange rate have not led to loss of competitiveness owing to continued wage moderation, which allows for better profitability for the firms and then for potential cuts in profit margins. Such an achievement has naturally been facilitated by the absence of any discernible permanent trend in the real effective rate. Nevertheless, such developments might induce over time a change in the specialization of the economy toward sectors where it could have a greater price-maker role. Further staff analysis would certainly be welcome on this matter, especially if, given external developments, a more permanent trend were to appear. I think Mr. Mirakhor also alluded to this issue.

This naturally leads me to the subject developed very well in the background paper: wage moderation, productivity of the economy, and the current account surplus.

The question of the development of a pattern of current account surplus has been analyzed in several recent background papers, for example, on Switzerland, Denmark, and Belgium. The analysis used is not always the same: here, the staff paper concentrates on the macro relationship between savings and investment, whereas in the case of Denmark, the focus was more on the nature of the trade balance through a close analysis of imports and exports. It would be extremely useful if the staff could publish as an Occasional Paper the collective knowledge accumulated on this matter.

Indeed, I believe that this subject raises several general questions for which I certainly do not pretend to have answers. Let me limit myself to a few short remarks.

I read Chapters I and III of the background paper, keeping in mind Box 3 of the last World Economic Outlook, which describes capital formation and employment patterns in Europe and in the United States. Indeed, one could understand from the background paper that during the past decade, the Netherlands has tried to implement a kind of U.S. pattern within a European model, that is, low real wage growth, a low capital-labor ratio, and rapid employment growth.

The question is whether this economy is developing a new pattern, an intermediate one between stable equilibrium--the European pattern--and another--the U.S. pattern--while keeping a level of regulation and social transfers which still epitomizes a European vision and a relatively unique model of consensus. In other words, throughout the past ten years, growth has come from employment rather than from productivity, as shown by Chart 4 in

the background paper. Is this going to continue, or is investment going to pick up following improvements in profitability? If the former, then presumably the economic policy should aim at lowering to the full extent the nonemployment rate.

This is empirically a difficult question, as one does not know to what extent the high nonemployment rate in the Netherlands, and in particular the very high level of part-time work, expresses merely a social choice or reveals distortionary practices.

But it is certainly a relevant question, in view of a direct relationship between real wage increase and productivity increase, as illustrated in Chart 5. A strategy of wage moderation can only gain from being accompanied by major labor market reforms so that a trade-off between employment and real wage growth can effectively take place. Otherwise, the risk is that all that would be achieved is to slow growth and reduce potential output growth.

Accordingly, I very much welcome the structural measures described in the report as regards both labor market reforms and the medium-term program of deregulation of product markets--in view of the high level of distortions in the Netherlands' sheltered sector, which, according to the background paper, is one of the main reasons for the saving-investment disequilibrium. From this point of view, I noted with interest the argument for a strategy of fiscal consolidation concentrated on reduction of fiscal expenditures so as to increase the relative share of demand for the tradable sector, potentially leading to a rise in investment. And this brings me back to the first subject I mentioned.

Mr. Al-Jasser said that he agreed with Mr. Sirat that a study on the Fund's experience in the analysis of the current account position of various countries would be of considerable interest to economists, and would be a major contribution to balance of payments analysis.

Mr. Mirakhor said that the study proposed by Mr. Sirat should also consider the influence of wage moderation, unemployment, productivity, and investment in capital-intensive technology on the current account position of a country. In that regard, he noted that the staff had emphasized that wage moderation in the Netherlands, which had been stronger than in other European countries, had helped to reduce unemployment.

Mr. Waterman made the following statement:

As others have noted, the Netherlands economy is progressing well on most fronts. Indeed, most would envy recent and prospective economic performance in the Netherlands. If this is a



result of the "Dutch disease," some in this constituency would not mind catching it, at least on the macro side.

On a more serious note, in my view the Netherlands is a case where we can apply our surveillance more selectively. I say that bearing in mind the strength of the external sector and the strong likelihood that macroeconomic stability will be maintained over the medium term. As in any economy, there are ongoing structural problems that have already been referred to, on the fiscal and the labor market side in particular, but in the areas directly related to the Fund's mandate the performance is very good.

Like Mr. Kiekens, one area that caught my attention is the very high rate of private sector saving. In the World Economic Outlook the Netherlands stands out as one of the top performers in this area, particularly in comparison with other industrial countries. I note with some envy, for example, that the Netherlands supplies almost the same amount of savings to the world economy as Australia consumes. With this in mind, I find it interesting and somewhat surprising that potential output growth in the Netherlands has been less than average for the small industrial countries over the past 15 years. This raises questions about the strength of the relationship between economic growth and national saving, and the staff background paper is helpful in answering some, but not all, of these queries.

It is possible that the relatively low domestic investment growth has been depressing underlying productivity growth and therefore potential output. Perhaps the staff would elaborate on this link. Another explanation is that it is a measurement problem. In view of the importance of capital outflow, perhaps the focus should be on GNP, not GDP, but even with the former measure, there may be problems in measuring fully the benefits of such investment, particularly given a tax system that does not encourage the distribution of dividends. I note in passing that there may be a similar issue in relation to measurement of progress in real living standards in Switzerland.

On the savings side, it is important to draw distinctions between policy-induced reasons and other reasons for the high private savings rate. The former could have implications for the policies of other member countries who are having troubles lifting their private saving rate. On this front, I find a number of factors intriguing. I am surprised that higher saving in the business sector is not feeding into higher consumption by households via increased wealth. This might suggest, for example, that biasing tax systems toward achieving greater business profitability and higher retention of those profits could be a way of lifting private sector savings rates, but I am somewhat skeptical about that. Over time, I would have also expected

substantial offsets in terms of household savings behavior from the fully funded pension scheme. In the short run, one would expect some increase in savings to the extent that compulsory contributions are being paid by liquidity constrained consumers. But eventually these liquidity constraints should be relaxed through a number of avenues. Nevertheless, I see the Dutch system of forced contractual household saving as having some attractive features, and I find it difficult to believe that the Dutch economy could be suffering greatly from oversaving by households. The problem--to the extent that there is one--may be the relatively low growth in business investment domestically and the reasons for that.

Ms. Lissakers made the following statement:

The Netherlands weathered the global economic downturn better than many of its neighbors and looks well positioned to build on the recovery. Output growth has rebounded strongly, underpinned by robust exports, lower long-term interest rates, and a resulting boost in investment levels. The reduction in public debt in 1994 adds to this encouraging picture. Further improvements in household savings, employment, and growth envisioned in 1995 suggest a basically sound direction of macroeconomic policy in the Netherlands.

The excellent set of staff papers gives due attention to these positive trends. The papers are equally up front regarding the battles still to be won by the Dutch authorities. I am in general agreement with the staff's appraisal on both fronts. I will therefore focus my remarks on a few of the key challenges still ahead, specifically in the areas of the fiscal adjustment process and public debt reduction, and the need for continued efforts to address longstanding structural rigidities, most notably in the labor market.

Having based the medium-term fiscal package on conservative economic growth projections, the Netherlands' current predicament of having to decide how to use windfall revenue gains stemming from higher than expected growth is a difficulty many of us would like to face. The Madrid Declaration could perhaps not find a better test case. The Cabinet of Ministers' early consideration of the 1996 budget, which Mr. Wijnholds discusses in his statement, is commendable, although I must say I have some questions about the outcome of those deliberations.

The trade-offs between using excess revenues to reduce the collective burden that has evolved to support broad-based social security benefits versus further consolidation of the fiscal deficit continue to be at the center of Dutch political debate. The fiscal implications of each are illustrated clearly in

Chart 6. Like Mr. Murphy and others, I found the staff's case a strong one as to why cyclical revenue gains should be used for deficit and debt reduction as opposed to tax cuts. Allocating higher revenues from social security contributions to the reduction of transfers to the social security system would also seem to be a key component of deficit-reduction efforts.

The recent decision by the Council of Ministers to reduce the collective burden by f. 9 billion in two years instead of four years as originally planned in the Coalition Agreement therefore seems to us a missed opportunity, although understandable from a political standpoint.

Indeed, the measures outlined by Mr. Wijnholds appear solely composed of tax cuts and expenditure hikes. Excess revenues and lower than programmed expenditures are to provide the room for this, and we are assured by the authorities that expenditure targets will still be met. Missing from Mr. Wijnholds's statement, however, is what is slated to happen on the revenue side, and what the overall implications will be for fiscal adjustment. I therefore appreciated his clarification that revenue measures will be more fully discussed in the summer. Still, his news that the reduction of the fiscal deficit will be slower than previously anticipated and that the debt/GDP ratio will increase accordingly were rather disturbing.

I wonder, however, whether the staff has any estimation of the potential impact on private consumption that could come about from the envisioned tax cuts.

Two statements by Mr. Wijnholds struck me as being somewhat contradictory. He states that in next year's budget "social security benefits will be fully linked to contractual private wages," but also notes that "one should take into account that over the years the policy of delinking wages and social security benefits has resulted in a significant relative reduction in social security benefits. This has led to high job creation rates--in comparison with other European countries--particularly at the lower end of the wage scale." This raises the question of whether employment will be adversely affected by the renewed linkage of social security benefits and wages, as well as the relaxation of expenditure restraint implied by the policy change. The staff's view would be appreciated. With the most conservative, although not complete, estimate of joblessness--the basic unemployment rate--having increased substantially in 1994, I would think any potential disincentive to job creation would be worrisome to the authorities.

From whatever angle a start is made, reducing fiscal pressures will hinge on addressing the structural distortions

inherent in the Netherlands' social security regime and labor market. A number of important steps have been taken in recent years, particularly in the area of disability insurance reform, which has accounted for a large percentage of social support. The background paper on social security reform presents a mixed picture of results to date and future prospects.

On the positive side of the ledger, the total number of disability recipients has declined. Re-examinations on the basis of stronger eligibility requirements have contributed to this encouraging trend. The footnote on page 17 of the background paper dampens the assessment somewhat by noting that the first group being re-examined is that of young workers, not particularly representative of the total population of disabled. Furthermore, with the average public sector disability benefit having declined only slightly from 75 percent to 73 percent of the last earned wage, the underlying incentive for employees to take up disability has hardly changed. Prospects for reform of the disability insurance scheme, and the social security system as a whole, will rest on a having a stronger incentive structure in place for both employers and employees.

On a separate issue still related to the labor market, the paper notes that the incidence of part-time work is particularly high in the Netherlands. Could the staff provide some explanation for this: is this primarily a function of women seeking part-time work, or are there other factors involved?

Finally, I would like to commend the staff on its analysis in the background papers of the Dutch current account surplus and of real exchange rate and competitiveness issues. These types of studies should be an integral part of our surveillance efforts. With respect to the current account surplus, I found the staff's case compelling that the savings-investment equation underlying the large current account surplus was attributable more to relatively low investment in the Netherlands than to oversaving.

In that regard, Mr. Waterman's comments and questions were well taken. I would look forward to hearing the staff's comments on this question of the external investment rate. In the recent world economic outlook discussions (EBM/95/34, 4/5/95 and EBM/95/36, 4/7/95), the staff expressed a good deal of skepticism about the impact of tax policies on savings and investment rates. The Netherlands case seems to suggest that there is a very close linkage--or the staff analysis suggests that there is such a linkage. This seems to give further credence to the remarks that Ms. Srejber made in that discussion about the Swedish experience, and this is an area that the staff might re-examine.

Although several factors behind these trends seem to be nondistortionary, and therefore may not suggest a public policy response, the need for strengthened competition to address distortions in the sheltered sector is fairly clear. More interesting, perhaps, is the message that the potential impact of budget deficit on the current account surplus could be offset by a reorientation of relative demand toward tradable goods, as long as fiscal consolidation is concentrated on the expenditure side.

With respect to exchange rate policy, I would concur that the guilder's stability in the wake of recent financial market turbulence is further indication of the success of Dutch monetary and exchange rate policy. Continued support from the fiscal side will be essential to underpin the exchange rate link with the deutsche mark.

Mr. Lanciotti made the following statement:

Today's discussion is about one of the very few European countries where the authorities have successfully established a macroeconomic environment characterized by noninflationary growth, relatively low interest rates, declining budget deficits, and a stable exchange rate.

A credible and tight monetary policy is probably the most important factor behind the strength of the Dutch economy, although I would agree that the successful fiscal consolidation effort undertaken in the course of the past decade has played an important part in the process of increasing confidence in the Dutch economy.

During recent years, the conduct of monetary policy has de facto established a close link between the guilder and the German mark--intermediate target. The success of this strategy is demonstrated by the fact that the guilder has been unaffected by the turmoil in the ERM and by the large capital inflow registered during the 1992-93 crises. As a result, inflation has remained particularly subdued during recent years, generally below that in Germany.

In this regard, the old index shows a decline in the inflation rate, whereas the new index as well as the consumption implicit deflator (Table A9 of the background paper) evidence an increase in the inflation rate vis-à-vis 1993. Could the staff clarify these divergences and comment on the apparent rise in inflation during 1994?

The major problems with the Dutch economy are of a structural nature and pertain to the fiscal situation and the labor market. As the latter problem has been extensively covered in the staff

report as well as by previous speakers, I will limit my brief comments to the fiscal problem.

The authorities have been pursuing a serious fiscal consolidation effort during recent years and have succeeded in setting the deficit on a downward trend. However, the public debt, which is the result of the more expansionary policies of the 1970s and early 1980s, remains relatively high--80 percent of GDP. Hence, an ambitious fiscal consolidation effort would be needed. In this respect, the switch to an expenditure-based medium-term fiscal strategy is the most appropriate, as also noted by the staff.

Most of the expenditure cuts, which are to be considered in real terms, are in social security, a field in which the Netherlands is one of the most generous country in Europe. This is always an uneasy task, but the Government must remain committed to the goal of expenditure reduction.

As concerns revenues, a comment is warranted on the debate between the staff and the authorities concerning the use of unexpected higher revenues from taxes owing to stronger than projected GDP growth. I am supportive of the idea that the additional revenues should be used mainly to reduce the deficit further, although reduction of the collective burden remains an important priority.

It is somewhat surprising that the staff report does not discuss the trade-off between a restrictive monetary policy and the fiscal consolidation effort. In fact, with such a high debt/GDP ratio, monetary policy must have a very limited degree of maneuver; that is, even small interest rate changes would have a large impact on debt-service payments and therefore on the fiscal deficit.

To this I would add that, although long-term interest rates in the Netherlands are low when compared to European standards--about 7 percent on government bonds--they are not low compared to those prevailing in the United States or Japan, nor low by historical standards. In this respect, the continuation of the fiscal consolidation effort is a necessary condition for a reduction of long-term interest rates, which would in turn help reduce the interest rate burden.

Mr. Fernández made the following statement:

Let me first commend the Dutch authorities for their success in achieving the targets of low inflation and stable exchange rate. However, the adjustment of public finances is improving very slowly, and the weaknesses in the labor market are well described in the staff papers.

I will concentrate my comments on the fiscal adjustment strategy agreed by the Dutch authorities. In this regard, I agree with those who consider the Dutch convergence program not to be ambitious enough. In addition, and more worrisome, the program is not front-loaded as it should be, in view of the too high level debt to GDP ratio.

At the same time, there are not explicit targets for the general government deficit and debt reduction. Even under the most optimistic growth alternative considered in the Convergence Program, the debt/GDP ratio largely exceeds the Maastricht standard for 1997-98. It is disappointing that the authorities do not seem to be ready, at this time, to design and implement a structural fiscal adjustment program that would clearly aim at reducing the debt/GDP ratio to more acceptable levels.

Merely counting on growth expectations to comply with the excessive deficit criteria makes the target of monetary union for the Netherlands contingent, to a grater extent, on an exogenous factor. There are, therefore, risks and uncertainties regarding the Dutch authorities' strategy of fiscal adjustment. Less reliance on good luck would be a more prudent approach. Mr. Murphy's statement contains good advice.

These comments are made under the assumption that expenditure targets will be met. I am not in a position to express doubts, but I note that the European Commission has stated that, "There is also a danger that the far-reaching reform of the social security system might take more time than it is currently envisaged or might be only partially implemented."

Moreover, simply complying with the flow aspect of the excessive deficit criteria is not enough to comply with the stock aspect, as we know from the arithmetic of the debt dynamic.

Finally, let me say that the formal exchange rate agreement with Germany should not produce the perverse effect of delaying the needed stronger fiscal adjustment path.

Mr. Mesaki made the following statement:

The Netherlands has had several things to boast about lately concerning its economic performance. One is its success in reducing the fiscal deficit in the face of the economic slowdown. I commend the authorities for their strong leadership.

As faster than programmed revenue is highly likely in 1996, how to use this windfall seems to have been a central issue discussed between the authorities and the staff. In this regard, I agree with most of the staff's views. The staff's arguments in the staff report are convincing, and I support its conclusion that cyclical revenue gains should be used to reduce the deficit rather than lower the collective burden, and that the cyclical increase in social security premiums should be used to reduce the budgetary transfers to the social security system. In particular, I fully share the staff's view that large expenditures arising in the long term from the aging of the population argue for debt reduction now. In addition, no one can be sure that the greater than expected revenues will last long. As in a certain other country, a sluggish economy for three consecutive years might be in store.

With respect to monetary and exchange policy, I basically support the authorities' policies. Inflation has been contained, and the guilder remains intact after the past crises in the European Monetary System (EMS) and the tensions in foreign exchange markets in recent weeks. The authorities' credibility on monetary policy is so strong that, although advocates of greater independence for the central bank might argue differently, I believe the link to the deutsche mark should be maintained, at least for the time being.

However, the link to the deutsche mark alone does not guarantee success of economic performance. I would emphasize that the successful stabilization of the economy is predicated upon the Netherlands' economic fundamentals being consistent with those of Germany. In view of the good economic performance of Germany, the authorities should continue to make efforts at implementing strong measures to keep pace with Germany. This viewpoint also complements the necessity for the authorities to adopt ambitious measures for the reduction of the fiscal deficit.

On the issue of the labor market, the World Economic Outlook analyzes the various reasons for the high employment in the United States and for the high unemployment in the European countries. As a pleasant exception to the general phenomenon, the Netherlands has achieved growth in employment as high as in the United States. The staff's conclusion on this point is simple and clear--the higher growth in Dutch employment is attributable to the low



growth of real wages. This experience has lessons for other European countries that are concerned about high unemployment.

That said, the employment policy in the Netherlands is not totally free from the serious problems experienced by most European countries. Many of the new jobs are part-time and the participation rate adjusted for hours worked remains low. Although the official unemployment rate is less than 10 percent, some 25 percent of the working age population benefits from social support, and broad unemployment, which takes account of the number of beneficiaries of social benefits, is 26 percent. This shows that the authorities should continue to give priority to this labor issue.

I agree with the staff on the three main factors behind these problems: high labor costs, the tax and welfare system, and institutional rigidities and skills mismatches. It is encouraging that the authorities fully recognize these factors and are making efforts to address them. However, I share the staff's concern that the Government's proposed employment programs will not resolve the underlying problem, because they are not based on market mechanisms. I believe that top priority should be given to enhancing work incentives by reviewing comprehensively the social benefits.

Regarding the tax measures, the staff says that the reduction of the tax and social security wedge incorporated in the proposed reform package is not large in itself and seems to indicate that more drastic measures might be warranted.

However, I would suggest that the authorities take a look at the other side of the coin--the necessity of fiscal consolidation. I believe that the impact of these tax measures on the incentive to work is rather limited, and that more importance should be attached to fiscal consolidation, in view of the current situation of the Netherlands. I would appreciate the staff's comment on the trade-off between tax measures aimed at improving the labor market and fiscal consolidation, and on the weight that each should be given.

The staff representative from the European I Department said that, notwithstanding their recent success in reducing the fiscal deficit, the authorities should use the opportunity provided by the current cyclical upswing to make further progress in fiscal consolidation. Adequate progress in reducing the fiscal deficit through expenditure cuts, particularly in the area of social security provision, was required for supporting and enhancing confidence in monetary policy and structural reform.

The authorities had been concerned about the high collective burden, which had been reduced by 1 percentage point of GDP in 1994, the staff

representative observed. With the help of the intended front-loaded tax reductions in 1996, and further efforts thereafter, the authorities were expecting to reduce the collective burden by a total of 3 percentage points of GDP by 1998.

The anticipated reduction in the budget deficit of the general government to only 2.5 percent of GDP in 1996 was somewhat smaller than what the staff had hoped for. At the same time, the debt/GDP ratio would remain virtually unchanged despite the recent cyclical upswing.

After the finalization of the staff's growth forecast, the Dutch guilder, along with some other European currencies, had appreciated further by about 5 percent in nominal as well as real effective terms, the staff representative noted. The appreciation of the guilder, if sustained, could reduce economic growth by approximately 0.25 to 0.5 percent of GDP in the succeeding two years. However, the recent reduction in interest rates would offset some of the negative effects of the exchange rate appreciation on growth. A more expansionary fiscal policy would not be the appropriate response to offset the effects of the real appreciation of the guilder.

Long-term interest rates in the Netherlands were largely determined by rates prevalent in Germany, and not by the degree of domestic fiscal consolidation, the staff representative stated.

The link with the deutsche mark was the only intermediate target of monetary policy that the Dutch central bank observed, the staff representative noted. The central bank had been successful in ensuring price stability, which was the ultimate target of monetary policy.

There had been no evidence of "oversaving" in the Netherlands, the staff representative observed. Household saving--largely contributions to a pension fund--had not increased in recent years. In contrast, corporate savings had risen rapidly owing to increased profitability of private companies. While relatively high double taxation of dividends in the Netherlands might have encouraged businesses to retain earnings, the absence of a capital gains tax might also have had some influence on business savings.

Policy distortions in the sheltered sector that had depressed investment were a key issue in the Netherlands, the staff representative noted. A shift in demand--which had been induced by the growth in the size of the government sector--from tradable to nontradable goods that were mainly produced by the sheltered sector, added to the distortions. Moreover, as aggregate income had risen, the demand for nontradable goods had increased, and as the production of the latter had been relatively less capital-intensive, investment had been reduced.

The Government was in the process of implementing policies for deregulating the sheltered sector, which would increase investment and affect the current account of the balance of payments, the staff

representative remarked. Given the role played by the expansion of the government sector in shifting demand toward the nontradables sector, fiscal consolidation based on expenditure cuts--rather than revenue increases--would help to eliminate the distortions caused by the sheltered sector.

Since the 1970s, wage restraint had been exercised through negotiations between the social partners, the staff representative stated. As the Dutch authorities had not pursued a deliberate incomes policy, and had not intervened in the wage negotiation process, wage restraint had not been distortionary. Wage restraint had increased employment, and had reduced the capital-labor ratio, as there was relatively less labor saving investment taking place in the economy as a whole.

The full indexation in 1996 of social benefits to wages--rather than the half indexation that had been initially envisaged--would have some negative impact on the labor market and its reform program, the staff representative commented. With full indexation social benefits would rise rapidly, and would result in a high reservation wage that would reduce the demand for labor, and increase unemployment.

Sample surveys had shown that part-time work and the voluntary participation of women in the labor force had increased in parallel in recent years, not because full-time employment opportunities had been lacking, but because the Dutch labor market had been flexible enough to accommodate those who preferred to work part-time, the staff representative remarked.

The inclusion of certain government services and taxes, and the exclusion of insured medical services in the new Consumer Price Index (CPI) had raised the inflation rate recorded by that index, the staff representative observed.

Fiscal consolidation and support for labor market reform through tax reductions could be carried out simultaneously, provided there was strong emphasis on expenditure reduction, the staff representative noted. The authorities had emphasized that the expenditure-reduction program was the focal point of their fiscal consolidation effort. Nevertheless, further expenditure reductions of a permanent nature would be essential to release resources for more labor market reform. Reducing taxes on low-paid workers and raising them for the high end of the wage scale would be required for reducing the vast disparities in wage scales.

Despite the fiscal consolidation program, the level of official development assistance in 1994 had not diminished, and would not do so during 1995-98, the staff representative concluded.

Mr. Al-Jasser said that, while investment had declined sharply during 1989-93, government expenditures had declined only moderately. Given the continued increase in social expenditures, he wondered what role government expenditures had played in the overall investment decline. He recalled

that, in the case of the Nordic countries, several disincentives hindered business investment. For example, in the case of Sweden, double taxation and the tendency to retain a substantial share of earnings and "penalties" for distributing dividends were depriving potentially productive industries from obtaining the needed investment resources. Financing high levels of government spending through tax revenues had a negative impact on private sector development, and consequently on long-run investment and economic growth.

A good savings performance, by itself, would not encourage investment, nor would it lead to higher economic growth, Mr. Al-Jasser concluded. While savings were a necessary condition, other issues such as labor market reform needed to be resolved in order to promote investment and growth.

The staff representative from the European I Department said that, in the long run, the expansion of the government sector had been associated with a declining trend in investment. The cyclical downswing in the early 1990s that depressed investment had not changed that long-run relationship.

Mr. Zhang made the following statement:

The Netherlands authorities have maintained an impressive economic record over the past several years and deserve to be commended. In addition to the strong external position and successful monetary policy aimed at price and exchange rate stability, the authorities' consistent efforts in pursuing prudent fiscal consolidation are particularly noteworthy.

As the staff rightly points out, however, further work is required to continue the fiscal consolidation and reform the labor market and social support system, in view of the robust growth and uncertainties in the international financial market.

The shift in fiscal strategy to a real expenditure norm has enabled the authorities to focus on the root of the budgetary problem--the high level of public expenditure. The dilemma with regard to the allocation, either to further reduce the deficit or to reduce the collective burden, calls for a concerted medium-term adjustment approach, as price and exchange rate stability and competitiveness are closely interrelated. We note from Mr. Wijnholds's clear statement the measures contained in the authorities' medium-term strategy, which have been formulated in a way that gradually reduces the central government deficit while lowering the high collective burden.

Many components in the authorities' expenditure-reduction program are reform oriented, especially with regard to some social benefit systems. We join the staff in encouraging the authorities to keep firmly to the plan, especially regarding deficit and debt reduction. A more solid fiscal position will better place the

authorities in the changing environment, considering the extremely open economy and fixed exchange rate policy. We therefore share the staff's view that cyclical revenue gains should be used to reduce the deficit. Lowering the collective burden could be done, in part, in line with reforms in the welfare system.

The high level of unemployment has been a major policy challenge for the authorities; less incentive to work is a major distortion of the system. Determination is required to bring more market-oriented mechanisms into the system. We note that the authorities have taken a series of measures to address the problem, but more remains to be done.

With regard to the monetary and exchange rate policy, we have nothing to add except to say that we support the authorities' policy aimed at price and exchange rate stability through a close link with the deutsche mark.

Mr. Andersen made the following statement:

Let me join other Directors in commending the staff for a fine set of papers. Let me also join others in commending the Dutch authorities for their remarkable successes in recent years owing to their continued stability-oriented policies. One of the cornerstones for the good track record has been the highly credible exchange rate and monetary policies with a tight link between the guilder and the deutsche mark. The strength of this approach, which I fully support, has been demonstrated on several occasions and has contributed to interest rates broadly in line with German interest rates, and sometimes even below. Underlying this, I would also like to emphasize another key element, namely, that the Netherlands has pursued fiscal consolidation for a number of years and has persisted with these efforts also during the economic downswing in the early 1990s, unlike most countries with fiscal problems.

Against this background, I see the main challenge for the Netherlands as ensuring a continuation of their good track record of stability-oriented policies in order to maintain the excellent record of currency and financial market stability. The staff as well as the authorities rightly focus on the two key areas, namely, the problems in the labor market and public finances. Although I am in broad agreement with the staff's analysis and conclusions and have little to add to what has been said by other Directors, I wish to make some brief comments on fiscal policy.

I welcome the reform of the budget and the focus on real expenditure reduction. Within this framework, I fully agree with Mr. Murphy that the main lesson from recent developments is that the gains from sustained past fiscal effort should not be

undermined by slowing down at this point, particularly in view of the high public debt ratio. A main theme in this year's consultation has been the use to be made of the likely faster than programmed revenue growth. Although I appreciate the fact that the budgetary policy is based on cautious growth assumptions and strict expenditure ceilings, I, too, support the thrust of the staff's analysis and recommend that more emphasis be given to deficit reductions in order not to undermine the hard-won fiscal credibility. The staff, as well as Mr. Murphy, lists a number of arguments in favor of letting automatic stabilizers work fully during the upswing. I agree with these arguments and would especially stress the need for ensuring a more substantial reduction in the ratio of public debt to GDP over the medium term and the need for providing sufficient room for maneuver in the event of a future recession. Furthermore, as was said by this chair during the discussions on the implementation of the Madrid Declaration (EBM/95/29, 3/27/95), a policy of letting the automatic stabilizers operate during the upswing to prevent a deterioration of the fiscal deficit in structural terms even falls somewhat short of the goal of achieving fiscal adjustment beyond the effects of cyclical recovery. Thus, more ambitious fiscal consolidation seems to be needed and would be more in line with the good track record of the latter part of the 1980s and early 1990s, which has played a major role in Netherlands' achievements in terms of low inflation and exchange rate stability. Moreover, without questioning the ability and willingness of the Dutch Government to achieve the planned real expenditure reductions, success will crucially depend on the strict implementation of the planned expenditure cuts. Consequently, the execution of savings will have to be closely monitored and supplemented when necessary.

On problems related to the labor market I have not much to add to what has already been said by other Directors and the staff. I welcome the fact that the authorities have taken a series of measures in order to promote participation in the labor market and reduce the still too high level of unemployment. I would only urge the authorities not to lose the momentum in these efforts.

Mr. Verjbitski made the following statement:

As I am in agreement with the thrust of the staff appraisal, and in view of the fact that we are dealing with one of the most prosperous economies in the world, I shall focus my comments on several broad issues.

On monetary policy, the Netherlands obviously benefited in the past from the guilder's close link with the deutsche mark in terms of relatively low--by European standards--long-term interest rates, and the added credibility of the authorities' own

anti-inflationary stance. This linkage to the currency of the largest economy in the region--and the Netherlands' most important trading partner--has helped the guilder to go unscathed through the turbulence in the European foreign exchange markets, and the linkage should be continued.

As economic recovery in Europe exceeded all expectations in 1994 and resulted in large unanticipated revenues, particularly for Europe's small, open economies, the main theme of this year's policy discussions between the staff and the Dutch authorities has been how to make better use of these windfall gains in the period ahead. I note from Mr. Wijnholds's statement that the authorities eventually decided to fulfill in two years--1995-96--instead of four, their political commitments under the Coalition Agreement pertaining to reducing the collective burden. This decision means that, unfortunately, as in many other countries, political considerations prevailed vis-à-vis economically impeccable advice from the staff, which had recommended applying the total of surplus revenue toward reducing the fiscal deficit and public debt. As the general government deficit in the Netherlands has not yet been brought below the 3 percent "ceiling" in terms of GDP, and the public debt still has to be lowered from about 80 percent of GDP to closer to 60 percent of GDP, the Dutch authorities need to intensify their fiscal consolidation efforts aimed at satisfying the convergence criteria under the Maastricht Treaty while favorable cyclical economic conditions last. I believe that front-loading progress in this area would be more desirable than reducing further the collective tax burden.

A relatively high level of unemployment in the Netherlands, or as the staff prefers to put it "nonemployment," is primarily the result of structural rigidities in the Dutch labor market. The high costs of employing or dismissing employees, on the one hand, and strong disincentives to seek employment under the system of extremely generous unemployment and disability benefits, on the other, continue to affect the labor market on both the demand and supply sides. Structural reform in these areas and measures to stimulate competition in the economy through privatization and deregulation are the most appropriate ways to address the problem of unemployment in the Netherlands in a sustainable way. In this regard, like the staff, I am not too optimistic about the authorities' intentions to expand public employment programs by some 60,000 persons in the near term. Elsewhere in Europe, these programs have become a form of hiding unemployment expenditure under a different name with adverse fiscal implications and without meaningful progress on the employment front.

I note from the interesting staff supplement that, since the early 1980s, the persistence of large current account surpluses in the Netherlands has been due primarily to asymmetric recovery of

saving and investment. The high level of saving in the Netherlands of around 23-25 percent of GDP has been primarily accounted for by private saving, as the public sector's saving has been consistently negative.

In this regard, the staff indicates that the Dutch tax system results in severe double taxation of dividends, with a mere 26 percent of distributed profits reaching shareholders after tax, less than half the levels in Germany or in the United Kingdom. In combination with the absence of a capital gains tax, there appear to be strong incentives to withhold corporate earnings to achieve an early growth of share prices. Another reason for high private saving in the Netherlands is the proliferation of supplementary private pension schemes that cover about 90 percent of all employees. The assets of these funds, reportedly, exceeded \$260 billion at end-1993, equivalent to more than 80 percent of the Dutch GDP--the highest proportion among the EU countries. In this respect, I wonder, like Mr. Waterman and other speakers, whether the Dutch framework in this area could serve as a model for other countries, where the need to boost savings is even more pronounced than in the Netherlands in the face of future financial pressures related to the aging of populations.

Finally, although the staff and the Dutch authorities do not regard the recent appreciation of the guilder as seriously damaging the country's competitiveness in the medium term, these developments should remain under close review, as the potential risks in the Dutch case should not be underestimated.

In conclusion, I can support continuing consultations with the Netherlands on a 12-month cycle and would like to wish the authorities every success in the implementation of their medium-term program.

Mr. Kannan said that, despite the Dutch authorities' success in implementing appropriate fiscal policies, a substantial reduction in the debt/GDP ratio would not be achieved unless substantial reduction in the fiscal deficit were realized in the coming years. In that context, he agreed with the staff recommended measures for further fiscal consolidation and structural reform. He wished to commend the authorities for their generous official development assistance, which was expected to be well in excess of the UN target.

Mr. Cippa made the following statement:

At this stage of the discussion, any additional remark might well be a repetition of what has been said by previous speakers or a paraphrase of the excellent staff analysis, which I broadly share.



Therefore, I will limit myself to joining the Board in congratulating the Dutch authorities for their remarkable performance in achieving a number of important policy goals and wish them well for the task that still lies ahead, in particular, in the domain of structural public spending and labor market policies.

I also endorse Mr. Sirat's suggestion to consolidate in one single paper the expertise so far acquired by the staff in countries, including my own, with high savings rates and persistent current account surpluses.

Mrs. Guti made the following statement:

I join other Directors in commending the Netherlands authorities for their credible record in implementing sound economic policies which have fostered the strong performance of the economy in terms of output growth, exchange rate stability, and low inflation. The policies outlined by the new Government are an encouraging signal of the authorities' determination to sustain the momentum. The immediate task ahead, as already noted by other Directors, is to achieve a perceptible reduction in the overall budget deficit and gross debt/GDP ratio, as well as to bring down the high unemployment rate.

I am in general agreement with the thrust of the staff's analysis and policy recommendations. I would, therefore, limit my intervention to only a few observations.

I agree that further fiscal consolidation efforts are required in order to bring the budget deficit and gross debt/GDP ratio down. In this context, I welcome the Government's medium-term strategy of fiscal consolidation with emphasis on targeted reduction of general government spending, in real terms, and prescribed ceilings on the overall budget deficit. A strict adherence to the full implementation of the measures adopted is critical to reducing imbalances, and the regular appraisal of such measures should help to determine if further strengthening is required.

On the social security system, the necessary reduction of the existing generous benefits would be facilitated if the authorities embark, as a matter of priority, on a more comprehensive reform of the system. Meanwhile, they should ensure the strict enforcement of the reform measures recently introduced, particularly in the area of disability insurance. A comprehensive reform in the context of other structural policies, including the elimination of the existing institutional rigidities in the labor market should help to address the problem of the high broad unemployment rate in a sustainable manner.

Regarding the issue of the use of anticipated revenue windfall gains in 1995, although I agree with the staff that such cyclical revenue gains should be utilized for reducing the budget deficit and outstanding debt stock, there appears to be a prior commitment by the Government that part of the expected gains would be used to reduce the collective tax burden. The political risk of nonfulfillment may be difficult to ignore as Mr. Wijnholds seems to indicate in his statement. In this regard, I would go along with Mr Murphy's proposal that part of the initial revenue gains be applied to lower the collective burden, while emphasis should shift more decisively to deficit and debt-stock reduction later on.

The tight stance of monetary policy appears to have adequately met the important objectives of maintaining a strong and stable exchange rate and keeping inflation low. However, we have some concerns about using the exchange rate as the intermediate target for monetary policy objectives. In particular, the staff has identified the risk of loss of competitiveness and export market share when exchange rate appreciation becomes persistent. Over time, the appreciation of the Dutch guilder has been for very short durations that allowed the impact of such appreciation to be absorbed, mainly by variation in the level of profitability of the affected sector. I wonder how sustainable the situation would be if the appreciation is sustained for longer periods while competitor countries adopt a more flexible exchange rate policy to gain competitive advantage. I would appreciate the staff's comments.

Finally, I would also like to commend the authorities for their good record on development assistance.

Mr. Mirakhor made the following statement:

I join other Directors in commending the Dutch authorities for their policy successes in achieving and maintaining price stability but, above all, for the high level of credibility that their monetary and exchange rate policy stance has attained in the markets. It seems that, contrary to some recent pronouncements, markets do pay attention to the fundamentals. In the case of the Netherlands, it appears that when markets are convinced of policy credibility, they are more reluctant to test the resolve of the authorities. Moreover, even when there is evidence of weakness in some of the fundamentals, as long as the markets are convinced that policies are on the right track, as is the case with fiscal and labor market policies in the Netherlands, they give the authorities the benefit of the doubt.

I have only one additional comment, related to the labor market. Although I agree with the staff that policies are on the

right track, in the past few years, although the growth of employment has decelerated, it still remains at a relatively high level compared with other European countries. Nevertheless, the total number of persons receiving unemployment benefits, at an estimated three fourths of a million, is a postwar high, as is the ratio of inactive persons receiving benefits to workers holding jobs. I listened with interest to the staff on the responsiveness of unemployment to the level of benefits. A recent study estimates that in the Netherlands the long-run elasticity of unemployment to the level of benefits is 1.0; this is twice as large as previous estimates. If this is valid, Mr. Shaalan and Mr. Fernández are correct that more ambitious action on the reform of the benefit system could produce quicker and more substantial results. Additionally, as Mr. Mesaki and others have pointed out, reducing the wedge between gross and net wages, and liberalization of dismissal legislation, can further strengthen labor market flexibility.

Finally, the authorities should be commended for maintaining their commitment to official development assistance despite continuing fiscal consolidation, demonstrating again that the two need not be mutually exclusive.

The staff representative from the European I Department said that, while the labor market policies adopted by the authorities had been in the right direction, much more needed to be done in order to reduce labor costs and increase the incentives for the unemployed to seek work. Specifically, indexation and social security benefits would need to be reduced, and the existing labor laws and regulations strictly implemented. A great deal of slippages in the implementation of labor laws had occurred, because social partners had undermined law enforcement.

Mr. Wijnholds thanked his colleagues for their comments, which he would convey to the Netherlands' authorities. The nonparticipation--for the first time in 70 years--of the Christian Democratic Party in the coalition government that had been formed in August 1994, was having some impact on economic policy in the Netherlands.

Measures to liberalize procedures for starting businesses and to implement a strong anti-cartel policy indicated that prospects for further progress in deregulation were good, Mr. Wijnholds continued.

The authorities had moved expeditiously to reduce the high collective tax burden, which they had considered a hindrance to further private sector development, Mr. Wijnholds observed. The high priority given to reducing the collective burden had been debated in the country, and the Governor of the central bank had openly expressed his views on that matter, thus demonstrating the independence of the central bank in policy matters. As a result of the acceleration of action to reduce the collective burden, the budget deficit could not be reduced as fast as the authorities had wished.

Nevertheless, the authorities remained fully committed to achieving the budget deficit and public debt reductions needed to meet the Maastricht convergence criteria.

Directors had agreed that it was important to maintain the present policy of linking the guilder to the deutsche mark, Mr. Wijnholds noted. As the Netherlands had a current account surplus and Germany had a deficit, pegging the guilder to the German mark had not posed any problems. Furthermore, the appreciation of the guilder in recent times had not caused any loss of competitiveness. The authorities were committed to maintaining the link with the deutsche mark as long as it would take to move to the EMU.

The authorities had agreed that further labor market reform was essential, Mr. Wijnholds stated. In that regard, although they had taken some action and were contemplating additional measures in the area of social security, progress had been slow. As the government did not follow an incomes policy, there was no interference in restraining wages. However, in their discussions with social partners, government representatives had underlined the importance of wage moderation for attaining social goals.

Many Dutch people, particularly females, preferred not to work full-time, because they wanted to combine raising a family with some participation in the labor force, Mr. Wijnholds observed. Part-time employment was relatively popular among the Dutch.

The authorities held a somewhat different view on developments in saving, investment, and the current account, Mr. Wijnholds remarked. They had noted that the large current account surplus, among other things, had been influenced by demographic factors. Furthermore, interest earnings from investments made by the civil service pension scheme made a substantial contribution to the foreign exchange earnings of the Netherlands.

As regards the relationship between the sheltered sectors and the growth of the public sector, the authorities had pointed out that the share of the government sector in GDP had declined steadily since 1980, Mr. Wijnholds recalled.

Data from the annual report of the Netherlands Bank had shown that the average fixed business investment level in the Netherlands, during the period 1985-94, of 12.7 percent of GDP had been higher than in Belgium, Germany, France, Italy, the United Kingdom, and the United States, but lower than in Japan, Mr. Wijnholds concluded. Furthermore, the outward-looking policies of large multinational Dutch companies might explain the relatively large outflow of capital for direct investment in projects all over the world. Traditionally, the Netherlands had been a large exporter of capital.

The Acting Chairman made the following summing up:

Executive Directors welcomed the very good recent economic performance of the Netherlands and commended the authorities for the strong policy credibility that they had established. Fiscal consolidation had reduced the general government deficit to a level well below that of the beginning of the 1990s, and tensions in foreign exchange markets had left the guilder unscathed. Growth had picked up in 1994 in line with that in neighboring countries, while inflation had remained low. Wage moderation had helped contain the decline in competitiveness in a period of strong appreciation of the guilder. Despite these successes, there remained a number of concerns: the fiscal deficit and public debt were high and needed to be reduced further; the burden arising from large public expenditure, especially for social security, was still heavy; unemployment was too high and labor participation rates relatively low; and labor and product markets also remained subject to many rigidities.

Directors supported the monetary policy objective of price stability through the linking of the guilder to the deutsche mark. Financial markets had not questioned the guilder's strength, even during times of turbulence, and interest rates in the Netherlands were among the lowest in Europe. Savings in the Netherlands were high, Directors observed, and the economy continued to run sizable external current account surpluses. In that context, some Directors called for a broader analysis of current account behavior, covering also other countries and pulling together the various approaches to analyzing the current account.

Regarding fiscal policy, Directors commended the authorities for their medium-term program that emphasized expenditure reduction, in particular in the area of social spending. On this basis, both a reduction in the fiscal deficit and some lowering of the burden of taxes and social security charges was expected to be achieved. Directors emphasized that the authorities needed to keep firmly to the program of curtailing expenditures and to resist pressures to dilute it. Many speakers observed that the 1995 fiscal policy objectives were not particularly ambitious; in fact, fiscal consolidation was seen to be marking time in a phase of economic upswing. Speakers generally urged the authorities to let the automatic stabilizers work, and to use the higher tax revenues resulting from the faster than assumed economic growth for further reduction in the deficit and the debt/GDP ratio rather than in a cut in taxes. Taking advantage now of the opportunity to cut the deficit and lower debt while economic growth is strong would be important not only to ensure confidence, but also to prepare for the long-run fiscal pressures arising from population aging. Although a lowering of the presently high burden of taxes

and social security charges was certainly desirable, this required a lasting further reduction in spending.

Directors noted that the generous welfare system and high tax and social security wedge inhibited the functioning of the labor market, especially at the low-pay end. Noting the planned reduction in the tax and social security contribution wedge, Directors observed that stronger measures would be necessary to cut labor costs through additional cuts in social benefits. Directors also stressed that further reforms in collective bargaining arrangements could help improve the functioning of the labor market. As for other structural policies, they welcomed the adoption of the medium-term program of deregulating product markets; regulations bore particularly heavily on the nontradable goods sector, keeping investment there low.

Directors commended the authorities for their high level of assistance provided to developing countries and the former centrally planned economies.

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

## 2. ANTIGUA AND BARBUDA - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with Antigua and Barbuda (SM/95/66, 4/5/95). They also had before them a background paper on recent economic developments in Antigua and Barbuda (SM/95/75, 4/14/95).

Mr. Clark made the following statement

My Antiguan authorities express their appreciation for the professional manner in which the staff carried out the work for the Article IV consultation, and for the clarity and candor that they brought to bear on the discussions. As a result of the exercise the authorities are left with a clear sense of the challenges facing them in the period ahead, and of the nature of the measures required to meet these challenges.

Owing to a pickup in tourism, real growth strengthened from 3.4 percent in 1993 to an estimated 4.2 percent in 1994. Owing to the disciplines of the common monetary regime of the Eastern Caribbean countries, including Antigua and Barbuda, prices remained restrained, with the upward movement in 12-month inflation from 1.5 percent at end-1991 to 3.8 percent at end-1994, largely reflecting imported inflation.

Notwithstanding the relatively strong real GDP growth and the stability of prices, the serious domestic and external imbalances that have been affecting the economy in recent years worsened in 1994. The current deficit of the public sector widened to 4 percent of GDP, with the Central Government accounting for 60 percent of this, and the overall public sector deficit increased to 6.5 percent of GDP, with the Central Government contributing three fourths of this result. In the balance of payments, the external current account deficit narrowed from nearly 7 percent of GDP in 1993 to 5.4 percent of GDP in 1994, continuing the declining trend in the external current account deficit observed in recent years, a result mainly of the growth in tourism. The overall balance of payments deficit also narrowed, declining from 10 percent of GDP in 1993 to 7.6 percent in 1994. However, the stock of public external debt outstanding, including interest arrears, increased slightly to 81.3 percent of GDP, and the stock of external arrears grew to 68.3 percent of GDP.

The baseline projections for 1995 indicate a further decrease in the overall external deficit, as well as a narrowing of the current and overall deficits of the public sector, owing largely to revenue growing faster than expenditure. There would be, as well, a slight drop in the ratio of public external debt to GDP. At the same time, under this scenario, the external current account deficit would widen slightly, and the stock of external arrears would grow further to over 69 percent of GDP.

The balance of payments deficit typically has been financed in recent years substantially by accumulating arrears. The public sector deficit has similarly been supported by the accumulation of external and domestic arrears combined with domestic borrowing.

The authorities have indicated increased consciousness of the fact that the imbalances pose a serious threat to the sustainability in the medium term of the short-run growth performance of the economy. They have taken note that the staff has stressed, once more, the urgent need for a comprehensive adjustment program, possibly supported by an arrangement with the Fund and by rescheduling of overdue obligations to Paris Club creditors. The authorities accept that they must introduce strong adjustment measures and are attempting, for the time being, to pursue this through efforts to reschedule external debt bilaterally and through the design of a "home-grown" adjustment program, in connection with which they have had the benefit of a report produced late last year by a joint team drawn from the Caribbean Development Bank, the Eastern Caribbean Central Bank (ECCB), and the Economic Affairs Secretariat of the Organization of East Caribbean States. These agencies have signified that the report they have produced does not constitute an adjustment

program as such, but rather a basis for the formulation of a program.

The Government has accepted some of the recommendations in the report of the regional agencies and incorporated them into a package of revenue-enhancing measures introduced at the end of 1994, which would yield 2.8 percentage points of GDP in 1995. At the same time, on the expenditure side, the authorities are committed to avoiding any general wage increases in 1995 and 1996. Although the revenue measures provoked protest demonstrations when they were introduced, the authorities nevertheless face the challenge of carrying the momentum of this development further, in the direction of a more comprehensive adjustment effort. They look forward to maintaining consultation with the Fund as they address attention to further measures to strengthen the adjustment process.

Mr. Shields made the following statement:

The small country of Antigua and Barbuda accounts for about a quarter of the total GDP of the Organization of East Caribbean states. Therefore, the health of Antigua's economy is important not only to its population of 70,000 people, but also for stability in the whole of the Eastern Caribbean region.

In 1994, the country's economic growth accelerated to just over 4 percent, and annual inflation remained below 4 percent. These developments, while enabling Antigua to maintain its relatively high level of income per capita at around \$7,000, masked a fast-deteriorating situation for the economy as a whole. The current account deficit is about 5.5 percent of GDP; the gross domestic investment ratio is expected to fall to under 20 percent in 1995; and GDP growth is expected to slow down to about 2 percent a year, within the succeeding four years. Most important, the external debt stands at 80 percent of GDP, with an alarmingly high level of external arrears amounting to nearly 70 percent of GDP.

Underlying these deteriorating indicators is a persistent fiscal deficit exacerbated by a growing government wage bill, accompanied by very low public investment, projected to drop to about 1.5 percent of GDP by the year 2000, with consequences for infrastructure deterioration. We also continue to see loss-making public enterprises and growing government arrears both to external and domestic creditors. In short, the Government is currently funding its imprudent management of the public finances simply by increasing its unpaid debts, and the situation clearly is not sustainable.



Few domestic banks and some nonbank institutions, which are prepared to lend to the Government, are extracting a much higher price for doing so, further compounding the existing problems.

The most severe problem appears to be that the pressure on public finances is leading to a further squeeze on already low public investment. The result is that the country's infrastructure is decaying, which is bound to have a direct effect on the standards of living and also on the tourist industry on which Antigua has become heavily dependent. The staff report highlights one instance of pollution caused by poor waste disposal procedures. Without adequate investment, such instances can only increase. The authorities claim that Antigua's rather more up-market tourists are less susceptible to changes in Antigua's competitiveness relative to other tourist destinations. However, they should equally recognize that it is probably the up-market tourist who will show least tolerance to environmental degradation and deteriorating infrastructure.

Mr. Clark had stated that the Antiguan authorities are increasingly conscious of the threat posed to the economy by the present fiscal imbalances. I welcome this increased consciousness, which would not be enough by itself. The government's efforts to develop a so-called "home-grown" adjustment program--with help from the Caribbean Development Bank (CDB) and the Eastern Caribbean Central Bank (ECCB)--is a step in the right direction. However, as both the CDB and the ECCB have made clear, these efforts seem to be falling far short of the more comprehensive adjustment program which Antigua urgently needs. A more comprehensive program would require both deeper fiscal adjustment and a significant reduction in external arrears.

On fiscal adjustment, as the proposed tax increases in the draft 1995 budget are inadequate, additional measures to improve tax collection and reduce exemptions are urgently needed. It would also seem prudent to reintroduce personal income tax. There is also a very clear need for improvements in the performance of the public utilities in order to render them suitable for privatization. The authorities should aim to privatize all utilities eventually.

The Government's proposals for wage restraint do not seem to be going far enough. It is not enough to "strictly limit the hiring of government workers." What is needed is a strategy to reduce the numbers of public sector employees. Although it is an extremely difficult political task, a controlled reduction in current expenditures in the long run must be politically preferable to a wholesale collapse, with the Government simply unable to meet basic obligations, including wages.

A reduction in external arrears has to be a central element of the adjustment effort in Antigua and Barbuda. In my view, the country must approach the Paris Club--which in turn clearly means approaching the Fund. The authorities seem to have hopes of bilateral rescheduling agreements outside the Paris Club, but such an approach is clearly not acceptable to the U.K.. It is unlikely that other creditors would appear with new sources of financing until the arrears are settled. I am rather dismayed that the authorities have failed to realize that the Fund could help them to design and implement a strong Fund-endorsed program, which would open the way for Paris Club rescheduling. The authorities should not consider a Fund-endorsed program as the Fund imposing itself on Antigua. Rather, they should realize that the Fund could provide Antigua with an invaluable means to start addressing its problems, and they should be eager to take the hand that is being offered to them.

In conclusion, I do fully endorse the staff appraisal. The staff has set out an alternative medium-term scenario, which will permit a higher rate of public investment while bringing the public sector back into balance by the year 2000. This would avoid a yet further accumulation of external arrears, and would allow the authorities to begin dealing with existing arrears. The development path is predicated on Paris Club rescheduling, and hence a financial arrangement with the Fund. But it does remain to be seen whether the authorities actually have the political will to follow this path. I would strongly advise them to do so.

Ms. Chang Fong made the following statement:

There were positive developments in Antigua and Barbuda in 1994. Real growth has been maintained and strengthened in 1994--4.2 percent of GDP--while unemployment--7 percent--and inflation--3 1/2 percent--remain relatively low. The tourism sector continues to lead the way, with increases in the arrivals from Europe as the economic recovery there accelerated. These positive indicators, however, mask the serious underlying problems facing the economy, as noted by Mr. Shields. To a large extent, the currency board arrangement of the ECCB and the exchange rate anchor have been a mixed blessing, insulating the economy from the results of deficit financing but precipitating the growing problem of arrears.

The staff report concisely addresses the relevant outstanding challenges that have been evident for some time, and my comments will, therefore, be brief and intended to emphasize the seriousness with which we view the staff's broad assessment.

It was disappointing that, for yet another year, addressing the major imbalances in the economy and reforming the fiscal

system have been postponed. Also of concern is the resulting continued accumulation of arrears to a range of creditors both domestic and external--arrears now account for nearly 85 percent of the total external debt, which stood at 80 percent of GDP at the end of 1994, and arrears to the social security scheme, equivalent to 12 percent of GDP could be a very serious problem in the next few years when claims are expected to outstrip cash inflows. As also underlined by Mr. Shields, new credit to the Government appears to be increasingly secured by "earmarking" revenues, with the potential risk that remaining revenue flows may be insufficient to meet basic expenditure.

A home-grown program would be welcome because of the promise of greater acceptability by the population at large but, in the final analysis, such a program must address the needed reforms. Some of these are outlined in the alternative scenario in the staff report, including cost recovery in public utility tariffs, tax reform, rationalization of public sector employment, and prioritization of public investment projects. However, we are disappointed that measures included in the proposed budget for 1995 suggest only a piecemeal approach to tackling the imbalance between revenue and expenditure. It is unfortunate that current expenditure continues to pre-empt a larger share of revenue when the revenue base is being constrained by increasing tax exemptions, preclusion of a personal income tax, and commitments to reduce import duties in line with the Caribbean Community external tariff structure.

In respect of revenues, although improved administration will secure some improvement in collection, we would expect marginal gains to decline. In respect of expenditure, the increase in employment in the public service in 1994 and the large wage award further raise the ratio of current expenditure to GDP and will further diminish the Government's ability to deliver the infrastructure investment needed to support future growth. There is also an overhang of the wage award to be included in the 1995 fiscal accounts.

Although the diversification strategy appears to be realistic in view of the limited range of natural resources, failure to develop necessary infrastructure will affect the outcome of such a strategy.

To the extent that additional investment will rely on external savings, failure to address the debt problem will constrain the participation of external investors. Although the authorities are hopeful of resolving the external debt problem through bilateral negotiations, credible and coherent policies to strengthen the fiscal position will go a long way toward

accelerating the process--perhaps an understatement having regard to the comments made by Mr. Shields.

Antigua and Barbuda is better placed than most to implement the changes necessary to put the economy on a more sound footing--per capita income is among the highest in the region and tourism receipts are fairly strong. We would urge the authorities to take advantage of the current favorable environment and not allow this opportunity to slip.

Mr. Ruocco made the following statement:

I find the staff's recommendations regarding Antigua's economy appropriate to the problems it is facing, and I also find that the authorities of Antigua and Barbuda are well aware of the country's situation and what they should do to correct it. However, the authorities do not seem fully able to put in place the required solutions because of the adverse short-run political and social conditions, which they have already experienced in the recent past. This seems to be the main message in Mr. Clark's statement, and therefore indicates the type of challenge facing the authorities.

The positive results showed by Antigua's economy during the past two years, in terms of the growth and inflation rates, may be short-lived if measures are not taken to strengthen the economic policy environment. The accumulation of arrears and the continued reduction of foreign financing, as well as the decline in investment, are the most worrisome signs for the future development of the economy. It will not be possible to sustain economic growth without putting in place strong fundamentals that encourage economic agents to invest in a medium and long-term horizon.

As I concur with the staff's analysis and recommendations, I will limit myself to only three points.

First, the arrears problem, both external and domestic, cannot be sustained by the economy for long. It is necessary to generate enough domestic savings and to create appropriate domestic financial channels to permit their use. In this sense, a comprehensive economic program would favor better access to foreign financial markets and foster direct foreign investment, at the same time that it would help to solve the problems of external and domestic arrears.

A solution to the arrears problem has become extremely important as these are not only related to foreign creditors but also to private domestic creditors. These arrears point to the potential disruption of economic activity, or to a further

increase in the cost of public financing which would worsen the deficit situation.

Second, it is necessary to strengthen public savings in two ways: by increasing revenues and by reducing expenditures, in line with the staff's recommendations. As well, different solutions have been suggested by the staff to deal with the debt burden, and I concur with them.

Third, the economy of Antigua and Barbuda is inherently risky because of its high dependence on the tourism industry. In view of this, the authorities should encourage private activities in other areas in order to promote diversification and to become less susceptible to adverse external shocks. Again, a positive foreign scenario would help substantially in this direction.

Finally, I would encourage the Antiguan authorities to take advantage of the current economic situation of strong growth, and low unemployment and inflation rates, to introduce the necessary corrective measures to achieve healthy economic growth with external and domestic equilibria. Otherwise, sooner or later, measures will surely have to be adopted, in a more restrictive and difficult situation, as experience has repeatedly shown.

Mr. Abbott made the following statement:

Year by year, Antigua has been digging itself a deeper and deeper fiscal hole that is undermining the long-run health of the economy. Up to a point, the symptoms of this deterioration have been masked. Because Antigua is an open economy, the private sector has been able to go on expanding despite public sector insolvency. Inflation has not become a problem because Antigua's membership in the Eastern Caribbean Currency Union does not provide scope for the Government to create money to cover its obligations. Instead, cash shortages in the public sector are resolved by progressively larger arrears, both domestically and externally.

The strains of this situation are becoming more evident. The authorities have no serious plan to deal with there fiscal problems, and the policies being followed are only likely to worsen the situation.

It is worth highlighting some of the additional evidence of further fiscal deterioration over the past year that is presented in the staff report.

Over the past year, the authorities have turned to bank borrowing at premium rates to cover their cash shortfall. To obtain credit, they have had to earmark specific revenues as

collateral, thereby limiting the free cash available to meet already overextended commitments.

Wage costs in the public sector were up 15 percent in 1994 despite the fact that half of the agreed 8.0 percent general increase in wages was deferred until this year. Employment in the public sector is providing all the job growth.

Wage costs in Antigua are rising relative to competitor countries in the region.

Public sector entities are increasingly cannibalizing each other for financial resources as each fails to pay the other. In consequence, service deteriorates, essential maintenance is not performed, and infrastructure investment is being deferred.

Government default on payments to the social security system is generating pressure for increased contributions from the private sector, adding further to cost pressures and a weakening of competitiveness.

In these circumstances, it is disturbing that the authorities seem to have no coherent plans to correct fiscal weaknesses; in fact, some of their policies will aggravate the problem. Expanding labor costs in the public sector are not an accident. They are the logical consequence of a policy that makes the public sector effectively the employer of first resort. Similarly, the intention of the social security administration to get into the business of housing development and mortgage financing only pushes the public sector deeper into activities that could better be handled in the private sector. Rationalized pricing by public utilities would be a major improvement, but the report indicates little support for such an initiative or for other needed revenue augmentation. Budgetary plans that call for public investment of 12 percent of GDP suggest that budgeting is not taken very seriously. The staff estimates show that within available resources, Antigua will do well if public sector investment reaches 2.0 percent of GDP in 1995.

Under present and prospective policies, we would expect continuing deterioration of Antigua's fiscal position and a gradual frustration of the economies' development potential. This is unfortunate and unnecessary. We would encourage the authorities to take up the useful policy recommendations in the staff report and begin to put their financial affairs in better order.

Mr. Song made the following statement:

I would like to join previous speakers in congratulating the authorities on their achievements in adjusting the economy, in particular in attaining a relatively strong GDP growth and price stability. The staff is also commended for the excellent paper. As I am in broad agreement with the staff appraisal and the policy recommendations, I wish only to stress the following two points.

Although it is encouraging to see that the authorities have been making efforts to develop their economy, I would like to stress that the importance of providing them with financing and technical assistance from international and regional organizations in assisting their economic adjustment efforts cannot be overemphasized. As rightly pointed out in Mr. Clark's helpful statement, the balance of payments deficit and accumulation of external account arrears have become a formidable obstacle to economic growth as well as to foreign investments. In this respect, it is encouraging to note that the authorities will take revenue-increasing and expenditure-reduction measures that will contribute to a narrowing of the current and overall deficits of the public sector. However, like others, we are very concerned that the balance of payments deficit has been financed mainly by accumulating arrears in recent years. Therefore, we join the staff in stressing that these issues should be addressed under a comprehensive adjustment program, which could be supported by an arrangement with the Fund. We also hope that the Paris Club will take the initiative in rescheduling the country's heavy debt.

With regard to fiscal policy, the authorities are encouraged to take a bolder and firmer stance on the limitation of the current account deficit in general, and wage increases in particular. The authorities are encouraged to make further efforts in liberalizing the labor market to enhance productivity. In order to increase revenue and enhance the country's capability to cope with the unfavorable external developments, we agree with the staff that the authorities should pay extra attention to the diversification of the economy.

Ms. Petana made the following statement:

I would like to thank the staff for a frank assessment of the economy of Antigua and Barbuda. Notwithstanding the more positive aspects, such as a 4.2 percent growth in real GDP in 1994--driven strongly by tourism--and a low rate of inflation of 3.5 percent--helped by its membership in the common monetary regime of the Eastern Caribbean countries--the seriousness of the mounting imbalances highlighted in the staff report makes it imperative that the authorities take adjustment efforts in addition to those proposed in its home-grown adjustment program. The openness of

its small island economy to exogenous factors combined with internal imbalances can only worsen the credibility situation it now faces, unless greater effort is undertaken to strengthen its public finance and restore relations with its external creditors. I am therefore in agreement with the staff's recommendations.

As tourism is likely to remain the mainstay of the economy, I welcome efforts to diversify the tourist market. However, the low levels of investment in support of the projected expansion in tourist infrastructure, environmental problems already occurring from inadequate waste disposal, and essential maintenance of existing infrastructure require stronger action on the fiscal front if Antigua and Barbuda's share of tourism in the region is to be sustained and improved upon.

The most critical task facing the authorities, therefore, is to build up domestic savings to raise investment in view of the declining level of foreign savings. I am in agreement with the staff about the need to take stronger measures in raising revenue, including the reintroduction of personal income taxes, reduction in tax exemptions, increasing tariffs on water and electricity, and improve collection by strengthening the administration of revenue-collecting agencies.

On the expenditure side, I encourage the authorities to contain the wage bill by a more restrained wages and incomes policy, and a reduction in the size of the public sector. This is critical given the size of the public sector wage bill--currently at 12.1 percent of GDP. I would also agree that the proposed legal minimum wage would further constrain labor market flexibility with implications for the country's competitiveness. Already, as the staff has pointed out, this competitiveness may have been undermined by the recent 7 percent increase in private sector wages as a result of more rapid growth in public sector wages. The envisaged expansion of tourist capacity will create additional pressures on domestic resources, and in view of the already high proportion of foreign labor out of the total labor force, those pressures are most likely to lead to upward wage costs and further increased foreign labor.

The problem of interenterprise arrears reflects the problem of dissavings in public enterprises and the lack of fiscal discipline in the public sector itself. The reduction of these arrears and improvement of the capital base will require an increase in tariffs, necessary to break the vicious circle of interenterprise arrears, and to strengthen the financial standing of these institutions. This will facilitate the task of privatizing these institutions in the future.



I am very much concerned, however, at the magnitude of arrears accumulated by the Government against the social security and medical benefit schemes. As the authorities have indicated their intention to close the financing gap by domestic borrowing, I am particularly conscious of their dependence on the resources of these nonbanking financial institutions to augment the financing of the budget, as was done in 1994, accumulating arrears to both institutions. The actuarial review of the social security scheme in 1994 provides a clear picture of the serious situation facing this scheme by 1998, if the Government fails to meet its outstanding obligations.

The deteriorating state of the public sector's finances and the uncertainty about the outcome of bilateral discussions with Antigua's external creditors makes the normative scenario by the staff all the more appropriate to follow. In this regard, I would urge the authorities to consider the proposal for a Fund-endorsed program, or else to strengthen their adjustment efforts along the lines suggested by the staff.

I just have one question, and that is on this aspect of privatization. Is there absorptive capacity in the private sector to accommodate the transfer of public enterprises? In this regard, what is the managerial capacity within the country?

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

The staff representative from the Western Hemisphere Department said that domestic entrepreneurs participated in the ownership and management of enterprises in some specific sectors, such as hotels, banking, communications, and commerce. However, foreign investment could play an important role in the privatization process.

Mr. Clark thanked his colleagues for their comments and the staff for its comprehensive report.

The Government could privatize the utilities and other quasi-public enterprises, or prepare them for privatization, Mr. Clark remarked. The Antiguanians had the human resources and access to other resources in the Caribbean region to carry out successfully a privatization program.

Realizing the serious situation facing the economy, the authorities had taken some measures since the previous Article IV discussion in the Board, Mr. Clark observed. The staff had found those measures to be inadequate to deal with the serious challenges facing the economy.

The "image" of the Fund constrained the implementation of any adjustment measures in countries of his constituency, Mr. Clark concluded. Most Antiguanians tended to associate the Fund with strict austerity measures. However, as the staff had pointed out, the economic situation in Antigua was

unsustainable and the country would not be able to avoid an austerity program for much longer. Although a small country like Antigua would not pose a systemic threat, it would be useful for the staff, management, and some Directors to discuss effective means of communicating to the authorities the Board's concerns about the urgency of policy action.

The Acting Chairman said that, in view of the authorities' recognition of the seriousness of the economic situation in Antigua and the anticipated reactions of the Board, he had discussed with some Executive Directors how the Fund should approach Antigua's adjustment problems. In that regard, he would explore further with the Executive Directors the available options.

The Acting Chairman made the following summing up:

Executive Directors were in general agreement with the staff appraisal. They welcomed the relatively strong growth performance with low inflation, but expressed serious concern that yet another year had passed without the authorities' taking serious adjustment measures. They noted the continued deterioration in the fiscal situation and the lack of progress toward normalizing relations with external creditors. Further delays in taking the necessary fiscal measures would force additional cuts in spending on infrastructure, the environment, and ultimately for tourism, thereby jeopardizing the prospects for economic growth. Directors expressed concern that unpaid bills were accumulating and that revenues were increasingly earmarked for payments on new loans; this practice would make it difficult for the public sector to cover its basic spending obligations. Against this background, Directors called on the authorities to adopt a comprehensive program that would raise public savings and deal with the country's arrears problem as well as help mobilize resources for much-needed investment in the areas of infrastructure and environmental protection.

Although welcoming the increased consciousness on the part of the authorities to sustain corrective policy action, Directors noted that the fiscal measures taken in late 1994 and early 1995, as part of a program developed with help from the Eastern Caribbean Central Bank and other regional institutions, fell well short of what was needed to redress the country's serious fiscal and external imbalances and external arrears. Directors urged that the program be strengthened by additional measures, including a public employment reduction program and additional revenue measures. In this regard, the reintroduction of the personal income tax and increases in public tariffs would make important contributions, as well as the reduction or abolition of certain tax incentives and tax exemptions. Directors urged the authorities to improve the performance of the public utilities and to use proceeds of privatization to help reduce overdue external obligations.

Directors stressed the importance of maintaining Antigua and Barbuda's external competitiveness, particularly in view of its dependence on the tourist industry. Strict adherence to the decision to freeze government wages would help curb the growth of the wage bill and encourage private sector wage discipline. In addition, public employment should be reduced.

Directors exhorted the authorities not to lose more time in approaching the Paris Club for dealing with the arrears problem and in availing themselves of the assistance of the Fund staff to articulate and implement an adjustment program that the Fund could endorse.

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

#### DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/42 (4/21/95) and EBM/94/43 (5/1/95).

#### 3. RELATIONS WITH WORLD TRADE ORGANIZATION - COMMITTEE ON LIAISON WITH THE CONTRACTING PARTIES TO THE GATT

##### Change of Committee Name and Terms of Reference

The Executive Board decides that:

a. the Committee on Liaison with the CONTRACTING PARTIES to the GATT shall henceforth be known as the Committee on Liaison with the WTO; and

b. the terms of reference of the Committee shall be "to assist in the establishment of arrangements for the relationship of the Fund with the World Trade Organization (WTO) and in the ongoing relationship of the Fund with the CONTRACTING PARTIES to the GATT (GATT 1947) for as long as the latter continues to exist. As appropriate, the Committee shall examine and make recommendations to the Executive Board on issues relating to the Fund's relationship with the WTO and the CONTRACTING PARTIES. (EBD/95/56, 4/18/95)

Decision No. 10967-(95/43), adopted  
April 21, 1995

Guidelines/Framework for Fund Staff Collaboration with  
the World Trade Organization

The Executive Board decides that the draft guidelines/framework for Fund staff collaboration with the World Trade Organization (WTO), set forth in EB/CGATT/95/1, Supplement 1 (4/18/95), may be used by the staff to discuss cooperation with the WTO staff, with the goal of reaching agreement on collaboration between the institutions.  
(EBD/95/56, 4/18/95)

Decision No. 10968-(95/43), adopted  
April 21, 1995

4. MEDICAL BENEFITS PLAN - FINANCES - STATUS OF RESERVE

The Executive Board approves the recommendation by the Committee on Administrative Policies to rescind the decision authorizing a refund to the Fund and participants from the Medical Benefits Plan (Decision No. A-10233-(95/1), as set forth in EBAP/95/33 (4/19/95).

Adopted April 24, 1995

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAM/95/60 (4/20/95), by Advisors to Executive Directors as set forth in EBAM/95/60 (4/20/95) and EBM/95/62 (4/24/95), and by an Assistant to Executive Director as set forth in EBAM/95/61 (4/21/95) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/95/34 (4/28/95) is approved.

APPROVAL: May 29, 1996

LEO VAN HOUTVEN  
Secretary