Netherlands vs Germany: 0-2?

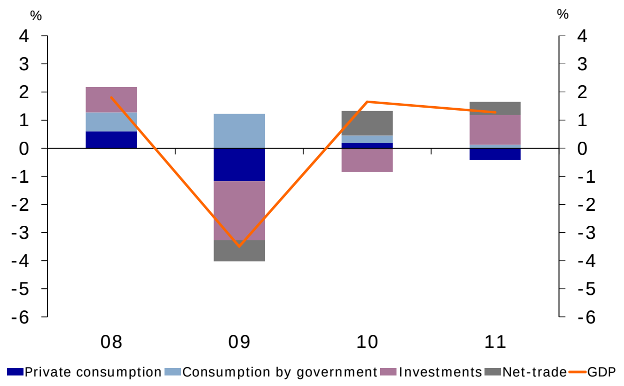
As a result of its open character, the Dutch economy fluctuates along with the international economic cycle. The economic developments in Germany play an especially significant role here, since this country is the Netherlands' most important trading partner. Both the German and the Dutch economies began to contract at the same time, in the second quarter of 2008. Although the recession in Germany was deeper than in the Netherlands, the German economy recovered faster. GDP growth in the Netherlands has significantly lagged behind Germany in the last two years (figures 1 and 2). The Netherlands is now again in recession, while GDP in Germany continues to grow. Is the grass greener in the East?[1]

Germany benefits from emerging markets

In the past two years, net trade has contributed more to growth in Germany than in the Netherlands. This divergence can largely be explained by a difference in the composition of exports and the geographical orientation of trade flows. Dutch exports are heavily focused on the European hinterland, due to the geographical position of the Netherlands and good infrastructure connections with the rest of the European continent. Around three-quarters of the Netherlands' exports go in this direction. Over time, the German business community has increasingly focused on the emerging Asian and Latin American economies. The recession in 2008-2009 was deeper in the emerging economies than in Europe and the United States, however the recovery was also more powerful. As a result of the difference in economic performance and therefore differing demand for imports from these countries, export volume fell faster in Germany in 2008-2009 than it did in the Netherlands, and rose more in 2010-2011.

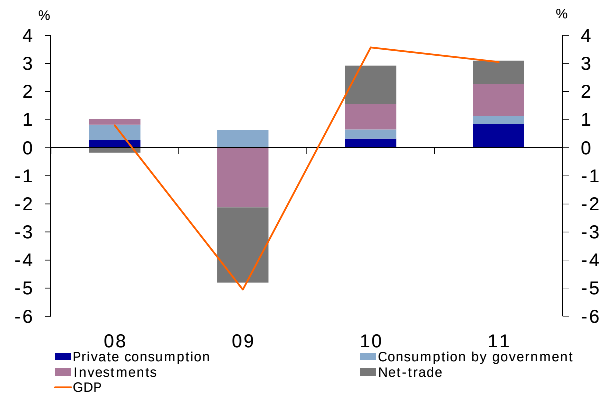
[1] This article is a summary of Van de Belt, R. and D. Piljic, *Nederland vs Duitsland: 0-2?* Special 12/02, Rabobank Nederland.

Figure 1: Contributors to growth in the Netherlands



Source: Eurostat, Rabobank

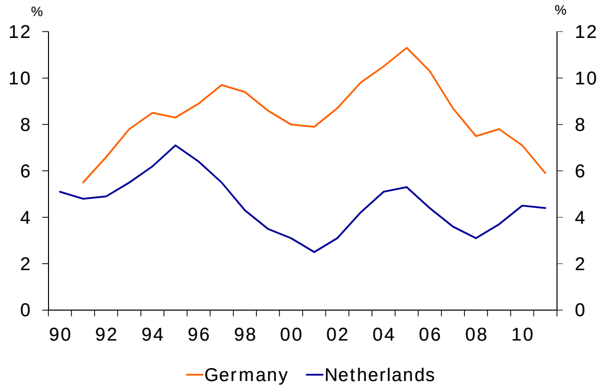
Figure 2: Contributors to growth in Germany



Source: Eurostat, Rabobank

Generally speaking, the emerging economies have relatively strong demand for capital goods. Germany's most important export products are machinery and transport equipment, which account for 49% of total exports. These products are also the most important component of Dutch exports, but their share of total exports is much lower at 28%. Moreover, Dutch exports consist mainly of re-exports, while Germany exports many products that are domestically produced. Re-exports contribute much less to the domestic economy than the export of domestically produced items.

Figure 3: German and Dutch unemployment gradually converge



Source: Eurostat

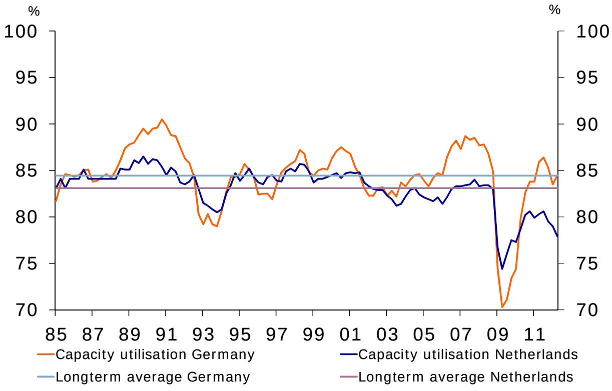
Consumption in Germany is healthy

The contribution to growth made by private consumption has also been significantly greater in Germany than in the Netherlands in the past two years. This can be explained by the more favourable circumstances for household consumption in Germany. There is less pressure on disposable income in Germany, while contractual wages (excluding extraordinary payments) in the Dutch market sector have shown little or no growth after adjustment for inflation. Furthermore, unemployment is falling in Germany and rising in the Netherlands (figure 3). The German *Arbeitsmarktwunder* (labour market miracle) can not only be explained by the reforms to the labour market, the country also has a shrinking working population. In addition, German companies, like their Dutch counterparts, retained many people during the crisis so that unemployment rose only to a limited extent during the Great Recession. Shortened working hours, flexitime schemes and *Bündnisse für Arbeit*, whereby employees accept wage restraints in return for guaranteed employment, have all contributed.

In terms of capital, the Netherlands also scores worse. Since the peak in August 2008, house prices in the Netherlands have fallen by approximately 11%. The development of house prices has been much more favourable in Germany, with a rise of 9% since 2007. Another factor is that Dutch households are more sensitive to stock market losses than their German counterparts due to the structure of the Dutch pension system. The Dutch supplementary pension system is largely based on full funding, whereby the employee's pension premium is invested in the stock market by a pension fund and the pension benefit is paid out of the invested capital. Low interest rates and yields cause the coverage ratios of Dutch pension funds to decline, threatening the viability of pension payments.

The German pension system is based on ‘Pay As You Go’, whereby benefits are paid directly out of current contributions. The system is therefore unaffected by fluctuations in yields and interest rates. In the present economic environment this is an advantage, however in the long term the German pension system is less prepared for increasing payments of pension benefits as a result of the ageing population.

Figure 4: Capacity utilisation in Germany and the Netherlands



Source: Eurostat

German businessmen are returning to form

Both the Netherlands and Germany have traditionally had current account surpluses. In other words, these countries earn more than they spend and have a national savings surplus. In Germany this is due to consumers, while in the Netherlands savings are held by non-financial businesses. Producers in the Netherlands have little reason to acquire capital goods. Since production is still 6% below the level before the Great Recession, capacity utilisation is still below the long-term average (figure 4). In Germany, capacity utilisation is running at the long-term average of the total available production capacity. Since 2011, industrial production in Germany has been above its pre-crisis level. Nonetheless the investment ratio in Germany is low in a European context, as it is in the Netherlands, while the financial position of businesses in both countries is healthy, partly due to wage restraint.

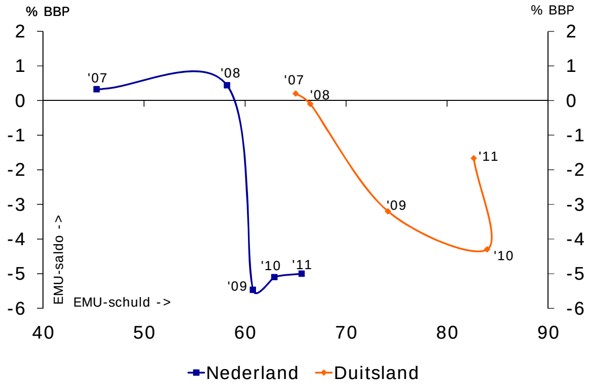
Governments to take action

The Great Recession has severely affected government finances in both the Netherlands and Germany. The budget deficit and the level of government debt have risen significantly in both countries (figure 5). The deficits have increased mostly because both governments have chosen to let automatic stabilisers take full effect. In addition, both governments have followed a discretionary budget policy in the form of additional spending and reductions in tax and social insurance. The OECD (2009)[2] estimates that the stimulus package added 0.5% to German GDP in 2009 and 0.2% in 2010. The stimulative policy in the Netherlands, including the effect of automatic stabilisers, reduced the economic slowdown by 1.5%-point in 2009 and added 1%-point to GDP in 2010 (CPB, 2011)[3].

[2] OECD (2009), *OECD Economic Outlook,* No. 86, OECD, Paris.
[3] CPB (2011), *Effecten stimuleringspakket*, CPB Communication.

Like many other European countries, Germany and the Netherlands have entered an excess deficit procedure as a result of deteriorating government finances. Both countries have to reduce their budget balance to less than 3% of GDP in 2013. With an estimated budget deficit of 0.7% of GDP in 2013 Germany would seem to be well on track, however it is questionable whether the Netherlands can achieve this, even with the spending cuts agreed in the Spring Agreement.

Figure 5: Financial position of the Dutch and German governments



Source: Eurostat

In the long term, the Netherlands and Germany face similar problems. The OECD (2010)[4] estimates potential economic growth in the period 2012-2025 at 1.5% for the Netherlands and 1.3% for Germany. This is low compared to the OECD average of 1.9%. This is mostly due to the ageing population and dejuvenation faced by both countries. Unlike Germany, the Netherlands has relatively generous social security provisions and an extensive public health care system. As a result of the ageing population, if policy remains unchanged government spending in the Netherlands in these areas will rise by nearly 5 percentage points of GDP to 22.4% of GDP in the period 2010-2030. This increase in Germany is expected to be about half this amount. It is thus urgent for the Netherlands to increase the pensionable age to 67 years in short order, in combination with further linkage to life expectancy and reducing public health care expenditure funded from the Exceptional Medical Expenses Compensation Act [AWBZ].

Conclusion

Germany has outperformed the Netherlands in economic terms in the last two years. At first sight therefore, it would seem that the grass is greener in the East. However this is because the grass in Germany is of a different type. The strong pick-up in the German economy is partly due to the relatively large proportion of trade with Asia and the composition of German exports. In addition, German consumers are making a significant contribution to economic growth. Dutch consumers on the other hand are thrifty, and little help can be expected from the government. Germany is expected to generate better growth than the Netherlands this year as well. So it looks like 3-0 to Germany. Can the Netherlands stop this in the short term?
It will be difficult. The composition of Dutch exports and the destination of those exports are more or less set in the near term.

[4] OECD (2009), *OECD Economic Outlook,* No. 88, OECD, Paris.

The grass is greener to the East

If growth slows in the Netherlands' primary export market, the rest of Europe, this will by definition harm the economic outlook for the Netherlands. The best one can hope for is that the currently very negative effect of sentiment on consumption in the Netherlands will become a little less negative. The negative effects of declining housing equity however remain. Because clarity is by definition associated with reforms of and reductions in the mortgage interest rate deduction, meaning that prices will not stabilise for the time being.

Although it looks as though Germany might go further ahead in the short term, the game is not over. The potential economic growth in the coming years will not be much more than 1.5% in either country, mainly due to the ageing working population. This will actually affect Germany somewhat more than it will the Netherlands. This same ageing population moreover poses a challenge for government finances. Without structural reforms, government spending on social security and health care will increase sharply in the coming years, threatening the sustainability of government debt levels. While Germany would appear to be in a better position, this is where the potential lies for the Netherlands to catch up. Dealing energetically with the structural problems in relation to matters like labour market flexibility, health care and the housing market combined with an investment in the competitiveness of the Dutch economy (quality of education and infrastructure) can increase economic performance. The Netherlands achieved this in the 1990s, while Germany performed better during the most recent decade. The challenge facing the Netherlands is great. But the history of football has shown the Dutch that beating the Germans, even on their own territory, is possible.

Translated by Walker Language Consultancy B.V.

Ruth van de Belt
R.Belt@rn.rabobank.nl

Danijela Piljic
D.Piljic@rn.rabobank.nl