INTERNATIONAL MONETARY FUND

Kingdom of the Netherlands—The Netherlands
2011 Article IV Consultation: Preliminary Conclusions

March 28, 2011

We expect growth to decelerate slightly in 2011-12. The outlook hinges critically on global developments and is unusually uncertain, but risks appear tilted downward. Bank capital buffers seem robust, but proactive measures to increase them further are advisable in light of Basel III standards. Efforts should also continue to further strengthen the regulatory framework, supervision of large international financial institutions and crisis resolution arrangements. The commitment to fiscal consolidation is welcome, but the sizable front-loading of the adjustment ought to be handled flexibly in light of the still frail recovery and in particular in case of a serious downturn in the economy. The momentum of structural reform should be restored and reinforced.

Economic situation

1. **The Netherlands emerged from a deep recession in mid-2009, but the recovery is still frail**. The slump was caused by adverse trade and financial spillovers from the global crisis, which also forced large public intervention in the financial sector. Conversely, the subsequent resurgence has been stimulated by strong exports. Despite a somewhat slower pace of recovery in the second half of the year, GDP grew 1¾ percent in 2010. Unemployment has risen only modestly, in part because of labor hoarding, and has been slightly declining since mid-2010. With output still well below potential, inflation has remained subdued until recently, though it is now picking up, also because of rising oil prices. Several indicators suggest that external competitiveness is adequate.

2. **Banking system soundness has improved significantly, though fragilities remain in the financial sector.** Banks' regulatory capital adequacy has risen markedly since 2008, largely reflecting government intervention, but equity relative to (unweighted) assets is still comparatively low, with regulatory capital reflecting the low risk-weighting of mortgages. Nonperforming loans remain manageable at about 3 percent of total loans. Bank profitability, though still weak, has recovered slightly. However, the coverage ratio for many pension funds is under pressure, owing to extended longevity and persistent low interest rates. The insurance industry is also under strain. A well-designed strategy of gradual exit from the extraordinary public support is being implemented, amid continued restructuring of the financial sector.

3. **The housing and mortgage markets appear relatively stable, although vulnerabilities are rising**.

- House prices steadied from mid-2009 to mid-2010, but seem to have resumed a slow downward drift since then. Affordability-based raw indicators of their sustainability remain elevated, albeit having stabilized and slightly improved from two years ago. On the other hand, econometric models do not indicate that house prices are misaligned with fundamentals. On balance, the risks of a severe contraction of house prices are considered to be of medium intensity.

- Net financial assets of households have recovered from the lows of 2008-09. With banks having first charge at default and full recourse against borrowers, and only a comparatively modest increase in unemployment, mortgage default rates remain very low. However, household debt has grown substantially in relation to disposable income, to over 270 percent in 2010, among the highest in advanced economies. In addition, the loan-to-value (LTV) ratio of new mortgages has continued to rise from its already unusually elevated levels, and exceeded 120 percent in 2010 according to some measures. Liberal mortgage interest tax deductibility (MID) has inflated mortgage size, and also led to the proliferation of interest-only non-amortizing mortgages since the mid-1990s.

4. **The fiscal position deteriorated sharply in 2009, but is already improving.** The general government balance weakened considerably in 2009, reaching a deficit of 5½ percent of GDP, on account of substantial stimulus measures and free operation of automatic stabilizers to help stem the impact of the global crisis. However, unexpectedly strong tax receipts in 2010 helped reduce the deficit slightly to 5¼ percent of GDP. The mission estimates that the structural fiscal position excluding interest payments and gas revenues (the "robust" balance) worsened by 2¾ percentage points over 2009-10, to a deficit of 5 percent of GDP. Public debt has risen to almost 64 percent of GDP at end-2010, owing also to financial sector assistance not reflected in the deficit.

5. **Pressures from population aging complicate achievement of fiscal sustainability**. Aging-related public spending is expected to increase by nine percent of GDP from 2011 to 2060, on account of pensions, health- and old-age care. Also, several crisis-related factors have made sustainability more difficult to attain: (i) the marked structural fiscal relaxation in 2009; (ii) large operations in support of the financial sector, which have not increased the deficit but added to public debt; and (iii) weaker potential output. As a result, the robust balance after 2012 would need to be permanently higher than in the current-policies path by about 7½ percent of GDP (the fiscal sustainability gap) to ensure sustainability of public finances. If corrective measures announced by the government for 2012-15 (some 2½ percent of GDP, in addition to the 1 percent of GDP in 2011) are enacted, the sustainability gap will be correspondingly reduced. In addition, the mission recognizes that, if the large external current account surplus unwinds as a rising number of retirees draw down accumulated pensions, consumption-based tax revenues will increase as share of output over the long run. All else equal, the sustainability gap could then be lower, but the size of this effect is quite uncertain.

Outlook and risks

6. **The mission expects GDP growth to decline slightly to 1½ percent over 2011–12**. The deceleration reflects the dissipation of base effects, moderation in the pace of exports, and commencement of fiscal consolidation both domestically and in most advanced economies. Consumption and investment will be constrained by diminished household net worth, persistent uncertainty about economic prospects, increased unemployment, and tight credit. Accordingly, output will remain below potential and inflation stay modest. The supply potential of the economy, in level terms, may have been significantly curbed by the crisis owing to a large contraction in investment, possible modest rise in structural unemployment, and deceleration in total factor productivity from financing constraints and increased risk aversion. And aging could depress potential growth over the medium and long run.

7. **The outlook is unusually uncertain and risks—primarily from external sources—appear tilted downwards**. On the downside, unprecedented global levels of sovereign financing needs and jittery investors could lead to higher-than-anticipated vulnerability to disruptions in sovereign debt markets. Risks also arise from possible external default shocks owing to high and concentrated cross-border financial exposures. The contractionary impact of simultaneous fiscal tightening in several advanced European countries could prove sharper than currently estimated. And insufficient progress in resolving global imbalances could constrain the world trade outlook and dampen export demand. As noted, house price misalignment is a possible domestic vulnerability. Upside risks originate from unexpectedly positive effects of policy relaxation measures in the United States; and stronger-than-anticipated emerging market growth, which could boost Dutch exports above the central projection. Further depreciation of the euro could have a similar effect.

Policies

8. **Against this background, the Netherlands must secure the recovery, mitigate lingering vulnerabilities, and address long-term sustainability issues**. In the near to medium term, with euro-area monetary policy close to the limits of its ability to shore up demand, fiscal policy must strike a balance between support of economic activity and preventing budget deterioration. Longer-term policies should strengthen financial stability, ensure fiscal sustainability, and advance structural reforms to boost potential output.

Financial sector

9. **The mission recommends continued vigilance on bank capital and liquidity, given also increasingly robust regulatory requirements**. Stress tests conducted in the context of the Financial Sector Assessment Program (FSAP) update found that bank capital buffers are strong enough to withstand even the extreme shocks assumed in the exercise. Nevertheless, with equity capital-asset ratios still relatively low and tighter capital standards to be phased in under Basel III, proactive measures—including restraint on dividend payments or raising additional capital—to fill any residual gaps are desirable. This will also

be helpful to unwind the government's substantial ownership interests in some important financial institutions. Moreover, strong capital and liquidity buffers will facilitate bank restructuring pursuant to EC competition directives.

10. **Action to mitigate housing market vulnerabilities and distortions is needed, including a gradual reduction in MID**. Given heavy exposure of the financial system to the housing market, a determined response to the buildup of vulnerabilities is warranted. The mission welcomes as a useful first step the authorities' plans to limit the maximum LTV ratio for new mortgages to 110 percent and require that 50 percent of new mortgages be amortized over their lifetime (thus reducing risks in bank mortgage portfolios as well as household indebtedness). The mission, however, encourages the authorities to take additional measures that could stem vulnerabilities, including even tighter conditions (closer to international practice) on LTV ratios and minimum principal repayments, setting greater risk weights on high LTV mortgages, and giving DNB the authority to impose further LTV restrictions if macro-prudential conditions signal this need. Moreover, the mission stresses that a key distortion fueling housing market risks is the generosity of MID. Thus, it should be gradually lowered, for example through capping MID in nominal terms. It would be helpful to make a clear and credible statement in this regard soon, to eliminate uncertainty and minimize the possible impact on the housing market. Broader regulatory reform of the housing sector to reduce distortions in the private rental market and in social housing is also recommended, together with lowering the house sales tax, high in international comparison.

11. **Despite improved supervisory practices, the mission notes that the effectiveness of supervision and crisis resolution mechanisms can be further buttressed**. The FSAP update found a high compliance with the Basel Core Principles (BCP), IOSCO principles, and Insurance Core Principles (ICP). The twin peaks model, with the AFM responsible for the conduct-of-business supervision and DNB for both micro- and macro-prudential supervision, seems appropriate for the Dutch financial system and helps DNB take a comprehensive approach to systemic risk. Nonetheless, the crisis exposed areas for improvement in supervision. These include rule-making authority and legal protections of supervisors; adequacy of data reporting requirements; banking supervision culture; resource limitations; and the crisis resolution framework. Welcome efforts are being made to address them; in particular, proposals on crisis intervention tools have been circulated for discussion. The mission urges further early and sustained action in this regard, particularly with a focus on intensifying and coordinating supervision of large international financial institutions and improving reporting requirements. The insurance sector warrants careful monitoring too, given its tarnished reputation, and the financial pressures under which it is operating. Also, DNB and the AFM should be provided with broad supervisory discretion over macro-prudential instruments, in line with their respective responsibilities, and a single regime created for resolving banks under official control. Plans recently announced by the government for improving the design of the deposit insurance system seem aligned with FSAP update recommendations and are welcome.

12. **To restore pension fund viability, a reassessment of second-pillar pension benefits is called for**. With interest rates not expected to return to pre-crisis levels in the near- to medium-term and with improved longevity, pension fund coverage ratios have declined markedly. Thus, the indexation of benefits has been widely abandoned during the crisis, while even maintenance of nominal commitments is under threat in many funds. A reduction in retirement benefits (through lowering of the replacement rate or further raising of the retirement age) or an increase in contributions is thus required to re-establish solvency. Moreover, ongoing tripartite discussions among government, employers, and employees may lead to changes in risk-sharing arrangements between pension funds and customers. These need to be transparent and communicated effectively to the public to ensure broad social acceptance and appropriate changes in household saving behavior.

Fiscal

13. **The authorities plan strong and distinctly front-loaded fiscal adjustment over 2011–15**. Under our macro projections, measures envisaged will reduce the headline deficit to 3¾ percent of GDP in 2011, and 1¼ percent of GDP by 2015. Structural tightening of 1 percent of GDP is envisaged for 2011 and 2012, with the pace of retrenchment declining to about ¾ percent of GDP for 2013, and dropping to ½ percent of GDP for 2014 and 2015.

14. **The mission welcomes the authorities' commitment to consolidation, but its marked front-loading should be handled flexibly in case of a serious slowdown**.

- The conflicting objectives of reducing the output gap and making progress towards fiscal sustainability have to be balanced. For this reason, in the last Article IV consultation, the Fund supported the authorities' gradual structural adjustment plan (about ½ percent of GDP in 2011 and ¾ percent of GDP thereafter), aimed at bringing the headline deficit below the SGP ceiling by 2013 without jeopardizing the recovery. Such a path was also consistent with closing the fiscal sustainability gap within about 10 years, a period that the mission still considers appropriate.

- The tightening now envisaged is more front-loaded than that previously scheduled, and both the authorities and the mission have correspondingly incorporated some depressive impact on short-term growth in their central projections. At the same time, the accelerated adjustment is expected to benefit fiscal sustainability considerably, with potential positive effects on consumer and investor confidence. Nevertheless, historical experience indicates that negative effects on demand from budget consolidation are likely to be higher when monetary policy is not able to accommodate tightening, as is currently the case. Our analysis also suggests that spillovers to the Netherlands from the concomitant fiscal retrenchment in Europe are sizable, making more challenging the moderation of budget tightening which would be warranted if an unexpected slowdown occurs. While both these factors have in principle been taken into account in our baseline scenario, in the mission's view, a

significant downside risk is that the contractionary impact of simultaneous fiscal tightening in several advanced European countries could prove sharper than currently estimated (¶7).

- In addition, the mission observes that, despite a substantial sustainability gap, there is no immediate fiscal credibility issue, and debt is lower than in many advanced economies; hence pressure from markets with regard to Dutch financing requirements is negligible. Furthermore, evidence of bubbles in fiscal revenues that could justify more substantive early tightening is scant.

- These considerations suggest that flexibility in the implementation of the planned fiscal adjustment is both possible and desirable should economic outcomes be significantly worse than anticipated, so as not to exacerbate downside risks for growth prospects in the near-term.

15. **Specifically, if the recovery were to stall, automatic stabilizers ought to function unhindered and contingency plans developed to moderate the adjustment**. In this context, the mission recommends excluding unemployment benefits from expenditure ceilings, thereby allowing for free operation of automatic stabilizers. In particular, unexpected serious setbacks to the recovery that cause the headline deficit to rise substantially above targeted levels should not trigger further discretionary retrenchment. The mission also advises that contingency plans be prepared to ease the envisioned fiscal tightening, so that prompt action is possible in the event that economic indicators point to a petering out or even reversal of the upturn. In addition, we stress that it might be preferable to substitute part of the headline tightening with those structural measures (such as increasing the retirement age), which significantly improve fiscal sustainability, but only modestly affect demand in the short-run.

16. **The mission regards measures that directly reduce the impact of aging on public expenditures or broaden the tax base as a key plank of adjustment**. Expenditure-based consolidations have generally been more successful than tax-centered ones, according to international evidence. Moreover, given international competition to lower corporate taxation and relatively large tax wedges on earned income that discourage work, direct tax rates have little upward room. The mission therefore recommends that revenues be augmented by expanding the base—for example by curtailing the generosity of MID, a large tax expenditure—and a further shift from labor to less distortionary taxation of consumption and property, including by cutting the number of items on reduced VAT rates. Concerning fiscal outlays, the priority is to increase the effective retirement age and to restrain growth in demand for and costs of health- and long-term care, not least by raising co-payments and user fees.

17. **The authorities' corrective steps aptly focus on constraining outlays, but renewed emphasis should be placed on structural fiscal reform efforts**. A concern of the

mission is that the ambitious fiscal objectives throughout 2015 should not come at the expense of progress in structural reforms with beneficial budgetary implications, which seem to have been given limited prominence in the new government's plan. For example, despite much public discussion, the momentum to tighten the MID regime appears to have lost steam. Also, it had been envisaged to lift the statutory retirement age by two years to 67, but this has now been reduced to 66. The mission nevertheless understands that a majority in parliament could support linking the retirement age to life expectancy, and we would welcome such a development.

Structural reform

18. **To maintain potential growth amid a stagnating population and aging pressures, the mission supports policies to encourage greater work effort and productivity**. Apart from increasing the retirement age, labor market reforms should overhaul tax and benefit systems to curtail disincentives to full-time female and elderly work. Unemployment benefits are fairly generous and discourage job search, worsening unemployment duration. Fostering research and development (R&D) expenditure, which is fairly modest, and combating traffic congestion would enhance productivity. Various estimates put the Netherlands among the countries with the highest congestion costs. Stepped-up investment in roads and railways, requiring some relaxation of strict zoning regulations, opening the transportation sector to more competition, and enhanced recourse to road pricing schemes could alleviate congestion and thus spur productivity.

Other

19. The mission welcomes that the Netherlands' ODA contributions at 0.7 percent of GNP meet the United Nations ODA target.

20. The mission is grateful for the high quality and openness of the discussions, and for the cooperation and hospitality received from the Dutch authorities and private sector.