The Netherlands—2013 Article IV Consultation: Concluding Statement of the IMF Mission

March 19, 2013

The ongoing but necessary deleveraging of household and bank balance sheets will continue to weigh on economic activity over the medium term. A pick-up in activity is predicated on a bottoming out of the housing market and a reduction in uncertainty. Policies should be geared towards supporting growth while minimizing downside risks and allowing for an orderly adjustment of private sector balance sheets. Given this balance sheet recession, fiscal policy should maintain its focus on medium-term structural targets while allowing automatic stabilizers to operate . The banking system should shore up its capital buffers through private sources and retained earnings to reduce its vulnerability to funding and housing market uncertainty, and to prepare for Basel III capital requirements. Structural reforms to support long term growth and reduce volatility are required, although some of these will need to be sequenced appropriately.

Private sector balance sheet adjustment will continue to weigh on economic activity

1. **Balance sheet deleveraging will continue to be a drag on the recovery.** Despite the nominal 20 percent correction in house prices since 2008, there remains considerable uncertainty surrounding the future path of house prices, and the adjustment of household balance sheets to lower levels of indebtedness is expected to continue. This will continue to weigh on sentiment and consumption over the medium term. The banking system still remains heavily exposed to the real estate sector and dependent on wholesale funding, and its process of balance sheet adjustment is also expected to remain in train for the foreseeable future. Exports to the rest of the euro area are expected to pick up only gradually. Overall, under the baseline we therefore expect output to contract by 0.5 percent in 2013 before gradually recovering by 1.1 percent in 2014.

2. **The baseline outlook is subject to a number of risks that are tilted to the downside.** The interaction of household and bank balance sheets linked through changes in house prices makes the outlook subject to unusually large uncertainty. Expectations that house prices need to adjust by more than is currently assumed would restrain both household consumption and lending by banks, which could in turn lead to a continuing cycle of falling house prices and deleveraging. Should uncertainty about fiscal and structural policies persist, household spending could remain subdued, postponing the recovery. External developments, especially in the rest of the euro area, that add to uncertainty, weaken consumer confidence, and lower exports, would further affect activity adversely in the Netherlands. On the upside, a rapid reduction in uncertainty and a recovery in consumer confidence could help support the outlook.

3. **At the broadest level, the main policy priority is to restore growth and manage downside risks, while allowing for an orderly adjustment of private sector balance sheets.** Given an environment of weak consumer confidence and considerable uncertainty, we recommend policies that help minimize downside risks to growth and avoid exacerbating the pace of adjustment of the private sector's balance sheets. We also see it as important that policies focus on anchoring medium-term expectations to enable a sustained recovery to take hold.

Fiscal policies should focus on structural targets and allow automatic stabilizers to operate

4. **The Netherlands enjoys strong credibility with regard to fiscal policy.** The Netherlands' long-standing track record of sound fiscal policies and its robust institutional framework underpin its role as a safe haven and its low borrowing costs in international markets. We see this strength as deriving from policy credibility and a focus on medium-term objectives consistent with sustainable public debt dynamics. This is underscored by the Netherlands' fiscal framework, which includes trend-based fiscal policy with medium term real net expenditure ceilings, and the articulation of specific medium- term structural adjustment measures outlined in the government's December 2012 Update of the Stability Program.

5. **The plan for no further fiscal consolidation in 2013 is appropriate.** With activity this year projected to be weaker than previously anticipated, we support the authorities' plan for no further consolidation this year. This would be consistent with a headline deficit of 3.4 percent of GDP in 2013, but reflects a very substantial underlying structural adjustment in the robust balance of 2.5 percent of GDP during 2012-2013 that has been undertaken under very difficult macroeconomic circumstances.

6. **Given the uncertainty surrounding the timing and the pace of recovery, a focus on structural fiscal targets is appropriate.** In order to anchor expectations and reduce uncertainty, we are of the view that fiscal policy beyond 2013 should focus on the structural adjustment outlined in the December 2012 Update of the Netherlands' Stability Program, while allowing automatic stabilizers to respond to macroeconomic developments as they occur. A firm focus on medium term objectives will further cement the Netherlands' policy credibility and role as an anchor at the core of the euro area, and mitigate policy uncertainty. Procyclical fiscal policies could also damage potential growth should they prolong the downturn.

The process of financial sector and housing adjustment needs to continue

7. **The financial system needs to continue reducing its dependence on wholesale financing.** Given banks' vulnerability to developments in the real estate sector, proactive measures should be taken to shore up capital from private sources and retained earnings. This should include issuance of common equity and reducing the payout ratio where possible. A higher capital buffer would also help banks extend the duration and terms of their wholesale financing, making the system less vulnerable to abrupt shifts in funding conditions, and prepare banks for Basel III capital requirements. Banks should also increase allowances for loan losses in the commercial real estate portfolio given its ongoing weakness and inconsistencies in asset revaluation. Banks should be encouraged to simplify their corporate structure and prepare living wills to help bank resolution and reduce costs to the taxpayer.

8. **The numerous distortions in the housing market need to be gradually wound down.** The main principles that should be observed in reducing housing sector distortions are that the natural adjustment of prices should proceed unimpeded, that banks continue to reduce their reliance on wholesale funding, that risk from exposure to the real estate sector is priced transparently and appropriately, and that the government does not take on additional contingent liabilities.

9. **The plan to reduce maximum loan-to-value ratios from 106 to 100 percent in incremental steps, and the elimination of mortgage interest deductibility for non-amortizing mortgages are welcome steps**. These measures are important initial steps in reducing the excesses emanating from the housing sector. Once the housing market has stabilized, additional measures to remove distortionary incentives can be examined. Over the longer term, the market for rental housing will need to be broadened by limiting the role of housing corporations to providing accommodation only for those genuinely in need. In addition, the supply of homes for ownership should be made less inelastic by reducing constraints on new dwellings.

Progress on structural reforms needs to continue to safeguard the economy's long-term potential

10. **Further measures to improve the functioning of labor markets and raise human capital will be needed.** Measures to further reduce the duality in labor markets by increasing the protection for temporary workers while reducing rigidities for permanent workers will help improve equity and preserve flexibility. In addition, the reduction of the period of unemployment benefits to two years and additional measures to increase incentives to re-enter employment within a year of unemployment are welcome. Making resources available for fundamental research and improving the quality of education will be an essential building block of raising the productivity of the labor force.

11. **Measures should be taken to safeguard the sustainability of the pension system, while rendering it less procyclical.** Ensuring that the Pillar II pension system remains fully funded is an important anchor of stability, but the system could be made even less procyclical to help smooth domestic demand. Measures already introduced to reduce volatility in the market-based discount rate, as well as the lengthening of the recovery period and the spreading of benefit reductions, are important first steps. In addition, limiting the rate and income ceiling for tax-advantageous pension accrual in Pillar II and III pension schemes could also improve the sustainability of the system.

12. **Long term health care costs must be contained.** Over the longer term, the rise in the Netherlands' health care costs could adversely affect public finances and competitiveness. Measures outlined in the December 2012 Stability Program Update provide important steps in this direction. These include a greater emphasis on rigorous evaluation of cost effectiveness for new treatments and the integration of homecare with municipal care, while protecting the most vulnerable.

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The mission would like to thank the authorities and other counterparts for their warm hospitality, candor and close cooperation during the discussions.