Netherlands
Less austerity in 2015 Budget

- **The Dutch economy is slowly turning around.**
- **The 2015 Budget will contain less austerity measures than previous budgets.**
- **Next year's provincial council elections will be key to the stability of the government coalition.**
- **The recovery, mainly driven by exports and investment, is likely to be lacklustre.**

Economic Forecasts

	2012	2013	2014 (1)	2015 (1)
GDP (%)	-1.6	-0.7	0.5	0.9
CPI (%)	2.5	2.5	1.0	1.7
Gen. Gov. Budget (% GDP)	-3.8	-2.3	-2.6	-2.4
Gross Gov. Debt (% GDP)	66.5	68.6	70.1	70.4

Source: BNP Paribas

Declining credit to enterprises

Loans of MFIs to non-financial enterprises — y/y m/m (rhs)

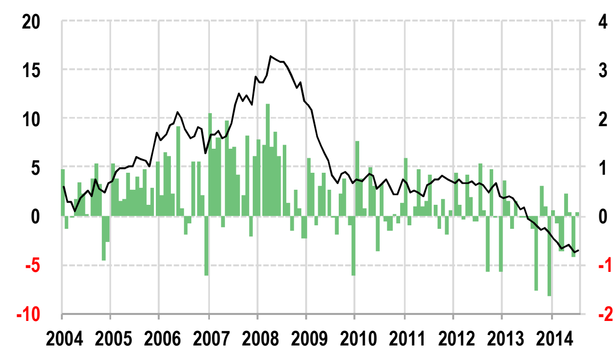

Chart 1 Source: De Nederlandsche Bank

Turnaround in slow-motion

The Dutch economy is slowly recovering from the financial and economic crisis in 2008-2009. In 2013, GDP was still 3% below the peak in 2008. Domestic demand has been restrained by the continued balance sheet adjustment by the government, households, banks, and pension funds. The government has aimed at reducing the deficit to below 3% of GDP, as agreed with the European partners. This resulted in a higher tax burden and the freezing of public sector wages and social benefits. Also in the private sector, wage increases have moderated against the backdrop of rising unemployment. The decline in house prices has left about 30% of mortgages "under water"[1] As a consequence, homeowners have increased their savings (early repayment of their debt), although with limited success at a macro level. The free savings rate – i.e. excluding contributions to mandatory private pension schemes – has actually declined. The funding ratio of pension funds has deteriorated, largely because of a fall in interest rates. This prompted many funds to take measures such a freezing or even lowering pension benefits. Finally, the financial sector has shrunk by a third to improve the capitalisation of the system. This has been mainly done by the disposal of foreign activities. In addition, banks have tightened their lending standards. Credit to non-financial corporations has slowed considerably and since July 2013 the year-on-year change is even in negative territory (chart 1).

As usual, the recovery was mainly supported by the external sector. However, this time the export motor was much weaker as all industrial countries were involved in similar processes of balance sheet adjustment. The relevant world trade for the Netherlands, reweighted for products and destinations, slowed to only 0.7% in 2012 before rebounding by 1.7% in 2013. Thanks to wage moderation, Dutch enterprises have remained competitive in world markets, despite the appreciation of the euro.

Over the past year, some improvement has been noted. For example, the housing market is showing signs of stabilisation. House purchases are on a rising trend since mid-2013 and the year-on-year change has turned positive. The labour market is tightening again. Since February 2014, the unemployment rate is on a declining trend. This is largely related to the retirement of the post-war baby boomers. Moreover, the funding ratio of the pension funds has risen to 111%. The improvement has also been reflected in the turnaround of sentiment indicators. (chart 2).

A looming government crisis

On Tuesday, 16 September, the government presented the 2015 Budget. It contains savings measures worth around EUR 6 billion. This is EUR 1 billion less than earlier agreed. It is also substantially less than the EUR 13 billion savings measures implemented both in 2012 and 2013. Public expenditure is projected to inch down to 46.3% of GDP, thanks to the freezing of the public sector salaries and social security benefits and the reduction of the number of civil servants. The tax burden (taxes and social security contributions) is projected to increase to 37.7% of GDP, 0.5 point higher than in 2014. In tax burden in 2009 amounted to 35.4% of GDP. The increase is related to a limitation of the deductibility of pension contributions and higher taxation of redundancy pay. By contrast, the in-work tax credit will be increased by EUR 100, which will be beneficial for low and middle income earners. All tax payers will benefit from the increase in the general tax credit by EUR 80. The purchasing power of the average wage earner will improve by 0.5%. The proposals are best for middle and high income earners, whose purchasing power is set to increase by 0.75%. By contrast, pensioners' after-tax income is expected to remain unchanged. The government parties VVD

[1] *A mortgage is called to be « under water »when the loan is higher than the market value of the property.*

(Liberals) and PvdA (Labour) have the majority in the second chamber of parliament but only hold 30 of the 75 seats in the senate (first chamber). To assure a smooth passage of the proposals through both houses of parliament, the government has consulted some opposition parties before the presentation of the budget.

Despite its difficult position, the government has broadly succeeded in implementing the coalition agreement. However, even though the coalition parties agree on the need of simplifying the tax system, opinions are too far apart to come up with new proposals in the short term. In March 2015, voters will go to the ballot boxes again for provincial council elections. The newly elected provincial councillors will, in their turn, vote for the senate. Both government parties are likely to suffer heavy losses compared with the 2012 general election and remain in the minority in the senate. The provincial council elections could undermine the stability of the government. If Christian Democrats (CDA) and Social-Liberals (D66) gain substantially, it is tempting for the VVD to look for other coalition partners before the end of the parliamentary term in March 2017.

A lacklustre recovery

Growth is projected to remain sluggish in the coming quarters, despite a loosening of the monetary stance by the ECB and a less tight fiscal stance. Lending conditions are likely to remain rather tight as banks are still in the process of strengthening their balance sheet in compliance with stricter international rules (Basel III). The effect of the depreciation of the euro – the EURUSD rate could reach 1.20 in September 2015 – might be limited. First, most Dutch trade is with Eurozone countries. Second, Dutch exporters are mostly price takers i.e. they set their prices in accordance with local market prices. This would also allow them to offset the increase in production costs due to higher wages and energy costs. Nevertheless, exports remain an important engine for growth, largely driven by developments in world trade.

Investment is likely to become increasingly supportive to growth. Capacity utilisation ratios have improved compared to last year, although they are still well below those measured before the financial crisis. However, as capacity shortages are appearing, the lack of bank credit has become increasingly an obstacle for investment.

Private consumption is likely to grow modestly on the back of gains in purchasing power and confidence. As the labour market tightens, wages are likely to inch higher. Moreover, public sector wages could rise strongly in 2016, after the end of the wage freeze and the improvement in public sector finances.

Inflation is likely to pick up in the coming quarters, partly due to higher energy costs following the depreciation of the euro. Moreover, enterprises are likely to pass on the higher production costs, thanks to better demand conditions.

The government budget deficit is projected to inch down to 2% by 2016.

Sentiment indicators have turned around

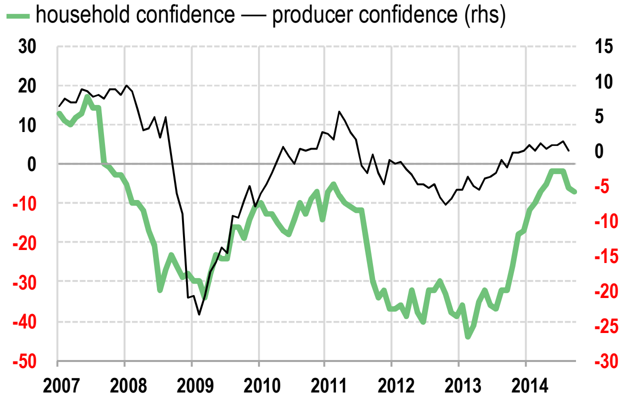

Chart 2 Source: Statistics Netherlands