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Macroeconomic Imbalances – The Netherlands 2014

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

The Netherlands continues to experience *macroeconomic imbalances, which require monitoring and policy action*. In particular, macroeconomic developments regarding private sector debt and ongoing deleveraging, coupled with remaining inefficiencies in the housing market, deserve attention. Although the large current account surplus does not raise risks similar to large deficits, and is partly linked to the need for deleveraging, the Commission will follow the developments of the current account in the Netherlands in the context of the European Semester.

More specifically, rigidities and distorted incentives have built up over decades to shape house financing and sectorial savings patterns. Balance sheets of financial institutions became heavily geared towards housing finance, as households leveraged up against housing wealth. In parallel, since the mid-1990s, non-financial corporates moved into a structural savings surplus. This has resulted in a substantial and persistent current account surplus going hand-in-hand with a high level of both gross household debt and household net assets. In recent years, subdued domestic demand in the wake of the global crisis has further pushed up the external surplus. Over the past years there have been improvements in this regard with policies implemented to curb mortgage-financing. Deleveraging will continue to weigh on economic activity but a stabilising housing market and a significantly positive net asset position of households limit the risks. As regards public finances, the Netherlands is forecast to miss its headline deficit target in 2014, the year in which the excessive deficit should be corrected, although it is expected to have adopted the structural measures of the recommended size in 2013-14.

Excerpt of country-specific findings on The Netherlands, COM(2014) 150 final, 5.3.2014

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EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that the Netherlands was experiencing macroeconomic imbalances, in particular as regards developments related to the current account surplus, external competitiveness and public and private indebtedness. In the Alert Mechanism Report (AMR) published on 13 November 2013, the Commission found it useful, also taking into account the identification of imbalances in April, to examine further the persistence of imbalances or their unwinding. To this end this In-Depth Review (IDR) provides an economic analysis of the Dutch economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP). The main observations and findings of this analysis are:

• **The Netherlands' current account has been persistently in surplus for over three decades.** Rigidities and policy incentives have built up over time to shape house financing, sectoral savings and leverage patterns. Households leveraged up against housing wealth and reduced the pool of domestic savings not earmarked for pension savings. Disposable household income registered relatively muted gains, partly through increases in social security contributions, taxes and contributions to pension schemes, and came under pressure in the aftermath of the crisis. Household savings fell markedly since the mid-1990s. In parallel, nonfinancial corporations moved into a structural and large savings surplus. This has contributed to the emergence of a substantial and persistent current account surplus going hand in hand with a high level of both gross household debt and gross household assets. The net international investment position improved, also driven by valuation effects in the wake of the crisis.

• **The Dutch current account surplus reflects a combination of cyclical factors, alongside structural determinants of savings-investment balances across sectors**. Net energy exports have an upward impact on the balance, mainly mirroring exports of natural gas. The role of international capital flows, partly related to the operations of multinational companies, along with statistical discrepancies related to the measurement of cross-border flows seem also to account for part of the structural surplus. In recent years, weak economic activity and deleveraging pressures combined to push up the surplus.

• **The competitiveness and export performance of the Dutch economy appears to be benign overall**. The loss of global market share for exports of goods and services is limited in comparison with most other mature Western European economies. This loss does not appear to be rooted in unfavourable domestic price and cost developments, as the indicators for these have been growing broadly in line with the country's main trading partners and the real effective exchange rate has not shown any particular trend.

• **The funding patterns of Dutch assets and liabilities have made the Dutch economy sensitive to fluctuations in international capital markets.** At the aggregate level, financial flows show large simultaneous capital outflows and net borrowing from abroad, with an uneven distribution across sectors. This increases the sensitivity of balance sheets of some sectors of the economy to portfolio shifts and flight-to-quality. Domestic bank balance sheets have become tilted towards mortgages. Coupled with the comparatively low level of household savings flowing into deposits, this has left banks with a sizeable funding gap.

• **Notwithstanding mitigating circumstances, the high level of private-sector debt, in particular household indebtedness, warrants attention.** Long-standing tax incentives and financial sector developments have encouraged households to become highly indebted in mortgage debt, and also had a particularly stark impact on housing prices. Recent adjustments in the housing market, along with policy and supervisory measures to reduce the incentives for households to take up housing debt and lower loan to value ratios, should ultimately lead to reduce housing-related debt and leverage ratios. However, it will take a long time for these adjustments to feed through. The overhang of gross household debt remains a source of vulnerability and points to continued deleveraging pressures in the near term, though mitigated by broadly commensurate increases in net household assets. Substantial financial buffers with corporations also provide cushion.

• **The leveraging of household balance sheets implies risks for both mortgage borrowers and lenders.** Financing trends have heightened the sensitivity of the Dutch economy, and especially of leveraged households, to negative shocks, such as a fall in house prices, weak economic growth or a real interest rate shock. Financial institutions are still readjusting to altered market conditions and changes in regulations; the global economic and financial crisis hampered the ability of Dutch banks to borrow in wholesale markets. Given the importance of securitised funding, this pushed up domestic lending rates especially for housing finance. New EU banking regulations underscore the importance of larger buffers to absorb losses and to restore confidence and secure market access. After almost five years of house price falls, the Dutch housing market seems to be recovering slowly. House price falls are decelerating. Property transactions seem to be recovering, albeit modestly. On the rental market, rent increases have become more pronounced than in recent years. Surcharges are being used to encourage tenants with high incomes, remaining in the regulated rental segment, to move into private rental or owner-occupied homes.

• **In addition, current housing policies have implications for public finances**, notably in terms of foregone tax revenues and of the implicit liabilities stemming from housing-related guarantees.

The IDR also discusses some policy challenges stemming from these developments and possible ways forward. A number of elements could be considered:

• **Recent sluggish productivity increases and the low value added of re-exports underline the importance of focusing on fostering innovation and competitiveness.** Cyclical effects, finance bottlenecks, continuing uncertainty and the impact of (expected) balance sheet adjustments all seem to play a role in the relatively low domestic rate of capital formation, yet there may also be a structural element at play. For firms, the challenge is about rethinking the balance between home and foreign investments. A balanced adjustment of saving, expenditure and investment patterns across the Dutch economy would have a beneficial effect on the domestic investment climate and growth potential, hence improving economic prospects in the long term.

• **Making use of the existing room in the institutional framework to allow for more differentiated wage increases could help support household income.** The depth and the protracted nature of the slump since the crisis imply that more robust income developments in households could support the recovery and rebalancing of the economy. Naturally, such an approach would have to take due account of the situation of firms as regards productivity, profitability and prevailing buffers so as not to weaken their viability or competitiveness. Reversing trends in social security contributions, taxes and pension premiums, which seem to have played an important role in dampening disposable household income in recent years, would also help.

• **The overhang of gross household debt remains a source of vulnerability, though mitigated by broadly commensurate increases in net household assets.** Ongoing policy and supervisory measures to reduce the incentives for households to take up housing debt and lower loan to value ratios should ultimately lead to reduced housing-related debt and leverage ratios. However, existing debt overhangs may require a long adjustment period. The regulatory measures, in particular the limitation of mortgage interest deductibility, are strongly back-loaded and discriminate new versus existing mortgage loans.

• **Not all rigidities in the housing market have been corrected, including those that have prevented the emergence of a functioning private rental market of appropriate size.** The private rental market is still not functioning fully and there are still inefficiencies concerning the allocation of social housing to dwellers in need. It is important to keep up and advance the pace of reforms of the housing market by improving the functioning of this segment and reducing inefficiencies and dead-weight losses associated with the operations of social housing corporations.

1. INTRODUCTION

On 13 November 2013, the European Commission presented its second Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device, which helps to identify Member States that warrant further in depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific "in-depth reviews" (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists and what type of follow-up it will recommend to the Council.

For the Netherlands, the AMR suggested a need to look more closely at whether the country is exhibiting macroeconomic imbalances of an external and internal nature. On the external side, the AMR highlighted a long series of large current account surpluses, which coincided with a loss in market shares in recent years. On the internal side, the high level of private debt was identified as a potential concern, mainly since household indebtedness had built up in the context of past increases in house prices. Recent years have witnessed falling house prices, with an impact on the real economy through negative wealth and confidence effects. Despite signs of stabilisation, household indebtedness remains very high. This IDR provides an economic analysis of the Dutch economy in line with the scope of surveillance under the Macroeconomic Imbalance Procedure (MIP).

Against this background, Section 2 of this in-depth review looks into macroeconomic developments. Section 3 focuses specifically on the imbalances and risks. Section 4 discusses specific topics. Section 5 concludes with policy considerations.

2. MACROECONOMIC DEVELOPMENTS

2.1. THE MACROECONOMIC SITUATION IN PERSPECTIVE

At the current juncture, the Netherlands is expected to gradually emerge from a protracted recession, largely due to feeble domestic demand. According to the Commission Winter 2014 forecast real GDP growth is expected to be positive in 2014, at 1%, from -0.8% in 2013 and to strengthen further in 2015. The current state of the Dutch economy and its outlook are shaped by the mutual interaction of structural and institutional settings which define its adjustment trajectory. This section starts with a brief introduction to some important structural features of the Dutch economy that determines some of the outcomes (such as sectoral debt trends and the external accounts that are the focus of the investigation into potential imbalances). The household sector plays a key role in accounting for trends in sectoral and national savings, expenditure and financial flows, hence the choice to begin with a brief sketch of some of its main characteristics. Also interactions with sectors such as nonfinancial corporations and financial institutions, which are briefly touched upon subsequently, determine the macroeconomic situation. The section ends with a brief summary of the short term macroeconomic outlook for the Netherlands.

Household Sector

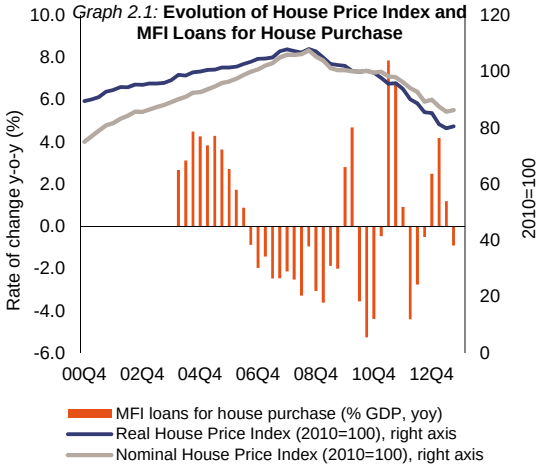
For the household sector, income flows, wealth accumulation and saving-and-expenditure decisions are to a large extent shaped by the institutional environment. A feature is the long-standing tradition of institutionalised dialogue between social partners, reflected in several entities where social partners interact with politics, exercising formal responsibilities and having a great influence in areas such as the labour market, including wage determination, social security, and the pension system. Prevailing institutional arrangements often find their origin in the period of reconstruction right after the second World War or even earlier (notably the 1930s). The institutional set-up defines important regulatory parameters but is partly also mirrored in behavioural patterns of economic agents.

The Netherlands has a three pillar pension system with a large second (occupational) pillar([1]), which resulted in a strong gross and net asset position of Dutch households. A large number of dedicated pension funds manage pension savings of almost 150% of GDP, with a large degree of international diversification of financial assets. Premia to the second-pillar pension funds are an important item in the household accounts and depend on the coverage ratio of assets to liabilities. Thus, they tend to respond to (cyclical) conditions in financial markets and due to their procyclicality they also have an important influence on household disposable income and thus the cycle.

Next to pension savings, housing wealth forms a substantial part of household balance sheets. Home ownership has been stimulated through several policies; in particular mortgage interest deductibility (MID) which had its origin in the 1890s and until recently was not capped. There is also a public mortgage guarantee scheme (NHG). The way the banking sector leveraged financial incentives in the housing market led to high loan-to-value (LTV) ratios. MID and associated financial products gave people the incentive to take on large interest-only mortgages, which has resulted in long balance sheets of households, domestic bank lending portfolios skewed towards domestic mortgages, and a high gross debt level of households. Recently, policies have been enacted to mitigate these leveraging incentives (see section 3 for an elaboration). Other institutional characteristics, notably spatial regulation and governance in the rental market also have a large impact on the housing market. Due to spatial restrictions, partly reflecting geographical features of the Netherlands, the supply of new houses could only weakly respond to increasing demand in the run-up of the crisis, translating increasing borrowing capacity into a long period of steadily increasing house prices (Graph 2.1), which only did reverse with the financial crisis, although not resulting in similarly sharp drops as experienced in other countries.

([1]) All residents above 65 are entitled to a flat-rate public pension that is financed through a pay-as-you-go (PAYG) scheme. An estimated 90% of the labour force is furthermore covered by supplementary occupational pensions. The third pillar of the Dutch pension system comprises individual, voluntary pension plans.

Graph 2.1: **Evolution of House Price Index and MFI Loans for House Purchase**



Source: Eurostat, ECB, Commission services.

Home ownership is also indirectly supported by a malfunctioning rental market. The rental market is dominated by a large social housing segment which in effect crowds out the private rental market. Even though a third of all dwellings are owned by social housing corporations, long waiting lists still exist due to misallocation of houses, reflecting prevailing regulations. In particular, housing corporations have limited options to enforce mobility of their tenants in function of changing incomes. These features of the rental market provide a strong incentive for people into buying their own property. Labour mobility is restrained by the way social houses are allocated. This impedes an efficient allocation of human capital and negatively impacts employment, especially of the lower-skilled.

Financial and corporate sectors

A large financial sector and the presence of many multinationals shape the economy, the current account and financial flows going through the Netherlands.

The Netherlands has one of the largest financial sectors in the EU In terms of its balance sheet relative to the GDP. Two of the four largest banks are currently state-owned and a third one received government support. Restructuring of the sector, also in light of new regulations, is ongoing and capital bases are strengthened. This is needed to improve the resilience of the financial sector. The financial sector has been deleveraging for a few years in light of financial and economic trends and new financial regulations. Changes to the housing market in particular are expected to positively influence the composition of banks' balance sheets in terms of reducing mismatches. The financial sector is not only highly exposed to domestic mortgages, but also to a sizeable funding gap, due to fiscal disincentives to save and a pension system that collects substantial savings outside the banking sector (see section 4).

Additionally, the Netherlands has been home to multinationals and has actively welcomed foreign companies to set up their global headquarters in the country. Multinationals are attracted by a favourable legal framework and a beneficial tax treatment([2]) of repatriated foreign income, which partly seems to determine the size and direction of associated financial flows. The absence of withholding tax on outbound royalties and interest payments and the fact that the Dutch tax administration gives clarity in advance on the tax consequences for such activities has contributed to companies being registered in the Netherlands, even without having a substantial physical presence there. This generates gross financial flows which are channelled through the Netherlands via special purpose entities. The associated gross financial flows currently amount to more than three times the GDP of the Netherlands.

These headquarters do not only serve as a transit point for international capital flows to other jurisdictions, but also generate profits that are far above the EU average. As Foreign Direct Investment (FDI) outflows have increased, investment earnings in the form of profit remittances received from foreign operations have also grown substantially.

([2]) Traditionally, the participation exemption on cross-border intra-firm dividend payments (as well as capital gains) from subsidiary companies abroad has been a major attractor of companies to the Netherlands. It implies that when transnational companies repatriate affiliate income, or in other words, pay themselves dividends from abroad, the tax treatment of this income is not subject to domestic taxation. Although this system is applied in most EU countries, with the exception of Greece, Ireland, Spain and the United Kingdom, the extent to which income is fully or partially exempted varies across countries and is affected by the provisions of bilateral tax treaties. Other factors that make the Netherlands fiscally attractive are the the large Dutch Double Taxation Treaty (DTT) network and the "advance tax ruling" system.

Employment and labour costs

Exports remain strong on the back of a fundamentally competitive economy. A favourable geographical position, a long tradition of integration in global trade and an increasing importance of re-exports (reflecting the integration of the Dutch economy in global value chains) support exports. Although the direct relation between export performance and wage developments is weak at best, the Netherlands has had for decades a strong and institutionalised tradition of supporting competitiveness through wage moderation. Since the beginning of the crisis the decreasing purchasing power of households resulted in decreasing private consumption, as simultaneous deleveraging pressures started to be felt. Apart from employment trends the recent muted development of household disposable income partly reflected increases in taxation and pension premia, negative wealth effects and partly subdued wage developments.

A broad welfare system and favourable labour market developments in the decades before the global financial crisis have had a positive impact on social indicators. This broadly holds, even though the labour market situation has worsened since the beginning of the crisis. The unemployment rate was 5.3% in 2012 and has risen further to 6.7% in 2013, mainly on the back of weak internal demand. Poverty and social inclusion indicators also still show strong readings in comparison to most other Member States. Important reasons for the relatively low level of unemployment are good education that matches the needs of the labour market, an efficient system of private employment services, a widespread use of flexible labour contracts and the availability of part time work (including child care facilities). Some of these features have become under pressure recently, e.g. by planned measures to reduce the flexibility of flexible contracts, which is intended to increase job security of people with a flexible contract, but, in times of rising unemployment, could also lead to an increasing number of dismissals.

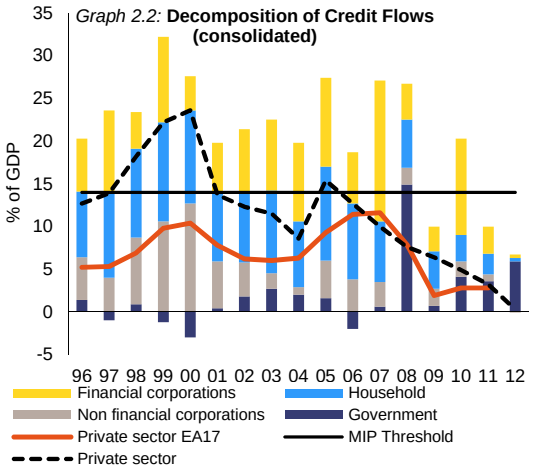
2.2. SHORT-TERM OUTLOOK

The institutional setup of the Netherlands as sketched above, in combination with adjustment dynamics, policy choices and deleveraging needs (mainly of households, banks and the government) are important forces behind the weak near-term economic outlook. Following a contraction in real GDP in 2013 of 0.8%, an increase of 1% is expected for 2014 with economic growth accelerating to 1.3% in 2015. The fragile transition towards positive growth in 2013 was chiefly supported by net exports. By contrast, domestic demand remained a drag on activity, despite gross fixed capital formation rebounding in line with an improved business outlook, and is projected to remain sluggish in 2014. Private consumption will be still held back by the unfavourable development of employment and the incurred negative wealth effects over the past years. In 2014 domestic demand is expected to gradually move towards positive territory and to overtake net exports as the main growth driver. In particular, investments are picking up, especially in the private sector. Investment is forecast to veer up on the back of a recovery in production and profitability. The recent rises in the capacity utilisation rate, coupled with improved producer confidence, support this outlook. Existing cash buffers at large companies, but also to some degree at SMEs, should enable firms to finance investments even in an environment of bank deleveraging. Additionally, larger companies increasingly tap the capital market directly to finance investments. So, overall financing constrains do not appear to be a major factor in holding back a recovery in economic activity.

The positive effects of a recovering housing market would not suffice to offset the still weak real disposable income and adverse labour market trends in the near term. Even though the total net asset position of the household sector is getting even stronger, mismatches in its composition and distributional effects still imply an overall drag on macro-economic activity. Negative and decreasing housing equity has encouraged households to deleverage. With previous LTV ratios often markedly exceeding one and given decreasing house prices, in particular younger households try to avoid negative housing equity. This implies an incentive to pay back debt, a development supported by low interest rates and comparatively high tax rates on savings.

Deleveraging is gaining pace with credit flows to the private sector (excluding the government) having come to a standstill. Credit flows have been decreasing strongly compared to pre-crisis years but flows have virtually dried out in 2012 if the government is excluded (Graph 2.2). With a lagged effect this will strongly influence the gross debt position of the private sector. Weak internal demand and deleveraging of households and other sectors explain a current account surplus that is forecast to reach around 9% of GDP in 2014 and 10% of GDP in 2015.

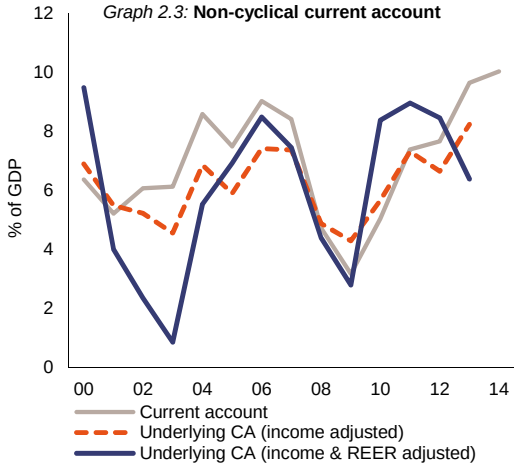
Graph 2.2: **Decomposition of Credit Flows (consolidated)**



source: Eurostat.

Part of the current account surplus is explained by the cyclical position of the Dutch economy, especially weak domestic demand. The cyclically-adjusted current account surplus is estimated to be 6.4% in 2013 (Graph 2.3). In the medium term the surplus is expected to decrease on the back of increasing consumption and investment expenditure. But due to deleveraging pressure that will persist for years to come, this decrease will be decelerated by the deleveraging that is happening in the household and government sectors. As long as households, the financial sector and the government are proceeding with the necessary deleveraging, the current account surplus will remain artificially high.

Graph 2.3: **Non-cyclical current account**



Source: Commission Services.

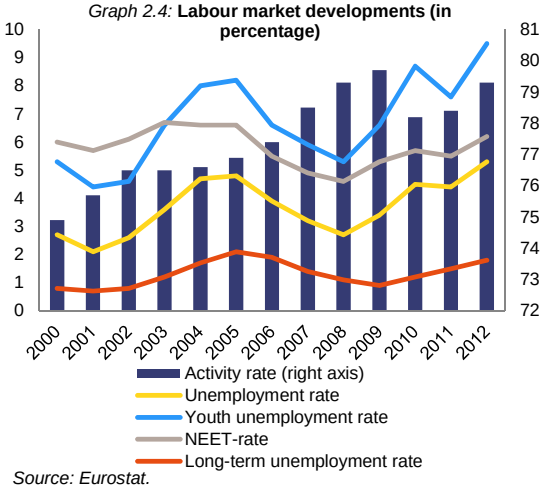
Access to finance remains a challenge, in particular for SMEs, but overall its negative impact seems limited. According to the most recent ECB survey([3]), 20% of SMEs name access to finance as their most pressing problem, one of the highest percentages in the EU. For the moment the negative impact on an aggregate scale of this situation appears to be limited due to the fact that many SMEs are currently not in need of external financing, a situation that can be expected to change if the economy stays as weak as projected. To what extent this worsened situation is the result of a weaker economic environment or rather of deleveraging of banks is difficult to tell but has a strong influence on the prospects for economic recovery. However, as banks are mainly deleveraging through retained profits, selling assets and the issuance liabilities that count for some equity ratios and the fact that many SMEs recently had to change bank - and usually applied at different banks for loans - with a resulting push in rejection rates, the overall supply of credit does not seem to be a major constraint to a recovery as such. Furthermore, large corporations and dynamic SMEs still have enough sources of funding to sustain an increase in investment. Additionally, the virtual disappearance of interest-only mortgages from the mortgage market and the resulting shrinkage of the mortgage portfolio of banks should, in the medium term, free up assets and capital to provide credit for more productive sectors of the economy. However, the overhang

([3]) Source: www.ecb.int/stats/money/surveys/sme/html/index.en.html

from existing financing structures will take some considerable time to adjust.

The unemployment rate is expected to increase and the government budget deficit to stay around 3% of GDP. The unemployment rate is expected to increase from 6.7% in 2013 to 7.4% in 2014 and 7.2% in 2015. With weak internal demand, rising unemployment and positive developments mainly coming from (relatively tax-poor) exports, the general government deficit is expected to come out at 3.1% of GDP in 2013 and 3.2% in 2014. In 2015, the deficit is forecast to fall to 2.9% of GDP on unchanged policies. Youth and long-term unemployment follow a similar pattern: 9.5% of the youth was unemployed in 2012 and this has risen to 11.5% in the third quarter of 2013 (Graph 2.4). Nevertheless, the Not in Education, Employment, or Training (NEET)-rate (6.2% in 2012) remains one of the lowest in Europe. Although the long-term unemployment rate (1.8% in 2012) is less than half of the EU-average (4.7%), it has been increasing with a higher magnitude in the first two quarters of 2013.

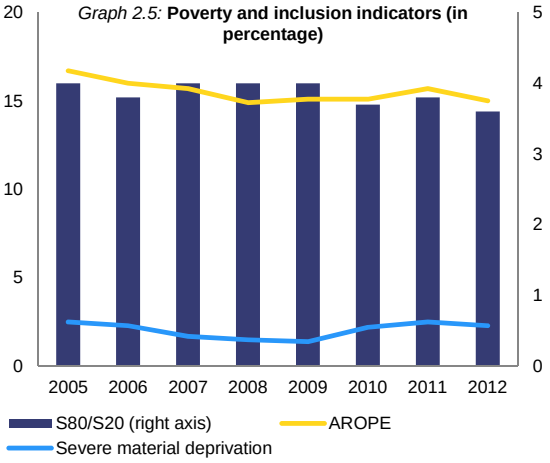
Graph 2.4: **Labour market developments (in percentage)**



Source: Eurostat.

The ratio of people at risk of poverty and social exclusion to the whole population has been decreasing since 2005, stabilised since 2008 (Graph 2.5) and is well below the EU-average (24.8%). Likewise, severe material deprivation for the total population remains at very low levels (2.3% in 2012) but has somewhat increased since the onset of the crisis. The decreasing ratio of average incomes of the last and first quintile of the income distribution does not show any increase in income inequality due to the weak economic situation.

Graph 2.5: **Poverty and inclusion indicators (in percentage)**



Source: Eurostat.

Risks to this short-term outlook are slightly on the downside. Uncertainties on the policy side regarding the implementation and effects of foreseen measures in areas such as pensions or the decentralisation of competencies to municipalities may hamper the recovery of domestic demand. However, a faster stabilisation of the housing market could provide an additional boost.

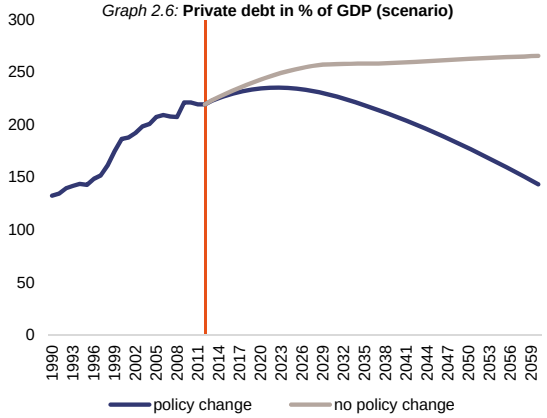
2.3. LONG-TERM EFFECTS OF SELECTED REFORMS

Since the beginning of 2013, interest payments on new mortgages are only tax-deductible in the case of annuity or linear mortgages. The full effect of this measure will only be seen gradually, given the large outstanding stock of existing mortgages. This notwithstanding, in the medium to long run, changes to the fiscal treatment of housing loans will not only have a positive effect on the government's budget but will also reduce the funding gap of banks and could facilitate the renewed use of securitisation as a financing instrument going forward. As instalments for new mortgages include the repayment of principal, this measures will also positively influence the gross debt position of households and help contribute to shortening their balance sheets.

Under plausible assumptions about future economic growth, house prices, etc., scenarios can be sketched of how the private sector debt

ratio (as % of GDP) is likely to develop under the new tax regime.([4]) Graph 2.6 summarises the results of this scenario analysis. Historical data are used until 2012 (highlighted by a vertical line) with two alternative subsequent scenarios after 2012. The first scenario is the no-policy-change benchmark. In this (hypothetical) case, private debt would continue to rise and stabilise around 260% of GDP. The second scenario is one which takes into account the recently implemented changes to the fiscal regime governing housing loans (but not the recent decline in credit flows as discussed above, this is assumed to be mainly cyclical). In this case the private debt ratio is expected to initially increase further before steadily decreasing to around 140% of GDP in 2060. In the short term, old and small mortgages are replaced by larger mortgages (even though house prices recently decreased, they are still much higher in nominal terms than 30 years ago), resulting in a short-term increase of the debt-to-GDP ratio. In the medium term, the "annuity effect" dominates and the private debt ratio (in % of GDP) decreases significantly.

Graph 2.6: **Private debt in % of GDP (scenario)**



Source: based on data from Statistics Netherlands and OECD.

Under the policy change scenario, private sector debt is expected to be more than 120 pp of GDP lower in 2060 than under a no policy change scenario. This long-term deleveraging of the private sector will impact inter alia internal demand, economic growth, financial stability and the current account position.

([4]) Both scenarios assume constant nominal GDP growth, constant ratios of private household debt (non-mortgages) to GDP, a constant number of transactions (average 1995-2011), a constant LTV ratio of 1 and house prices that develop in line with nominal GDP. Repaid mortgages are approximated by historical house prices. Both scenarios are very insensitive to changes in these assumptions.

Table 2.1:

Key economic, financial and social indicators - the Netherlands

							Forecast		
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP (yoy)	3.9	1.8	-3.7	1.5	0.9	-1.2	-0.8	1.0	1.3
Private consumption (yoy)	1.8	1.3	-2.1	0.3	-1.1	-1.6	-2.1	-0.5	1.0
Public consumption (yoy)	3.5	2.8	5.0	0.5	0.2	-0.7	-0.7	0.3	-0.9
Gross fixed capital formation (yoy)	5.5	4.5	-12.0	-7.4	6.1	-4.0	-4.9	5.7	3.1
Exports of goods and services (yoy)	6.4	2.0	-7.7	11.6	4.1	3.2	1.3	2.9	5.0
Imports of goods and services (yoy)	5.6	2.3	-7.1	10.3	4.2	3.3	-0.5	3.2	5.0
Output gap	2.1	2.1	-2.5	-1.5	-1.0	-2.5	-3.3	-2.7	-1.9
Contribution to GDP growth:									
Domestic demand (yoy)	2.8	2.2	-2.1	-1.1	0.6	-1.7	-2.0	0.7	0.7
Inventories (yoy)	0.1	-0.4	-0.4	1.1	0.1	0.2	-0.3	0.2	0.1
Net exports (yoy)	1.0	0.0	-1.1	1.6	0.2	0.2	1.5	0.1	0.5
Current account balance BoP (% of GDP)	6.7	4.3	5.2	7.4	9.5	9.4	.	.	.
Trade balance (% of GDP), BoP	8.9	8.5	7.0	8.2	8.7	8.6	.	.	.
Terms of trade of goods and services (yoy)	-0.2	0.1	-0.1	-1.1	0.1	-0.6	0.5	-0.1	0.9
Net international investment position (% of GDP)	-6.0	4.2	16.7	24.5	33.6	46.8	.	.	.
Net external debt (% of GDP)	20.4	29.2	24.4	37.2	38.8	32.5	.	.	.
Gross external debt (% of GDP)	308.9	290.9	293.5	307.2	320.3	316.6	.	.	.
Export performance vs. advanced countries (5 years % change)	.	.	.	.	.	.	.	.	.
Export market share, goods and services (%)	.	.	.	.	.	.	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	6.9	5.9	5.6	3.3	4.9	4.1	.	.	.
Private credit flow (consolidated, % of GDP)	10.0	7.6	6.4	4.9	3.2	0.3	.	.	.
Private sector debt, consolidated (% of GDP)	207.9	207.5	221.2	221.2	219.3	219.4	.	.	.
Deflated house price index (yoy)	3.0	1.0	-3.9	-3.0	-4.2	-8.7	.	.	.
Residential investment (% of GDP)	6.4	6.3	5.7	4.9	4.7	4.2	.	.	.
Total Financial Sector Liabilities, non-consolidated (yoy)	16.3	-0.6	6.1	7.1	8.5	4.9	.	.	.
Tier 1 ratio (1)	.	9.6	12.4	11.8	11.7	12.1	.	.	.
Overall solvency ratio (2)	.	12.0	15.0	14.1	13.7	14.5	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	.	1.9	2.6	2.3	2.4	2.7	.	.	.
Employment, persons (yoy)	2.0	1.2	-0.6	-0.4	0.6	-0.2	-1.0	-0.4	0.6
Unemployment rate	3.6	3.1	3.7	4.5	4.4	5.3	6.7	7.4	7.2
Long-term unemployment rate (% of active population)	1.4	1.1	0.9	1.2	1.5	1.8	.	.	.
Youth unemployment rate (% of active population in the same age group)	7.0	6.3	7.7	8.7	7.6	9.5	11.0	.	.
Activity rate (15-64 years)	78.5	79.3	79.7	78.2	78.4	79.3	.	.	.
Young people not in employment, education or training (% of total population)	3.5	3.4	4.1	4.3	3.8	4.3	.	.	.
People at-risk poverty or social exclusion (% total population)	15.7	14.9	15.1	15.1	15.7	15.0	.	.	.
At-risk poverty rate (% of total population)	10.2	10.5	11.1	10.3	11.0	10.1	.	.	.
Severe material deprivation rate (% of total population)	1.7	1.5	1.4	2.2	2.5	2.3	.	.	.
Persons living in households with very low work intensity (% of total population)	9.7	8.2	8.5	8.4	8.9	8.9	.	.	.
GDP deflator (yoy)	1.8	2.1	0.1	0.8	1.1	1.3	1.7	0.8	2.2
Harmonised index of consumer prices (yoy)	1.6	2.2	1.0	0.9	2.5	2.8	2.6	1.1	1.3
Nominal compensation per employee (yoy)	3.4	3.3	2.5	1.5	1.6	1.9	0.2	1.9	1.3
Labour Productivity (real, person employed, yoy)	1.3	0.3	-3.0	1.9	0.2	-1.1	.	.	.
Unit labour costs (whole economy, yoy)	1.7	3.0	5.3	-0.6	1.2	2.9	-0.3	0.5	0.6
Real unit labour costs (yoy)	-0.1	0.8	5.2	-1.4	0.0	1.5	-2.0	-0.3	-1.6
REER (ULC, yoy)	1.1	1.3	2.7	-2.6	0.4	-1.1	0.3	0.5	-0.7
REER (HICP, yoy)	0.2	0.5	1.9	-3.9	-0.4	-1.8	2.7	0.7	-0.5
General government balance (% of GDP)	0.2	0.5	-5.6	-5.1	-4.3	-4.1	-3.1	-3.2	-2.9
Structural budget balance (% of GDP)	-1.0	-0.7	-4.2	-4.1	-3.7	-2.7	-1.8	-1.8	-1.8
General government gross debt (% of GDP)	45.3	58.5	60.8	63.4	65.7	71.3	74.3	75.3	75.6

(1) domestic banking groups and stand-alone banks.

(2) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.

Source: Eurostat, ECB, AMECO.

3. IMBALANCES AND RISKS

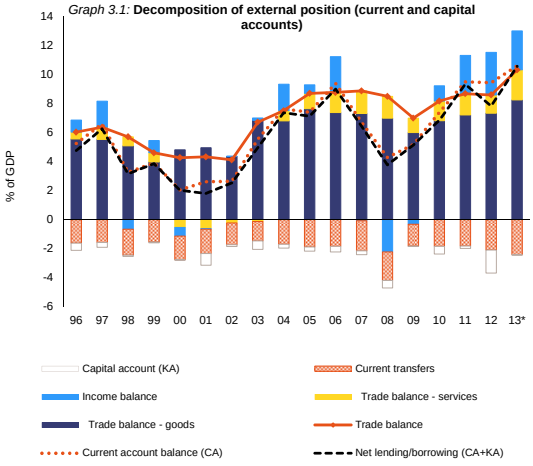
This chapter focuses on the two main areas relevant to the identification of potential imbalances: the current account surplus, and the level of private (in particular household) debt, also with reference to the MIP scoreboard. The approach followed for the analysis of the current account balance stresses underlying determinants in terms of sectoral savings patterns and characteristics of income formation in the household sector, with special reference to labour market institutions. These collectively are underlying determinants of the current account balance (and of leverage patterns), and for this reason any structural issues, bottlenecks or risks originating there are relevant in discussing the Dutch surplus. As regards determinants of private sector debt, the housing market and housing debt of households plays a central role. Associated vulnerabilities and risks are also discussed.

3.1. CURRENT ACCOUNT

The Netherlands has recorded persistent current account surpluses for over three decades and currently has one of the highest in the euro area. The surplus on the current account, which had averaged around 5% of GDP during the 1990s, increased to some 6% of GDP during the 2000s, and reached a record of 9.5% of GDP in 2011. According to the MIP scoreboard headline indicators, the 3 year average of current account balances over 2010 – 2012 was 8.8% for the Netherlands. The Commission services Winter 2014 Forecast indicates a slight decrease of the current account surplus in 2014, followed by an increase to just around 10% of GDP in 2015.

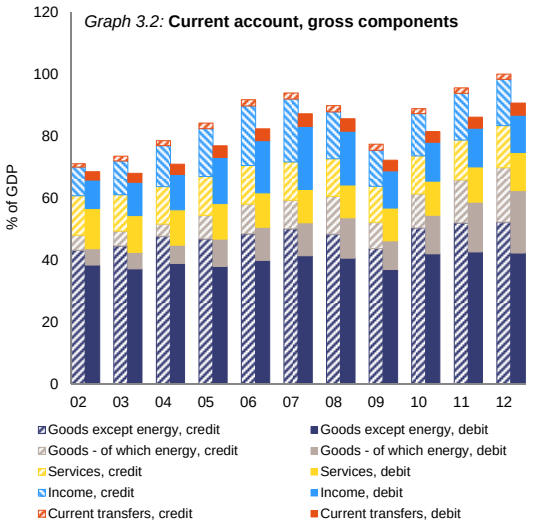
The current account surplus has mainly been driven by a large positive goods trade balance, with the contribution of other components being relatively small (Graphs 3.1 and 3.2).

Graph 3.1: **Decomposition of external position (current and capital accounts)**



Source: Eurostat.

Graph 3.2: **Current account, gross components**



Source: Eurostat.

The positive trade balance in goods has increasingly mirrored the contribution of re-exports([5]), which have grown spectacularly due to a combination of the on-going globalisation and the rise of 'global production chains'. In 2013 re-exports accounted for roughly one half of the Dutch goods balance compared to one third in 1995. They contributed some 2 percentage points to the total current account surplus.

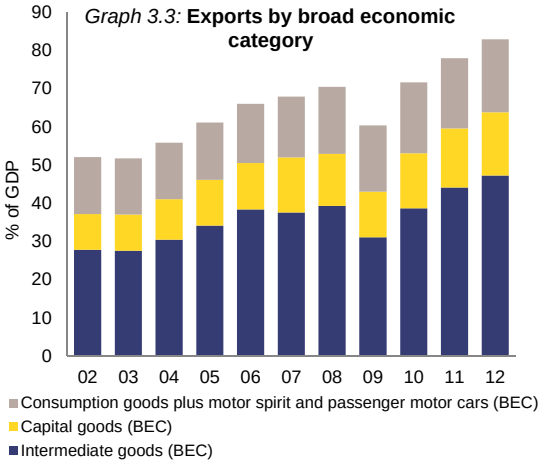
([5]) Re-exports are defined as goods owned by a Dutch resident at some point and subsequently by a foreign resident. If there is no transfer of ownership at any stage, the goods are deemed to be in transit. Goods are counted as domestically-produced exports if they undergo processing. Other important re-exporting countries include Singapore, Belgium and Germany.

The geographical location of the Netherlands (with the port of Rotterdam being a trade gateway to Germany) and a competitive transport and logistics sector accentuate the shifts towards re-exports (Netherlands Bureau for Economic Policy Analysis, 2007). The relative underperformance of domestically-produced exports can partly be explained by differences in product mix. Domestically-produced exports are dominated by agricultural products, foodstuffs, chemical products, rubber and plastics, machinery and transport equipment. By contrast, computers and electronic equipment account for nearly half of re-exports while re-exports account for around two thirds of the total exports of machinery and transport equipment. Since global demand for agricultural products and foodstuffs tends to grow less rapidly than the world markets for electronic and telecommunications equipment, the percentage share of Dutch domestically-produced exports in world trade is falling.

Net exports of natural gas constitute another, albeit limited, structural factor adding to the surplus, accounting for about 1 to 2.5 pp of GDP. This contribution mainly reflects the combined net exports of domestically-produced gas and the associated reduced need for energy imports. Additionally, the Netherlands has become an important node in the intra-European gas trade. The importance of the natural gas production to the Dutch economy is bound to gradually fade as domestic reserves are being depleted. In early 2014 production ceilings were put in place in order to mitigate the sensitivity to gas production-related earthquakes in the northern province of Groningen.

Since 2004 the income and services balances have to a large extent driven changes in the current account balance. The services balance had been negative for several years before turning positive in 2004. Moreover, the dividend policy of Dutch multinationals appears to have created an upward bias on the current account([6]). In addition, investment income in the form of profit remittances([7]) has become an increasingly important contributor to the surplus due to increases in profits repatriated by foreign subsidiaries of Dutch enterprises. Such repatriated profits increased from 1.1% of GDP in 2004 to 4.7% of GDP in 2011. A large share of total cross-border profits are earned by listed multinational companies. Dividend payments by these companies to foreign investors, which reduce the balance on the income account, have remained broadly constant since 2007 (around 0.8% of GDP). Data limitations, partly linked to statistical confidentiality, limit the extent to which more light can be shed on the role of multinationals and possible associated upward biases to the measured current account balance.

Graph 3.3: **Exports by broad economic category**

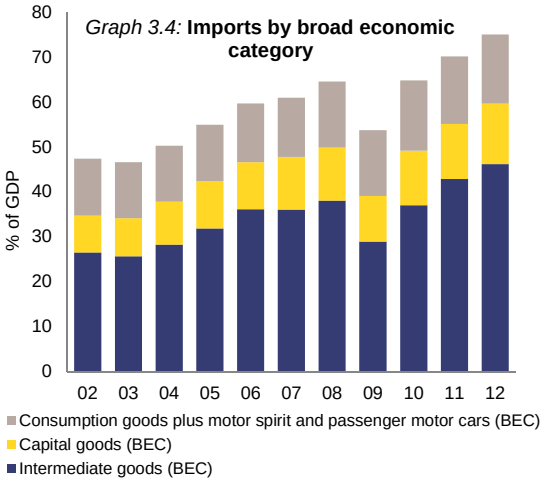


Source: Eurostat.

([6]) De Nederlandsche Bank (2013c) estimates the net effect of both directions at approximately 2% of GDP in the years 2006 to 2008, afterwards reversing to -0.5% of GDP.

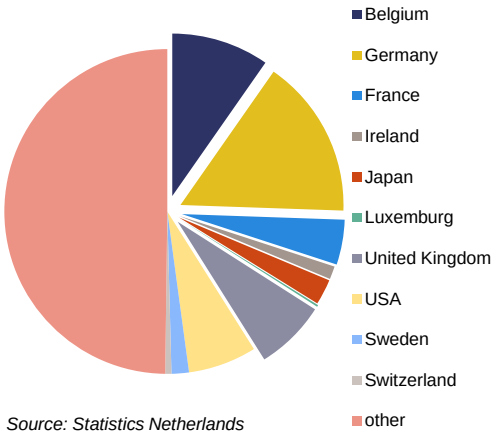
([7]) Profit remittances on FDI not only cover payments of direct investment income, which consist of income on equity dividends, branch profits, and reinvested earnings, but also income on intercompany debt (interest). Some of the profit remittances relate to, for example, royalties on intellectual property, which can fairly easily be shifted to other tax jurisdictions.

Graph 3.4: **Imports by broad economic category**



Source: Eurostat.

Graph 3.5: **Imports of goods (market share)**



Source: Statistics Netherlands

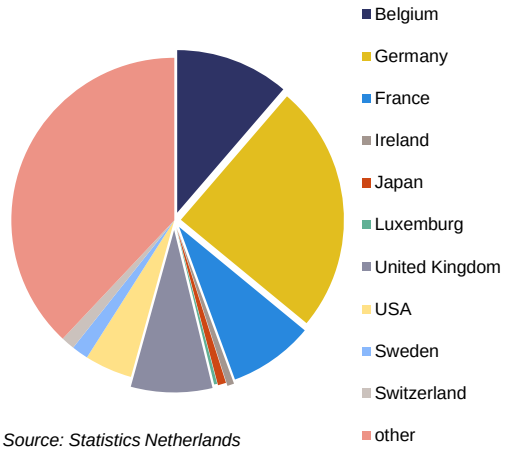
3.1.1. Trade Linkages

The Netherlands has been strengthening its position as an international trading hub for goods flowing into the European markets. Graphs 3.3 and 3.4 show the increasing trade in intermediate goods, underlining the increased importance of global value chains for the Dutch economy. Graph 3.5 shows that imports from outside the EU account for almost half of total gross imports, whereas roughly three quarters of gross exports are directed towards the EU.

The most important trading partners are traditional ones such as Germany, Belgium and the United Kingdom. An increasing share of imports stems from emerging markets such as the People's Republic of China and Russia, underlining the increased importance of global value chains and the Dutch role therein. EU Member States which acceded since 2004 have an import share of below 5%. The combined import share of southern EU countries (Spain, Italy, Portugal, and Greece) is also comparatively small, at slightly above 4%.

Goods exports are strongly geared towards Germany, with a share of almost 25% (Graph 3.6). The share of emerging markets in direct gross exports is still very small: only 1.8% of all exports goes to China and 1.6% to Russia.

Graph 3.6: **Exports of goods (market share)**

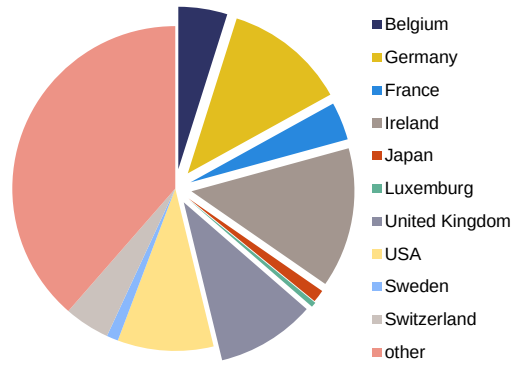


Source: Statistics Netherlands

Gross imports and exports of services show a slightly different geographical orientation (Graphs 3.7 and 3.8). Around half of all registered direct imports of services come from other EU Member States, mainly the United Kingdom, Germany and France. The main import markets from outside the EU are the USA and the British Overseas Territory Bermuda and Switzerland. The combined share of services imports from southern European countries (Spain, Italy, Portugal, Greece) accounts for only 6.3% of the total. Services exports are more strongly tilted

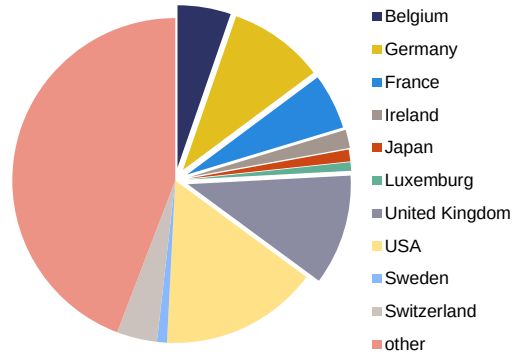
towards the EU, with Ireland, Germany and the United Kingdom being the main export markets.

Graph 3.7: **Exports of services (market share)**



Source: Statistics Netherlands

Graph 3.8: **Imports of services (market share)**

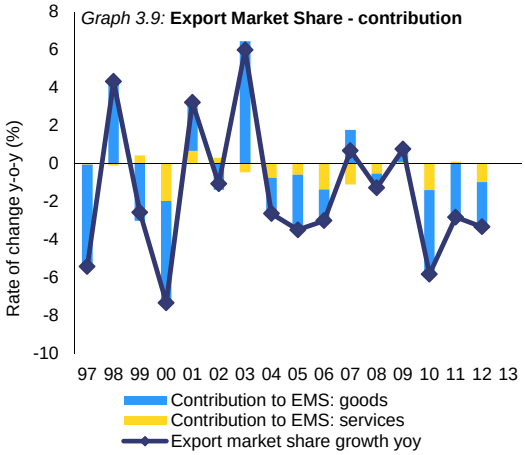


Source: Statistics Netherlands

The Netherlands has been using its position as a trade hub for goods to secure a share of profits from trading these goods. Apparently, the Netherlands is able to extract added value from this trade that goes beyond pure transit. This partly also accounts for the increasing positive contribution of the trade in services to the surplus. However, the gross trade flows do not allow to trace the ultimate origin and destination of goods or services trade. For that, and to fully assess the linkages via global value chains, one would have to take into account the input-output structure of the economy. Moreover, the data available do not distinguish domestically produced exports and re-exports.

Export market shares have been under pressure in recent years (Graph 3.9) but this development is in line with other developed economies that lose market share to developing economies.

Graph 3.9: **Export Market Share - contribution**

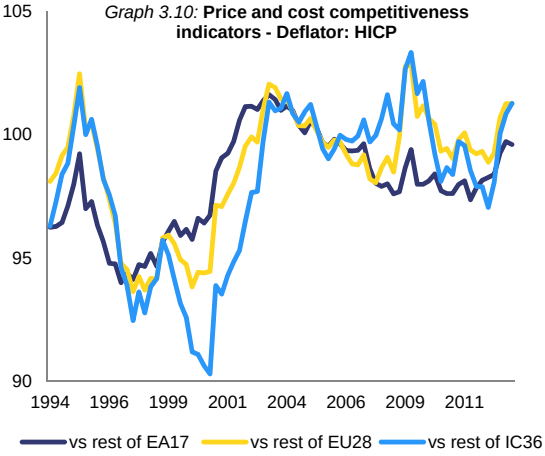


Source: Eurostat.

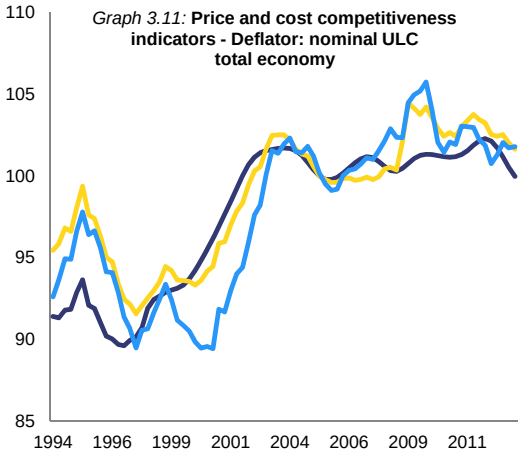
Trends in competitiveness

Price and cost competitiveness indicators show some deterioration in competitiveness from 1997 to 2002, and point to stabilisation since. Standard indicators do not reveal any strong tendency of competitiveness measures in the last decade or so (Graphs 3.10 to 3.13).

Graph 3.10: **Price and cost competitiveness indicators - Deflator: HICP**

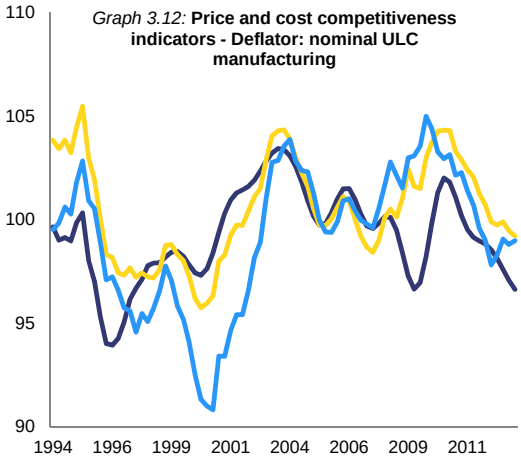


Source: Commission Services.



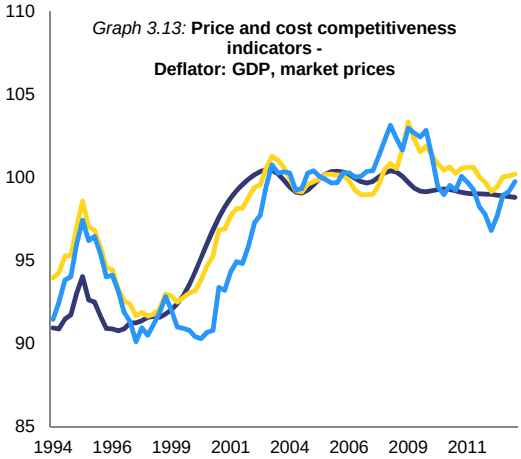
Graph 3.11: **Price and cost competitiveness indicators - Deflator: nominal ULC total economy**

Source: Commission Services.



Graph 3.12: **Price and cost competitiveness indicators - Deflator: nominal ULC manufacturing**

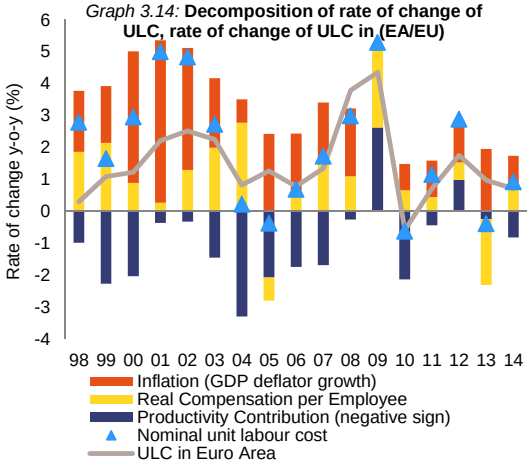
Source: Commission Services.



Graph 3.13: **Price and cost competitiveness indicators - Deflator: GDP, market prices**

Source: Commission Services.

Until the early 1980s, unit labour costs in the Netherlands had increased at a faster pace than in its main competitor countries. This had led to a deterioration in profitability and competitiveness which was followed by a prolonged period of wage moderation. During the period 1980 to 1999 unit labour costs rose only by around 26% in the Netherlands vs. 67% in Belgium, 42% in Germany and 78% in France. From 2000 to 2010, unit labour costs rose by around 24% overall in the Netherlands, which is somewhat above the 22.5% increases in France and Belgium, but markedly above the 4% increase in Germany over the same period. Since 2011, nominal unit labour cost increases have been moderate, as has real compensation per employee (graph 3.14).



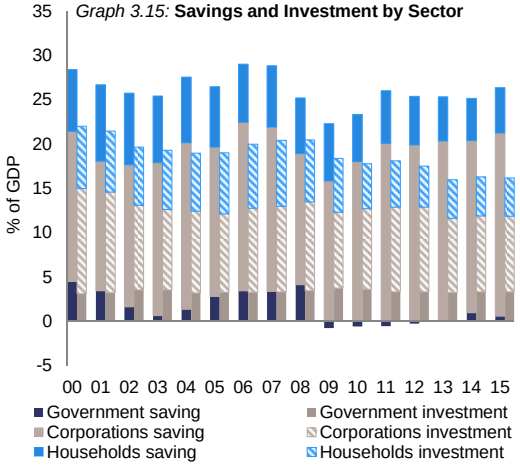
Graph 3.14: **Decomposition of rate of change of ULC, rate of change of ULC in (EA/EU)**

Source: Ameco.

3.1.2. Domestic Savings and Investments

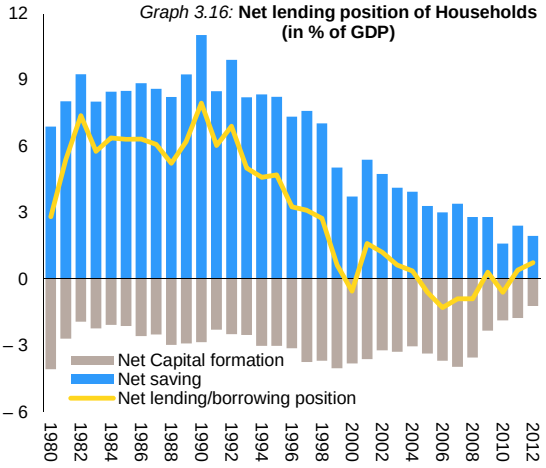
The current account balance ultimately reflects the outcome of saving and investment decisions of domestic sectors. The most striking development in the sectoral breakdown of the Dutch current account balanced (Graph 3.15) is the switch from a significant savings surplus emanating from households towards a savings surplus of non-financial corporations from the late 1990s onwards. One important explanatory factor for this shift is the increase in financial leverage of households, largely reflecting trends in housing and mortgage markets. On aggregate, the corporate sector currently accounts for the lion's share of the savings/investments balances at sectoral level that determine the current account surplus.

Graph 3.15: **Savings and Investment by Sector**



Source: Eurostat.

Graph 3.16: **Net lending position of Households (in % of GDP)**



Source: Eurostat.

Households

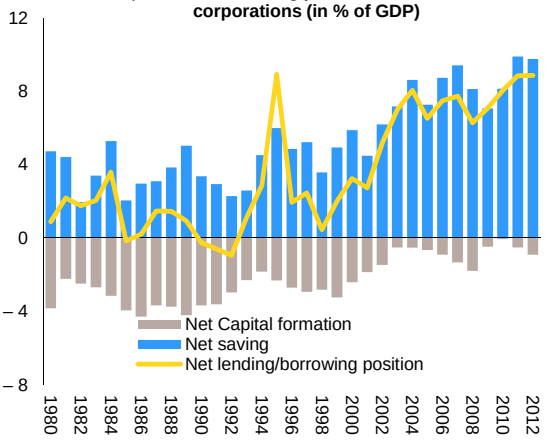
For many decades Dutch households recorded a sizeable saving surplus (Graph 3.16). Traditionally, virtually all of household net saving took place through the pension funds which manage the assets accumulated in the second pillar (occupational) pension scheme. However, increasing household leverage and debt service, mainly related to housing debt, led to a shift in this pattern. This led to a trend decline in the savings surplus. Since 2002, total savings of Dutch households have been below the euro area average([8]). From 2005 onwards, the household net lending position even turned into a deficit, before turning into slight surplus again since 2011. Since the onset of the crisis increases in pension premia, taxes and social contributions, coupled with muted wage increases, held back net disposable household income.

([8]) In 2011 the households' gross savings rate in the Netherlands was 11.6% vs. 16.5% in Germany, 13.1% in the euro area and 11.0% in the EU27.

Non-financial corporations

Non-financial corporations have shown a persistent savings surplus (Graph 3.17). The excess of gross corporate saving over fixed investment widened since the late 1990s, mirroring a roughly equivalent rise in gross saving and a fall in gross fixed capital formation. Since 1998 the non-financial corporate sector has run an increasing savings surplus which is the main factor behind the overall current account surplus. Corporate savings have been higher than in other surplus countries while domestic investments have been at a broadly similar level and have been decreasing in recent years, chiefly in construction. Residential investment has dropped to particularly low levels as the housing market turned.

Graph 3.17: **Net lending position of non financial corporations (in % of GDP)**

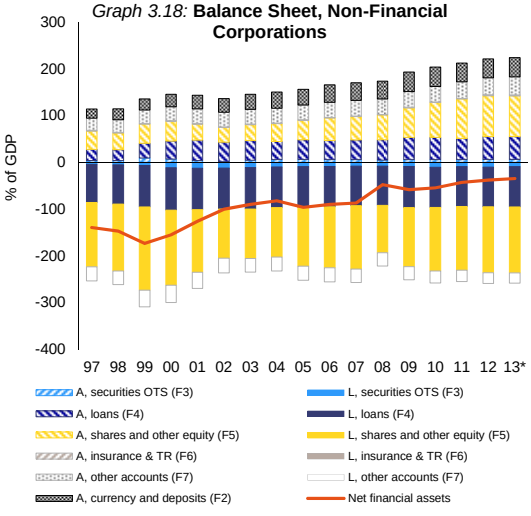


Source: Eurostat.

Sluggish capital formation may partly reflect a capital saving bias in fixed investment related to new technologies. Cyclical weakness also accounts for part of the aenemic business investment observed in recent years. To some extent a substitution of domestic capital formation with outward foreign direct and portfolio investment may have been at play. Non-financial corporations have used direct investments to penetrate new markets or to achieve efficiency gains through redirecting value chains. However, it is unlikely that this was a full offset.

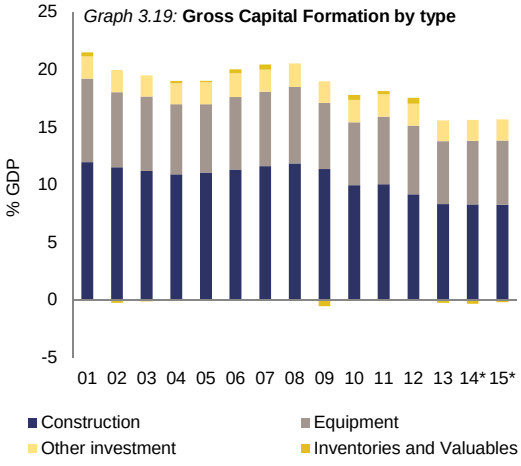
It is not clear to what extent foreign capital flows represent "round-tripping". Indeed, FDI data are affected by specific transactions generally take place via intra-company channels. Such inter-company transfers often lead to profit shifts between countries. Against this background, part of gross FDI flows are likely to mirror the strong presence of multinational companies residing in the Netherland. The *net* measured impact on the balance of payments of outward FDI results from subtracting the FDI outflow from all the positive flows associated with the outflow, mainly repatriated profits, dividends and interest (on the income account), and net receipts of royalties and license payments (on the services account).

Graph 3.18: **Balance Sheet, Non-Financial Corporations**



*Source: Eurostat. Note: * indicates estimated figure using quarterly data.*

Graph 3.19: **Gross Capital Formation by type**



Source: AMECO, Eurostat.

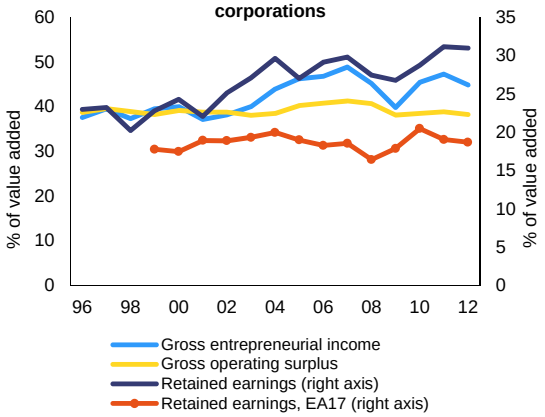
Strong corporate savings reflect increasing profit shares, and likely have been partly related to higher profits received from foreign operations. Dutch multinational companies make a large contribution to the Dutch current account surplus as registered in the official data because part of their earnings are retained and reinvested, rather than being paid out as income to foreign portfolio investors, thus driving measured corporate savings. Profit remittances (both distributed and non-distributed profits or reinvested earnings) realised abroad through foreign subsidiaries are accounted for as income attributed to the Netherlands.([9])

It is possible that this implies some upward impact on the registered current account balance. The exact size of such impact is difficult-to-assess, however. Graph 3.20 shows that the profits generated by Dutch (multinational) companies are far above the EU average, especially those that are retained. The Netherlands is relatively sensitive to this effect (Dutch shares in foreign hands amounted to 55% of GDP in 2011 compared to only 20% in Germany and 15% in the United States). Dutch pension funds, by far taking the lion's share of Dutch shareholders' interests in foreign companies, counterbalance this upward effect to a limited extent only, since distributed

([9]) Profit remittances on FDI not only cover payments of direct investment income, which consist of income on equity dividends, branch profits, and reinvested earnings, but also income on the intercompany debt (interest). Some of these profits do not derive from physical goods, but from, for example, royalties on intellectual property, which makes it easier to shift them to a tax haven.

dividends are attributed as revenue to the Netherlands.([10])

Graph 3.20: **Profit margins, non-financial corporations**



Source: Eurostat.

Labour market arrangements

Wage developments and wage setting institutions are an important determinant of household income. Households use their income to spend, pay taxes and/or social security contributions, deleverage and/or change the share of savings dedicated to pensions. This contribution can only offer an initial assessment of the of wage and income developments in the household sector and their possible wider ramifications for competitiveness, sectoral balance sheet position and growth determinants. It should be stressed at the outset that it is very difficult to provide quantitative or normative benchmarks for what constitutes a balanced and optimal path for labour remuneration, taxes and profits. Feedback effects from the cycle, considerations of dynamic efficiency, global determinants of competitiveness, and technological innovations all play a role in determining the outcome.

Historically, social partners have been fully in charge of wage agreements and guiding sector-specific agreements from a central level. The process of agreeing to the around 700 wage agreements is very formalised and starts at a centralised level. Social partners meet at the *Stichting van de Arbeid* ("Labour Foundation") to come to a central agreement that provides general guidelines for the sectoral negotiations. The outcomes of these can then be declared binding for an entire sector or industry.

The Netherlands embarked on a wage moderation strategy in the early 1980s, following the Wassenaar agreement, reached in 1982 between employers' organizations and trade unions. The agreement implied restrained wage growth in return for the adoption of policies to combat unemployment and inflation, such as reductions in working hours and the expansion of part-time employment.

Wage developments in recent years have had different driving forces, but there may be some institutionally embedded tendencies to yield aggregate wage moderation. Weak cyclical conditions in the aftermath of the crisis implied moderate wage increases which, coupled with rising unemployment, translated into muted gains in the contribution of wages to household income. Multiannual nominal wage freezes in the public sector added to this. This was compounded by procyclical increases in taxes and pension premiums, which led to real wages falling.

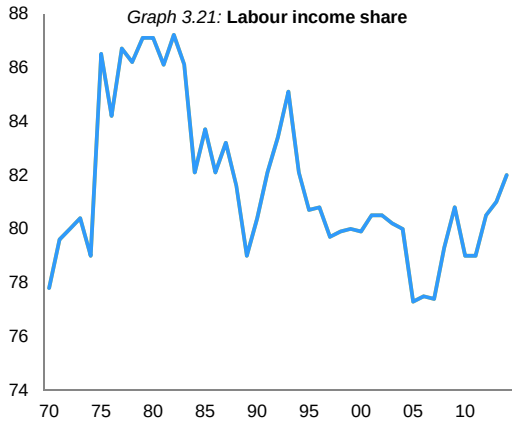
The wedge between labour costs and labour income

The labour income share of GDP([11]) has been roughly constant since the mid-1980s despite cyclical fluctuations (Graph 3.21), at first sight indicating that wage developments have been broadly in line with productivity in the aggregate. As noted above, this is confirmed an assessment on the basis of standard price and cost competitiveness indicators.

([10]) De Nederlandsche Bank (2013c).

([11]) Defined as compensation of employees (wages, salaries and employers' social contributions) over gross value added at basic prices.

Graph 3.21: **Labour income share**



Source: Centraal Planbureau.

Nevertheless, the share of household disposable income in GDP decreased substantially in the last twenty years. Whereas, in 1992, disposable income still accounted for more than 54% of GDP, that share has dropped to somewhat below 45% in 2012([12]). Growth of disposable household income in the Netherlands has been lagging behind growth of the GDP for two decades. To an extent this is an opposite movement as witnessed for non-financial corporations, which registered significant increases in its income share. If part of corporate surpluses had been distributed as dividends in full, disposable income of households and other shareholders could have been higher.

An increasing part of the income earned in the country accrues to households in a different way. Higher pension contributions played a role, although they, of course, ultimately will benefit households. The government also has a larger income share than twenty years ago, which is mainly being spent on higher individual government consumption. The goods and services in question, for instance education and healthcare, are financed collectively. Whereas individual government consumption accounted for some 12.5% of GDP in 1992, this had increased to 17.5% of GDP by 2012. This is mainly due to the sharp increase in collective healthcare spending after the turn of the century.([13]) The pension contributions paid by employers and employees doubled (from 3 to 6% GDP) in fifteen years' time.

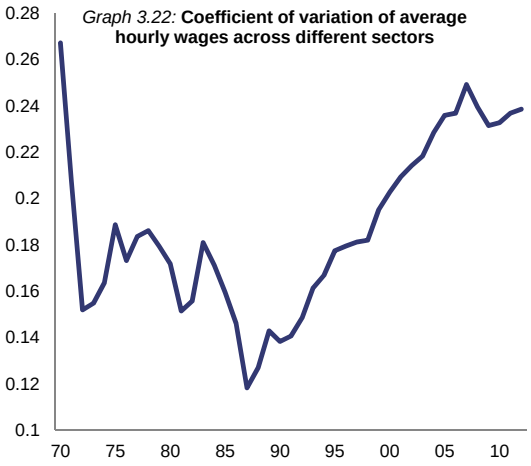
Since the crisis, gains in disposable income for households have come under pressure, weighing on purchasing power. Partly this was due to rises in the burden of taxes, social and pension premia, partly to moderate wage developments. Social security payments (by employers and employees) accounted for slightly above 45% of total gross household income in 2009 but have increased to almost 50% in 2012.([14]) Falling income of self-employed, rising unemployment, increasing energy prices, and negative wealth effects have added to the already existing pressures. Going forward, deleveraging pressures on household balance sheets may continue to burden household disposable income in the near term.

Patterns in wage differentiation

Overall, wage costs have developed broadly proportionally to gross value added and wage differentiation has increased slightly since the mid-1980s. The coefficient of variation of average hourly wages across different main industries of the economy (standardised by the economy-wide average hourly wage) has increased since around 1987, when it had reached its lowest level since 1969 (Graph 3.22). However, the overall degree of wage dispersion appears to have remained fairly low. This is a crude measure of wage dispersion as hourly wages are influenced by, for example, wage agreements, industry structure the skill composition and incidence of part-time work, and changes in the share of self-employed. The modest tendency towards more dispersion seems to have abated since the onset of the global financial crisis.

([12]) De Nederlandsche Bank (2013b).
([13]) De Nederlandsche Bank (2013b).
([14]) Centraal Planbureau (2013).

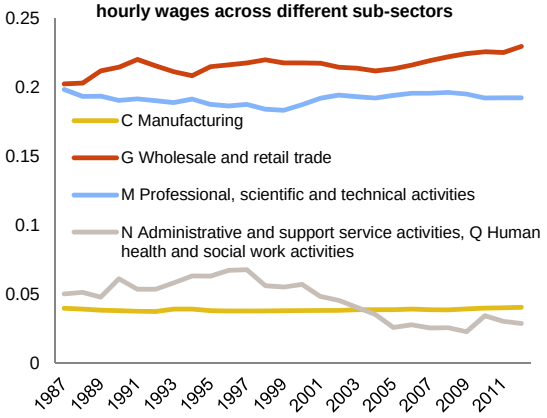
Graph 3.22: **Coefficient of variation of average hourly wages across different sectors**



Source: calculations based on CBS data.

There is not much wage dispersion across subsectors. The coefficient of variation across subsectors within the main branches of industry has remained fairly stable since 1987 (see Graph 3.23([15]). This indicates that, as the variation of average wages within subsectors appears to have remained broadly constant, the variation between main industries has been the driving force behind the overall still modest increase in the wage differentiation as depicted in Graph 3.23.

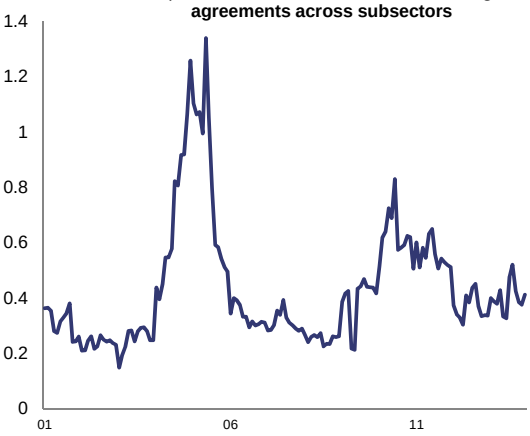
Graph 3.23: **Coefficient of variation of average hourly wages across different sub-sectors**



Source: calculations based on CBS data.

It is striking that wage increases do not vary much across subsectors. Even though in the existing institutional framework social partners have a lot of freedom in negotiating collective agreements, it seems that they do not fully use the room they have to negotiate wage increases that differentiate more according to productivity and profitability differentials across subsectors (industries defined at lower aggregation level) or even large firms. Changes in hourly wages are to a large extent determined by the currently around 700 collective wage agreements that cover approximately 80% of the workforce. These collective agreements often are legally binding within the industries for which they are concluded. The standardised variation of wage increases across subsectors has experienced some peaks in recent years but has the tendency to return to a level that seems to have remained relatively stable since the beginning of the century (Graph 3.24).

Graph 3.24: **Coefficient of variation of wage agreements across subsectors**



Source: calculations based on CBS data.

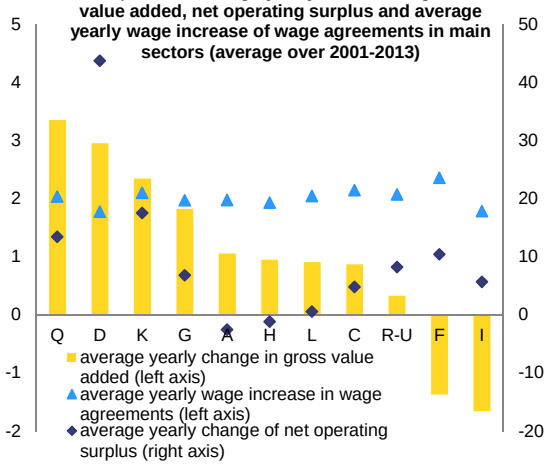
The prevailing low degree of variation of wage agreements contrasts with observed substantial differential productivity developments across industries. Graph 3.25 shows that the average agreed yearly wage increases were around 2% in all industries([16]), despite substantial differences in the increase in gross value added and net operating surplus. This observation holds when examining the relationship over time. Graph 3.26 shows the same variables for manufacturing since 2001. Statutory wage increases closely followed the overall increases agreed to across industries and

([15]) The shown subsectors entail around 60% of the total labour force.

([16]) Q: Health and social work activities, D: Electricity and gas supply, K: Financial institutions, G: Wholesale and retail trade, A: Agriculture, forestry and fishing, H: Transportation and storage, L: Renting, buying, selling real estate, C: Manufacturing, R-U: Culture, recreation, other services, F: Construction, I: Accommodation and food serving.

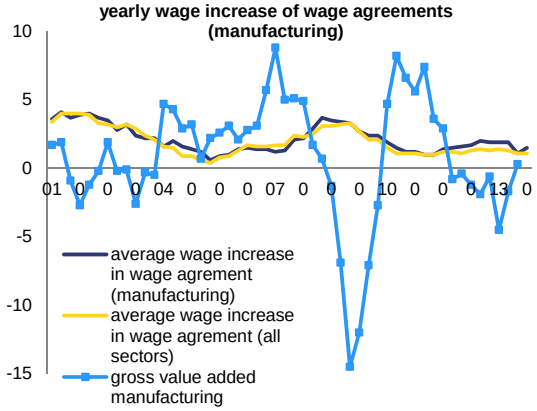
appear to respond fairly weakly to the cyclical position of the economy, given customary lags.

Graph 3.25: **Average yearly increase in gross value added, net operating surplus and average yearly wage increase of wage agreements in main sectors (average over 2001-2013)**



Source: calculations based on CBS data.

Graph 3.26: **Average yearly increase in gross value added, net operating surplus and average yearly wage increase of wage agreements (manufacturing)**



Source: Statistics Netherlands.

One reason for the strong correlation of collectively agreed wages across industries is that under prevailing arrangements wage changes *within* sectors or industries are often evened out by the binding nature of collective wage agreements. This reduces the scope for wage differentiation across companies within sectors. Currently around 13% of all employees are subject to a mandatory sector-wide wage agreement, even though their company is not directly involved in the bargaining process among social partners. This percentage is substantially higher for people outside the government and government-related sectors, such as education and health care. For example, the share is 28.7% in the agricultural, 26.1% in the construction, 22.5% in the transport and communication and 19.7% in the for-profit services industries.([17])

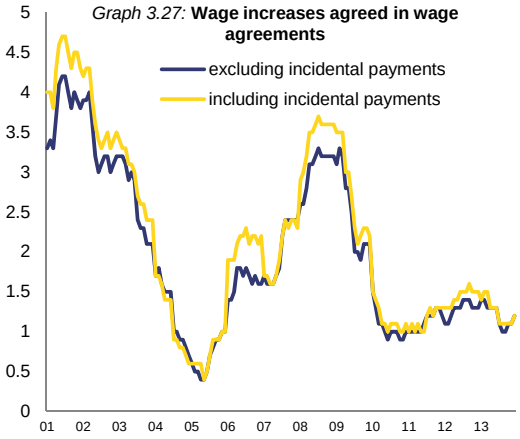
A larger differentiation of wage increases across firms and industries, with a closer alignment to productivity increases, might provide a stronger incentive for reallocation of production factors, increasing the overall efficiency of production. Moreover, exploiting wage differentiation opportunities while aligning to productivity more fully might allow a more differentiated support to the purchasing power of households without jeopardising the viability or competitiveness of firms. Naturally, such an approach would have to take due account of the situation of firms as regards profitability and prevailing buffers, implying a truly decentralised approach. Possibly, in the Netherlands the deeply engrained and institutionally embedded tendency towards wage moderation has yielded an unintended aggregate outcome in the aftermath of the crisis, in which households did receive less support from employment income than otherwise could have been the case. Given the prevailing deleveraging overhang, this does not mean that private consumption would have been much higher. This also does not imply that there is no cyclical sensitivity of labour costs to the cycle. There is (see below). An undifferentiated wage impulse could negatively affect employment and weaken the viability of firms in vulnerable industries. Yet more robust income developments for households could help support domestic demand in an environment of protracted economic downturn.

At the aggregate level, labour remuneration is responsive to the cycle. Flexible elements of remuneration increase the degree of wage differentiation somewhat. Wage agreements often include so-called 'incidental' or discretionary payments, sometimes connected to collective or individual performance. In 2012, around 30% of all wage agreements included such payments. Most of these also included additional or non-recurring payments linked to individual (or somewhat collective) performance. Around 15% of all employees are subject to such schemes. All in all, economy-wide agreed wage increases are quite responsive to the cycle, in spite of a low degree of dispersion, as can be seen from Graph 3.27.

([17]) Ministerie van Sociale Zaken en Werkgelegenheid (2013).

Incidental payments account for around 10% of the total wage increases. The figures suggest a procyclical correlation with aggregate wage increases, but a fairly small overall effect of incidental components.

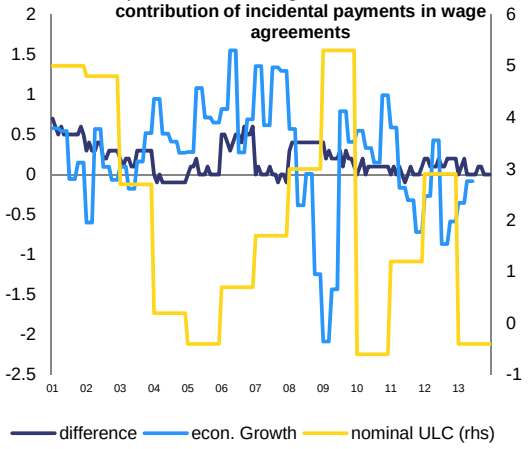
Graph 3.27: **Wage increases agreed in wage agreements**



Source: Statistics Netherlands.

The incidence of incidental payments correlates somewhat with nominal unit labour costs (Graph 3.28). When unit labour costs increase, incidental payments are usually higher as well. This reflects the fact that incidental payments are usually agreed to be between 5 and 10% of the agreed wage increase. Since 2001 the importance of incidental payments has been stable.

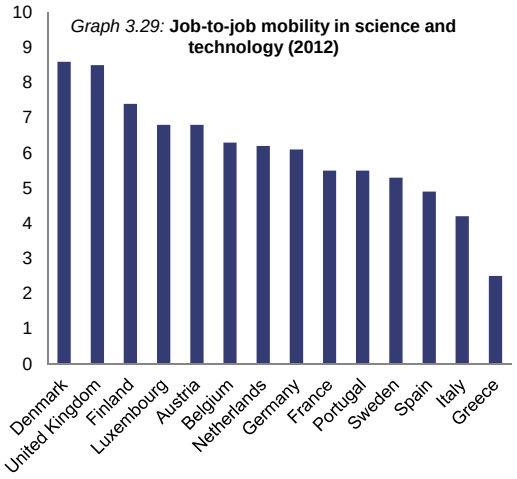
Graph 3.28: **Economic growth, nominal ULC and contribution of incidental payments in wage agreements**



Source: Statistics Netherlands.

More difficult to pinpoint is whether increased differentiation in wage setting might also increase the overall productivity of the Dutch economy through a faster reallocation of human capital towards more productive sectors. Currently, labour mobility of highly-skilled people in science and technology in the Netherlands is only around the EU15 average (Graph 3.29).

Graph 3.29: **Job-to-job mobility in science and technology (2012)**



Source: Eurostat.

Medium-term outlook

Since the onset of the crisis, cyclical factors have pushed up the current account surplus. The weakness of domestic demand has been a particular feature of the Dutch economy which had an upward impact on the headline current account surplus. This effect should fade as a recovery sets in. Consistent with this, the cyclically-adjusted current account surplus is estimated to be much lower than the actually observed value (see Graph 2.3 in section 2).

Deleveraging pressures hinder an adjustment of the current account balance. Ongoing and simultaneous deleveraging in the financial and non-financial sectors and of households, coupled with fiscal retrenchment, in the near term puts pressure on internal demand and pushes up savings in the course of the adjustment process. In light of the size of the sector and the impact of new regulations, banks are currently deleveraging partly to meet the strengthened capital requirements. Government deleveraging strategies aim at ensuring fiscal sustainability. Already for a few years, non-financial corporations have been deleveraging, mainly by reducing domestic investments. The balance sheet of these companies has been showing a strengthening of the financial assets position in recent decades, mainly through

increases in the holding of shares and other equity (Graph 3.18).

In the medium to long term, the normalisation of the cyclical position of the economy, demographic changes, easing deleveraging pressure and dwindling stocks of natural gas are expected to lead to a significantly lower surplus on the current account. Given ongoing demographic changes, including ageing, pension funds are likely to see a trend towards larger net pay-outs, likely to result in a lower rate of asset accumulation. In view of the large share of international assets in the portfolios of Dutch pension funds, this is likely to reduce the current account surplus. From this perspective, the Dutch current account surplus is partly an attempt to increase welfare intertemporally through the operations of pension funds. Decreasing net exports of natural gas should also support an adjustment of the current account in the longer term.

All this notwithstanding, the Netherlands is very likely to maintain a sizeable current account surplus in the coming years. For a part this should help prepare for the demographic changes the country is currently undergoing. Moreover, the fact that households are actively reducing their gross debt position is a welcome development. Direct macro-financial stability risks are unlikely to result from the surplus.

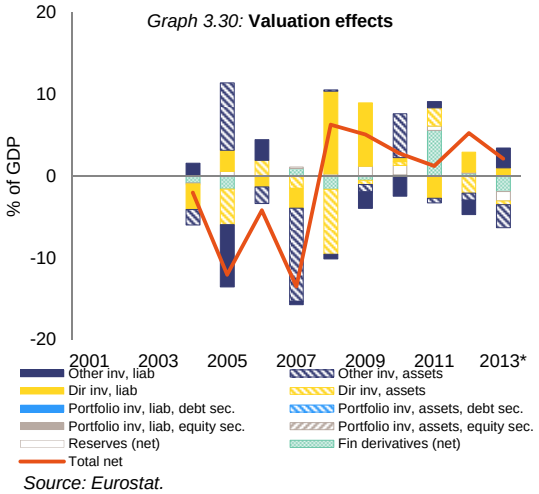
Adjustments in institutional determinants of savings and expenditure could support a reduction in the structural part of the surplus. For instance, mobilising savings could support spending. Improving the scope for wage differentiation may be another option. While overall labour costs do not appear to have been out of line with fundamentals and did not seem to have led to a marked change in the overall competitiveness of the Dutch economy, a higher degree of wage differentiation could help reduce the corporate savings surplus and support human capital formation and to some extent also improve the purchasing power of households. To the extent that institutional changes may help to reallocate capital to more dynamic sectors, this could also improve the growth potential of the Dutch economy.

Net International Investment Position

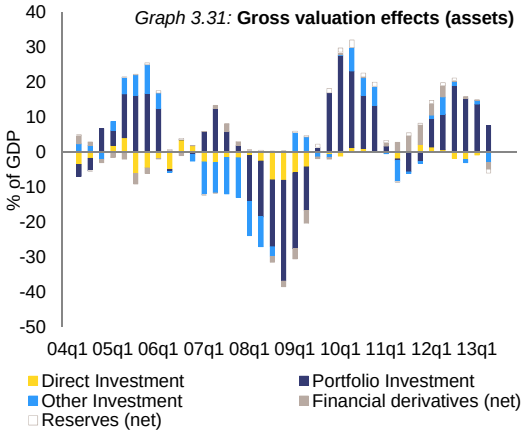
Despite persistent current account surpluses, the Dutch net international investment position (NIIP) has for a long time remained relatively weak, also due to valuation effects. The development of the NIIP is strongly influenced by the structure of the portfolio structure. The Netherlands has a strongly positive net position in direct investments and a strongly negative position in portfolio investments/ debt securities. The valuations of these types of assets have a different sensitivity to the cycle and they have also moved in different directions since the onset of the crisis, on balance resulting in an additional strengthening of the NIIP in the recent years over and above the external surpluses generated.

Swings in asset prices influence the valuation of both assets and liabilities (see Graphs 3.30, 3.31 and 3.32). The impact of valuation effects has become increasingly important because the gross stocks of assets and liabilities have been increasing relative to GDP in the last decades. Outward foreign direct investments in particular seem to show stronger negative valuation effects than inward direct investments.

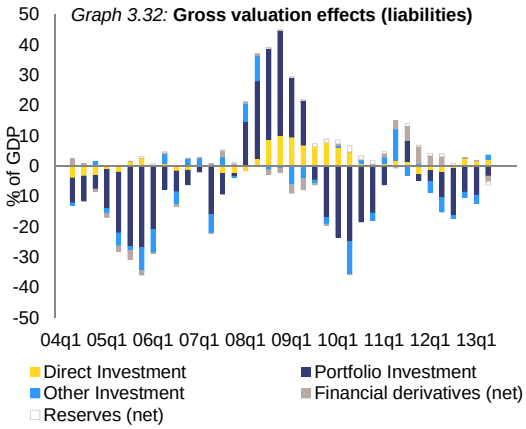
Graph 3.30: **Valuation effects**



Source: Eurostat.



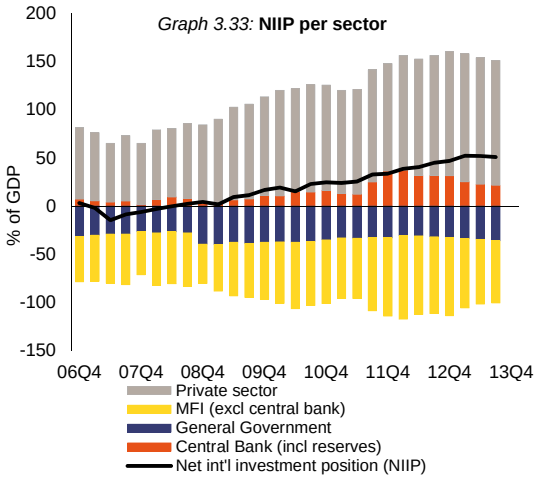
Source: Eurostat.



Source: Eurostat.

The apparent high net stock of international direct investments is partly the result of intra-company tax optimisation. The engagement of firms in international direct investments is offset by a negative net position of other forms of investment (e.g. portfolio investments). Domestic equity and bonds are owned to a large degree by international investors.

The NIIP across sectors is very diverse (Graph 3.33). The internationally-oriented banking sector has a strongly negative NIIP, reflecting the international orientation of its balance sheet. The Dutch central bank on the other hand has been involved in operations supporting the functioning of financial markets and as a result has built up assets, positively contributing to the international asset position. With a debt stock that has increased substantially in the last years, the general government adds negatively to the NIIP. The domestic private sector has a strong and increasing positive net international asset position, chiefly on account of strong balance sheets of households, while non-financial corporations have a negative NIIP.



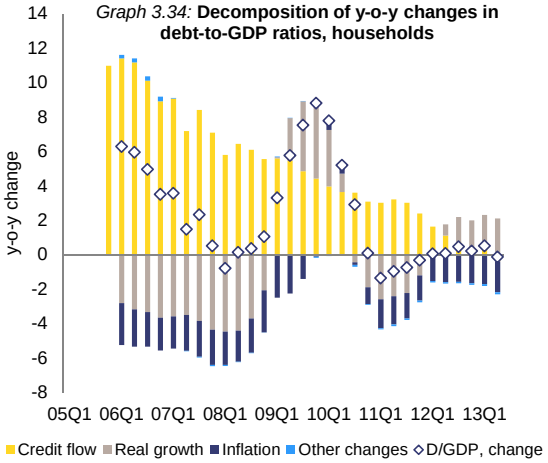
Source: Eurostat.

The pension system has resulted in a strong net asset position of Dutch households and influences financial flows and the external balance. As mentioned above, pension assets currently amount to almost 150% of GDP. As over 80% of these assets are invested abroad, significant international financial flows are the result. The institutional features that constitute the foundation of the current portfolio of international assets and liabilities are creating financial flows that also influence the current account.

3.2. HOUSING MARKET DEVELOPMENTS AND HOUSEHOLD DEBT

The total mortgage debt of Dutch households is high. However, since 2012 leverage ratios have started to decrease slightly, despite economic contraction. This is due to a decrease in nominal household debt, partly due to increased repayment of mortgages. As economic growth is expected to turn positive from 2014 onwards, a more marked decline in the household debt ratio can be expected.

Graph 3.34: **Decomposition of y-o-y changes in debt-to-GDP ratios, households**



Source: Eurostat.

Several factors contributed to the build-up of household debt in the past decades. First, the incentive to take out higher loans in order to take full advantage of uncapped mortgage interest relief. Second, the rise of financial products to maximise the fiscal benefits. Banks designed instruments to allow borrowers to benefit to the maximum extent from mortgage interest deductibility such as bullet-type mortgage loans which kept deductible interest high until maturity. This allowed borrowers to postpone paying off the principal until the loan matured. The importance of interest-only mortgages and the like soared in the 1990s. Third, the relaxation of lending standards. In the course of the 1990s in particular, banks started taking second incomes into account to assess borrowing capacity. In addition, high loan-to-value (LTV) ratios in excess of 100% became possible. In 2010 the vast majority (92%) of outstanding mortgages thus consisted of non-amortising loans. Fourth, rigidities in housing supply, partly linked to spatial and zoning regulations. Fifth, the existence of the National Mortgage Guarantee (NHG) acting as a further incentive for households to maintain high mortgage debt levels, as the risk of default is largely transferred to the guarantee scheme at a relatively low premium for the coverage. Moreover, the transfer of credit risk gave banks an incentive to apply relatively relaxed acceptance criteria within the NHG for (the part of) mortgages up to the threshold. The lower capital requirements for NHG-backed loans further reduced the funding costs for banks. Lastly, the prolonged uptrend in house prices and mortgage debt between the mid-1980s and 2008 also reflected a combination of changing household behaviour patterns, increased participation rates in the labour market, and changes in financing conditions – notably increases in affordability due to lower interest rates.

An adjustment in the housing market is underway. This is partly the result of policy measures (see box 3.1). House prices have been falling since end 2008. By the end of 2013, nominal house prices have fallen from their peak reached in August 2008 by some 20%. In the purchase segment transactions appear to have bottomed out in the course of 2013, with a muted increase in the number of transactions evident in the latter part of the year. Overall, house prices stabilised in 2013, even though in some parts of the country, in particular urban areas in the west, the recovery seems to have started.

Table 3.1:

Housing and Mortgage Markets: Main Indicators

Variable	Time	2009	2010	2011	2012	2012		2013		
	Transformation					Q3	Q4	Q1	Q2	Q3
Nominal house price index	Index (2010=1	101.5	100.0	98.1	91.6	89.3	90.0	87.6	85.8	86.3
	Annual/yoy %	-4.4	-1.5	-1.9	-6.7	-8.9	-6.4	-7.0	-7.5	-3.3
Relative house prices	Index (2010=1	103.0	100.0	95.8	87.4	85.6	85.3	81.3	79.8	80.5
(consumption deflated)	Annual/yoy %	-3.9	-3.0	-4.2	-8.7	-10.8	-9.1	-9.8	-10.0	-5.9
Credit flows (NCO)*	Households	4.4	3.1	2.4	0.4	0.5	-0.4	-0.1	-0.5	.
(% of GDP)	Firms	1.9	-0.4	-1.1	-0.6	-1.4	.	1.3	0.2	.
Outstanding debt (NCO)*	Households	127.9	128.0	127.7	127.9	128.3	127.9	127.0	126.5	.
(% of GDP)	Firms	96.7	96.6	94.7	94.9	93.6	93.3	94.0	93.8	.
Building permits	Index (2005=1	119.2	100.2	91.5	61.3	67.3	66.9	36.3	42.2	39.3
	Annual/yoy %	-16.7	-15.9	-8.7	-33.0	-21.4	-36.2	-30.7	-27.8	-41.6
Residential Investment	Index (2005=1	105.5	91.5	91.1	80.2	79.2	75.8	72.6	70.9	71.4
	Annual/yoy %	-12.5	-13.2	-0.5	-11.9	-9.1	-12.7	-13.9	-13.1	-9.8

* Excludes derivatives.

Household mortgage debt ratios appear to have peaked. Due to falling house prices and lower transaction volumes, the growth in mortgage lending flattened in the wake of the crisis and turned negative from the third quarter of 2012 onwards. This reflects a number of developments. On the one hand, the size of total mortgage debt continued to rise (Graph 3.35) even as the housing market turned. Due to past price increases many first-time buyers still need to take out a higher loans than those repaid by previous cohorts. Also the amount of repayments on existing mortgage loans is rising. Furthermore, trends in interest rates provided an incentive for some to refinance housing loans. On the other hand, households' borrowing capacity has been put under pressure, due to weak disposable income and adverse labour market prospects. Also, there is evidence that the lending policies of banks have become more restrictive since the crisis, partly since market funding has become significantly more expensive for banks. In addition, other measures have been

Box 3.1: Housing market-related measures

New mortgage loans (i.e. those initiated for a dwelling purchased in 2013 and beyond) must take an annuity or linear form in order for mortgage interest to be deductible and also to qualify for a NHG guarantee. In other words interest can only be tax-deducted for mortgages amortised over a maximum of 30 years.

Moreover, from 2014 onwards, the maximum deduction rate of 52% (for the highest income tax bracket) will fall to 38% in steps of half a percentage point per year (over 28 years). This reform will be applicable to new as well as existing mortgage loans (those with mortgages secured on a dwelling purchased before 1 January 2013).

Some additional small measures have been taken to cushion the near-term impact:

More funding will be made available for providing loans to first-time buyers. The Housing Stimulation Fund Dutch municipalities (SVn) will receive additional funding of EUR 50 million. Banks will be given more room to take future income growth of customers into account and the property transfer tax has been lowered permanently to 2%.

There is also new approach concerning residual debt from the sale of a former property: from 2014 onwards, the interest payment of residual debt will become fiscally deductible for a maximum of 5 years (under certain conditions).

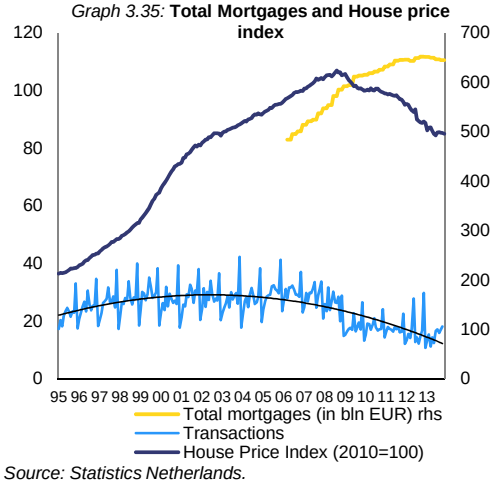
In parallel to changes in the purchase segment, measures in the rental market were announced:

For tenants in the social housing sector, maximum rent increases will become income-dependent. Tenants with a household income of less than EUR 33614 have to pay up to 1.5 pp above the inflation rate. For tenants with and income between EUR 33614 and EUR 43000 the difference to inflation will be 2 pp, and those with incomes above EUR 43000 face extra rent increases up to 4 pp above inflation. Landlords will be allowed to differentiate the rent increases among their properties, while tenants experiencing income decreases can obtain rent decreases, and lower-income households are partly compensated with higher rent subsidies.

Social housing corporations should focus more on their prime task of constructing and managing social housing and will be more closely controlled by municipalities. The additional rental income of corporations resulting from the rent increases will be skimmed by a landlord levy, amounting to EUR 50 million in 2013, rising to EUR 1.7 billion by 2017 (0.3% of GDP). The adjustment of the remuneration of directors of housing corporations is accelerated through a law on normalisation of top incomes. Rules for selling part of the social housing corporations' property will be loosened.

taken to moderate mortgage lending, such as the Code of Conduct for mortgage financing (GHF) and a stricter interpretation of the former code. Finally, maximum LTV values are being lowered.

Graph 3.35: **Total Mortgages and House price index**



Source: Statistics Netherlands.

The Dutch government has enacted various legislations that are reshaping the Dutch mortgage market substantially. Since April 2012 various policy initiatives have been enacted, mostly affecting the purchase segment. The most important recent legislative change relates to the eligibility for mortgage interest deductibility (or MID). New mortgages initiated from 2013 onwards must take an annuity or linear form in order for interest to be tax deductible and to qualify for an NHG guarantee. Also, interest can only be deducted for mortgages amortised over a maximum of 30 years. The former adjustment in the fiscal treatment of mortgages eliminates the tax incentives to take out non-amortising mortgage loans which virtually completely disappeared from the market. Since interest payments automatically decline over time in amortising structures, the absolute size of the associated tax advantage will also decline. Limiting the mortgage interest tax relief to bring it in line with full annuity repayment does not fully remove distortions in housing taxation, but it does reduce them. It may also gradually reduce fiscal deductions and relieve the Dutch banking sector's dependency on market funding, thus reducing the vulnerability and leverage of both Dutch households and banks.

The phasing in of the limitation of mortgage interest deductibility is in effect strongly back-loaded due to the gradual phase-in for existing mortgages. The possibility to grandfather full mortgage interest deductibility for existing loans when refinancing or moving home implies a substantial back-loading of the actual impact on the existing stock of mortgages. Therefore, given the size of the outstanding stock of existing mortgages (which for the majority consists of interest-only loans in various guises) the measures will only gradually reduce interest deductions. On the other hand, the incentive to repay mortgages has clearly increased.

Since the full effect will be phased in only very gradually, the current plans imply a difference in the fiscal treatment between new and existing mortgages. The latter will face a more favourable treatment, partly due to grandfathering provisions. Indeed, the old tax regime is portable until a maximum of 30 years after taking out the original mortgage loan, even in the case of refinancing.

A further aspect of the change in the tax treatment of housing finance relates to the gradual reduction in the deductible rate from 52% to 38%. From 2014 onwards, the maximum deduction rate of 52% (for the highest income tax bracket) will fall to 38% in steps of half a percentage point per year. This reform will be applicable to new as well as existing mortgage loans, but the impact will only be felt very gradually because of slow phasing in and grandfathering clauses which allow tax advantages to persist on refinancing or relocation of an existing housing loan. So the current plan to phase in this measure over a period of 28 years is unlikely to have a significant impact on amortising behaviour in the near term. For the first 20 years only those with taxable income in the highest income tax bracket of 52% will be affected, while as a result of the gradual reduction of the general tax credit, taxpayers in the 42% tax bracket will get an effective deduction rate of 44% in 2014. Of course the signalling impact of the changes may well be greater.

First-time home buyers bear the brunt of more restrictive bank lending conditions, including the stepwise reduction over five years in the maximum loan-to-value (LTV) ratio to 100%. Reducing the maximum LTV ratio translates into a limitation of the borrowing capacity of more liquidity-constrained home buyers and thus

accentuates further the existing slump in the housing market, due to the interaction with restrictions on mortgage interest deductibility for new housing loans. On the other hand, lower house prices and interest rates have a positive effect on the affordability of housing, in particular of first-time home buyers.

The adjustment in the housing market, coupled with policy initiatives, brought deleveraging pressures to the fore and have increased vulnerabilities among homeowners. Declining house prices have led to a deterioration in the net wealth position of Dutch households, and even pushed a substantial number of households into negative equity. The impact is differential across age groups, with especially young first-time buyers finding themselves with negative equity.

The adjustment in the housing market has revealed bottlenecks in the funding model of banks. With mortgage loans forming a substantial part of Dutch bank balance sheets (almost 30%), associated credit risk has come under attention. With falling house prices default risk increased, even if the default rate still is quite low, certainly by international standards. Moreover, with Dutch banks heavily reliant on wholesale funding and securitisation in the run-up to the crisis a 'deposit financing gap' opened up.

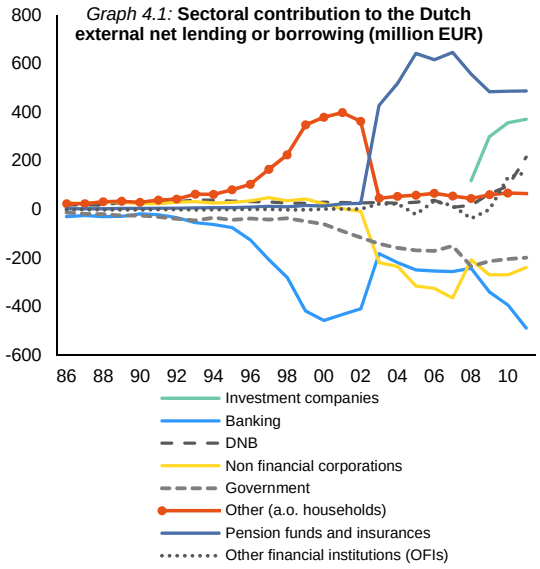
Furthermore, there is indirect fiscal risk through guarantees. Such risks explicitly apply to the National Mortgage Guarantee (NHG), via the safety-net role that the government plays in the Homeownership Guarantee Fund (WEW). Through this fund, the government acts as a second-tier guarantor for over EUR 140 billion worth (around 24% of GDP) of mortgages. However, the WEW only has EUR 730 million of capital to absorb direct losses. In the event of a serious stress scenario, the government may have to step in.

4. SPECIFIC TOPICS

An important characteristic of the Dutch economy is the extent to which substantial financing flows exist both between domestic sectors and with the rest of the world, translating into leveraged balance sheets across a number of dimensions. The particular financing structure of the Dutch economy reflects institutional factors, including the pension system, the existence of a highly developed financial sector (with large banks, large pension and insurance funds, but also large "special financial institutions"), fiscal arrangements and incentives, as well as a high degree of international integration (with an important role for large multi-national companies and cross-border financial institutions). Owing to its geographical location, historical ties, and a traditionally strong competitive position and institutional setting, the Netherlands has become a hub for international trade and capital flows.

With reference to indicators in the MIP scoreboard on the current account and private debt, the determinants of balance sheet positions are of particular interest for the assessment of potential imbalances. Moreover, across sectors the crisis instilled strong adjustment dynamics associated with the respective balance sheet positions and financing dynamics, revealing some particular risks or vulnerabilities. These are the focus of this chapter, with some special reference to the central role the household sector plays in determining the accumulation of private debt and wealth. In the Netherlands, persistent current account surpluses have gone hand in hand with the accumulation of significant external assets in the private sector, in particular by pension funds and insurance companies, followed by investment companies and 'other financial institutions'([18]). This is reflected in the sectoral contributions to external net lending (Graph 4.1)([19]). Pension funds account for substantial holdings of foreign assets. Households' leveraged balance sheets are reflected in modest net savings, apart from pensions. By contrast, the strong international linkages of the banking and non-financial corporate sectors are mirrored in a net borrowing position vis-à-vis the rest of the world.

Graph 4.1: **Sectoral contribution to the Dutch external net lending or borrowing (million EUR)**



Source: De Nederlandsche Bank.

The Netherlands has accumulated a large amount of pension wealth of approximately 165% of GDP, the bulk of which is invested outside the Netherlands.([20]) In the wake of the global financial crisis the net returns of these institutional investors have been disappointing and their buffers significantly decreased since 2008. Solvency requirements in pension funds required higher pension premia, lower pension pay-outs or a combination of the two. These, in combination with negative wealth effects from the housing market, weighed on consumer confidence and private consumption.

Along with substantial pension savings, Dutch households for a long time considered it attractive to finance a home with a relatively large debt, often not repayable until maturity. This in turn, confronted the banks with funding mismatches, thereby increasing vulnerability to developments in the financial markets and also increasing the volatility of lending in the Netherlands.

The crisis revealed the vulnerability of the funding model of banks. The combination of securitised funding drying up as a source of funding, changes in the debt-to-asset position of

([18]) Including a.o. investment funds, financial holding companies, special purpose vehicles (SPVs) and special financial institutions (SFIs).

([19]) The data on pension funds were included into the 'other/households' category until 2002; from 2003 on they are registered apart in a 'pension funds and insurances' category, explaining the break in continuity between 2002 and 2003.

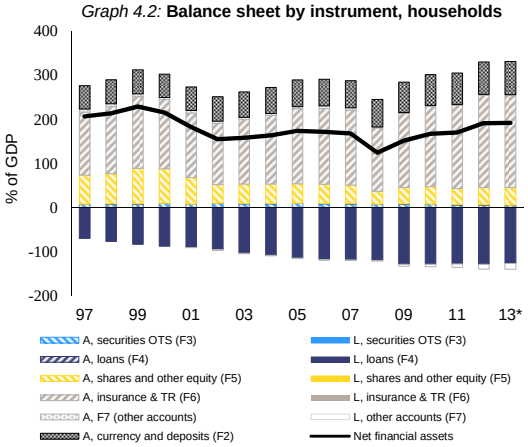
([20]) De Nederlandsche Bank (2013a).

Dutch households, and (expected) changes in regulation and fiscal incentives have highlighted the exposure of banks to longer-term mismatches on their balance sheets. This resulted in deposit funding gaps, also reflecting the relatively high level of external leverage in the banking sector. With the domestic banking system highly exposed to real estate, needing to rely less on wholesale funding, and needing to fulfil changing regulatory requirements, the adjustment of bank balance sheets is underway.

4.1. HOUSEHOLD DEBT

Household debt reached an all-time high of 128.5% of GDP, or 266% of disposable income, in 2010 (Graph 4.2). Mortgage debt accounts for the largest part of household debt. The rise in house prices and residential mortgage debt has lengthened households' balance sheets in the run-up to the crisis, increasing the sensitivity to valuation changes.

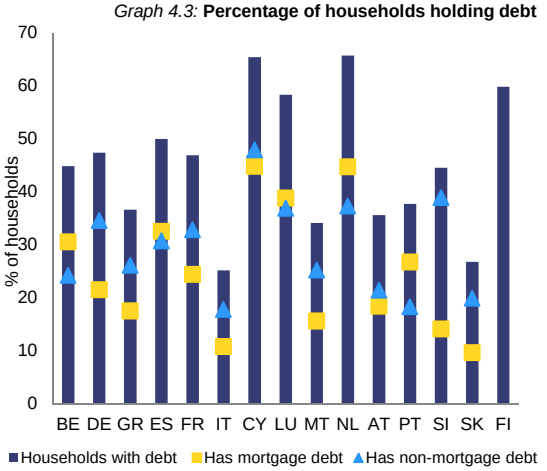
Graph 4.2: **Balance sheet by instrument, households**



Source: Eurostat.
*Note: * indicates estimated figure using quarterly data.*

The percentage of households holding debt is high in the Netherlands, at 65.7%. Of All households, 44.7% have mortgage debt, while 37% have non-mortgage debt (Graph 4.3).

Graph 4.3: **Percentage of households holding debt**

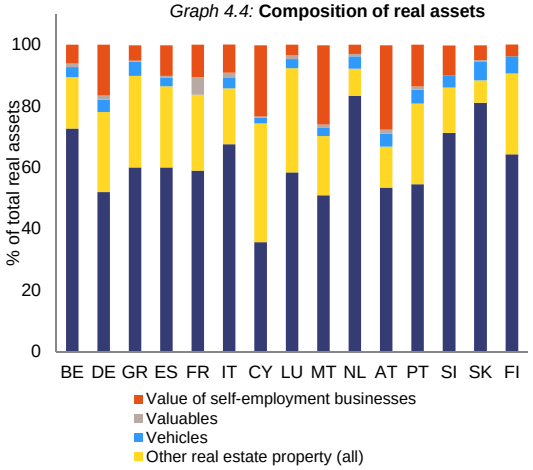


Source: Eurosystem Household Finance and Consumption Survey

From a balance sheet perspective, the strong overall wealth position of Dutch households mitigates risks. Much of the build-up in mortgage debt has been mirrored by even steeper increases in total household wealth. Households have capitalised on rising house prices in the expansionary phase: the total value of the owner-occupied housing stock was estimated at some 192% of GDP in 2011.([21]) The share of housing in total household wealth rose from 31% in 1993 to 39% in 2011. The recent fall in house prices obviously led to a deterioration in the market value of housing and a shift in the asset composition. For several households this led to a negative net equity position (see below), with a strong differentiation between age groups. Apart from home ownership, which has become the most important real asset in household portfolios (Graph 4.4), pension wealth constitutes the principal financial asset, reflecting the large holdings of second pillar pension assets. In this respect, the Netherlands differs considerably from most other countries (Graph 4.5). In 2011, gross financial assets of households roughly equalled 300% of GDP.

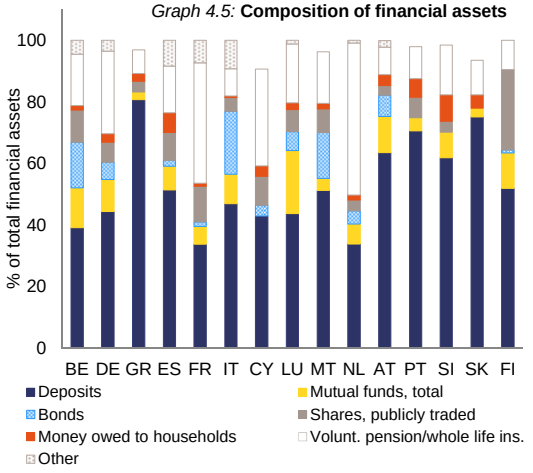
([21]) Also important are holdings in insurance companies and retirement savings in pension funds of EUR 1117 billion in 2011. Other financial assets include deposits in banks and savings accounts (EUR 332 billion in 2011). Households also possess bonds and equities to the tune of EUR 200 billion. Total household assets (including housing, financial and other assets, but not holdings in insurance companies and pension funds) reached EUR 1952 billion in 2011, or 324% of GDP (including pension funds: EUR 3068 billion or 510% of GDP) – Statistics Netherlands.

Graph 4.4: **Composition of real assets**



Source: Eurosystem Household Finance and Consumption Survey.

Graph 4.5: **Composition of financial assets**

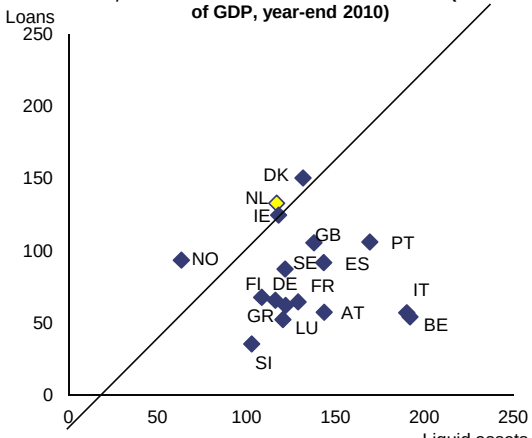


Source: Eurosystem Household Finance and Consumption Survey.

Moreover, Dutch households have a relatively low ratio of risky to non-risky assets, thanks to relatively high currency and deposits positions, and relatively low asset positions in shares and other equity.

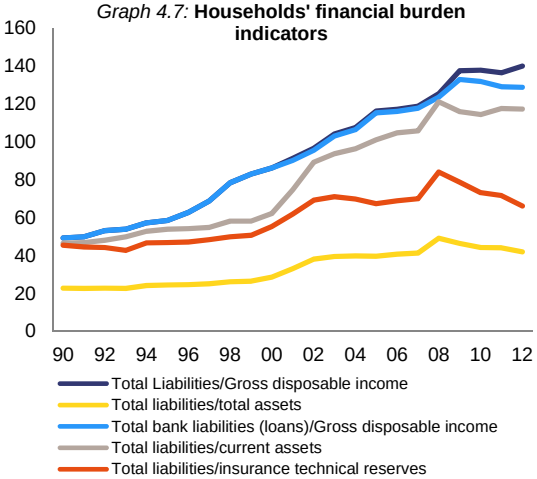
Nevertheless, the liquid assets buffer for absorbing direct income or asset shocks of Dutch households is relatively modest (Graph 4.6)([22]). Home-owning households usually have invested a large fraction of their wealth in real estate, which is relatively illiquid and non-diversifiable. Potential problems with debt servicing are therefore harder to mitigate by selling liquid assets. Pension fund and life insurance assets are tied up and not marketable without significant penalty, also in view of their fiscal treatment. Still, relatively few households face acute financial problems, in view of rising unemployment and a relatively steep 20.3% fall in house prices from the peak in 2008. Even so, household balance sheets are now arguably more vulnerable than during earlier recessions (Graph 4.7).

Graph 4.6: **Financial assets of households (in % of GDP, year-end 2010)**



Source: Eurostat.

Graph 4.7: **Households' financial burden indicators**



Source: Eurostat.

Negative equity

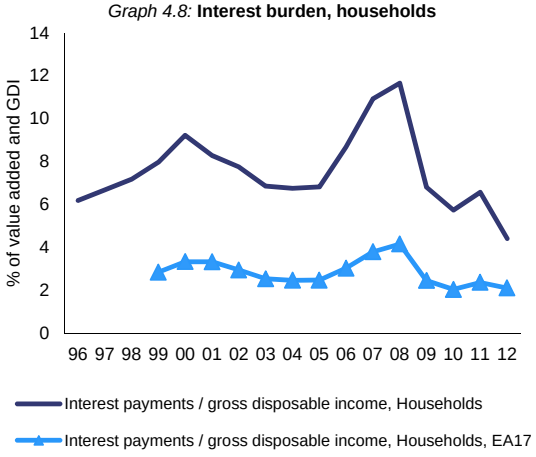
In recent years, low or even negative returns on pension assets and declining house prices have led to a deterioration in the net wealth position of Dutch households. This trend affected homeowners in differential ways, owing to the

([22]) If the value of the both owner-occupied housing stock and holdings in insurance companies and pension funds is excluded, households have a liquid assets position (including currency and deposits, shares and other equity, and securities) of 117% of GDP in 2011.

differences in starting positions. Homeowners who bought their dwellings long ago accumulated considerable home equity. On the other hand, given the fall in house prices since 2008, a number of first-time buyers, concentrated in the 25-35 age group, have not yet realised any excess value on their housing purchase, and now face a negative home equity position. It is estimated that for around 25-30% of housing loans -the equivalent of 1.3 million mortgages- the market value of the house is currently below that of the outstanding mortgage debt([23]). The incidence of decreasing house prices leading to negative equity reflects the fact that LTV ratios well above 100 were the norm.

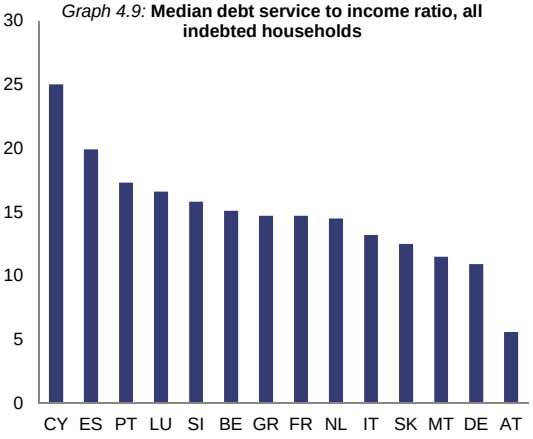
Even without further falls in house prices, rising interest rates would negatively impact disposable income. As real and nominal interest rates have declined, the rise in household indebtedness has been associated with relatively limited increases in the debt service burden. A trend decline in mortgage rates has made it possible for households to service a growing debt stock without allocating a larger share of their budgets to debt servicing, from 2000 to 2005. However, total interest expenditure as a share of disposable income did rise fairly sharply from 2005 onwards (Graph 4.8). Still, according to ECB survey results, vis-à-vis other EU countries, the Netherlands still occupies a median position in terms of debt service to income ratio (Graph 4.9).

Graph 4.8: **Interest burden, households**



Source: Eurostat.

Graph 4.9: **Median debt service to income ratio, all indebted households**

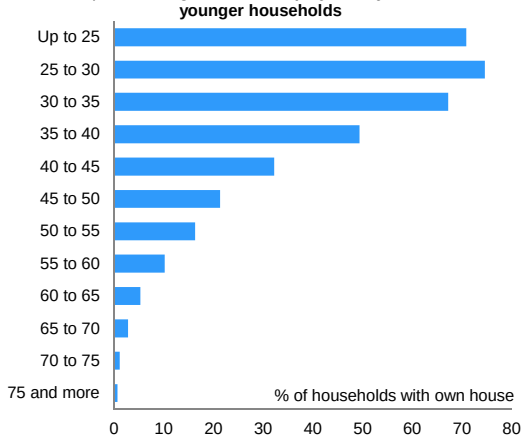


Source: ECB Household Finance and Consumption Survey (carried out in late 2010/early 2011).

The group of younger first-time buyers mostly account for households with negative net equity (Graph 4.10). They have taken out high mortgages relative to their income, savings and the value of their home, which declined in the aftermath of the crisis. Young people also spend a higher percentage of their gross income on interest charges (Graph 4.11). These factors expose them to heightened risks, stemming in particular from unemployment.

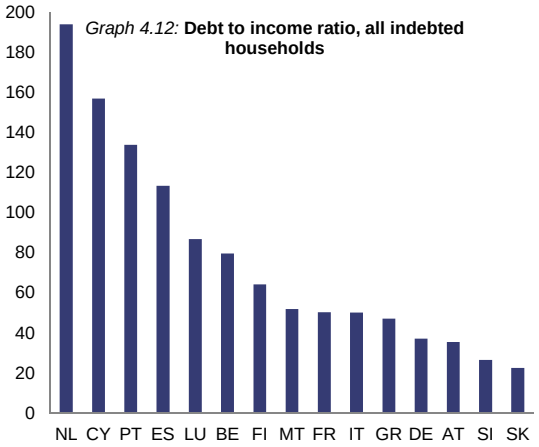
([23]) In order to partly address this issue, from 2014 onwards the interest payment on residual debt will still be tax deductible for a maximum of 5 years (up to 10 years for residual debt originating between 29 October 2012 and 31 December 2017). Nevertheless, actual costs for these homeowners will still rise substantially if they sell their properties, as banks will require the remaining debt to be reimbursed over a period of 10 years. Moreover, although these measures may contribute to an orderly adjustment of the housing market in the medium run, their short-term stimulus effect is far less certain.

Graph 4.10: **Negative home equity mainly found in younger households**



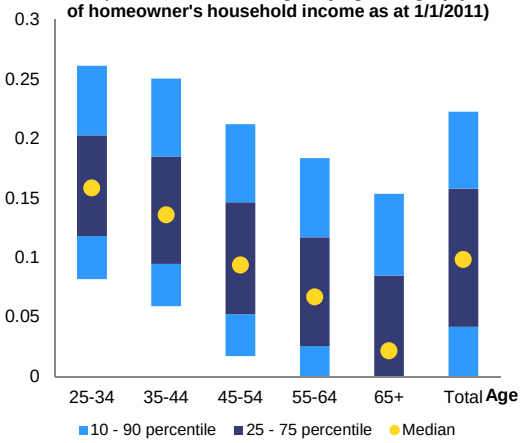
Source: Statistics Netherlands.

Graph 4.12: **Debt to income ratio, all indebted households**



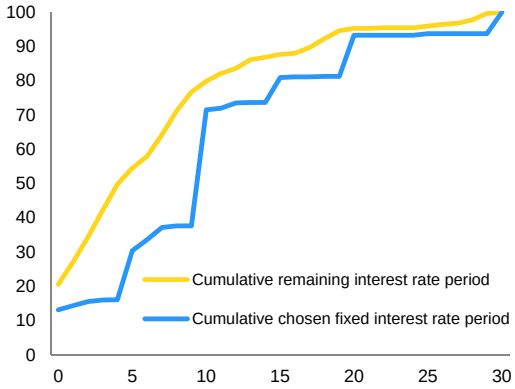
Source: *ECB Household Finance and Consumption Survey (carried out in late 2010/early 2011).*

Graph 4.11: **Interest charges by age category (% of homeowner's household income as at 1/1/2011)**



Source: De Nederlandsche Bank.

Graph 4.13: **Cumulative distribution of fixed interest rate period and remaining fixed interest rate term in years (% of total number mortgages)**



Source: DNB Household Survey 2008.

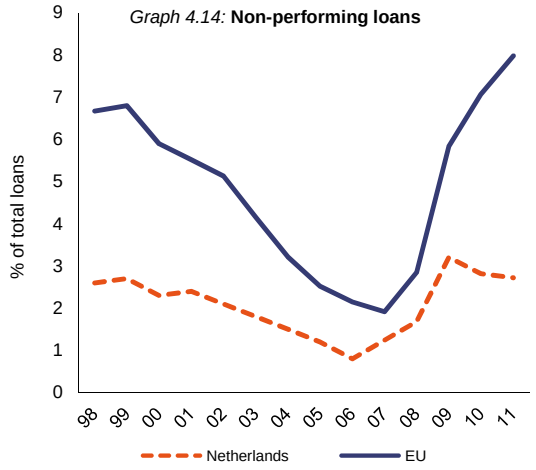
Compared to other EU countries, many households spend a high proportion of their income on mortgage commitments (Graph 4.12). On the other hand, households are accelerating their mortgage repayment schedule. According to a survey with the four largest mortgage lenders, homeowners significantly increased their mortgage repayments in 2013, compared to 2012. One bank received more than 60% extra repayments by end of October. Factors at play are the low interest rate on savings accounts, the uncertainty on the housing market and negative equity.

The current distribution of refinancing profiles still provides protection against the pass-through of increases in mortgage interest rates. In 2009, about half of all mortgages had a remaining fixed interest period of 4 years or less, while one-fifth had a remaining fixed interest period of less than one year (Graph 4.13). Looking further ahead, households in negative equity may not have sufficient buffer to repay their mortgage debt once the maximum interest relief period expires.

Repayments arrears have however remained very low by international standards so far. Similarly, the rate of household defaults on housing debt is still very much contained and much lower than the EU average (Graph 4.14). This is not only due to strong creditors' rights, but

also to the existence of an extensive social security system. Another important factor is the significant rise in house prices from the 1980s until 2008, which means the collateral value for older mortgage loans is mostly sufficient. Moreover, mortgage debt has mainly been incurred by those with higher incomes. A full 60% of all mortgages are held by the highest-earning fifth of households, whereas the lowest-earning fifth only hold about 3% of total debt. High-income earners usually face a lower risk of unemployment and income shocks and should thus be more able to take on debt. Problems concerning forced sales are therefore mostly the result of unexpected life events, such as long-term unemployment, disability, death, and most importantly divorce.

Graph 4.14: **Non-performing loans**



Source: Commission Services.

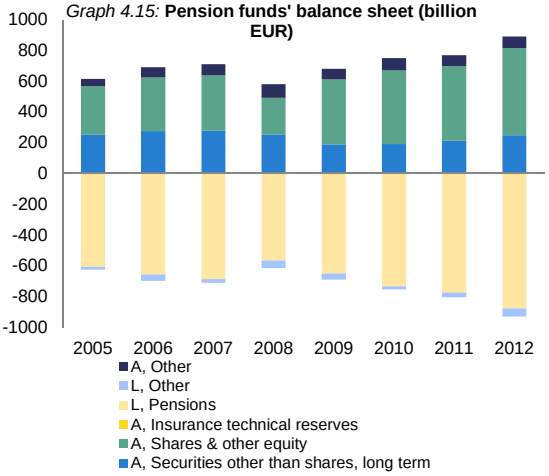
4.2. THE FINANCIAL SECTOR

The financial system comprises three main sectors—banking, pensions, and insurance. Banks, with assets equal to almost 400 percent of GDP, account for the largest part of the financial sector. Pension funds are the second most important subsector, with assets under management equal to approximately 150 percent of GDP. Although there are 545 registered pension schemes in the Netherlands, the two largest and ten largest funds manage 44 and 78 percent of scheme assets, respectively. The insurance sector holds assets of approximately 75 percent of GDP, with life insurance representing the bulk (89 percent) of this.

4.2.1. Pension funds and insurers

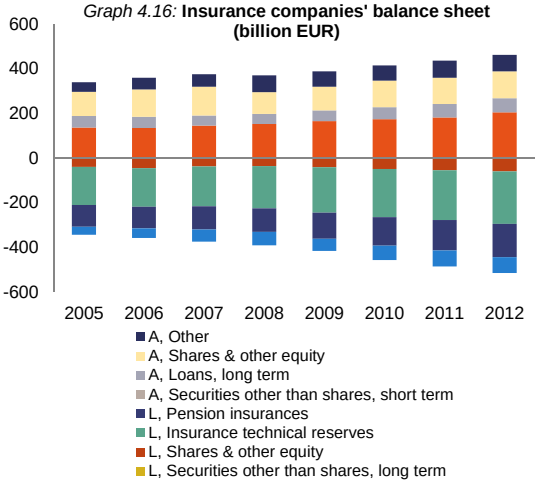
The Netherlands has a pension and insurance system, which is second only to the banking sector in size and potential systemic importance. Total assets of the Dutch pension and insurance sector amounted to almost EUR 1.350 billion (225% of GDP) in 2012 (Graphs 4.15 and 4.16). Only in France and Germany is the pension and insurance sector larger than the Netherlands.

Graph 4.15: **Pension funds' balance sheet (billion EUR)**



Source: Statistics Netherlands.

Graph 4.16: **Insurance companies' balance sheet (billion EUR)**



Source: Statistics Netherlands.

Over the past seven years, the liabilities of Dutch pension funds have grown more than twice as fast as their assets. Consequently the coverage ratios of the assets of funds to pension commitments fell from 130% to around 100% on average at end-2010, below the 105% minimum

required by the regulator.([24]) The coverage ratio of several funds dropped even below the required value.

This fall in coverage ratios is due to a combination of rising life expectancy, falling interest rates and low investment returns in the wake of the crisis. Dutch pension funds have an internationally diversified portfolio. The financial crisis resulted in a combination of falls in equity prices and low interest rates which proved to have very adverse effects on coverage ratios, given the size of the shock. Pension funds have been attempting to restore their coverage ratios through a combination of contribution increases, adjusted indexation, and, as a last resort, renegotiations or unilateral adjustment of existing arrangements leading to a decrease in pension pay-outs. Overall, this has led to a pro-cyclical burden on the disposable income of households, one of the factors accounting for sluggish private consumption in the Netherlands in recent years. The issue of long-term sustainability of the current Dutch pension system, with its guaranteed benefits, has been brought to the fore at a relatively early stage because of the high level of transparency in accounting and disclosure practices.

Several changes were introduced in the September 2013 "pension package" to ensure sustainability and mitigate the pro-cyclicality of the pension system. First, the introduction of a so-called ultimate forward rate (UFR), allowing for a more stable yield curve used for accounting over long maturities. This yielded a more stable valuation of future commitments. Second, more flexibility for pension funds to gradually adjust pension contributions in response to coverage ratios falling under the statutory minimum. The third measure concerns the ability to spread any reductions in pension entitlements over time and to limit them to a decrease of no more than 7% per year in 2013 and 2014. The pension package entailed further measures, including providing for a faster increase in the statutory retirement age to 67, the automatic inclusion of any further life expectancy increases in the calculation of existing pension entitlements, and deferral of indexation until the coverage ratio of a pension fund has reached at least 110%.

A protracted period of low long-term interest rates could negatively affect pension funds and insurance companies on both the asset and the liability sides of their balance sheet. Defined benefit pension funds and life insurers have a long funded balance sheet structure, and, unless they are hedged, a negative duration gap (the duration of liabilities typically exceeding the duration of assets). The extent of the associated reinvestment risk depends on the extent of the duration mismatch. The longer the maturity of the liabilities the larger any negative impact of protracted low interest rates on defined benefit pension funds and insurers. The commitment of these institutions to policyholders and members are often very long-lasting and therefore quickly rise in value when interest rates fall. The investments held against these long-term, interest-rate-sensitive liabilities often have a shorter term to maturity and therefore tend to rise less. Such effects become immediately visible as balance sheets are valued at market value. In recent years, life insurance companies have significantly reduced their exposure to equity and real estate markets, but remain sensitive to interest rate risk.

The exact impact of duration gaps on net pension and insurance obligations depends on the asset and maturity mix. In general, pension funds have lower allocations to bonds, and higher allocations to equities, relative to life insurance companies. Insurers and pension funds have sought to increase the duration of their assets in order to reduce mismatches. Dutch pension funds are increasingly engaging in maturity-matching and interest-risk-hedging activities by increasing their allocation to low-risk long-term assets, such as government bonds, and by increasing the duration of their investment portfolios. These liability-driven investment strategies create potential further downward pressure on bond yields with possible implications for solvency ratios.

The issue of the sustainability of the current Dutch pension system, with its conditionally guaranteed benefits, has been brought to the

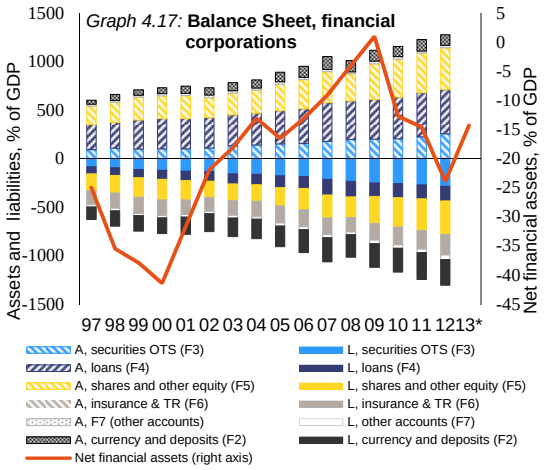
([24]) The Financial Assessment Framework, which is part of the new Pension Act for second pillar pension, sets out the statutory requirements. These include thresholds for the coverage ratio (i.e. the relationship between assets and liabilities) and equity buffers. The pension fund's investment results as well as the liabilities are valued at market price.

fore by the crisis, given the pro-cyclical feedbacks to the financial sector and the real economy. The relatively high level of transparency in accounting and disclosure practices also increased the profile of the issue in public debate. The pension agreement that the Dutch government reached with social partners offers a starting point for a modernised pension system. The agreement incorporates elements such as the linking of the retirement age to life expectancy, a focus on less pro-cyclicality, and increased transparency in terms of pension benefits and as regards the division of risks among stakeholders. Negotiations between social partners on the details of risk sharing and risk transfer in pension contracts are underway. The implications for intergenerational transfers and risk sharing warrant closer investigation. Reforms may also be pursued along other dimensions.

4.2.2. Banks

The Dutch banking sector is large from an EU perspective, with the total value of bank balance sheets equivalent to almost 5 times GDP, lower than the banking sector in the UK (650% of GDP), but much higher than that in France and Germany. Moreover, there is a high degree of concentration, with three major players (Rabobank, ABN Amro and ING). Dutch banks have a relatively large share of mortgage loans on their balance sheets (Graph 4.17).

Graph 4.17: **Balance Sheet, financial corporations**



Source: Eurostat.
*Note: * indicates estimated figure using quarterly data.*

Funding: the key challenge

The domestic Dutch banking sector faces a deposit funding gap reflecting the large size of mortgage portfolios relative to the domestic deposit base. Banks are lending approximately twice as much to Dutch households and businesses as they are receiving in the form of savings deposits. The current total funding gap of Dutch banks is estimated to amount to some 75% of GDP. This is larger than elsewhere in the EU, despite the national savings surplus.

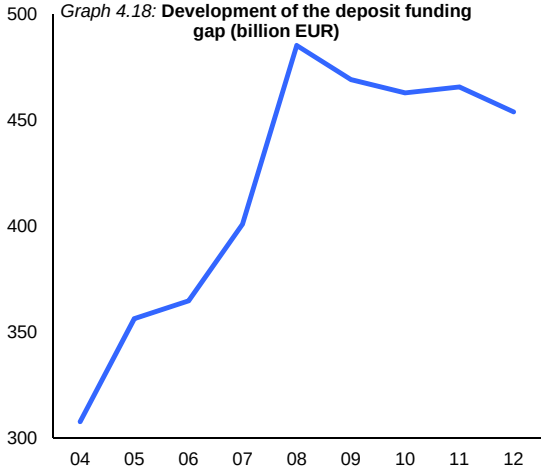
The loan-to-deposit (LTD) ratio rose to more than 200% before the crisis – high by international standards. In 2011 only Ireland had a higher ratio than the Netherlands within the euro area. In the predominantly bank-based European financial sector, institutional investors such as insurers and pension funds largely finance businesses and households in Europe indirectly by purchasing bank bonds.

The high level of mortgage debt is an important factor accounting for the size of the funding gap. Dutch banks hold relatively large domestic mortgage portfolios compared to other EU countries, amounting to around 90% of GDP, double the average in the euro area. In the ten years preceding the credit crisis, the Dutch LTD ratio rose from 161% to 205%. That period coincided with an ongoing, protracted rise in house prices, leading to a marked increase in mortgage debt. As pension capital is not accrued in banks but rather in pension funds this has limited domestic

funding sources. Moreover, consumers have traditionally used life insurers to save for the redemption of part of their mortgage principal. As in the expansionary phase new mortgage loans were generally much higher than expiring ones, which gradually disappeared from banks' balance sheets as they were repaid, the inherent dynamic tended to exacerbate the funding gap.

Since 2008, the funding gap has slightly decreased, along with a rise in deposits (Graph 4.18). The narrowing of the funding gap is the combined result of a slowdown in lending due to the economic downturn, a weak housing market and more restrictive credit policies. Furthermore, the introduction of bank savings products ("banksparen") has enabled banks to raise extra deposits since 2008 in a market that was previously the preserve of insurers.

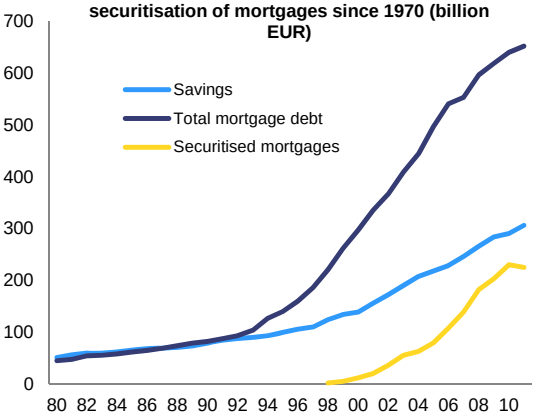
Graph 4.18: **Development of the deposit funding gap (billion EUR)**



Source: De Nederlandsche Bank.

The Dutch banking system remains relatively dependent on wholesale funding and savings from abroad. In the aftermath of the crisis, Dutch banks have been attempting to find alternatives to wholesale funding, securitisation in particular (Graph 4.19).([25]) Still, about two-thirds of the consolidated balance sheet of the Dutch banking system is funded in financial markets. Existing securitisations may overall be regarded as less creditworthy, reducing their value as collateral. The issuance of RMBS fell back after 2008 when it had reached EUR 49 billion.

Graph 4.19: **Savings, mortgage debt and securitisation of mortgages since 1970 (billion EUR)**



Source: Central Planning Bureau.

The fall in interest rates in recent years reduced funding costs. As interest rates are falling, the costs of raising finance tend to fall faster than the interest rates on existing loans, thus supporting profits. However, going forward a rise in interest rates could have an adverse impact on bank profitability via the existing bond and mortgage portfolio while only a part of the risk usually is hedged through interest rate derivatives. A rise in interest rates without economic recovery would pose a particular vulnerability through the associated rise in credit risk.

The dependence on market funding leaves Dutch banks vulnerable to developments in financial markets. The relatively high LTD ratio and the orientation towards housing finance are relevant in this regard. Mortgage financing is generally issued with long maturity. As financing via financial markets is geared towards short maturities, this leaves banks with higher refinancing risks compared to deposit funding.

Towards a better balance

Rebalancing the structure of funding could help reduce the deposit funding gap and mitigate deleveraging pressures. This rebalancing can take several forms and have broader ramifications for

([25]) Roughly one third of Dutch mortgages are bundled and issued as residential mortgage-backed securities (RMBS). Large institutional investors, such as pension funds, buy these RMBS as part of their investment portfolio. The 'packaging' of residential mortgage loans and other credits to be sold on to companies specially carried out to create financial manoeuvring room, are called 'special purpose vehicles' or SPVs. Dutch SPVs account for a rather high share (20% DNB, Statistical Bulletin June 2008) of European securitisations.

the sectoral distribution of asset holdings and financial flows between (sub)sectors. As regards the mortgage market, the prevailing system of public guarantees of mortgages through the NHG is complex and discourages international investors to buy Dutch securitisations. Also, individual banks can only securitise and sell their own mortgage portfolio, resulting in diseconomies of scale. An infrastructure that allows more standardisation and transparency of securitisations, increased bundling, and a different approach to guarantees could increase the willingness of foreign investors in particular to invest. Initiatives towards creating a National Mortgage Institute (see Box 4.1) could be seen as a step in this direction. With regard to the new rules on securitisations, since 2011, and following the introduction of Art. 122a in the Capital Requirements Directive II (CRD II), rules are in place to oblige the originator to retain at least 5% of the securitisations and to provide additional information about the portfolio at loan level and an obligation for investors to undertake adequate due diligence. Furthermore, progress with banking union could help increase the deposit base from which Dutch mortgages are funded e.g. by facilitating cross-border deposit taking.

A larger role for Dutch pension funds and insurers in the mortgage market could also help in rebalancing. Mortgages are long-term investments that generally carry a fixed interest rate, making them relatively suitable for covering long-term commitments, such as those of pension funds. Life insurers have already become more active on the Dutch mortgage market; their mortgage portfolio has grown by 28% over the last two years. To make it attractive for private Dutch pension funds to step in more, it will be important to ensure that adequate incentives to invest are in place in terms of the risk-return trade-off.

There may also be some scope for covered bonds to help improve the funding profile. However, in the near term the additional scope may be limited as the resulting asset encumbrance can affect the credit risk exposure of other lenders, including depositors. There is a trade-off between the security for holders of covered bonds and the implications for unsecured creditors. This balance depends, inter alia, on the extent to which banks pledge more assets as collateral than they receive in funding (overcollateralisation). Since the Dutch residential mortgage market is characterised by high loan-to-value ratios with traditionally a large share of interest-only mortgage loans, this overcollateralisation generally reaches more than 25% for Dutch covered bonds (a high margin in international perspective). Moreover, asset encumbrance also increases the interconnectedness and pro-cyclicality in the financial system. An adequate degree of overcollateralisation and transparency and adequate pricing of the encumbrance could impose discipline on banks, foster appropriate risk assessment by investors, and contribute to increased market confidence.

Ultimately, banks need to structure their balance sheets in such a way that domestic assets and liabilities are more in balance, with

Box 4.1: **The National Mortgage Institute**

In order to improve the availability and pricing of mortgage financing, the Dutch government is considering the creation of a National Mortgage Institute (*Nationale Hypotheek Instelling*, NHI), as part of a broader strategy to finance the Dutch housing market. The idea is to transfer guaranteed mortgages from banks to (inter)national institutional investors through "National Mortgage Bonds", issued by a National Mortgage Institute to be created. Currently, the mortgage portfolio of Dutch banks that falls under the national mortgage insurance scheme (NHG), ultimately guaranteed by the government, amounts to EUR 150 billion, around 25% of GDP. By bundling mortgages from different banks and simplifying the guarantee structure of the products, potential liquidity in the market of such securitised products could be improved. Depending on its size, the NHI could help reduce banks' balance sheets and their deposit funding gap, reduce mortgage interest rates and stimulate the housing market[1].

[1] This does not preclude any future ruling of the European Commission on the competition related aspects of this issue.

lower leverage and less maturity transformation. Banks have not yet sufficiently strengthened their capital position as provided for under Basel III. However, building up buffers to the required level is a lengthy process since the losses suffered must first be made good, which in the current bleak and uncertain level of economic growth is an obstacle to profitability. A worrying development is that the initially rapid strengthening of capital ratios in 2008 and 2009 is now levelling off. There was actually a slight decline in banks' solvency last year. Banks need to improve their liquidity position as well. In this context, Basel III sets standards both for short-term liquidity and for longer-term funding. The challenges for the Dutch banking industry lie mainly in the latter area. Despite their high risk-weighted capital ratio, Dutch banks continue to have relatively high leverage form an international perspective. Due to the lowering of this leverage by shrinking the balance sheet, however, credit to households and businesses has been under pressure. Finally, banks need to be sufficiently transparent about exposures on the asset side of their balance sheets.

All in all, efforts to improve the funding of banks, coupled with efforts to reduce vulnerabilities in household balance sheets, and broader initiative to mobilise 'locked up' capital in other parts of the economy, may have an important bearing on the development of intersectoral balance sheet positions and financing flows. This may help mitigate potential imbalances in the Dutch economy and reduce the vulnerability to financial and cyclical shocks. However, any rebalancing will take time.

5. POLICY CHALLENGES

The analysis in this IDR indicates that macroeconomic developments regarding private sector debt and deleveraging pressures, coupled with remaining inefficiencies in the housing market, continue to be a challenge in the Netherlands. It is worth recalling that a relevant policy recommendation on the housing market was already part of the country-specific recommendations issued to the Netherlands in 2012 and 2013. The full assessment of progress in the implementation of this recommendation will take place in the context of the assessment of the Dutch National Reform Programme and Stability Programme under the 2014 European Semester. While the large current account surplus does not raise immediate stability risks, the development of the current account also deserves attention. The surplus mirrors cyclical influences, but it also appears to reflect more deeply embedded structural issues, for instance as regards the determinants of cross-sectoral financing and savings-investment patterns and the functioning of labour market institutions.

Several avenues could be envisaged to address the challenges identified in this IDR.

The Netherlands has to a large extent been tapping financial flows from abroad in an original, yet potentially risky way which could merit reorientation. Dutch household savings primarily end up with pension funds and insurance vehicles, which channel the bulk of these savings abroad. In recent years the net returns of these institutional investors have been disappointing and their buffers to be able to cope with financial setbacks have significantly decreased since 2008. Along with large pension savings, Dutch households took on substantial gross housing debt, in turn shaping the funding patterns of the financial sector. At the same time, profits received from foreign affiliates have spurred registered non-financial corporation's savings, creating a net savings surplus. Owing to its geographical location, historical ties, a traditionally strong competitive position and sound and credible institutional setting, the Netherlands has become a hub for international trade and capital flows. This allowed non-financial corporations (mostly multinationals) to channel FDI and "route" income flows, via entities in the Netherlands, between a company in one country and subsidiaries or affiliates in other countries. A partial and gradual reorientation of overall savings and funding flows towards more balanced patterns across sectors could help mitigate risks.

Profitable segments of the economy with a strong competitive edge can help to underpin domestic demand. Making use of the existing room in the institutional framework to allow for more differentiated wage increases could help support household income. Naturally, such an approach would have to take due account of the situation of firms as regards productivity, profitability and prevailing buffers so as not to weaken their viability or competitiveness. The depth and the protracted nature of the slump since the crisis imply that more robust income developments in households could support the recovery and rebalancing of the economy.

Productivity increases in the most recent period have been sluggish and the value added of re-exports, the most buoyant segment of exports, low. Cyclical effects, finance bottlenecks, continuing uncertainty and the impact of (expected) balance sheet adjustments all seem to play a role in the relatively low domestic rate of capital formation, yet there may also be a structural element at play. For firms, a balance has not always been struck between home and foreign investments. A balanced adjustment of saving and investment patterns across the Dutch economy would have a beneficial impact on the investment climate and growth potential, including economic prospects in the long term.

Ongoing policy and supervisory measures to reduce the incentives for households to take up housing debt and lower loan to value ratios should ultimately lead to reduced housing-related debt and leverage ratios. However, existing debt overhangs may require a long adjustment period. The regulatory measures, in particular the limitation of mortgage interest deductibility, are in effect strongly back-loaded and discriminate new versus existing mortgage loans.

Although measures have been taken to correct the rigidities in the housing market, the private rental market is still not functioning fully. Moreover, inefficiencies and the risks of dead-

weight losses associated with the operations of social housing corporations continue to exist. Reform steps in this area would need to protect the segment of dwellers in need of social housing, and factor in positive externalities of prevailing spatial regulation.

The imminent policy challenge is to contain balance sheet adjustments and harness growth potential while simultaneously stabilising public finances. Given the depth and protracted nature of the downturn following the global financial crisis, deleveraging pressures are likely to pose risks and a drag to the recovery for some time to come. Against this backdrop it is important to find an appropriate balance between adjustment needs and supporting near-term activity. Long-run gains of reforms could even be larger if, after successful fiscal stabilisation, part of the budgetary savings were to be channelled back into the economy by tax relief aimed at reducing the costs of labour, promoting investment, or a combination of such measures.

Box 5.1: A Current Account norm for the Netherlands

Identifying current account determinants through panel regressions across many countries are a widely used tool for assessing external balances. ([1]) The literature assesses which part of a country's current account balance can be explained by 'fundamental' determinants (such as resources or demographic factors) and temporary/policy factors (such as the fiscal balance). The common feature of such regressions is that they primarily consider the savings-investment perspective of the current account (through determinants such as ageing), complemented by the trade perspective (through factors such as terms of trade).

The general feature of such panel regressions is that they are in 'reduced form' and thus data-driven, which leaves a substantial part of current account balances unexplained. ([2]) Interpretations of such residuals differ: a 'normative' strand of the literature interprets the unexplained part of the current account as the deviation of the actual current account from what is justified by fundamentals. In contrast, the 'positive' viewpoint attributes these residuals to factors that have not yet been accounted for (which may be 'soft' factors, such as culture or peculiar policy settings). ([3]) Despite such semantic differences however, the main objective of the literature is to estimate the current account that is explained by 'hard' fundamentals.

The estimation here provides an illustration of the panel regression approach. It follows the latest strand of such attempts (spearheaded by IMF, 2012), which aim to provide multilateral consistent estimates of current account balances. The methodology accounts for the fact that since world current account balances net out to zero, they are influenced by cross-country *differences* in temporary and fundamental factors.[4] For instance, ageing is frequently cited as a motive for high savings and low investment in the Netherlands. However, what matters for the current account balance is not whether the Dutch population ageing, but how much faster the country is ageing compared to its trade and financial partners.

Technically, the estimation here is a panel regression for 64 countries that models current account balances as a function of a wide array of determinants, closely following IMF (2013). The set of countries covers more than 90% of the world and it is estimated for a period between 1986 and 2012 (total number of observations 1263). The variables used here encompass those of IMF (2013), except for commodity terms of trade and institutional set-up (which are marginally significant). In addition, this estimation includes construction investment as % of GDP, credit growth, and REER change (all lagged, and with respect to the rest of the world). Each of these determinants compares the country factor in % of GDP to the GDP-weighted world average. The estimation provides elasticities for each factor that allows to compute its contribution in explaining the current account balance for each country in the sample. These elasticity estimates display a non-negligible degree of statistical uncertainty that is similar to other studies in the field.

1. According to the estimations, the fundamental current account surplus, i.e. the level that is justified by the underlying economic conditions is estimated to be around 5%, and has been at that level for the whole sample considered since the early 1990s (Graph 1). The analysis undertaken here differentiates between the 'deep' factors (demographics, oil and gas resources, relative GDP per worker, and the constant ([5]) - shown in blue in Graph 1) and international financial factors, determinants that the country can only influence either partially or very slowly (an index of financial stability, reserve currency status and net foreign assets, shown in green). Given the country's inability to affect them some studies consider them part

([1]) See Salto and Turrini (2010) for a literature overview.
([2]) This contrasts with more theory-driven 'structural' approaches, which explain all of current account balances from a theoretical viewpoint.
([3]) Under the positive view, the explained part of current account balance for a country can be understood as the 'typical' balance given the country's characteristics.
([4]) Given the nature of the estimation, the results are best understood in comparative terms. For example, the contribution of ageing in Graph 1 for 2012 is about 1% of GDP. This implies, that given our model and sample, the Netherlands pattern of aging in relation to the other countries in the sample, justifies it having a 1 pp higher CA than it would have had, if its ageing was comparable to that of the 'average' country.
([5]) The constant arises technically from the estimation set-up and reflects its sample composition. In comparable studies, the constant has a similar magnitude.

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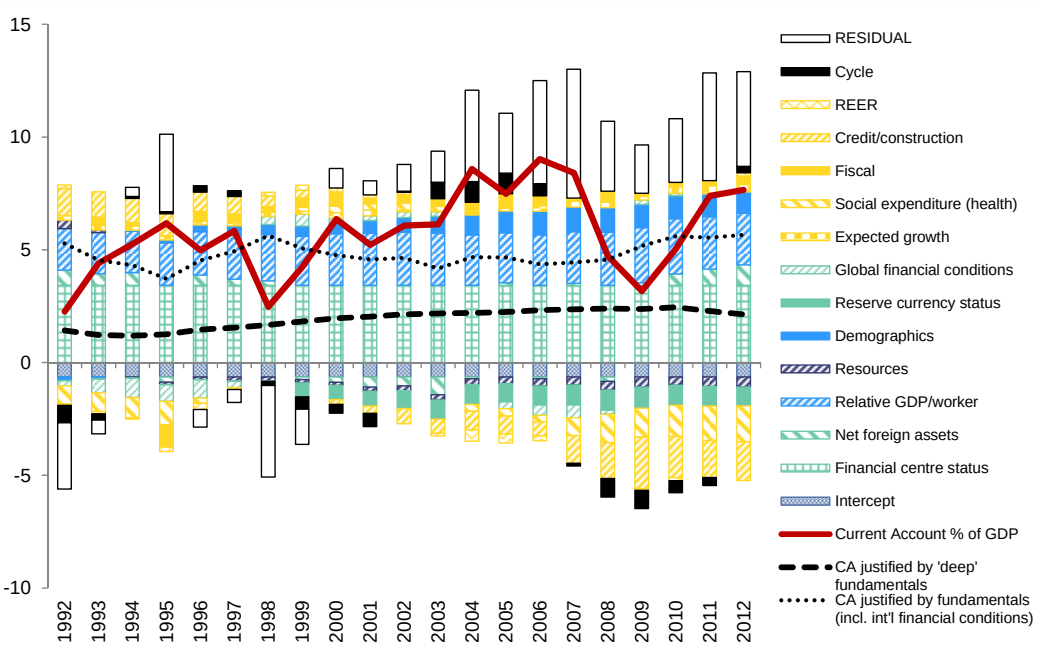
Box (continued)

of the fundamentals. ([6]) The **financial centre status** of the Netherlands plays an important role in terms of fundamental behaviour. It coincides empirically with surpluses, similar to Luxembourg, Switzerland or Singapore, and other off-shore financial centres. The effect of other financial current account determinants broadly nets out in the Dutch case. **Demography** seems to contribute at least 1 pp. to the total surplus. This result is in line with most cross-country empirical studies which have identified demographic factors as a driver of current account balances.



2. **According to the estimations, macro variables that are either policy-related or are the result of economic behaviour([7]), shown in yellow, tend to contribute negatively to the surplus**: social protection/expenditure weakens household's motives for precautionary savings, thus contributing negatively to the current account balance (as it does for most advanced economies). The same effect holds for the high level of private indebtedness, however, it is less strong than in other euro area countries as it is mitigated through muted Dutch construction investment (compared to peers). The fact that fiscal tightening in the Netherlands has proceeded faster than in peer economies has slightly contributed to the increase in the Dutch surplus over recent years.

3. In 2012, the cyclically adjusted Dutch current account surplus was lower than its actual level. In that year, the Dutch output gap was wider than that of its trade partners, explaining the, rather small, positive contribution of the business cycle. In the preceding years, the situation was reverse.

4. Lastly, the results show that for the period from 2004 on, there is a substantial component that remains unexplained by this model. In other words, neither the position on the business cycle (the Netherlands or its partners), nor policy choices or underlying economic needs, explain this residual of the

([6]) Note that the fundamental determinants of current account balances applied here encompass the 'fundamental' factors employed by the established academic literature on the topic. In contrast, there is less consensus in the literature on the appropriate set of policy (or non-fundamental) current account determinants.

([7]) The analysis shown here considers the following policy variables: the REER, public health expenditure (a proxy for social infrastructure), construction investment, domestic credit, as well as fiscal policy and last the level of expected GDP growth (a proxy for underlying potential growth). These are considerably diverse in nature, and only some of them are directly controlled by public policies. All, however, are effectively controlled by the economic agents of each country.

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Box (continued)

surplus. The decline in the current account surplus between 2006 and 2009 can be partly explained by policy factors (in particular soaring domestic credit), but so far, current account regressions are unable to empirically identify the reasons for the fast surplus increase since 2009.

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