Special Report 2012/03

The Netherlands – deservedly core

In this Special Report we argue that although the budgetary outlook and the current political and economic situation in the Netherlands raise some eyebrows abroad, the fundamentals still point out that the Netherlands belongs to the core of the euro area.

Economic outlook

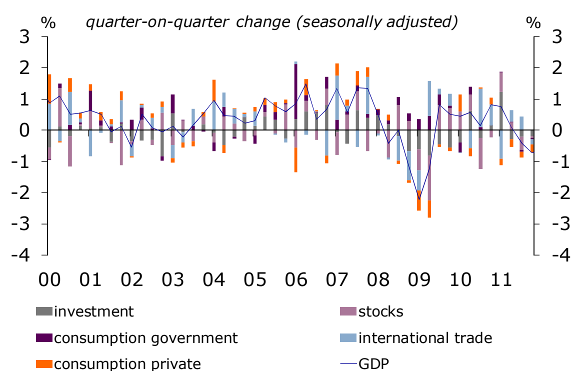
The Dutch real GDP was up by 1.2% in 2011 compared to 2010, even though the economy went into a recession in the second half of the year following uncertainties about the European sovereign debt crisis, declining consumer and producer confidence and the cooling down of world trade. Real GDP shrank on a quarterly basis by 0.4% in the third quarter and 0.6% in the last quarter of 2011. Until recently the Dutch economy did not quite underperform the eurozone. The recent weakness was caused by a simultaneous weakness in foreign and domestic. It already became obvious in 2011 that net foreign trade would no longer be able to drive the economy on its own due to stagnating growth in world trade. Consumers, producers and the government did not, however, contribute to growth. From a European perspective Dutch private consumption growth is extremely weak. While household spending in the euro area was back on a par with the 2008 levels, Dutch consumption volume remained 3% lower than the pre-crisis level. This was mainly due to subdued income growth – also from a European perspective – and declining house prices.[1]

The Dutch economy is expected to shrink by ¾% y-o-y in 2012. This sharp decline is predominantly the result of a considerable negative carry-over from 2011 (-0.7%).[2] In the first half of 2012 we expect the economy to contract, but to a much lesser extent than in the fourth quarter of 2011. For the remainder of the year, a subdued recovery is envisaged. The carry-over will conversely be positive in 2013 and we foresee a modest real growth of 1% y-o-y in 2013 (figure 1).

External demand

Net exports are expected to remain the only component yielding a positive contribution to growth this year. They are, however, likely to suffer from weakening external demand, with this weakness mainly coming from the rest of the euro area. In 2013, worldwide economic growth is expected to pick up and this should result in positive net trade; once again boosting the Dutch economy.

Figure 1: Netherlands in recession



Source: Statistics Netherlands, Rabobank

Domestic demand

The real growth rate of private consumption – already negative for four consecutive quarters in 2011 – is expected to remain negative in 2012. This is mainly a result of government consolidation measures affecting households and negative wealth effects. The latter mainly emanate from falling prices in the housing market. On top of this, rising unemployment and announced pension cuts as of 2013, along with the expectation of additional fiscal consolidation measures, may give rise to precautionary savings in the household sector. More-

[1] DNB (2012), *The uncharacteristic Dutch consumption pattern.* Available at: http://www.dnb.nl/en/news/news-and-archive/dnbulletin-2012/dnb268792.jsp

[2] The contraction at the end of 2011 has a negative effect on growth this year.

over, the bad news stacked up in recent months, making consumers uncertain and causing them to postpone purchases.
Private investment is expected to pick up in the second half of 2012 in line with the forecasted international economic recovery and the accompanying recovery in demand. This will, however, not be enough to bring about an increase in the investment volume on an annual basis: we foresee a contraction of 2¼% for 2012. We are more optimistic for 2013 due to the global economic recovery and expect growth to amount to 2% in that year (table 1).

Table 1: Netherlands key figures

	2011	2012	2013
Year-on-year change in %			
Gross Domestic Product	1.2	-¾	1
Private consumption	-0.9	-1¼	-½
Government expenditures	0.4	-1	-1¼
Private investment	5.8	-2¼	2
Exports of goods and services	3.7	1¾	5
Imports of goods and services	3.5	1	4¼
Consumer price index	2.4	2¼	2
Unemployment (% labour force)	4.5	5½	5½
Government budget (% GDP)	-5	-4½	-4½
Government debt (% GDP)	65.4	69½	73
Current account balance (% GDP)	6¾	7¼	7

Note: Providing the policy remains unchanged, the budget deficit is expected to equal 4½% of GDP in both 2012 and 2013. If the Dutch government introduces additional spending cuts, the deficit will decrease accordingly. The extent of the decrease depends on the design of the austerity measures and the GDP growth.
Source: Statistics Netherlands, Rabobank

Dutch economy versus German economy
With 1.2%, last year's economic growth rate in the Netherlands was significantly lower than Germany's 3.1%. Also in 2010 the German economy outperformed the Dutch economy. In 2009, it was the other way around. One of the main explanations for this difference is that German exports reacted more sharply to the international trade developments. Firstly, the export basket of the two countries differs. Germany exports especially machinery, cars and other capital goods, while the Dutch export basket is mainly concentrated in food products. As a result Germany exports far more goods to the emerging economies, whereas the Netherlands acts as a transit port for the goods destined for other European countries. Besides, Germany exports far more homemade products than the Netherlands and these homemade products contribute more to the GDP-growth than re-exported products. Moreover, the Dutch domestic demand contributed far less to the GDP-growth since 2008 compared to the domestic demand in Germany. This is in particular true for household consumption. Not only are Dutch consumers much more pessimistic about their own financial situation than the Germans, they are also more gloomy about the labour market outlook. Capital losses of Dutch households due to the decreasing house prices in the past three years may also have had a negative effect on household spending.[3] Dutch consumers may react stronger to the stock market losses because the stock markets have an effect on the Dutch pension system.

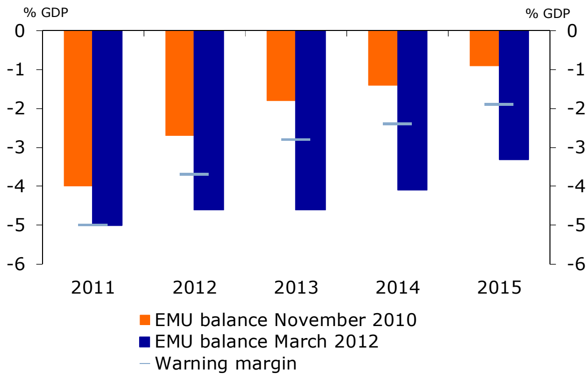
Budgetary outlook

As in most other European countries, the crisis has left its mark on the Netherlands' fiscal position. Despite previous austerity measures and primarily due to the deteriorating growth outlook, the budget deficit in 2012 is expected to stand at 4.6% of GDP. This is around 2%-point higher than the deficit stated in the financial statement of the coalition agreement in November 2010. As such it will exceed the warning margin of 1% of GDP.[4] Figure 2 shows the budget deficits over the 2012-2015 horizon as projected in the the financial statement of the coalition agreement in November 2010, as well as the Central Planning Bureau's (CPB's) latest update of its budgetary projections. The

[3] German private consumption is probably less sensitive to fluctuations in house prices, because home ownership as well as loan-to-value ratios is lower in Germany.
[4] The warning margin refers to the 1%-point deviation of the current EMU-balance projection from the projections in the budgetary framework underlying the coalition agreement (November 2010). In case the warning margin is reached, the cabinet has committed itself to take extra consolidation measures.

CPB updates are based on a no-policy-change assumption. The horizontal blue lines indicate the warning margin.

Figure 2: Budget deficit higher than expected



Source: CPB, Dutch Ministry of Finance

However, the structural Dutch fiscal position is strong relative to most other eurozone countries. This is due in part to budget surpluses in the three years prior to the crisis and the relatively low public debt level (45% of GDP in 2007) at the onset of the crisis. The debt ratio is 20%-points below the euro area average, which is projected to be 90% of GDP at the end of 2012, despite the estimate for the Dutch fiscal deficit in 2012 that is well over 1%-point of GDP above the euro area average. Only two other triple-A member countries, Finland and Luxemburg, are in a better position. Germany's public debt is projected to be around 81% of GDP.

In order to lower the budget deficit next year to the European deficit standard of 3% of GDP, the Dutch government is currently exploring additional austerity measures. A new package of at least € 9 billion (1.5% of GDP) in additional spending cuts is expected to be announced in April. The next important question to answer is where these cuts are going to come from. The current subdued Dutch growth prospects underline the need for structural reforms to reinforce the growth potential of the economy. These reforms will need to tackle controversial issues including the retirement age, the labour market for older employees, healthcare and the housing market. However, the benefits of such structural reforms, even if all were successfully agreed and implemented, would be scarcely noticeable in the short term. In addition, Dutch politicians have limited their room for manoeuvre with regards to achieving the 3% maximum budget deficit target by their insistence that the eurozone must have rock-solid budget agreements. Therefore, we believe the Dutch government has no choice but to carry out more austerity in order to set a good example and maintain its credibility in the markets, but above all in Europe.

If the Netherlands wants to meet the tightened budget rules in 2013, the Dutch government will have no choice but to take short term austerity measures to curb the budget deficit. It will have to take such measures even if they are likely to damage the economy in the short term. Therefore, we expect the Dutch government to either introduce spending cuts (e.g. public sector wage freezes) or to pass the bill to businesses and households (e.g. increasing VAT). However, taking these short-term measures might have the effect of decreasing the urgency and will of politicians to implement the much-needed structural reforms. Unfortunately, the longer it takes to make the necessary reforms, the greater the cost will ultimately be for taxpayers.

Current political situation

The coalition government of the Christian Democratic Party (CDA) and the Liberal Party (VVD) depends for a majority in the Lower House of Parliament on support from the Freedom Party (PVV). Although the PVV supports the minority right-wing coalition on most issues, on certain other issues (such as foreign policy and fiscal measures regarding European sovereign debt crisis) the government is forced to seek the backing of opposition parties. On March 20, a member of parliament for the PVV, decided to leave the party. As a consequence the minority coalition plus the PVV, can muster the backing of just 75 members of parliament

(which is exactly half of the 150 members that make up the Dutch parliament). However, the member has said that he intends to continue to support the government. In the meantime the Dutch Prime Minister Rutte has dismissed calls from opposition parties for new Dutch elections, saying that it would delay the agreement of new austerity measures.

Table 2: Dutch Lower House of Parliament

Party	Leader in parliament	Number of seats in parliament
Liberal Party (VVD)	Stef Blok	31
Christan Democrats (CDA)	Sybrand van Haersma Buma	21
Freedom Party (PVV)	Geert Wilders	23
Labour Party (PvdA)	Diederik Samsom	30
Socialist Party (SP)	Emile Roemer	15
Democrats 66 (D66)	Alexander Pechthold	10
Green Left Party (GL)	Jolande Sap	10
Christan Union (CU)	Arie Slob	5
Reformed Political Party (SGP)	Kees van der Staaij	2
Party for the Animals (PvdD)	Esther Ouwehand	2
Independent	Hero Brinkman	1

Nonetheless, the political situation remains uncertain because the Prime Minister (without a majority) can no longer rely on any agreed measures to be automatically passed in the Lower House of Parliament. In addition, the negotiating position of the PVV has deteriorated, which could possibly reduce its resistance to structural reforms. The PVV seems to play hard-to-get, but the party did the same in 2010 when the coalition ultimately reached an agreement. Regarding the polls, new elections are not a favourable option for any of the negotiating parties.

Is the market reflecting fundamentals?

In order to take a view of sovereign risk, we have constructed a Sovereign Vulnerability Index (SVI) which is based on eight different indicators.[5] Our SVI shows that we can be less concerned about the current account surplus countries such as the Netherlands, Germany and Scandinavian countries (table 3).

Table 3: Sovereign Vulnerability Index

	Average Z-scores	Ranking based on CDS spreads	Ranking based on RSVI 2012
Greece	6,95	1	1
Italy	4,19	4	2
Japan	2,72	9	3
Portugal	2,22	2	4
Spain	1,01	5	5
US	0,74	17	6
Ireland	0,03	3	7
France	-0,41	7	8
Germany	-0,41	12	9
Belgium	-0,58	6	10
Australia	-1,18	14	11
UK	-1,41	13	12
Austria	-1,55	8	13
Finland	-2,37	15	14
Netherlands	-2,45	11	15
Denmark	-2,68	10	16
Switzerland	-3,43	18	17
Sweden	-4,01	16	18

Source: Rabobank

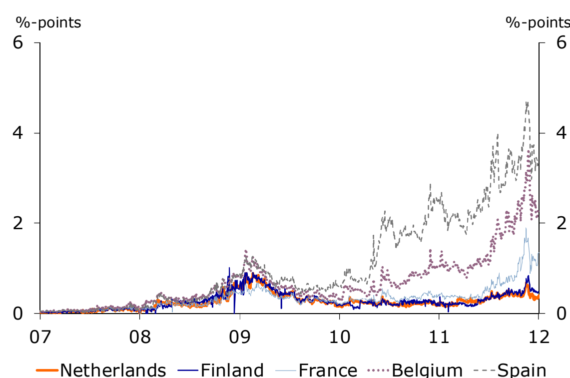
To benchmark our SVI rankings, we have compared it with the markets' rankings. Overall, our SVI's ranking is strongly correlated with the financial markets' ranking. Interestingly, the Netherlands appears to be less vulnerable to a sovereign debt crisis than Germany according to our SVI. This implies that markets may be too pessimistic on the Dutch economy and focusing too much on the short-term economic developments.[6] The spread on 10Y Dutch government bonds relating to Germany has been widening in the past couple of weeks to almost 60 basis points, and is significantly higher than the 10-year average of 20 basis points. However, the interest level on Dutch 10Y government bonds is still historically low. The recent research form ECB (2012) and IMF (2010) finds that the increasing spreads for the Netherlands, can particularly be explained by the safe haven flows to Germany. The studies find that the deterioration in public finances

[5] The SVI is based on eight indicators: interest-growth differential, the cyclically adjusted primary balance (% of potential GDP), interest payments (% of government revenues), gross public debt (% of GDP), old age dependency ratio, gross financing needs (% of GDP), current account balance (% of GDP) and the worldwide governance indicators. Once the variables are selected, a z-score is constructed in order to be able to interpret the countries' relative positions. Note that the greater a country's z-score, the more vulnerable the country is to a sovereign debt crisis.

[6] For more information on solvability of Dutch public finances and creditworthiness see: H.W. Stegeman and D. Piljic (2010), *Greece in the North Sea?*, Rabobank Special 2010/03 (only in Dutch).

has a negligible effect on the spreads for the Netherlands. According to the IMF research the spreads might increase by 0.5 basis point if the government budget balance worsens by 1%-point of GDP. The ECB study shows no significant effect of worsening of the budgetary situation on the spreads.[7] However, the spread is still lower than at the end of last year and the beginning of 2009 (figure 4). In the last mentioned year the problems in the banking sector may have played an important role in the increased sovereign spreads, suggesting that the banking sector is a source of financial risk to government when the perception of aggregate risk increases (Gerlach, *et al.*, 2010).[8] Nevertheless, it remains very difficult to assess the impact of the political crisis on the credit rating and the spreads in relation to the German government bonds.

Figure 4: Spread on 10Y government bonds relative to Germany



Source: Reuters EcoWin, Rabobank

Despite the uncertain short-term outlook, the Netherlands is the second wealthiest member of the euro area (after Luxemburg) in terms of real GDP per capita (in PPP terms). The current account balance has consistently been in surplus since 1981, and is expected to reach 7¼% of GDP in 2012. The unemployment rate is among the lowest in the euro area. We expect the unemployment rate to increase to 5.5% of the labour force in 2012, just over half of the euro area average. The rise in the unemployment rate so far has mainly been the result of an increase in the labour supply rather than a decline in the demand for labour. And although the capital-based pension scheme is currently under pressure, pension assets in the Netherlands amounted to EUR 945bn at the end of 2011. Related to GDP (156%), Dutch pension assets are among the largest worldwide.

According to the European Commission (2012) scoreboard the Dutch economy remains one of the fittest in Europe.[9] In the past decades, the Netherlands recorded persistent large current account surpluses, mainly driven by the trade balance (table 4). Despite some rise in nominal unit labour costs, the losses in export market shares have been contained. Furthermore, the surpluses also reflect high saving in the corporate sector coupled with subdued investment.

Table 4: Dutch scoreboard

	00	01	02	03	04	05	06	07	08	09	10
Current account balance (% GDP)		2.7	2.3	3.5	5.2	6.8	8.0	7.8	6.8	5.2	5.5
Net international investment position (% GDP)		-13	-24	-2	4	-3	3	-6	2	17	29
Real effective exchange rate (3 years % change)		0.0	3.2	10.9	7.2	3.3	-1.1	-1.0	0.7	2.8	-1.0
Export market shares (5 years % change)		-5.2	-4	-3.1	-2.6	1.4	-4.7	-2.1	-8.0	-4.1	-6.5
Nominal unit labour cost (3 years % change)		9.9	13.3	13.1	7.9	2.6	0.5	2.1	5.5	10.2	7.4
House prices (y-o-y changes relative to Eurostat consumption deflator)	13.5	6.1	2.7	1.0	3.0	1.8	2.2	2.7	0.2	-4.9	-2.9
Private sector credit flow (% GDP)	23.5	13.8	12.2	10.2	7.0	14.6	12.7	9.2	7.6	6.8	-0.7
Private sector debt (% GDP)	190	191	195	203	205	210	213	211	210	222	223
General government sector debt (% GDP)	54	51	51	52	52	52	47	45	58	61	63

Source: Dutch Ministry of Finance

[7] ECB (2012), *The euro area sovereign debt crisis. Save haven, credit rating agencies and the spread of the fever from Greece, Ierland and Portugal*, Working Paper Series No 1419.
IMF (2010), *Sovereign Spreads: Global risk aversion, contagion or fundamentals?*, IMF Working Paper 10/120.
[8] S. Gerlach, et al. (2010), *Banking and sovereign risk in the euro area*, CEPR Discussion Paper No. 7833.

[9] European Commission (2012), *Alert Mechanism Report*, COM(2012) 68 final, Brussels.

According to the European Commission the risk to the Dutch economy mainly relate to the relatively high private sector debt and real estate markets. Partly related to fiscal incentives making mortgage debt attractive, household debt-to-GDP and house prices increased. However, the net financial asset position of Dutch households is positive (circa EUR 770bn) due to the considerable amount of private and retirement savings and high value of owner-occupied stock.[10]

Conclusion

Since the second half of last year the Dutch economy is once again in a recession. Compared to the other core euro countries the Netherlands has to cope with a weak domestic demand, especially household consumption. We expect the Dutch economy to climb out of the recession in the course of this year due to a gradual pick-up in exports. The consequences of the disappointing economic performance for the government budget are serious. This underlines once more that structural reforms are needed in order to strengthen the Dutch growth potential and at the same time lower the public debt. The current Dutch political constellation (minority coalition) makes the negotiations over an extra consolidation package of EUR 9bn (1.5% of GDP) extremely difficult. However, we expect that the parties will eventually reach an agreement. Not only have they nothing to gain from the new elections, also the strong Dutch reputation of fiscal discipline is at stake. The political issues notwithstanding, we are convinced that the Netherlands is a well-deserved core country.

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[10] M. van der Molen (2012), *Dutch mortgage market: a liability?*, Rabobank Special Report 2012/02.