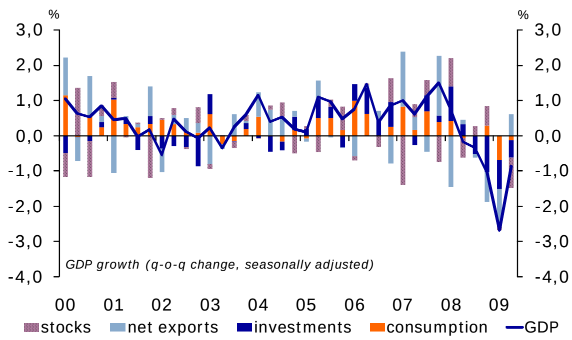
The Netherlands

Over the worst?

The Dutch economy slid into the deepest recession since the Second World War in the wake of the financial crisis in the past year. Recent months have produced increasing signs that the worst may be behind us. But the way back up will be an arduous climb. International trade is providing something of a foothold but not much stability. Domestic developments in the Netherlands will continue to trend down in the second half of this year and next year. Investment levels are declining sharply and consumption is under pressure due to rising unemployment. The government is largely forced to watch with increasing disquiet.. Even without additional spending initiatives, the budget deficit is rising steeply.

Figure 1: Worst contraction over



Source: CBS, Rabobank

Looking ahead

The fact that there is a recession has been incontestable for some time now. The current debate centres chiefly on what shape a recovery might take. The various scenarios are designated by three consecutive letters in the alphabet, U, V and W, which refer to the shape of the graph plotting economic growth. Optimists predict a swift recovery, likened to the letter V. If growth is delayed, charted growth will look more like a U. The pessimistic view of the economy's trajectory is reflected in the shape of a W. Its proponents believe that any recovery will be short-lived and followed by a new recession.

The data on real economic growth in the first six months in the Netherlands offer something for everyone. The real economy shrank by 0.9% in the second quarter compared to the preceding quarter (figure 1). The decline is therefore significantly flatter than in the first quarter, when the economy contracted by 2.7% compared to the preceding quarter. Pessimists will point mainly to the fact that the real economy shrank 5.1% in the second quarter compared to a year ago, accelerating from 4.5% for the first quarter. Optimists could counter that consequently the worst year-on-year contraction is likely to be behind us. At any rate, these numbers confirm that the Dutch economy is in a historically deep recession. Volume growth has been negative for no fewer than five successive quarters. Even optimists will find it hard to put a positive spin on that fact. Economic activity is expected to shrink by an average of 5% this year. The Dutch economy has not contracted by that much in any single year since the Second World War. The optimists are therefore largely looking ahead. And even then pessimists will find enough reasons to support their gloomy outlook on economic developments. Because while the worst contraction may appear to be behind us,

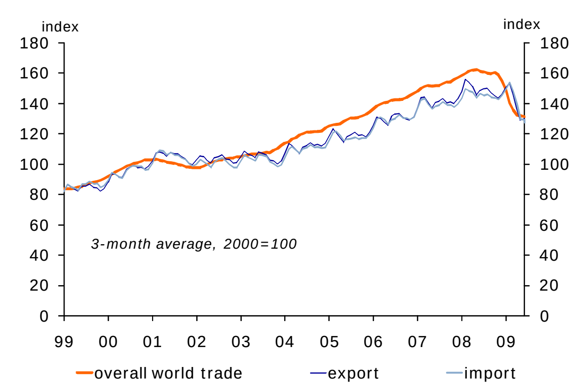
no recovery is as yet in sight. The economy will return to real-term growth in the course of 2010 at the earliest, we expect – but without much conviction.
The positive signs of the past few months have arisen because world trade is picking up. Part of the rise in global demand is fuelled by companies that are replenishing their stocks, which had been drawn down substantially in the past few months. Governments' stimulus packages are another demand driver. In both cases the effect on demand is temporary. This indicates how shaky the soil beneath the green shoots of economic recovery is.
At the same time, many were favourably surprised by the second quarter diagrams. After a very poor first quarter, expectations were far from high. Accordingly, we also have to allow for upside risks. The poor first quarter was partly due to consumption, which declined despite positive purchasing power, as people saved substantially. If this sentiment reverses it could give rise to an unexpectedly strong (temporary?) resurgence. A small plus in our outlook for the growth of the Dutch economy in the coming year reflects the cautiousness that is appropriate to these uncertainties.

Full circle

That the economy plummeted as speedily as it did was mainly due to a strong decline in overall world trade[1] in the second half of 2008 (figure 2). That is not very surprising, as the open Dutch economy depends significantly on demand for our export products. Because the Dutch economy has no major domestic growth driver –as France does in its large domestic market, for instance– on which to fall back in these circumstances, it did not take long for the rest of the economy

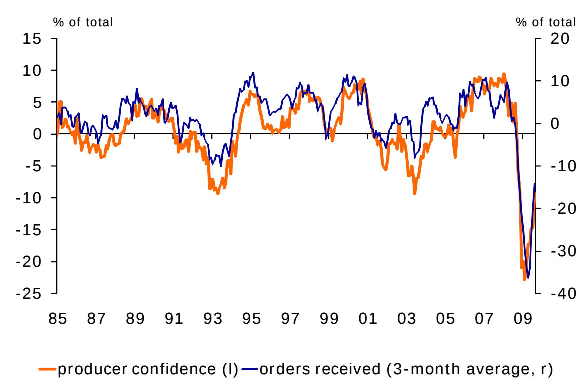
[1] Growth in overall world trade may deviate from the growth in world trade that is relevant to the Netherlands, which concerns import volume growth of the countries to which the Netherlands exports.

Figure 2: Overall world trade stabilising



Source: CBS, CPB

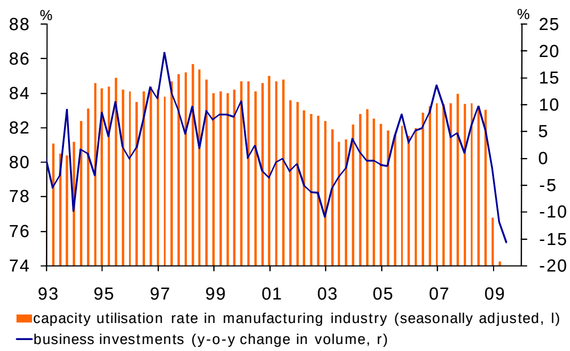
Figure 3: Producers wait and see



Source: CBS

to be pulled into the economic trough in the wake of the export sector. Conversely, it is international trade that is expected to stimulate economic recovery, coming full circle. Export volumes fell by an average of 14% in the first four months of this year compared to the same period of last year. Although far fewer goods were also sold to other countries in May than a year earlier, at 10% in real terms the decline in volumes was significantly slower in that month. We expect volumes to contract by some 9¾% on average for the full year 2009. Next year Dutch exports are set to rise slightly, by 2¼%, due to the impetus of improving world trade, but the level will still remain substantially below that of 2008.

Figure 4: Capacity utilisation rate and investments



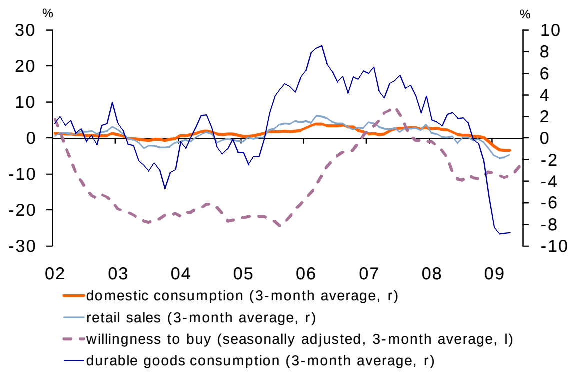
Source: CBS

Imports are likewise under pressure, with volumes falling by over 10% in the first and the second quarter. With declining consumption and significantly lower business investments, demand for foreign goods and services is likewise falling. Businesses have cut spending on machinery and company cars, in the main, and these are precisely the goods that are often imported from abroad. In the second quarter, the fall in imports accordingly outstripped that of exports. Net exports therefore were the only contributor to economic growth (figure 1) in the second quarter. In 2009, import volumes are expected to decline by 8¾% on average. Because imports are likely to grow less strongly next year than exports, net exports will then contribute to economic growth.

Businesses are less pessimistic

Business confidence rose to -9.3 in August. The mood among entrepreneurs has improved after bottoming in February but the pessimists are still in the majority. Entrepreneurs were optimistic in August mainly about expected production in the coming three months and in their assessment of the order position (figure 3). The upbeat sentiment about the order position indicates that production in the Netherlands might climb out of the trough to some extent in the next few months. The stock cycle plays a major part in this. The coming months will see businesses replenishing their stocks, which could provide an impetus to global demand and hence production. The steep decline in economic activity is reflected in a historically low level of capacity utilisation at businesses (figure 4). As long as machines in place are operating at low levels, businesses will see little need to invest. In addition, profitability is pressured as businesses are only able to adjust their workforce to production with some delay. Overall, private investments will fall by around 15% on average in 2009. Only the public sector will invest 2% more this year than a year ago. But as its share in the total volume of investments is small, the increase in public sector investment this year is little more than a drop in the ocean. The volume of private investment will continue to decline next year, by 6½%, although production is expected to fall less strongly in that year.

Figure 5: Consumption still low



Source: CBS

The consumer is the weak link

The consumer made a subdued start to this year. In the past six months, consumers spent 2.5% less on average than a year earlier. Purchases of durable goods in particular were cut back substantially. In the first six months of this year the consumption volume spent on this consumption category, which is sensitive to economic trends, fell by 8.5% (figure 5). Conversely, people saved more. Since the beginning of the year, savings balances have been increasing by over 14% each month compared to the corresponding period a year ago and the savings ratio has been growing considerably.

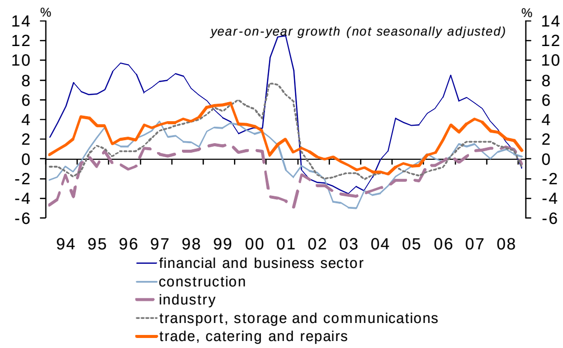
At present, consumers' reluctance to spend does not appear to be attributable to the development of their real income, which is still relatively favourable thanks to high contractual wage increases, cuts in taxes and social security contributions at the start of the year and the pronounced fall in inflation. Rather, it is chiefly due to increasing uncertainty about the future. Although unemployment rose only to a limited extent in the past few months, the fear of losing their jobs was sufficient reason for consumers to keep their purses tightly shut. Consumer sentiment did improve in the summer months but a reversal is still not in sight. Consumer confidence is depressed mainly due to the sombre unemployment outlook. Moreover Dutch households have been hit hard in terms of their net worth by the crisis. For the full year 2009, we expect a decline in consumption of 2¾%. Private consumption is expected to continue to fall by 1% next year as well, as rising unemployment will be the main driver of a significant fall in real income compared to this year.

Recession also affects housing market

Like the rest of the economy, the Dutch housing market is also in stormy weather. The problems are not as severe as in the United States, Ireland, the United Kingdom or Spain for instance, where underlying problems in the housing market are currently leading to significant price adjustments.

But sentiment also plays a large role in the Netherlands when it comes to relocation decisions. Due to the widespread uncertainty among consumers and the gloomy labour market outlook, people are opting to be cautious. Houses remain on the market longer and fewer houses have been sold in the past few months. Nonetheless, the fall in house prices has been limited so far. We do not expect any dramatic falls in house prices for the coming period either. For this year and the next we expect a limited nominal price adjustment of the average house price.[2] This is negligible, however, compared to the U.S. for instance, where houses have already shed around one third of their value.

Figure 6: Employment in market sector down



Source: CBS

No concerns about deflation

Inflation softened to 0.2% in July compared to the same period of last year, headlining at its lowest level since December 1987. The fall in the price index is driven chiefly by the sharp fall in energy bills. Gas rates were cut substantially by 20%, which depresses inflation by 1 percentage point. While the cheap energy is currently still resulting in very low price increases, in the coming months the base effects (the undertow of the strong fall in oil prices a year ago is eliminated from the inflation figure after twelve months) will reverse and conversely result in accelerated inflation. In addition, the scope for producers to reduce their prices is limited as margins are pressured due to the rise in labour costs per product unit. On the other hand, the unutilised capacity in the economy will lead to a decline in core inflation (i.e. inflation excluding volatile components such as energy and food). Businesses will be eager to boost their margins by pushing up prices, but can only do so if there is sufficient demand. On balance, average price levels will edge up in the coming months. With inflation averaging around 1% in both this and the next year, price increases in the Netherlands are expected to remain well below the ECB target of 2% for the eurozone.

Labour market: employment opportunities down

Given the very poor production figures of the past few months and the brittle outlook, it is not surprising that the labour market is facing troubled times, the first signs of which are already manifest. Unemployment rose to 4.9% in July and the jobless number is up 78 thousand from a year ago.

[2] For a detailed update on the housing market see: Rabobank, *Dutch Housing Market Quarterly,* August 2009.

Unemployment is therefore at about the same level as at the start of 2007. The rise in unemployment is largely attributable to a significant decrease in employment opportunities. After the record number of jobs created at the end of 2008, there were 90 thousand fewer jobs in the second quarter of this year than in the same period a year ago. The number of jobs was down 84 thousand from the first quarter of this year, the largest quarter-on-quarter fall ever recorded. This represents a clear break with the job growth of the past few years.
Jobs are being cut chiefly in business services, industry and transport (figure 6). These sectors accounted for some 90% of total job losses in the first quarter of this year compared to the last quarter of 2008. Within business services the number of temporary agency workers, which were employed mainly in industry, fell sharply, as job losses mostly affect flexible labour first. In 2008, around 9% of employees had flexible contracts. These are quite often young men with low-level qualifications working in the market sector. This explains to some extent why three quarters of the increase in unemployment in the past year has concerned men (figure 7). Job growth in the public sector redresses the balance only to a very limited extent. In the first place, the public sector is considerably smaller. In addition, employment is only growing in some parts of the public sector, particularly in the healthcare and welfare sectors. As employment is expected to continue to develop favourably in the healthcare sector and to a lesser extent in education and public services, women and highly-qualified employees are expected to be hit less severely.

The part-time unemployment scheme introduced by the cabinet has a minor effect on the rising unemployment in the current year and will be unable to prevent an expected average of 5% of the working population to be unemployed in 2009. The scope of this scheme is relatively limited. Next year, when the slump in production will cause employment to contract further, unemployment is expected to rise to an average of 7½%. By comparison, in 1983 and 1984 unemployment was higher at 10.2% in both years, while in the 1930s the unemployment rate even reached 19.4% in 1935.

Public finances deep in the red

After the public sector budget in 2008 had, for the third year in succession, posted a small surplus, the public deficit is expected to reach 4½% GDP this year. There is no scope for further support initiatives. The substantial deterioration is, to a large extent, the result of the economic downturn. Income from tax and social security contributions is declining at the same time as spending on social security is increasing steeply. By way of illustration, if economic growth backtracks by 1 percentage point, the budget balance will fall by around 0.5 percentage point. In setting the budget for 2009 the cabinet had assumed GDP growth of 1¼% in 2009. The actual number is expected to be a contraction of 5%; a negative swing by 6¼ percentage points versus the

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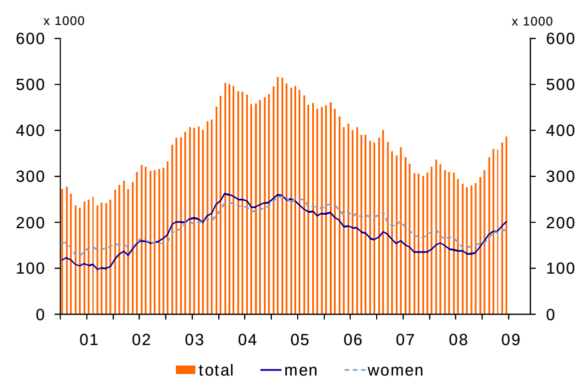
budget. For the public budget, the cabinet had assumed a surplus of 1.2% GDP on Prinsjesdag (Budget Day). We expect a deficit of 4½% GDP. Therefore, around 3.3 percentage points of the 5.7% fall in 2009 is attributable to economic developments. The costs of the stimulus package and declining income from natural gas need to be factored in on top of this. The deficit is set to rise further to 6¾% GDP next year. To prevent public debt, which has already risen substantially as it is, from continuing to rise explosively in the coming years, plans for structural measures to improve the public accounts already need to be put in place now. Doing nothing is not an option (see also the focus article *Budget policy*).

Conclusion

The past few months have seen increasing signals that the global economy is over the worst. The combination of government measures and a turnaround in the worldwide stock cycle play an important part in this respect. The Dutch economy has also benefited from the stabilisation of world trade. The contraction in the second quarter of this year at 0.9% (quarter-on-quarter) was accordingly less pronounced than the unprecedented contraction of 2.7% in the first quarter. The worst does appear to be behind us.

But that does not mean there is nothing to worry about any more. Government incentives and the stock cycle can only produce a temporary upturn. When this effect weakens, business investments and household spending will have to take over to bring about a sustained recovery. Yet the outlook for these two spending categories is not rosy. Nor should we expect much from the government, with a budget that is deep in the red. After a substantial contraction in the current year, we can only conclude that the envisaged recovery will be meagre in 2010. As stated above, the way back up will be an arduous climb.

Figure 7: Unemployment up mainly among men



Source: CBS

Table 1: Key data for the Netherlands

annual averages, y-o-y change in %	'08	'09	'10
Gross Domestic Product	2,0	-5	¼
Private consumption	1,3	-2¾	-1
Public sector expenditure	2	2	¾
Private investments	4,7	-15	-6½
Export of goods and services	2,7	-9¾	2¼
Import of goods and services	3,7	-8¾	1
Consumer price index	2,5	1	1¼
Unemployment (% of labour force)	3,9	5	7½
Government balance (% GDP)	0,6	-4½	-6¾
Current account balance (% GDP)	6,7	6,1	6,3

Source: CBS, Rabobank

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