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The Netherlands: between hope and fear

Since the third quarter of 2009 the Netherlands is officially out of recession. A recession that has caused the real economy to shrink by 5.5% in total. The statistics tell us that economic activity has found the way upwards, but for many people this will sound hollow as they experience declining purchasing power and increased taxation. The expected real economic growth of a meagre 1% in the Netherlands in 2010 illustrates the painful and uncertain recovery that lies ahead.

A shaky recovery

During the last quarter of 2008 and the first quarter of 2009, the Dutch economy fell into a deep hole. In the first quarter of this year, the economy contracted by 5.4% compared to a year earlier. In the second quarter, the economy continued to shrink, but the decline of 1.1% quarter-on-quarter was less marked than the previous quarter (*Figure 29*). This improvement continued in the third quarter, showing quarter-on-quarter economic growth for the first time since early 2008. It would appear therefore, that the economy, at least in growth terms has gradually begun to emerge from the hole. But the fall it took was very severe, and the climb back up will be an unsteady one. The challenges ahead remain undiminished.

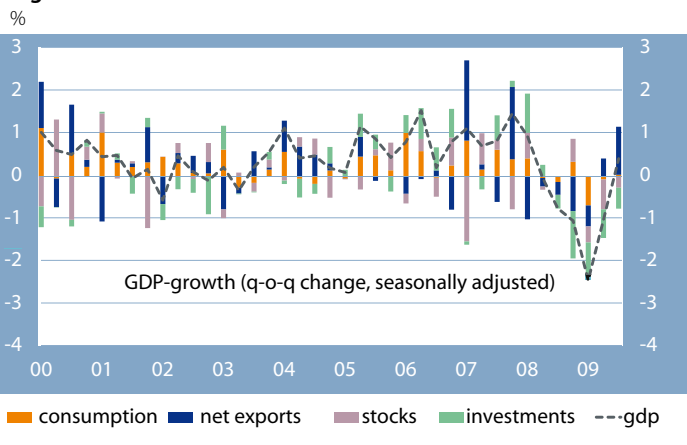
The focus on growth percentages masks the actual consequences of the economic recession for the prosperity of the Dutch. As soon as growth is positive, the recession is officially over, we are told. But it can take years before the loss of output has been restored. In 2009 the Dutch economy is expected to contract by an average of 4%. This means that our standard of living, expressed in terms of the size of the Dutch economy, will be comparable at the end of 2009 to that of late 2006 (Figure 30). In our estimation, it will take until 2014 for us to get back to the wealth levels of mid-2008 before the economy hurtled down the hill.

What goes down, must come up?

In terms of growth, the economic outlook may seem more positive than in terms of levels; but the percentual change of those levels gives cause for concern too. In the short term, growth will chiefly be determined by cyclical factors. Actual growth is now lower as a result of the economic consequences of the financial crisis, such as loss of confidence, wealth losses and a decline in credit growth.

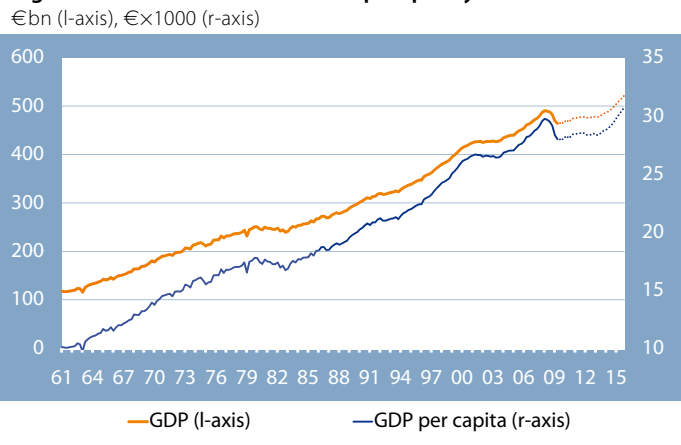
In the long term, growth depends on the so-called growth potential. Potential growth is determined by the long-term growth of labour productivity and the change in equilibrium unemployment. Important aspects in this respect include the development of labour participation and the innovative capacity of the economy. Population ageing, for instance, will, unless addressed, contribute to slower growth of the labour supply, pushing the growth potential downwards. In 2006 the Netherlands Bureau for Economic Policy Analysis (CPB) estimated the growth potential of the Dutch economy for the period 2008-2011 at 2%.¹ In the short term, growth may turn out to be lower than potential growth, but the opposite is also possible. The difference between actual and potential production levels is known as the output gap. Partly due to the current crisis, we now have a negative output gap. We are producing at a level that is well below potential.

Figure 29: Over the worst



Source: CBS

Figure 30: Crisis causes a loss of prosperity



Source: CBS, Rabobank

The question is whether the recession has consequences for the growth potential of the Dutch economy? Or is the loss of production compared to the old growth path merely temporary? In the latter scenario, the economy will duly return to pre-crisis levels of production. This means a relatively rapid and steep recovery of economic growth. However, this optimistic scenario is unlikely for a number of reasons. In our estimation, the economy will recover more slowly, at a pace of 1% in 2010. On the basis of our expectations, actual growth during the period 2008-2011 will average at 0%. The loss of production, in relation to production potential will amount to about 8% for this period.

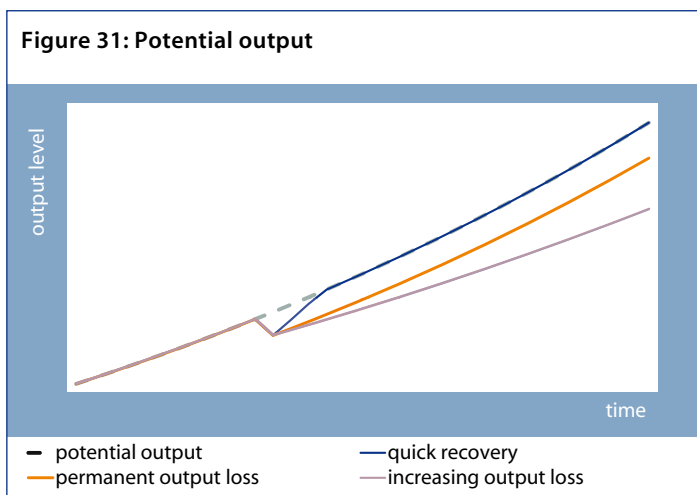
According to most analyses of previous serious financial crises, the loss of production during and after a recession is generally not made up by higher growth in the years immediately following. The economy does not revert within a short period to pre-crisis levels. The IMF has studied almost ninety bank crises that occurred during the last century and has concluded that average production levels seven years after a banking crisis were almost 10% lower than the pre-crisis trend.² An important aspect in this respect is the local nature of the crises that were analysed. The experiences in Japan and Sweden, which suffered financial crises in the nineties show that the implications for production loss and growth path can vary greatly from one country to another and largely depend on the policy response. In contrast to Japan, the Swedish authorities' prompt tackling of the problems in the banking sector and their radical restructuring of the Swedish economy ensured that production losses caused by the crisis were made up by stronger growth in the years following. However, in view of the global character of the current crisis and the severe economic contraction of recent quarters, the IMF's above conclusions would appear to be applicable today. The longer and the deeper a recession, the less is invested in capital goods and in R&D and innovation. Furthermore, companies can only adapt staffing levels to production with a lag. This slows productivity growth, and places a drag on economic growth potential in the medium term. Moreover, the financial crisis has put a large dent in the government budget. The Dutch budgetary deficit is expected to rise to 6¼% of GDP next year. The government's efforts to restore order to its finances via cutbacks and tax hikes will likely put downward pressure on economic growth during the coming years. Our earlier calculations show that economic growth in the Netherlands will be slowed by on average 0.2% to 0.3%-points per annum for an eight year period.³ We expect that real growth in the medium term in the Netherlands will average at 1½ to 1¾%. There is considerable uncertainty surrounding the exact growth potential, because government plans for the coming years are not fully known. However, it may be said with some confidence that the potential growth in the years ahead is lower than the 2% stated. Thus the economy will embark on a long-term lower growth path, and production losses in relation to the potential pre-crisis level will increase further in the future (*Figure 31*). By 2015 production losses will rise to some 9 to 10% of real GDP, which is more than the 8% that the country has already endured, and is approximately equal to the damage historically inflicted on an economy by a financial crisis.

Recovery in world trade gives grounds for hope

Signs of recovery in world trade give the greatest grounds for hope to the Dutch economy. The volume of Dutch exports has already benefited in recent months from the improved conditions, such as increased production among important trade partners compared to previous months. In the period from May to July, month-on-month volume development of exports was positive. However, in August, export volume recorded a drop of over 5% compared to a month earlier. And compared to a year ago, the decline in export volume in August was almost 9% compared to a decline of 6% in the previous month. Despite this slight deterioration, the trend in export volume is still an improvement on the first six months of 2009, when real exports fell by an average of almost 13% year on year (Figure 32). All the same, a further improvement in exports during the final months of this year will not be able to prevent the volume of exports for 2009 from being some 8½% lower than in 2008. In 2010 growth is expected to reach a modest 4½%, making a return to the prodigious year-on-year growth averaging at 8% of the boom years of 2004-2007 highly unlikely. After 2010 we expect exports to grow by an average of 4½% annually, in line with projected world trade growth – lower than what we were accustomed to in recent years.⁴

Imports are undergoing a similar development, although the year-on-year decline since May has been greater than that for exports. On balance, therefore, net exports have made a positive contribution to growth in the second and the third quarter (Figure 29). In 2010 GDP growth is expected to be virtually entirely driven by international trade. The subdued development of domestic demand is putting downward pressure on the development of real imports. For 2010 on balance we expect to see modest growth of import volumes by an average of 3%, lagging behind the growth of exports. Likewise, in the period 2011-2015, the growth of real imports will be below the long-term average, amounting to some 4% year-on-year. This compares to a rate of 5% in the past decades.

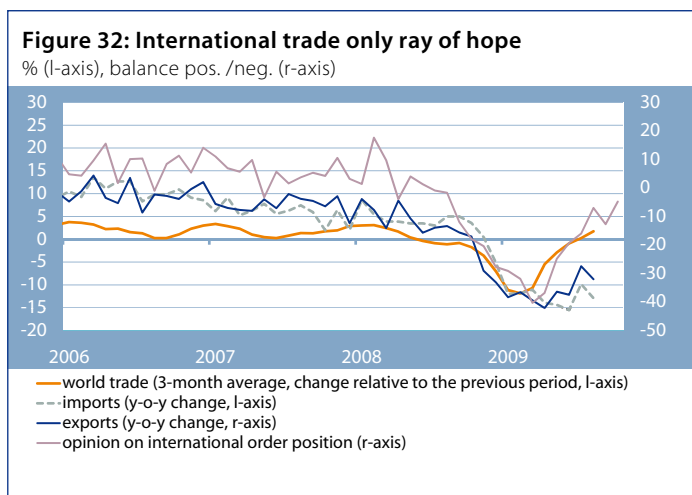
Figure 31: Potential output



Source: Rabobank

Figure 32: International trade only ray of hope

% (l-axis), balance pos. /neg. (r-axis)



Source: CPB, CBS

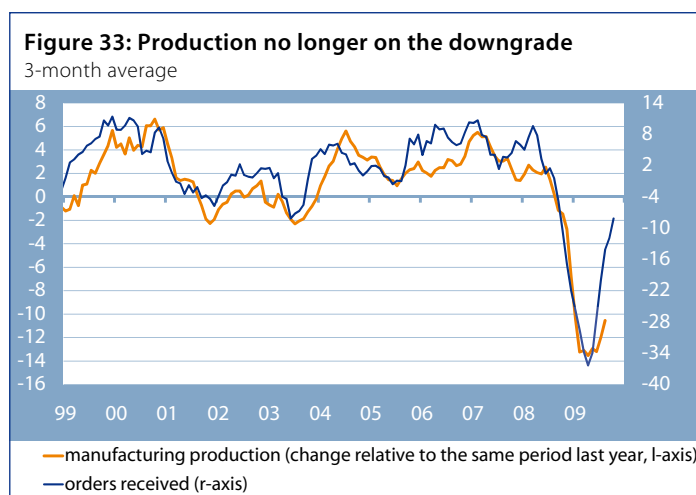
The moderately positive picture for international trade is couched in major global uncertainties. Government stimulus packages worldwide have boosted demand for cars, for instance. However, the temporary nature of these measures means that their effect will have worn off or even disappeared completely in 2010. Governments are battling with enormous budgetary deficits. Consequently there is little room for further stimulus policy in 2010 to the same extent, let alone increasing the measures. Accordingly, demand will be lower than a year earlier. Likewise, inventory re-building, which accounted for some extra production in recent months, will only make a temporary contribution to global demand.

Mood improving among producers

At the same time, producers have become considerably less negative about their order books in recent months (*Figure 33*), and sentiment has improved. Whereas the indicator was down at almost -22 in February, by October producer confidence had risen to -7.8.

This improvement in mood would appear justified, because production volumes rose in July and August month-on-month. Nonetheless, volumes remain much lower on a year-on-year basis – down by some 8% in August. This puts real production still at an exceptionally low level. The same applies to capacity utilization. In October, only 77.5% of available production capacity was in use.

Against this background it is unsurprising that the volume of private investment is expected to decline by 15% in 2009. And for next year, we expect a further average drop in corporate investment of 3¾%. At the same time, companies' profitability will improve next year, albeit at the expense of jobs, which can be expected to lead to some recovery in investment activity in the course of the year. In any case, investment is necessary in the long term. During the period 2011-2015 we expect the volume of investment to grow by 3¾% on average annually. Thus the growth of real investment will be just above the long-term average of over 3%, partly as a result of the catch-up effect of the initial period.

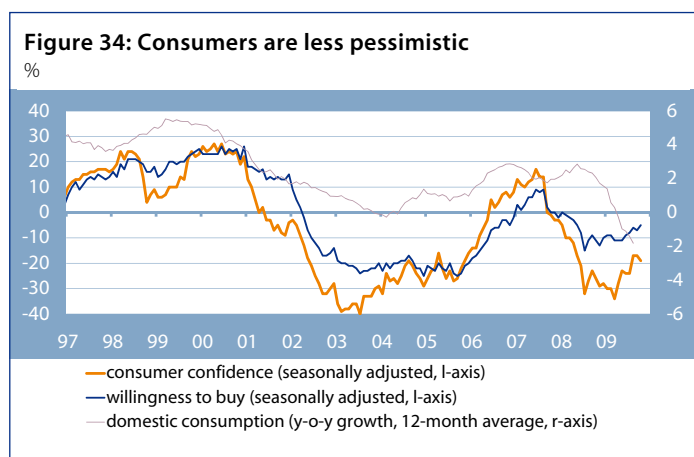


Source: CBS

Consumers are uncertain

Like producers, consumers are somewhat more confident about the future. Consumer confidence improved from -34 in March to -19 in October. Still, as is the case with producers, the pessimists hold sway. The improvement in consumer sentiment, such as it is, offers cold comfort for the development of consumption, which faces rising unemployment and diminishing purchasing power in the months ahead. In August, the volume of consumption dropped by over 4% month-on-month, while the development of real consumer spending had been positive in the months of May to July. It appears that consumers are putting off the purchase of durable goods in particular. Accordingly, the decline in real consumption can mainly be attributed to savings in this category. On the whole, the volume of consumption is expected to drop by an average of 2¾% in 2009. Next year, the consumer will spend even less, and real consumption will likely drop by a further 1%. Nor are the long-term prospects much better: we envisage an average growth of ¼% in the volume of consumer spending for the period 2011-2015. After averaging 3% for years, consumers are clearly playing cautious.

While consumers are clearly reluctant to spend money, they show no inhibition about doing the opposite: saving. In 2009 and 2010, consumers will save some 14% of their disposable income. Thus they will try to compensate for wealth losses. Uncertainty about the future is also influencing saving patterns. The recession pushed up unemployment from 3.7% in September 2008 to 5.1% a year later. In the coming months unemployment is expected to rise further to an average of 5% and 7¼% in 2009 and 2010 respectively. And with an expected average jobless figure of 6½% in the period 2011-2015 the situation on the labour market is not set to improve for a while. At the same time, the spectre of the 1980s need not be feared. Fundamental changes in the labour market mean that conditions are better than was the case then (see the chapter 'The spectre of the eighties' later in this publication).



Source: CBS

Inflation the only upside

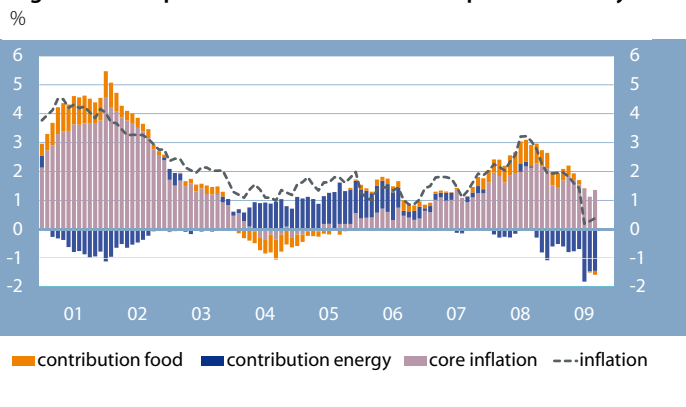
The good news in 2009 comes from inflation. At an expected average of 1% for the year, inflation is low. With prices rising only slightly compared to income development, purchasing power is strong. However, this is not without risks, particularly in combination with overcapacity in the economy and the expected slow pace of economic recovery. Inflation could easily turn into deflation – a decline in average prices. Deflation initially means an increase in purchasing power, but this in turn can mean that purchases are postponed in the hope that prices will drop further. This can push the economy into a downward spiral. However, it is our view that fear for deflation in the Netherlands is unjustified.

Inflation fell sharply in July – from 1.4% compared to a year earlier in June to 0.2% (Figure 35). This was chiefly due to the half-yearly energy price adjustment in July. However, since reaching a trough in December 2008, the price of crude oil has been steadily climbing, strengthened by the recovery in the global economy. This has been reflected by a slight rise in inflation between July and October from 0.2% to 0.7%. We expect inflation to be pushed up further in the coming months by rising fuel prices. The strong position of the euro vis à vis the dollar on the other hand, is pushing import prices down. Core inflation (which excludes price changes in food and energy) was still at 1.3% in October. This represents a drop of 0.1% on the previous month, but a rise of 0.2% compared to July. On balance we expect a moderate rise of some 1% in the average price for 2009 and 2010. In the longer term, inflation will remain very moderate at 1¼% for the 2011-2015 period.

Housing market stabilising

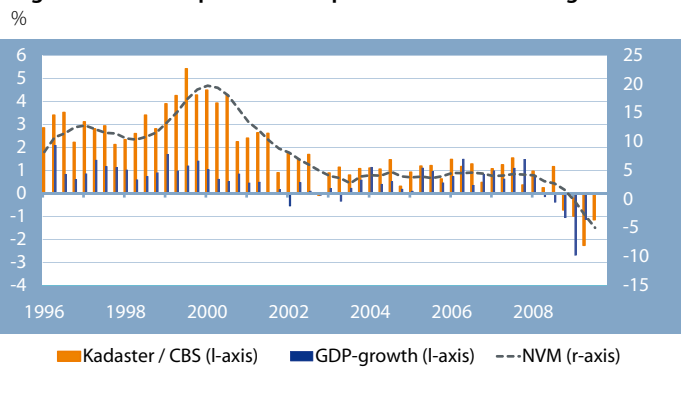
In line with the general economic picture, the Dutch housing market appears to be recovering somewhat. Although the number of transactions is still about one third lower than a year ago, prices seem to have more or less reached their bottom. Accordingly, house prices are reacting strongly (although with a lag) to the development of economic growth in the past year: the most acute decline in house prices – measured on various indices - occurred hot on the heels of the quarters with the strongest decline in economic activity.

Figure 35: Drop in inflation seems to have passed already



Source: CBS

Figure 36: House price development and economic growth



Source: Kadaster, CBS, NVM

House prices are still declining on a year-on-year basis (*Figure 36*). The median house price as calculated by the Netherlands Association of Real Estate Brokers (NVM) has fallen by 6.9% during the past four quarters. This drop took place entirely during the fourth quarter of 2008 and the first quarter of 2009. After this the curve moved cautiously upward. Furthermore, the rising trend in the past half year applies to all house types with only one exception. Apartments, which dropped least sharply in the first place, were €1,000 cheaper in the third quarter compared to the second quarter. Some things can be said though against the NVM figures, particularly in the light of compositional effects. For example, fewer houses in the expensive bracket are currently changing hands, which automatically pushes the median (the middle observation) house price down. Thus the current median house being sold is of poorer quality and/or smaller than a year ago. Nonetheless, the NVM data are relevant, particularly as they precede other Dutch house price series by about three months. The other series take better account of the fact that during an economic slowdown it is more expensive houses that sell slowest. These indices, such as the PBK series of CBS/Land Registry and the WOX series of ABF Valuation are expected to show a drop in average house prices for 2009 of some 3%, assuming the market to be stabilising.

In 2010 house prices will again move in tandem with economic development. On the one hand, there will probably be a slight improvement in confidence thanks to better economic news. On the other hand, however, unemployment is rising. A stabilisation of the current price level, accompanied by an ongoing relatively low number of transactions is the most likely scenario..

Government finances: procrastination not the solution

We remain concerned about Dutch government finances.⁵ In 2010, the government budget deficit is expected to total 6¼% of GDP. This hole will have to be plugged in the years ahead by cutbacks or higher taxes. However, the government has put off making these painful decisions by first awaiting the advice of administrative working groups in various policy areas. These think-tanks have been charged with finding ways to map out savings of up to 20% in some cases. The danger is that by postponing these difficult and ambitious retrenchment decisions they will be put off altogether, or at least toned down, particularly with the general elections of 2011 around the corner.

To conclude

The Dutch economy is caught between hope and fear. Hope, because the recession in the Netherlands is over. Hope, thanks to the encouraging recovery in world trade. Fear, that the recovery will not be sustained on account of a lack of final demand. Fear, that restoring order to government finances will be a drag on growth in the coming years. And fear of the spectre of the eighties regarding unemployment and with it deflation, although this is largely unfounded. The labour market is in a better position than it was thirty years ago. And the deflation genie in the Netherlands will soon be firmly back in its bottle.

However, it seems inevitable that this crisis has inflicted long-term damage on the growth potential of the Dutch economy and that it will take more than five years to recoup the wealth lost during the past year. While 2010 will show some positive growth figures, it should mainly be seen as a year of stabilisation. And stabilisation is always better than the dramatic numbers of the past year. We also expect the housing market to enter calmer waters amid these cyclical waves.

Table 3: The Netherlands key figures

year-on-year volume change (%) unless stated otherwise

	2008	2009	2010	2011-2015
Gross domestic product	2.0	-4	1	1¾
Private consumption	1.3	-2¾	-1	¼
Government spending	2.5	2	1	0
Private investment	6.6	-15	-3¾	3¾
Exports of goods and services	2.7	-8½	4½	4½
Imports of goods and services	3.7	-9	3¼	4
Consumer price index	2.3	1	1	1¼
Unemployment (% labour force)	3.9	5	7¼	6½
Government budget balance (% GDP)	0.6	-4½	-6¼	-4½
Balance of trade (% GDP)	6.7	6	6½	7¼

1 *Het groeipotentieel van de Nederlandse economie tot 2011*, CPB Document 117, June 2006

2 *What's the damage? Medium-term output dynamics after financial crises*, IMF, World Economic Outlook, Chapter 4, October 2009

3 See the focus article on *budgetary policy in the Economic Quarterly* of September 2009

4 See the chapter '*Globalization at a crossroads: World Trade*' in the special report that has been published in conjunction with this Outlook

5 See also the Rabobank Special Report 2009/17 on the 2010 national budget.