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Minutes of Executive Board Meeting 86/46

10:00 a.m., March 14, 1986

R. D. Erb, Acting Chairman

Executive Directors

J. de Groote

H. Fujino
G. Grosche
Huang F.

Y. A. Nimatallah

J. J. Polak
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J. de la Herrán, Temporary
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A. Vasudevan, Temporary
N. Coumbis
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L. Van Houtven, Secretary
K. S. Friedman, Assistant

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Also Present

European Department: P. Beaugrand, H. B. Junz, G. E. Mackenzie,
K.-W. Riechel, H. O. Schmitt, J. S. Van't dack. Exchange and Trade
Relations Department: J. T. Boorman. Legal Department: A. O. Liuksila.
Personal Assistant to the Managing Director: R. M. G. Brown. Advisors
to Executive Directors: L. P. Ebrill, G. Nguyen, J.-C. Obame,
G. W. K. Pickering. Assistants to Executive Directors: M. Arif,
A. Bertuch-Samuels, B. Bogdanovic, L. Hubloue, O. Isleifsson, S. King,
H. Kobayashi, R. Msadek, K. Murakami, J. E. Rodríguez, A. J. Tregilgas,
H. van der Burg.

1. NETHERLANDS - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with the Netherlands (SM/86/32, 2/20/86; and Sup. 1, 3/11/86). They also had before them a staff report on recent economic developments in the Netherlands (SM/86/50, 3/3/86).

Mr. Polak made the following statement:

As usual the Netherlands authorities are in general agreement with the staff's assessment of the economic performance and policies of their country. Economic policy in the Netherlands continues to be framed in a medium-term perspective. Its aim is sustainable noninflationary growth, not the fine tuning of short-term demand. The staff appears to agree with this general stance. In pursuing such policies, the authorities have stressed the need to revitalize the market sector and to reduce the size of the public sector, which had expanded very rapidly up to a few years ago. Strong priority has been accorded to a reduction of the financial deficit of the public sector, to be achieved primarily through constraining expenditure. The collective burden--the incidence of taxes and social premiums--has also come down somewhat since 1983, from a very high level. The business sector was accorded considerable relief, including cuts in the corporation tax. It has not yet proved possible to lower income taxes, although the purchasing power of consumers has recently been positively influenced by lower social premiums.

Economic developments in the Netherlands showed further, though not spectacular, progress in 1985. Moderate economic growth continued, with the initially export-led recovery becoming more broadly based. Private consumption started increasing again in real terms for the first time in five years. Enterprise investment accelerated to a rate of increase of 8 percent. Overall investment was less buoyant, however, because of a decline in residential construction, which suffered from the severe winter conditions early in the year as well as from the continuation of structural problems. The outlook is for a stronger increase in private consumption this year, rising to perhaps 3 1/2 percent, and for a continued rise in investment.

A turn for the better was clearly discernible in the labor market. For the first time in many years employment in the private sector increased. Besides the continued recovery, wage restraint and reductions in working hours contributed to this result. At the end of December 1985, the number of unemployed had fallen to under 750,000, which equals 15 percent of the dependent labor force--Dutch definition: the figure would be slightly under 13 percent on the basis of the OECD standardized unemployment definition. The overall reduction of unemployment from its peak in June 1984 amounts to more than 100,000 persons,

about half of which is, however, attributable to the exclusion from the unemployment definition of unemployed persons near retirement age. While this decline is a positive development, unemployment remains much too high in the view of the authorities. Incidentally, it is interesting to note that the staff is somewhat more optimistic than the authorities as regards the growth of employment in coming years. The authorities have been careful in recent years not to be too optimistic in their projections and, in fact, may be erring somewhat on the side of caution in their projections for economic growth and employment.

Important progress has been made in recent years in bringing down increases in wages and prices. Last year, wages--as measured by the wage bill per employee--rose by 1.5 percent, which though somewhat more than in 1984, is still quite low in a historical and international perspective. Although the wage increase was somewhat smaller than the increase in consumer prices, real disposable wage income rose somewhat because of a lower burden of social premiums, thus contributing to the pickup in private consumption. Inflation, at 2.3 percent, has come down to the lowest level since 1961. A further decline is expected this year; the decline in the US dollar against the guilder and the fall in oil prices could make for a small decrease in consumer prices.

The staff expresses concern that the recovery in employment may induce large wage increases, leading to a return of former excessive levels. In this connection it points to the generosity of the social security system and suggests that further reductions in benefits are necessary. The labor market situation in the Netherlands at present is indeed difficult to judge. There appears to be some pressure for larger wage claims; this may especially be the case if further demands for work sharing, which are not popular with most employers, are not met. There is also the phenomenon that despite the large number of unemployed persons, there has been evidence of shortages of skilled personnel in a few areas. This points in the direction of a less than satisfactory functioning of the labor market. Improvement in the situation could be brought about by further adjustments in the system of benefits and incentives, as well as through better training opportunities. As the staff points out, a number of measures have already been taken to lower benefits. Furthermore, the Government is committed to a comprehensive reform of the social security system which it hopes will be adopted by Parliament before the general elections to be held in May. As to training, the social partners last year agreed on an increase in opportunities for on-the-job training for youths. A development of some significance is also that wage formation is gradually becoming more decentralized, so that wage increases granted in strong sectors are less likely than before to be followed in sectors that are unable to afford them.

The Government's financial position improved further in 1985. The most recent information indicates that the deficit of the total government sector amounted to 7.3 percent of net national income, which is 0.5 percent of net national income lower than estimated in the budget memorandum 1986. This more favorable result can be attributed to higher revenues due to stronger growth of the economy, to somewhat lower expenditure and to sizable early repayment to the Government of loans for subsidized housing. As submitted in September 1985, the budget for 1986 showed a modest further decline in the central government deficit, which if realized would come down by 3 percent net national income from its peak of 1983. However, given the considerable swing in the financial balance of the social security funds to a deficit in 1986, on account of a cut in social premiums, the total public sector deficit was expected to rise somewhat. It may be pointed out, however, that the deficit projected for the social security funds is to be financed entirely out of surpluses accumulated in the past. Since over time the accounts of the social security funds are balanced, their temporary deficit need not be a cause for concern. Moreover, as unemployment continues to decline, the position of these funds will tend to strengthen.

In the meantime the projections for the total government sector deficit for 1986 have been revised further downward, largely owing to much higher estimates for early repayment of subsidized housing loans. At the same time, the budgetary situation is expected to become much more difficult in 1987 when revenues will undergo the full effects of the lagged adjustment of natural gas prices to lower oil prices. Given the importance of natural gas sales for government revenue, these effects are expected to be very substantial. Recent estimates suggest a loss of revenue of as much as 3 percent of net national income on account of this factor. Since there is a general feeling that the government deficit should come down further in coming years, perhaps to a level of 4 percent of net national income, the setback expected for 1987 has triggered an extensive debate on the need for corrective action.

The main aim of monetary policy in the Netherlands is to maintain a fixed relationship between the guilder and the deutsche mark. Although the authorities are willing to allow in present circumstances somewhat greater changes in the domestic monetary aggregates than they would otherwise have been inclined to accept, they are certainly not indifferent to the growth of the money supply, particularly where domestic sources of money creation are concerned. It cannot be denied that monetary conditions have been expansionary in the Netherlands in recent years. In 1985 the broad money supply, M2, increased by over 8 percent. Since 1982 the annual growth rate of the money supply has been twice or three times that of national income.

As a consequence the national liquidity ratio--M2 as a percentage of net national income--has risen by over 6 percentage points to nearly 44 percent. For the present the Netherlands Bank is willing to continue to accept relatively easy monetary conditions as an inevitable element of the business sector's financial recovery and in view of the current very satisfactory prospects for inflation. Nevertheless it is felt that if the present rapid monetary expansion were to continue unabated, the current price stability would eventually be endangered, even though this is not to be feared in the near future.

In recent discussions with the banks, which led to an agreement on a target for their money creating activities, the Netherlands Bank indicated that domestic money creation should no longer contribute to the rise in the national liquidity ratio. The growth rate of the money supply attributable to money creation by the banks should therefore in its view not exceed that of the trend-based increase in nominal national income, consisting of a long-term real growth component of 2-3 percent and an expected increase in the price level of 1 percent or even less. The banks should therefore limit the creation of money to a level that would be compatible with a stabilization of the national liquidity ratio--namely, a growth in the money supply of about 4 percent for 1986. This corresponds to a maximum increase of 5 1/2 to 6 percent in the credit of the banking system to the private sector plus their long-term lending to the public sector minus their long-term liabilities. The representative organizations of the banking system have agreed to this target. It should be pointed out that gross lending by the banks can increase by a larger percentage, as long as it is matched by increases in their long-term liabilities. The Netherlands Bank feels that a growth rate of net bank credit of 5 1/2-6 percent should not dampen economic growth and expects that it will contribute to consolidation of the results achieved thus far with regard to inflation and the increase in employment.

Preliminary figures for the balance of payments for 1985 show a somewhat larger surplus on current account--on a transaction basis--than last year--f. 18.7 billion versus f. 16.6 billion. This outcome ensued despite a rapid increase in imports--9 percent, excluding energy--and a considerably lower increase in exports than the year before. Besides a strong improvement in the energy account, which is expected to be temporary, the increase in the surplus can be attributed to higher earnings on invisibles, particularly on account of increased capital income from abroad. The large national savings surplus, about 4 percent of GNP, was matched to a high degree by capital outflows, particularly of long-term private capital. Direct investment outflows reached the record level of over f. 10 billion, more than 2 percent of GNP. Foreign borrowers, including the World Bank, have continued to make use of the openness of the Dutch capital

market and borrowed sizable amounts. Given the large outflow of capital, the increase in international reserves was limited to f. 2 billion. For this year a fall in the surplus on current account in the order of magnitude of f. 2 billion is projected as domestic demand continues to expand.

With respect to the exchange rate, the authorities continue to value greatly the stability offered by participation in the European Monetary System and the greater convergence of economic performance achieved within that context. As is well known, the authorities aim to maintain a strong position of the guilder within the European Monetary System. The competitive position of the Netherlands warrants such a stance. It may be expected that in any future readjustment of EMS exchange rates, the current guilder-deutsche mark rate will be maintained. Interest rate policy is strongly geared toward maintaining the position of the guilder within the European Monetary System. In this context the rate differential with Germany is of particular significance. In real terms, both short- and long-term interest rates in the Netherlands have remained high by historical standards, and the lowering of the official discount rate by 1/2 percentage point to 4 1/2 percent last week is particularly welcome from the point of aiding the recovery of investment. It is hoped that interest rates can come down even more in the future. But given the openness of Dutch financial markets this will depend to a large extent on international or regional developments.

Mr. Grosche said that in many important respects the position of the Netherlands economy was better than it had been several years previously. The recovery was in its third year and had been based increasingly on domestic demand, particularly private investment, while the rate of inflation had continued to fall. In addition, there were clear indications of an improvement in the employment situation; the rate of unemployment had recently declined for the first time in many years.

Nevertheless, important problems remained, Mr. Grosche continued. The rate of unemployment remained among the highest of the OECD countries and might well contain a large structural component. That problem, together with the imbalances in the public sector, continued to be the major causes for concern, as they were serious impediments to achieving sustainable long-term growth. Despite the authorities' successful adjustment efforts during the previous three years, the public sector deficit remained large and total government gross debt had continued to rise and was already more than 75 percent of net national income. In addition, interest payments already accounted for 14 percent of total current expenditure and were progressively narrowing the room in which the Government could maneuver in the financial area.

The loss of revenue expected in 1987 as a result of the adjustment of natural gas prices would place additional strain on the budget in 1987, Mr. Grosche noted. Accordingly, the authorities had little choice but to strengthen fiscal discipline even further, particularly as debt interest payments would continue to grow strongly. Indeed, it seemed essential to reduce the fiscal deficit by an amount that would stabilize debt interest payments as a share of net national income by 1990. In view of the already heavy burden of taxes and social security contributions, any further reduction of the deficit must be achieved through additional expenditure cuts. However, since the authorities had already made considerable cuts in social benefits and in public sector wages, the scope for further expenditure reductions seemed to exist mainly in the area of transfers to households and enterprises, including subsidies to ailing industries.

Still, given the size of the fiscal problem, he agreed with the staff that all expenditure categories would have to be carefully scrutinized, Mr. Grosche went on. Mr. Polak's opening statement suggested that the expectation of setbacks in 1987 had triggered an intensive debate within the Netherlands on the need for corrective action, and he himself had noted with interest recent press reports that the Finance Minister had already proposed further cuts. He wondered whether detailed information was available on specific measures that the authorities were considering, and whether the authorities still believed that they could limit the Government's new borrowing to 3 percent--as stated on page 40 of the recent economic development paper--of net national income by 1990 in order to stabilize the relative share of interest payments. Given the need to make further progress in reducing the deficit, a lowering of the tax burden--as desirable as it might well be--did not seem to be feasible for the time being. However, the authorities could consider reforms of the tax structure with a view to reducing the high tax brackets, something that would, inter alia, increase the incentive to work.

There had been unsatisfactory progress in the labor market, Mr. Grosche considered. Given Germany's experience, he was well aware of the difficulty in reducing unemployment. While the magnitude of the problem might be different in each country, the causes and policy prescription to deal with it were essentially the same: significant improvements could be expected only if distortions and rigidities in the labor market were progressively reduced.

Correcting the wage formation process and modifying the occasionally excessively generous social safety net would take time and would require action on several fronts, Mr. Grosche continued. An increase in wage differentiation--both vertically and horizontally--was needed. Greater differentiation between the upper and lower ends of the income spectrum would reduce incentives to replace labor with capital and would increase the incentive to seek more qualified persons to fill positions, thereby enhancing the absorption of labor, as unfilled vacancies remained partly because of a lack of skilled personnel. In addition, decisions on wage increases should take into account more than hitherto the particular

economic situation of individual enterprises and sectors, thereby promoting a shift of labor into expanding and more competitive sectors. The determination of wages was of course the responsibility of all the social partners, but the authorities had an important role to play in removing the distortions and incentives for which they were responsible. They should work toward narrowing the wedge between gross and net earnings and they should scale down social benefits that were sometimes excessively generous in comparison to employment income. In that connection, the recently adopted measures that were part of the reform of the social security system, and the new unemployment legislation that was to become effective in mid-1986 were welcome.

He continued to have serious doubts about the usefulness of further reductions in labor time and an increase in work sharing as means of tackling the unemployment problem, Mr. Grosche said. There were great risks that further steps in those directions would undermine the flexibility of enterprises, would be inconsistent with the objective of removing rigidities in the labor market, and would fail to produce significant positive employment effects.

He warmly welcomed the change in the direction of industrial policy with the shift in emphasis from the support of ailing industries to the promotion of new technologies, Mr. Grosche stated. He was confident that in due course that strategy would contribute to the creation of new and secure jobs.

The decline in real wages and the associated reduction in labor costs in recent years had brought about a much needed improvement in the financial position of Dutch enterprises and had offset a substantial portion of earlier losses in competitiveness, Mr. Grosche noted. Those gains should be further consolidated; they had made an important contribution to the recovery of private investment and to the improvement in the employment situation. He agreed with the staff that a resurgence of wage pressure must be avoided and that unemployed labor should be reabsorbed in a noninflationary manner.

The authorities had made commendable progress in reducing the rate of inflation, Mr. Grosche said. A further decline was expected as a result of the recent sharp drop in oil prices, but the continued strong rise in domestic liquidity was a cause for concern. While monetary expansion had not yet resulted in upward pressure on prices, the acceptance by the authorities of the staff's recommendation to tighten monetary conditions moderately was welcome. The recent agreement with the banks on limits on the expansion of domestic credit should be helpful. For some time, fiscal and monetary policy would continue to be confined to meeting that consolidation objective, and a resurgence of demand must therefore rely mainly on growth in the private sector. Hence, the Netherlands Bank's recent decision to lower its interest rates by half a percentage point was welcome. That step--which had been made easier by the reduction of interest rates in other industrial countries--could make a further contribution to strengthening the growth prospects.

The authorities were to be commended for their firm commitment to free trade, Mr. Grosche stated. In addition, they had maintained a high level of official development assistance, despite the substantial constraints on the budget.

Mr. de Groote remarked that the authorities were making progress in their adjustment effort. The level of the consolidated public sector deficit had been reduced from nearly 11 percent of net national income in 1982 to less than 8 percent in 1985, the public revenue burden had decreased slightly, and labor costs in the energy sector had fallen from 91 percent of value added to 83.5 percent, yielding a substantial recovery of the competitiveness of enterprises and enabling the economy to respond strongly to the pickup in foreign demand in 1983/84. The reduction of the fiscal deficit and the increase in profit margins had apparently established the foundation for an expansion of business investment.

The effects of the structural adjustment measures on the growth and employment prospects were still somewhat disappointing, particularly in view of the considerable efforts that the Government had made to reverse the imbalances that it had inherited, Mr. de Groote continued. More strenuous efforts might be needed to eliminate the remaining imbalances, since according to the revised growth projections for 1986 the Netherlands would be one of the few industrial countries that would not experience an increase in output and aggregate demand as a result of the decline in oil prices. The main task facing the authorities was to continue on their chosen policy path while ensuring that the additional adjustment efforts would be made as efficiently as possible in order to achieve a growth path that would be consistent with a sizable reduction in unemployment. His comments would therefore focus on prospective wage policies and public sector developments, including their implications for growth and development.

The 3 percent reduction since 1982 in the share of the public sector deficit in net national income was a remarkably good performance, given the fact that it had been accomplished by reducing public expenditure, something that was difficult in the highly socialized Dutch economy, Mr. de Groote remarked. The public sector deficit and the share of public expenditure in GNP were still very high by international standards: the public sector deficit was the equivalent of about 8 percent of net national income, and public expenditure was the equivalent of about 70 percent of net national income, one of the highest proportions of any country. Reducing public sector expenditure in the long term should perhaps be given a higher priority than reducing the budget deficit itself.

There were several conflicting policy goals, Mr. de Groote went on. He fully agreed with the authorities that fiscal policy should be aimed at reducing the budget deficit sufficiently to stabilize the stock of public debt and associated interest payments in terms of national income. However, a strict commitment to continuous reductions of the budget

deficit left little room in which to reduce the heavy burden of taxes and social security charges. Nevertheless, a moderate easing of that burden would give a welcome boost to domestic demand and would be fully justified by both the high rate of unemployment and the external current account surplus.

Although the authorities had not acknowledged that they had adopted a somewhat more expansionary budget stance, the 1986 budget seemed to take a moderate step in that direction, as lower social security charges would cause the overall public sector deficit to rise for the first time since 1982, Mr. de Groote commented. He wondered why the authorities believed that that change did not constitute an easing of fiscal policy, as the deficit in the social security sector would be fully covered by surpluses accumulated in previous years. The deficit in the social security sector probably would not be temporary; after the surpluses accumulated in previous years had been consumed, the deficit would re-emerge and would have to be covered either by raising social security charges to their old level or by running a somewhat larger public sector deficit. The authorities faced a dilemma: they must choose between the long-term benefits of further fiscal restraint and the short-term benefits of the boost to domestic demand that would be obtained through a moderate fiscal stimulus.

The authorities would face a similar dilemma in 1987, when they would have to decide whether to offset the shortfall in natural gas revenue by making additional expenditure cuts or by tolerating a temporary increase in the budget deficit, Mr. de Groote continued. If the authorities expected that the revenue shortfall would be temporary, they should not abandon their cautious but sustained approach to expenditure reduction over the previous three years. A temporary upsurge in the fiscal deficit might be the best response. However, if the decline in natural gas revenue was felt to be structural in nature, corrective action accelerating the pace of spending cuts might be unavoidable. It would be unwise to make that adjustment too sudden or too drastic, thereby possibly prematurely shutting off the upsurge of domestic demand that was expected in 1986.

Domestic demand considerations should also guide the authorities in the formulation of their wage and incomes policy, Mr. de Groote said. There had been a substantial transfer of resources from households to enterprises over the previous five years as a result of the moderation of income growth. The restoration of external competitiveness that had been achieved through that policy was clearly reflected in Chart 5, which showed that the real effective depreciation of the guilder since 1980 had yielded a sizable gain in market shares for the Netherlands' nonenergy exports. Consolidating those gains, rather than attempting to increase them, seemed to be the best approach at the present stage of the adjustment effort; a reinforcement of wage moderation might well have a dampening effect on income and employment. The slight upward pressure on wages that might result from an increase in employment owing to the recovery of domestic demand was no longer a cause for serious concern. The more

important question was whether the desired increase in employment would materialize. The job time-sharing formulas and the effort to reduce structural rigidities in the labor market had thus far failed to reduce unemployment. The recent increase in the flexibility in the labor market could lead to a significant increase in the demand for labor only if there was a substantial expansion of private investment. The staff and the authorities expected foreign demand to decline, and the impetus for an improved investment outlook would have to come from a sustained expansion of domestic demand. It was therefore crucially important that, given the more favorable monetary conditions and the surge of domestic demand expected in 1986, fiscal and incomes policy should be formulated in such a way that the benefits to the economy of lower oil prices would be maximized.

The authorities were to be commended for their continuous commitment to a development assistance target of 1.5 percent of national income, Mr. de Groote stated. Most of the Netherlands' aid was in the form of official development assistance. The Netherlands' aid record was matched by very few other industrial countries.

Mr. Templeman remarked that the authorities' economic strategy was focused on medium-term objectives, including structural reforms, especially in the labor market and in the fiscal accounts. Substantial progress had been made in some areas. Unit labor costs in manufacturing had fallen in 1983-85 and were expected to rise by only about 1/2 percent in 1986. That trend had clearly helped Dutch competitiveness. In the fiscal area, total revenue and the collective burden of taxes and social security service contributions had been stabilized and slightly reduced as a percentage of net national income after reaching peaks in 1983. In addition, the ratio of public sector expenditure to net national income had fallen from the peak in 1983 of almost 73 percent to the 1985 estimate of about 69 percent.

However, some serious problems remained, Mr. Templeman continued. The unemployment rate was still very high--15 percent--even though it had fallen slightly since 1984, and modest employment growth had occurred in 1985. The staff had suggested that any further rise in employment could pose a threat to continued restraint on the growth of real wages, a conclusion that underscored the persistence of the serious labor market rigidities. Moreover, the wage wedge between gross and net wages and salaries remained large, reflecting the high labor costs that continued to confront business managers when they considered new hires and the relatively lower take-home pay and work incentives for laborers seeking work.

While the authorities were well aware of the labor and fiscal problems that still had to be dealt with, they had continued to follow a rather gradualist approach to maintaining economic growth and external balance, Mr. Templeman noted. Indeed, the staff had concluded that the policy stance for 1986 was essentially one of no change. That conclusion raised questions about the effects of the authorities' policies on

world economic growth and global external balance. For example, total domestic demand had been rising at a very moderate rate since the 1981/82 recession, and growth of only about 2-2 1/2 percent was expected in both 1985 and 1986 even after the positive impact of the oil price decline. In addition, the recovery of savings in both the public and business sectors had generated total domestic savings which exceeded the demand for investment in the Netherlands, thereby causing a savings to be sent abroad and current account surpluses to accumulate. Such surpluses did not seem inappropriate for the Netherlands, but they had been growing steadily as a share of GNP, from 2 percent in 1981 to nearly 4 percent in 1984 and 1985, and the surplus was expected to fall only slightly, to about 3.6 percent, in 1986, even after the adverse effects of the drop in world oil prices were taken into account. Although he did not wish to stretch the analogy too far, those ratios were only slightly less than those of Japan. A comment on the contribution by the Dutch economy to world economic growth and external balance would be helpful.

The staff had noted that the improvement in the profitability of business enterprises was being used to a substantial extent to strengthen the balance sheets of businesses rather than to accelerate business fixed investment, and that the large debt burden of businesses would require some increase in the equity base if a sustainable pattern of business investment was to be achieved in the future, Mr. Templeman remarked. A further comment on means of increasing the mobilization of equity capital, including from sources outside enterprises, would be helpful.

The direction of industrial policy was being changed: the attention given to assisting industrial sectors in trouble was being reduced, and greater attention was being paid to industries with growth potential, Mr. Templeman observed. Apparently the rationalization of industries such as the steel, automobile, and aircraft industries was nearly complete, and subsidies to shipbuilding were to be terminated at the end of 1986. Emphasis was being given to encouraging the growth of high technology industries and to capital formation. For philosophical and practical reasons, he was skeptical about the significant involvement of government in those matters. There was often a great temptation to bail out ailing industries and to subsidize the growth of new industries in which a country might not enjoy a comparative advantage, and he hoped that in maintaining an active industrial policy the authorities would strongly resist those temptations.

Wage restraint had clearly had substantial success in constraining wage costs, Mr. Templeman said. It was less clear that greater wage differentiation had been achieved, although the gradual decentralization of wage formation to which Mr. Polak had referred in his opening statement might be helpful. In addition, the progress that had been made in overall wage restraint apparently was fragile, serious labor market rigidities seemed to remain, and his authorities remained skeptical about work sharing as a means of attacking the unemployment problem. The reoccupation ratio--the ratio of new jobs created for each 1 percent

cut in hours worked--of 25-30 percent was not reassuring, although the authorities might feel compelled to maintain the work-sharing approach as part of their overall effort to deal with the exceptionally high rate of unemployment. However, other more fundamental measures to make hiring more attractive to business managers and work more attractive to laborers should be implemented vigorously. In particular, additional training might be required to deal with the mismatch of demand and supply for skilled and unskilled labor. Moreover, while the unemployment entitlement period was likely to be reduced around mid-1986, persons who were currently listed as unemployed would not be affected. While replacement ratios with respect to unemployment insurance and disability benefits were cut in 1984 and 1985, respectively, the replacement ratio of 70 percent seemed very high. He wondered whether further steps were being planned to reduce that ratio and whether the authorities were considering eliminating the equivalency between the net minimum wage and the net minimum social benefit in order to increase work incentives.

Moderate progress had been made in reducing the size of government and in cutting the public sector deficit, Mr. Templeman remarked. However, the ratio of the public sector deficit to net national income had been in the range of 7-11 percent in 1980-85, was expected to be about 7 1/2 percent in 1986, and could considerably increase in 1987 owing to the decline in gas revenues; that trend was a cause for serious concern. He agreed with the staff that such ratios were unsustainable and he hoped that the ratio would be substantially reduced, particularly through expenditure restraint. Such large deficits could have significant actual and potential effects on interest rates, interest payments, the public debt burden, and debt management. In addition, the existence of an exceptionally high public sector expenditure ratio--nearly 70 percent--and the broad agreement on the need to increase private investment to create jobs suggested that there was a continued need to reconcile important competing policy objectives. Over the medium term, the authorities planned to reduce the ratio of expenditure to national income, but the revenue ratio would remain essentially flat. However, that strategy apparently was still expected to produce a ratio of the government deficit to net national income of 4-4 1/2 percent by 1990. Given the ratio of public debt--including local government debt--to net national income of 75 percent in 1984, he wondered whether the objectives for the expenditure and revenue ratios and the fiscal deficit were sufficiently ambitious.

He welcomed the staff's preliminary calculations on the effects of the recent oil price drop on the balance of payments, fiscal accounts, and the outlook for economic growth, Mr. Templeman remarked. The external current account surplus was expected to be lower by 0.3 percent of GNP in 1986 than had been previously forecast. He wondered whether the staff had also recalculated the projected current account position in 1987. There had been a clear and steady rise in the Netherlands' share of non-energy export markets in 1978-85. In light of recent exchange rate movements, he wondered whether the staff had re-evaluated its conclusion that the Netherlands was likely to become modestly less competitive in 1986. The generally liberal trade policy that the authorities had maintained

within the EC and in other forums was commendable; that conclusion was particularly applicable to agriculture, services, and video cassette recorders. The authorities' support for a new round of multilateral trade negotiations was welcome.

The authorities continued to struggle with a very high rate of unemployment and related market rigidities as well as an unusually large public sector, Mr. Templeman commented. Some progress was being made, but he wondered whether the pace of improvement was fully adequate. Faster progress would be beneficial not only for the domestic economy but also for the overall world adjustment process. The Dutch economy was large and had traditionally been very open to the rest of the world. A better economic performance in the Netherlands could make a substantial contribution to satisfactory world economic growth and better external balance.

Mr. de Forges said that the picture of the Dutch economy was somewhat brighter than it had been during the 1985 Article IV consultation. The authorities were to be commended for their achievements in the areas of growth, inflation, and the external current account. At the same time, there were still deeply embedded imbalances in the economy; the unemployment rate was among the highest, and the size of the budget deficit was among the largest, of the industrial countries and were clearly unsustainable.

The mixed performance reflected the structural problems in the Dutch economy, Mr. de Forges continued. The present situation of the Netherlands was traceable to the extensive and social benefits system. Since 1982, the authorities had been implementing adjustment policies aimed at correcting the structural problems and had avoided trying to tune short-term demand. That strategy was commendable, although progress had been slow, as efforts to reverse fundamental trends took time. The thrust of the staff's appraisal was appropriate; it was in line with the appraisal in the staff report for the 1985 Article IV consultation (SM/85/104, 4/10/85).

Despite some progress in the area of public finances, the public sector deficit's share of net national income remained at the 1981 peak, Mr. de Forges remarked. The public sector deficit--7.3 percent of net national income--was below the 1982 peak but was expected to rise again in 1986 and 1987. Gross public debt had increased by 13 percent of net national income over the previous two years alone, and interest payments had risen by 3 percent of net national income between 1980 and 1985. The prospects for the fiscal position were worrying, particularly in light of the drop in natural gas revenues. In the circumstances, he wondered whether the staff continued to believe that some fiscal stimulus was appropriate. On page 21 the staff had noted that a short-term stimulus to consumer demand had been obtained, but perhaps at the cost of somewhat greater uncertainty regarding the long-term prospects for the public debt. An increase in the public sector deficit could wrongly give the

impression that the authorities were relaxing their policy stance. He agreed with the staff that future expenditure cuts might well be required in all expenditure categories.

The overall rate of unemployment had increased by 8 percent between 1980 and 1985, as stated on page 9 of the staff report, but the private sector had been losing jobs at a rate of almost 12 percent during that period, Mr. de Forges noted. The manufacturing and construction sectors had recorded the largest losses of jobs. The recent decline in the rate of unemployment seemed to have been impeded by structural obstacles; indeed, half of the decline in unemployment was attributable to changes in the definition of unemployment. The real costs of the difficult employment situation--part-time employment and workman's disability payments--could only be assessed in the long run. He wondered whether international comparisons of the costs of such factors were available. The authorities intended to modify the system of investment subsidies by, for example, cutting off subsidies to the shipbuilding industry. An estimate of the effect of those modifications on employment would be useful.

The external sector had performed fairly well during the previous three years, owing to the combination of the slack in domestic demand and the improvement in competitiveness as a result of wage moderation and increased productivity, Mr. de Forges noted. Market shares--especially in the United States--had increased steadily. Given the appreciation of the guilder against the U.S. dollar, a comment on the Netherlands' export prospects would be helpful, particularly in view of the large discrepancy between the projections by the staff and the authorities.

The authorities' strategy of gradual adjustment, compared with the more active approach favored by some observers, should be re-examined in the light of recent developments, Mr. de Forges considered. The various areas of policy action should be reviewed, preferably in a joint effort by all the social partners. That review should be designed to set appropriate priorities, particularly those affecting the maintenance of the welfare state, which had been established under more favorable conditions in the past but which at present hindered the effort to stabilize the public finances and exacerbated the unemployment problems through the many rigidities that were described in the staff report. He hoped that the comprehensive reform of the social security system to which the Government was committed would be completed.

The reduction in interest rates should help to reduce the burden of the public debt--and thereby the budget deficit--and to sustain investment, mainly in the housing sector, as well as domestic demand and employment, Mr. de Forges remarked. The Netherlands should take all available opportunities--especially the stronger growth in its main trading partner, Germany--to make further progress. To that end, the authorities must maintain a sufficiently competitive edge, primarily through continued wage restraint. Moreover, given the greater convergence of economic

policies and performance in Europe, the rigidity resulting from the close link between the guilder and the deutsche mark seemed less necessary than in the past.

A further comment on the main factors in the current debate in the Netherlands on the effects of the drop in energy prices would be helpful, Mr. de Forges said. What was the initial forecast by the authorities of the distribution of the expected benefits--including the correction of imbalances and especially in the fiscal area--from the decline in energy prices?

The openness and dual character of the Netherlands economy were common to some of the Netherlands' neighbors, and useful lessons could be drawn from the evolution of the Netherlands economy, Mr. de Forges remarked. Finally, the authorities were to be commended for their official development assistance performance.

Mr. Nimatallah observed that the economy continued to suffer from several weaknesses that were slowing its growth: big government, a large fiscal deficit, high unemployment and labor costs, and, above all, structural rigidities. The Government had recently had some success in dealing with those weaknesses, as both the fiscal deficit and labor costs had been slightly reduced while the rate of unemployment had declined somewhat. The authorities were to be commended for those efforts, but further progress was needed on all fronts.

In the medium term, the authorities should focus on two major problems, the large size of the government sector, and the structural impediments to growth, Mr. Nimatallah continued. At present, the government sector absorbed a relatively large share of national resources by any standard in the industrial world. The size of the public sector had increased sharply, from about 40 percent of GNP in 1970 to about 60 percent in 1985. Moreover, much of that increase had been due to the growth of the social security system, which meant that the quality of government expenditure had deteriorated. Increases in Government expenditure in the form of transfer payments usually resulted in resource misallocation. His remarking on the large size of the Government was not meant as a criticism of the Dutch system. After all, the Dutch people generally seemed to be pleased with the present social system. However, if the Dutch Government and people were to achieve a higher rate of growth, there would have to be a transfer of resources from the government sector to the private sector, and apparently the authorities themselves agreed that further reductions in the size of government would be desirable.

The staff had noted that the recent reduction in the fiscal deficit had released savings at a faster rate than the recovery in business investment could absorb, Mr. Nimatallah continued. The transfer of resources from the government sector to the private sector should be made carefully to ensure that the private sector would be prepared to utilize the resources effectively. The authorities should encourage the private sector to take up the slack as fiscal retrenchment took hold. There were

of course a number of ways in which the private sector could be encouraged. There had recently been important steps to reduce the rediscount rate, cut labor costs, and make tax modifications with a view to enhancing business sector profitability.

Unemployment had increased rapidly in the early 1980s and, while it had recently declined, it remained very high, Mr. Nimatallah remarked. Fiscal reform clearly had a role to play in alleviating that problem, but further efforts were needed to reduce structural rigidities in order to improve the functioning of the labor market itself. He agreed with Mr. Polak that further adjustments in the system of benefits and incentives were needed and that better training opportunities should be made available. The recent initiative to reform the social security system was welcome and should be completed as soon as possible. It would make a direct contribution to increasing the flexibility in the labor market and would help to meet the goal of reducing government expenditure. The authorities' use of innovative schemes, such as the current work-sharing arrangements, was also encouraging. On previous occasions he had suggested that the same approach would help to solve the problem of unemployment in the United Kingdom and some other industrial countries. The arrangements were a helpful innovation, but there should be a reduction in the cost of separation, which had discouraged employers from taking on additional workers and had encouraged them to use overtime instead. The most effective solution to the unemployment problem was to create an environment in which the private sector could readily increase its investment expenditure.

A significant feature of the recent recovery of the economy was the emergence of a large external current account surplus, Mr. Nimatallah observed. There had been an increase in long-term private capital outflows, particularly net investment abroad. While that trend could be beneficial from a global viewpoint--the World Bank had been able to raise funds in the Netherlands--it was further evidence that, despite the recent progress, the attractiveness of domestic investment might need to be further enhanced.

The authorities were to be commended for their firm commitment to the principle of free trade and for their generous official development assistance program, Mr. Nimatallah stated. They were also to be commended for their efforts to tackle the medium-term problems facing the economy in order to restore balance to the economy and to enhance growth. The authorities should aim to meet the following medium-term targets: to reduce the size of government by about 40 percent, to its size in 1970; and to increase the ratio of investment to GNP to the 1980 level of 22 percent. In addition, the private sector should be encouraged through policies designed to increase profitability. That effort would help to reduce further the rate of unemployment.

Mr. Rye said that, at first glance, the Netherlands economy appeared to have made reasonable progress on most fronts. Indeed, in some areas, such as the rate of inflation and the external balance, the results would

perhaps be envied by many other countries. However, a deeper look at the economy suggested that caution was called for; once an economy moved too far off course and economic relationships became seriously unhinged, a policy of gradualism would at best produce only gradual results and at worse ran the risk of reaching a dead end. Performance in a number of key areas--such as monetary policy--had been favorable. The authorities were sufficiently aware of the eventual risks of the continuation of the present rapid monetary expansion. In addition, the exchange rate policy was appropriate. The hard-currency approach and the stability from participation in the European Monetary System had much to offer. Of course, in both the monetary and exchange rate areas, the Netherlands, which was interrelated with the German and other economies, did not have considerable room in which to maneuver. However, the room that was available had been wisely used.

Another constraint on both monetary and exchange rate policy was the massive fiscal deficit, Mr. Rye went on. It was in that area and in the authorities' approach to structural issues that present policies were more open to substantial criticism. The authorities' approach to fiscal consolidation was obviously a gradual one and could at best yield only gradual results. The fiscal targets were modest, and the actual recent achievements were even more so. A decline of 2 1/2 percent in the ratio of the public sector deficit to GNP over the previous four years would hardly have been dramatic, and the failure to achieve even that target was regrettable, especially in light of what remained to be done. A number of countries had decided that they must and could move much faster in fiscal consolidation than the Netherlands. Such comparisons were often questionable, but the longer-term benefits of more rapid movement in the Netherlands probably far outweighed the short-term costs.

He was worried that the Netherlands was running the risk of becoming locked into large public sector deficits indefinitely because of the decline in revenues following the fall in natural gas prices and the growing debt servicing burden, Mr. Rye continued. Those risks were evident in Table 19 of the staff report on recent economic developments in the Netherlands. Interest on the public debt had risen from less than 8 percent of total budgetary current expenditure in 1981 to an estimated 15 1/2 percent in 1986, and the ratio was still growing quickly. That rise had more than offset the sharp decline in the share of transfers to the social security system.

As for the results of the authorities' gradual adjustment efforts, those also had obviously been gradual, Mr. Rye remarked. In his opening statement Mr. Polak had noted that in 1985 a turn for the better had been clearly discernible in the labor market. However, Mr. Polak had also underscored the magnitude of the employment problem in stating that the increase in private sector employment in 1985 was the first in many years. The projected growth in output of about 2 percent a year promised at best no more than further marginal improvements in employment.

Private investment growth must be strengthened if the overall economic performance was to improve, Mr. Rye commented. The staff had noted on page 19 of its report that enterprise investment could well grow at about 7 percent per year in real terms, bringing the investment ratio back to more traditional levels within five or six years. The fact that so much time would be needed to restore the investment ratio underscored the depth of the problems facing the economy. Indeed, it seemed unlikely that the Netherlands would be able to maintain enterprise investment growth of about 7 percent in real terms over the long run while the public sector continued to draw heavily on national resources. He wondered whether the 7 percent figure was meant to be a serious forecast or merely an illustration of what would be required for a return to a normal growth pattern. If the figure were a forecast, he wondered why such a rapid rate was expected.

The staff had raised the question on page 12 whether a case could be made for easing the pace at which the public sector deficit was being reduced, Mr. Rye noted. That question seemed inconsistent with the staff's assessment on page 21 that the fiscal deficit remained unsustainably large, and in his view, no convincing such case could be made. He agreed with the staff that more needed to be done to curtail the generosity of the social security system, especially as benefits seemed to impinge on the relative attractiveness of work.

While he hesitated to advocate an increase in taxation, the oil price fall seemed to offer an opportunity as well as a challenge for the Netherlands, Mr. Rye commented. The authorities in most countries faced a choice between allowing lower oil prices to flow through to consumers or increasing consumer taxes on oil and associated products to aid in fiscal consolidation. In many countries, a balance between those two objectives needed to be struck. In the Netherlands, that balance should lean heavily toward fiscal consolidation.

That the authorities had not yet adopted quantified medium-term fiscal targets for the period beyond 1986 was disappointing, Mr. Rye said. At the least, as the staff had suggested, the authorities should seek a 4.5 percent deficit by 1990 in order to stabilize by 1994 the proportion of interest payments to net national income. Apparently those targets would involve more rapid adjustment than hitherto.

He harbored some doubts about the authorities' approach to dealing with structural problems, Mr. Rye commented. Such policies as work sharing were palliatives at best and were likely in many cases to prove to be counterproductive. There was nothing in the Netherlands' experience to suggest that that conclusion did not imply. Indeed, the staff report clearly showed that the difficulties caused by the work-sharing program were rapidly increasing. He hoped that the authorities would re-examine their support for work sharing.

On page 15 the staff had noted the change in the authorities' industrial policy with their adoption of a more aggressive and selective stance designed to encourage the development of new and profitable technologies, Mr. Rye remarked. That effort seemed equivalent to the practice of "picking winners," an effort for which most governments had shown little facility. The "priority sectors" in the Netherlands--information processing, microelectronics, telecommunications, and biotechnology--were the same sectors that most other governments were favoring. As a result, the Netherlands' various efforts in those areas were likely to yield small benefits. A further comment on any real comparative advantage that the Netherlands enjoyed in those areas would be helpful.

The staff had noted on page 16 that the authorities had stressed their commitment to a liberal trade and payments system within the terms of the common commercial and the common agricultural policies of the European Communities, Mr. Rye noted. However, that commendation had been dampened by the staff's comment on the same page that the record of the European Communities in recent years had been respectable in the view of the Dutch authorities. Many countries outside the European Communities had a much less favorable view of its trade policies.

Mr. Fujino remarked that the Dutch economy had continued to recover in 1985 from its most severe postwar recession. Private investment had continued to pick up rapidly, and the 1.4 percent increase in private consumption in 1985 seemed to indicate that the long-awaited restoration of consumer confidence had finally occurred. The rate of inflation, as measured by the consumer price index, had decelerated to 2.3 percent in 1985, and unemployment had declined further.

During the initial period of the present recovery of the Dutch economy, the marked improvement in cost competitiveness had enabled Dutch manufacturing industries to respond strongly to the recovery of the world economy, Mr. Fujino continued. The improvement in competitiveness had stemmed not only from a moderate depreciation of the guilder in effective terms but also from a substantial decline in relative unit labor costs. The authorities' efforts to moderate wages and the strong gains in productivity in the manufacturing sector had contributed to that favorable outcome.

The relatively strong recovery of private investment in 1985 was reflected in the increase in investment in enterprises whose capacity utilization had neared their maximum, Mr. Fujino commented. However, the level of private investment remained very low in relation to the improved profitability and by historical standards. That outcome could be explained partly by the high level of interest rates and by the uncertainties about the sustainability of the economic recovery. A sustained recovery of investment would be facilitated by a reduction of the public sector in total economic activity, removal of the rigidities in the labor market, a broadening of the equity base of enterprises, and a reduction of the corporate tax burden. The shift in industrial policy was welcome,

but the excessive reliance on that policy had run the danger of weakening private initiative. A further comment on the role of industrial policy in the Netherlands would be helpful.

Although the unemployment rate had continued to decline, it was still about 15 percent, Mr. Fujino noted. The decline in unemployment in 1984 and 1985 had been concentrated on persons who had been unemployed for a relatively short period; long-term unemployment had continued to rise during those years. At the same time, however, unfilled vacancies had been increasing, and the expansion of employment during the economic upswing ran the risk of a resurgence of wage pressure. There was a clear need to improve the quality and mobility of labor. In that connection, the staff had correctly underscored the adverse effects of the work-sharing program. Work sharing would have to be implemented in a more selective manner in the future. Reforming the social security system by reducing unemployment benefits would help to enhance the incentive to seek work. A series of minimum wages would also contribute to that objective.

The Dutch guilder had weakened within the European Monetary System at the beginning of 1985, Mr. Fujino observed. That movement had been gradually reversed during the year, as the short-term interest rate differential with Germany had widened in the Netherlands' favor. That weakening of the guilder could be interpreted as an indication of a lack of confidence in the guilder in comparison with the deutsche mark. That possibility underscored the need to restore confidence in the economy.

He endorsed the thrust of the staff appraisal, Mr. Fujino said. In line with the authorities' basic objective of correcting the structural imbalances in public finances, expenditure control had been used to reduce the deficit of the total government to 7.3 percent of net national income in 1985. While the 1986 budget provided for a further decline in the central government deficit, the total public sector deficit was expected to increase somewhat owing to a cut in social security premiums. That possibility should not be interpreted as an easing of the fiscal policy stance. Given the continued high level of the government deficit, further reductions in that deficit would be needed over the coming years, as the authorities themselves had recognized. However, a substantial shortfall in revenue was expected because of the reduced price of natural gas, and the magnitude of the required expenditure restraint after 1987 would involve much greater determination by the authorities.

The growth of the monetary aggregates had continued to be on the high side in 1985, Mr. Fujino observed. The level of investment was admittedly still too low, but appropriate caution was called for with respect to the future course of the money supply, particularly in light of the money supply's upward pressure on prices and downward pressure on the exchange rate. The authorities had recently adopted a moral suasion approach to maintaining monetary restraint, and a comment on its effectiveness would be helpful. Interest rates continued to be high by historical standards, and the recent reduction of the official discount

rate was welcome, as it should help to promote the recovery of private investment. Finally, the authorities' firm commitment to a liberal trade system and their continued opposition to protectionist pressures were welcome.

Mr. Foot commented that economic policy in the Netherlands continued to be framed in a medium-term perspective and was aimed at achieving sustainable noninflationary growth. The authorities had made impressive progress toward achieving price stability, and the economy was entering its fourth year of economic growth. Those major achievements should be borne in mind during an examination of the problems facing the Dutch economy; those problems were common to many other European countries. In particular, despite the significant success in reducing the rate of inflation and in consolidating the fiscal position, unemployment remained stubbornly high, even after allowing for what appeared to be the flourishing parallel market, something that was also common to other European countries. The Dutch Government as well as the authorities in most of the other European countries faced the major challenge of placing unemployment on a firm downward trend.

The authorities apparently needed to improve the functioning of the supply side of the economy in general and of the labor market in particular, Mr. Foot remarked. Future staff reports on the Netherlands should assess the progress that was being made in the implementation of the diverse available measures to deal with those areas.

The authorities had already introduced a wide range of supply-side measures, Mr. Foot continued. The further measures that were being considered included a major review of the social security system and an examination of the minimum wage. Additional measures to improve the social security system not only would provide significant fiscal benefits but also could improve incentives. The social security system in the United Kingdom contained substantial disincentives to work, and Mr. Foot recognized that reforming the system was difficult because of the interest groups involved and because of the sheer complexity of the system.

Additional measures to improve the supply-side performance of the economy seemed appropriate, especially to promote profitable domestic investment opportunities and to discourage the strong outflow of private sector savings that seemed to have occurred in recent years, implying the need to improve the outlook for domestic industry, Mr. Foot went on. In that connection, the strong recovery of profitability was encouraging, but private investment remained at historically low levels in comparison to the flow of domestic savings.

Policy measures in other areas could contribute to the main objective of improving the supply-side performance of the economy, Mr. Foot continued. In 1985, the Government had made further progress in reducing the share of public expenditure in national income and in curbing the public sector deficit. The policies that had helped to achieve those objectives would need to be maintained over the medium run if greater

room was to be created in which to promote private sector activity. In that context, expenditure on social security would have to be examined closely. The outlook for fiscal policy in the short run was negatively affected by the prospects for gas revenues, especially in 1987 and beyond. The weakened gas revenue performance was likely to place an additional burden on the fiscal position over the coming several years and underscored the need to avoid any relaxation of fiscal policy in the short run. In any event, the overall public deficit was expected to increase in 1986, owing mainly to the projected deficit in the social security fund. That increase in the overall public sector deficit was perhaps not a sign of a weakening of the underlying fiscal condition because it had resulted from the need to run down the surpluses that had been accumulated by the social security funds in recent years, but it underscored the need to avoid any further fiscal stimulus. The public sector deficit should continue to be an important indicator of developments in the economy, as it represented the actual burden of the public sector on the private sector and the capital markets in any given year.

Monetary policy continued to be aimed at maintaining a fixed relationship between the guilder and the deutsche mark, Mr. Foot said. To the extent that the German economy gained relatively more from the fall in the price of oil and gas than the Dutch economy, monetary policy might come under some pressure. The differential between Dutch and German short-term interest rates might need to be increased. A comment on the likely extent of those pressures and on the means by which the authorities might best respond to them would be helpful.

The arrangements with the main banking associations to restrain the growth of certain parts of banks' balance sheets suggested two conclusions, Mr. Foot remarked. First, the Dutch banking system faced limited competition. The United Kingdom had been unable to make such an approach work since the early 1960s, when the U.K. banking system had still been cartelized, and even then the results in the form of a rapid and not particularly helpful form of disintermediation had been disquieting. Second, the authorities had considerable confidence in their ability to establish the appropriate ceilings for bank lending and broad money that were compatible with the maintenance of a fixed relationship between the guilder and the deutsche mark.

He strongly supported the medium-term objectives that the authorities were pursuing in an effort to deal with the serious structural problems, Mr. Foot said. The modest recovery and gradual fall in unemployment over the previous year suggested that those policies were beginning to bear fruit, and the authorities should maintain and, where appropriate, strengthen them in coming months.

The authorities were to be commended on the level of Dutch development aid, Mr. Foot commented. In addition, there had been a significant improvement in Dutch statistics: the availability over the previous

six months or so of quarterly GNP data was a critical element in the surveillance of the Netherlands economy, which was an important one in the context of the world economy.

Mr. Fugmann commented that 1985 was the third year of the recovery of the Dutch economy after the 1981-82 recession. The economy's performance in 1985 was encouraging in many respects, although it was clearly not spectacular: GNP was estimated to have expanded, albeit modestly, while inflation had been virtually squeezed out of the economy and unemployment was declining. Despite those welcome improvements, the Dutch economy was still characterized by significant domestic imbalances on the budget side and in the labor market as well as by a substantial external surplus.

There had clearly been improvements in public finances, although the outlook in that area was nevertheless uncertain, Mr. Fugmann remarked. The deficit of the consolidated public sector had been reduced from a peak of nearly 11 percent of net national income in 1982 to 7.3 percent in 1985. The authorities had not expected to reach a rate as low as 7.3 percent until 1986. However, unless the Government made severe expenditure cuts, the deficit was likely to increase again, first in 1986, owing to the cut in social security contributions, and again in 1987, when revenues from gas were likely to decline by perhaps as much as 3 percent of net national income. Although substantial retrenchment had been achieved through expenditure restraint, clearly more had to be done in that area in order to reduce the government deficit without once more raising the revenue burden, which was hardly an option given the size of the Dutch public sector. Social security benefits and civil servants' pay had been carrying the brunt of the retrenchment effort over the previous three years, and there were of course limits on feasible expenditure cuts in those areas. However, any assessment of the limits on cuts in social security benefits should reflect the relative generosity of the Dutch social security benefits in comparison with the benefits provided by other countries. Mr. Polak's assurance of the Government's commitment to a comprehensive reform of the social security system was welcome. It had been noted that the education allowances and rent subsidies had been pointed out as offering good prospects for cuts, but he agreed with the staff that potential cuts in all expenditure categories should be considered.

The staff had stated twice in its appraisal that the fiscal deficit was unsustainably large, Mr. Fugmann noted. It seemed that the staff's sense of drama had been allowed to emerge with full strength. Sizable budget deficits should of course be avoided, but the staff should have spelled out more clearly the grounds on which its judgment on the Dutch deficits was based. A comment on the demarcation line between sustainable and unsustainable deficits in the Netherlands would be helpful. The staff report for the next Article IV consultation with the Netherlands should illustrate more clearly the structural deficit in the Netherlands, along the lines of the staff analysis of the adjusted public sector borrowing requirement data for the United Kingdom. Such data was helpful in assessing the underlying trend of fiscal policy. The present staff

report confirmed the conclusion that he had reached during the 1984 Article IV consultation with the Netherlands that medium-term projections of the fiscal deficit and the external current account should be included in the staff report.

Commenting on the employment situation in the Netherlands, Mr. Fugmann said that the staff report concentrated on wage developments rather than on many of the structural aspects of the labor market. He welcomed the several measures that the authorities had taken to ameliorate the unemployment situation. He also welcomed the review of the minimum wage--a wage that often hurt the very persons that it was meant to protect--as well as the reform of the social security system; Parliament was considering a proposal to reduce unemployment benefits. The staff should comment on how the new benefit structure would affect the so-called replacement ratio. Given the structural rigidities that still dominated the labor market, further steps were clearly needed to deal with those rigidities. Further steps should be taken to increase wage differentiation and to improve the efficient functioning of the labor market--for example, through greater decentralization of the wage bargaining process.

The narrowing of the Netherlands' industrial base over the previous 15 years was a cause for concern, Mr. Fugmann remarked. That industrial policy was no longer geared to the management of the decline and support of ailing industries was welcome. The rationalization of the steel, automobile, and aircraft industries and the elimination of subsidies to the shipbuilding industry were encouraging. The authorities' present industrial policy represented an aggressive and selective stance that was concerned with the development of new and profitable technologies and the promotion of capital formation. The staff had mentioned that the authorities were subsidizing research in selected areas and were maintaining a system of investment subsidies. He wondered how far the authorities were prepared to go in providing preferential treatment of industries.

The authorities were to be commended for their liberal trade policy and for their strong support for a liberal international trade system, Mr. Fugmann said. Moreover, they had made the largest contribution of official development assistance relative to GNP among the Development Assistance Committee countries.

In concluding, Mr. Fugmann said that he would make an observation on the staff report from the viewpoint of the Fund's surveillance role. In its assessment of the world economic outlook during the previous 12 months the staff had repeatedly stressed that the most important task facing European countries was to tackle effectively structural problems with a view to restoring the basis for higher growth and for reducing unemployment, and the Executive Board had generally endorsed that view. In that context, the staff report was meager. The Netherlands was a G-10 country that, despite recent favorable developments, was still characterized by major domestic and external imbalances and still faced significant structural problems. The authorities faced political difficulties in dealing with those problems, but that fact should not have

prevented the staff from being more daring in providing advice on how to achieve a more vigorous approach to adjustment in the Netherlands that might well have helped to strengthen confidence in the economy, thereby supporting the desired expansion of investment and other elements of private demand.

Mr. Leonard recalled that in his opening statement Mr. Polak had noted that the Netherlands economy had made further, although not spectacular, progress in 1985, the third consecutive year of growth and adjustment. The prospects were that, apart from some fiscal slippage and monetary slackening, the same solid progress would continue through 1986 and into 1987. The firmness and prudence of economic management were the main sources of the recovery from the recession of the early 1980s, and the authorities were to be commended for them.

There were still substantial unemployed resources in the economy, Mr. Leonard continued. The number of unemployed persons, even on the basis of the standard OECD measure, was markedly higher than in most other industrial countries. Moreover, effective unemployment in the Netherlands was appreciably higher than the official figures suggested. The official figures excluded unemployed persons near retirement age and persons who were regarded as being medically disabled, even though many of them probably were capable of taking up employment. An unemployment rate of 16 percent was unacceptable and, not surprisingly, it was the subject of the authorities' increasing attention. Attacking the unemployment problem would not be easy. Any attempt to use demand management to deal with the problem would have to take into account the trade-off between stimulating the economy and jeopardizing the achievement of the goal of greater fiscal balance and price stability. In addition, there was a danger that social discontent would arise if the social safety net were made less ample than at present in order to stimulate a more energetic pursuit of employment by unemployed persons. A closely related risk was that of upsetting the delicate pattern of social and political relationships that had made possible the successful implementation in varying degrees of an incomes policy in the Netherlands.

Those particular features of the Dutch economy made it difficult for an outsider to form a balanced view of what should or should not be done in the coming period, Mr. Leonard commented. However, it seemed reasonably safe to come to a few conclusions. First, economies in public expenditure could be costly if they involved excessively rapid or sizable cuts in social welfare. If such cuts were made and employment opportunities did not increase, public and trade union calls for action on unemployment might escalate, thereby intensifying the pressure on the Government to maintain a more expansionary policy stance than the authorities felt was advisable. The authorities should perhaps explore more closely the mismatch between supply and demand for certain categories of workers and identify the actions in the areas of training, industrial policy, or other policy areas that could help to eliminate or reduce that mismatch.

That approach held the promise of making fuller use of available resources while minimizing the danger of overheating and of excessive pay increases at any given level of economic activity.

Another conclusion that could be safely drawn was that the government and public sector deficits were still large, and that the potential increases in those deficits in 1987 was unsatisfactory, Mr. Leonard continued. The fiscal deficit was not a cause for immediate concern and it reflected to a significant extent capital spending that could be properly covered by borrowing. In addition, the deficit had arisen in the context of an external current account surplus, a lack of private investment, and capital outflows. The fiscal deficit was a cause for concern in the longer run because it was likely to grow, thereby increasing the fiscal burden and limiting the future room for maneuver with respect to fiscal policy and placing in jeopardy the achievement of the authorities' medium-term objectives.

He fully agreed with the authorities' goals of reducing the role of the public sector in the economy and of giving more room for private initiative, Mr. Leonard said. Those objectives were appropriate for other EEC members as well; a restructuring of activities and innovative actions were called for within the European Communities. However, he wondered whether the Netherlands' industrial policy was fully consistent with that approach. The Government had identified priority areas for the promotion of technological advance and had made arrangements to subsidize research in those areas. That approach seemed to be close to the approach of picking winners by the Government that had initially been popular but had subsequently been heavily criticized in the 1970s. The flawed nature of the Netherlands' industrial policy was underscored by the fact that the priority sectors that the Netherlands authorities had chosen were the same ones that many other industrial and industrializing countries were emphasizing. He wondered how much the industrial policy had been debated in the Netherlands and the extent to which the authorities had been able to resolve the various conflicting issues involved. Finally, the extent of official development assistance provided by the Netherlands and the fact that the assistance had been constantly rising were commendable.

Mr. Zecchini remarked that there had been limited but significant progress in economic performance in 1985: GNP growth had accelerated slightly; the rate of inflation had decelerated somewhat from the already slow pace of 1984; and, even more important, the rate of unemployment had fallen for the first time in the 1980s. Given the trends in the major variables, it was his impression that the authorities were maintaining a gradual policy approach designed to make slow but continuous progress in reducing the domestic imbalances. That approach seemed fully justified, as the imbalances were systemic in nature, rather than cyclical.

Demand management was playing the leading role at the present stage in the development of the economy, Mr. Zecchini noted. In 1985, the main contribution to GNP growth was the expansion of domestic demand rather than the foreign balance. In 1980-82, the deceleration of economic growth

had been caused mainly by the contraction of domestic demand. Although, as Mr. Polak had said in his opening statement, the authorities were not trying to fine tune short-term demand, they apparently were prepared to use demand management to contribute to lasting economic growth.

An assessment of the authorities' approach to structural change must be based on an understanding of the systemic imbalances in the economy, Mr. Zecchini commented. In that connection, the Netherlands' small, highly open economy could be examined on the basis of the interaction of the present booming sector, the present lagging sector, and the nontradable goods sector.

Over the previous decade, the booming sector of the economy had been the energy sector, Mr. Zecchini continued. The rapid growth of output and revenue of that sector had led it to absorb an increasing proportion of resources from other sectors, thereby generating strong cost pressures in the other sectors, especially labor. While the nontradeables sector--including agriculture--had been able to adjust its prices approximately in line with increases in costs, the sector open to external competition--manufacturing--had had to adjust its output, and its share in GNP had fallen as profit margins had contracted. The economy was on the verge of experiencing an unwinding of that process. Any scaling down of the energy sector following the fall in the sector's prices and profitability could release resources to the tradables sector, thereby causing a marked easing of domestic cost pressures, particularly in manufacturing, if excess demand did not emerge in the short run.

If that interpretation of the problems facing the economy was correct, one of the major tasks facing the authorities was to encourage a smooth shift of resources among the two sectors that he had described, Mr. Zecchini said. That problem could best be handled through the implementation of so-called supply-side policies. However, aggregate demand management remained crucial, as it could help to avoid the emergence of bottlenecks on the supply side and of excess demand in the sectors that were expected to expand. He would consider some of the implications of this problem for labor market policy, fiscal policy, and monetary policy in turn. In its next report the staff should give greater emphasis to the sectoral dimension of the problems facing the Netherlands economy and the implications of that dimension.

He doubted whether there was sufficient flexibility in the mobility of labor and in the setting of wages to permit a smooth reallocation of labor resources between sectors, Mr. Zecchini commented. One piece of evidence of that problem was the lack of sufficient elasticity of demand with respect to the decline in unit labor costs. Sectoral analysis could help in assessing the extent of the insufficient elasticity and the areas in which intervention was necessary. The minimum wages, training of displaced workers, vocational training, unemployment benefits, and the social security system could make an important contribution if they were better directed to promote the creation of job opportunities and the

reallocation of workers. There was a particular need to narrow the huge gap between gross and net wages, although that effort should not involve a transfer of additional costs to the public finances.

To the extent that the decline in energy prices and the improvement in the terms of trade would support an expansion of domestic demand and real growth, there was no reason to depart from the medium-term objective of consolidating the fiscal position, Mr. Zecchini remarked. A further reduction in the fiscal deficit at the same gradual pace of the previous two years was appropriate; it would create room for future action aimed at business cycle stabilization. It would be helpful to know the comparative impact of the decline in energy prices on oil tax revenue and on the tax revenue related to the higher level of economic activity.

If the loss of oil revenue were to offset the overall income effect of the decline in oil prices, greater caution than hitherto should be used in withdrawing the fiscal impulse, Mr. Zecchini considered. However, the authorities should in any event undertake some restructuring of expenditure and revenue. Enterprises should be able to make smaller social security contributions. At the same time, the subsidization of a large number of enterprises was a cause for concern because of the resultant distortion in the allocation of resources. The authorities should reduce the tax burden throughout the manufacturing sector.

He doubted whether the policy of maintaining a stable relationship between the guilder and the deutsche mark was appropriate both in periods of rising and declining energy prices, Mr. Zecchini commented. During the period of rising energy prices, the maintenance of a stable relationship between the guilder and the deutsche mark might have helped to limit the squeeze on the manufacturing sector resulting from the depreciation of the deutsche mark. At present, the deutsche mark was appreciating and the stable relationship between the guilder and the deutsche mark might be depriving the manufacturing sector of some overdue support of its competitiveness.

It was understandable that, despite the differences in production factor endowment between the Netherlands and Germany, the Dutch authorities wished to maintain a fixed relationship between the two currencies because of the extensive economic and financial integration of the two national markets and because that relationship provided an anchor for the anti-inflationary strategy, Mr. Zecchini said. However, it was possible that the exchange market had already perceived the different consequences of recent commodity market trends for the two economies owing to their different sectoral composition and accordingly had discounted a change in the exchange rate relationship. The monetary response to pressure in the exchange market had been a rise in short-term interest rates as well as in the interest rate differential between the Netherlands and Germany. However, that response did not seem to be fully consistent with the need to support the level of aggregate demand in a period in which a more stringent fiscal position was being maintained.

The increase in the interest differential could be explained by the growth of domestic liquidity and the need to check it, Mr. Zecchini continued. If it was to be accepted, that explanation must be based on a clear understanding of the factors behind the growing liquidity preference of domestic sectors and, more important, a comparison of liquidity creation and preference in Germany and the Netherlands.

Mr. Huang remarked that the Netherlands economy had recorded a number of significant achievements in 1985, including a low rate of inflation, moderate economic growth, and a significant improvement in the Government's financial position. While the gradual recovery had continued in 1985, the rate of inflation had fallen to 2-3 percent--the lowest rate since 1961--and the public sector deficit was expected to be reduced from nearly 11 percent of net national income in 1982 to 7.3 percent in 1986. The authorities were to be commended for those achievements.

He broadly agreed with the staff appraisal, Mr. Huang continued. The rate of unemployment remained excessively high, even though it had declined from 17 percent in 1983 to 15 percent in 1985. It would be difficult for political and economic reasons for the Netherlands to sustain such a high rate of unemployment over the long run, and the matter was understandably a source of serious concern to the authorities. The staff seemed to attach less importance than the authorities to the unemployment problem. He sympathized with the authorities, who had insisted that the unemployment problem deserved greater attention than hitherto.

Stressing the need to reduce unemployment did not mean that the authorities should necessarily concentrate on short-term demand management and establish full employment as their primary policy target, Mr. Huang went on. The authorities should design economic policies in a medium-term perspective and with a view to achieving noninflationary growth, and they should not try to fine tune short-term demand. The unemployment problem was somewhat overlooked in the staff report. The staff had not analyzed the unemployment problem in the Netherlands to show the relationship between the high rate of unemployment and the insufficient aggregate demand, and the need for structural change; nor had the staff commented on appropriate policies to cope with the different types of unemployment in the Netherlands.

The staff had noted that one of the structural impediments to long-term growth was the high cost of labor, which had risen to 91 percent of the value added in the manufacturing sector in 1981 and had fallen slightly to 83.5 percent in 1985, although that change had involved an increase in unemployment, Mr. Huang remarked. The high cost of labor had undoubtedly negatively affected investment and commodity competitiveness as well as the incentive to work. He agreed with the staff that in the long term the solution to the problem of high labor costs should be based on lower growth of real wages relative to productivity growth. Accordingly, the most important objective was to achieve a considerable increase in productivity growth in coming years. That objective apparently could

be achieved through the introduction of new technology and the promotion of capital formation. He was pleased that the authorities had emphasized industrial policy and had reoriented it to promote technological advances instead of to provide subsidies for disadvantaged enterprises. Technological advances would help to increase productivity, reduce labor costs, improve profits, and make additional room for wage increases. Enormous investment would be needed to promote new technology. Fortunately, over the years a large surplus of national savings had been accumulated, although there had also been considerable capital outflows. A major task facing the authorities was to adopt appropriate policies to take full advantage of the large savings surplus to promote technological advances.

Mr. de la Herrán considered that an analysis of the performance of the Dutch economy should be made in the context of an appreciation that economic policy in the Netherlands had continued to be formulated in a medium-term perspective. In 1985, the economy had continued the recovery that had started in 1982: there had been improvements in most macro-economic areas, including in particular a low rate of inflation. However, there were still structural disequilibria in the public sector and the labor market.

He was pleased that real improvements were being made in the labor market, Mr. de la Herrán went on. The lack of response of unemployment to the demand pull underscored the strength of the rigidities in the labor market. The authorities had responded with an imaginative labor strategy based on a combination of a work-sharing program, early retirement, promotion of part-time employment, and formulas designed to create opportunities for first-job seekers, the group that was experiencing the highest rate of unemployment. In addition, the incomes policy had helped to achieve the much-needed wage moderation.

In the past, the work-sharing program had helped to increase employment, but in recent months it seemed to have caused some strain between trade unions and employers, Mr. de la Herrán remarked. There was some risk that wage claims would increase if an agreement on the use of the work-sharing program in the coming period was not reached soon. He wondered to what extent the program was responsible for creating mismatches between labor supply and demand. Mr. Polak had noted the shortage of skilled workers despite the large number of unemployed persons, and unfilled vacancies had grown rapidly in 1984 and 1985, from 9,500 to 24,000. He doubted whether policies based on early retirement and subsidies to promote part-time employment were effective in the medium term. Both measures reduced the number of people who registered as unemployed but only at the expense of a corresponding increase in public expenditure and social security outlays.

The social benefits system should be revised, Mr. de la Herrán considered. The downward trend in unemployment and disability compensation was welcome. It could facilitate an improvement in the functioning of

supply and demand forces and contribute to a more equitable sharing of the burden of unemployment between active wage earners and the recipients of social benefits.

The authorities' policy for alleviating unemployment among young persons was commendable, Mr. de la Herrán said. For example, the so-called JOB program was aimed at generating more employment for long-term unemployed young persons. There should probably be a closer relationship between that program and the Government's role as an intermediary to reinforce collaboration between business and universities.

The projected deterioration in the fiscal position in 1987 was worrying, Mr. de la Herrán commented. Given the already large fiscal deficit, that forecast called for an immediate reaction by the authorities. The recent decline in oil prices and the uncertainties surrounding the energy market meant that revenue policy could not be used effectively in the effort to reduce the fiscal imbalance. The possible formulas for further fiscal retrenchment should include a sharp cut in expenditure. In that connection, the room in which to maneuver apparently was very limited. The staff report had noted the possibility of cutting expenditure on education allowances and individual rent subsidies. A further comment should be made on the extensive debate in the Netherlands on the need for corrective action in the fiscal area.

Monetary policy was designed to maintain a strong position for the guilder, Mr. de la Herrán noted. Monetary policy played an accommodative role in terms of domestic activity. The authorities faced a policy dilemma: German interest rates had to be followed in order to maintain stability within the European Monetary System and to avoid any depreciation of the guilder; at the same time, the already large fiscal imbalance meant that expansionary measures had to concentrate on the monetary side rather than on the fiscal side. Finally, the authorities were to be commended for maintaining a high level of development aid despite the strong fiscal constraint.

Mr. Mawakani noted that the staff and Mr. Polak had concluded that in many respects the Netherlands' economic performance in 1985 was encouraging. The rate of economic growth recorded in 1984 had been maintained in 1985, the external current account surplus had been consolidated, and the public sector deficit as a percentage of net national income had been further reduced. Moreover, the rate of inflation--as measured by the consumer price index--had declined further and remained among the lowest of the OECD countries.

Those achievements, which had been made possible by the implementation in the early 1980s of economic and financial policies aimed at a gradual recovery of investment, competitiveness, and profitability, were commendable, Mr. Mawakani continued. They underscored the appropriateness of the Government's economic strategy for solving the various economic and financial problems. However, despite those achievements, some economic

problems remained, especially the high rate of unemployment, which had exceeded 15 percent of the dependent labor force at the end of 1985 and continued to be a cause for concern.

The ongoing improvements in the labor market were welcome, Mr. Mawakani stated. Employment in the private sector had increased for the first time in many years. While unemployment was high by OECD standards, certain sectors of the economy faced shortages of skilled personnel, and the emphasis on providing more training opportunities and the agreement reached in 1985 among the social partners to increase on-the-job training were therefore welcome. However, it was clear that if the economy were to be competitive in the long run and to provide more job opportunities, an appropriate wage policy should be implemented in both the public and private sectors. The minimum wage in the Netherlands exceeded that wage in other industrial countries and was being reviewed by the authorities. In addition, new unemployment legislation was being considered. While the provisions of that legislation would help to reduce the rigidities in the labor market, the authorities should consider the staff's recommendation that greater decentralization in the wage determination process could help to improve the efficient functioning of the labor market.

The authorities were to be commended for maintaining a high level of official development assistance with a significant concessionary element, Mr. Mawakani said. The focus of the Netherlands' aid on the improvement of the rural sector of recipients was encouraging, and he was pleased that further progress in the Netherlands' aid program was expected in 1986.

The staff representative from the European Department recalled that the question had been raised concerning the contribution of the Netherlands' stabilization efforts to the international recovery. Given the continued large size of the fiscal imbalance in the Netherlands, the authorities had little or no choice but to continue to try to contain the deficit. The attempt to achieve the medium-term objective of reducing the weight of government in the economy together with the effort to reduce the fiscal deficit would inevitably have a deflationary effect. However, if the authorities were to reduce their efforts to achieve those objectives, the Netherlands would probably make a negative contribution to the international economy in the medium term, rather than a positive contribution.

Appropriate means of stimulating investment should be encouraged, the staff representative continued. The fairly slow recovery of investment was clearly the most disappointing aspect of the recent overall performance of the economy. At the same time, the rate of increase in investment in real terms was not negligible; it had been 7 percent in 1985. If that rate were maintained, the traditional investment ratio would be restored in five or six years.

Given the usual uncertainties about five-year projections, the staff saw no particular reason why the recovery of the Netherlands economy could not proceed at the rate that it had projected, the staff representative went on. After all, world trade was expected to continue to grow, interest rates were expected to continue to decline, and the Netherlands' competitiveness and profitability were strong. Assuming that those trends would continue, the staff's projection did not seem to be overambitious. If the investment recovery were to continue at the expected pace, the Netherlands should fit well into the international economy. The external current account surplus--which was perhaps a measure of the inadequacy of investment--was already shrinking, mainly because of the decline in gas exports. The surplus had originally been projected at 3.5 percent of GNP in 1987 and had recently been revised to 2.6 percent. There seemed to be little room--even given the present external outlook--in which to increase domestic demand before the effects of such efforts on the Netherlands' payments position would have to be taken into account.

The prospect of a decline in fiscal revenues from natural gas created a problem, and there was some question about the sort of measures that should be introduced to minimize the increase in the fiscal deficit, the staff representative remarked. The 1987 budget was being discussed in the Netherlands, and it was difficult to anticipate what the final budgetary decisions would be. The measures being considered included further cuts in subsidies to industries and additional cuts in housing subsidies and housing loans. An increase in charges for public transportation and a reduction in credit guarantees and credit insurance had been proposed. A reduction in defense outlays was also being contemplated. Ideally a reduction in development assistance would not be required, but there might be a reduction in employment programs. An increase in the excise tax was also being examined. The clear impression was that the authorities seriously intended to keep the fiscal deficit to a minimum and if possible to avoid an increase in the deficit in 1987.

It was difficult to determine the dividing line between a sustainable and an unsustainable fiscal deficit, the staff representative said. However, in its report the staff had suggested two considerations that might be taken into account in a judgment of the sustainability of the deficit. First, the staff had recommended that the authorities should stabilize the ratio of interest payments on the public debt to GNP to maintain some flexibility in public finances in the longer run. Second, additional interest charges to the Government should be avoided unless the additional costs were related to expenditures that would contribute to economic growth. A considerable amount of estimation was involved in such efforts, and much depended upon the particular GNP forecasts in real and nominal terms.

The chart on page 96a of SM/86/50 provided various measures of the underlying structural fiscal deficit, the staff representative noted. Of course, such indicators had to be approached with caution; there was room for debate about what should be taken into account in the adjustments involved, just as there was room for debate about the appropriate targets

for the absolute size of the fiscal deficit in the coming period. There was a question whether the reduction in gas revenues was permanent or temporary. That question had to be kept in mind in any consideration of the extent to which it would be appropriate to counteract a decline in revenues and an increase in the fiscal deficit in 1987. The staff was uncertain whether the decline in energy prices was temporary or longer term in nature, and that issue would certainly have to be kept in mind in the coming period.

At first glance, the Netherlands' industrial policy appeared to be one of trying to pick winners, the staff representative remarked. However, the kind of measures that the authorities had in mind would not involve subsidies for specific industries or lines of production. Instead, the measures would be designed to permit the Netherlands to take advantage of existing comparative advantage. Hitherto, the Dutch industrial sector had tended to be somewhat more energy intensive and somewhat less based on advanced technology than some other industrial countries. The authorities in the Netherlands did not wish to promote industries based on advanced technology in direct competition with other countries that were promoting the same industries; rather, they wished to be certain that advanced technology industries in the Netherlands would not suffer any unnecessary disadvantage owing to a lack of the research and development that were common in other countries and that could be easily matched in the Netherlands. In any event, the importance of the industrial policy should not be overemphasized. Only f. 750 million, or 0.4 percent of central government expenditure, was devoted to implementing the industrial policy in 1985.

The staff had not examined closely the labor supply and demand elasticities in various sectors in the Netherlands, the staff representative said. Apparently the elasticity of demand for labor was much lower in the energy sector than in the manufacturing sector. The reduction in unit labor costs had not resulted in a large increase in employment. That conclusion probably had less to do with the issue of the elasticity of demand in each sector than with the scale of aggregate demand. As a number of speakers had noted, the amount of absorption of labor in the future would depend mainly on the prospect for aggregate demand and for domestic demand in particular, which, in turn, would depend considerably on the kinds of stimulus that might be given to investment.

The question had been raised about the authorities' ability to predict the demand for money, the staff representative recalled. The authorities had recently reached an agreement with the commercial banks on a particular formula for the expansion of domestic credit. The assumption had been made that the domestic contribution to monetary expansion should not exceed the increase in nominal GNP. However, that agreement did not necessarily depend upon a precise notion of what the demand for money might be relative to GNP. To a large extent the Netherlands operated with an exchange rate that was fixed in relation to a number of strong partner countries' currencies. The authorities did not have a strict target for the domestic contribution to the stock of money. Any

shortfall or excess in the money supply with respect to the domestic demand for liquidity would probably be reflected in exchange rates. The Netherlands probably did not need to have as clear a notion of the demand for money as the United Kingdom because the exchange rate in the Netherlands was not as flexible as the exchange rate in the United Kingdom.

The increase in the interest rate differential between Germany and the Netherlands could adversely affect the level of interest rates in the Netherlands, the staff representative commented. Interest rates in the Netherlands could be lower than at present if the authorities did not wish to maintain the close relationship between the deutsche mark and the guilder. In fact, in recent months, interest rates in the Netherlands had been falling along with the deceleration in the rate of inflation and with the decline in interest rates abroad. There seemed to be no reason to fear that interest rates in the Netherlands would be excessively high in the coming period.

Agreements between the authorities and the commercial banks had been effective in the Netherlands not because of the concentration of the banking system, but rather because of the residual powers of the Netherlands Bank, the staff representative remarked. If the authorities were to find that the present degree of moral suasion was not effective, they were prepared to increase it. The banks were well aware of that fact.

There were benefits and disadvantages for the Netherlands resulting from the decline in oil prices, the staff representative from the European Department said. The decline in energy prices contributed to the low rate of inflation in the Netherlands which, in turn, helped to encourage investment. However, the generally weak world demand for energy products adversely affected the Netherlands' gas exports. The advantages and disadvantages of energy price developments did not hit the Netherlands at the same time, since there was typically roughly a six-month lag between a decline in oil prices and a drop in gas prices. Accordingly, in the initial stage of the decline in oil prices the Netherlands should experience an improvement in its terms of trade. As oil prices began to stabilize, gas prices would probably continue declining for a while, and the Netherlands would probably experience a net disadvantage from energy price developments, as economic activity might well be restricted as investors and producers moved back into manufactures.

Mr. Di Mauro remarked that the staff seemed to have concluded that there was some scope in the Netherlands to use the fiscal deficit as a means of stimulating economic growth. On page 12 the staff had stated that given the persistence of very high unemployment, combined with a continued substantial external current account surplus, the staff had wondered whether a case could not be made for easing the pace at which the public sector deficit was being reduced. That conclusion need not mean that fiscal policy should be designed solely to stimulate economic

growth. There seemed to be some room in which to maneuver in the short term in the fiscal policy area while maintaining the medium-term perspective in which fiscal policy was framed.

The staff representative from the European Department commented that the staff had asked the authorities why they wished to continue the fiscal consolidation at as rapid a pace as possible. In posing that question the staff had not meant to prejudge its position on fiscal policy in the Netherlands. Rather, the staff had wished to understand the authorities' reasons for their policy of rapid fiscal consolidation, and the authorities had made a convincing case for their policy stance. They had argued that, given the large size of the fiscal deficit and the high level of government spending, the reduction of the fiscal deficit should not be excessively gradual. If the authorities had increased the fiscal deficit in the short run in order to stimulate economic activity, they would have eventually had to act to reduce the fiscal deficit, and their action would have had a deflationary effect. Repeated efforts to stimulate the economy and subsequently to reduce the fiscal deficit would have resulted in considerable swings in economic activity, and the authorities preferred to maintain economic activity consistently in the proper direction. The staff had finally agreed with the authorities that the more quickly the fiscal deficit could be reduced, the better the outturn would be in the medium term.

Mr. Nimatallah remarked that the staff had noted that the reduction in the fiscal deficit and the improvement in profit margins had released savings at a faster rate than the recovery in business investment could readily absorb. In his comments the staff representative had suggested that the gradual nature of the reduction of the fiscal deficit should not be overemphasized. In his view, the main issue concerning fiscal policy was not the pace of fiscal consolidation but the need to reduce the fiscal deficit in line with the encouragement that was given to the private sector in order to ensure that the resources released by the public sector to the private sector would be used efficiently.

Mr. Foot commented that the financial environment should be supportive of a full recovery of private sector investment. To that end, the costs of financial intermediation should be cut as much as possible; those costs were not as low in the Netherlands' banking system as in some other countries. In addition, the development of new forms of financial intermediation could have substantial benefits for economic activity. For example, in the United Kingdom, the innovations in home finance instruments had had a considerable impact on the level of residential construction activity. There had also been an increasing use of bonds to finance infrastructure projects that would yield a cash flow only relatively far along in the project implementation process. Those examples showed how the development of financial markets could support the authorities' effort to encourage an acceleration of private investment. In many countries there was a growing interrelationship between capital markets and the banking sector, with banking institutions playing an increasing role in the securitization of banking activity. The

Netherlands apparently had an open and strong capital market, and he wondered whether that alone would be sufficient. Presumably the banking sector in the Netherlands should be structured in a way that would encourage banks to seek to expand their activities. In that connection, he doubted whether moral suasion would be sufficient.

Mr. Templeman said that in his comments on the role of the Dutch economy in sustaining world economic growth and reducing external imbalances he had not meant to suggest that the Dutch authorities should ease fiscal policy. Instead, he had meant to focus on the weak business demand in the Netherlands, which apparently was the result largely of the rigidities in the labor market. An increase in business demand in the Netherlands would not only help to increase domestic demand but would also reduce the Netherlands' large external current account surplus.

The staff representative from the European Department remarked that the Dutch financial system was fairly concentrated--more so than the financial systems of some other industrial countries. However, it was becoming less concentrated as a result of steps that the authorities had recently taken. Before those reforms, individual Dutch financial institutions had already faced some keen competition from other domestic institutions and from institutions outside the Netherlands. The concentration of the Dutch financial system probably had not added much to the cost of borrowing, as interest rates in the Netherlands had to reflect interest rates abroad. The Dutch money markets, like the markets in other industrial countries, were opening up as much as possible.

The staff had suggested that the authorities ought to consider calibrating the reduction in the fiscal deficit with the recovery of investment, the staff representative commented. The pace of the reduction of the fiscal deficit in the Netherlands had been somewhat faster than the authorities had intended, and it could be argued that that fact gave the authorities some margin for acting within their medium-term strategy to slow the speed of the fiscal consolidation. However, it was difficult to predict at the beginning of a budget year how much investment would increase in the year and to calibrate the pace of fiscal consolidation accordingly, especially if it was suspected that the strength of the recovery in general and of investment in particular might depend on the confidence with which investors viewed the authorities' determination to reduce the fiscal deficit as quickly as possible. In the Netherlands, the authorities' resolve was said to be a major factor in investor confidence. Hence, it would be difficult to balance precisely the pace of fiscal consolidation with the recovery of investment.

The extent to which an increase in domestic demand in the Netherlands would help to reduce the external surplus would depend largely on the degree of investors' confidence in the economy, the supply-side measures in the labor market, as well as the fiscal consolidation, the staff representative from the European Department said. A considerable effort

had already been made to reduce the external surplus. In any event, a portion of that surplus was more apparent than real, and the authorities' margin for further reducing the surplus should not be overestimated.

Mr. Polak remarked that there was still a major debate in the Netherlands about what to do in response to the declining price of natural gas. The Finance Minister had taken the initiative in proposing under the 1987 budget a f. 10 billion reduction in expenditure and a f. 4 billion increase in various taxes, including a reduction in the various tax facilities for business and a significant increase in the gasoline tax. If that budget were adopted, there would be a further slight reduction in the fiscal deficit as a percentage of net national income. The debate in the Netherlands centered on whether all those steps were necessary and whether sufficient attention was being paid to the positive effects of the reduction in energy costs in terms of an expansion of tax receipts and a reduction in unemployment expenditures.

There was no target of a fiscal deficit of 1 percent of net national income in 1990, Mr. Polak said. The present target was of the order of 4 percent by 1990, which would be sufficient to bring about a constant ratio of interest payments to net national income. The achievement of such a ratio was the main criterion on which the sustainability of the fiscal position was judged.

One speaker had said that he was not convinced by the argument that it was more helpful to concentrate on the government deficit for 1986 and to exclude the increased deficit on the social security account, Mr. Polak continued. That comment was also related to the question of the sustainability of the fiscal position. In that connection, it was useful to recall that many Executive Directors had recently noted that the reduction in the U.K. fiscal deficit had been caused by temporary factors, such as sales of assets. Just as such a deficit reduction should not be counted as an achievement, a temporary deficit in the social security accounts in the Netherlands should not be seen as a cause for concern.

The Dutch authorities could make an appropriate contribution to world demand by sticking to their present policy course, Mr. Polak remarked. They would not necessarily be able to make that contribution soon, in 1986, but they would be able to do so eventually. The Netherlands' external current account position had fluctuated considerably in the past. The fact that the surplus had remained at a particular level over the previous three years was not sufficient reason to expect that it would stay there indefinitely. The level could change rapidly.

The need to provide more equity capital for Dutch industry was a cause for considerable concern in the Netherlands, and a number of actions were being proposed, Mr. Polak commented. One possible measure was to eliminate the double taxation of dividends--the present taxes on profits and on personal dividend income. However, revenue considerations had stood in the way of that action. A second measure would permit tax

deductions for investment in shares by individuals, as was already permitted in Belgium and France. The fear of a reduction in income tax revenue had kept that measure from being implemented. However, pension funds had been given greater freedom to invest in shares, and there had been substantial deregulation of the Dutch capital markets.

The major improvement in Dutch industrial policy over the previous several years was not the effort aimed at picking winners but the cessation of the practice of backing losers, Mr. Polak said. Support for weak industries had been the main disadvantage of the system of subsidies to various industries, such as shipbuilding, which had been very costly and were being eliminated. The modest amounts of money that were being spent on subsidies for research were a small step in the direction of improving the climate in which strong industries could develop; one of the arguments in favor of that step was that other European countries were doing the same.

Important changes were also being made in the subsidies for investment, Mr. Polak continued. Successive staff reports had recommended that the Government should eliminate those subsidies. That point was not made in the present staff report presumably because the authorities were gradually eliminating those subsidies for loss-making enterprises and might well eliminate all investment subsidies in the next budget.

The authorities' policy stance was admittedly a gradualist one, Mr. Polak commented. However, given the social conditions and the substantial expansion in government services, only gradual reductions could be made in the excessive role that the Government played in the economy. Accordingly, most of the results of the authorities' policy efforts were gradual--for example, in reducing unemployment and in expanding production--but that outcome was accepted in the Netherlands. Some of the results had been achieved fairly rapidly. There had been a striking improvement in the business climate and in business profitability. In 1983 the aggregate level of profits had been zero. At present, Dutch businesses were profitable, and it was conceivable that investment would increase more rapidly than the 7 percent a year that the staff had mentioned.

The authorities respected the Common Market trading policy but they did not particularly like it and had argued for a more liberal stance in a number of areas, Mr. Polak noted.

The authorities certainly disapproved of the extreme cases of excessive social benefits for certain individuals, Mr. Polak commented. Their tenacious efforts to improve public finances were aimed partly at eliminating such excesses.

It was true that the commercial banks were being handled rather gently by the Netherlands Bank, Mr. Polak said. The main reason for that treatment was that the Netherlands Bank was trying to avoid any further

loosening of monetary conditions, and the arrangement with the banks under which the authorities were trying to do so should be thought of as a gentleman's agreement rather than as moral suasion.

The energy sector used very little labor, Mr. Polak remarked. Accordingly, there was not a strong correlation between energy sector developments and the demand for labor.

The authorities were convinced that, given its small size, the Netherlands was not an optimal currency area and therefore benefited considerably from the fixed exchange rate relationships within the European Monetary System, Mr. Polak said. The authorities felt comfortable with the guilder's position at the top of the range of the European Monetary System currencies, and the authorities wished to stay in that position by maintaining an exchange rate fixed on the deutsche mark. They believed that such a position could be maintained, even though the guilder's position contained a small petro element. Indeed, the authorities believed that other European countries, with a somewhat larger petro element in their currencies, would benefit from joining the European Monetary System.

The Chairman made the following summing up:

Directors commended the Dutch authorities for their steady pursuit of medium-term policies that have supported and strengthened the economic recovery over the past three years. Directors were pleased that the policy of fiscal expenditure cuts and deficit reduction had continued to be pursued since the last consultation, that labor market policies had given rise to a marked improvement of profitability and competitiveness, and that monetary policy had provided a framework in which the recovery could take place without inflationary pressures.

Directors noted that, on the basis of these policies, the economy now appeared to have returned to sustained growth, although with a relatively low growth rate. They particularly welcomed the broadening base of the economic upturn as it started to spread from the external to the domestic sector. Investment spending by enterprises, although still low by historical standards, was rising steadily. The profitability of enterprises had been restored to more adequate levels. Price stability was virtually achieved, and, last but not least, employment in the private sector appeared to have started to rise again.

Against these achievements Directors observed that, like a number of other European economies, the Dutch economy continued to suffer from excessive government involvement and public sector deficits that were seen to be unsustainable. In addition, unemployment remained among the highest in industrial countries and included a large structural component. Furthermore, the

enterprise sector and the labor market continued to exhibit structural weaknesses and rigidities. The economic outlook and the policy record of recent years suggested that reducing these weaknesses might be a rather slow process.

Directors welcomed the reductions in unit labor costs that had substantially improved the competitiveness of the Dutch economy. Directors welcomed steps to reduce the rigidities in the labor market, including the greater decentralization of wage formation. However, Directors cautioned that a resurgent demand for labor could again lead to unwarranted wage growth and might also inhibit the growth of private sector investment. Among the factors which could cause such wage pressures were the emergence of mismatches in some sectors of the labor market and the compression of net income differentials, particularly at the lower end of the income scale. In this connection, Directors stressed the need to address more vigorously the disincentive effects of income-related transfers. Reforms in the structure of transfers would greatly improve the flexibility of the labor market by allowing wider wage and income differentials. Directors urged a further increase in the gap between labor income and income replacing benefits, and the early adoption of reforms in the social security system that were before Parliament. Even with these changes, it was felt that the social security system in the Netherlands might still be too generous to discourage excessive wage claims and perhaps placed too heavy a burden for the budget to bear. It was also suggested that lower marginal tax rates might be a means to increase incentives to work and invest.

Directors welcomed the fiscal consolidation that had been achieved to date. They noted that the reduction in the fiscal deficit had been achieved mainly through expenditure reduction and without recourse to revenue enhancements, although the cyclical upturn of the economy and temporary revenue inflows had certainly aided the effort. Given the present size of the public sector and of the public sector debt, and taking into account the rising share of interest payments as well as the prospect of a sharp fall in natural gas revenues in 1987, Directors generally felt that fiscal retrenchment would have to be continued. With regard to the pace of fiscal retrenchment, a number of Directors cautioned against excessively drastic action for fear that it might exceed the pace at which the private sector could absorb the additional savings in the form of productive investments. Other Directors, however, stressing again the outlook for unsustainably large fiscal deficits in the medium term, stressed that there was no room for relaxation of the fiscal consolidation effort. They urged that the slight easing of the fiscal stance of the public sector as a whole, as a result of the social security funds swinging into deficit in 1986, should be temporary, and that the deficit of the Central

Government and the local authorities should be kept below the target that was set for the year. A number of Directors believed that the revenue shortfall from natural gas could be offset, considering that there was still ample scope for expenditure cuts in transfers to households and subsidies to enterprises.

Regarding industrial policy, Directors welcomed the shift away from a policy of assisting ailing industries, but a number of Directors questioned the desirability and indeed the effectiveness of a policy of supporting newly emerging industries. It was recognized that a similar approach was followed in other countries, but it was suggested that this increased the risks of such a policy, especially if other countries support the same industries.

Directors observed that monetary policy continued to be aimed at maintaining the exchange rate of the guilder unchanged with respect to the deutsche mark. They noted that this policy had been accompanied by a steady increase in domestic liquidity, well above the rate of growth of national income, reflecting a buildup of liquidity mainly in the enterprise sector. A number of Directors voiced concern about the increasing contribution of domestic credit expansion to this buildup. They welcomed, therefore, the recent actions by the monetary authorities to bring domestic credit expansion more in line with the growth of nominal incomes. At the same time, noting that interest rate policy is strongly geared to developments in the Federal Republic of Germany, a number of Directors welcomed the recent reduction of interest rates, which should assist the recovery of private investment in the Netherlands. In that connection, some Directors stressed the desirability of strengthening the private sector.

Directors commended the Dutch authorities for their continued commitment to a liberal trade and payments system and encouraged them to seek both in regional and multilateral forums further liberalization of existing barriers to trade. Directors also regarded the maintenance of a high level of official development assistance as a major achievement of the Government.

The next Article IV consultation with the Netherlands is expected to take place 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/86/45 (3/12/86) and EBM/86/46 (3/14/86).

2. PAKISTAN - 1985 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1985 Article IV consultation with Pakistan to not later than March 31, 1986. (EBD/86/68, 3/11/86)

Decision No. 8225-(86/46), adopted
March 13, 1986

3. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAP/86/58 (3/12/86) is approved.

4. STAFF TRAVEL

Travel by the Managing Director as set forth in EBAP/86/59 (3/13/86) is approved.

APPROVED: November 25, 1986

LEO VAN HOUTVEN
Secretary

