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Intelligence Memorandum

Wage-Price Turmoil In The Netherlands: A Major Election Issue

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ER IM 71-65
April 1971

Copy No. 47

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
April 1971

INTELLIGENCE MEMORANDUM

Wage-Price Turmoil In The Netherlands: A Major Election Issue

Introduction

1. The governing center-right coalition enters the lists for parliamentary elections on 28 April harassed by overheating of the economy. Inflation is a major campaign issue. Moreover, skyrocketing construction costs have contributed to the government's failure to meet its goal for new housing completions, adding to discontent. The government has used price controls for some time and more recently has added wage controls. But opposition from labor promises to limit the effectiveness of these counterinflationary policies, and a worsening wage price spiral is likely. This memorandum examines the causes and likely course of wage-price inflation in the Netherlands and the impact on the economy and on labor relations.

Discussion

Background

2. During most of the 1950s and early 1960s, the Netherlands enjoyed relative price stability (from 1952 to 1963 the average annual increase in the consumer price was 2.4%). The price trend steepened in 1964, however, and from 1964 to 1970 the average annual increase of the consumer price index -- based on annual averages of monthly

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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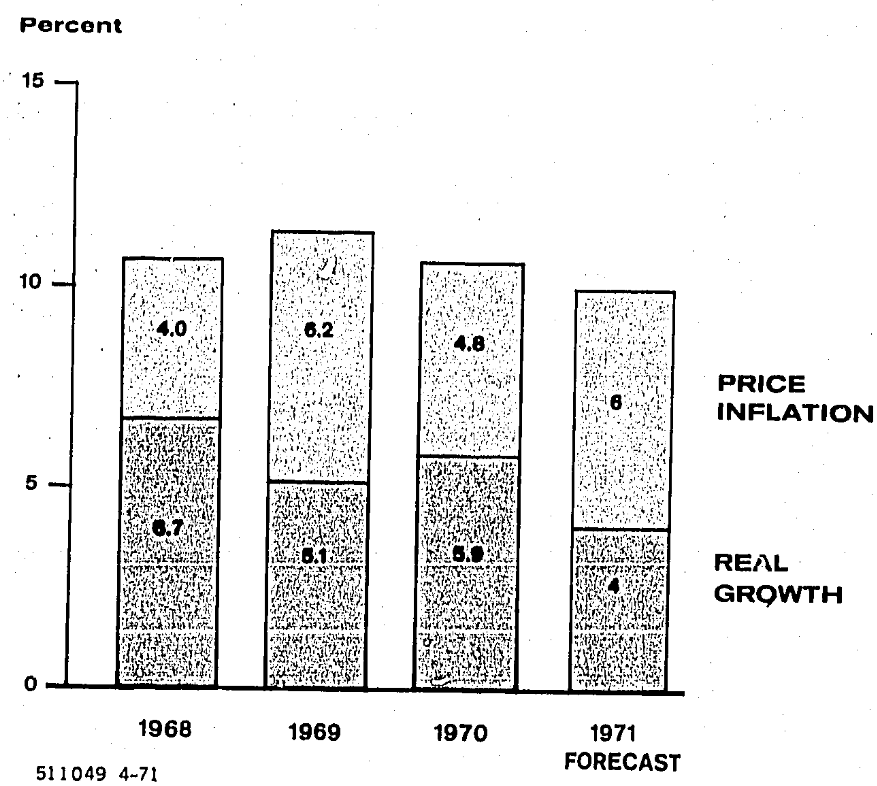
data -- was 5%, one of the highest recorded in the Industrial West. Inflation became a major headache for the De Jong government by 1969, when there was an alarming 7.5% rise in consumer prices -- the sharpest increase since the Korean War boom in 1951. Although GNP rose 11.3% in 1969, more than half of the increase reflected price inflation (see Figure 1). Inflationary pressures were

GROWTH OF GNP

Figure 1

(Annual percentage increases in GNP at current market prices)



still strong in 1970, but the increase in consumer prices (4.4%) was less than in the previous year, and a smaller proportion of the total rise in GNP represented price inflation.

3. The rise in consumer prices in the Netherlands during 1969 and 1970 was more rapid than in West Germany and Belgium -- countries that account for nearly half of the Netherlands' external trade.

More serious is the prospect for 1971 that inflation will accelerate in the Netherlands, while it will probably ease in Germany and many other European countries. With imports and exports each equivalent to roughly 40% of its GNP, the Netherlands cannot for long tolerate inflation substantially greater than that experienced by its major trading partners.

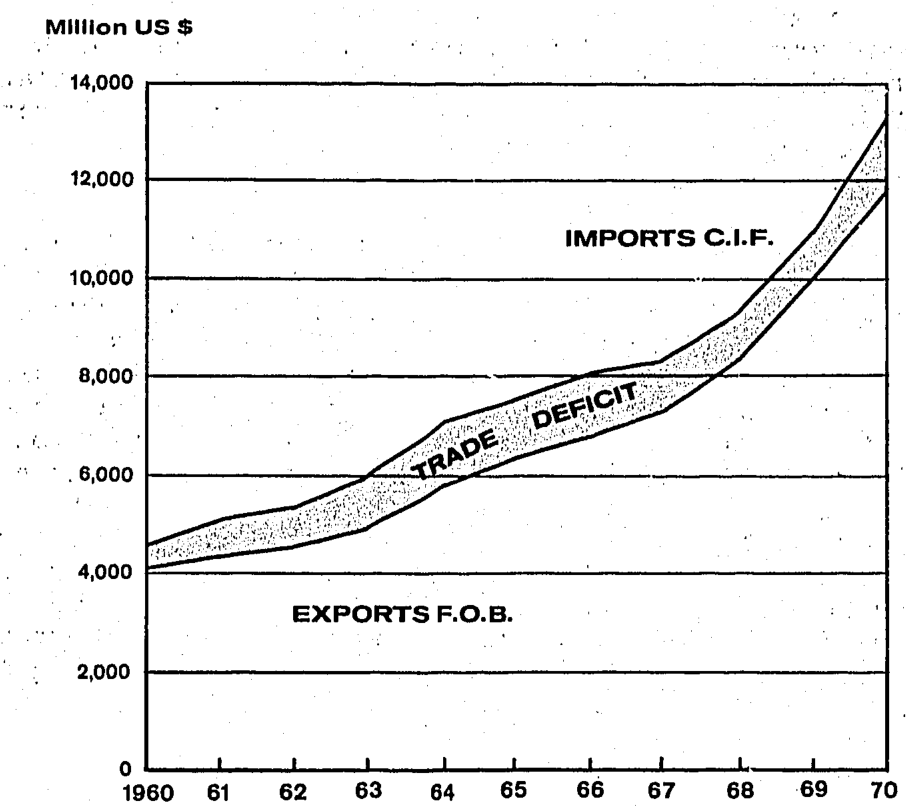
4. Overheating of the economy has proved to be a major obstacle to eradicating the housing shortage. Despite the completion of an average of 101,000 dwellings annually in 1960-68, a shortage persisted -- estimated at some 93,000 units early in 1969 and concentrated in the heavily populated West. Rising costs in residential construction along with a tight capital market, continuously rising interest rates, and shortages of skilled labor in the construction industry contributed to the government's failure to meet its goal for completion of 125,000 units a year. In 1969 the shortfall was 2,000 units; last year the program fell further behind, with the shortfall rising to nearly 8,000 units.

Inflationary Pressures

5. A number of factors have contributed to the strong surge in prices since 1968. The most notable has been a strong expansion in overall demand (particularly export demand) together with the switchover from a turnover (or "cascade") system of indirect taxation to a value-added tax system in accordance with the Netherlands' commitments to the European Community. Rapidly rising wage rates, especially in 1970, have also contributed substantially to price pressures.

6. An unprecedented boom in foreign demand has been the major cause for the growth of overall demand. After rising an average 8.5% in 1961-68, the volume of exports increased by 16.9% in 1969 and 13% in 1970. In value terms, export growth has been even more rapid -- 19.4% in 1969 (a postwar growth record) and 18.2% in 1970. The trend is shown in Figure 2. Revaluation of the Deutschemark in late 1969 exacerbated extreme demand pressures. The value of exports to West Germany, the Netherlands' chief trading partner, increased 25% in 1970.

FOREIGN TRADE DEVELOPMENTS Figure 2



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7. Booming foreign demand has been accompanied by a steady increase in domestic demand. Real consumer spending rose 7.4% and capital investment by enterprises about 10% in 1970, compared with averages of 5.8% and 7.5%, respectively, in 1961-68. Increases in domestic demand were also reflected in a sharply rising volume of imports -- 14.8% in 1969 and an estimated 13% in 1970, compared with 8.6% per year in 1961-68 -- in spite of a nearly 8% rise in import prices. The resulting import bill led to a $600 million increase in the trade deficit in 1970 and contributed to the first large current account deficit since 1966.

8. As overall demand rose, there was an increasing strain in the labor market. Unemployment, which averaged a low 2.1% of the labor force in

1968, by 1970 had shrunk to only 1.4%; job vacancies approached a record level (see Figure 3). Moreover, as demand caught up with production capacity, industrial growth began to slow -- after an increase of 11.9% in 1969, output rose by 9.4% last year.

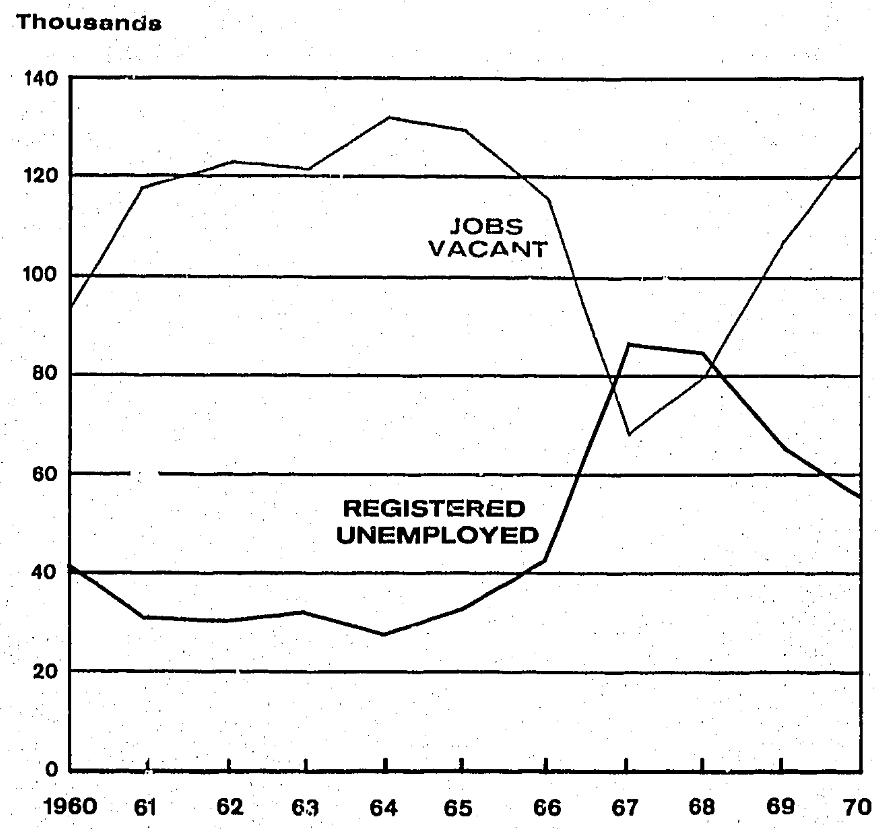
9. The pressure on prices was aggravated substantially when the tax on value-added replaced the turnover (or "cascade") tax on 1 January 1969. According to government computations, this tax revision accounted for less than 20% of the total cost of living increase during 1969, as shown below:

Sources of Increase in Cost of Living	Impact on Overall Cost of Living (Percent Increase)	Share of Total Increase in Cost of Living (Percent)
All sources	*7.5*	*100.0*
Indirect taxes	1.5	20.0
Of which:		
Value-added tax	1.4	18.7
Labor costs	1.5	20.0
Import prices	1.2	16.0
Rent costs	0.5	6.7
Other	2.8	37.3

The actual impact on prices, however, was probably greater than estimated by the government. Anticipating that additional price and wage increases would follow implementation of the tax revision, many producers raised selected prices more than necessary to compensate for the new tax. In the four months following implementation of the value-added tax, there was a rise of more than 6% in consumer prices, certainly indicative of a strong link between the two events.

10. By 1970, pressures on prices resulting from booming demand and the value-added tax were

EMPLOYMENT TRENDS Figure 3



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being aggravated by strong increases in wage rates (see the table). A 9.3% rise in hourly earnings in 1969 was followed by a 10.7% increase in 1970 -- the largest wage jump since 1964. Wage pressures increased markedly late in 1970 following the wildcat dock strike in September. Resolution of the conflict resulted in the granting of a bonus of 400 guilders ($110) to dockworkers. Echoes of this settlement quickly reverberated throughout the country, resulting in comparable wage increases in most sectors of the economy.

<u>Counterinflationary Policies: 1969-70</u>

11. Government steps to check inflation were generally ineffective, mainly because of a breakdown in government-labor cooperation -- at one

Annual Growth of Consumer Prices and Wages

Percent

Year	Consumer Prices	Hourly Earnings in Industry (Males)
1960-68	3.7	9.1 a/
1967	3.8	6.4
1968	3.7	8.0
1969	7.5	9.3
1970	4.4	10.7

a. Including the effect of the steep 16% increase posted in 1964.

time a uniquely harmonious relationship which had contributed substantially to price stability. As a result of unions' increasingly independent temper in a full employment situation, the government in effect lost the ability to negotiate wage restraints and had to rely on price controls and monetary and fiscal restraints.

12. The government-labor consultative system, which provided for government participation and guidance in wage negotiations, had progressively broken down during the 1960s and was nearly inoperative by 1969. Although the government had resorted to wage controls sporadically in the decade, it nevertheless was attempting to achieve progressive reduction in its interference in labor relations. Finally in 1967 it relinquished its right of giving prior approval of collective wage agreements through the semiofficial Board of National Mediators. The government retained its power to invalidate individual wage contracts and to impose wage pauses of up to six months as provided in a wage bill introduced in 1968 and legislated in 1970. Labor leaders, however, were jealous of their new freedom and power, feared their control of the unions could be challenged by militants, and balked at any enforcement of government restraints. Indeed, objections to the wage bill were so strong that in September 1969 a major labor confederation (Nederlands Verbond van Vakerenigingen -- NVV) refused to take part

in any consultation with the Social-Economic Council (an important advisory body to the government) as a protest against the state's authority to veto individual wage contracts. Thus the government -- threatened with a serious breach in labor relations and with the 1971 elections in mind -- exercised little real control over wages from 1968 through 1970.

13. The heart of the government's counter-inflationary policy was a price freeze. In April 1969, all prices were frozen by decree, and price increases since 1 October 1968 that could not be justified by cost increases were to be rolled back. This policy resulted in a slight decline of 0.5% in the consumer price index from April to August 1969. Price controls were loosened in September 1969, permitting firms -- after obtaining approval from the Ministry of Economic Affairs -- to raise prices to cover external cost increases (such as materials, freight, repairs, and publicity cost increases as well as higher taxes and duties) occurring since 14 March. Prices again began to move up sharply, rising 0.9% from August to December, underlining the restraining but non-curative nature of price controls. The price control policy was again modified in August 1970; ministry approval was no longer required but price increases had to be reported one month before their introduction.

14. Accompanying the price freeze in early 1969 was a restrictive monetary policy. The restrictive monetary measures included the reintroduction of ceilings for short-term bank credit and of guidelines for types of lending as well as an increase in the discount rate. Later in the year, because of the Netherland's close trade ties with West Germany it was widely believed that a revaluation of the Deutschemark would be followed by revaluation of the guilder. Speculation was rife. A speculative inflow of capital substantially increased the liquidity of the banking system, reducing the effectiveness of the restrictive measures. The overall impact of public finance has at best been neutral, as the overall budget deficit rose from $641 million in 1969 to $789 million in 1970.

Deflationary Policies for 1971

15. Seriously concerned about inflation, a deterioration in the trade balance and shrinking business profits, the government last September proposed a tough deflationary program for 1971. Among the principal fiscal measures proposed were:

a. The freezing of 140 million guilders ($39 million), 0.4% of the original 1970 government budget, through postponing outlays for a wide variety of projects in fields such as transportation, waterways, science, education, housing, and defense;

b. A 3% surcharge on income, wage, corporate, gasoline, and automobile taxes effective 1 January 1971;

c. An increase in the value-added tax from 12% to 14%;

Together these fiscal measures are expected to reduce the budget deficit from 2,856 million guilders ($789 million) in 1970 to 2,062 million guilders ($570 million) in 1971.

d. Restrictions on consumer credit and state guaranteeing of loans outside the house-building sector;

e. A surcharge and permit system on new industrial construction in certain areas;

f. Continuation of existing price controls; and

g. Contingent on agreement of the social and economic council, there will be a temporary wage freeze.

The government has altered its attack recently with two major revisions regarding wage and price controls:

a. Stricter price controls were implemented specifying which external costs may be passed on in prices effective from 5 November 1970 to 16 March 1971.

b. Facing strong opposition from labor, the government was forced to water down its initial proposed wage freeze and accept a modified version. As collective labor agreements expire in 1971, they will be subject to a six-month "control period." During the period, wages may be increased by a maximum of 4% (3% at the beginning of the period and 1% after three months). After the six-month control period, new labor agreements may be concluded.

Outlook

16. The Dutch economy will grow at a less rapid rate in 1971 -- perhaps around 4% compared with 5.9% in 1970 -- in response to the government's restrictive economic policies and a probable easing of export demand.

17. Nevertheless, inflationary pressures are likely to continue. This is a sore spot with Dutch voters and will remain the key problem facing the government after the 28 April election. It is unlikely that price and wage increases can be held significantly below the 1970 gains. The wage-price spiral will continue with businesses feeling impelled to raise prices in order to combat shrinkage of profits resulting from increased labor costs and labor unions demanding higher wages in order to prevent their real incomes from shrinking. In fact, price and wage inflation may accelerate if controls (scheduled to expire at mid-year) are lifted. Consumer price increases of 5.5%-6% are forecast for 1971, compared with 4.4% in 1970.

18. Although strong political pressure to expand housing construction has excluded housing from the government's deflationary measures (specifically from the construction surcharge and limitations on construction loans), the outlook

for housebuilding is not encouraging. Because of the inflationary pressures anticipated this year, the government is unlikely to attain its announced goal of 127,000 housing completions, and housing will continue to be a major problem area for the next government.

19. The government, or a new coalition emerging from the April elections, will have to cope with an increasingly recalcitrant labor force. As demonstrated by the unsanctioned dock strike in September 1970, the unions no longer have close control over their rank and file. Thus, even if the unions become more cooperative, it is unlikely that the old harmonious wage-setting arrangement between government and labor could be reestablished. Indeed, a major labor confrontation may await the next government. Inflationary pressures are expected to be strongest in the first half of the year, a time when workers' real income will probably be showing no significant gains. Hence, when the wage pause lapses in July (70 labor contracts come up for negotiation at that time), the unions will probably bargain hard and a major wage explosion could occur. This would upset current forecasts for 10% wage gains and augur further price increases. If the government evokes its power to invalidate these contracts in the "public interest," labor's response could be long and costly strikes.