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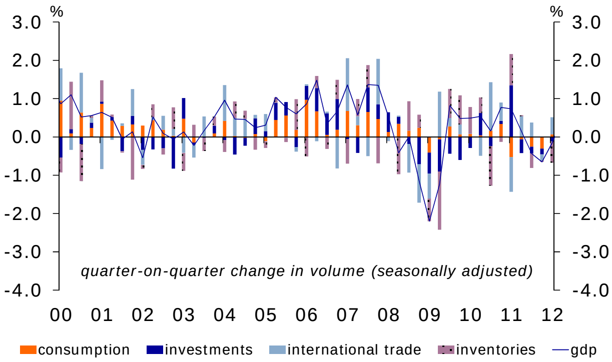
Uncertainty continues

For the second time in almost two years, Dutch citizens are facing a package of unprecedented spending cuts and increases in tax and social insurance contributions, at least by Dutch standards. The Spring Agreement should be seen as the start of further budgetary consolidation. Clarity regarding the exact size and nature of budgetary measures will only emerge after the elections and the subsequent coalition negotiations. Meanwhile, the Dutch economy contracted in the first three months of this year for the third consecutive quarter. The economy is expected to pick up in the course of 2012, although quarter-on-quarter growth will probably be meagre. Over the whole of 2012 the economy is expected to contract in real terms by an average of 1¼%. Gross domestic product (GDP) will most likely only show very slight growth in 2013. The cuts will have a negative effect on the already weak outlook.

Figure 1: Already three quarters in recession



Source: CBS

Further contraction in the first quarter

While the 0.2% contraction in the Dutch economy was less negative than that seen in the previous quarter, it was much lower than the growth rate in Germany for instance (0.5%) and Belgium (0.3%) (see also the article 'Focus: The grass is greener to the East'). In addition to the virtual stagnation of world trade growth in the course of 2011, continuing weak domestic dynamics are causing further contraction (figure 1).

Furthermore, the level of uncertainty remains high. The calm in the financial markets that the ECB managed to impose at the end of last year with its accommodative monetary stance has been short-lived. Tensions regarding Greece have resurfaced in recent months, because political parties have been unable to agree on the need for further cuts in exchange for emergency financial support from the EU and the IMF. The problems in the Spanish banking sector have also featured frequently in the news lately.

The short-term outlook is that the Dutch economy will show a modest recovery in the course of this year. The recovery in the Netherlands will, as in previous years, mainly depend on foreign trade, now assisted by the weak euro. The assumption implicit in the current forecasts is that the European debt crisis will not get out of hand, and that it will not be resolved in the near future either. The expectation is that the average size of the Dutch economy will shrink by 1¼% compared to last year.

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This sharp contraction is mainly due to the negative spillover effect[1] (of -0.7) from 2011. On the other hand, this effect is expected to be positive in 2013 and net trade will increase slightly, with year-on-year growth in real terms estimated at ½%. The cuts will mean that domestic spending will be under further pressure.

Growth depends on foreign trade

The Netherlands has a very open economy. In 2011, its 'degree of openness' (total exports and imports divided by GDP) was nearly 150%. International trade is therefore a strong determining factor in the ups and downs of the economy. A total of three-quarters of goods (in values) are exported within the EU, while the remainder is exported outside the EU. Within the Eurozone, the Netherlands is by far the largest beneficiary from the trade of goods with other euro countries. The trade surplus with the eurozone in 2011 was € 147 billion[2]. In 2011 9.8% of the value of total Dutch exports was going to the worst-hit GIIPS countries (Greece, Italy, Ireland, Portugal and Spain; see figure 2). Germany is by far the most important export destination, accounting for as much as a quarter of goods exports. Exporters in the Netherlands have recently benefited from a strong German economy, although the German IFO business climate index has been indicating a slowdown in economic activity in recent months. The economic outlook for much of the rest of the eurozone has been gloomy for some.

On the other hand, despite the anaemic development of (relevant) world trade, domestically produced exports can still hold up well as a result of the favourable development of price competitiveness. Given the current loose labour market, wage growth is limited, making labour and therefore produced goods relatively cheap (figure 3). The weaker euro is also helping to improve price competitiveness in comparison to non-euro competitors.

Without the positive contribution to growth from foreign net trade, the contraction of the economy in the first quarter would have been 0.4%-point worse than the actual figure. In the first three months of 2012, import and export volumes increased on average by 4.2% and 4.1%, respectively, compared to the previous quarter. However, the spending cuts in the Netherlands and abroad will pressure the growth in foreign trade in 2012 and 2013. The volume of exports is expected to rise only by a meagre 1¾% in 2012 compared to a year earlier. Demand for foreign goods also remains limited, with import volume expected to rise by 1% compared to 2011.

In 2013, growth in export volume is expected to rise to 4¼% against a backdrop of increasing world trade. Growth in import volume in 2013 is estimated at 3¼%.

[1] The contraction at the end of 2011 has a negative effect on the average growth in this year compared to last year.
[2] Draper, H. (2012), *Handelsoverschot Nederland grootste binnen eurozone* (Dutch trade surplus is the largest within the eurozone), CBS Webmagazine, 30 May.

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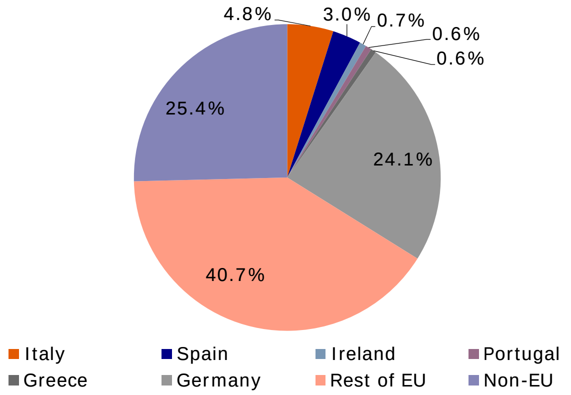
A tough package, but is it enough?

The Rutte I cabinet unexpectedly ran into trouble in May over a package of additional cuts necessary to meet European budget rules, but nonetheless managed to present a closing budget for 2013 with the support of the opposition parties D66, GroenLinks and the ChristenUnie. While there is now an agreement, it remains to be seen whether its shelf life will extend beyond 12 September 2012, the date of new elections. A new cabinet could amend the agreement, or even throw it out completely. The latter outcome would appear to be unlikely, since several of the measures are broadly supported in the Lower House of Parliament.

The agreement contains cuts in government spending (mainly with a wage freeze in the public sector), but the majority of the proceeds of € 12 billion will be paid by citizens and businesses through an increase in the highest VAT rate bracket, the own risk excess in healthcare and the scrapping of tax-free reimbursement of travel expenses. The measures are expected to reduce the government's budget deficit from an estimated 4% of GDP in 2012 to 3¼% in 2013. In 2011, the budget deficit was still 5% of GDP. However, this will be at the expense of growth, which is expected to be ½%-point lower in 2013 as a result of the measures in the Spring Agreement.

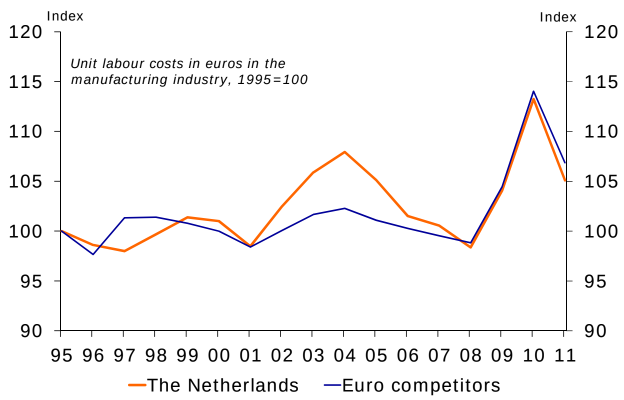
From an economic point of view, swingeing cuts are not the wisest course in times of economic weakness. Politically however, the cabinet had no other choice than to comply with the European budgetary rules. The Netherlands has repeatedly stressed the importance of budgetary discipline in Brussels; countries that do not obey the rules received little sympathy.

Figure 2: Exports by destination



Source: CBS

Figure 3: Unit labour costs



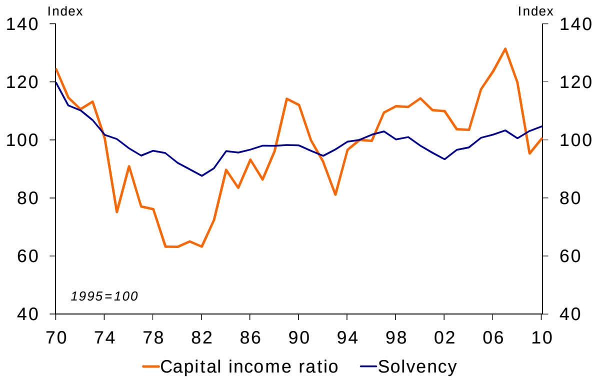
Source: CPB

The Spring Agreement is thus mainly focused on the short term. The cabinet hopes it will be able to reduce the deficit to 3% of GDP, mainly through higher taxes and social insurance contributions. This will, however, not solve the real problem of the Dutch government's finances, which lies in its future commitments which are unaccounted for. Compared to other countries, the Netherlands has relatively generous social insurance provisions and an extensive public healthcare system. Given current policy, government spending will rise sharply as a result of population ageing. To guarantee the sustainability of the government's finances in the long term, structural reforms are needed in the housing market (both to buy and to rent), in healthcare and in the labour market to provide adequate revenues to the Treasury after the current cabinet's term. Euro commissioner Rehn recently referred to the need for further reforms in a reaction to the Spring Agreement. The crisis agreement is a good first step, but further measures are still needed.

Businesses are drawing down their reserves

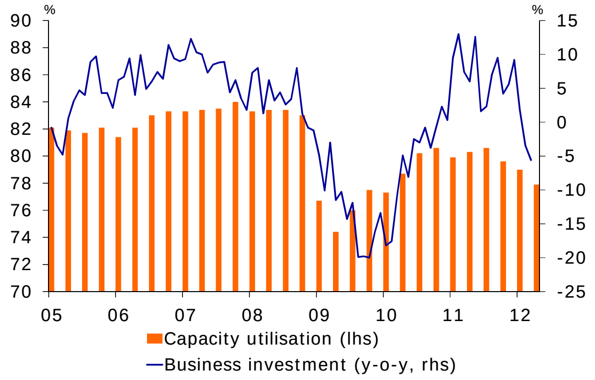
While the current recession is mild in comparison to the economic contraction that occurred in 2009, the situation may be perceived as worse: financial reserves are lower and unemployment is higher. This is clearly evident from the fall in profitability of non-financial companies in recent years. The capital income ratio of the non-financial sector, an indicator of profitability, declined sharply after the 2009 crisis (figure 4). Nevertheless, the solvency of the market sector is still holding up well. The mirror of the capital income ratio is the labour income ratio, which expresses the fraction of value added earned by employees. The labour income ratio increased after the crisis, because production declined while there was hardly any effect on employment. In recent years employers therefore lost a relatively large proportion of value added going to labour costs.

Figure 4: Business profitability is declining



Source: CPB

Figure 5: Little incentive to invest



Source: CBS

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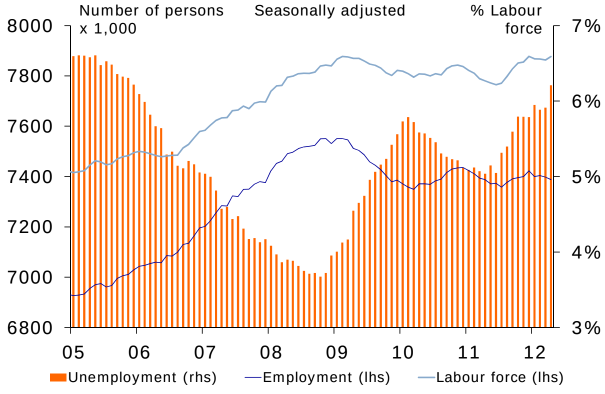
Domestic production is not expected to pick up soon, as a result of low domestic spending and moderate growth in world trade. The labour income ratio is set to decline as a result of falling employment. Capacity utilisation of capital goods is currently 77.9%. This is well below its pre-crisis level, and it has not been this low since the beginning of 2010. In addition, producer confidence has been constantly declining since the end of last year.

Private investment fell by 1.2% in volume terms in the first quarter compared to the previous quarter. Apart from replacement investments that are needed, the need and potential for investment in the coming period will remain limited. Business investment is expected to show a slight increase as a result of a modest pick-up in the international economy in the course of 2012, although it is not likely that this will be enough to bring about an increase in investment volume on an annual basis. Investment is expected to contract by 2¾% over the whole of 2012. Investment volume is expected to rise in 2013 due to the global economic recovery, but only to a limited extent of 1%. Moreover, investment volume is still well below (14.2%-point) its pre-crisis level.

Unemployment is rising

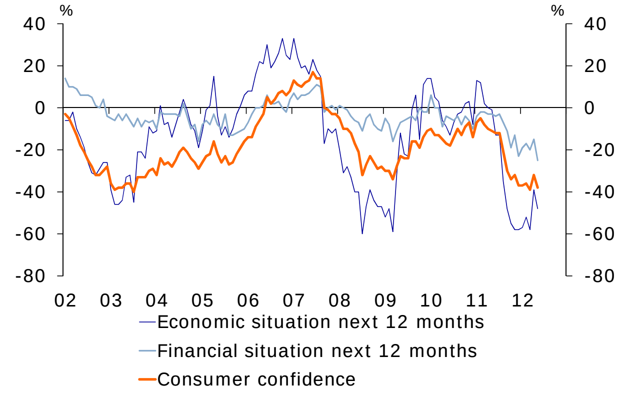
The number of unemployed people (people looking for paid work of at least 12 hours per week) in April was 489,000, an increase of 24,000 from the previous month. The labour supply rose by 14,000 in April, while there were 10,000 fewer people employed in that month. This brought the unemployment rate to 6.2% in April, an increase of 0.3%-point compared to the prior 3-month period (figure 6). Unemployment has risen surprisingly fast since the summer of 2011. At that time, 5% of the working population (people aged between 15 and 65) had no job.

Figure 6: Unemployment increases sharply



Source: CBS

Figure 7: Consumer gloom continues



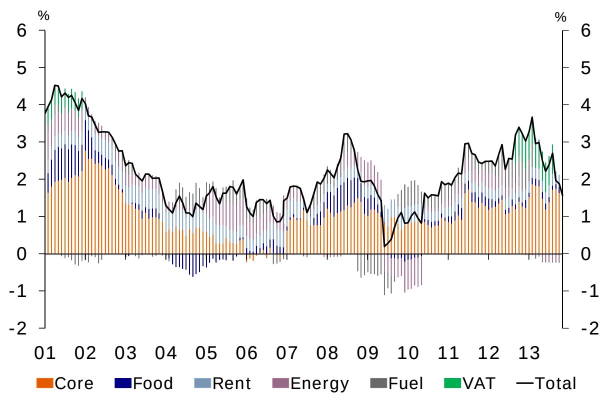
Source: CBS

The increase was due first of all to a relatively large number of graduates entering the labour market in the summer months, mostly students who had chosen to extend their studies during the recession. A second factor was a sharp increase in the number of people aged between 45 and 65 looking for work, as some of the discouraged unemployed tried their luck again on the labour market. In addition, due to the phasing out of early retirement schemes elderly workers keep supplying their labour for a longer period. Unemployment is expected to rise further during this year. Many government jobs will disappear. The demissionary Rutte cabinet announced cuts equalling € 6.1 billion on civil service in its 2010 coalition agreement. A large proportion of the savings will have to come from a smaller and more efficient government, with fewer civil servants and management layers. The effects of this package were already clearly visible in 2011, with the loss of 13,000 jobs in the public administration and government services sector. However, employment is expected to contract in the private sector as well, and is estimated to average 6½% in 2012 and to rise further in 2013 to 7%, as a result of pressure on economic growth and businesses being forced to cut costs.

Consumers more gloomy than in 2009

Consumers have recently had quite a lot to deal with: purchasing power has been falling for some years now, as have house prices. We see no end to this process either this year or the next. In addition, unemployment is rising and many people are facing a decline in home equity, as well as the value of other assets. There is much uncertainty with regard to pensions, the debt crisis and government policy. These factors are in turn affecting consumer confidence, and consumers are extremely downbeat regarding their personal financial situation in the coming twelve months.

Figure 8: Inflation to rise due to higher VAT



Source: CBS, Rabobank

Table 1: Netherlands key figures

	2011	2012	2013
Year-on-year change in %			
Gross Domestic Product	1.2	-1¼	½
Private consumption	-0.9	-1½	-1¼
Government expenditures	0.4	-1½	-2
Private investment	5.8	-2¾	1
Exports of goods and services	3.7	1¾	4¼
Imports of goods and services	3.5	1	3¼
Consumer price index	2.4	2¾	2¾
Unemployment (% labour force)	5.4	6½	7
Government budget (% GDP)	-5	-4	-3¼
Government debt (% GDP)	65.4	70¼	73
Current account balance (% GDP)	6¾	7¼	7

Source: CBS, Rabobank

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Consumer confidence accordingly fell to -38 in May, reaching a lower level than seen during the economic recession in 2009 (figure 7). The lack of confidence is an obstacle to a sustainable economic recovery. Consumer spending is expected to decline by 1½% in 2012, and consumption volume is also expected to fall 1¼% in 2013.

Inflation has been steady for months

Inflation has been fluctuating around 2.5% since November last year. In April this year prices were 2.4% higher than a year ago. Almost a third of inflation can be explained by factors relating to housing, such as rents and energy prices (figure 8). The increase in the latter was due to the higher oil price. This was also very visible at the pump, where prices were up between 5% and nearly 9% compared to a year ago. Average inflation in 2012 is expected to be 2¾%. The impact of energy and fuel prices on inflation will fall from the second half of the year, but the higher VAT will raise the average price level. It is likely that, as was the case with the VAT increase in 2001, producers will not pass the entire increase on to customers. Weak consumer demand, menu costs (costs of adjusting prices) and considerations relating to competitiveness will all be factors here. In 2001, the VAT increase from 17.5% to 19% led to an additional price increase of 0.5%-point. The current VAT increase from 19% to 21% is expected to generate an additional price increase of ¾%-point. The remainder of the increase will come at the detriment of corporate profit margins.
Besides the increase in VAT, the excise duties on beer, wine and tobacco are also set to rise. This will lead to an additional price increase of around 0.1%-point, which is limited because these products collectively account for only 3% of total consumer spending. On average, prices are expected to rise by 2¾% next year in comparison to 2012.

Conclusion

Continuing uncertainty is standing in the way of a recovery in the Dutch economy. Budgetary consolidation at home and abroad will restrain spending, both in the Netherlands and for our trading partners. Exports, the most important engine of growth, will be under heavy pressure in 2012 and 2013. The Dutch government has manoeuvred itself into a difficult position. In times of an economic headwind, cuts are not helpful in the short term. But as one of the proponents of strict budgetary discipline in Europe, the cabinet has no choice. Real clarity will only come once the outlines of a new coalition agreement emerge after the elections. This will not be easy, given the divided opinions among the political parties regarding the necessary reforms. Hence we see no end to the uncertainty for the time being.

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