INTERNATIONAL MONETARY FUND

Kingdom of the Netherlands—The Netherlands
2009 Article IV Consultation: Preliminary Conclusions

November 2, 2009

We expect growth, albeit sluggish, to resume in 2010. The outlook hinges critically on global developments and domestic policies to support aggregate demand and address financial weaknesses. Risks appear broadly balanced. Where needed, efforts to resolve troubled assets and institutions and strengthen bank capital should be continued to nurture recuperation of the financial sector. Budgetary stimulus in 2009-10 is appropriate, but a strong and credible commitment to fiscal sustainability is crucial; consolidation could begin in 2011, provided a firm recovery is underway. Renewed momentum is called for with structural reforms.

Economic situation

1. **The Netherlands has proven markedly vulnerable to the global crisis given its large financial sector and strong trade and financial linkages.** Thus, the economy entered a deep recession in Q2-08 and GDP fell an unprecedented 5 percent in Q2-09 (y-o-y), with collapsing exports and investment. Unemployment, however, began to rise only late in 2008 and has remained low so far, to some extent because of government-subsidized temporary reduced-hours schemes. With output now below potential, inflation has declined rapidly. Several indicators suggest that external competitiveness stays adequate.

2. **The financial sector has been hit hard**. Banks have suffered major declines in asset quality, profits, and capital, with the bulk of direct losses coming from foreign troubled assets and sizeable declines in asset prices. Consequently, massive government intervention in the financial sector was required and lending conditions have tightened noticeably. Insurance sector profits and solvency as well as pension funds' average funding ratios also dropped sharply.

3. **But the mortgage and housing markets have been relatively stable so far**. The large mortgage loan portfolio, dominance of non-amortizing mortgages, and high loan-to-value ratios are important financial sector vulnerabilities. Households also have a significant exposure to housing price developments. However, risks for the financial system appear contained by the banks' first charge at default, full recourse against the borrower, and collateral maintained against part of non-amortizing mortgages in investment/insurance accounts. In this connection, mortgage default rates remain extremely low. Some raw indicators point to overvaluation of home prices and household balance sheet vulnerabilities. Nevertheless, taking account of tight regulatory constraints on home supply and generous tax treatment of mortgage interest, the analyses of both the mission and other institutions indicate

that house prices are broadly aligned with fundamentals and balance sheet risks are unlikely to materialize.

4. **Fiscal policy has shifted priority to supporting growth**. After attaining significant surpluses in 2006-08, the general government is projected to run a large 4½ percent of GDP deficit in 2009, further worsening to 6 percent of GDP in 2010 amid falling revenues and soaring expenditures (relative to GDP). The spending surge is associated with a stimulus package introduced in early 2009, but was also in part already enshrined in the 2008 medium-term budget. In this context, the mission estimates that the structural fiscal position excluding interest payments and gas revenues (the "robust" balance) will decline by about 2¾ percent of GDP over 2009-10 to a deficit of 5 percent of GDP. Public debt has surged in 2008-09 and is to approach 65 percent of GDP by 2010, as a result of the ongoing budget relaxation, but equally due to the financial sector assistance, largely reported as financing transactions on the assumption that disbursements will be recouped once the economy recovers.

5. **At the same time, population aging remains a millstone on fiscal sustainability**. Recent ECFIN estimates indicate that aging-related expenditures will rise almost 9 percent of GDP over 2011-60, on account of health, old-age care, and pensions. Aging pressures are compounded by the decline in the robust balance over 2008-10, the large increase in public debt, and a likely contraction in potential output as a result of the crisis. Therefore, to ensure sustainability, the structural primary balance after 2011 would need to be permanently higher than in the current-policies path by about 8 percent of GDP—a much larger fiscal sustainability gap than estimated in recent years. If corrective measures announced by the government (about 1¾ percent of GDP) are enacted, the sustainability gap will be reduced accordingly. In addition, the mission recognizes that, if the large external current account surplus unwinds as a rising number of retirees draw down their accumulated pensions, consumption-based tax revenues will increase over the long run as share of output. Then, the sustainability gap could also end up being lower, but the size of this effect is quite uncertain.

Outlook and risks

6. **The mission expects real GDP to contract by 4¼ percent this year and expand modestly by ¾ percent in 2010.** Accordingly, output will fall well below potential, and inflation remain subdued. Consumption and investment will be constrained by diminishing household net worth, rising unemployment, tighter credit, and large capacity overhangs. Ongoing financial tightening will have a significant adverse impact on activity. Moreover, the globally synchronized downturn limits the potential for an export-driven recovery, but fiscal stimulus measures and large automatic stabilizers will help limit the downturn.

7. **The outlook is unusually uncertain, but the risks seem roughly balanced.** Forceful policies have moderated tail-risks of a systemic collapse and the financial situation has improved. Key risks in our view include deviations around the baseline in global

developments, lending and other financial conditions, the size or effect of policy measures, and house prices. The mission believes that upside and downside deviations are equally probable, but their dispersion is marked, because of the unprecedented nature of the global crisis and lingering doubts about the timing of its resolution.

8. **The level of potential output has probably been severely curtailed by the crisis.** Indeed, the mission considers that potential growth may run considerably lower than before the downturn in the near to medium term, owing to the disruption of financial intermediation, large contraction in investment, likely rise in structural unemployment (possibly discouraging labor force participation), and a deceleration in total factor productivity from financing constraints and increased risk aversion. Although potential growth is expected broadly to return to its pre-crisis trend over the medium term, a rapidly aging population could reduce it further in the longer-run. Income-per-capita raises will therefore depend on boosting labor force participation and productivity-enhancing reforms.

Policies

9. **Against this background, securing the recovery and long-term sustainability are the key policy priorities.** Near-term actions should focus on restoring health to the financial sector and an accommodative fiscal stance to support resumption of growth. These policies ought to be couched in a longer-run framework strengthening financial stability, ensuring fiscal sustainability, and adopting structural reforms to reinvigorate potential output.

Financial sector

10. **The mission views state interventions as broadly appropriate and effective.** The enlargement of deposit insurance and systemic liquidity were in line with EU-wide measures. While the government has nationalized the Dutch activities of Fortis, and purchased Fortis' share of ABN-AMRO, it has no interest in long-term state ownership and recognizes the danger of competitive distortions. The injections of capital in the form of preferred shares, linking preferred and equity dividends, restrictions on equity dividends, and incentives for quick redemptions are consistent with a sound "fix-it-and-exit" approach. The mission also supports the authorities' decision to permit pension funds five years to restore funding ratios, and encourages a gradual move toward a more balanced mix of defined-contribution and -benefit plans.

11. **While systemic risks have been addressed effectively, to allow expanded lending when credit demand picks up, more capital may be needed.** The mission recognizes that risk-weighted capital ratios are comfortable, but most Dutch banks—like several European counterparts—have relatively low equity capital. Building up equity to levels deemed more adequate in recent regulatory reform proposals, enhancing existing buffers, and brisker lending to support the economic recovery may require considerable additional capital. In this context, the state's commitment to restoring intervened banks to health and the ongoing restructuring and divestment of non-strategic businesses should improve these banks' market

access further, ensuring that extra capital may be tapped without sizable government injections.

12. **Thus, the mission stresses that efforts should be maintained towards thorough clean-up and appropriate capitalization.** In particular, domestic stress testing should continue to center on a comprehensive review of capital needs and viability on an institution-by-institution basis, considering the impact of the recession on capital. If needed, the authorities ought to require prompt remedial measures from concerned banks and consider public support with appropriate burden-sharing by shareholders and unsecured creditors.

13. **The mission supports the authorities' actions to strengthen banks.** In the wake of recent losses, prospects of higher capital standards and a tepid recovery, the banks may be justifiably reluctant to expand credit rapidly. Steps that may facilitate accelerated, but judicious, lending to support the budding economic upturn include: (i) improved quality of capital and a higher proportion of equity; (ii) suitably limiting dividend pay-outs; and (iii) urging banks to use proactively opportunities for market access to build buffers. In addition, actions together with the EU and Basle committee are needed to ameliorate counter-cyclicality of bank capital, and transparency and robustness of valuation.

14. **Going forward, reforms in regulation and supervision should further buttress the financial system.** The mission in particular advocates: (i) higher risk-weightings and capital requirements, as well as better diligence, for resecuritizations, complex, illiquid, or lower-rated exposures, and high-LTV-ratio mortgages; (ii) reduction of incentives for high LTV loans, such as limitations on mortgage interest deductibility; (iii) lowering of industry-wide LTV ratios or other risky exposures through a stronger code of conduct and enforcement; (iv) better data on and stress testing of risks emanating from house price movements; and (v) for securitizations, appropriate capital standards favoring "clean" transfer of risks through "true sale" securitizations rather than transactions involving complex support arrangements from originators. Cross-country supervision and resolution should be strengthened at the European level, broadly in line with the de Larosière proposals, while intensified cooperation between concerned supervisors would render domestic supervision more effective.

15. **The mission advises early preparations for the eventual exit from the heavy public support of the financial sector.** Enhancements to liquidity expansion, deposit insurance, and loan guarantees should be withdrawn or reduced in concert with the rest of the EU. However, the mission recommends to assess already now the impact of removing these programs. The objective should be tailoring the timing and speed of the exit so as to ensure that the markets and institutions concerned remain robust and well-informed to withstand their phasing out. Furthermore, the authorities and banks concerned should begin development of institution-specific restructuring and divestment plans for the large entities in which the state has injected equity or quasi-equity.

16. **The authorities intend to usher in sound executive compensation policies broadly in line with the recent G-20 recommendations.** Specifically, the private sector is being asked to prepare a voluntary code of conduct embracing: (i) policies linking remuneration and bonuses to long-term performance; (ii) development of explicit corporate policies by Compensation Committees of independent directors; (iii) annual disclosure of compliance; and (iv) coverage of at least senior managers and key trading personnel. The mission welcomes these efforts to rationalize executive compensation. The code of conduct in combination with taxation policies should aim for distributional fairness and discouraging risk-taking deemed excessive from a social perspective, while providing incentives for effective managerial practices and good governance.

Fiscal

17. **The fiscal relaxation in 2009 and 2010 is appropriate, as part of an EU-wide fiscal stimulus package.** An accommodative fiscal policy is indicated from a cyclical perspective—given the large negative output gaps as well as uncertainty still surrounding the economic recovery in 2010. It is also feasible—because of the comparatively favorable initial public debt burden. Its effectiveness is augmented by the broad harmonization of discretionary easing implemented by most EU members.

18. **But the mission has some concerns about the composition of the rise in expenditures.** Fiscal loosening should rely on initiatives that reduce economic distortions or that can be quickly reversed once growth prospects revive. The measures in the stimulus package largely fulfill such requirements, but the broader surge in spending during 2009-10 (resulting from planned expenditure not being adjusted down with the collapse in GDP) is less amenable to fast retrenchment, being largely made of recurrent outlays. Measures to cut spending are currently under study (paragraph 22).

19. **The mission emphasizes that, in light of the large sustainability gap, a strong commitment to fiscal consolidation is crucial.** As part of an exit strategy, the authorities should build consensus around a credible plan to restore the medium-term fiscal position to health. In particular, as envisaged in the 2010 Budget Memorandum, fiscal policy should be gradually tightened from 2011, provided growth has firmed, with a view to erase the sustainability gap within a reasonable period, bearing in mind the need to balance the twin objectives of closing the output and fiscal sustainability gaps. With parliamentary elections in 2011, time-bound fiscal adjustment targets and supporting measures should be identified and enshrined in the coalition agreement that will lead to the formation of the new government. To reinforce the credibility of the adjustment, frontloading the retrenchment in 2012-15—the next government's term—if economic conditions permit, is important. Under our baseline macroeconomic scenario, targets should be ambitious enough to comply with the Stability and Growth Pact (SGP) ceilings on the headline deficit before 2015.

20. **Fiscal adjustment measures should focus on expenditure retrenchment and tax-base broadening.** The expenditure-to-GDP ratio is set to rise further with population aging, and prevailing tax rates and international tax competition seem to leave little upward room. Moreover, international experience indicates that expenditure-based consolidations are generally more durable, and efficiency enhancements are key to reducing spending without jeopardizing public service provision.

21. **In this regard, pension, health and old-age-care reforms are key to containing—particularly aging-related—expenditure.** The mission sees scope to trim pension spending by raising the retirement age (as is currently planned), and relying more on means-testing and second pillar pensions. Also, given high income elasticity of health-services demand, an increase in user fees could moderate its growth. Tighter definition of entitlements in long-term care could spawn significant savings in an area where aging pressures will be strong. On the supply side, the mission notes that sustained productivity increases in health- and long-term care (achieved in some OECD countries) would significantly lower projected rises in spending. Reducing the maximum duration of unemployment benefits, high by international standards, could save budget resources, while still adequately supporting job search.

22. **The mission commends the authorities for their comprehensive approach to identify options for fiscal consolidation.** Besides the package cited in paragraph 5 (increase in the retirement age to 67 years, capping mortgage interest deductibility for high-priced homes, reduction in health-care allowances, and savings in the provision of medical services), nineteen working groups have been set up to formulate by Spring 2010 proposals for savings of up to 20 percent of budget expenditure. Another group is tasked with reexamining tax policy within the same time-frame. The authorities thus intend to identify concrete steps to reduce credibly existing budget imbalances. In this connection, the authorities' proposal to embed the SGP in Dutch law could usefully strengthen the commitment to deficit reduction once the recovery is on a solid footing.

23. **The Dutch budgetary system deserves high marks, but needs further refinement to attenuate its procyclicality and clarify conditions for resetting expenditure ceilings.** The mission recommends that cyclically sensitive outlays, such as unemployment benefits and nontax revenues, be permanently removed from the expenditure ceilings to prevent undesirable cuts in other spending during recessions. Also, such ceilings ought to be updated in response to significant changes in potential growth or large deviations of actual growth from its trend. This would allow for discretionary stimulus measures in case of sizable downturns, without forcing a breach of the ceilings, thereby enhancing their credibility. Finally, in the mission's view, exceptions to the 2 percent deficit trigger for fiscal tightening should be explicitly envisioned if the economy undergoes substantial contraction.

Structural reform

24. **Renewed momentum with structural reforms would alleviate the adverse impacts of the crisis and population aging on growth**. Building on past progress, labor market reforms should aim to increase participation further (including reforms of the tax and benefit systems—in particular to curtail disincentives to female, disadvantaged youth, and elderly work—and increasing the retirement age), while productivity could be enhanced through reforms directed at strengthening innovation and competition—notably, the OECD suggests to reduce barriers to entry. As mentioned, pension and healthcare reforms are also required to support fiscal sustainability.

Other

25. The mission welcomes that the Netherlands' ODA contributions at 0.8 percent of GDP continue to exceed the United Nations ODA target.

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