The Netherlands: becoming accustomed to a lower growth path

2010 has been a year of picking up the pieces. The economy is emerging from a deep recession. After an economic contraction of almost 4% in 2009, real GDP is expected to increase by an average of 1¾% in 2010. This is not enough to bring production back to pre-crisis levels. The Dutch economy has benefited in 2010 from export growth and from the government stimulus memasures. For the time being, consumers remain cautious, while on the investment front, activity is limited. For the coming years, real GDP growth - which is expected to average 1½% - will be lower than in 2010. Factors to blame include the levelling off of world trade growth and the austerity measures implemented by the government. Because the proposed cuts will also affect consumer spending, a resurgence of growth is not expected during the 2012-2016 period.

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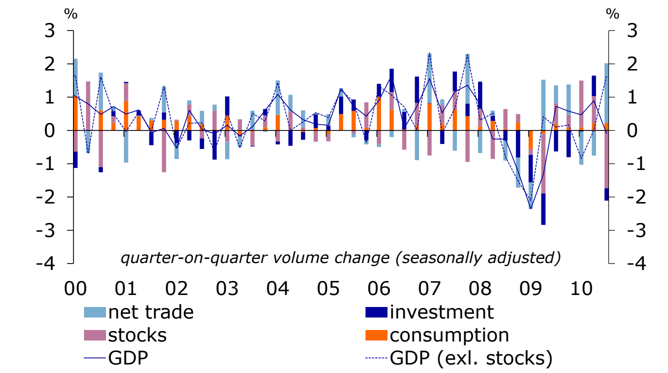
Economic recovery losing momentum

In the wake of the flattening growth in world trade, the economic recovery in the Netherlands likewise entered a soft patch after the second quarter. While second quarter growth in 2010 was up 0.9% on the previous quarter, the economy contracted by 0.1% on a quarterly basis in the third quarter *(figure 29)*. However, this contraction does not mean that we are about to enter a new recession. Recovery after a financial crisis typically progresses in fits and starts. The quarter-on-quarter negative growth is largely due to companies having reduced their investment in inventories. Inventories had first been sharply run down during the crisis. This was followed by a period of inventory rebuilding during the first half of 2010, creating a positive stimulus for demand and boosting economic growth. Without the effect of inventory rebuilding, the growth figures for the second and third quarters would have looked quite different *(figure 29)*. In the third quarter, the volume of GDP would have increased by almost 2% on the second quarter whereas there would have been almost no GDP increase in the second quarter.

Figure 29: Economic recovery slows



Source: Statistics Netherlands (CBS)

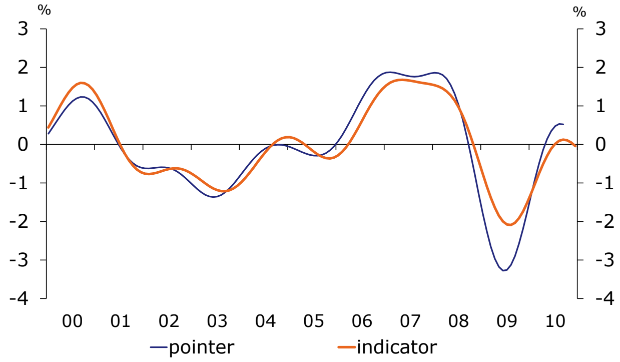
The ordinary person will not really be aware of the negative inventory effect in the third quarter. In fact, consumers spent more in the third quarter, particularly on durable consumer goods, such as cars and electronics. Thus the volume of consumption grew by 0.1% compared to the second quarter. By contrast, corporate investment was down by over 2%, on the previous quarter, while it had increased significantly in the second quarter.

The slackening growth in the second half of 2010 had been forecast by the Rabobank economic growth indicator on the basis of leading indicators such as lending, consumer confidence, long-term interest rates, industrial orders and the German IFO index *(figure 30)*. For the coming months, the indicator points to a further slowdown in the economic recovery, forecasting that by the end of 2010, economic growth in the Netherlands will be below trend and will remain at that level in 2011. It is estimated that real GDP growth in 2011 will average at 1½%, lower than the average for 2010 (1¾%).

The economic contraction in the third quarter has heightened anxiety about the dreaded double dip. In keeping with the economic definition of a recession, we already have one foot in a second recession, as evidenced by one quarter of negative growth. Two such quarters in succession would meet the criteria for the definition of a recession. However, it must be said, that with growth percentages around the zero mark, there is little difference between a percentage marginally above or marginally below that level. It also means that the likelihood of another quarter of negative q-o-q growth is slim. In any case, our base case is for modest, but positive quarterly growth.

The scars from the Great Recession will also remain visible in the years after 2011. Globally, governments are battling with large budget deficits, and the resulting cost-cutting measures are making consumers feel the pinch, thus dampening the volume

Figure 30: Economic growth indicator shows slowdown



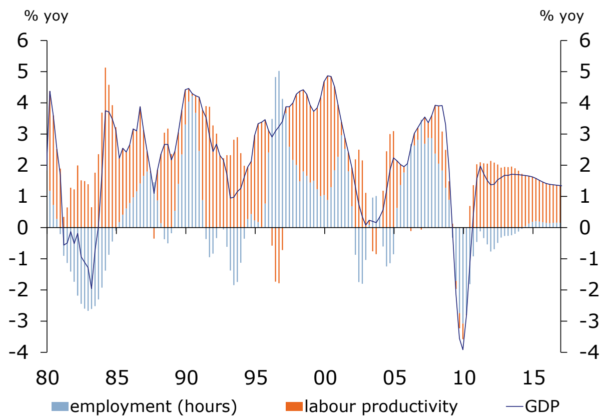
Source: Rabobank

Box 5: Fewer people, less growth

The Great Recession of 2009 has left its mark, even long after a return to growth. During the year of the crisis, the economy ground to an abrupt halt, but the rise in unemployment was limited. This resulted in a sharp decline in labour productivity *(figure 31)*. Production was considerably lower, yet there were still lots of people at work. Because the economy is now recovering and unemployment appears to be stabilising at the current level, labour productivity is improving again. However, productivity growth remains low, and the low level of investment is one of the reasons for this. In recent years, technological innovation brought about a substantial increase in labour productivity. In some cases, this was the fruit of sizeable investment.

The increase in labour productivity is one of the factors that determine how much the Netherlands as a country can produce in the future: potential growth. Another determining factor is the size of the (potential) workforce. If all other factors remain unchanged - such as workforce participation level - then growth of the workforce numbers will slow due to population ageing and will even decline in the future. Together with a limited rise in labour productivity, this means that future potential growth will be lower than the rate we have been accustomed to. However, this is not to say that there will be less affluence per person in the future, since the population will also be shrinking in the longer term. However, the pace of economic growth in general will be reduced.

Figure 31: Contribution of employment and labour productivity to GDP growth



Source: Rabobank

of world trade. After a severe contraction of average investment spending in 2009 and 2010, little pent-up growth is expected for 2011 and beyond. Consequently, it will take quite some time before the ground lost in 2009 and 2010 has been made up *(see also box 5)*. Average annual growth in the Dutch economy for the period 2012 to 2016 is expected to be much lower than in pre-crisis years, and is estimated to average 1½%.

Trade motor gears down a notch

Since the second half of 2009, exports have been the driving force of the economic recovery. The volume of exports increased by over 10% during the first half of this year compared to a year earlier, thanks to a global rise in demand. Dutch exporters also profited from the decline of the euro relative to the currencies of their trade partners. In the first six months of this year, the real effective exchange rate (corrected for inflation differences) declined by over 6%, after which it rose again slightly *(figure 32)*. During the coming period, the pace of world trade growth is expected to slacken, which will push down the growth of exports. Nonetheless export volume growth will be strong in 2010, and is expected to reach 9½% compared to 2009. In 2011 the increase is expected to be lower, averaging some 4¾%. Imports also rose strongly this year. Owing to inventory rebuilding in the first half of the year and the sharp rise in the re-exporting business, the rise in import volumes is expected to average 10% for 2010. In 2011 import volume growth will be a lot slower, and will be below that of exports, at 3¾%. This puts the growth of imports and exports at slightly below the long-term average. There will be little change in this scenario for the period 2012-2016. During these years, real exports are expected to show average annual growth of around 4½%, while import volumes will increase at the slightly lower rate of 4%.

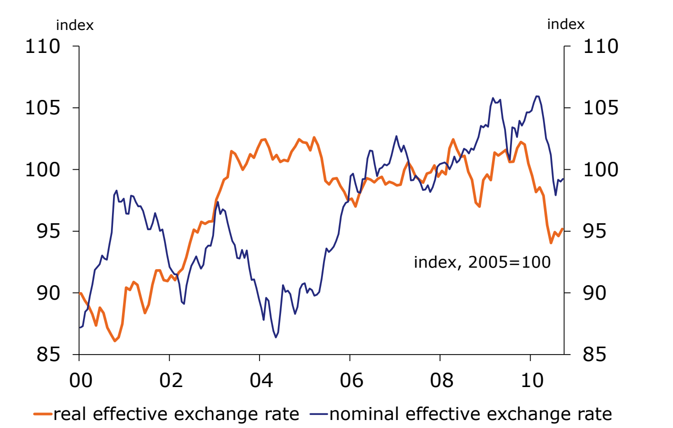
Little reason for new investment

On the back of growing world demand since the spring of 2009, industrial output was cranked up again. Machinery that had been switched off during the recession was turned on again to meet the growing demand. Yet a large proportion of production capacity remains unused *(figure 33)*. In September a little over 80% of the available production capacity in the industrial sector was in use; while this was a major improvement on the level of April 2009 (75%), it is still below the long term average. Consequently there is little need for investment in expansion. This situation is further exacerbated by the slackening pace of world trade growth and the cautious attitude of consumers (see below). This means the outlook for future production is only moderately positive. Despite a favourable investment climate (with relatively low interest rates), the volume of investment in 2010 will decline further by an average of 5% compared to last year. In 2011 the investment volume is expected to grow by 2¾% on average. And with an average projected annual growth of 3¾% in the period 2012-2016, the level of investment by 2016 will still be far from that attained before the crisis.

Cabinet takes a step in the right direction

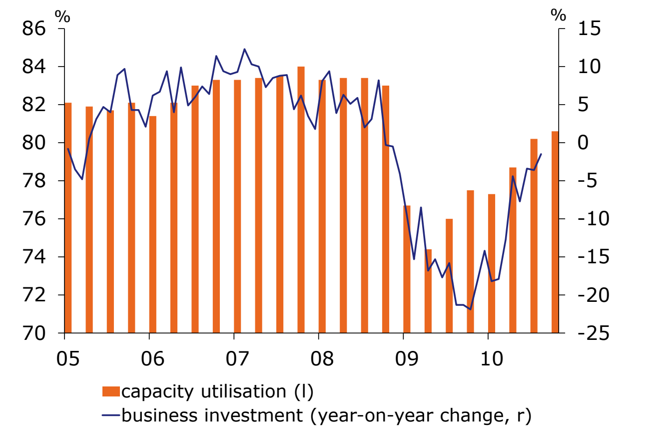
The recession has thrown the government finances off balance; but even without the crisis, the state of government finances would not have been sustainable in the long term. Because of population ageing and increased life expectancy, some public

Figure 32: Cheaper euro drives exports



Source: BIS

Figure 33: Capacity utilisation remains low

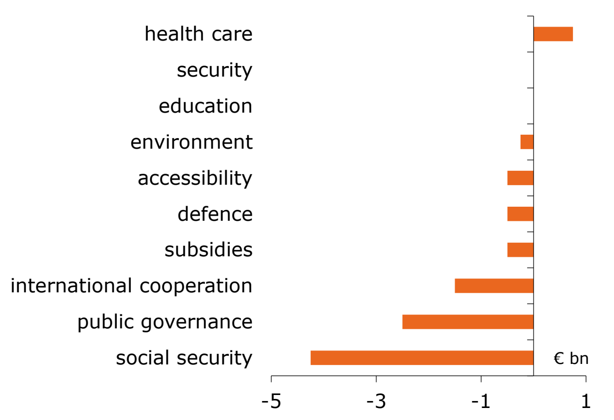


Source: Statistics Netherlands (CBS)

services in their current form were destined to become unaffordable in the future. Financial consolidation is therefore necessary, particularly for solidarity between the generations.

This message has also hit home in The Hague. The budget that was presented by the outgoing government, as well as the coalition agreement signed by the new cabinet show that government spending will be curbed during the coming years. For the period 2011-2015 a planned €18 billion will be saved. The main cutbacks will be made in public administration (€ 2.5 billion), social security (€ 4.3 billion) and international cooperation (€ 1.9 bn) *(figure 34)*. The proposed savings are expected to reduce the government's budget deficit from 6% of GDP in 2010 to ¾% GDP by late 2016. And government debt during the same period is to be reduced from 66% to 65% GDP, as a result of an increase in GDP. On the other hand, the question remains as to whether the cabinet will indeed succeed in implementing the planned cost-cutting measures during the coming period of government. As a rule, cutbacks deliver less savings than initially hoped for. Previous governments have tried for instance to reduce the number of civil servants; however, they have often been unsuccessful or only partly successful in their attempts. With regard to EU contributions, these can only be reduced if the other member states are in agreement, which is very questionable. On the other hand, the repayment of support to the banks has not been factored in; assuming the banks can repay the loans, this could reduce the state debt more than has been allowed for in the above five-year plan.

Figure 34: Austerity measures 2015 (2010 prices, bn euros)



Source: Netherlands Bureau for Economic Policy Analysis (CPB)

In order to address the ageing problem, the pensionable age will be raised to 66 years from 1 January 2020. However, this measure will not be sufficient. The age for pension entitlement should be raised to 67, and sooner than 2020. It should also be linked as soon as possible to the remaining life expectancy after retirement. If not, future generations will be saddled with a major financial burden. The government is also trying to cut spending on health care; however, on balance, the net result is more rather than less spending. While the axe is applied to curative care, spending on elderly care continues to rise. Because of population ageing this situation is likely to be exacerbated in the future. In the long term, the challenges facing the government remain as large as ever.

The growth of real GDP will be dampened by the effects of the proposed austerity measures contained in the coalition agreement. This is mainly because consumption will be lower on account of increased unemployment (see below) and higher taxes, compared to a scenario without these measures. According to an analysis by the Netherlands Bureau for Economic Policy Analysis (CPB), the proposed measures will lead to a decline in purchasing power by an annual average of ½%-point in the period 2011-2015.

Consumers continue to fill their piggy banks

In spite of the government's proposed cost-cutting plans, Dutch consumers have gained more confidence in the future. Consumer confidence rose in November to -6, the highest level since January 2010 *(figure 35)*. The number of people who are optimistic about the future economic situation is larger than the number of people who are pessimistic; however, a small majority is still pessimistic about their own future financial situation. The improved confidence may partly be due to the removal of uncertainty about the government's plans. On the other hand, new uncertainties have recently emerged concerning the level of future pension payments. Currently, some pension funds are raising their premiums and/or are omitting indexation. If this proves inadequate to meet payment obligations, then a reduction of pension payments may be the next step. Uncertainty in this regard may have a negative impact on confidence during the coming period.

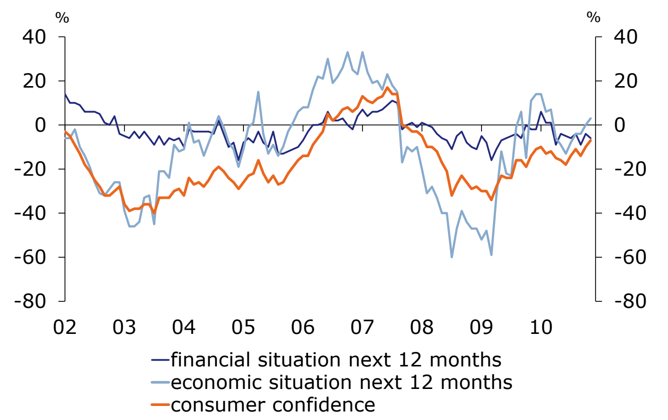
For several successive months, consumers have been spending more than in the same period last year. In September, the volume of private consumption rose by 1.5% year-on-year. The increase in spending on durable consumer goods was particularly marked (5.6%). For the year as a whole, we expect to see a slight rise in real consumer spending of ¼%. This means that consumers have not yet abandoned their cautious stance. On the contrary, in fact, since the start of the crisis, there has been an increase in the individual savings rate (disposable income minus consumer spending). In other words, consumers are saving a larger share of their disposable income. Accordingly, our forecast for the medium term is only moderately positive. For the period 2012-2016 we envisage an annual increase in the volume of consumption of ¾%. The necessary cost-cutting measures to be implemented in the years ahead will keep a lid on the individual savings rate as well as consumer spending. Various extra taxes and charges will reduce the disposable income of certain groups. Moreover, there will be a negative knock-on effect from the jobs lost due to government cutbacks (see below), which will likely affect consumers.

The labour market continues to surprise

There was more good news from the labour market in the third quarter. The seasonally adjusted unemployment rate fell from 5.5% in July to 5.2% in October *(figure 36)*. Although the decline in unemployment by 2,000 persons in October was less marked than in the previous months (which had averaged a drop of 6,000 persons), this was positive news nonetheless. This is because the workforce rose by 47,000 persons, while it had declined by an average of 2,000 in the preceding months. Newcomers to the labour market were mainly among younger and older age groups. The unemployment rate for 2010 is expected to pan out at 5½% and will decline to 5¼% in 2011.

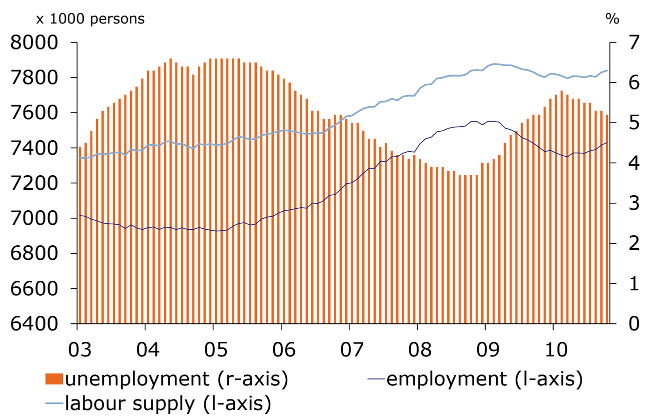
In the medium and short term, the government's austerity programme is expected to lead to a drop in employment. Although jobs will be created in the area of care for the elderly and the handicapped as well as with the police force, many jobs will be lost through cuts in the civil service and government apparatus at national, provincial and regional level. There will also be a cap on jobs in social programmes such as sheltered workshops. On balance, the number of (semi-)state employees will be drastically cut. Since there will be a considerable time lag in implementing the reforms, the decline in employment in the government sector will likely be concentrated in the later years of the cabinet period. However, it is not only state employees who will feel the effects of these measures. The cutbacks will also impact on demand for goods and services, which means employment in the private sector can also be

Figure 35: Consumers more confident



Source: Statistics Netherlands (CBS)

Figure 36: Unemployment continues to drop



Source: Statistics Netherlands (CBS)

expected to decline. At the same time, however, the labour supply will dwindle in the medium and short term due to population ageing. Accordingly, there will be a drop in the potential workforce, as many baby boomers reach retirement age during the coming years. OECD data predict that the ratio of people aged 65+ to those aged 15 to 65 will rise from 29.3% in 2010 to 34.8% in 2015. This could lead to a labour shortage, particularly in the government and education sectors. For the period 2012-2016 we envisage an average unemployment rate of 5½%.

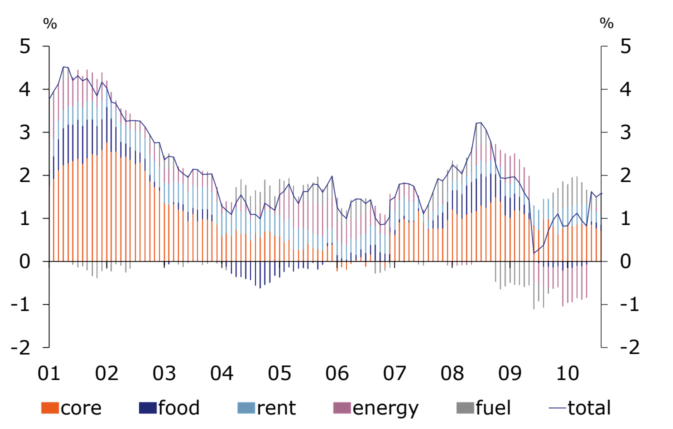
Inflation low but above zero

In October consumer prices were up 1.6% year-on-year *(figure 37)*. Inflation has been hovering around this percentage since July, when it jumped from 0.8% to 1.6%, mainly on the back of the half-yearly adjustment of energy and gas prices. Core inflation (which excludes food and energy) was around 1% in October. This low number reflects the current economic situation in which real output is lower than potential output, with little opportunity for producers to raise prices. For 2010 and 2011 as a whole, inflation is expected to average at 1¼%. For the period 2012-2016 we anticipate a moderate rise in the average price level of around 1½%.

House prices to come down slightly next year

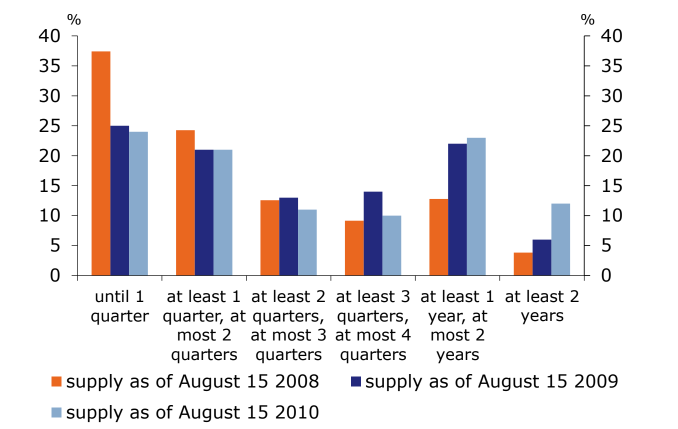
After falling for six successive quarters, house prices in the Netherlands rebounded somewhat during the course of 2010. According to the existing homes price index of the CBS/Land Registry, house prices rose on a quarterly basis during the second and third quarters of this year by 0.3% and 0.1% respectively. Nonetheless, the average price level during the first nine months of this year was still 2.3% below that of last year, and some 6% below the peak in the third quarter of 2008. We expect prices to stabilise in the remainder of 2010. However, on an annual basis, there will be a drop of 2% as a result of the still declining prices in late 2009 and early 2010.

Figure 37: Inflation remains tempered



Source: Statistics Netherlands (CBS), Rabobank

Figure 38: Houses slower to sell



Source: Dutch Association of Real Estate Brokers (NVM)

It should be borne in mind that the current price developments are based on a historically low number of transactions. Disappointing house sales are the result of negative market sentiment, which can be blamed on uncertainty about government policy and economic developments. Currently, the number of sales is stabilising around a 12-month average of 130,000 - 40% below of the peak of mid-2006. Measured halfway through the third quarter of 2010, houses were on the market for an average of 243 days, which is a little over eight months. Of those houses, 12% were for sale for at least a year, which is double the duration of a year earlier *(figure 38)*.

The number of houses on the market has increased by some 44% since the third quarter of 2008 to nearly 181,000 houses in October this year. Furthermore, the years ahead will be characterised by cutbacks and tax increases, which will erode the disposable income of households. This means many house vendors will be forced to reduce the selling price, in order to maximise their chances of making a sale. Accordingly, house prices can be expected to drop slightly by an average of 1% in 2011. But if it wasn't for the low interest rates and stabilising unemployment, prices might have dropped further. However, (pent-up) demand for houses will push up the sales numbers next year, helped by the new cabinet's proposals to leave the mortgage relief facility unchanged. This (pent-up) demand may possibly give the consumption of durable goods a temporary boost. Beyond 2011 we are likely to see a slight rise in house prices as a result.

In conclusion

After the freefall of early 2009, the Dutch economy now finds itself on firmer ground, with prospects looking fairly good. The government deficit is smaller than that of many other countries; unemployment is the lowest in the eurozone, and in keeping with tradition, the balance of payments is in excellent health. However, this does not mean that we can rest on our laurels. Structural reforms are needed to consolidate this position, in order to ensure that social security remains affordable in the future, and does not encumber future generations. The ground on which the Dutch economy has landed remains strewn with pitfalls, which hamper a convincing recovery. The global recovery is softening, the Dutch government is planning cutbacks, and the general uncertainty is making consumers cautious. As a result, economic growth is likely to slow in 2011, and to remain lower than usual in the years to follow. This lower growth rate may well become part of a new reality. The contracting workforce which results from ageing will soon lead to tightness in the labour market, resulting in a lower growth potential. This lower growth rate, while in sharp contrast to the years of the boom, will be more sustainable. In the years 2004-2008 real GDP grew by an average of almost 3% year-on-year, with the economy in overdrive. The expected average growth rate of 1½% in the period 2012-2016 is much closer to a sustainable growth path.

Table 5: The Netherlands, key data

Year-on-year % change	*2009*	*2010*	*2011*	*2012-2016*
Gross domestic product	-3.9	1¾	1½	1½
Private consumption	-2.5	¼	½	¾
Government expenditures	3.7	½	¾	0
Private investment	-16.5	-5	2¾	3¾
Exports of goods and services	-7.9	9½	4¾	4½
Imports of goods and services	-8.5	10	3¾	4
Consumer price index	1.2	1¼	1 ¼	1½
Unemployment (% labour force)	4.9	5½	5¼	5½
Government budget (% GDP)	-5.4	-6	-4	-¾*
Government debt (% GDP)	60.8	65	66	65*
Current account balance (% GDP)	3.4	5½	6½	7
House prices	-3.3	-2	-1	1¾

** end 2016*

Source: Statistics Netherlands (CBS), Rabobank

1. See: Analyse economische effecten financieel kader, Netherlands Bureau for Economic Policy Analysis (CPB), 27 September 2010 (only available in Dutch).