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No. 82 July 1990

COUNTRY STUDIES

Belgium

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CONTENTS

Graphs :

Tables :

1. INTRODUCTION

This paper describes and analyses the period 1985-1990 during which Belgium successfully completed the process of restructuring its economy in order to cope with the imbalances it was left with at the beginning of the decade. Although this story is predominantly one of success, one major problem remains unresolved : the high public debt burden and the moderate progress in reducing the current budget deficit. In this context particular attention will be paid to the implications of the regional devolution process for fiscal consolidation. With respect to monetary policy new instruments are in preparation and the position of the Belgian franc was strengthened leading to the public commitment to follow the strong EMS-currencies. Also in the field of the adaptation of financial market to a more competitive environment, progress has been made which should however be consolidated by intensifying the modernization effort.

After reviewing briefly the situation of the Belgian economy in the first half of the 1980s, the paper analyses developments since 1985 and gives macroeconomic forecasts for 1991 (chap. 2). It looks in turn at the stance and results of budgetary policy (Chap. 3), developments in exchange rate policy and monetary policy instruments (Chap. 4) and, lastly, the efforts made to modernize and develop financial markets and services in the run-up to 1992 (Chap. 5).

2. ECONOMIC PERFORMANCE SINCE 1985 AND OUTLOOK FOR 1990-91

2.1 Recent growth performance

In the early 1980s, the Belgian economy suffered from serious imbalances: sluggish growth, mounting unemployment, a sizable current account deficit, a high inflation rate and a deteriorating public finance situation.

The 1982 devaluation of the Belgian franc and the set of accompanying measures marked a turning point in economic policy, which resulted in a steady but firm move to recovery. By 1985, the current balance reached equilibrium, mainly as a result of depressed domestic demand. Although a dominant component of government strategy was the restoration of competitiveness and of enterprise profitability, investment figures remained disappointing. 1985 however was the last year that GDP grew by less than 1%; 1986 showed the first signs of a fundamental recovery as GDP grew 1.6% in real terms; private consumption was the main factor of growth, reflecting the upsurge in real disposable income of households after several years of downward adjustment - through index jumps and other measures - which served to restore company's profitability ratio.

TABLE 1 : MAIN ECONOMIC INDICATORS.

	80	81	82	83	84	85	86	87	88	89	90	91
GDP, 1985 prices, % p.a.												
Belgium	4.3	-1.0	1.5	.4	2.1	.9	1.6	1.9	4.3	4.5	3.0	2.5
EUR-12	1.3	.2	.9	1.6	2.3	2.5	2.6	2.7	3.7	3.3	3.0	3.1
GDP per head (in SPA index e12=100)	104.2	103.3	104.2	103.2	103.2	101.8	101.0	100.2	100.9	102.3	102.8	102.7
Total employment, % p.a.												
Belgium	.0	-2.0	-1.3	-1.1	.0	.8	1.0	.4	1.4	1.1	.6	.2
EUR-12	.3	-1.2	-.9	-.7	.2	.6	.8	1.4	1.6	1.7	1.4	.9
GDP deflator, % p.a.												
Belgium	3.8	4.7	7.1	5.6	5.2	6.0	3.5	2.1	2.0	3.5	4.0	3.0
EUR-12	10.9	9.7	8.3	5.1	5.6	4.8	3.2	2.5	4.3	5.1	4.1	4.3
Unemployment rate, as % of civilian labour force												
Belgium	7.9	10.2	11.9	12.6	12.6	11.7	11.9	11.5	10.4	9.5	8.9	8.5
EUR-9 (2)	5.8	7.6	8.9	9.2	9.8	9.7	9.8	9.4	9.0	8.2	8.0	7.9
Current balance of payments position, (as % of GDP)	-4.3	-3.8	-3.7	-.8	-.6	.3	2.0	1.2	1.0	1.0	1.0	.7
Capacity / borrowing requirement of general government, (as % of GDP)	-9.2	-12.8	-11.0	-11.2	-9.0	-8.5	-9.0	-7.1	-6.7	-6.3	-6.1	-6.3
Exchange rate (yearly averages)												
1 USD = ... BFR	29.2	37.0	45.6	51.0	57.7	59.1	44.6	37.3	36.7	39.4	34.9	34.3
1 ECU = ... BFR	40.6	41.3	44.7	45.4	45.4	44.9	43.8	43.0	43.4	43.4	42.6	42.6
ERM effective exchange rate (1)	100.0	99.9	91.8	90.2	90.2	91.4	91.9	93.0	92.9	92.5	93.1	93.0
19 Partners effective exchange rate (1)	100.0	94.2	85.5	83.1	81.3	82.0	86.5	90.0	88.9	88.1	92.0	92.3

(1) exchange rate mecanism, double weighted for exports. index 1980
(2) except Greece, Spain, Portugal
Sources : Commission departments
For 1990 and 1991 : Commission staff forecasts (May 1990)

Another remarkable feature was the back-drop of inflation. The process of inflation reduction had been going on for several years through the containment of domestic cost components. However, the fall in inflation was mainly due to the evolution of import prices, which fell on average by more than 15%. Although inflation virtually stopped, import price falls were not completely passed through into final prices. As a consequence, profit margins, which already had recovered substantially, were further improved.

The picture for 1987 was quite similar: private consumption was sustained notwithstanding the third index jump and the full implementation of a number of measures contained in the 1986 St Anna plan to reduce the net borrowing requirement. Private investment picked up reflecting the return of confidence of entrepreneurs and the strong improvement in the financial position of firms.

In 1988, business investment rose by an estimated 14%; to this was added an explosion in residential construction of over 20%. Unlike previous years when replacement investment dominated, the surge in investment activity was mainly concentrated in an expansion of capacity.

Private consumption was healthy. Exports of goods and services rose by 7.4% in real terms as Belgium continued to gain market shares in an expanding international trade environment. Imports increased by the same amount under the influence of the expansion of final demand; the fact that the increase was still relatively low (given the traditional high import elasticity of demand components like investment and private consumption) reflects the structural adjustment of Belgian industry, which resulted in a better response to emerging demands. It is also clear that Belgium now took advantage of the system of automatic wage indexation, through which the fall in inflation was directly passed through into wages. As a result, 1988 GDP grew by some 4.3%, above the Community average.

Developments in 1989 have shown almost the same picture: a boom in investment by enterprises, strong activity in the construction sector, healthy exports and a sustained domestic consumption demand. The intensity of the investment boom reflected the need to anticipate emerging capacity constraints, although no immediate signs of overheating were apparent.

TABLE 2 : ANALYSIS OF GDP USES

as % - current prices

	80	81	82	83	84	85	86	87	88	89	90	91
Private consumption	62.9	65.2	65.6	65.2	64.9	65.6	64.1	64.4	63.1	62.3	62.2	62.6
Public consumption	17.8	18.6	18.0	17.5	17.0	17.1	16.7	16.3	15.3	14.8	14.5	14.4
GFCF	21.1	18.0	17.3	16.2	16.0	15.6	15.7	16.0	17.8	19.6	20.2	20.3
Of which : equipment	6.3	6.3	6.5	6.3	6.9	6.8	7.0	7.3	8.2	9.3	9.9	10.3
Change in stocks	.7	-.1	.1	-.7	.4	-.8	-.5	.2	.5	.5	.5	.4
Balance of goods and services	-2.5	-1.6	-1.0	1.8	1.7	2.5	4.0	3.1	3.4	2.9	2.8	2.4
Exports	62.9	68.1	71.8	74.6	79.0	76.9	70.7	69.7	72.3	77.2	77.2	79.7
Imports	65.4	69.8	72.8	72.8	77.3	74.3	66.7	66.5	69.0	74.3	74.5	77.3

Source : Commission departments
For 1990 and 1991 : Commission staff forecasts (May 1990)

TABLE 3 : CHANGE IN DEMAND COMPONENTS (a) AND CONTRIBUTION TO GDP GROWTH (b)

1985 prices

	80	81	82	83	84	85	86	87	88	89	90	91
Change (a)												
Private consumption	2.0	-1.2	1.4	-1.6	1.2	2.0	2.5	2.8	2.4	3.6	3.6	3.5
Public consumption	1.5	.3	-1.4	-.1	.2	2.6	1.2	1.2	-1.4	.4	.2	.0
GFCF	4.6	-16.2	-1.7	-4.4	1.7	.6	4.2	5.2	16.0	14.4	6.6	3.0
Domestic demand (including stocks)	2.4	-3.8	.4	-1.8	1.1	1.9	2.5	2.9	4.0	5.0	3.6	2.9
Exports	2.5	2.3	1.2	2.7	5.3	1.1	5.9	6.4	7.4	7.9	5.9	6.3
Imports	-.4	-3.2	.1	-1.3	5.6	.8	7.8	8.6	7.3	8.5	6.6	6.7
Contribution to growth (b)												
Final domestic demand	2.7	-5.1	.7	-2.5	2.2	.5	2.9	3.5	4.3	5.0	3.6	2.9
Foreign balance	2.1	4.0	.8	2.9	-.1	.3	-1.3	-1.6	.0	-.5	-.7	-.4
GDP (a)	4.3	-1.0	1.5	.4	2.1	.9	1.6	1.9	4.3	4.5	3.0	2.5

(a) change as % p.a. (b) change as % of GDP of preceding year
Source : Commission departments
For 1990 and 1991 : Commission staff forecasts (May 1990)

As in the case of the rest of the Community, the forecasts for 1990 and 1991[1] point to something of a slowdown in economic growth from the particularly high rates of growth recorded in 1988 and 1989. The composition of growth is expected to change somewhat, with investment and exports slowing down while private consumption continues to grow at the same rate. All in all, GDP growth (3% and 2.5%) respectively is expected to be slightly higher than the Community average (3.0% and 3.1%), with domestic demand probably being a little firmer.

2.2 Labour market developments

After several years of decline, employment picked up in 1985 and has continued to rise until now. Job creation was exclusively concentrated in the private sector, reflecting the influence of the higher levels of activity; government employment virtually stagnated over the period. Measured by the number of persons, the average yearly growth rate was near one per cent with an acceleration in 1988 and 1989. On a full-time equivalent basis, growth was however significantly lower, because of a strong rise in part-time jobs. This phenomenon is partially related to the actual low share of part-time jobs in Belgium compared to the one in neighbouring countries - in 1987, part-time jobs represented 9% of total employment against 25% in the Netherlands, 22% in the UK, 13% in Germany and 12% in France; furthermore, unemployment benefits can be aggregated with part-time income, which makes this way of working particularly advantageous from the point of view of the wage-earner.

From a sectoral point of view employment creation has been broadly based in recent years. It should be seen in the context of the strong expansion of capacity-widening investment in 1988 and 1989; as a result, the trend of employment destruction in manufacturing industry has been reversed.

The evolution of the labour force over the period was moderate, due to the absence of strong demographic factors and mainly because of the continued effect of several labour containment policy measures like early retirement schemes and the career interruption scheme which originated in the early eighties. As a result, the unemployment rate has fallen from 11.7% in 1985 to some 8.9% in 1990.

Notwithstanding this positive evolution, the labour market appears far from balanced : the number of unfilled vacancies has grown sharply while the proportion of the long-term unemployed is still rising. Furthermore, interregional and interprofessional mobility problems are occuring in a number of sectors which have known a strong upsurge in demand in recent years.

(1) Commission departments, May 1990.

Labour market policy should consequently be oriented more towards enhancing training facilities; the room for manoeuvre in this respect has however been seriously limited by previous efforts to contain the overall evolution of government expenditure. Since training of the unemployed has now become a responsibility of the linguistic communities it may become more efficient and less constrained. In addition, a number of measures seem necessary to improve interregional mobility with a view to ensuring that the imbalances between the different subregions in the country are not aggravated.

2.3 Wage formation, price developments and competitiveness

The inflation rate, which was still around 6% in 1985, i.e. four percentage points higher than in Germany and the Netherlands, fell sharply up to 1988 (1.8%). The differential vis-à-vis Germany has been eliminated. External disinflationary factors, which were accentuated by a firmer exchange rate, played a crucial role in 1986-87 whereas it was domestic factors that were more important in 1987-88. The effects of wage restraint on prices were, however, mitigated as a result of the appreciable improvement in firms' profit margins. A mechanical breakdown of the inflation rate shows, among other things, that the increase in the gross operating surplus has, in practically every year since 1982, contributed around one percentage point to the increase in the price deflator for total final expenditure (cf. Table 5).

Whereas, in the period 1982-86, the Government had pursued an active incomes policy with the twofold aim of restoring business profitability and improving export competitiveness, wage bargaining has since become decentralized once again. Automatic wage indexation is being applied in the form devised in 1983, i.e. on the basis of a four-month moving average for the consumer price index and no longer on the basis of the monthly index as had been the case prior to 1982. The Government has, nevertheless, given itself the necessary statutory powers to safeguard competitiveness as broadly defined should it be threatened. Under the Law passed in January 1989 (see box), the level of competitiveness is regularly monitored by the Central Economic Council applying a range of indicators that includes an outturn indicator - relative export performances - and indicators measuring conditions. The latter include not only relative changes in wage costs per person employed compared with the country's seven leading trading partners[1] but also data such as the comparative trend in financial costs, energy costs and the "structural" determinants of competitiveness, as a function of capital expenditure by firms. Among the different forms of intervention envisaged, the Government can be empowered to suspend wage indexation temporarily.

(1) Germany, France, Italy, Netherlands, United Kingdom, United States, Japan.

TABLE 4 : WAGES , PRODUCTIVITY AND TERMS OF TRADE

	80	81	82	83	84	85	86	87	88	89	90	91
Nominal wages / employees	9.6	6.2	7.6	6.0	6.6	4.3	4.4	2.2	2.0	5.3	5.3	5.6
Real wages (priv. consumption prices)	3.0	-2.3	-.3	-1.1	.8	-1.5	4.1	.4	.1	2.2	2.1	2.8
Productivity (whole economy) (real GDP/person employed)	4.4	1.0	2.9	1.5	2.1	.1	.6	1.5	2.9	3.4	2.3	2.3
Unit wage costs (whole economy)	5.0	5.2	4.5	4.5	4.4	4.2	3.8	.7	-.9	1.9	3.0	3.3
Terms of trade (goods and services)	-3.8	-3.8	-.2	-.1	.0	.7	4.4	.8	.2	-.4	.5	-.3
Wage share (1) (whole economy)	1.2	.5	-2.4	-1.1	-.8	-1.7	.2	-1.4	-2.8	-1.5	-1.0	.2

(1) real unit wage costs
Source : Commission departments
For 1990 and 1991 : Commission staff forecasts (May 1990)

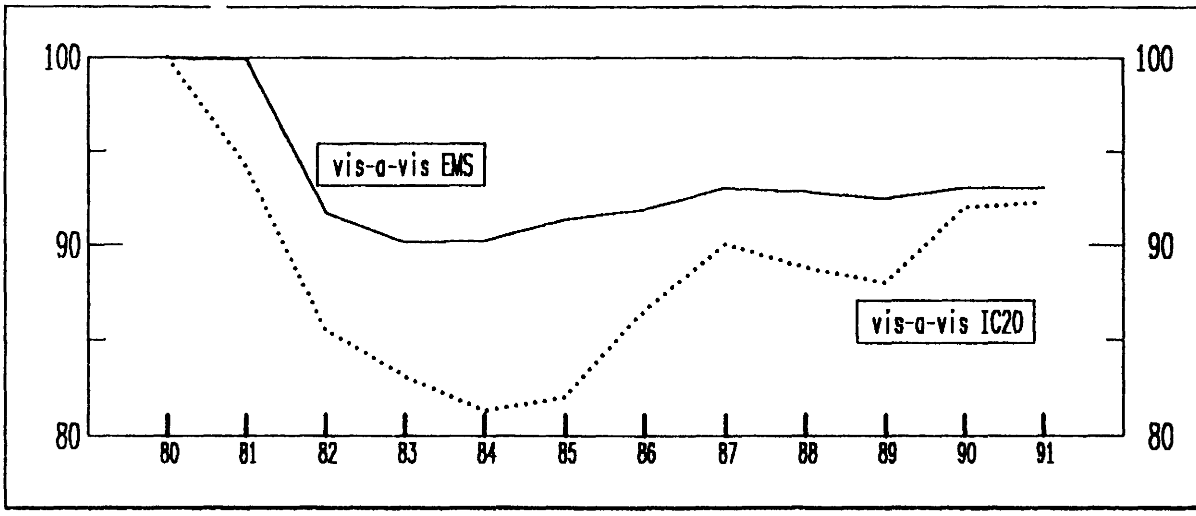
The increase in nominal wages per person employed has slowed down appreciably since 1984. During the period 1984-88, it averaged 3% a year, as against close on 5% for all the countries participating in the EMS exchange-rate mechanism. However, if account is taken of the comparative trend of productivity, which had been particularly weak throughout the Belgian economy up to 1986, the slowdown in wages meant that unit wage costs moved in parallel with unit wage costs in Belgium's partners between 1984 and 1986. The upturn in activity in 1987 and 1988, coupled with a very slight increase in nominal wages, lead to a decline in unit wage costs (see Table 4).

Over the period 1984-89, the policy of wage restraint meant that cost competitiveness remained at the relatively favourable level achieved following the devaluation of the Belgian franc. Taking unit wage costs in Belgium compared with its EMS partners, the real exchange rate experienced, it is true, a temporary appreciation in 1984-85 as a result of the tighter exchange-rate policy pursued by the authorities. In 1987 and 1988, however, the decline in unit wage costs in Belgium produced a fall in the real exchange rate despite a slight appreciation in nominal terms (see Graphs 1 and 2).

Price and cost developments in 1989 and the outlook for 1990 and 1991 are less satisfactory. The industry agreements concluded at the end of 1988 for the period 1989-90 envisage an average increase in real wages of 2% a year for most industries. According to the most recent Commission forecasts,(1) the rise in unit wage costs is expected to accelerate (+3.0% in 1989 and +3.3% in 1990) while remaining modest and close to the expected average for all the countries participating in the exchange-rate mechanism. In manufacturing, as a result of the anticipated productivity gains, the increase will probably be a little slower than elsewhere in the economy. Assuming that the present exchange-rate policy is maintained, the competitiveness of the Belgian economy in terms of relative costs vis-à-vis Belgium's EMS partners could worsen slightly (see Graph 2).

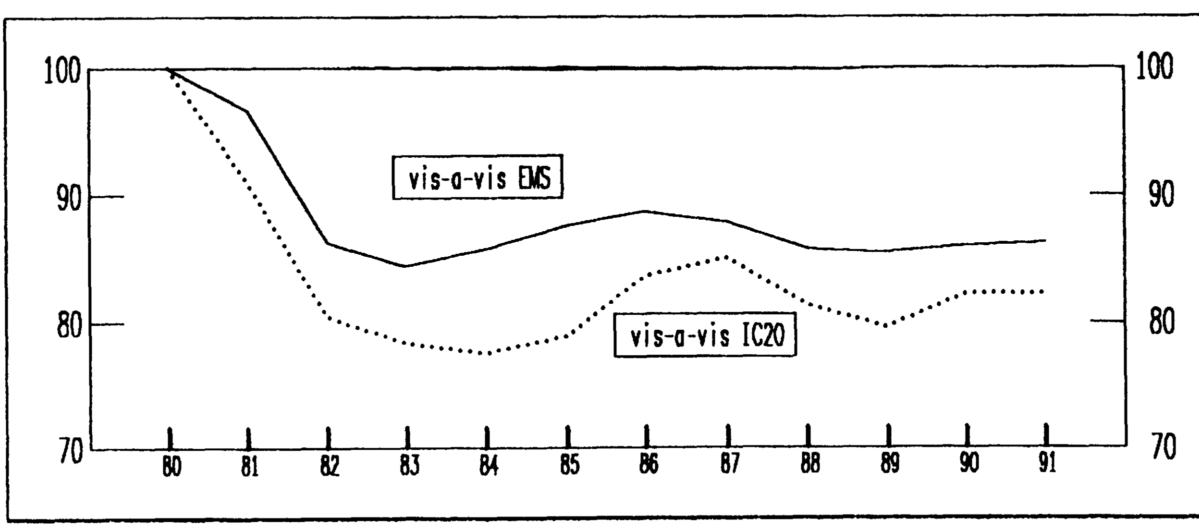
(1) On the basis of the May 1990 economic forecasts.

GRAPH 1 : NOMINAL EFFECTIVE EXCHANGE RATE



1990 and 1991 : forecasts of March 1990
Source : Commission departments

GRAPH 2 : REAL EFFECTIVE EXCHANGE RATE
(whole economy)(1)



(1) On the basis of unit wage costs.
1990 and 1991 : forecasts of May 1990
Source : Commission departments

As in most Member States, the faster pace of inflation discernible since mid-1988 stemmed initially from higher energy prices and the appreciation of the dollar. These external factors have been compounded by the price increases announced for certain public services in 1989 and especially, by the increase in certain excise duties in 1989 and 1990, designed to offset in part the budgetary impact of the reform of direct taxation(1). The inflation rate quickened from 1% in mid-1988 to 3.4% in February 1990. Since profit margins have been steadily reconstituted since 1982, an increase in import costs can, to begin with, be offset by trimming back those margins. Even so, if the external pressures on costs continue and eventually feed through into prices, they will influence wages via the indexation mechanism. As for the increase in excise duties, its impact will be automatically amplified through its repercussions on wages.

According to the interim report on competitiveness submitted in September by the Central Economic Council, there is also some risk that the situation will worsen: while Belgium continues to capture market shares and while relative profitability remains sound, domestic costs will rise much more rapidly in 1990 than the average for the seven partner countries mentioned.

In the medium term, the outlook for inflation will also depend on the pressures associated with a continuing, sustained rate of activity. The rate of productive capacity utilization has risen appreciably since the end of 1987; while, taking the average for industry, it still stood at only 80.5% in mid-1989, levels approaching or exceeding 90% in some industries have been recorded(2). Major problems are being encountered in the construction industry particularly. In some other branches, however, the recent investment drive has focused on capacity-augmenting schemes. There is also a danger that the labour-market bottlenecks arising from a geographical and occupational mismatch between supply and demand will fuel rising inflation via the pressures on wages that might be generated.

(1) Excise duties have been increased in three stages (January 1989, August 1989 and January 1990). The direct impact on the index is put at some 0.7% for the two years. Taking the induced effects (wage indexation and maintenance of profit margins in real terms), the final impact will probably be 1.1%.

(2) EC business surveys.

Law to safeguard competitiveness[1]

1. Criteria for assessing competitiveness

- Changes in export performances measured on the basis of BLEU gains or losses of market shares compared with the performances of the five main trading partners in the Community;

- Changes in wage costs calculated on the basis of the wage cost per person employed in the private sector, expressed in terms of a common currency, compared with the weighted average for the seven main trading partners (five in the Community plus the United States and Japan);

- Changes in financial costs measured inter alia on the basis of movements in short-term, medium-term and long-term interest rates in Belgium compared with the situation in the seven main trading partners;

- Changes in energy costs measured on the basis of an indicator of price movements for each energy product and for each category of consumers, expressed in terms of a common currency, compared with the situation in the five main trading partners in the Community;

- Changes in the structural determinants of competitiveness measured inter alia on the basis of firms' gross fixed capital formation and R&D expenditure (a distinction being drawn between public and private financing) expressed as % of GDP, compared with the five main trading partners in Europe.

2. Normal procedure for assessing competitiveness

The Central Economic Council prepares each year an interim report (by 31 September) and a final report (by 31 March) on the competitiveness of Belgian firms. These reports are discussed with the two sides of industry, which have one month in which to adopt measures to safeguard or restore competitiveness. If, on expiry of that period, the Government takes the view that competitiveness is still threatened, it may make a reasoned statement on the matter to the two houses of parliament .

Competitiveness is threatened where the criterion of export performance and at least one other criterion points to a worsening in the situation.

3. Procedure in exceptional circumstances

In the case of external developments, including a sudden upheaval in exchange rates, which are expected to have rapid and significant effects on competitiveness, the Law provides for an emergency procedure allowing the Government to intervene.

(1) Moniteur belge, 31 January 1989.

4. Instruments for safeguarding or restoring competitiveness

The King is empowered to take the following temporary measures once the upper and lower houses of Parliament have established that the competitiveness of Belgian firms is threatened:

- the factors determining the nominal growth of earned income not to be taken fully into account, and equivalent moderation for the other categories of income;

- establishment of the framework for any agreement on adjustments to earned income, and equivalent measures for the other categories of income;

- adoption of appropriate measures for reducing financial costs;

- limited reduction in employers' social security contributions in the industries exposed to international competition;

- increase in tax relief for investment;

- increase in tax relief for R&D investment.

2.4 Saving, investment and financial balances

The resumption of growth has been preceded by a major redistribution of national income in favour of firms. During the 1980s, firms' savings ratio virtually doubled (see Table 6). This initially lead to a corresponding increase in their financial surplus, the resurgence in investment being relatively slow to materialize. One explanation for this delay is the fact that managements were concerned first and foremost with overhauling their financial structures as a result of the particularly high levels of debt that had built up throughout the 1970s. Importance was also attached to financial investments given the high real interest rates and especially the continuing relative weakness of demand, at least until 1986. An analysis of firms' balance sheets (see Table 8) bears witness to the movements in the macroeconomic indicators:

- the average level of indebtedness in industry, expressed as a proportion of equity capital, was reduced from over 90% at the beginning of the 1980s to around 50% in 1986 and 1987;

- the share of financial assets in the balance-sheet total rose from around 20% to over 30% in 1986-87.

Since 1987, however, fixed capital investment by firms has risen at an annual rate of some 10%-12% in volume terms. The present trend is still very firm although it is slackening a little.

The financial surplus of households has fallen significantly, from 10% of GDP to around 5% in 1988. This was due initially to a relative reduction in personal income, together with a decline in the savings ratio as a percentage of disposable income. More recently, personal-sector investments have shown a noticeable increase.

The size of the public deficit has been halved, from 16% of GDP in 1981 to 8% in 1988. Until 1986, this resulted in a corresponding increase in national saving. In recent years, however, the nation's financial balance has tended to decline although it continues to show a slight surplus.

The increase in the national savings ratio and the remarkable recovery in the financial position of businesses have paved the way for higher investment. The surplus of private domestic saving over private investment remains substantial (6.7 % of GDP) although it has been narrowing over the last three years. However, considerable investment could still be needed in the Belgian economy in the years ahead given the relatively low investment ratio (18% of GDP) compared with other European countries in particular (see Table 7) and given the need to adapt supply in the run-up to the Community-wide market in 1992.

Table 5: Saving and investment in EC-countries

- 1989, as % of GDP -

	Private saving	Private investment	Difference	Public sector saving	Public Investment
Belgium	24.8	18.1	6.7	- 4.1	1.7
Germany	22.6	19.4	3.2	3.7	2.4
France	18.4	18.2	0.2	2.2	3.4
Italy	26.1	19.1	7.0	- 5.7	3.5
Netherlands	25.6	19.3	6.3	- 0.8	2.3

Source: Commission departments, May 1990 forecasts

2.5 Balance of payments

Whether we look at Belgium (on a national accounts basis) or the Belgo-Luxembourg Economic Union (on a balance-of-payments basis), the current-account balance has improved significantly during the 1980s. The BLEU deficit, equivalent to 4% of GDP in 1980-81, was eliminated in 1984-85 (see Table 6) and annual surpluses of the order of 2%-2.5% of GDP have been recorded since. For Belgium alone, the current-account surplus is equivalent to some 1% of GDP and, according to the latest forecasts, is expected to be of a similar order of magnitude in 1991 (see Table 1).

The performance of the current account has been influenced primarily by the improvement in the trade balance (up to 1988) and by a continuing surplus in 1989 despite the faster pace of import prices and the high level of investment. Certain indicators suggest that a real improvement in trade performance could be under way. During the first half of the 1980s, the reduction in the deficit stemmed first and foremost from the weakness of domestic demand. Since then, alongside an improvement in the terms of trade in 1986, foreign trade has been influenced by the following factors:

- the continuation of a relatively favourable level of price competitiveness has certainly contributed to a better export performance and has doubtless benefited the position of Belgian firms on the domestic market;

- the composition by product of BLEU exports and their geographical breakdown, which had been serious handicaps during the 1970s, have had beneficial effects in recent years. The expansion in BLEU's market shares has been particularly firm, possibly because of two factors: more buoyant demand for its main products and on its main export markets, and/or a shift in production towards expanding new markets. In the case of Belgium, both factors have probably been at work although the industry statistics available do not capture recent developments;

- an analysis of a number of structural indicators, notably export market shares, suggests that an improvement is under way in other factors of competitiveness following the major investment drive in recent years.

In the run-up to establishment of the internal market, Belgium is relatively well placed in that its degree of openness to intra-Community trade is already significant (75% of exports and 70% of imports) and its export performance in those industries deemed to be particularly responsive to the 1992 target date is generally satisfactory. Even so, Belgian industry has serious weaknesses, notably in rapidly expanding activities such as

TABLE 6 : BLEU BALANCE OF PAYMENTS (transaction basis)
(as % of GDP)

	85	86	87	88
1. Current account	.8	2.6	1.9	2.2
2. Trade balance	.9	2.4	1.5	2.1
3. Services and factor income	.6	1.0	1.4	1.2
4. Transfers	-.6	-.8	-1.0	-1.1
5. Capital movements	-1.2	-2.7	.6	-1.2
6. General government (1)	.5	1.1	.6	.3
7. Commercial credits	-.3	.1	.0	-.2
8. Public enterprises (2)	.0	-.1	-.1	-.1
9. Private enterprises (2) and individuals	-1.0	-2.9	-.2	-1.1
Of which : portfolio investment	-1.9	-2.1	-1.1	-1.5
Direct investment	.9	-.8	-.2	.9
10. Banking sector	-.4	-.8	.5	-.2
Of which : non-residents' BFR assets and liabilities	.3	-.6	.8	1.2
11. Errors and omissions	.1	-.1	.1	.0
12. Counterpart of (de)monetization of monetary gold	.0	.0	-.2	.0
13. Change in net official reserves (3)	-.2	.1	1.5	.4

(1) Including foreign currency transactions with resident credit institutions
(2) excluding monetary institutions
(3) increase (+), decrease (-)
Source : National Bank of Belgium

information technology, office electronics, and telecommunications, where the Belgian market is dominated by foreign manufacturers. In the protected sectors that will be concerned by the opening-up of government procurement such as railway equipment and heavy electrical plant, the small size of Belgian firms could be a handicap. Proper sectoral strategies are essential and will entail not only considerable investment but also a search for synergies with other European firms, whether in the form of alliances, mergers, take-overs or attempts to attract plants to Belgium.

A lasting improvement in the BLEU's trade performance would be all the more desirable in that the balance on services and factor incomes is unlikely to show many gains. The deficit on tourism is tending to widen. The burden of servicing the external public debt, equivalent to just under 2% of GDP in 1985, is already much lighter as a result of the fall in international interest rates in 1985-86 but also as a result of the changes in debt management. Investment income is tending to grow in terms of flows but is still showing only a small surplus.

For the monetary authorities, the maintenance of a current-account surplus is the necessary counterpart to the propensity to export a proportion of financial saving. Net outflows of private capital have fluctuated between 1% and 3% of GDP in recent years. Alongside the general trend towards globalization of portfolios and the growing role of collective investment undertakings in the channelling of saving, tax considerations, and in particular the withholding tax on investment income (levied at a rate of 25% until March 1990) have led investors to look abroad. As regards direct investment, flows are set to expand given the move towards international integration among businesses.

3. PUBLIC FINANCES

3.1 Fiscal adjustment policy

The public finance situation has changed markedly since 1985. Total expenditure as a percentage of GDP fell from 57% to some 51% in 1989; total revenue was slightly reduced from 47.5% to 45%. As a result, the net borrowing requirement fell from 8,5% to 6,3% of GDP. The share of interest payments in current expenditure rose to some 21% in 1989 while the amount of outstanding debt reached 128% of GDP.

The evolution of these aggregates is partially related to the adjustment measures implemented during the last five years. In March 1984, the authorities availed themselves of their remaining special powers to formulate a new three-year fiscal adjustment

TABLE 7 : MAIN PUBLIC FINANCE INDICATORS

	80	81	82	83	84	85	86	87	88	89	90	91
1. Current public receipts,% of GDP												
Belgium	45.2	46.0	47.7	47.1	48.1	48.3	47.6	48.0	46.5	45.3	45.0	44.6
EUR-12	41.0	41.9	42.8	43.4	43.6	43.9	43.7	43.8	43.4	43.8	43.4	43.4
2. Current public expenditure,% of GDP												
Belgium	49.5	54.3	54.7	54.6	54.0	54.0	53.9	52.9	51.0	49.5	49.1	49.0
EUR-12	40.8	43.2	44.4	45.0	45.1	45.1	44.8	44.4	43.7	43.1	43.1	42.8
3. GFCF, % of GDP												
Belgium	3.9	3.8	3.4	3.0	2.6	2.2	2.0	1.9	1.8	1.7	1.6	1.5
EUR-12	.0	3.0	3.0	2.9	2.8	2.9	2.8	2.7	2.7	2.8	2.9	2.9
4. General government borrowing requirement, as % of GDP												
Belgium	-9.2	-12.8	-11.0	-11.2	-9.0	-8.5	-9.0	-7.1	-6.7	-6.3	-6.1	-6.3
EUR-12	.0	-5.3	-5.5	-5.3	-5.3	-5.2	-4.8	-4.1	-3.6	-2.8	-3.3	-2.9
5. General government net financing balance on a cash basis, as % of GDP	11.6	16.4	15.1	14.6	11.6	12.2	11.7	9.9	8.9	8.1		
6. Interest on public debt, % of GDP	6.1	8.0	9.3	9.5	10.0	10.8	11.4	10.9	10.4	10.7	11.3	11.8
7. Gross public debt,% of GDP	77.3	89.7	97.5	107.3	111.6	118.0	121.9	128.8	129.8	128.4	127.9	129.4
Of which : State debt (1)	56.7	68.3	79.4	90.2	96.4	104.0	108.8	113.3	116.3	115.0		
In foreign currencies (1)	4.5	10.9	16.5	20.0	23.0	20.9	20.5	20.2	19.9	18.5		

(1) for 1989 = May 1989.
Source : Commission departments
and National Bank of Belgium
For 1990 and 1991 : Commission staff forecasts (May 1990)

TABLE 8 : GENERAL GOVERNMENT INCOME AND EXPENDITURE

	80	81	82	83	84	85	86	87	88	89	90	91
Indirect taxes	11.9	12.2	12.3	12.4	12.1	11.8	11.6	11.9	11.8	12.0	12.2	12.2
Direct taxes	18.3	18.3	19.8	19.0	19.5	19.5	19.0	18.8	18.1	16.9	16.5	16.2
Social security contributions	12.7	13.0	13.0	13.5	14.3	14.7	14.9	15.3	14.7	14.6	14.3	14.2
Other current resources	2.2	2.5	2.7	2.1	2.2	2.2	2.0	2.0	1.9	1.9	2.0	1.9
TOTAL CURRENT RESOURCES	45.2	46.0	47.7	47.1	48.1	48.3	47.6	48.0	46.5	45.3	45.0	44.6
Current transfers	24.8	26.8	26.5	26.8	26.1	25.3	24.9	24.8	24.3	23.1	22.3	21.9
Of which : to enterprises	2.7	2.8	2.6	2.6	2.6	2.5	2.4	2.0	2.1	1.9	1.8	1.7
Public consumption	18.6	19.5	18.9	18.4	17.9	17.9	17.6	17.2	16.3	15.7	15.5	15.4
Of which : wages	13.7	14.3	14.0	13.5	13.1	13.1	12.9	12.4	11.7	11.3	11.1	11.2
Interests	6.1	8.0	9.3	9.5	10.0	10.8	11.4	10.9	10.4	10.7	11.3	11.8
TOTAL CURRENT EXPENDITURE	49.5	54.3	54.7	54.6	54.0	54.0	53.9	52.9	51.0	49.5	49.1	49.0
Net capital transfers	.9	.8	.6	.6	.6	.6	.6	.3	.4	.4	.4	.3
GFCF	3.9	3.8	3.4	3.0	2.6	2.2	2.0	1.9	1.8	1.7	1.6	1.5
TOTAL EXPENDITURE	54.3	58.8	58.7	58.2	57.1	56.8	56.5	55.1	53.2	51.6	51.1	50.9
Lending / borrowing	-9.2	-12.8	-11.0	-11.2	-9.0	-8.5	-9.0	-7.1	-6.7	-6.3	-6.1	-6.3
Interests / current expenditure (as %)	12.4	14.7	17.0	17.4	18.5	20.0	21.2	20.5	20.4	21.7	23.1	24.0
Non-interest current expenditure	43.4	46.3	45.4	45.2	44.0	43.2	42.5	42.1	40.6	38.8	37.8	37.2

Source : Commission departments
For 1990 and 1991 : Commission staff forecasts (May 1990)

programme with the aim of reducing the central government net financing requirement to 7% of GDP by 1987. The adjustment programme rested on a combination of wage moderation in the public sector and fiscal measures in the private sector (of which the main feature was the suspension of the first indexation adjustment of 2% in 1984, 1985 and 1987) in favour of the social security system and the Treasury , savings in expenditure on goods and services and restrictions affecting social transfers. The 7% target first appeared in 1982 as an objective for 1985; it was at that time set to be equal to the assumed growth rate of nominal GDP in the medium term and was intended to stabilise the debt/GDP ratio.

By the end of 1985, however, it became clear that the target set for 1987 again would be overshot; the 7% objective was pushed back to 1989 and a new fiscal adjustment package - called the St.Anna programme - was released in May 1986. In contrast with previous efforts, the programme relied more heavily on expenditure cuts and contained only a minor set of revenue-raising measures; the bulk of the programme's measures were intended to take effect in 1987 in order to reach an interim deficit target of some 8% of GDP. The significant cuts in social expenditure affected unemployment compensation, pensions, health care and education; public investment was further reduced and subsidies to public utilities were scaled down. The St.Anna programme also introduced an important new form of debudgetization through the creation of special eight-year Treasury bonds, issued to settle part of the interest payments on public debt. Such "rescheduled" interest payments do not appear in the Treasury deficit, but still affect the net borrowing requirement.

The impact of the programme on the net borrowing requirement was significant; further progress through new policy initiatives was hampered by the long political crisis of 1987-1988, however, although the unexpected recovery of economic growth and the decline of international interest rates had a positive impact on fiscal deficits.

At its formation in May 1988 the new government reconfirmed the 7% objective for 1989, and adopted a double budget norm for the medium term (i.e. from 1990 to 1992). The first target is to stop non-interest expenditure growing in real terms; the second requires the treasury deficit not to increase from one year to the next in nominal terms.

With an actual outturn of 6.8%, the 1989 central government budget nominally meets the 7% target, but a heavy resort to debudgetization and shifting of expenditure had to be made. The most important budgetary measure is a renewed shift of interest charges on the public debt (BEF 28 billion), which together with other expenditure shifting operations makes up about half of the required savings (78 billion). The same remarks hold with respect to the 1990 draft budget which is the first that has to satisfy the dual target strategy : as far as measures are actually known, there will be no substantial improvement in the general government borrowing requirement compared to 1989.

Fiscal consolidation could in future be further complicated by the 1988 devolution of a number of powers to the communities and the regions; the expenditure involved represents roughly one third of the Treasury's 1989 budget. The constituent parts of the federation have not been granted any real fiscal autonomy; instead, a complex system of intergovernmental transfers has been set up, some details of which are explained in the appendix. The amounts transferred are insufficient to cover the expenses of the regions and communities, implying that Central Government has decentralised part of its deficit to the federal entities.

A remarkable phenomenon in this context is the fact that the outturn of the 1989 Treasury deficit (397 billion BEF which consolidates the balances of Central government, Regions and Communities) has been realised despite the fact that several ten billions BEF which had to be transferred in that year to the Regions and Communities is still due by the Central Government. Consequently, these federal entities have managed to exert their powers without these amounts and nevertheless have broadly met their own deficit target. If these amounts are transferred during the current year - as they legally should - it is by no means evident that Regions and Communities will use them to generate surpluses instead of running into additional spending.

3.2 Taxation policies

Until 1985 the boom in expenditure was partly financed by a steady rise in revenue, more specifically through rising income taxes. Since income tax thresholds were not automatically adjusted for inflation, the average tax rate rose strongly in these years.

A first important downward adjustment was voted in August 1985. Over a period of four years, the minimum income subject to tax was raised, tax thresholds were linked to the consumer price index, marginal tax rates were lowered and the fiscal position of married couples was improved.

A second reform of personal taxation came into effect on January 1989. It is expected to lower income taxes for individuals by some BEF 91 billion on a gross basis. Basic principles underlying the reform are a cut in the number of marginal tax rates from 13 to 7, a lowering of the top rate from 72 to 55 percent, the extension of the indexation to all amounts contained in tax legislation, and a modification of the fiscal treatment of married couples (one-earner as well as two-earner).

Given the difficult budgetary situation, the reform has from the start been conceived to be neutral with respect to government revenue. Consequently, half of the 91 billion will be recovered through lower deductions and exemptions both in personal and in corporate tax. The rest is mainly made up through significant increases in excise duties and the induced VAT increases.

The increase in excise duties can be considered to be an anticipation of the harmonisation of indirect taxation which is currently under discussion at the Community level. Broadly speaking, Belgian excise dutieswere relatively low while VAT rates were too high.

Commission estimates of the budgetary impact of harmonisation proposals suggested that the loss implied by the lowering of VAT rates would be compensated for by the increase in excise duties. Since the upward adjustment in excise duties has been used for the major part to finance the personal income tax reform, future harmonisation of VAT rates will imply a significant loss of revenue of about 0,7% of GDP.

The same budgetary constraint applied to the problem of the downward adjustment of the withholding tax on income from savings, which took effect on March 1 1990 in order to cope with the integration of capital markets. Although the reduction had long been considered necessary from a policy point of view, the problem of the negative impact on tax revenues was a serious impediment.

Taxation of enterprises has been modified several times during the eighties to reconcile budgetary needs with investment-stimulating measures. As a result, corporate taxation has become very complex and the relation between the nominal tax rate of 43% and the effective rate is very difficult to assess. The opening of internal market frontiers has consequently led the government to express its intention to add to the reform of personal income tax a fundamental revision of corporate taxation, which among other things should simplify it substantially, make it more transparent and lower substantially the nominal rate. The government has enforced this intention by already deciding to lower the rate to 41% in 1990 and to 39% in 1991, as a partial compensation for the abolition of certain tax deductions.

3.3 Process of regional devolution and financing arrangements

The current phase of institutional reform has its roots in the 1971 revision of the constitutional law, at which time the principle of three regions (Flanders, Wallonia and Brussels) and three communities (French, Dutch and German speaking) was introduced, each having a limited number of institutions and competences. The 1980 reform added a number of additional institutions and competences to the existing ones and broadened their financial powers.

In the logic of this system, each community and each region has its own parliamentary assembly (Council) and its own government (Executive) and administration. In practice, however, there are only five assemblies, governments and administrations, since the councils and executives of the Flemish Region and Community are organised and managed as one entity. In Brussels, there are in addition three "subcommunities" each having their own "commission".

The fall of the cabinet in 1987 over linguistic matters made apparent the need to add a more decisive phase to the regional devolution process. In August 1988, new legislation was passed devolving education to the communities; the regions gained competence over infrastructre policy, regional transport networks (excluding railways), export policy, regional aspects of energy, employment policy, housing, provinces and municipalities, and environmental protection. Regions also became responsible for economic policy (including the five sectors which in the 1980 reform remained national : steel, textiles, glass, shipyards, coalmines) except for those matters explicitly attributed to central government : monetary policy, financial policy, prices and incomes, competition policy, etc.. Central government has also kept the sole responsibility for social security and for the service of the outstanding national debt.

Overall, the total amounts involved represent about one third of expenditure of central government before devolution; regions receive about 60% of this total.

The financing mechanisms accompaying the reform are complex; they have been dealt with in a separate special law of 16/01/89[1]. The law is special in the sense that a majority of two thirds is required in both chambers, together with a simple majority in each linguistic group of each chamber.

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(1) It is to be remembered that the small German Community (which has no powers with respect to education) will be dealt with in a separate law.

The different financing mechanism will not be dealt with in detail but a survey of some of the most important features will be useful to assess the general concept. The complexity of the overall system results from the combination in five different submechanisms, intended to cover i) transfers for education (communities), ii) current expenditure on new powers of the regions (excluding municipalities and provinces), iii) investment expenditure on new powers of the regions, iv) the Municipalities and Provinces Fund (regions) and v) expenditure on new powers of the communities together with expenditure for existing powers of communities and regions (previous allocations).

A first principle has been to finance regions as a function of their contribution to the overall personal income tax yield : in the final system, the contribution of a region to total personal income tax yield will determine its share of the total amount of money transferred to the regions as a whole. Since the present distribution of expenditure on the items that have been devolved to the regions is not - or only partially - based on this principle, an eleven-year transition period has been introduced which will serve to adjust gradually amounts transferred.

Apart from the distribution basis, the total amount of money to be transferred to the regions and communities has to be determined. Here the basic principle is that calculations should be based on what central government would have spent on the devolved items in the absence of devolution. The calculations start off from the amounts related to devolved items in the original 1989 central government budget. Since the current government has constrained non-interest expenditure to grow no faster than inflation, this same rule is applied to determine the total transfer until 1999. In the final stage, however, the amount to be distributed will not only be corrected for inflation, but also for real GDP growth.

With respect to expenditure on education, an additional correction is applied to take account of the evolution of the number of pupils, because it is assumed that this evolution would have equally influenced the amount spent in the national budget in the absence of devolution. For the next ten years, the result will be divided between the Flemish and French Community in the proportion 57.55% to 42.45%. Afterwards, the relative distribution of pupils will determine the proportion.

The devolution process is based on the principle of financial responsibility, implying that regions and communities can autonomously decide how to spend their revenues - notwithstanding the fact that the calculation of the amounts to be transferred is based on predictions of the evolution of certain expenditure categories.

Next, regions are allowed to a certain extent to conduct their own taxation policy. Indeed, apart from a small number of taxes which become regional, regions are allowed to levy surtaxes or grant tax reductions with respect to personal tax revenues collected on their territory. However, in order to prevent distortions of the Economic and Monetary Union of the nation, central government could impose maxima or minima in this respect. Taxation policy, both at regional and at national level, will be discussed in the Consultative Structure Central Government - Regional Executives.

The principle of interregional solidarity is maintained and formalised. If tax revenues per head in one region are below the national average, a solidarity transfer is calculated which is a function of this discrepancy. In the transitional period the solidarity transfer will be paid for by the regions; in the final financing mechanism changes in the solidarity transfer will be payed for by the central budget.

Next, the idea is introduced that regions and communities should during the eleven-year transitional period bear part of the adjustment burden of public finances. Two mechanisms are provided to take account of this purpose. The first concerns the determination of the basic amounts to be distributed; as has been mentioned before, no real growth is taken into account.

The second mechanism is more complex. The basic idea is that in the absence of devolution, central government would have had to borrow to make possible expenditure on devolved items, since overall revenues are insufficient. This insufficiency ratio is estimated to be 14.3%. Consequently, for devolved current expenditure (excluding education transfers) only 85.7% is transferred to the regions and communities, forcing them either to cut back expenditure or - as is the intention - to borrow.

However, Central government will share in servicing the debt, again for an amount of 85.7% (100% for expenditure related to existing powers) through annuities calculated over a period of nine or ten years and based on the rate of interest of the first state loan of the year.

With respect to devolved expenditure items related to investment, the insufficiency ratio is set at 100%. Again, regional entities will have to borrow, but will enjoy a participation of 85.7% by central government in debt servicing through the system of a ten-year annuity.

The principle of a distribution scheme based on the regions' contribution to national personal tax revenue is gradually introduced during the transitional period. This will, however, imply that a region could gain or lose compared to what would have been spent in the region in the absence of devolution. For some expenditure items this was not considered desirable. Consequently, the total amount of money to be transferred is augmented, so that, after applying the distribution scheme, the potential loser has neutralised his loss. The other regions have, however, received more than they would have in the absence of this compensation policy. The amount gained is called a "boni", whereas the system as such is commonly referred to as the "Moureaux-key". The expenditure items concerned are the initial allocations (which date from the previous constitutional reform) and the allocations to provinces and municipalities.

Regions and communities are allowed to <u>borrow on domestic financial markets in BEF</u>. A consulting procedure to harmonize public issues with the issue calendar of the Treasury is imposed; private borrowing is not subject to any constraint. With respect to borrowing in foreign currencies or in BEF abroad, the prior agreement of the national Minister of Finance is required.

A new commission is established which should advise central government with respect to the evolution of the borrowing requirement of total government. If internal or external equilibrium is threatened, the monetary union of the nation is endangered or a structural disruption of the borrowing requirement is likely, it may advise that the lending capacities of regional or community governments be restricted. The Council of Ministers can accordingly, for a period of two years, subject any lending to prior agreement.

3.4 <u>Evaluation and prospects</u>

3.4.1. <u>*Assessment of the current fiscal policy targets*</u>

The analysis of the public finance problem in the Belgian context has in recent years almost exclusively been conducted in terms of "halting the snowball". The snowball image refers to the problem of explosive public debt growth caused by the accumulation of interest payments. If the primary deficit - i.e. the deficit excluding interest payments - is not well contained, the ratio of public debt/GDP will keep rising if the rate of growth of GDP is smaller than the average rate of interest on the debt.

Halting the snowball consequently means attaining a level of primary deficit which is sufficient to ensure that in the next period total debt will not grow more than GDP.

The snowball image has the merit of explaining some of the internal dynamics of current expenditure, by pointing to the impossibility of compressing one of its components, namely the interest payments. Halting the snowball, however, is nothing more than the objective of stabilizing the debt/GDP ratio. The disadvantage of talking in terms of halting the snowball is that the objective of reducing the debt/GDP ratio cannot be dealt with in this framework.

5)

The interest accumulation framework also introduces the concept of the primary balance, which in the Belgian case shows a remarkable evolution from a serious deficit (-4,8% of GDP in 1981) to a significant surplus (+4,3% in 1989). As such, it well illustrates the remarkable result of past adjustment policies; nevertheless, the concept does not allow to assess the actual nor the future stance of public finance, in particular if the existing stock of government debt is taken into account.

The government has added to this medium-term objective of halting the interest payments snowball two strategic targets from 1990 on. The first target - no rise in real non-interest expenditure - indicates that the authorities want every new initiative or increase in expenditure to be compensated for on the expenditure side. The second target - no rise in the nominal deficit - constrains the accumulation of debt and consequently requires additional cut-backs in non-interest expenditure or an increase in revenues if interest charges exceed the current primary surplus by more than last year's total deficit.

Although the dual target strategy is a political commitment to the end of 1992 (i.e. the end of the normal period of office of the current government), the stabilisation of the debt-to-GDP ratio has already been achieved in 1989, due to the strenght and solidness of economic growth. Consequently, a fall in growth performance could easily cause a renewed increase in this ratio unless a further reduction in the yearly deficit would have been obtained in the meantime. Of course, in the long run the second constraint will in the end result in stabilizing the ratio if average nominal growth of nominal GDP remains positive.

Next, meeting one target (for instance the real expenditure one) might - but would not automatically - lead to better than required performance with respect to the other. This one could then become binding as an upper limit next year and might consequently induce a downward adjustment that was stronger than expected at first sight. The interaction of both constraints consequently could yield much stronger results than foreseen at the moment of their conception.

A basic problem with objectives formulated as percentages of GDP (whether they refer to a deficit or the level of debt) is that they are procyclical by definition. In periods of accelerating nominal growth they relax the necessary effort to attain the goal that is get; this has been the case in Belgium in 1989, when a goal of 7% was set.

It could be argued that a norm should be counter-cyclical, thus strenghtening fiscal consolidation in periods of strong economic growth. The dual-target strategy avoids any direct relation to GDP, but it is clear that the drafting of the 1990 budget would have been more difficult if current prospects were less bright.

Of course, the positive effect of growth on revenues should not be overestimated; recent estimates seem to suggest that the elasticity of fiscal receipts with respect to GDP is decreasing.

3.4.2. *Some problems in assessing the consolidation results*

The dual-target strategy is formulated with respect to the treasury deficit, thus excluding social security and local government. However, it has been longstanding practice in Belgian politics to resort to debudgetisation of central government expenditure.

In the early eighties, payments were generally deferred by means of prefinancing operation, carried out by autonomous public sector funds. More recently, the practice of "interest rescheduling" has become operational. As mentioned before, the system works through an reconversion of part of the due interest payments on longterm debt into so-called "Treasury-bonds". The system, which had to be the subject of a protocol agreement with the domestic financial sector which holds these assets, causes the deferred interest payments to disappear from the central government Treasury deficit. The net borrowing requirement is nevertheless unaffected. Although at the time of its creation in 1986 conceived to be a one-time operation (affecting successive years) the interest deferment system has been used an additional two times since then; both the 1989 and the 1990 budget make extensive use of it.

TABLE 9 : DEFERMENT OF INTEREST PAYMENTS
(billions BEF)

	1986	1987	1988	1989	1990
Treasury bonds creation					
1986 agreement	6,0	33,1	35,2	21,0	11,0
1988 agreement				28,0	
1989 agreement					20,0
Total	6,0	33,1	35,2	49,0	31,0
As % of Treasury deficit (for 1990 : budget)	1,1	7,7	8,1	12,2	7,7

3.4.3 *The effect of the 1988 constitutional reform on fiscal consolidation*

An unresolved question of high importance is the effect of the constitutional reform on fiscal consolidation. (Details on the transfer of powers and on the complex financing mechanism can be found in appendix IV).

Reduced to its bare essentials - and thus simplifying - the financing law transfers increasing amounts of money to the regions, which during the first years of the transitional period will be insufficient to cover expenses, even under the assumption that these expenses do not grow faster than inflation. After 1995, under the same hypothesis, transfers will exceed projected expenses. As a consequence, regions will have to borrow considerably during the first period - or cut back expenses - and will run surpluses afterwards if they maintain zero real growth of expenditure. After 1999 (the end of the transition period) transfers to the regions will grow in line with nominal GDP.

With respect to the linguistic communities, transfers for education (i.e. the larger part of their responsibilities) will be made as a function of the number of young people under 18 and will be adjusted for inflation. Other devolved expenditure to the communities will be financed in an analogous way to the regions.

A first important feature from the point of view of fiscal policy is that regionalisation involves a <u>long-term commitment from central government to transfer increasing amounts of money to other political entities</u>. Although the calculation of these transfers has been based on restrictive grounds - especially during the first years - they involve nevertheless an amount of expenditure which has, from the point of view of the central government, some of the characteristics of the interest payment component : they keep growing and do not allow any reduction.

Moreover, regional authorities <u>do not have to contribute to the servicing of the existing national debt</u> : neither amortization nor interest payments. As a consequence, central government has the sole responsibility for servicing past debt; since the larger part of expenditure cannot be compressed, additional consolidation efforts would imply very strong falls in real non-interest expenditure of the central government or significant increases in tax pressure.The 1990 central government draft budget confirms this view : the heavy recourse to debudgetisation and hence the non-attainment of the target was justified by this reduced mass of compressible expenditure.

At the regional and community level, it is important to note that no budgetary norm has been devolved, nor has the central government the power to impose in the future any target for fiscal policy on the regions or communities. In this respect, it is to be remembered that regions and communities from a juridical point of view cannot be considered to be local or subordinate entities. As a consequence,the behaviour of regional authorities in this respect is unknown and uncontrollable; in fact, there is no built-in incentive for them to avoid running deficits or to create surpluses.

In addition, the system of annuities through which the central government participates for the major part in the debt service of regions and communities could stimulate their non-interest expenditure, since there is no obligation for them to use these amounts to service their debt. The same holds with respect to the system of the bonuses, through which for two regions more is transferred than actually needed.

It is virtually impossible to quantify the effect of the new financing mechanism on the evolution of total debt. Many important parameters are uncertain : the rate of growth and inflation; future population growth; the budgetary targeting of central government and regional entities etc. Given these difficulties, in a recent study published by the National Bank of Belgium, an attempt has been made to calculate mechanically the evolution of total debt over a period of twenty years, under different scenarios and behavioural assumptions (see box).

An important conclusion that can be drawn from this exercise is that even in the most restrictive system, i.e. the first hypothesis of scenario one, in which in fact the regional and community entities apply an expenditure norm which is more stringent than the zero real growth rate of central government, the process of budgetary consolidation is slowed down compared to the one under the hypothesis of no devolution.

The impact of regional devolution on total debt[1]

The evolution of total debt in the absence of devolution is compared to the one which results from the application of the finance law. A constant rate of real growth (2,1%), inflation rate (2,4%) and interest rates (8% long term and 7% short term) are common to all scenarios. The difference between scenarios is the assumption with respect to the behaviour of policy entities, i.e. central government and regional and community governments. The first scenario assumes an unchanged expenditure policy over the period. In the second one expenditure policy of each entity is unchanged until their debt is eliminated; afterwards a balanced budget is aimed at. The third scenario assumes an unchanged expenditure policy until balance is reached, which will be maintained afterwards.

Unchanged policy means for central government no increase in real expenditure, interest payments excluded. Regions and communities are assumed to change real spending, interest payments excluded, by:

Assumption 1. -0.8% for education and 0% for the remaining powers
" 2. 0.0% for all powers
" 3. +1.0% for all powers

The results for the evolution of debt as a percentage of GDP for the three scenarios under the three expenditure assumptions are shown below:

Scenario 1

	Without devolution	Assump- tion 1	Assump- tion 2	Assump- tion 3
1989	115.8	115.9	115.9	115.9
1990	117.7	118.2	118.3	118.4
1991	119.1	120.1	120.2	120.5
1992	119.6	121.2	121.5	122.1
1993	119.5	121.6	122.0	123.0
1994	118.7	121.3	121.9	123.4
...				
2007	56.0	62.7	68.7	85.8
2008	47.1	53.9	60.6	79.7

(1) Claeys J., and Famerée H., "La loi spéciale du 16 janvier 1989 relative au financement des Communautés et des Régions", Cahier N°3, juillet 1989.

Scenario 2

	Without devolution	Assumption 1	Assumption 2	Assumption 3
1989	115.8	115.9	115.9	115.9
1990	117.7	118.2	118.3	118.4
1991	119.1	120.1	120.2	120.5
1992	119.6	121.2	121.5	122.1
1993	119.5	121.6	122.0	123.0
1994	118.7	121.3	121.9	123.4
...				
2007	56.0	72.5	75.2	88.6
2008	47.1	65.3	68.3	83.0

Scenario 3

	Without devolution	Assumption 1	Assumption 2	Assumption 3
1989	115.8	115.9	115.9	115.9
1990	117.7	118.2	118.3	118.4
1991	119.1	120.1	120.2	120.5
1992	119.6	121.2	121.5	122.1
1993	119.5	121.7	122.0	123.0
1994	118.7	121.4	121.9	123.4
...				
2007	74.4	81.6	84.4	97.1
2008	71.2	78.0	81.1	95.0

4. MONETARY POLICY :

4.1 Introduction

One of the distinctive features of monetary policy in Belgium (now in the process of change, see section 4.3 below) has been its reliance on a single instrument, interest rates. The two-tier exchange market had not been actively used since the 1982 devaluation, and was finally abolished in March 1990 ; and changes in monetary and credit aggregates are not a factor influencing the direction of monetary policy. This is because the authorities have always taken the view that, in a very open economy such as that of Belgium, the relationship between exchange rate movements and price movements is more stable than that between changes in a particular aggregate and the rate of inflation. Indeed, due to the importance of international trade to the Belgian economy (exports and imports each amount to more than 70% of GDP) a strong relation is observed between the evolution of the domestic price level and the exchange rate, while the freedom of capital movements is viewed as making the relation between a monetary aggregate and inflation less reliable.

As a consequence of this dependence on a single instrument the conduct of monetary policy in Belgium has often faced a dilemma between a domestic objective and an external objective. The external objective is the stability of the Belgian franc's exchange rate within the EMS, the domestic objective being to lighten the public debt burden and to promote productive investment by firms in so far as domestic conditions are appropriate. Monetary policy was then directed at keeping interest rates at the lowest possible level compatible with the EMS constraint.

In recent years, the stance of exchange rate policy has gradually shifted in the direction of stability vis-à-vis the strong currencies in the EMS. This option has been reflected in the interest rate differential relative to Germany which has been following a steadier path for some two years now. The authorities publicly committed themselves to the strong currency option in June 1990.

4.2 Exchange rate and interest rates

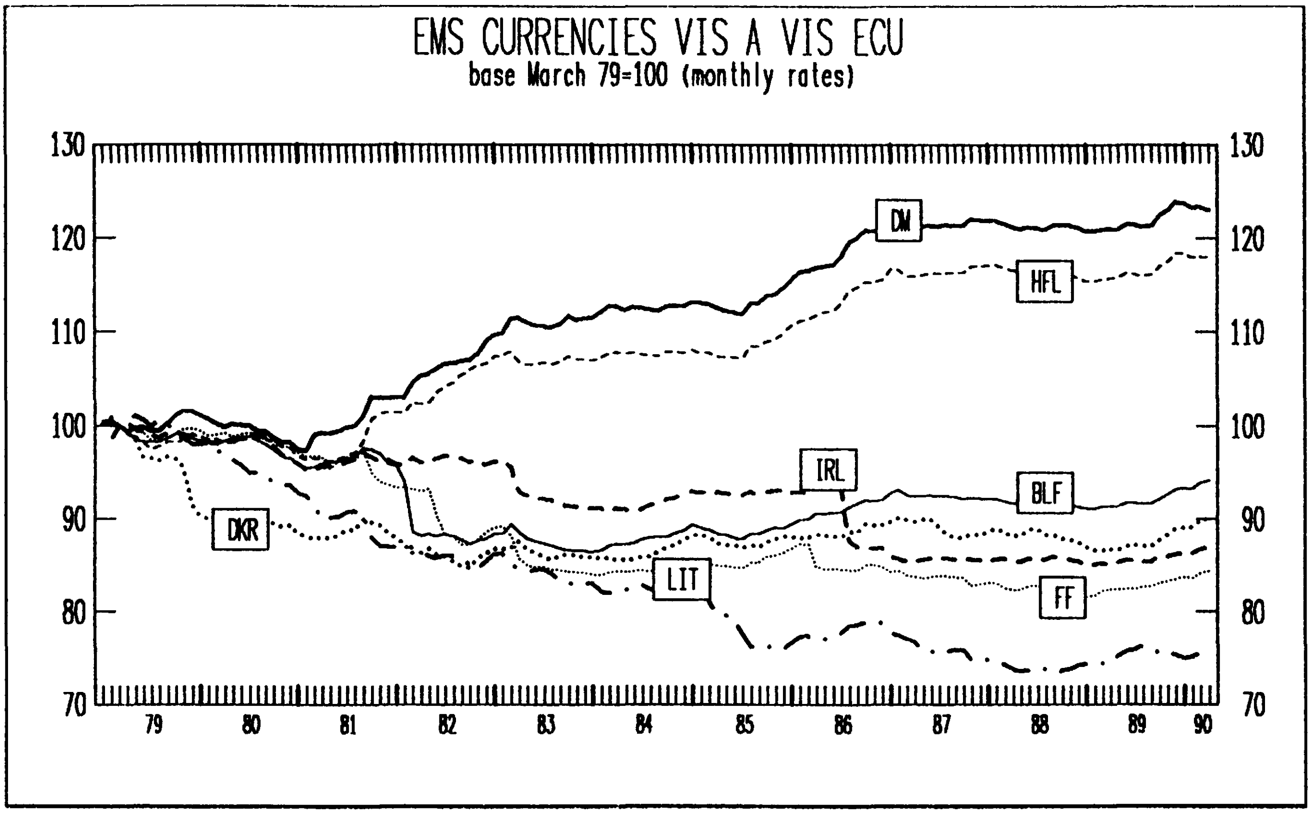
The Belgian franc's position in the EMS has progressively strengthened since 1984. Whereas its ecu central rate fell by 12% between 1979 and 1983, it has since shown an overall appreciation of some 5.5%. An increasingly tight exchange-rate policy has resulted in <u>increasingly small rates of devaluation against the German mark</u>. For instance, on the occasion of the most recent realignment in January 1987, the Belgian franc rose by 2% against the ecu and registered no more than a 1% fall against the German mark.

<u>In recent years</u>, the monetary authorities have pursued the following objectives:

- maintenance of the Belgian franc's stability within the EMS;

- gradual reconstitution of exchange reserves;
- exploitation of the fundamental improvement in the situation in order to narrow the interest-rate differential with the strongest European currencies.

GRAPH 3 : THE POSITION OF THE BELGIAN FRANC IN THE EUROPEAN MONETARY SYSTEM



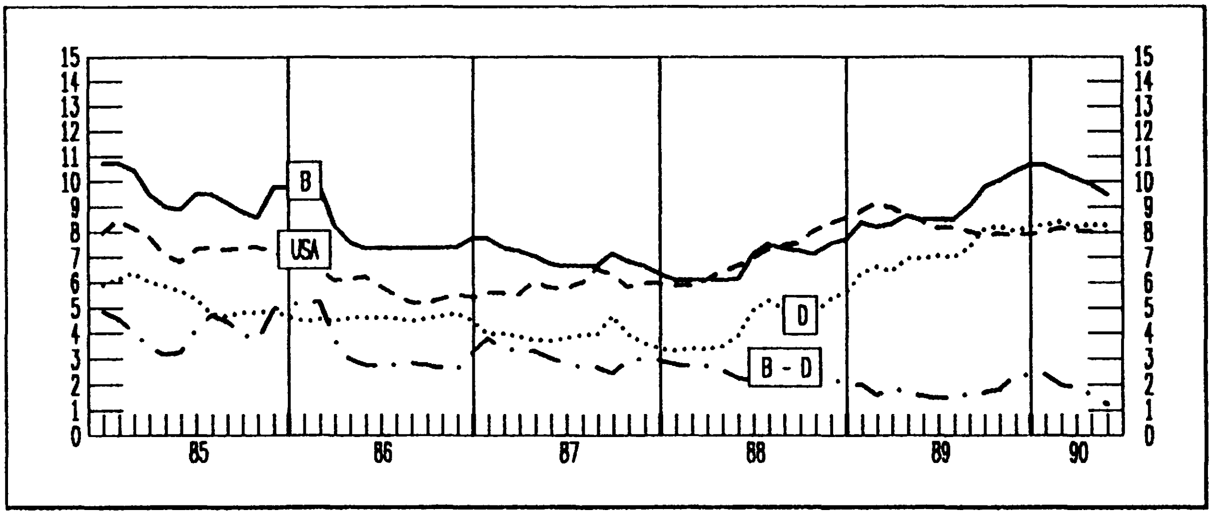
Source : Commission departments

These targets have been met without any major difficulties being encountered. The Belgian franc has remained virtually stable against the ecu. Following a slight decline in October/November 1987, it remained unchanged against the German mark until the beginning of 1990. In practice, it has not come under any pressure, and the gap between the regulated and the unregulated markets has remained very small, exceeding 1% only for very short periods, notably when major financial transactions were being conducted[1] (see Graph 7).

Exchange reserves have risen significantly under the combined impact of the surplus in "autonomous" balance-of-payment transactions and continued foreign-currency borrowing by the public authorities.

The decline in short-term interest rates (see Graph 4) from 7.75% at the beginning of 1987 to 6.1% in mid-1988 was more pronounced than in other European countries because of the particularly marked fall in inflation, which led to complete elimination of the inflation differential with Germany. The increase up to 1989 (from 6.1% to 9.6% in October 1989) has been less steep, with the Belgian franc benefiting from the periods of relative weakness of the German mark against the US dollar. The short-term interest-rate differential relative to German rates thus narrowed almost continually until mid-1989, from three percentage points in 1987 to around 1.5 percentage points.

GRAPH 4 : NOMINAL SHORT-TERM INTEREST RATES

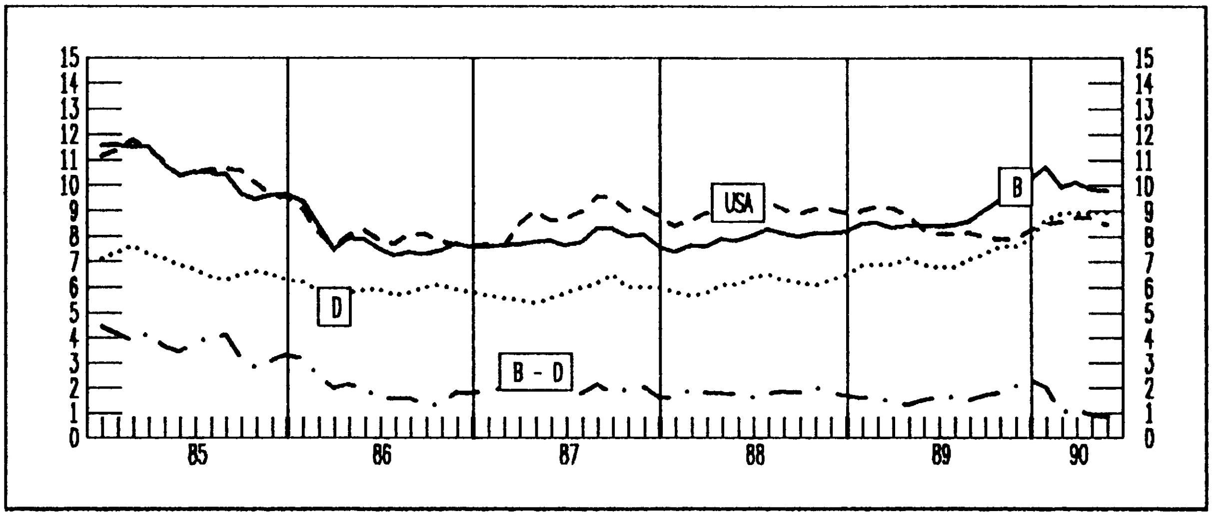


Source : Commission departments.

(1) Transactions in securities issued by the Société Générale de Belgique.

At the end of 1989 and during the first few months of 1990, the markets were dominated by considerations relating to the possible consequences of the events in Eastern Europe and by the prospect of German monetary unification. The general upward movement in rates in the Community produced in Belgium rates of over 10% at both the short end and long end. The relative weakening of the German mark within the EMS made for a narrowing of the interest-rate differential.

GRAPH 5 : NOMINAL LONG-TERM INTEREST RATES



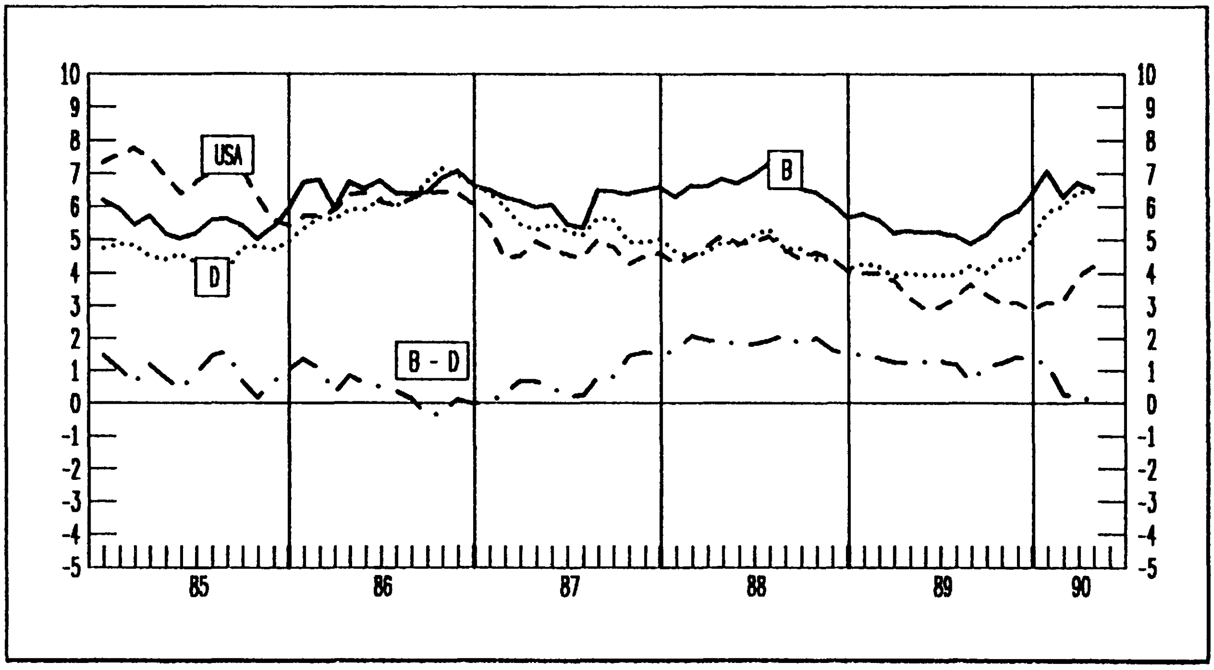
Source : Commission departments.

However, any assessment of the role of monetary policy and the headroom it affords should also take account of the following:

- the differential between interest rates adjusted for current inflation in Belgium and Germany was still relatively wide until the end of 1989 (see Graph 6). This can be ascribed to various factors including: (i) the withholding tax on income from savings in Belgium; (ii) the smaller size and lower efficiency of financial markets in Belgium; (iii) the high level of public borrowing, which necessitates a sustained adjustment, even though the risk of monetization and hence the exchange risk are low, given the scale of domestic private saving;

- the need to take account of the domestic objective of monetary policy has traditionally been reflected in a small or negative differential between long-term and short-term rates. Since the State is the main borrower, long-term interest rates are heavily influenced by the negotiations between the Treasury and a consortium of financial intermediaries. The government's ability to force down long-term interest rates is, however, limited by the fact that an unduly low interest rate relative to rates abroad would simply speed up the already very large volume of long-term capital outflows. The Treasury tends, therefore, to increase its short-term financing when long-term rates are deemed to be too high. As a result, the yield curve is generally flatter or more inverted than in other countries. While such a situation could be regarded as being favourable from the point of view of the public-debt burden (60% of which is made up of medium-term and long-term securities) and productive investment as opposed to investment in financial assets, it may be a source of instability for capital movements with other countries by favouring short-term over long-term investments.

GRAPH 6 : LONG-TERM INTEREST RATE ADJUSTED BY CURRENT INFLATION



<u>Source</u> : Commission departments.

The generally positive picture as far as the exchange rate, interest rates and the inflation-rate differential are concerned has, it is true, been favourably influenced by the relative stability that has been a feature of the EMS for more than two years. Basically, however, it stems from the fact that <u>the effects of the domestic adjustment policy, engendered by income moderation, and the effects of the gradual strengthening of the exchange rate in the EMS have been self-reinforcing.</u> The strong currency option, publicly confirmed in June 1990, will further enhance credibility and contribute to the virtuous circle.

Following a period in which the exchange rate has gradually strengthened within the EMS, Belgium seems to be comparatively well prepared for the process of economic and monetary unification in the Community. The success of the announced policy of following the strong Community currencies depends on the ability to impose new constraints on the other aspects of economic policy, notably in order to influence the following:

- the trend in underlying inflation: at the moment, Belgium is in the group of Community countries with low inflation. However, as in most other Member States, the forecasts of wage costs for 1990 point to an appreciable acceleration in inflation. Admittedly, the exchange-rate option can, in a very open economy like Belgium's, contribute to a healthy inflation performance but the process of wage formation and the way in which rising costs are passed on in prices also play a crucial role;

- the scope for running a continuing current-account surplus: the trend in the factors influencing real competitiveness will be crucial and will depend among other things on the effects of the current wave of investment and on the ability to carry through appropriate sectoral strategies in the run-up to establishment of the internal market;

- pursuit of a restrictive budgetary policy: prompt achievement of the objective of stabilizing and then reducing the debt/GDP ratio is essential. Moreover, the need to maintain a current-account surplus while, at the same time, fostering a major private-investment drive calls for a simultaneous contraction in public dissaving.

4.3 Extending the panoply of monetary policy instruments

For fifteen years or so, the central bank has exerted influence over the money market primarily through its manipulation of interest rates. The quantitative measures for controlling the supply of credit directly or indirectly - rediscount ceilings, compulsory monetary reserves, obligation to reinvest in government stock and securities - have not been actively used since 1975.

Alongside the official and special rediscount rates and the rates for advances, the central bank itself fixes the rates on very short-term Treasury certificates (one, two and three months). The rate on three-month certificates has, during the 1980s, gradually become the benchmark rate for the money market because of the amount of such securities held in financial intermediaries' portfolios and because they are issued continuously(1). Under the circumstances, the action of the central bank is both efficient and flexible, the aim being to influence the entire structure of short-term interest rates.

Within the framework of a monetary policy geared primarily to safeguarding the external value of the currency, the interest-rate policy pursued aims mainly to influence short-term capital flows. According to the needs of reserve management, the central bank also influences the way in which any market intervention is financed: by determining the differential between the discount rate and the rate on short-term certificates, it can either promote Treasury financing on the money market or, on the contrary, encourage the Treasury to borrow in foreign currencies. In May 1985, the method of fixing the discount rate was modified in order to allow more flexible manipulation of this rate differential. In recent years, the discount rate has nearly always been held at a level higher than the rate on Treasury certificates and the banks have virtually never availed themselves of the rediscount facilities or central bank advances in order to boost their liquidity.

The effectiveness of the policy on interest rates is, therefore, entirely dependent on the predominant role played by Treasury certificates. Now, in a constantly changing financial environment where, among other things, new financial instruments need to be deployed, the influence of the central bank on the money market might weaken. Consequently, the authorities have taken pre-emptive action, equipping the central bank with new instruments:

- Since very little use is made of rediscounting, a new system of fixed-term advances (14 days) was introduced in March 1989 with a view to restoring a more direct link between the central bank and financial intermediaries. It involves weekly tenders of advances against government bills, and sale and repurchase transactions in commercial bills. Such operations have so far been carried out on a relatively limited scale. The system was devised in particular to allow the central bank to influence very short-term interest rates and, by fixing both the volume and the interest rate, to provide the market with pointers as

(1) Taken together, Treasury certificates at not more than one year and four-month certificates issued by the "Fonds des Rentes" account for over 85% of financial intermediaries' liquidity.

Monetary policy instruments

	Instruments linked to BNB operations	Regulatory instruments available	Other instruments
Exchange-rate policy	Intervention via exchange reserves		Intervention via foreign-currency borrowing by the public authorities
Interest-rate policy	Rediscount rate, rate on advances, rate on sale and repurchase operations		Rate on Treasury certificates
Action affecting the liquidity of financial inter-mediaries	Rediscount ceilings and quotas for advances	Monetary reserve; reinvestment in government bills and securities	
Direct action affecting the supply of credit		Credit controls	

Source: Banque Nationale de Belgique (BNB), Département des Etudes.

to the direction of monetary policy without necessarily adjusting the rate on Treasury certificates. In practice, however, the main function until now of this new form of financing has been to allow the monetary authorities to be better informed of market expectations;

- When the central bank's statute was revised in December 1988, the legal provisions governing the reserve requirement were amended(1). The central bank may now impose a permanent reserve requirement according to a scale that ranges from 8% (maximum) for sight deposits to 4.5% for deposits at not more than one year and 2% for liabilities at more than one year. Although the authorities have no intention at the moment of applying it, this arrangement is intended first and foremost to contend with the structural trend of the demand for notes, associated inter alia with technological innovation, which tends to reduce the central bank's influence over the activities of financial institutions.

- In May 1990 the National Bank of Belgium announced a reorganisation of the market for Treasury certificates, its main vehicle for the conduct of monetary policy. The present system of issuing Treasury certificates on tap will be replaced on 1.1.1991 by tenders on a weekly basis for 3 month certificates or on a monthly basis for 12 month certificates. Moreover, the certificates will be dematerialized and the market which was until now restricted to domestic (and Luxembourg) financial institutions will be enlarged to all investors. In order to compete effectively with foreign financial markets the creation of an active secondary market for Treasury certificates will be stimulated through the setting up of a system of Primary Dealers and an efficient clearing system.

- In addition to the substantial reform of the Treasury certificates market, the National Bank of Belgium announced that it is seeking to further develop the new techniques for intervening on domestic money markets, basically, the periodical tenders for advances (introduced in March 1989) and in between the tenders to make use of repurchase agreements, foreign exchange swaps and open market operations.

(1) Law of 23 December 1988. Previously, the Law of 1973 imposed restrictions on the compulsory reserve instrument, making its use conditional on the presence of cyclical imperatives and limiting its operation to a period of six months. The need to act in accordance with cyclical imperatives has been retained in the new law but the six-month time limit has been dispensed with.

This extension in the panoply of monetary policy instruments satisfies the new requirements of domestic monetary control but is also consistent with the moves towards economic and monetary union in the Community in so far as:

- the monetary authorities wished to have at their disposal the same instruments as were available in most other Member States: Harmonizing the means of action available to central banks within an integrated financial area is a necessary prerequisite for closer monetary cooperation;

- one main aspect of Belgium's strategy of preparing for the large internal market is to develop, modernize and open-up capital and money markets.

4.4 <u>Degree of central bank autonomy</u>

Legally speaking, the degree of autonomy enjoyed by the National Bank is relatively limited:

- at institutional level, the central government holds by law half of the Bank's capital. The government appoints the directors on a proposal from the "Conseil de Régence" and designates a government commissioner who is responsible for supervising the Bank's operations and has a right of suspensory veto over any measures deemed by him to be contrary to the "interests of the State";

- joint consultations are held on interest-rate policy: the rates on very short-term certificates (one, two and three months) are set by the Bank itself while the rates on short-term certificates (six, nine and twelve months) and certificates issued by the "Fonds des Rentes" are fixed after consultations with the Treasury and the" Fonds des Rentes" respectively;

- following the recent revision of its statute, and in particular the rules governing the imposition of reserve requirements, the National Bank is empowered to issue duly reasoned regulations imposing such requirements after consulting the Banking Commission and after receiving ministerial approval.

In practice, however, the government does not intervene in the day-to-day conduct of monetary policy and its right of veto has never been used.

Monetary aspects of public-deficit financing

1. Financing channels for the Treasury

The Treasury has recourse to three types of financing: the issuing of bonds on the domestic capital market (see point 5.2), money-market borrowing in Belgian francs, and borrowing in foreign currencies.

1.1 The Treasury has two credit lines with the central bank that are subject to flat-rate ceilings:

- since 1977, the direct credit line has been limited to BFR 37 bn and has been fully used at all times;

- in order to cover "seasonal and unforeseen deficits", the Treasury has access to indirect financing from the central bank in the form of special advances granted to the "Fonds des Rentes" for the purpose of subscribing for Treasury certificates. The ceiling on this indirect credit line is laid down by agreement between the central bank and the "Fonds des Rentes" in the light of Treasury requirements and the money-market situation. This ceiling, which was at BFR 30 billion in 1978, was quickly raised in line with the deterioration in public finances to stand at BFR 210 billion in 1983, where it remained until September 1987. Since then, with the substantial reduction in the Treasury borrowing requirement and with the increase in money-market liquidity notably as a result of the improvement in the current-account balance, the ceiling for special advances was progressively lowered to BFR 130 billion by mid-1989. Actual recourse to this type of financing has declined steadily in the meantime.

1.2 The opening of a "third window" for Treasury financing depends on the central bank's interest-rate policy. This is because the gap between the discount rate and the yield on Treasury certificates, both fixed by the central bank, determines whether or not financial intermediaries have recourse to the refinancing facilities available to them at the central bank, subject to the authorized ceilings set, and whether they decide, therefore, to hold fewer or more government bills. This "third window" can be a very effective way of boosting money creation. However, if the rate of money creation needs to be curbed, this window will necessarily have to be shut, as it has been in recent years.

1.3 Central government borrowing in foreign currencies, the proceeds of which are transferred direct to the central bank, is the fourth way in which Treasury financing can result in liquidity creation. The external borrowing policy of the Belgian authorities depends on the current-account situation, private capital movements and the targets set for management of the exchange reserves. A further benefit of external borrowing is that it reduces the pressure on domestic interest rates but, in return, entails a future burden on the current-account balance and a possible exchange risk.

Direct and indirect Treasury borrowing
in Belgian francs from the National Bank
of Belgium
(amount outstanding at end of period)

in BFR bn

	Total lending	of which: direct	indirect	Maximum amount of indirect lending authorized	Net Treasury balance to be financed
1978	53	37	16	30	183
1983	225	37	188	210	524
1986	246	37	209	210	555
1987	165	37	128	180	431
1988	144	37	107	160	434
1989	103	37	66	110	397
1990 (4 m)	59	37	22	110	254

Source: Banque Nationale de Belgique.

2. Reform of the State and financing of other public sector entities

Among the provisions of the reform of the State aimed at preserving economic union and safeguarding the currency is a measure requiring approval from the Minister of Finance for borrowing operations undertaken by the Communities and the regions the terms of which may affect monetary and exchange-rate policy, i.e. foreign borrowing in Belgian francs and foreign-currency borrowing. The floating of public loans on the Belgian capital markets will have to be compatible with the calendar set by the Ministerial Council, after consulting the executive bodies concerned. Only private loans in Belgian francs will be completely free from restrictions. Safeguard clauses have, however, been included in the legislation, enabling the national government to limit the borrowing capacity of one or more entities for a maximum of two years, with a view to:

- ensuring that divergent movements in financing requirements do not endanger economic union and the currency;
- safeguarding domestic price stability and the balance-of-payments equilibrium;
- preventing a structural deterioration in public finances.

The government would act on the advice of a consultative body set up within the "Conseil supérieur des Finances".

5. ADAPTATION OF FINANCIAL MARKETS WITH A VIEW TO 1992

In a fast-changing economic and financial environment, and in particular with a view to European financial integration and completion of the single market, the Belgian financial market seems insufficiently developed. This situation has led the Government to devise, in collaboration with those concerned, and to begin implementing a major programme of reform. Various aspects of the operation of financial markets and the conditions of competition among financial intermediaries have been addressed. The measures already adopted or being considered can be divided into : abolition of the two-tier exchange market; reform of public debt management; reform of the Brussels stock exchange; plans to restructure public credit institutions; deregulation of interest rates; and reduction of withholding tax.

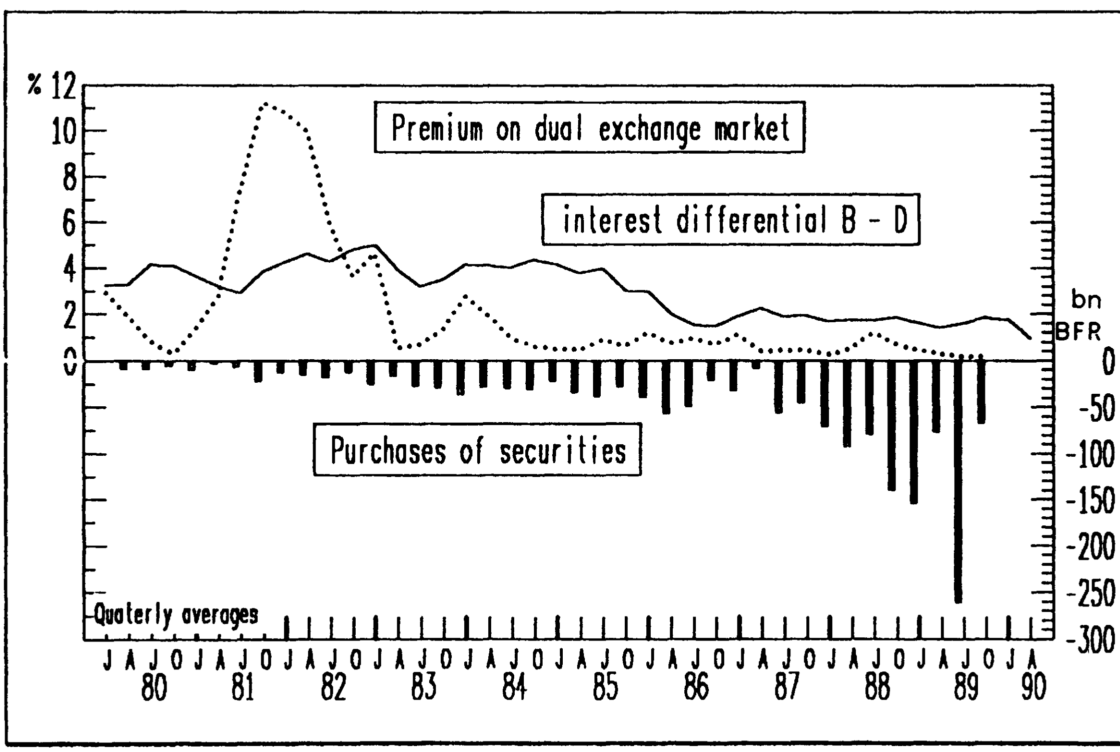
5.1 Abolition of the two-tier exchange rate

A two-tier exchange market was introduced in Belgium and Luxembourg on 18 July 1955 within the framework of BLEU (Belgo-Luxembourg Economic Union). On the regulated market, where the bulk of commercial transactions were carried out, the monetary authorities intervened in order to stabilize the exchange rate in line with international agreements (Bretton Woods, the "snake", the EMS). As a general rule, the unregulated market, on which the monetary authorities did not intervene, provided the channel for capital movements. This arrangement was designed, on the one hand, to limit the amount of intervention and, on the other, to discourage capital outflows by raising the premium payable on purchases of foreign exchange in the event of speculation against the Belgian franc.

In order to determine which transactions would take place on which market, a system of controls was introduced which hindered the settlement of both financial and commercial international transactions. What is more, the dividing line between the two markets was not clear-cut. For instance, certain current transactions could be carried out on the unregulated market (conversion of income received from portfolio investments abroad, tourist expenditure, transactions in gold and diamonds) while certain capital movements (transactions involving deposits in convertible Belgian francs or involving deposits in regulated currencies, direct investment) were carried out on the regulated market.

The drawbacks of the two-tier exchange market as regards transparancy and cumbersome control procedures, its loss of effectiveness (see Graph 7) and especially its lack of usefulness as the Belgian franc has gradually strengthened within the EMS over the last two years - these factors to be viewed against the background of the Community Directive scrapping all restrictions on capital movements in most Member States on 1 July 1990 [1] - prompted the Belgian and Luxembourg authorities to abolish the two-tier market on 5 March 1990. However, the necessary arrangements for compiling statistics remain in place.

GRAPH 7 : TWO TIER EXCHANGE MARKET, CAPITAL OUTFLOWS AND LONG-TERM INTEREST-RATE DIFFERENTIAL



Source : National Bank of Belgium;
Commission departments.

(1) Under this Directive (88/361/EEC, of 24 June 1988, OJ n° L 178 of 8 July 1988), Belgium and Luxembourg were though authorized to keep the two-tier exchange market in place until 31 December 1992.

The economic context was favourable. The current account had been in surplus since 1985 (1% of GDP in 1989) and the Belgian franc was performing soundly in the European monetary system, with an average discount against the German mark in 1989 of 1.60% and a divergence indicator of +50. Under the circumstances, abolition of the two-tier exchange market passed without any problems, as illustrated by the stable interest-rate differential in Belgium and Germany (see Graph 7),and has not prevented a strengthening of the Belgian franc within the European monetary system (see graph 3).

5.2 Management of the public debt

With the main purpose of reducing the burden of public debt as much as possible, the Treasury has been striving for several years to improve the way it is managed, not only through specific debt-conversion operations but also through initiatives likely to encourage the development and modernization of the Belgian financial market.

The determination to pursue a more active public debt policy was first given practical shape as of 1984, when steps were taken to restructure the foreign-currency debt. The aim was to reduce the burden of interest payments, in particular through early redemption with refinancing on more favourable terms, currency swaps and the introduction of the Euro-commercial paper programme(1). The proportion of the foreign-currency debt accounted for by the strong EMS currencies (the German mark and the guilder) rose from 37% in 1984 to 47% in 1989.

Since 1986 the Treasury has also made changes in the management of the Belgian franc debt, introducing new borrowing techniques, the main effects of which should be to enlarge access to markets in government securities and to extend the average maturity of the debt. Besides specific measures such as regularization of part of the debt towards banks(2) or the use of the gold stock of the

(1) Placing of short-term foreign-currency loans with foreign commercial groups, thereby enabling the issue proceeds to be swapped.

(2) On three occasions (1986, 1988 and 1989), debt-rescheduling agreements were reached between the Ministry of Finance and the financial institutions, with part of the interest due on earlier loans being converted into "Treasury bonds" with a maturity of six or eight years and carrying rates linked to market interest rates.

central bank,[1] the authorities have embarked on a more thorough reform of central government financing techniques:

- alongside the traditional system of underwriting by a consortium of financial institutions, the government has started issuing "linear bonds"[2]. Within a credit line, the loans are issued in successive instalments and placed as a function of the amounts and prices offered. These new borrowing arrangements should not only make it possible to enlarge the primary market in long-term government securities but also make the secondary market more active and more attractive to foreign investors. First, each new instalment should increase market liquidity, the secondary market having been fairly illiquid and inactive to date, with over 50% of the debt held in the portfolios of domestic banks. Second, interest will be paid in full, and not, as with traditional forms of borrowing, net of withholding tax with subsequent refunding of tax to foreign investors;

- the secondary market in short-term Treasury certificates has been open to insurance companies and pension funds since the middle of 1987. The government is considering taking other measures of this kind as well as admitting non-financial enterprises and foreign banks to the primary or secondary market;

- the structure of quotas and commissions for the underwriting consortium was recently changed. In particular, the share earmarked for foreign banks was raised from 5.5% to 9.6%.

(1) Gold is sold in two separate ways: (i) the sale of commemorative coins, with the volume of gold used for minting such coins being specified by law and with profits going to the Treasury. In 1987, the central bank sold gold with a market value of BFR 10 billion to the Treasury for the issue of ecu coins; (ii) sales of gold on the market, notably at the beginning of 1989 the profits of which are placed in a reserve fund that cannot be touched, while the income from the investment of the foreign currency acquired is paid to the Treasury.

(2) A system similar to the French "*obligations assimilables du Trésor*". The first linear issue was floated in May 1989.

5.3 Reform of the stock exchange

Compared with the other exchanges in Europe, the Brussels stock exchange is of minor importance. The capitalization of domestic shares listed in 1988 accounted for only 3.7% of the total capitalization of the twelve exchanges in the Community (dominated by London with 42.2%), with bond capitalization scarcely any higher.

TABLE 10 : STRUCTURAL DATA FOR THE STOCK EXCHANGE IN 1989

	Shares	Bonds
Securities quoted	478	147(a)
domestic	304	138
foreign	174	9
Capitalization of domestic securities BFR billion	2678	3641(a)
% domestic GDP	44	60
% capitalization EUR 12 (b)	3.7	4.7
Volume of transactions BFR billion	304	201(a)
% capitalization	11.4	5.5
Volume of issues (BFR billion) Private sector	103.3	7.8
Public sector		545.4
International institutions		6.0

(a) Including bonds issued by international institutions
(b) 1988

Source : Brussels stock exchange;
Committee of Stock Exchanges in the EEC.

Until recently, the bond market was confined to the placing of medium-term government securities (in 1987, only 3% of the public debt was in the form of securities with a maturity of more than ten years) through an underwritting consortium of financial institutions. It is dominated by banks and credit institutions[1] which hold 45% of public Belgian-franc bonds accessible to all

(1) Primarily monetary institutions, savings banks and public credit institutions.

investors. The volume of off-exchange dealing is very large, and this does not enhance transparency. It is thought to be five times that of dealings transacted on the exchange, i.e. less than in Luxembourg but more than elsewhere.

The stock exchange plays, if anything, a modest role in the financing of the private sector, although its role has expanded since the 1970s. In 1989, the provision of new capital in the form of share issues doubled compared with the previous year, to BFR 103,3 billion (16% of total new liabilities of non-financial enterprises). The bond market, however, does not represent a net source of capital for firms as redemptions exceed new issues. This minor role contrasts with the stock exchange's key role in the financing of the State, which issued public bonds totalling BFR 545.4 billion in 1989.

Development of the stock exchange is being hampered by various regulations, a lack of transparency and transactions cost that is generally higher than elsewhere.The steps taken a few years ago to boost trading on the stock exchange - establishment of an options market (for call options only) and a junior market in 1985 - had only limited success, partly because of the very restrictive guarantee and admission conditions. The Brussels stock exchange remained a local market where scant progress had been made with computerization and to which only approved brokers were admitted. Radical reform was required if Brussels was to achieve its ambition of becoming a European financial centre; this led to the setting-up in 1988 of specialized committees to study and propose to the government measures aimed in particular at modernizing the operation of stock markets, reviewing the role of brokers and extending the range of financial instruments on offer(1).

Some of the proposals made by these committees have already been adopted. For example, it has been decided to introduce a continuous market with longer trading sessions and, since January 1989, deals have been recorded using a computer-assisted trading system (CATS(2)), which makes for greater transparency (and hence smaller price discrepancies) and reduces the volume of off-exchange dealing.

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(1) The committees were the "*Commissions Maystadt I* and *II*", made up of experts and chaired by the Minister of Finance.

(2) This system has been in use in Toronto since 1979 and was introduced in Paris in 1986 and Madrid in April 1989.

Other changes are expected during the transition period (1989-92)[1]. They include:

- ending of the monopoly enjoyed by brokers. Financial institutions will have access to stock exchange operations through stock-market firms. In the initial stages, the holdings of financial institutions in the capital of these firms will be limited to 25%; the limit will be phased out gradually and removed entirely by 1992. Moreover, the minimum percentage of orders that must be transmitted via brokers will be gradually reduced, from 80% in 1989 to 20% in 1992, and as of 1993 all orders may be transmitted via stock-market firms;

- increase in the ceilings on off-exchange dealing, from BFR 10 million to BFR 20 million for cash transactions and to BFR 30 million for forward transactions;

- reduction in commissions, the actual reduction becoming larger as the volume of transactions increases. New apportionment formulae as between banks and brokers are also to be introduced;

- development of new products and markets, such as instruments in ecus and forward contracts in government securities;

- adoption of the regulations on collective investment undertakings; this will permit the establishment of SICAVs (open-ended investment companies) in Belgium; since 1 October 1989, the marketing of units of foreign collective invesmtent undertakings meeting the requirements of the EEC Directive[2] has been possible in Belgium, whereas the marketing of units of Belgian undertakings has not been possible abroad;

- introduction of a new supervisory structure, including transformation of the Banking Commission into a Banking and Financial Commission responsible for market supervision and coordination;

Alongside these basic reforms, which should ensure that the structure of the Brussels stock exchange is similar to that of the

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(1) The draft law on financial operations and financial markets is at present under discussion.
(2) Directive of 20 December 1985 (OJ n° L 375 of 31 December 1985).

major European financial centres, there have also been changes in the stock-exchange rules:

- certain rules have been in force since September 1989 concerning insider dealing, which was not previously covered[1];

- new rules have been introduced for takeover bids: since May 1989, shareholders with more than 5% of a company's capital must disclose[2] their identity; the procedures to be followed for a takeover bid[3] were clarified in November 1989.

5.4 Restructuring of public credit institutions

Adjusting to the 8% solvency ratio imposed by a Community directive[4] will require an effort on the part of credit institutions, especially those in the public sector.

TABLE 11 : PROFITABILITY AND SOLVENCY OF CREDIT INSTITUTIONS

	Banks	6 PCIs	Savings banks
Profitability (a) (average 1986-87)	0,33	0,12	0,63
Solvency (b) (end 1987)	6,7 (c)	7,7	14,9 (d)

(a) Net profits as a proportion of own and borrowed funds.
(b) Weighted value of risks on and off the balance sheet as a proportion of own funds.
(c) Only the four largest banks.
(d) Only the four largest savings banks.

Source : Institutions publiques de crédit 1992, Commission d'experts (Rapport Verplaetse), Bulletin de Documentation Ministère des Finances, mars-avril 1989.

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(1) Royal Decree of 4 September 1989 (Moniteur Belge of 16 September 1989. Subsequent to the "insider dealing" Directive of 13 November 1989 (OJ n° L334 of 18 November 1989), the draft law on financial operations and financial markets provides for a number of amendments.
(2) Royal Decree of 10 May 1989 (Moniteur Belge of 24 May 1989) adopted pursuant to the Directive of 12 December 1988 concerning major holdings (OJ n° L 348 of 17 December 1988).
(3) Royal Decree of 8 November 1989 (Moniteur Belge of 11 November 1989) adopted in anticipation of the Directive on takeover bids being prepared by the Commission (OJ n° C 64 of 14 March 1989).
(4) Directive of 18 December 1989 (OJ n° L 386 of 30 November 1989) applicable with effect from 1 January 1993.

For, although public credit institutions (PCIs) have a higher solvency ratio than banks, their position is not altogether comfortable. Their market share has been declining for a number of years[(1)] and their poor profitability (see Table 11) makes it difficult to generate equity capital by setting aside profits. What is more, the size of the public debt of the State, which is the largest shareholder, does not permit any strengthening of equity capital by way of capital increases.

In order to boost profitability and to prepare PCIs for a more competitive environment by 1992, the Government, on 29 September 1989, tabled a draft law that is based on the work of a committee of experts[(2)] and proposes a restructuring of the six PCIs into two groups : one centred on the Caisse Générale d'Epargne et de Retraite (CGER), and the other on the Crédit Communal. The State will remain the main shareholder, with the result that the public nature of these institutions will be preserved. The draft law also provides for measures to bring the conditions of competition into line with those facing banks[(3)]. And so, the PCIs will be subject to control by the Banking Commission and the State guarantee for liabilities will be abolished.

5.5 Deregulation of interest rates

The rules governing interest rates, notably on savings accounts, imposes a burden on financial intermediation in Belgium. They were designed to preserve "healthy" competition on the savings market and to be of assistance in the conduct of monetary policy. What is more, the regulation of interest rates on financial assets that are substitutes for State bonds created conditions favourable to the financing of the budget deficit. Such regulation also made it possible for financial intermediaries to attract relatively low-cost funds. However, savers are now increasingly shunning national credit institutions. In 1989, only around 40%[(4)] of new financial assets owned by individuals and firms were held with Belgium intermediaries. Against this, 70% of their new liabilities are loans contracted with Belgian intermediaires.

(1) In 1970, the PCIs accounted for 46.3% of all the financial assets held by firms and individuals with national financial intermediaries. This figure fell to 36.9% in October 1989.

(2) Institutions publiques de crédit, Commission d'experts (rapport Verplaetse), Bulletin de Documentation, Ministère des Finances, March-April 1989.

(3) Following the report by a committee chaired by Mr Van de Voorde (harmonisation des conditions de fonctionnement des institutions de crédit, Bulletin de Documentation, Ministère des Finances, May 1988).

(4) National Bank of Belgium, Annual Report 1989.

Since they were aware that such an imbalance added to the costs of intermediation, and under pressure from the small banks, which were pursuing a more aggressive commercial policy, the authorities relaxed the rules(1) by Royal Decree of 1 June 1989 with a view to allowing greater competition(2). This partial deregulation does not, however, appear to have been sufficient and a new draft law is being prepared.

The regulation of mortgage interest rates is also a handicap. Apart from Greece and Denmark, Belgium is the only country in the Community that does not authorize variable mortgage interest rates(3). The draft law currently under preparation proposes greater flexibility while retaining the possibility of applying fixed interest rates. These new rules should make it possible to compete more effectively with mortgage products offered by foreign companies once the relevant Community directives have entered into force(4).

5.6 Reduction of withholding tax

Together with the rigidity of certain deposit rates, the 25% withholding tax on investment income can be regarded as one of the main reasons why savings denominated in Belgian francs are now a less attractive proposition for residents. At the beginning of the 1980s, 73% of savings formed during the year were held in belgian francs. In 1989, this figure had fallen to 42% (see Table 12). In addition to the shortfall in financial resources for the national economy, the heavy burden of taxation on savings is hampering the development of new financial activities in Belgium. For example, the bulk of funds invested in collective investment undertakings are raised by Luxembourg institutions (set up in many cases by the Luxembourg-based subsidiaries of Belgian banks).

(1) The rules, which had been introduced by Royal Decree of 13 March 1986, had the effect of reducing competition, which was deemed to be excessive and was, therefore, holding back any downward movement in interest rates (see also L. Buffel, De Belgische Kredietinstellingen op weg naar 1992, Bulletin de Documentation, Ministère des Finances, March-April 1990.

(2) Without entailing any loss of entitlement to the tax exemption, the ceiling on loyalty and growth premiums was raised from 35% to 50% of the base interest rate, which is still fixed by Royal Decree.

(3) At most, interest rates may be adjusted every five years in line with market developments.

(4) The second Banking Directive (OJ n° L386 of 30 December 1986) enters into force on 1 January 1993 and a Directive on mortgage credit is being prepared (OJ n° C 161 of 19 June 1987).

TABLE 12 : COMPOSITION OF CORPORATE AND PERSONAL SAVINGS

	as % 1981-85	1989(a)
In Belgian francs of which	73	42
bonds and notes at more than one year	38	11
shares	3	5
In foreign currency of which	15	33
bonds	12	19
shares	-	5
other	12	25
financial gold	1	-
undefined (b)	11	25
Total	100	100
for information :		
coll. investment undertakings	2	12
of which Luxembourg institutions	-	12(c)
(in BFR bn)	(647)	(1244)
(as % of GDP)	(15)	(20)

(a) Extrapolation on the basis of 10 months' figures.
(b) Errors and ommissions in balance of payments and claims on banks (abroad).
(c) Extrapolation on the basis of 9 months' figures.

Source : National Bank of Belgium, Annual Report 1989, own calculations.

The growing share of investment in other countries and in SICAVs could represent a problem in reducing the revenue raised by the withholding tax. However, until now, this problem has not really arisen, because withholding tax as a proportion of total tax revenue has been increasing steadily(1) notwithstanding the investment of savings abroad and in Luxembourg SICAVs. This favourable evolution of the revenue raised by the withholding tax could, however, be reversed in the future, as indicated by figures for 1989 : only the revenue raised by the withholding tax on dividends is increasing while that on interest is decreasing.

(1) In 1974, the withholding tax accounted for 4.9% of total tax revenue whereas, in 1989, its share was 9.6%.

Under the circumstances, the Belgian authorities on 1 March 1990 lowered from 25% to 10% the withholding tax[1] on interest[2] charged on new issues of financial assets. As a result, financial markets in Belgium are in a less unfavourable position than their counterparts in the rest of the Community[3].

In order to make good the revenue shortfall, put at BFR 8.9 bn in the first year[4] the authorities have taken two measures :

- increase in the tax burden on coordination centres (BFR 1.4 bn);
- reduction in the tax concessions for firms which increased their capital in 1982/83 (BFR 7,0 bn).

They have also acted to discourage banks from buying back existing notes (carrying a 25% withholding tax) in order to replace them with new notes (on which withholding tax will be charged at only 10%). This conversion would add significantly to the shortfall in tax revenue[5].

The lowering of the withholding tax has been warmly welcomed on the capital market with the authorities being in a position in March 1990 to place a bond issue at a nominal rate of 10% (attracting withholding tax at 10%) entirely with private investors without recourse to the banking consortium.

(1) Withholding tax was introduced in 1962 at 15%. In 1967, it was increased to 20%. When it was raised to 25% in 1984, it was in full discharge of tax liability.
(2) Dividends are still subject withholding tax at a rate of 25%.
(3) On 8 February 1989, the Commission presented a draft Directive (COM(89)60) with a view to harmonizing withholding tax on interest at the minimum level of 15%. The draft Directive was not, however, adopted.
(4) In July revised to BFR 5,5 bn due to a shift from savings accounts where interest income up to BFR 50.000 is exempted from the withholding tax to other savings instruments which are subject to the withholding tax.
(5) Such common forms of saving totalled BFR 2 400 bn in 1989 (some 40% of personal and corporate savings with credit institutions). Taking an average interest rate of 8%, a 25% withholding tax will yield BFR 48 bn. At the new rate of 10%, the figure will be only BFR 19,2 bn.

6. CONCLUSIONS

6.1 In a favourable external environment, Belgium's economic policies have contributed to a considerable improvement in the economic situation during the second half of the 1980s. A more sustained growth rate has been restored (4% a year), mainly in response to investment and exports. Although unemployment is still high, employment is expanding. Inflation is still moderate, despite a rise in recent months. There has been a small current account surplus since 1986.

The main features of the macroeconomic policies adopted at the beginning of the 1980s have been as follows:

- exchange-rate policy was gradually tightened up, leading in June 1990 to the formal and public commitment to follow the strong EMS currencies. This will further enhance the credibility of the monetary authorities ;

- the policy of wage moderation was continued and the competitiveness of the economy identified as an economic policy objective the importance of which, with a view to 1992, was recognized by both sides of industry;

- budgetary policy was guided by two principles: a reduction in the public deficit designed to interrupt the process of debt and interest accumulation and a reform of the tax system based on priorities that have, however, changed in recent years.

Structural reforms have also been embarked upon that will affect how the Belgian economy fits into the single European market after 1992:

- the modernization and reorganization of financial markets through more active public-debt management and a reform of the Brussels stock exchange should encourage the development of financial activity, which has so far been very local in nature;

- the reform of taxation, which started with measures adopted in the 1989 and 1990 budgets, is essentially consistent with the aims of simplifying and reducing taxation of personal incomes and eventually of corporate incomes;

- a change in approach towards intervention by the authorities in the monetary and financial fields, due regard being had to the prospect of economic and monetary union in Europe. In this connection, mention can be made of the abolition of the two-tier exchange market, which had become superfluous, the lowering of the withholding tax on fixed income from new financial assets and the intention of adjusting and enlarging the panoply of monetary policy instruments with a view, among other things, to making the central bank more independent of the budgetary authorities.

6.2 However, there are still major disequilibria, and the strategy embarked upon with a view to adapting the Belgian economy to the Community-wide market must take account of a number of risks:

- like most Community countries, Belgium must bear in mind the risk of faster inflation due to the greater uncertainty of external factors, the pressure of demand in relation to productive capacity in certain industries and the strains on wages that might result from the imbalances discernible on the labour market;

- on the labour market, the unemployment rate still stands at 9% of the labour force, and the number of long-term unemployed is very high. Possible improvements are hampered by a mismatch between supply and demand;

- the public deficit is still equivalent to 6% of GDP and is unlikely to decline in the short term. The burden of interest payments absorbs 25% of current revenue (11% of GDP) and, although the government's dual-target budget strategy has made for a stabilization of the debt/GDP ratio, the latter stands at around 130%;

- a tightening of monetary policies in Europe, which Belgium would now be more liable to follow because of its strong currency option, would be felt more severely than elsewhere because of the budgetary situation and the impact of any rise in short term rates on debt servicing costs.

- although the national savings ratio has increased and the financial structures of firms have improved considerably, the level at which savings match investment is still fairly low, especially in view of the adjustment needs of industry and the service sector faced as they are with the prospect of the Community-wide market. It will therefore be difficult to preserve the financial equilibria Belgium has only recently restored. The high level of dissaving in the public sector must, under the circumstances, remain a major concern;

- the efficiency of financial markets appears to have been weakened by a lack of transparency and by an unduly rigid approach to the setting of interests rates which is restricting competition and impeding development of Brussels as a financial centre;

- the structural reforms under way in the financial field should be speeded up in order to ensure that neither the stock exchange nor the banking system fall behind as regards the progressive establishment of a European financial area.

6.3 A decisive step was taken in the process of institutional reform started at the beginning of the 1970s, by the adoption in August 1988 of the law extending the powers of the Regions and the Communities (concerning in particular the transfer of responsibility for education) and in January 1989 of the law organizing their financing. At the moment, the budgetary implications of federalization are still difficult to assess.

Some points can nevertheless be stated :

- the resources which will be granted to the Communities and to the Regions have been calculated on a relatively restrictive basis;

- it can certainly be hoped that regionalization will result in a better allocation of resources and greater efficiency op public expenditure from an economic point of view. In the long term the financial responsibility granted to local bodies is likely to favour sounder management;

- however, the new system does not really involve any incentives for the local bodies to contain their deficits. There could, however, be limits of two types : (i) first, the borrowing conditions which are imposed by the market - even though the Regions and Communities have the advantage, compared with the central government, of starting from a healthy situation insofar as the debt of the past is not their responsibilitiy; (ii) second, the application of one of the safeguard clauses provided for by the law, which enable the government to place a temporary limit on the borrowing capacity of one or more bodies;

- for the central government, the amounts to be transferred to the local bodies are a mass of irreducible expenditure, as is the burden of interest on the existing public debt.

More generally, and looking ahead to the achievement of an Economic and Monetary Union in Europe, the very complexity of the system established in Belgium could make inegration more difficult because of the multiplicity of authorities (three Regions and three Communities which do not overlap) and because of the complex financial relationships which have been established and which are liable to harm the transparency of budgetary policy.

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