AFSCHEIDSLEZING

The meaning of our enormous structural current account surplus

A NEGLECTED OPPORTUNITY

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I

For a long time now, the Netherlands have had a sizeable surplus on the current account of its balance of payments, being the total of trade in goods and services and capital income. From 2000 onwards, this surplus has never been less than 3.2 percent of GDP. In 2000 it was 5.2 percent, in 2007 8.4 percent, and in recent years – 2013 and 2014 – 9.7 percent and 9.75 percent. This is a very large amount, the largest among European countries. And Germany with 7.6 percent in 2013 is next in line (CEP, 2014).

In our public discussion very little attention has been given to this remarkable aspect of our economy, nor have even politics or the announcements of the Dutch Central Bank (DNB) drawn attention to it. Perhaps because it does seem to throw some doubt on the government's need for large budget cuts. In the European Union there is a rule about balance of payments, deficits and surpluses. Surpluses should not for any length of time be higher than six percent of GDP. But neither the European Commission nor the Dutch government ever seems to have evoked this rule in discussions of the budget deficit.

II

In itself, such a surplus is of course favourable. It increases our international reserves and wealth. But is it also favourable to the growth of our economy? In a system where the exchange rate cannot be adjusted – such as the present Monetary Union – the balance of payments cannot be brought to an equilibrium by an adjustment of the exchange rate. As in the old gold standard system, equilibrium would then be brought about by a movement of the national income. Deficits with gold losses would force a country to follow a restricted policy reducing incomes and imports. Surplus countries on the other hand would receive payment in gold, which would increase their reserves. This would *enable* them also to introduce an expansionary policy, but they would *not be forced* to do so. They could maintain their surplus situation and accumulate more gold. This was called the 'deflationary tendency of the gold standard'. The present European Monetary Union clearly also suffers from such a deflationary tendency. Thus, our enormous balance of payments surplus does not force us to a more expansionary policy, although in itself it would create a tendency towards a certain growth of the national income that would increase imports and therefore reduce the surplus. The extra income increase during this process would then also increase consumption, tax payments and savings. A stationary situation would be reached when the total of additions to the income stream would equal the leakages from it. This would be when the budget deficit and the payments surplus together would equal the savings surplus. In that way, *a multiplier process could be set in motion* showing how much the income would increase as a consequence of an increase in exports or, as the case may be, of additional government expenditures. The size of this multiplier depends on how much of the extra income flows away from the income stream through imports, savings or taxes. It is then also important in how far these savings would bring about larger investments, so that leakage would cease, and whether the government would spend the additional tax receipts.

III

In the present Dutch situation, we have a balance of payments surplus of more than nine percent and a budget deficit of three percent of GDP. This means that there should be a savings surplus of no less than twelve percent of GDP. That is the other side of the balance of payments surplus. So, how should we judge this?

There are two components in this savings surplus: business saving in the form of retained profits that are not used for investment in our country, and the savings of pension funds and life insurance companies that are not invested within our country. There are no exact figures as to the size of these components. But we know from an investigation by DNB that only fourteen percent of the investments of pension funds stays within our country (DNBulletin, 2013). As these savings are more than six percent of GDP, it follows that their contribution to the savings surplus must be five percent of GDP. That would then leave seven percent of GDP for business companies. This saving surplus has helped to bring down the rate of interest to levels below two percent, but investment has not reacted upon this with an increase. Thus, in this way a recession developed. This failure of an equilibrium mechanism on the capital market is the essential element of the theory that J.M. Keynes developed in 1936, *The general theory of employment, interest and money*. And our experience during this recession completely confirms his theory.

Of course it is disappointing that policy makers in Europe seem to have completely forgotten these relationships. In the United States, this also goes for the Republican party – though the former chairman of the Federal Reserve system, Ben Bernanke, has shown clear insight in the business cycle mechanism, but was only able to instigate a very expansionary monetary policy because Congress left too little room for any stimulating additional expenditures.

IV

But we must recognise that it has been the development of economic science which was greatly responsible for all this. After the Second World War, new economic theories were developed on the basis of 'rational expectations'. Starting out from that assumption, they had been able to build on earlier equilibrium theories, such as the system of Leon Walras (16 December 1834 – 5 January 1910) who formulated a general economic equilibrium with beautiful mathematical equations. These new theories made far-reaching assumptions, for instance asserting that all markets would always precisely and immediately reach an equilibrium. All economic subjects would act rationally on behalf of their own interests and were entirely able to foresee the future. And because in the markets all economic subjects together allegedly created an equilibrium that reflected their preferences, government intervention would not be necessary. The inventors of these neo-classical theories, like for example Robert Lucas Jr. (American economist, born 15 September 1937), won Nobel prizes in economics (the Sveriges Riksbank Prize) and found quite some general support. In these equilibrium systems, there could therefore be no business cycle. As there is clearly some fluctuation in the real world, theories were developed that explain fluctuations by changes in real data for the economy.

In this way, economists have created a 'platonic world' of perfect efficiency, as Robert Skidelsky put it in his clear and amusing book *Keynes, the return of the master* (Skidelsky, 2010). That world has little to do with the real world of unexpected events and mass psychological reactions, which often constitute unreasonable and dangerous disequilibria. But the political visions developed during the Reagan-Thatcher revolution were strongly influenced by these neo-classical theories. These theories were in tune with their political instincts: budgets should be balanced, and monetary policy should only focus on price stability and be carried out by independent central banks. The unfortunate deregulation of the financial sector in the United States by the repeal of the Glass-Steagall Act also resulted from this thinking that regarded all markets as working perfectly.

V

Returning now to the situation in the Netherlands, we have seen a very large savings surplus (difference between savings and investments). This surplus started around the year 2000, when investments fell below savings. After that, the savings surplus increased by six to eight percent of GDP. Saving increased to the highest level ever, while investment sank to a longtime low. This is shown clearly in figure 1.

This also shows that saving and investment in the European Union and in the core countries of the European Union remain close to each other and are at a much lower level. So, we may now say that this large saving surplus is a rather unique Dutch phenomenon. We should regard it as a serious disequilibrium in the economy – for, although it means that our national wealth increases, it also implies that our production capacity is expanding inefficiently, so that not enough employment is created for our workers. This might lead to structural unemployment, which could be very damaging and bring suffering to part of our working population while limiting the growth of our national product.

VI

The government has worsened this recession by a policy of severely cutting the budget deficit, in order to satisfy its European maximum of three percent for the budget deficit. In setting an aim for the necessary coordination of budgetary policies in the eurozone, European policy makers have been strongly influenced by Germany and by the neo-classical economic theories, so that the final aim was set very low, at 0.5 percent, while the earlier goal of three percent became an absolute maximum. As most European countries have large budget deficits and the recession tended to increase the deficit even further, this has led to very severe and painful austerity measures. In 2000, the budget deficit in the Netherlands was still very low at 0.8 percent, but during the recession – with falling tax receipts and rising unemployment expenditures – it increased to 5.6 percent while, notwithstanding severe budget-cutting policies, the deficit remained above three percent until 2013, when the recession seemed to end. These budget cuts of course decreased incomes and caused unemployment, setting in motion a negative multiplier mechanism. Economic studies from the International Monetary Fund made it clear that such multipliers were much larger than assumed in the past. Different estimates have been made as to this multiplier (Blanchard and Leigh, 2013). It has become clear that its size depends on the business cycle situation. In a situation of full employment and fully used capital equipment, an increase in savings would also leave more room for investments, but in a recession this would not be the case. On the contrary, then investments would also fall because of the reduction in demand. And in that way, a savings surplus would result. The rate of interest might fall, but this would not lead to any larger investment as assumed in the classical economic theories. In the Central Economic Plan of 2013, the conclusion is that in this recessionary situation these multipliers are much higher than one, so that expenditure cuts would scarcely succeed in reducing the deficit (Centraal Economisch Plan, 2013).

In this way we are pushed into a negative vicious cycle, with budget cuts reducing incomes that diminish tax receipts and increase unemployment benefits, so that the budget deficit would increase again. Therefore, expectations that deficits would come down were disappointed time and again. This unfortunate process has caused great production losses, besides the painful experience of a growing number of unemployed and the bankruptcy of many small companies. In the Netherlands, unemployment is now around eight percent; in some of the southern European economies it has reached much higher percentages, hitting especially the younger workers. And of course, it has also made the European Union very unpopular.

All this is the tragic outcome of the total lack of Keynesian anti-cyclical budgetary policies. It is indeed time for the 'the return of the master', as Robert Skidelsky suggested.

VII

Nevertheless, we need to ask: how and to what extent is Keynes *able* to return in the present situation? In two respects, the situation in Europe is now quite different from that in the United Kingdom of 1936, when Keynes wrote his *General theory of employment, interest and money*.

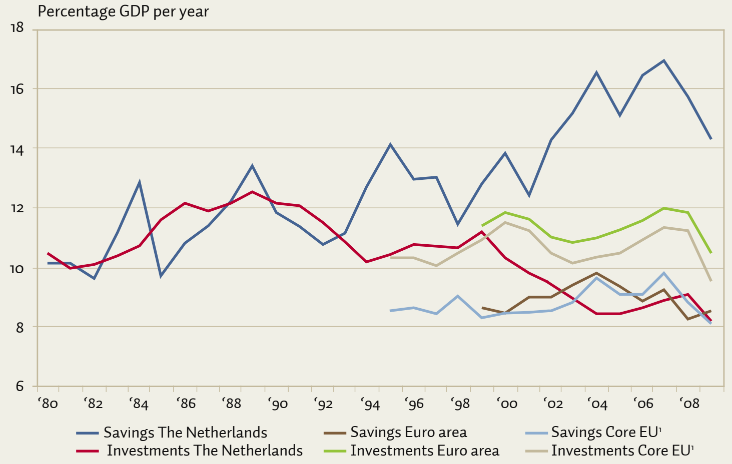
In the first place, there are limits to the possibility of financing budget deficits. If government debts increase too much, they may cause an escalating crisis in which the payment of interest increases the budget deficit further and further. Then repaying the debt becomes more difficult, so that investors want higher interest rates in order to finance the deficit. In this way, the financial markets have acquired a very important role in the European Union. At the outset of the Monetary Union, they had made it very easy for some countries to profit by the lower European interest rates. But this situation was sharply reversed when the crisis came and the interest rates for the loans of these countries increased unsustainably. And the fact that many investors in these markets were also influenced in their thinking by neo-classical theories made these barriers so much stronger.

So, what kind of policies might a Keynesian European Commission and Council have followed in this situation of our Monetary Union, and what policies should they follow now? It seems to me essential to make a clear distinction between structural deficits and temporary cyclical elements in the budget. The structural deficit is what would result if normal growth would continue with a reasonably fully occupied production capacity. This structural deficit often tends to be hidden by cyclical influences on tax proceeds and spending. It is very necessary that this structural deficit is kept under three percent of GDP or less. This is a difficult task, for there are many categories of expenditures with a strong tendency to increase more than the national income. The expenditures for our health care are a clear example. The continuing improvement of medical technology often causes huge cost increases, and as we live longer – also because of this improving health care – there are more older people requiring more expensive care. And there is also a growing need for homecare for the elderly.

A very different factor is our system of deducting the interest of mortgage payments entirely from taxable incomes. This has caused large reductions in tax receipts and has created a 'bubble' in the housing market. It has left us with a relatively high mortgage debt, which has become painful now that house prices have fallen.

FIGUUR 1

Gross savings and investments of non-financial corporations



[1] Core- EU: Germany, France, Belgium en Italy.

Source: Leering and Schotten, 2012

Apart from all of these influences, there are in many countries – though not so much here in our generally so well-organised nation – increasing expenditures that go towards certain groups in the population as payments for their political support. So, it is an essential task for governments to force through the structural reforms of such expenditures and clamp down on political clientelism and of course also abolish other unreasonable favours. If Keynes were alive today he would certainly fully support such structural measures.

But, as we have seen, in a recession such measures have the great disadvantage that they reduce incomes, thereby causing the 'vicious spiral' of a shrinking economy. What Keynes might have done in such a case is *to combine* these *permanent structural reforms* with *temporary stimulating measures* which would help the struggling economy but would not increase the structural deficit. As a Minister of Finance in 1970, I created a mechanism for this purpose – with the unanimous support of parliament – of temporary additions to or deductions from the most important taxes of five percent maximum. These changes could immediately be introduced by the government for reasons of business cycle policy, with the approval of parliament *after* their introduction. In that way, the government could act quickly, which is very necessary in business-cycle policy. I myself have used this so-called 'wobble tax' in order to put a brake on the economy in 1970 when it was growing too fast, while my successor augmented this temporary tax increase even further and abolished it afterwards. After that, it was never used again. But it could have been used now, as a strong antidote to the overpowering negative influence of structural expenditure cuts.

Besides this, the government could also increase investment in the needed infrastructure, which might be financed now with an exceptionally low rate of interest and which would thus alleviate any budgetary problems later on. I myself had suggested several times to accelerate the implementation of the Delta Plan, in order to strengthen our defences against the rising sea level that we must expect. Eventually, it was possible to finance this through a special fund, so that it was kept separate from all other expenditures under the austerity regime of those days.

An important aspect of such a policy stance was that it helped the government to show *confidence* in the future. And, as I will show in my conclusion, basic confidence is at the present time an essential necessity for our economy.

It goes without saying that our large balance of payments surplus could give us ample room for such stimulating measures. Such payments would also be favourable within the context of the European Union, because they could help the weaker countries with their balance of payment deficits. Although, in a monetary union, the separate balance of payment situations for the individual European countries are not visible, they do exist and might cause financial flows between central banks. So, it remains necessary for the European Union to gradually move closer to balancing the internal European payments.

VIII

A very different limitation to Keynesian budgetary policies follows from the fundamental international shift in the *relative scarcity* of different production factors. It was Professor Bertil Ohlin (Swedish economist, 23 April 1899 – 3 August 1979) who analysed how the structure of international trade depends on the relative scarcity of the main factors of production, labour, capital and entrepreneurial capacity (Witteveen, 2012). As a consequence of the increasing efficiency and therefore of the lower costs of international transportation and communications, some low-income countries have now been able to fully engage in international trade, becoming 'emerging economies'. This means that the great abundance of labour in for example China, where more than one billion people still live in absolute poverty, makes it possible to produce labour-intensive products very cheaply. This has had a great impact on the industrial countries, which could not compete with such cheap products and therefore imported them. This has made labour in their own countries relatively more redundant. In relation to this, capital had become scarcer because many capital installations are in need of being replaced or adjusted to the new scarcity and price relationships in the world markets. In the United States this resulted in a relative lowering of real wages, which had not increased over the last ten years while productivity continued to grow. Against this, profits did increase and especially entrepreneurial income went up in sky-high bonuses. And in Europe similar tendencies can be seen.

With respect to Keynesian policies, this scarcity of capital means that the industrial countries need to increase their savings. That can be an argument to aim for low budgetary deficits. Germany's policies then fit in with this fundamental situation. For the Netherlands however, with its large saving surplus, the problem is rather to bring business investments to a higher level.

IX

This brings me back to the beginning of our large structural savings surplus. There are two aspects to it. We have seen that we now have a savings surplus of approximately eight percent of GDP in the non-financial business sector: high retained profits and low investment. The other element is formed by the savings from pension funds and life insurance companies of six percent of GDP. How can this be explained?

As Schotten and Leering (2012) point out, the elements in this situation are perhaps that we have a relatively large number of multinational companies with their head offices in the Netherlands, which then receive dividends from daughter companies in other countries. Dividend taxes in our country are relatively low and the sharp decrease of the rate of interest has also helped.

But a more fundamental factor seems to me that international capital movements have greatly increased in recent years. Limiting government regulations have mostly been abolished and financial communications have improved. Due to this, emerging economies like China, Brazil and others can grow very strongly and attract large capital imports in order to do so. Then multinational companies are able to find more attractive investment possibilities in these economies than here. This is of course an aspect of the change in the relative scarcity of the production factors – labour and capital – I mentioned earlier. The resulting scarcity of capital becomes manifest here by the large outflows of capital in the form of direct investments or of participation in the shared capital of foreign companies. Dr. J. van Duijn, who wrote a very penetrating article about our economic disequilibrium (Van Duijn, 2013), also discerns a shift in power here from labour to capital, with lower real wages and higher profits as a result, a tendency strengthened by the general lowering of profit taxes. An interesting aspect of this development is also that large companies are more easily taken over by competitors, and have to defend themselves against this or prepare to take over other companies themselves. This leads to an accumulation of large cash holdings. Also Schotten and Leering have mentioned these, and see this as a precaution against greater economic volatility.

X

This raises the question what view governments should take of all this. The present paradigm includes complete freedom of international capital movements. The idea is that efficient markets know best. But, apart from the question whether it is always best for shareholders, large take-overs can sometimes clearly damage the national interest with respect to employment and growth. It is clear that governments of the larger European countries sometimes interfere, visibly or invisibly. It seems to me that in our small country – though medium-sized with respect to economics – the government should have the power, as in the United Kingdom, to veto large take-overs when they consider them not in the national interest. With such a power our government could have prevented the very unfortunate and destructive take-over of ABN Amro by Fortis, the Royal Bank of Scotland and Banco Santander. Our central bank – de Nederlandsche Bank – had foreseen the great difficulties arising from this, but the government saw no possibilities to act. The result was finally that we lost a large network of foreign bank offices, that had been built up over the centuries and had proved very helpful to our exporters. Banking services were also an export category in which we had a comparative advantage. So, this meant a loss to the national economy.

Apart from this, the relatively low level of our investments is an argument for a fiscal regime that is more favourable to investment and innovation. Research spending should be stimulated and we should have ample opportunities for an accelerated depreciation of investment expenditures that can be a very effective stimulus to investments. This could also be variable as an instrument for anti-cyclical policy.

XI

Then there is also the question of the lack of financing. This plays a part as regards medium and small-scale businesses, which brings us to the other element in our saving surplus: pension funds and life insurance companies. Our government has seen the great potential in these enormous savings, 85 percent of which are now flowing out of the country. It has engaged these institutions in discussions to induce them to increase their financing in Dutch businesses. However, this discussion seems to have deadlocked, because these institutions fear that the returns on such credits would be relatively lower. Therefore, they are at least asking for government guarantees, which naturally the Minister of Finance is not prepared to give.

Is there a way out of this deadlock? Then we will first have to recognise that the present supervisory rules forcing these institutions to aim for the highest possible returns, are completely unreasonable. They are unreasonable because they require the funds to build up a capital from which all future obligations, over the next thirty or forty years, can be financed at the present exceptionally low rate of interest. If we would moderate this accounting rule by taking the moving average over the last ten years of this rate of interest, then their financing problems would be alleviated and these institutions would have more room for credit to medium and small-scaled businesses with lower returns. Against this, the government should then re-introduce a maximum for investment in shares and participations in large corporations, which is the largest share of the total investments of pension funds: 323 billion euro of a total of 959.6 billion euro (DNBulletin, 2013).

CONCLUSION

When we examine the condition of our economy in its different aspects – over-saving, lack of investment, super-cautious rules for pension funds and insurance companies, and large liquidity holdings by businesses for precautionary reasons – we can see a single basic spiritual weakness behind it. Clearly, a saving surplus reflects a lack of confidence, of trust. The results of investments depend on developments in the future, and the future is uncertain. There are risks, but there are also basic opportunities. Some basic confidence, some optimism is needed. Keynes has written about the 'long-term state of expectations' and the need for 'animal spirits': "But individual initiative will only be adequate when reasonable calculation is supplemented and supported by animal spirits, so that the thought of ultimate loss which often overtakes pioneers, as experience undoubtedly tells us and them, is put aside as a healthy man puts aside the expectation of death." (Keynes 1936).

I would like to add that human beings, faced with all the future changes and dangers in the material world, are always able to find astounding strength and insight in their inner life. Yet we will have to discover this turning of our attention from the outer material world to the inner spiritual world, in order to find this One Source of Energy, Life and Light.

What we need is the power of confidence: Faith!

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