BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
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TO: Federal Open Market Committee

FROM: Ralph A. Young

SUBJECT: Report of President Holtrop

For the information of the Committee, I enclose the "General Survey" which Dr. Marius Holtrop recently presented as part of his report to the Annual Meeting of the Netherlands Bank.

Dr. Holtrop, apart from briefly reviewing the Netherlands situation, considers some general problems of fiscal, income, and price policy, and especially their relation to the functions of central banking.

Of particular interest to the Committee is his concluding discussion on balance of payments problems (pages 19-30), which includes, in addition to some general observations, a lengthy analysis of the U. S. balance of payments together with policy recommendations for eliminating the U. S. payments deficit (pages 25-30).

RAY

Enclosure.

Unofficial translation

THE PRESIDENT'S REPORT

GENERAL SURVEY

In the light of the year 1961's results our last Report expressed a certain uneasiness about what the year then in prospect might bring forth for the Netherlands; but now it must be said that the course of events in 1962 was much more favourable to our country's economy as a whole than could be foreseen. The uncertainties which were present in the spring of 1962 were of two kinds. On the one hand there was reason to fear that the strained state of economic activity might lead to over-spending in the country, coupled with a balance of payments deficit and followed by an inevitable reaction, as had happened in 1956/57. On the other hand there appeared to be some danger that the current steep rise of labour costs per unit of production would endanger exports, and hence employment, as soon as any recession occurred abroad. Neither of these dangers materialised. There has been no over-spending, nor any economic setback. And although various industries encountered difficulties, while the economy in general suffered contraction of profit margins, the national income as a whole showed reasonable growth. The prospects for the coming year also now seem less unfavourable than a year ago. Thanks to the policy pursued in different spheres there is less reason than a year ago to allow for the risk that domestic trends will become uncontrolled in one direction or another. Possible disturbances to the stability of the Netherlands' economy in the near future are now rather to be apprehended from the course of events abroad than from that at home, particularly if costs should continue to rise in foreign countries or demand there should contract.

The most important results of the past year can be briefly summarised as follows: by comparison with 1961 the volume of the national product increased by over 2½ per cent and that of industrial production by 4 per cent. This last meant that per capita productivity in industry improved by 2½ per cent, a result which may be regarded as not unfavourable when it is borne in mind that the average working time per week is estimated to have been shorter by 1½ per cent than in 1961. The increase of production was stimulated by growth of demand; the volume of consumption rose by 4½ per cent, capital investment by 4 per cent and exports of goods by as much as 7 per cent.

While therefore the real quantities in the national accounts showed satisfactory and balanced growth, there was less ground for satisfaction in the fact that the growth in nominal exceeded that in real terms, thereby betokening a certain measure of continued price inflation. The nominal national income rose by 6 per cent, that is by 4½ per cent per head of the gainfully active population; the total wage per worker was up by 8 per cent, and the cost of living index by 3½ per cent. As a result of the great rise in wages and salaries the entire increase of the national income for the second year in succession came to the benefit of wage and salary earners, of course to the detriment of the relative share going to other income groups, including more particularly enterprises.

The rise in the volume of Netherlands goods exports by 7 per cent, and that in the export of manufactured products by no less than 9 per cent, were undoubtedly among the most reassuring facts of the year under report. These rises did after all indicate that, despite higher labour costs, the Netherlands' ability to compete was not yet impaired. Nevertheless the fact that by now the price level of exported manufactured goods has fallen slightly each year for five years calls for some caution in view of the movement in costs. In the last two years the prices of exported finished products have fallen by some 3 per cent, and those of imported raw materials and semi-finished goods by about 5 per cent, while on the other hand the cost of labour per unit of industrial production has risen by 12 per cent.

This raises the question whether the course of per capita productivity in our export industries has been favourable enough to maintain an adequate gross margin for producers.

The course of exports was so favourable that the further deterioration which had been feared in the balance of payments did not occur. The current account on a transaction basis yielded a surplus of fl. 650 million, which was practically equal to that for the previous year. Since the capital account showed a deficit of like amount without allowance for the banking system's capital transactions, which are not significant in this context (they amount in fact to conferring a somewhat less liquid character on the banks' assets employed abroad), it can be said that in the year under report the economy of the Netherlands, remarkably enough, realised exactly a position of equilibrium in the balance of payments.

Although this result was of course partly due to circumstances which cannot be controlled, or at least not in detail, it can also be regarded as due to the financial and economic policy pursued; this was expressly directed to avoiding not only over-spending, and a deficit in the balance of payments, but also any renewed increase of the official gold and foreign exchange holding. If the favourable results are partly attributed to policy, there is good reason to wonder whether the less satisfactory outcome as regards the movement in nominal quantities perhaps also resulted from it. In this connection it may be useful to consider for a moment what function the various policy instruments used in our country performed, both last year and in the preceding period.

The policy instruments which in the Netherlands are deliberately directed to influencing the economy's general internal and external equilibrium - this does not exclude the possibility that some of them may at the same time be directed towards achieving internal social objectives - are of widely differing character, and fall within the competence of separate authorities. Five policies may be mentioned, namely (1) that of the Finance Minister concerning the budget and other financial matters, (2) that of the Minister for Housing and the Building Industry with regard to building, (3) that of the Minister for Social Affairs and Public Health regarding wages, (4) that of the Minister for Economic Affairs regarding prices and (5) the monetary policy of the Central Bank. In the cyclical circumstances which have now prevailed in our country for years on end the use made of each of these policy instruments has been, on the whole, restrictive in character. Their application therefore imposes on those who are subject to it certain restrictions which are felt to be hindrances and which often, although perhaps only for a time, entail a real sacrifice of prosperity. It is no wonder that each of these restrictions is a target for criticism.

The principles governing the budgetary and financial policy of the present Finance Minister have been explained by him in the last three budget statements. Their effect is briefly that a distinction must be made between structural and cyclical policy. In the Minister's view the structural policy must take account, on the one hand, of the opportunities which the trend growth of the real national income affords for expanding public expenditure, but on the other hand of the limitations which that growth imposes on such expansion. For the Netherlands, in the light of recent experience, the trend growth may be put at 4% per annum. Owing to the progressive element in the tax system this growth produces a trend rise of 5 1/3 per cent per annum in Government revenues. It is this amount which affords the total margin available for increasing expenditure and reducing taxation. It is necessary to decide, according to a scale of priorities, which of the innumerable desiderata can be met within those limits. The declared object of the Government, now approaching the end of its term of office, was to keep the trend increase of its own expenditure below that of the national income so as to make room for reducing the burden of taxation. It must be borne in mind that the starting level of this latter was high; among other things tax revenues cover virtually the whole of capital expenditure, with the inclusion of publicly assisted housing, and accordingly contribute to keeping the level of the country's total saving also high.

The object of cyclical policy is through control of expenditure and taxation, as well as through other means, to exert such an influence on the country's total spending that it shall accord with the real possibilities of production. Cyclical policy must accordingly be directed to limiting expenditure when conditions are strained, but on the other hand to expanding it when they are slack. In some measure structural budgetary policy, if it is being adhered to, will already by itself tend to stabilise the business cycle, since, under such policy, cyclical fluctuations of tax income are not being allowed to affect the level of expenditure. But to use expenditure policy in addition to this as a means of offsetting cyclical fluctuations appears to be almost impossible in times of prosperity. The proportion of total budgeted expenditure which can be postponed is too small for this to be practicable.

What can be done is to exert a certain compensatory effect through tax policy. One example of this was the reintroduction in 1958, and the partial abolition in 1960, of the investment allowance; another was the increasing in 1959, and the limiting in 1960, of the facilities for anticipated depreciation - these things being done first in order to stimulate, and later to check, capital investment. It was likewise for cyclical reasons that the lowering of income tax, although the decision to lower it had been taken much earlier, was postponed until July 1, 1962.

The Finance Minister's remaining instruments of cyclical control include in particular his borrowing policy, which of course also has structurally important aspects. The cyclical significance of borrowing policy is that in times of cyclical tension the Treasury can borrow in the capital market funds not required for financing expenditure, as was done in the years 1959 to 1961; or conversely in times of slackness it can refrain from borrowing in the capital market funds which it needs for financing, the object being to bring down interest rates and so stimulate additional spending by others. The structural aspect of borrowing policy lies in the choice between financing through loans or through taxation. As the Finance Minister argued in the last budget statement, this choice must be partly influenced by the question whether private saving tends structurally to lag behind the private investment (at home and abroad) which is required for ensuring satisfactory growth of the national economy, or just tends to exceed such investment. In the former case, where there is a shortage of saving, it is desirable to cover a smaller part of public expenditure by borrowing; in the latter case, where there is an excess of saving, it is desirable so to cover a greater part of it. If the authorities do not conform in this way to the conditions prevailing in the private sector, the danger is that there will be in the one case a certain overstrain and tendency to inflation, in the other a failure to advance, under-employment and hence inadequate growth.

There is no doubt that the last few years' overall budgetary and financial policy has done much towards controlling the business cycle, while moderating in some degree the pace at which nominal domestic parameters were adjusted to the conditions for equilibrium imposed by foreign transactions - some part of that adjustment having been effected by the March, 1961 revaluation. Whether structural policy was not at times in the course of that process sacrificed too much to cyclical policy will no doubt always remain a matter of dispute.

The question how far also in 1962 the results achieved by policy agreed with its objects cannot be so easily answered. Where a period of only one year is considered the structural and cyclical elements become confused. In the year under report there were tax reductions, some of them taking effect only from July 1, which amount on a yearly basis to fl. 650 million or roughly 6 per cent of the tax revenues. The burden of taxation fell, for the first time since 1955, from almost 26 per cent of the national income in 1961 to about 25 per cent of it in 1962. To that extent, therefore, one object of structural policy was achieved. But this was partly due to the disappointing yield of the corporation tax; and that in turn resulted from a cyclical cause, namely from the shift in income distribution to the detriment of enterprises. One object of both structural and cyclical policy, namely to keep the rise in Government expenditure below that in the national income, was not quite realised. Government expenditure on a cash basis rose by 7 per cent, thereby somewhat exceeding the increase of the national income. The substantial growth of wages and salaries prevented fulfilment of the original policy intentions.

As regards borrowing policy - in preceding years definitely directed to withdrawing funds from the capital market, even though they were not required to cover any financing deficit - the target of neutral financing, set for the year under report, was overshot; partly because tax revenues were disappointing the Government had a liquidity deficit of over fl. 200 million,

Up to a point the Finance Minister, in cooperation with the Minister for Interior Affairs, can exert some influence on the policy of the local authorities and in particular of the municipalities. Except in very special circumstances he can exert no such influence on their spending, regarding which they are autonomous within the limits of the opportunities for financing available to them, but he can influence their financing. This is because, at the instance of the Government, the provincial executives make sure that the municipalities do not overstep certain standards set for their maximum permissible financing through short-term debt. As soon as the First Chamber has passed the relevant bill, already adopted by the Second Chamber in March, 1963, this supervision will be given a specific legal basis. Its object is to ensure that the municipalities will in general finance their capital expenditure in a monetarily neutral manner, that is by obtaining funds in the capital market and not through the issue of short-term debt. Experience gained in the 1956/57 period of over-spending had shown that the very high credit standing assigned by the money market and private lenders to public authorities had created almost unlimited possibilities for the latter to engage in inflationary financing of their capital expenditure. These possibilities had to be limited. The measure passed by the Second Chamber satisfactorily meets this need.

Also under the control exerted in the year under report policy was directed to ensuring that the municipalities' capital expenditure should be financed in a neutral manner, of course with due regard for the margin allowed to them within the standard set. It now appears that a rather extensive use has been made of that margin. Thanks to the possibility of again increasing within the set standard their floating debt, which in the previous year had dropped almost to nothing, but unfortunately also in part as a result of overstepping the standard in force, the local authorities were able to keep their capital market borrowing down to more than fl. 600 million below the amount of the deficit which had to be financed.

It must therefore be stated that within the period under report the rule as to neutral financing by public authorities was not observed. This fact was partly offset by an accumulation of liquidity in the hands of the institutional investors. For the rest the local authorities' financing must be deemed to have contributed towards causing a switch of the banks' lending from the private to the public sector, together with some increase of cyclical tension and some decrease in the surplus on the balance of payments.

Among the financial policy instruments for the use of which the Finance Minister bears ultimate responsibility it remains to mention two that directly affect the balance of payments, namely the anticipated redemption of external debt and the permitting of foreign security issues. Both represent special balancing items among international payments; in the Netherlands they rank, so to speak, as refined control devices.

Foreign security issues, which as an element in the foreign exchange movement are still subject to approval by the Netherlands Bank, have in general been permitted only where a surplus in the balance of payments coincided with one in the capital market; anticipated redemption of debt has been practised when considerations of international equilibrium made this desirable. In 1962 such permitted issues amounted to nearly fl. 150 million, and the debt redeemed before maturity to over fl. 100 million.

Something quite different from overall influencing of internal and external equilibrium by financial means is the direct interference with the actions of the business, private and public sectors that is entailed by the building policy for which the Minister for Housing and the Building Industry is responsible.

So far as that policy is directed for social reasons to maximum promotion of a particular form of house construction, namely Housing Act building, it is not directly significant from the point of view of internal and external equilibrium. The aspect of building policy which is essentially significant from that point of view is the limitation of the total amount of building in order to prevent a rise in building costs which is deemed undesirable for both social and economic reasons. In this respect building policy may be regarded as an important element of wage and price policy. It is no longer, as it was in the first post-war period, a policy partly designed to prevent the spending of excess liquidity held by the personal and business sector, and hence directly to support monetary and balance of payments policy. It has gradually come to be a policy directed to preventing excessive concentration of demand on an industry which has limited production capacity and in which, owing to the absence of the regulating influence of foreign competition, such concentration of demand would lead to wage and price increases which might easily spread to other fields - and which then, by impairing ability to export, might endanger the external balance of the economy. This policy has of course slowed down the expansion of the building trade. The sacrifices entailed by limiting that expansion were great; they have become even more drastic since industrial building, which previously enjoyed absolute priority, was included within their scope from May, 1960 onwards. The importance of that limitation is reflected in the so-called reservoir of held-up permits for non-residential building; by the end of 1962 this already amounted to 1.8 times a year's output.

A certain unquantifiable influence on internal and external equilibrium is undoubtedly exerted by building policy. Without the limitation mentioned both wages and costs in the building trade would certainly be higher than they now are; the experience of Germany clearly points to that conclusion. In our small country, with its homogeneous wage structure, the danger that cost increases might spread to other industries would, however, be much greater than there. As to external equilibrium it is moreover certain that with a free building market more productive forces would be employed in building, and therefore less of them would become available in other sectors, including production for export. This would on the other hand be accompanied by a certain switch of domestic demand towards building and away from imports, but also by a greater demand on the available liquidity and the available credit.

It may be assumed by way of conclusion that building policy makes a positive contribution towards controlling the level of costs in the Netherlands and that by this means, as well as through a certain enforced limitation of spending, it tends to increase the surplus or reduce the deficit in the balance of payments. Precise weighing of the results achieved by the policy on this matter, as compared with the unmistakable and accumulating difficulties, is not practicable. In existing circumstances the usefulness of the limiting influence on spending, regarded in itself, may be doubted. On the other hand that of the influence produced on the level of costs must continuously be rated high.

Wage policy in the Netherlands since the end of the war has throughout been of great importance. It too, like building policy, is by its origin and nature restrictive; it is directed to ensuring such control of the rise in nominal wages as to prevent a cost inflation, with resulting risk of a balance of payments deficit and unemployment. One task of price policy has been to ensure that the said nominal wages should nevertheless be given the greatest possible real content. Originally the need for controlling wages was due to the excessive abundance of liquidity after the war; but later it was labour market tension, caused by the favourable course of the business cycle during the last ten years, which rendered it necessary to continue a policy of wage control.

Another important subsidiary feature of that policy was that it ensured the coordinating - particularly desirable on social grounds - of wage movements in the various sectors of the economy; this prevented recurrence of the extreme and unjustified wage differentials which had marked the period between the two wars. The extremely positive and constructive contribution which the Netherlands trade union movement made in the course of years towards implementing wage policy was inspired by the trade unions' own properly understood higher interest, namely their interest in ranking the size of the real wage and the permanence of employment higher than that of an incidental large nominal wage. That contribution will always have to be recognised, and may be held up to many countries as an example.

The technique of wage control has been altered several times in the course of the years; in particular it was substantially changed with effect from January 1, 1963. Up till then the ultimate responsibility for approving collective labour agreements had lain with the Board of Government Mediators, who were subject to directives laid down by the Government; but now responsibility for the overall wage level, and for the coordination of wages, has been largely transferred to the Council of Labour, the highest organ for cooperation between the associations of employers and employed. An important advisory function has likewise been assigned to the Social Economic Council. It is necessary to wait and see how the new system of wage formation will work. The first result was the conclusion in the first months of 1963 of a series of important collective labour agreements, including those for the metal-using and textile industries, in which wage costs were raised by about 2.7 per cent - a result which was certainly not unfavourable. It must be considered a great step forward that the amendment of the wage-forming system now places greater direct responsibility on the employers and employed themselves and that no attempt is any longer made to apply the principle which governed wage formation for some years, even though it was in theory hard to defend and in the long run could not in practice be executed, namely that this must largely conform to the movement of per capita productivity in individual industries.

The significance of wage policy for maintaining or constantly approximating to internal and external equilibrium in the economy can hardly be over-estimated. One need only study the problems of countries where an earlier or still slowly continuing cost inflation has created problems of under-employment and balance of payments deficit, or where a wage struggle based on power relationship leads to constant recurrence of serious labour conflicts, to appreciate how greatly a wage formation process governed by rational principles of wage policy can contribute towards balanced development. Needless to say, of course, even then a certain element of conflict cannot be entirely eliminated. Too many uncertainties about future trends remain involved for it to be possible to eliminate that element completely. Neither employers nor employed, nor even a Goverment inspired by the best intentions, can expect to claim all margins of uncertainty for their own benefit.

A rational wage policy can provide important support for monetary policy. It can help to prevent this latter from already becoming unduly restrictive, at an early stage of the business cycle, with the exclusive object of averting a cost inflation which is feared. It saves those responsible for monetary policy, after cost inflation has occurred and been followed by unemployment and a balance of payments deficit, from the disagreeable need to pursue, for the sake of external equilibrium, a policy which delays the recovery of internal activity.

It is less easy in the case of price policy than of wage policy to define its precise place in relation to the maintenance of internal and external equilibrium. Now, unlike the years shortly after the war, money is not over-abundant nor are goods scarce. On that ground it might be thought sufficient to rely on free competition as a means of ensuring reasonable price formation. There is however little doubt that, in certain fields, competition does not produce sufficient effect; where it does not, price policy can in some measure take the place of cartel supervision, which is evidently so much harder to apply. The fact that price policy directly affects the price level, and hence the stability of money, is in itself an attractive aspect of that policy instrument. On the other hand there is an unmistakable danger that, if such policy is too stringently applied in particular fields, lags in the movement of prices may accumulate and may cause a state of suppressed inflation to be mistaken for one of stability.

The mainly repressive price policy now pursued is based on three principles, namely that altered costs of raw and auxiliary materials are charged in prices, that on the other hand wage increases are not in general so charged, and that the amount - but therefore not the percentage - of the trader's margin remains unchanged. Unfortunately, as a result of Benelux and EEC commitments, the system of import duties is no longer available as an instrument of sovereign price control. It is obvious that in the circumstances of recent years a unilateral lowering of import duties - a measure essentially similar to an upward currency revaluation applying only to imports - might have performed a particularly useful function.

With regard to the price policy measures available the question may be asked whether application of the principle that wage increases shall not be charged in prices does not entail the very danger which has just been mentioned. Greatly as that principle may contribute towards checking unjustified wage movements in protected industries, not exposed to the influence of foreign competition, it must be said that in the long run it is unfair - and even causes economic harm - if steps are taken to prevent the charging in prices (where market conditions would permit it) of wage increases which have been found unavoidable on grounds of the necessary wage coordination, but which exceed the rise of per capita productivity in the industry concerned and have thus operated to raise costs. Failure to charge wage increases in this way prevents the quantitative adjustment of demand which would have resulted from a price-rise. Where demand is highly elastic, this means that production is wrongly maintained in forms which ought to make way for others. Where demand is not elastic, it means that an industry is deprived of the ability to continue its obviously necessary production in a proper manner. For wage and salary earners, moreover, the fixation of prices means an increase of real income in a manner which does not accord with lasting economic equilibrium and which later, when that increase is ultimately cancelled out by the inevitable price adjustment, may give rise to unjustified requests for compensation. It is difficult to judge whether the price lags which have already come about through application of this rule are by now a significant factor. But it does certainly seem that a warning against the dangers inherent in a possible cumulation of such price lags will not be out of place.

It is against the background of these many other policy instruments that the function of Central Bank policy in the Netherlands needs to be seen. The task of the Netherlands Bank is twofold. On the one hand it has to regulate the credit system in such a way that domestic monetary equilibrium is preserved, and the internal purchasing power of the currency remains as stable as possible; on the other hand it must maintain the parity of the currency, and it bears joint responsibility for the proper working of the international monetary system. Unfortunately this double task involves it in constantly recurring dilemmas.

As regards the first part of its task the Netherlands Bank aims in principle at so regulating the expansion of credit by the banking system that domestic liquidity creation conforms to the increased need for liquidity entailed by the estimated possible rise in the national income, reckoned at constant prices. In the light of recent years' experience this rise can be put at an average of about 4 per cent per annum. In each separate year there may of course be special reasons for anticipating some other particular rate. The liquidity requirement entailed by the rise in incomes is estimated by the Netherlands Bank at something over 40 per cent of that rise. If - as is now the case - no balance of payments surplus is being aimed at, this means that domestic liquidity creation can be permitted at a rate averaging about 1.6 per cent of the national income. If and in so far as the public authorities act neutrally in their financing, this liquidity creation can take place entirely through expansion of lending to the private sector and of capital market investment by the whole of the money-creating institutions. If the gap is not filled from these sources, there will be room for some creation of liquidity by the authorities; if these sources show a tendency to exceed the standard as thus calculated, and if this is found to be accompanied by cyclical strains, it will be for monetary policy to exert a restrictive influence.

It is this reasoning which governed the Netherlands Bank's policy during the past years. It was in the light of these considerations that the commercial banks and agricultural credit institutions were directed in 1961 to limit the expansion of their short-term private-sector lending to about 12 per cent, and in the year under report to limit it to about 8 per cent, per annum. When it was found likely about the end of 1962 that credit expansion would conform to the required standard, even in the absence of special limiting measures, the restrictions were suspended in January, 1963. At the same time the official discount rate, which in April, 1962 had been raised by ½ per cent to 4 per cent in order to support the restrictive policy pursued, was brought down again to 3½ per cent.

In fact however internal prices have not remained constant, and the national income has risen by more in nominal than in real terms. The standard for domestic liquidity creation cannot of course be simply adjusted to the nominal liquidity requirement (which is thus also rising), since that would mean taking as the standard that the country's own price inflation should be financed - without any resistance - from domestic sources. The principle must on the contrary be that the source of finance for a rise in domestic prices shall be a surplus on transactions with foreign countries.

It was entirely in conformity with this principle that the banks' expansion of credit in 1959 and 1960 fell short of the rise in the nominal liquidity requirement. Since in addition the authorities took liquidity out of circulation, total domestic liquidity creation was actually negative. The increase in the need for liquidity during those years was entirely met by the surpluses on transactions with foreign countries; these surpluses were at the same time the primary cause of the excess in the rise of incomes during recent years.

Of course it is evident that many of the domestic price-rises can be related to domestic wage increases, especially in the case of farm products and services, and also, with great delay, in that of rents; and it must even be stated that import prices since 1958 have continuously shown a slight downward tendency. But it is also a fact that in the years mentioned there was so great a foreign demand for products of the Netherlands as to cause substantial surpluses on the balance of payments. It is this process, completely escaping the influence of the Central Bank, which caused the labour market tension that led, with some delay, to the great wage increases in 1960 and succeeding years. It was also this process which, because of the inevitability of the restoration in the long run of external equilibrium, after all provided economic justification for wage rises which, from the point of view of internal equilibrium,were too great in nominal terms.

The trends in 1961 and 1962 need to be regarded in the light of what has just been written. The process of adjusting costs to the foreign level gained in strength during those years. In addition - when the unexpected opportunity for it occurred - a certain adjustment, by a piece of shock action, was applied by way of the revaluation of March, 1961. That year moreover saw the introduction of the 45-hour working week, which nullified the rise in average per capita productivity and also exerted some influence on the movement of productivity during 1962. And in the monetary context there was an important change by comparison with the position in preceding years, inasmuch as domestic liquidity creation ran ahead of the real rise in the national income, so that in fact the rise of prices and costs was financed from internal sources. In 1961 this divergence from the standards set by policy had been mainly due to the unexpectedly rapid shortening of working hours. In 1962 it was inflationary financing by the authorities which underlay the excessive domestic liquidity creation.

Against the background of the trends just described the results achieved in the year under report were indeed in many respects better than could have been expected. Despite the recent great cost increases, directly caused by the extent to which the increase of incomes exceeded that of productivity, despite the revaluation, and also despite the relatively large creation of liquidity within the country, the course of exports remained satisfactory and the structural external equilibrium, already accomplished in 1961, was retained. The drawback to all this was however the further impairing of the internal value of money that inevitably followed from adjustment of costs.

The experience of recent years thus raises, in a clearly defined form, the question of how far the standards set for monetary policy can be realised. These standards do require an effort to preserve price stability at home and balance of payments equilibrium abroad - the first of these objects to be achieved so far as possible while full employment is maintained, the latter while so far as possible maintaining fixed exchange rates. The standard as regards stability of prices has not been realised. We live, as it is said, in an age of creeping and continued price inflation. It is necessary to ask how far this is right, and how far it could have been avoided.

In point of fact the cost of living index, with social charges and taxation excluded, has risen in the last seven years by an average of 2.6 per cent per year, and has done so despite the 5 per cent upward revaluation of the currency which intervened. But the wholesale price index rose in the same period by an annual average of only 0.2 per cent, while the indices of import and export prices actually showed annual average declines of 0.4 and 0.3 per cent respectively. In the same seven years nominal wages rose by an average of 6.8 per cent each year; and the average yearly rise in the real wage, including social security provisions, was 4.1 per cent. If the rise in the cost of living is broken down it is found that domestic agricultural products, rents and services were important elements in it, while the rise in prices for industrial products was a very small one.

The idea that it is possible to maintain stability in the price-level - which means for present purposes the cost of living index - is based on the assumption that it must be possible to ensure that the average rise in wages shall not exceed that in per capita productivity. Broadly therefore the price-rise ought to be confined to those sectors where the improvement of per capita productivity is lagging behind, and a compensatory price-fall ought to occur in those sectors where the opposite is the case. These sectors will include a large part of industry, especially those industries where growth is greatest. But the realisation of such a programme cannot be controlled through national policy measures alone. Open economies are in contact with, and exert an influence on, each other. The laws which govern international trade relations impose limits on national policy.

No country can in the long run refrain from striving for equilibrium in its balance of payments. This means that its exports of goods and services must cover its imports plus or minus net structural capital movements. Whether its exports can do this will depend on its ability to compete in the world market, and therefore on the costs incurred by exporters of goods and services. It is the prices realised at a given level of exchange rates by the marginal exporter (that is the exporter whose contribution to exports is in the long run just indispensable for the purpose of preserving balance of payments equilibrium), and the per capita productivity prevailing in his industry, that determine what level of costs - and therefore of wages - is compatible with the continuing ability of his enterprise to compete. Wages in the rest of the economy will tend to be not lower than those in the exporting industries. The level of doméstic prices, and hence that of real incomes, will be governed by the overall level of nominal wages and the average per capita productivity.

From these premises a number of important conclusions follow. The first is that, while goods in international trade do tend towards a uniform price-level, this by no means necessarily applies either to national prices or to national wages. The nominal national wage level is in the last resort governed by international prices and by per capita productivity in the country's marginal exporting industry. This means that the nominal wage level may be relatively high in countries where exports can remain limited to the products of industries having high per capita productivity; and this will be more readily possible in so far as the exports are relatively small. In our country that is not so. The Netherlands' exports of goods and services are relatively great, and must necessarily extend to include the products of industries in which no particularly high per capita productivity can be expected. For this reason, on an international comparison with countries which are less dependent on exports but are otherwise in comparable circumstances, the nominal wage level in the Netherlands will always have to be on the low side. The same will also apply to the price-level, however, since this is favourably affected by a reasonable domestic productivity.

In the second place it follows from the facts described that the domestic price-level will tend to be lowered by favourable average per capita productivity, but raised by favourable per capita productivity in the marginal exporting industry, since the latter exerts so great an influence on wage costs. The more closely the average per capita productivity and the per capita productivity in the marginal exporting industry approximate to each other, the "cheaper" a country will tend to be, and the further apart they are the "dearer" it will tend to become.

Finally it follows from this reasoning that, if and in so far as changes in circumstances lead to a widening of the gap between per capita productivity on the average and that in the exporting industries (which will probably happen in every period of rapid technological progress), the necessary maintenance of international equilibrium requires that: (a) a constant domestic price-level, based inter alia on international limitation of the rise in wages to not more than that in average per capita productivity, shall be accompanied by falling export prices, and/or that (b) where the level of prices for exported goods remains the same, nothing can be done to prevent a rise from occurring in the internal price-level (as measured by the range of consumer expenditure, which includes many services), this rise being larger to the extent that the difference between the per capita productivity in the exporting industries and the lower average per capita productivity becomes greater.

In point of fact these processes are to a certain extent clearly in evidence. There is a clear divergence between, on the one hand, the movement of national price-levels as reflected in the cost of living index, and on the other hand that of the international price-level as reflected in the indices for import and export prices. But it also appears that in this connection there has been little or no decline in prices for exports, especially in those for industrial goods. This explains why it has proved impossible in the Netherlands to prevent the rapid advance in prosperity, which has actually been nothing else but a fast rise in per capita productivity, from being accompanied by a certain upward movement in the cost of living. And this - subject, be it said, to the reservation that the maintenance of structural equilibrium in the balance of payments shall not presently be found to have been after all endangered - not as a consequence of errors of domestic policy, nor of misuse of power by domestic pressure groups, but as the effect of the forces engendered by the trends in past years, and of the laws which govern international trade.

In an international payments system with fixed exchange rates the dependence of a country's economic equilibrium and of its currency's stability on international relationships is such that every country is closely concerned in the policy conducted by the principal countries with which it trades. The reason is that every cumulative divergence from equilibrium in any given country disturbs the balance of the rest. Obstinate balance of payment deficits, whether financed through delivery of gold or through provision of international monetary credit, cause other countries to have balance of payment surpluses, the effect of which is sooner or later inevitably reflected in cyclical tension coupled with wage and price rises. To counteract those deficits by trade restrictions damages the special interests of other countries' industries which are affected by the said measures, and is in principle forbidden by international agreements. To deal with them by altering the parity, whether downwards or upwards, exposes the economies both at home and abroad to abrupt adjustments the consequences of which can hardly be foreseen.

Realisation of this mutual interdependence is reflected in increasingly close monetary cooperation, concentrated at world level in the International Monetary Fund, and more intimately expressed in the regular consultation which takes place concerning monetary and cyclical problems in the organs of the Organisation for Economic Cooperation and Development and of the European Economic Community, as well as between the most important Central Banks in their regular meetings at the Bank for International Settlements in Basle.

Definite advances in monetary cooperation were achieved during the year under report and in the early part of 1963 through the ratifying by virtually all the countries concerned, including the Netherlands, of the so-called "borrowing arrangements" made to the extent of $ 6 billion* for the benefit of the International Monetary Fund, and through the series of mutual swap agreements, concluded by the Federal Reserve Bank of New York to a total extent of $ 1.1 billion with a number of European Central Banks and the Bank of Canada, in which the Netherlands Bank took a $ 50 million share. The essential effect of these agreements is to permit mutual lending at short term in the creditor country's currency.

A further example of international monetary cooperation was the joint action by a number of Central Banks including the Federal Reserve Bank of New York, the Bank of England and several on the continent of Europe, including our institution, to limit fluctuations on the free gold market in London. And the particularly swift and resolute combined action by the Canadian, American and British authorities to resolve the Canadian exchange crisis in June, 1962 also proved the usefulness of cooperation between monetary authorities.

It must however be admitted that, however great the value of cooperation designed to defend the international monetary system against the shocks caused by speculative capital movements may be, such cooperation in itself does nothing to remedy the deeper causes of those speculative movements, that is to say the obstinate deficits and surpluses which continue to occur in international balances of payments. The very perfecting of such cooperation even entails a danger of contributing towards continued postponement of the remedy.

Although as regards restoration of fundamental equilibrium in international payments the year under report certainly did not bring solution of all the problems, it can

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* 1 billion = 1,000,000,000.

nevertheless be said that progress was achieved, especially with regard to the position of European countries. The United Kingdom, which in 1961 had been through an exchange crisis and in that year showed a substantial deficit, notably improved its balance of payments position on both current and capital account. On both accounts the year 1962 yielded a surplus, the durability of which however still appears uncertain, since it partly resulted from a reaction - favourable from the balance of payments angle - to the restrictive policy applied in 1961; but that policy also contributed towards increasing unemployment, and for that reason has in the meantime been largely abandoned. Nevertheless the United Kingdom managed to repay the whole of its large 1961 drawing on the International Monetary Fund. The countries of the European Economic Community as a whole also moved towards equilibrium. Their surplus on current account was roughly halved, while after their voluntary anticipated repayment of debt that on overall account was no more than a few hundred million dollars. In fact France was the only one of these countries which still had a significant surplus.

To the United States, however, the deterioration in the balance of payments of the principal countries on the continent of Europe afforded no relief. That country on the contrary suffered deterioration of its position both on current account and on long-term private capital movements. This deterioration can be explained on the one hand by the relatively favourable state of internal economic activity, which inevitably caused imports to increase by more than exports, and on the other hand by the effect produced on the American position by the notable and rapid improvement in the balance of payments of one of its principal trading partners, namely Japan. The protective measures adopted in Canada also chiefly hit the United States. Even if allowance is made for these special factors, however, the outcome of the American balance of payments must be regarded as disappointing. A deficit of over $ 2 billion, indeed of not much less than $ 3 billion if the debt repayments extra-contractually received are reckoned as compensatory items, is too great to be lastingly squared in the normal manner, that is to a large extent by parting with gold; it is moreover so great that it cannot fail, sooner or later, to exert an appreciable inflationary influence on the rest of the world.

This deficit sets serious policy problems not only for the United States Government but also for the European and other industrially developed countries, whose combined balance of payments must be ultimately regarded - although with fluctuations from year to year - as the counterpart to that of the United States. According to the old rules of the gold standard the balance would relatively soon be restored by allowing free play to the monetary mechanism, with the result of a certain inflation in Europe and in the other trading countries together with a certain deflation in the United States.

The first part of this prescription is now being followed willy-nilly. The deliberate compensatory monetary policy, adopted at the outset in some countries, is no longer being pursued. In general, it is true, policy is still directed towards delaying in some measure the inflationary effects of the surpluses. The extent to which wage increases exceed the rise of per capita productivity in the European surplus countries incidentally bears witness to the smoothness with which the adjustment is now in fact taking place. In various countries the point has even been already reached where there is no longer any delay in the process of adjustment, and where domestic liquidity creation is already keeping pace with or even outstripping the nominal rise of incomes. Consequently the balance of payments surplus in various countries has already disappeared, or there is even a danger that conditions may occur in which nothing but the occurrence of a deficit in the balance of payments can any longer help to check the inflationary trend. It is clear that this exceeds the limits of permissible adjustment, and that such countries are themselves threatening to become a source of new inflationary impulses.

The second part of the traditional remedy, namely deflation in the United States, is rejected. To this, in itself, there can be no objection. Since wages show an incurable resistance to downward adjustment any deflation would lead only to depression, which in itself would entail unacceptable waste of productive forces and which moreover, once it had degenerated into a spiral movement, would spread to other countries. Not only is deflation rejected, but many people in the United States actually advocate a policy of reflation, to be stimulated by cheap credit, with the object of thereby reducing the still unduly high unemployment ratio. It must now be regarded as highly probable that with the same object a policy of tax reduction will be adopted, and that this will be accompanied by an increase of the budget deficit. From the point of view of internal economic activity such a policy can be favourably judged, since the level of Federal taxation in the United States is in fact so high that with the economy reasonably fully employed there would be a budget surplus, which would produce a definitely deflationary effect. Tax reduction need entail no directly inflationary effect provided that the resulting increase of the deficit is financed out of saving capacity, which - as appears from the extensive exports of capital at long term - shows a substantial surplus over domestic investment. Only in that event does there seem to be ground for hoping that reduction of taxes might contribute towards improving the balance of payments. In itself the prospective rise in the national income will of course raise imports more than exports, as indeed has already happened in the year under report.

Thus the United States, like the countries of Europe, appear to be still confronted by a potential conflict between aims of internal and of external policy. It is remarkable that in the discussions about this matter the suggestion is only rarely heard that, justifiable as it is to reject deflationary monetary treatment because this (although it would favourably affect the balance of payments) would only make the cyclical situation worse, this might make it necessary deliberately to use other economic policy instruments like those applied in various European countries.

Improvement in the American balance of payments will have to be essentially achieved by improving the current account, which means in practice increasing exports, or by improving the capital account, which means in practice reducing exports of capital. Some part of these improvements may perhaps be produced in the sphere of public spending through a reduction of United States' military expenditure abroad, an increase of foreign military procurement in the United States, and a decrease in the economic aid given by that country except where such aid is already tied to expenditure in America. These expedients will however remove only a part of the deficit. For the rest it is changes in connection with private transactions which must provide the solution.

In the private sector the exports of both goods and capital would without doubt be favourably affected by a lowering of American   costs. To this cost aspect, however, too little attention is as yet being paid. Most of those who discuss wage policy at all confine themselves to saying that wages must not rise by more than the improvement of per capita productivity permits. But in the case of countries with an obstinate balance of payments deficit that standard is inadequate. Countries in that position can perhaps stand some raising of real wages, but hardly a rise in nominal wages.

True, the United States can claim that in the last four years the labour costs per unit of industrial production have fallen by about 3 per cent. During the same period, as reckoned in dollars, they rose in the Netherlands by 14 per cent and in Germany by 21 per cent. But the fall in the United States resulted in part from a rise in the output per employed person which was disproportionately large, having been greatly favoured by the cyclical upturns in 1959 and 1962. In the same four years the total wages paid per person employed rose by 17 per cent. Even without any need for a deflationary fall in wages, therefore, a reduction in the cost of American industrial production would have been perfectly possible in those years. During those years however the index for prices of American exports rose by 4 per cent, and that for industrial finished products by as much as 9 per cent.

A certain uneasiness about the tendency of costs in the United States is confirmed when it is observed that the settlement of quite important labour conflicts still involves wage increases which clearly exceed the rise in average per capita productivity, that even new collective labour agreements continue to include various forms of "featherbedding" (with the natural result that productivity is impaired), and that despite governmental exhortations to the contrary the workers' representatives constantly press for further cuts in working hours. None of this would concern Europe if there were no balance of payments problem; Europe, however, becomes involved if it may soon again find itself confronted with undesired surpluses, or if it is asked to join the United States in adopting measures designed to safeguard stability in the international system of payments.

A similar problem arises regarding the historically conditioned, almost allergic, sensitivity which exists in some American circles about upward movements of interest rates. There is no doubt that Europe's experience in the post-war period was favourable as regards the connection between the level of such rates and the balance of payments. That experience suggests that deliberate maintenance of low interest rates contributes to create a balance of payments deficit, and that per contra the acceptance of a rise in interest rates can be a particularly effective means of causing a deficit to disappear. That experience is of course known to the American monetary authorities; yet the adoption by them of a policy on those lines runs into many an internal obstacle.

In this connection it must be fully admitted that for a very large country like the United States it is harder to accept the necessity of submitting to the effect produced on the domestic economy by a balance of payments deficit, small in relation to the national income, than it is in European countries where the relative relationships are more favourable. Nevertheless it is reasonable to expect that, through a certain adjustment of their internal price and cost structure and of their interest rate policy to the requirements of external equilibrium, the deficit countries too shall contribute towards restoring the international balance, lest the burden of such adjustment shall not exclusively be laid on the countries having a balance of payments surplus. The former too must choose between merely allowing free play to natural forces, one of which would then be monetary deflation, and using financial and economic policy instruments that impose certain sacrifices and restrictions on free enterprise, even if these things are not always welcome to those concerned.

The problem of international balance of payments equilibrium thus continues to confront the authorities, both in Europe and in the United States, with difficult policy problems. Solution of these problems cannot be found in drastic changes of the international payments system, which is indeed continuously evolving through cooperation, nor in general raising of the price of gold. Most of the proposals on those lines tend merely to increase the inflationary potential which is available as an aid to postponing solution of the real problems. Attention should at the present time be concentrated on the problems of relative costs and relative interest rate levels.

We have already said, in our last year's Report, that the contributions towards restoring the balance must come from both sides. It may now be stated that in connection with the problem of costs Europe has contributed certainly not too little, but already rather too much, by submitting to nominal cost increases which were not reconcilable with internal price stability, which threaten to impair the social structure, and which have created an inflationary atmosphere that will yet cause many difficulties. It would not be reasonable to expect Europe to proceed still further in that direction.

Europe could make a new constructive contribution through a positive attitude towards the emergent problem of mutual tariff reduction, a process which for the opposite party would be equivalent in its effect to a certain lowering of costs, and which moreover would induce within the country a desirable tendency towards price reduction. Perhaps moreover some European countries might make further attempts to lower their interest rate level through improved organisation of their capital markets, thereby reducing the perverse interest differential between surplus and deficit countries.

As against this the United States should pay greater attention to the problem of internal costs; and, while setting aside the fear of a possible rise in interest rates, should try to apply their capital market surplus on a greater scale to domestic use. By thus concentrating policy on the fundamental factors of equilibrium further improvement of balance of payment conditions in the private sector will certainly be achieved.