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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/117

10:00 a.m., July 16, 1986

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

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
	T. Alhaimus
H. Fujino	M. Sugita
G. Grosche	
	Wang X., Temporary
J. E. Ismael	
	J. R. N. Almeida, Temporary
T. P. Lankester	
H. Lundstrom	
	L. Leonard
	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	
P. Pérez	
H. Ploix	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, Deputy Director; M. Auberger, P. Beaugrand, P. Dhonte, C. Liuksila, K.-W. Riechel, H. Vittas. Exchange and Trade Relations Department: E. H. Brau, B. de Schaetzen. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, S. M. Hassan, G. D. Hodgson, G. Nguyen, A. Vasudevan. Assistants to Executive Directors: H. Aloui-Abdallaoui, A. Bertuch-Samuels, O. S.-M. Bethel, J. de la Herrân, J. J. Dreizzen, R. Fox, L. Hubloue, T. Morita, W. K. Parmena, S. Rebecchini, M. Rasyid, S. Simonsen, H. van der Burg, P. Verly, B. D. White.

1. BELGIUM - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Belgium (SM/86/140, 6/17/86). They also had before them a report on recent economic developments in Belgium (SM/86/156, 7/2/86).

Mr. de Groote made the following statement:

Though the appraisal of Belgium's economic situation is found to be especially severe, the staff's judgments and recommendations have been accepted by my authorities in a constructive spirit and provide powerful encouragement to the Government to pursue the adjustment task to which it has committed its political destiny.

The discussions in Brussels were focused on the comprehensive fiscal austerity plan which the Government announced during the period of the staff's visit and which aims to accomplish the last phase of the economic adjustment program launched in 1982. The first phase of this program has been carried out successfully: business profitability and external competitiveness have been restored to adequate levels through the combined effect of the devaluation of the Belgian franc and the implementation of strong income and price policies, including the temporary suspension of the wage indexation mechanism. Progress with the restoration of the soundness of the public finances has lagged, however, and the targets of the 1984 fiscal program, designed to stabilize the ratio of public debt to GDP by the end of 1987, have been exceeded by a considerable margin.

Various factors have contributed to this disappointing outcome. A radical reduction of the public deficit has long been resisted because the ease with which the public sector borrowing requirement was met seemed to many to constitute an implicit justification for the domestic absorption of excess savings by the incurring of relatively large deficits. This easy access to the international markets and the abundance of domestic household savings had already led, at the beginning of the 1970s, to the expedient of financing the high costs of the external shocks, rather than adopting timely adjustment measures in response to them. However, this more gradualistic approach fell short of arresting the rise of the public debt to its present critical level where the interest charges exceed nominal GDP growth. Not only does this situation entail a remote risk that sooner or later the limits of the Government's debt capacity will be reached; it also largely neutralizes the fiscal restraint effectively achieved since 1981 by cutting noninterest expenditures by about 4 percent of GDP.

The difficulty of correcting the public deficit has been further compounded by the weak response of private business activity to the favorable investment and export conditions created since 1982, so that the fiscal imbalance could not be absorbed through higher levels of economic growth. On the contrary, the sluggishness of domestic activity, together with the weak demand for Belgian exports, have kept unemployment at critical levels, and the Government has been forced to create extensive employment schemes in order to maintain the social consensus it needs to support its tight income policies. My authorities share the staff's view that the root cause of Belgium's poor investment and growth performance is the fiscal problem itself. They are aware that the high levels of personal income taxation, especially at marginal rates, the expectations of further tax increases created by persistent large budget deficits, and the general uncertainty created by the public debt overhang tend to depress the motivation of employees and entrepreneurs alike and thus affect the general investment climate and the economy's competitiveness in the broadest sense. The previous Government took a limited step toward increasing employees' work incentives in 1985 by reducing the bracket creep for personal taxation, but even at that time it was clear that a more fundamental reconsideration of the Government's budget policies would still be needed to durably reduce the public sector burden to sustainable levels.

The new Government which was elected in October 1985 with the public mandate of implementing a strong fiscal austerity plan therefore embarked on a systematic and exhaustive examination of all its budgetary programs. This time-consuming exercise, which used the principles of zero-base budgeting, was completed during the period of the staff's visit with the announcement of a comprehensive package of budgetary savings totaling BF 195 billion and aimed at reaching the treasury deficit to 8 percent of GNP in 1987 and to 7 percent in 1989, which my authorities consider is a level consistent with the long-term supply of private savings. Unlike previous fiscal programs, this package consists essentially of spending cuts, most of them permanent, which makes the budgetary effort to reduce the deficit by 4 percent of GNP over the next 18 months more valuable. Though spread over the entire range of budgetary outlays, the bulk of the savings has been concentrated in areas such as education and social transfers which according to European Communities (EC) standards have been absorbing an excessive share of public revenues. The details of the fiscal adjustment plan are now being discussed with the social partners and formalized in legal texts so as to allow the Government to present the 1987 budget to Parliament before the end of September. The 1986 budget, which had been postponed to enable the Government to introduce the greatest possible number of planned savings measures with effect from this year, aims at a slight nominal reduction of the treasury deficit from last year's level and is expected to receive parliamentary approval before the end of this month.

The Government is aware that its savings plan will evoke strong resistance because it attempts to modify many deep-rooted social relationships which have long impeded Belgium's movement toward an economic and social reorganization better suited to the new international rules which have emerged from the economic shocks of the 1970s. My authorities are determined to allow no slippages from their objectives, however, and various built-in and procedural safeguards have been provided to ensure that none occur: first, they have based their fiscal program on conservative assumptions with respect to growth and interest rate behavior; and second, they have made provisions to prevent cash outlays from exceeding budgetary programs. In February 1987, they will review the execution of this program and use their special legislative powers to take any needed additional measures.

In order to succeed, the correction of public finances will have to be supported by monetary policies that are conducive to adjustment without endangering the position of the exchange rate. The significant improvement of the external current account, which is expected to run sizable surpluses in the coming years, has permitted my authorities to abandon the setting of formal targets with respect to foreign reserve holdings and to scrutinize more actively any possibility of lowering long-term interest rates. While these efforts have at times been frustrated by market uncertainties over interest rate developments abroad, my authorities consider that on the whole their actions have given support to the positive differential that has now arisen in favor of the return on equity, thus creating conditions under which domestic investments should attract an increasing share of excess savings. Of course, the accommodation of long-term rates to domestic considerations requires flexibility in the setting of short-term interest rates in order to relieve any pressure that might arise from the exchange markets. To improve the quickness of their response to short-term market movements, the monetary authorities reshaped the institutional framework for setting official interest rates in May 1985, which gave them the ability to align the central bank's discount rate frequently and flexibly in response to market developments, thus reducing the significance which the markets used to attach to this rate as a determinant of long-term interest rates.

The Government's commitment to a strong fiscal policy, and to a strong position of the Belgian franc in the European Monetary System (EMS), can be only maintained over time if the competitiveness of Belgian industry is guaranteed by a flexible labor market and a dynamic investment climate, rather than by the continuation of extensive wage and price controls. Too prolonged a reliance on policies that favor a nondynamic business sector at the expense of household incomes and domestic absorption run the risk of creating an undesirable economic situation in which high savings and external surpluses coexist with feeble growth and poor investment performance. Remedies to forestall this risk take time to bear fruit and must be implemented carefully so as not to endanger the acceptance that adjustment has already gained in terms of social consensus, on which the political possibility of continuing the adjustment efforts critically depends. The restructuring of obsolescent industries involves high social costs, which have partly been absorbed by the creation of employment programs supported by the Central Government. My authorities are aware, however, that these are only intermediate solutions, and they have made provision in the new fiscal program for shifting the financing of these programs gradually to the employers of the workers administered under these schemes.

As to incomes policy, my authorities feel that early abandonment of control over the wage formation process, though it would benefit increased wage differentiation and labor market flexibility, might partly reverse the gains made so far in restoring labor costs competitiveness. Since the risk of a catch-up rise in real wages cannot be ignored, the full liberalization of wage negotiations should preferably be dealt with in connection with a reduction of the large differential between wage costs and take-home pay which the high social tax levied on labor inputs has created over the years. The issue of wage controls and that of the high social tax can hardly be separated: they ultimately reflect the structural problems of Belgium's social security system which stem from the large disparity in numbers between the active workers who contribute to the system and the larger inactive population who receive the bulk of its benefits. My authorities consider that their prospects for finding lasting and socially acceptable solutions to those issues would be considerably improved in an international climate in which higher growth and increased wage flexibility would allow them to pursue their adjustment efforts more flexibly without endangering Belgium's international competitiveness.

Mr. Wijnholds made the following statement:

Like some other small industrial countries, Belgium has experienced a number of difficult years characterized by sluggish economic activity, high unemployment, and a variety of structural problems. However, in 1985 the performance of the Belgian economy clearly lagged behind that of similar European economies. Whereas growth and employment picked up in these countries, growth had actually decelerated in Belgium while employment remained stagnant. Although there were a few positive developments, such as the fall of inflation and the recovery of exports, they were overshadowed by the less than satisfactory performance of the real economy, the higher than expected fiscal deficit, and the slow pace of progress in strengthening the private sector. Against this background, the Government decided in May, after long and arduous deliberations, to introduce a courageous package of budgetary measures. It is to be hoped that this program, called the Sint Anna program, will be a watershed for the Belgian economy and enable it to catch up with other industrial countries.

I am in full agreement with the staff's view, which is also the view of the Organization for Economic Cooperation and Development (OECD) and the European Communities (EC), that a rapid and sizable reduction of the public sector deficit is absolutely essential to ensure a satisfactory performance of the economy in coming years. In previous years the authorities have been mainly concerned with cyclical considerations, and their policies have not sufficiently addressed the important structural problems, including the much needed overhaul of the public sector finances. Recently the Government has made a determined effort in the area of public sector finances, although the preoccupation with cyclical effects seems to linger, as several passages in the staff report indicate. For instance, the staff report mentions the authorities' concern with the possible adverse effects on economic activity of the recently adopted fiscal package. In addition, the authorities are cited as arguing that a larger fiscal package would not only not have been possible politically--an assessment I would not wish to challenge--but also would not have been economically desirable because of the deflationary impact of such large expenditure cuts. Like the staff, I feel that the authorities do not give sufficient weight to confidence factors, "crowding-in" effects on the presently overburdened domestic capital market, interest rate effects, avoidance of a higher tax burden, and other dynamic factors such as improved efficiency in the public sector that would result from a drastic reduction of the public sector deficit. In this regard, I would mention the example of Denmark, where the consideration of such factors--which are generally not incorporated into macroeconomic models--presumably has contributed to very favorable results.

The size of the planned fiscal deficit reduction--4 percent of GNP--is unprecedented in Belgium, and the authorities deserve to be commended for its adoption. I also welcome the fact that the authorities are determined to avoid any slippage, as Mr. de Groote mentioned. In light of the actual outturn for the fiscal deficit for 1985--which is less favorable than foreseen--one can understand that the authorities did not go beyond the target of 8 percent of GNP for the deficit in 1987, even though a larger reduction would have been preferable because this target implies an increase when compared to the original goal. However, like the staff, I have doubts whether the Sint Anna program is sufficient to achieve the envisaged deficit reduction. Some of the measures are not permanent, and the projections underlying it appear to be optimistic. Therefore, additional measures may well be needed.

In this connection, I would also note that the presentation of a nonspecified plan to reduce the Government's interest burden has contributed to a certain unrest in the financial markets, which appears to have had the short-term effect of keeping interest rates high, rather than lowering them. Another concern is the failure to attain a stabilization of the debt/GNP ratio. While the original aim was the stabilization of this rate at 100 percent of GNP by 1985, it now seems that that goal will not be reached before 1990, and then at 130 percent of GNP. Against this background, and in view of the fact that Belgium's debt/GNP ratio is one of the highest among industrial countries, the fiscal targets set by the Government for 1988 and 1989 hardly seem ambitious.

The staff also raises the question of the tax cuts and, somewhat graphically, coins the term confiscatory marginal tax rates. As in several European countries, taxes in Belgium are certainly too high. However, with the forecast of a quite high budget deficit in the coming years, I cannot envisage that there would be room for a tax cut, which is something that would deserve high priority only after a more healthy budgetary situation has been attained.

The substantial reduction in the monetary financing of the budget deficit during 1985 is welcome. It is important that this policy be continued even if it contributes temporarily to somewhat higher long-term interest rates. Long-term interest rates, net of withholding tax, have fallen to levels that have contributed to sizable long-term capital outflows, which has put pressure on the Belgian franc. The point is clearly recognized by the authorities, who believe that the decline in the long-term rate had gone too far. In fact, a question arises in this regard as to whether the net benefits of the tax do not warrant maintaining it.

Regarding monetary policy, the authorities have attempted to compromise between the aims of bringing interest rates down as low as possible for cyclical reasons and maintaining rates that were high enough to defend the exchange rate. While I welcome the goal of keeping the rate of the currency as strong as other major European currencies, I share the staff's concern about the tendency to lower interest rates as soon as external circumstances offer any leeway. I wonder whether lowering rates as soon as possible has not actually led to higher rates than would otherwise have been attainable, given the market's anticipation of such moves. Indeed, the recent lowering of money market rates after the April realignment of the EMS seems to have been somewhat hasty. The result has been the repetition of a familiar pattern whereby the Belgian franc fell to the lower half of the EMS band. This tends to underscore the impression that the authorities only allow the rate to move down in the case of realignments within the EMS and not up--a practice that strengthens the market perception of a one-sided currency risk that can be expected to contribute to higher interest rates. The argument mentioned on pages 11-12 of the staff report--that lower interest rates prevented an appreciation of the Belgian franc, which, in turn, would have forestalled a reflow of short-term capital and the replenishment of reserves--is difficult to understand. I would have thought that lower interest rates would not be conducive to attracting capital.

The staff draws attention to the fact that Belgium, unlike other European countries, has not moved toward a deregulation of its capital market. Perhaps from a broad perspective it would be wise for Belgium to follow the example of some other countries in the EMS. While on the subject of deregulation and liberalization, I should say that I support the staff recommendation to eliminate the dual exchange market soon.

Although enterprise profitability has improved substantially, it is questionable whether it has been sufficiently restored. It should also be pointed out that much of the higher profitability appears to have been achieved through labor shedding. Although a policy of wage restraint continues to be pursued, its actual implementation deserves fuller attention, especially in view of the fact that wage costs in Belgium rose in 1985. The expectation that by limiting wage increases to increases in prices at a time of decelerating inflation Belgium would be gaining a wage-cost advantage over trading partners may well turn out to be too optimistic. It should be realized that in a climate of falling inflation, indexation in fact leads to upward pressure on real wages. Also, it remains to be seen to what extent the deceleration of inflation will affect wages in other countries. Furthermore, it should not be forgotten that at the moment, temporary external factors are playing an important role in price behavior, and an indexation mechanism will produce an acceleration of wage costs after these factors no longer exist.

In conclusion, let me reiterate that the recent Belgian fiscal measures are timely and courageous. However, it is doubtful whether they will be sufficient given the magnitude of the imbalance. In the succeeding phase, the authorities would do well to aim for at least a stabilization of the debt/GNP ratio in the short run. In addition, more should be done to correct other structural rigidities in the economy.

Mr. Leonard made the following statement:

Since the Board's discussion of the previous Article IV consultation with Belgium in January 1985 (EBM/85/4, 1/11/85), the the conviction that the underlying weaknesses of the economy were gradually being overcome has diminished. That consumer price inflation has slowed down has not only been due to falling import prices but also to the firm management of incomes by the authorities. Also, that the line is being held on the level of unemployment is the result of specific government measures, even though some of them may be of questionable value in the medium term. Overall, there has been some growth in GNP, and corporate profitability has increased; however, those are the extent of the good developments. The problems are not always perceptible in the economic data, but they have been painstakingly uncovered by the staff. Even what initially was thought to be an improved outturn in the current external account in 1985, now has been analyzed by the staff as attributable to external factors--such as gains in the terms of trade--that have served to conceal dwindling competitiveness, outmoded product structure, and loss of market share. In addition, long-term private capital outflows are seen as suggesting a lack of confidence in Belgian investments as much as an understandable and healthy desire for portfolio diversification. A more obvious and disturbing development has been the renewed deterioration of the public sector accounts, with an intended treasury deficit of 10.4 percent of GNP slipping to 12 percent. Moreover, conflicting objectives in monetary management have become evident, and the response of the economy in general to a better external environment than in earlier years has lacked vitality.

In the face of these adverse factors, the recognition by the Government that took office earlier this year that strong corrective action had to be taken is welcome. However, the staff questions the adequacy in a number of respects of the remedial measures and suggests that the root causes of present imbalances may yet have to be addressed more fully. At the same time, the opening paragraph of Mr. de Groote's statement suggests that differences of position may be based more on timing than on the substance and degree of necessary action.

I will confine my remarks to the fiscal situation because therein rest many of the causes of the present difficulties. There is no doubt that the new Government is taking extensive and firm action to reduce the treasury deficit in 1987 and beyond. The authorities believe that a figure of 8 percent in 1987 and 7 percent in 1989 is achievable and in line with the long-term supply of domestic savings needed to finance the deficit and avoid further recourse to foreign borrowing. The staff does not agree, and on balance, I find its analysis compelling. In spite of Belgium's past savings record, it is doubtful that the domestic resources to finance deficits of the order that is envisaged will be forthcoming. The staff's calculations point to an inexorable rise in the relative size of the public debt and the burden of servicing it, and therefore the deficit is more than likely to continue to undermine the confidence of economic agents, reduce domestic investment, and lead to capital outflows.

Therefore, I agree with the staff that a more demanding target for the reduction of the deficit is called for. Also, the reduction should be brought about through expenditure restraint. The social security system, which accounts for about 60 percent of government noninterest expenditure, is an obvious target. A system that provides subsidies in one form or another for 70-80 percent of households is bound to be wasteful, even if only through the transfer mechanism. That policy may also represent an ideal of social support that is incompatible with vigorous economic enterprise. I believe that the authorities have been both courageous and correct in the measures of reform that they have already selected, and I would encourage them to take the process further.

It is also important that expenditure cuts achieved at one level of government do not become meaningless because of increased outlays elsewhere. This potential problem is evident in the efforts to cut expenditure on public pay by reducing the number of civil servants while at the same time other expenditure is being incurred on special government programs aimed at bringing down unemployment. The fact that a reduction in transfers from the Central Government might give rise to deficits at subsidiary levels is also a danger. The Government should stand firmly on its December 1982 decree requiring local authorities to achieve and maintain balanced budgets for 1988.

The paper on recent economic developments refers to the continuing problem of the Limburg coal mines, which constantly need operating subsidies that will be funded through the sales of shares in firms within the national sector that have resumed profitable operations. I wonder whether similar sales of shares in parts of the Limburg mines themselves might be possible and help the return to profitability of the entire operation.

I appreciate the extent of the difficulty for the Government in reducing budgetary expenditure and departing from social values that have informed political thinking for some decades now. That difficulty derives not least from the fact that for a small country, the good results of rigorous economic management can be quickly undone by external factors. The kind of adjustment advocated by the staff and now being pursued by the Government cannot be guaranteed to yield quickly, if at all, the growth and employment benefits at which they are aimed. The main incentive to the Government and economic agents to change necessarily remains the depressing possibility that without fiscal retrenchment and more economic liberalization, Belgium may be bypassed by the opportunities arising out of economic recovery elsewhere. Neither Belgium nor its friends wish to see that development happen.

Mr. Grosche made the following statement:

I welcome the encouraging signs of improvement in the Belgian economy during 1985, particularly the reduction in the rate of inflation, the improvement in the external current account, the further recovery of enterprise profitability, and the recent pickup in investment activity.

Nevertheless, as Mr. de Groote says in his remarkably frank statement, economic performance on the whole has been rather disappointing, and the public sector deficit and the high rate of unemployment remain major causes for concern. Despite a favorable external environment, economic activity has not picked up sufficiently to make much of an impact on employment and the fiscal imbalance. By the end of the year the budget deficit had risen to 12 percent of GNP, increasing the public sector debt to over 100 percent of GNP.

While I welcome the efforts undertaken by the authorities in recent years to address the structural imbalances in the public sector and in the labor market, they have clearly fallen short of bringing the economy back onto a sustainable path. In fact, the Government's room for financial maneuver has been progressively narrowed, with interest payments on public debt taking up approximately 18 percent of total expenditure in 1985, up from 10.5 percent in 1980.

Against this background, I welcome the authorities' announcement of a new fiscal adjustment package that aims at a substantial reduction of the deficit. What is particularly commendable is the fact that it concentrates, unlike previous packages, exclusively on the expenditure side. While I appreciate the authorities' concerns that the envisaged domestic spending cuts might have some short-term deflationary effects, I nevertheless feel that anything short of these measures would have even more serious implications over the medium term--for example, the "unfavorable scenario" on page 7 of the staff report. Moreover, even the present target of lowering the deficit to 7 percent of GNP by 1989 falls short of what would be required to stabilize the public debt ratio, and I would therefore agree with the staff that a more ambitious medium-term deficit target would be desirable.

In any case, what is important now is that the authorities adhere to a strict course of expenditure restraint that allows for no slippages. This would go a long way toward strengthening confidence in the private sector and improving incentives to invest. It would also provide the needed signal to the public that there will be no recourse to further tax increases in the future. In fact, the disincentive effects of the already high level of taxation, especially the high marginal tax rates, seem to provide at least a partial explanation for the relative sluggishness of investment in Belgium. Furthermore, as the staff points out, the widening of the "wage wedge" appears to have hampered domestic activity by dampening private consumption and demotivating the work force. Thus, while welcoming the policy of reducing the bracket creep on personal taxation, I agree with Mr. Wijnholds that by taking a more ambitious approach toward spending cuts, the authorities could create over time the necessary room for a further reduction in the total tax burden.

Turning briefly to monetary developments, I feel that given the high recourse of the Government to domestic credit and the independent management of the long-term interest rate by the Treasury, the central bank's policies have, on the whole, been appropriate. However, in order to defend the exchange rate, the central bank had to resort to frequent adjustments of short-term rates. The divorce of short- from long-term interest rate management has hampered the effectiveness of interest rate policy and contributed to the large capital outflows toward the end of 1985. Also, while the greater flexibility in setting the discount rate has been a welcome step, the pace of deregulation of Belgium's financial markets fell short of that witnessed in other European countries. In view of this I would, therefore, encourage the authorities to review their interest rate policy with a view to achieving greater consistency and also to take a bolder approach toward deregulation and liberalization of financial markets, including the early elimination of the dual exchange arrangement.

I welcome the authorities' intentions to rely largely on domestic policies to strengthen Belgium's external competitiveness and address its external imbalances. However, apart from appropriate fiscal and monetary policies, such a stance requires a comprehensive structural effort aimed at modernizing Belgium's industrial structure and removing rigidities in the economy. Further wage restraint is certainly a major prerequisite to improve the country's competitiveness, and a certain degree of government intervention might be unavoidable in the short run. But I also support the staff's view that a lasting improvement in the labor markets has to be achieved by addressing underlying structural weaknesses, including the restoration of more flexibility in wage negotiations.

Finally, I would encourage the authorities to take a bold approach toward removing price controls, which only create distortions in the allocation of resources, and to continue pursuing an active industrial restructuring policy--a policy that would gradually obviate the need to grant protection to nonviable sectors.

Mrs. Ploix made the following statement:

The economic situation in Belgium has to be put into a medium-term framework to measure the ground covered since 1982 and to suggest what should still be done. Compared with the bleak picture of 1981, significant results have been achieved by successive Governments in accomplishing most of the original objectives, as illustrated by the numerous charts and tables in the staff paper. I should mention the achievements made in the reduction of inflation, in the restoration of profitability, in the increase in business investments, and in the current account balance, which moved from a deficit of 4.5 percent of GNP in 1981 to a surplus of 0.8 percent in 1985. These improvements were necessary because Belgium, as an open economy, cannot afford to do less well than its trading partners.

Indeed, some backsliding has also been recorded, especially on the objective of reducing the public sector deficit to 7 percent of GNP by 1987. Little progress has also been made so far in reducing unemployment, a problem that Belgium shares with its European partners, unfortunately. The reorganization of industry is still lagging somewhat, and painful decisions have to be made regarding dying activities. These decisions are all the more difficult, given the regional locations of those activities. This picture leaves no room for complacency; even though Belgium has not been lax in recent years, there must not be a break in its efforts while so much remains to be done. The staff, too, clearly calls for further action.

With its unsustainable ratios to GNP of expenditures, 62.4 percent; debt, 119 percent; and public sector deficit, 12 percent; and a high interest burden, the public finance situation in Belgium presents several similarities to that of Italy. Therefore, the recommendations put forward in the Italian case can be renewed in this case. Numerous comments have been made on government debt in the course of previous Article IV consultations with Belgium, as well as in the staff reports and by other speakers this morning. I cannot but regret the postponement until 1989 of the goal of a 7 percent of GNP target for the public sector deficit. The reduction of the public sector deficit must remain a major concern; even if a choice has to be made between what is ambitiously desirable and what is politically achievable, my authorities consider the decision to review the recent fiscal austerity plan and to reinforce it if necessary by February 1987 as the strict minimum to be done. In saying that, I share some of the staff's observations regarding the nature of expenditure cuts--and the provisions to be made as far as their side effects are concerned, especially those regarding education--and debt management.

Although difficult to implement, the present meritorious efforts have to be pursued. They are only a step--even if it is a very important one--toward the strengthening of public finances, which, in turn, would alleviate fiscal pressures. In addition, the success of associated policies is conditional upon strengthening the public finances, especially monetary policy. The present trend in international interest rates and the absence of particular pressures within the EMS will certainly contribute to allowing the monetary authorities more flexibility in improving the structure of interest rates and in lowering the rates in order to boost investment.

The staff and the authorities seem to disagree on the issue of competitiveness. The staff argues that owing to the return to full wage indexation and the deceleration in productivity from work-sharing programs, competitiveness has eroded somewhat in the past two years. The staff, however, does not seem to link this factor with the loss of market shares. Therefore, I would appreciate some clarification: does this loss affect the position of Belgium as an international merchant or as a producer of manufactured goods?

In the current system of wage determination, the staff, holding to its orthodox view concerning indexation, regrets that it does not allow much room for greater differentiation. Mr. de Groote has opposed the risk of a "catch-up" in wages and defended the use of the "competitiveness norm" as a safeguard. Given the present favorable circumstances, I would have preferred a bolder approach toward suppressing indexation and returning to contractual bargaining.

The issue of unemployment remains a prime cause for concern. The unemployment rate, at 13.1 percent, stands well above the EC average. However, encouraging signs of a reversal of the trend have recently appeared, as illustrated by Chart 7 on labor market developments and Chart 5 on capacity utilization in manufacturing in the paper on recent economic developments. The staff, while unhappy with the use of some artificial employment schemes that are costly for the budget, acknowledges that positive changes have occurred. The reduction of unemployment is a long process which cannot be carried out overnight, and a stronger rate of economic growth is an instrumental requirement. Unfortunately, it is to be feared that the growth rate for 1987 will be lower than hoped and, thus, insufficient in creating the expected employment opportunities.

The third structural issue concerns industrial policy. The problem of unemployment points to the need to create conditions propitious to investment and enterprises. There have been substantial reforms aimed at improving business profitability and at reviewing income distribution, but, as noted by the staff, a number of handicaps still impair local investments. This is clearly evidenced in a survey recently completed by the American Chamber of Commerce in Belgium. This survey pinpointed four major obstacles to investment in the Belgian system: excessive individual taxation, exorbitant social security charges, restrictive social regulations, and complex government measures. Given the openness of the economy and the importance of foreign firms in Belgium, it would be essential to remove these disincentives so as to retain and attract investment by improving the rate of return on equity and coverage risks. The second area on which the authorities should focus their attention deals with the restructuring of ailing industries. Much has been done within the European Communities' framework, but this is a painful process, all the more so since the problem is aggravated by specific regional difficulties.

I support the staff's recommendation on the dual exchange system: its existence does not seem to be justified any more, as proved by the very low discount of the financial franc.

To sum up, the medium-term framework within which the strategy has been set seems appropriate in order to give the financial and structural policies the necessary time to be put in place, implemented, and corrected if necessary. I would, however, urge the authorities to take full advantage of the better economic outlook--improvements in terms of trade and the deceleration of inflation--to speed up somewhat the process of reorganizing the economy. In this respect, firm compliance with the objectives on public finances is instrumental for the credibility of governmental strategy. Finally, I wish to commend the authorities for their performance on official development assistance.

Mr. Pérez made the following statement:

The staff appraisal starts by indicating that on the whole, the performance of the Belgian economy has been disappointing during the past 18 months. I would agree with the assertion that results have not been as positive as expected, and that given the serious fiscal problem, more rapid improvements should be expected. The authorities have been engaged in a good number of measures, although not enough to lessen the burden of an immense public debt mortgaging the entire economy. Despite this uncertain panorama in the fiscal area, the good results obtained in other fields--including an increase in the consumer price index of 2 percent forecast for 1986 allow some room for action. Given the openness of the economy, the favorable evolution of prices and wages has made it possible to achieve a good level of competitiveness vis-à-vis its main trading partners and substantial improvements in its trade and current account.

It is clear from a review of the staff papers that the situation on the fiscal front constitutes a problem of the first magnitude and constrains the evolution of Belgium's economy as a whole. In fact, as Mr. de Groote has pointed out, "the root cause of Belgium's poor investment and growth performance is the fiscal problem itself." It is also clear that increased noninterest expenditures are contributing the present fiscal problems, especially subsidies and transfers to households. In this connection, the authorities are facing a difficult structural problem in curbing such expenditures that could have substantial implications for the relationship between the Treasury and the various regional authorities. The overrun in noninterest payments in the past makes the recently approved 1986 fiscal package rank as the most important instrument in the economic program of the authorities.

The package is aimed fundamentally at restraining noninterest expenditures, and it is most welcome, although, like the staff, we are not certain that some of the assumptions are realistic enough. There are a number of uncertainties regarding investment activity that the authorities have decided to view rather optimistically. Given the recent experience in this field, I would caution against being too optimistic before a real improvement and a restoration of profitability take place. After past failures in achieving fiscal targets, the task of promoting the resurgence of investment now rests on the Government.

The increasing public sector debt is rightly stressed in the staff papers. Table 30 of the paper on recent economic developments is most illustrative in this respect. On the decision of the authorities to restructure part of the debt, I would appreciate some comments from Mr. de Groote. In principle, Belgium's policy in trying to cope with the fiscal problem is framed within a medium-term strategy. It is my understanding that by such refinancing, interest payments would be reduced in 1987, and the payments of the increased principal, transferred beyond 1990. Such movement could be interpreted as deferring the problem, thus clouding the medium-term prospects.

The persistence of unemployment is not, unfortunately, unique to Belgium. Despite the diversity of measures already implemented in this area, the problem remains serious. In Belgium, the sluggishness of demand has exacerbated the traditional rigidities of the labor market that usually accompany high unemployment rates. Certainly, the 1.7 percent growth of GNP projected for 1986 and 1987 is not very encouraging. Perhaps the continuation of a favorable external environment might positively influence employment, contribute to a stronger economic activity, and reactivate demand. However, the bulk of the problem of job creation still depends on the elimination of market rigidities. Massive introduction of part-time jobs has improved the situation for some groups in the labor force. Also, wage policy has been very cautious. The wage indexation system, together with the low inflation rate, should give Belgium a competitive advantage. Unit labor costs in manufacturing are projected to increase only 0.7 percent in 1986, a reduction of the 3.1 percent increase in 1985. In addition, the collective labor contract scheme is a useful device in creating employment. Those enterprises which have utilized this type of arrangement raised the rate of employment by 2 percent in 1983 and by 1.1 percent in 1984.

My last point on the labor market deals with the issue of statistics. Recent changes introduced in unemployment statistics are not easy to interpret: older unemployed people have no obligation to register; teachers hired for the summer months are not considered unemployed; and so forth. Therefore, the efficacy of employment measures should be considered in the light of all these changes. In fact, as the staff points out, if account is taken of official employment schemes, the unemployment rate is likely to be close to 20 percent.

As inflationary pressures seem to be under control, monetary policy is primarily directed at defending the exchange rate. For this purpose, the main tool at hand has been interest rate management. The divergent points of view between the Treasury and the central bank regarding interest rate policies should be a cause for concern. While long-term rates are determined by the Treasury, short-term rates are serving different goals under the guidance of the central bank, and, in the process, movements of both variables are interfering with one another causing a worrisome dichotomy.

In conclusion, we are pleased to note that the authorities are aware of the seriousness of the fiscal problem, and we welcome their firm intention to cope with it through a less gradual approach. The favorable international environment should provide them with enough room to implement the necessary reforms.

Mr. Nimatallah said that Belgium's economy suffered primarily from high fiscal debt, a frustrated private sector, and structural imbalances. However, in some respects, the recent performance of the economy had been encouraging. In particular, inflation had continued to decelerate, and the current account had moved into surplus. Nevertheless, against that positive picture, overall economic growth had been lackluster, owing in large part to a decline in private sector investment. Obviously, adopting measures to redress a downturn in private sector investment should receive the highest priority. Above all, attention had to be focused on the course of fiscal policy. Specifically, recent trends in fiscal policy had had a number of distinct adverse impacts on economic activity in general.

At the macroeconomic level, the treasury deficit in 1985, at about 12 percent of GNP, was large, Mr. Nimatallah continued. Fiscal deficits of that magnitude tended to crowd out the private sector. Furthermore, with government debt already at about 120 percent of GNP, and given the fixed interest rates on that debt, the deficit would eventually feed upon itself. Currently, more than 10 percent of GNP tended to be absorbed by interest payments, reducing flexibility in the conduct of fiscal policy.

In that connection, he commended the authorities for their commitment to a bold deficit reduction initiative under the Sint Anna program, Mr. Nimatallah went on. The program would put the economy on the path to attaining a treasury deficit equivalent to only 7 percent of GNP by 1989, a promising first step. However, it should only be the first step. Further adjustment was needed since at current rates of nominal output growth, the deficit needed to be reduced to at least 6 percent of GNP merely to stabilize the debt/GNP ratio. Furthermore, the conduct of fiscal policy had had an adverse impact on the private sector in particular, evidence of which could be found in the appendix to the paper on recent economic developments where the shift in Belgian investor portfolios from physical to financial assets was analyzed. The interesting thing about that analysis was that the enterprise sector was not supplying the financial assets. It was argued that the persistence of the fiscal deficit and the uncertainty over how it would be reduced had resulted in the unwillingness of the private business sector to invest. The repeated postponement of the 7 percent of GNP target for the net financing requirement of the Treasury had affected business expectations negatively. That unwillingness to invest had been exacerbated by the existence of a gamut of government regulations.

With the benefit of hindsight, it was possible to see that the gradualist approach to adjustment in general might have had a negative impact and been a frustration for the private sector, Mr. Nimatallah remarked. Therefore, decisive action by the authorities was necessary if investors were to be convinced that a true change in policy was taking place. In that context the recent deficit reduction initiative was a step in the right direction because of its comprehensive nature. However, if that improvement was to be sustained, it would have to be reinforced by similar actions in the years to come, a point raised in the staff's medium-term scenario.

In addition to the size of the fiscal deficit, decisive action was also needed on the structure of taxes, Mr. Nimatallah considered. In particular, with the indexation of personal income tax brackets, the underlying elasticity of the tax system would be reduced; and in contrast, given the importance of social expenditure, the elasticity of expenditures would remain high. Furthermore, as things stood at present, the burden of taxation, which had increased steadily to about 50 percent of GNP in 1985, was high. Therefore, he welcomed the focus on expenditure reductions in the recent fiscal package. However, that focus would need to be maintained and strengthened.

More generally, it was important for the authorities to continue their efforts to reduce the extent of regulation, and in the process, to encourage a more flexible and realistic pricing structure, Mr. Nimatallah commented. For example, he had noted that the system of wage determination in Belgium was very complex and heavily regulated. With a reversal of the partial deindexation of wages and the adoption of the competitiveness norm, the ability of relative wages to adjust to changes in circumstances was limited, an important issue in light of Belgium's high unemployment rate. While the transition to a more flexible system of wage determination must be approached with caution, he hoped that progress could be made in that area in order to link future wage increases to productivity gains. In that context he agreed wholeheartedly with Mr. de Groote's statement that "the Government's commitment to a strong fiscal policy and to a strong position for the Belgian franc in the European Monetary System could only be maintained over time if the competitiveness of Belgian industry is guaranteed by a flexible labor market and a dynamic investment climate, rather than by the continuation of extensive wage and price controls."

Belgium continued to maintain a dual exchange rate, Mr. Nimatallah noted. However, he understood that the two rates were quite close and that the central bank had been exploring the possibility of unifying the exchange rate. He would appreciate further comment by the staff or Mr. de Groote on that point.

He commended the authorities for their commitment to a liberal trading system, Mr. Nimatallah said. However, as his chair had pointed out on several occasions in the context of other industrial country Article IV consultations, it was important that that commitment be extended as far as possible in order to eliminate agricultural trade restrictions, in particular, and to open markets to developing countries' exports, in general. In particular, it was important that the authorities continue their efforts to restructure the steel and textile industries.

He commended the authorities for the bold measures they had adopted to address the fiscal imbalances and to alleviate structural weaknesses, Mr. Nimatallah said in closing. The important first step had been taken, and he hoped that the authorities would intensify their adjustment efforts, particularly in the structural areas.

Mr. Fujino made the following statement:

> Since the Board's discussion of the previous Article IV consultation with Belgium, progress has been made in some important areas of the economy, although favorable external developments contributed to a considerable extent to this outcome. The rate of inflation was reduced to 1.5 percent in the fiscal year ending April 1986, and wages were kept from rising above the rate of inflation. The current account has moved into surplus. There has also been a marked improvement in the profitability of enterprises, and it is particularly noteworthy that the rate of return on equity has risen above the real interest rate. By contrast, the growth rate of real GNP has been disappointing, and the fiscal deficit and unemployment, two related structural problems, remain critical.
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> Against this backdrop, an important initiative was taken in the fiscal area in May 1986 toward a sustained reduction in the fiscal deficit over the medium term. In what is called the Sint

Anna program, the authorities committed themselves to a number of measures of expenditure restraint, including cuts in unemployment compensation, pensions, and employment programs. Involving permanent expenditure cuts equivalent to 3 percent of GNP, the program is expected to have the effect of reducing the treasury deficit to 8 percent of GNP in 1987 and to 7 percent in 1989. This is a step in the right direction, but given the magnitude of the fiscal deficit and the size of the public debt, the present program does not appear to be strong enough to bring about a major turnaround in public finance. However, it is encouraging to note that Mr. de Groote's authorities share the staff's views that the root cause of Belgium's poor performance is the fiscal problem.

At 119 percent of GNP, the public debt of Belgium is one of the highest among industrial countries, and in order to contain its size relative to GNP, the treasury deficit cannot rise beyond 6 percent of GNP, according to staff calculations. I believe that this deficit ratio should be regarded as a minimum for any program that aims at fiscal adjustment. It is therefore regrettable that the target set for 1989 by the Sint Anna program falls short of this requirement. In selecting a rather gradualistic approach, the authorities seem to place their hopes on relatively large existing financial savings that can be tapped for government finance. However, as Appendix II of the paper on recent economic developments shows, such large financial savings may be a mere reflection of stagnant private investment that should not be counted upon as a reliable source of finance in any sound economic strategy. Indeed, the lack of buoyancy in private investment is a source of serious concern and may be associated with an already high tax burden and worsening prospects for future tax increases arising from the buildup of public debts. Under such circumstances, additional fiscal adjustment is clearly needed, and more emphasis should be placed on expenditure restraint rather than revenue increase. From my own country's experience, I fully understand the difficulties of cutting expenditure, particularly if the cuts involve a reduction in social benefits. They require not only strong determination by the authorities but also broad support from the general public. It is, therefore, important for the authorities to appeal to the public for an understanding of the critical condition of the public finances and try to build a consensus on a comprehensive adjustment program.

The burden of public debt manifests itself also as a severe constraint on the conduct of monetary policy. In managing the long-term interest rate, the utmost importance is attached to the cost of treasury funding, and as a consequence, the burden of adjustment arising from exchange market pressures falls almost exclusively on the management of short-term interest rates. This has led to a pattern of long-term capital outflow compensated for by an inflow of volatile short-term capital, thus making the balance of payments structure somewhat unstable. A flexible policy for both short- and long-term interest rates will be essential to maintain the confidence of public debt holders and also for exchange rate considerations. I hope that the more flexible adjustments in the discount rate represent a step toward such flexibility rather than compensation for the rigidities surrounding long-term interest rates.

With respect to the exchange rate policy, the decision made by the authorities on the occasion of the latest EMS realignment was a commendable one, although it needs to be buttressed by stronger policies of fiscal and structural adjustment.

This brings me to the structural problems. The extremely high unemployment rate remains one of the most intractable problems in Belgium. While the rate of unemployment has stabilized over the previous year, it remains one of the highest in the developed world, and the duration of the average case of unemployment is still lengthening. Various measures that have been taken with a view to reducing the unemployment rate, such as the government employment scheme and work sharing, may have exerted a favorable effect in the short run but over the long term could add to the structural difficulties by increasing the burden on public finances and the productivity losses of enterprises. Perhaps only the restoration of confidence in the medium-term prospects for the reduction of the government deficit and the heavy tax burden can offer a lasting solution to the problem of unemployment, through revitalization of private investment and sustainable economic growth supported by private initiatives. As to the measures more directly related to the labor market, on the demand side more wage differentiation will have to be sought in order to reduce job mismatches. On the supply side, further re-examination of the level of unemployment will be necessary, although the Sint Anna package includes a step in this direction.

The relatively slow progress in the structural reform of industries is another source of concern. The authorities have pursued an active industrial policy for some time, but the question arises whether such policy has actually contributed to a positive structural change or rather to a cushioning of the impact. I will be interested in any comment the staff or Mr. de Groote may have on this point. A slow change in industrial structure tends, I am afraid, to give rise to protectionist sentiments.

Finally, I expect that the courageous efforts of the authorities in fiscal reform will be continued and further strengthened.

Mr. Lankester said the the Belgian authorities were to be commended for recognizing the need for a major fiscal adjustment that concentrated on lasting expenditure reductions in order to reduce the size of the public sector deficit and restrain the growth of the public debt. Indeed the situation had reached a critical and unsustainable point. The package of fiscal measures announced in May, if rigorously implemented, would go a long way toward achieving the authorities' goal of halving the treasury deficit by 1989. It was unfortunate that action could not have been taken sooner, and in that respect he noted that the 1984 fiscal package adjusted for the subsequent fall in inflation would imply a treasury deficit of about 2 percentage points less in 1987 than the authorities currently intended. However, that development should not detract from the measures that had been taken. He fully appreciated Mr. de Groote's remarks about the need to proceed carefully so as not to endanger the political and social consensus on which the scope for intensifying the adjustment effort critically depended.

Traditionally, the authorities had been concerned about the possible deflationary effects of fiscal retrenchment, particularly in the short term, Mr. Lankester continued. The Belgian authorities were not alone in being worried on that score. However, in many countries experience over the past few years had shown that the positive benefits even in the short run of reducing fiscal deficits had been underestimated. Consequently, he was pleased to note that despite the fiscal retrenchment, economic growth in Belgium was projected to accelerate somewhat in 1986 and 1987. And as the authorities recognized, the positive effects of their strategy on private sector activity would in the long run outweigh the short-term cost. Nevertheless, care would be needed to prevent slippage in achieving the targets, and therefore he welcomed Mr. de Groote's assurances of the authorities' determination.

It was clear from the staff paper that a more radical change in the business environment was necessary if the foundations were to be laid for the medium-term growth rates that the authorities were seeking, Mr. Lankester went on. The Belgian economy was an exceptionally open one, but in spite of fairly rapid increases in foreign demand in 1985--up by almost 5 percent--the economy had failed to benefit very much, even with the substantial improvement in labor cost competitiveness over the previous three years. Furthermore, even with a significant improvement in the rate of return on equity in recent years relative to real interest rates, there was as yet no sign of the much needed revival in private investment. Consequently, in order to make room for the necessary increase in private sector incentives--including reductions in nonwage and other business costs, as well as high rates of personal taxation--an intensification of the fiscal effort was required. Domestic adjustment indeed appeared to be the key to improved performance, and he agreed with the staff that additional measures would be needed if the authorities' fiscal goals were to be achieved.

He was concerned about the implications of the separate management of short- and long-term interest rates, Mr. Lankester went on. That practice reduced long-term interest rates, after allowing for withholding tax, to well below international levels, which, in turn, generated large capital outflows and caused excessive reliance on short-term interest rates to attract balance of payments financing. He urged the authorities to address the problem in order to stem the outflow of long-term capital, improve the supply of funds for domestic investment, and reduce pressure on short-term interest rates.

The Government was committed to a strong position for the Belgian franc in the European Monetary System, Mr. Lankester commented. However, the implications of such a policy on competitiveness would need to be kept under review in light of the renewed upward course of relative wage costs in 1985, which was worrying given the nonprice impediments to competitiveness. To the extent that exchange rate adjustments were constrained by participation in the EMS, greater reliance was put on domestic policies to restrain wages. Wage controls clearly had a role to play in improving competitiveness up until 1984, but the result had been a severely limited scope for wage differentiation and reduced labor market flexibility. He agreed with Mr. de Groote that abandoning wage controls would risk a catch-up increase in real wages unless accompanied by a lower personal tax. But the slowdown in inflation ought to provide a helpful backdrop to wage liberalization, which was essential as a medium-term objective if the economy's supply response was to be improved.

He would urge the authorities to consider seriously unifying the two rates in the dual exchange market in view of the continuing small differential, Mr. Lankester said in closing. He would appreciate Mr. de Groote's comments on the authorities' thinking on that point. He endorsed the quite severe staff appraisal of Belgium's economic situation.

Mr. Zecchini made the following statement:

> In 1985 the Belgian economy continued to have a good performance as a result of the considerable adjustment efforts undertaken in the previous four years. The most commendable results appear to be the attainment of both a sizable current account surplus and a trade balance surplus, which is partly due to significant improvements in competitiveness during 1982-84; the deceleration in consumer price inflation; and the continued rise in enterprise profitability, as a consequence of progress in cost containment and of a partial recovery of economic activity. Still, some other less favorable developments highlight the need for continuing and extending adjustment efforts. Among these developments, real GNP has been growing between only 0.7 percent and 1.5 percent; private sector employment continued to decline; and public sector finances deteriorated allowing the public sector debt to reach 119 percent of GNP.

We agree with the staff assessment of the causes of such imbalances and particularly with its recommendations for continuing medium-term fiscal adjustment and the elimination of excessive government regulations. We therefore greatly welcome the adoption, on the part of the Belgian authorities, of the Sint Anna medium-term fiscal adjustment plan. We also consider it important that the implementation of this package will not cause a relaxation of the successful income policies pursued in the last few years. In fact, such policies have proved extremely important in reconciling the objective of exchange rate stability with the aim of improving external competitiveness and, consequently, the current account balance. This, in turn, seems crucial to foster employment at a time when the role of government expenditure in supporting economic growth and employment is bound to decline as a result of the measures aimed at redressing public finances.

The slight improvements that have occurred in public finances in 1984 were reversed in 1985, as the net financing requirement as a percentage of GNP turned out to be higher than targeted. Therefore, we support the adoption of the new adjustment package. However, given the objective of stabilizing the debt to GNP ratio, and in view of the large size of the imbalances, the new target of bringing the deficit down to 7 percent of GNP in 1989 does not appear in line with the desired stabilization of the debt ratio. This may lead one to think that the current program is not suffcciently ambitious, since the stabilization of the debt to GNP ratio should be considered as a minimum objective for 1989.

Furthermore, such an objective should be pursued through a reduction in expenditure growth, especially current expenditure, rather than through an increase in the fiscal burden, which already is high. In this respect we agree with the criteria applied in the new adjustment plan, which contrary to previous plans, relies mostly on expenditure cuts. Most expenditure reductions are of a structural nature and clearly aim at checking some key components of the more or less automatic growth of expenditures over the long-term--such as social transfers, education expenditures, and subsidies to the productive sector. Moreover, we welcome the fact that the Government has received legislative power until March 31, 1987 to take additional corrective measures if necessary. However, the decision of the authorities to reduce the share of public fixed investment on overall expenditure seems questionable, unless this is seen as the counterpart of an expected strong expansion of private investment.

In assessing the conduct of monetary policy it is important to take into account the objective constraints that the Belgian monetary authorities face. In such an open economy, the objectives of price and exchange rate stability may often conflict with the need to finance the public sector deficit under favorable conditions. This may have led to a split interest rate policy, which has given rise to a negatively sloping yield curve. After-tax, long-term rates have been below international levels for some time, thereby promoting capital outflows, which have been offset by inducing short-term capital inflows through relatively higher short-term interest rates. This term structure of interest rates, if it is maintained for a long period, may cause misallocation of resources and a situation of potential instability in the balance of payments position, owing to the high volatility of short-term capital flows.

With respect to the structural aspects of monetary policy, the slow progress in deregulating financial markets should be noticed. Progress in improving efficiency in financial intermediation, as well as in enhancing the role of Belgium as an international financial center, may ultimately contribute to the reduction of the cost of public deficit financing. In addition, there is a need to increase the flexibility of the interest rate policy. At present, because of the nonconstraining nature of rediscount ceilings for commercial banks, attempts to control the liquidity conditions of the economy only through the discount mechanism have proved to be less than effective. Consequently, central bank financing of the Treasury, as pointed out by the staff, "has become a permanent source of government funding." In spite of the positive innovations in setting the discount rate and in closing the so-called third window, more needs to be done in order to bring about a more flexible interest rate policy and, consequently, a better control of liquidity. In this light, the regulation by decree of the rate on passbook savings accounts cannot be considered a step in the right direction.

As to the exchange rate policies, the authorities should be commended for their success in reconciling a large measure of stability of the Belgian franc within the EMS exchange agreement with their objective of preserving, if not improving, external competitiveness. Therefore, the remarkable improvement in the current account balance and the narrowing of the gap between the two exchange rates for the Belgian franc make the maintenance of a two-tier exchange rate system less justifiable than ever.

As to the medium-term outlook, the planning bureau projects a 3.3 percent annual growth of GDP in 1988-90, a sharp increase in the current account surplus, and the reduction of the annual public sector deficits. As pointed out by the staff, an important feature of these projections is given by the sustained growth of business fixed investment that is expected to average 5.3 percent per year in 1988-90 against 1.3 percent in the first half of the 1980s. This investment recovery is based on the assumption of a sharp rise in profitability as a result of improvements in terms of trade.

There is reason to believe that the impact of profitability on investment may turn out to be less relevant than expected. Since the major factor for increased profitability is assumed to be the terms of trade improvements, it is implied that enterprises will not fully transfer such cost improvements into final prices. This is possible only if enterprises and trading partners will follow a parallel course of action. Otherwise, a loss of competitiveness may result. As a consequence, renewed efforts have to be deployed in order both to check the dynamics of unit labor costs and to remove those structural factors that still hamper investment in the industrial sector.

In the latter respect, the staff singles out government regulations, uncertainties due to public finance imbalances, and high marginal rates of taxation. While the correction of the latter two factors is the object of the fiscal adjustment plan approved recently, some clarification is still needed on the extent of the impact of excessive government regulations on investment expansion.

Other points that need some clarification pertain to the savings/investment balance. First, the staff questions the assumption that private savings would remain much above private investment over the medium term, mainly because the recent increase reflected special factors rather than a lasting pattern of behavior. The conclusion is that "as these [factors] disappear, the flow of financial savings might diminish rapidly." The staff might perhaps elaborate on what such special factors are and why they can easily disappear.

Second, it appears that the authorities, as in the past, do not intend to rely on external borrowing to finance the fiscal deficits. On which ground is this appropriate, given that the ratio of foreign debt to GNP is not a source of concern? Resorting to external borrowing in the present favorable conditions in international capital markets might lower the cost of treasury financing and ease pressure on domestic savings.

Mr. Sengupta made the following statement:

I agree with Mr. de Groote's analysis of the fiscal problems of Belgium, especially the effect of high public deficits and the difficulties of reducing them too fast and the constraint imposed by the need "to maintain the social consensus." The year 1985 was disappointing for Belgium, notwithstanding the impressive performance in respect of the external current account and the moderation in the inflation rate. The deceleration in real GNP growth and the high unemployment rates are matters of concern. There was a slowdown in private productive investment, even though the household savings ratio continued to be high; a large proportion of these savings is in the form of financial assets. Nevertheless, the fact that production of investment goods has picked up substantially in 1985, together with improved capacity utilization, could be viewed as providing an opportunity to Belgian entrepreneurs to raise the productive capacity of the economy.

However, there is no proof that the investment climate has improved. There is, in fact, evidence of rising unit labor costs and falling profit rates in manufacturing. There is also the uncertain demand prospect. The fall in net disposable income of households over the last four years has much to do with the losses in real wage and salary incomes as well as in social benefits, and a more than proportional growth of direct taxes and social security contributions. Clearly, in order to improve investment and growth, it is necessary to examine alternative sources of demand.

The fiscal performance, as reflected in the deficit and high personal taxation, is one of the major disappointments described by the staff, a point that Mr. de Groote indicates is recognized by his authorities. The May 1986 fiscal adjustment package, however, is based essentially on expenditure cuts. In particular the measures affect social transfers, investments, education expenditures, and subsidies to public utilities. The package is welcome because it is expected to bring down the treasury deficit from 12 percent of GNP in 1985 to 8 percent of GNP in 1987 and 7 percent in 1989. This is necessary to reduce the acceleration in central government debt, which has reached a high figure of 104 percent of GNP in 1985, and to be consistent with the long-term supply of private savings. An unsatisfactory element in the package, however, relates to the stringent cuts in capital expenditure, which has in fact been declining in real terms at a rate of more than 5 percent since 1981, and is likely to show a further decline in 1986 and 1987. Within the category of capital expenditure, the cut has fallen heavily on fixed investment, which could have added to production capacity; yet at the same time unproductive capital expenditure on providing financial support to sick industries has actually increased. I would like Mr. de Groote to comment on this dilemma that cannot be easily resolved by condemning public expenditure policies and hoping that the private sector will become automatically dynamic if the public sector is contracted. If industries that should have been closed down or contracted because they have lost their comparative advantage--such as steel, shipbuilding, or textiles--are kept alive by public subsidies or transfers, it reflects the desire of the Government--and in a democratic government like Belgium, the desire of the people who vote for that Government--to maintain them, just as support for other social consumption and welfare expenditures exists because of what Mr. de Groote describes as "social consensus." In any case, this does not show that the public sector per se is inefficient or nondynamic.

Interest rate management was helped by an improvement in the external position, a reduced inflation rate at home, and falling interest rates abroad. The short-term rates remained generally above those of the major European trading partners--Germany and the Netherlands--and pretax, real interest rate differentials on long-term rates also fared relatively well. It appears from Mr. de Groote's statement that more recently a positive differential in favor of the return on equity has arisen. There is, however, not much sign of buoyancy in private investment, as Mr. Lankester observed.

Belgium's competitiveness depends to a considerable extent on wage costs. So far the Government's intervention in this area has helped to ensure that labor costs are within the competitiveness norm. I agree with Mr. de Groote that early abandonment of control over the wage formation process, while increasing wage differentiation and labor market flexibility, might well generate the risk of pushing up real wages. This is not an opportune time to relax incomes policy, particularly when profit rates in manufacturing are low and the need to raise domestic productive investment is urgent. I would also like to hear from Mr. de Groote whether he agrees with the staff that appropriate interest rate policies would be sufficent to eliminate the dual exchange market. The Belgian approach to maintaining a dual market seems to me to be more efficient than a system of capital controls. The present practice of narrowing the gap in the rates of the two markets is quite sufficient and should be pursued.

Like the staff, we would urge the authorities to maintain Belgium's tradition of free trade in setting agricultural prices and in the renewal of the Multifiber Arrangement. We also urge them to restore official development assistance to the 1983 level of 0.59 percent of GNP and thereafter to make efforts to reach the UN target of 0.7 percent of GNP.

Mr. Huang made the following statement:

In the past year and a half, the Belgian economy achieved some positive progress on several fronts. The increase in inflation, as measured by the consumer price index, slowed down from 4.9 percent in 1985 to 1.5 percent in April 1986. The improvement in the balance of payments position was particularly significant.

Nevertheless, in some areas serious problems remain. Business investment failed to keep its momentum and began to taper off in 1985. The level of unemployment continues to be high at 14.3 percent, and GNP growth did not reach its expected level, even under circumstances of favorable foreign demand. Exports, which account for 83 percent of GNP, are essential to the Belgian economy. The inability of the economy to grow in response to foreign demand indicates that adequate attention needs to be paid to domestic demand management.

An excessive level of public spending has exerted pressure on the domestic financial market and affected business investment and the authorities' job-creating efforts. Resorting to foreign borrowing will build up the level of foreign debt. The competitiveness of Belgian exports has also been affected in a broader sense because of relatively higher costs as a consequence of the large public spending, which could weaken the current account position. In addition, higher marginal tax rates have had an adverse impact on investment and consumption.

Since large borrowing to finance public spending, either from the domestic market or abroad, is likely to produce undesirable effects on the economy at the present time, trimming government spending would seem to be a better choice to cope with such a difficult situation. The 4 percent spending cut embodied in the fiscal package is a positive step, but whether such a cut is sufficient and whether additional policy measures, such as further tax actions, are needed remains to be seen.

Regarding the recent cut in official development assistance, I do not believe that it indicates that the authorities are no longer sympathetic toward the developing countries, but rather that they will increase the level as their economic situation improves.

Mr. A. R. Ismael made the following statement:

The staff papers indicate that while there were some positive developments in the Belgian economy in the past year and a half, the overall performance was not quite up to expectations. In 1985, helped by favorable external developments, inflation fell, and the external current account balance turned positive. However, there was a deterioration in some sectors of the economy and a reversal in some of the gains achieved earlier. The fiscal deficit increased in 1985, and the unemployment rate has remained high.

It appears that the authorities are very much aware of and concerned about the increase in the fiscal imbalance. The new fiscal package unveiled earlier in the year is an indication of this cognizance and their intention to deal with the problem. Its focus on expenditure-reducing measures rather than on revenue-increasing ones is quite appropriate, especially in the present context of the Belgian economy. Furthermore, I welcome the permanent nature of some of these expenditure cuts, as they might contribute toward a lasting restructuring of government spending and, thus, make the future attainment of a balanced budget more likely.

On this same subject, I note that the staff is suggesting a more ambitious reduction in expenditure. While I can understand its position, I am also aware that there might be strong deflationary consequences. Therefore, the gradual approach of the authorities might not be altogether inappropriate. It would appear normal not to overlook the social and political constraints to a rapid reduction in the fiscal deficit, especially in the context of the prevailing high unemployment. Nevertheless, I would urge the authorities to make every effort to ensure the success of the present fiscal program. Failure to achieve the stated targets could lead to increased inflationary expectations, a higher debt burden, and a loss of competitiveness.

I note that the authorities have had some success in their approach to containing increases in labor costs. However, structural rigidities remain, and the gains in productivity and competitiveness achieved earlier seem to have slowed down in 1985. The Belgian authorities might consider developing a comprehensive set of policies designed to alleviate the unemployment problem in the long run. Measures such as work sharing can only be short-term solutions as they do not address the structural problem. Policies in the areas of investment, wages, prices, taxation, and the exchange rate need to be re-examined and recast in a framework that will stimulate employment and economic growth.

It seems that the authorities have relied on interest rates as the main instrument of monetary policy. This single instrument has been used to defend the exchange rate and to meet the requirements of the public sector as well as those of the private sector. Although a difficult task, the authorities have had a certain amount of success in their undertaking. Over the past year, taking advantage of improved domestic and international conditions, the authorities were able to lower interest rates in general. However, I note that short-term rates are still higher than in many trading partners' markets, while long-term rates are lower. Such a structure of interest rates favors an outflow of long-term capital with adverse consequences not only for the external accounts but for the investment and growth potential as well. A re-examination of those rates would, therefore, seem appropriate.

In conclusion, it seems that in some sectors of the economy, the policies being currently followed, although appropriate, need to be strengthened, while in others a change of emphasis is needed. The authorities should consider taking advantage of the improved international economic situation to tackle the many structural rigidities in the economy, with a view to increasing productivity and competitiveness, and to encourage investment. And, lastly, I would like to commend the Belgian authorities on their commitment to an open trade system.

Mr. Nebbia made the following statement:

Since the Board's discussion of the previous Article IV consultation with Belgium in January 1985, the country has had a mixed economic performance. Among the positive developments, it should be mentioned that inflation has slowed down, the current account has moved into surplus, and changes in relative prices have improved the conditions for private investment and exports. Yet private employment has fallen further; the level of unemployment has remained very high indeed; economic activity has been weak; and the course of fiscal policies has been disappointing.

As I broadly agree with the staff assessment, let me refer to the following specific issues. I welcome the Government's intention of improving fiscal policies and procedures to maintain firm control over the future course of the public sector deficit. At the same time, however, I fully share the staff's concern that in order to meet its fiscal targets and consolidate its financial credibility, the Government will have to accomplish, in the coming months, a major policy reversal, replacing revenue raising measures with expenditure cutting actions.

Although in Belgium fiscal measures have to be examined considering their effect on domestic demand and the overall need to find a solution to the problem of unemployment, urgent actions are required both to reduce the deficit, which was equivalent to 13 percent of GNP in 1985, and to slow further increases in the extremely high ratio of public debt. The staff is less optimistic than the authorities in the attainment of the 8 percent deficit target in 1987. We would urge the authorities to fully implement the measures that have been introduced and to provide contingency measures to further reduce expenditures if signs of slippages are evident.

In the report there is a paragraph that refers to the negative effects of high real interest rates on both economic activity and the fiscal deficit. Likewise, we believe that the impact of interest rates on private investment and the cost of the treasury funding is not sufficiently taken into account in the case of many developing countries with Fund-supported programs. In this respect, we welcome the discussion the Executive Board will hold soon on the strategy for the growth-oriented theoretical aspects of the design of adjustment programs.

In past years Belgium has maintained restrictive trade practices in agricultural products under the common agricultural policy of the EC, in textiles under the Multifiber Arrangement, and in imports of certain industries such as steel under the EC commercial policy. We recognize that the Belgian authorities formulate their trade policies within the European Communities, and that Belgium may be one of the more liberal member countries of the EC. Although this argument may constitute an effective legal or political shield against charges of applying protectionist policies, it does not solve the distortions that these policies introduce into domestic and external markets and the disruptive effects on trade flows. In particular, it is much more difficult for indebted developing countries to finance the drop of exports and the current account deficits caused by these protectionist measures than for the industrial countries that apply these measures to obtain external finance in international capital markets. Although the staff paper speaks out against these policies, noting that indeed they run counter to the principle of free trade, there is no specific recommendation for a trade liberalization program. We would like to see the staff of the European Department discuss concrete actions in this respect with the national authorities of the different countries.

As to structural issues, it is of course regrettable that more was not accomplished during the past few months on dismantling Belgium's extensive system of exchange and trade restrictions. Especially with the tight system of price and wage controls in place, the time seemed ideally ripe for an in-depth liberalization of the country's economic structure. Since existing controls over wages cannot be maintained over an extended period and the authorities have announced their intention of liberalizing the formation of wages and prices in the near future, they may soon find themselves again faced with the weaknesses of a very rigid economy and unable to reconcile the objective of a satisfactory growth rate with external and domestic financial stability.

In conclusion, I do not find the corrective actions announced by the Belgian authorities fully convincing in the embryonic form in which they are presented to us today. Given the magnitude of the fiscal deficit and, above all, the high debt/GNP ratio, I urge the authorities to make the utmost commitment to redress the situation. We would also like to express our concern on the reduction in official development assistance envisaged by the Belgian Government.

Mr. Dallara made the following statement:

The Article IV consultation with Belgium is generally a very interesting and, in some respects, rewarding occasion for the Fund. This is not because the problems of Belgium's economy are minimal nor because all of the advice offered by the Fund is readily and quickly accepted by the authorities. It is perhaps because, as other Directors have suggested, there is a particularly constructive relationship between the Fund and the Belgian authorities, a relationship that is reflected in the staff reports and in the Article IV process that we have observed. I would like to take this opportunity to commend management, the European Department, and Mr. de Groote for the roles they have all played in building and maintaining this particularly constructive and mutually beneficial relationship, a relationship which all members of the Fund, perhaps particularly the major industrial countries, could use as an example.

A year and a half ago in the Board's discussion of the previous Article IV consultation with Belgium, we commented that Belgium was making slow but steady progress toward its growth and external objectives. Since that time, as others have noted, inflation has continued to fall, and the current account of the balance of payments has moved into surplus. On the other side, real growth was less than 1 percent last year, and gross fixed investment hardly grew at all. This particular development regarding investment may well be at the heart of, or reflect the essence of, Belgium's economic problems. The staff report notes that the primary aim of the authorities in recent years was to reduce labor costs, which would bring about a decline in the very high unemployment rate, and that the very large fiscal imbalance had not earlier been given very high priority. In fact, rather good success has been achieved in reducing labor costs, but it continues to depend on extensive government intervention in the wage determination process. The unemployment rate seems stuck over 14 percent, and private sector employment continues to decline.

There has, of course, been a major shift in policy in recent months, reflected in the substantial action to address the fiscal problem. Like other Directors, we join in commending the Belgian authorities for this action. We welcome it. But perhaps even more heartening is the determination that this action apparently reflects to tackle the fiscal problem. The staff referred to this effort as a first step, and I am encouraged by the fact that the authorities recognize that this is the beginning of something that needs to be a sustained and substantial effort to reduce the fiscal deficit.

Economic prospects for 1986 and 1987, as shown in staff projections, look favorable in some respects. In particular, gross fixed investment would rise at a more rapid pace, and inflation would fall to the 1.5-2.0 percent range. There would be substantial current account surpluses, and the fiscal deficit would be reduced to 8 percent of GNP by 1987. Medium-term forecasts through 1990 show a similar positive pattern.

Yet, as others have suggested, there are reasons for concern and, perhaps, for some doubt that some of the more positive aspects of the medium-term projections will be fully realized. Governments are, of course, entitled to incorporate whatever degree of optimism in their forecast they may deem appropriate, and each Government tends to reflect that optimism with respect to its own particular concern for special variables. In the case of Belgium, we do not see a particularly optimistic approach in growth projections. But with regard to the projections relating to the developments in savings and investment, there is perhaps some room to believe that the underlying assumptions are somewhat optimistic.

Much has already been said concerning the seriousness of the fiscal imbalance, and the data have been repeated a number of times. And I need not make points of detail concerning the ratios of debt to GNP, which speak for themselves. But perhaps the size of the fiscal deficit in Belgium does not present such a convincing case for urgent government action, at least a priori, that it might in other countries. I say this not because of the lack of need for urgent action but because other circumstances in the economy appear to make it somewhat difficult for the authorities to build the broad consensus needed to tackle this problem as ambitiously as might be required. That the building of this consensus is under way is quite evident from the actions we have seen. Yet the absence of external constraints, the availability of substantial private savings--in particular, financial savings--perhaps give the authorities--or, if not the authorities, certainly the public--a false sense of comfort about the seriousness of their fiscal problems. This suggests that the educational task faced by the authorities is perhaps greater than in most other cases in which the explanation and the rationale for urgent fiscal action may well be understood by economists but not so easily understood by everyone. After all, unless you are one of the unemployed in Belgium, I suspect it is rather difficult to understand why long-standing social and economic relationships really need to be altered.

Therefore, it is important that an educational effort be put forward in a rather coherent and technical fashion by the staff and Mr. de Groote, which in turn needs to be put forward in a broader political context if the seriousness and scope of the problem is to be fully understood and its correction achieved. As the staff points out, the recent slippages in the efforts to correct the treasury deficit have reinforced concerns and underlay some of the skepticism about the ability of the authorities to fully achieve their current deficit objectives. However, what distinguishes the latest fiscal package from previous ones is its focus on expenditures rather than revenues. Also, we would note the inclusion of actions involving politically sensitive social benefits such as unemployment compensation and pensions, which we take as signs of a growing consensus. The existence until March 31, 1987 of special powers to allow the authorities to adapt and reinforce the fiscal program is also reassuring, and I would urge them not to hesitate to use that additional authority if necessary.

We share the staff's view that in the medium-term perspective corrective actions may be insufficient, especially in halting the rise in the public debt ratio. Data in the staff paper amply demonstrate the still very high tax burden and the very high level of public spending in the Belgian economy. We are not persuaded by the authorities' argument that they should be concerned about the significantly depressing effect on real economic activity of excessively reducing the levels of public spending. We would not dispute, of course, that there may be some transitional negative effects, but over the medium term, we cannot but feel that they will be overcome at an early stage by positive effects on the economy, and particularly on investment incentives. Another negative factor in our view is the fact that under Belgium's industrial policy, high public spending includes transfers to businesses in difficulty.

One can readily understand the hesitation of the authorities to move forward in any broad effort to cut tax rates in a fashion that would reduce overall revenues. But one nevertheless wonders whether there is not now scope within the structure of Belgium's fiscal position for some tax reform measures that might enhance incentives for production and, in particular, for investment, while not adversely affecting overall revenue levels. I would urge the authorities to take a look at the possibilities in this area. If the fiscal deficit cannot be reduced more substantially and the tax and spending burdens cannot be scaled back, it is unfortunately likely that Belgium's competitiveness will come under further strain, and the prospects for sustainable growth could be in jeopardy.

Progress in achieving a more competitive level of labor costs has been quite good, but the staff report highlights a broader concept of competitiveness that goes beyond international trade to the ability to attract both domestic and foreign capital for investment in Belgium. For a small, open economy which is so intimately integrated into Europe's large economy and the rest of the industrial world, this must be a very important consideration. While I have the impression that the authorities to a certain extent are putting in place a comprehensive view of fiscal adjustment, a comprehensive strategy in dealing with other structural problems in the economy, particularly those relating to the labor market, has not evolved quite as far. If this overall strategy and the objectives of the authorities are to be achieved, an approach to labor market policies and practices, including those that are determined at the local and provincial levels, will need to be developed to complement the broad thrust of fiscal efforts. While relative unit labor costs in Belgium have fallen substantially between 1981 and 1985, there have clearly been some less favorable side effects that need to be addressed. For example, the staff report shows evidence of a large and widening wage wedge between labor costs and take-home pay, with undesirable effects on incentives to work and to hire new employees.

One recognizes the very difficult temporary judgments that need to be made by any government undertaking the kind of adjustment which is taking place in Belgium. For example, the Government needs to ease the pain of transition that is occurring in certain sectors of the economy. But I wonder whether in that process an excessive discount has not been placed on future economic welfare, to the extent that the achievement of significantly lower rates of unemployment might be unduly delayed by efforts to provide special assistance to particular industries. I wonder, more generally, whether these adjustment programs do not reflect a certain ambivalence in the context of the rather impressive determination by the authorities to move ahead in reducing their fiscal deficit. I urge them to reflect on the medium-term cost of some of the transitional arrangements that are currently in place.

Wage differentiation has not been fostered by the wage rate mechanism, and the persistence of government-imposed limits on wage bargaining continues to demonstrate the existence of grave labor market rigidities. We found it rather surprising that, with an unemployment rate above 14 percent, it is still possible for wages to get out of control if they were determined by freer collective bargaining. In fact, it is disappointing that it has not been possible to eliminate full wage indexation, rather than allowing it to continue in force, while having to suppress its effects. The argument that selective price controls continue to be necessary so long as wages are under some administrative control is not one that we find particularly persuasive. We would urge the authorities to review their approach to that matter.

My comments on the external accounts and on monetary policy have largely been covered by other speakers and are broadly consistent with the thrust of the staff analysis. I shall not elaborate on them, therefore, but only make two particular points. First, we would underscore the importance attached by the staff to a more active use of long-term interest rate policy, as well as short-term interest rate policy, because the authorities clearly are having some difficulty in resolving their rather conflicting objectives in implementing monetary policy. And in light of the relative attractiveness of investment in Belgium, it will be important for a more viable long-term evolution of their external accounts for the authorities to make a more active use of long-term interest rate policy. I would also join other Directors in commenting that while we understand the realities of how trade policy decisions are made in the European Communities, we nevertheless believe that it is important that the staff engage the Belgian authorities specifically on trade policy matters, since the collective nature of the European Communities' decision making can never supplant national sovereignty.

In concluding, we commend the authorities for the bold action that they have taken in various areas in recent months and years. We would, however, stress the substantial scope of the remaining problem and encourage them to intensify their efforts to broaden the social consensus that will be needed for the basic evolutionary changes in economic relationships in Belgium that appear necessary to attain a more sustainable higher level of growth and to reduce the worrisome level of unemployment. We believe this will involve a substantial educational effort, which is at present under way. We hope that the Fund can, as guided by the authorities, play a constructive role in this effort.

Mr. Lundstrom made the following statement:

On some important counts, the Belgian economy has improved over the last 18 months. Inflation has been decelerating, and the current account has moved into a surplus. Another welcome development is the recovery of the profitability of enterprises.

In 1985, however, despite buoyant foreign demand, real GNP growth developed much less favorably than inflation and the current account. It appears that private sector employment continued to decline. The growth of productivity seems to have slowed down. Furthermore, as a consequence of the slow growth, 1985 saw a further deterioration in the public sector accounts, with the treasury deficit overshooting the target by a substantial margin.

In order to curb the treasury deficit, the Belgian authorities announced a comprehensive fiscal adjustment package in May. Given the need to at least stabilize the record high debt to GNP ratio, this package--politically courageous as it may be--does not seem overly ambitious in its medium-term implications. I concur with the staff's recommendation that the stabilization of the debt to GNP ratio be retained as the minimum objective for 1989. This means halving the 1985 GNP-related treasury deficit. I note the staff's comments regarding whether the expenditure measures are enough to reach the stated targets and whether expenditure cuts at the treasury level would simply lead to larger deficits in other government entities. I wonder whether Mr. de Groote has anything to say on this.

With regard to monetary policy, the Belgian authorities face the not uncommon task of seeking a compromise between the aim of achieving the lowest level possible for domestic interest rates and the need to defend the exchange rate. Interest rate management continues to be the main instrument of monetary policy, which seems appropriate for a medium-sized and very open economy.

Belgium's financial markets have not taken part in the deregulation movement seen in several European countries recently. This seems rather unfortunate as Belgium needs to take part in the financial liberalization in Europe in order to attract foreign capital for investment. Regarding the dual exchange market arrangement, it is also important that the authorities conduct interest rate policies geared to the elimination of this practice.

Given the exceptional openness of the Belgian economy, it is vital that competitiveness be maintained or improved. The Belgian authorities have indicated that they want to keep the franc in line with the stronger currencies in the EMS and rely on domestic policies to maintain competitiveness--a policy that I have great sympathy for. In this connection, let me note that the staff may be more skeptical toward the Belgian exchange rate policy within the EMS than is warranted. That impression is reinforced by the somewhat surprising place of this subject in the staff report--namely, under the heading of structural policies.

Wage costs are contained by employing a competitiveness norm, which links Belgian wage developments with those in partner countries. The competitiveness norm will expire in its current form by end-1986. Hopefully, the social partners will come to an agreement on a new norm. Stability in the labor market is clearly of great importance. It is easy to understand the authorities' concern that, in the current labor market relations climate, wage developments could get out of hand in the absence of incomes policy and that this could lead to a loss of competitiveness. One would hope that a less mechanistic approach to wage determination--indexation--could be taken. While the maintenance of a competitiveness norm seems to make good sense, a partial or total suspension of wage indexation ought to be considered, now that the rate of price increase has come down to about 2 percent. Such a move would give the parties in the labor market scope for negotiating more differentiated wage increases.

With respect to industrial policy, it is a little disappointing that the consultation discussions do not seem to have pursued, again this year, the problem of structural rigidities other than those stemming from the wage determination system and the fiscal imbalance. Belgium seems to be one of the European countries where industrial activity is clearly hampered by what the staff calls "the pervasiveness of government regulations." I fully recognize that a more aggressive and market-oriented industrial policy is difficult to implement when unemployment is still at a very high level.

This raises the more fundamental question of the general economic policy strategy to be followed in the coming years. Mr. de Groote provided us with some very stimulating reflections on this question in his admirably frank and constructive statement. Like some previous speakers who have also referred to this strategy, I wonder whether the favorable current account projections would not make it possible to pursue a less gradualistic approach to adjustment. In view of the low level of foreign debt, a somewhat lower external surplus could be aimed at through a more vigorous fiscal policy, combining cuts in public expenditure with tax cuts tailored to address structural problems. If implemented in a determined manner, such a policy would stimulate confidence and activity, thereby creating employment and a climate more conducive to deregulation. It might also--through the increased revenues stemming from a higher level of economic activity--lead to a larger reduction in the budget deficit than that resulting from expenditure cuts alone. I would appreciate any comments that Mr. de Groote or the staff might have on such a scenario.

Finally, and like the staff, I regret the recent cuts in official development assistance. I also concur with the staff that the exceptional openness of the economy requires a strong commitment to Belgium's tradition of free trade.

Mr. Alhaimus made the following statement:

Some important developments have taken place recently in the Belgian economic scene, especially in the further deceleration of inflation that has taken place, the large improvement in the external sector, and, more important, in the major shift of economic strategy toward more pronounced fiscal adjustment through expenditure reduction.

The deceleration in the inflation rate in 1985 and the first part of this year is fairly clear. The rate of consumer price increase fell from well over 6 percent in 1984 to 1.5 percent in the year ending April 1986. In the external sector there was a swing in the current account of 1 percentage point of GNP, turning it from a deficit to a small surplus. Both improvements, however, were largely due to declining import prices and the consequent gains in terms of trade that resulted from the general fall in international commodity prices, both oil and non-oil. Furthermore, no favorable results appeared in general economic activity, and the unemployment rate, a major concern of the authorities for years, still remained high at 12.5 percent of the labor force, and private sector employment, in fact, declined.

The most significant policy shift in tackling structural problems in Belgium is the recent fiscal package which constituted a major departure from the course pursued by the authorities in the past few years of placing emphasis on the reduction in real labor costs as the means to achieve a lower unemployment rate. This approach, which gave lower priority to curbing public spending, had led to an unsustainable deterioration of the treasury deficit to 12 percent of GNP in 1985 and a buildup of public sector debt to nearly 120 percent of GNP, a level rarely reached in an industrial country, as the staff reminds us. Against this background, the recent fiscal package is a much needed and welcome shift in policy. The extent of fiscal adjustment should have been even larger, aiming at more expenditure cuts, as the staff argues, if an increase in the ratio of public debt to GNP were to be avoided. However, the fiscal objective will remain a treasury deficit of 8 percent of GNP in 1988 and 7 percent in 1989.

On more specific policy areas, I strongly endorse the staff's urging that the authorities maintain the tradition of free trade in the coming trade negotiations and share the regret that the recent fiscal package includes a cut in official development assistance.

Mr. Salehhkou said that Belgium's overall economic and financial performance in 1985 and early 1986 had been unsatisfactory in spite of a substantial improvement with respect to inflation, which had slowed to 4.9 percent in 1985 and was projected at 2 percent in 1986, and the external account position, which had turned into a surplus in 1985. Both the staff and Mr. de Groote had considered the performance to be disappointing, referring not only to the maintenance of a high rate of unemployment in spite of costly administrative employment schemes, but also to the weak level of investment and failure of economic activity to benefit from relatively stronger foreign demand and improved external competitiveness. Furthermore, the Belgian authorities appeared to be in broad agreement with the staff on the contribution of imbalances in government finances to the low overall performance of the economy and to the persistence of large structural weaknesses.

Strong efforts to deal with financial and structural imbalances and to adapt the economy to the changing conditions of the late 1970s and early 1980s had often been postponed, allowing the fiscal deficit to reach unsustainable levels and public debt to become a major handicap to financial and structural adjustment, Mr. Salehkhou continued. Belgium's public debt, projected to be 119 percent of GNP by 1989, was one of the highest among industrial countries. Public debt had imposed excessive interest charges and had to a large extent upset the fiscal restraint effectively achieved because the deficit remained very high in spite of the curtailment of noninterest expenditure by about 4 percent of GNP since 1981.

In the previous five years or more, Belgium's industries and high rate of unemployment, as well as its need for political and social consensus to deal with rising imbalances and a more unfavorable external environment, had led to short-term solutions to the problem of large fiscal deficits, Mr. Salehkhou went on. It was encouraging to note, however, that the authorities had received a new mandate to implement stronger fiscal policies and to bring Belgium's performance more in line with that of its EMS partners. Nevertheless, the staff considered the targets of the comprehensive package of measures announced in May 1986 as insufficiently ambitious, particularly in view of the earlier target adopted under the 1984 budget, the continued risk of slippage from the treasury deficit to other public entities, and the dependence on a stronger economic growth than currently envisaged to achieve the adopted targets. The staff also considered the 1989 target of a fiscal deficit of 7 percent of GNP to be inconsistent with the recognized need to stabilize the public debt to GNP ratio. However, the fiscal package appeared to signal a considerable strengthening of Belgium's adjustment policies and the authorities' determination to face the critical issue of rising public debt. In view of existing political and social constraints and the adverse effect of fiscal restraint on economic growth, the savings envisaged under the May fiscal package, estimated at about 4 percent of GNP, were impressive. Furthermore, the concentration of adjustment measures on expenditures, including the equivalent of about 3 percent of GNP in permanent savings, was particularly welcome considering the excessive level of taxation in Belgium. Equally noteworthy in that regard were the relatively conservative assumptions regarding interest rate behavior and the adoption of safeguards to prevent slippages in the implementation of the budget. Improvement in fiscal performance would go a long way in supporting Belgium's objectives with respect to monetary and exchange rate policies, which should also benefit from improved external environment. It would also support the authorities' commitment to rely on domestic measures to correct the economy's imbalances and to reduce inflation to the level of that of its trading partners.

Finally, an improved fiscal performance would remove the uncertainty regarding future taxation, which appeared to be the main factor preventing the recovery of private investment, Mr. Salehkhou went on. Notwithstanding the remarkable increase and rate of return on equity and the improved wage cost competitiveness, such uncertainty regarding taxation appeared to undermine efforts to stem the heavy outflow of long-term private capital and to attract foreign investment.

Considering the openness of the Belgian economy it was obvious that Belgium's financial and structural adjustment would be more flexible and significantly facilitated in an international climate of higher growth, Mr. Salehkhou commented. It should also be noted that in spite of such overall openness, a large number of import restrictions were maintained by Belgium and its EC partners that were particularly directed against products from the developing countries. While improved external competitiveness should encourage Belgium to remove those restrictions, it was also important that the target of official development assistance of 0.7 percent of GNP be reinstated to reverse cuts introduced in the recent fiscal package.

Mr. Romuáldez made the following statement:

During the Board's discussion of the 1985 Article IV consultation, we expressed some optimism about the direction the economy seemed to be taking in 1984. Adjustment efforts had been strengthened. Private sector employment had been stabilized. Output had recovered by 2 percent which, though modest, constituted an encouraging first step on the road to recovery. Export performance, though still poor, had improved somewhat over that of previous years. The profitability of enterprises had picked up, and investments had registered a slight upturn. We concluded our remarks by encouraging the Belgian authorities to sustain--and even intensify--their adjustment efforts, particularly in the areas of wages and the labor market and industrial policy. We were confident then that, with appropriate fiscal and monetary policies, Belgium's recovery would at last have an opportunity for a more solid, even if not entirely rapid, takeoff.

While our expectations have not been realized as much as we would have liked, our suggestions, especially regarding wages and industrial policy, are still applicable today, and we feel that we can be optimistic about the coming year. A significant decline in the rate of inflation was achieved in 1985. A surplus of about 3/4 of 1 percent of GNP was registered in the current account of the balance of payments. The profitability of enterprises was raised once again with returns on equity reaching levels above the real rate of interest. To be sure, fiscal performance in 1985 fell far short of the targets, with the treasury deficit equivalent to 12 percent of GNP, as compared to a 10.4 percent target. Public sector debt rose to 119 percent of GNP by end-1985. We are concerned moreover that, in spite of an improved environment, opportunities for greater vigor in economic activity have not been taken advantage of. Foreign demand has risen, and company finances are high. Investments in enterprises have nevertheless tapered down and private employment seems to have declined further. These developments, needless to say, and growing interest payments on the public debt, have served only to aggravate the fiscal position and intensify the tax pressure.

The authorities seem fully aware of what they need to focus on this year in order to bring their program back on track. Indeed, they have announced a fiscal adjustment package for 1986, which we welcome. We are particularly pleased to note its emphasis on permanent expenditure cuts equivalent to 3 percent of GNP, one half of which, we have been advised, has been designed to bring about increased savings over time either by further reductions--and even the elimination of social transfers and other similar expenditures, some of which could be politically sensitive--or by further tightening of expenditure control procedures. The authorities are determined to allow no slippages and have provided for built-in and procedural safeguards that would ensure that none occur, as much in the preparation as in the monitoring of the program.

Since we share some of the staff's fears and reservations about the faint-hearted ambition of the program and its inadequacy even in terms of its present targets, we regard as essential the provision in the program for a review in February 1987 and particularly appreciate the special legislative powers the Government has received to enable the authorities to take whatever additional measures they must to achieve their goals.

In the meantime, we believe it important that the authorities take to heart the staff suggestion that "fiscal policy could make a difference in directing medium-term developments toward either of two scenarios by improving confidence, lowering interest rates, and avoiding further increase in the tax burden."

We are caught up in the process of dialogue between the authorities and the staff. Our understanding of the Belgian situation, of the authorities' views, and of the staff's own analyses has been enhanced by the lucid presentation of each side of the various issues that apparently divide them. In the end, nevertheless, we are left with the view that, as one Director has said, the staff and the authorities agree on the essentials of remedies but disagree on the timing of their application, and, as a result, on the intensity of the application of remedies at certain moments of the program. Distant as we are from the political/social context within which the authorities must operate, we tend to go along with the staff in advocating the recommendation that emerged from their analysis.

We also join the staff in urging the authorities to maintain a strong commitment to Belgium's tradition of free trade, particularly in the various trade negotiations in which they are participating--the renewal of the Multifiber Arrangement and the setting of farm prices, practices that my authorities believe are in need of greater liberalization.

We, of course, wish the authorities success in their efforts to cope with their economic problems, in a context of difficult adjustments leading toward a social reorganization that cannot but result in the modification of deeply rooted social relationships. To deal with each area by itself is a formidable task; the overall challenge may genuinely strengthen national integrity.

The staff representative from the European Department remarked that one speaker had posed a question about the factors that had led the staff to feel that the flow of financial savings might not remain at a very high level. Beginning in 1981, a combination of developments in Belgium had produced a slump in the housing market and consequently a decline in the prices of houses. Therefore, home owners suddenly had a shortfall in their assets that had to be made up for. Also, inflation was eroding the real value of financial assets, and it was necessary to save in order to compensate. In addition, the worldwide increase in real interest rates was being felt in Belgium, which at the time had a successful program of fiscal incentives for investments in equity enterprises. In short, one factor was reducing the real value of assets--thus creating the need to reconstitute them--while at the same time the change in the structure of rates meant that the assets that were reconstituted fell into the category of financial assets rather than physical assets. The transitory element in those developments was that inflation had fallen sharply, and therefore the need to save in order to reconstitute assets had been decreased. In fact, the differential between the return on financial assets and the return on physical assets had lessened and in some respects had been reversed. Therefore, if the staff's thinking was correct, the factors that had contributed to the big increase in the flow of financial savings would be somewhat reversed and would bring things back to a more normal situation, one that would have the positive aspect of constituting a sort of exogenous stimulation of demand in the economy that would be very welcome.

Another speaker had asked why the Government should shy away from foreign financing, given the small size of the foreign debt and the general condition of Belgium's accounts, the staff representative continued. There was both a technical aspect and a broad economic strategic aspect to that question. In the first instance, whereas he would agree that money should be found where it was cheapest, he was not certain that it was cheaper abroad than in Belgium. As for the other aspect, in Belgium the availability of financial savings from the private sector was sufficient to cover the public sector deficit. Therefore, there was no need to force a greater flow of financial savings from the domestic sector by merely increasing rates strongly. The question was whether it was less expensive to borrow from the Belgian saver in Belgian francs or to borrow from the foreign investor. The answer was that it was not cheaper to borrow from abroad. In addition, the authorities felt that it was politically sound to live within the resources of their domestic financial market. As Mr. Dallara had put it, that was one of the educational tools at the authorities' disposal.

Another financial question concerned what would be achieved by restructuring or refinancing some of the public debt, the staff representative went on. The most simple answer was that a better management of the debt would be achieved. There would be no actual gain because there would be no savings on the interest burden. The authorities were practicing what was called a market conforming operation; they would pay the full interest burden, but they would spread it over time, which would give them some freedom of movement to survive the most difficult period of the fiscal adjustment.

There were a number of comments and questions on the dual market arrangement, the staff representative commented. The narrowness of the spread between the two markets was not an accident. There was an increasing permeability between the two markets, which reflected both the constraints of the market and a certain evolution of the authorities' thinking and policymaking. As for whether interest rate management could offer the same safeguard as the financial market, he felt that it could. The relevant point was that the authorities were fully determined that if and when they did away with the dual market, capital controls would not be introduced instead. The system would eventually be totally free and unified, and its stability would depend on the restoration of some basic economic conditions as well as proper management of interest rates and other tools of economic policy. On the same issue, the way the staff had discussed the exchange rate in the report was to categorize the move by the authorities to elevate the Belgian franc to the zone of the stronger currencies in the EMS as a structural policy decision. That choice reflected what the staff felt was really the approach of the authorities, who would make other policy decisions in accordance with that basic determination. Those decisions, which had been discussed during the meeting, had a number of implications for public finance and for wage behavior.

A possible scenario had been developed by Mr. Lundstrom in which there would be tax cuts to remove some of the worst distortions in the existing fiscal system and hopefully stimulate activity, the staff representative said. Such a scenario certainly would have considerable appeal. However, if there were additional expenditure cuts to match the tax cuts, he was not sure that the tax cuts in the short term would have a positive impact on GNP and thus pay for themselves. Unless the authorities demonstrated convincingly to the markets that they were doing what was necesary to reduce the deficit, there would be many negative responses, as the staff report had described. A program that included larger tax cuts would have to be matched by larger expenditure cuts, an outcome that clearly would be difficult to achieve.

The authorities' industrial policy involved a play on words, the staff representative continued, because since 1981 the policy had been to restore business profitability. Indeed, in that respect, the economy was in much better shape than it had been five years previously.

Most interventions that addressed the nationalized sectors essentially recommended their being phased out, the staff representative went on. In fact, that process had been completed in the case of textiles, which were at present very competitive. The big difficulty was steel, where considerable progress nevertheless had been made; it was the Government's intention to stop any further assistance to that sector in 1986. The coal mines of Limburg posed an extremely difficult social problem. Small subsidiaries of those mines were viable, but basically the whole sector was extremely costly. There was no hope of returning it to a sound, autonomous footing. The current target was to minimize the subsidy and keep it at a financially acceptable level.

One speaker had inquired about the possible link between market share development and competitiveness, the staff representative remarked. The staff had not tried to establish a direct causal link between them but had regarded them as two indicators of the vitality of the economy--the general idea being that if an enterprise was competitive, it would make money, and it would make the investments necessary to meet the demand wherever it appeared. If the loss of market shares could be offset, it would be a prima facie indication that all was well in the economy.

Questions had been posed by Mr. Nebbia and Mr. Dallara about the status of trade issues in staff discussions with a member of the European Communities, the staff representative said. He could reassure the Board that a great deal of time and energy was spent discussing those issues with the national authorities. In the present case, the staff had had the full attention of the Minister of Economic Affairs on the matter.

As for Mr. Dallara's plea for educating the public, it was true that it was fairly abstract to say that the public debt in Belgium had risen by 15 percent of GNP in five years, the staff representative from the European Department noted. Consequently, the staff had sought another way to drive the point home, by stating that the debt being incurred at present would have to be serviced over time by future generations. The increment in debt had been divided by the number of new babies born during the period 1980 to 1985 and the debt figure amounted to $100,000 per baby. However, it was also important to avoid the risk of despondency in Belgium, and to emphasize the positive side. The country had made considerable policy efforts over the previous five years, and to overemphasize how much more there was to do might create the feeling that nothing had been accomplished. Indeed, it was necessary to underscore the importance of the accomplishments that had been recorded in the industrial sphere, as well as the ability for four years in a row to reduce noninterest public expenditure by about 1 percent a year.

The staff representative from the Exchange and Trade Relations Department, commenting on the rationale for the dual market in Belgium and whether it was an efficient means for the implementation of capital controls, said that the basic question that needed to be addressed concerned the economic rationale for differential pricing of current account transactions and capital account transactions. Without going into that issue, he noted that Belgium was one of the few countries that retained a dual market; several other industrial countries had dispensed with theirs in recent years. He would agree that if capital controls were believed to be necessary it would be more efficient to implement the controls through pricing rather than through a quantity rationing system. However, the Belgian case was difficult. Current account transactions were involved in the second market, and therefore a multiple currency practice would arise if the differential between the two rates were in excess of 2 percent, which at present it was not. Indeed, the larger the spread between the exchange rates in the two markets, the more difficult it would be to prevent leakages between the markets.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/116 (7/15/86) and EBM/86/117 (7/16/86).

2. CENTRAL AFRICAN REPUBLIC - TECHNICAL CHANGES TO STAND-BY ARRANGEMENT

Paragraph 4(b) of the stand-by arrangement for the Central African Republic (EBS/85/204, Sup. 2) as amended by Executive Board Decision No. 8316-(86/103), adopted June 25, 1986, is amended as follows:

"(b) After December 1, 1985, March 1, 1986, and January 1, 1987, respectively, until understandings have been reached between the Fund and the Central African Republic pursuant to the reviews contemplated in paragraph 24 of the attached letter of June 20, 1985 and paragraph 15 of the attached letter of March 13, 1986, or after such understandings have been reached, while they are not being observed;". (EBS/86/143, 7/8/86)

Decision No. 8334-(86/117), adopted
July 15, 1986

3. NICARAGUA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1

1. The complaint of the Acting Managing Director dated July 8, 1986 regarding Nicaragua's overdue obligations in the SDR Department, in EBS/86/144 (7/8/86), is noted. It shall be placed on the agenda of the Executive Board for August 5, 1986. If by that time Nicaragua has not become current in its obligations to pay charges and an assessment in the SDR Department, the Fund will consider suspending the right of Nicaragua to use SDRs it acquires after the suspension pursuant to Article XXIII, Section 2(b).

2. The Fund urges Nicaragua to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule S-1 particularly affects Nicaragua. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representive.

Decision No. 8335-(86/117) S, adopted
July 15, 1986

4. SIERRA LEONE - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE S-1

1. The complaint of the Acting Managing Director dated July 8, 1986 regarding Sierra Leone's overdue obligations in the SDR Department, in EBS/86/145 (7/8/86), is noted. It shall be placed on the agenda of the Executive Board for August 5, 1986. If by that time Sierra Leone has not become current in its obligations to pay charges and an assessment in the SDR Department, the Fund will consider suspending the right of Sierra Leone to use SDRs it acquires after the suspension pursuant to Article XXIII, Section 2(b).

2. The Fund urges Sierra Leone to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

3. Consideration of the complaint in accordance with Rule S-1 particularly affects Sierra Leone. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 8336-(86/117) S, adopted
July 15, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by an Advisor to Executive Director as set forth in EBAP/86/171 (7/14/86) is approved.

APPROVED: April 9, 1987

LEO VAN HOUTVEN
Secretary