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Recent Economic Developments in the Netherlands:
January-June 1966

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Summary

Economic activity continued to expand strongly during the first half of 1966; in fact, the rate of expansion may well have been slightly above that recorded in the last half of 1965.[1/] Industrial output rose at an annual rate of 8.7 per cent during the first four months of 1966 as compared with an annual rate of 6.2 per cent during the last half of 1965. (See Chart.) This output growth was largely the result of continued large increases in productivity despite the reportedly almost full utilization of available resources.

Despite the fast growth of output, supplies have remained insufficient to meet demand. The lack of labor remains the chief constraint upon further growth of supply, although there are signs that labor shortages are no longer intensifying. At the same time that supply possibilities remain limited, aggregate demand is rising rapidly. Growing personal incomes are stimulating private consumption demand, particularly because of the added stimulus of higher price expectations; private investment demand is expanding faster than in 1965 and government demand also appears to be growing more rapidly.

1/ For a review of earlier developments, see "Recent Economic Developments in the Netherlands: September-December 1965", dated January 21, 1966.

This situation has been reflected in an acceleration of the upward trend of wage and price movements and in a substantial deterioration of the Dutch balance of payments position. Although a number of special factors accounted for part of the deterioration in the economic situation, there can be no doubt about the strengthening of underlying inflationary trends.

Consequently, the Government decided in May to take new anti-inflationary measures involving further fiscal and monetary restraints and certain direct wage and price controls. Nevertheless, the Central Planning Bureau, after incorporating the new developments in its estimates, still foresees a stronger rise in wage incomes, consumption demand, government expenditures and consumer prices than had been forecast in January 1966. In addition, the $110 million current account surplus originally forecast for 1966 is now expected to turn into a $110 million deficit.1/ However, most of the deterioration in the economic balance appears to have already taken place; the second half of 1966, therefore, should show at least a halt in the deterioration, if not a decided improvement.

The basic strength of the growth in demand originates in very buoyant consumer spending. In the opening months of the year, consumer spending had been expected to fall substantially from the high levels reached in the last quarter of 1965. At that time, retail sales had accelerated substantially in anticipation of higher excise taxes to be introduced on January 1, 1966. In fact, consumption expenditures tailed

1/ Later estimates of the Social Economic Council (published in July) foresee an even larger deficit of $171 million on current account for 1966.

off only slightly during the first quarter of 1966 and still achieved a year-to-year growth of 8.1 per cent, not much less than the 9.3 per cent rise recorded between the first quarter of 1964 and the first quarter of 1965. In addition, Government spending increased more rapidly than the budget had foreseen; the Finance Minister announced in May that budget expenditures in 1966 would probably rise some fl. 910 million above the fl. 18.1 billion originally budgeted. Further expansionary impulses came from the side of export demand, which also continued to rise despite a slackening of demand in Germany.

These growing demand pressures upon internal resources were reflected in accelerated advances in prices and wages. Although eighty wage contracts approved during the first five months of 1966 provided for average increases of 7.5 per cent (only slightly above the upper limit of 7 per cent proposed by the Government), a further forty contracts still pending entailed increases averaging 10.5 per cent. At the same time, price increases also accelerated. (See Chart.) To a certain extent, these rises reflected special factors: higher indirect taxes and higher world market prices for raw materials. But much of the 5.8 per cent rise in consumer prices between December and May and the 3.5 per cent rise in wholesale prices between December and March undoubtedly reflected higher internal costs, both of labor and financing, and the pressure of rising demand.

The strengthening of inflationary tendencies led the Government to respond on May 21 with a series of measures designed to hold down rises in prices, wages, and Government spending.

1. No contracts providing for wage increases of more than 7 per cent would be approved for the remainder of the year and approval of contracts would be suspended until July 1.

2. Only increased costs of raw materials could be passed on in price increases; wage increases were not to be passed on in higher prices unless they would prevent a well-run firm from obtaining a "normal" return on capital.

3. For the remainder of the year, all domestic price increases would have to be reported to the authorities, with an explanation of the increase.[1/]

4. Until October 1, 1966, (the beginning of the new fiscal year) no new government contracts for investment projects would be concluded unless postponement was impossible for technical reasons.

5. No new employees could be taken on by government through end of the year and efforts would be made to economize on other government spending.[2/]

To the extent that rising inflationary presssures furthered the growth of imports, they contributed to the deterioration of the Netherlands trade position and the widening of the overall payments deficit. The deterioration of the trade balance cannot, however, be laid entirely to added inflationary pressures. Investment, which has a very high import content, has been rising more rapidly this year than last. A substantial part of investment expenditures this year is connected with deliveries of ships, of airplanes to KLM, and of material for the construction of the natural gas distribution network. These expenditures are of a particularly lumpy character and all of them involve import payments swelling the Netherlands' import bill. However, all of these investments

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1/ Previously reporting of price increases was voluntary.

2/ In July, the Government announced spending cuts of fl. 159 million for fiscal 1966.

should contribute directly to an improvement of the current account in the future because they will replace imports as well as provide export deliveries of natural gas, and will improve freight and transport services. On the other hand, the import bill in the first quarter was held below what it might have been because of heavy inventory buying of consumer goods in the last part of 1965 in anticipation of higher excise taxes at the beginning of 1966.

While imports exhibited substantial strength, exports were unusually depressed during the first quarter because hoof and mouth disease held down cattle deliveries. These developments, combined with a substantial decrease in service receipts and an outflow of private capital connected with tightening credit conditions in other financial centers, resulted in a widening of the overall payments deficit from only fl. 17 million in the first quarter of 1965 to fl. 784 million in the first quarter of 1966. The fourth quarter 1965 deficit was fl. 230 million, but seasonal movements tend to produce a deterioration in the payments position during the first half of the year.

In view of the increase in inflationary pressures in the first part of the year, the Central Planning Bureau revised its forecast of the economy's performance in 1966. The new estimates also incorporate effects of the new government measures. The major changes are in the area of wage incomes, private consumption demand, and investment in inventories, all of which are to grow faster than expected earlier. (See Table 1.) However, aggregate final demand, industrial output, and labor productivity continue to be estimated to rise in line with the earlier forecast. As a result, the impact of the greater growth in certain sectors is offset by slower growth in others, notably exports and industrial investment. In addition, the increase in consumer spending is expected to push consumer prices up by 5.5 per cent instead of the 4.5 per cent estimated earlier. Because of these developments, the Central Planning Bureau now expects a deterioration in the current account balance for calendar 1966 from the initial forecast of a fl. 400 million

Table 1. Netherlands: Projections and Results of the Economy's Performance, 1965-1966
(percentage change over previous year)

	1965		1966	
	Revised Estimate	Results	January Estimate	Revised Estimate
Gross National Product 1/	4	5	5.5	5.5
Industrial production	4.5	5.5	6	6
Private consumption expenditures 1/	6	7	4	4.5
Gross fixed investment by enterprises 1/				
Housing	9	12	7	7
Other	3.5	3.5	9	8
Inventories (fl. billions, levels)	0.75	0.95	1.50	1.65
Export of goods 1/	7	9	10	8.5
Import of goods 1/	5.5	5.5	10	10
Productivity in enterprises	3.5	4	5.	5
Wage sum per worker in industry (incl. social charges)	11	11	9.5	10.5
Investment goods prices	4.5	3.5	3.5	3.5
Consumer prices	5	4.5	4.5	5.5
Export prices	2	1.5	1	1
Current account balance (fl. billions)	-0.10	0.48	0.40	-0.40

1/ Volume increase.
Source: Central Planning Bureau and Netherlands Bank.

surplus to a deficit of fl. 400 million ($110 million); later estimates of another Government body indicate this deficit is expected to expand even further to a fl. 620 million ($171 million).

The new estimates of the performance of the Dutch economy in 1966 indicate that, as compared with the performance in 1965, the volume of aggregate demand, industrial output and labor productivity all will grow slightly faster. (See Table 1.) The greater rise of output will be augmented by a large increase in the volume of imports. The additional resources are to be taken up in part by a more rapid expansion of enterprises' gross fixed investment in plant and equipment,1/ by rising consumer expenditures and by an increase in inventories.

The strength of consumer demand will be maintained by the fact that total wages per worker in industry are now expected to rise almost as strongly this year as last. However, since increased demand is expected to contribute to a rise of 5.5 per cent in consumer prices, a sharper increase than the 4.5 per cent recorded last year, higher prices will absorb a larger part of income. As a result, the volume of private consumer expenditure will rise substantially less in 1966 than in 1965. On the whole, the Dutch economy will grow somewhat faster in 1966 than in 1965, but the attainment of balanced economic growth and the realization of the policy goals of a small surplus on current account and reasonable price stability will not be realized.

1/ Government and private enterprises combined.

The Netherlands Bank has consequently found it necessary to continue its restrictive monetary policy. The Bank has been pursuing a restrictive monetary policy since late 1963, primarily through the medium of direct controls on credit expansion. Although credit expansion has still advanced rather strongly, in part because banks have persistently exceeded the permissible rate of expansion designated by the Netherlands Bank, the cumulative effects of the past two and a half years of credit restriction recently have begun to make themselves felt.

In recent months, the combination of the rising demand for funds by the public and the continuing restrictions on bank lending has led to an increasingly strong advance in interest rate levels. (See Chart.) During the course of 1965, the rate on Treasury bills rose from 3.68 per cent to 4.29 per cent and by April 1966 it increased further to 4.50 per cent. Long-term government bond yields advanced 76 basis points to 6.97 per cent from December 1964 to December 1965 and rose a further 45 basis points to 6.54 per cent by April 1966. In May, a loan issued by the Bank for Dutch Municipalities which carried a coupon of 7 per cent and was offered at 99-1/2 per cent of par established a new high in coupon offerings.

Rising domestic interest rates made it increasingly attractive for banks to discount paper at the Netherlands Bank and to relend at a profit. Discounting at the central bank consequently rose from fl. 7 million at the end of 1965 to a very high fl. 115 million in April. In order to put an end to this and to place an additional damper on inflationary pressures, the Netherlands Bank raised its discount rate by one-half per cent from 4.5 to 5.0 per cent on May 2. After the discount rate increase, Treasury bill yields rose to 4.9 per cent and have remained at that level through July. Bond yields also steadied; the 7 per cent loan of the Bank for Dutch Municipalities is currently quoted at 1-1/2 points above par and the Government has announced it will float a fl. 200 million bond issue in August on the same terms at which the Municipalities loan was offered. On the whole, it would seem that interest rates have, for the time being, stabilized around the very high levels reached in May.

<u>Strong expansion of demand</u>

A strong growth of demand in both the public and private sectors caused a strong expansion of economic activity in the Netherlands in the first five months of 1966 and a marked increase in inflationary pressures. The extent of the demand expansion in this period was greater than had been anticipated in the Central Planning Bureau's original economic forecast for 1966, a fact which led the Planning Bureau in May to revise its estimates for the year.

Private consumer demand, which has been a leading expansionary force in the economy, proved to be greater and more resilient than had been expected. Consumer demand was expected to show a relatively substantial, if only temporary, easing in the first few months of 1966 in reaction to a heavy buying wave at the end of 1965 anticipating of the imposition of higher indirect taxes on January 1. Although retail sales and imports slacked off in the first few months of the year, the easing of consumer demand was less pronounced than had been expected. Estimates of the growth of private consumer expenditures for the entire year have consequently been revised upward from 4 to 4.5 per cent (in real terms).

Strong consumer demand was accompanied by a growth of investment demand, both government and private. Private industry continued the process of inventory restrocking begun during the second half of 1965 and both private industry and government appear to have moved ahead with their fixed investment. The growth of overall demand for investment in fixed assets and inventories was reflected by a lengthening of order backlogs over the previous year's levels in the capital and intermediate goods industries (see Table 2) and in a marked rise of imports of raw materials, semi-finished products, and finished capital goods.

Table 2. Netherlands: Order Backlog, 1964-May 1966
(orders in terms of months of production, end-Jan. 1965 = 100)

End of Month	All Industries 1/			Consumer Goods Sector			Investment Goods and All Other		
	1964	1965	1966	1964	1965	1966	1964	1965	1966
January	103	100	100	105	100	100	102	100	101
February	104	99	99	106	99	97	104	99	100
March	104	97	99	107	100	94	103	97	100
April	104	100	99	110	102	100	102	100	99
May	102	100	102	110	104	98	101	99	102
June	102	100	101	109	103	97	101	99	102
October	102	102		107	102		101	102	
November	102	102		102	103		101	102	
December	101	100		100	101		101	100	

1/ Excluding the chemical industry.
Source: Centraal Bureau voor de Statistiek.

Industrial production expands strongly

Rising demand continued to be met with further substantial gains in industrial production. After having risen 5.5 per cent in 1965, thus exceeding official forecasts by a full per cent, industrial production continued to expand strongly in the first four months of 1966. Production rose at an annual rate of 8.7 per cent during the first four months of 1966 as compared with an annual rate of 6.2 per cent during the last half of 1965. (See Chart.)

Since 1963, industrial output in the Netherlands has been expanding at a rate considerably faster than that experienced in the years immediately preceding. The average annual rate of growth of industrial production was 6.5 per cent in 1963-1965 as compared to an annual average rate of 4.8 per cent in 1961 and 1962. The major factor behind these higher rates of growth was substantially larger increases in productivity. Productivity in enterprises rose 7.5 per cent in 1964 and 4 per cent in 1965 but averaged increases of only 2.0 per cent during the 1961-1963 period.

A number of factors have contributed to the strong expansion of productivity since 1963. Prior to the 1963 wage settlements, productivity may have been unnaturally depressed by the unrest and dissatisfaction which pervaded the labor scene at that time; with the 1964 wage adjustment, morale probably improved significantly. There have, in fact, been reports of declining absenteeism and an improvement in the attitude of workers. It is difficult, however, to judge how much this factor may have influenced productivity.

The large increases in labor costs which have taken place since 1963--15 per cent in 1964, 11 per cent in 1965 and an estimated increase of almost 11 per cent again this year--have encouraged businessmen to make large investments in labor-saving machinery and to use existing labor more productively. This development has undoubtedly been of great, if not leading, importance in raising productivity and restraining the rise of unit labor costs and prices. Following the initial large wage settlement in 1963, gross investment of enterprises in fixed capital rose 17 per cent in 1964 (in real terms) and a further 5.5 per cent in 1965.1/ Gross investment in fixed capital had risen only 3.8 per cent in 1962 and 2.7 per cent in 1963. Although investment in plant and capital by enterprises did not grow steadily in 1964 and 1965, the growth was important in absolute terms.

Labor situation

The more efficient use of labor and the strong rise of productivity made possible by the intensive investment effort of enterprises has been reflected by a small, gradual decline in the unsatisfied demand for labor since the end of 1964. Although the number of job openings still outnumbers the number of unemployed people by more than three to one, this ratio has declined notably. (See Chart.)

The decline in the unemployment/vacancies ratio resulted from a slight increase in the number of unemployed. This may have occurred as a result of lay-offs during equipment installment or because of some

1/ Includes Government expenditures on the natural gas system.

displacement of workers by new equipment in certain industries. However, these increases in unemployment have created few difficulties in a labor market where job openings are so much in excess of unemployed workers. Dismissed workers have in most cases been readily reabsorbed and total demand for labor has remained unsatisfied even though the labor force expanded at the relatively high rate of 1.5 per cent annually through 1965.

Strong demand for labor continued to place unions in a good bargaining position and wage agreements submitted to the authorities for approval through May provided for further substantial wage increases. By the last part of May, 80 contracts entailing an average wage increase of 7.5 per cent and covering about one million workers had been approved by the Board of Mediators. A further 45 wage contracts covering 570,000 workers, involving an average wage increase of 10.6 per cent, had been submitted to the Board, but had not yet been approved. Negotiated wage settlements exceeded, therefore, the 6 to 7 per cent indicated by the Government as the maximum increase permissible in the current economic situation.

Troubled by the size of wage settlements and by accelerating price increases, (see Chart) the Government announced a number of measures on May 21 designed to dampen mounting inflationary pressures. In the area of wages, the Government announced that it would approve no further contracts until July 15 and no contracts providing for wage increases in excess of 7 per cent. Allowing for the wage increases which already had been approved, the expected wage drift, increased employer contributions to social security payments and larger holiday bonuses, the Central Planning Bureau now estimates that the wage cost per employee in industry will rise 10.5 per cent in 1966 rather than the 9.5 per cent estimated in January.

Price increases accelerate

Persistent pressure behind wages was accompanied by an accelerated increase in prices during the first few months of the year. Prices generally increased sharply but rose most rapidly on the retail levels. (See Chart.) Consumer prices rose 4.5 per cent in 1965 but advanced more strongly following the turn of the year so that in April the consumer price index stood 6.7 per cent above the year-ago level. Part of the price increase resulted from the imposition of higher indirect taxes and an increase in controlled rents at the beginning of the year. Food prices also exhibited a sharp seasonal rise. But rising prices of manufactures also pushed up the index.

Wholesale price of manufactures moved up strongly at the beginning of the year, rising 3.5 per cent between December and March to a level 6.4 per cent above March 1965, after having risen an average of only 2.8 per cent between 1964 and 1965. Higher prices of manufactures probably reflected in part higher costs of raw materials but a good part of the price increase would also seem to reflect the rising cost of labor.

In response to the rapid increase of prices, the Netherlands Government accompanied its May wage action with the announcement that:

1. All domestic price increases during the remainder of 1966 must be reported to the authorities with an explanation of the increase;

2. Only increased costs of raw materials could be passed on in higher prices; wage increases were not to be passed on unless they would prevent a well-run firm from earning a "normal" return on capital.

Despite these measures, the Central Planning Bureau now forecasts an average increase in consumer prices for 1966 of 5.5 per cent, one percentage point higher than its January estimate.

Export prices, on the other hand, have shown much less tendency to rise, increasing an average of only 1.5 per cent in 1965 (as indicated by the average value index) and remaining through May 1966 at the August 1965 level. The slower rise of export prices may reflect a conscious effort of exporters to protect their relative price competitiveness in world markets, a factor of grave importance in the open Netherlands economy where exports are equivalent to approximately 50 per cent of GNP.

Trade deficit widens

Although the emergence of stronger inflationary pressures in the Netherlands encouraged the growth of imports, there were other important factors which influenced import development during the first five months of the year. Investment activity, which traditionally involves a high import content, has swollen the import bill. Deliveries of ships, KLM airplanes, and pipeline for the natural gas distirubtion network, all of which involve payments of a particularly large and lumpy character, were made during the January-May period. Moreover, the resumption of stock-building by industry led to a further substantial increase of imports of raw materials and semi-finished goods. (See Table 3.)

The import bill was probably held below what it might have been, however, as a result of an earlier acceleration of consumer good imports in anticipation of higher excise taxes beginning January 1, 1966. The fact that imports of consumer goods nonetheless grew as much as they did

Table 3. Netherlands: Structure of Foreign Trade
(percentage change over previous year)

	1965 Jan.-Apr.	1965 May-Aug.	1965 Sept.-Dec.	1966 Jan.-Apr.
Imports, total	+ 1.3	+ 3.8	+13.3	+14.5
Raw materials and semi-finished goods	- 0.3	+ 1.6	+ 8.6	+11.6
Fuels, excl. crude oil	-21.8	+ 2.3	- 2.3	+13.2
Consumer goods	+15.2	+14.0	+30.4	+22.3
Capital goods	+ 6.3	+ 7.8	+25.3	+23.0
Exports, total	+10.9	+11.5	+ 9.3	+ 5.3
Unprocessed agricultural products	+20.5	+13.2	+11.8	- 9.1
Finished goods	+ 9.0	+10.8	+ 8.1	+ 6.6

Source: Centraal Bureau voor de Statistiek.

in the January-April period is an indication of the strength of consumer demand. The combination of strong consumer demand and expanded investment activity is expected to cause imports to rise 10 per cent in 1966, almost twice as fast as last year.

Exports, on the other hand, were depressed during the January-April period as a result of a cattle disease, which caused exports of unprocessed agricultural products to fall 9 per cent below year ago levels. (See Table 3.) Although exports had begun to recover in April and May, when they rose strongly, export growth in 1966 is still expected to average 8.5 per cent over 1965 as compared with the 9 per cent increase realized in 1965. The anticipation of a slower rate of growth is largely based upon the slower growth of import demand in Germany, which takes approximately one-quarter of Dutch exports.

For the first five months of 1966, the Netherlands's trade balance fell to a seasonally-adjusted deficit of $601 million following one of only $583 million in the last five months of 1965. (See Chart.) The portion of imports covered by exports shrank from 82.3 per cent in the last five months of 1965 to 82.0 per cent for the first five months of 1966 although the improvement in April and May raised the export cover to an average of 85.7 per cent in those two months.

Balance of payments deteriorates

The widening of the trade deficit contributed to the deterioration of the current account and to an expanded payments deficit in the first quarter of 1966. Shrunken receipts from investment income and from other services contributed to an even greater extent, however, to the enlarged deficit on current account, which rose from fl. 49 million (cash basis) in the fourth quarter of 1965 to fl. 487 million in the first quarter. (See Table 4.) This swollen deficit led the Central Planning Bureau to revise its forecast of the current account balance for 1966 from a surplus of fl. 400 million (transactions basis) to a deficit of the same size. Inflationary pressures will, therefore, keep Dutch authorities this year from realizing their policy goal of attaining a surplus on current account equivalent to 1 per cent of national income.

Private capital flows showed another--although considerably smaller--deficit in the first quarter following the initial appearance of one in the fourth quarter of 1965. The deficit on overall capital account arose primarily from the extension of both bank and non-bank longer-term foreign credits. Despite continuing tightness in Dutch

Table 4. Netherlands: Balance of Payments, 1965-March 1966
(cash basis, millions of guilders)

	1965 I	1965 II	1965 III	1965 IV	1966 I
Current Account					
Trade balance	-625	-555	-579	-662	-794
Investment income	222	- 44	353	188	39
Other services	411	297	353	425	268
Total	8	-302	127	- 49	-487
(Current Account-transactions basis)	(13)	(-395)	(484)	(-54)	(757)
Private Capital					
Transactions in domestic securities	183	90	127	48	178
Transactions in foreign securities	- 84	- 94	25	- 12	- 39
Direct investments	- 87	-100	- 12	- 8	- 87
Long-term credits	140	106	- 38	- 28	-172
Other	16	1	- 42	-176	105
Total	168	3	60	-176	- 15
Commercial Banks Capital					
Total	-167	-149	-229	18	-266
Government Capital					
Debt repayments	- 1	- 28	--	- 22	--
Other	- 25	2	49	- 1	- 16
Total	- 26	- 26	49	- 23	- 16
Surplus or Deficit (-)	- 17	-474	7	-230	-784
Financing (increase -):					
Commercial Banks					
Net foreign exchange position	- 18	465	306	221	639
Central Bank					
IMF position	- 13	-218	-107	--	- 52
Consolidated credits	4	1	1	1	1
Gold and foreign exchange	44	226	-207	8	196
Total	35	9	-313	9	145
Total Financing	17	474	- 7	230	784

Source: Netherlands Bank, 1965 Annual Report; Ministry of Finance.

financial markets, yields are apparently sufficiently attractive elsewhere to cause capital outflows. Particularly high yields in Germany are probably proving especially attractive to Dutch investors.

The overall payments deficit, therefore, widened markedly in the first quarter, rising to fl. 784 million from fl. 230 million in the previous quarter. The deficit was financed in the main part by a drawing down of commercial banks' net short-term foreign exchange positions. Official gold and foreign exchange holdings declined somewhat as well.

<u>Government spending expansionary</u>

Rapidly rising Government expenditures were an important factor behind the strong demand expansion in the first half of the year. Central Government expenditures rose considerably more rapidly in the opening months of the year than originally foreseen, a fact which led the Netherlands Government in May to introduce economy measures designed to hold down Government spending during the remainder of the year. Despite these measures, a substantial upward revision of budget expenditures and an enlarged deficit for 1966 were still necessary.

In 1961, the Government introduced the principle that the margin available for a rise in Government expenditures, or a possible reduction of taxes, was to be circumscribed by the potential increase in revenue which could be expected in any one year on the basis of the trend rate of growth of national income.[1/] However, this rate of increase, has been exceeded in each year since 1961.

1/ Certain expenditures, including those which do not lead to disbursements at home as well as repayments of long-term debt and civil servant salary increases, are not included in the calculation of this standard.

The Government, which since April 1965 again included the Labor Party, has defended the greater than prescribed growth rate of expenditures in the past few years on the grounds that the rapidly expanding economy required a certain level of social investments. The impact of recent budgets has apparently, however, been more expansionary than anticipated by the authorities. The reason for this lies in the fact that initial Government budget estimates have consistently underestimated the actual rise in expenditures by substantial amounts in past years and the disparity between estimated and actual expenditures has only rarely been compensated for by sufficiently greater revenues than originally estimated. In 1965, the budget closed with a deficit of fl. 1,488 million in contrast to the initial deficit estimate of fl. 916 million because expenditures rose fl. 1.4 billion over the original budget estimate. (See Table 5.)

Table 5. Netherlands: Central Government Budgets, Original Estimates and Results, 1964-1966
(fl. millions)

	1964		1965		1966	
	Original Estimate	Results	Original Estimate	Results	Original Estimate	May Revision
Revenue	11,449	13,180	14,090	14,951	16,931	17,081
Expenditures	13,077	14,575	15,006	16,439	18,080	18,990
Budget deficit	-1,628	-1,395	- 916	-1,488	-1,149	-1,909

Source: Ministry of Finance, Financieel Overzicht, and Government Budget Memoranda for 1965 and 1966.

This year Government spending again rose much more rapidly than originally foreseen because of particularly heavy expenditures in the areas of education, agricultural subsidies, subsidized housing and higher salaries for Government employees. The additional expenditures were taken up by the specified categories as follows:

- education	fl. 375 million
- civil servant salaries	fl. 245 million
- agricultural subsidies and related	fl. 190 million
- accelerated construction of subsidized housing	fl. 100 million
Total	fl. 910 million

The large discrepancies between budgeted and actual expenditures, particularly in such areas as civil servant salaries, where the Government should have an especially firm basis for its estimates, suggests that the Government has not been realistic in formulating the budget.

The Government consequently presented a revised budget estimate to Parliament on May 21, indicating that expenditures would rise fl. 910 million more and revenues fl. 150 million more than laid down in the original budget document, thereby causing the deficit to rise from fl. 1,149 million to fl. 1,909 million. At the same time, the Government announced the following measures designed to hold down the rise of Government spending during the remainder of the fiscal year:

1. until October 1, 1966, no new contracts for government investments would be concluded unless postponement were impossible for technical reasons;

2. no new civil servants were to be hired through the end of 1966;

3. efforts would be made to economize on other government spending.

These further efforts resulted in expenditure cuts of fl. 159 million announced in July, which would reduce the deficit to fl. 1.75 billion in 1966.

Credit expansion

Since Government spending remained expansionary, the task of controlling inflationary pressures continued to fall to the Netherlands Bank. As a result, the monetary policy of the central bank continued along the restrictive lines inaugurated in late 1963 when the old wage and price control system was relaxed and wages were allowed to advance sharply.

The Netherlands Bank has relied primarily on direct controls over credit expansion as its chief policy tool in preference to the use of a cash reserve ratio, another possible choice, because of the ease with which commercial banks could repatriate their large foreign exchange holdings and offset the effects of any such move. In 1966, the credit restrictions were tightened somewhat. In January-April, commercial bank credit extensions were to rise no more than 5 per cent above average permissible lendings in the fourth quarter of 1965, a permissible increase of fl. 325-350 million; for the May-August period commercial banks were told to reduce their outstanding short- and medium-term credits by 1 per cent of the amount of average permissible lending in the fourth quarter of 1965, or by about fl. 65-70 million.

Credit expansion has proceeded quite strongly despite the restrictive measures because (1) banks continually exceeded the permissible short- and medium-term credit extension limits and (2) long-term credit grew rapidly. Until June 1965, there were no controls on long-term bank lending. Long-term credit expansion in the past had expanded only moderately and so long as credit expansion did not grow more rapidly than long-term resources, the Netherlands Bank considered it to be non-inflationary. In 1964 and 1965, however, the growth of long-term credits exceeded the growth of long-term resources by fl. 170 million and fl. 456 million respectively. In June 1965, therefore, the Netherlands Bank reached an agreement with the commercial banks, which in stipulating that banks' long-term loans increase no more rapidly than their long-term resources, formalized the Bank's attitude towards long-term lending.

To increase the effectiveness of controls on short-term credit expansion, the Netherlands Bank announced in July 1966 that penalties would be stiffened for banks consistently exceeding the permissible ceiling. Banks which exceed the credit ceiling in three consecutive months or in four out of six months and by greater amounts than they did last year will have their credit ceilings lowered. These banks will furthermore have to maintain penalty deposits equivalent to the amount of overlending on each day in the following month instead of on a monthly average basis as has been the case.

Interest rates continue to rise

The restrictive policy of the Netherlands Bank has apparently begun to pinch increasingly. Although credit expansion has been relatively substantial, the demand for funds has evidently grown considerably more, with the consequence that interest rates have risen steadily since 1964. (See Chart.)

The financing of the rapid growth of the economy in conjunction with the restrictive credit policy of the central bank had reduced the liquidity ratio of the economy from 40.7 per cent at the end of 1963 to 37.4 per cent at the end of 1965.[1/] By the end of March the liquidity ratio was down to 36 per cent. The consequently increased demand for funds has, in recent months, led to an acceleration of the trend towards rising interest rates. This tendency has been most noticeable in the long-term market. Yields on long-term government bonds, which increased by 76 basis points to 6.09 per cent in 1965, rose 45 basis points to 6.54 per cent in April. (See Chart.) Terms of capital market offerings were made steadily more attractive to investors in order to procure desired investment funds. At the beginning of the year, a coupon rate of 6-1/4 per cent was placed on a Bank for Dutch Municipalities loan after a 6 per cent offering in November had failed to find full placement. In April, a second loan of the same institution carried a 6-1/2 per cent coupon and in May the coupon rate on a third bond issue was raised to 7 per cent. This last loan was snapped up by market and is now quoted 1-1/2 points above par. On the whole, interest rate movements appear to have stabilized

1/ The ratio of total liquid assets in the possession of the public to national income.

at these higher levels. Yields on shorter-term maturities rose also and the rate on Treasury bills rose from 3.68 per cent at the end of 1964 to 4.29 per cent in December 1965 to 4.90 per cent by mid-July.

The upward trend of domestic interest rates made it increasingly profitable for commercial banks to rediscount heavily at the Netherlands Bank and relend the funds. In April the volume of discounting rose to the high level of fl. 115 million from only fl. 7 million at the end of 1965. This strong increase in bank discounting and the strengthening of inflationary pressures in the first few months of the year led the Netherlands Bank on May 2 to raise its discount rate from 4.5 to 5 per cent.

The Netherlands Bank had preferred to conduct its restrictive policies through the use of direct controls and apparently raised discount rate primarily because of the need for a technical realignment of interest rate levels. Certain domestic and international considerations had, however, apparently caused the authorities to hesitate to make this move. On the external side, hesitations centered around the fact that inflows of capital had followed discount rate increases on past occassions, thereby interfering with the aims of monetary policy. Tightening of credit conditions in most major financial centers during the past year largely eliminated this hesitation however. On the domestic side, there has been concern about the situation of the small enterprise. Small domestic enterprises have been less able than large ones to absorb the burden of greatly increased wage costs and the rising cost and diminished availability of financing. As a result, bankruptcies have been rising. Further increases in credit costs would bear most heavily on these small firms. This hesitation was apparently overcome, however, by concern over mounting inflationary pressures.