Netherlands

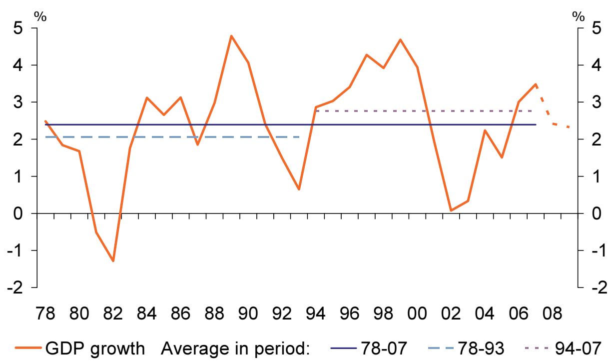
Cold front from the west

The Dutch economy can look back on two very good years. In 2008 GDP growth will slow substantially owing to the poorer external environment. For 2009 we are expecting the influence of a recovery of the global economy to prompt economic growth to pick up again during the year. Due to the strong growth of GDP in the last two quarters of 2007 the full-year figure for 2008 GDP growth will reach a very respectable 2½%, despite the slowdown. There is virtually no such favourable effect on annual growth in 2009. The annual growth estimated at 2¼% consequently masks the fact that the economy will be recovering in 2009 from the dip it is experiencing at present.

Warmed-up Dutch economy …

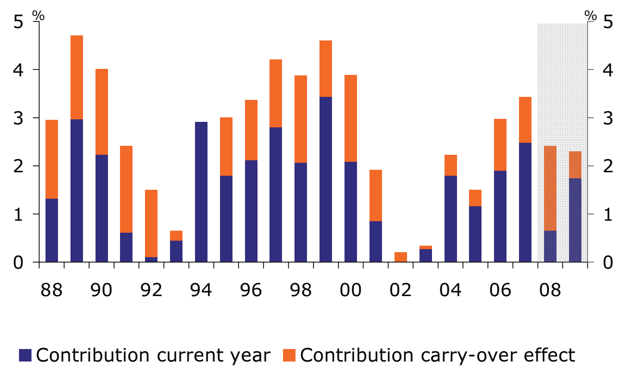
At 3% in 2006 and 3.5% in 2007 real Gross Domestic Product (GDP) growth in the past two years outpaced the long-term average (figure 1). Unemployment receded sharply in both years. This substantial growth will come to an end this year. Economic growth will decline and the fall in unemployment will be small. We are expecting GDP growth in 2008 of 2.5% compared to the year before. This full-year figure is strongly influenced by the high economic growth recorded in the last two quarters of 2007. As a result of this high growth, the starting level for GDP in 2008 was already substantially above the 2007 average. If GDP does not rise further for the whole of 2008 (and the Netherlands therefore produces the same volume of goods and services each quarter as in the preceding quarter) the average level of GDP compared to that of 2007 will still be 1.75% higher (figure 2). This increase contributed by the preceding year is called 'carry-over'. Looking at the growth that will be attained in the year 2008 itself clearly reveals that the Netherlands is facing a significant slowdown in the course of this year. The contribution to GDP growth of the current year falls from 2.5 percentage points in 2007 to some ¾ percentage points in 2008. In the first three quarters of this year the quarter-on-quarter growth in GDP will be

Figure 1: GDP growth: actual and averages



Source: CBS

Figure 2: GDP growth: current year and carry-over



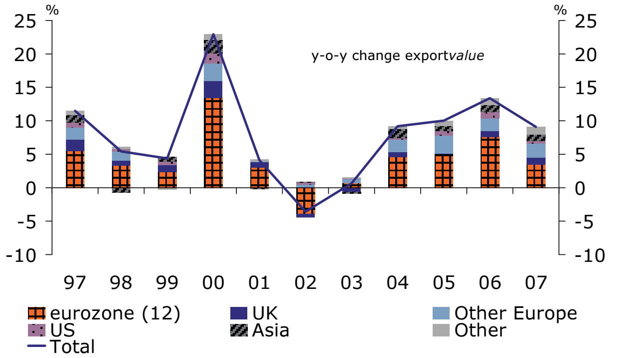
Source: CBS

very limited. From the last quarter of 2008 economic expansion will pick up again to some extent and in mid-2009 growth will approach the average quarter-on-quarter increase achieved in the years 2006 and 2007. Owing to the weak quarterly growth in 2008 the spill-over effect in 2009 will be limited, while the contribution from growth in the ongoing year will conversely be rising to 1¾ percentage points at the same time.

… will be cooled down by external environment

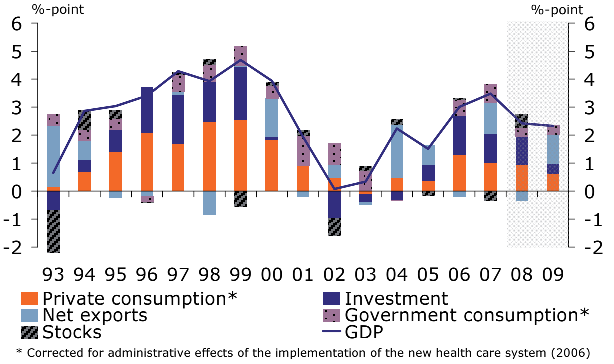
The cooling-off of the Dutch economy will be due to a less favourable external environment in particular. The United States will experience a recession this year following the enormous downturn in the housing market and the credit crisis to which it gave rise. The United Kingdom will also have to contend with a substantial slowdown this year, under the influence of the US recession, the impact of the credit crisis and a downturn in the UK housing market. The US and UK central banks have cut interest rates while the ECB has kept its policy interest rate unchanged. In tandem with the relatively favourable outlook for economic growth in the eurozone this has led to a strong appreciation of the euro versus both the US dollar and pound sterling. Goods and services from the eurozone have accordingly become more expensive for the Americans and British while the US and the UK will also import less due to weaker economic growth. The US and the UK jointly account for some 16% of Dutch exports. The problems in these countries will therefore hit the Dutch economy in terms of exports. But the Netherlands are of course not the only country to feel the effects of these problems. All countries in the eurozone will suffer from reduced exports to the UK and the US, which will adversely impact economic growth in the region. This will produce a second negative effect on Dutch exports. With a share of around 55% the eurozone is the Netherlands' largest export market and therefore largely determines growth in exports from the Netherlands (figure 3). This has remained reasonably stable so far. But for the coming quarters we expect a significant reduction. As growth in domestic

Figure 3: Growth contributions to export of goods



Source: CBS, Rabobank

Figure 4: Contributions to GDP growth



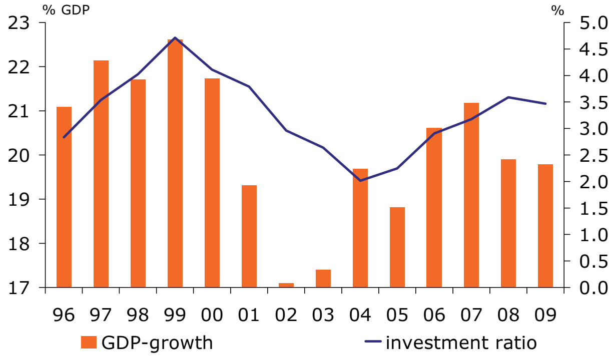
Source: CBS, Rabobank

demand will be comparatively little changed (see next section) the increase in imports will outstrip that of exports this year. On balance, foreign trade will consequently make a negative contribution to GDP growth this year (figure 4). We expect conditions in the US to improve towards the end of this year and the euro to weaken somewhat. This will enable exports to recover to some extent in 2009. Growth in imports will conversely decline next year due to slower growth in domestic demand. Net trade will accordingly make a positive contribution to economic growth in that year.

Investment cycle is past its peak

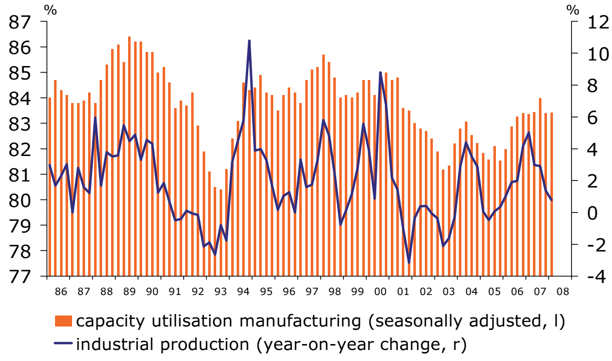
Amidst all the turbulence in the world and its influence on the Dutch economy we might almost lose sight of the fact there is also a 'normal' economic cycle. This is clearly reflected in investments. Last year was a superb year. The economy had already grown strongly in 2006 and the outlook was good. So there was every reason to invest. Accordingly the investment ratio - the volume of investments as a percentage of GDP – increased strongly (figure 5). The financing for investments has meanwhile become more expensive. The delayed impact of the tightening in ECB policy from end-2005 to mid-2007 is starting to affect the propensity to invest. The credit crisis may have led Trichet and his colleagues to stop increasing interest rates earlier than had been expected, but in the market the crisis means that higher credit mark-ups are applied. On balance this represents a further tightening, as the cost of borrowing is driven up. At the same time businesses have less reason to invest. Capacity utilisation is falling again, meaning there is a diminished need to invest in expansion (figure 6). Most businesses (86%, CBS) state that production capacity is sufficient. The decline in capacity utilisation is a logical consequence of developments in industrial production. In the past year the growth of production volumes has progressively

Figure 5: Investments as percentage of GDP



Source: CBS

Figure 6: Capacity utilisation and industrial production



Source: CBS

slowed. Businesses in industry are again expecting lower activity levels for the period ahead and have pegged down their assessment of the order position. That the increase in investments and hence also the investment ratio is still growing this year is due in particular to the completion of very large projects and the delivery of transport equipment. This partly masks the fact that the underlying pattern in investment growth is declining sharply. The contribution of investments to GDP growth, which is still strong this year, will accordingly subside sharply in 2009.

What about the credit crisis?
The effects of the housing market crisis in the US for the Dutch economy are most keenly felt in terms of lower exports and sharply dented consumer confidence. The question is however whether banks have become more cautious in lending to businesses and whether this is slowing the economy down. The last effect in particular is unlikely. The peak of the economic cycle is already behind us and growth in investments is already levelling off significantly. The downturn in the cycle is exacerbated by poorer external conditions. This also depresses businesses' need for financing. That the data nonetheless shows strong growth in lending to businesses since the beginning of the crisis reflects the fact that access to capital markets became much more difficult for businesses. This is likely to have caused them to turn to bank loans and make more extensive use of their existing credit lines than in the past few years. On balance lending by banks has therefore not declined. Money has become somewhat more expensive for everyone owing to the larger risk mark-ups. These effects are limited, however, and comparable with one or two quarter percentage points of monetary tightening, which would certainly have occurred without the credit crisis.

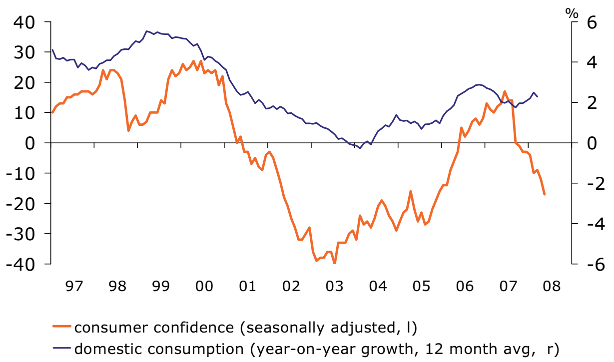
What will consumers do?
Halfway through last year consumers were in a sunny mood. And there was every reason for this. Unemployment had fallen steeply in the two preceding years, the collective wage negotiations reflected employees' improved bargaining position and the economic outlook was good. But consumer confidence has dropped significantly since the credit crisis broke out. Consumption over the past few months has not yet visibly been affected by this, however (figure 7). In addition the labour market is buoyant and this continues to underpin consumption. In April seasonally adjusted unemployment fell to 4%. This is a major decline compared to the peak in unemployment in the spring of 2005 when it was still at 6.7%. The fall in unemployment is accompanied by an increase in the working population (figure 8). Not only did unemployed people find jobs in the past few years; people entering or re-entering the labour market also found work. An increase in

employment together with wage increases leads to a growth in disposable real income and thereby supports consumption. For the current year we expect comparatively sound growth in disposable real income, which will flatten slightly next year. The difference is due to higher inflation in 2009 and lower growth in employment. Disposable income is, however, not the only factor determining growth in consumption. If consumers experience times as uncertain and their propensity to consume declines, they can decide to save part of their income. Consumer sentiment will in our view not easily improve. It is not at all certain that there will be no more bad news. In addition, consumer sentiment will be depressed by inflation in the coming period (see below). And the cabinet intends to raise VAT in January 2009. Although this will be compensated for employees by the elimination of the Unemployment Insurance Contribution, consumers will be faced with the increased VAT in all their purchases. The question therefore is what consumers will do in the period ahead. We are assuming that in both 2008 and 2009 volume growth in consumption will be outpaced by the growth in disposable real income. For 2008 we are expecting real growth in consumption of 2%, but almost ½ a percentage point of this can be attributed to a statistical shift resulting from the elimination of the no-claim system and introduction of a deductible in healthcare. Although income growth has accelerated this year compared to last year, this means a decline in the growth of consumption compared to 2007 of ½ a percentage point. We expect consumption to grow 1¼% next year.

Turbulent inflation ahead

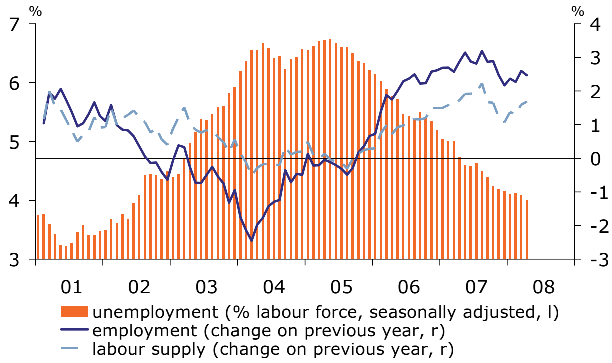
The world is in the grip of inflation, which has risen strongly since the middle of last year due to the sharp increase in the prices of oil, food and other commodities. Eurozone inflation rose by over 1¾ percentage points, from 1.75% in August of last year to 3.6% in March of this year. In the Netherlands, where inflation has been below the average

Figure 7: Confidence and consumption



Source: CBS

Figure 8: Unemployment and labour supply



Source: CBS

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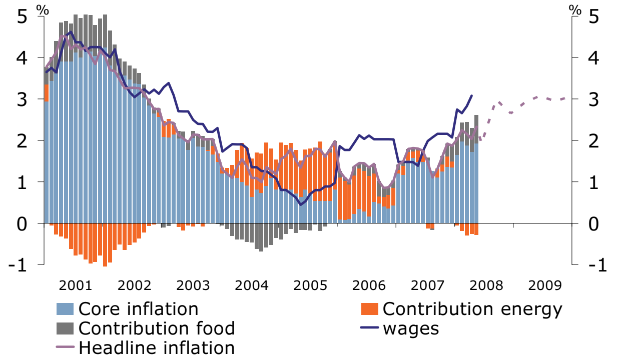
for the eurozone since 2004, the increase to date has been limited to less than 1 percentage point (harmonised Eurostat index). In the first four months of this year average inflation in the Netherlands was accordingly almost 1.5 percentage points below that for the eurozone. This comfortable position will come to an abrupt end in July, however. Although Dutch drivers have already felt the effects of rising oil prices, the high oil price has not yet reached household energy bills. The rates for gas and electricity are set every six months. An increase in the oil price therefore is usually not reflected in a higher energy bill until six months later. The oil price (measured in euros) rose 20% in the second half of 2007 compared to the first half of that year. But energy bills in January were not much higher. This has given rise to the curious situation that energy prices in the Netherlands have in the past four months limited inflation (figure 9). The major energy suppliers have meanwhile announced a price increase as of July. This will lead to a rise in inflation of 0.5 percentage points. In the first five months of this year the average oil prices were in fact 15% higher again than in the last six months of 2007. A further substantial increase in energy prices can therefore again be expected at the beginning of 2009. In both July 2008 and January 2009 the high energy price will be accompanied by price-increasing tax measures. Increasing wages will in addition lead to an increase in core inflation. Inflation is set to rise significantly in July and January and will only gradually ease towards the end of 2009.

Conclusion

The warmed-up Dutch economy will be cooled this year by a fresh breeze from the Atlantic Ocean. The benefit of this cooling-off is that the ongoing rise in inflation will not additionally be fuelled by increasing tension in the economy in the coming years.

Figure 9: Contribution to inflation



Source: CBS

Table 1: Key data for the Netherlands

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

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

Source: CBS, Rabobank

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