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Executive Board Attendance

P. R. Narvekar, Acting Chairman

Executive Directors

A. A. Al-Tuwaijri
M.-A. Autheman

B. S. Dlamini

J. E. Ismael

W. Kiekens

A. Mirakhor

S. Schoenberg

E. L. Waterman
J. de Beaufort Wijnholds
Zhang Z.

Alternate Executive Directors

V. J. Fernández
C. X. O'Loughlin

J. Shields
R. Kannan, Temporary
N. Coumbis
L. M. Cheong
D. Gotz-Kozierkiewicz
J. C. Estrella, Temporary

H. A. Barro Chambrier
B. S. Newman
H. Ono

A. G. Zoccali

Y. Y. Mohammed
T. K. Gaspard, Temporary
B. Andersen
A. V. Mozhin

Y. G. Yakusha

L. Van Houtven, Secretary and Counsellor
W. S. Tseng, Acting Secretary
P. Cirillo, Assistant

Also Present

European I Department: M. C. Deppler, Deputy Director; B. B. Bakker, H. M. Flickenschild, I. Halikias, F. M. Lakwijk, J. V. Levy, C. M. Watson. Policy Development and Review Department: J. Ferrán. Secretary's Department: R. H. Munzberg, Associate Secretary; K. S. Friedman. Advisors to Executive Directors: P. A. Akatu, P. Cailleteau, K. M. Heinonen, M. F. Melhem, G. Mucibabici, J.-C. Obame, R. von Kleist. Assistants to Executive Directors: P. I. Botoucharov, M. A. Brettschneider, J. A. Costa, D. Daco, C. M. Gonzalez, U. Issaev, G. A. Kyriacou, F. A. Schilthuis, V. Trivedi, L. B. J. van Geest, Zheng H.

1. EXECUTIVE DIRECTOR

The Acting Chairman welcomed Mr. Yakusha as Alternate Executive Director for the Republic of Armenia, Bulgaria, the Republic of Croatia, Cyprus, Georgia, Israel, the former Yugoslav Republic of Macedonia, the Republic of Moldova, the Netherlands, Romania, and Ukraine.

2. KINGDOM OF THE NETHERLANDS—NETHERLANDS— 1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with the Netherlands (SM/96/107, 5/8/96). They also had before them a background paper on selected issues and a statistical appendix (SM/96/118, 5/20/96; and Sup. 1, 5/20/96).

Mr. Wijnholds made the following statement:

As per tradition the Netherlands authorities have very much appreciated the discussions with Fund officials. While analysis and assessment are generally shared to a very high degree, the need to explain policies to an international audience helps to sharpen and focus the debate and can shed new light on well-known problems.

The staff projections for economic growth and inflation in 1996 are very similar to those of the Netherlands authorities. They expect a rate of growth of 2 percent (compared to a staff estimate of 1¾ percent) and a rate of inflation 2.5 percent (compared to 2.3 percent). The recent growth performance of the Netherlands compares rather favorably with that of other members of the hard-core European exchange rate mechanism (ERM).

As to monetary and exchange rate policy, monetary policy in the Netherlands is aimed at maintaining a close link between the guilder and the deutsche mark. The success of the Netherlands in attaining this goal over a long period is evidenced by the fact that many view the Netherlands as part of a de facto monetary union. I am inclined to take the absence of any explicit discussion of monetary policy in the staff appraisal as a sign that the staff sees no problems in this area and holds the view that the Netherlands is ready to enter the European Economic and Monetary Union (EMU) with no more than technical changes in the monetary sphere. The relative strength of the guilder has allowed the authorities to lower interest rates to quite low levels (the rate for advances is now 2.5 percent, the lowest post-war level), sometimes independently from Germany. Factors contributing to the strong performance of the exchange rate include public spending control, wage restraint and the external current account surplus. The peg to the deutsche mark combined with moderate wage developments and fiscal restraint have led to a low level of inflation. The authorities are comfortable with inflation prospects; further interest rate cuts could be contemplated if developments in the financial markets provide scope for such adjustments.

In regard to fiscal policy, fiscal consolidation has been the main economic policy issue in the Netherlands since the beginning of the eighties. In view of the initial serious imbalances, fiscal policy had to aim at attaining specific targets for a long time, precluding the use of automatic stabilizers. By the time the present government took office (the summer of 1994), however, the fiscal situation had been improved sufficiently to allow for a modest working of the automatic stabilizers. Present policies aim at a decreasing trend in real expenditures over the period 1995–98. Revenue forecasts are based on cautious assumptions and windfall revenue gains from higher than expected growth will be used, at least in part, to lower the deficit further. In order to safeguard fiscal consolidation, annual indicative ceilings have been set for the deficit as well. An expenditure focused approach is preferred by the authorities over a structural deficit based strategy, in view of the large margin of error in the calculation of structural deficits. Moreover, the expenditure focused approach tackles the problem at the root: the relatively high level of expenditures. The Netherlands is the only European Union member that is expected to reduce its public expenditure in real terms both in 1995 and 1996. In fact government expenditure and revenue ratios declined by over 4 percent of GDP in the period 1993–95 and are now expected to approach the average European level.

The latest projections for 1996 suggest a deficit of 3.2 percent of GDP, somewhat higher than envisaged in the autumn of 1995. Tax revenues are expected to be lower, mainly as a consequence of slower economic growth in 1995 and 1996; the overall spending norms, however, are expected to be observed, and indeed to be undershot (a slight overshooting in the health sector is more than offset by lower expenditures in other areas). The deficit will still be slightly below the ceiling of 3.3 percent of GDP that would necessitate additional measures.

The authorities share the tenor of the analysis and recommendations by the staff for fiscal policy in 1997, which they consider to be a crucial year with a view to first-round participation in the EMU. Final decisions regarding the budget for 1997 will be taken later this summer. The authorities are strongly committed to produce a budget with a deficit remaining safely under the Maastricht ceiling of 3 percent of GDP and with a clearly declining debt ratio. It should be clear that room under the spending norms should not be taken up by expenditures on other budgetary categories. There is no scope at present to cut taxes and social premiums further; in fact, it will not be easy to avoid having to raise premiums. Fortunately, there is now a widely shared view in the Netherlands that—given the expenditure norms—the emphasis has to be shifted from tax and social premium cuts to deficit and debt reduction.

The authorities agree with the staff that in the longer term further reductions of the deficit are necessary so as to ensure a decline of the debt ratio. The idea to aim for a balanced budget is attractive, but decisions in this area are a matter for the next government. Further fiscal consolidation is not only warranted with an eye to the EMU, but more importantly with an eye to the aging population. Calculations on the associated costs are always open to margins of error (increased labor market participation, not at all unlikely in view

of the present low level in the Netherlands, might provide some buffer to the aging of the labor force). Moreover, the Netherlands boasts very sizable fully funded pension funds to cover the supplementary pensions. Still, the aging population will entail major costs that have not been provided for as yet (costs for the pay-as-you-go public pension scheme have been estimated at about 3 percent of GDP and 4 percent of gross wages). A durable reduction in the debt ratio might be the more effective way to create room to deal with the costs of an aging population, as straightforward measures to lower costs are sometimes rendered less effective as a consequence of the complicated pension system in the Netherlands with its interdependencies between public and supplementary pensions.

In another vein, the staff has suggested to improve incentives through a revenue-neutral tax reform. This issue is presently being studied within the Ministry of Finance, where a working party is looking into the streamlining of taxes on labor with the intention to produce specific proposals this summer.

Concerning labor market, structural policies and the external sector, the Netherlands unemployment figure (1996: 8.3 percent) stands out favorably compared to those of other European economies. However, this figure masks the high level of non participation in the Netherlands (in 1995 the participation rate was 56.2 percent measured in labor years and 60.7 percent measured in persons). Enhanced economic growth of a higher labor intensity is necessary to make a dent in the low participation rate. The Netherlands has made some progress in this area. Continued moderate wage developments, partly due to unions that overcome classic insider-outsider problems, have already stimulated an impressive employment growth, especially in the more labor intensive services sector. Measures to improve the functioning of the labor market have contributed as well. The tax wedge has been reduced over the last 10 years, especially at the lower wage end of the labor market where non participation is the highest. A modest change in the wage bargaining system has been introduced, now that the Minister of Social Affairs can abstain from declaring the lowest wage scales binding if they are still above the statutory minimum wage. Moreover, rules regarding working hours have been relaxed, while changes in certain other labor market regulations (minimum wages and hiring) are being studied. The authorities, however, maintain that further structural adjustment in the labor market must also take account of the consequences for income position of the lower paid, one of the most sensitive political issues in the Netherlands.

Attention is also being given to further improving economic growth performance. While the investment ratio compares rather favorably with other European Union members, there is scope for improvement. The authorities have therefore embarked on a series of structural adjustment measures, especially in the product markets. This effort has become an integral and continuous part of economic policy as is evidenced by the creation of a special ministerial commission. Notable changes have been introduced regarding anti-cartel measures and the regulation of business licensing as well as shopping hours. In a number of fields new legislation is under preparation (regulations on working conditions, environmental licenses, taxi transportation and legal services), while

in other areas studies are being undertaken. Some estimates indicate that the benefits of increased competition might amount to some half a percent of GDP per year.

Mr. Schoenberg made the following statement:

We welcome the timing of this discussion on the Netherlands, which closely follows our discussion on Austria. Both countries have a lot in common, being small, open economies, members of the European Union and very successfully using a currency peg as nominal anchor and focal point of monetary policy. Both countries are above average performers in Europe regarding growth and employment. The main weaknesses in both cases are the fiscal situation, especially the fiscal deficit and the level of debt in relation to GDP and some remaining structural problems, especially on labor markets.

We broadly share the staff's assessment and its policy recommendations for the Netherlands. I also want to commend the Dutch authorities for some very important policy measures that were enacted during the past few years. Among these achievements are the reduction of the level of government involvement in the economy, which manifests itself through a reduction of the share of expenditures and revenue in GDP, the restructuring of parts of the social security system and the privatization of health insurance. Other measures have led to a capping of non-wage labor costs and welfare expenditures. Together with important deregulation steps, for instance concerning shopping hours, the authorities have made significant progress towards modernizing their welfare system and injecting additional dynamism into the economy.

These achievements may not, however, mask the existing challenges especially in the areas of fiscal policy and unemployment. Instead of being reduced, the fiscal deficit further increased during the past year, thereby making the achievement of this year's originally envisaged deficit target unattainable. The staff report also does not point to already specified measures, of how the target of a deficit of 2 percent to 2½ percent of GDP could be reached in 1997. These troubles with the deficit translate into a stagnant debt to GDP level at about 80 percent. It is at the moment not quite clear how the authorities will be able to achieve a significant and lasting reduction of the debt level towards the Maastricht threshold. Since the current deficit is predominantly of a structural nature, structural changes will be needed on the revenue and—above all—on the expenditure side of the budget to achieve a durable basis for stable public finances. I agree with Mr. Wijnholds that while the Maastricht deficit-benchmark constitutes an inevitable short-term fiscal policy objective, the medium-term consolidation of the budget must be the central goal for fiscal policy—not least given the expected demographic developments in the Netherlands.

The Netherlands have, like many other countries in the EU, experienced a marked slowdown of growth in the course of this year. While wage increases have so far been moderate, it is important that this moderation is kept up. In a medium-term framework, we support the measures suggested by the staff to increase incentives to work and further reduce non-wage labor costs. The OECD

further suggests that additional employment could be created through an increased flexibility of the educational framework and increasing opportunities for investment in venture capital.

We share the staff's concern regarding the high number of non-full-time employed. This number comprises not only the increasing share of part-time employment but also significant participation in social programs. At least to a certain extent, these social programs have to be regarded as hidden unemployment. It also remains to be seen, whether the increasing number of part-time employees can be maintained while reducing the structural deficit to below 1 percent of GDP and without sacrificing the Netherlands' external competitiveness.

The single-minded pursuit of monetary and exchange rate policy of an exchange rate peg has been very successful for the Netherlands, even to the extent that interest rates are somewhat lower than in the anchor country. In so far I would not quarrel with Mr. Wijnholds's view that the Netherlands are ready for EMU. The very high credibility of this policy approach has been hard earned and the authorities should make sure that unsustainable fiscal positions do not undermine this achievement.

Lastly, it is worth mentioning that the Netherlands owe their economic success not least to an open trade policy. It is therefore in their best self-interest to continue to also influence EU trade policy in that direction.

Mr. Ismael made the following statement:

The European economic slowdown of late 1995 and early 1996 has indeed affected the Dutch growth to a larger extent than anticipated. Nevertheless, I believe that the prospects for the Netherlands in 1996 are to be better than those of many European countries. Consumers are most likely to benefit from an unexpectedly strong labor market recovery, the lack of substantial budget austerity and from a low level of interest rates.

Following this brief overview, let me first look at the inflation prospect more closely. Mr. Wijnholds's statement that "the authorities are comfortable with inflation prospects" is, to a certain extent, warranted. Inflation in 1995 has indeed eased, and the decline was in line with the overall inflation decrease in Europe and well below the European Union average (of 3.0 percent). The prospects for inflation for 1996 and 1997 remain favorable as most of the upside pressure on prices from increasing private consumption can be easily offset by decreasing producer prices on the back of improving labor market conditions.

In addition, the 1995 upbeat fixed asset investment will, in my opinion, help twofold to keep consumer prices mild. First, new and more efficient equipment helps to keep production costs low, and second, due to a higher volume of production avoids bottlenecks for an extended time period at the retail, wholesale and production level.

However, by 1998 inflation might well have picked up significantly for the following reasons: (1) the labor market may have reached a certain tightness where the first signs of bottlenecks may appear; (2) the labor market situation leads to higher private consumption and lower savings; (3) this will feed through to an increased demand; and (4) with general elections to be held in 1998, the authorities may be tempted to trade off employment for inflation.

Turning now to fiscal policy, I agree with Mr. Wijnholds that "there is no scope at present to cut taxes and social premiums further; in fact, it will not be easy to avoid having to raise premiums."

Although the 1995 fiscal situation is indeed better than anticipated, where both the deficit and debt fell faster than had been forecast in last September's presentation of the 1996 budget, however, lower 1996 economic growth will raise problems due to lower tax revenues. The fear is that the shortfall in tax revenue will not be offset by less than projected interest payments due to a lower than forecast interest rate level. In view of this, the 1996 official budget deficit target of 2.8 percent, set by the authorities last September, might well need to be revised upward.

I look toward the 1997 outlook with somewhat mixed feelings. The Prime Minister and the Minister of Finance have both announced that the focus of fiscal policy will be on lowering the budget deficit and the debt to prepare the Dutch EMU entry. All the same, the Prime Minister said in a more recent speech that reductions in social premiums and taxes may be still possible in 1997. However, I tend to think that the achieving of the 3 percent EMU target and the convergence toward the 60 percent debt to GDP ratio will not leave any room for further tax cuts in the future; rather, this calls for tax increases instead.

Finally, a few comments on monetary policy. Last year could be called the year of the hard Guilder. The U.S. dollar lost more than 10 percent against the guilder, while the lira, the Swedish krona and the peseta shed about 20 percent of their value since 1992.

The strength of the guilder, no doubt, is causing problems for the industry. On the other hand, demand for Dutch goods is relatively inelastic due to the fact that the Netherlands mainly export less cyclically sensible goods, such as agricultural products, raw materials and semi manufactures. In addition, Germany is the Netherlands' biggest trading partner, accounting for more than 25 percent of both imports and exports. By shadowing Bundesbank policy and, therefore, linking the guilder to the deutsche mark, foreign exchange uncertainties are removed for a significant part of the trade. This year's expected slowdown in export growth, which will also affect other external sector accounts, is not so much a result of the guilder's strength, but due to the weakness of some of the Netherlands' most important trading partners. I, therefore, recommend that monetary policy be left unchanged.

Mr. Kiekens made the following statement:

In the 1995 Annual Report of the Nederlandsche Bank, Governor Duisenberg describes the Netherlands' economic performance for that year as "not bad." This assessment seems rather modest if we compare the Dutch performance with those of its neighbors or even with those of the "outer-ring" countries as defined in the last *World Economic Outlook* (WEO). The Netherlands has preserved satisfactory growth and competitiveness without accepting currency depreciations. The confidence effects of a sound policy stance are hard to quantify but there can be no doubt that they had much to do with 1995's growth performance. The soundness of the fundamentals, particularly the wide acceptance of wage restraint, the surplus on the external current account and the strength of the guilder in the EMS, has allowed an easing of monetary conditions that has brought interest rates to record lows. The economy is consequently well positioned to return to a higher growth rate. The latest figures from the Netherlands indicate that growth was faster than expected during the first quarter of 1996, principally due to the impetus of private consumption.

Though it is a small, open economy, the Netherlands seems better sheltered from unfavorable external developments than other economies. Both during the cyclical weakness of 1992-1993 and during the slowdown that began in the second half of last year, the Dutch economy has weakened more slowly than the EU average. Also, between 1989 and 1995, Dutch GDP grew at an average annual rate of over 2.5 percent, compared with an EU average of about 2 percent during the same period. The stable conditions provided by pegging the guilder to the deutsche mark, combined with wage moderation, the growing importance of the services sector, and the ongoing structural efforts to make the economy more flexible, are responsible for the good economic performance of the last several years.

Without wage moderation, the economic performance of recent years could not have been so favorable.) Wage moderation and the ability of exporters to accept smaller profit margins offset the nominal effective appreciation of the Dutch guilder sufficiently to preserve the competitiveness of Dutch exports. According to the OECD, Dutch exporters have even managed to increase their market shares during the last five years.

Wage moderation also allowed a significant increase in employment, whether measured in numbers of employees or numbers of man-years, and the rate of employment growth now also exceeds the EU average. The Netherlands has succeeded better than other European countries in increasing employment, not only by slowing down labor shedding in industry, but equally or more important, by speeding up the growth of labor intensive activities, especially services. In 1995, employment growth was concentrated in the services sector, where employment, measured in man-years, grew by some 4 percent. Incidentally, the staff very interestingly attributes the growth of the Dutch services sector to a combination of high income elasticity and cost sensitivity.

The other side of the coin, however, is that the increase in the employment was the counterpart of slower growth in labor productivity, which caused unit labor costs to rise by 1.5 percent in 1995 despite wage moderation. It is difficult to measure labor productivity in the services sector, but Dutch industry's specialization in labor intensive products with rather high price sensitivity makes it vulnerable to competition from low wage countries. Furthermore, in light of the low rate of participation, high labor productivity may be essential to the Dutch economy, since continually increasing unit labor costs will sooner or later begin to squeeze profits and threaten competitiveness, even in such sheltered sectors as the service sector. All these arguments show that avoiding real labor cost increases that exceed the increase in labor productivity will be a key requirement for safeguarding the competitiveness and profitability of enterprises and further employment growth.

The increased flexibility of the Dutch economy in the last few years has permitted job creation even under conditions of relatively slow growth. The Dutch authorities have taken many innovative measures that have stimulated part-time employment, which seems to fill a societal need, and the entry of low skilled workers into the labor market. However, it is more difficult to reduce long-term unemployment, as shown by the increase of its relative share in overall unemployment. The government has therefore decided to create 40,000 basic social jobs in the public sector, to fulfill social needs that remain unaddressed in most modern economies. These jobs will tend to become permanent and will increase the state's role in the economy. I think that this initiative will have positive results. However, I would like to know from Mr. Wijnholds or the staff what are the net costs of these measures for the budget and whether alternatives have been examined in order to promote the creation of these jobs by the private sector.

When the present government assumed office in August 1994, it abandoned the former budget strategy based on a deficit target and replaced it with spending norms. The new budgetary strategy reflects a healthy view of the public finances, since it permits the authorities to avoid the disadvantages often associated with strategies based on deficit targets. These include procyclical effects, a bias toward a higher tax burden, and distortions in the composition of government expenditures.

This concern for optimizing government finances in the long term is also reflected by the emphasis given by the Dutch authorities to reducing the tax burden in parallel with cuts in government spending. Lowering the tax burden is a major means of strengthening the supply-side of an economy. But although government spending has declined in the Netherlands in the last few years, the reductions made in the tax burden have outpaced the actual cutting of government expenditures. In 1995, the reduction of the tax burden was achieved to some extent by sacrificing effective deficit reduction and exhausting the safety margin. The government deficit, as defined by EMU, increased from 3.2 percent of GDP in 1994 to 3.7 percent in 1995, and the staff expects that it will again exceed 3 percent of GDP in 1996.

Unless a strong and rapid recovery materializes in the Netherlands' trading partners, a deficit below 3 percent of GDP will not be achievable in 1997 without a temporary increase in social contributions. We would therefore agree that despite the undeniable long-term advantages of the present budget strategy, it would be strongly advisable to move the emphasis from reducing the tax burden to reducing the deficit, if for no other reason than to create a safety margin to cushion possible setbacks affecting the 1997 budget. The fact that the debt ratio has not moved far from 80 percent of GDP since 1991 is a further indication of the importance of bold deficit reduction. Reducing the debt service burden to make room for the increased expenses connected with the aging of the population can only be accomplished by reducing the debt ratio. I therefore emphatically agree with Mr. Wijnholds's view that the assets which are accumulating in the civil servants' and teachers pension fund do nothing to eliminate the urgent need to reduce the burden of servicing the public debt. Structural reforms in the tax and social security systems that are needed to avoid a further decline of the revenue elasticity of income taxes and to improve work incentives, especially for the low paid workers, ought therefore to be implemented in ways that do not jeopardize the reduction of the deficit and debt ratios. I am sure that the Dutch authorities will find the appropriate balance as they devise their medium-term strategy for the public finances.

In conclusion, I agree with the overall tenor of the staff's well-balanced appraisal and policy recommendations. I trust that at our next Article IV consultation with the Netherlands we will once more find much to learn from their experiences.

Mr. Waterman made the following statement:

I agree with Mr. Kiekens, most of us would be delighted to get a report card like this. It is interesting as Mr. Wijnholds observes there is very little by way of discussion of monetary (and I might add exchange rate policy) which are issues of key interest to the Fund. And I agree that can be taken as a sign of Fund confidence in the performance of the Netherlands. The Netherlands has been very successful in maintaining a firm link to the deutsche mark. At the same time has bond yields equal to those in Germany, while short-term interest rates are lower than those across the border. You do not pass these tests unless your overall performance is excellent. So we should give the Netherlands a mark of 8 or 9 on a scale of 10 and move only to the next country. But we do not operate like that. To paraphrase the speech by Mark Anthony to the Romans, our role is to bury Onno, not to praise him.

Much of the focus in the staff paper is understandably on fiscal policy. This is an area where the Netherlands has made good progress in recent times, but it is an ongoing issue for the authorities, particularly the consequences of an aging population for expenditure on pensions and health. Initially, I thought that the staff was being a little tough on the authorities in terms of what they think the authorities should be aiming for, but I am convinced by the analysis that further measures will be required in coming years and, clearly, the earlier the authorities move, the easier the budgetary problems become. Nevertheless, I

have sympathy for Mr. Wijnholds's comments on the operational usefulness of structural deficits as policy benchmark, particularly given the uncertainties involved in their calculation. (This is not to question their analytical value.) It is also the case that the level of taxation in the Netherlands is very high and I would question whether it is necessarily sustainable in the longer term. So I think an expenditure-focused approach to further reductions in the deficit makes a lot of sense. Good progress seems to have been made recently in keeping spending under tight control.

On the revenue side, there may be limited scope for tax reductions in the period immediately ahead, but there is clearly going to be ongoing pressure to reduce tax rates, particularly as Europe becomes more integrated. As an aside, I am not aware this issue receives a lot of attention, but with an increasingly integrated Europe, there will be growing pressure for members of the EU to have comparable tax structures with particularly important implications for the more highly taxed countries such as the Netherlands.

Apart from integration within Europe, there is obviously a resistance to the current levels of taxation in the Netherlands. Expenditure programs will need to be adjusted (particularly welfare entitlements) if the further needed progress in reducing public dissaving is to be made. While this is a central issue for the authorities, it also needs to be acknowledged that the Netherlands maintains a very high overall level of national savings as reflected in the large current account surplus and it is not clear that there is a need to boost total savings, as opposed to getting a better balance between saving in the private and public sectors.

On a somewhat related point, private investment has been reasonably high in the Netherlands but it seems that the country will continue to generate very sizable current account surpluses in the years to come, reflecting the high level of overall savings in the country. I could not help but wonder on reading the report whether the very high rate of taxation in the Netherlands, particularly the double taxation of dividends, is a factor contributing to the very strong outflow of direct investment. Possibly under a different (less onerous) tax structure, the level of domestic investment would be higher, contributing to faster growth and more employment and a current account surplus somewhat lower than it is at present.

Unemployment in the Netherlands is relatively low by European standards but, as the report notes, the participation rate is relatively low. As in my own country, the Netherlands got into trouble due to excessive real wage increases in the 1970s, but the Netherlands has seen the benefits of real wage restraint in recent times although, as the report notes, that seems to have come at the cost of some reduced flexibility in the labor market. Changing labor market structures can be very difficult politically but it seems that the Netherlands, like Australia, will benefit from further reforms of the wage determination system and other disincentives relating to taking on full-time employees.

On a related issue, at one level I can understand the pressure to use the wage system to protect lower-income earners through measures such as minimum wage laws, but it is often the case that you end up disadvantaging the very people you are trying to assist (the outsiders) by limiting employment opportunities. In Australia, some of the more successful employment support schemes have been those that have effectively lowered the cost of employing workers, but they also had significant budgetary costs. The report also draws out the fact that low participation rates can also be influenced importantly by a combination of relatively high tax rates and generous social welfare benefits. This is certainly a problem that has been experienced in a number of countries in this constituency. It is reassuring, nevertheless, that the nature of these problems is recognized by the authorities and that they are making progress in addressing the issues. The point made in the paper on the link between restrictions in the product markets and inefficiency and problems in the labor market also strikes a familiar chord.

Well, to end where I began, we must pay the Netherlands an unqualified compliment in terms of its overall economic performance and management. There are ongoing challenges but they seem to be well-recognized by the authorities. What we are really debating is the speed of the adjustment process. And at the end of the day, these are essentially political issues on which the authorities need to make the call.

Mr. Shields made the following statement:

As others have noted, the macroeconomic framework used by the Netherlands' authorities has stood them in good stead over the years. Indeed, it is impressive how well the Dutch economy has even outperformed the anchor currency country, Germany, recently. However, growth has slowed over the last six months, owing largely to a technical recession in Germany. Nevertheless, it is impressive that there has continued to be some growth. With nearly 30 percent of Dutch exports going to Germany in 1995, it is an economy dependent on the German economy.

Consumer confidence appears to be quite high, with the growth in domestic demand exceeding output growth. It seems that the Dutch electorate has become used to fiscal retrenchment and, therefore, perhaps is not as dismayed by this as some of its European partners. The good employment record over the years has probably helped to maintain a reasonable level of consumer confidence. This good background should make it easier for the authorities to put in place the continued fiscal adjustments which are still needed, and to carry on with the changes in the labor market.

On fiscal policy, I agree with the staff appraisal. The debt/GDP ratio is still about 80 percent, and this means that the appropriate focus must be on deficit and debt reduction, rather than tax cuts. I was encouraged by the comments of Mr. Wijnholds in this regard, and I noted his optimism that the Dutch electorate broadly endorses such a focus.

The staff suggestion of aiming at a deficit next year of close to 2 percent to 2½ percent of GDP is appropriate, with further deficit reductions over the medium term. I agree with the staff's suggestion of aiming for a balanced budget by the end of the decade, and perhaps fiscal surpluses beyond that. Also, there is a need for revenue-neutral tax reform to be implemented, because some of the high marginal rates must be brought down. The simulations of debt dynamics in the staff report were convincing, particularly in the light of inevitable demands on pensions and on health. All the gains are to be had from keeping the deficit down and bringing about further reductions in the debt level.

The most significant medium-term fiscal issue concerns pensions. The generosity of the Dutch system makes the demographic time bomb potentially quite serious. It is reassuring to note that the issue is a matter of concern in the Netherlands itself, and that a review of pension funding will be held soon.

There will have to be structural reforms dealing with the way that pensions are financed and disbursed; however, the underlying fact is that the only way to address the problem is through creating fiscal room by aiming for budget surpluses and reducing entitlement levels. Most important, labor force participation rates must be increased. That is the only way to ensure that there will be fewer dependents and more people available to finance them.

It is crucial that labor market issues are worked out in a sustainable fashion. Labor market concerns have bedeviled policy making in the Netherlands for a long time. This goes back about 20 years, with the legacy of the "Dutch disease," and a generous level of assistance to those at the margins of the labor market has kept labor force participation rates low, despite the impressive employment record of recent years. It is to the Netherlands' credit that it has been reforming, but not at the expense of withdrawal of support to the neediest, or increasing inequality. The staff's suggestions, such as aiming for policies that concentrate more on income support, rather than high flat-rate benefit entitlements and a high minimum wage, are appropriate. The system has to move toward one in which there are financial rewards to both employers and employees for taking on new labor, and I have been impressed at the innovative attitude toward labor market policies recently.

Against this background, this desire always to make change, but nevertheless to make humane change, means that it has been easier to achieve consensus in the labor market. That has paid off well, with wage moderation reinforcing a good competitive position, and hence validating the fixed exchange rate. The benefits are now becoming clear through lower interest rates. Indeed, the recent fall in the value of the deutsche mark has improved the overall competitive position of the Dutch economy further.

In conclusion, I am delighted to be able to make constructive comments on a fellow European Union member, and I wish the Netherlands' authorities every success.

Mr. Coumbis made the following statement:

The performance of the Dutch economy in 1995 continued to be satisfactory on many fronts and especially in the areas of price inflation, the external current account, and the growth rates of investment, GDP, and employment. In past Board meetings, we have praised the macroeconomic policies followed by the Dutch authorities which contributed to fostering corporate and consumer confidence. This confidence was expressed in the strength of the guilder and in the fact that short-term interest rates are now 30 to 40 basis points below German rates while long-term interest rates are at parity with German rates.

However, there are some well-known problems in the areas of fiscal consolidation, the level of public debt, and structural reforms, especially in the labor and product markets. Despite substantial progress made in these areas in recent years, much more needs to be done in the fiscal area, the general government deficit was 3.7 percent of GDP in 1995 and the gross debt of the public sector was 79 percent. Moreover, in 1995 the structural deficit is slightly higher than in 1994 while for 1996 the initial budget targets will be missed because of slower-than-expected economic activity and revenue elasticity. As a result, the public debt ratio increased in 1995 and showed a negligible decrease in 1996. I would like to stress at this point the fact that the problem with respect to the Maastricht criteria are concentrated mainly in the level of the debt and the size and the increase of the structural deficit in 1994-1995. The deficit of the general budget is very close to 3 percent. However, the experience in many European countries indicates that the closer we get to the 3 percent target, the more difficult it becomes to attain it. For 1997, the staff has the view that if current policies with respect to fiscal revenues and expenditures do not change, the deficit cannot approach to 2 or 2.25 targets even if real GDP growth is near to its potential rate.

There is no doubt that fiscal adjustment in the late 1980s was quite successful and brought the deficit down from 8 percent in 1982-83 to about 3 percent in 1993. We have expressed the view, along with other Directors, that the excellent record of the guilder and the remarkable stability of the guilder-mark rate over a decade is part of the successful long-term fiscal adjustment process. However, since 1993 it seems that the authorities are marking time and, as a result, both the deficit and the debt ratio are essentially unchanged since then. This indicates a change in priorities in the area of fiscal policy. The new priorities are directed toward cutting expenditures and, at the same time, improving incentives by cutting back taxes and social security contributions. Actually, revenue and expenditure ratios fell by some 4 points of GDP between 1993 and 1994, which, in fact, is an impressive performance.

In the Board meetings of 1994 and 1995 we supported the staff's view that the authorities should change their priorities toward a preference for a reduction of the public deficit and public debt. The arguments in favor of this approach are well known: attainment of the Maastricht criteria in the first round, maintenance of market confidence and the credibility of the financial policies

followed by the authorities, and, last but not least, creation of the necessary margins to face successfully the long-term factors connected with health care and public pension expenditure which will be adversely affected by demographic trends. For the 1997 budget, further tax reduction should be made only to the extent that matching expenditure cuts can be identified or through a revenue-neutral tax reform, for instance by broadening the tax base. With respect to the longer-term outlook of public finances, I think that the staff's view is very useful that long-term entitlement reform appears essential to address the demographic risk to public finances. This brings us to the structural problems of the Dutch economy. Since I am in full agreement with the staff's analysis and suggestions, I will make only a few remarks.

Although substantial progress has been made in recent years in the areas of labor and product markets aiming at increasing the responsiveness of these markets, much more remains to be done. It is interesting to note that some of these measures have already had positive effects on employment growth.

Although I agree that collective bargaining agreements may reduce flexibility, I maintain the view that wage moderation in the Netherlands, which contributed substantially to the successful performance of the economy, is to a certain extent connected with the existing collective bargaining process and, therefore, should be maintained. This, of course, does not mean that we should not try to improve the existing mechanisms and reduce, as much as possible, features that are not friendly to job creation or entry of new firms.

In the area of monetary policy, we do not have anything to add to what the staff has said so far. We would only like to express a word of caution as to the pace of interest rate reductions. Dutch short-term interest rates are already 30 to 40 basis points below German rates.

Finally, with respect to the outlook for 1996, I would like to ask the staff about their GDP projections. Initially it seemed to me that the 1.75 percent increase was rather optimistic, taking into account developments in other European countries and the recent substantial downward revisions of GDP growth in most of them. However, Mr. Wijnholds's statement points out that the authorities are expecting a rate of GDP growth of 2 percent while data published in yesterday's *Financial Times* indicate that the annual rate of GDP growth in the first quarter of the year was 1.8 percent. From data released by the Dutch central statistical office, we see that consumer spending in the first quarter of 1996 increased on an annual basis by 3.2 percent which is the highest level in 3.5 years. The staff's analyses indicate that the rise in consumer spending is connected with the expected increase in disposable income which, according to the staff, is partly due to the increase in employment. I suppose that we may reasonably assume that the reduction in taxes in 1994 and 1995 has also played an important role in the increase of disposable income and thus of consumption during this period. Is it possible that the expected improved performance of the Dutch economy with respect to GDP growth compared with the other European countries is due to the fiscal policies followed by the Dutch authorities during the last two years? If this is so, what lessons can we draw from this case for the

policies of other European economies in 1996? I would appreciate some comments from the staff.

Mr. Newman made the following statement:

After reading the background papers prepared by the staff, I was initially at somewhat of a loss as to what to discuss today. Like Mr. Kiekens, I was struck by the very favorable performance of the Dutch economy compared to other European countries. Clearly, the loss of monetary independence and the efforts to achieve Maastricht have not been harmful. In fact, they have served as a useful spur to making some of the important structural changes necessary in the economy.

However, like Mr. Waterman, I was struck by our Article IV obligations, which require us to continue surveillance, even of good economies, particularly with regard to the international consequences of national policies. The principal transmission vehicle for these effects is the current account position. The Netherlands has a large and growing surplus, which in other economies has been a subject of some debate in the Board. I raise this issue not because I have a particular concern about the current account, but rather because it seems to me it raises a number of issues and lessons to be learned in the Dutch case that might be applicable with regard to other European countries undergoing monetary union.

In his written statement, Mr. Wijnholds notes that the Netherlands is already part of a de facto monetary union. Consequently, the traditional means of adjusting external imbalances—exchange rate policy to change the relative price of tradeable and non-tradeable goods, and fiscal policy to deal with a savings/investment imbalance—are not readily available. This leaves us with microeconomic policies and structural reforms to correct unsustainable imbalances. I focus on the external side not because it raises new issues, but because it provides a different way of looking at some of the internal issues that the Dutch have been confronting and dealing with so successfully.

As we know, the concept of sustainability is difficult to define, let alone quantify. A background paper for last year's consultation took a somewhat different approach by examining whether the current account surplus was caused by distortions that contributed to excessive savings and/or inadequate domestic investment in the economy. The Netherlands enjoys a high savings rate relative to the rest of Europe, which is driven partly by a natural Dutch prudence but also a pension system that encourages private savings to supplement the public safety net, and, as Mr. Waterman pointed out, also by a tax system that encourages businesses to retain earnings rather than to invest them in the economy or declare dividends. The staff does not view these high private savings as an undesirable distortion as they are consistent with the financial requirements of an aging population. However, one wonders whether the level of savings in the supplementary system would be as large if the individual was not required to put aside a substantial nest egg and could instead elect to have fewer benefits in the future or a longer working life. This reminds me of an issue we had in the

context of Singapore, where they had a forced savings system that was resulting in savings rates in the neighborhood of 40 to 50 percent of GDP.

Last year's background paper on the Dutch current account surplus determined that the savings/investment balance underlying the large current account surplus is attributable more to comparatively low investment in the Netherlands than to "over"-saving. While domestic investment in the Netherlands has been relatively high in recent years when compared to its neighbors, it has still been outpaced by savings growth. In part, the low investment reflects the success in moderating wages which has encouraged greater use of labor instead of capital, which has helped to absorb increased labor market participation rates and led to a somewhat lower level of unemployment in the Netherlands than in its partners.

The low investment also reflects the past increased role of the state and public consumption which tends to be less capital intensive than private output. However, rigidities in Dutch product and labor markets have also acted as disincentives to investment. The paper outlines a range of measures that are being implemented to reduce those rigidities, including liberalizing shopping hours, reducing cartelization, and general liberalization of business regulations. Clearly, more is needed to build on this momentum, but the Dutch authorities seem to be ahead of the game in comparison to other EU members facing the same issues. I think this will become increasingly important as Union proceeds.

The authorities, however, cannot afford to rest on their laurels. Given the prospect that participation rates are likely to increase in coming years, particularly if benefits from not working are reduced, continued wage moderation now will be all the more important and beneficial. While further fiscal consolidation will tend to increase the current account surplus, this trend can be moderated by continuing to rely on expenditure reduction rather than tax increases, which raises the same issues that others have done in a somewhat different vein about the need to achieve savings by cutting benefits rather than raising taxes.

We see many of these issues as lessons for other European economies as the EMU materializes. While external imbalances will increasingly become internalized with EMU, the need for adjustment remains. This could be one of the last opportunities we have a chance to talk about the Dutch current account surplus, as it is likely to disappear in a few years' time with Union.

Moreover—and this is the more important point—the adjustment is likely to be slower and more difficult, given the need to rely on micro rather than macro policy tools. This will heighten the need to focus on measures to improve the flexibility of wages, especially given the limited scope for labor mobility between European countries. There is a danger that inadequate reforms in this area could lead to pressures for inefficient industrial subsidies—something that we are seeing increasingly in the United States, which some view as the principal optimum currency area, where individual states vie, through fiscal incentives, to

attract investment and employment because they do not have other ways to adjust as easily as a nation state does.

Finally, the loss of adjustment tools is likely to lead to pressures for greater intra-EU transfers that are likely to exceed substantially even the current levels, and this will have important implications for the budget positions of individual EU states, as they contribute to the EU in particular. In fact, the Netherlands may be finding its savings being used to finance employment in other parts of Europe instead of investing in or achieving investment income for the future.

The work program indicates that the staff is preparing a paper on the implications of European Monetary Union for the international monetary system. I would hope that changes in the nature of the adjustment process for correcting savings and investment imbalances within Europe will be given as much attention in the paper as the monetary and financial implications of the Union.

Mr. Autheman made the following statement:

As stated by previous speakers, there is much to be praised in the Netherlands, as last year; but there are also a few disappointing features, especially in the fiscal policy. It is quite comforting to have the opportunity to discuss the case of a country where the currency is robust; the current account surplus appears to be solid and the pace of expansion uninfluenced by what happens to partner economies. This will be my first question.

I understand better why Mr. Wijnholds could not agree easily with Mr. Mussa during the WEO discussion, because the case of the Netherlands is clearly at odds with the analysis of European growth which was developed at that time. There is an interesting view at the beginning of the staff report which tends to relate the good macroeconomic performance of the Netherlands to the remarkable stability of its fiscal and monetary policy, which appears to never be used to accommodate output fluctuations.

Is this an opportunity which is available to the Netherlands because it is a smaller economy—I would not like to say “small,” if the Netherlands is a small economy, there are not many moderate-sized economies in the world—and a very open one, or is it the consequence of the fact that, when a country refrains from using monetary and fiscal policy to influence growth fluctuations, it derives long-term benefits? Indeed, the very interesting background paper on monetary policy tends to give some ground to this hypothesis.

I am disappointed with the fiscal performance. Quite frankly, this is not what we expected. I remember that last year the staff expressed some disappointment at the lack of ambition of the Netherlands' authorities, considering that they had the opportunity to achieve a faster fall in the general government deficit than the one they envisaged; but the outturn has been quite different.

Although the Netherlands has enjoyed a better growth performance than some of its partners, it is one of the few European countries where the fiscal deficit did not decline in 1995; and the fiscal deficit is almost exclusively structural. Of course, the position of the Netherlands remains better than many others. The interruption of the fiscal consolidation process is worrisome. I therefore support the staff's view that the Dutch authorities should consider at least more ambitious action than what they undertook during the last two years. A not-negligible consequence of this regrettable evolution has been the persistence of a very high level of public debt, which will become a critical issue in the coming months.

Finally, I was interested in the background paper on unemployment. I share Mr. Newman's approach. There are lessons to be learned from the Dutch case, at least for the other European countries. Why is it that a country which epitomizes so well the European social model has such a different performance in the field of employment from its partners? Clearly, it is not related to the adoption of a U.S. labor market model by the Netherlands 10 years ago.

The staff relates employment performance to the low real wage growth of the Netherlands and explains that, when real wage growth is very slow, after some time it leads to employment growth. This is more a description than an explanation. You can say, like Molière, that opium makes you sleep because opium makes you sleep. The question is: why is there a different tradeoff between wage growth and productivity growth in the Netherlands and in neighboring countries?

We could say that unemployment is growing elsewhere because productivity is growing; but why is productivity growth higher in similar European countries—I mean countries which have a similar trend of growth and a similar level of human capital? Why is it higher, let us say, in Belgium or France than it is in the Netherlands? It is an issue which deserves to be given continued attention, since it will be easier to convince the French or Germans to follow a Dutch model than a non-European one.

Mr. Newman noted that the Netherlands had been able to maintain moderate wage growth, in part because of the tendency of the social welfare system to guarantee an individual a fairly high standard of living while staying outside the labor force. However, given the need to curtail budget deficits and the increasing fiscal pressures caused by an aging population, it was questionable whether such a model could be sustained. Also, it was not clear whether Mr. Autheman regarded the maintenance of the exchange rate anchor as an end, or as a means to help the authorities address much-needed structural measures.

Mr. Mirakhor stated that some of the wage moderation had been the result of the significant decline of the size and impact of labor unions in the 1980s, similar to what had occurred in the United States. Also, the background paper produced by the staff, particularly the section on the monetary policy transmission mechanism, should be published, because it addressed many important issues, especially the question of how close German monetary policy could be copied by other European countries. However, it rightly concluded that many issues remained unresolved, and that more work needed to be done in the area.

Mr. Schoenberg said that he agreed with Mr. Newman that, as members joined the European Monetary Union, their ability to exercise independent macroeconomic policies would be curtailed, and microeconomic policies would play an increasingly large role. That underlined the importance of achieving convergence at the point of entry into EMU. Also, much of the Netherlands' recent positive performance was due to the decline in unit labor costs—by about 15 percent in relation to Germany since 1992—which suggested that Dutch labor unions had had more moderate demands than their German counterparts. Moreover, the good economic performance proved that a country did not need to manipulate the exchange rate instrument to preserve growth in employment.

Mr. Fernández stated that it was important to distinguish between the microeconomic and macroeconomic aspects of the labor market issue. The micro aspect dealt with the structure of the labor market, and that revealed quite a negative series of developments in the case of the Netherlands, particularly regarding a rigid minimum wage rate, high social security contributions, the large share of part-time workers, and high level of long-term unemployment. Indeed, a recent report by the OECD compared the degree of rigidity in the labor market in the Netherlands with the situation in Italy and Spain, long considered among the least flexible labor markets in Europe. On the macro aspect, the Netherlands had performed relatively well, particularly because trade unions had understood the importance of maintaining competitiveness, exchange rate stability, and low inflation, and had accordingly moderated their wage demands.

Mr. Autheman noted that the "Dutch model" had produced better employment growth between 1984 and 1994 than most other European countries. While Mr. Newman had been correct to ask about the sustainability of the model, it was clear that lessons could be learned by the Netherlands' neighbors regarding possible alternative methods of encouraging employment growth.

Mr. Ono made the following statement:

The recent economic situation in the Netherlands has been favorable. Many economic indicators—growth in the GDP, employment growth, and the inflation rate—reflect the relatively good performance of the Dutch economy, especially compared with that of other EU countries, which suggests that the Dutch macroeconomic policy is effective. The staff predicts that growth will slow down slightly in 1996 (from 2.4 percent to 1.7 percent), which seems inevitable given that, in Germany and many other European countries, the tempo of the recovery has been much slower than anticipated.

First, I would like to commend the authorities for their strong policy credibility and their adequate macroeconomic policy. Given the good recent economic performance of the Dutch economy, this year's staff consultation report seems to focus more on medium-term fiscal policy and on structural policy. This approach is both timely and appropriate. I am in general agreement with the staff's appraisal and will, therefore, focus my remarks on a few key points.

With respect to monetary and exchange-rate policy, I support the Dutch authorities' policies and, in particular, their goal of achieving price stability

through linking the guilder to the deutsche mark. This exchange-rate policy has functioned well in recent years, although there seems to be a virtuous circle between the strong guilder and lower interest rates. I would like to point out, however, that such a positive correlation between exchange rates and interest rates is not always a given under exchange rate regimes like the ERM. It is not necessary to mention the experience of the United Kingdom in late 1980 to emphasize this point. In the case of the Netherlands, the strong guilder results from economic policy credibility as well as from economic fundamentals; of course, this includes public spending control. I believe that the link to the deutsche mark can be maintained without major difficulty as long as the Dutch economy continues to perform well.

Regarding fiscal policy, the government's commitment to and efforts toward fiscal consolidation are to be praised. However, the widening structural deficit during the economic upswing of 1994–1995 (2.7 percent in 1993, 3.2 percent in 1994, and 3.3 percent in 1995) merits attention, especially since both the deficit and the debt ratio had plateaued during this same period. I fully share the staff's view that a cautious approach to fiscal policy is needed, and that a high priority should be given to expenditure and deficit reduction. In this connection, the staff's suggestion that the 1996 expenditure ceiling be strictly observed seems useful and appropriate.

As for the labor market, although some measures—the freezing of the minimum wage and of social benefits and cuts in the tax wedge—have been taken, there remain substantial problems; for example, how to best utilize lower-skilled workers and how to improve incentives to seek employment. In tackling this difficult and deep-rooted problem, as this chair emphasized at the board discussion last year, it is quite important to have basic principles to introduce market forces or market mechanisms into the labor market. In this regard, some prescriptions, which the staff suggests (pages 9–10), are worth consideration; among them, further reforms in the collective bargaining agreement in particular could help to improve the functioning of the labor market.

Finally, concerning deregulation, I would like to commend the authorities' effort and significant progress in product market reform, in preparing an anti-trust law, in liberalizing regulations for shopping hours, and in enhancing competition among taxis and in legal services. I strongly believe that these measures can help promote economic efficiency and improve the competitiveness of the Dutch economy, and look forward to hearing of continued progress in these areas.

With these remarks, I wish the authorities every success in the future.

Mr. Andersen made the following statement:

At this stage of the discussion I find it difficult to add to the already long list of well-deserved superlatives regarding the economic performance of the Netherlands. As rightly noted by Mr. Wijnholds in his very informative

statement, recent growth performance of the Netherlands compares rather favorably with that of other members of the hard core ERM, and the same conclusion could be drawn for other variables as well.

Not only are the fundamentals relatively strong, but the markets have shown their continued appreciation of the policies by not questioning the close link of the guilder to the deutsche mark.

Against this background, it is indeed a major challenge to contribute with much beyond the advice simply to stay the course. However, as shown in the well-written and interesting set of staff papers, an important agenda of structural reforms remains, together with the need to press ahead with an elimination of the excessive budget deficit.

I am in broad agreement with the staff's recommendations, but would like to offer some comments on monetary and exchange rate policy, fiscal policy and labor market issues.

I do consider the highly credible monetary and exchange rate policy with a tight link between the guilder and the deutsche mark to be a cornerstone in Netherlands' good track record. The strength of this approach, which I fully support, has been demonstrated on several occasions where the ERM has been under pressure. The background paper contains an analysis of aspects of monetary policy transmission in the Netherlands as already mentioned by several previous speakers. This analysis concludes that there are rather delicate tradeoffs involved in the Dutch model, with inherent limits if potential risks of an adverse effect on inflation are to be contained and, on the other hand, costs in terms of economic growth to an unchecked appreciation. While I do not want to challenge the conclusion in theory, especially if the necessary support from fiscal and income policies are lacking, I think it is fair to say that the close link to the deutsche mark definitely has demonstrated its strong value for the Netherlands, and I wonder whether there are anyone in the Netherlands that seriously is questioning the appropriateness of the exchange rate link. Moreover, like Mr. Schoenberg, I would like to emphasize the important lesson from page 2c in the staff report, namely that you do not need the exchange rate instrument to improve the competitiveness. Accordingly, I can fully endorse the view of Mr. Wijnholds that the absence of any explicit discussion of the monetary policy in the staff appraisal can be seen as an indication that there are no problems in this area and that the Netherlands is ready to enter the third stage of EMU with no more than technical changes in the monetary sphere.

Let me now turn to the fiscal policy. Last year a number of us around this table were concerned that fiscal consolidation seemed to be marking time in a phase of an economic upswing as already noted by Mr. Coumbis. Unfortunately, the actual developments did not put those concerns to shame. While I certainly welcome the tight control of public spending and fully agree with Mr. Wijnholds that there is a large error of margin in the calculation of structural deficits, I find it worrisome to note that there are indications of even a widening of the structural deficit during the economic upswing in 1994-95, which is also

illustrated by the plateauing of the deficit, as well as of the debt level, in recent years. Thus, whereas the Netherlands was quite successful in pursuing fiscal consolidation during the economic downswing in the early 1990s, unlike most other countries with fiscal problems, the progress after the birth of the Madrid Declaration has been somewhat lesser striking. Thus, with the benefit of hindsight, a more frontloaded fiscal consolidation would not only have been more in line with the Madrid Declaration, but would also have improved the prospects for bringing an end to the excessive budget deficit in the Maastricht context. Accordingly, while I can fully endorse an expenditure focused approach, I think that the Dutch authorities now would be well advised to set supplementary targets to ensure that the consolidation is structural in nature.

It is obvious that the recent slackening of economic activity does not make it easy to pursue stronger consolidation at present. It was therefore encouraging to note from Mr. Wijnholds's statement that the authorities are strongly committed to produce a 1997 budget with a deficit safely below the 3 percent and with a clearly declining debt ratio, as well as that it is a widely shared view in the Netherlands that the emphasis has to be shifted from tax and social premium cuts to deficit and debt reduction. Given the uncertainties regarding the timing and the strength of any renewed upswing in Europe, prudence will also call for some contingency planning. In that connection, the staff may want to comment on what they consider to be the main risks to the projections, including whether they see a risk that consumer confidence may start to deteriorate as in many other European countries.

Looking further ahead, I share the view that to move in the direction of a balanced budget or maybe even a modest budget surplus may be warranted in light of longer-term trends. I also agree that there may be scope for improving incentives through a revenue-neutral tax reform. The longer-term demographic risk to the public finances is an issue that not only the Netherlands has to cope with, as demonstrated by many other recent Article IV discussions, but I think that Mr. Wijnholds has an important point when he underscore that cost calculations are open to margins of error and that, in the case of the Netherlands, increased labor market participation may provide some buffer to the aging of the labor force.

That leads me to comment briefly on the labor market. The unemployment rate cannot be considered alarmingly high by European standards and employment creation has been relatively strong. Thus, the authorities deserve to be commended for implementing a number of measures in recent years with the aim of improving the functioning of the labor market. However, a substantial proportion of the recent employment growth has been occurring in part-time jobs, and the participation rate, although increasing, continues to be low as just mentioned.

One of the most salient developments in the labor market has been the first significant decline in decades in the number of disabled. However, a recent study by the OECD indicates that a large proportion of persons who were removed from the disability scheme joined the unemployment or other social

security schemes. According to the OECD, this shift of beneficiaries within the social security system has also slowed the decline in the so-called broad unemployment, a concept which includes unemployed, other inactive persons of the working age receiving a social security benefit, and persons enrolled in special job creation programs. This broad unemployment rate has been well above 25 percent in full-time equivalents for over a decade and may have declined only moderately in 1995 according to the OECD. Consequently, it is important that the authorities do not lose the momentum in their efforts, and I generally agree in the staff's recommendations. In particular, I would guess that a substantial tightening of the targeting of social benefits, including the eligibility rules, would likely prove beneficial for the economy, together with increased emphasis on training and education.

Let me conclude by expressing my admiration of the Netherlands' open trade policy and that, notwithstanding the priority given to real expenditure reduction, the authorities have indicated their commitment to a continuing, sizable official development assistant (ODA) program. I fully agree that a continuation of the Netherlands' strong record in providing ODA deserves strong encouragement.

The staff representative from the European I Department noted the long experience in the Netherlands with nominal deficit targets, followed in recent years by the use of expenditure norms with other subordinate targets. There had been significant benefits from the use of medium-term expenditure norms as a means of fiscal control, in that it had become clear in advance which departments would have to implement various spending measures. Safety margins that appeared in one department would not be transferred to another, but would become part of the safety margin in the overall budget. Those ambitious expenditure targets had translated into almost zero real growth in general government expenditure, and resulted in the shift from cutting capital expenditure to the successful containment of current expenditure. During the discussions with the authorities, the staff had pointed out that the high quality of the recent fiscal adjustment suggested that there was scope to continue with such a medium-term expenditure path. Over time, it would become increasingly important to aim for a reduction in revenues, and the staff had expressed sympathy for the government's objectives to reduce tax and social welfare contribution rates, which were among the highest in the industrialized world. However, a reduction in revenues should not exacerbate the overall debt problem, and any tax cuts should be preceded by interest savings from a reduction of the overall deficit.

Mr. Mirakhor asked how successful the government had been in heightening the public's awareness of the importance of achieving the medium-term expenditure targets.

The staff representative from the European I Department stated that the government published each year a major budget note that explained the rationale of fiscal policy.

Mr. Fernández asked why the staff had not recommended a specific target on the flow deficit that would work to achieve the stock of debt level required under the Maastricht criteria. During the recent Article IV consultation discussions with Belgium, the staff and the Board, with the exception of his chair, had endorsed the targeting of the primary deficit—a target that would breach the Maastricht criteria.

The staff representative from the European I Department remarked that, as in other countries, the core of fiscal restraint had to be the restraint of public expenditure, especially current expenditure, because it was the most difficult to control. Recent research had suggested that the effect on growth of fiscal adjustment depended strongly on the quality and composition of the adjustment, and that restraining current expenditure was a high-quality path to follow. The Dutch had established a technical and political mechanism that worked to achieve a government consensus on controlling current expenditure, and that had worked well. Focusing on the Maastricht flow criteria of a 3 percent of GDP deficit would not be an ambitious target for the Netherlands, because the fundamental fiscal problems associated with an aging population implied severe fiscal challenges over time. As a result, the staff had recommended continuing the medium-term expenditure targeting, but also a nominal target of balancing the budget by 2000 or 2002. Expenditure targeting, moreover, would reduce the revenue share of government in terms of GDP, which was quite high in the Netherlands. In the case of Belgium, the Belgian authorities had been persuaded to aim for a primary budget surplus in order to shift the public's attention onto current primary expenditure, and to reduce, over time, the level of debt.

Mr. Fernández stated that the risk in the case of Belgium was that, given the low level of interest rates, any increase in interest rates in Germany would drive up rates in Belgium, and, as a result, would reduce any windfall savings from lower rates. That would make reaching the Maastricht targets more difficult.

The staff representative of the European I Department responded that, if the Maastricht process was successful and kept inflation low, then long-term interest rates throughout Europe might moderate, and, since most of Belgium's debt was funded over the long term, the risk that Belgium's interest rate burden would increase sharply over the medium term was not severe.

The use of structural deficit measures was difficult to quantify, particularly in a country such as the Netherlands where there was not an estimate of the capital stock, and therefore one was working with approximations of the level of the structural deficit, the staff representative continued. Perhaps one lesson that emerged from the Netherlands' recent experience was that too much emphasis should not be placed on the nominal deficit in an economic upswing, and on the structural deficit in a downswing.

Regarding the outlook for 1997, the staff believed that growth was close to potential and that medium-term spending norms would be observed by departments, which would lead to a deficit of about 2.7 percent of GDP, the staff representative explained. Moreover, there was likely to be a temporary increase in contributions aimed at rebuilding the social funds, which would result in a deficit closer to 2.5 percent of GDP. Therefore, based on those assumptions, there did not seem to be a need for tax increases in 1997.

The gross cost of the government's job creation program was likely to be about 0.1 percent of GDP over 1996 and 1997, but would likely be lower if the social security savings resulting from the program were taken into account, the staff representative said.

The benefits accruing from the stability of the macro policy framework had been substantial, and the staff had viewed the Netherlands as increasingly part of a de facto currency union, the staff representative remarked. While the fixed link to the deutsche mark had been the main factor contributing to the recent impressive economic growth rate, the background paper

on the aspects of monetary policy transmission had suggested that short-term fluctuations in the premium or discount compared to German rates might have been reflected in a slightly greater variability of inflation. Nevertheless, the longer-term benefits of joining EMU would likely outweigh any short-term disadvantages.

The authorities' long-term commitment to deficit reduction had had substantial positive effects on the prospects for growth and employment, the staff representative noted. Against the background of the pressures of an aging population and of meeting the Maastricht criteria, the statement of confidence in the authorities' fiscal policy had allowed the savings ratio to play a stabilizing role. That credibility had been maintained, despite the plateauing deficit, owing to the quality of expenditure restraint recently.

The staff believed that the double taxation of dividends at high rates should be eliminated, owing to its distortionary impact on savings and investment, the staff representative continued; however, the main issue remained that the rate of return on domestic investment needed to be raised, and the root of that problem was in the distortions in the labor and product markets.

There were several possible sources of distortions that might have raised savings, including generous tax allowances and the supplementary pension scheme, the staff representative noted. There was some evidence, outlined in the background paper that suggested that if people were allowed more choice, they would opt for a lower replacement rate than the current 70 percent of their final year's salary. However, from a macroeconomic perspective, there was not an unduly high level of savings in the private sector, given the likely fiscal shocks associated with an aging population.

While slow wage growth should not be considered as beneficial in the long run, the recent wage moderation in the Netherlands had had a positive effect on employment growth, but had been a correction of previous highly distorted wage behavior, the staff representative said. However, as participation and unemployment rates declined, employment growth would not likely continue unless the structural reforms recommended by the staff and the Board were implemented.

The previously high degree of unionization had had mixed effects on wage behavior in the Netherlands, the staff representative noted. While average real wage increases had remained subdued, a low degree of wage dispersion had been a cost. In countries such as the Netherlands and Belgium, there had been discussion about how to avoid such results, and the literature on labor markets pointed in two different directions—one toward an organized labor market, the other toward a fragmented labor market. The difficulty was moving from an equilibrium point toward either direction, and experiments at modifying collective wage agreements to allow exemptions for young or low paid workers were attempts to tread carefully away from the status quo. While the success of such a strategy was questionable in the long run, currently it was having some positive effect.

The staff estimate of 1.75 percent growth for 1996 seemed appropriate, particularly given strong domestic demand in the Netherlands in the first quarter which might offset the lower growth estimates for Germany, the staff representative remarked.

Mr. Wijnholds noted that the budgetary system used recently had been focused on expenditure. Previously, fiscal adjustment had taken the form of tax increases, but the level of taxation in the Netherlands remained high compared to other European countries. As a result, the authorities had chosen to focus on expenditure, while setting annual indicative ceilings for the deficit, particularly with a view to fulfilling the Maastricht criteria. Also, as Mr. Waterman had noted, as the EU integrated further, there would be increasing emphasis placed on harmonizing fiscal regimes within the EU, and the Dutch authorities needed to focus on reducing the revenue ratio to a level that was closer to its EU partners.

Mrs. Gotz-Kozierkiewicz made the following statement:

Stability-oriented financial policies have brought very good results in the past year. The majority of economic indicators for the Netherlands appears to be better than the corresponding OECD average figures. The main shadow in this good economic performance has been the high public debt/GDP ratio with a trend pointing toward its stabilization in the coming years instead of a strongly desired reduction. The issue has been comprehensively discussed in the staff report and supplemented with a detailed analysis of changes in the pension system under consideration. There is very little to be added, and the staff's advice on slightly higher fiscal efforts to achieve much more satisfying results in terms of public debt development seems to be worth paying attention to.

The developments on the labor market over the last years are especially noteworthy. Although measures to improve its functioning are under way, regulations regarding labor market relations still seem to be comprehensive and rather rigid, driving up non-wage labor costs and diminishing the chances for outsiders to join the workforce. As a result, enterprises are offering more flexible types of employment enabling them to cut overheads and respond quickly to changes in demand and technological advances. The increase in job opportunities is therefore largely due to the continued expansion of contract work and part-time employment. Although the private sector has thus been effective in creating jobs, this has not primarily happened via traditional full-time employment. In order to avoid an excessively split labor market, more attention should probably be paid by the authorities to further regulatory reforms in the labor market.

At the end, let me comment shortly on aspects of monetary policy transmission considered in Chapter IV of the background paper, regarding selected issues. The subject may deserve particular attention, as it concerns not only the economy of the Netherlands, but also other countries. The results of the analysis point to a very substantial impact of nominal appreciation of the currency on economic growth. The appreciation of 1 percent of the guilder brings to a reduction of the rate of economic growth of 0.5 percent. Of course, the result is affected by the relatively high openness of the economy. Nevertheless, even in the case of economies with lower shares of foreign trade to GDP, but with domestic demand more strictly kept under control, the impact of a nominal appreciation of the exchange rate on the rate of economic growth does not seem to be negligible. Keeping that fact in mind seems to be quite important,

in particular in the context of a discussion about volatile international capital flows and the choice of exchange rate policies.

Mr. Al-Tuwaijri made the following statement:

The economy of the Kingdom of the Netherlands continued its favorable performance over the past year. Unemployment declined, the inflation rate fell to a very low level, and growth was relatively strong. The authorities should be commended for this most satisfactory situation.

These encouraging developments, however, are not without some clouds. The slowdown of economic activity in the second half of 1995 and the higher-than-budgeted fiscal deficit in 1996 underscore the vulnerability of the economy to external developments. Thus, additional efforts in the fiscal and structural areas remain essential for continued success.

In the fiscal area, a number of considerations, including the aging of the population and the relatively high debt ratio argue for strengthened efforts. In view of these considerations, as well as the authorities' welcome objective of reducing the high level of taxation, it is important not to exceed the 1996 budgeted expenditures. Moreover, every effort should be made to maintain a tight spending policy in 1997 and over the medium term.

Important progress has been made in the structural reform area. In the labor market, the reduction in the tax and social security wedge is an important step. Equally important are the tightening of eligibility for social benefits and the reform of the disability scheme. Nevertheless, more ambitious reductions in both the collective burden and social benefits, especially those that entail disincentives to work, are still needed.

Achieving the full benefits of such labor market reforms would be greatly facilitated by product market deregulation. In this regard, the significant progress made in this area is welcome, and the authorities are encouraged to continue with their efforts.

Finally, I commend the authorities for their record in the provision of official development assistance and their role in promoting free trade. I wish them further success in their economic management.

Mr. Gaspard made the following statement:

The Dutch economy continues to exhibit healthy fundamentals, with a strong currency, and a non-inflationary growth in output and employment that has consistently exceeded the European average since the late 1980s. The authorities' financial policies, and particularly the anchoring of the guilder to the deutsche mark, have been instrumental in establishing an appropriate monetary and fiscal discipline, and in contributing to a favorable macroeconomic environment. The relatively moderate increase in real wages since the early 1980s, following the consensus reached between unions and employers in this

regard, has also contributed to this favorable outcome. The markets have rewarded these policies by accepting very narrow and, often, negative premia relative to German interest rates.

With exchange rate and monetary policies largely determined by German market developments, I will restrict my remaining comments to fiscal and structural reform issues, which are the focus of the government policies during 1995–98.

On fiscal policy, the reduction in both public sector expenditure and revenue by more than 4 percent of GDP during 1993–95 is a testimony to the authorities' remarkable fiscal consolidation efforts. While the public sector deficit is projected to decline in 1996, it is nonetheless expected to exceed the targeted deficit by some 0.6 percent of GDP, mainly on account of slower than projected economic growth and revenues. This outcome renders more difficult the attainment of the budgeted deficit of 2 to 2¼ percent for 1997, which is an important objective not only in relation to the Maastricht deficit criterion but also in view of the need to establish favorable debt dynamics at a relatively early stage before the Netherlands joins the EMU. There are also other risks to attaining the 1997 fiscal objective, should the assumed growth rate prove to be over-optimistic. Moreover, should the authorities introduce tax cuts in 1997—although Mr. Wijnholds's statement seems to indicate that this is no longer under serious consideration—in order to satisfy the apparently strong public opinion favoring an offsetting compensation for the increase in social contributions, the fiscal target may prove to be still more elusive. These latter measures, if implemented, could further undermine the fiscal position in the future since the tax cuts would be permanent whereas the increase in social contributions would be temporary. I would therefore agree with staff that these cuts be implemented only if matched by additional expenditure cuts.

Taking a longer term perspective of the fiscal situation, the Netherlands' unfavorable debt dynamics, which are closely related to its demographic trends particularly regarding health care spending, call for a more ambitious fiscal goal for 1997 and for the establishment of fiscal balance at a relatively early stage. I may have missed this in the staff's excellent papers—and although Mr. Watson just briefly alluded to it—but I would also draw attention to the not unimportant risk of an increase in interest rates that could accompany a change in the monetary stance following, for instance, growing fears of inflationary pressures in industrial countries. The risk would, of course be greater should the authorities' assumption of close-to-potential growth rate in 1997 materialize. Thus, given the relatively high debt level of the Netherlands, an increase in interest rates could translate, in the medium to long term, into a significant adverse impact on the fiscal position. Taken together, these short and long-term risks thus constitute quite a compelling argument for a front loaded fiscal adjustment effort.

On the structural reform front, the authorities' recent and prospective measures aiming at enhancing the competitive environment through greater market deregulation are clearly welcome. Although, as noted by the staff, the

tradition of restrictive business practices in the Netherlands does not appear to have unduly hampered the growth of new firms or jobs, the size of new firms has tended to be very small with little job creating potential. It is also noteworthy in this regard that most of the employment growth in the Netherlands since the mid-1980s has been of the part-time variety. I wonder whether this pattern of employment growth is mainly the result of the country's specific market structure or is more the reflection of a new trend in work practices that is gradually emerging in industrial societies. The staff's comments would be appreciated.

Finally, the pension and unemployment schemes, which are among the most generous in the industrial world, underline the need for early progress in this area to support the fiscal consolidation program. I can generally agree with the staff proposed reform measures to address the structural rigidities in the Netherlands' labor market and in its system of social benefits. These issues, which are characteristic of industrial and especially European economies, have been discussed at length at previous occasions. I would merely emphasize, in this respect, the importance of the proposal to raise the retirement age as this would significantly reduce public pension costs by expanding the pension contribution base while raising the labor participation rate in the upper age group. It is thus interesting to note that Denmark, which is the only other industrial country with a more generous unemployment benefit scheme than the Netherlands and with an almost identical average pension, has managed, by raising its retirement age to 67 years, to bring down the net present value of its basic public pension liabilities to less than half that of the Netherlands. And, of course, this is notwithstanding the fact that raising the retirement age would also lower the dependency ratio and probably raise the growth potential of the economy.

Mr. Zhang made the following statement:

Continuing to display a good record of economic policy credibility, the Dutch economy performed favorably in 1995, with major economic indicators remaining at comfortable levels and even outperforming most EU countries. Underscoring this achievement lay the authorities' commendable endeavors in the structural area aimed at increasing market flexibility and fiscal consolidation. I concur with the main thrust of the staff's appraisal, especially sharing their sense of caution toward balancing the relationship between fiscal consolidation and tax reform. Furthermore, the high unemployment level, though not the highest of the EU countries, warrants considerable attention.

On fiscal policy, the authorities have in the past made efforts to stabilize fiscal deficits at around the Maastricht level. In view of the deceleration of its neighboring economies and the decline in revenue elasticities, the authorities are encouraged to strictly maintain their deficit-to-GDP ratio to within a 3.3 percent ceiling. I am pleased to note from Mr. Wijnholds's statement that spending norms will be observed or even undercut.

The unemployment situation in the Netherlands has compared favorably with the OECD average since 1990. However, we have also noticed the

participation rate is low. Perhaps further efforts in this area are warranted. The authorities have made commendable progress on wage moderation, tax and social contribution reduction, and tightening the eligibility for benefits. We hope such policy thrusts will be continued, preferably in an accelerated fashion. In this regard, I very much welcome the planned exemptions to the legal minimum wage.

In the medium-term, among other things, fiscal consolidation faces two main challenges: the high public debt, and an adverse demographic trend. In terms of debt reduction, I welcome the staff's scenario with an early adjustment to surplus, which will tend to sharply reduce the debt to 60 percent of GDP and lead to a durable decline in this ratio to about 30 percent. In view of the demographic trend, though the situation in the Netherlands is more favorable than other EU countries in terms of its lower deficit and fully-funded supplementary pension scheme, its generous social benefits system and the high present value of public pension liabilities suggest that any adverse impact resulting from a demographic trend will be the most acute among EU countries, although not to be felt for another forty years. Therefore, early reform in this area should be high on the agenda. Meanwhile, this demographic trend also emphasizes the case for drastically reducing the public debt in order to allow room for maneuvering.

I have not much to add on monetary policies, as the de facto monetary union system has served the Netherlands well. The recent widening of the current account surplus to 4 percent of GDP is encouraging because it has demonstrated the strong competitiveness of Dutch exports and the past progress in fiscal consolidation. In view of the low investment relative to savings, we are pleased to note that strong product market reform will continue and the benefits of increased competition will hopefully amount to half a percent of GDP per year.

Finally, I would like to highly commend the authorities for their efforts in promoting multilateral trade liberalization and their generous official development assistance contributions, which are above UN targets.

I wish the authorities greater success in their future endeavors.

Mr. Mozhin made the following statement:

Over the past several years, the performance of the Netherlands' economy has been relatively good, as both inflation and unemployment have been among the lowest in the European Union, while growth has been somewhat higher than in the neighboring countries.

Perhaps, the most visible success has been in reducing both government expenditure and revenue ratios by about 5 percentage points of GDP over the past three years. At the same time, there has been practically no progress with respect to the fiscal deficit and the public debt ratio. Given the still very high government revenue ratio in the Netherlands, one can understand the high

priority attached by the authorities to reducing the tax burden. However, the long-term fiscal scenarios provided by the staff demonstrate that, in the absence of more forceful deficit reduction, further tax cuts may prove unsustainable. The obvious way out of having to choose between reducing the fiscal deficit and reducing the tax burden would be to reduce both by more decisively reducing government expenditure. Perhaps, this suggestion is too demanding for a country that, according to Mr. Wijnholds, is the only European Union member that is expected to reduce government expenditure in real terms both in 1995 and 1996. Whatever the trade-off between the deficit reduction and revenue reduction, the very fact that the timetable for balancing the budget is now under consideration is most encouraging.

I believe that a range of structural policy measures implemented in the Netherlands in recent years has already been duly rewarded. Perhaps, the most remarkable achievement has been the modest and declining level of unemployment despite a strong increase in labor force participation. However, as far as I understand, the minimum wage level remains an obstacle for job creation at the low-paid end of the labor market. For that reason, the continuation of the minimum wage freeze would be highly desirable. On top of that, the implementation of planned exemptions to the minimum wage would further improve labor market flexibility.

Mr. Barro Chambrier made the following statement:

From the excellent staff papers before us, there is a strong evidence that the Dutch economy has continued to perform relatively well as compared with other countries of the EU.

In 1995, real GDP growth remained strong, inflation low, and the external current account surplus increased further. This satisfactory performance gives credit to the soundness of the monetary policy that the authorities are pursuing and which focus on controlling inflation, by maintaining a tight link between the guider and the deutsche mark, while continuing with a steady fiscal consolidation.

Despite this enviable track record, the staff has identified two main areas where the Dutch authorities would need to focus more forcefully their attention, namely the fiscal adjustment and in particular the still high public debt/GDP ratio in the context of the Maastricht convergence criteria, and the unemployment situation. I would like to concentrate my brief comments on these two areas before concluding with some remarks on ODA.

On the fiscal situation, while it is reassuring to note from the staff report and Mr. Wijnholds's statement that the continued budgetary consolidation remains the key objective of the Dutch authorities, the revised figure for the 1996 budgetary deficit, which is higher than previously projected (3.2 percent of GDP against 2.7 percent of GDP), raises some questions regarding the current pace and priority of the fiscal adjustment. Like previous speakers we would like to encourage the authorities to strengthen their stance in enforcing strict ceiling

on current expenditure and, in particular, on health spending. In this regard, we support the pragmatic expenditure focused approach being followed by the authorities rather than the structural deficit based strategy for the reasons provided by Mr. Wijnholds in his statement. This being said, the challenge facing the authorities is, in the short run, to lower the budgetary deficit under the Maastricht ceiling of 3 percent of GDP, so as to also reduce the debt ratio. To this end, the staff has made a number of suggestions that the authorities seem to share, including the improvement of incentives through a revenue-neutral tax-reform and increased labor market participation. While urging the authorities to consider the feasibility of these suggestions including the indexation of public pensions at less than the rate of increase of wages so as to reduce the cost of public pensions, it appears however that the best course of action towards deficit reduction rests on a strategy that will focus on continuing with tight expenditure policies. Regarding revenue, it would seem that the Dutch authorities could consider as suggested by the staff measures aimed at eliminating or capping the exemptions allowed under the personal income tax. On expenditure, taking into account the observation made by the staff on the need to restore a safety margin in the public finances, which seems to be exhausted, perhaps the staff could comment further on the specific additional cuts on the central government expenditure that they believe the authorities could make?

On the labor market situation, it is fair to recognize that the Dutch authorities have, over the past few years, made substantial progress in reducing unemployment mainly as a result of a large consensus on a wage restraint policy accepted by unions, employers and political parties. This wage moderation policy stance, has also been instrumental in increasing the competitiveness of the Dutch economy while enhancing the expansion of productive capacity. Despite that progress, it appears that the main challenge to be confronted by the authorities remains the high level of non participation in the labor market. We note that the authorities are keenly aware of that problem and are taking steps to correct it. In this regard, we urge them also to give due consideration to the suggestions made by the staff in this area and in particular, to the need to improve incentives on the supply side of the labor market, by reviewing the current policy which set the minimum social benefit at the same level as the minimum wage.

Finally, this chair would like to congratulate the Netherlands authorities for one of the best record among European countries on ODA, which, despite the pursue of their fiscal consolidation objective, at 0.8 percent of GDP in 1994, is above the minimum level required by the UN (0.7 percent). This only underscores that fiscal consolidation could be achieved without sacrificing international aid. With these remarks we wish the Dutch authorities well in their future endeavors.

Mr. O'Loughlin made the following statement:

The Netherlands continues to achieve solid economic and employment growth. It also continues to promise a solid future performance—with a satisfactory level of investment and an apparent broad consensus support for a competitive evolution of costs and for further structural reform to enhance labor

and product market efficiency. The authorities are to be commended for the contribution which public policy continues to make to economic progress.

Misgivings—such as they are—center around the recent evolution of the fiscal balance. The opportunity for deficit-reduction offered by economic advance through 1994 and 1995 was inadequately grasped—presumably in the expectation of a better economic outlook for 1996/97 than now seems likely. We must hope that such steps as the Netherlands may now have to take to meet EMU “1997” requirements will not in any way undermine the public consensus which seems to surround current policy. There is encouragement on this in the fact that greater progress on the deficit has been hindered by the desire to cut taxation a little farther than might have been done—rather than by the more intractable matter of inability to restrain spending.

Given the assurances about the Netherlands’ continuing commitment to meeting the EMU requirements next year which Mr. Wijnholds recalls in his statement, and the obvious ability of the authorities to carry through their intentions—as demonstrated, for example, by many years of adherence to a strong exchange stance, by continuing progress on structural reform or by the tight containment of spending over recent years—perhaps the most profitable thing we might do is to consider what lessons the Netherlands’ recent experience holds for all of us. There would seem to be a few potentially profitable lessons—at least for countries with larger government sectors. First, it is possible to restrain real growth in public expenditure to a low level over a long period. Hence, it is possible, even against the background of moderate economic growth, to envisage achieving both budgetary consolidation and modest revenue reduction at the same time. Such an approach, the Netherlands case suggests, could well serve to cement social order—by helping to expand employment more rapidly than might otherwise have occurred and thus reducing the social exclusion and alienation which involuntary unemployment implies. Finally, for those countries faced with the prospect of substantial extra costs for health, pensions and the like, as their populations “age,” perhaps there is some comfort in the fact that the Netherlands seems to have been able to increase the proportion of those of working age who choose to be in the labor force. Indeed, the staff might care to comment on the degree to which countries could lessen the adjustment to pension schemes and the like which ageing will make inevitable—by taking steps to push (effective) labor force participation above levels which, today, might be regarded as “normal.”

Apart from these comments, I have one query. So far as I can trace (I have only looked back to the 1970s), the Netherlands seems, almost every year, to have run a surplus on the current account of the balance of payments. It is not clear to me why, in consequence, the Netherlands balance of payments does not now show a consistent net inflow of factor payments. Perhaps the staff or Mr. Wijnholds might comment on this situation.

Mr. Fernández made the following statement:

On the fiscal issues, and in particular on the stock of debt, I have already pointed to the rigidity of the 80 percent level in relation to the gross domestic product. The staff rightly points to that problem, and to the plateauing of the deficit and the debt ratio that has taken place since 1993. Nevertheless, the authorities are making efforts to improve their fiscal management: the level of taxes and expenditures vis-à-vis the GDP has been decreasing.

On the other hand, the low level of interest rates already achieved by the Dutch authorities, through their commendable monetary policy management, will likely not be reduced further. As a result, the tax burden of an 80 percent debt-to-GDP level will be present for some time.

Within EMU, the degree of competition among member countries to adjust taxation levels in order to attract investment will increase. This point has been raised before during previous Board meetings, and Mr. Wijnholds has pointed out the issue of Dutch nationals moving to other countries where taxes are lower. Since the question of tax harmonization will take some time to be resolved within EMU, the Netherlands' high debt stock will likely pose severe financial challenges to the authorities. This problem underlines the fact that more needs to be done to reduce the stock of debt.

I agree with Mr. Wijnholds that it would not be a good idea to target the structural deficit, especially because it is difficult to measure and compare across countries—much like the difficulties associated with comparing unemployment rates across countries. It is also true that the deficit in the Netherlands is essentially a structural deficit, and it will be more difficult to move to a lower deficit flow.

In the labor market, the authorities have made progress, but problems remain. While there has been an increase in unemployment recently, there has also been an increase in the total level of employment beginning about 1986/87. However, in the case of the Netherlands, we have to distinguish between an increase in the number of persons who are officially recorded as employed, and the measurement that is called full-time equivalence. If we refer to the full-time equivalence measure, we will see that during the period of real interest rate increases, between the early 1970s and the mid-1980s, there was not an increase in employment. Also, starting 1986/87, there was an increase in unemployment under both measurements. Nevertheless, it is true that the economy is creating jobs, and growth in Holland is more labor intensive, which, in my view, is closely related to wage moderation. It is not by chance that wage moderation in fixed exchange rate countries is a practice that is followed even by trade unions, because trade unions expect that inflation will remain low and stable, and therefore moderate their wage demands.

Finally, I would like to commend the authorities for their high level of official development assistance. I believe this should be taken as an example for other countries to follow.

Mr. Zoccali made the following statement:

Since I agree with the staff appraisal and many of the points made by previous speakers I will limit my remarks to just a few issues for emphasis. The Netherlands' authorities should be commended for the relatively strong performance of their economy in terms of GDP growth and employment, the continued low inflation and the comfortable external position reflecting, in part, the scope of the structural policies already implemented and the exemplary monetary and exchange discipline from adherence to a rigid nominal exchange rate anchor.

Notwithstanding these commendable results, which included a reduction of the public sector's share of GDP by some four points between 1993 and 1995 while preserving the quality of outlays, further fiscal consolidation to meet the fiscal balance and, in particular, the stock of debt criteria under the Maastricht Treaty seems warranted.

As the authorities have stressed the importance of a strict interpretation of the criteria while expecting to be counted among the countries inaugurating Stage III of EMU, I share the staff's view that the overriding priority now should be the reduction of the deficit, particularly through expenditure restraint in items such as health care and social security, which pose long term risks in view of the demographic trends. While it is reassuring from Mr. Wijnholds's statement that the goal of deficit reduction is widely shared in the Netherlands, it contrasts, however, with the statement in page 6 of the staff paper that in order to offset the temporary increase in social contributions projected for 1997 there is a strong current of opinion favoring further tax cuts. Some clarification by the staff would be welcomed.

Achieving deficit and debt reduction while pursuing at the same time a decline of the tax burden puts all the weight of adjustment on expenditure control. In that regard, I side with those that consider that cutting revenues at the expense of deficit reduction could make the policy of diminishing the fiscal burden unsustainable over the long run, in part because the debt ratio would still remain at a relatively high level. The scope seen for achieving a less distortive tax system while maintaining the level of revenues relative to GDP should be taken advantage of fully. I therefore welcome the fact that specific proposals on a revenue-neutral tax reform are expected by this summer, as indicated by Mr. Wijnholds. I also share the remarks of Mr. Waterman regarding the need to pay closer attention to the tax system's implications of European integration.

On structural policies, I agree with the earlier comments regarding the favorable contribution of micro policies in the Netherlands to foster external sustainability, wage moderation and job creation. At the same time, I see a need for greater flexibility of labor and product markets particularly taking into account the policy constraints associated with the European Economic and Monetary Union. With respect to the labor market, the lack of incentives to seek employment needs to be addressed and strategies such as job-search tests on

benefits and the conversion of welfare benefits to wage subsidies further strengthened. With respect to product markets, the first paragraph of page 11 of the main report linking the absence of leveraging by the enterprise sector to finance investment and the sizable net outflows of direct investment with distortions in other markets might warrant some clarification as it gives the impression that foreign direct investment will only occur when distortions are present in domestic markets.

Finally, I wish to join previous speakers in commending the authorities for their open trade stance and for maintaining a substantial level of overseas development assistance despite the ongoing fiscal consolidation effort in the Netherlands.

Mr. Dlamini made the following statement:

I join my colleagues in commending the Dutch authorities for the success of recent efforts to foster financial stability and improve the responsiveness of both the labor and product markets. The policies pursued have enabled the Netherlands maintain a strong competitive position and achieve macroeconomic results which have been superior in some respects to those of its neighbors. In this regard, I note the authorities' strong anti-inflationary monetary policy stance anchored on the exchange rate link to the deutsche mark, their track record of firm expenditure restraint and the continued wage moderation.

However, despite the impressive employment growth since the early 1980s, unemployment remains an area for concern. There are also significant risks in the longer-term fiscal outlook arising from the public pension scheme and health care spending, while substantial structural problems remain in the product and labor markets. I am in broad agreement with the staff appraisal.

Finally, like Mr. Anderson, Mr. Barro Chambrier and others, I commend the Dutch authorities for the country's exemplary development assistance record and welcome their commitment to maintain the effort, notwithstanding the priority given to real expenditure reductions.

Mr. Estrella made the following statement:

The Netherlands' 1994-95 macroeconomic performance has been generally impressive. Wage moderation has continued, CPI inflation has declined, and the current account surplus has widened. In 1995, job creation picked up, and the unemployment rate declined, despite a strong increase in labor force participation. Although, real GDP growth has slowed and is projected to decelerate, widening the output gap to more than 1 percent of GDP, the unemployment rate is expected to decline further in 1996. However, as the 1996 OECD report on the Netherlands notes, the slowdown is likely to be less pronounced than in the EU on average, and economic activity is expected to pick up again in 1997.

A major policy challenge for the authorities is to reduce the level of unemployment. The labor market is characterized by a low participation rate, among the lowest in Europe, and a very high incidence of voluntary part-time work. The tax wedge inhibits proper functioning of the labor market at low-pay levels, as there is little incentive to work because of the high welfare benefits linked to the minimum wage. To help redress the problem, a series of measures has been taken, including lowering the tax wedge for minimum wage earners; reforming the disability and other social security laws; and augmenting employment programs. However, the figures are indicative of deep structural rigidities and call for stronger corrective measures by the authorities. The government still makes its presence felt through many regulations, permit requirements, and welfare programs affecting most aspects of economic activity.

On the fiscal front, the main objective in recent years was to reduce the budget deficit of the central government with a combination of lower expenditures, taxes and social security contributions. In fact, revenue and expenditure ratios fell by some 4 points of GDP between 1993 and 1995. For the 1997 budget, the authorities noted that the maintenance of agreed expenditures could bring the deficit to about 2.3 percent of GDP, which will be lower than the Maastricht flow ceiling of 3 percent of GDP in 1997.

However, the authorities are confronting a fiscal policy choice between deficit and debt reduction and alleviation of the collective burden. We consider that the debt ratio of about 80 percent of GDP should be reduced as early as possible. As the staff said, cutting revenues at the expense of deficit reduction would likely leave the debt ratio at a vulnerable level. We welcome Mr. Wijnholds's statement supporting this view.

We commend the efforts being made by the authorities and do not envy the task which remains ahead.

Mr. Mirakhor remarked that the Netherlands stood as an example of a country that could maintain a high level of ODA, despite significant fiscal challenges.

Mr. Kannan said that he commended the authorities for maintaining a generous level of ODA.

The staff representative from the European I Department noted that the current budget projections for 1997 had some margin of safety in case interest rates increased unexpectedly. The staff had recommended further expenditure cuts, if necessary, in the areas of central government welfare transfers and subsidies to enterprises. Over the medium term, the authorities should also focus on increasing the incentives for patients and providers in the health care system to economize on expenditure.

There had been public pressure for further tax cuts, and it remained to be seen whether the authorities could successfully deflect that pressure, the staff representative said.

The latest data on ODA showed that the Netherlands had maintained its level of ODA at 0.8 percent of GDP in 1995, the staff representative remarked.

Recent surveys on the level of part-time work in the Netherlands, the staff representative continued, suggested that there was a preference, particularly among women, to work on a part-time basis; however, those preferences might also reflect the tax benefit structure in the Netherlands, and improvements in that structure might influence people to move to full-time work.

An earlier staff paper had dealt with econometric simulations of the long-term fiscal implications of an aging population, and it had shown that significant savings—about 2–3 percent of GDP—would result from structural policy improvements in the Netherlands' labor market, the staff representative remarked.

On foreign direct investment, it was not clear whether the net balance reflected distortions, the staff representative said. The staff had attempted to look at why there had been strong net outward balance, and it had questioned whether domestic investment was being restrained by product and labor market restrictions, but the evidence was not clear.

It was striking to note that, despite having had a current account surplus for many years, the Netherlands had not registered much net factor income, the staff representative stated. The current account surplus might be somewhat understated because some of that income might be kept abroad, and therefore not fully recorded. Also, the appreciation of the guilder might have affected the level of net factor inflows, as had the historical investment strategy of Dutch individuals.

Mr. Wijnholds remarked that the idea of tax cuts was being considered by some people in the Netherlands, but that the authorities were committed to following the path set out in the staff report and move toward deficit reduction. Also, there was a renewed effort to attack the structural imbalances that plagued the Dutch economy. One symbol of that was the recent liberalization of shopping hours, while another example was the ambitious anti-cartel policy.

The current account surplus had been high for some time, but the concept of the current account balance mattered less than the actual behavior of savings and investment, Mr. Wijnholds continued. Savings remained high in the Netherlands, but they might decline as changes were introduced to the supplementary pension scheme. The investment level in the Netherlands was relatively high compared with its EU partners, but the authorities did believe that it could be higher, and they aimed to boost it through structural reforms, particularly the liberalization of product markets.

The cause of the buoyant job creation and the wage moderation was not entirely clear, Mr. Wijnholds noted, but much had to do with the moderate wage demands of labor unions. Also, the low inflation environment and the deutsche mark link had contributed positively to wage moderation, as had the increase in the participation rate among married women.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. The highly commendable economic performance in the Netherlands in recent years had compared favorably with that in neighboring countries, particularly with regard to employment growth. By fostering financial stability, macroeconomic policies had made a crucial contribution, while structural

policies and wage moderation had also played an important role. In their comments, Directors made a number of interesting remarks on the changing nature of the adjustment process in the Netherlands and in other EU countries, including in particular the reduced role and scope of macroeconomic policy and the increased importance of micro policies and structural reforms. With regard to the latter, Directors noted that an important agenda of economic reforms remained—including further fiscal consolidation, continuing labor and product market reforms, the economic consequences of an aging population, and structural improvements in the tax system

Speakers confirmed their confidence in the Netherlands' monetary and exchange rate policy, and considered that the long-standing policy of a tight link between the guilder and the deutsche mark had clearly benefitted the Netherlands' economy. Directors noted that strong economic fundamentals and the credibility of the authorities' policies were reflected in short-term interest rates lower than in the anchor country. They also welcomed the authorities' commitment to achieving first-round participation in the final stage of European Economic and Monetary Union.

Turning to fiscal policy, Directors welcomed the firm expenditure restraint that had been achieved in recent years, regarding it as a cornerstone of durable fiscal consolidation. However, they noted with concern that the fiscal deficit had continued to be above 3 percent of GDP over the last few years, and that the public debt ratio had remained at about 80 percent of GDP.

Observing that the actual deficit was likely to remain significantly above 3 percent of GDP in 1996, Directors urged the authorities to ensure that spending ceilings were fully adhered to in 1996, and stressed the importance of maintaining a safety margin in expenditure plans. In addition, Directors urged that overriding priority now be given to reduction of the fiscal deficit and the public debt ratio. That would imply sticking firmly to the existing medium-term expenditure ceilings in 1997, and cutting taxes only to the extent that further, matching reductions could be made in public spending. In fact, a number of Directors doubted whether there would soon arise room to cut taxes or social security premiums further. Thus, the policy priority should remain absolutely on getting fiscal consolidation back on track, and to reducing the deficit to well below the 3 percent of GDP level that was needed for Maastricht, as well as to prepare for the health and social expenditures of an aging population.

Looking beyond 1997, Directors urged the authorities to pursue a strategy of reducing the debt ratio from its present high level, and of minimizing the risk that it might balloon again over the longer term as demographic pressures on public expenditure began to be felt. In that connection, Directors stressed the importance of structural reforms that would keep the long-term rise in pension and health care spending within manageable limits. Directors noted that further rapid reduction in the fiscal deficit would generate interest savings that would facilitate a further reduction in the tax wedge. Directors also observed that, as European union progressed, there would be increasing pressure to achieve comparable tax structures, a development that would affect

particularly the high-tax countries such as the Netherlands. At the same time, Directors encouraged the authorities to review the scope for a revenue-neutral tax reform to minimize distortions and remove impediments to private investment.

Directors commended the authorities' efforts to improve the functioning of labor and product markets. They considered that wage moderation, sizable reductions in the tax wedge, and the freezing of the minimum wage and the social benefits had achieved positive results in terms of employment growth. Continuing the thrust of those policies would help to create jobs, particularly among the less-skilled, and to reduce under-employment. Over the medium term, the minimum wage should be set at levels that would not impede employment creation. Noting the high nonparticipation rate in the Netherlands, Directors thought that further steps should also be taken to ensure that social benefits were structured in ways that would strengthen the supply side of the labor market. Directors welcomed the continuing deregulation of the sheltered sector of the economy, and suggested that efforts to further reduce barriers to competition be pursued vigorously. They noted that labor and product market liberalization, together with fiscal reform, should help reduce distortions that might be depressing investment.

Directors warmly welcomed the authorities' strong support for trade liberalization, and the relatively high level of ODA.

The next Article IV consultation with the Netherlands will be held on the standard 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/52 (5/31/96) and EBM/96/53 (6/3/96).

3. SDR DEPARTMENT—DESIGNATION PLAN FOR JUNE–AUGUST 1996

The Executive Board approves the designation plan for the quarterly period beginning June 3, 1996, as set out in EBS/96/74 (5/15/96).

Decision No. 11267-(96/53) S, adopted
May 31, 1996

4. OPERATIONAL BUDGET FOR JUNE–AUGUST 1996

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/96/75, page 2, footnote 4, and the operational budget for the quarterly period June–August 1996 as set out in EBS/96/75 (5/15/96).

Decision No. 11268-(96/53), adopted
May 31, 1996

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 95/5 and 95/63 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAM/96/86 (5/28/96) is approved.

APPROVAL: April 25, 1997

REINHARD H. MUNZBERG
Secretary

