Business Brief

The Dutch disease

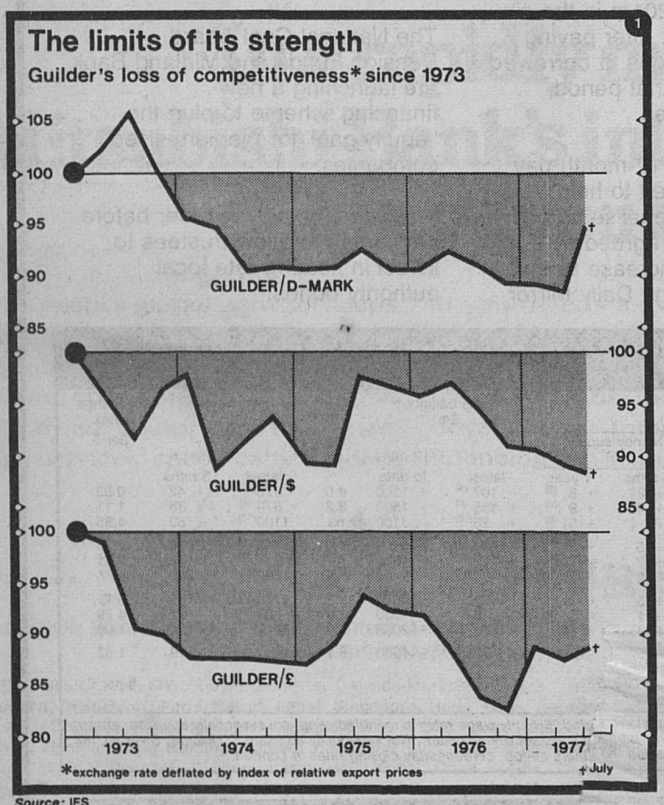
That enviable reputation which the Dutch economy enjoyed for many years has been losing its shine. Every European country has suffered from the post-Opec recession, but Holland has been particularly badly hit.

Industrial production has not risen at all since 1974. Gross corporate investment has fallen nearly 15%. The share of profits in national income, which averaged 16.8% between 1965 and 1970, fell to only 3.5% during the next five years. Unemployment now stands at 5.1% of the workforce compared with 1.1% in 1970. Within that total, the proportion qualifying for long-term benefits has risen from 20% in 1965 to more than 60%. Employment in manufacturing industry has fallen 16% since 1970.

Yet externally, Holland appears strong. The guilder has been one of the hardest currencies in the world, having risen in trade-weighted terms by 16.4% since December, 1971. The current account, which showed an annual deficit of $130m between 1967-71, remained strongly in surplus right through the shock of higher oil prices—averaging nearly $2 billion a year between 1972-76.

This contrast—between external health and internal ailments—is the symptom of "the Dutch disease". Since it is widely believed to derive from Holland's gas reserves, its spectre is beginning to haunt Britain—especially after sterling's recent strength. The fear is that the North Sea windfall will be abused: that it may serve only to mask the malignancy of the better known British disease, and that, in the words of Lord Kahn, "when the flow of North Sea oil and gas begins to diminish, about the turn of the century, our island will become desolate".

Any disease which threatens that kind of apocalypse deserves close attention. The Dutch version has three component causes, only one of them external.



Source: IFS

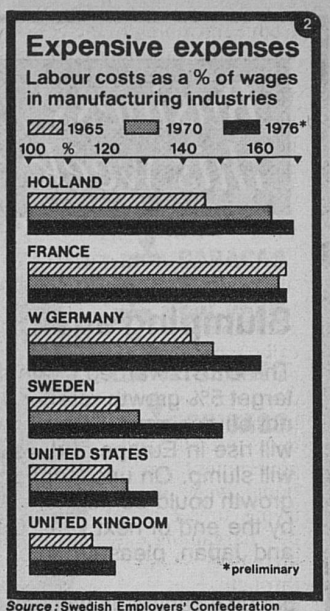
Strong guilder

(1) Too strong a currency. Large quantities of gas were first discovered in 1959, in the balmy days of cheap oil and the expectation of abundant, safe nuclear energy within 20 years. Understandably, therefore, the Dutch authorities planned to exploit the gas as quickly as possible. This meant encouraging the domestic use of gas through low prices; by 1975, gas accounted for 58% of Dutch energy consumption. In addition, massive long-term export contracts were drawn up—with prices linked to the oil price, but only after a lag.

The current account benefited accordingly. The gas contribution cannot be precisely measured; but the simple arithmetic shows that, last year, gas export revenues were $2 billion, while the saving on energy that would otherwise have had to be imported was $3.5 billion. These benefits will continue to grow. Half the total production is still being exported (of which 45% goes to West Germany, 22% to Belgium, the rest to France and Italy). Nearly 40% of Holland's proven reserves of 1,700 billion cubic metres are committed to existing export contracts over the next 15 years. But no new contracts will be made, and it is now government policy to restrict the domestic use of gas, so spinning the reserves out until the end of the century.

The strength of the current account has been partly offset by capital outflows. All outward exchange controls have been removed; official foreign borrowers are now being encouraged to come to the Amsterdam market; and certain minor controls on inflows (eg, Dutch companies investing in Holland must raise their money at home) have been introduced. On top of that, the authorities have relieved some external demand for the guilder directly, by increasing official reserves: they rose from $3.2 billion in 1970 to $8.0 billion in September of this year.

But the main plank of official policy has been to keep Dutch interest rates low by international standards. That, combined with depressed profitablility at home, has encouraged a considerable growth in overseas investment. Largely unnoticed, Holland has now become the biggest foreign investor in the United States: at the end of 1976, it held



Source: Swedish Employers' Confederation

$6.2 billion of assets, overtaking both Canada and Britain. Meanwhile foreigners invested less in Holland last year than at any time in the past ten years. Between 1967-71, Holland was on balance a recipient of foreign investment; during the next five years, it became a net overseas investor, to the tune of $1.6 billion. So far this has provoked little reaction from Dutch unions—partly because their economically literate leaders know that, to the extent that capital outflows help prevent the guilder rising too high, Dutch industry is not priced out of its large export markets. But if unemployment carries on rising, opposition to the "export of jobs" may grow.

All this has mitigated, but not prevented, the rise in the guilder. However, it is not a strong exchange rate per se which gives rise to the Dutch disease: rather, the divergence between the internal and external values of the currency. Many Dutch policymakers welcome an appreciating guilder, which cuts the rise in import prices and so helps to dampen inflation. So long as domestic costs (predominantly wages) fully adjust to the higher external value, there is indeed a virtuous circle of lower inflation and a higher exchange rate. But unit wage costs have risen faster than import prices (in guilder terms). So real incomes are higher, profit margins lower than they would have been without a rise in the exchange rate. The guilder is now significantly less competitive (see chart 1), than it was five years ago, because gas, buoying up the current account, has prevented the exchange rate

from conforming to the country's underlying inflationary position. So Dutch consumers are roughly 10% better off than they would have been, but companies have been able to compete only by paring their profit margins.

High costs

(2) Other industrial costs. With unit wage costs growing more rapidly than those elsewhere, government policy should logically have sought to close that gap, either by encouraging productivity improvements or by providing some relief to industry's overall labour costs. The government has sponsored national wage agreements; but in trying to set a fair climate for pay bargaining, it has sharply increased industrial costs, through:

- Minimum-wage legislation. This seems to have added to the upward pressure on all wages, despite the government's wish to narrow pre-tax differentials.
- Social security payments. From the early 1970s, social security benefits were raised considerably: as a proportion of national income, from 16.5% (1970) to over 23% last year. Roughly 40% of this comes from employers' contributions, and slightly less from employees. The government has now recognised the effects this rise has had on industry's costs; it is increasing its own contribution, which has the same effect as a wage subsidy.
- Environmental and emplement standards. Pollution controls, health and safety regulations, and the licensing requirements for new industrial development have been tightened considerably. Redundancies are difficult to implement, and expensive (three months' earnings). While such effects cannot be quantified, many multinational companies now think standards to be more rigorous in Holland than elsewhere in Europe. Largely as a result of these government measures, the non-wage element on labour costs is, by international standards, very high (see chart 2).

Another pint of that gas, please

Spent, not invested

(3) Use of gas revenues. Through taxing profits, its ownership of DSM and its stake in Gas Unie, the government receives about 80% of revenue from gas. Last year this accounted for 11½% of total treasury receipts. The government has never formally earmarked these for specific purposes, so the use to which the gas has been put can only be judged by looking at overall fiscal policy. This might have been expected to show a general bias towards investment, as a prudent way of redeploying a wasting capital asset.

Far from it. Government spending has grown very rapidly, and now takes a larger share of gdp than in any other west European country. The great bulk of this increase has gone on transfer payments (pensions, unemployment benefit, etc.) while public investment has actually been taking a smaller slice of the national income (chart 3).

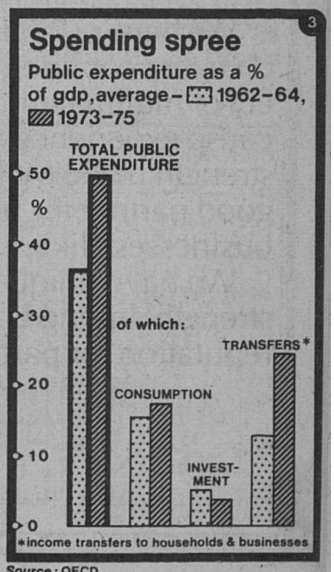
Investment in alternative energy supplies—one obvious way of perpetuating the benefits of gas—has been stymied by indecision over nuclear power. Holland has two nuclear stations (500MW in all); it also has a vocal ecolobby, and raising the nuclear issue now would add to the political strains of a country divided by coalition infighting. It is unlikely that any new nuclear capacity will be built before 1990. Instead, measures to encourage energy conservation are now being taken: new subsidies to industry for energy-saving investment, and next year a national insulation programme.

Gas revenues have not on their own been enough to finance the increase in government spending. Like other countries, Holland has over the past few years run a large budget deficit. But, chiefly for reasons of monetary control, this has a de facto ceiling (5% of gdp). As well as borrowing, the government has steadily raised taxes, both direct and indirect. As a proportion of national income, they grew by 2.7% a year (1970-73), and by 1.8% a year (1974-77). This has boosted wage inflation, since unions were quick to adopt post-tax bargaining targets. Last year the government took steps to limit the growth in its spending to 1% a year, and this "rule" now sets the medium-term budgetary framework.

Over the next five years, the rate at which gas output and revenue has been growing will slow down; in 25 years' time, it will be more or less exhausted and the Dutch will again have to live on their wits. This re-entry phase is crucial. It will not be painless, but gradual adjustment will be easier than waking up one morning in the twenty-first century with a monumental hangover.

Re-entry will be assisted by the build up of overseas investment, which will provide a permanent source of foreign income to replace export revenues from gas. More important, gas reserves will fall gradually, so the exchange rate will fall gently into line with internal costs, not come down with a bump. As it falls, industry will have the chance to revive. And imports of gas (from Norway now, and liquefied natural gas from Algeria in 1984) will work in the same direction. But unless the trend in government spending is reversed, taxation will have to rise as gas revenues decline.

Will Britain catch the Dutch disease? Perhaps, but only if it chooses to. Possessing large energy reserves is a necessary, but not sufficient, condition for succumbing to the disease. Holland at least can claim to have begun its spree at a time of energy optimism, and before the disease was really diagnosed. Britain, with the Dutch as an example, will have no such excuse.



Source: OECD