

INTERNATIONAL MONETARY FUND

**Kingdom of the Netherlands—The Netherlands  
2007 Article IV Consultation: Preliminary Conclusions**

April 10, 2007

*The very positive performance of the Dutch economy reflects favorable international economic developments and the fruits of good domestic economic policies. Nonetheless, important challenges lie ahead, especially in dealing with the economic consequences of an aging population. The mission encourages the authorities to take advantage of the strong macroeconomic environment to press ahead with fiscal consolidation and labor market and other reforms to enhance the sustainable growth rate of the economy.*

1. ***Economic conditions are good.*** The recovery is firmly entrenched, with broad-based growth of 2.9 percent in 2006. Thus, growth was almost double that in the previous year and compares favorably with the euro-area average. Wage and price inflation have also been in check. Meanwhile, economic expansion and rising stock market values have contributed to a cyclical strengthening of the financial sector, especially pension funds.

2. ***Much has been achieved on the fiscal front.*** Since the breach of the Maastricht deficit ceiling in 2003, the consolidation of the public finances has been impressive, with the latest data showing a general government surplus of 0.6 percent of GDP in 2006. The adjustment from 2003 to 2006 had a large structural component, was welcome in light of the need for fiscal saving to deal with population aging, and was all the more impressive while meeting the United Nations' target for overseas development assistance.

3. ***One of the major challenges facing policymakers remains an aging population.*** Thankfully, a large, fully-funded, second pension pillar helps mitigate the burden of aging. Nevertheless, the authorities are well aware of the policy requirements for securing fiscal sustainability in the face of aging based on the excellent background work by the Bureau for Economic Policy Analysis (CPB). As emphasized by the Study Group on the Budget Margin, the new government needs to target a higher fiscal surplus, and to take additional sustainability-enhancing measures—notably by reducing spending associated with aging-related institutions and by increasing labor participation.

4. ***The mission believes that it is important to build on the significant progress recently made.*** This progress includes not only the turnaround in the public finances, but also several, oftentimes difficult, structural reforms—among them, reform of health care and disability benefits, the strengthening of the administration of social benefits, and the reduction in the administrative burden. While much has been done to prepare for population

aging—more than in many countries—much remains to be done as well. In this regard, the current situation of robust economic growth and a tightening labor market provides a very favorable environment for continuing fiscal consolidation as well as introducing further measures to enhance labor market flexibility and participation.

### **Near-Term Outlook and Risks**

5. ***The mission's baseline projection sees continued strong growth.*** In all, the mission projects real GDP growth of 2.9 and 2.7 percent, respectively, this year and next, compared with the mission's estimate of potential growth of about 2¼ percent. Export growth is likely to remain strong as long as external competitiveness does not deteriorate. Moreover, with high consumer and business confidence, the momentum of domestic demand is expected to carry through into 2008. This will bring output above potential, exerting upward pressure on price inflation, which the mission projects to approach 2 percent by 2008.

6. ***Upward pressure on wages also seems inevitable.*** The unemployment rate has declined over the past year to around 5 percent (national definition), while vacancies have been increasing. When economic conditions tightened the last time around, high wage increases (and the lagged response of wages to the economic cycle turning down) undermined external competitiveness and contributed to the weak economic growth earlier in this decade. As widely recognized in the mission's discussions, wage moderation is therefore important to take full advantage of the favorable international environment—a point underscored by the expected moderate wage growth in competitor countries.

7. ***There are other risks to the baseline.*** The possibility of higher-than-projected oil prices, a further significant appreciation of the euro, and slower-than-expected growth in trading partners could dampen the upswing. The strong world economic outlook presents some upside potential too. For example, re-exports (and related services income) could be higher than anticipated. And, with a favorable domestic economic outlook, private consumption could also be higher than projected, though resulting higher inflation would cut into real incomes and dampen domestic demand.

8. ***While the mission applauds the impressive fiscal adjustment of recent years, fiscal stimulus in 2007 would be unhelpful at a time when resource constraints have emerged.*** Following the fiscal surplus in 2006, the mission projects a small deficit in 2007 (about 0.1 percent of GDP), implying significant stimulus. Changing the 2007 budget at this stage would, of course, be problematic. Moreover, some budget components—related, for example, to gas revenues, health spending, and local government activities—are either inherently volatile or not fully under central government control in the given year. Nevertheless, in light of the macroeconomic conjuncture, it is important to take whatever opportunities are available to tighten the fiscal stance, whether by locking in any unexpected saving in 2007 or in the context of preparing the budget for 2008.

## Fiscal Policy Over the Medium Term

9. ***Looking further ahead, the new government has announced a target, broadly supported by the mission, of a general government structural surplus of 1 percent of GDP by 2011.*** The target is consistent with the IMF's recommendations during the previous Article IV consultation. But the mission also recognizes that, according to CPB estimates, a "sustainability gap" of some 2½ percent of GDP would still remain. The mission agrees with the Study Group on the Budget Margin and the Social Economic Council (SER) on the benefits of identifying and implementing other sustainability-enhancing measures as quickly as possible to close this gap. Doing so, by avoiding bigger interest payments than would otherwise occur from higher debt, would provide a larger margin for addressing the aging problem, in addition to giving greater assurance of intergenerational equity.

10. ***Measures proposed by the new government envisage closing part of the sustainability gap.*** The measures proposed are estimated to contribute 0.7 percentage point of GDP to closing the gap, with the next two cabinets expected to take the remaining measures. While the mission would have preferred measures to close the gap more rapidly, it is encouraged by the widespread awareness of the need to contain health care expenditure and increase the supply of labor—though consensus on specific measures has yet to be reached. As discussed below, the mission also believes a number of reforms to the labor market merit serious consideration, partly with a view to raising participation.

11. ***The mission sees a persuasive case for taking any available opportunities to lock in a higher-than-targeted surplus by 2011.*** A structural surplus of, say, 1½ percent of GDP instead of 1 percent of GDP, although high by recent Dutch experience, would help lessen resource pressures and act as insurance against the uncertainties surrounding key macroeconomic and reform parameters of the long-term projections and analysis. The case for this recommendation is stronger because the fiscal framework is no longer based on a cautious scenario and because a significant portion of the sustainability gap remains unfilled. After the complex negotiations to finalize the coalition agreement, and recognizing that the authorities' plans compare favorably with those of other European countries in terms of feasibility and ambition, the mission is not calling for an overhaul of the fiscal target. Rather, it recommends erring on the side of higher surpluses in executing fiscal policy and setting the expenditure ceilings.

12. ***It is important that the 2008 budget return to the course of fiscal consolidation.*** The forthcoming budget for 2008 will define the annual expenditure ceilings through 2011. The coalition agreement includes specific revenue measures frontloaded for 2008, broadly offset by (unidentified) revenue reductions in later years. From this standpoint, it should be possible to target a government surplus clearly greater than ½ percent of GDP in the 2008 budget (the CPB projects a surplus of 0.7 percent of GDP without incorporating measures in the coalition

agreement). At the same time, however, the coalition agreement envisages specific measures over 2008–11 that would increase expenditure by 1.1 percent of GDP. This is intended to be mostly offset by a commitment to reductions in other expenditures, with an important role for efficiency savings in the civil service.

13. ***Continued improvement in the underlying fiscal position therefore requires tight spending control.*** Before implementing the agreed expenditure increases, the offsetting expenditure-reducing measures should preferably be in place, with a view to minimizing the risk of underperformance. The phasing envisaged in the coalition agreement is encouraging in this respect. Moreover, spending overruns remain a perennial risk in the health sector. While the mission welcomes the efforts to restrain costs—through introducing greater competition and “yardstick benchmarking”—careful monitoring will be required, with a view to taking timely remedial actions if needed.

14. ***The commitment to the highly commendable fiscal framework provides an added degree of comfort that fiscal policy will stay disciplined and transparent.*** Moreover, the 2006 mission that prepared the fiscal ROSC (Report on the Observance of Standards and Codes) found that the Netherlands achieves or exceeds good practice standards. Many of the new refinements to the framework are in line with the recommendations of that mission. These refinements include lowering the safety margin for the Maastricht ceiling (the so-called signal value), placing interest payments outside the expenditure ceilings in order to avoid pro-cyclical policy, and better management of the resources of the budgetary fund on gas revenues (FES) and reporting of tax expenditures.

### **Financial Sector Issues**

15. ***The health of the financial sector has continued to improve, reflecting both cyclical and structural factors.*** Rising equity prices and long-term bond rates have particularly contributed to further increases in pension fund coverage ratios and insurance company solvency ratios, which are now back up to around 2001 levels. Stress testing exercises conducted by De Nederlandsche Bank (DNB) indicate that, currently, most banks, pension funds, and insurers would be adequately placed to weather even fairly sharp adverse macroeconomic shocks. The strengthening of pension coverage ratios also has the beneficial effect of making the funds less prone to procyclical premium adjustments.

16. ***Beyond the cyclical improvement in the position of the financial sector, institutional developments are making deeper structural improvements in financial stability.*** The new financial sector supervisory framework has already begun to yield important improvements in the quality of supervision and risk management practices of financial firms. Discussions with both supervisors and supervised institutions indicate that all parties are benefiting from the integration of macro-prudential financial stability analysis into risk management through stress testing exercises, and the implementation of risk-based

supervision. The Dutch financial sector is also ahead of most countries in terms of implementing new international standards for capital adequacy, risk management, and auditing standards, including Basel II, Solvency II, and IFRS (International Financial Reporting Standards). Self-assessments, pioneered by the Authority for Financial Markets (AFM), are also likely to be valuable tools in identifying priority areas for improving risk management practices. Overall, the Dutch supervisory framework and its implementation should be regarded, in many respects, as a model of best international practice that other countries could emulate.

17. ***That being said, the mission found a few areas to flag:***

? The mandate of the AFM has expanded substantially in the areas of supervision and licensing, in response to both domestic legislation and EU directives. There is a danger that efforts to improve the effective and efficient execution of its core responsibilities will suffer if AFM is charged with additional responsibilities too quickly.

? The possible restructuring or merger of any large Dutch bank could have important implications for supervision that would need to be addressed. For example, if a cross-border bank were established, the relocation of important bank functions would require corresponding changes in supervisory arrangements and close cooperation between different national supervisors.

? The pension sector is also likely to see increased competition from foreign-based providers. The authorities will need to consider how to adapt measures to increase domestic pension plan transparency to foreign-based pension plans offered to Dutch consumers. A high degree of transparency and mechanisms to provide comparability between plans would ensure that employers and unions can make well-informed choices.

18. ***The housing market is affected by several major distortions, which have adverse effects on housing access and affordability, labor mobility, and household financial leveraging.*** The lack of progress in reforming the housing market stands in sharp contrast with the Netherlands' commendable willingness to tackle other difficult areas.

? By promoting high borrowing, mortgage interest deductibility contributes to high housing prices. These effects are compounded by supply side measures such as rent controls and other restrictions on the supply of new housing. These distortions lead to a chronic shortage of housing, impeding labor mobility. The major distortions in the housing market should be addressed by eliminating rather than adding to them. What is needed is a commitment to move in this direction, including by examining whether rent controls and administrative allocations mechanisms appropriately serve their intended social and economic purpose.

? The new mortgage code of conduct, which limits lending and protects households from excessive debt service risks, is a prudent and welcome measure that supervisors want to see applied properly. However, the code does not address the underlying incentive for households to maximize the size of their mortgage debt that is generated by the tax deductibility of mortgage interest payments. The resulting high loan-to-value and loan-to-income ratios expose households to significant interest rate and housing price risks. While many homeowners are at least partly insulated from interest rate changes by fixed-rate mortgages, about one-third are exposed, and all are exposed to housing price risks.

### **Structural Reform**

19. *Efforts on a broad front to increase employment rates are of considerable urgency, both to ease a tight labor market and support economic activity, and to address the problems associated with population aging.*

? Even with the economy benefiting from recent reforms—including to the disability scheme and by making early retirement actuarially fair—the employment rate, measured in hours, remains low. Addressing inactivity traps and making work pay is therefore important. The coalition agreement rightly envisages several measures to raise participation.

? As our discussions revealed, these measures need to be carefully designed. For example, measures focused on particular groups—whether low-income, women, or senior workers—may affect the labor supply incentives facing other groups, which would need to be taken into account in designing the measures to avoid unintended side effects. Potentially, one of the most effective measures to raise the rewards from work is the phasing out of the transferability of the general tax credit. Though movement in this direction is welcome, for this measure to have a significant and more immediate impact, the authorities should consider phasing out the credit over a much shorter period than 20 years.

? With respect to other policies, though the mission is encouraged by the recent shortening of the duration of unemployment benefits, it sees room for further reform. In particular, a maximum period much shorter than three years would seem sufficient for unemployment benefits to serve their purpose from the standpoint of job search. Regarding the “life-course” scheme, any reform should continue to avoid the danger of it becoming a vehicle for subsidizing early retirement. Additional measures, as recommended in earlier concluding statements, remain pertinent.

? The mission understands the sensitivity in the Netherlands to the proposal to raise the retirement age to 67 years. However, there may be less reason for concern than may appear at first glance, especially for workers close to retirement. This is because an increase could be phased in in such a way that even workers ten years away from retirement would be little

affected. Moreover, in light of recent increases in life expectancy, younger workers and future generations would still enjoy more years in retirement than their parents.

20. ***A range of structural measures has been aimed at boosting productivity and sustainable growth.*** One important avenue for stimulating innovation and productivity is by enhancing competition. The mission therefore welcomes efforts to increase the role of market forces in various sectors, including construction, network industries, health care, and other services. A strengthening of the investigative powers of the competition authority (NMa) is also welcome. In addition, the mission applauds the reduction of red tape in recent years and the new government's aim of another 25 percent reduction during its term. After all, the success of official efforts to encourage innovation will depend, fundamentally, on providing an environment conducive to entrepreneurship and competition.

21. ***In this connection, there is substantial scope for further measures to promote productivity gains.*** Employment protection legislation (EPL) acts as a tax on new hiring, reducing labor participation, and hampering the movement of labor toward areas of high productivity and innovation. While some progress has been made recently on increasing flexibility, it would be desirable to re-open discussion at the SER and reach agreement on making EPL less stringent. Greater wage differentiation would help attract labor to higher productivity companies and sectors, while strengthening the incentives for human capital investment, one of the government's goals. The overarching objective should be to enable market-based incentives that further strengthen the innovation capacity of the Dutch economy.

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As always, the mission is grateful for the high quality and openness of the discussions, and the cooperation and hospitality received from the Dutch authorities and private sector and non-government representatives. We very much appreciate the time and effort everyone has put into this consultation.