The Netherlands

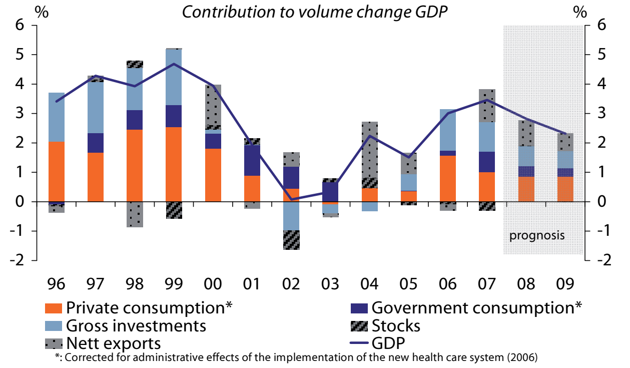
The Dutch Indian Summer

2007 was a top year featuring economic growth of 3½%. While we expect economic activity to level off somewhat in 2008 and 2009, we still forecast growth percentages that are at or above the long-term Dutch average. The Netherlands will also perform relatively better than the rest of Europe in 2008, although this difference is expected to be eliminated in 2009. In order to ensure that the Netherlands remains competitive in the long term decisive action must be taken now to address the country's labour market shortages and the declining educational level of the working population. Measures must likewise be taken to curb healthcare costs. Otherwise government expenditure will be in danger of not being able to keep pace with government earnings.

Enjoy the Indian Summer …

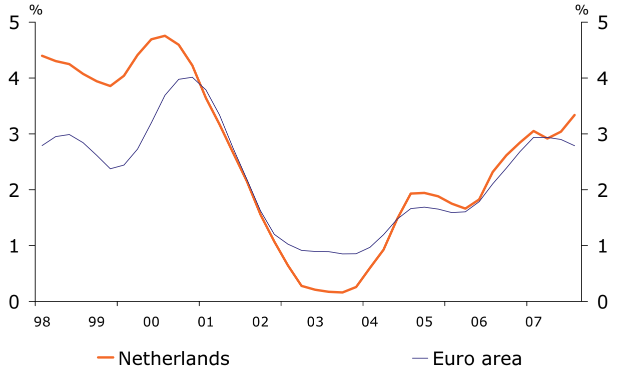
Despite the negative reports from the financial world, the Netherlands was actually positioned at the top of this economic cycle in the second half of 2007. With growth percentages that had not been achieved before in this century, the Netherlands demonstrated its ability to weather the financial turmoil for the time being. While the growth was broadly based, exports and investments played a particularly important role in achieving the expansion (chart 1). The Netherlands' performance in recent quarters in comparison to other European countries is remarkable to say the least (chart 2). This divergent performance relative to the rest of Europe is due in part to incidental factors. For example, Dutch exports benefit comparatively more than other countries from the increasing demand for natural gas. As a result the Netherlands' exports continue to perform relatively well. What's more, like all other small open economies, the Netherlands gains greater benefits from international trade than larger economies that generally rely more on domestic spending (this will be discussed in greater detail elsewhere in this Quarterly Report).
The Netherlands is still in good shape from a structural standpoint. This is reflected in the fact that contract wages have risen relatively moderately to date, government finances are reasonably stable and there is low unemployment.

Chart 1: Contribution to change in volume of GDP



Source: CBS, Rabobank

Chart 2: Growth in the Netherlands and Europe



Source: Reuters EcoWin, Rabobank

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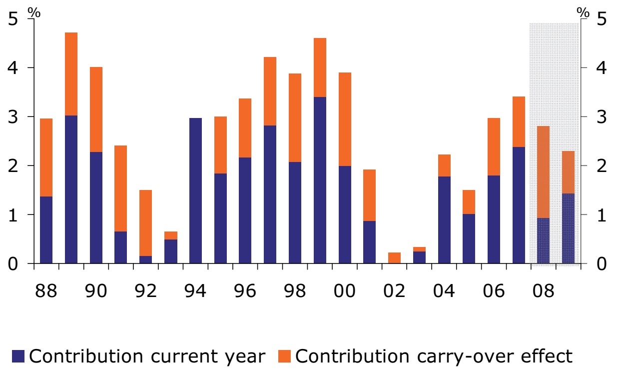
...or prepare for stormy weather ahead?

One of the advantages of the excellent growth figures realised in the second half of 2007 is that we can now already say with certainty that there will be a relatively high increase in real GDP in 2008 as well. This is because the annual growth figures for the economy are calculated by dividing the average level of Gross Domestic Product (GDP) in one year by the average GDP level in the previous year. This means that if the rate of economic growth picks up at the end of the year, the starting level of GDP at the beginning of the new year will be higher than the annual average of the preceding year. This effect is called the carry-over effect, i.e. the proportion of growth that is actually the result of growth in the previous year. So, in the case of 2008, even if the economy does not grow any more for the entire year, the volume of the economy in comparison to the average in 2007 will still be 1.9% greater (chart 3).

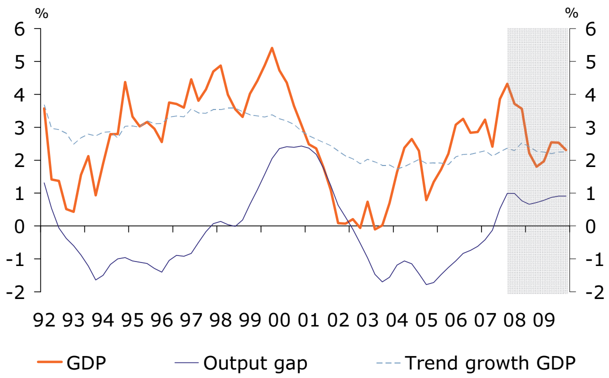
In order to provide a better assessment of the development of the Dutch economy, it is consequently more effective to examine the underlying quarterly figures. Our assessment indicates that economic growth will slow down considerably in the first half of 2008. This is primarily as a result of the slowdown in worldwide growth, which has ensued from the mortgage crisis in the US. There are not, however, signs of recession. This slowdown in growth is completely in line with the developments in the rest of Europe. The dip is, however, only temporary in nature. While average growth will indeed continue to slow down further in 2009, the economy will still perform above trend (refer to chart 4) as is also revealed in the so-called output gap. This indicator shows whether the economy has a growth rate that is above or below the level that the economy can sustain in the long term. Because the Netherlands has now been growing for some time at a rate that is higher than is possible in the long term due to the development of the country's productivity and labour supply, the tensions within the economy are beginning to mount.

Chart 3: Contributions to economic growth in the current and the previous year



Source: CBS, Rabobank

Chart 4: The Netherlands grows above trend

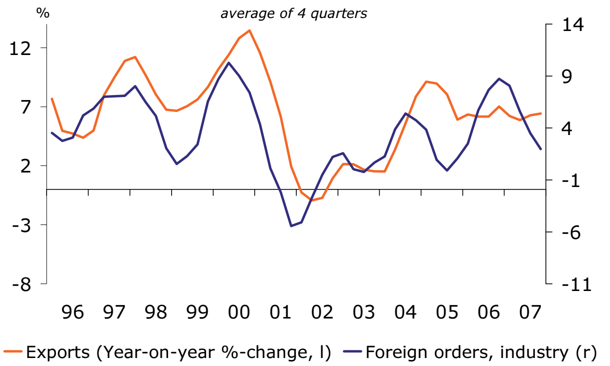


Source: CBS, Rabobank

A few storm clouds are consequently looming above the lovely Indian summer. Notably, the tight labour market is making it more difficult for employers to resist employee wage demands. In addition, the actual wages in many sectors are increasing at a faster rate than was originally agreed in the Collective Labour Agreements. Higher inflation, partly fuelled by higher commodity prices, could speed up this process. Besides the strong euro, higher labour costs are threatening to damage the competitive position of the Dutch business community. While this will not result in a sharp fall in economic growth in the Netherlands in 2008 and 2009, it will lead to a rate of growth that is more in line with the rest of Europe.

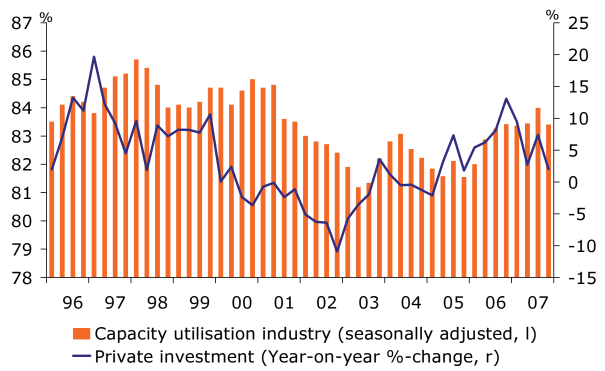
The business community has not yet put on the brakes ...
The Dutch business community is performing well. Producers are still extremely optimistic, particularly with regard to the anticipated activity. The foreign order intake has, however, passed its peak (chart 5). The capacity utilisation rate is also not as high as in the late 1990s and as a result there is not a very considerable need for companies to invest in expansion (chart 6).
In light of decreasing world trade, we expect exports to grow with relatively less exuberance in 2008 and 2009 in comparison to 2007. Exports of goods produced in the Netherlands become more expensive due to higher labour costs in 2009. This will be partially compensated by a temporary decrease in the value of the euro in comparison to the dollar, which will make Dutch exports less expensive. The decline in world trade will also cause re-exports to grow at a slower pace. This decrease will, however, be modest as growth in the Eurozone will also decrease on only a limited scale. Other European countries will continue to be the Netherlands' most important trading partners by far. The effect of the turmoil in the financial markets on the investment climate has been minimal so far. The excellent profits achieved in recent years have in general led to strong company balance sheets. As a result companies are not dependent upon loan capital for all their investments.

Chart 5: Exports and foreign order intake



Source: CBS, Rabobank

Chart 6: Capacity utilisation rate and company investments



Source: CBS, Rabobank

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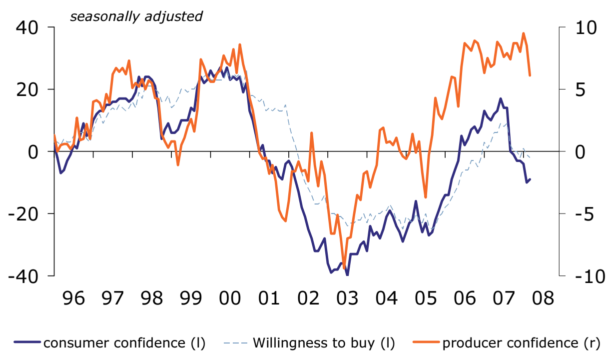
Interest rate premiums, especially for high-risk investments and mergers and acquisitions, have risen considerably in recent months. While investments in capital goods have until now not been categorised as extremely high risk, a knock-on effect vis-à-vis all financial risks is still conceivable. We still believe, however, that the business community will be impacted more by the lack of well-qualified personnel than by the difficulties in the credit market.

...while consumers are downshifting

Normally speaking consumers take over the baton from investment and exports to move forward as the engine driving economic growth. This has occurred to a lesser degree this time. This is partially linked to pessimism among consumers and partially to an increase in the tax and premium burden, and limited positive, or even negative wealth effects.

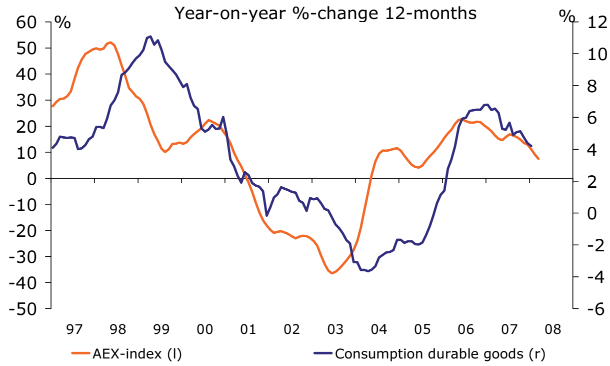
While growth in consumer spending has already fallen from 2.7% in 2006 to 2.1% in 2007, growth in consumer spending is set to be even lower this year. The wobbly AEX-index, which is the most visible outward expression of the unrest in the financial markets, does not instil families with confidence that they can earn capital gains. Consumer confidence has consequently fallen in recent months and shows a completely different picture than producer confidence (chart 7). The decrease in willingness to buy has not been as great and this sub-indicator frequently provides a better prediction of growth in consumer spending. However, decreases in financial wealth generally have a greater effect on consumer spending than increases in wealth do. The current uncertainty in financial markets will consequently not result in consumers spending as freely as they did in the late 1990s. In addition, the higher wage increases in 2008 will be countered by an increase in the tax and premium burden and higher inflation, primarily as a result of higher healthcare premiums.

Chart 7: Divergent consumer and producer confidence



Source: CBS, Rabobank

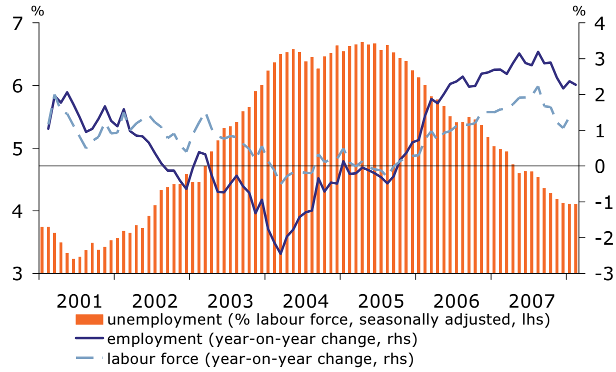
Chart 8: AEX index and durable goods consumption



Source: CBS, Rabobank

Growth in consumer spending volume will be somewhat lower than in 2007 at 1¾%, although this figure is distorted by a statistical shift connected with the process of replacing the health insurance's no-claim system with a system of personal contributions. When corrected for this effect, private consumption growth is 0.4 percentage points less. 2009 will be a better year for consumers. Fewer increases in the tax and premium burden have been announced by the Dutch government and domestic spending will also be boosted by a continuing trend of considerable wage increases. The proposed abolition of the Unemployment Insurance Contribution for employees will also bolster consumer spending. The opposing VAT increase is not expected to entirely wipe out this positive effect on buying power because we anticipate that part of the VAT increase will not be charged on to consumers. Increasing inflation *and* healthcare premiums that in all probability will once again rise sharply can, however, throw a spanner in the works.

Chart 9: Falling unemployment, decreasing growth in labour supply



Source: CBS, Rabobank

Continuing shortages on the labour market...

The effects of an ageing population are already becoming evident in the labour market. This is reflected in the stabilisation of the labour supply, which could suggest a higher outflow of baby-boomers (diagram 9). The oldest baby-boomers (born in 1945) are now around 62 years old, which is the average retirement age in the Netherlands. We will see growing numbers of older people leaving the labour market in the years ahead and this will lead to decreased growth in and eventually to a decline in the supply of labour. Unemployment is set to decrease further due to a slight rise in employment. This will once again create extremely tight conditions in the labour market. As a result of both structural shortages and new regulations that have been implemented in recent years (such as the Work and Welfare Act and shortening the duration of unemployment benefits), the number of people receiving unemployment benefits has decreased. This figure also does not fluctuate as much in tandem with the prevailing economic conditions. The costs of ageing-related social security (state pension payments) has consequently increased substantially. While 1.5 times as much was spent on state pensions as on unemployment benefits in 1986, more than three times as much was spent on state pensions in 2006. This means that people in employment pay less and less for their own income provision should they lose their job, but pay more and more for retirees. This could eventually undermine solidarity. It is, after all, with good reason that the OESO wrote last month in a report on the Netherlands that the labour market shortage constitutes a greater threat to economic growth than the credit crisis. It is consequently crucial to ensure that as many people as possible find work and to encourage older people to continue working longer.

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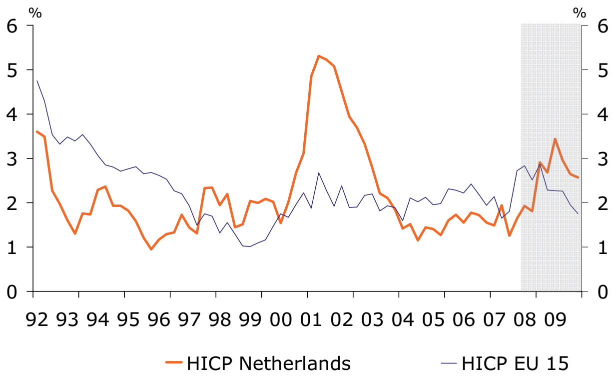
The shortage in the labour market will cause workers to *demand* and increasingly *receive* higher wage increases in collective labour agreement negotiations. Collective labour agreement wages, which rose by 2.4% in late 2007, will increase by a considerably larger percentage next year. Workers will also more frequently succeed in their efforts to negotiate added bonuses and as a result employers' total wage costs will increase further.

Chart 10: Inflation in the Netherlands is rising faster than in the rest of Europe



Source: Reuters EcoWin, Rabobank

In addition to focussing on the size of the Dutch labour potential, it is also important to work on improving the quality of the working population. While the average level of education is rising sharply in many countries, the Netherlands has been unable to keep pace with this upward educational curve in recent years. As a result the level of education of young Dutch people has fallen behind that of other countries (refer to chart 12). This is an extremely worrying development for a country that seeks to profile itself as a knowledge economy. This is also not a beneficial development in view of the Lisbon agenda, which is aimed at transforming Europe into an internationally competitive knowledge society. This also gives rise to the question whether enough effort is being made in the field of policy in the Netherlands: The Netherlands is still one of the countries that allocates relatively limited funds to education.

...is one of the causes of higher inflation

Viewed from a European perspective, inflation in the Netherlands was low last year at 1.6% (chart 10). A number of factors led to this difference with the rest of Europe. The continuing intense competition between supermarkets has meant that food price increases have not been passed on to Dutch consumers as much as in other countries.

House prices have been linked to inflation since last year. As a result the rise in rental prices in the Netherlands was historically low at 1.4%. We also expect a limited rise in rental prices of 1¾% for 2008. A third factor that has kept inflation at a relatively low level in the Netherlands until now is the lower rise in energy prices. The fact that prices for natural gas and electricity are adjusted less frequently in the Netherlands than in other countries means that price changes have a more delayed reaction on inflation. We will, however, be faced with price rises this year because the price of electricity will most likely go up in June.

We expect inflation to rise more rapidly both this year and next year. Rising commodity prices and higher labour costs will primarily lead to higher inflation this

year. These factors will be compounded next year by a somewhat stronger dollar on average, and thus higher import prices.
In addition, the Dutch government is going to raise the VAT rate by 1 percentage point on 1 January, which will result in a 0.3 percentage point increase in inflation. This is one reason why inflation in the Netherlands will rise to above the European average in 2009 for the first time since 2003.

Table 1: Key data for the Netherlands

year-on-year %	2006	2007	2008	2009
Gross domestic product	3.0	3.5	2 3/4	2 1/4
Private consumption	2.7	2.1	2 3/4	2 1/4
Government expenditures	2.2	2.9	1 3/4	1 3/4
Private investment	8.2	5.2	1 2/4	1 1/4
Gross fixed capital formation	7.2	4.9	1 2/4	1 1/4
Exports of goods and services	7.0	6.4	3 1/4	2 3/4
Imports of goods and services	8.1	5.6	4 3/4	4 1/4
Consumer price index	1.1	1.6	2 2/4	3
Unemployment (% labour force)	5.5	4.5	3 3/4	3 3/4
Public budget (% GDP)	0.6	0.4	1/2	1
Current account (% GDP)	7.5	7.8	7 1/2	7 1/2

* corrected for the administrative effects of the implementation of the new Health care system in 2006

Source: Reuters EcoWin, Rabobank

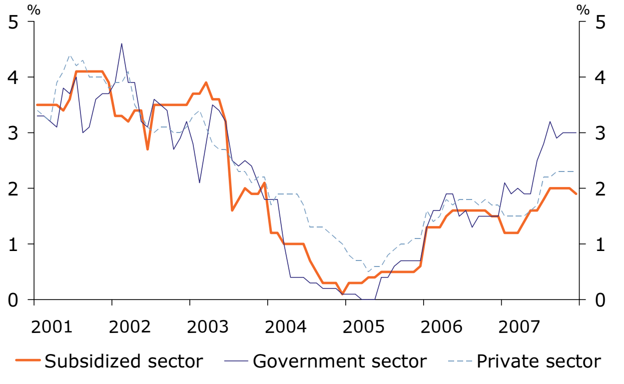
Government

The high economic growth of recent years has generated increased tax income for the state. Higher natural gas income has furthermore contributed to enabling government finances to end the year 2007 with a surplus rather than the previously expected deficit. While the higher than expected natural gas income is naturally a welcome source of extra income for the treasury, it remains to be seen how long the government will benefit from this windfall because oil prices can go back down again and we know that our supply of natural gas is finite. The Dutch Minister of Finance must consequently not give in to the temptation to pay for structural expenditures from incidental windfalls.

We also expect that the government will be able to close both 2008 and 2009 with a positive balance. The Netherlands consequently stands out positively from other large European countries in this sense.
The fact that structural reforms, such as measures in the labour market, have failed to materialise can in itself throw a spanner in the works in the short term. The issues surrounding the collective labour negotiations for the Dutch police force forcefully illustrates that, in its role as employer, the Dutch government will not be the last party to be faced with higher wage demands (chart 11). Wage increases were, in fact, higher in the government sector than in the market sector in late 2007. While this partially constitutes a catch-up process (because the previous government froze government wages for a couple of years), the ageing government workforce is creating a large demand for new government personnel. In order to meet this demand, the government will have to pay more and this entails a risk that government spending will spiral out of control. Healthcare spending is particularly expected to rise. This will lead to higher healthcare premiums again next year, and the end of this trend is still not in sight by far. The question is consequently to what extend this development will be tenable in the longer term. The main reasons for the rising healthcare costs are technological progress in healthcare and an ageing population.
The latter could eventually lead to waning support among those members of society who bear the brunt of the healthcare costs (employers and employees).

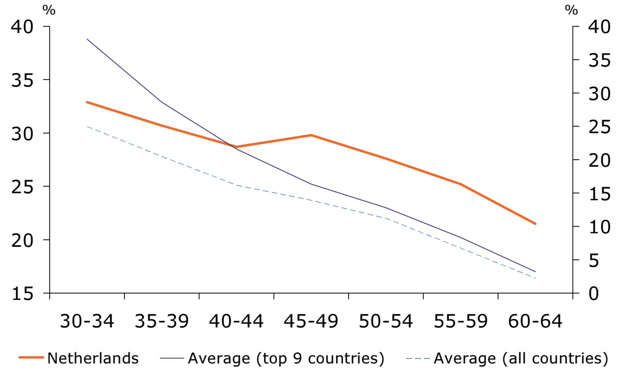
It is consequently imperative to take action now to create the conditions for budget surpluses that can also be realised during periods of economic headwind. This demands structural reforms, such as amending the right of dismissal in certain instances and measures aimed at maintaining the affordability of an ageing population, for example by increasing the pensionable age.
If such measures are not implemented, it remains to be seen whether current government policy will be able to withstand economic headwind. This could cause a balmy Indian Summer to rapidly turn into a blustery autumn storm for government finances.

Chart 11: Government takes the lead in accelerated wage development



Source: CBS, Rabobank

Chart 12: Educational level of Dutch youth lags behind internationally



Source: OESO, Rabobank

Hans Stegeman
H.W.Stegeman@rn.rabobank.nl