



*Rabobank*

# Beyond the business cycle

The economy up to 2014

July 2008

*Economic Research Department*

# Contents

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<b>Summary</b>	<b>3</b>
The economy up to 2014	
<b>Introduction</b>	<b>5</b>
Beyond the business cycle	
<b>Starting point</b>	<b>7</b>
The economy in 2008 and 2009	
<b>Structural development</b>	<b>10</b>
From trend to structure	
<b>Base scenario</b>	<b>14</b>
Lower global growth	
The Netherlands: tight labour market	
<b>Alternative scenarios</b>	<b>22</b>
Quantifying the risks	
Scenario 1: Oil price to 220 dollars	
Scenario 2: Weakness dollar	
Scenario 3: Recession in Asia	
Scenario 4: Labour potential higher	
<b>In conclusion</b>	<b>36</b>
Opportunities or threats?	
<b>Economic key figures</b>	<b>38</b>
<b>Colophon</b>	<b>39</b>

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**Closing date: 24 July 2008**

# Summary

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## The economy up to 2014

The past few years have been economically good to us in the Netherlands. Economic growth is expected to slow to some extent this year and next. A recession is and for the time being will stay far away. In 2009 the global economy will return to growth in line with the existing trend, as the effects of the credit crunch and also the increase in commodity prices will wane.

The economic situation in 2009 represents the starting point for the medium-term analyses in this document. Economic analyses based on the long-term focus on other matters than cyclical fluctuations. Forecasts beyond a period of two years into the future are much more concerned with the growth potential of the economy, in which structural factors such as productivity and the availability of factors of production play an important role. Medium-term projections are in fact an intermediate form. Starting from a situation of disequilibrium in which the economy finds itself, you tend towards a long-term equilibrium in that period.

In the base scenario up to 2014 we outline what we consider to be the most likely development of the world economy and the Dutch economy. We start with a description of global developments. Given the principle of closing the output gap (a trend-free medium-term projection), this translates into slightly lower growth rates in the medium term than in the recent past. This is mainly due to a number of developments: growth of the labour supply is lower in Western countries, while the growth spurt of emerging economies simultaneously moderates to a slightly lower growth rate. Growth in these countries will by our standards still be considerable.

As a small open economy, the Netherlands is experiencing the consequences of the changes in the international environment as described above. In the Netherlands itself, a number of factors have also changed conclusively compared to the past few years. The main determinant of the situation is the slowing growth of the potential working population. This limits the possibilities for growth and simultaneously represents the main threat to that growth. Wage costs may rise, impairing the ability of the Netherlands to compete internationally. Moreover the costs of the ageing of the population will have to be borne by fewer workers.

We have projected the risks attending the base scenario in detail in four alternative scenarios. These spotlight what we have identified as the main threats to growth and, in the case of the last scenario, the opportunities.

# Summary

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The economic consequences of an oil price rising to a level that is 80 dollars above its current level are considerable for both the world as a whole and for the Dutch economy. Though a higher oil price will not give rise to a recession, growth rates will clearly be trimmed back. Due to the diminishing energy intensity in this scenario, the oil price will in the end rise by less than 80 dollars owing to declining demand. If innovations accelerate the decline in demand, the effects of the higher oil price will be less pronounced. The reverse obviously also holds true: if demand proves insensitive to the high oil price, the economic consequences will be more disastrous.

The impact of a strong decrease of the dollar exchange rate, to 2 dollars per euro, will be most keenly felt in the US economy. The effects on the eurozone are relatively modest. While Europe's competitive position versus the US will suffer, this variant turns out to be relatively good for the eurozone because European interest rates and inflation will fall. For the Netherlands, a substantially weaker dollar will initially lead to diminished growth rates, because, as a small, open economy, the Netherlands is especially sensitive to changes in international trade.

The effects of a substantial crisis in Asia will not be too severe for the Netherlands. While demand from China will decline, which is especially disadvantageous for open economies, inflation will decrease worldwide due to the lower oil price and other factors. This will stimulate domestic demand in Western countries and will compensate the temporarily flagging demand from Asia.

In the medium term, the addition of 400,000 people to the labour supply will not benefit the Dutch economy very greatly. But that does not mean that expanding the labour supply is not advisable. In the longer term, say up to 2040, the effects are expected to be more significant. In particular, the costs of ageing will be absorbed more readily, as more people will be able to contribute to the costs for state old age pensions and healthcare.

The preceding scenarios each show a glimpse of what will happen if one particular development occurs. In the coming years, we are sure to see numerous developments occur simultaneously. And other, as yet unforeseen, developments are sure to occur as well. But that does not detract from the value of this analysis, as a consistent vision of foreseeable developments provides a good starting point for further research.

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# Introduction

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## Beyond the business cycle

Economic news is often about the short term. It concerns questions such as 'What is the effect of the low unemployment on the economy?'. Or 'What does a high inflation rate mean for our own spending?'. Most analyses – including those of Knowledge and Economic Research – therefore look mainly to the near future. This is easily explained by the importance of current trends for the decisions that units of the Rabobank Group and our clients have to take in the short term.

But that does not mean that in the longer term, more than two years into the future, very different developments cannot be important. It is sometimes useful to step outside the real-time current events and urgencies of the day and switch to a long-term perspective. To look beyond the waves of current trends to see in which direction the compass is actually pointing. In this study we use the macro-econometric world model NiGEM to do so. We use this model in our analysis to ensure we take account of all relevant interdependencies. In the description, we will zoom in on the economic developments in the Netherlands especially.

This study primarily provides an insight into long-term developments of the economy, pinpointing bottlenecks as well as opportunities for future economic growth. The first part accordingly outlines a base scenario for economic developments up to the end of 2014. This reveals that the growth potential of countries depends to a significant extent on technological developments and growth of the working population. The faster the working population grows, the faster total income grows. Countries in which total income grows rapidly offer more opportunities for business and trade. In countries whose working population is declining, as in the Netherlands due to the ageing of the baby boom generation, growth in the coming years is expected to be some 2% lower than we have been used to in the past few years.

A longer-term perspective can moreover shed more light on 'what if' questions. What are the economic consequences if the oil price reaches and remains at 220 dollars? What if the dollar falls and no longer plays the role of global currency? What will it mean for the Netherlands if there is a recession in China? What are the consequences for the Dutch economy if the Netherlands does succeed in getting more people into employment? These scenarios are explored in the second part of the study. They should not be read as reflecting the most likely developments, but they do spotlight the uncertainties relating to the base scenario. The substantial extent to which the Dutch economy is dependent on international developments is clearly highlighted.

# Introduction

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On the one hand this makes us vulnerable to fluctuations in international trade, on the other hand it also offers opportunities in a world in which international interdependencies are becoming increasingly important.

By presenting scenarios, we develop a more acute understanding of the range of possible economic developments in the coming years. Obviously, the effects described in the scenarios will in practice to some extent occur simultaneously, and economic effects will be enhanced or conversely tempered accordingly.

# Starting point

## The economy in 2008 and 2009

*Prospects for growth up to the end of 2009 are moderately positive. Many countries are recovering from a growth dip, prompted by the problems in the housing markets, the credit crunch and high commodity prices. Growth in 2009, especially in the OECD countries, will be higher than in 2008, but lower than the long-term average. The Netherlands will in 2008 and 2009 sway along with the waves of international economic developments. But in considering this, the Dutch growth rate has to be interpreted correctly.*

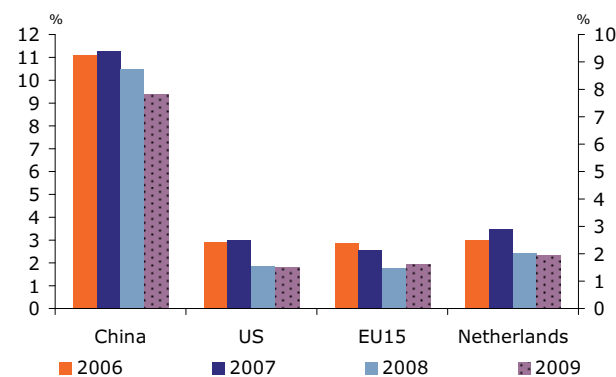
### Global slowdown in growth ...

This year's global economic growth will be lower than in preceding years, mainly because the US contribution to growth has largely been eroded. The Asian countries will maintain their high growth rate in both 2008 and 2009 and as yet appear to be hardly feeling the effects of the credit crunch. This originally American mortgage crisis has caused not just losses due to falling house prices but also major uncertainties in the financial markets. The US has been hit hardest by this. In addition, the high energy and food prices are currently causing major concern. We expect that the largest price increases have already taken place this year for virtually all commodities. Next year will be considerably calmer in that respect, although commodity prices are unlikely to return to the levels of the recent past.

### ... is only temporary

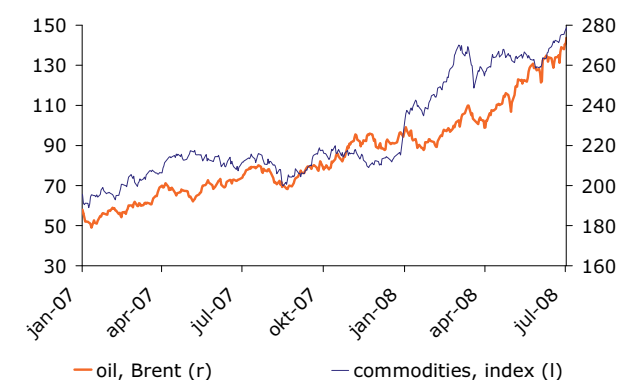
At present it appears –despite continuing bad news on the credit crunch– that the recession in the US is likely to be moderate. The position of non-financial businesses is fundamentally robust and the service sector is already picking up again, which will in time boost job creation. Overall, we are therefore assuming that the US economy will manage to grow by 1% in 2008, after 2.2% in 2007. We are expecting some recovery in 2009, up to 1½% GDP growth. That is still lagging behind the trend and comparable to the last US recession in 2001.

Figure 1: GDP growth in various countries



Source: Reuters EcoWin/Rabobank

Figure 2: Commodity prices continue to rise



Source: Reuters EcoWin

# Starting point

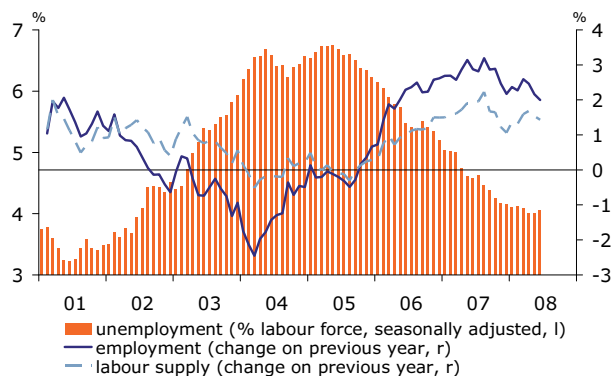
The housing market will continue to hamper the US economy deep into 2009. The housing supply surplus is still very significant and the current sales rate is low. The dollar will appreciate again and is expected to reach a level of 1.43 per euro by the end of 2009. This strengthening of the dollar will be fuelled mainly by the cyclical recovery of the US economy.

## European growth also slightly lower ...

The problems in the US (of this and last year) have an adverse effect on worldwide economic growth. Due to flagging domestic spending, growth in US demand for goods and services produced abroad will slow. Consequently, economic activity in countries that export to the US will also decline. In Europe we are also seeing a substantial appreciation of the euro versus the dollar. As a result, imports of European goods and services have become less attractive for countries outside the eurozone. In tandem with high and still-rising energy, commodity and food prices, a significant decline in growth is also expected for Europe in 2008, of up to 1¾%.

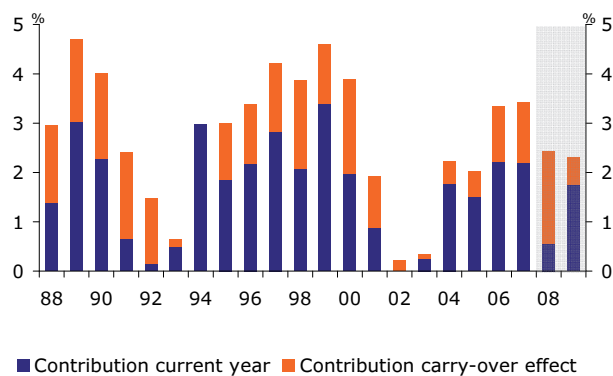
As said above, we expect the dollar to be able to regain some ground against the euro in the coming period. On that basis we also expect slightly higher growth in exports for Europe next year, while import growth will conversely edge down. Economic growth in the euro area could then pick up to around 2%. Notably, European consumers will not contribute significantly to this recovery in growth, as consumption volumes will grow by around 1½% both this and next year. On the one hand, we expect inflation to fall somewhat in the course of this year and at the start of next year, slowing the erosion of purchasing power. On the other hand, the labour market will cool down, depressing income growth. On balance, we remain optimistic about the momentum of the European economy, with an expected recovery of growth in 2009.

**Figure 3: Unemployment and labour supply**



Source: CBS

**Figure 4: GDP growth: current year and spill-over**



Source: CBS



# Starting point

But at the same time we will in both the current and next year face a slightly lower average economic growth rate than in the past few years.

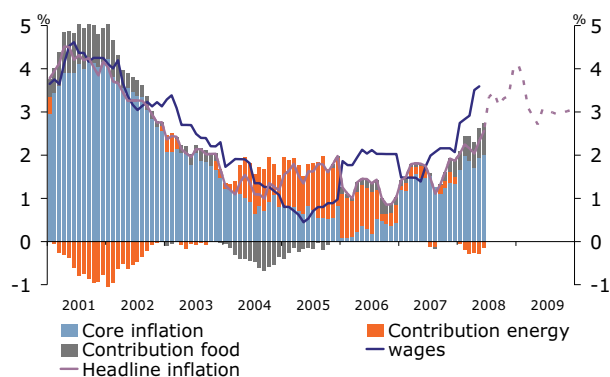
## ... and the Dutch economy sways along

The situation for the Netherlands in 2008 is actually fairly favourable compared to the rest of Europe – at least in terms of average economic growth on an annual basis. The good third and fourth quarters of 2007 laid a solid foundation for annual growth in 2008. The first quarter of 2008 was in fact reasonable in the end, though quarter-on-quarter economic growth of 0.4% was substantially down from the two preceding quarters. The cooling-down is attributable to the external environment, since as a small, open economy the Netherlands is certainly not unsusceptible to the global slowdown.

In 2009 the Dutch economy will again sway along with the waves of the international economy. Although economic growth on an annual basis will be lower than in 2008, the quarterly figures will distinctly improve in the course of the year. Like the rest of the world, the Netherlands will also face higher inflation. The difference is that this already started to emerge in most of Europe at the start of 2008, while the Netherlands only have to expect sharply higher prices from mid-2008. In 2009 the government is likely to add to this by stepping up the VAT rate by 1 percentage point.

Although the economy will cool down in 2008, the Dutch labour market will still remain tight in 2009. In part this is due to continuing growth in employment, but a further, more permanent reason is that the increase of the labour supply is continually tapering off. Consequently unemployment will stay at a low level in 2009 as well. Good news for employees, as they will be able to demand higher wages, but bad news for the long-term international competitive position of the Netherlands.

**Figure 5: Factors contributing to inflation**



Source: CBS

**Table 1: Key figures 2006-2009**

year-on-year %	2006	2007	2008	2009
Gross domestic product	3.0	3.5	2½	2¼
Private consumption*	2.7	2.1	2	1¼
Government expenditures*	2.2	2.7	1¼	1½
Private investment	8.2	5.4	5¼	1¾
Gross fixed capital formation	7.2	5.1	4¾	1½
Exports of goods and services	7.0	6.4	4½	3¾
Imports of goods and services	8.1	5.5	5½	2¾
Consumer price index	1.1	1.6	2¾	3
Unemployment (% labour force)	5.5	4.5	4	4
Government budget (% GDP)	0.5	0.4	1	1
Current account (% GDP)	7.6	8.4	5¾	6½

Source: Niesr/Rabobank

# Structural development

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## From trend to structure

*Economic analyses based on the long-term focus on other matters than cyclical fluctuations. Forecasts beyond a period of two years into the future are much more concerned with the growth potential of the economy, in which structural factors such as productivity and the availability of factors of production play an important role. Medium-term projections are in fact an intermediate form. Starting from a situation of disequilibrium in which the economy finds itself, you tend towards a long-term equilibrium in that period.*

### Long term versus short term

In the short term economic development is determined mainly by sentiments, actual figures and cyclical economic fluctuations. In the long term structural developments play a more important role. This refers particularly to the changes on the supply side of the economy: where is production capacity heading, as this determines the scope for growth of a country. Production capacity depends on the available capital goods supply, the level of technology and the available number of people who can work with this technology and machines. This concept is also known as the potential production. In an overheated economy, actual production exceeds potential production. In that case prices and wages will rise and pull the economy back towards equilibrium.

Potential production should not be seen as a technical 'ceiling' up to where an economy can grow, but as the maximum sustainable level of production given the available technology, availability of factors of production and preferences of individuals. Production might be higher, for example because employees increasingly work many overtime hours. This cannot be sustained over time, however. Employees will for instance demand higher wages, making labour more expensive. This will cause a deterioration of the competitive position, which in turn will trim back demand. In the long run production will 'automatically' return to a lower level. Technological progress and increased availability of the factors of production labour and capital lead to potential growth. Actual growth ultimately depends on the utilisation of these possibilities.

A concept that plays an important role here is that of the 'output gap', which is the difference between the level of potential production and the actual production of an economy. If the output gap is negative, meaning less is produced than would be possible, the adaptive mechanisms in the economy (pricing) will cause growth to reach the equilibrium level again eventually. The same applies if the output gap is positive. In practice, the economy will not often produce an output gap of exactly zero (see Figures 6 and 7), and it is even less likely that this should be the case for several economies simultaneously. All kinds of disruptions, incidents and unexpected events cause economies not to be precisely in equilibrium.

# Structural development

## Assumptions in medium-term projections

In medium-term projections we have to use assumptions for a number of variables, as a 'real' projection is almost impossible. We therefore use the following assumptions in this study. First, we are only assuming trend-compliant technological development. This means we are assuming that no structural changes occur in the structure of production. These could occur in the form of innovations that lead to major changes in the method of production. Such quantum leaps (examples of which are the industrial revolution, computer, internet) cannot be predicted.

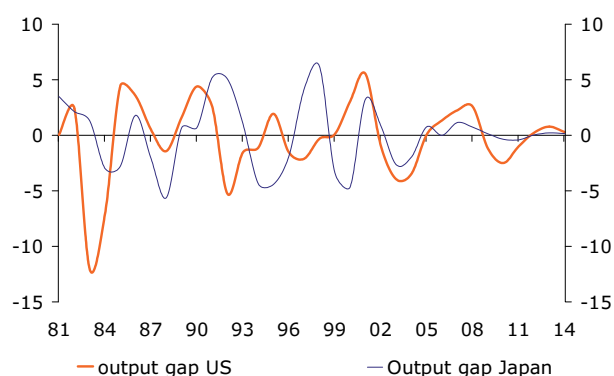
We assume that trend-compliant technological progress in all countries in the world converge to the level of technology in the US ('catch-up' effect). This is the chosen operative assumption because the US is technologically the most advanced economy at present. The time required before an economy reaches the level of US technology differs for each country. Countries with more technological ground to make up will in the coming years, due to this assumption, also experience a greater increase in technological progress.

This assumption is, however, not undisputed. Productivity gains in the services sector in particular are harder to achieve, because they are not merely a consequence of imitating new techniques and technologies. Rather, management and work methods play an important role in this respect.<sup>1</sup> This 'soft' technological progress is probably partly culturally determined.

The long-term capital goods supply can also vary, but given the assumptions in the longer term concerning, for example, the interest rate (see below), this,

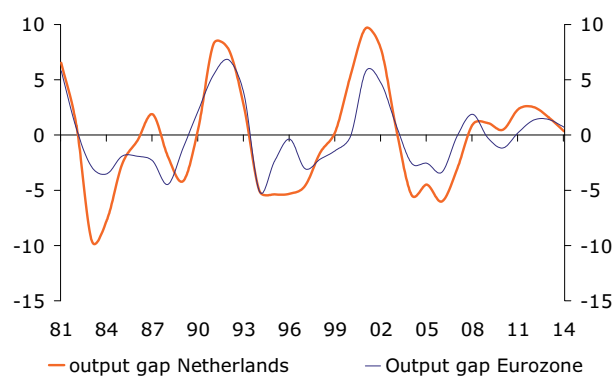
<sup>1</sup> See Ark, B., M. Mahony and M. Timmer, The Productivity Gap between Europe and the United States: Trends and Causes, in Journal of Economic Perspectives, Winter 2008, vol 22/1.

Figure 6: Output gap for the US and Japan



Source: Rabobank

Figure 7: Output gap for the Netherlands and the eurozone



Source: Rabobank

# Structural development

together with differences in capital intensity and human capital, only to a limited extent explains the divergent developments between countries. In general, the degree of technological progress in the predicted period therefore does not differ greatly and differences in growth rates are determined in the main by differences in the development of the working population.

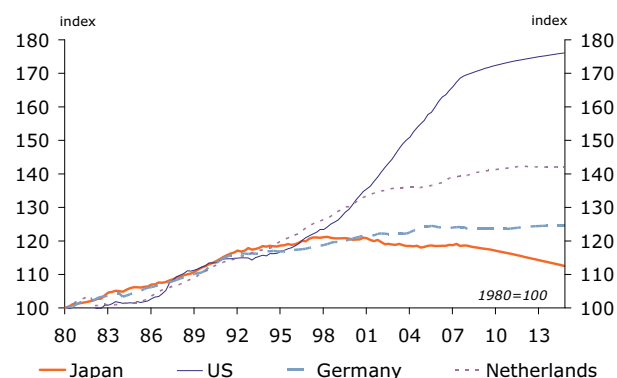
Secondly, we are assuming that the interest rate (both in the US and in Europe) will trend towards a 'structural' level from the end of 2009, based mainly on long-term inflation expectations. We are locking the dollar exchange rate in at the year-end 2009 level. This assumption is based on the fact that both the interest rate and the growth differentials will not diverge fundamentally in the projection period between the US and the eurozone.

In addition, we are not allowing for active government policy. We are assuming a stable public sector balance and are disregarding both positive and negative policy effects. These could for example include positive effects on productivity due to better education as a favourable effect of government policy. These types of structural effects are difficult to gauge in a macromodel and are also difficult to predict for longer periods. We therefore do not take these into account.

## Trend towards a situation of equilibrium

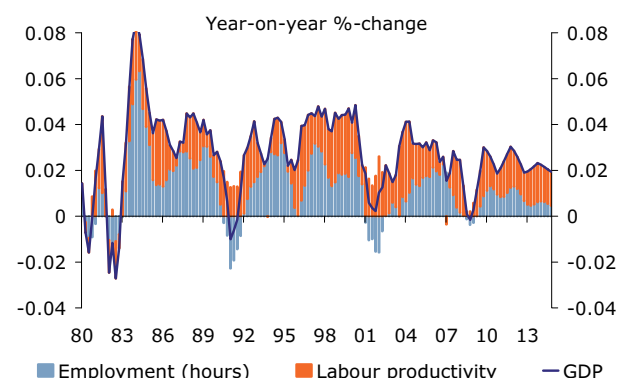
It is impossible to foresee all possible fluctuations in longer-term projections. It is therefore customary in predictions extending beyond two years into the future to assume that economies tend towards equilibrium. In itself this is a logical and frequently used assumption. After all, as long as no disruptions of the economic process are anticipated, the forces in the economy will automatically tend in the direction of a situation of equilibrium.

**Figure 8: Growth of labour supply in different countries**



Source: Rabobank

**Figure 9: GDP growth in the US by contribution of employment and labour productivity**



Source: Rabobank

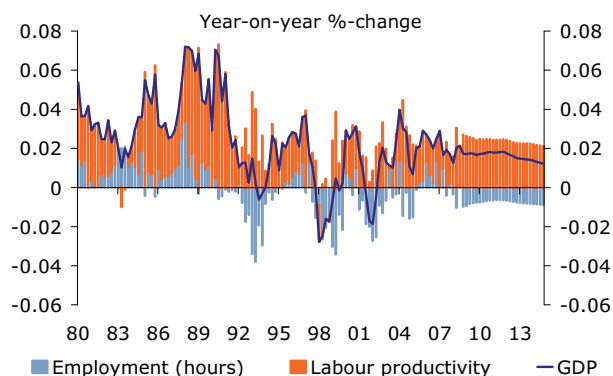
# Structural development

In the base scenario that we discuss in the next section, we are accordingly assuming that the output gap in all economies will be approximately zero at year-end 2014. The development in that period (often represented as an average) therefore reflects the tendency towards a situation of equilibrium, starting from the projection for 2009 (which is influenced by cyclical economic factors).

The level of potential growth differs between countries. This is mainly due to differences in technological progress and the availability of factors of production. The latter concerns mainly the growth or decline in the number of people able to work, i.e. the (potential) labour supply.

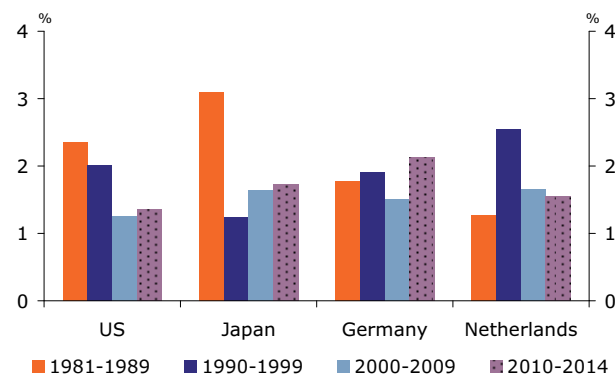
Major differences can therefore arise. In countries with strong population growth (see Figure 8) the economy can (as well as must) grow faster to create greater prosperity per capita of the population. In countries with a stagnating or even declining working population potential growth will be lower. In the US the working population will still grow to some extent, as will labour productivity (see Figure 9). Japan is a good example of a country that is confronted with a decline in the number of workers: the working population decreases, and consequently expected growth, measured in terms of GDP, is lower than in many other countries. The contribution to growth by the factor of production labour is negative, then, for Japan (see Figure 10). Because labour productivity does still increase considerably (more than in the US for example), GDP per capita of the population in fact outstrips that in the US (see Figure 11). In other words, income growth per person in Japan outpaces that in the US, despite the fact that the economy as a whole is growing more slowly.

**Figure 10: GDP growth in Japan by contribution of employment and labour productivity**



Source: Rabobank

**Figure 11: Development of GDP per capita in different countries**



Source: Rabobank

# Base scenario

## Lower global growth

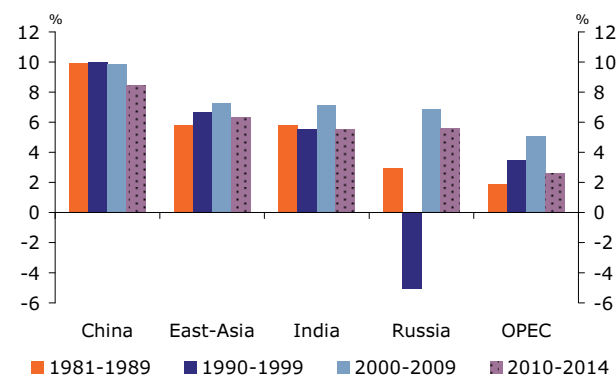
*In this base scenario we outline what we consider to be the most likely development of the world economy and the Dutch economy in the medium term, i.e. up to 2014. We start with a description of global developments. Given the principle of closing the output gap, this translates into slightly lower growth rates in the medium term than in the recent past. This is mainly due to a number of developments: growth of the labour supply is lower in Western countries, while the growth spurt of emerging economies simultaneously moderates to a slightly lower growth rate. Growth in these countries will by our standards still be considerable.*

### Lasting but lower growth

The global economic recovery started in 2009 will consolidate in the next few years. Because we apply the assumption that economies will tend towards an equilibrium level, we do not predict a new economic boom period either. The world economy will grow 3¾% in the period 2010-2014 and GDP of OECD countries will advance 2¼%, both of which are lower than in the period 2005-2009. Consequently, the volume of global trade will likewise increase less. Due to the expected moderate development of commodity prices and the assumption that all economies tend towards equilibrium, prices worldwide will also rise more slowly.

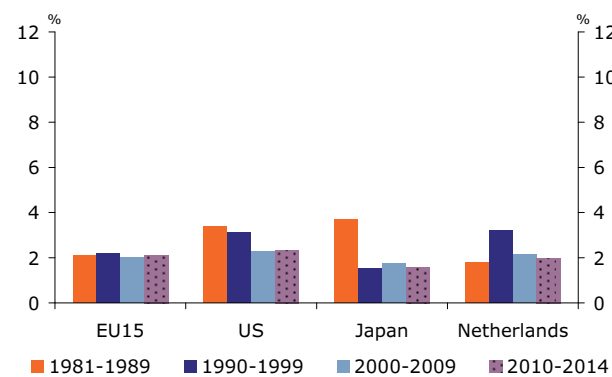
Because the Asian countries have experienced a growth spurt in the past few years and grown above their potential, we expect growth in those countries to moderate to some extent. The tensions will slowly ease out of the economy there, which in the first instance will still be accompanied by slightly higher inflation. Compared to the period 2005-2009, growth in Asia, Russia and the OPEC will taper off, without declining substantially. Mainly due to the higher growth of the working population, but also due to the narrowing of the technological gaps, the growth in these countries will still be higher

Figure 12: GDP growth in Asia, Russia and OPEC



Source: Rabobank

Figure 13: GDP growth in developed countries



Source: Rabobank

# Base scenario

than in the developed economies such as the US and Europe. Growth in China is accordingly expected to reach 8½%, while it has averaged almost 10% since 1980 (see Figure 12).

Growth rates of other emerging countries may be slightly lower than in the period 2005-2009, but are still markedly higher than in the highly developed countries, including the Netherlands (see Figure 13). This is attributable to stronger growth of the labour supply in those countries and a faster increase in labour productivity. The gap in terms of labour productivity of these countries will therefore continually narrow in the projection period. Consequently, in the period up to 2014 an increasing portion of economic growth will continue to come from Asia and the importance of these countries for Dutch and global economic growth is only set to increase.

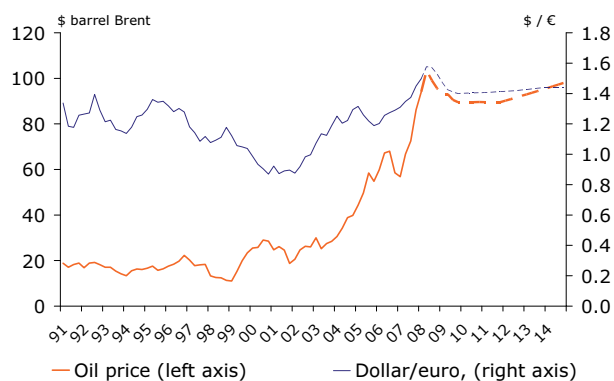
Economic growth in the US in the base scenario is expected to be slightly higher on average than in the euro area as potential growth is higher there. This is due to a slightly stronger growth of the working population. The differences between Western countries are however slight.

The growth in the eurozone is expected to be around 2%, almost level with potential growth. The reason for this is that the output gap is already virtually zero in 2009.

## Calm commodity and financial markets

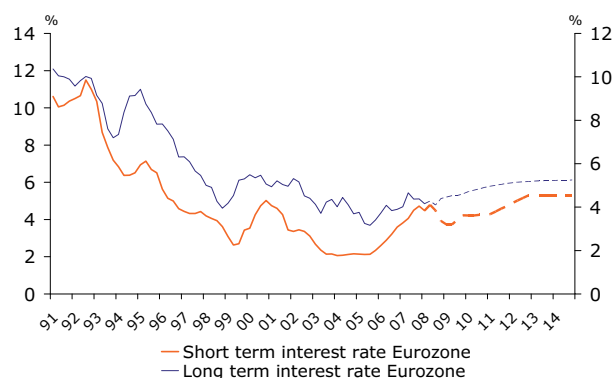
We expect commodity markets to stabilise. The enormous increase in food and commodity prices that we have seen in the past year is temporary in our judgement. Incidental factors, including poor harvests and 'safe haven effects' due to the credit crunch have recently lifted prices above a level that can be explained on the basis of structural factors.

**Figure 14: Oil price and dollar exchange rate**



Source: Rabobank

**Figure 15: Short and long interest rates in euro area**



Source: Rabobank

# Base scenario

While the prices of most commodities, such as (precious) metals and food, will increase again from 2010 on the back of a sustained increase in demand, this increase will be far more moderate. Similarly, we expect the oil price to have

provisionally peaked for now (see Figure 14). But structural factors (increased demand, decline in supply over time) will ensure that the price for a barrel of oil will not return again to the levels to which we were accustomed until recently. We have included a scenario in the next section in which we show the consequences of sustained high oil prices.

From 2010 inflation will increase by some 1¾% in the OECD countries and therefore be at considerably lower levels than for this and next year. This is mainly because the increase in commodity prices has come to a halt. By

contrast, inflation in the emerging economies will remain at a higher level.

In line with our assumptions, the dollar is set to stabilise at the level of year-end 2009. But the possibility can certainly not be excluded that the dollar will yield even further, or conversely appreciate more rapidly. We illustrate this in the next section on the basis of a scenario in which the US currency depreciates to two dollars per euro.

Almost the same applies to interest rates as to the US dollar exchange rate (see Figure 15). Both long and short term interest rates are gradually moving to a structural level. We therefore certainly do not envisage the kind of turbulence in the financial markets that we have seen recently. We have also assumed that the budgetary policy of the US in particular will become less expansive. This derives from our assumption that the public sector balance in all countries should move towards zero. Due to the current relatively large deficit, this has a more significant effect for the US than for the Netherlands.

## Risks

The risk that a projection will not prove accurate naturally increases the further the prediction period is in the future. If, for example, the new US President continues to spend more money than is coming in, the capital market interest rate could be higher.

There will continue to be significant uncertainties concerning the development of oil prices in the coming period. Geopolitical tensions can bolster oil prices for an extended period, but by the same token energy-saving measures can slow down the expected demand for energy sooner than expected.

**Table 2: International key figures**

<i>Key figures world economy</i>	<i>00-04</i>	<i>04-09</i>	<i>10-14</i>
GDP-growth OECD	2.4	2.5	2.3
GDP-growth world	3.6	4.5	3.8
Growth world trade volume	6.4	7.3	5.3
World consumer price	3.9	4.4	2.9
Oil price (\$, Brent)	27.8	75.1	92.2
Dollar (\$ per €)	1.01	1.36	1.42
Long term interest rate Euro area	4.68	4.08	5.09
Short term interest rate Euro area	3.28	3.57	4.89

Source: Rabobank



# Base scenario

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The dollar exchange rate is and continues to be another uncertainty. The dollar exchange rate we anticipate here is not yet low enough to lead to a global equilibrium between balances of payments.

The US current account continues to show a deficit of around 5% GDP in the base scenario. The dollar could therefore depreciate even more sharply versus the euro, with adverse consequences for the euro area in the short term. On the other hand, the past has shown that the dollar can also hold up for long periods despite balance of payments deficits, although such periods invariably ended in a sharp depreciation of the dollar. These uncertainties in the projection are worked out in greater detail in the next section.

# Base scenario

## The Netherlands: tight labour market

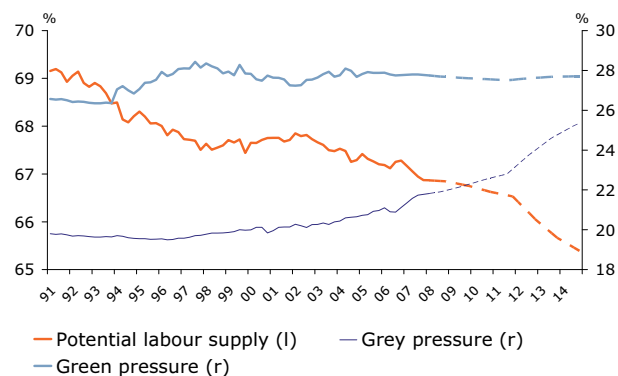
*As a small open economy, the Netherlands is experiencing the consequences of the changes in the international environment as described above. In the Netherlands itself a number of factors have changed conclusively compared to the past few years. The main determinant of the situation is the slowing growth of the working population. This limits the possibilities for growth and simultaneously represents the main threat to that growth.*

It is often said at present that the Dutch economy is fundamentally sound. But is that in fact true? Firstly, it clearly depends on the country with which you choose to compare the Netherlands. Compared to Italy for instance, the Netherlands is doing well: public finances are reasonably solid, supplementary pensions are based on full funding, social security has been made relatively future-proof in the past few years and Dutch exports are still doing well. So nothing much to worry about, you might say.

But a few clouds will appear on the Dutch horizon as well in the coming years. The labour market will become fundamentally tighter due to the ageing of the population (see Figure 16). The ageing will go on, meaning the tightness that has emerged in the labour market in the past few years will not be alleviated by people entering the labour market. Consequently, the growth of employment in the coming years will hardly contribute to growth (see Figure 17). Moreover, the number of new workers entering the labour market will continually decline in the coming years. The growth in the number of older people will give rise to increasing demand for healthcare and an increase in state old age pension spending. This problem is more acute in the Netherlands than in many other countries. Although the country is ageing comparatively slowly, on the other hand there are a relatively small number of unemployed people.

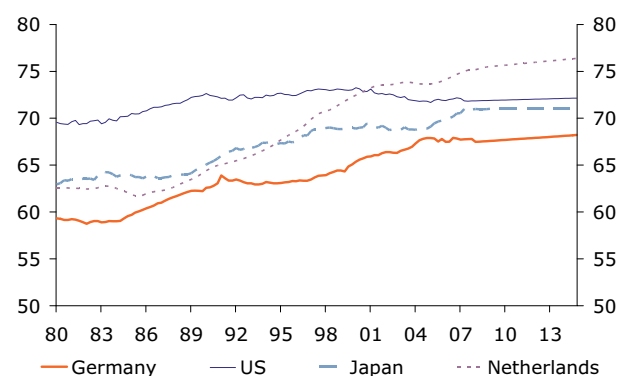
In the absence of policy changes this will lead to an increase in the tax burden on workers. In tandem with the tightness in the labour market this will result in

**Figure 16: Grey and green pressure in the Netherlands**



Source: Rabobank

**Figure 17: Labour participation**



Source: Rabobank

# Base scenario

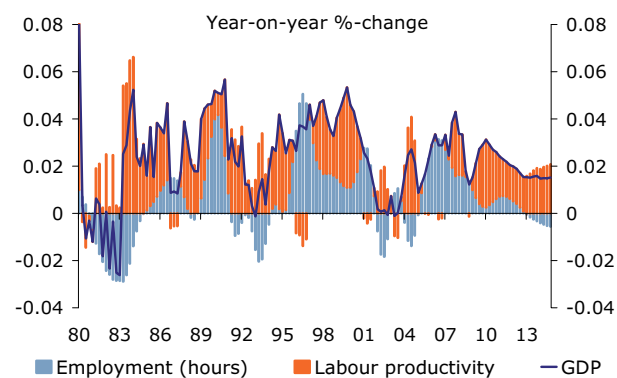
higher wage increases than could be justified on the basis of productivity growth. In the longer term this will cause the Dutch competitive position to deteriorate.

Labour participation is set to increase in our projection (see Figure 17), but not as rapidly as the government would want it to. The government has set the target that in 2016 80% of the Dutch population should participate in the labour market, while this percentage is currently at around 74%. The policy considered necessary to achieve this, as formulated for example by the Bakker Committee, includes steps such as increasing the retirement age. But at present the government appears to be postponing actual measures far into the future.

The contribution made by women in particular to the increase in labour participation will be substantially reduced in the coming years. This is because their participation has now reached a level that is relatively high in an international perspective. Likewise, the average number of hours people work per week will hardly change in our projection. While people in the Netherlands work comparatively few hours a year, there is no reason to assume that working part-time will become any less popular in the next five years. This would require a major cultural change, and of that there is yet no sign. We do not assume in our projection that the cabinet will manage to get 400,000 extra people into employment by the end of 2016. Should it nevertheless succeed, this could have an enormous effect. This has therefore been worked out in a separate scenario in the next section.

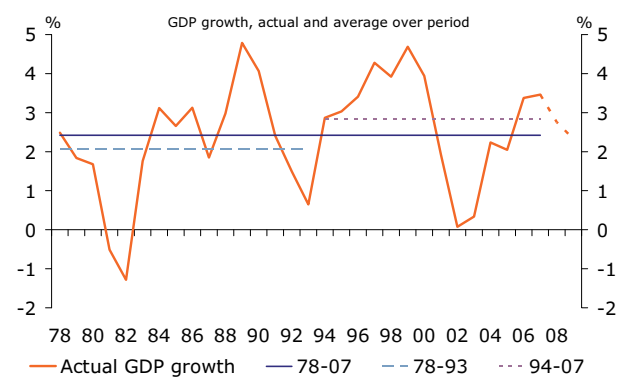
To return to the question at the start of this section: compared to the past, the position of the Netherlands is in fact sound. Indicators on which the country has based itself in the past thirty or forty years, which include unemployment and the public sector deficit, are not in the red as yet. But the structural change brought about by ageing must not be underestimated. More than in the past the

**Figure 18: GDP growth in the Netherlands by contribution of employment and labour productivity**



Source: Rabobank

**Figure 19: Growth projection versus historical averages**

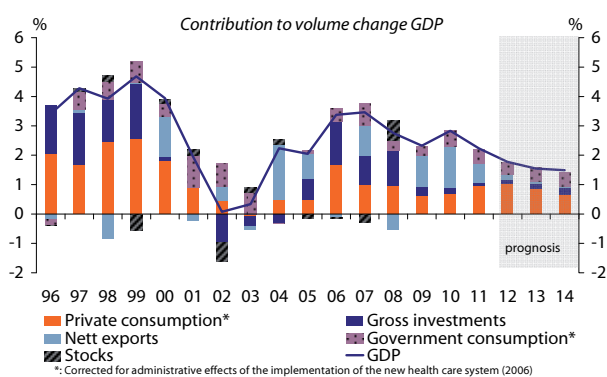


Source: Rabobank

# Base scenario

Netherlands depends on labour-saving technological progress for growth (see also Figure 18).

**Figure 20: Contribution to change in GDP volume**



Source: CBS/Rabobank

The declining labour force will in future not contribute any more to the growth of the total economy. Working smarter – preferably also more smartly than competitors – is becoming increasingly important to be able to finance increasing healthcare costs, pensions and improvements in the (knowledge) infrastructure. In the projection we have assumed that the current development of increasing labour productivity will continue. In itself it is a logical assumption to expect technological changes to reach the Netherlands from the US, and differences between the Netherlands and the US to be eliminated over time. But this does not necessarily have to happen. Without a properly trained working population and active

innovation policy, labour productivity may not increase fast enough to be able to remain competitive.

## Consumption will remain on par, growth in exports accelerates

Economic growth in the period 2010-2014 will be lower in the Netherlands than in the period 2005-2009 (see Table 3), and near the level of potential growth. Figure 19 also shows that the growth of the Dutch economy will fall below the average growth trend of the past thirty years. If we compare the projection period with current years, the slowdown in the growth in exports is especially notable (see also Figure 20). In part this is the consequence of the changing international environment: lower world trade growth and the sustained strength of the euro. But rising labour costs in the Netherlands due to a tight labour market also play a major role. As a result of these three factors the Dutch economy will have a less favourable competitive position in the coming period than in the past few years.

Consumption will remain reasonably on par in the projection period, shored up mainly by the comparatively high real wage increases deriving from the tightness of the labour market. But because exports will grow faster than consumption in the projection period as well, the consumption ratio (share of consumer spending in GDP) will decrease, albeit less rapidly than in past years.

Inflation will in our view peak in 2009 at over 3%, and then return to a stable level of 1¾%. As commodity prices stabilise, their contribution to inflation will decline compared to 2008 and 2009.

# Base scenario

In addition, inflationary pressures arising from labour costs will be limited as labour productivity will make a large part of the wage increases possible. Because we also expect the dollar exchange rate to stabilise, no inflation will be imported anymore either.

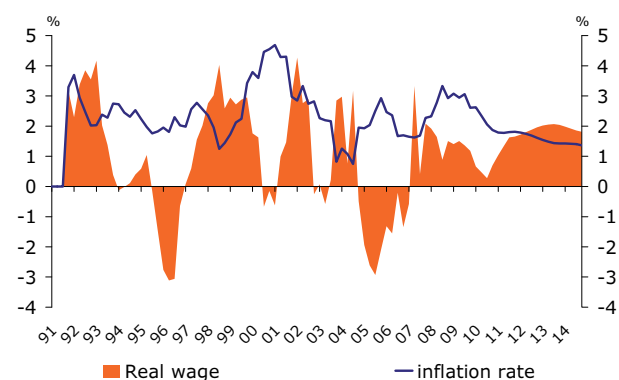
Investments will grow moderately, but that is to be expected if the economy stays near equilibrium. The utilisation of production capacity will in that case provide little incentive for expansion. In addition, the slight rise of long interest rates in the projection period will hamper investment growth.

In terms of government policy, we have assumed that the budget deficit for the period 2010-2014 will be zero on average. This corresponds to a scenario marked by low policy density, in which public spending is at a long-term average and tax income has to be increased to cover rising state old age pension and healthcare expenditure. Consequently, the contribution to growth from government policy is considerably lower than in the past ten years. Supplementary policy is required to achieve the desired budget surplus of at least 1% in 2011. We have not worked this out in detail; that is up to the present government and its successors.

## Risks

The Dutch economy will continue to grow in the coming years as well. We do not envisage a recession. The growth potential of the Dutch economy is threatened however by several fundamental changes. Ageing will lead to higher government spending in the coming years, while there will be fewer workers to finance those costs. Due to the risk of high wages, the tightness in the labour market is a threat to the Dutch international competitive position. In addition, the inflation situation and the related commodity prices and dollar exchange rate represent major risk factors. The effects of these factors on future economic growth are worked out in detail in the next section.

**Figure 21: Real wage development and inflation**



Source: Rabobank

**Table 3: Key figures for the Netherlands 2000-2014**

<i>Key figures Netherlands</i>	00-04	04-09	10-14
GDP	1.7	2.5	2.0
Private consumption	1.5	1.8	1.8
Private investment	-2.3	4.6	1.0
Government consumption	2.5	3.0	2.0
Government investment	4.2	3.0	0.1
Exports	5.1	5.5	3.6
Imports	4.5	5.5	3.4
Stock building	0.0	-0.1	0.0
Current account	3.2	7.4	5.7
Government balance (% GDP)	-1.0	0.5	0.3
Government debt (%GDP)	51.6	45.7	34.7
Unemployment (% labour force)	4.6	5.0	4.0
Inflation (CPI)	3.0	2.0	1.8

Source: Rabobank

# Alternative scenarios

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## Quantifying the risks

*The previous sections described the economic developments that we anticipate if no major changes take place. As we also indicated, there are great uncertainties that could cause the situation to evolve quite differently. We will further quantify several of these risks in this section.*

### **How to interpret scenarios**

The scenarios presented here mainly zoom in on what we see as the main risks for economic development. The last scenario also illustrates the effects of a possible improvement of the growth potential of the Dutch economy. The scenarios should not be interpreted as Rabobank expectations that are set in stone. They are intended primarily to depict the consequences of rather extreme situations. This is also expressly a model exercise. It is impossible to anticipate all of the structural changes or innovations (such as the consequences of a higher oil price).

In the previous section, we presented the figures up to 2014. In this section, we decided to present figures for eight years into the future. Our intention is not to focus on the exact developments, but rather to show how the balancing mechanisms work and what delays could be involved. We will examine what the consequences would be if the oil price rose to 220 dollars, if the value of the dollar dropped to 2 dollars per euro, if a recession occurred in Asia and if there were 400,000 extra people employed in the Netherlands. For each scenario, the focus ultimately lies on the consequences for the Dutch economy.

# Alternative scenarios

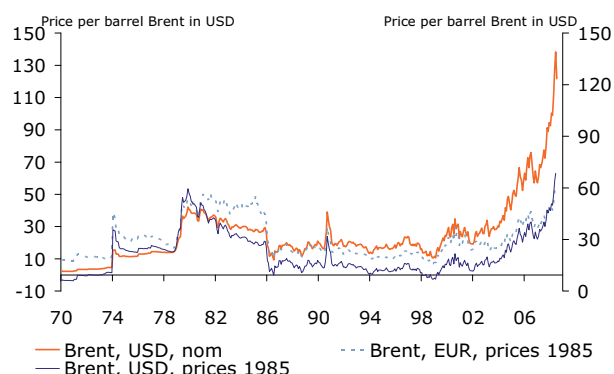
## Scenario 1: Oil price to 220 dollars

*It is possible that the oil price could continue to reach new record highs. However, opinions are divided over the possible developments. In this scenario, we calculate what the effects would be if the oil price rose to 220 dollars a barrel. In the 1970s, considerably smaller increases in energy prices led to major economic problems. In this scenario, we demonstrate that the economic consequences of a higher oil price would be significant, but not as disastrous as in the 1970s.*

Not so long ago, we thought the oil price was high if it exceeded 50 dollars a barrel. Times change, sometimes very quickly. In the meantime, we have paid more than 140 dollars for a barrel of oil, which is more than double the price of a year ago (see Figure 22). It is now clear that we are starting to feel a 'crunch', but without the economy coming to a complete stop. The high oil price hurts less than it did in the 1970s. We are 'lucky' that the dollar has depreciated in relation to the euro, which means that the effective oil price has risen less dramatically in Europe than in the US. This difference is 20% compared to the increase without the depreciation of the dollar. In addition, the energy intensity of the world economies has dropped significantly in the past 30 years (see Figure 23). But because economies continue to grow and the relatively energy-intensive Chinese economy is developing faster than other economies, the demand for energy continues to increase.

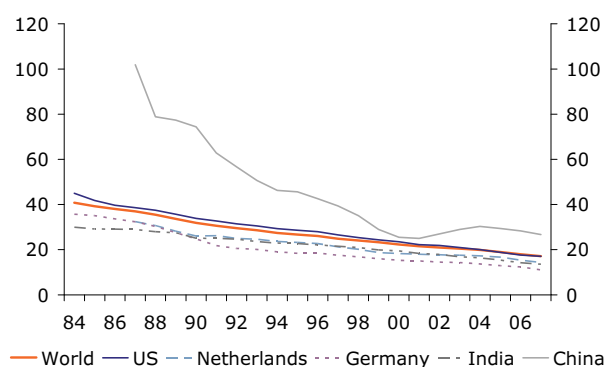
In this scenario, we show the oil price increasing with 80 dollars compared to the baseline. This is not entirely improbable, in view of the developments of the past year. Instability in the Middle East or Russia could quickly lead to major price fluctuations. We are also taking account of the fact that a gradual substitution is gaining momentum: economies are looking

**Figure 22: Oil price in 2005 prices in dollars and euros**



Source: Reuters EcoWin

**Figure 23: Energy intensity**



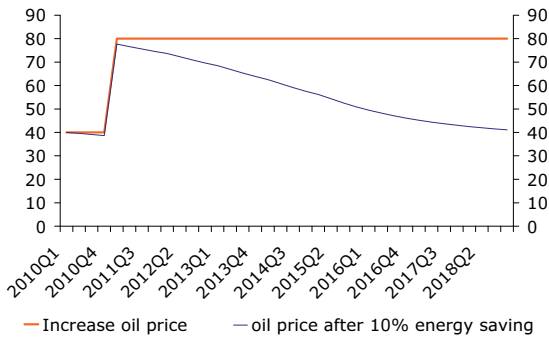
Source: Bloomberg

# Alternative scenarios

for alternative energy sources and opportunities to save energy. This results in a decreased demand for oil, which means the oil price could also drop somewhat.

Figure 24 maps out these effects separately: first, the oil price is increased by 40 dollars in 2010, and by another 40 dollars in 2011. It is then assumed that the energy intensity, and therefore also the demand for oil, will gradually decline by a total of 10% by 2015.

**Figure 24: Development of the oil price as a result of a decrease in energy intensity**



Source: Rabobank

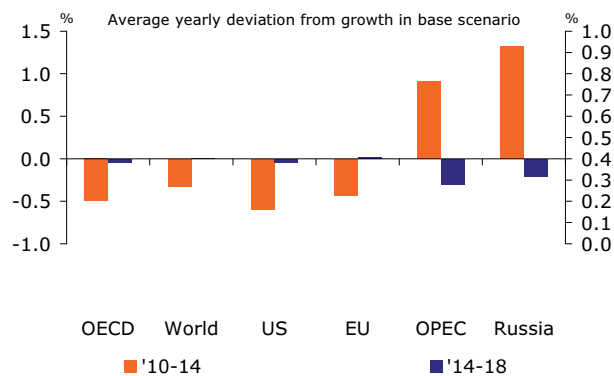
As a result, in 2015 approximately 50 dollars will remain of the initial increase of 80 dollars. In the years that follow, the difference will further diminish. If no energy is saved, the effects below will be around 60% greater.

For the Netherlands, we have also taken the natural gas benefits into consideration: as a result of the higher oil price and the linked

natural gas price, more income will be earned by the Dutch government. We assume that this extra money will be credited to the treasury. In reality, there is a significant chance that the government will squander it away for other purposes. It would be more prudent, however, to either utilise these funds to promote the development of alternative energy sources or to place it in government securities.<sup>2</sup>

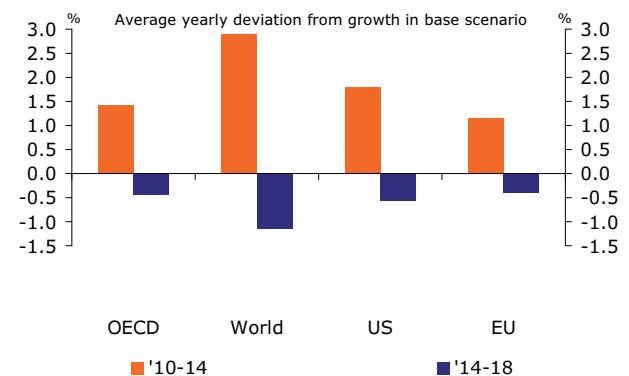
<sup>2</sup> For an elaboration of this idea, see, for example, W.W. Boonstra, *Aardgasbaten, vergrijzing en infrastructuur: Waarom heeft Nederland geen SWF?* [Natural gas benefits, ageing and infrastructure: Why doesn't the Netherlands have an SWF?], Rabobank Nederland, January 2008.

**Figure 25: Lower growth in energy-importing countries**



Source: Rabobank

**Figure 26: Higher inflation**



Source: Rabobank



# Alternative scenarios

The oil-importing countries will spend more money on energy, leading to an increase in production and other costs, and in turn, a rise in inflation (see Figure 26). Even if energy-saving technology is taken into account, this situation puts the brakes on growth. At the same time, however, oil-producing countries such as OPEC and Russia will end up profiting from the high oil price (see Figure 25).

Because the oil price increase will be permanent, most of the resulting higher income from oil will be spent. Consequently, production and imports will rise. Higher inflation will lead to an increase in the official interest rates, which will have a greater effect on interest rates in the US than in the eurozone. This is a result of the fact that the US economy is more energy intensive than the European economy. This fact also slows down growth in the short term. In a slightly longer term, however, the world economy will slowly return to growth in line with the existing trend.

The effects on the Dutch economy will be considerable. In the medium term, the Dutch economy will grow 0.6 percentage point more slowly than the baseline. This amounts to almost one third of the expected growth. All categories will contribute less to growth. First of all, the growth of consumer spending will drop sharply. The higher inflation rate will lead to a decrease in the growth of actual disposable income. Slightly later, salaries will rise, which in turn will improve consumption growth somewhat in the longer term. The decline in the growth of foreign demand will lead to a partial reduction in export growth. This effect will be long term in nature. Due to the lower demand development combined with higher interest rates, investment growth will also lag behind.

The significantly higher natural gas income will strongly improve the EMU balance. Our assumption that the current government will keep the money in its pocket means that this will not lead to additional growth. The EMU debt will drop considerably, which will have a positive effect in the long term on the growth realised, as a result of falling government interest expenses. This will overcome part of the ageing population issue.

**Table 4: Effects of an 80-dollar oil price increase on the international economy**

	10-14	14-18
average deviation from base in %-points		
GDP-growth OECD	-0.5	0.0
GDP-growth world	-0.3	0.0
Growth world trade volume	-1.4	0.4
World consumer price	2.9	-1.2
Current account US	-0.4	-0.1
Absolute deviation from base (level)		
Oil price (\$, Brent)	60.0	41.7
Dollar (\$ per €)	0.0	0.0
Long term interest rate Euro area	0.0	0.0
Short term interest rate Euro area	0.4	-0.1

Source: Rabobank

**Table 5: Effects of an 80-dollar oil price increase on the Dutch economy**

	10-14	14-18
average deviation from base in %-points		
GDP	-0.6	0.3
Private consumption	-0.4	0.9
Private investment	-0.5	0.8
Exports	-1.5	0.4
Imports	-1.3	0.8
Absolute deviation from base (level)		
Current account	0.2	-0.5
real disposable income	-0.5	1.5
Government balance (abs. dev.)	0.6	-0.5
Government debt (abs. dev.)	-18.5	-32.5
Unemployment (abs. deviation)	-0.4	-0.2
Employment	0.1	0.0
Inflation (CPI)	1.3	-0.1
Contractual wages	0.6	0.0

Source: Rabobank

# Alternative scenarios

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## **Conclusion**

The economic consequences of a higher oil price are considerable for both the world as a whole and for the Dutch economy. Though a higher oil price will not give rise to a recession, growth rates will clearly be trimmed back. Due to the diminishing energy intensity in this scenario, 50 dollars will remain of the initial price increase of 80 dollars. If innovations accelerate the decline in demand, the effects of the higher oil price will be less pronounced.

# Alternative scenarios

## Scenario 2: Weakness dollar

*In our base scenario, the dollar remained constant at 1.43 dollars per euro. However, it is possible that the bottom could drop out of the dollar in the longer term. If the dollar were no longer considered a global currency, this could lead to a dramatic depreciation. In this scenario, we present the effects of a dollar that is only worth half of a euro.*

In our base scenario, the dollar stabilised at a level of approximately 1.43 dollars per euro. There are a number of arguments that demonstrate why the dollar could weaken further in the longer term.<sup>3</sup> First of all, the large US savings deficit, expressed in the shortage in the current account, is not sustainable in the long term. In the future, other countries will be less willing to fund the US shortfalls in dollars. The US will have to realise a savings surplus, or at least equilibrium on the current account of the balance of payments. This means lower growth, a lower dollar, or both. Furthermore, the dollar will continue to lose ground in its role as anchor currency. This will be accompanied by a downward modification in the exchange rate versus other major currencies.

To show the effects of the abovementioned developments, we will lower the dollar exchange rate in this scenario to 2 dollars per euro. The exchange rates of other countries will be kept unchanged compared to the euro, which means that the dollar will depreciate nearly 30% compared to all other currencies. In fact, this situation would only involve the continuation of the trend that began at the start of this year (see Figure 27). Since mid-2001, the dollar's value compared to the euro has fallen by almost 50%.

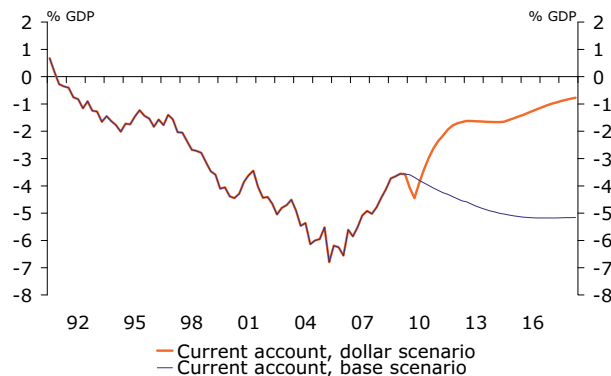
<sup>3</sup> See also W.W. Boonstra and P. Marey, *Einde dollarstijdperk* [End of the dollar era], Economic Quarterly Report, Rabobank Nederland, June 2008.

**Figure 27: The dollar has been falling for a while**



Source: Reuters EcoWin

**Figure 28: Balance on US current account**

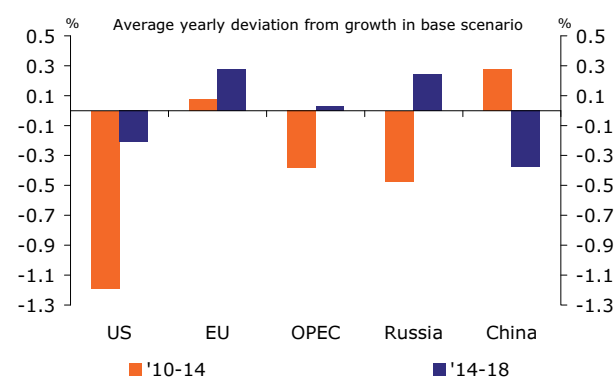


Source: Rabobank

# Scenarios

At first, the US current account will deteriorate even more, but then improve considerably, by more than 4.3 percentage points of GDP in 2018 (see Figure 28). This 'J-curve' effect is caused by the immediate change in the relative

**Figure 29: Lower US growth, higher EU growth**



Source: Rabobank

prices as a result of the exchange rate modification, while the import and export response to this will be delayed. Owing to the changes in relative prices, all countries, except the US, will see a worsening of their competitive position compared to the US. Imports from the US will become more attractive, while exports to the US will be less advantageous. This will have several effects. In the US, prices will increase due to the higher import prices. In turn, the US interest rates will rise, partly as a result of this. This (considerably) higher interest rate will result in lower investments, while the higher prices will erode purchasing power and therefore reduce

consumer spending. These two effects will more than cancel out the positive effect of higher exports. Consequently, annual growth in the US will be 1.2 percentage points lower than in the baseline (see Figure 29).

The inflation outside the US will drop due to the lower import prices. This will reinforce domestic private spending in these countries. However, Europe will see a deterioration of its competitive position, causing exports to decline. The lower interest rates in the eurozone will lead to higher investments, such that the growth in the eurozone will increase slightly on balance.

**Table 6: Effects of a dollar worth half a euro on the international economy**

	10-14	14-18
average deviation from base in %-points		
GDP-growth OECD	-0.5	0.2
GDP-growth world	-0.3	0.1
Growth world trade volume	-0.9	0.9
World consumer price	2.7	-0.8
Current account US	3.3	4.3
Absolute deviation from base (level)		
Oil price (\$, Brent)	26.8	24.4
Dollar (\$ per €)	0.6	0.6
Long term interest rate Euro area	-2.0	-2.0
Short term interest rate Euro area	-1.9	-2.1

Source: Rabobank

**Table 7: Effects of a dollar worth half a euro on the Dutch economy**

	10-14	14-18
average deviation from base in %-points		
GDP	-0.2	0.7
Private consumption	-0.2	0.6
Private investment	1.7	0.9
Exports	-0.4	1.1
Imports	0.1	0.9
Current account	0.0	0.0
real disposable income	-0.4	0.8
Government balance (abs. dev.)	0.1	0.0
Government debt (abs. dev.)	1.6	-2.2
Unemployment (abs. deviation)	0.9	0.1
Employment	-0.2	0.2
Inflation (CPI)	-0.5	-0.8
Contractual wages	-0.3	-0.4

Source: Rabobank

# Scenarios

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The energy-producing countries, which enjoyed a significant advantage in the previous scenario, are now encountering serious disadvantages because oil is paid for in dollars. Even though the oil price is rising, these countries are experiencing a drop in their income in the local currency. This slows down their growth.

For the Netherlands as a small open economy, the effects are different than for the total eurozone. The deterioration of the competitive position will hit us relatively hard, and consequently the growth in the period to 2014 will amount to being 0.2 percentage point lower on average. Indeed, inflation and the interest rates will drop, leading to an increase in investments and stronger purchasing power. But this is not sufficient to offset the loss in exports. As a result of the decreased demand from abroad, production in the Netherlands will drop and unemployment will rise. This will worsen the negotiating position of the trade unions, and therefore wages will increase considerably slower than in the baseline. Lower inflation will also contribute to this. Reduced growth in employment and the slightly smaller increase in purchasing power will mean less growth in actual disposable income. In addition, actual disposable income will be lower due to higher taxes.

Because we will retain the same EMU balance as in the baseline, the higher government expenditure on unemployment benefits will have to be compensated for by higher taxes. All of this will mean that the growth in consumer spending will be halved in the medium term compared to the baseline if the dollar depreciates as assumed in this scenario.

The equilibrating mechanisms will begin to regain momentum in the period after 2014: exports will begin to grow, as will investments. On balance, GDP will grow more rapidly to 2018 inclusive than in the baseline, but will ultimately end up at a lower level. In short: as a result of the depreciating dollar in 2010, we will still be poorer in 2018 than without this depreciation.

## **Conclusion**

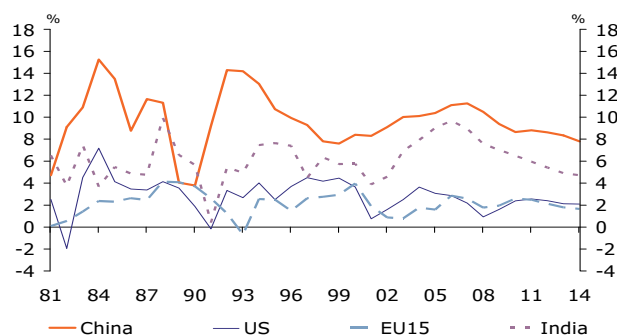
The impact of a strong decrease in the dollar exchange rate will be most keenly felt in the US economy. The effects on the eurozone are relatively modest. For the Netherlands, a substantially weaker dollar will initially lead to flatter growth, because, as a small open economy, the Netherlands is especially sensitive to changes in international trade.

# Scenarios

## Scenario 3: Recession in Asia

*China in particular has been very important for the growth of the world economy in recent years. However, it is quite possible that its growth will be lower in the years to come. This scenario analyses the consequences for the rest of the world of a decline in growth in domestic demand in China and India.*

**Figure 30: GDP growth in China, India, the US and the eurozone**



Source: Rabobank

In recent years, China and India have been the major drivers behind the growth of the world economy. The growth rates of these economies have been considerably higher than those of the OESO countries (see Figure 30). But what happens now, if these drivers stall? It is unthinkable that growth in China and India would completely grind to a halt, but a growth rate equal to half of the current figure (4 to 5%) would come close to forming a recession in these countries. We are going to assume in this scenario that the economic disruption in

these countries has a domestic cause. To this end, we suppose that the growth of domestic demand will virtually cease in 2010, and gradually recover after this. This could happen if, for example, investments would not experience double-digit growth for a year, but instead were to stabilise for one or more years.

Why would this happen? Viewed separately, the forecasts for the Chinese economy are still positive, but tension is increasing. Problems with the infrastructure, pollution and/or political tensions can impede economic prosperity. What are the potential consequences of a sharp decline in domestic spending in China and India on the rest of the world?

First of all, the effect on India would be significant, due to its dependence on China. As such, the ultimate impact on Indian growth would be greater than on Chinese growth. Declining growth in China would mean that the Chinese demand for foreign products would drop. This would translate throughout the world into less international trade. In addition to the neighbouring countries that China conducts significant trade with, the open economies, such as the Dutch economy, would suffer relatively serious consequences. Despite the fact that the Dutch total exports to China amount to less than 2% of the total export volume, Dutch export growth would drop by approximately 0.4 percentage point per year in the period 2010-2014 compared to the baseline.

For the US and the EU together, the total effects on GDP would be virtually zero (Figure 31). Exports would drop for these areas as well, but worldwide inflation would also fall. China and India, as countries with a relatively large demand for

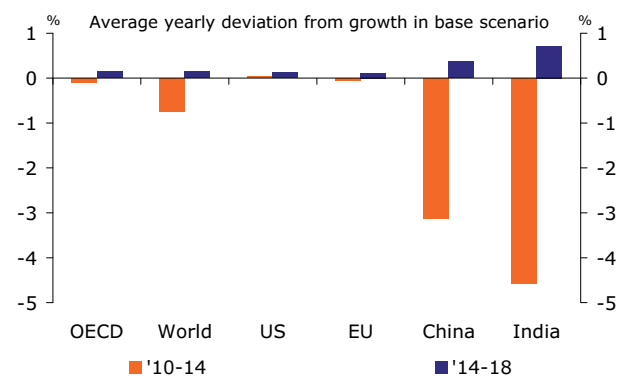
# Scenarios

commodities (especially oil), have significantly driven up worldwide inflation in the recent period. Due to the lower growth in this variant, their demand for raw materials will also decline. This translates into lower inflation for the entire world. This effect on inflation will mean that a reduction will be possible in the interest rates (both short and long term). As such, this will stimulate investments internationally. Because domestic demand is also supported in part by lower inflation, this effect will virtually eliminate the negative consequences for exports in relatively closed economies, such as the US. The drawback for the US is that its current account deficit will further increase. Exports will be lower for the entire period, whereas domestic demand will start to improve.

The Netherlands is subject to a similar course of events as described above. The effect on exports is relatively strong (see Table 9). However, on balance, the change in GDP will average only 0.2 percentage points lower for the 2010-2014 period than in the baseline. How is this possible? Because this effect on exports leads to a decrease in employment and an increase in unemployment (see Figure 32). This increase, combined with lower inflation, means that wages will also not rise as quickly. At first, these lower wages and the lower employment rate will result in lower consumer spending. Imports will also drop as a result. But because the (European) interest rates will fall, investments will become more interesting in time (after an initial regression in 2010). This will make a positive contribution to GDP growth.

In the period after 2014, the equilibrating mechanisms will start up once again. Internationally, and also for the Netherlands, the growth in these years will be slightly higher than in the baseline. The gap that has emerged since 2010 will be closed in the Netherlands in 2017. At that time, Dutch production will once again be the same as in a projection without the Asian crisis.

**Figure 31: Effects of a crisis in Asia on GDP growth**



Source: Rabobank

**Table 8: Effects of a crisis in Asia on the international economy**

	10-14	14-18
average deviation from base in %-points		
GDP-growth OECD	-0.1	0.1
GDP-growth world	-0.8	0.1
Growth world trade volume	-1.2	0.8
World consumer price	-0.3	-0.2
Current account US	-0.9	-0.7
Absolute deviation from base (level)		
Oil price (\$, Brent)	-0.8	-1.5
Dollar (\$ per €)	0.0	0.0
Long term interest rate Euro area	-0.6	-0.5
Short term interest rate Euro area	-0.8	-0.6

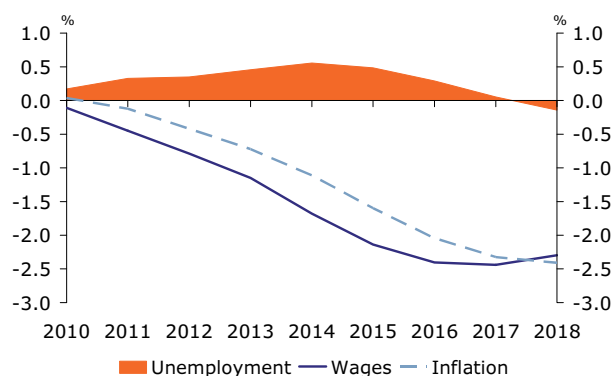
Source: Rabobank

# Scenarios

## Conclusion

The effects of a substantial crisis in Asia will probably not be too severe for Western countries, including the Netherlands. While demand from China will decline, which is especially disadvantageous for open economies, inflation will decrease worldwide. This will stimulate the domestic demand in Western countries and will compensate for the temporarily flagging demand from Asia.

**Figure 32: Development in unemployment, wages and inflation in the Netherlands**



Source: Rabobank

**Table 9: Effects of a recession in Asia on the Dutch economy**

	10-14	14-18
average deviation from base in %-points		
GDP	-0.2	0.3
Private consumption	-0.2	0.1
Private investment	0.5	0.5
Exports	-0.4	0.5
Imports	-0.3	0.4
Current account	-0.2	0.0
Real disposable income	-0.4	0.3
Government balance (abs. dev.)	0.0	0.0
Government debt (abs. dev.)	1.1	-0.3
Unemployment (abs. deviation)	0.6	-0.1
Employment	-0.1	0.1
Inflation (CPI)	-0.2	-0.3
Contractual wages	-0.3	-0.1

Source: Rabobank

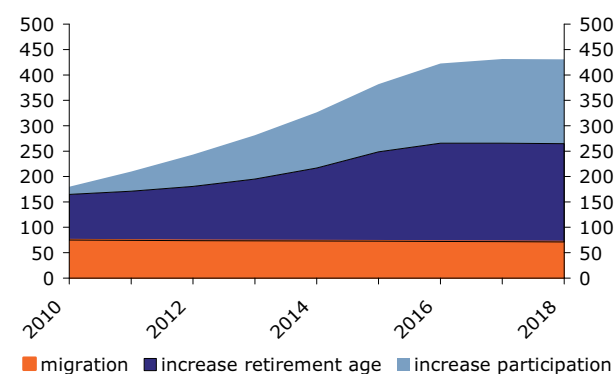


# Scenarios

## Scenario 4: Labour potential higher

*In the previous three scenarios, we demonstrated mainly the negative risks for the world economy. However, there are many positive stimuli that can also be studied. This final scenario shows what would happen if the working population in the Netherlands were to increase. The effects on the rest of the world are marginal and therefore will not be taken into account.*

**Figure 33: Increase in the labour supply by means of three channels**



Source: Rabobank

As demonstrated from the base scenario, the shortage on the labour market will increasingly be a problem area for the Dutch economy. However, there are several things that can be done to help resolve this problem: using more labour from abroad (migration), working more (increasing the labour participation rate in hours and people) and working longer (increasing the retirement age). Many methods are possible, as indicated in the report from the Bakker Committee<sup>4</sup>, and this is more than necessary. Starting in 2010, the

working population will decline, while the Netherlands will need more hands on deck to continue growing.

In this scenario, we assume that (1) 100,000 people will come to work in the Netherlands from other countries (the expectation is that they will come from the new EU member states). These people will have an average level of education, and will work more than the average Dutch citizen (as they are coming here to work).

We also assume that (2) the retirement age will gradually be increased, which means that people will continue to work longer (including before their 65<sup>th</sup> birthday) and the state old age pension will become more affordable. In this exercise, this also means an additional labour supply of approximately 100,000 people. We do not indicate here exactly how this will be achieved: by switching state pension contributions to public funding, increasing the retirement age or other measures. Our only assumption is that this will not cost the government any money in the medium term, nor will bring in any money (except for the additional tax income from the working population).

Finally, (3) we assume that the labour participation rate will increase. And to the extent that the total of these three impulses will result in the same target as indicated by the Bakker Committee: 400,000 additional people being available for the labour market in 2016. Again, our goal is not to flesh out exactly how

<sup>4</sup> Advice from the Labour Participation Committee, *Naar een toekomst die werkt* [En route to a future that works], Rotterdam, 2008.

# Verenigde Staten

these measures will be carried out, but to show the possible effects on the Dutch economy.

We also assume that migration will quickly gather steam (a question of just

'opening the door') and that stimulating working longer and encouraging labour participation will have a gradual effect, with the maximum volume being reached in 2016 (Figure 33).

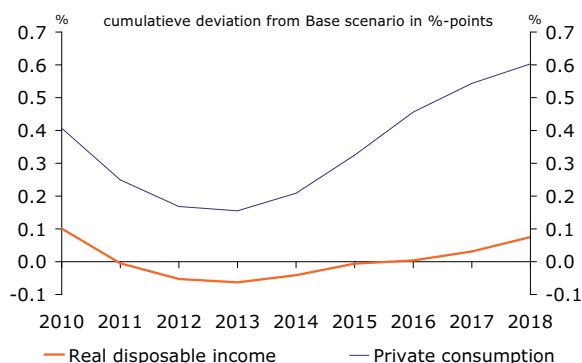
The total effect on the world economy as a result of this increase in the labour supply in the Netherlands is obviously small. For this reason, we do not take these effects into account here.

The increase in the labour supply will change the ratio between labour and capital. You could say that the people will be available, but the machines will not (at least not yet). As a

result, labour productivity will first drop in the Netherlands (and rise in the migrants' home countries). In the longer term, the capital stock will increase, and investments will rise rather quickly for this purpose.

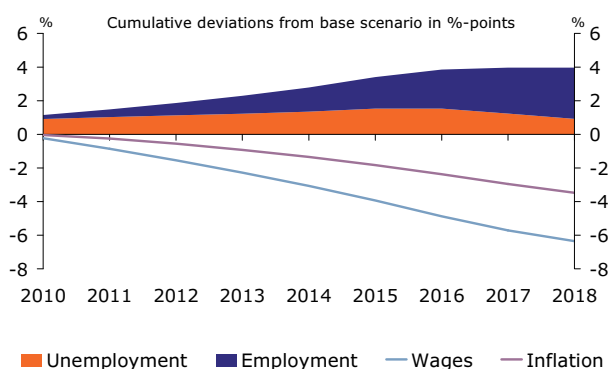
In the first instance, all three impulses will lead to a higher labour supply. This will result in higher consumption, because there are more people to spend more money (Figure 34). However, a large part of the new labour supply will initially be unable to find a job. Unemployment will rise and this will put pressure on wage growth (see Figure 35). Because wages will fall first compared to the base, and prices will only drop after this, the actual disposable income will decline and consumption, after first rising, will decrease compared to the baseline (see Figure 34).

**Figure 34: Development of actual disposable income and consumption**



Source: Rabobank

**Figure 35: Effects of an increase in the labour supply on wages, inflation and unemployment**



Source: Rabobank

**Table 10: Effects of an increase in the labour supply on the Dutch economy**

	10-14	14-18
average deviation from base in %-points		
GDP	0.1	0.1
Private consumption	0.0	0.1
Private investment	0.5	0.3
Exports	0.0	0.0
Imports	0.1	0.1
Current account	-0.1	-0.1
real disposable income	0.0	0.0
Government balance (abs. dev.)	0.0	0.0
labour productivity	-0.1	-0.1
Unemployment (abs. deviation)	1.4	0.9
Employment	0.3	0.3
Inflation (CPI)	-0.3	-0.4
Contractual wages	-0.6	-0.7

Source: Rabobank

# Scenarios

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However, the wage-moderation effect will mean that labour will become relatively less expensive. This will encourage investments from companies and provide for additional job opportunities. And because the Netherlands can produce more cheaply, this will eventually lead to higher exports. The effects of this are small however. Ultimately, after four years, GDP will only be ½ percentage point higher than in the base scenario (additional growth of 0.1 percentage point per year).

On balance, the effects of this impulse from the labour supply are quite minimal compared to the other scenarios. This only reinforces the fact that, as a small open economy, the Netherlands is strongly dependent on developments abroad over which it has no control. In the longer term, however, the labour impulse described above will lead to an improvement in the Netherlands' competitive position, due to the lower increase in the labour costs per unit of product. The affordability of the public sector finances will improve, because the lower state pension expenses will be borne by a larger number of employed people. The horizon on which these effects are clearly visible, however, is further than the coming eight years that we have mapped out here. It should also be taken into account that this is the only scenario in which action can be undertaken in the Netherlands.

## **Conclusion**

In the medium term, an increase in the labour supply will not yet benefit the Dutch economy very greatly in terms of additional economic growth. But that does not mean that expanding the labour supply is not advisable. In the short term, wages will fall and the Dutch economy's competitive position will improve. In the longer term, say up to 2040, the effects are expected to be more significant. In particular, the costs of ageing will be absorbed more readily, as more people will be able to contribute to the costs for state old age pensions and healthcare.

# In conclusion

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## Opportunities or threats?

*The scenarios described above demonstrate the potential consequences for the economy if we do not move towards the projected equilibrium, but instead are confronted with other developments. The situation can then change very quickly compared to the base scenario, as illustrated in the first few sections.*

The past few years have been economically good to the Netherlands. Economic growth is expected to slow to some extent this year and next. The economic situation in 2009 represents the starting point for the medium-term analyses in this document. In the base scenario up to 2014, we outline what we consider to be the most likely development of the world economy and the Dutch economy. Given the principle of closing the output gap (a trend-free medium-term projection), this translates into slightly lower growth rates in the medium term than in the recent past. As a small open economy, the Netherlands is experiencing the consequences of the changes in the international environment as described above. In the Netherlands itself, a number of factors have also changed conclusively compared to the past few years. The main determinant of the situation is the slowing growth of the working population. This limits the possibilities for growth and simultaneously represents the main threat to that growth.

We have projected the risks attending the base scenario in detail in four alternative scenarios. These spotlight what we have identified as the main threats to growth, but which also may be opportunities for future economic developments.

The economic consequences of an oil price rising to a level that is 80 dollars above its current level are considerable for both the world as a whole and for the Dutch economy. Though a higher oil price will not give rise to a recession, growth rates will clearly be trimmed back. This is clearly a threat to economic growth, but it can also be seen as an opportunity. The high oil price stimulates research into energy-saving production methods and into alternative, and often cleaner, energy sources. Success in this area is not just an opportunity in an economic sense, but is also an important impulse to reduce environmental pollution.

The impact of a strong decrease of the dollar exchange rate, to 2 dollars per euro, will be most keenly felt in the US economy. The effects on the eurozone are relatively modest. The positive side of this scenario is that equilibrium will finally be reached in the worldwide economic relationships, or at least a different equilibrium. In this scenario, the US will not be able to continue consuming at the expense of the rest of the world. Of course, the sustained strength of the euro will remain a threat to the Dutch economy.

# In conclusion

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The effects of a substantial crisis in Asia will not be too severe for the Netherlands. While demand from China will decline, which is especially disadvantageous for open economies, inflation will decrease worldwide due to the lower oil price and other factors. This is good news for most countries. The advantage of slightly less robust growth on the part of the Chinese economy is that the associated growing pains, reflected in such things as environmental pollution and high inflation, will decrease. In addition, this presents opportunities for other Asian economies to jump in the gap that China has left behind.

In the medium term, the addition of 400,000 people to the labour supply will not benefit the Dutch economy very greatly in terms of economic growth. But that does not mean that expanding the labour supply is not advisable. The larger labour supply will slow down wage growth, which will reinforce the competitive strength of the Dutch economy and lead to higher growth in time. In the longer term, say up to 2040, more people working means that it will be easier to absorb the costs associated with the ageing population, as more individuals will contribute to the costs for state old age pensions and healthcare.

The negative side of this scenario is that productivity will fall initially. The reason for this – simply stated – is that there will be more people working than machines available for them to work on. In any case, it will be necessary to quickly jack up productivity in the Netherlands in order to remain competitive.

Each scenario can therefore be seen as either an opportunity or a threat, depending on the chosen perspective. The fact remains that it is more sensible to occasionally look at the compass to determine the correct course, than to be overrun by waves of the business cycle that obscure the ability to see the potential opportunities of the situation.

# Economic key figures

## Key figures

Year-on-year change in volume in %	2008	2009	2010-2014
<b>International</b>			
GDP			
United States	1	1½	2¼
EMU	1¾	2	2
World	4¼	4¼	3¾
Oil price (Brent, in \$, level)	98	92	92
Dollar exchange rate (\$ per €, level)	1.54	1.43	1.43
<b>Netherlands</b>			
GDP	2½	2¼	2
Consumer spending	2	1¼	1¾
Gross investments	4¾	1½	1
Export of goods and services	4½	3¾	3½
Import of goods and services	5½	2¾	3½
Inflation (%)	2¾	3	1¾
Unemployment (% working population)	4	4	4
Net public sector debt (% GDP)	1	1	¼
Balance on the current account (% GDP)	5¾	6½	5¾

## Results of scenarios 2010-2014

Year-on-year change in volume in %	Oil	Dollar	Asia	Labour market
<b>International</b>				
GDP				
United States	1.7	1.1	2.3	2.3
EMU	1.7	2.2	2.0	2.1
World	3.5	2.9	2.6	3.8
Oil price (Brent, in \$, level)	152	119	91	92
Dollar exchange rate (\$ per €, level)	1.41	2.00	1.41	1.43
<b>Netherlands</b>				
GDP	1.4	1.7	1.8	2.1
Consumer spending	1.4	1.6	1.6	1.9
Gross investments	0.4	2.7	1.4	1.4
Export of goods and services	2.1	3.1	3.2	3.6
Import of goods and services	2.1	3.4	3.1	3.5
Inflation (%)	3.1	1.3	1.6	1.5
Unemployment (% working population)	3.6	4.9	4.6	5.4
Net public sector debt (% GDP)	0.8	0.3	0.3	0.3
Balance on the current account (% GDP)	6.0	5.7	5.5	5.6

# Colophon

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