FOR AGENDA

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CONTAINS CONFIDENTIAL INFORMATION

December 30, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Netherlands - Staff Report for the 1982 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with the Netherlands.

This subject has been tentatively scheduled for discussion on Monday, February 7, 1983. However, this scheduled date may need to be reviewed when the timing of the Interim Committee meeting is set.

Att: (1)

Other Distribution:
Department Heads

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

THE NETHERLANDS

Staff Report f[illegible] 1982 Article IV Consultation

Prepared [illegible] Staff Representatives for the 1982 Consultation with the Kingdom of the Netherlands

Approved by L. A. Whittome and Subimal Mookerjee

December 28, 1982

I. Introduction

Discussions for the 1982 Article IV consultation with the Netherlands were held in The Hague and in Amsterdam from October 26 to November 5, 1982. The Netherlands authorities were represented by officials of the Ministries of Finance, Economic Affairs, and Social Affairs and Employment, the Central Planning Bureau; and the Netherlands Bank. Discussions were also held with the President of the Netherlands Bank, Dr. W. F. Duisenberg. The staff team consisted of Mrs. Junz, Messrs. Dhonte, de Schaetzen, van Til, and Van 't dack, with Miss Pike (all EUR) as secretary. Mr. J. J. Polak, Executive Director, participated as an observer in some of the meetings.

II. Report of the Mission

1. Recent economic trends

The Dutch economy is in its most serious recession of the postwar period. The economic situation has been deteriorating rapidly and significantly more than can be explained by the international environment. Until about 1977, Dutch economic output, as measured by real GDP, moved more or less in line with that recorded in the European Communities as a whole. Since then, however, Dutch growth performance has been consistently below the EC average.

In 1982, GDP, in volume terms, is likely to fall by about 1 per cent, as it did in 1981. The decline in aggregate output, however, is relatively moderate compared with the steep--about 7 per cent over the last two years--fall in the volume of domestic demand. Private consumption expenditures have been falling for three years in a row, and by the end of 1982 they are likely to be no higher than in 1977. The volume of business investment has dropped even more sharply, by almost one quarter over the three-year period ending in 1982. Whereas throughout the 1960s and early 1970s investment activity in the Netherlands tended to outstrip the European average, recent investment performance has been much worse than elsewhere in Europe (Table 1).

Table 1. Netherlands: Selected International Comparisons

(Average annual growth rates unless otherwise indicated)

	1970-77		1978-81		1982	
	Netherlands	EC	Netherlands	EC	Netherlands	EC
Growth of GDP	3.8	3.3	0.9	1.8	-0.5	0.3
Of which:						
Public consumption	3.1	3.2	2.2	2.4	-0.2	1.0
Private consumption	4.2	3.6	0.8	2.3	-2.1	0.1
Gross fixed capital formation	1.7	1.7	-3.3	0.8	-4.0	-3.0
Labor force	1.0	0.5	1.1	0.6	1.3	0.6
CPI	8.2	8.9	5.4	9.8	6.3	10.5
Investment ratio (as percentage of GDP)	22.7	22.1	20.6	21.0	17.8	20.1
Unemployment rate (as percentage of labor force) 1/	2.8	3.8 2/	5.2	6.3 2/	10.4	9.5 2/

Sources: European Commission; OECD; and staff estimates.

1/ OECD standardized unemployment rate.
2/ Germany, France, United Kingdom, Italy, Belgium and the Netherlands.

Production trends were cushioned to a considerable extent because a significant part of the fall in domestic demand was borne by foreign suppliers. The import component of business investment, both of inventories and fixed investment, is particularly high in the Netherlands. In addition, a good relative price performance and moderate wage settlements, which in guilder terms resulted in a reduction in relative unit labor costs by over 20 per cent since 1979, have improved Dutch competitiveness substantially. This has helped end the earlier trend toward growing import penetration and has supported a continuing increase in the volume of exports, despite subdued demand conditions in traditional Dutch export markets. Over the past three years, the effects of increased competitiveness at home and abroad, coupled with the shift in domestic expenditure patterns, offset about two thirds of the impact of the fall in domestic demand on aggregate output by about two thirds. As a consequence, the current account shifted from a deficit of 1 1/2 per cent of net national income (NNI) in 1979 into growing surplus, rising to an expected 4 per cent in 1982.

The prolonged weakness of economic activity, together with a moderate increase in productivity, led to a decline in private sector employment of 5.7 per cent over the past two years. While this fall is no steeper than that recorded elsewhere in Europe, the growth of the Dutch labor force has accelerated to 1.3 per cent per annum, a higher rate than in the rest of industrial Europe. Accordingly, unemployment soared by over 5 percentage points, from 5.2 per cent of the labor force in 1980 to over 10 per cent in 1982. If the hidden unemployment component in disability schemes is added, total unemployment currently might be as high as 16 per cent.

The rise in unemployment together with the large and growing proportion of private enterprises incurring losses has contributed significantly to the accelerating deterioration of the state of public finances. The cyclical weakness of revenue growth, the rigidity of expenditure programs, and the rising level of interest paid on the public debt have led to an almost doubling of the share of the public sector deficit in NNI from 5.3 per cent in 1979 to over 10 per cent in 1982. The latter is 3.5 percentage points above the level the authorities were aiming at in expenditure-cutting exercises throughout the year.

Credit developments in 1982 have been overshadowed by the huge demand of the public sector on the capital market as the public sector took up 70 per cent of the total supply of funds. In view of the virtual collapse of private credit demand, credit restrictions were suspended in mid-1981. Monetary policy in general was dominated by interest rate developments elsewhere as a result of the aim to keep the guilder in line with the deutsche mark. However, the monetary authorities availed themselves of every opportunity to lower short-term rates. The discount rate was cut six times in 1982, from 9 per cent to 5 per cent.

2. Prospects for 1983

Prospects for an economic recovery in 1983 are minimal. Dutch export markets are expected to stagnate and export volumes, because of some further increase in market shares, are projected to rise by 1-2 per cent at most. Domestic demand, in the absence of an outside stimulus, is projected to fall by around 1 per cent. Partly because of further increases in unemployment, the policy of wage moderation is likely to be successful. In addition, the Government is freezing nominal public sector salaries, minimum wages, and social security benefits, and is increasing employees' social security contributions. The consequent drop in real disposable incomes is projected to result in a 3 per cent decline in private consumption expenditures. Neither private investment nor residential construction are expected to pick up from their historically low levels and public investment is slated to decline.

With the continuing slide in activity, the decline in private sector employment, combined with the growth in the labor force, may cause officially recorded unemployment to rise to 13 per cent of the labor force. Labor shedding, together with moderate nominal wage increases, is expected to lead to a further small reduction in the share of wages in national income. This and the significant drop in interest rate levels should relieve the pressure on profits in the enterprise sector somewhat, albeit not sufficiently to help revive investment activity.

Despite some increase in stockbuilding, which tends to be import-intensive, the volume of merchandise imports is projected to rise by less than 1 per cent, and notwithstanding the expected sluggishness of export markets, the current account surplus could even exceed the 1982 outcome.

3. The structural problems

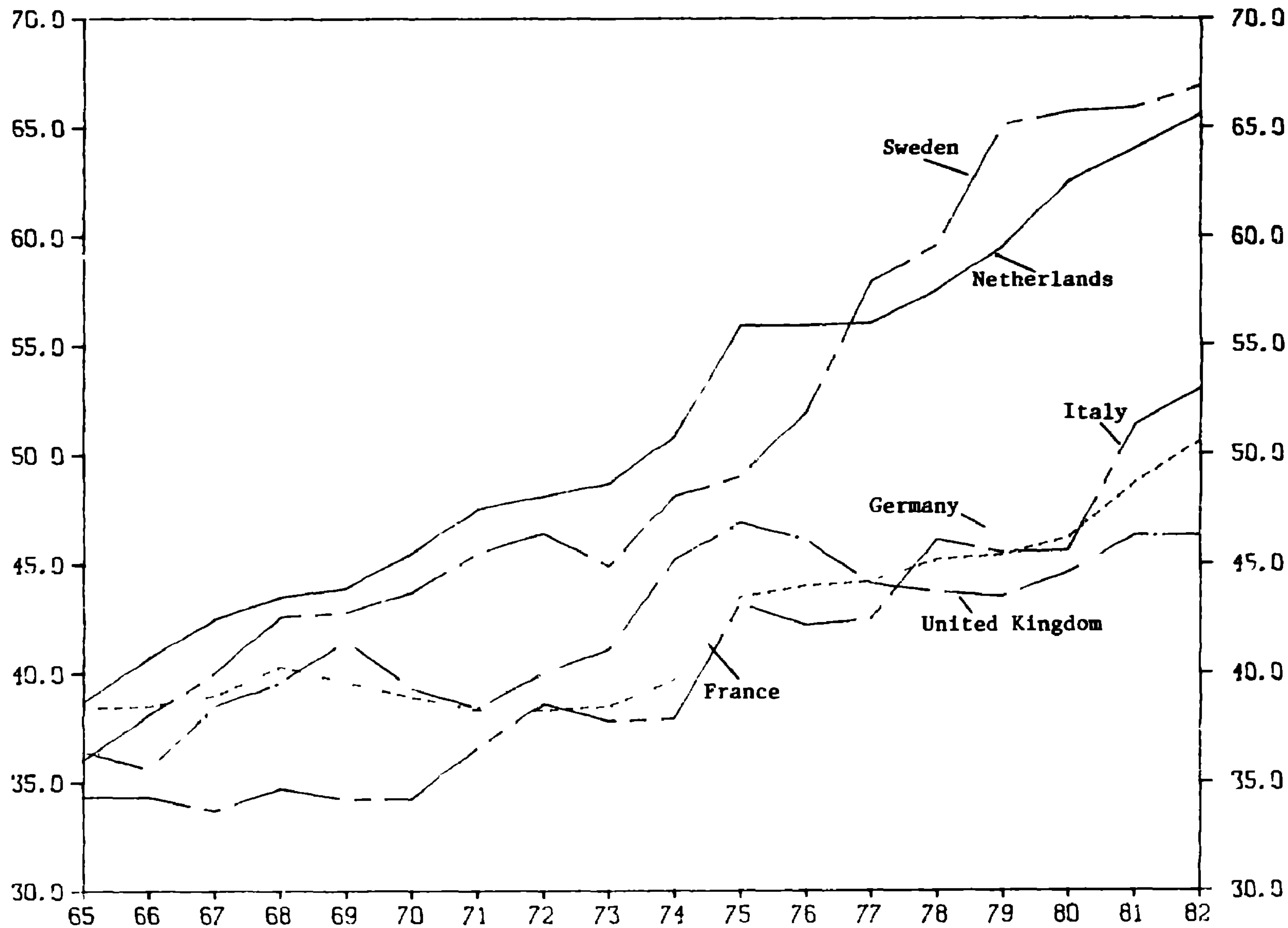
The deepening recession has thrown into clear relief the structural problems that have afflicted the Dutch economy much of the past decade. The basic problem, which has been the focus of government policies for a number of years, is the steady decline of private sector activity. The mirror image of this decline has been the inexorable growth of the public sector. Public sector expenditure has risen considerably faster than national income and its share of national income has risen from 48.2 per cent in 1970 to over 67 per cent in 1982, a percentage exceeded among industrial countries only by Sweden (Chart 1).

Along with the upward trend of public expenditures the tax burden in its widest sense rose from 47.3 per cent of national income in 1970 to 60 per cent in 1982. Even so, the financial deficit of the public sector has increased continuously from a low point of only 1.5 per cent of national income in 1973 to a projection of over 10 per cent in 1982.

Chart 1

NETHERLANDS

INTERNATIONAL COMPARISON: SHARES OF PUBLIC EXPENDITURE IN GDP



Sources: OECD, National Accounts; and staff estimates.

The growing demands of the public sector clearly contributed significantly to the shrinkage of the private sector. The flexibility of the economy has been reduced further through government interference in wage and price formation and by extensive regulation. In the end, expansion of productive potential of the Dutch economy has not only been lagging, but recently it has actually been eroded.

A government survey of the manufacturing sector indicates that between 1978 and 1980, the number of profitable firms shrank significantly and that repeated losses were incurred by firms employing about 50 per cent of the labor force.

Although incomes policy has been quite successful since 1980, particularly compared with other countries, the moderation in the growth of nominal wages occurred at a time when capacity utilization was falling and coincided with the worldwide escalation of interest rates. As a result, the effect of the reduction in the pressure of real wage costs has been limited and has been largely offset by rising capital costs. Corporate profits have been falling at an appalling rate, reaching zero in 1980, and are estimated to have become negative in 1982. As a result, the capital structure of corporate enterprises has weakened significantly. In 1980, own capital represented only one third of total capital, down from over one half in 1965. For the corporate enterprises other than the five large multinationals, the ratio of own capital to borrowed capital fell even more sharply, from 82 per cent in 1965 to 32 per cent in 1980. Since then the financial structure of the enterprise sector is likely to have weakened further, not in the least because the high long-term interest rates of the recent period have resulted in the enterprise sector becoming increasingly dependent on short-term borrowing. Accordingly, a very large number of firms currently is operating perilously close to the brink of bankruptcy (Table 2).

If private sector activity is to improve, the urgent need is to restore profitability. Policy has been oriented to this end for at least several years. However, the results have been disappointing, in part because policy was being formulated against a continuously worsening domestic and international background.

III. The Policy Discussions

Faced with a deepening recession, soaring unemployment, and the paradox of rising external surpluses and exploding public sector deficits, the authorities have come to the conclusion that their priority must be to regain control of public expenditure and of the deficit. The new Government, which was installed on November 4, shared the view of the outgoing Cabinet that steady reduction of the public deficit is the prime objective of economic policy at this time.

Table 2. Netherlands: Evolution of the Capital Structure of Corporate Enterprises, 1965-80

(As percentage of total balance sheets)

	1965	1970	1975	1979	1980
Shares	11	8	6	5	5
Reserves	44	36	29	27	28
Own capital	55	44	35	32	33
Short-term borrowing	24	30	34	36	36
Long-term borrowing	21	26	31	32	31
Total borrowing	45	56	65	68	67
Total own and borrowed capital	100	100	100	100	100
Ratio own capital/borrowed funds	120	80	55	48	49
Of which:					
Five multinationals	139	87	61	53	57
Other corporate enterprises	82	61	44	38	32

Sources: "Omvang en samenstelling van de nationale besparingen," White Paper, 1982; and information provided by the authorities.

The authorities were convinced that the past diversion of resources to the public sector had been detrimental to the growth and employment potential of the economy. They also felt that the support of private consumption through public transfers had not helped to bring about an upturn of investment. The structural situation had deteriorated so much that there was no scope for a successful implementation of anticyclical measures. Indeed, it had become almost impossible to separate structural from cyclical factors, except perhaps in relation to the construction sector. The external surplus reflected largely the fall in domestic demand, particularly in investment demand, and stimulation of domestic demand would, in the end, put upward pressure on capital costs and put in jeopardy the recent recovery of profitability. The latter was judged to have been very limited, and clearly insufficient to support an early upturn in the growth of productive capacity. Under unchanged policies, even an average growth rate of GDP of 2-3 per cent per year could not prevent unemployment from rising nor substantially reduce the budget deficit. Accordingly, only structural policies could bring the economy back to a sustainable growth path and the associated continued weakness of activity in 1983 would have to be accepted. Given these priorities, the authorities expressed the view that some form of concerted demand stimulation among industrial countries could be useful, although they themselves would be constrained in supporting such actions.

1. Fiscal policy

The policy of restoring order to the public finances rested on two elements: (i) stabilization and reduction of the collective burden in order to give the private sector more room to respond to market stimuli, and (ii) a steady reduction of the public sector borrowing requirement (PSBR) by about 1 percentage point a year over the 1983-86 period. The reduction in the PSBR should allow a decline in the very high current level of interest charges. Recent studies had indicated that a 1 percentage point cut in the ratio of the PSBR to national income could result in a 1 percentage point cut in long-term interest rates. This would benefit the capital position of enterprises, bring about an improvement in profitability, and, thereby, in productive investment.

Fiscal policy in 1981 and 1982 had also sought to contain the public sector deficit, indeed to reduce it in specified proportions to national income. At the same time, however, it intended to provide some support to domestic economic activity and to increase the resources available to the enterprise sector, through investment-oriented tax relief measures, labor market programs, and a rise in public residential construction to help offset the steep fall in private residential construction. However, this approach was continually frustrated by exogenous developments that resulted in expenditure overruns and shortfalls in revenues. Accordingly, the past two years have been characterized by virtually continuous ad hoc attempts to adjust budget plans to actual economic developments in order to close the large gap between originally planned and projected deficits, resulting in frequently announced budget cuts. These cuts are made from multiyear expenditure estimates, that assumed relatively high growth rates for the economy as well as for real public expenditures. Therefore, they are reductions from projected increases rather than cuts from actual levels.

Because of the failure to implement even these "cuts" fully and because revenue projections were too optimistic, the deficits continued to widen and the Government abandoned its medium-term aim to reduce, or at least stabilize, the tax burden. Accordingly, indirect taxes were increased and the Government reduced its subsidization of the social insurance funds, which in turn necessitated further increases in premia. Despite a widespread acceptance that a return to sustained economic growth requires vigorous restraint of incomes and public expenditures, especially of social security transfers, there has been considerable political conflict regarding its implementation. Time and again, the policies that sought to achieve the budget targets proved to be too difficult to realize. The political tensions associated with the various proposed programs explain in part why an increasing lack of control over public expenditures has emerged. In addition, revenue shortfalls reflect not only lower-than-projected income flows, but also, increasingly, delays in tax payments. Accordingly, the 1983 budget proposals need to deal with an inherited revenue shortfall from the 1982 budget of f. 8.8 billion coupled with an f. 3.3 billion excess of expenditures over intial appropriations as part of the proposed cuts were not carried out while increased outlays were incurred for unemployment and interest payments.

In drafting the 1983 budget, every effort was made to base it on a realistic economic projection; nevertheless, it already appears that the activity forecasts have been too optimistic. As it is, the budget proposals imply a public sector deficit of 10.8 per cent of net national income in 1983. This deficit arises even though the proposals project expenditure cuts and tax increases of some f. 13 billion from an unchanged policy baseline. These measures include freezes of public sector salaries and of social insurance benefits. The latter together with a further increase in social security contributions, will allow a reduction in state subsidies to the social security funds of f. 5.3 billion. In addition, income tax brackets will not be adjusted fully for inflation, and specific expenditure reductions amounting to some f. 3 billion will be implemented.

The authorities recognize, however, that the full achievement of the 1983 budget goals also would be difficult. Although the Government has been able to call off a projected price and wage freeze because the social partners came to an agreement about wage moderation, this by no means implies that a consensus on the measures included in the budget proposals has been forged.

2. Monetary and exchange rate policies

Monetary policy in the Netherlands has two basic objectives: to support the wage and incomes policies by helping to moderate price developments and to keep the relationship between the Dutch guilder and the deutsche mark stable.

Since the 1980 consultation, the guilder has traded in the upper half of the EMS band, except for a few months in the spring of 1981 when a widening of interest rate differentials caused it to weaken, and for brief periods following the realignments of October 5, 1981, and June 13, 1982 on the occasion of which the guilder appreciated, along with the deutsche mark, by 5.3 per cent and 3.5 per cent, respectively, against the ECU. 1/ In effective terms (MERM basis) the guilder depreciated by 10.4 per cent between the first quarter of 1980 and the third quarter of 1981, but most of this change was offset by a subsequent appreciation of 7.4 per cent through the third quarter of 1982 (Chart 2).

Since 1981, the sharp and prolonged decline in private sector activity, the associated drying up of credit demand by the private sector, and the emergence of large surpluses on the current account of the balance of payments have altered fundamentally the background to monetary policy. A reduction in the liquidity ratio was no longer a major objective of monetary policy; the authorities even felt that some increase in this ratio could be accepted, as long as it was not excessive. The Netherlands Bank also lifted the credit restraints on the private sector that had been in force since 1977. The rising current account surplus and the rapid rise of the financial deficit of the public sector, however, made it important to continue the policy of strictly limiting access of the public sector to monetary financing. Accordingly, net public sector demand on the capital market more than doubled between 1979 and 1981, rising from 3.7 per cent to 8 per cent of national income. By contrast, the traditionally accepted norm for such recourse to the capital market is only 4 per cent. These developments, coupled with the very large fall in private sector credit demand for long-term funds, have brought the share of total capital market supply taken up by the public sector from 29 per cent in 1979 to 61 per cent in 1981. It is estimated that nonresident holdings at the end of 1981 represented 30 per cent of publicly issued long-term public bonds, or 12 per cent of total long-term public debt. The authorities felt, however, that the secondary bond market was sufficiently broad to avoid any liquidity problems.

Despite the fact that the monetary financing of the public sector remained below the ceiling agreed with the Netherlands Bank, monetary expansion accelerated in late 1981 and reached 10 per cent in the year to July 1982. This resulted both from an increase in net foreign assets and from some recovery of credit expansion by the banking system owing

1/ The February 21, 1982 realignment gave rise to a very small depreciation of the guilder against the ECU due to an adjustment of the rate for the pound sterling.

to a combination of a sharp rise in long-term lending to the public sector and a slowdown in the growth of the banks' nonmonetary resources. This slowdown was attributed primarily to high direct purchases of government bonds by households, apparently in an attempt to lock in high interest rates. This suggested that, although direct monetary financing by the public sector had not increased, the ballooning of borrowing on the capital market had indirectly given rise to money creation. The monetary authorities accepted the rather fast expansion of the money supply not only because of the cyclical weakness of the economy but also because large short-term fluctuations in the money supply were a characteristic of the Netherlands economy as movements of funds by a few large multinational or institutional investors could affect the monetary aggregates strongly. However, they noted that overshooting the target over a longer period of time would be a source of concern as it would indicate that a liquidity overhang was in the making. In such cases they felt it was proper that excess money creation should have its counterpart in an increase in net foreign assets, as this would be more easily reversible.

The authorities felt that the leeway created by the current account surplus should be used to reduce interest rates in view of the urgent need to improve company balance sheets. They noted in this respect that a 1 percentage point change in the interest rate, given the size of the corporate debt, was of an order of magnitude equivalent to 1 per cent of the wage bill. Accordingly, as long as the guilder was inherently strong, all opportunities would be used to reduce interest rates at home. Over the past few quarters when the guilder was within the upper band of the EMS, it had been possible to lower short-term interest rates in the Netherlands somewhat more than in Germany. In fact, in late 1982, Dutch short-term rates were about 1/2 percentage point below comparable German interest rates. This implied that the strength of the guilder had allowed a reversal of the short-term interest rate differentials in favor of Germany that had persisted since the mid-1970s. In other words, the aim to maintain the stability between the Dutch guilder and the deutsche mark could currently be achieved at somewhat lower short-term interest rates for the Netherlands than had been usual in the past (Chart 3).

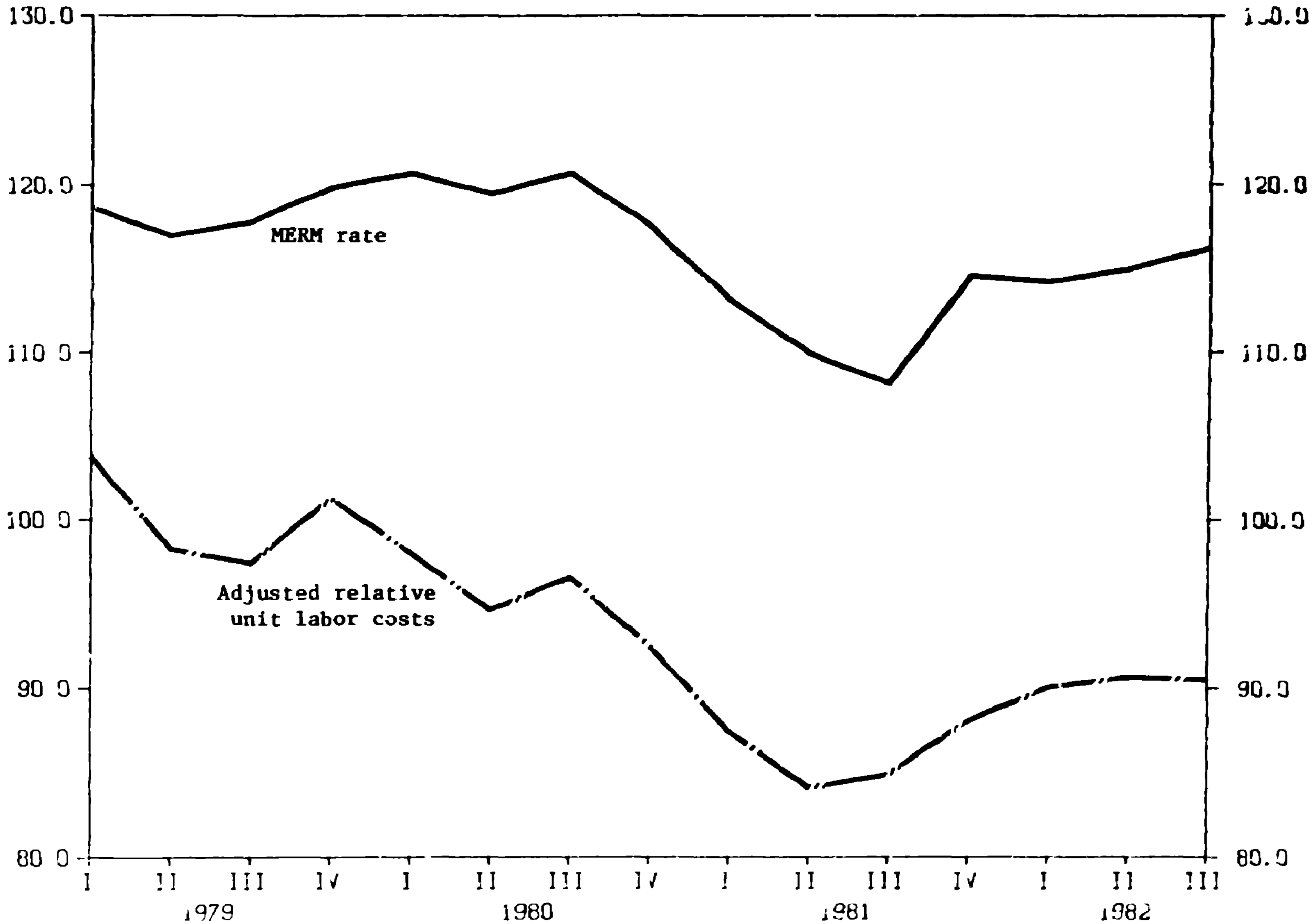
By contrast, the differential between German and Dutch long-term rates has remained little changed in favor of Dutch rates. The authorities believed that the large overhang of public sector borrowing on the Dutch capital market had impeded a fall in long-term interest rates. They felt that it would be detrimental to the confidence in the guilder if the public deficit were to be accommodated by monetary financing on a substantial scale. The resulting weakening of the guilder would eventually require the Bank to raise short-term interest rates and thus the beneficial effect of lower public recourse to the capital market would be lost.

Chart 2

NETHERLANDS

EFFECTIVE EXCHANGE RATES

(Indices 100=1975)



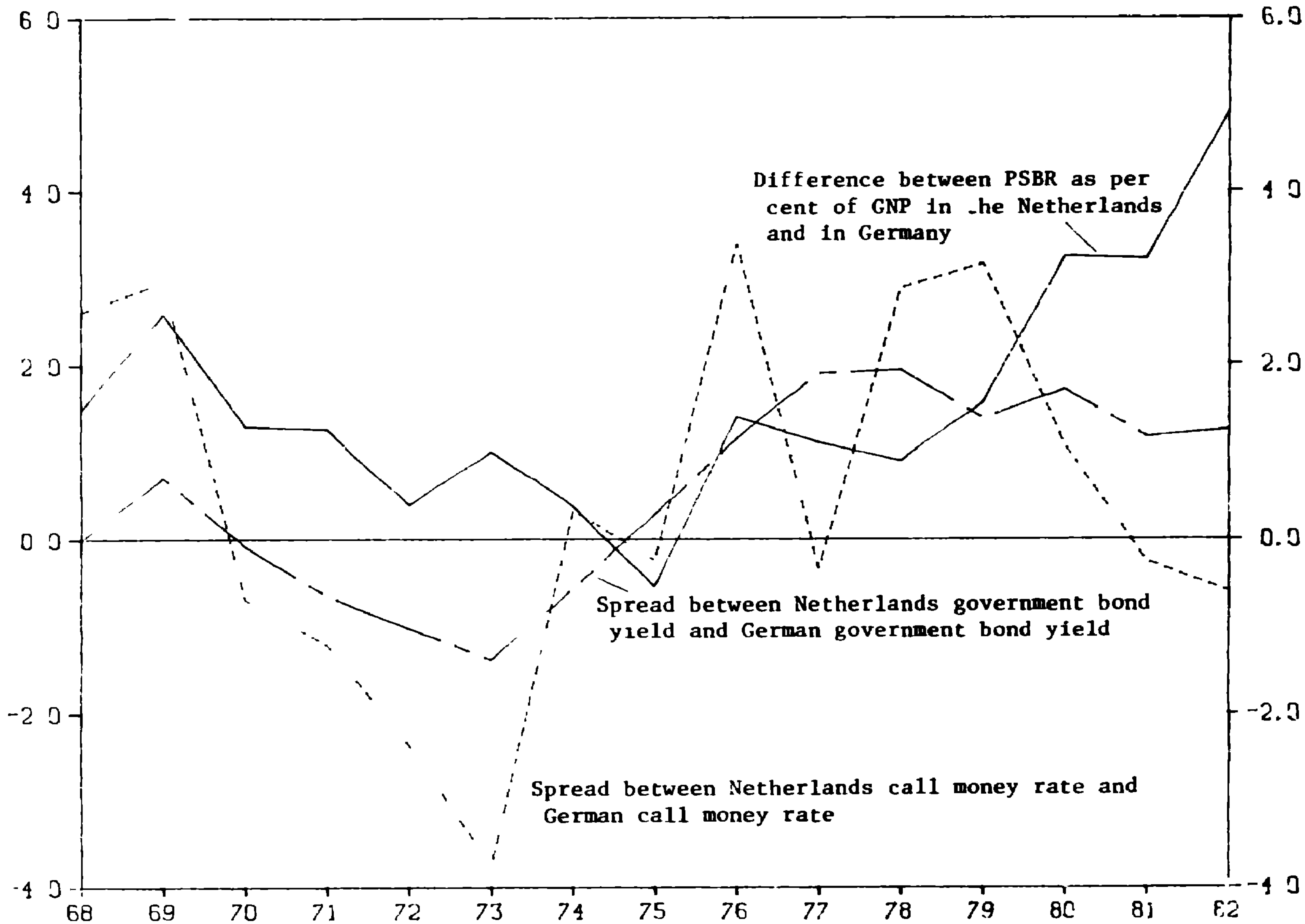
Source IMF, International Financial Statistics.

Chart 3

NETHERLANDS

BOND YIELD AND CALL MONEY RATE

(In per cent)



Sources: IMF, International Financial Statistics; and staff estimates.

3. Incomes policies

Wage restraint is a fundamental element of the Government's policy in order both to improve the profitability of enterprises and to restore the competitive position of the export sector. In principle, the Government seeks to influence wage formation by issuing guidelines for the negotiation of wages at the national level. However, time and again the social partners could not reach agreements acceptable to the Government. Consequently, government interference in wage and price formation has almost become the norm.

In 1980-81 and through 1982 the Government imposed a statutory incomes policy. This policy has been based on controlling nominal wage developments by partial deindexation, by limiting fringe benefits, in particular vacation allowances, and by restraining real wage improvements as contracted in collective labor agreements. In 1981 the average wage bill in enterprises increased by only 4 per cent and public sector wages were stabilized at about their 1980 levels. For 1982, the Government hoped to limit wage increases in the private sector to 6.5 per cent.

These policies, particularly as they were instituted against a background of rising unemployment, significantly reduced the growth of nominal wages. But the authorities felt that they also had led to a substantial reduction in income differentials and a severe compression of disposable incomes toward the bottom of the income scale. A study by the Central Planning Bureau, comparing trends in Germany and the Netherlands, concluded that the flattening of the income distribution led to relatively higher wage increases in the labor-intensive sectors in the Netherlands. Moreover, the lack of wage differentiation was seen as one of the factors accounting for the rigidities in the labor market that, inter alia, contributes to the rise in unemployment. The Government, in formulating its wage policy for 1983, intended to discontinue the statutory wage policy for the private sector, while freezing public sector wages at their 1982 levels. The freeing of private sector wage formation, however, was dependent upon the voluntary moderation of wage settlements.

The Government maintains a detailed system of price controls which, however, are implemented rather flexibly. According to the authorities, the impact of the controls on profitability is very limited and competition rather than price controls accounts for what appears to be a shortfall in the recovery of profit margins compared to what could have been expected from the reduction in cost pressures because of the moderation in labor costs and in import prices. The authorities consider that the main purpose of the system of price controls is to help secure agreement on wage moderation.

The wage restraint has resulted in some decrease in the wage share in 1982. However, the room created for a rise in profits by wage moderation has been taken up largely by increases in social security taxes and in interest costs. Although some worried about the beneficial effects of wage and price moderation being eroded by a continuous appreciation of the guilder, the authorities took the view that the strength of the guilder within the EMS was an essential element in the control of inflation and was also the most effective way to bring about a sustainable reduction of interest rates.

4. Industrial policy

The transfer of resources to enterprises under the Investment Law Scheme (WIR) is at the center of Dutch industrial policy. This instrument is considered superior to a general corporate income tax cut for three reasons: first, investment premiums can be paid to all enterprises, including new entities, which in their early stages of operation have a weak or negative profit performance; second, the use of WIR financial incentives is clearly linked to the realization of investment projects within the Netherlands; and third, the investment premiums are payable for investment by unincorporated businesses, which could not benefit from corporate tax cuts. The authorities considered the frequent changes in WIR premiums a weak point of the scheme, because it had created an atmosphere of uncertainty.

The authorities were also aware of the fact that regulations with respect to environmental issues and other regulatory procedures had a negative impact on investment activities and that inflexibility of hiring and firing procedures did not contribute to a favorable response to market stimuli.

5. Development assistance

The policy of the Netherlands is to appropriate budgetary resources equal to about 1.2 per cent of GNP for development assistance. This figure is expected to be achieved in 1982, and, for 1983, despite the severe budgetary constraints, the same percentage of GNP has been allocated.

IV. Staff Appraisal

In recent years, the Netherlands has achieved remarkable successes in moderating the growth of nominal wages and in keeping price developments in hand. Therefore, the authorities have a considerably lesser problem in dealing with the effects of ingrained inflationary expectations than do a number of other countries. These developments also have led to a partial restoration of the competitive position of the Dutch economy in international markets. As a result, some gain in market shares abroad and at home has been obtained despite falling world demand and even greater weakness of demand for the industrial goods the Netherlands produces.

However, relatively low inflation appears to have been bought at a very high price. The progressive redistribution of incomes of the past decade and the steadily increasing role of the public sector have undermined the productive capacity of the economy. Accordingly, despite the good inflation performance and a strong current account surplus, the economic situation is very somber. The official forecast for 1983 projects zero growth in real terms, after three years of actual or near declines, a further jump in unemployment to at least 13 per cent of the labor force, and an associated decline in domestic expenditure down to the level of 1977. It already seems that foreign market growth may be weaker than assumed and that even this outlook is likely to be too optimistic.

The situation of the private business sector is extremely difficult. The volume of private productive investment has fallen steadily from its admittedly relatively high level of 1979; it fell by 6 per cent in 1980, 14 per cent in 1981, and a projected 5 per cent in 1982. Business failures have tripled over the past several years, firms accounting for 50 per cent of employment in enterprises have been running losses for some time, and profits in the nonenergy sector for 1982 are down to zero, at best. As the labor force is estimated to increase strongly over the next several years, there is an urgent need to reverse the declining employment trend.

Years of continuous budget-cutting proposals have been unable to contain, let alone to reverse, the growth of claims of the public sector on domestic resources. And revenue growth, notwithstanding the strong increase in natural gas revenues and a steady rise in the burden of taxes and social security contributions, could not keep up with the acceleration of expenditures. The public sector deficit will exceed 10 per cent of net national income in 1982, and is likely, under present policies, to rise further in 1983. Over the past six years planned budget cuts cumulated to f. 17 1/4 billion, in real terms, but in practice expenditures exceeded plans by f. 17 1/2 billion.

The rising current account surplus is largely the result of a fall in investment outlays which cannot be remedied until there is a definite improvement of operating conditions in the business sector. Therefore the staff agrees that the leeway created by the current account should be used to achieve a sustainable reduction of interest rates. This view is also based on the opinion that the momentum of public expenditures and the pressures exerted by the public sector deficit have reached a point where they would preclude a sustainable recovery of activity. Accordingly, absolute priority should be given to the reduction of the size of the public sector and of the public sector deficit. However, the manner in which this is to be achieved is of prime importance. The steady rise in the tax burden has eaten into the productive potential of the private sector. The success of the policies of wage moderation is being eroded by continued increases in social security taxes, made necessary by the explosive trend of transfer payments, which by 1982 accounted for nearly a third of national income. As a result, in spite of a fall in real take-home pay, relief from pressure of wage costs has only just begun to surface. Regaining financial control over the public sector, therefore, means regaining control over expenditures so that reduction of the deficit does not depend on increases in the tax burden. In addition, the pattern of public spending needs to be shifted away from transfer payments toward productive expenditures. In the past, spending cuts have tended to move the structure of public expenditures in the opposite direction. The large overhang of public borrowing on the capital market is clearly a factor in the relative downward stickiness of long-term interest rates, particularly at a time when inflationary expectations do not appear to play a contributory role.

The staff further holds that the rigidities in the labor market that are being fostered by the linkage of social security benefits to private sector wages, by the extensive recourse to social security benefits, and by regulations that govern hiring and firing, strongly limit the benefits of wage moderation. The wage level in the Netherlands, despite the moderation of the past several years, is still among the highest in Europe. In particular, the very high minimum wage level by international standards may have contributed to the progressive disappearance of small labor-intensive enterprises and to the rise in youth unemployment. Although the acquiescence of the trade unions to the policy of wage moderation probably could not have been obtained if a policy toward greater wage differentiation had been pursued, the latter is essential if the fall in employment opportunities is to be reversed.

The progressive compression of the wage scale that has taken place over the past decade strongly militates in favor of decentralized wage formation. Although the recovery of profitability in the private enterprise sector requires continued wage restraint, market forces, if allowed fuller play, are likely to put downward pressure on wage claims over the foreseeable future. Officially recorded unemployment levels, at 10 per cent of the labor force, are among the highest in Europe. Hidden unemployment, fostered by generous disability payment schemes, may amount to about 6 per cent of the labor force. These schemes have contributed to the _de facto_ early retirement of a large part of the labor force of over 50 years of age. Participation rates in these age brackets have dropped precipitously between 1975 and 1982· by 10 percentage points for age 55-59 and by 22 percentage points for age 60-64.

Unless the labor market can operate more flexibly, restoration of the profitability of enterprises will also remain limited and the incentive to employ available investment funds abroad rather than at home will remain great. Under the circumstances, a revival of world demand will quickly bring mismatches in labor markets to the surface and bottlenecks could appear at a quite early stage in an economic upswing. Statutory incomes policies, as applied in the past, and, in particular, price and wage freezes could under present circumstances further deepen existing market impediments.

Less government involvement in labor markets needs to be coupled with lesser involvement in the enterprise sector as well. The fast growth of government transfers to enterprises clearly indicates the innate momentum of such programs. Most important, relatively large, and rising, amounts of scarce public financial resources are being devoted to the propping up of failing enterprises. Since business planning assumes the continuance of these programs, a sudden break would be counterproductive. However, the staff believes that such programs ought to be phased out, particularly in view of the urgent need to reverse the upward trend in the tax burden and to make room for significant tax relief for the enterprise sector. Financial resources are fungible and, in an open economy such as the Netherlands, as long as incentives to employ savings abroad rather than at home continue to exist, investment premiums, such as those provided under the WIR, are not necessarily additive, nor are they necessarily employed most efficiently.

With regard to exchange rate policy, the mission accepted the link to the deutsche mark as given. The strong-currency policy has increased the leeway for reductions of short-term interest rates in excess of the normal guilder-deutsche mark differentials. And this in turn is helping to restore the balance sheets of a very short-funded enterprise sector. It has also contributed to the control of inflation and thereby supported the deceleration of nominal wage increases.

Finally, the staff feels that it is of vital importance that the government program of regaining control of public spending actually be achieved. The past two years of falling incomes already have created the belief among the public that an austerity program leading to revitalization of the economy is well under way, whereas it has hardly begun. Continuing shortfalls from the Government's stated goals are eroding the credibility of the effectiveness of government policies.

Relations with the Fund

(As of November 30, 1982)

General Resources Account

Quota:	SDR 1,422.0 million.
Currency holdings:	SDR 930.7 million, or 65.5 per cent of the quota.

SDR Department

Allocation and holdings:	The Netherlands has received a net cumulative allocation of SDR 530.3 million; the Netherlands' holdings of SDRs amount to SDR 751.4 million of 141.7 per cent of the net cumulative allocation.
Lending to the Fund:	Oil facilities, 1974 and 1975: SDR 6.2 million. Supplementary financing facility: SDR 72.5 million. Total: SDR 78.7 million.
Gold restitution:	The Netherlands acquired 0.60 million fine ounces in the four gold restitution operations.
Last Article IV consultation:	The last Article IV consultation discussions were held October 15-27, 1980. The staff report (SM/80/267, 12/2/80) was considered by the Executive Board (EBM/80/189) on December 22, 1980.

Basic Data 1/

Population (mid-1982)	14.3 million
1981 GDP per capita	SDR 8,340

National accounts (1981 at current prices)	In billions of SDRs	In per cent of GDP
Private consumption	72.2	60.6
Public consumption	21.4	17.9
Gross fixed investment	22.6	19.0
Stockbuilding	-1.5	-1.3
Exports of goods and services	69.5	58.3
Imports of goods and services	65.1	54.6
GDP	119.2	100.0

Selected economic data (changes in per cent)	1979	1980	1981	1982 2/	1983 2/
Demand and output at 1977 prices					
Private consumption	2.9	-0.4	-2.6	-2.0	-2.8
Public consumption	2.8	1.0	1.2	-0.6	0.9
Gross fixed investment	-1.7	-2.6	-10.7	-4.4	-1.5
Stockbuilding 3/	-0.3	0.4	-1.8	0.6	0.8
Total domestic demand	1.6	-0.1	-5.3	-1.4	-1.2
Foreign balance 3/	0.6	1.1	4.1	0.2	0.9
GDP	2.1	0.9	-1.2	-1.0	-0.1
Prices, wages, employment					
Consumer price index	4.2	6.5	6.7	5.7	4.5
GDP deflator	4.2	5.3	5.6	6.5	3.7
Hourly wages	4.1	4.7	3.0	6.0	4.0
Employment in manufacturing	-1.0	-1.3	-3.4	-4.0	-2.5
Output in manufacturing	2.8	0.6	-0.5	1.0	1.0
Productivity in manufacturing	3.8	1.9	3.0	5.2	3.6
Unit labor costs in manufacturing	3.8	4.6	3.8	1.5	1.0
Registered unemployment (in thousands)	210	248	385	544	705
Incomes					
Compensation of employees	7.7	6.1	2.0	4.0	2.0
Other incomes	3.3	9.6	8.0	4.0	1.6
Transfers	9.7	8.8	9.0	9.2	6.5
Personal income	7.5	7.4	4.8	5.4	3.2
Direct taxes and social security contributions	8.9	8.3	3.9	8.5	5.3
Disposable income of households	6.8	6.9	5.1	4.0	2.2
Real disposable income of households	2.4	0.3	-1.5	-1.6	-2.2

1/ Sources: Official publications; and staff estimates and forecasts.
2/ Staff forecast.
3/ Contribution to growth of GDP.

	1979	1980	1981	1982 1/
Monetary aggregates				
Money (M_2 - IFS definition)	11.6	5.6	7.8	7.4
Liquidity ratio (end-of-year level)	35.4	36.5	36.2	36.9
	1965	1970	1981	1982 1/
Fiscal aggregates				
(in billions of guilders)				
Central government balance	-1.2	-1.3	-20.9	-27.9
Local authorities balance	-2.0	-2.7	-4.9	-5.8
(as per cent of NNI)				
General government borrowing requirement (cash basis)	5.3	3.8	8.2	10.3
Public expenditure (NIA basis)	41.4	48.2	65.8	67.3
Of which: Central Government	(13.6)	(14.0)	(20.0)	(...)
Other public bodies	(15.8)	(17.7)	(20.9)	(...)
Social insurance	(12.0)	(16.5)	(24.9)	(...)
"Collective burden" 2/	40.9	47.3	59.2	59.5
Balance of payments (in millions of SDRs)	1979	1980	1981	1982 1/
Trade balance (f.o.b.)	-1,089	-1,032	3,396	4,920
Balance on invisible transactions	131	-147	480	...
Private transfers	-469	-585	-560	...
Official transfers	-161	-357	-706	...
Current balance	-1,588	-2,121	2,610	4,430
(In per cent of NNI)	(-1.4)	(-1.8)	(2.4)	(4.0)
Long-term private capital	302	781	-1,380	...
Short-term private and official capital	-381	-142	-290	...
Banking sector	1,544	3,400	-731	...
Errors and omissions	-266	-1,108	-785	...
SDR allocations	98	96	89	...
Changes in reserves (- = increase)	291	-906	487	...
Official development assistance (as per cent of GDP)	0.93	1.03	1.08	1.2
Exchange rate (period averages)				
Guilders per U.S. dollar	2.01	1.99	2.50	2.67 3/
Guilders per SDR	2.59	2.59	2.94	2.95 3/

1/ Staff forecast.
2/ Tax and nontax revenues, and social security premiums.
3/ Eleven months.